Global Rebalancing with Financial Stability: Possible, Feasible, or Unlikely?

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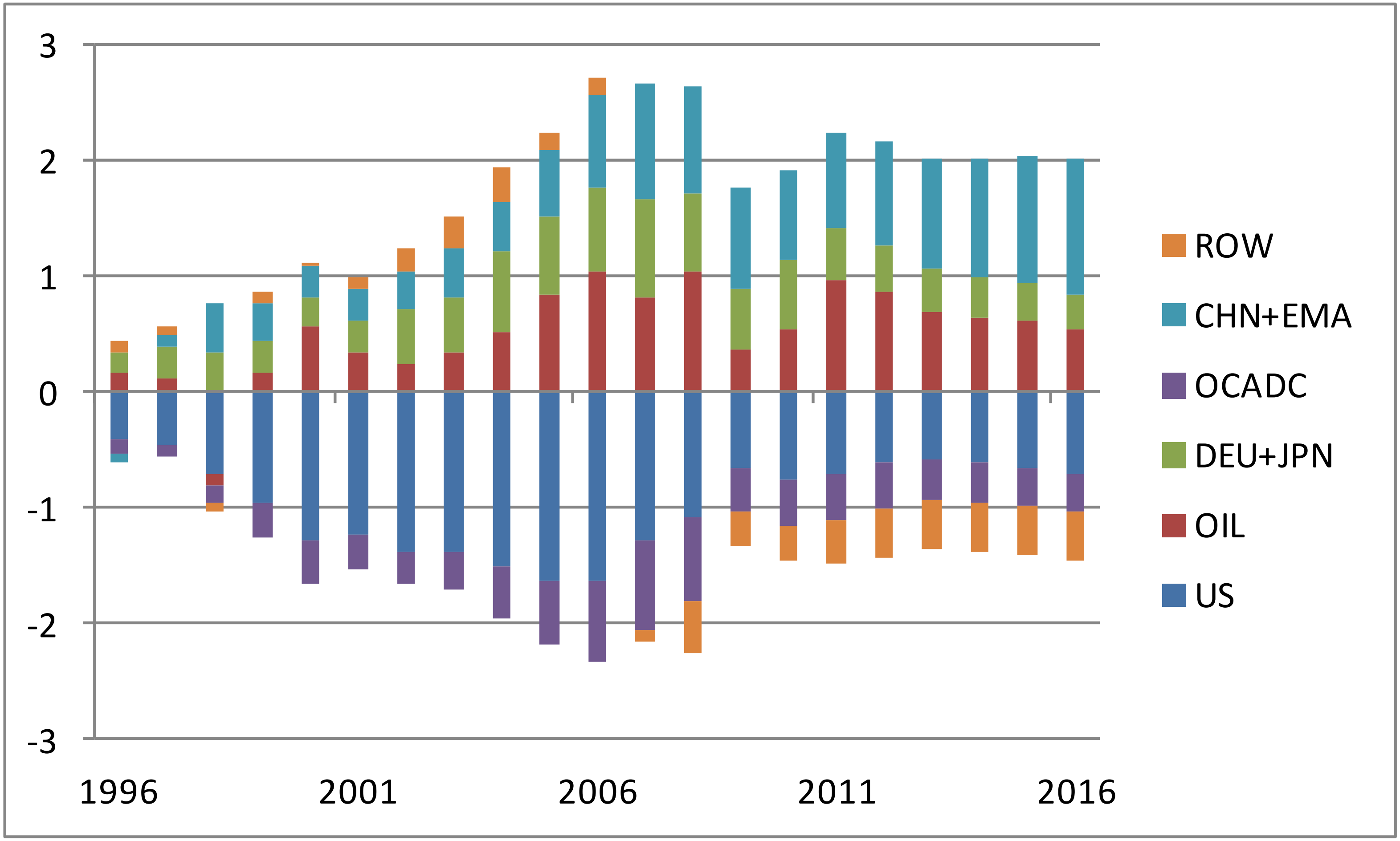
Three Questions and the Policy Implications

- What are the prospects for global rebalancing
- The two speed global recovery
- The implications for current account adjustment
- Capital flow developments
- Policy implications
- Summing up

Imbalances Past, Present and Possible Future



Source: IMF, *WEO*, Sep. 2011

On the Origins of Current Account Imbalances

Five categories

- Saving-investment balance
- Intertemporal approach
- Mercantilism
- Global saving glut
- Distortions in (domestic) financial markets

Projections from an Empirical Model (Chinn, Eichengreen, Ito, 2011)

- Budget balances matter for certain countries (US, UK)
- Saving glut variables (financial development, openness, and institutional development) matter, but have done so persistently
- Ignorance reigns (large, unexplained country-specific component)
- Imbalances will resume and persist with current policies in place

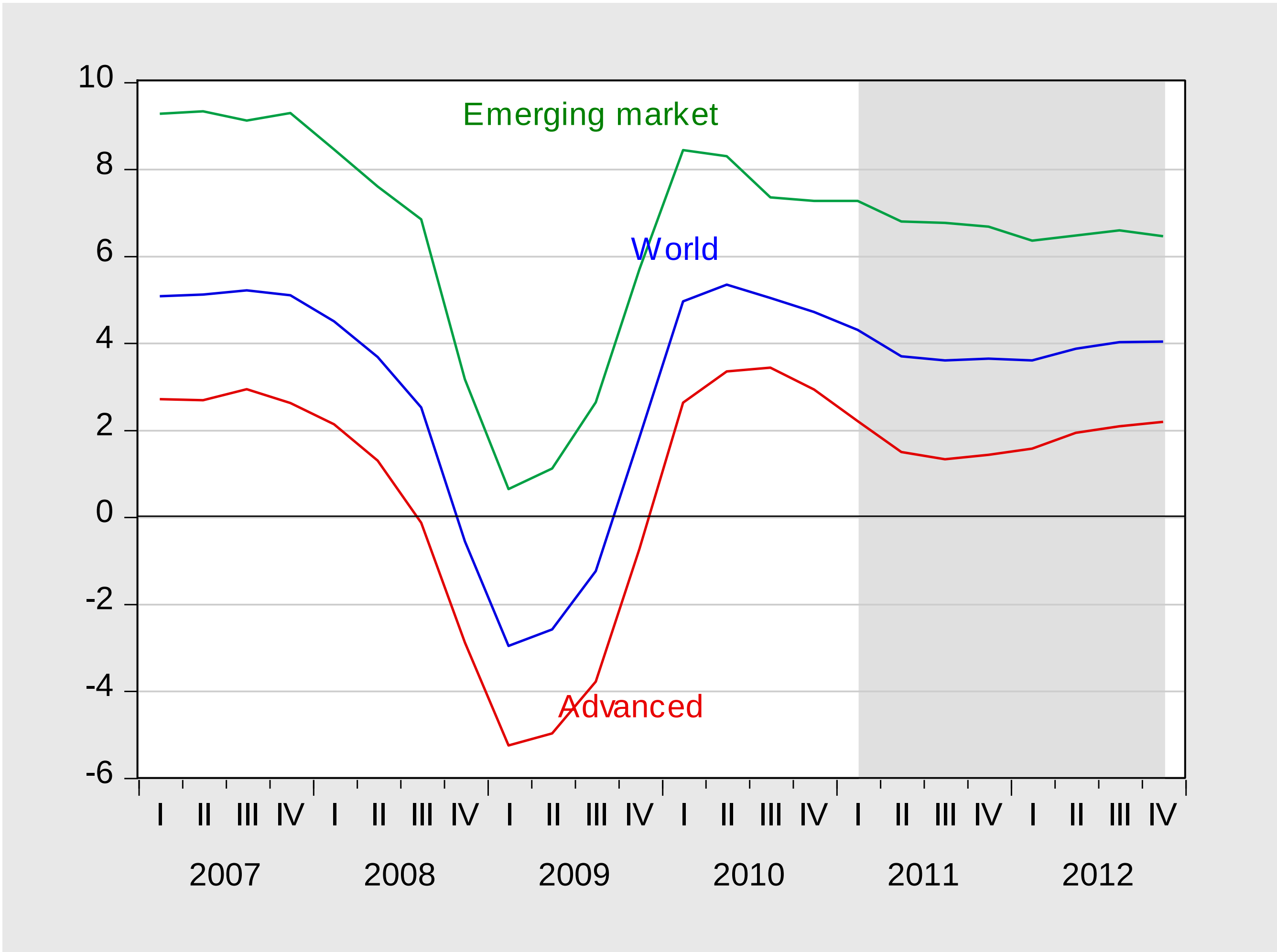
More Conclusions, and Three Caveats

- Fiscal consolidation in the US is not enough
- Financial development in China is not enough
- Lots of 2006-08 is unexplained
- Reversion to pre-boom norms might drive most of rebalancing
- These are medium term predictions

The Two Speed Recovery

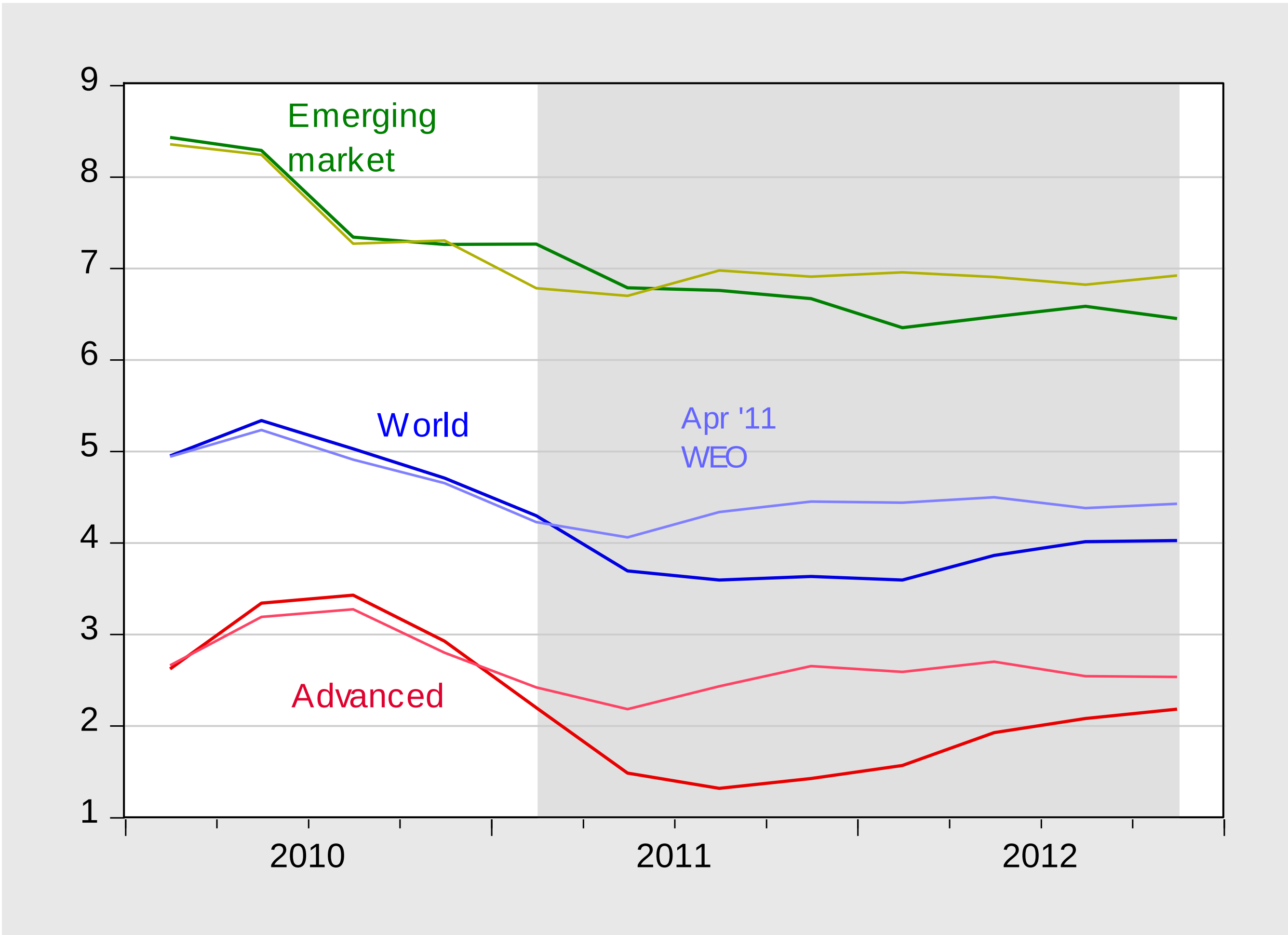
- The CEI approach abstracts from cyclical factors
- Faster growth in the emerging markets than in high income countries constrains current account imbalances
- But slow growth in high income countries hinders structural and policy adjustment

The Two Speed Recovery Illustrated



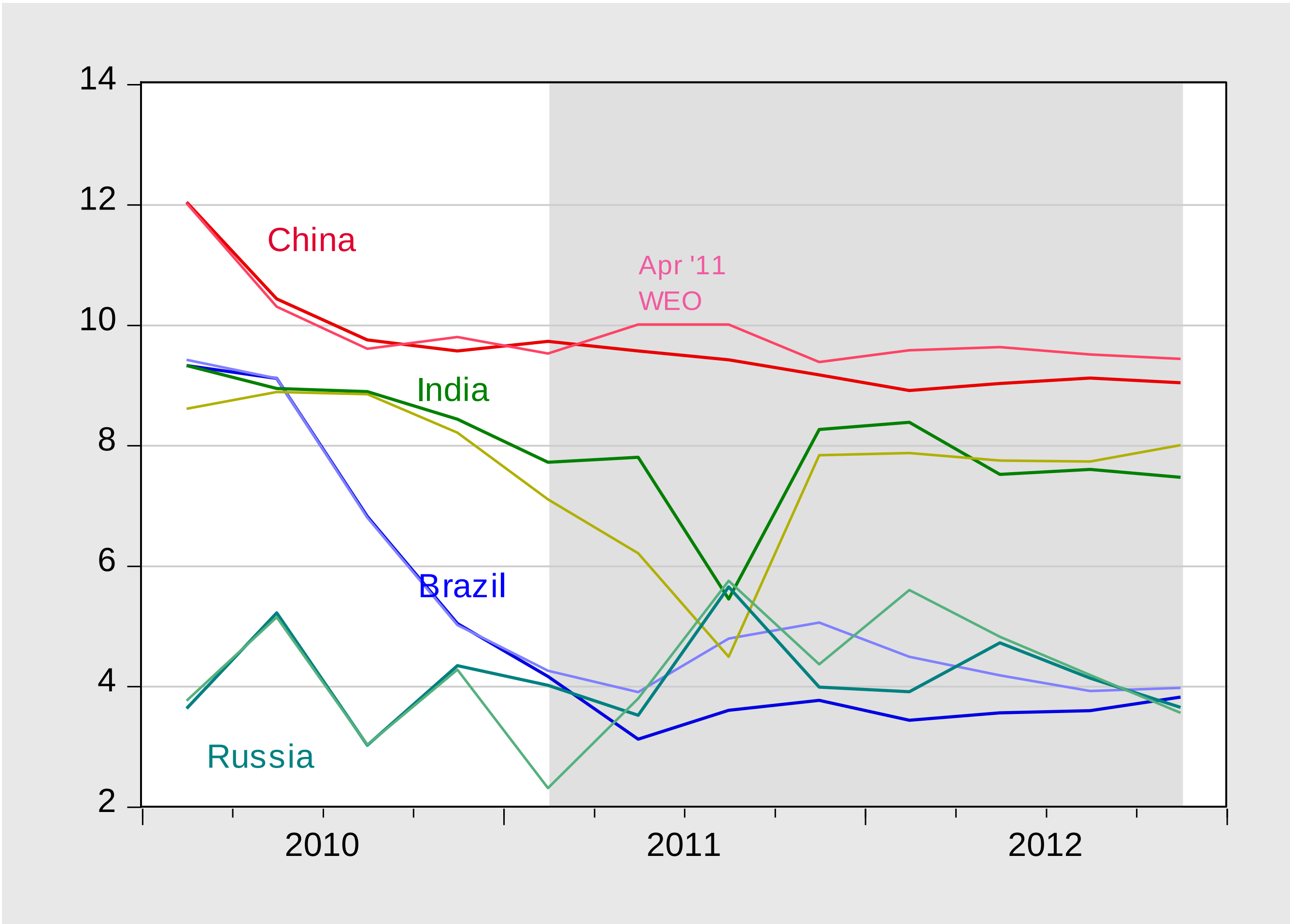
Source: IMF, *WEO*, Sep. 2011

Is Becoming More Pronounced



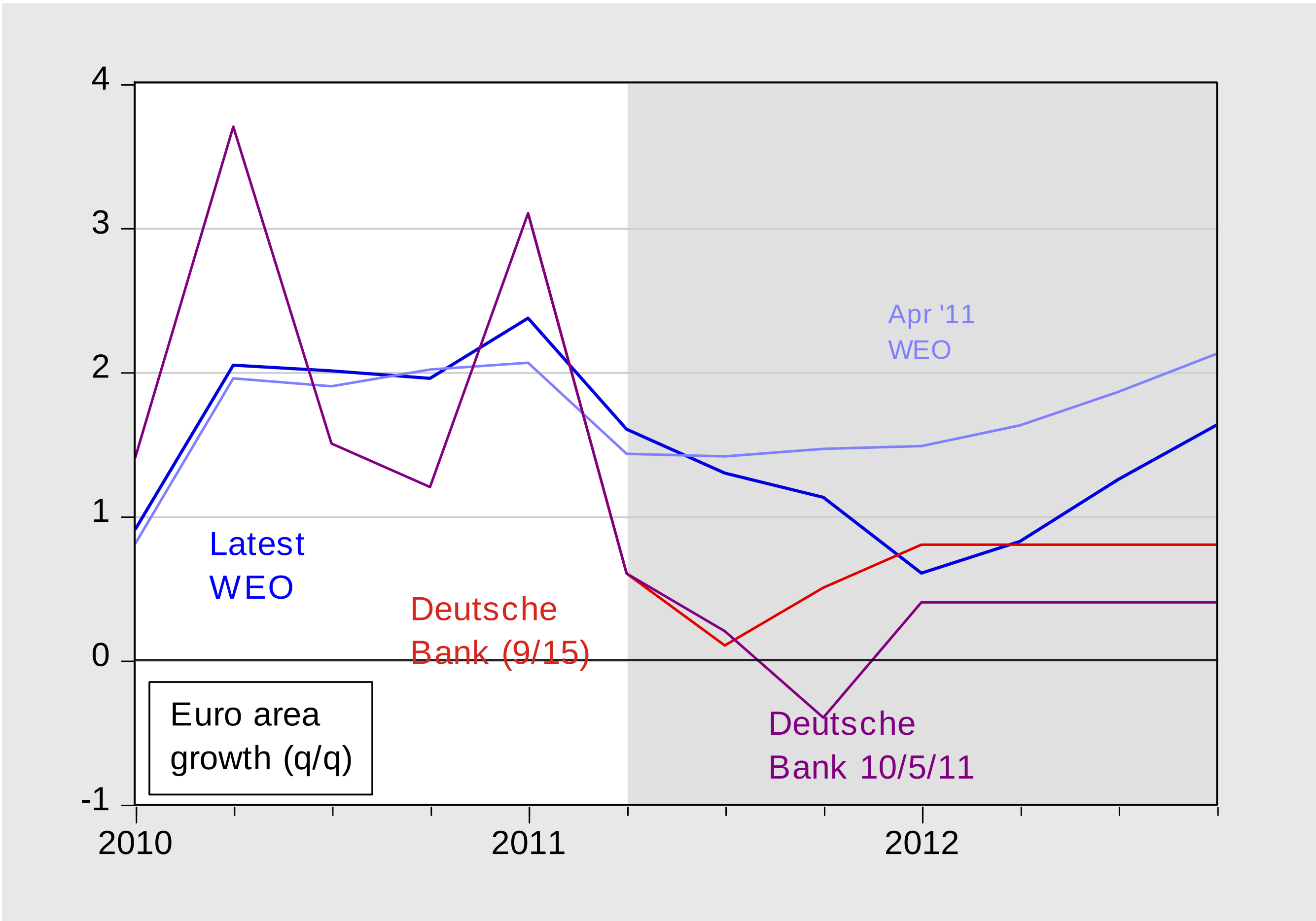
Source: IMF, *WEO*, Sep. 2011 and Apr. 2011

Growth Prospects in the BRICs



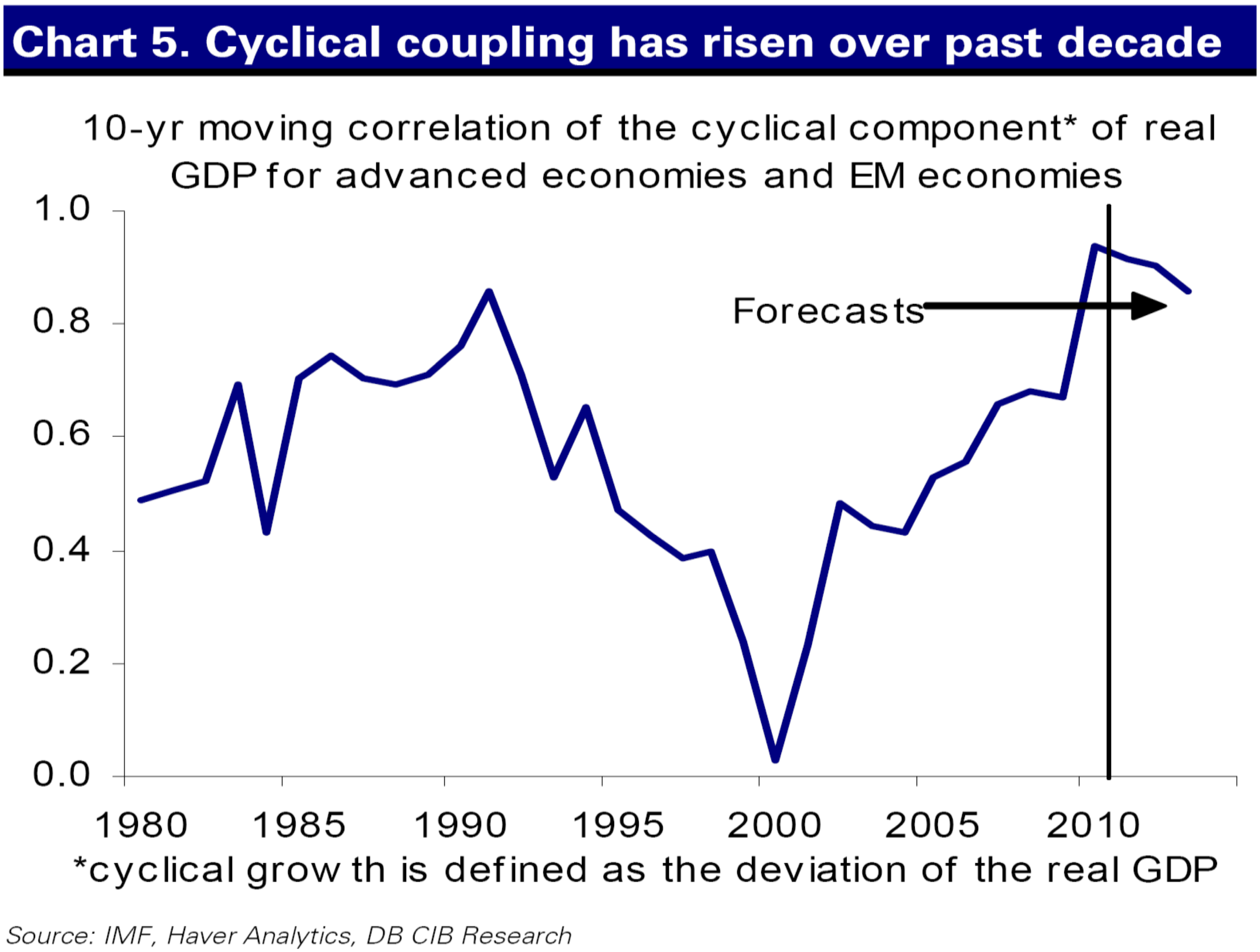
Source: IMF, *WEO*, Sep. 2011 and Apr 2011

A Big Shock in Europe?



Source: IMF, *WEO*, Sep. 2011 and Apr 2011, Deutsche Bank

Decoupling or Recoupling: Trend and Cycle



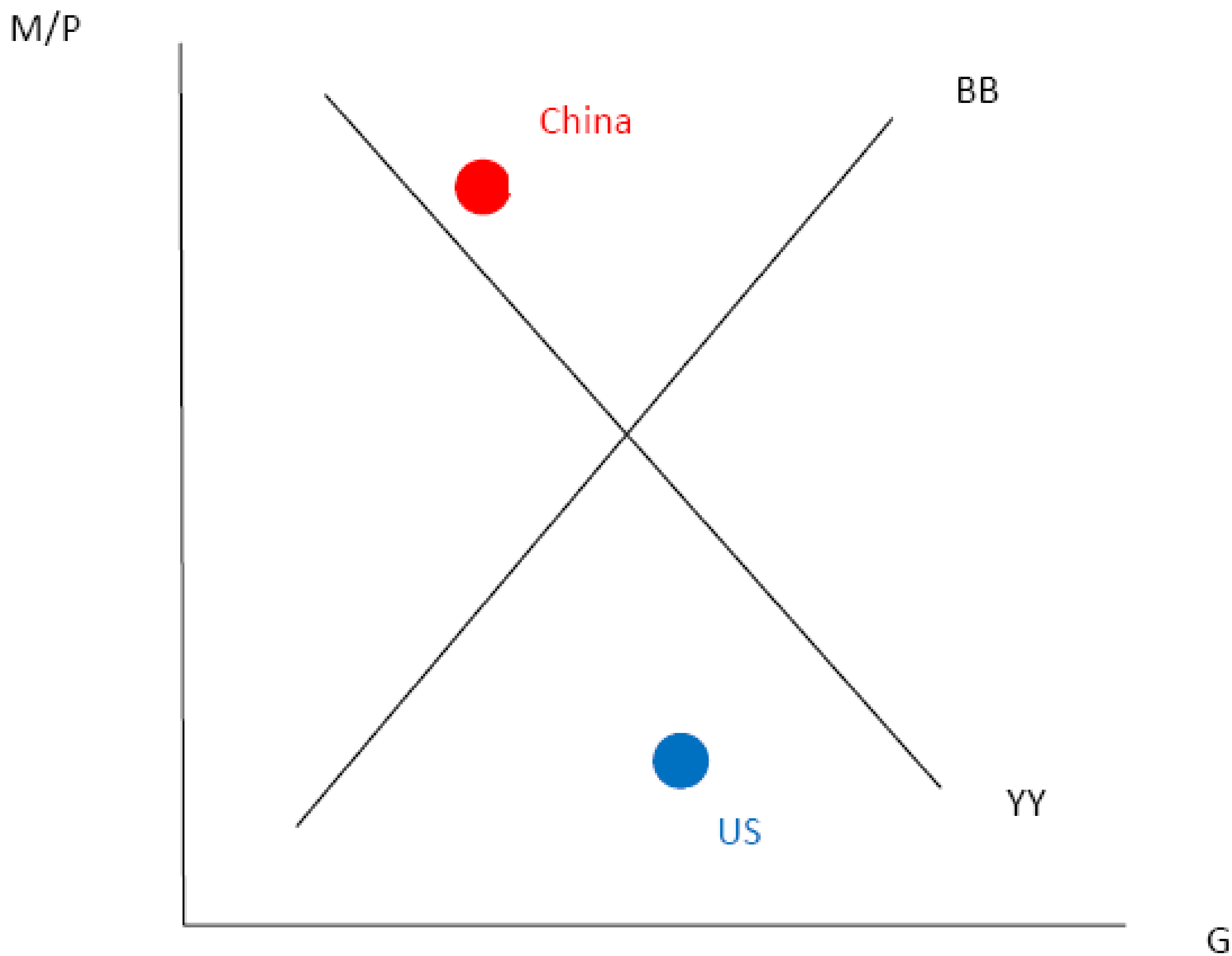
Source: Deutsche Bank, *World Outlook 2011Q4*, Oct. 3, 2011.

A Framework for Analysis

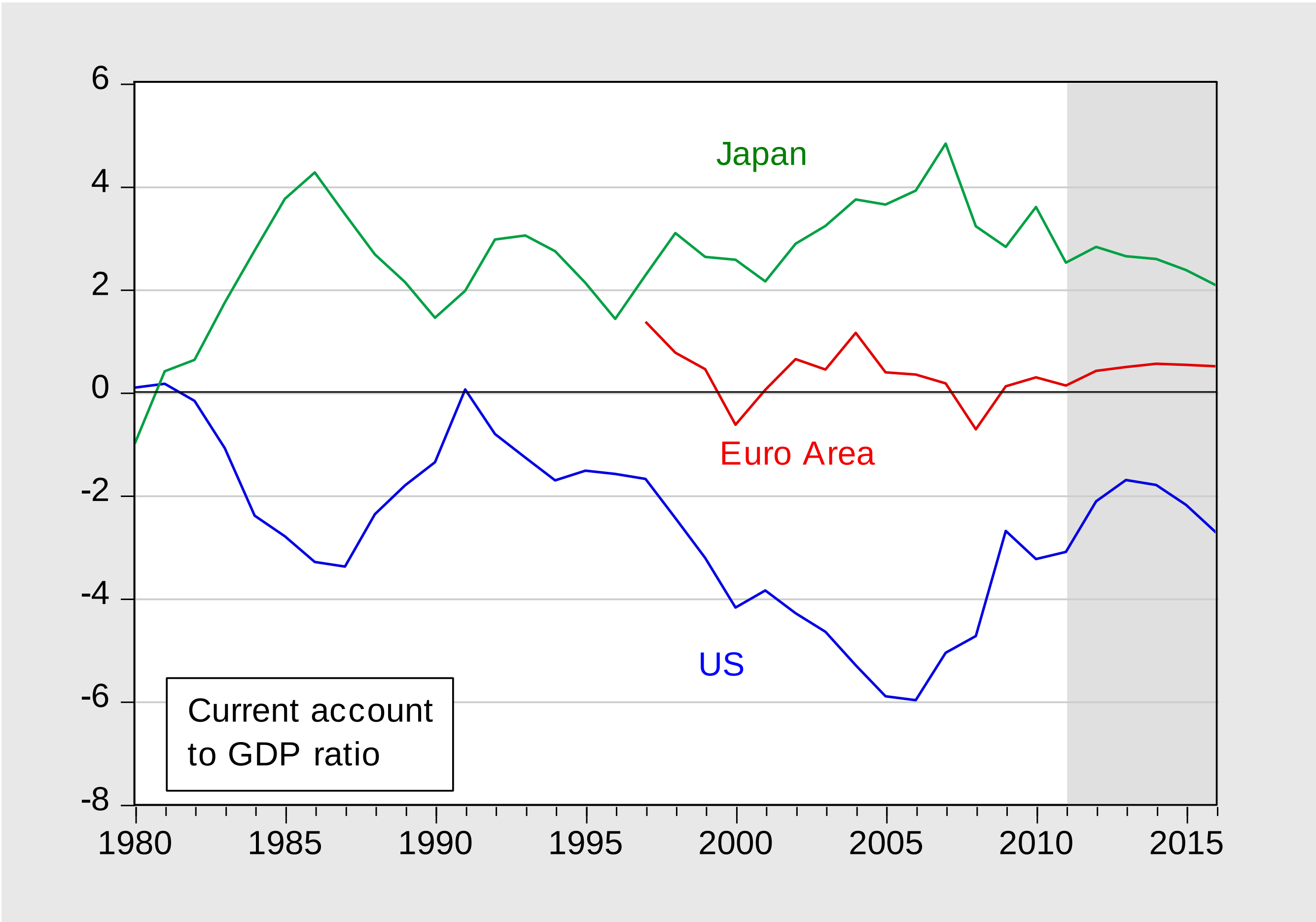
(1) $$Y^{AS} = Y^{AD} = \alpha_1 G + \alpha_2 (M/P)$$

(2) $$0 = TB = \beta_1 G + \beta_2 (M/P)$$

A Framework: Output Gaps and Current Account Balances

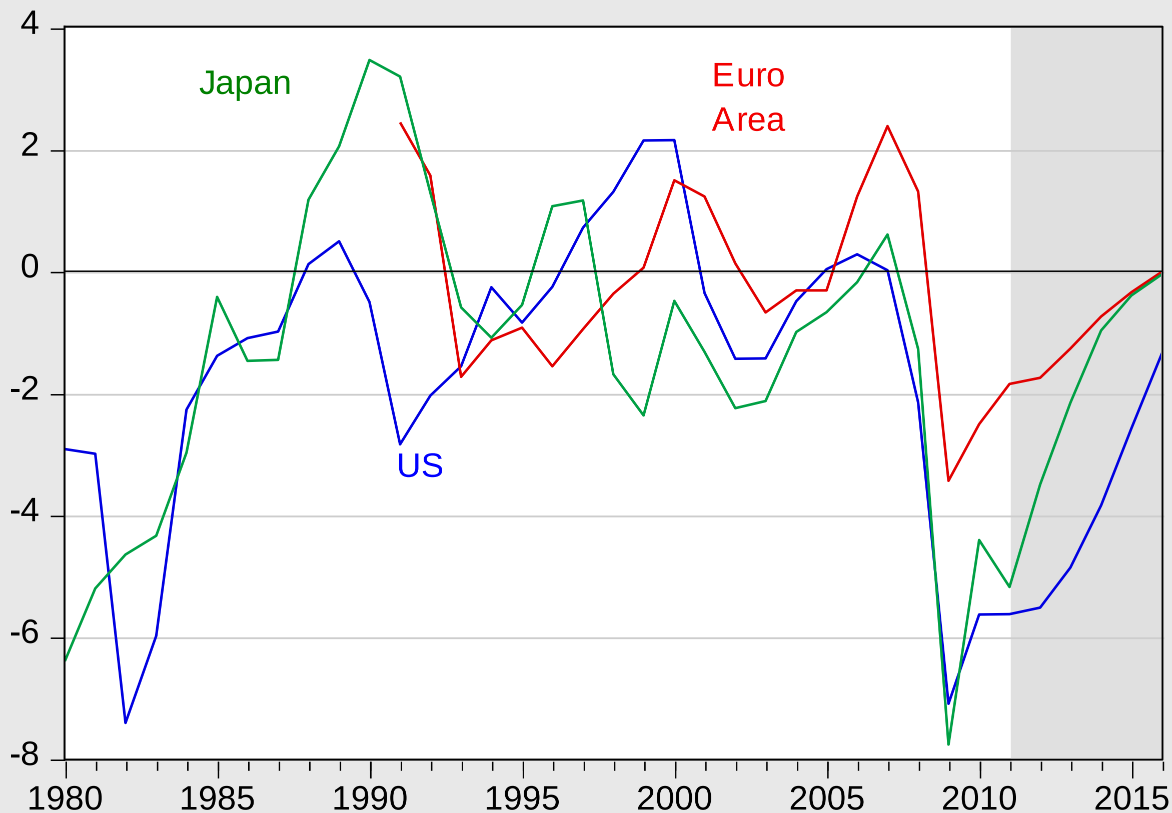


US, Euro Area, Japan Current Account Balances



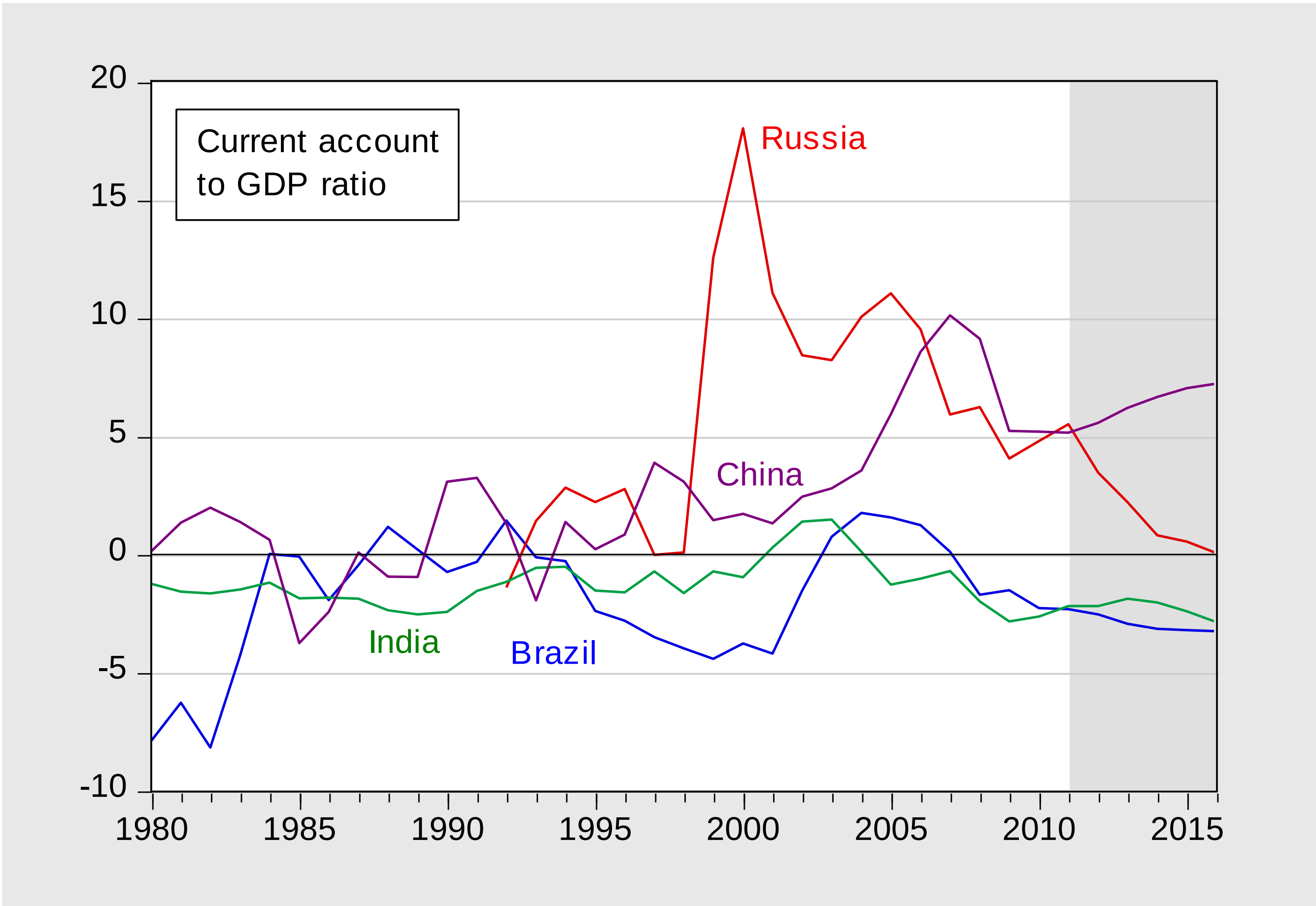
Source: IMF, *WEO*, Sep. 2011

US, Euro Area, Japan Output Gaps



Source: IMF, WEO, Sep. 2011

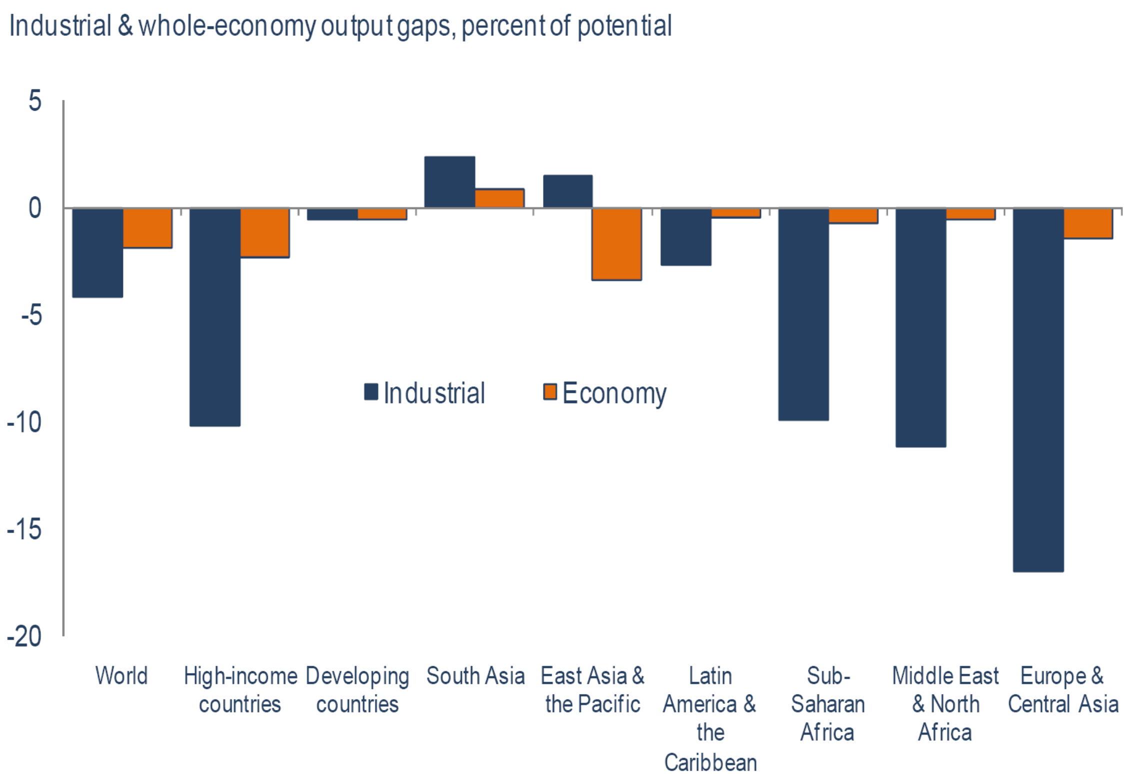
BRIC Current Accounts



Source: IMF, *WEO*, Sep. 2011

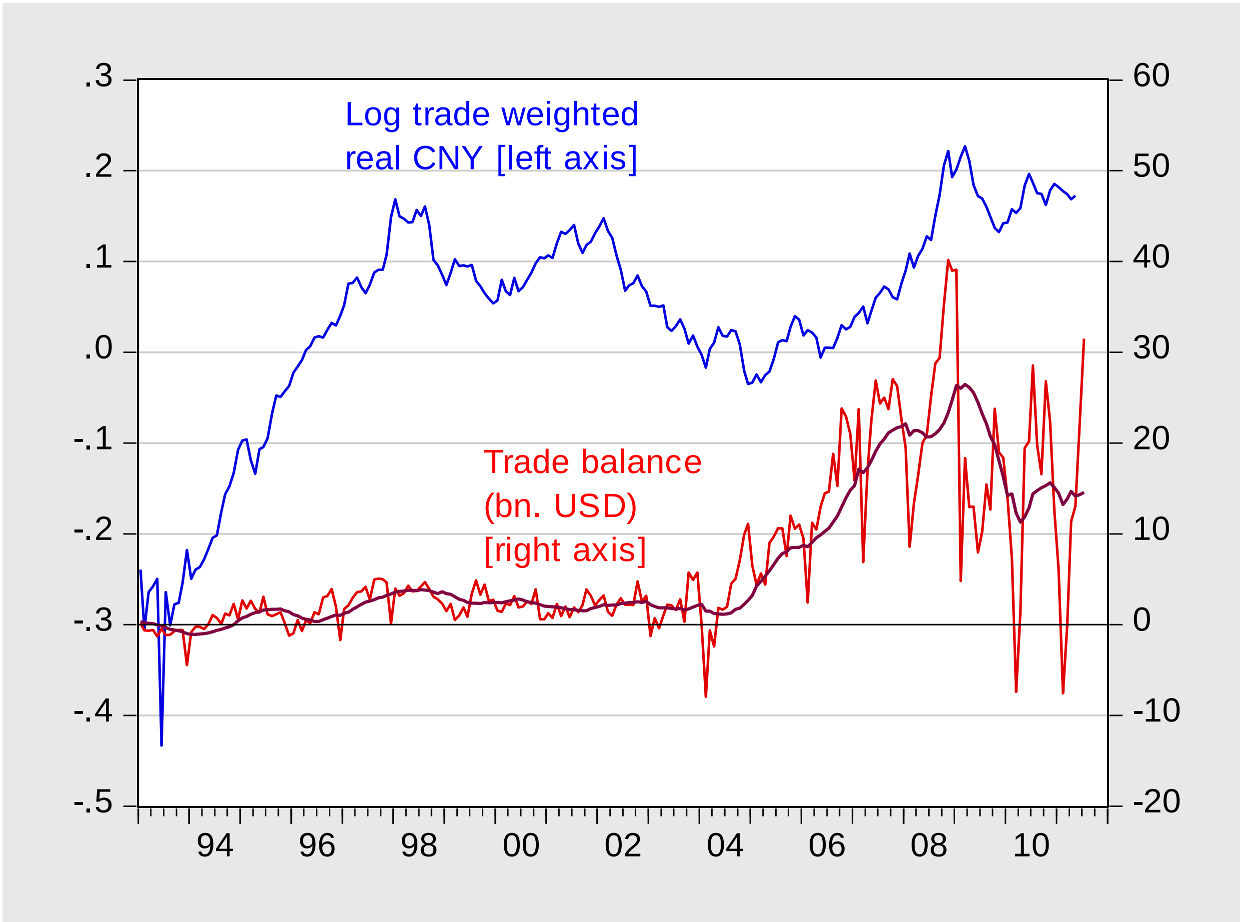
High income vs. Developing Country Output Gaps

Figure S1.8 Industrial spare capacity and economy wide capacity utilization across regions



Source: World Bank, *Global Economic Prospects*, Jan. 2011

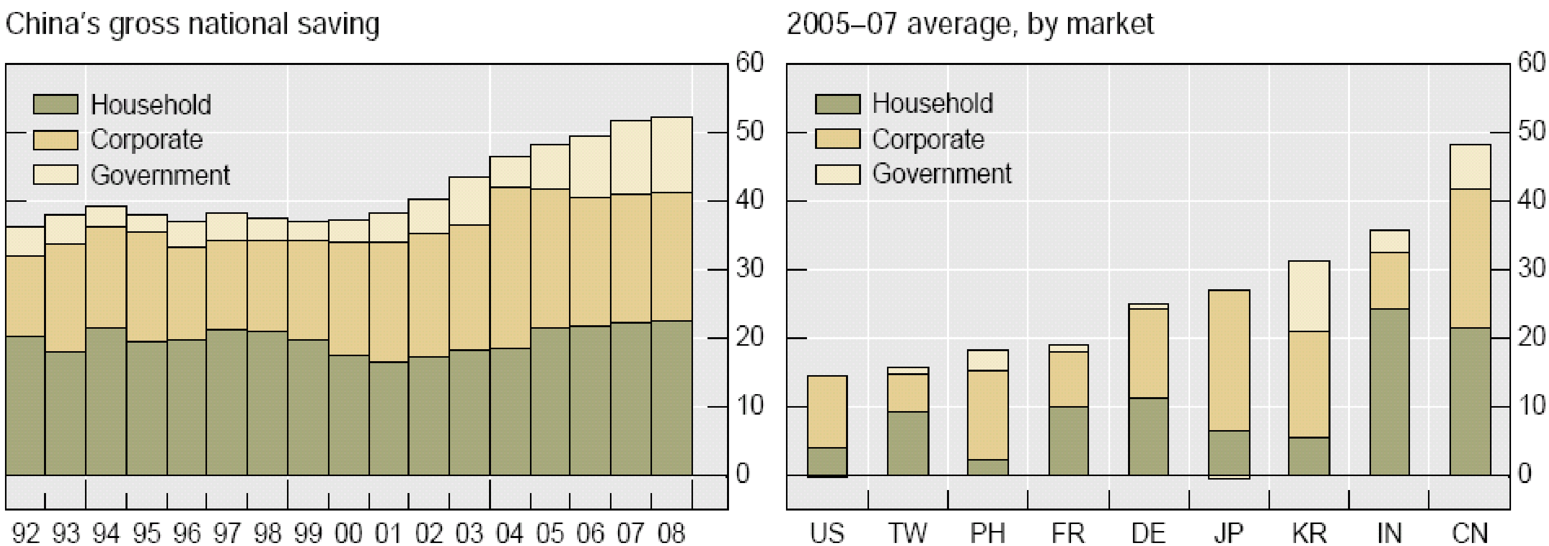
China: The RMB and the Trade Balance



Source: Cheung, Chinn, and Qian (2011)

China Medium Term Rebalancing: Saving Behavior

As a percentage of GDP

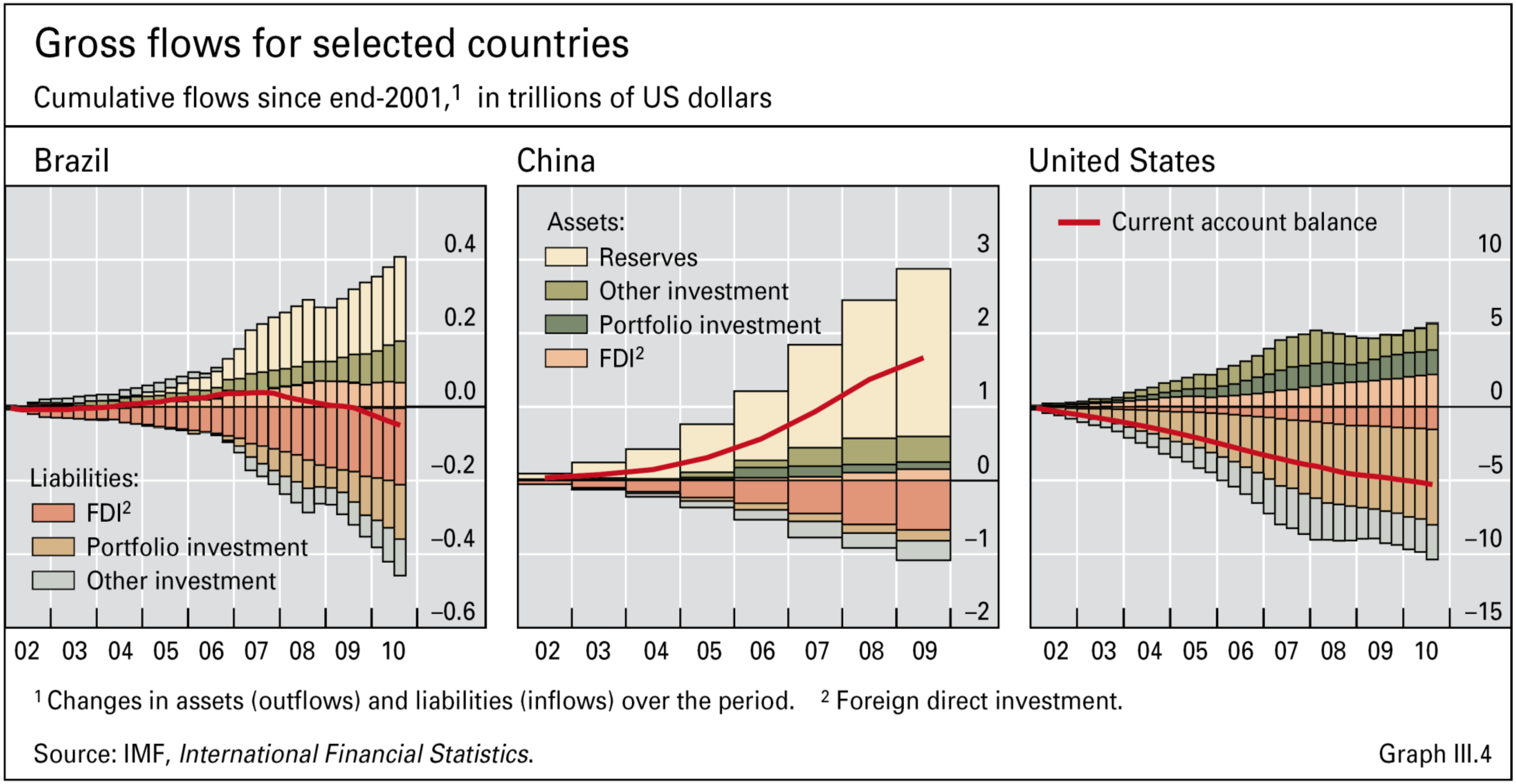


CN = China; DE = Germany; FR = France; IN = India, JP = Japan; KR = Korea; PH = Philippines; TW = Chinese Taipei; US = United States.

Sources: ADB; OECD; national data; authors' own estimates.

Source: Ma and Yi, *BIS Working Paper* No. 312 (June 2010)

Gross Capital Flows: Brazil, China, the U.S.



Source: BIS, *Annual Report,* June 2011

Policy Implications for Capital Surges

- The first line of defense against capital inflows is macroeconomic
- Countercyclical fiscal policy (IMF, *WEO* Oct. 2007)
- Appropriate macroeconomic responses include appreciation, adjustment of monetary policy

Complications

- Tightening monetary policy can exacerbate problems if it spurs greater inflows
- The last line of defense is capital controls and repression of the financial sector

Capital Controls

- The IMF has modified its stance on capital controls
- Empirical work suggests that controls can alter the composition of inflows, and mitigate the effect of negative shocks on growth
- The empirical work is vague on what types of capital controls work (inflows on types, etc.)

Capital Controls Re-reconsidered

- Capital controls can internalize externalities
- But other measures also can – prudential measures, e.g., capital standards, regulation
- Capital controls can also have spillover effects
- What if many countries impose controls? RoW interest rates fall

Summing Up

- An accentuated two speed world recovery
- Rebalancing is in abeyance, unless larger effects from deleveraging
- The emerging markets are not immune (cyclical recoupling)
- Capital flows to emerging markets likely to continue
- So the policy challenges will remain