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Offshoring & Subordinate Financialization in Underdeveloped Countries

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Note: This paper was originally submitted to the Martin School of Public Policy and Administration at the University of Kentucky as the author's undergraduate capstone project (BA Public Policy) under Dr. Cory Curl.

Abstract

This study aims to investigate the relationship between the globalization of capitalism via global value chain integration and the general financialization of various economies the Global South. It is intended for policy research committees in international development and trade organizations such as the United Nations (Commission on Trade and Development, Special Committee on Decolonization), the International Monetary Fund (Development Committee), the World Trade Organization, and World Bank.

The globalization of [economic] capitalist processes has been marked by the introduction of the global production network and the international division of production, or the offshoring of intermediate goods and services. Financialization represents the entrance of traditionally nonfinancial actors (namely firms, governments/banks, and households) into the financial system – a process that is growing in the Global South. Using a heterodox framework, this paper builds upon literature that synthesizes the two as "subordinate financialization" in developing countries.

This paper claims that North-led production chains have facilitated financialization in developing countries by (A) directly subjecting contract firms in developing countries to financial interests and shareholder value maximization and (B) creating competition amongst Global South firms to financialize so they appear attractive to investors and can maintain themselves against monopolies. Together, these have resulted in heightened vulnerability and inequality within and between developing countries. Addressing this phenomenon will require creative, international initiatives against productive and (now) financial subordination. Future work should aim to develop this introductory theory, a proper data analysis, and more specific policy recommendations.

Outsourcing and Subordinate Financialization in Developing Countries

The purpose of this study is to develop the literature connecting offshoring and financialization in periphery countries. It aims to theorize a causal mechanism and draft an empirical analysis plan for testing this relationship. In short, the global division of production serves to proletarianize the global labor force and extend capitalist processes (accumulation, exploitation) abroad; in effect, it acts as a vehicle of capitalist (economic) imperialism, as opposed to colonialism or pre-capitalist (extra-economic) imperialism. Financialization serves as an attempt to maximize the degree and extent of liquidity (circulation) in order to realize higher profits and increase productivity; in effect, it is another major vehicle for capitalist accumulation (specifically neoliberal capitalism). Evidence for the relationship between the two would suggest the emergence of a new, financialized imperial rent and would provide insight into the dual character of capitalism – from economic exclusion to inclusive expropriation.

This paper follows a straightforward format: first, reviewing literature for financialization and global value chains; then constructing a theory, supporting it with data, identifying implications, and noting shortcomings; and finally providing a variety of early-stage policy recommendations, based off on the nature of the theory and related consequences.

This project will be approaching the relationship from a critical perspective – not only reviewing mainstream concepts and theories but also using a heterodox framework to formulate and analyze the model. Finally, this study is aiming to synthesize the crucial works of William Milberg and Deborah Winkler (*Outsourcing Economics*, 2013); Bruno Bonizzi, Annina Kaltenbrunner, and Jeff Powell (*Subordinate Financialization in Emerging Capitalist Economies*, 2019); and Costas Lapavitsas and Aylin Soydan (*Financialisation in Developing Countries: Approaches, Concepts, and Metrics*, 2020).

Literature Review

Financialization

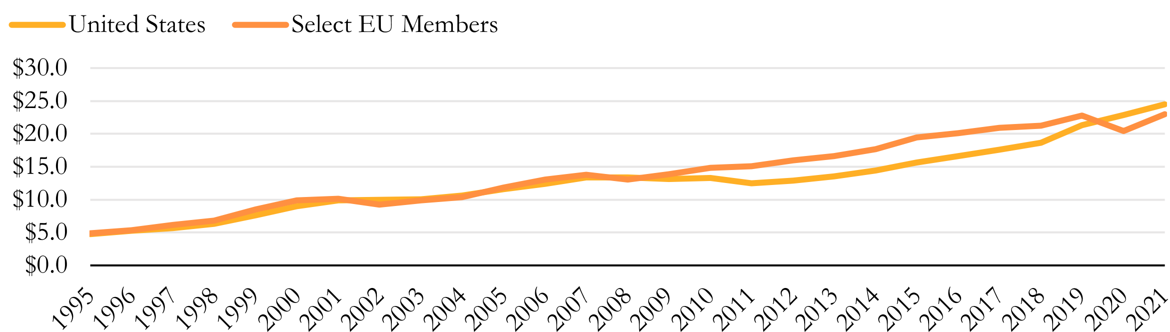
Following the financial crisis of 2008, financialization has gained considerable attention from scholars and policymakers across the world (Blakely, 2019; Mazzucato, 2018; Orhangazi, 2008). It was popularized by Krippner in her influential paper *The Financialization of the American Economy* (2005). Building on her definition, Lapavitsas (2014) refers to financialization as the integration of nonfinancial corporations, banks, and households into the financial system. More specifically, financialization has appeared in...

- *Nonfinancial corporations*, which have adopted self-financing strategies (as opposed to traditional bank financing) via loaning to consumers and financial trading for revenue;
- *Banks*, which have become more involved in open market mediation (fees, commissions, trading profits), household lending, and financial asset management; and
- *Households*, which have become increasingly subjected to securitized assets (mortgages, consumption, health, education) and financialized holdings (pensions, insurance, money market funds).

Financialization represents the [increasing] pursuit of financial profit by nonfinancial economic actors. Financial profit comes from *gearing*, which generates profit by capturing interest from loans (interest payments); *shareholding*, which generates profit by capturing returns on traded equity (dividends); and *trading*, which generates profit by capturing value from loanable capital (buybacks). Speculation (Orhangazi, 2008) and leverage (via debt obligations) are among the other key factors that determine financial profit and, by extension, capitalist reproduction (Lapavitsas, 2014).

A. Total Financial Assets Owned by Nonfinancial Firms

Billions USD, 1995 to 2021



Sources: FRED TFAABSNNCB (US); EuroStats NASA_10_F_BS Financial Assets of Nonfinancial Corporations (EU)

Note: "Select EU Members" excludes Iceland, Switzerland, Montenegro, N. Macedonia, Albania, Serbia, Turkey

Most mainstream literature typically associates financial profit with the Modigliani-Miller theorem (Harris & Raviv, 1991) and the principal-agent framework (Jensen & Meckling, 1976). From a heterodox perspective (Lapavitsas, 2014), gearing generates financial profit through financial expropriation and capitalist exploitation (Fine & Saad-Filho, 2016); shareholding generates financial profit through right to surplus value (property reclamation); and trading generates financial profit through founder's profit, or final buyer-advantage in realizing future surplus value (Itoh, 1988). In short, financial profit – the primary motive for the financialization of NFCs, banks, and households – is produced through surplus value extraction in the form of interest payments, buybacks, and dividends.

For background, the two major historical explanations for the rise of financialization are the shareholder value revolution and the increase in the gap between the rates of return on investment for manufacturing and financial assets. The shareholder value revolution of the late 1970s expanded shareholder rights and promoted share buyback investment through maximizing shareholder value (MSV) strategies (Dore, 2008). At the same time, a combination of

deregulation, tighter monetary policy, and the entrance of Japan as a manufacturing competitor impacted the rate of returns gap (Milberg & Winkler, 2013).

According to the efficient market hypothesis, MSV should promote economic efficiency (David & Kim, 2015). However, empirical studies have shown that financialization has led to decreased GDP growth (Ertuck, 2020; Thomaskovik-Devey et al., 2015), weaker productivity growth (Tori & Onaran, 2022; Alvarez, 2015; Tridico & Pariboni, 2018), heightened economic instability (Sen, 2020; Aalbers et al., 2015), higher unemployment (Lapavitsas, 2014), and increased inequality (Posey, 2019; Godechot, 2020; Dünhaupt, 2020).

Financialization also has vast social and political consequences – namely vast instability and diverse inequality. Government practices like private financing, contracting, and speculative returns have turned public stakeholders into financial shareholders – undermining democratic interests (Blakely, 2019; Pike et al., 2019; Nölke, 2020). The financialization of the legal system (Pattillo & Kirk, 2021), housing (Aalbers, 2017; Aalbers et al., 2015), education (Eaton et al., 2016; Yakovleva & Miglioli, 2022), and healthcare (Hunter & Murray, 2019; Appelbaum & Batt, 2021) have all drastically exacerbated inequality. Financialization has directly undermined welfare institutions and social policy initiatives across the Global North by serving as collateral for financial revenue, both in individual households and in public services like hospitals, schools, and local governments (Lavinas et al., 2022). In short, the real economy has become increasingly dependent on financial expropriation.

Before moving on, it should be noted that financialization does not refer to financial liberalization or financial globalization; while they both create the conditions for financialization and are intimately related, the phenomena themselves are separate (Lapavitsas & Soydan, 2022). Additionally, financialization should be understood as a cyclical process that manifests in

different ways across history (Alami et al., 2022), and this analysis only applies its neoliberal variant. Finally, financialization has been approached from several perspectives, especially as it has entered mainstream economics. The most prominent alternative interpretations are (a) an increase in the share of GDP by the financial sector or (2) an increase in gross international capital flows relative to world output and NFC trade.

Much of the literature on financialization and its effects has focused on advanced economies (AEs) in the Global North, but researchers have begun analyzing financialization in emerging and developing economies (EDEs) in the Global South. These scholars tend to approach EDE financialization as "subordinate" – which emphasizes imperialism and US dollar hegemony, drawing from Marxism (Bonizzi et al., 2019) – or "dependent" – which emphasizes macroeconomic policy decisions and AE financialization, drawing from Post-Keynesianism (Becker et al., 2010). Both approaches find that unequal international capital flows, monetary hierarchies, and dependency theory conclusions are fundamental.

Both approaches also find that EDE financialization resembles AE financialization in many ways. For example, NFCs have similarly shifted their resources away from productive activities toward high-yield, interest-bearing assets, especially public bonds (Akkemik & Özen, 2013). Additionally, many banks – supported by state actions (Alami, 2017) – have begun asset trading and lending to households through securitized loans, and households are increasingly subjected to bank loaning (Lapavitsas & Soydan, 2022).

However, they also find that financialization is qualitatively different in the Global South. For example, while most NFCs in EDEs cannot self-finance due to a lack of resources (Lapavitsas & Soydan, 2022), ones that can are more likely to undermine public debt securities, leading to increased regulations and decreased public investment (Alami, 2017). Furthermore,

central banks in EDEs are forced to perform sterilization operations to minimize the effects of currency premium-related inflation (Corrêa & Feijo, 2019), typically at the expense of workers and public opinion. Households in very poor EDEs remain unconnected to the financial system by loans, instead being indebted by microfinance and financialized social policy (Lavinas, 2018). In short, financialization in the Global South is structurally unequal due to their subordinate position in international production, the US monetary hegemony, and lower institutional capacity – along with other forms of international political-economic leverage.

Global Value Chains

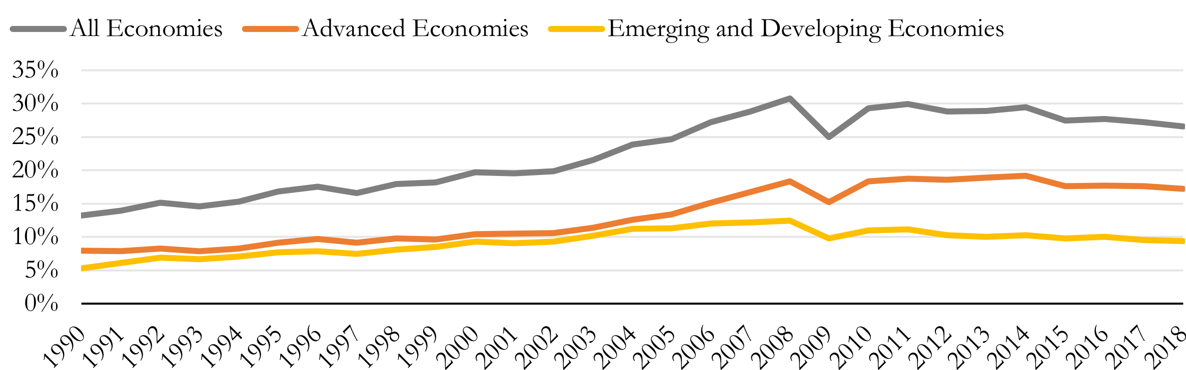
Since the 1970s, neoliberalism has emerged as the cultural and political-economic hegemony. According to Harvey (2005), neoliberalism is based upon the "[liberation of] individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets, and free trade." In other words, neoliberalism represents the proliferation of privatization, deregulation, austerity, and indebtedness. Various actors in the Global North – including governments and international organizations such as the IMF, OECD, World Bank, and WTO – have supported neoliberal trade and development strategies. They have also promoted international participation in the global production network (GPN), which is made up of global value chains (GVCs) (Cope, 2020; Smith, 2016). This – the international division of production – has been the distinguishing feature of neoliberal international trade.

According to Antrâs (2020), a GVC refers to "a series of stages involved in producing a product or service that is sold to consumers, with each stage adding value, and with at least two stages being produced in different countries". In mainstream approaches, they are typically associated with competitive advantage (Espino-Rodríguez & Rodríguez-Díaz, 2014) and the

"smiling curve", in which more value is captured at the beginning and end of production than the middle (manufacturing) (Shin et al., 2012; Lauesen & Cope, 2015). The beginning consists of upstream activities (resource extraction or management, finance, and R&D), the end consists of downstream activities (marketing, advertising, sales), and the middle consists of manufacturing and logistics (Hernández & Pedersen, 2017). Value chains can utilize "spider-like" or "snake-like" production. Spider-like production (sometimes called GPNs) entails multi-sourced, foreign components converging on a domestic assembly line. Snake-line production (traditional GVCs) entails the sequential production of intermediate goods, mostly in foreign countries but ending in the domestic country. Similarly, GPN participation can be either forwards/primary or backwards/support depending on the country's position and involvement in this process. Participation (and competitive advantage) is largely determined by factor endowment, institutions, political instability, and stickiness (World Bank, 2020).

B. Total Global Value Chain Participation

% of GDP, 1990 to 2018



Sources: UNCTAD Eora Database (GVC); World Bank NY.GDP.MKTP.CD (GDP)

Note: "Advanced Economies" and "Emerging and Developing Economies" categorized by IMF

GVCs have led to notable growth in firm-level productivity (Lopez-Gonzolez et al., 2015), made possible by international specialization (World Bank, 2020), decreased input costs (Andrews et al., 2018), and increased firm scale (Antrâs, 2020). The GPN also increases the

number of jobs and improves the labor market entry rate (Kleibert, 2016). While the benefits of GPN integration are traditionally expected to trickle down through spillover effects or "social upgrading", many scholars are critical of GVC theory.

To heterodox theorists, the "smiling curve" is inverted; they claim that more value is being produced by firms in EDEs relative to firms in AEs. (Selwyn, 2018). This approach is more consistent with the findings of UNCTAD (Selwyn & Leyden, 2022). According to Lauesen and Cope (2015), South-North value transfer occurs through "the repatriation of surplus value by means of foreign direct investment, the unequal exchange of products embodying different quantities of value, and extortion through debt servicing". Historically, this has occurred through colonial extraction and alienation; in other words, GVCs enable the extraction of value from EDEs to AEs (Newman, 2022; Quentin & Campling, 2017), thereby promoting inequality, instability, and exploitation in developing countries.

The first mechanism of value transfer is the "repatriation of surplus value", or global labor arbitrage (Smith, 2016), in EDEs. Here, the exploitative processes of capitalism are extended globally. Certain industries or skill levels are outsourced but labor ultimately remains subservient to capital accumulation led by AEs. One way in which this occurs is through the movement of unskilled-labor-intensive activity from high-wage/AE countries to low-wage/EDE countries (Timmer et al., 2014). In EDEs, this increases the relative demand for high-skilled workers, the number of skilled-labor-intensive jobs, and the number of capital-intensive firms – fueling the growth of wage inequality in developing countries (Antrâs, 2020).

The second mechanism of value transfer is unequal exchange. Here, GVCs allow large AE firms to appropriate value through cost-down pressures (Kumar, 2020; Selwyn & Leyden, 2022) and to pass risk onto suppliers through supply/source squeezing (Anner, 2020; Seabrooke

& Wigan, 2017). This harms suppliers, disproportionately located in the Global South; they don't have they economic or political infrastructure to handle the pressure. Because GVCs appear to benefit capital over workers (Timmer et al., 2014), they intensify inequalities, limit spillover effects, and facilitate social *downgrading* (Smichowski et al., 2020) – the opposite of neoclassical predictions. To be sure, these effects are not purely economic; for example, Selwyn (2018; and Selwyn et al., 2019) have demonstrated how GVCs have exacerbated gendered inequalities in EDEs.

The third mechanism of value transfer entails debt. International development organizations like the IMF facilitate the flow of money-capital to EDEs through various loaning strategies and monetary policy recommendations. When crises arise, they consolidate their investments in AEs at the expense of projects in other countries. Additionally, financial agencies tend to rate EDEs as high-risk, high-value assets in risk valuations. These factors have created to pro-cyclical money-credit flows, financial crisis transmission, high-risk (high-yield) public financial investment practices, and capital account vulnerabilities for EDEs (Alami, 2019).

Model and Analysis

Theory

This paper aims to identify how global value chain integration (measured as the degree of outsourcing) facilitates financialization in developing economies (the recipients of offshoring). The inverse of this – whether outsourcing facilitates financialization in advanced economies – was examined and validated by Milberg and Winkler (2013). They claim that outsourcing (offshoring and arm's length contracting) acts as a strategy to reduce costs and the need for investment spending by shifting parts of production to foreign companies. This enables higher profits, which can be realized by reinvesting into real capital (which is less crucial with

contracted production) or fictitious capital (pursuit of financial profit). “Therefore, financialization and globalization have reinforced each other for U.S. corporations.” They call this the Offshoring-Financialization Nexus.

Applying this insight to the Global South, a paper by Bonizzi, Kaltenbrunner, and Powell (2019) introduces the relationship between global value chains and subordinate financialization. Like Milberg and Winkler, they claim that firms can use profits accrued from outsourcing (GVCs) “to pay dividends, buyback shares, boost management salaries or purchase financial assets, with possibly deleterious effects for fixed investment.” Because firms in EDEs hold a subordinate position in international production, however, they capture less value and face more risk. Additionally, “GVCs are finance-intensive and might require the intermediation of financial institutions, which are embedded into global finance.” (Bruno Bonizzi, personal communication, October 22, 2022). This relational mechanism between global value chain integration and financialization, however, remains undertheorized; that is where this paper comes in.

So, from a firm-level perspective, global value chains – which tend to be led by large, financialized firms in AEs – facilitate the growth of financialization in developing countries...

A) By directly subjecting contracted EDE firms to short-term financial interests through MSV strategies, and
B) By creating competition amongst EDE firms to manage complexity and pursue investors.

For Hypothesis A, the extension of MSV corporate structuring into contracted firms introduces (a) asset liquidation and securitization, (b) a focus on short-term returns rather than long-term development, and (c) financial extraction through downward pressure on labor conditions/wages into EDEs. For Hypothesis B, GVCs increase the need for firms in EDEs to pursue financial profit by increasing competition between non-contract and contract firms. Due

to the financialized nature of the former, the latter is incentivized to integrate into the financial system to manage complex uncertainty. GVCs also increase competition between domestic EDE firms and international AE firms. Due to the monopolistic nature of the former, the latter is incentivized to integrate into financial system to appear attractive to investors. Lapavitsas and Soydan (2021) seem to agree with this logic: *"the opening to international capital flows and the growing presence of foreign financial institutions have facilitated the growth of foreign debt by the private sector, thus fostering domestic financialization and creating new mechanisms of financial profit making"*.

Data

UNCTAD's Eora database can be used to determine the degree of GVC integration among EDE firms. Indirect Domestic Value Added (DVX) represents the value added to foreign exports for upstream contributions; this is forward participation. Foreign Value Added (FVA) represents the value added to domestic exports for foreign-produced goods; this is backward participation. Overall participation is the sum of DVX and FVA. This measure is calculated as:

$$GVC\ Participation = \frac{DVX + FVA}{GDP}$$

The higher this measure is, the higher a given economy is involved in GVCs. Since both financialized contract EDE firms and financialized noncontract EDE firms are positively related to the degree of GVC integration of EDE firms, this data will be able to show the correlation between GPN integration and financialization. DVX, FVA, and GDP can be aggregated based on economy status (AE versus EDE) and then compared to determine respective GVC integration; a visualization was included in figure 2. This can then be used to validate the basic correlation between global value chains and EDE financialization.

The IMF's balance of payment (BoP) information can be used to determine the degree of financialization of EDE firms. FDI flows represent real investment, while Portfolio flows represent financial investment (Yoonbai Kim, personal communication, November 3, 2022). According to Bonizzi, this data should reveal "the 'extraction' of value created in Global South countries, flowing out in the form of profit and interest payments" (personal communication, October 22, 2022). An index of financialization can be constructed using the following equation:

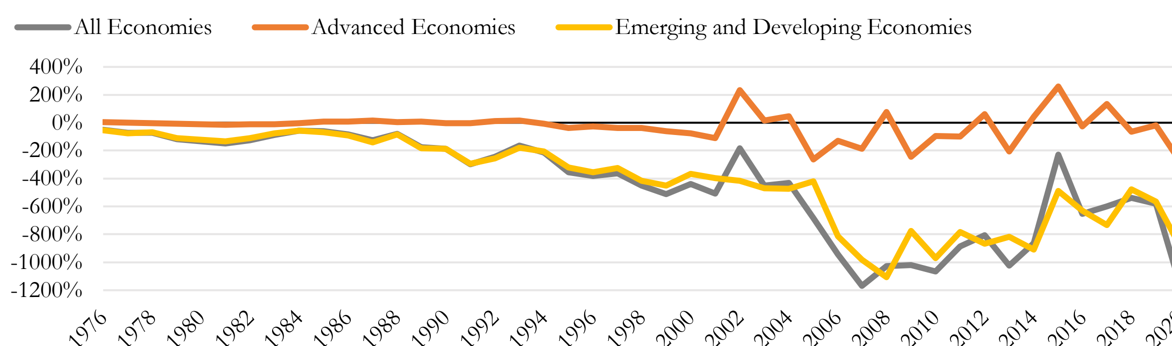
$$International\ Financialization = \frac{net\ investment_{FDI} - net\ investment_{Portfolio}}{GDP}$$

If F is positive, total real investments are greater than total financial investments. If F is negative, total real investments are less than total financial investments. Because EDE financialization largely occurs through the North-led international financial system, this measure should be representative of both (a) financial integration and financial extraction of the Global South and (b) respective financial gains by the Global North.

Analysis

C. **Total Foreign Direct Investment minus Total Portfolio Investment**

% of GDP, 1976 to 2020



Sources: World Bank BN.KLT.DINV.CD (Foreign Direct Investment), BN.KLT.PTXL.CD (Portfolio Investment); World Bank NY.GDP.MKTP.CD (GDP)

From the relationship between global value chains and subordinate financialization arises a contradiction of ownership; EDEs must pay imperial rent for GVC integration due to unequal

exchange and for financialization due to monetary hierarchies. Both have ties to colonial accumulation and serve to perpetuate value extraction through new, economic means.

A major consequence of financialized GVCs is that they create economic vulnerability in developing countries. Externally, this comes from the subjection of EDE firms to AE shareholder value speculation. EDEs are already risky investments for shareholders, but financialization makes this worse, and as productive capacity decreases in favor of financial investment, EDEs become even less attractive to investors. Economic crises exacerbate this disincentive (Alami, 2019); this can be seen in figure C. As the flow of money increases, so too does economic volatility. Vulnerability also manifests internally; EDEs lack the institutional strength to promote productive investment and manage regulations. As a result, bond finance and financial insecurity have risen while growth rates have slowed (Caldentey & Vernengo, 2021).

Financialized GVCs also create inequality by transferring value and by undermining markets. Because financial profit tends to accumulate for shareholders (largely in AEs) at the expense of workers (largely in EDEs), financialized GVCs enable the geographical alienation of surplus value from EDEs. This creates international inequality through the unequal distribution of financial profit. Because only the largest EDE firms can financialize, competition decreases and internal inequality increases. This further entrenches external influence (both financial and productive) into EDEs. As a result, underdeveloped public institutions spend resources to attract investors and maintain production at the expense of social programs.

Together, financialization harms the economic sustainability of global value chains – ultimately destabilizing EDEs and forcing shareholders in AEs to look elsewhere for outsourcing. GVCs and financialization act as circular yet contradictive means to distance ownership and extract rent from the Global South. Data forthcoming, a regression could be used

to test the correlation between GVC integration per industry and ECE firm-level financialization, controlling for various political and economic factors.

Assumptions and Future Research

This model has several assumptions. For example, hypothesis A assumes that AE firms directly extend shareholder priorities to EDE contract firms through the terms of the contract or top-down management. It could also be assumed that EDE contract firms are pressured to consider AE shareholder priorities, otherwise forfeiting the contract to other EDE firms that are willing to financialize. The logic of hypothesis B assumes that EDE firms view financialization as a way to improve security in the market, increase attractiveness for investors, and/or to manage complexity. It also assumes that shareholders are more likely to invest in AE firms for safety that EDE markets should either financialize or monopolize in response.

The methodology for data analysis also needs to be improved. First, it does not allow for the differentiation – and thus the individual validation – of each hypothesis. For that, future studies should use more advanced data methods that include regressions. One approach could be to utilize firm-level data that differentiates between contract and non-contract ECE firms. Another approach could look at sectoral data that compares GVC participation with financial integration for each industry. Finally, the two hypotheses here are certainly not the only potential mechanisms of financialization in developing countries, so further research should consider other factors. Similarly, because it assumes binary, one-directional value chains, this model is limited to measuring vertical extraction rather than horizontal extraction.

Conclusion

This paper asserts that developing countries experience pressure to financialize as they become integrated into the global capitalist system. This can occur through both external

pressures – including the extension of shareholder value strategies into contracted firms – and internal pressures – including the introduction of competition between financialized contract firms and non-contract firms. This process is fundamentally different for EDEs when compared to AEs due to unequal exchange in production and finance (and therefore money and institutions). While it remains theoretically and empirically under-researched, this study proposes an outline for future work. From this, rudimentary policy recommendations can be introduced.

To address vulnerability, policymakers should strengthen institutions in EDEs that enable proper oversight, regulation, and enforcement of harmful investment practices (over-investment in financial assets over real assets). Similarly, regional EDE unions should be able to bargain against AEs (governments, firms, and international organizations) that incentivize EDE firms to liberalize or face austerity. Policymakers should also promote financial re-regulation by making quotas for investors, where a certain percentage of their investment dollars should be allocated for EDEs, especially during crises. This could serve as a form of colonial and imperial reparations. In both AEs and EDEs, the drive to re-regulate finance should also target volatility by preventing hyper-speculative trading. Policymakers should ensure that their total productive investment-to-financial investment ratio is positive. Public surplus absorption should be favored over private surplus accumulation by creating a public financial fund to redistribute private financial profit (extracted surplus value). Finally, de-dollarization (and "de-Euroization", etc.) would strengthen monetary sovereignty and mitigate the effects of monetary hierarchies.

To address inequality, policymakers need to restructure value hierarchies. According to Quentin and Campling (2017), GVCs currently prioritize value capture over value creation, meaning they promote surplus value extraction (proletarianization, decreased labor conditions, etc.) and now financial extraction (through financialization) over real production and

development. To change this, they recommend a reinterpretation of "upgrading", or moving the tax burden up the chain to lead firms and the subsequent redistribution of revenue to contract firms in the Global South. This, too, could serve as a form of reparations. Furthermore, development organizations like the World Bank need to be more diligent in designing their policies around the negative effects of GVCs (World Bank, 2020). Again, the introduction of monetary sovereignty (through institutions, investment capacities, and de-dollarization) would promote both domestic and international competition, and it would decrease imperial rent – and thus financial subordination – due to currency premiums.

On an international scale, global value chains must be understood as global labor arbitrage; future research should explore this avenue and its implications. Financialization could be decreased through protections or public insurance against securitized assets, loan forgiveness for heavily indebted economies, or financial gains and trading taxes (especially if they are lower than taxes for real investment). Through strengthened regional EDE unions and progressive policies that emphasize international equitability and social responsibilities and transfer of property ownership, shareholders can be held accountable for undermining local welfare.

In short, economic growth has the potential to be so much more stable, equitable, and historically conscious. Policymakers in both EDEs and AEs should consider the long-term effects – direct or indirect, respectively – of global value chains and financialization, along with the circular, contradictive relationship between them.

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