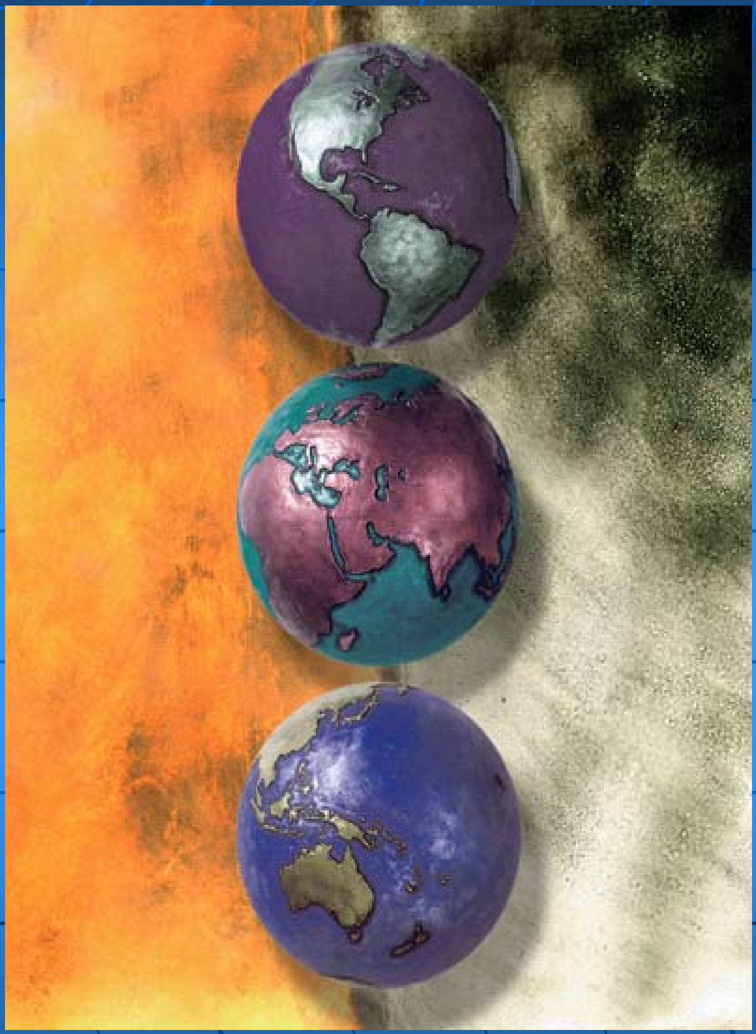

Globalization and External Imbalances

Project Link Meeting

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Motivation

- There is a sense that increased international economic and financial integration has changed the dynamics of both imbalances and adjustment.
  - Larger imbalances can be sustained for longer
  - Adjustment requires less real exchange rate change
- But.
- 1. Just how much has globalization changed fundamental parameters of adjustment?
  - Specialization in production
  - Expansion of service sectors---Share of tradable sectors has not increased
- 2. Risks and challenges associated with globalization.
  - Exposure to financial market volatility with larger imbalances
  - Abrupt reversals in capital flows and disorderly adjustment
  - Policy mistakes may have become costlier

What did we do?

- Examine the implications of globalization on external imbalances and their adjustment from a global perspective, and assess policy implications.
  - How has globalization affected external adjustment and the risks associated with it?
  - What are the implications for policy makers, in both deficit and surplus countries? To what extent should they deal differently with imbalances?

Organization

- Financial Globalization
- Real Globalization
- Effects of Globalization Through the Lenses of GEM

Home Bias

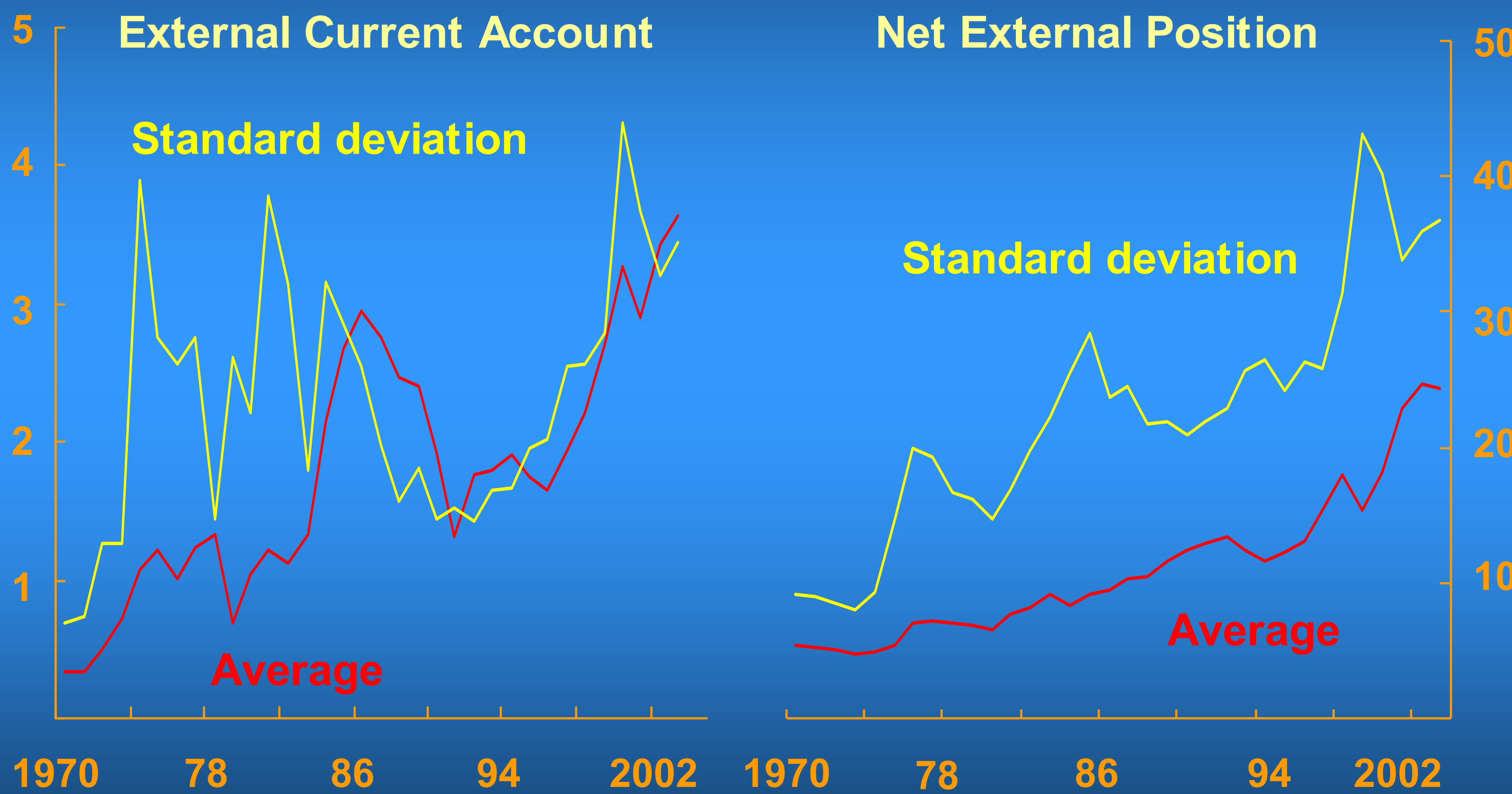
- Opportunities for international diversification have improved with globalization.
  - Obstacle (e.g., high cross-border transaction costs or regulatory barriers) have been reduced.
  - Expectation that home bias has decreased at the global level.

- The decline in home bias determines the extent to which desired current account balances—which depend on factors such as productivity growth differentials or demographic changes—are accommodated by international financial markets.
  - If home bias is strong, global demand for foreign assets will be low and price-inelastic. Large issuers of foreign liabilities will thus face high yields; this will discourage net external borrowing, and actual current account balances will likely be smaller than desired ones.

Evidence

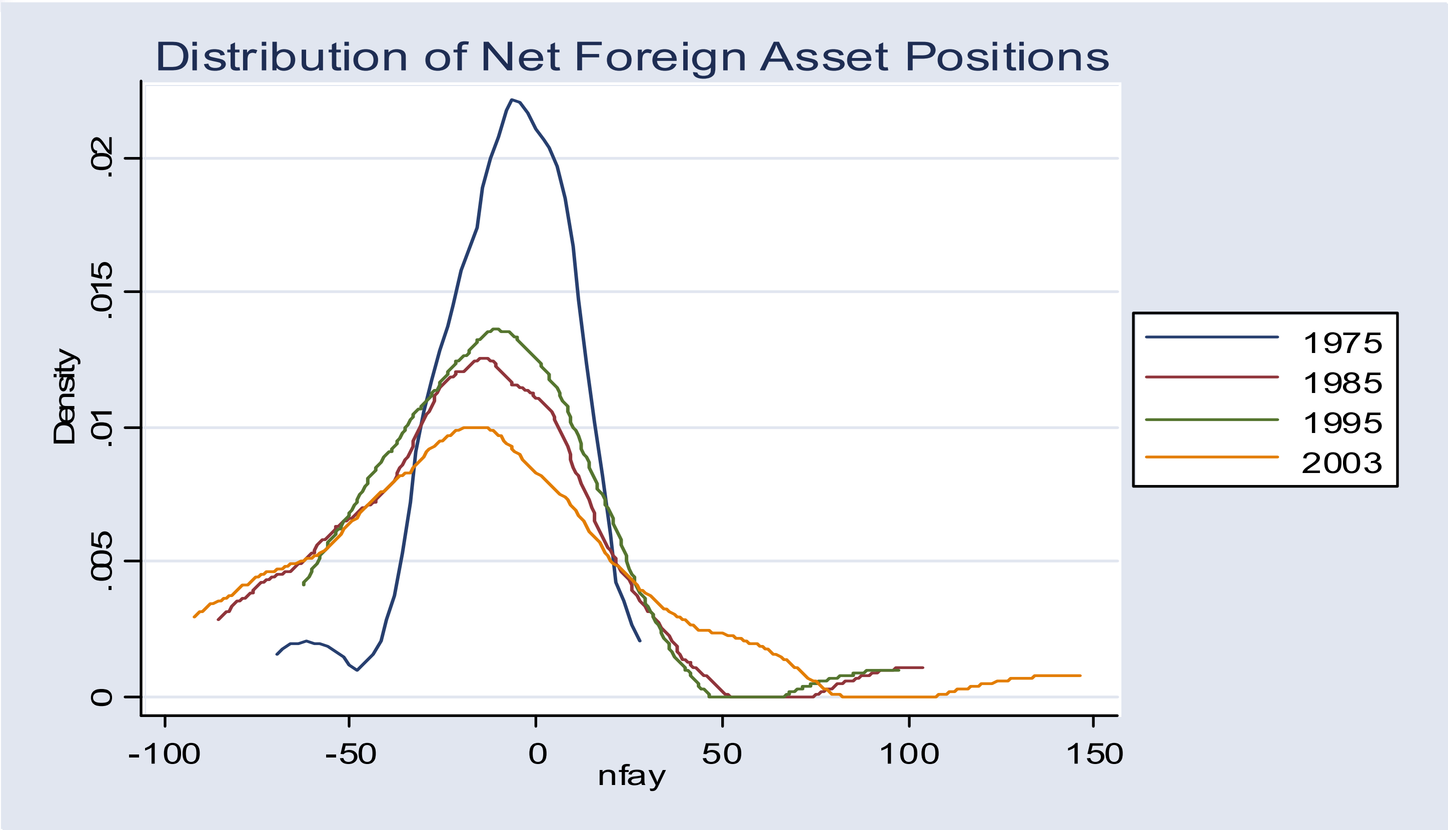
- Clear evidence that the home bias has declined and that restrictions on net external borrowing have eased.
  - Portfolio holdings of foreign bonds and equity have clearly increased compared to domestic market capitalization.
  - External current account deficits or surpluses (relative to domestic incomes) have, on average, increased.
  - Their dispersion across countries has widened in industrial countries and, to a lesser extent, in emerging market countries
  - Net external positions have, on average, widened also, as has their dispersion on account of the larger and more persistent current account deficits and surpluses.

Industrial Countries' External Current Account Balances and Net External Positions, 1970–2003
(Percent of GDP; absolute values)

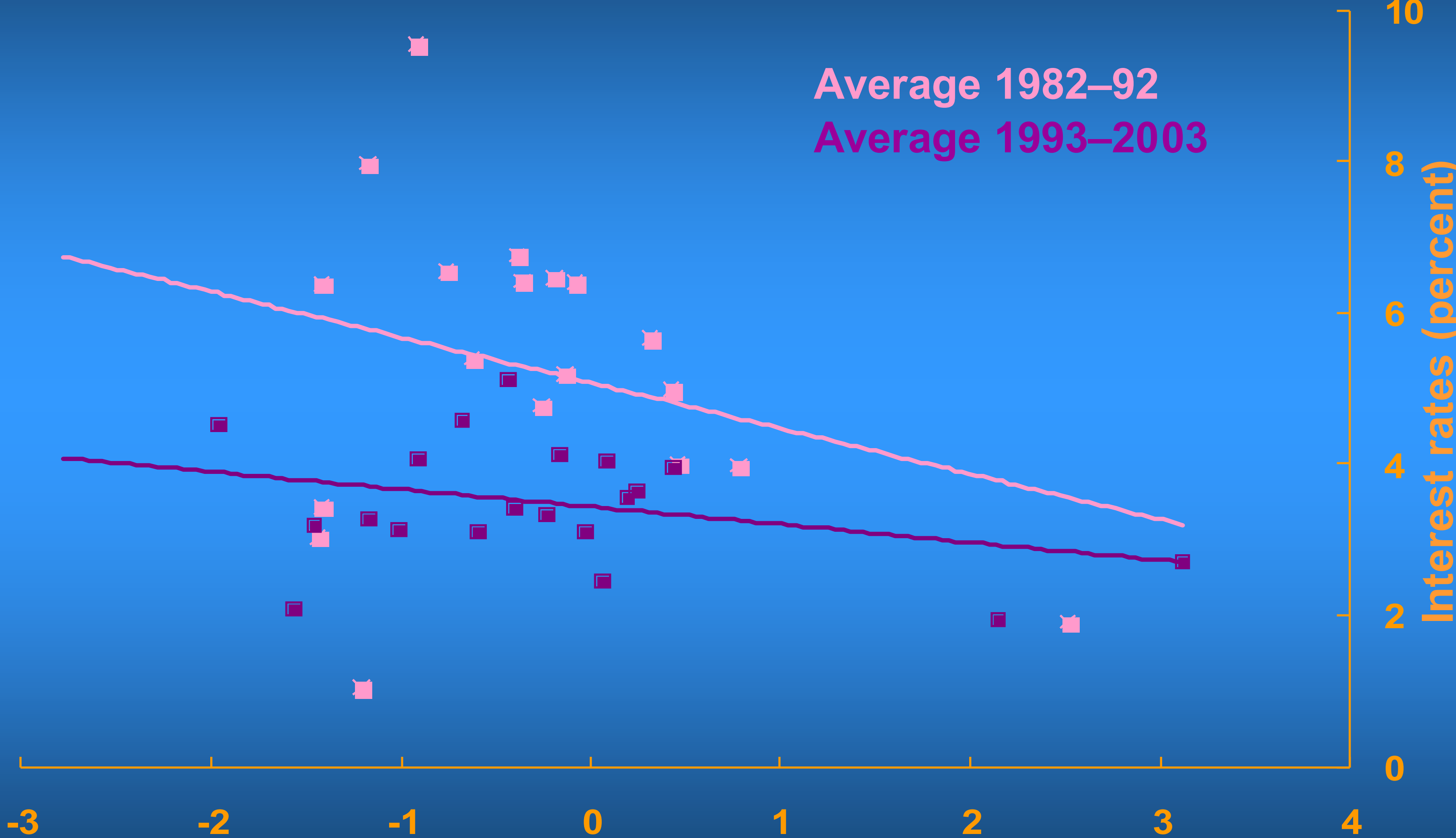


Sources: IMF, *International Financial Statistics*; IMF, *Balance of Payments Statistics*; Lane and Milesi-Ferretti (2005b); and IMF staff calculations.

Dispersion of Net External Positions



Industrial Countries: Long-Term Real Interest Rates and Net Foreign Assets

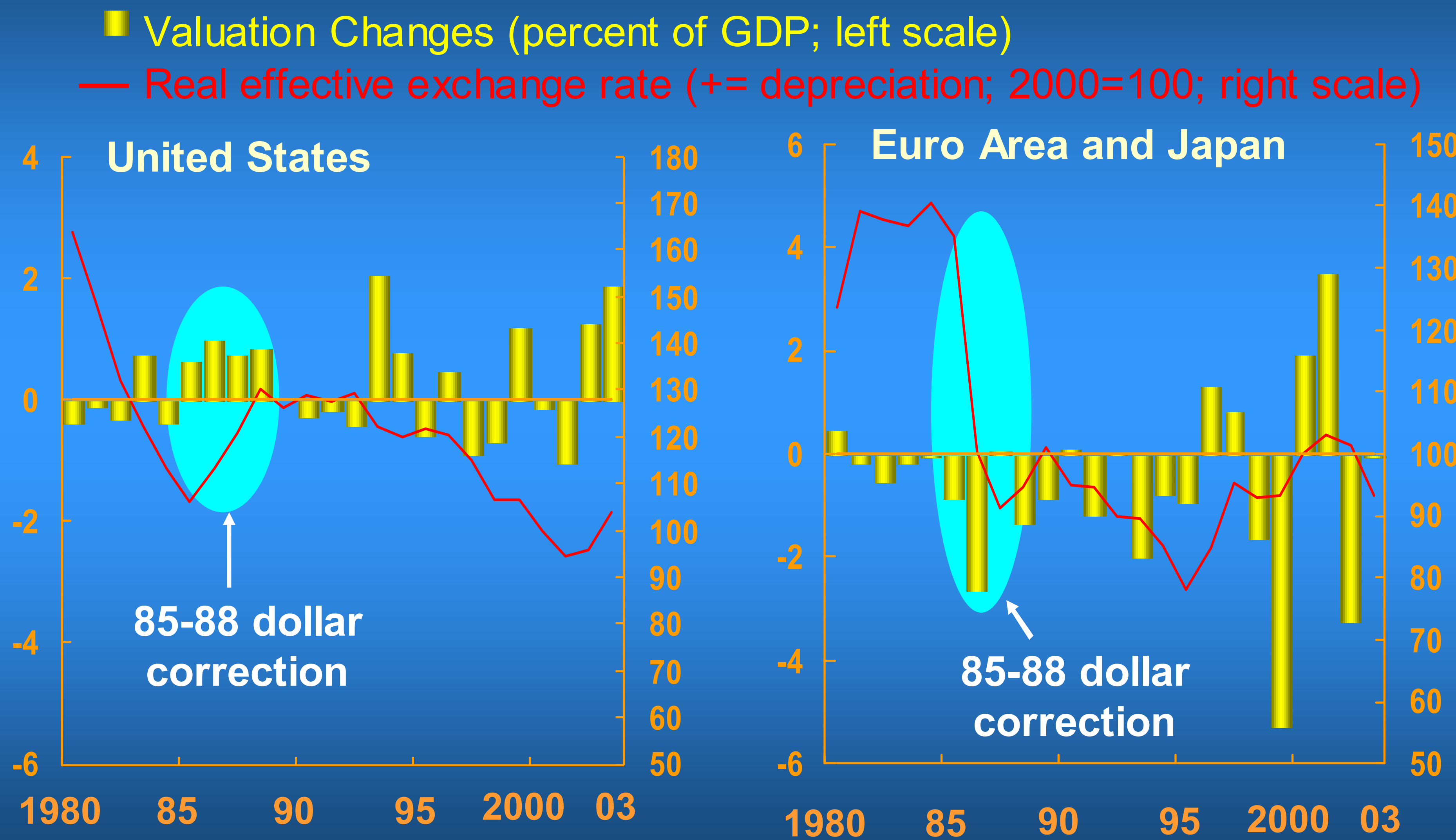


Sources: IMF, *International Financial Statistics*; Lane and Milesi-Ferretti (2005b); and IMF staff calculations.

Implications for Adjustment

- The real effects of exchange rate changes can thus play out over a longer time period.

Valuation Changes in Net Foreign Assets and Real Effective Exchange Rates



Sources: IMF, *Balance of Payments Statistics*; Lane and Milesi-Ferretti (2005b); and IMF staff calculations.

Real Globalization

- It's become cheaper to trade globally
- Global trade has become freer and has expanded rapidly.
  - Trade to worldwide GDP rose from 16 % in 1960 to 40 % by 2001
  - Trade patterns have changed dramatically
  - International competition has increased, affecting market structures worldwide
  - Consumers' and producers' preferences have shifted given the wider variety of goods and services available

- Implications:
  - home biases in tradable shares
  - mark-ups
  - real rigidities
  - cross-border vertical and horizontal integration

GEM Simulations

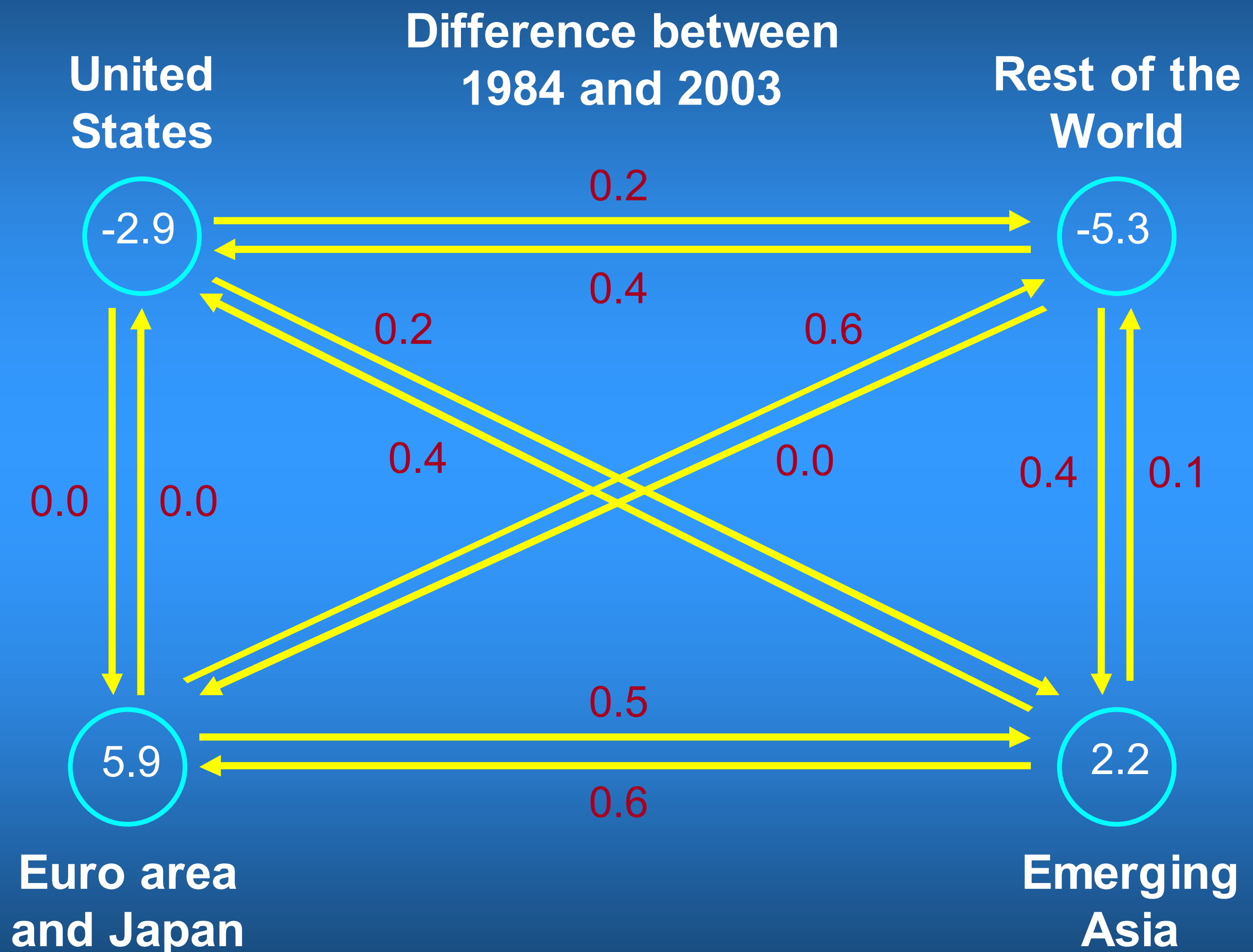
- Compare responses from 2 vintage calibrations of GEM (GEM-1980 vs. GEM-2000)

GEM-1980 vs. GEM-2000: KEY DIFFERENCES

- Country sizes (AS/JE↑, US/RW↓)
- Share of traded (↓) vs. non-traded (↑)
- Home biases (↓)
- Mark-ups (↓)
- Nominal rigidities (↓)
- Monetary policy more aggressive

Economies Relative Sizes and Trade Patterns

(Percent of world GDP)



Sources: IMF, *International Financial Statistics*; IMF, *Direction of Trade Statistics*; and IMF staff calculations.

Simulation 1

- How does real sector globalization affect the way external imbalances adjust?

- Subject to an **identical** cocktail shock, roughly reproducing today's imbalances
  - Drop in US public saving

    (large temporary, observable in US budget deficit and thence US government debt)
  - Drop in US private saving

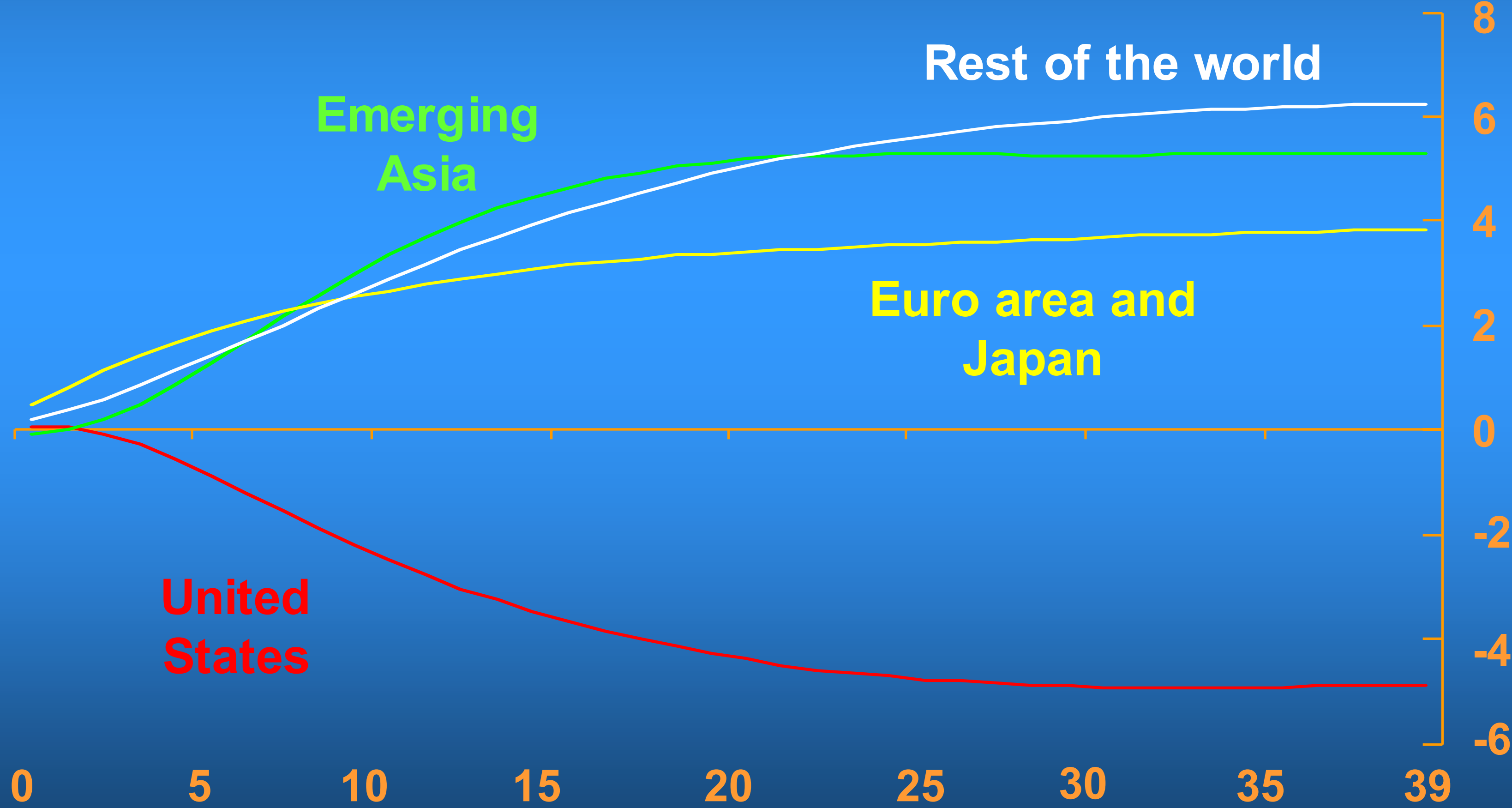
    (permanent, thru change in relative time-preference) increases NFL* and ↑Eq real R
  - Increased appetite for US assets (permanent change in desired NFA by non-US blocs)

Key results

- With globalization, external adjustment coincides with a smaller real depreciation of the U.S. dollar and more contained real appreciations in the other blocs.
- Globalization also implies smaller increases in real interest rates in the United States and in other blocs during the adjustment.
- As a result, smaller short-run declines in output growth in all blocs, apart from emerging Asia.
- The impact of globalization seems largest for the adjustment in emerging Asia, where output growth during the rebalancing is not as strong as in the absence of globalization.

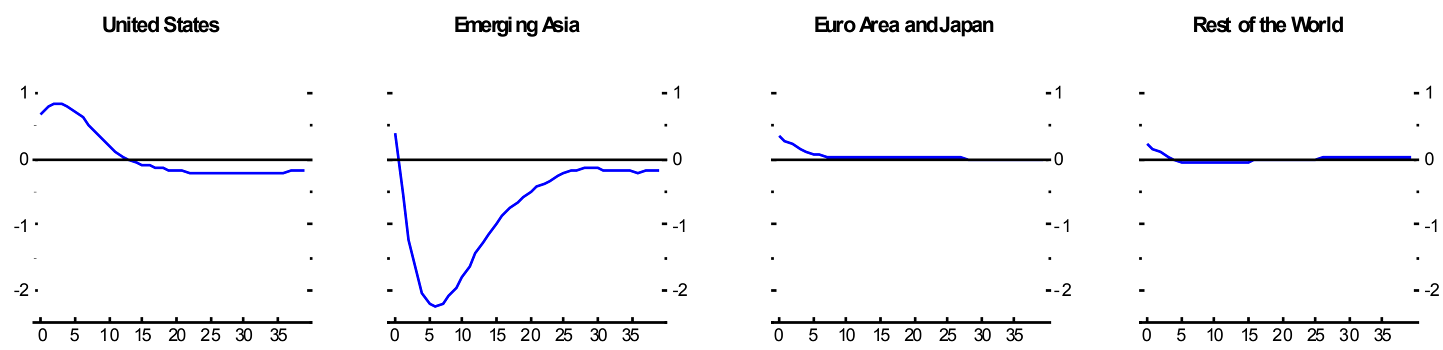
Global Rebalancing Under Benign Financial Market Conditions

(Deviations between baseline response in GEM 2000 and GEM 1980 calibrations; percentage points; x-axis in calendar quarters, 0 represents 2005Q1)



Source: IMF staff calculations.

Growth Response



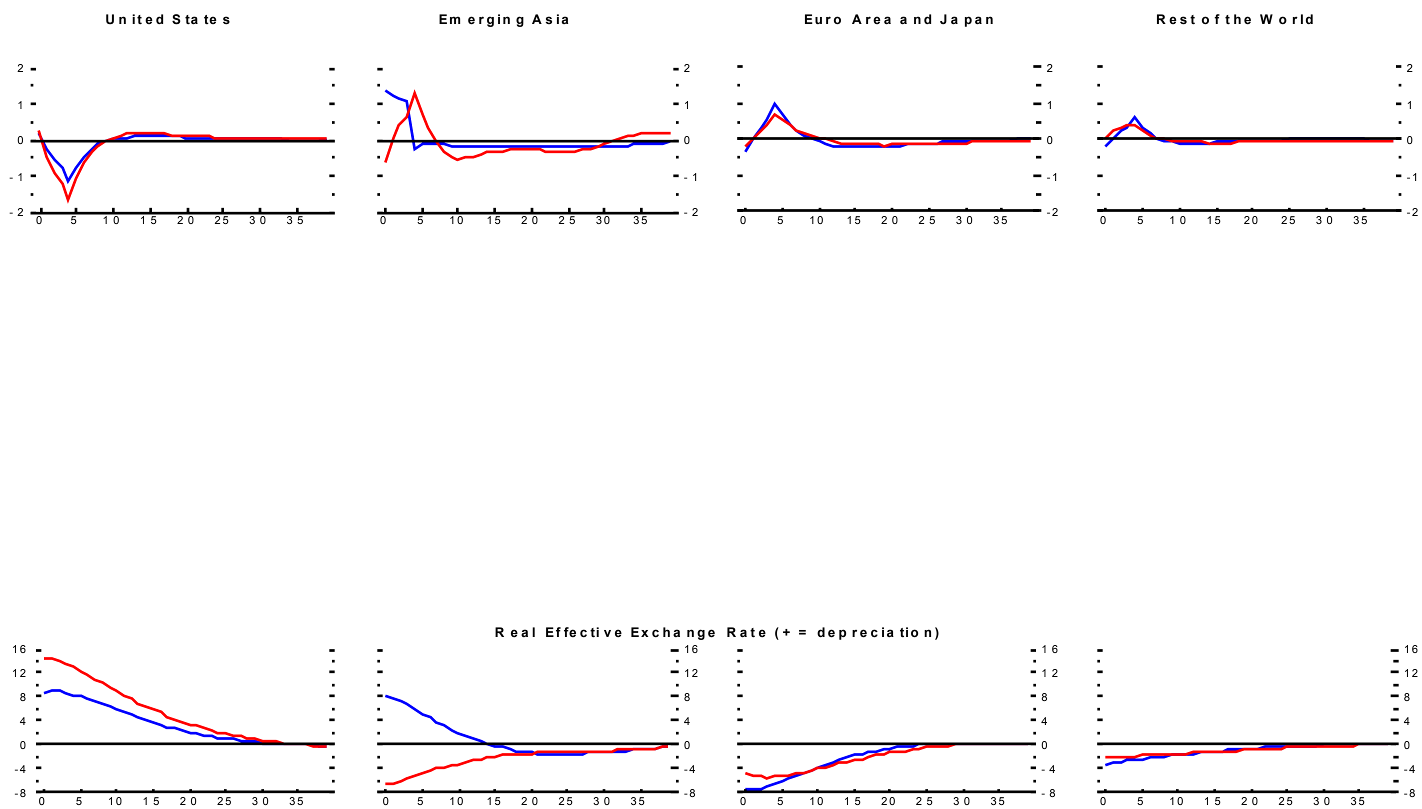
What explains the difference?

- *Direction of trade and trade shares*. More evenly distributed trade across blocs helps.
- *Economic size of the various blocs*. In the 1980s, the same amount of U.S. net foreign liabilities (relative to US GDP) was larger in terms of the economic sizes of emerging Asia, the euro area, and Japan were smaller, making it harder for them to absorb the same amount of U.S. assets. Hence, relatively smaller saving-investment balances today, and more limited real exchange rate changes and real interest rate changes.
- In addition, *differences in monetary policy strategies across time matter. More effective and credible* policies today require smaller interest rate changes to stabilize inflation following demand shocks and during adjustment.

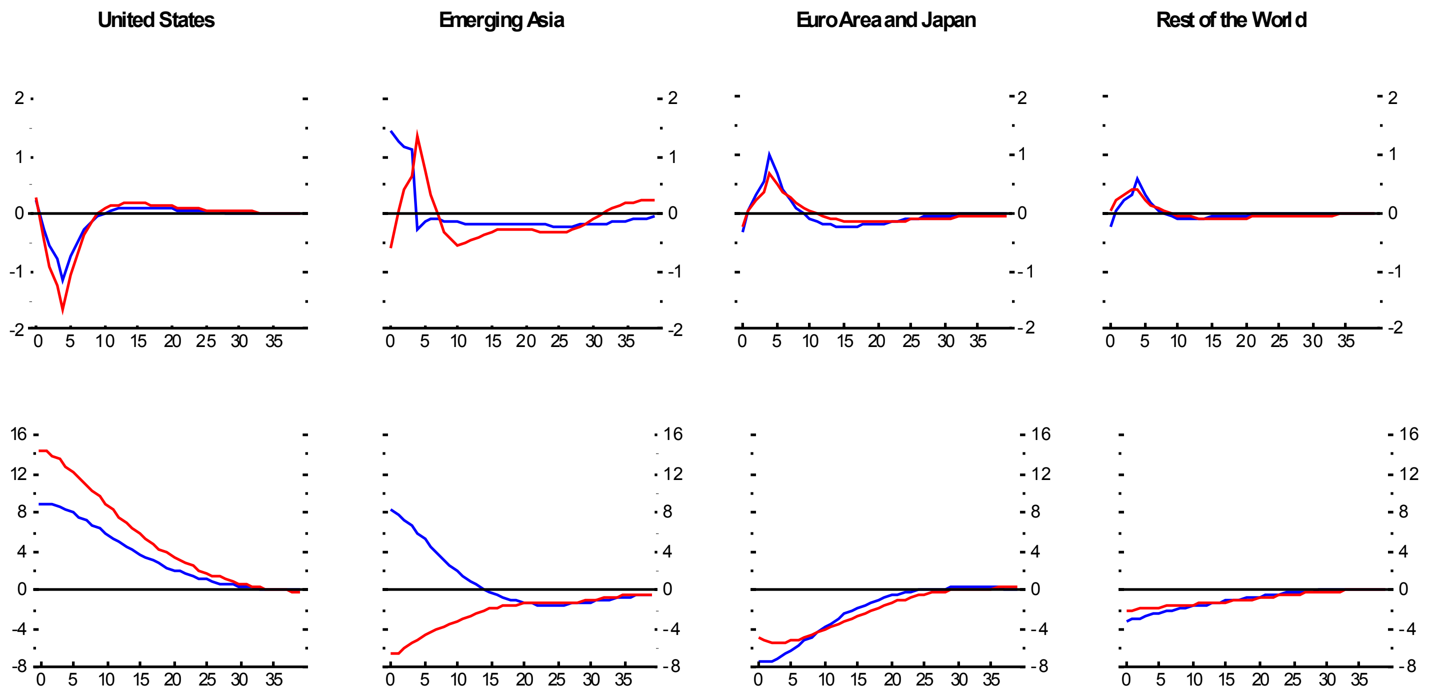
Risks: Simulations 2 and 3

- What happens when foreign investors are less willing to continue accumulating U.S. assets?
- Investors in the euro area, Japan, and the rest of the world are unwilling to continue accumulating U.S. assets and begin to gradually reduce their desired holdings of U.S. assets (back to 2001 levels by 2010).

- Capital flows to the United States slow sharply, requiring a more abrupt adjustment in the U.S. current account.
  - U.S. interest rates rise relative to the baseline scenario, the U.S. dollar has to depreciate sooner and more sharply, and U.S. output slows more markedly.
  - The depreciation of the U.S. dollar is matched by an appreciation of exchange rates—and lower trade and current account balances—in blocs with flexible exchange rates (Japan, the euro area, and the rest of the world). In emerging Asia, however, developments vary substantially across the two scenarios.
  - In both scenarios, real interest rates outside the United States fall, and—despite slower U.S. growth—GDP growth in the rest of the world rises moderately (or inemerging Asia stays broadly flat relative to the baseline in the first scenario).
  - This rather benign outcome partly reflects the specification of the shift in investor preferences, as the decline in desired asset holdings in the rest of the world is accompanied by a reduction in desired savings, which boosts consumption.
  - In practice, demand outside the United States could fail to pick up—for example, because of adverse confidence effects—and GDP growth would correspondingly be weaker.


United States
Emerging Asia
Euro Area and Japan
Rest of the World
Real Effective Exchange Rate (+ = depreciation)
2
1
0
-1
-2
16
12
8
4
0
-4
-8
0
5
10
15
20
25
30
35

Growth and REER Responses



Bottom Line

- **Globalization has created the scope for less costly global rebalancing if financial market conditions remain favorable and investors continue to accumulate U.S. assets.**
- **However, if investor preferences change, the risks of a more abrupt and costly adjustment—involving a sharp depreciation of the U.S. dollar, higher interest rates, and weaker output growth—are now greater.**
- **Therefore, global current account imbalances still remain a concern.**

Thank You

May 2005