# **Global imbalances**

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## 1. Globalization and global imbalances

Go back 20 years. If had had to guess ten years ago the implications of capital market integration, most would have guessed:

• Emerging countries.

Low wage, access to technology, so high investment.

Good growth prospects, low saving.

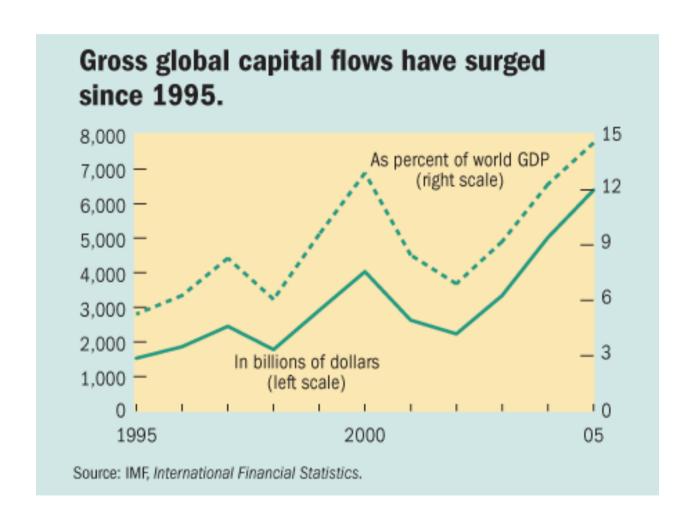
Large current account deficits.

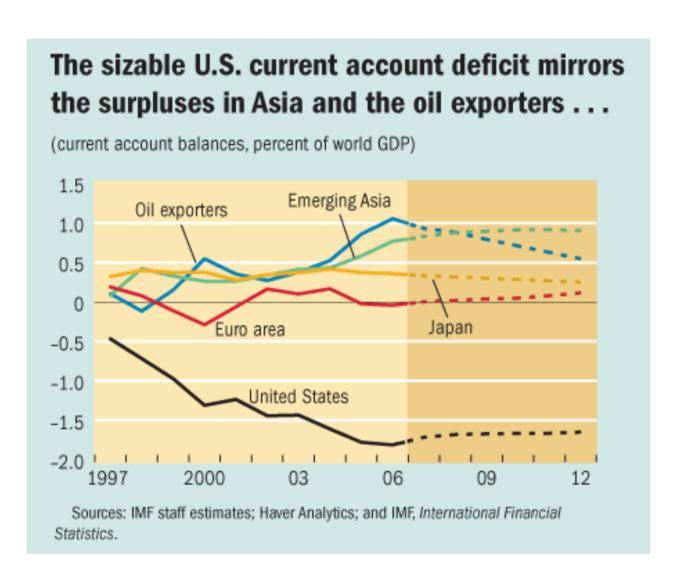
Rich countries

Lower investment, higher saving.

Large current account surpluses.

We are seeing just the opposite: Flows go from emerging to rich countries.





Current account deficits of the US vis a vis other countries. 2006

Total 856						
of which						
Europe	158		Asia		440	
Canada	43			China		261
Latin America	113			Japan		112
Mexico		71				
Middle East	48					

# The obvious questions: • What is going on? • Will it last? • How will it end?

### 1. What is going on?

- The Reagan quote in the 1980s. The US current account deficit reflects a vote of confidence of the rest of the world in the United States.

  Wrong then. But now (largely) right:
- On the push side: "Global savings glut". Emerging countries are saving a lot.
- On the push side: Financial intermediation and other problems limit investment in emerging countries.
- On the pull side: Low private and public saving in the US. (but the US fiscal deficit is a small part of the story. )
- All combine to give the picture above.

### The global savings glut

Why are emerging countries saving so much? Uncertainty, both individual, and aggregate; and oil.

Individual uncertainty, and high private saving.

Poster child: China. With markets, collapse of the safety net. Precautionary saving, even in the poor country side.

Why accumulation of reserves by PCB? Capital controls prevent individuals from investing abroad. Intermediation by the PCB.

Aggregate uncertainty, and the build up of reserves.

Accumulation of reserves, as a reaction to the Asian and other crises. Self insurance in case of sudden stops.

Saving out of oil revenues.

Set up of investment funds, to save a large part of oil revenues.

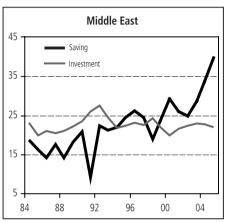
### Financial intermediation, and investment

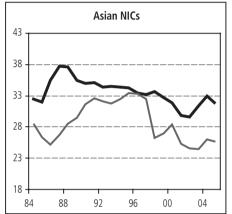
Investment in emerging countries typically high (China)—higher than in rich countries, but lower than saving. Why?

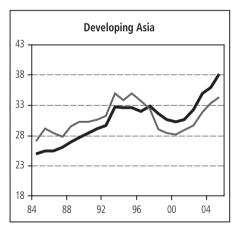
- Low wages and technology not enough. Property rights essential.
- Poor financial intermediation. Domestic residents want low risk. Investment high risk.

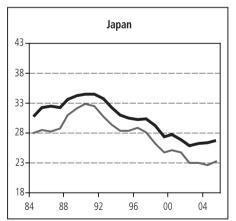
Risk transformation is not easy. Lessons from the Asian crisis.

Graph 7. Saving and investment in the saving-surplus regions, 1984-2005 (% of the region's GDP)









Source: IMF

### A preference for US assets

Why the US rather than, say, Europe?

- Low US private saving and fiscal deficits. But do not overstate role of fiscal deficits. Timing
- A preference of US assets.

Rate of return much lower on foreign holdings of US assets than on US holdings of foreign assets. Why?

- "Exorbitant privilege"? Invoice currency? Probably not.
- Low risk and high liquidity. US T-bill market
- Safety. Latin America and Miami.

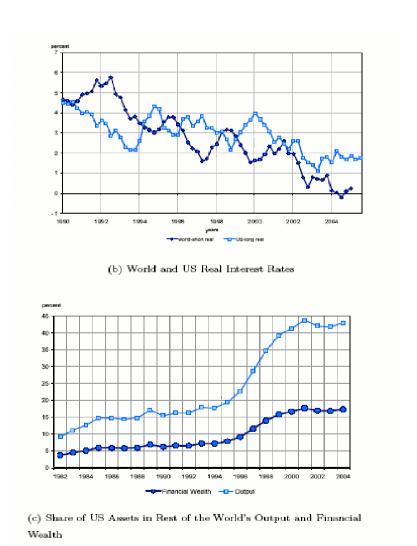
### 2. Implications, and what happens next?

- The structure of current account balances
- The low world real interest rate.
- The booming asset markets.
- A puzzle. The low price of risk.

### What happens next?

- At 850 billion dollars, requires an increase in proportion of US assets in US and foreign portfolios.
- Could go on for some time. But unlikely to. All stars aligned–South.

### Real rates and world portfolios



China's macro strategy, and the appreciation of the yen.

Increase insurance, increase consumption and internal demand.

If labor market pressure, need to keep external demand in check. Allow for appreciation of RMB.

Reserve accumulation and diversification.

Official reserve levels higher than needed. Better (less costly) hedging instruments.

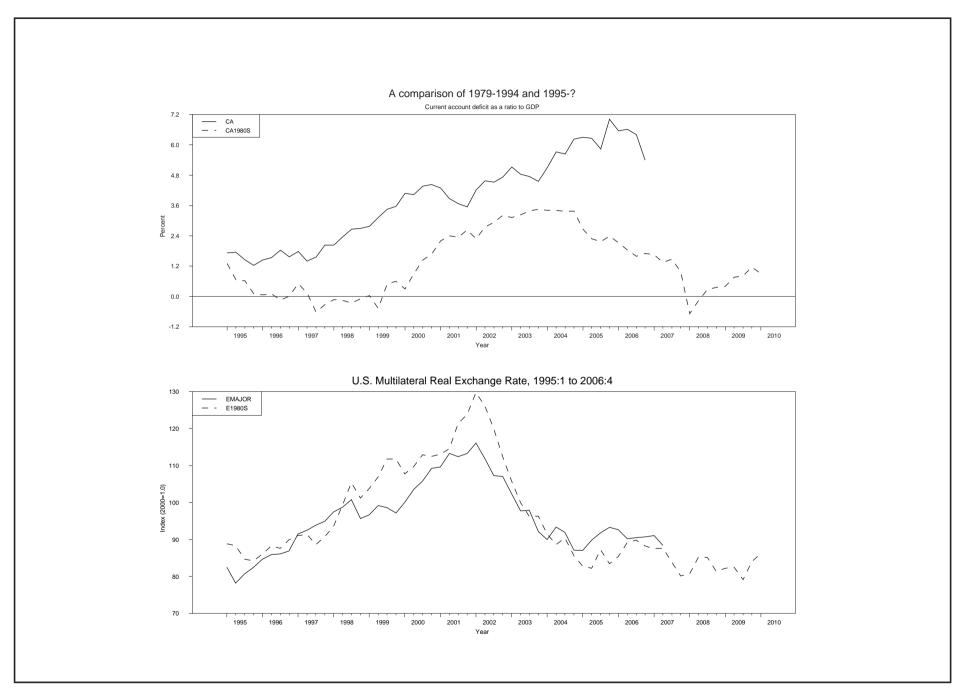
Diversification away from low-yielding US assets. The increasing attractiveness of the Euro markets.

- Increased spending out of oil revenues.
- Improving intermediation in emerging countries, and the likely rise of investment.

### A smooth adjustment?

Probably. Has already partly happened.

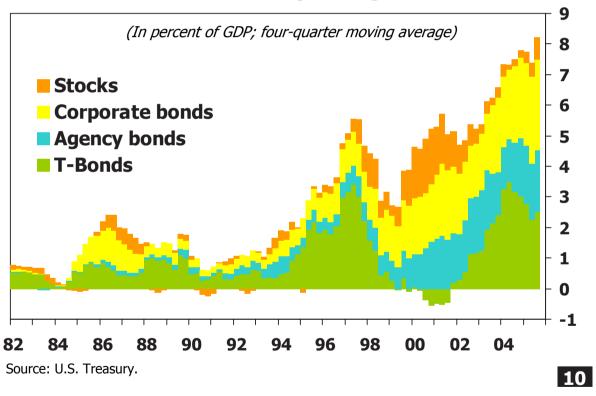
- Substantial depreciation of the dollar since 2001.
- Current account deficit continued to increase. J-curve and long lags.
- Worth comparing to the 1980s. Sharp depreciation from 1985 on, but improvement of the current account two years later.



### Looking forward

- A sudden stop scenario? Unlikely. Liabilities are in dollars. Equities, bonds, FDI, not bank loans.
- Most likely, a continued slow adjustment, a slow reduction of the current account deficit, with adjustment by the Fed and foreign CBs as needed.
- With a slow depreciation of the dollar. (US interest rate? depends on US fiscal policy.)
- Can it happen without real dollar depreciation? No. Need both the adjustment of saving and investment, and the depreciation.
- How much? Hard to be sure. But another 20% is conservative (could be over 10 years or more).





# Composition of foreign holdings of U.S. assets (billions of dollars) 2006

	Flows	Stocks
Total	1,406	11,946
T-bills	101	2,069
Official holdings	111	1,371
Private holdings	-10	698
Corporate equities	112	2,601
Corporate bonds	377	2,596
Direct investment	185	2018

### What does this imply for the Euro, or the peso?

Both in rough overall current account balance to start. What happens depends on the source of adjustment:

- Shift in portfolio preferences towards Euro assets.
  - Appreciation of the Euro real exchange rate.
- End of RMB peg, and RMB appreciation vis a vis the dollar.
  - Appreciation of the Euro vis a vis dollar. Depreciation of the Euro vis a vis the yen.
  - Stable (correctly weighted) real exchange rate. Changes in bilateral rates.
- Similar mechanisms relevant for the Peso? More likely to move with the dollar. Depreciation vis a vis Asia. Small appreciation vis a vis dollar.