Global Imbalances

Olivier Blanchard
Economic Counsellor
Research Department

Banco de España
July 1, 2010

The Road Map

- No point in reducing imbalances per se:
  - Imbalances can be good or bad
  - Important to identify the causes
- Evolutions
  - The past 15 years
  - The effects of the crisis
  - Likely future evolution
- Attacking the bad imbalances
  - Reducing distortions
  - Reducing systemic risks
  - Global liquidity provision

“Bad” Imbalances: Distortions

- **Domestic distortions**
  - High private saving reflecting lack of social insurance/poor firm governance
  - Low private saving driven by bubble-driven asset booms
  - Excess public borrowing
- **Systemic distortions**
  - Export-led growth strategies: Unfair competition?
  - Self-insurance leading to excess asset accumulation

"Bad Imbalances": Risks

"Good flows" interacting with other distortions.

- **Domestic risks**
  - Capital flows, appreciation, and the Dutch disease
  - Current account deficits and sudden stops.

- **Systemic risks**
  - Risk of disruptive adjustments from "large" imbalances

    Gross or net positions?

    Central Banks as large investors: Stabilizing or destabilizing?

Good or Bad in Practice?

Easier to identify in theory than in practice! Three interpretations for China:

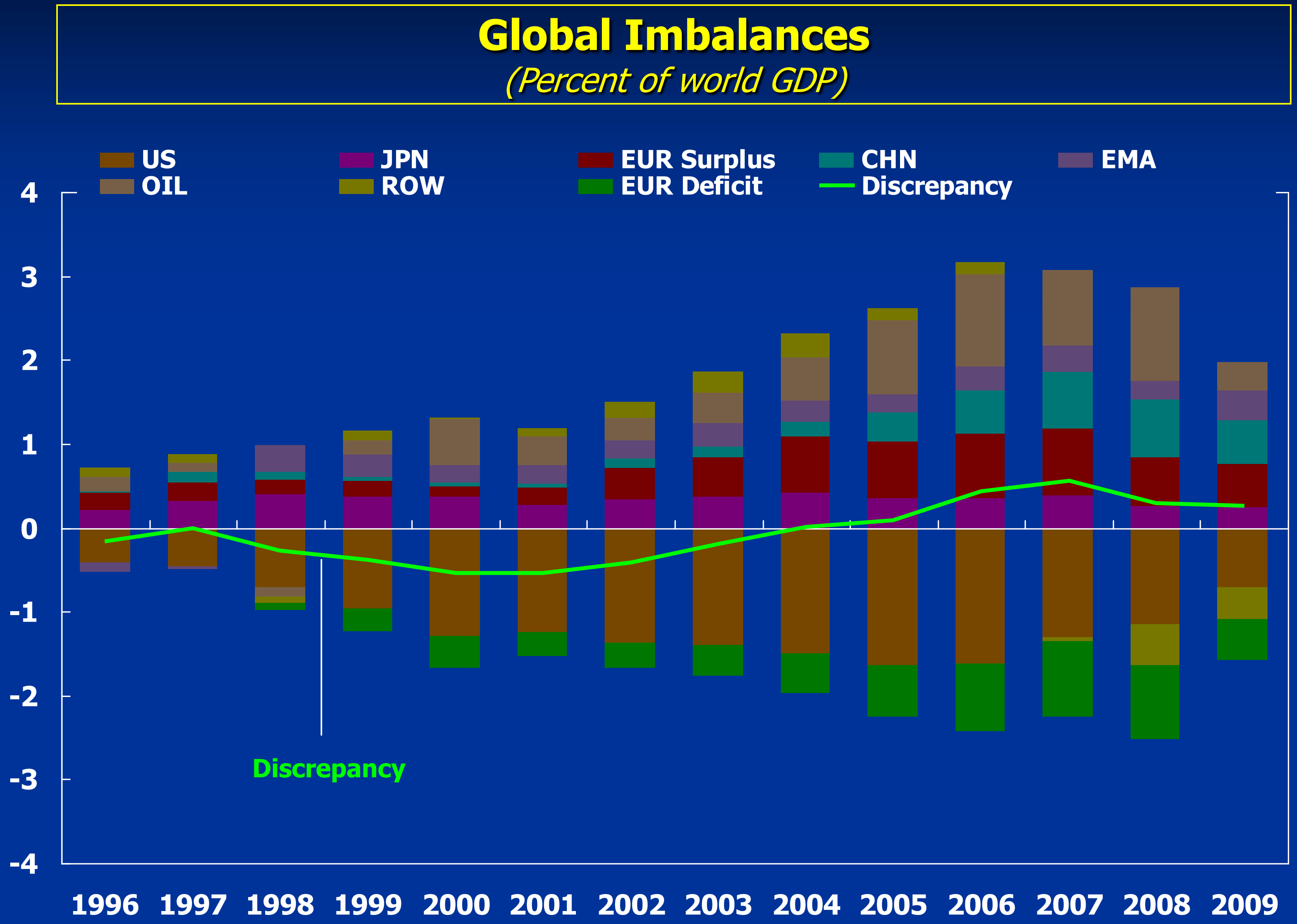
- High saving reflect cultural factors. Requires a low exchange rate.
- High saving reflect underprovision of social insurance/ poor governance. So long as persists, requires a low exchange rate.
- Intentional undervaluation of the exchange rate, together with policy induced high saving rate to avoid overheating.

A Time-Line for Imbalances

Three pre-crisis periods:

- 1996-2000: US investment boom, crisis in emerging Asia, recession in Japan
- 2001-2004: U.S. fiscal deficit, global slowdown and recovery
- 2005-2007/08: Asset price boom; oil price boom; China's increasing surplus; increasing deficits in "peripheral Europe"

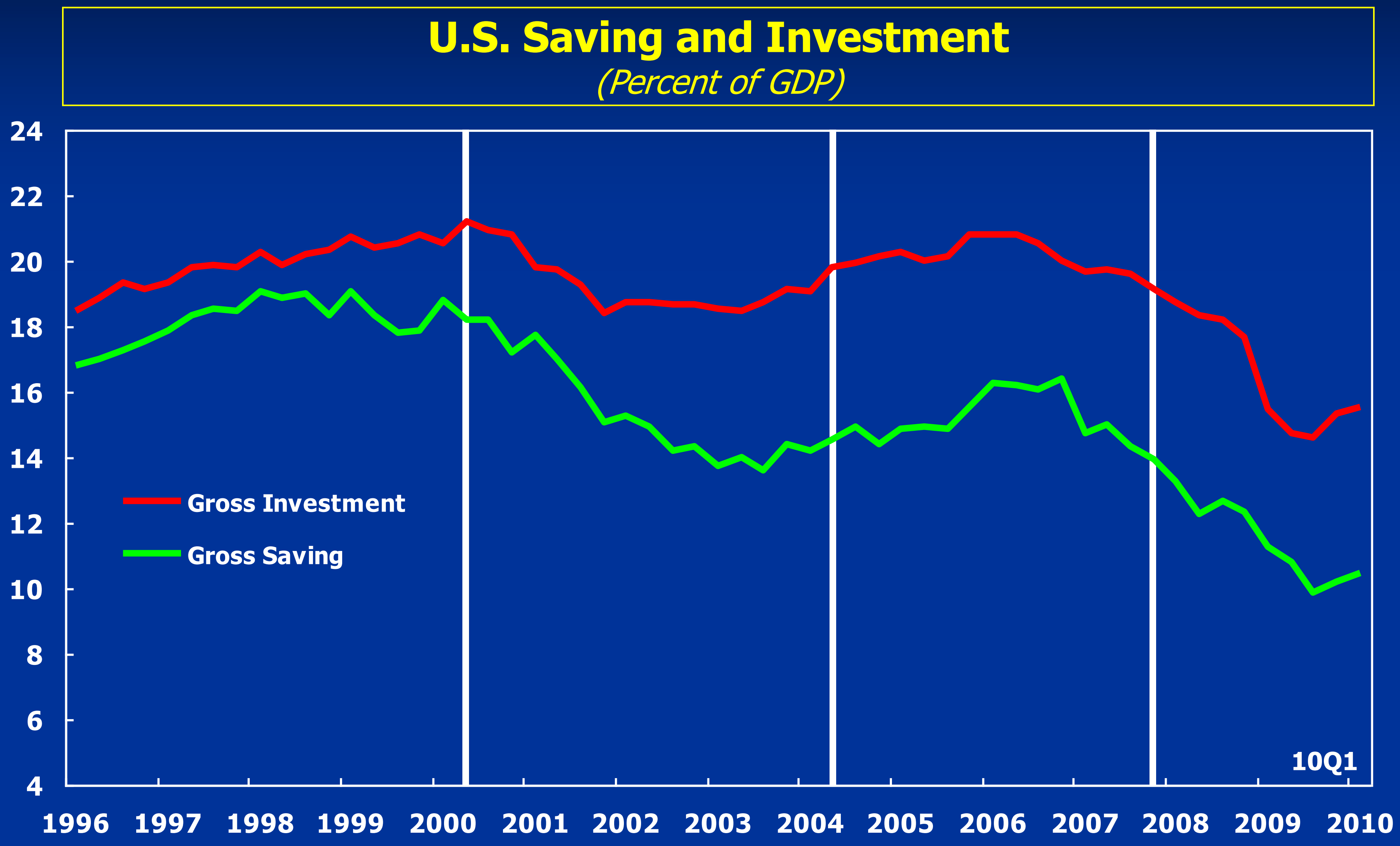
Imbalances during 1996-2009



So good or bad in practice?

- Good (mostly relevant for the past):
  - US productivity boom 1996-2000
  - (Part of) "convergence deficits" (Southern Europe, CEE)
  - (Part of) saving by oil exporters
- Bad (largely dominate the scene today):
  - US fiscal deficits
  - Excess saving in China
  - (Globally excessive) reserve accumulation

U.S. Saving and Investment



The impact of the crisis

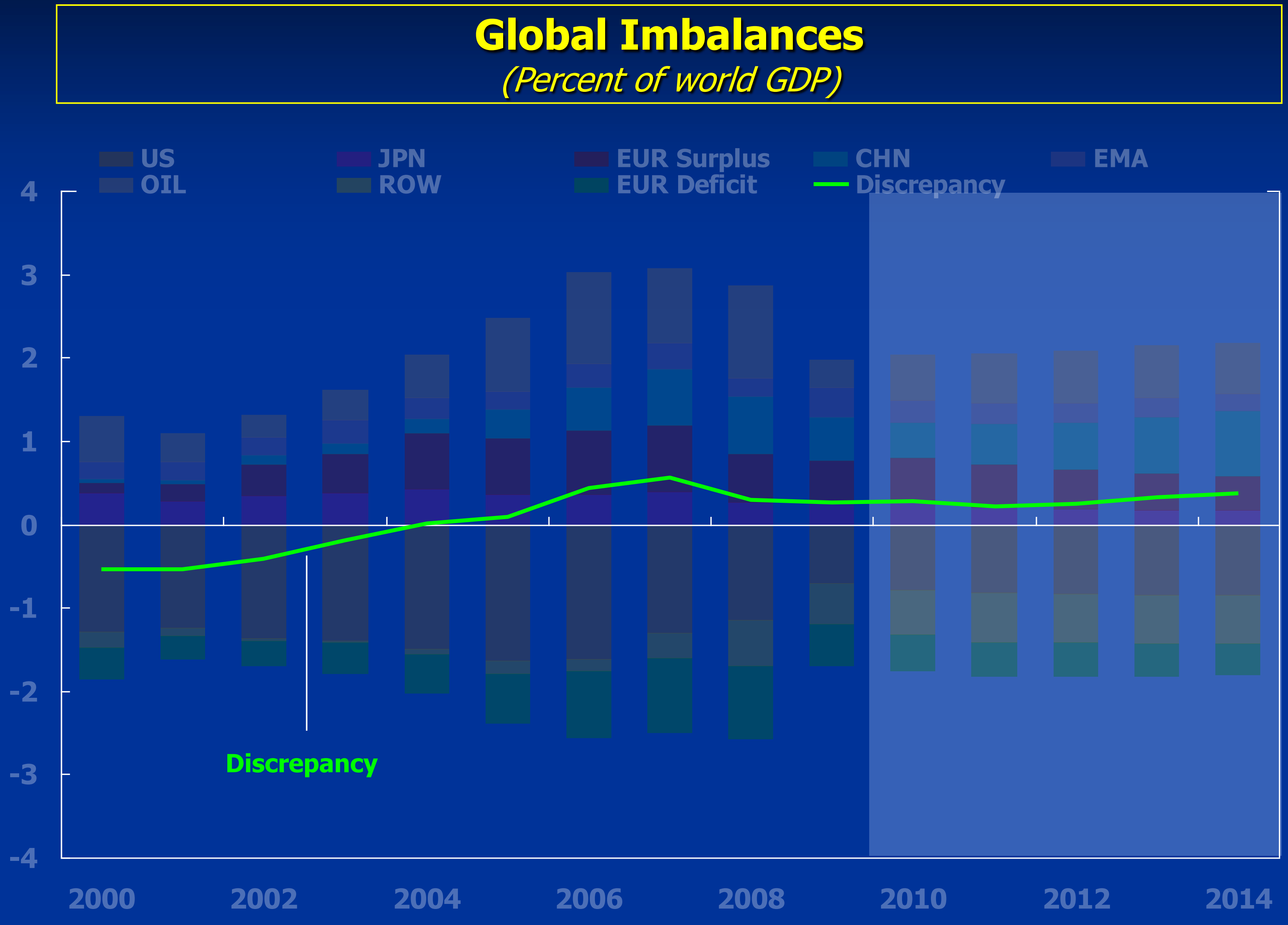
- Narrower imbalances in 2009
  - Lower oil prices
  - Asset price busts reducing demand in deficit countries
  - Reduced willingness to finance large deficits

- Will the narrowing last?
  - Oil prices have increased again
  - …but higher private saving in deficit countries
  - …and likely lower investment
  - Higher risk premia on external finance?

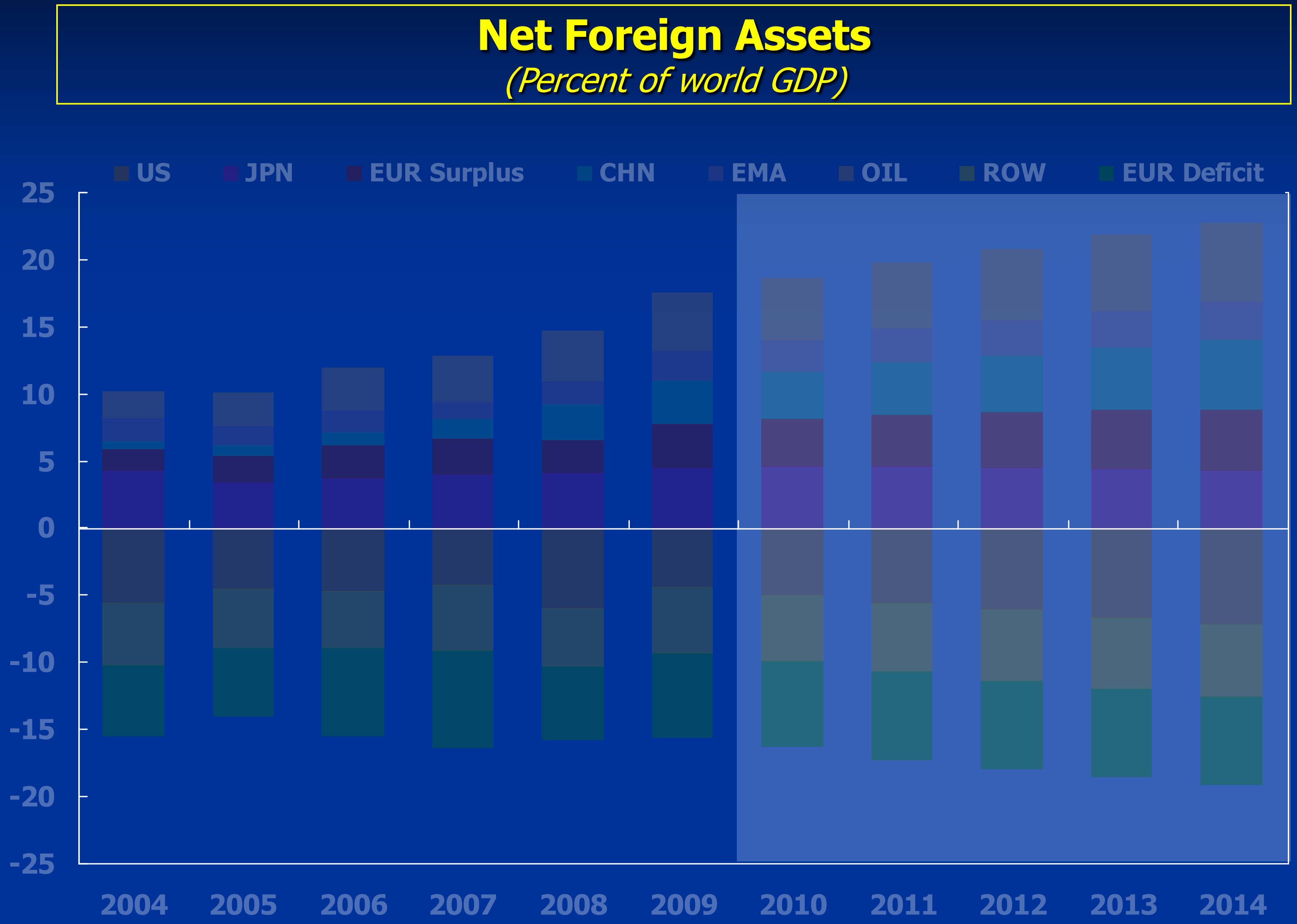
Possible scenarios

- "Ideal" scenario:
  - gradual adjustment in U.S. fiscal position;
  - Lower saving, more appreciated RMB, lower surplus in China
  - Rebalancing towards domestic demand and lower precautionary saving in emerging markets in emerging Asia and elsewhere
- Risky scenario 1:
  - Little saving/exchange rate adjustment in China and other emerging markets;
  - Insufficient fiscal adjustment in the US (to sustain demand)
  - Global imbalances widen again. Fiscal sustainability uncertain.
- Risky scenario 2:
  - Little saving/exchange rate adjustment in China and other emerging markets
  - US phases out fiscal stimulus, lower US growth
  - Result: relatively weak and unbalanced growth

Weo Forecasts



WEO forecasts. Net foreign asset positions



Policies going forward
I. Attacking Domestic Distortions

- Increase private and public U.S. saving

- Strengthen social insurance, corporate governance, access to credit for households and SMEs in China;

- Strengthen financial intermediation and institutions to increase investment in a number of emerging Asian countries.

- Move from export-led towards more domestic-demand led growth in a number of emerging market countries; let REER appreciate

Three simulations

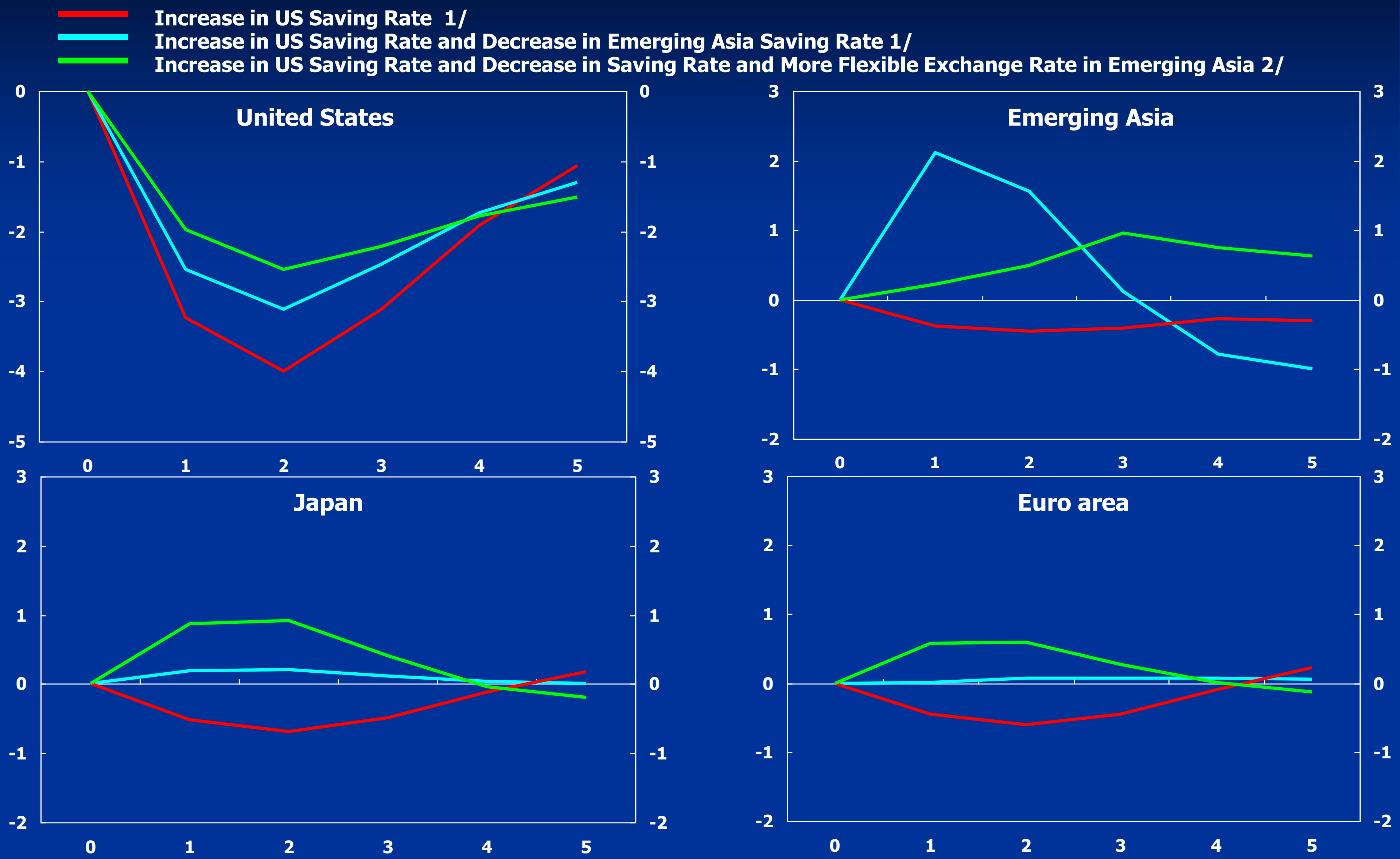
- Use GIMF. Five regions (one emerging Asia). Actual trade patterns.

1. Increase in saving in US (2%). Fixed rate in EM Asia. Interest rate rules elsewhere; zero interest rate bound for one year. (Red)
2. Same, and decrease in saving in EM Asia (2%). Interest rate rules elsewhere, with zero interest rate bound for one year (Blue)
3. Same, but appreciation of EM Asia currencies by 20%. (Green)

- Focus on US and EM Asia GDP.

Global Rebalancing Scenarios

Real GDP (percent deviation from baseline)



1/ Limited exchange rate flexibility (crawling peg) in Emerging Asia.

2/ Floating exchange rate in Emerging Asia, following large initial appreciation.

II. Attacking Systemic Distortions
Better global liquidity provision

- Decrease need for reserve accumulation
- Alleviate worry about current account deficits and external debt in some emerging markets – lower precautionary saving
- Bilateral credit lines. Swap lines. Fed, ECB, SNB, China.
- FCL. Introduced March 2009.
  - Large upfront disbursement, no ex-post conditionality
  - Three countries have taken, and renewed. Columbia, Poland, Mexico. Have not drawn.

Can the FCL be improved?
Solvency and Liquidity Provision

Less solvent →

Liquidity provision:

How to extend to the right?

Extending the FCL

- Decreasing size with increasing risk of insolvency? No
- Increasing ex-post conditionality with increasing risk of insolvency? Why?
- Increasing terms with increasing risk of insolvency?
- Higher rates than SBAs? Or/and Triggered by systemic liquidity shock? Defined how? Regional, global?