GLOBAL IMBALANCES

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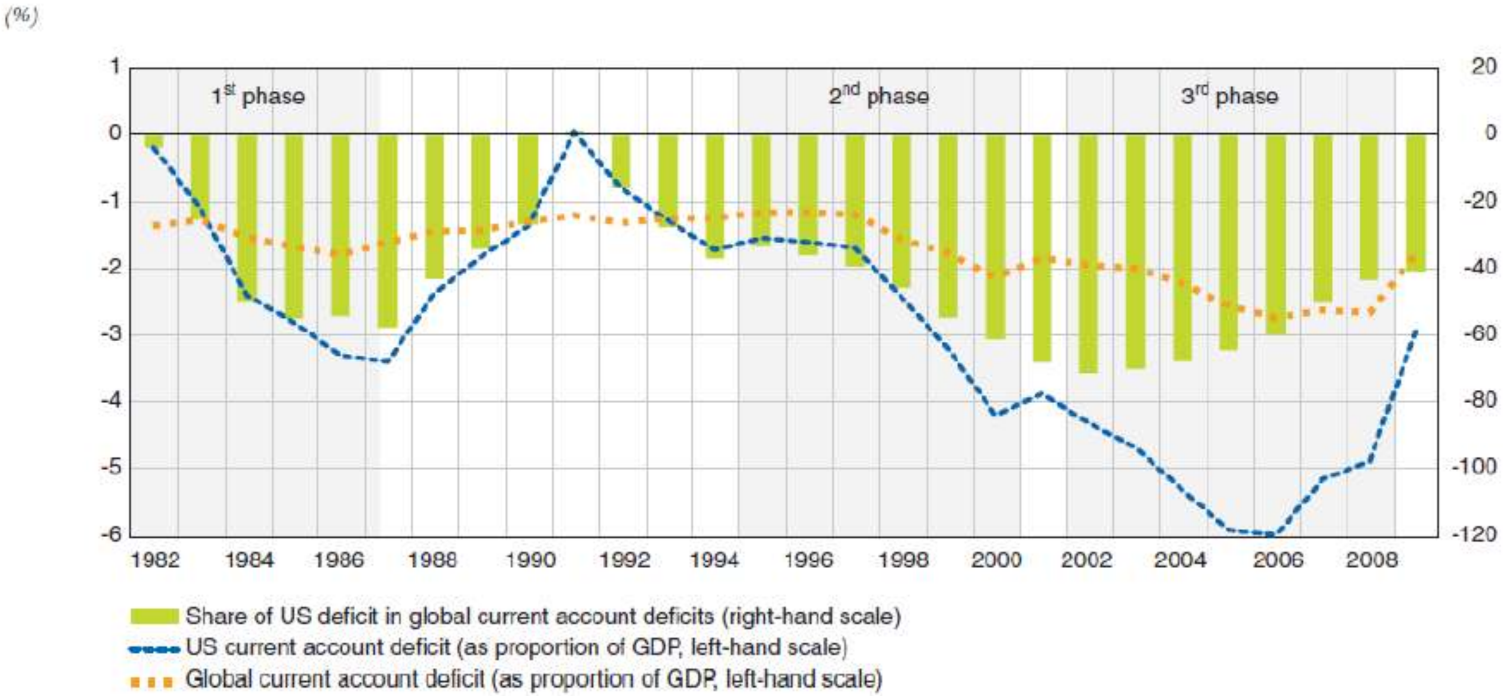
- The global financial crisis of 2008 has once again shifted the focus on the role of global imbalances.
- Global imbalances are not a new phenomena
- Looking at the period from the 80’s we can identify three major episodes of global imbalances episodes

Chart 1
Global imbalance trends



Source: Kim (2011)

- Two key features distinguish the global imbalances of the 80’s from the once that we have witnessed in the last two decades.
- Firstly, the magnitude of the imbalances in the 80’s was relatively modest compared to what we have witnessed more recently.
- Secondly, the external deficits of the United States and other advanced countries in the 80’s were largely funded by other advanced countries such as Japan and Germany

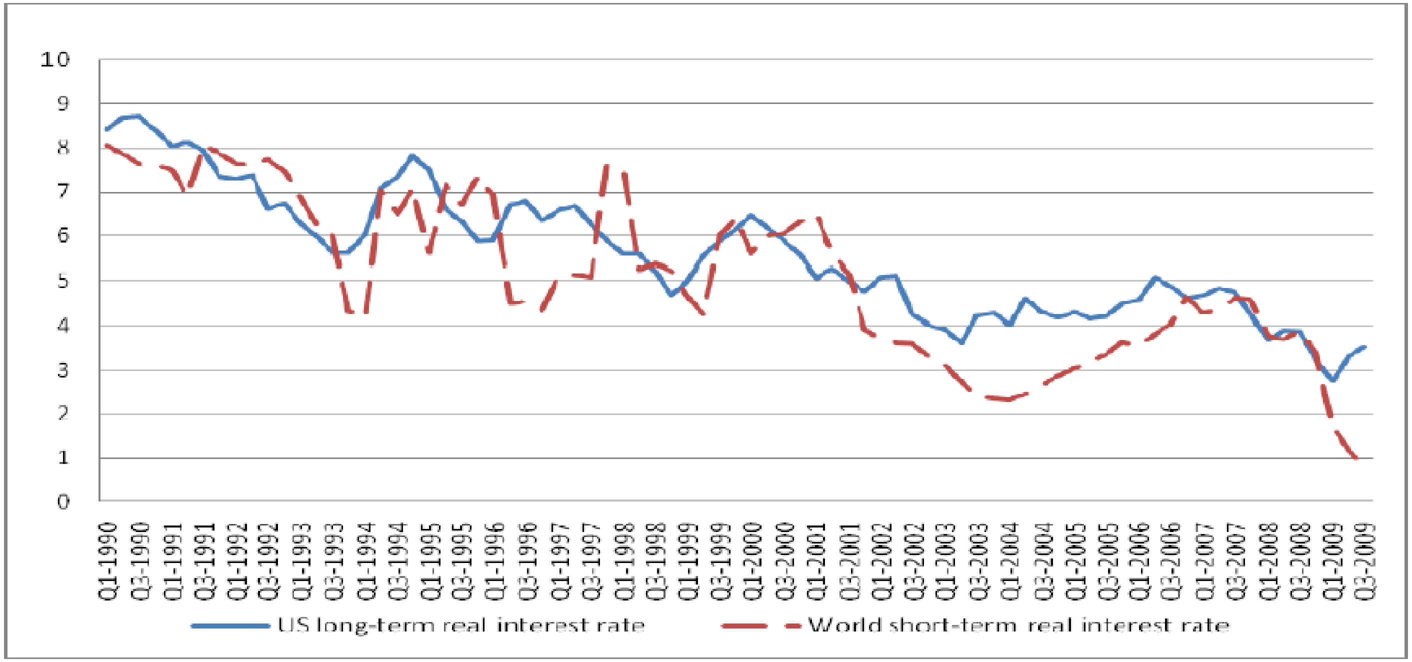
- This means that the most recent phase of global imbalances is characterized by the “Lucas Paradox,” wherein capital flowed from poorer to richer countries
- The broad consensus in the pre-crisis period was that global imbalances were not sustainable.
- They reflected macroeconomic imbalances such as exchange rate misalignment among major countries, the low savings rates and widened fiscal deficits of current account deficit countries.

- The correction of these imbalances would necessitate a US current account adjustment, reversal of capital and a major depreciation of the dollar.
- The general consensus was there would be a "hard landing"

Global imbalances and the crises?

- In the wake of the crises, a number of authors have argued that global imbalances were perhaps the single largest contributing factor to the crises.
- Prominent view, the “global savings glut”

Figure 2
Real interest rate on Public debt: Long term (10 years) short term (3 months)

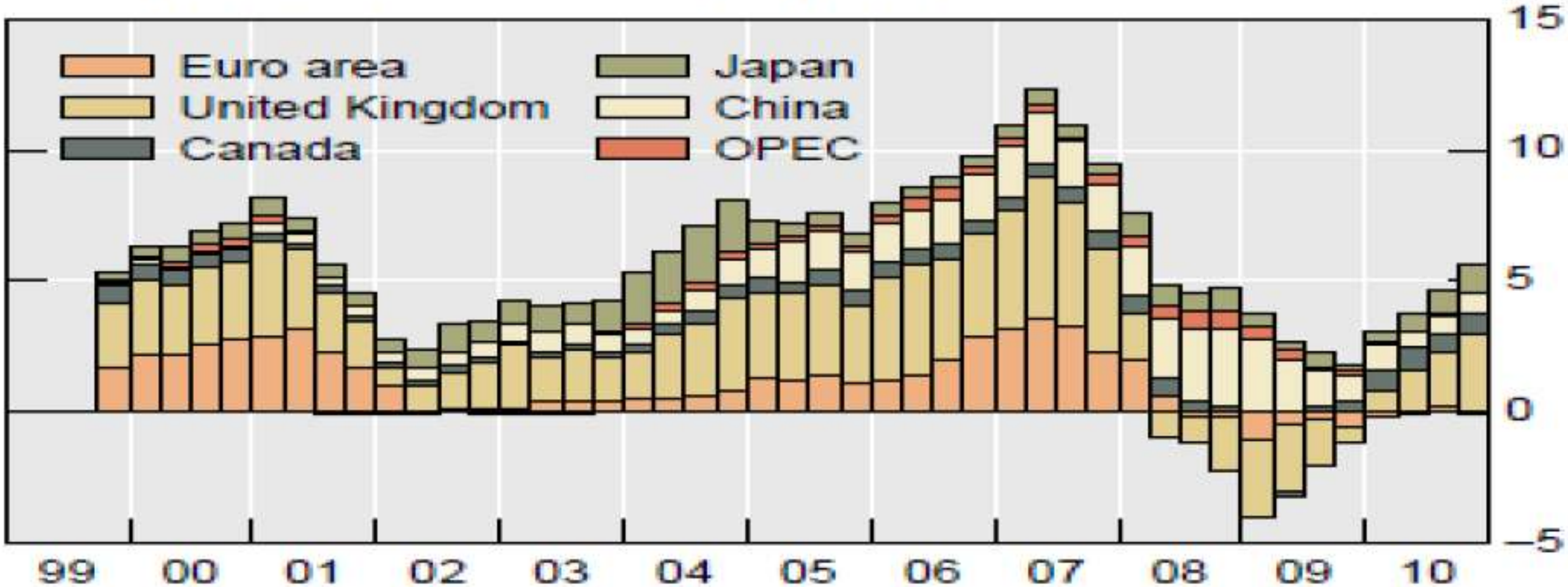


Source: Serven-Nguyen (2010)

- The real interest rate is determined by global savings and investment and not the pattern of its geographical distribution.
- In other words a given world real interest rate is equally consistent with large, small, or the absence of any current account imbalances.

- The pre-crises fear that the large external deficits in the United States would make it vulnerable to a sudden reversal in capital flows never really materialized .
- During the crisis net capital inflows to the United States were a stabilizing rather than a destabilizing force.
- The worse things became, the more domestic and foreign investors ran for cover to the United States.

Figure 3
Gross Capital Inflows into the US by region as a percentage of US GDP

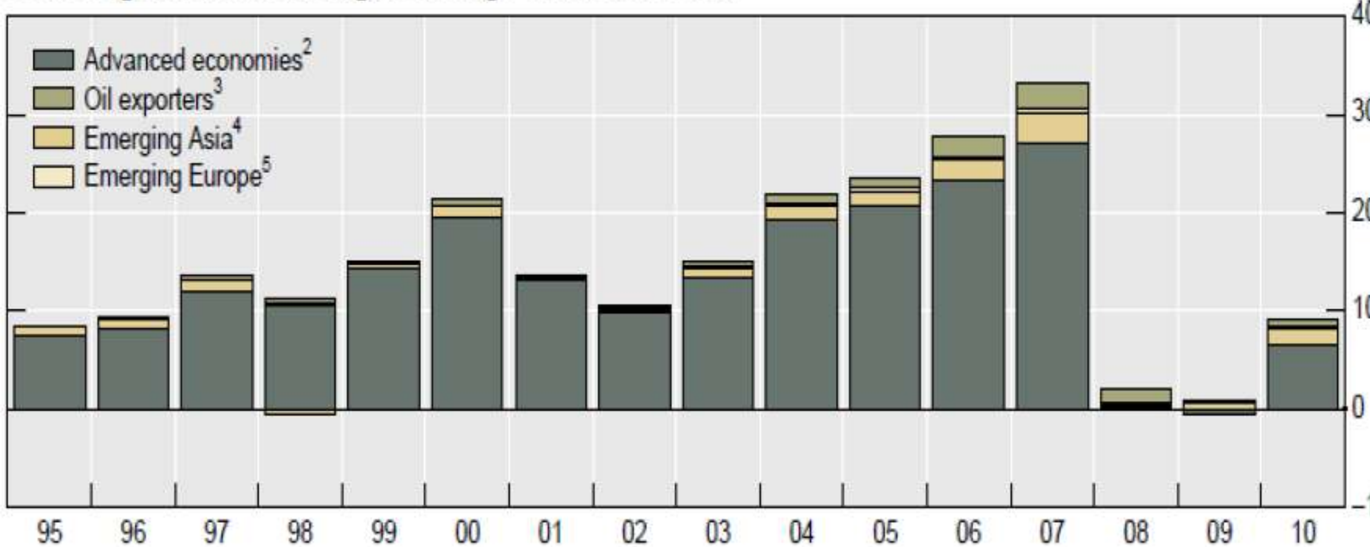


Source: Borio and Disyatat (2011)

- The most important source of capital into the United States was Europe and not emerging markets.
- Of this a majority of it came from the United Kingdom, which was a country that ran current account deficits.
- The rest came from the Euro area, whose current account was roughly in balance.

- The weak link between net capital flows and the global financial crises has led a number of authors to look at gross instead of net flows.
- There is a growing consensus that dangerous levels of gross assets can build up even in the absence of any net international flows and it is these flows which eventually set off the financial turmoil

Gross capital flows as a percentage of world GDP

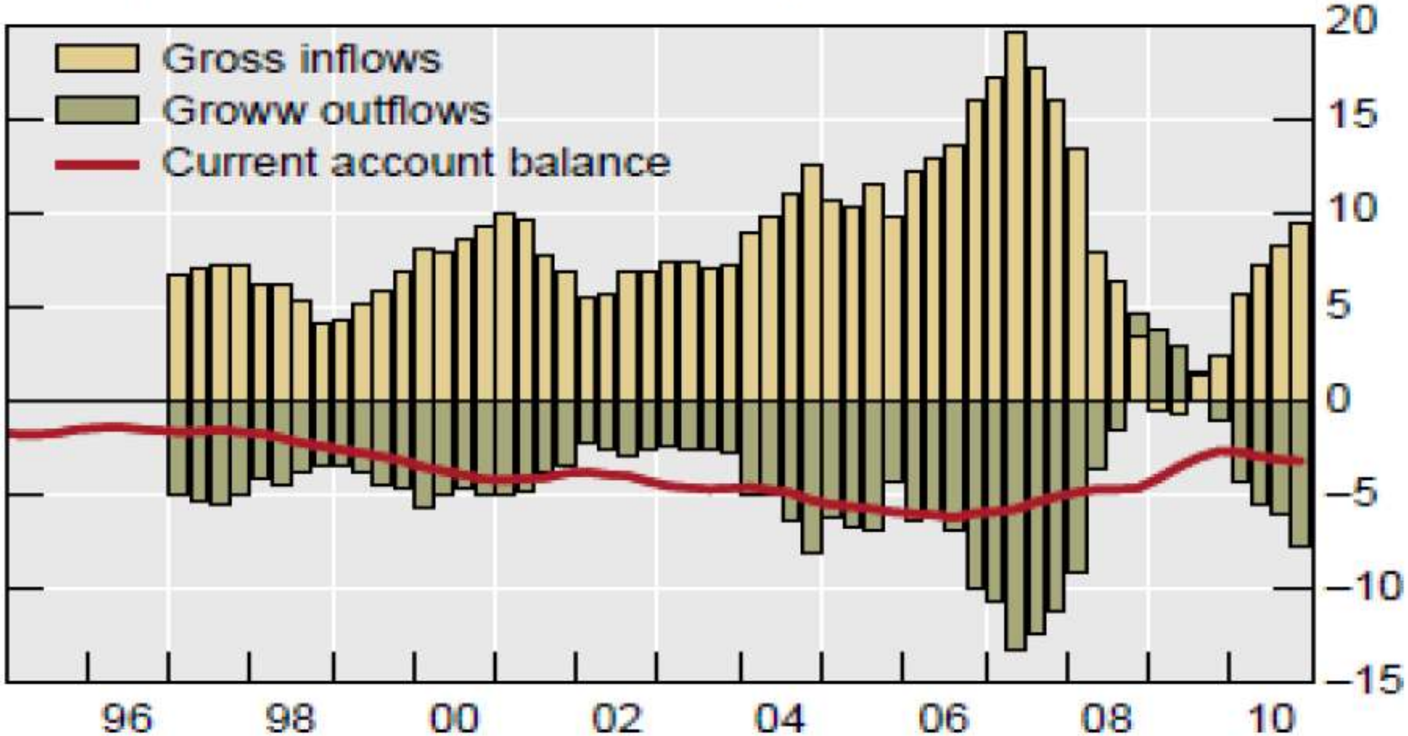


[1] Gross flows equals sum of inflows and outflows of direct, portfolio and other investments. [2] Australia, Canada, Denmark, the euro area, Japan, New Zealand, Sweden, the United Kingdom and the United States. [3] Algeria, Angola, Azerbaijan, Bahrain, Democratic Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kazakhstan, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syrian Arabic Republic, Trinidad and Tobago, the United Arab Emirates, Venezuela and Yemen. [4] China, Chinese Taipei, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Thailand and the 20 smaller Asian countries. [5] Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

Source: Borio and Disyatat (2011)

- Broner, Didier, Erce, and Schmukler (2011) document both gross capital inflows (CIF) and gross capital outflows (COD) for the period 1970– 2009 for 103 countries.
- The volatility of gross capital flows (CIF and COD) has been large and increasing.
- The volatility of net capital flows is much lower than volatility of gross capital flows.

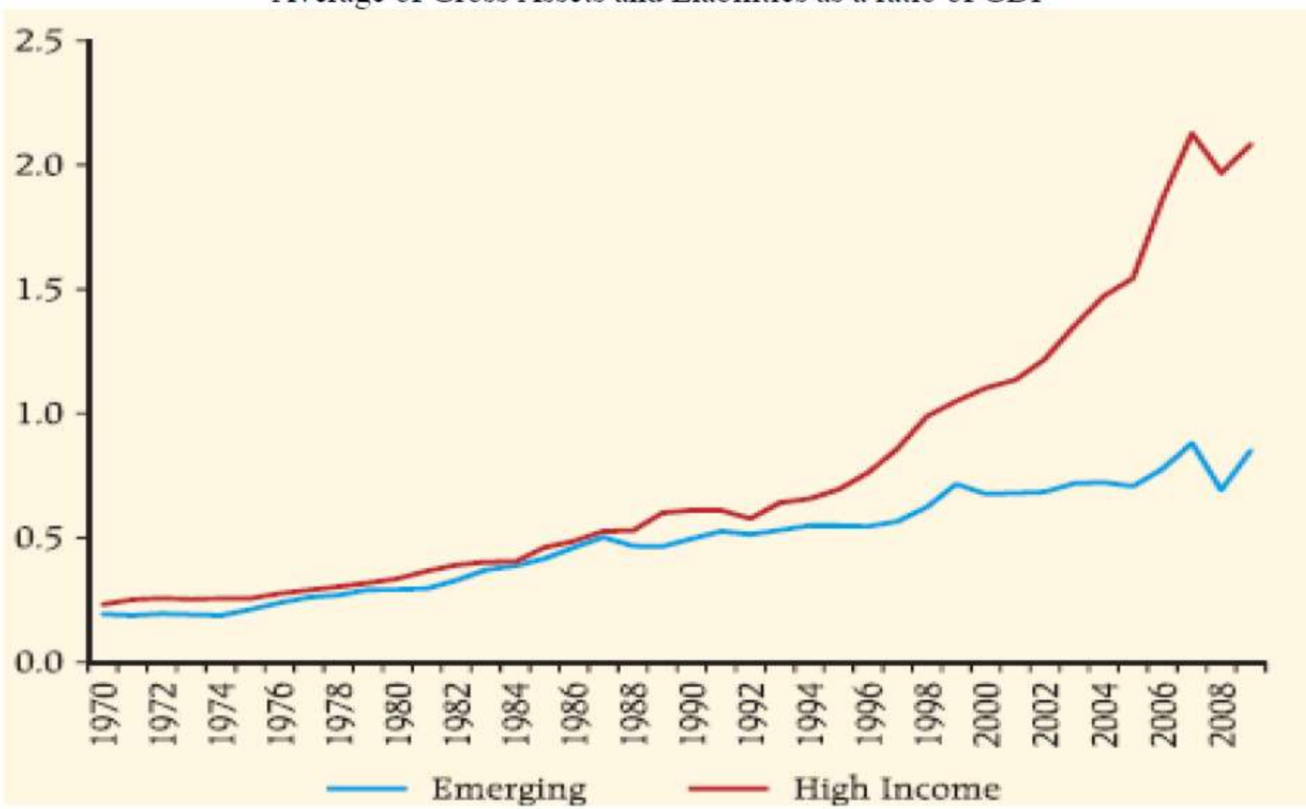
Gross Capital flows into US and Current Account as percentage of GDP



Source: Borio and Disyatat (2011)

- Net capital inflows (current account balances) remained relatively stable in 2008, gross capital inflows and outflows collapsed during this period.
- The drop of these gross flows were largely between the United States and Europe.
- The inflows from China, Japan and other emerging markets continued during this period and if anything, helped stabilize the overall environment

Average of Gross Assets and Liabilities as a ratio of GDP



Source: Obstfeld (2012)

- Gourinchas (2012)' takes the argument on gross flows a step further by advocating that one ought to focus on the liquidity of the gross assets and liabilities—not just the magnitudes.
- He points out that a mismatch between short term liabilities that need to be rolled over and a country's pledgeble assets could lead to "liquidity imbalances" making a country financially vulnerable.

- Acharya and Schnabl (2010) offer a classic study of how such liquidity imbalances triggered off the crises.
- Surplus countries and deficit countries generated large gross positions by selling short-term asset back commercial paper (ABCP) to risk-averse investors, predominantly US money market funds, and investing the proceeds primarily in long-term US assets.

- As a negative shock hit the US economy, banks in both surplus and deficit countries experienced difficulties in rolling over ABCP which helped kick off the global crises in August 2007.
- It is important to emphasize that this channel would be overlooked if one were to focus on only net capital inflows

Policy Implications

- The period since the crises has seen the global economy characterized by a dual pattern of growth.
- Monetary policy on the other hand has been resolutely expansionary in the advanced economies
- The differential patterns of growth and the record low interest rates have induced large capital inflows into emerging markets

- Taylor (2012)-in order to prevent the resultant appreciation of the exchange central banks in emerging markets tend to hold their interest rates lower than what would be appropriate for domestic stability.
- Such spillovers and externalities associated with monetary policy in individual countries call for some form of policy coordination.

- The run up to the GFC was characterized by low and stable inflation and robust growth--the so called “great moderation.”
- Ignored the credit bubble.
- Perhaps one needs to focus on maintaining financial stability in addition to inflation and growth stability.

- Shortage of liquid assets continues to plague the global economic system.
- The crisis if anything has exacerbated the problem.
- In this regard, the systematic use of central bank swap lines, multilateral provision of liquidity under IMF supervision are all steps in the right direction

- One of the root causes of financial crises is that liabilities are often funded by short term debt instruments.
- These transactions carry counterparty risk and are therefore a threat to global stability.
- Rogoff (2011) makes the interesting point that government policy actually incentivizes the appetite for debt.

- Tax systems in many countries favor debt over equity.
- Central banks have often bailed out debt far more aggressively than equity.
- Perhaps reducing the reliance on debt and increasing the share of liabilities funded by equity might make the financial system more resilient