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On the Existence of Systemic Issues and their Policy Implications*

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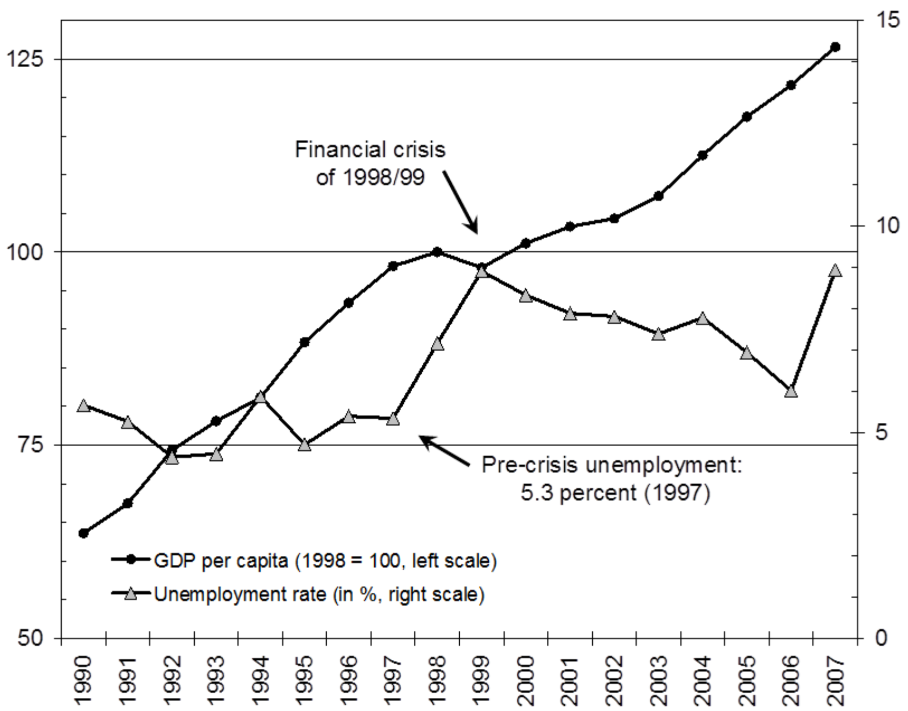
While the term had been used earlier, the idea of "systemic issues" as both a conceptual and a policy matter emerged in the first International Conference on Financing for Development (FfD) convened in Monterrey, Mexico in March 2002. In the "Monterrey Consensus" which was the outcome document of that conference, the idea of an "enabling international economic environment" as a necessary ingredient to support national development efforts (United Nations, 2003, paragraph 7) and a whole chapter called "Addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development" became components of the debate on international economic governance.

Systemic issues are issues that arise from the built-in features of the global system and the impact of the interaction of its parts; as implied in the chapter title in the Monterrey Consensus, it pertains to the coherence and consistency of the monetary, finance and trade systems. Systemic issues point at the weak points in the whole global financial "architecture," the international structures and mechanisms that are beyond the control of **individual** countries.

Systemic issues are a particular concern to developing countries, which have experienced their greatest development reversals during international payments crises. Macroeconomic volatility and periodic crises have long-lasting impact on growth and employment in developing countries, in contrast to the case of developed countries. Figure 1 indicates that, in the course of Chile's balance-of-payments crisis in 1998-99, the unemployment rate ratcheted up, despite the recovery of GDP. Similar pat-

Figure 1: Unemployment and Per Capita GDP, Chile



Source: United Nations (2010), Figure II.6, p. 32

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terns are found for Brazil, Indonesia, Malaysia and Turkey (United Nations, 2010, Chapter II). Growth volatility and investment volatility interact strongly and undermine efforts to spark sustainable private investment. These crises also destabilize public sector balances, part of which is due to the default international response to these crises which privilege rescuing international creditors and impose most of the adjustment costs to the debtor side.

The international policy community has walked away from these crises with a variety of theories and insights about various weaknesses specific to the economies swept into the crises. However, the pattern of synchronous crises among developing countries has been difficult to ignore and other thoughtful observers have harped on this pattern in their much earlier analyses (Ocampo, 2008). A recent rediscovery is in an IMF working paper of Fayad and Perrelli (2014) which attributes the key driver to be "lower trading partner demand" (page 4), but this study does not directly consider the shared causes of the synchronous pattern.

1. Global Episodes of Liquidity Booms and Busts

From the experience of developing countries, international payments crises have been associated with sudden stops in international liquidity. The most damaging episodes have followed years of booming international liquidity. In March 2011, with the intention of providing a warning on the fleeting nature of the global liquidity boom occasioned by the monetary easing-based responses of developed countries to the 2007-08 financial crisis, Akyüz (2011) published in a South Centre Research Paper a "Chart 1.b" on net private capital flows to developing countries. This chart showed that the 1982 developing country debt crisis and the 1997 financial crises which started in East Asia came from the end of liquidity booms. Figure 2 reproduces this Chart updated to 2012 data.

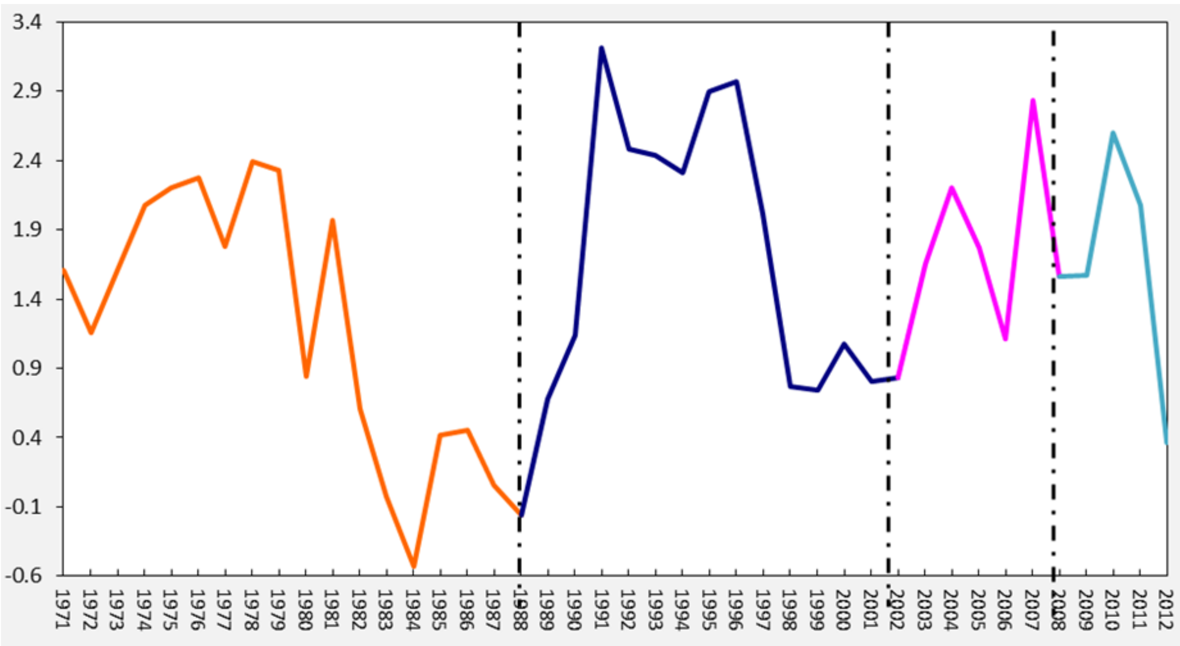
The importance of this chart is that it illustrates the existence of a systemic issue in liquidity booms. While there would have been features specific to the countries that were swept into the 1982 debt crises and the 1997 financial crises and features specific to each of these two global episodes (Montes, 2008), countries in the developing world collectively experienced the consequences of the end of a liquidity boom, marking the end of a period of low interest rates, the frantic search for new foreign borrowers on the part of international private financiers and rising commodity prices. This configuration corresponds to increasing international debt liabilities on the part of developing countries during the boom.

Akyüz (2011) sought to alert developing countries that, like the previous two large booms depicted in Figure 2, the liquidity boom of the 2000s, unsustainably extended by the Great Recession policy choices of the North Atlantic governments, will come to an end, and inaugurate another era of payments difficulties in the developing world.

There were two important contrary interpretations of the 2008-2010 experience of the booming economic situation in developing countries. Both were centred on signaling the permanence of the pleasant economic situation in developing countries at the very time that the developed countries were experiencing their deepest recessions since the 1930s. In insight, these contrary views were misinterpretations of the situation.

The first was posed by the UNDP (2013) in its 2013 human development report entitled "The Rise of the South: Human Progress in a Diverse World." The report high-

Figure 2: Net Private Capital Flows to Developing Countries *(Per cent of GDP)*



Source: Akyüz (2011), Chart 1.b, p. 6

lighted what it considered a profound shift in global dynamics, driven by the fast-rising new powers of the developing world (UNDP, 2013), pointing to the economic successes in China, India, Indonesia, Mexico, South Africa, Thailand, and Turkey that were becoming leading actors in the world stage.

The second misinterpretation came from a global policy discussion called "decoupling," sparked by research from the Bretton Woods institutions, which suggested that the dependence of growth in developing countries on economic performance of developed countries had significantly receded. These studies sought to test whether greater trade interdependence has increased the international synchronicity of business cycles. As stated in the abstract of a representative paper, during "the period of globalization (1985–2005)," (Kose, Otrok, and Prasad, 2008) there is evidence of divergence in the business cycle between the group of industrial countries and the group of emerging countries. Kose, Otrok, and Prasad (2008, p. 25) are careful to qualify their results as applying to "macroeconomic variables representing the real side of the economy, but leaves out financial ones." However, as is often the case, these kinds of qualifications are set aside in policy discussions and policy-making. In this policy atmosphere, the 2008-10 boom in developing countries could be interpreted as another data point consistent with the concept of "decoupling."

In fact, the decoupling misinterpretation was also the occasion for associating the happy situation in the developing world with successes in structural reforms reflected as "strengthened domestic policy frameworks, reduced external vulnerabilities (e.g. more flexible exchange rates, higher reserves etc.) and more prudent counter-cyclical policies" (van Rensburg, 2012), to quote from a World Bank blog in that period.

These misinterpretations also did not subvert the standard policy advice for both developed and developing countries. Austerity was required in developed countries to restore safe levels of public indebtedness, even if the accompanying policies reduced growth rates and worsened debt sustainability. While they appear to have been decoupled, developing countries were adversely affected by these austerity policies and the pivot of developed countries toward export competitiveness.

2. The IMF Discovers the Boom-Bust Pattern in International Private Liquidity

In a notable turnaround, the IMF's (2016) April 2016 World Economic Outlook presented a discussion of the episodic pattern of net capital inflows along the same lines as Akyüz's (2011) warning in its chapter 2, entitled "Understanding the Slowdown in Capital Flows to Emerging Markets." The chapter begins with "Figure 2.1" (reproduced here as Figure 3, see next page).

The pattern in net capital inflows from the IMF hews closely to the pattern in Akyüz's (2011) graph (Figure 2). The IMF figure uses total net capital flows, while Akyüz's figure traces only net private capital flows, but this difference is technically minor since private capital flows dominate the changes in direction of flows. With the use of data only from the developing economies with the largest volumes of capital flows, both graphs use the same basic methodology. The IMF figure skips the boom leading up to the 1982 developing country debt crises, whilst the Akyüz figure includes the boom and bust leading to the 1982 downturn. In the IMF figure, there is an additional depiction of the net capital inflows pattern excluding China and Russia, which does not materially change the pattern and an added set of bars showing the number of payments crises.

It could be said that in trying to understand the current conundrum facing developing countries in April 2016, the IMF discovers the pattern that Akyüz presented five years earlier, with Akyüz (2011) taking a more focused attention to the private sector aspect of the volatility of these flows. The IMF graph only references the authors that depicted the bars on the number of payments crises - so that otherwise the graph is fully created in the IMF. The IMF (2016) report has no reference at all to Akyüz (2011), with the possible inference that the IMF staff discovered this pattern on its own[1] even though the methodology of generating the graph was comparable.

3. Policy Implications

The IMF discussion can be seen as a turnaround of a sort in accepting the episodic global pattern of net capital flows, over which individual countries have no control – thus, a "systemic issue." Logically, a systemic issue cannot be managed only with individual country policies. However, in IMF's (2011) World Economic Outlook, this was still the view of IMF as expressed in the preface by IMF chief economist Olivier Blanchard (2011, p. xvi):

> Their response should be twofold: first, to rely on a combination of fiscal consolidation and higher interest rates to maintain output at potential and, second, to use macroprudential tools—including, where needed, capital controls— to avoid increases in systemic risk stemming from inflows. Countries are often tempted to resist the exchange rate appreciation that is likely to come with higher interest rates and higher inflows. But appreciation increases real income, is part of the desirable adjustment, and should not be resisted.

Despite the recognition of the systemic pattern in net capital flows, the discussion in IMF (2016) does not suggest a noticeable change in policy stance on the part of the IMF, a stance centred on relying heavily on exchange rate adjustments to wrestle with the Mundell-Fleming "trilemma" (Mundell, 1963).

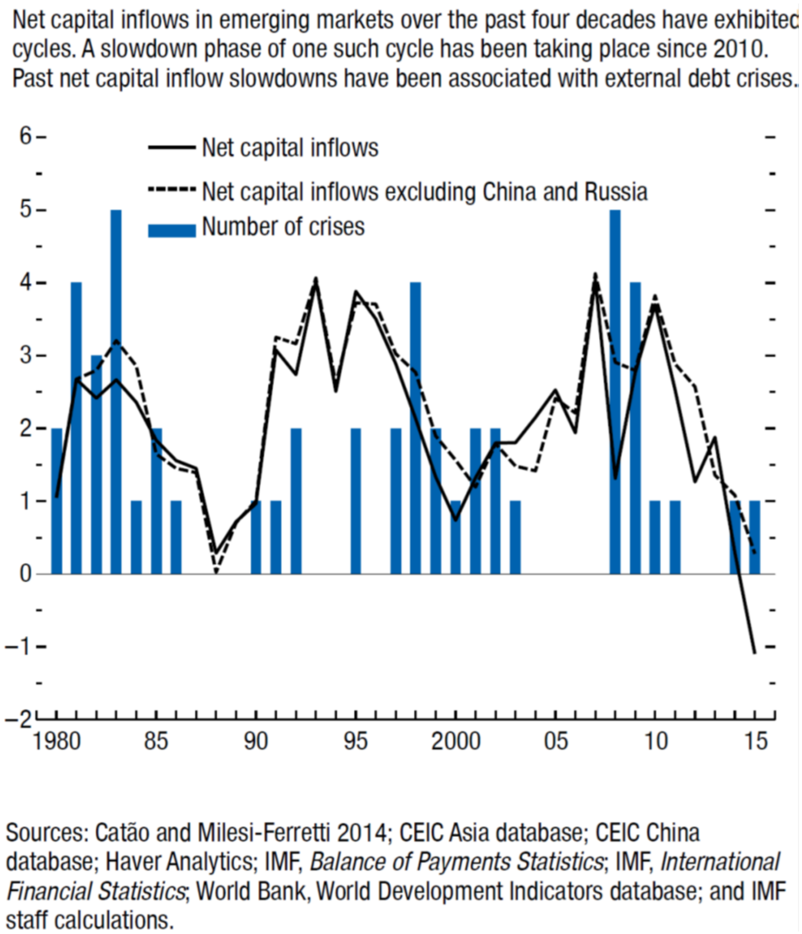
Before the Asian currency crises the dilemmas created by open capital accounts had been debated but the policy discussion has not moved markedly away from the IMF emphasis on exchange rate and fiscal adjustments. Developing countries are particularly disadvantaged by these kinds of priorities in adjusting to volatile private capital flows (Montes, 1997). Precipitous exchange appreciation causes loss of competitiveness in the tradables sector; exchange depreciation increases the debt service burden and is usually contractionary. Reducing or raising the public sector deficit in response to changes in the direction of net private capital flows induces a highly unstable fiscal policy pattern, public sector job dislocations and uncertainty in the ability to support long-term investment programs.

If private sector capital flow volatility is "systemic," more effective and coordinated financial regulation is called for, particularly in countries that are hosting financial centres. The situation also indicates the need for effective capital controls in developing countries, beyond the macroprudential controls that is acceptable to IMF, if not only for the reason that not all private capital transfers are intermediated in the banking system. More importantly, if priority is to achieve industrial development objectives and, indeed, to concomitantly develop the domestic financial sector itself as part of the overall development strategy, developing countries are foolish to rely on the portfolio-motivated investments from external or externally-connected actors which induces great domestic volatility and high borrowing costs for local financing of real sector projects (Montes, 2013).

Endnote:

[1] As part of a presentation on issues for the upcoming 2015 conference on financing for development (FFD), the author had an opportunity to present an updated version of Akyüz's (2011) graph at a technical group meeting of the G24, the developing country caucus of countries in the IMF and World Bank, in Cairo in September 2014. Developing country executive directors and some IMF staff were in attendance at this meeting.

Figure 3: IMF Graph on Net Capital Inflows to Emerging Market Economies and Number of Debt Crises, 1980-2015: Q3 *(Percent of GDP, unless noted otherwise)*



Source: IMF (2016), Figure 2.1, p. 64.

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