

Global Imbalances: An Eternal Subject?

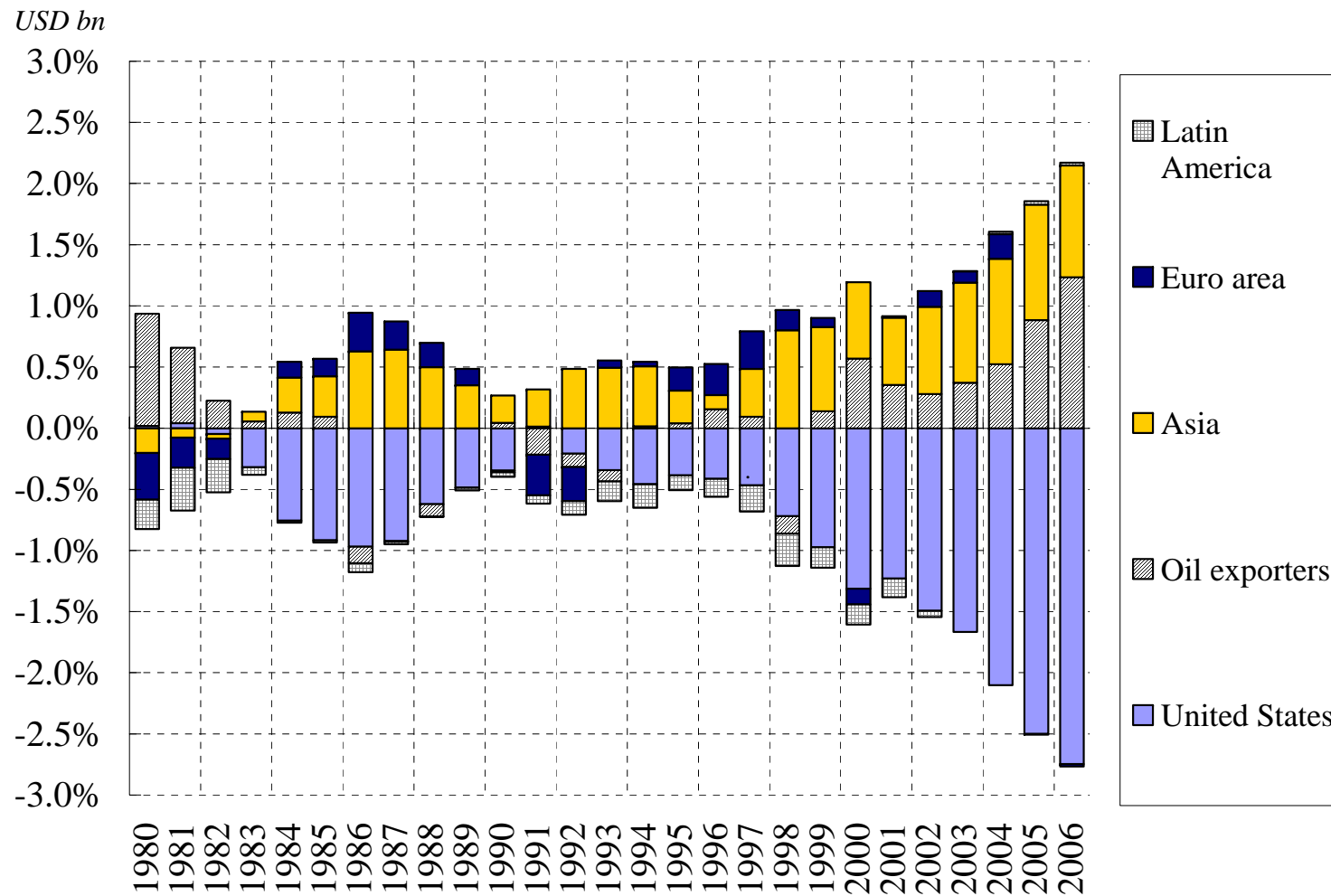
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**International Policy Analysis and Emerging Economies
European Central Bank**

**Meeting of Monetary Policy Managers
from Latin American Central Banks and the Eurosystem**

Frankfurt, 1-2 March 2007

Current Account Imbalances: The Big Picture



A. Definitions and Explanations

1. What are these “global imbalances” really?
 - Definition – *External positions of systemically important economies that entail significant distortions or risks for the global economy.*
2. Changing nature of global imbalances?
 - 2004 – Int. monetary system (Dooley et al., Bank of England)
 - 2005 – Savings glut/ investment slump (Bernanke, Rajan)
 - 2006 – Financial aspects (Caballero, Mendoza)
3. Is there another way to think about “global imbalances”?
 - Cyclical versus structural factors

B. Cyclical and structural factors driving imbalances

Cyclical Factors

- Diverging growth patterns
- Productivity differentials
- Macro policies (e.g. US fiscal policy)
- Oil prices

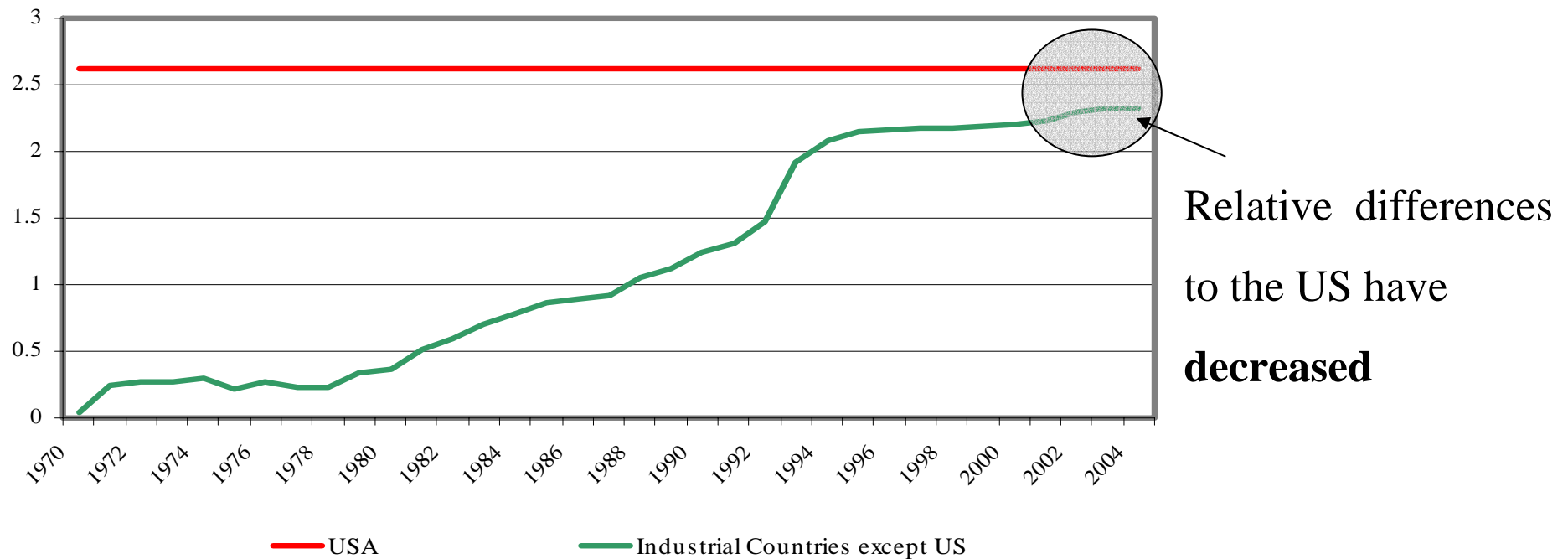
Structural Factors

- Global economic integration
- Financial integration
- Incomplete asset markets
- Differential impact of business cycle moderation

Structural Factors: Incomplete Financial Globalisation

Rise in financial openness is a global phenomenon.

Financial Openness Index, 1970-2004

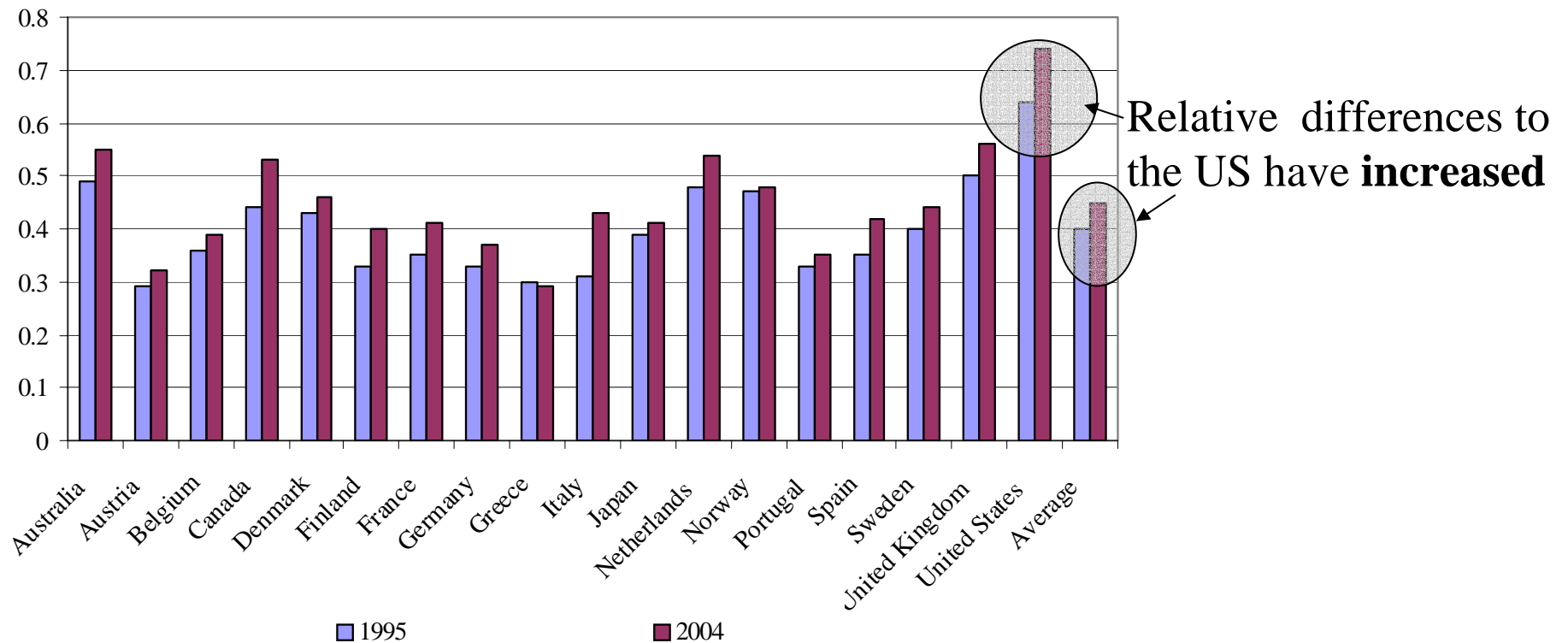


Source: Chinn and Ito (2005)

Note: Index measures changes in restrictions on cross-border financial flows.

Structural Factors: Incomplete Financial Globalisation

But financial development is still lagging behind the US.

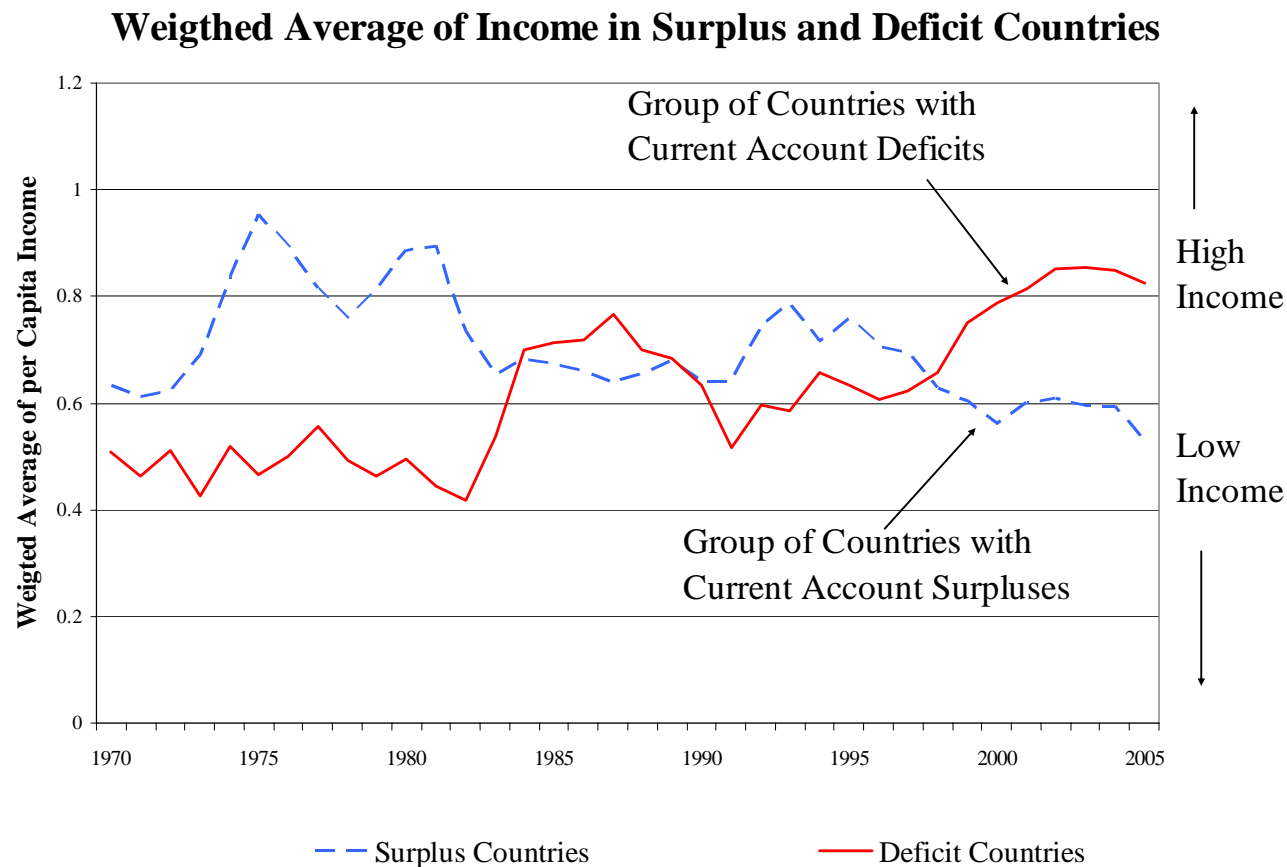


Source: IMF (2006)

Note: Index reflects various measures of financial market development.

Structural Factors: Incomplete Financial Globalisation

Incomplete Asset Markets: Lack of safe assets in emerging markets could trigger capital flows to industrial economies.

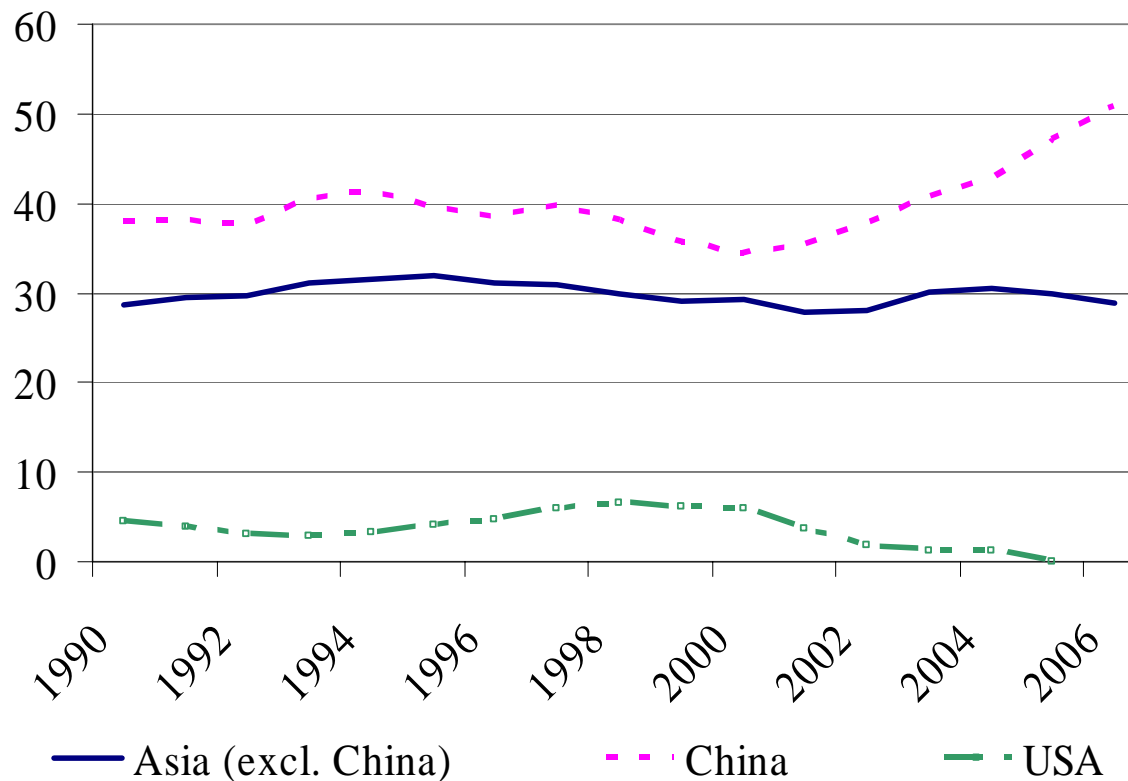


Source: Prasad, Rajan and Subramasian (2006)

Structural Factors: Incomplete Financial Globalisation

Lack of safe assets in Emerging Markets can impact savings rates (precautionary motives).

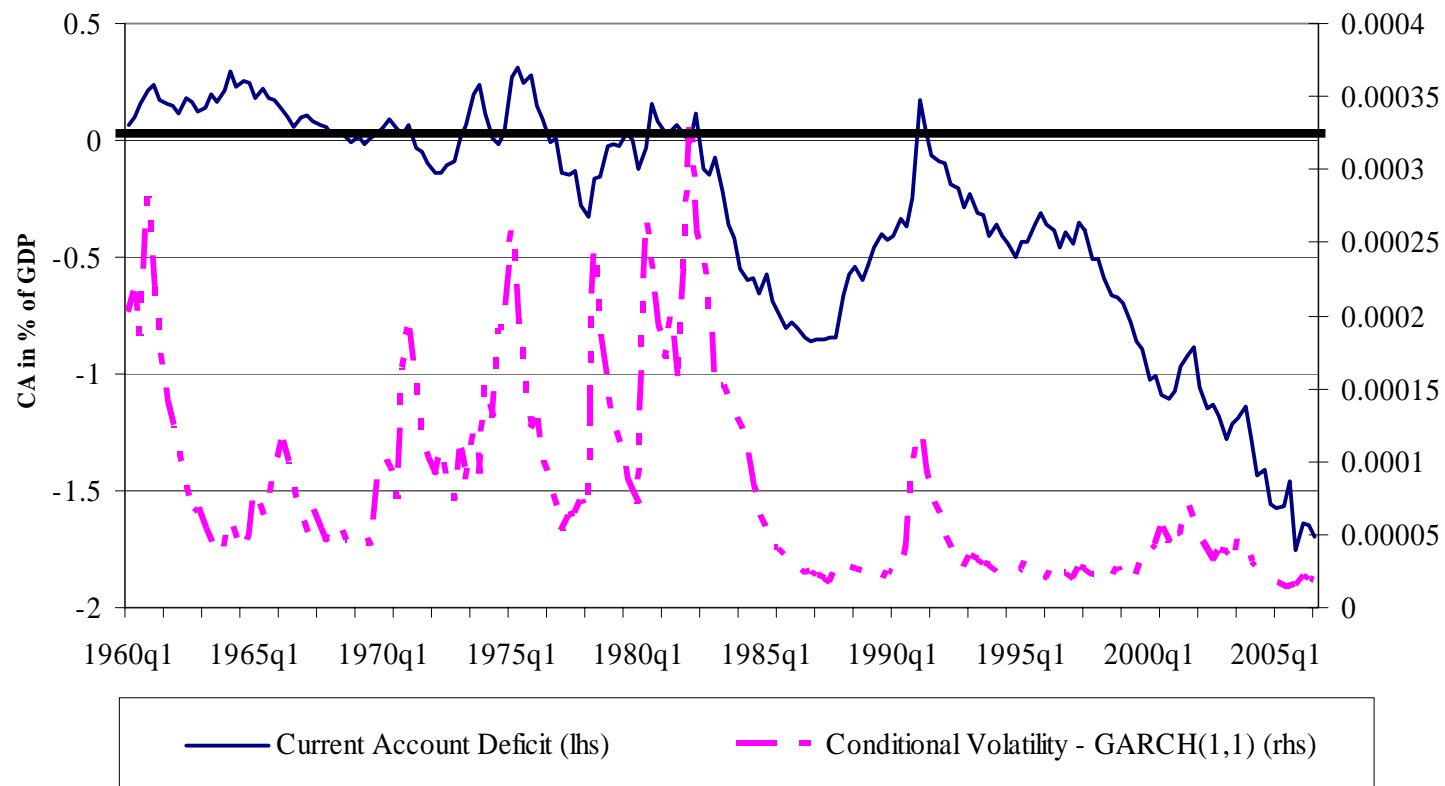
Savings (as % of GDP)



Structural Factors: Volatility and Precautionary Savings

Difference in savings rates might also be partly triggered by the change in business cycle volatility.

Business Cycle Volatility and External Imbalances in the US



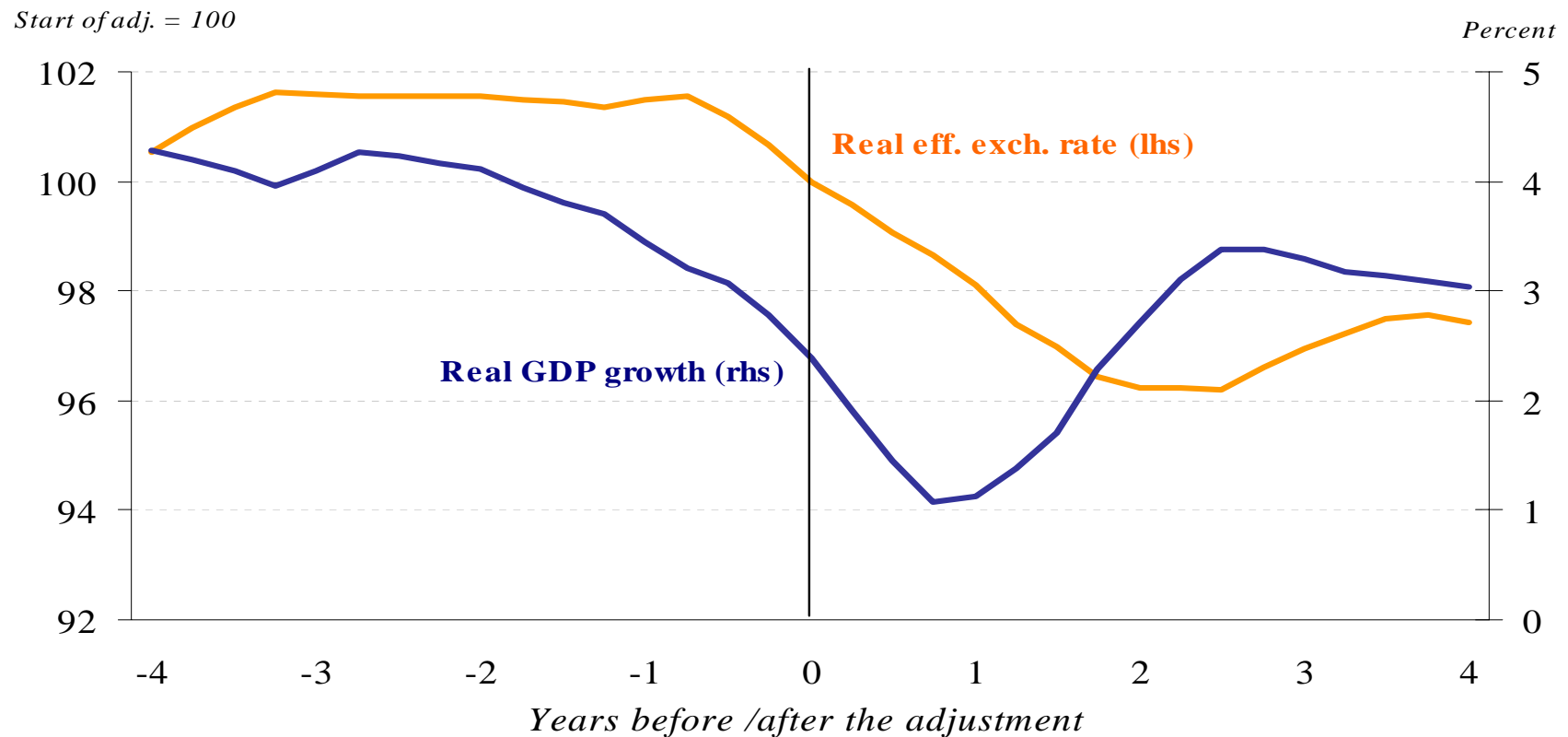
C. Global Imbalances: Unwinding

Historical Episodes:

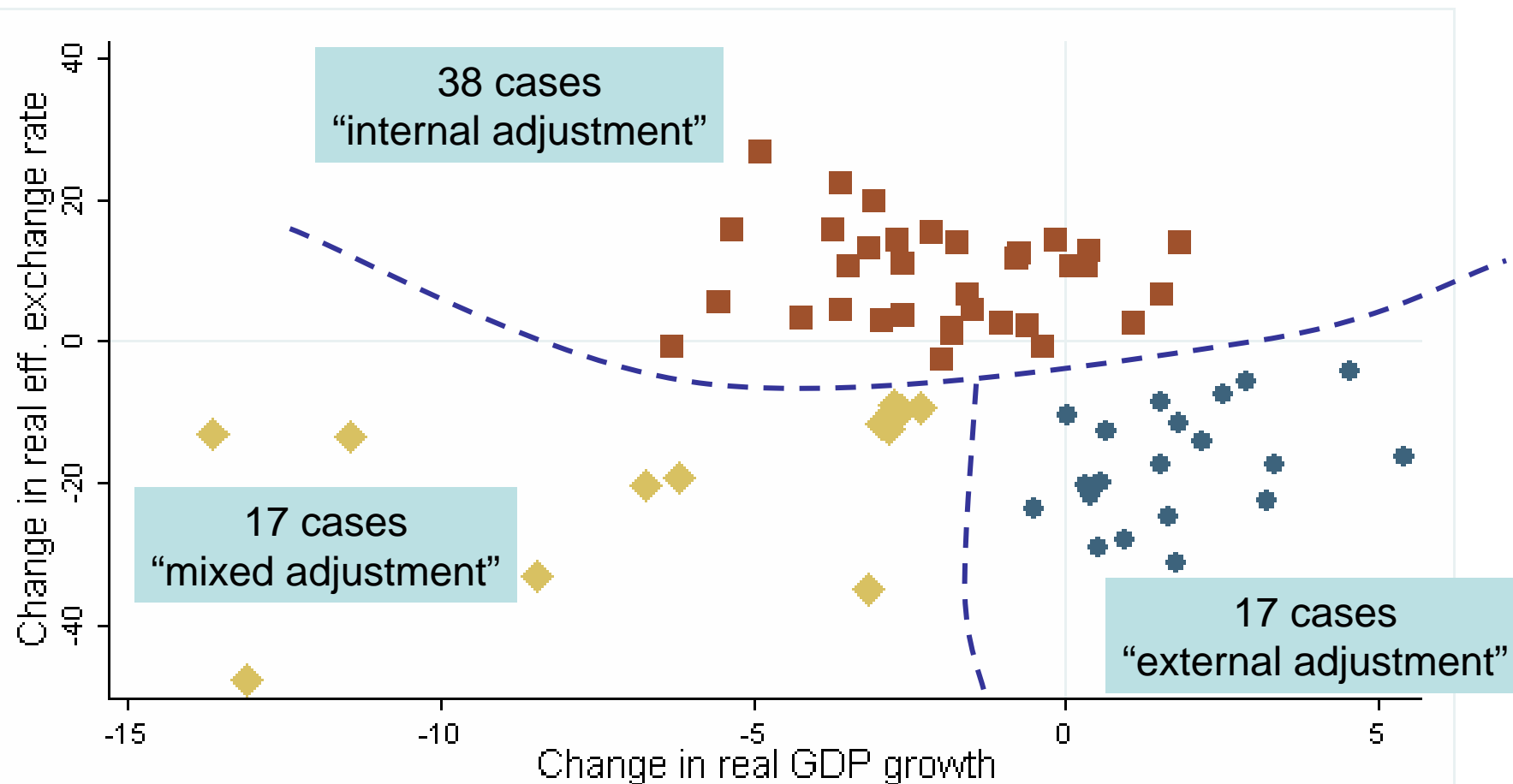
Era	Region		Happy ending for	
	Creditor	Debtor	Creditors ?	Debtors ?
Gold Standard (<1914)	North	South	Yes	Yes
Bretton Woods	None	None	Yes	Yes
1970s	South	South	No	No
1980s	North	North	Some	Yes
1990s	North	South	Yes	No
2000s	South	North	?	?

Unwinding: an empirical analysis

- Analysis of 72 episodes of large, rapid current account adjustment (Bracke and Algieri, 2007) since 1973



Average masks 3 adjustment types



Groups determined through cluster analysis.

What explains adjustment type?

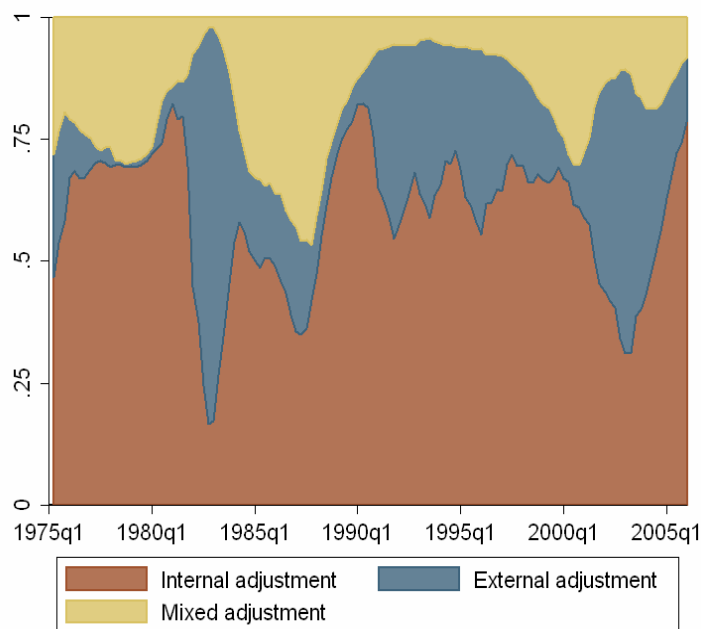
No apparent link with degree of openness or degree of industrialisation

Country group	Internal	External	Mixed
G7	6	4	5
Other industrial countries	17	6	5
EMEs	15	7	7

Predicting adjustment : Multinomial probit model

Variables and their sign

	Internal	External	Mixed
Import expansion	+	-	+
Overvaluation	.	+	+
Output gap	+	-	+
Credit expansion	.	+	.
Oil price (importers)	+	.	.



Some More Caveats on Exchange Rate Adjustments

1. Role of asset prices

- Historically, fluctuations in asset prices have been important for the US current account (Fratzscher, Juvenal and Sarno, 2007)
- Wealth effects (and not exchange rate shocks) appear to be the main drivers of the US current account deficit.

2. Role of the supply side

- Obstfeld-Rogoff (2005) find that a large exchange rate change is needed for closing the US external gap
- Caveats: supply side is assumed to be exogenous
- Endogenous supply side substantially reduces exchange rate change (Engler, Fidora and Thimann, 2007).

Policy Implication: Exchange rate can be part of the adjustment, but it does not have to be.

Concluding remarks

- Global Imbalances: in addition to cyclical factors, structural aspects are important in understanding imbalances.
- Adjustment can be driven by various factors, not only and not necessarily by exchange rates.
- Consider both cyclical and structural factors and the possibility of various adjustment paths of global imbalances for deriving appropriate policy responses.