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BACK TO GLOBAL IMBALANCES? [1]

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Abstract

The 2008-2009 financial crisis has shaken the prevailing equilibrium of the global economy, with a collapse in capital flows and international trade. How will the post-crisis constellation of current account imbalances look? Will the world resume financing the US, and continue sustaining large external imbalances there? Contrary to what many expected, some forces unleashed by the crisis have kept US assets attractive and the dollar strong, decreasing the need for an immediate reduction of global imbalances. Over the long run, however, real sector and financial sector forces are likely to impose a correction, perhaps involving a depreciation of the dollar and a major reallocation of international portfolios.

The implications of the current global financial crisis for the debate on "global imbalances" unfolded in an unexpected way. Prior to the crisis, many had argued that the cross-border current account imbalances were unsustainable and would be eliminated through a drop in the demand for US assets, implying a sharp devaluation of the US dollar and an increase in US interest rates. To the contrary, the crisis has brought an appreciation of the dollar and record-high US government bond prices. Will the recovery from the crisis thus entail a return to the old order? The new global equilibrium will be shaped by a number of real and financial forces, as outlined below.

The world economy exhibited large imbalances over the last ten years, as the US financed its mounting current account deficits by borrowing abroad (Figure 1). Booming capital inflows and rapidly growing exports—as well as favorable terms of trade for commodity exporters—allowed many developing countries to build up large foreign asset positions, in the form of reserves (largely placed in US T-bills) and investment in private assets. The accumulation of foreign assets was driven by several factors, including high savings rates in a number of Asian countries, the desire of emerging markets to self-insure against crises, and a policy to forestall further appreciation of developing country currencies and encourage export-based growth. The resulting equilibrium looked fragile to many since it hinged on foreign lenders willing to buy virtually unlimited amounts of US assets to continue financing US current account deficits. To others, the equilibrium looked more durable, as it enabled high-saving but financially underdeveloped countries to use the services of the financial markets of rich countries. But most observers expected an unwinding of global imbalances would happen sooner or later, implying a shift from US assets into other international assets, with the Euro bound to gain.

The crisis affected the magnitude and the financing of global imbalances. When the subprime crisis erupted in the US, world gross capital flows collapsed. Residents of most countries stopped sending capital abroad, and turned to domestic assets. Moreover, the collapse in global trade and

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commodity prices reduced the financing available from countries with large trade surpluses. Also, the US current account deficit shrank significantly, from 6.61% of GDP in Q4 2005 to 2.88% of GDP in Q1 2009. On net, however, the US was still able to finance its deficit (albeit a smaller one), partly by US residents bringing home their foreign securities (Figure 2).

The crisis also had some unexpected effects on the global economy. The fact that all major economies were hit (along with the US) undermined the expected shift out of US assets. Most notably, the propagation of the crisis to Europe (initially perceived to be less vulnerable to subprime risk) prevented a substitution of euros for dollars. In fact, the US dollar appreciated relative to reserve and non-reserve currencies around the world. Furthermore, the increase in risk aversion encouraged a portfolio shift to US T-bills by both US and foreign investors, at the expense of equity, corporate bonds, emerging market bonds, money market funds, bank deposits, and any other asset that entailed credit risk. Ultimately, the US dollar became the reserve currency of last resort and the US government became both the borrower and creditor of last resort. Throughout these events, although the US was the source of the crisis, it was still perceived as a safe haven by international investors.

Some of these trends are likely to be only temporary. As risk aversion diminishes (with companies returning to profit and creditworthiness), investors are likely to increase their appetite for risky assets, in the US and elsewhere, and the collapse in capital flows will abate. This will push asset prices up and appreciate exchange rates (against the US dollar), and/or imply higher US interest rates. In fact, stock prices and currencies in some emerging economies have rebounded (though from a very low level) since the beginning of the year.

The post-crisis global equilibrium, and the future of global imbalances, will be shaped by a variety of real and financial forces. But global imbalances may not fully disappear as a result of this crisis alone, at least in the short run. Some forces may in effect keep US assets attractive and the dollar strong, decreasing the need for a reduction of cross-border imbalances. At the global level, the current crisis has highlighted the effectiveness of self-insurance, as those countries that had amassed large stocks of liquid foreign assets have been able to weather the storm better than the rest. This may encourage countries to strengthen their external buffers, further increasing their holdings of safe and liquid world assets. Also, as international trade resumes and commodity prices stay above from their recent lows, emerging economies may return to large trade surpluses and foreign asset accumulation. Those asset holdings may be channeled again to the US, provided that adequate US government actions (including a timely unwinding of the recent expansion of the Fed's balance sheet) succeed in preventing inflation or depreciation from unduly undermining asset values. In addition, as the US economy recovers, the increase in private consumption, combined with the large fiscal expansion, may halt the decline in the US current account deficit. Lastly, the resilience of the US dollar and T-bills during the crisis, and the Fed's unique capacity to act as the lender of last resort and its undisputed record of having been a world leader in managing the current crisis, might attract more demand from investors that would have otherwise gone elsewhere, and might help in the US recovery.

But other adjustments could push the global equilibrium in the opposite direction. The incipient availability of enhanced country insurance mechanisms (such as the IMF's contingent credit facilities) may reduce the appeal of foreign asset hoarding for self-insurance purposes in emerging markets. Stricter financial regulation in advanced economies is likely to undermine the franchise value of financial institutions, adding to the adverse wealth effect on aggregate demand of weak asset prices, thus putting downward pressure on current account deficits, especially in the US. In turn, policies (such as enhanced safety nets and other expansionary fiscal actions) that reduce saving rates in Asian countries would

decrease their external surpluses. A major shift by international investors, and surplus countries in particular, towards currencies other than the dollar could also bring the current pattern of global imbalances to an end. Lastly, the future equilibrium outcome will be shaped by the effectiveness, and the unwinding, of US monetary and fiscal stimulus, which will affect the value of the net debt of the US government. If asset prices do not continue to firm up and the recovery takes long to materialize, or if expansionary policies are not reversed in a timely fashion, net US debt will be correspondingly higher and will likely result in a larger depreciation of the US dollar.

In sum, to the extent that the US is expected to outperform other major industrial countries in the medium term, it might continue receiving foreign capital and the previous pattern of global imbalances might be gradually restored, at least in part. In that case, and in a similar fashion as pre-crisis capital inflows to the US led to an exuberant expansion of the real estate sector, an appreciation in other (old or new) US risky assets may well develop. However, post-crisis real and financial adjustments suggest that the previous distribution of large imbalances will be difficult to be fully restored and even more difficult to sustain over the long run. Thus, it would be unwise to dismiss the prospects of an eventual major depreciation of the US dollar against different currencies around the world and of a correspondingly much higher diversification of emerging market holdings into non-US assets.

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Figure 1
US Current Account Balance and the Real Exchange Rate

This figure presents the US current account balance as a percentage of GDP compared to the real (price-adjusted) broad trade weighted exchange rate index for the period 1990 to 2008. The broad trade weighted exchange rate index is a weighted average of the foreign exchange value of the US dollar against the currencies of a broad group of major U.S. trading partners. An increase reflects an appreciation of the US dollar. Current account and GDP data are presented on a quarterly frequency and the broad exchange trade weighted index has been averaged for each quarter based on monthly data. Data on the US current account and GDP come from the Board of Governors of the Federal Reserve System and data on the broad trade weighted exchange rate come from the Bureau of Economic Analysis.

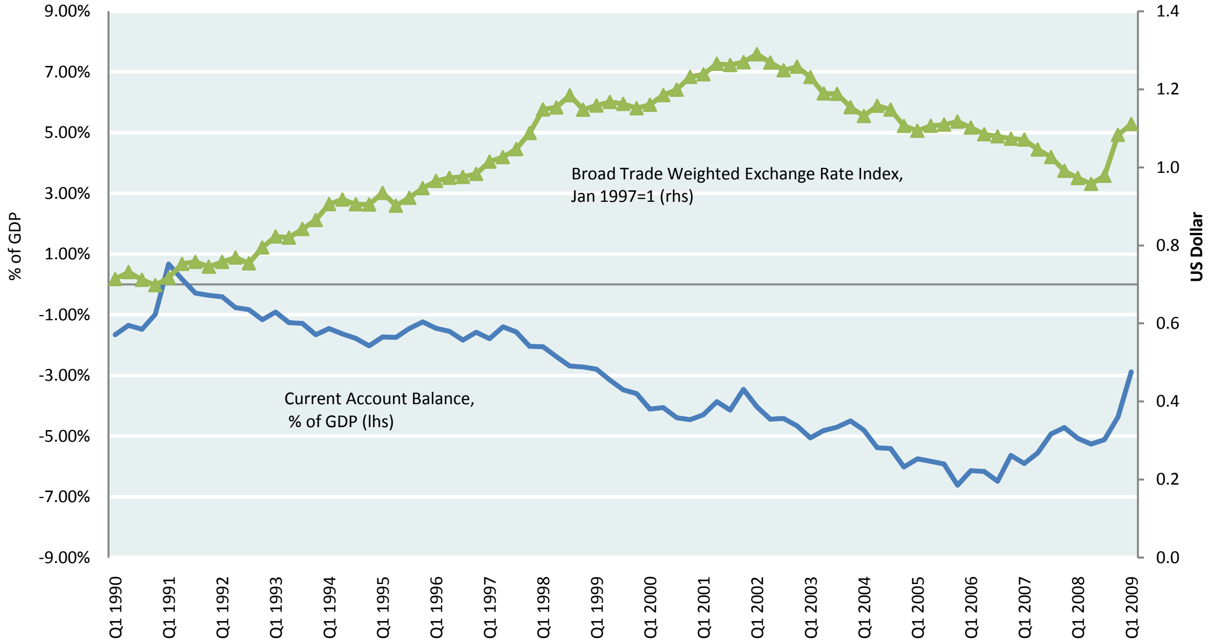

Figure 2
US Gross Capital (Long-Term Security) Flows

This figure presents gross inflows to the US by foreigners and by US residents, considering only long-term securities (excluding bank flows). Gross inflows by US residents are calculated as the negative of gross outflows, which are gross purchases of foreign stocks and long-term bonds by foreigners from US residents minus gross sales. Gross inflows to the US by foreigners are calculated as gross purchases of long-term US Treasury and Federal Financing Bank bonds and notes, bonds of US government and federally sponsored agencies, and US corporate bonds and stocks minus gross sales. Data are presented in millions of US dollars for the period 1990 to 2009 on a monthly frequency and come from the US Treasury Department.