

External Balance Assessments



Analyzing External Imbalances

IMF, February 2, 2012

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Key issues to keep in mind



Interdependence among the biggest countries -- Chinese and US current account dynamics are intertwined; Germany's and Europe's dynamics are intertwined. All are related to the global business cycle, and global financial and trade integrations.

- Global imbalances are beneath the radar screen when countries are close to full employment, and growing. A source of contentious conflicts in recessions.
- A tendency to focus too much on the nominal exchange rate [transparent and politically sensitive], instead of on the full vector of domestic policies and fundamentals.

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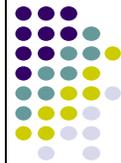
On the needed adjustments



- The crisis gives the illusion of progress by the scaling down of global imbalances, yet it's premature to ascertain if the internal adjustments of the US and China are adequate (chances are that not).
- Short of the emergence of new “demanders of last resort,” one hopes for a harmonious trajectory towards lower global imbalances.
- Yet, hope may not be enough.

3

On the gains from global savings flowing downhill



Tendency to overstate the gains from global savings flowing downhill [Gourinchas & Jeanne (2006), Aizenman et al. (2007), Prasad et al. (2007), Aizenman & Sushko (2011)].

- Even if demanders of last resort emerge, it is not clear if this will turn out to be good news for the global economy.
- Large gross and net positions may lead to greater turbulences down the road [Obstfeld (2010)].
- Some observers were content with the sizable current acct. deficits of several Eastern European countries in the first half of the 2000s, as examples of global savings flowing downhill, not any more.

4

The pre-crisis global imbalances are not sustainable



- It worked 'OK' as long as the US and Europe were close to full employment, and China was smaller.
- A common rationale for Chinese policies has been the 'learning by doing' (and by exporting) positive externality.
- To the degree that this externality holds, there is also the 'dis-learning by not-doing' (i.e., importing) negative externality.
- China has reached a size where the continuation of its large surpluses may backfire, inducing Europe and the US to invoke retaliatory domestic policies .

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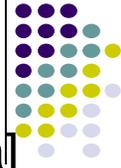
Patterns of uphill and downhill flows of capital



- Private sector funds tend to 'flow downhill,' from slower to faster growing countries [Alfaro et al. (2011)].
- Public sector funds tend to 'flow uphill,' and this pattern has dominated the global imbalances prior to the crisis of 2008-9.
- Global imbalances before the crisis were unsustainable, implying the need to modify the policies leading to the dominance of 'uphill flows.'

6

Adjustment challenges



- Scaling down post crisis global imbalances requires the key players [the US and China] to embark on internal adjustments.
- The US adjustment should deal with looming fiscal challenges associated with the overall low tax burden in the US relative to the total GDP share of the public sector, and its future commitments.
- The Chinese adjustment should deal with relaxing the severity of its massive financial repression, probably reducing the implicit subsidy to 'priority sectors', and balancing the structure of its investment and saving patterns.

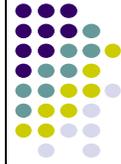
Adjustment challenges



- Chances are that such adjustments would be easier to implement if they were
 1. broadly based,
 2. more equal in burden sharing,
 3. gradual and
 4. persistent.
- Achieving it would test the political systems, and the social contracts in the involved countries.

Thanks for you attention

Background references



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