SOUTH CENTRE

South Unity, South Progress.

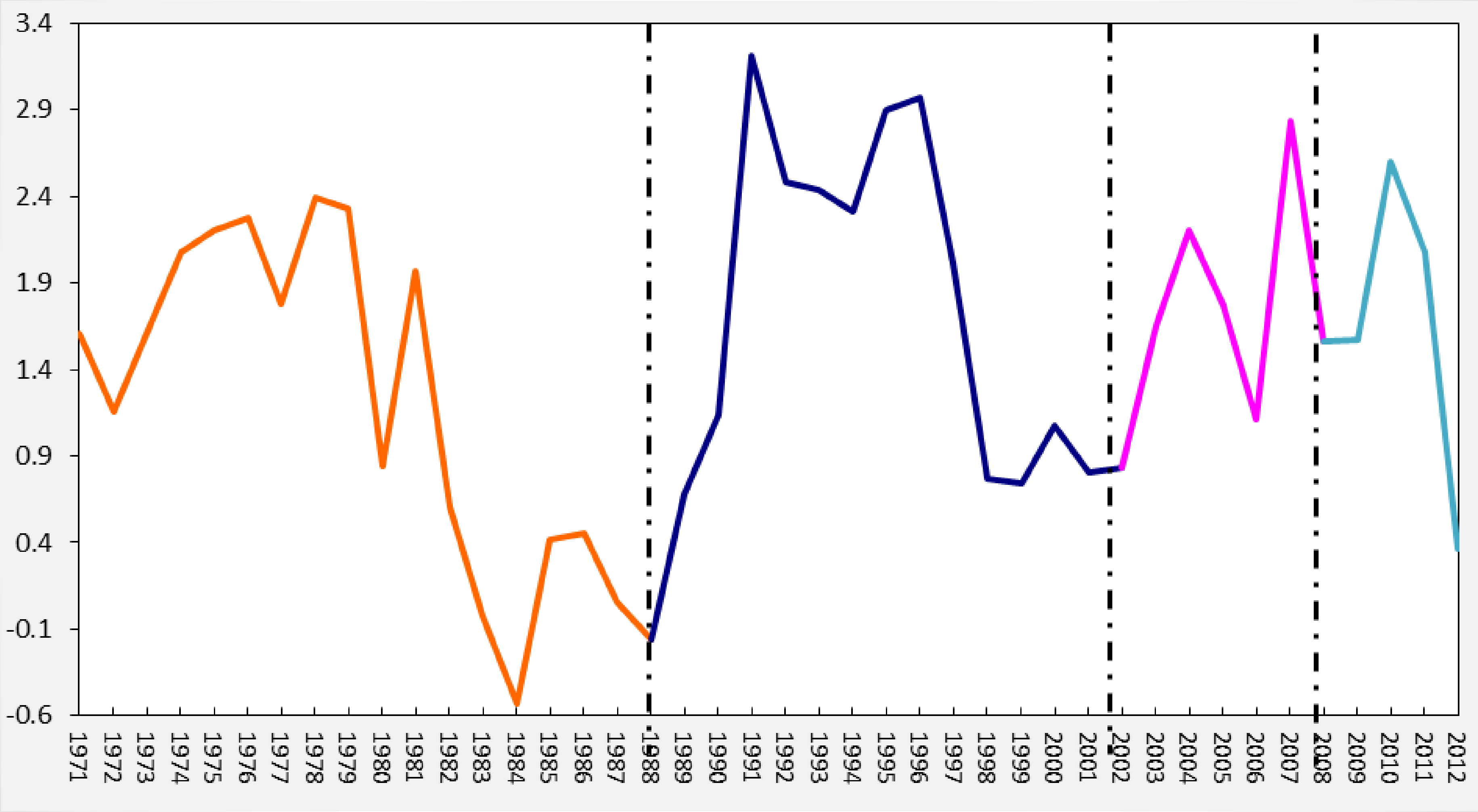
Systemic Issues and Debt in Trying Times: How Can the FFD Process Help?

Manuel F Montes

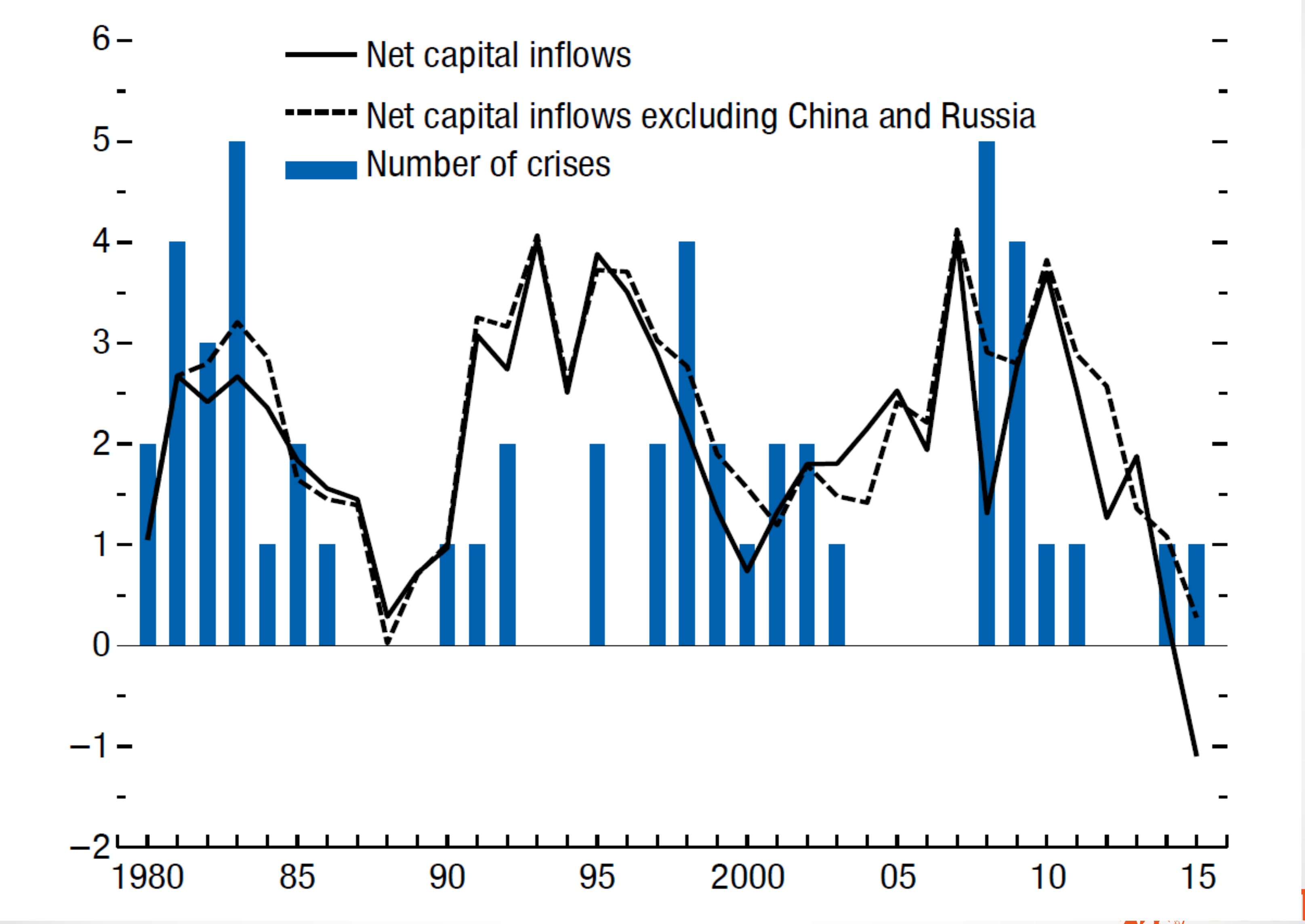
Side Event at the ECOSOC FFD Folllow-up

New York, 19 April 2016

Episodic Capital Flows – ca 2010 SC



Episodic Capital Flows – Apr 2016 IMF

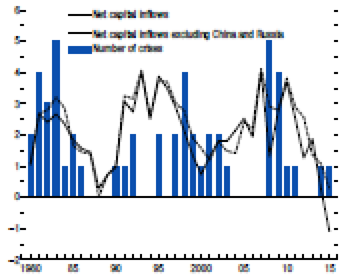
- 

Soutce: Figure 2.1 IMF 2016, WEO Apr 2016

IMF WEO April 2016, p. 64

Figure 2.1. Net Capital Inflows to Emerging Market Economies and Number of Debt Crises, 1980–2015:Q3
(Percent of GDP, unless noted otherwise)

Net capital inflows in emerging markets over the past four decades have exhibited cycles. A slowdown phase of one such cycle has been taking place since 2010. Past net capital inflow slowdowns have been associated with external debt crises.



Sources: Catão and Milesi-Ferretti 2014; CEIC Asia database; CEIC China database; Haver Analytics; IMF, *Balance of Payments Statistics*; IMF, *International Financial Statistics*; World Bank, World Development Indicators database; and IMF staff calculations.
Note: Calculations are based on a sample of 45 emerging market economies. The observation for 2015 refers to the first three quarters of 2015. Data on the number of crises refer to the external crisis variable in Catão and Milesi-Ferretti 2014, updated to the third quarter of 2015. See Annex 2.1 for the complete list of sample countries and external crisis episodes.

The analysis employs a variety of approaches, including accounting decompositions, event analyses, and panel regression methodologies. The models extend the set of possible explanatory variables and data coverage to capture regularities that may be more specific to the recent slowdown.

The chapter's main findings regarding the 2010–15 slowdown in net capital inflows are as follows:

- The slowdown affected three-quarters of the 45 sampled emerging market economies with available data. Both lower inflows and higher outflows contributed to the slowdown in net inflows. Countries that had relatively flexible exchange rate regimes in 2010 experienced large currency depreciations over the period.
- The current slowdown is similar in size and breadth to episodes in the 1980s and 1990s, but the contexts then and now are marked by several key differences:
  - Emerging market economies in the current episode have larger holdings of external liabilities and assets, including foreign reserve assets.
  - Capital outflows have become increasingly important for the dynamics of net capital inflows.
  - Exchange rates are now more flexible, and domestic prices seem better anchored, perhaps partly because of the widespread use of inflation-targeting regimes.
- Diminished prospects for growth in emerging markets relative to advanced economies can explain most of the slowdown in total capital flows to emerging markets since 2010, while national policies affect the cross-country distribution of those flows.
- In particular, flexible exchange rates appear to have helped some emerging markets mitigate the slowdown in capital flows so far by dampening the effects of global factors, as well as the effects of those economies' own slowing growth prospects.
- Swings in capital flows are also smaller in emerging markets with lower public debt, tighter capital controls, and higher foreign exchange reserves.

These findings have significant implications for both outlook and policy. On the positive side, they (1) corroborate that policy frameworks in emerging market economies have improved and (2) highlight these economies' reduced vulnerability due to a combination of much higher central bank reserves and lessened balance sheet exposure to currency risk (that is, less of the so-called original sin).

On the negative side, they point to two additional sources of risk. One is the narrowed growth differentials relative to advanced economies; the other is the dynamics of gross outflows. The narrowed growth differentials, which appear to be connected to much weaker gross capital inflows, may not be reversed anytime soon. Their persistence reinforces the need for prudent fiscal policies (as a diminished supply of external funds raises the cost of borrowing and servicing public debt), currency flexibility, and active reserve management policy as appropriate.

The second risk is more speculative and novel: in recent years, more sizable gross outflows contributed to the slowdown in net inflows, rather than mitigating it. This is because, in contrast to previous episodes, which featured a tight positive comovement between gross capital inflows and gross capital outflows (Broner and others 2013), such comovement has been much looser this time, including some negative comovement

IMF Discovery of Episodic K-Flows

- Figure 2.1 WEO April 2016 p. 64
- Reference for figure - Catao & Milesi-Ferreti 2014, *J. of Intl. Econ. 2014*: Vertical Bars
- No other references. NO REFERENCE to Akyuz in WEO or in Catao & Milesi-Ferreti 2014
- IMF discovery 2016-2011=5 years late
- In the meantime, developing countries increased external debt and have reduced policy space

Implications of Episodic Flows

- If international liquidity episodic, then debtor countries NOT completely in control when
  - Their international liabilities increase
  - When commodity prices are rising
  - When their external debt problems will begin
- There is a SYSTEMIC basis for external payments booms and busts and requires explanations beyond the “Rise of the South”

Competing Stories ca 2011-12

IMF	Others (including South Centre, UNCTAD)
High Growth in Developing Countries – **DECOUPLING** Developing Countries Grow Despite Great Recession in North Atlantic economies (Rise of 'the' South)	High Growth in developing world, Abundant global liquidity, high commodity prices **EPISODIC** - Eventual reversal of flows
Increased capital flows to developing countries **FRUIT** of earlier structural reforms (provable?)	Increased capital flows come from increased liquidity created by **Quantitative Easing**, which will have to be normalized in the future

South Centre
South Unity, South Progress.

Competing Stories ca 2011-12

IMF	Others (including South Centre, UNCTAD)
Austerity (public sector expenditure reductions) required in developed and developing countries to reverse increase in public indebtedness. Capital controls only for BOP crises	Fiscal spending required in North. Quantitative easing should be ended because it is causing "currency wars" and currency appreciation in developing countries. Capital controls needed both in boom and bust.
Outcomes: Successive IMF downgrades of potential output; Global trade collapses Now: Secular stagnation and danger of "Too Slow for Too Long" WEO April 2016	Danger of developing country private sector indebtedness Reversal of commodity price trends; Global trade collapses SDR allocation to provide liquidity

Unaddressed systemic issues

- Dependence on US dollar; global economy hostage to booms and busts in US political cycle -> increased use of SDRs
- Disciplines on reserve issuing economies
  - Beggar thy neighbor & limits of QE
- SDG 10.5 Strengthened financial regulation, especially regulation in financial centres
- <u>If there is a systemic cause, then need for intl debt workout system (good governance and rule of law)</u>
- Voice and participation of developing countries

SOUTH CENTRE
20 YEARS 1995 – 2015
South Unity, South Progress.

Role of FFD follow-up process

- Address unresolved global economic crisis ("trying times")
- Highlight **alternative** views and **alternative** policy proposals
- Acknowledge the EXISTENCE of systemic issues (crises not only due to proclivity for bad policy of individual countries)
- Forum for early warning and concerted action and response

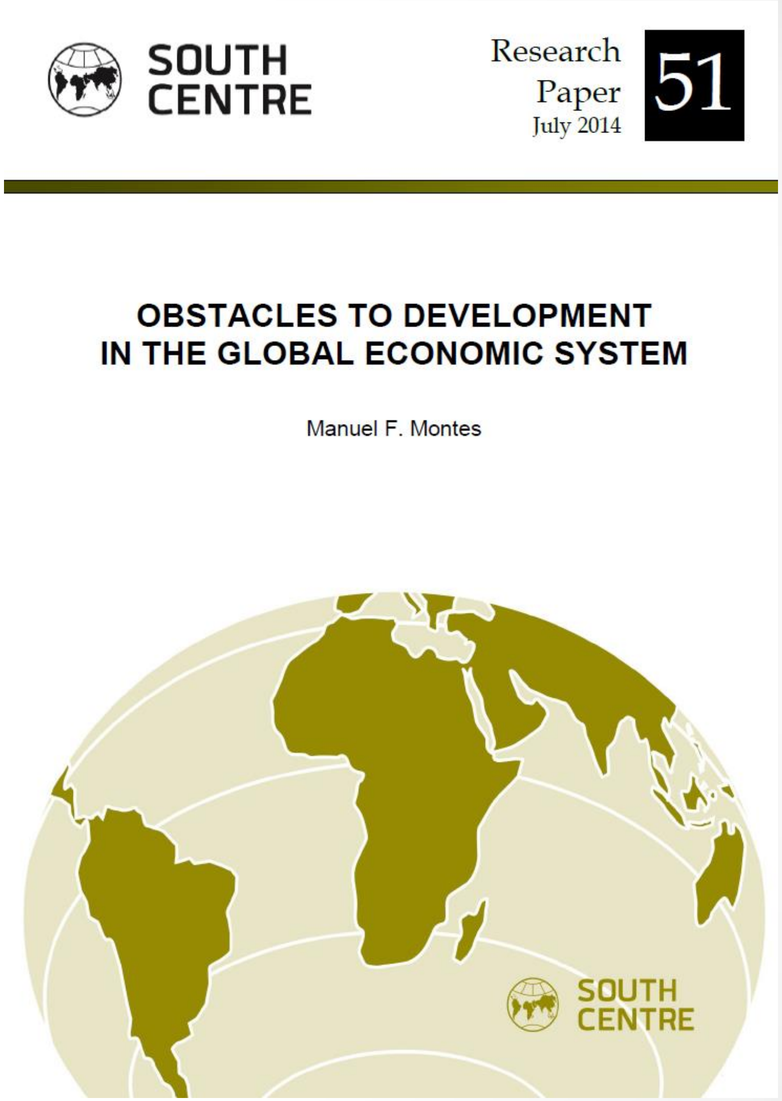
Thank you

montes@southcentre.int
www.southcentre.int

Tel: +41 22 791 80 50
Fax: +41 22 798 85 31

South Centre

Chemin du Champ d'Anier 17
C.P. 228 1211 Geneva 19
Switzerland



SOUTH CENTRE

Research Paper 51
July 2014

OBSTACLES TO DEVELOPMENT
IN THE GLOBAL ECONOMIC SYSTEM

Manuel F. Montes

SOUTH CENTRE

SOUTH CENTRE
YEARS 1995 – 2015
South Unity, South Progress.