Global Imbalances:
Reshaping the Debate

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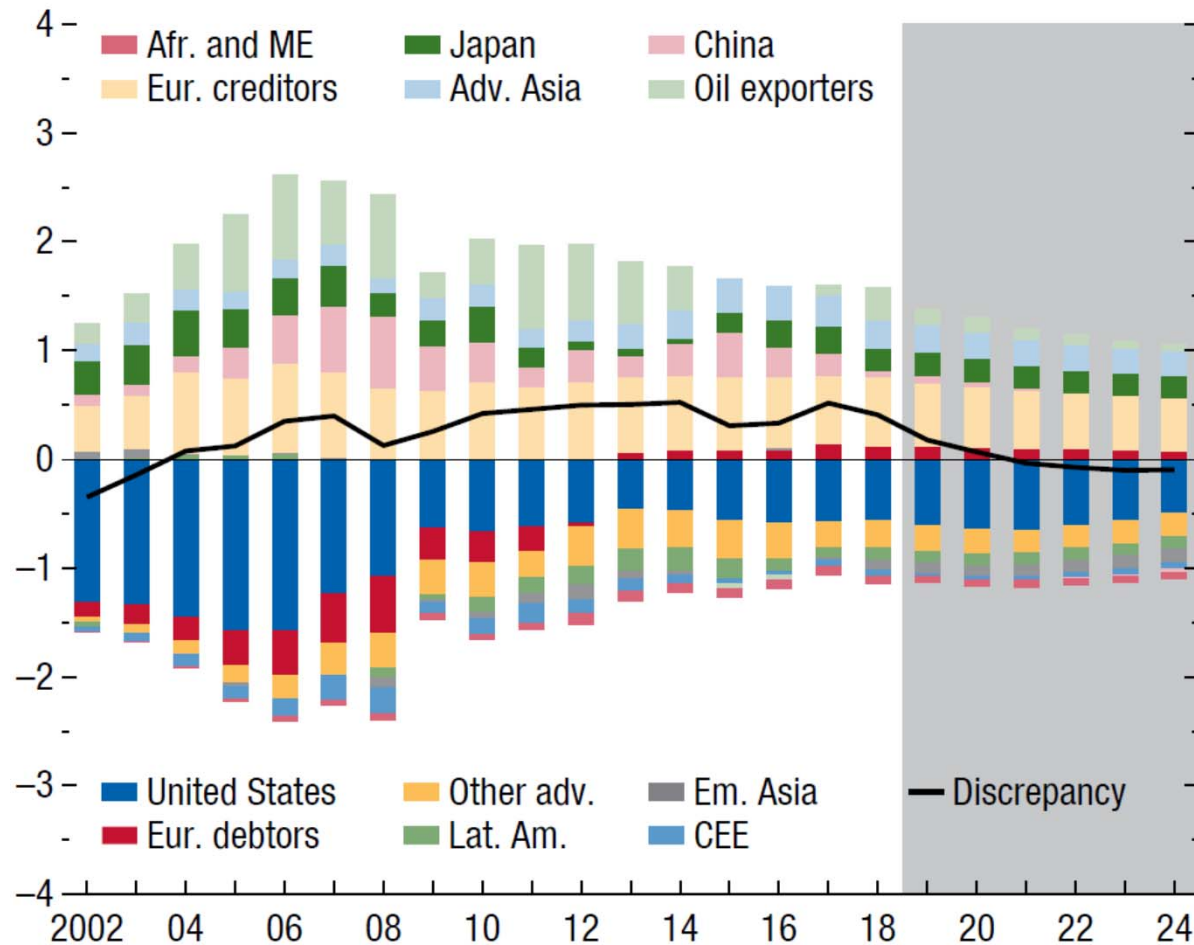
Global Imbalances: A Problem?

Global Current Account Balances
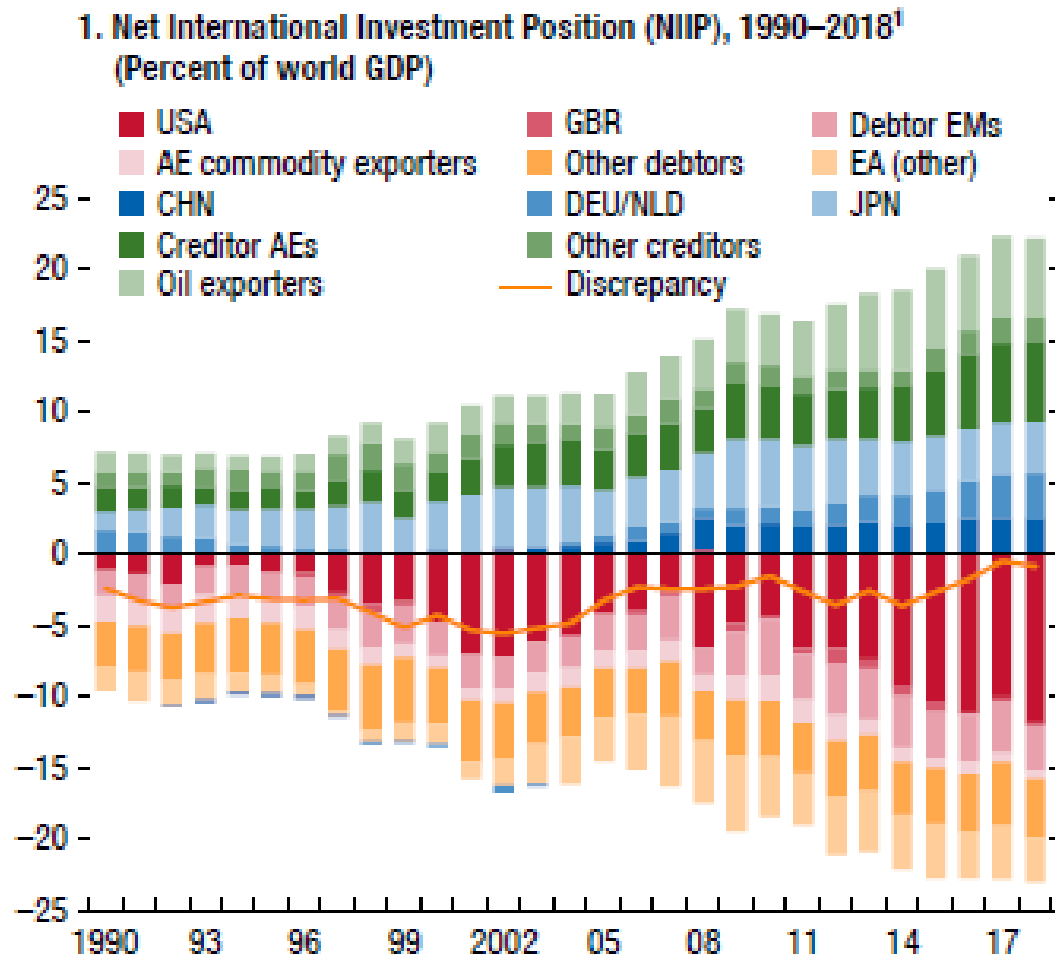(as % of global GDP)

Source: IMF World Economic Outlook, April 2019

Different Approaches to Imbalances

- Level of imbalances
- "Sustainable" level of deficits/surpluses
- Uses of capital flows/reserves
  - Important progress
  - Supports greater use of macroprudential tools
- **<u>Financial </u>drivers of imbalances**
  - Risks to external solvency
  - Vulnerability to different types of shocks

The "Stocks" Matter
Net International Investment Positions *(% of global GDP)*

1. Net International Investment Position (NIIP), 1990–2018[1]
(Percent of world GDP)

Legend:
- USA
- GBR
- Debtor EMs
- AE commodity exporters
- Other debtors
- EA (other)
- CHN
- DEU/NLD
- JPN
- Creditor AEs
- Other creditors
- Oil exporters
- — Discrepancy

Implies broader thinking on imbalances required

Source: IMF, External Sector Report, July 2019
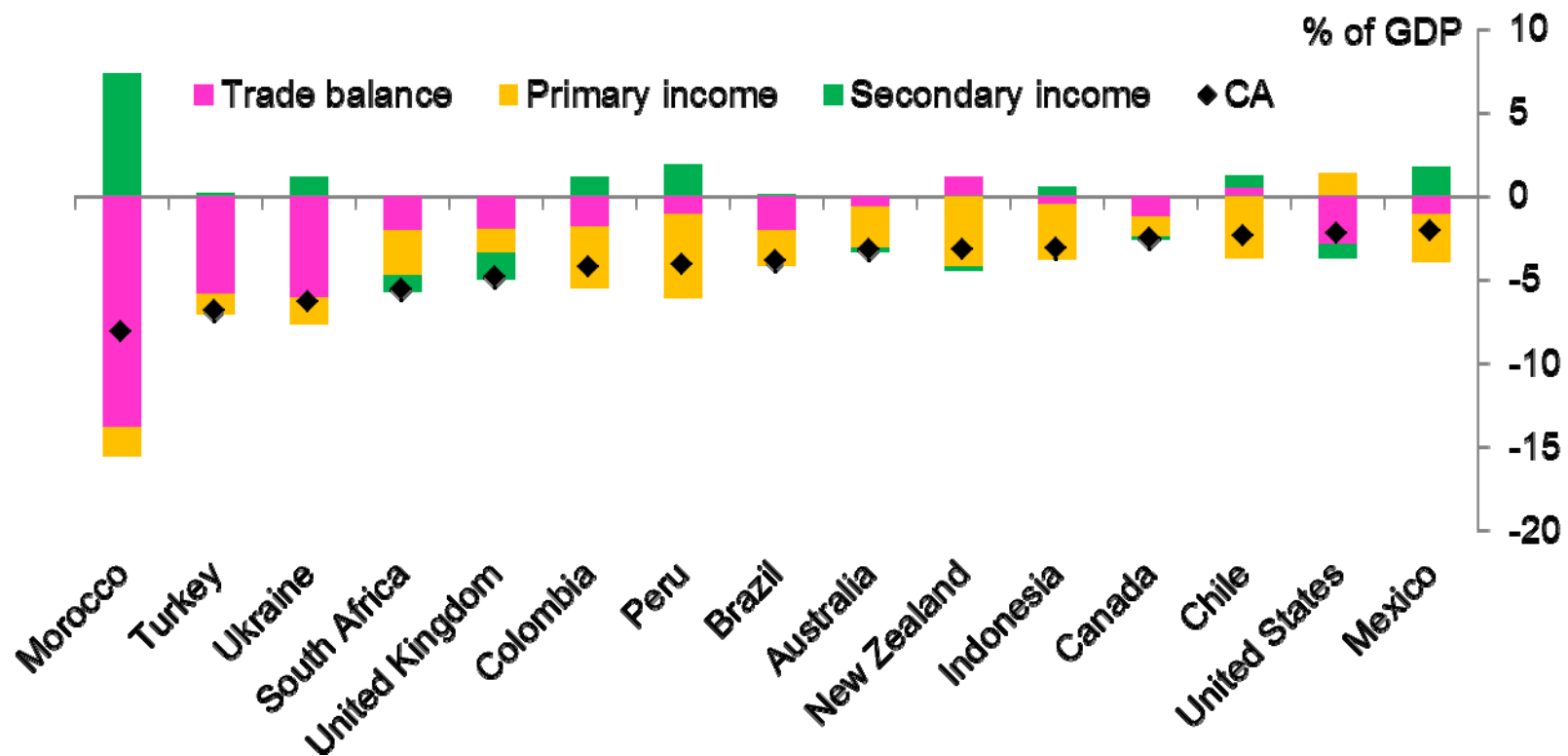
Current Account: Definitions

$$CA_{i,t} = TB_{i,t} + INVINC_{i,t} + SECINC_{i,t}$$

- CA = current account balance
- TB = trade balance
- $INVINC$ = primary investment income on NIIP
- $SECINC$ = secondary investment income on NIIP, transfers
- For country i at time t

Not just trade!
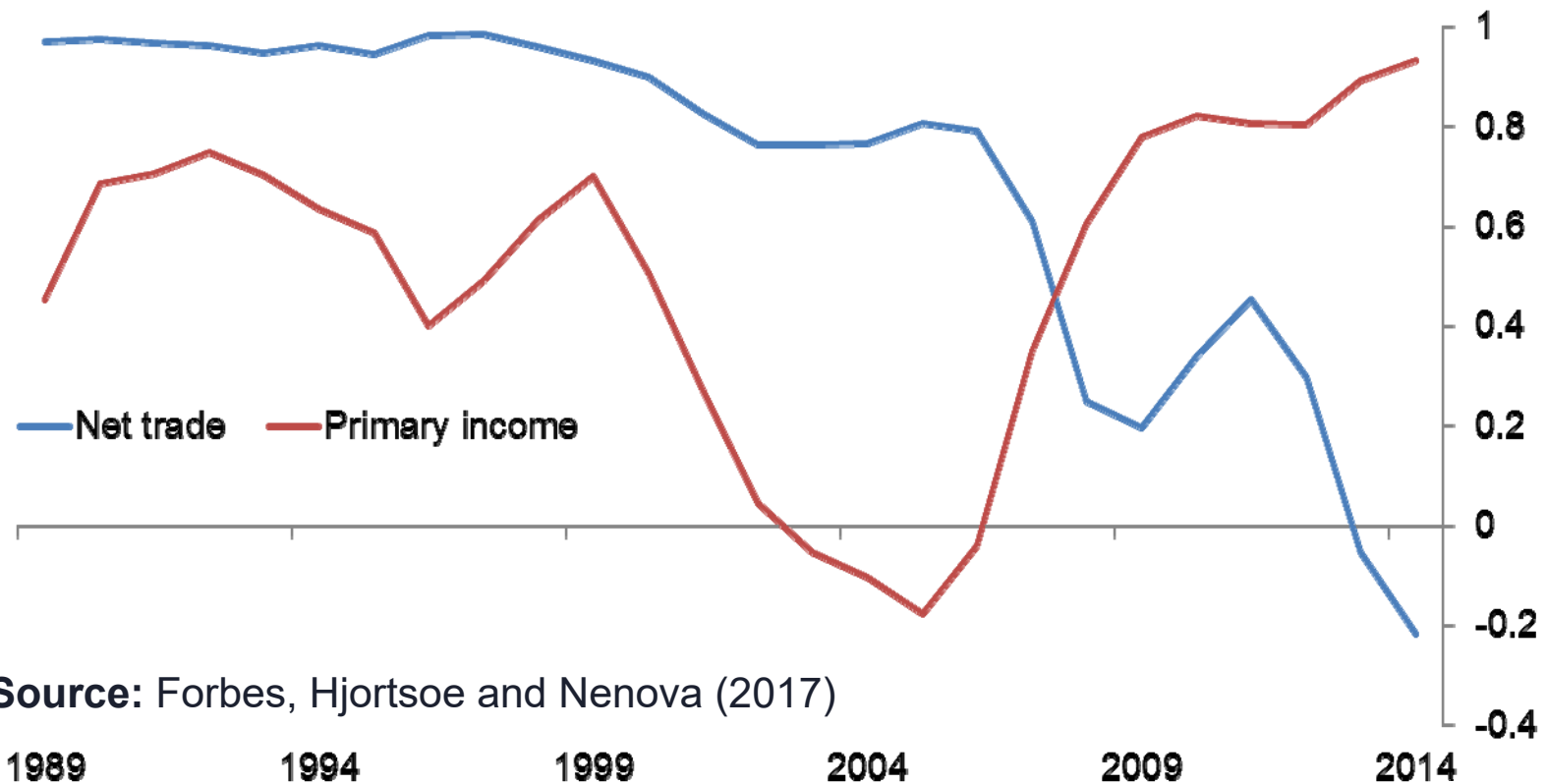
Role of Investment Income

Largest average current account imbalances for 2013-14 and their composition

Sample includes all countries with available data and average 2013-14 GDP of at least $100bn
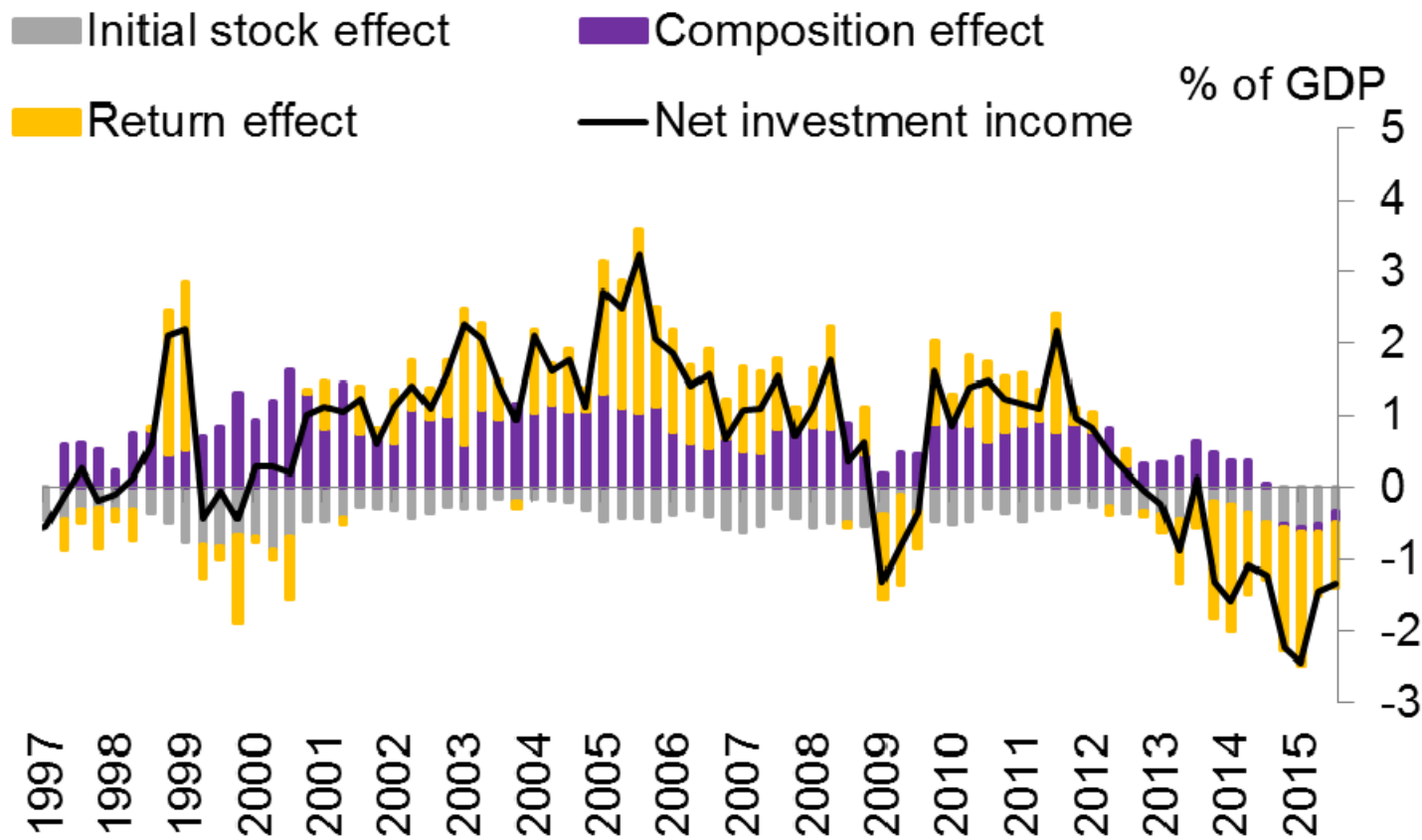
Particularly Striking in UK

10-year rolling correlation between UK current account balance and its net trade and primary income components

Net trade — Primary income

Source: Forbes, Hjortsoe and Nenova (2017)

More Detailed Decomposition
UK example

Legend:
- Initial stock effect (grey)
- Return effect (yellow)
- Composition effect (purple)
- Net investment income (black line)

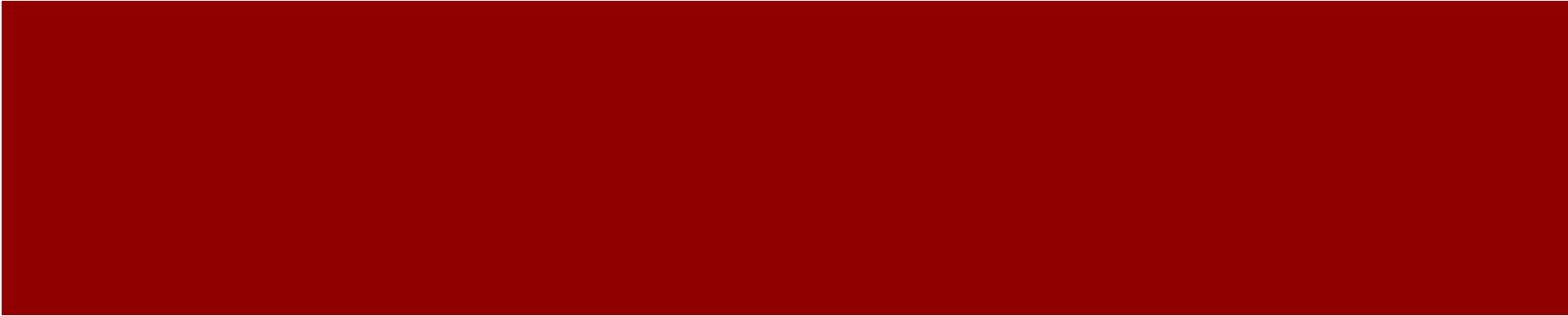% of GDP

$$INVINC_{i,t} = \sum_c \left[\frac{A_{i,t-1}^c}{\Delta ER_{i,t}^{A,c}} r_{i,t}^{A,c} \right] - \sum_c \left[\frac{L_{i,t-1}^c}{\Delta ER_{i,t}^{L,c}} r_{i,t}^{L,c} \right]$$

Source: Forbes, Hjortsoe and Nenova (2017)

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Even more important
than the flows…
The stocks
and external solvency

Implications for External Solvency
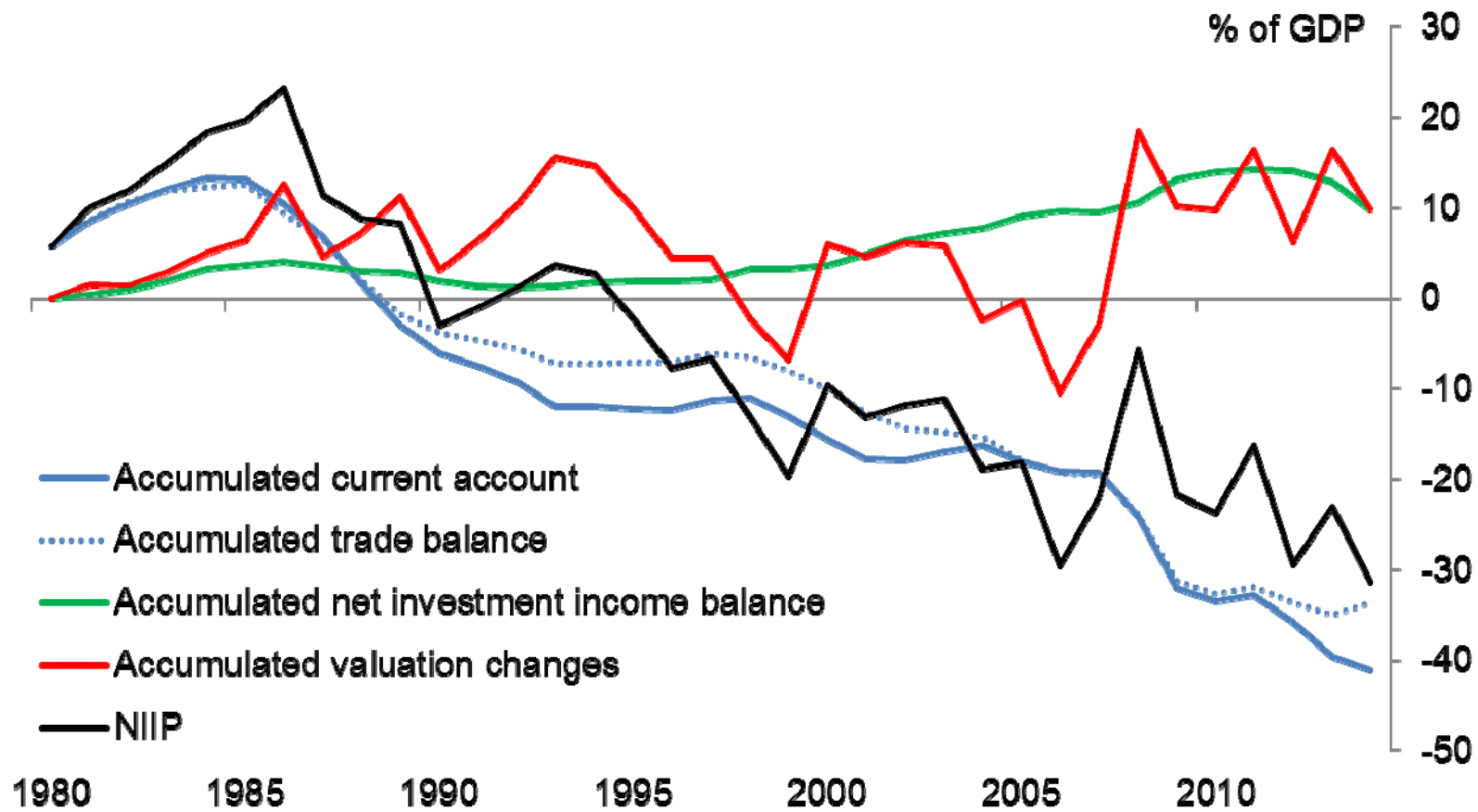## *(Net International Investment Position, NIIP)*

$$\Delta NIIP_{i,t} = TB_{i,t} + INVINC_{i,t} + \Delta VAL_{i,t} + E_{i,t}$$

- *NIIP* = net international investment position
- *TB* = trade balance
- *INVINC* = investment income on international positions
- *VAL* = valuation adjustments on international portfolio
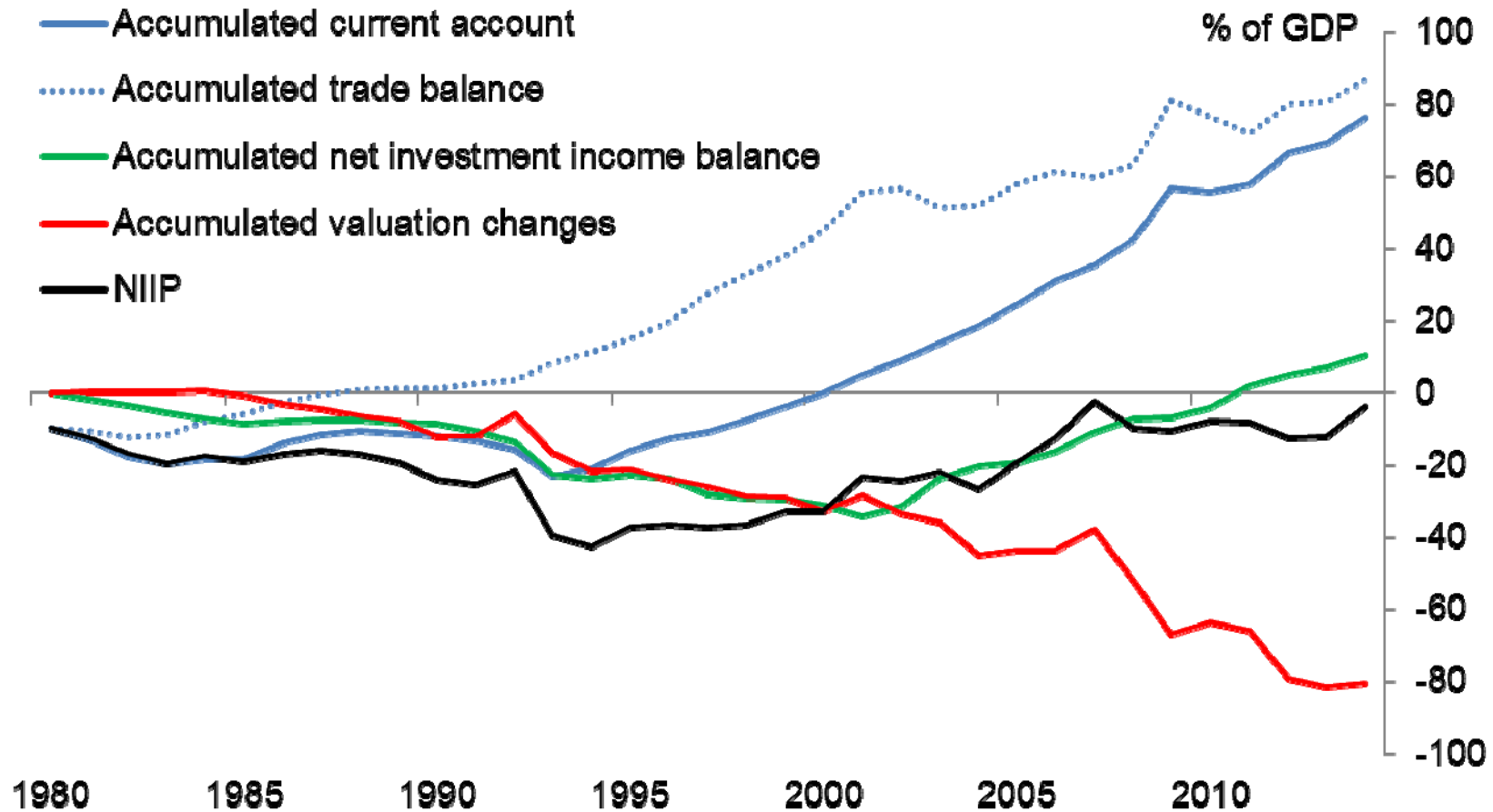- *E* = everything else (especially data issues & adjustments)

Can break down changes in net international investment position into 3 components:

- Trade balance
- Investment income on international assets and liabilities
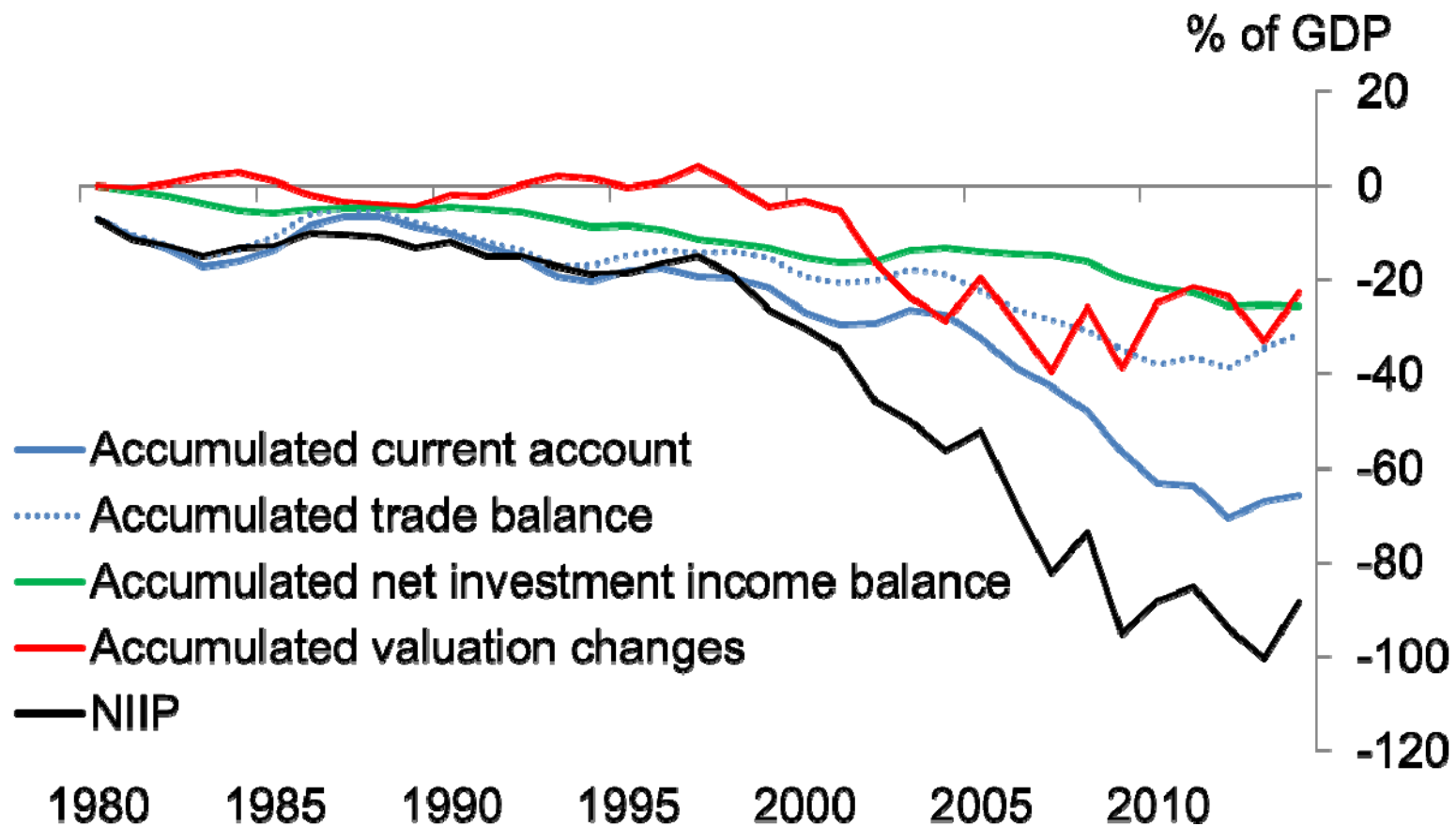- Valuation effects on current international assets & liabilities

NIIP Decomposition for the UK

NIIP Decomposition for Sweden

Accumulated current account
Accumulated trade balance
Accumulated net investment income balance
Accumulated valuation changes
NIIP

% of GDP

NIIP Decomposition for Spain

% of GDP

Legend:
- Accumulated current account
- Accumulated trade balance
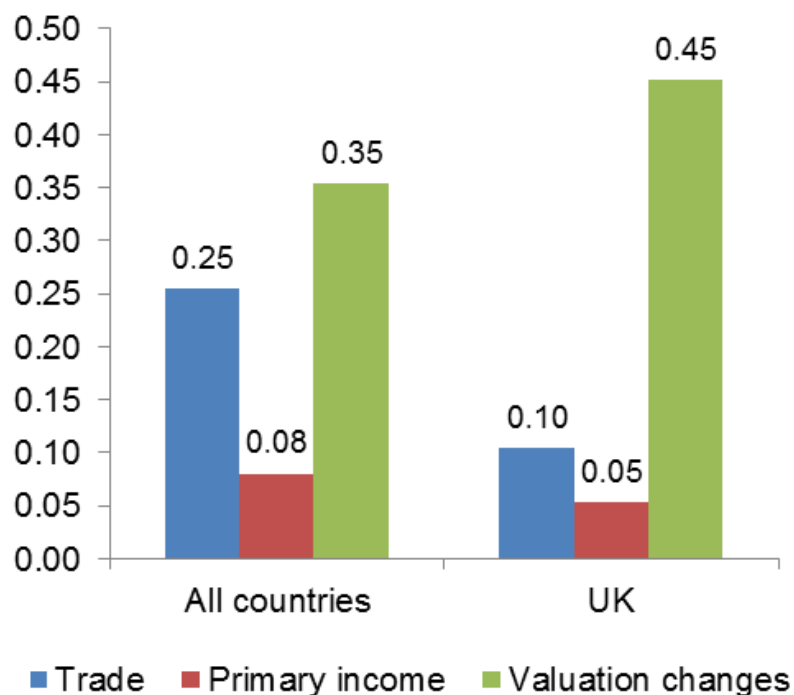- Accumulated net investment income balance
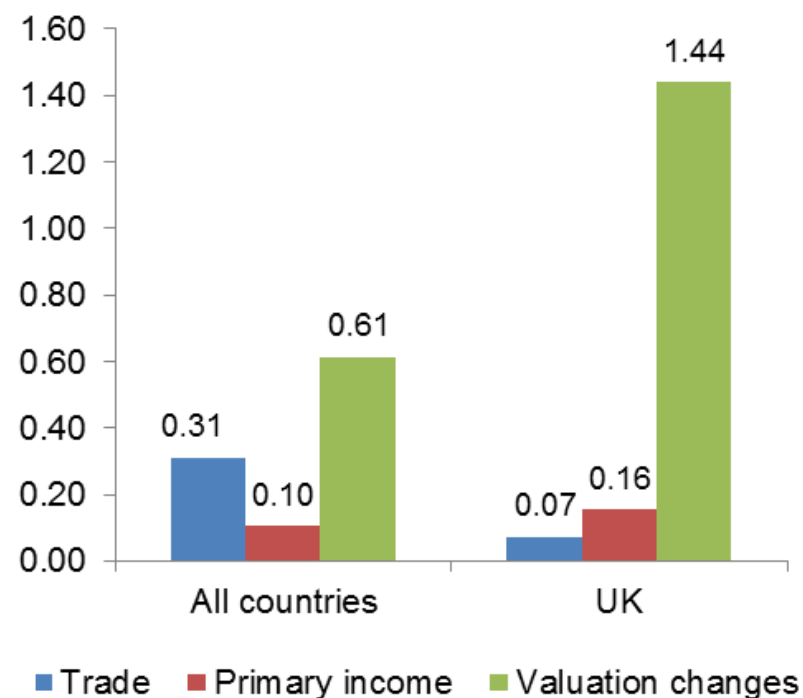- Accumulated valuation changes
- NIIP

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Share of NIIP Variance: *Explained by Selected Components*

(a) 1980-2014

(b) 2004-2014

Source: Forbes, Hjortsoe and Nenova (2017)

Key Insights

- ➢ **Less about trade imbalances**

- ➢ **More about financial components**

- ➢ **Financial components driven by:**
  - ▪ Exchange rate effects
  - ▪ Relative return effects
  - ▪ Composition effects
  - ▪ Initial positions/exposures

Vulnerabilities?

➢ **Key: how do each of the components vary during periods of heightened domestic and global risk?**

  ▪ Currency exposure of assets and liabilities

  ▪ Composition of assets (debt/equity) of assets and liabilities

  ▪ Exchange rate movements

➢ **Different approach to vulnerability & sustainability**

  ▪ **Current account deficits can be a "shock magnifier" or "shock absorber"**

  ▪ For equations and breakdowns by country, see Forbes, Hjortsoe and Nenova (2017), *Economic Journal.* May.

An Example: UK After Brexit

➢ **UK in 2015:** "Flagged" as risky, large current account deficit & reliance on "kindness of strangers"

➢ **Brexit vote in June 2016 (UK risk ↑):**
  ➢ Sterling depreciates (roughly 15%)
  ➢ UK interest rates and relative rate of return ↓
  ➢ Value of UK foreign assets ↑ (relative to UK GDP)
  ➢ Minimal impact on trade balance….but….

➢ **Effects through financial channels:**
  ➢ Estimate: Current account deficit shrink by 0.7% of GDP
    ➢ *Actual: Primary investment income share fell 1% of GDP (2015 vs. 2017)*
  ➢ Estimate: NIIP improve 25% of GDP
    ➢ *Actual: NIIP fell to about 0 from -20% of GDP (end-2015 vs end-2016)*

Final Thoughts: Global Imbalances

➢ **Reframing debate on global imbalances**
  ➢ Less about trade
  ➢ Less about levels/"structural equilibrium"
  ➢ More about financial components & sensitivities
  ➢ Critical: interaction of financial components with different risks

➢ **In some cases this increases country-specific vulnerabilities around imbalances, but in others reduces them**
  ➢ Exchange rates can be important

➢ **Global imbalances can be "risky" or "risk sharing"**