# Europe and Global Imbalances

by P. Lane and G.M. Milesi-Ferretti

Menzie D. Chinn

UW-Madison & NBER

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# Outline

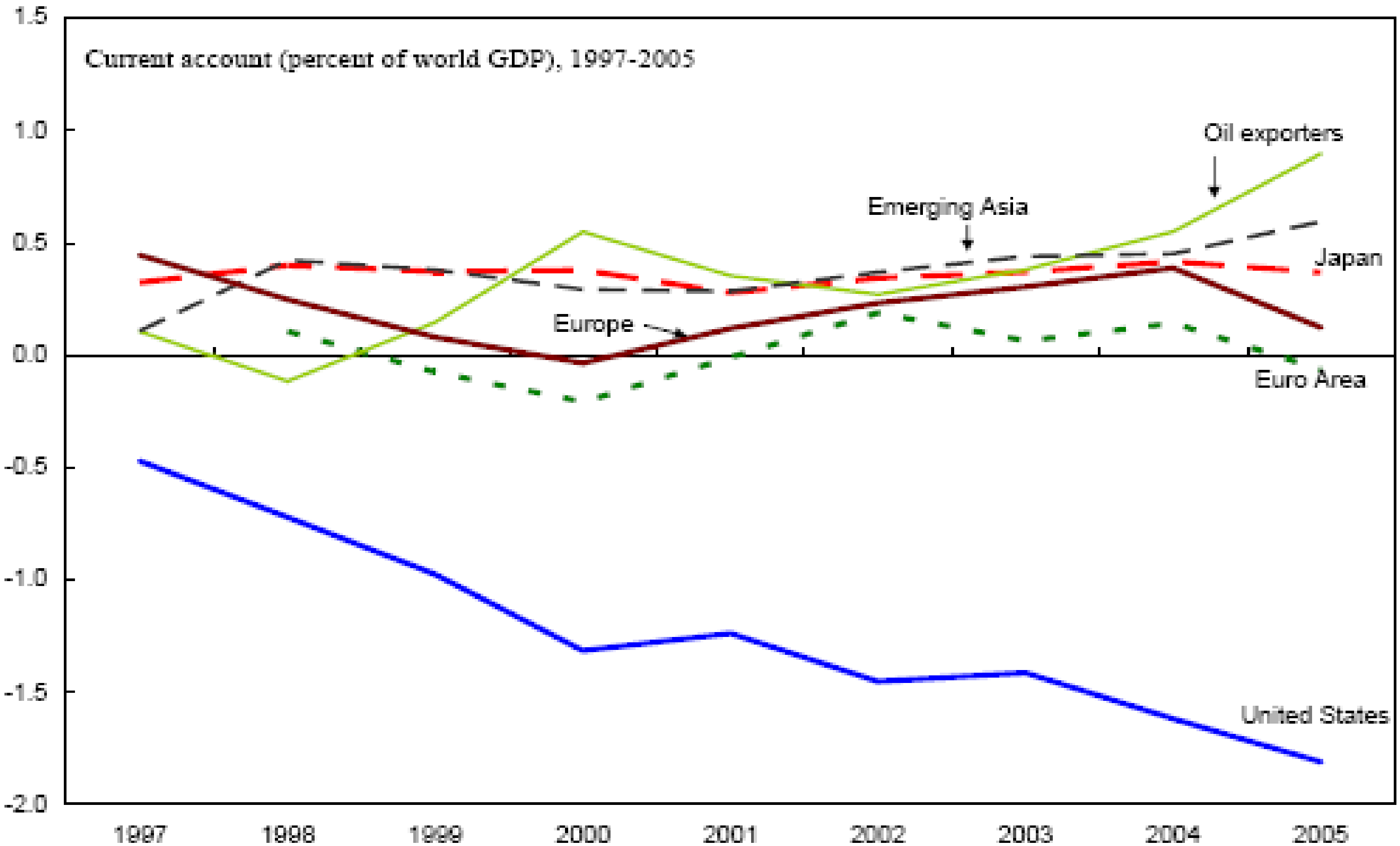
- What the paper does
- The policy implications
- Questions about stocks and the composition of stocks
- Questions about state and quasi-state actor behavior
- A Parting Question

# The Paper

- Documents the impact of valuation effects using the most updated information.
- Uses a DSGE (GEM) to analyze three scenarios of international adjustment: BAU, disruptive, and optimistic.
- Using these scenarios, they examine the implications via trade, and (most importantly) via valuation effects.
- Invaluable work: achieves aim of highlighting the role of Europe.

# Europe as a Bystander?

Figure 1. Current account balances, major regions, 1997-2005
(percent of world GDP)



# Implications

- Counter-intuitively, global rebalancing incorporating dollar depreciation has substantial impacts on Europe via trade and especially valuation effect.
- These impacts are substantially larger if Asia fails to allow substantial appreciation.
- But even within Europe there is substantial variation, with Central and Eastern Europe more vulnerable in a “disorderly adjustment”.

# A Two Step Process

- Step 1: GEM is used to simulate the outcomes of the scenarios.
- Step 2: Using given stocks of assets and liabilities, calculate the valuation effects.

# Thoughts on the Two Step Approach

- In DSGEs generally (but not always), the UIP is broken by virtue of an ad hoc risk premium.
- The basic simulations take this framework as given, then apply outcomes to draw out valuation effects.
- Methodological awkwardness. Most pronounced when examining the disorderly scenario.
- This procedure implies asset and liability holdings might not be driven by the possibility of the various scenarios.

# An Integrated Approach

- Is hard to do!
- The authors are aware of the possibility of alternative approaches (e.g., Engel and Matsumoto), but it may be that agents are behaving in a way where they are discounting heavily these extreme, discrete, outcomes.
- Then this approach may be yield a tractable first approximation to the solution.

# Uncertainty about Asset and Liability Stocks and *Composition*

- What is (are) the 300 pound gorilla(s) in the room?
- The oil exporters (not explicitly in the three region model).
- China "We have virtually no information on the currency composition of China's external position…" (p. 29).
- These are linked with the second big issue.

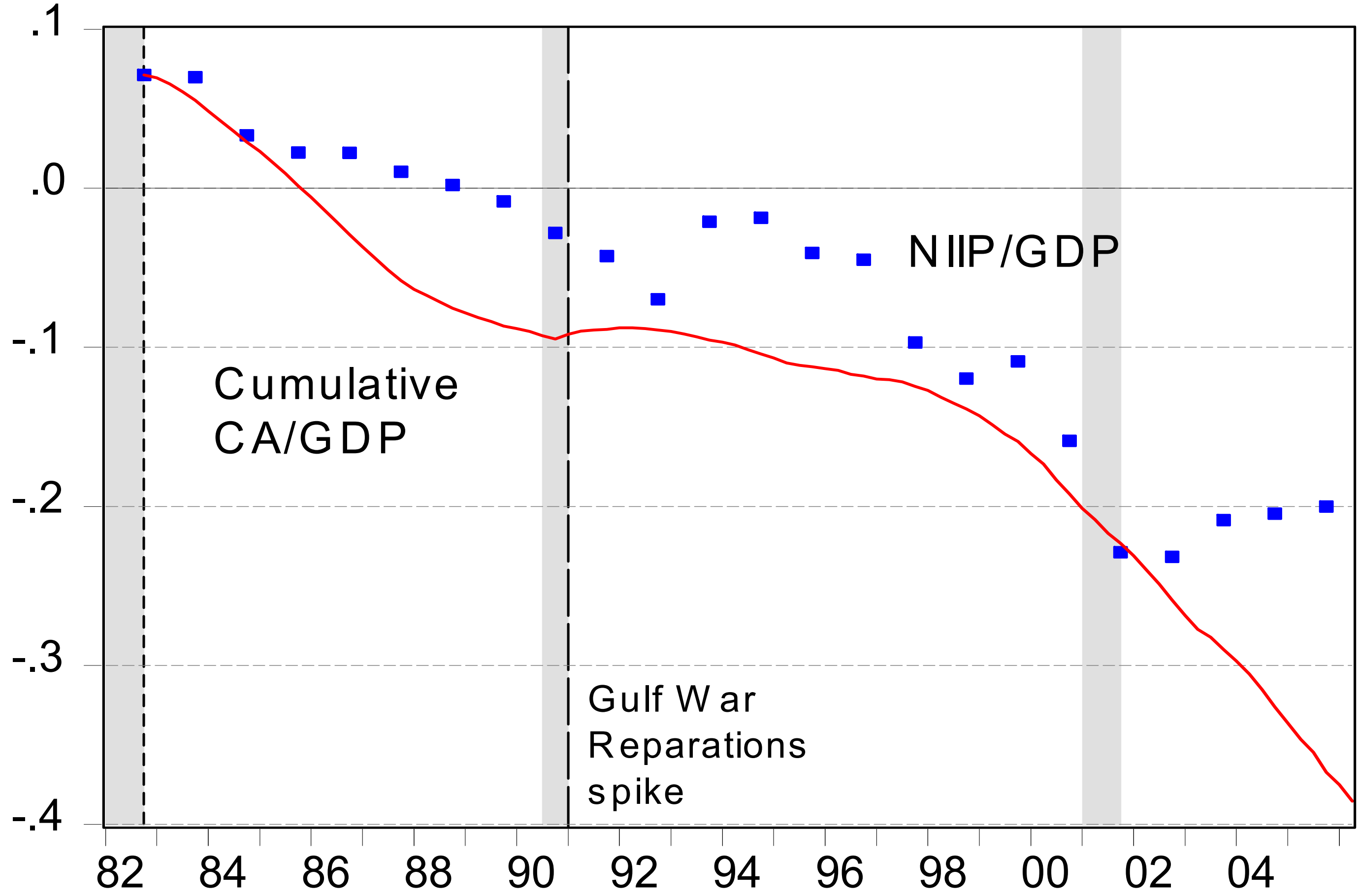
# Uncertainty about the Behavior of State Actors

- China (end-2004): Of the USD 913 bn of assets, USD 614 bn are forex reserves.
- Saudi Arabia: Of the USD 222 bn of assets, USD 27 bn are forex reserves.
- Kuwait: Of USD 138 bn of assets, USD 8 bn are forex reserves.
- Abu Dhabi (in UAE): of USD 241 bn USD 18.5 bn are forex reserves…but

# Quasi-state Actors: Not Always Minor Players

- But Investment Funds hold a lot in oil exporting countries.
- By late 2006, *guesses* are:
- Kuwait Investment Authority: USD 130-250 bn,
- Abu Dhabi (of UAE) Investment Authority: USD 300-600 bn.
- If these actors are inertial...

# A Parting Question: Can Gravity Be Defied?



# Valuation Effects May Have Transitory Impacts

"However, the size of long-run real exchange rate adjustment would be unchanged relative to the situation without valuation effects." (p.18)

- Reminiscent of findings by Cavallo and Tille (2006).
- UIP cannot hold in these scenarios.

# In Sum

- A very useful paper, using the state of the art DSGE macro models and
- Incorporating a role for increasingly important gross asset and liability stocks.
- Next steps involve learning more about asset and stock currency (and holding) composition
- And then finding out what state and quasi-state actors are holding (and doing).