Global Imbalances and Spillovers

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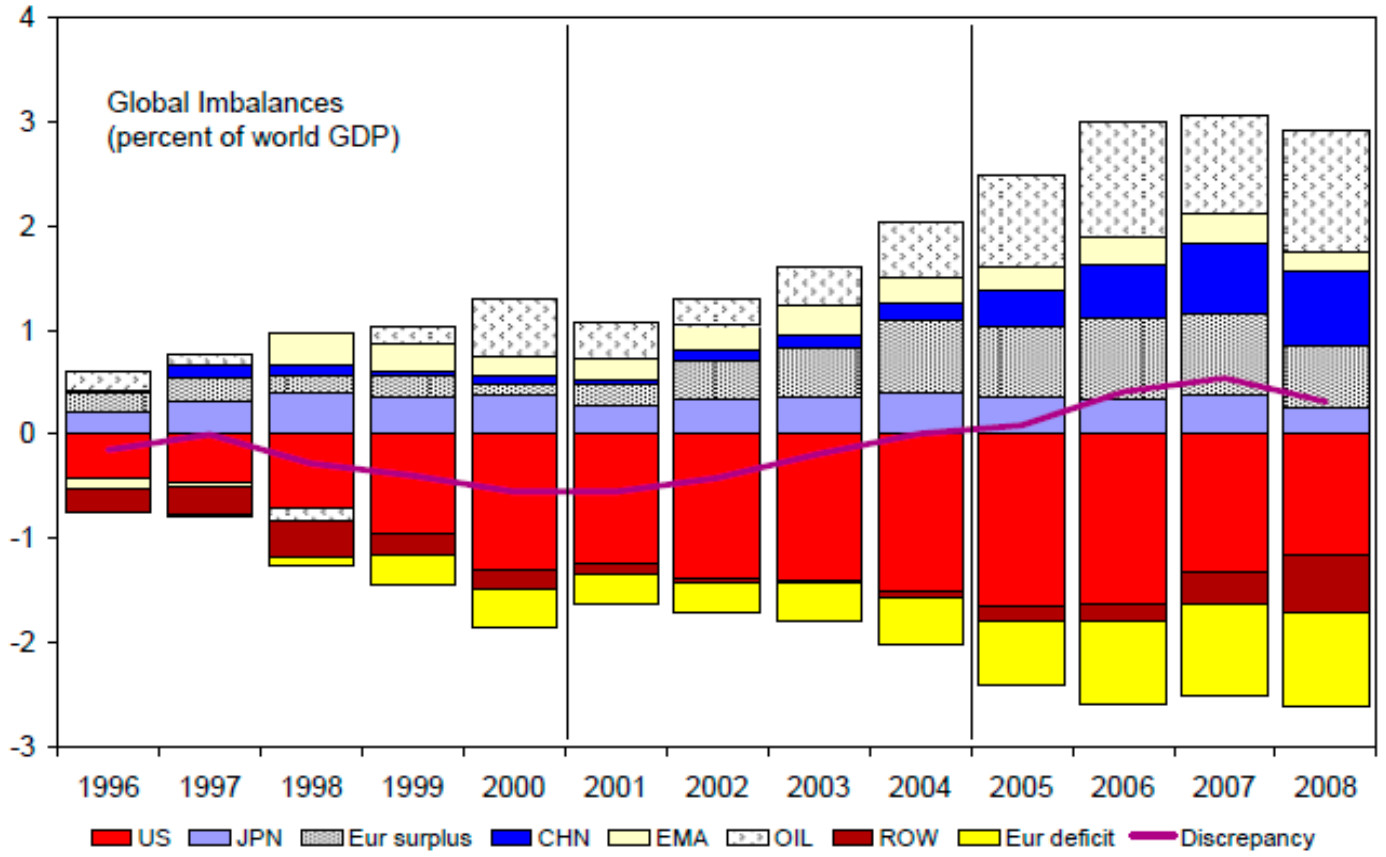
IMF Annual Research Conference

November 4, 2016

***THESE COMMENTS DO NOT REPRESENT THE VIEWS OF ANY INSTITUTION WITH WHICH I AM AFFILIATED**

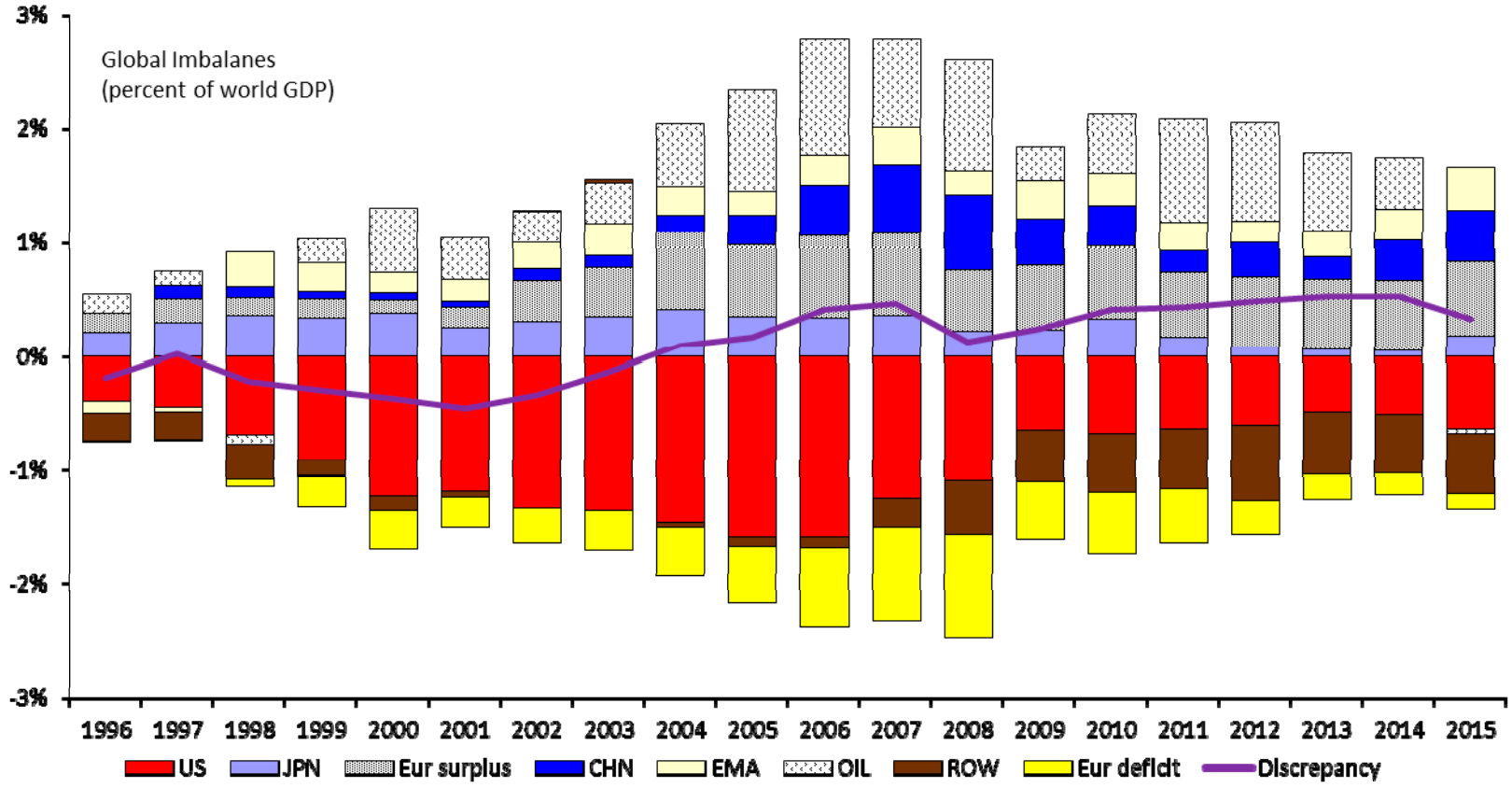
Blanchard's Insights

Global Imbalances in 2008



Source: Blanchard and Milesi-Ferretti (2009), "Global Imbalances: In Midstream?" IMF Staff Position Note SPN/09/29.

Global Imbalances Today



Source: WEO, IMF

Imbalances: Concerns

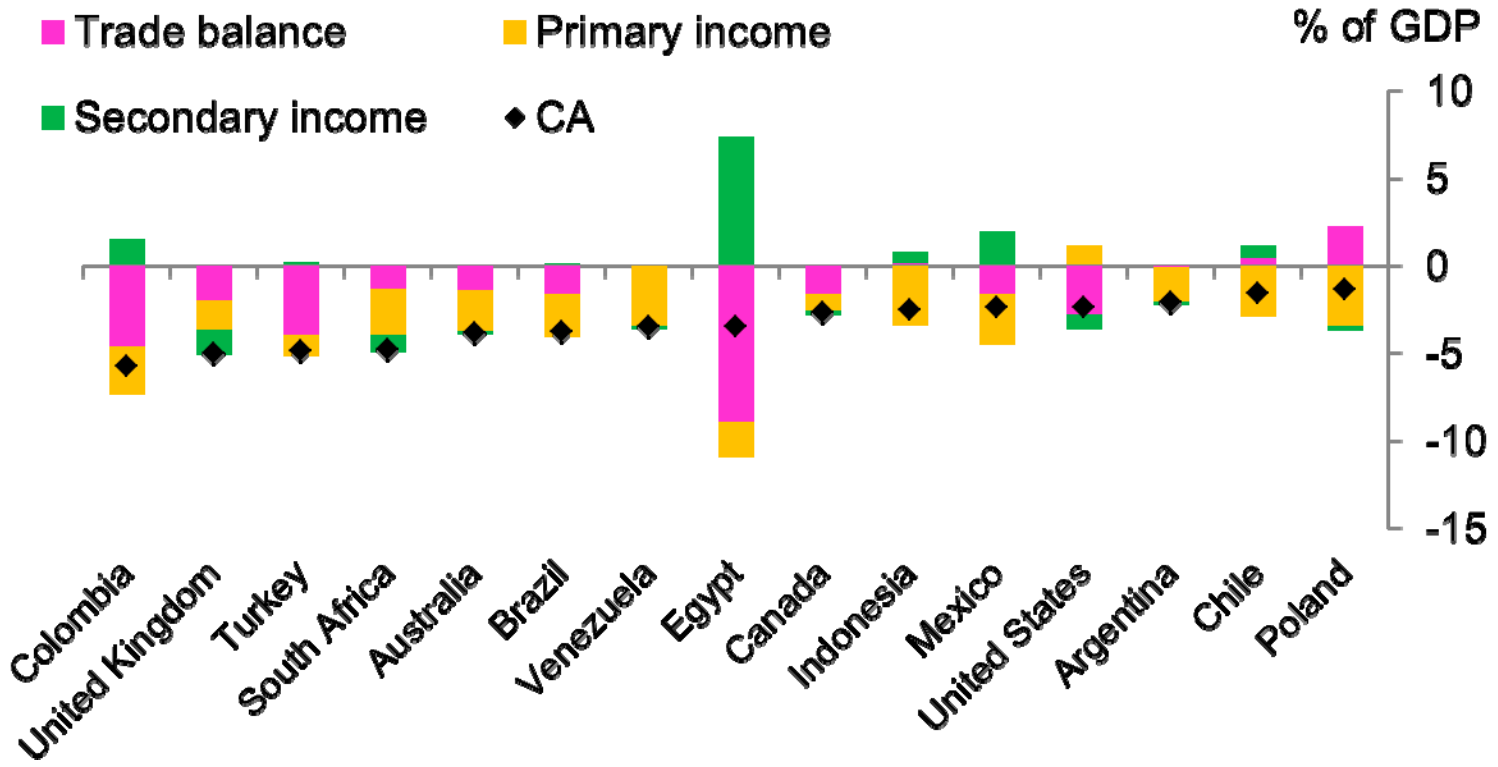
- Global concerns: Blanchard
  - Reflect domestic & systemic distortions
  - Increased domestic & systemic risks
- Domestic concerns/Current accounts: Obstfeld (2012)
  - Sudden stops
  - Deterioration in international investment position
  - Reflect unsustainable macro imbalances $\rightarrow$ painful reversals
- Other considerations: Forbes, Hjortsoe and Nenova (2016)
  - CA dynamics increasingly affected by changes in *investment income flows* instead of *trade*
  - Need to assess vulnerabilities related to how these flows are affected by various shocks

Current Account Balance ≠ Trade Balance

- $CA_{i,t} = TB_{i,t} + INVINC_{i,t} + SECINC_{i,t}$
  - *CA* = current account balance
  - *TB* = trade balance
  - *INVINC* = primary investment income on NIIP
  - *SECINC* = secondary investment income on NIIP
  - For country *i* at time *t*
- Larger gross positions & flows → greater impact of international investment income on current account
- Discussion of risks around imbalances needs to incorporate risks around investment income flows

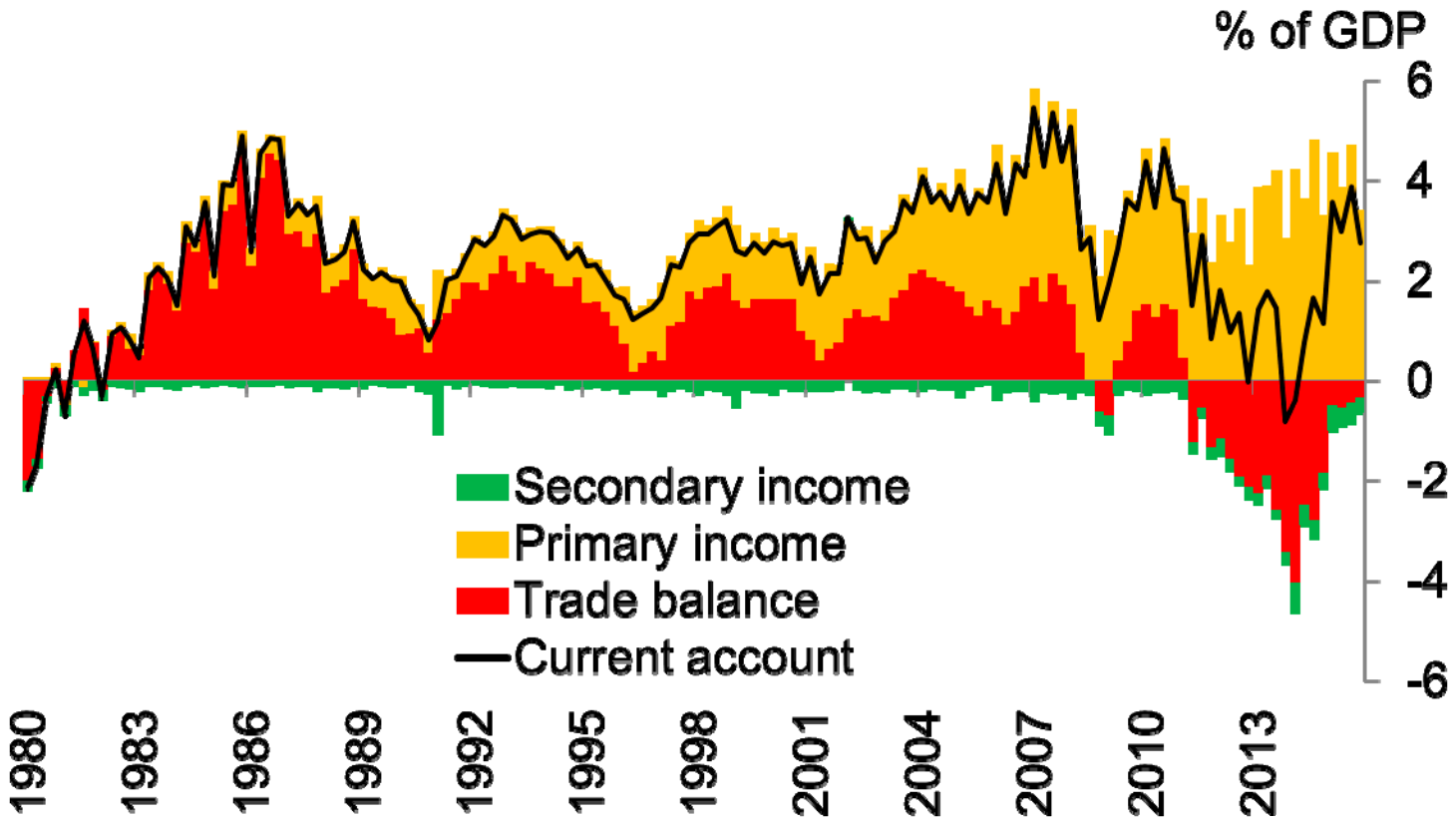
Current Account Deficit ≠ Trade Deficit

Largest average current account imbalances for 2014-15 and their composition



Sample includes all countries with available data and average 2014-15 GDP of at least $200bn

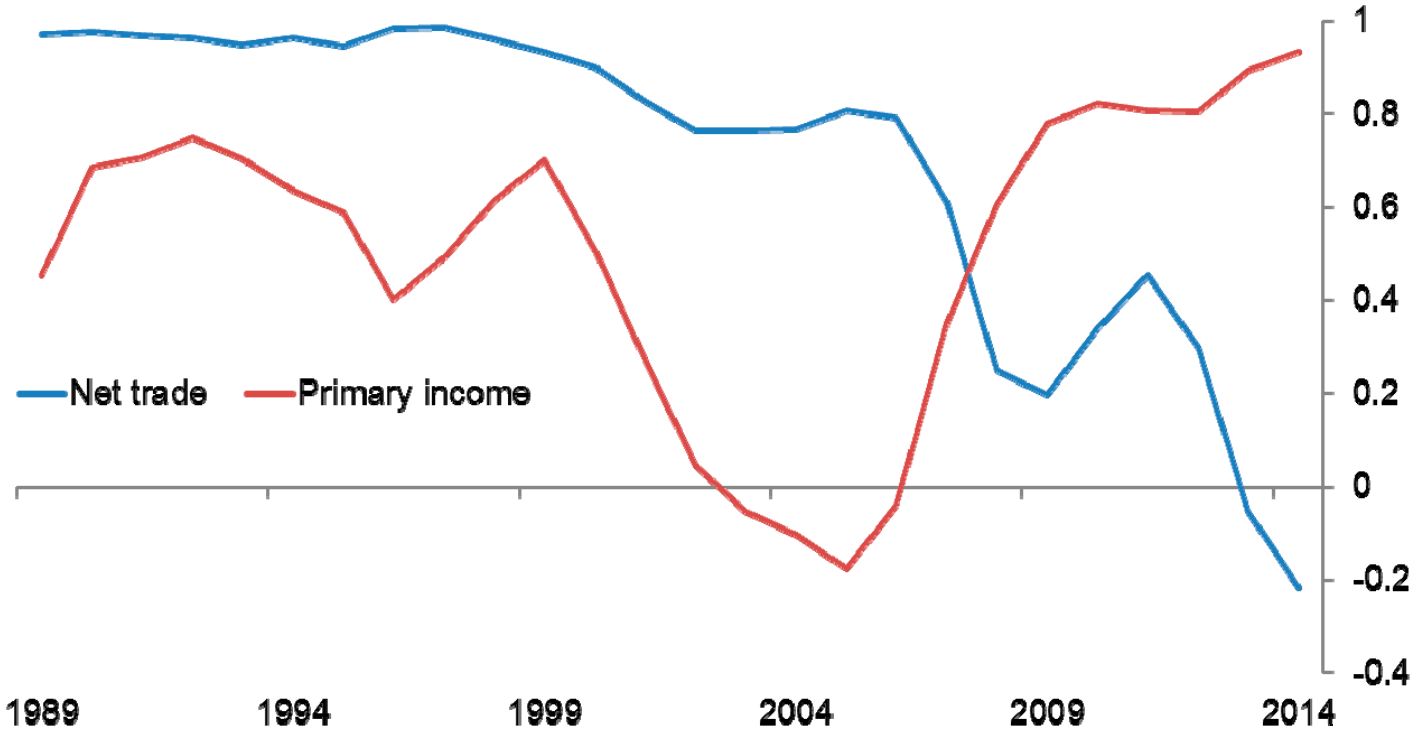
Japan: CA Surplus ≠ Trade Deficits



Source: Based on IMF, IFS data.

Key Driver of CA Dynamics

10-year rolling correlation between UK current account balance and its net trade and primary income components

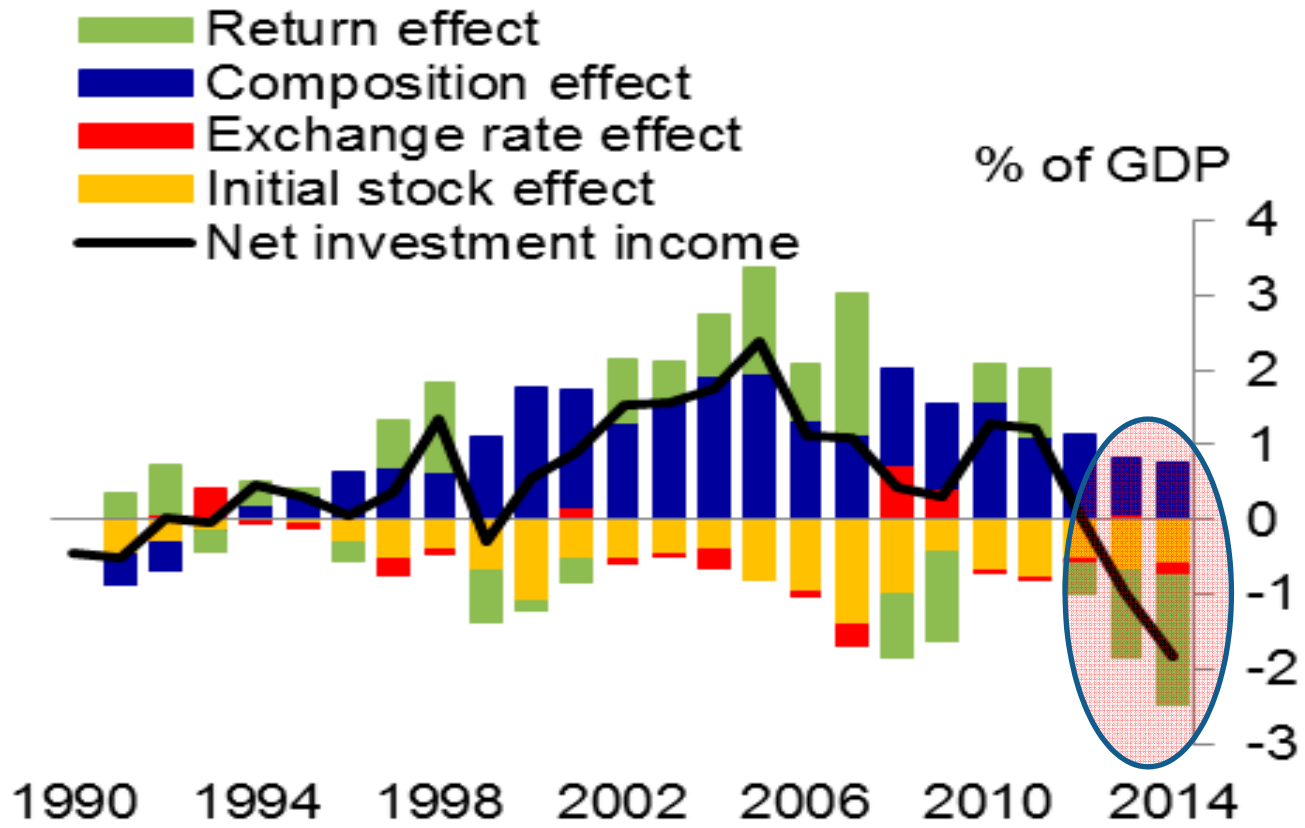


Implications

- Evaluation of vulnerabilities related to imbalances needs to pay greater attention to:
  - Investment income flows
  - How various shocks interact with these flows
  - Can these interactions mitigate or aggravate risks related to imbalances?
- Characteristics of a country's international portfolio determine if risks aggravated or mitigated during shocks
  - Size
  - Currency composition
  - Risk composition
  - Hedging ability of exchange rate

International Risk Sharing in UK

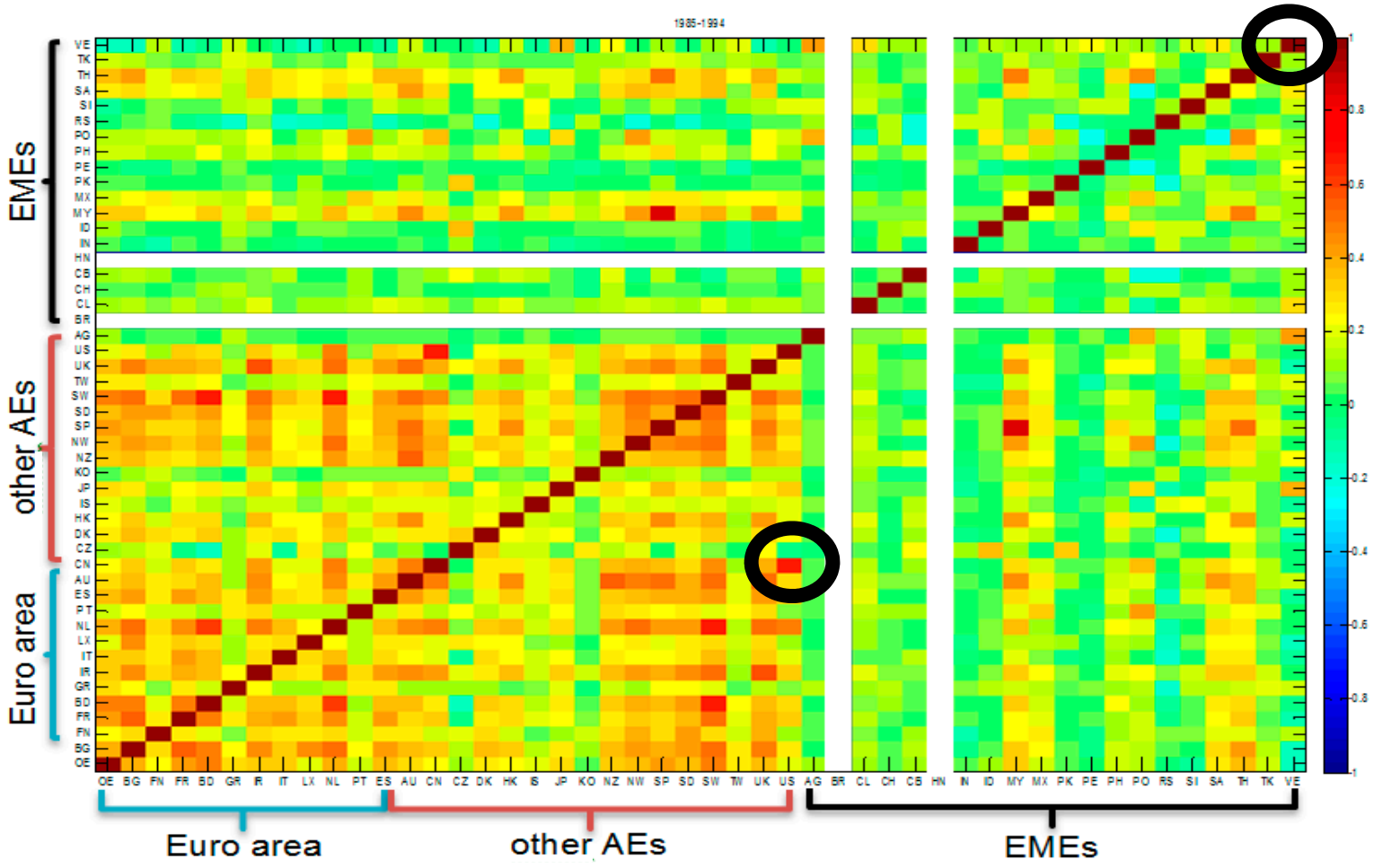
International Investment Income Decomposition



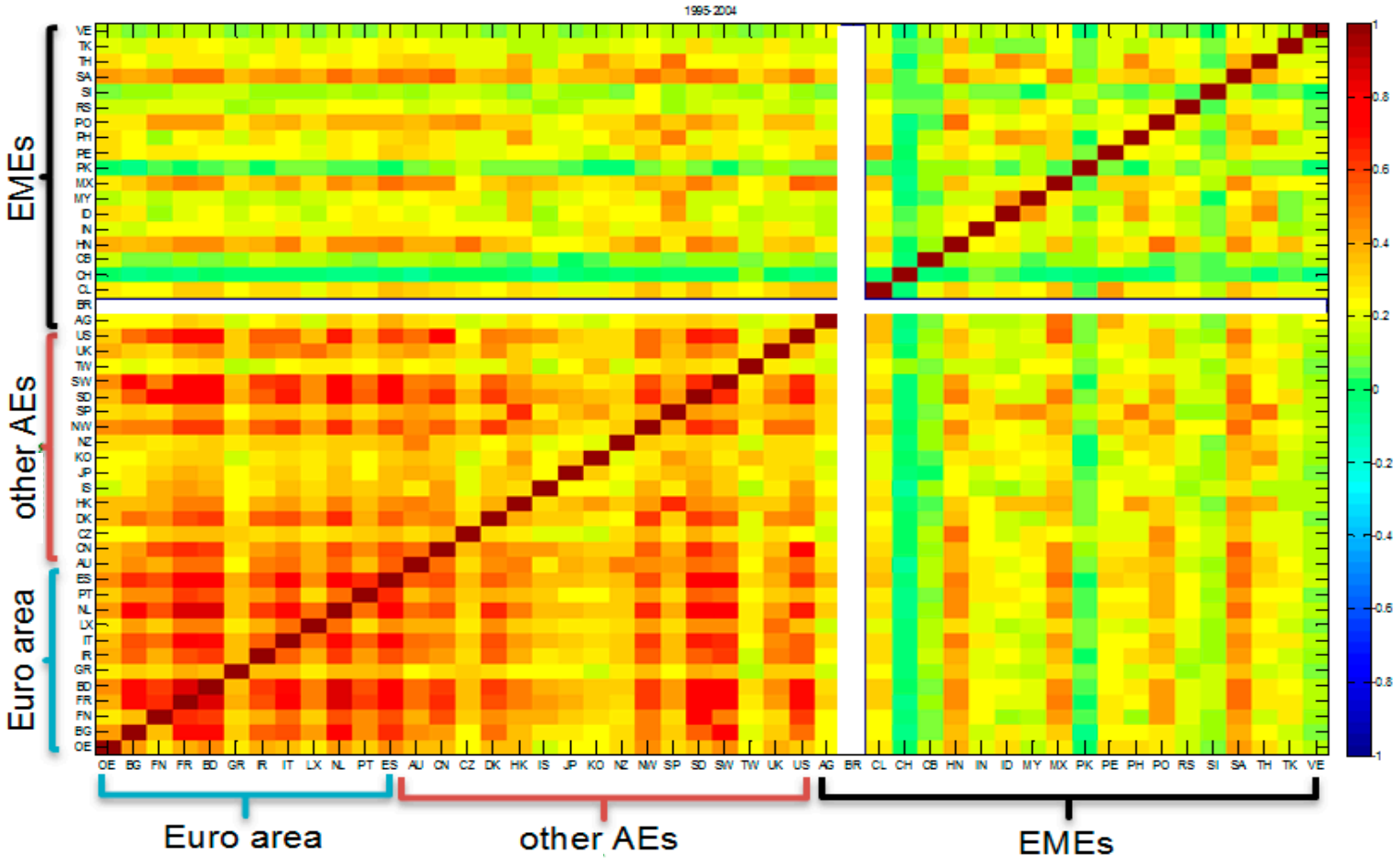
Source: Forbes, Hjortose and Nenova, (2016) "Current Account Deficits During Heightened Risk: Menacing or Mitigating?" Bank of England External MPC Unit Discussion Paper No. 46, forthcoming *Economic Journal*

Spillovers

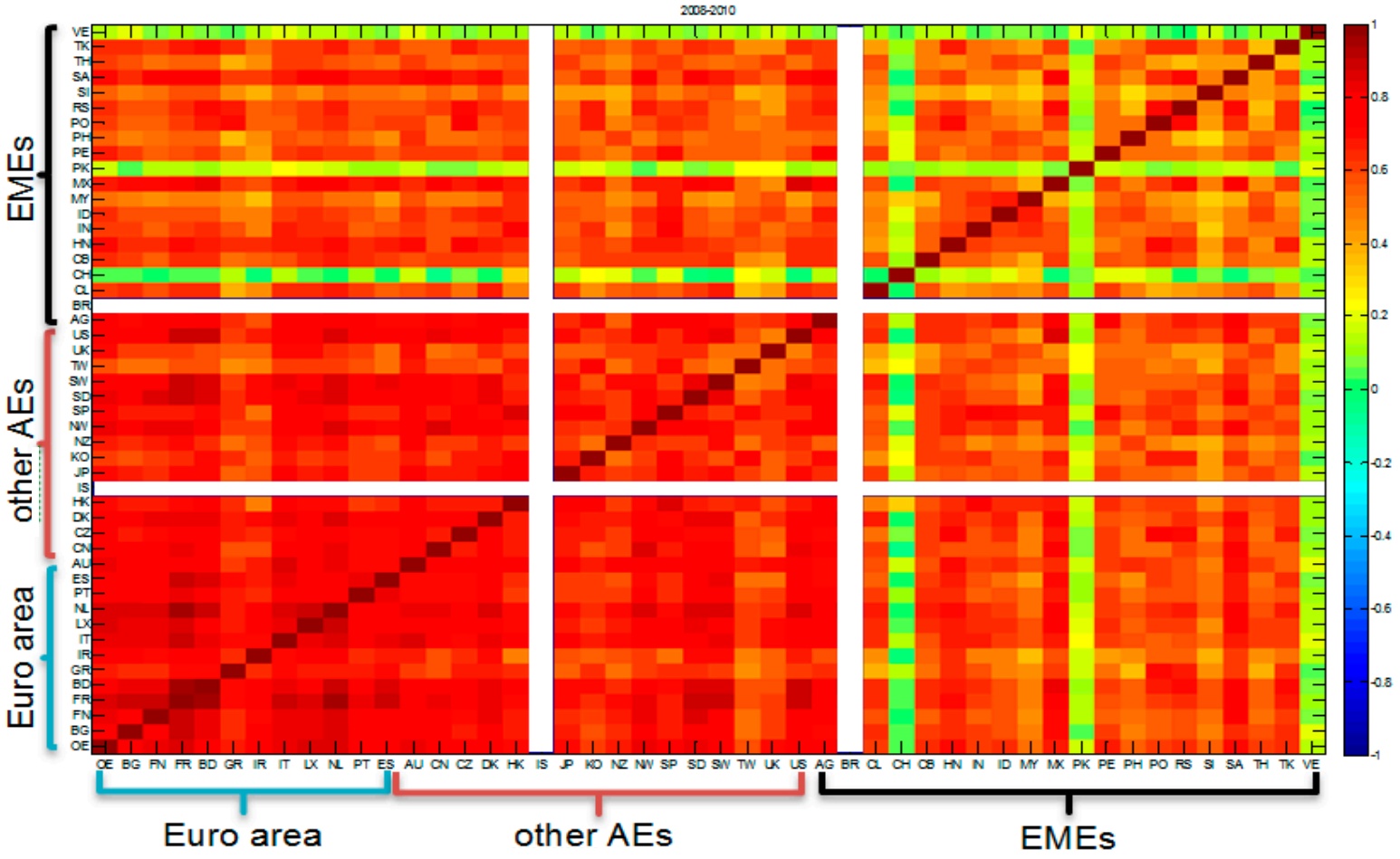
Equity Market Correlations: 1985-1994



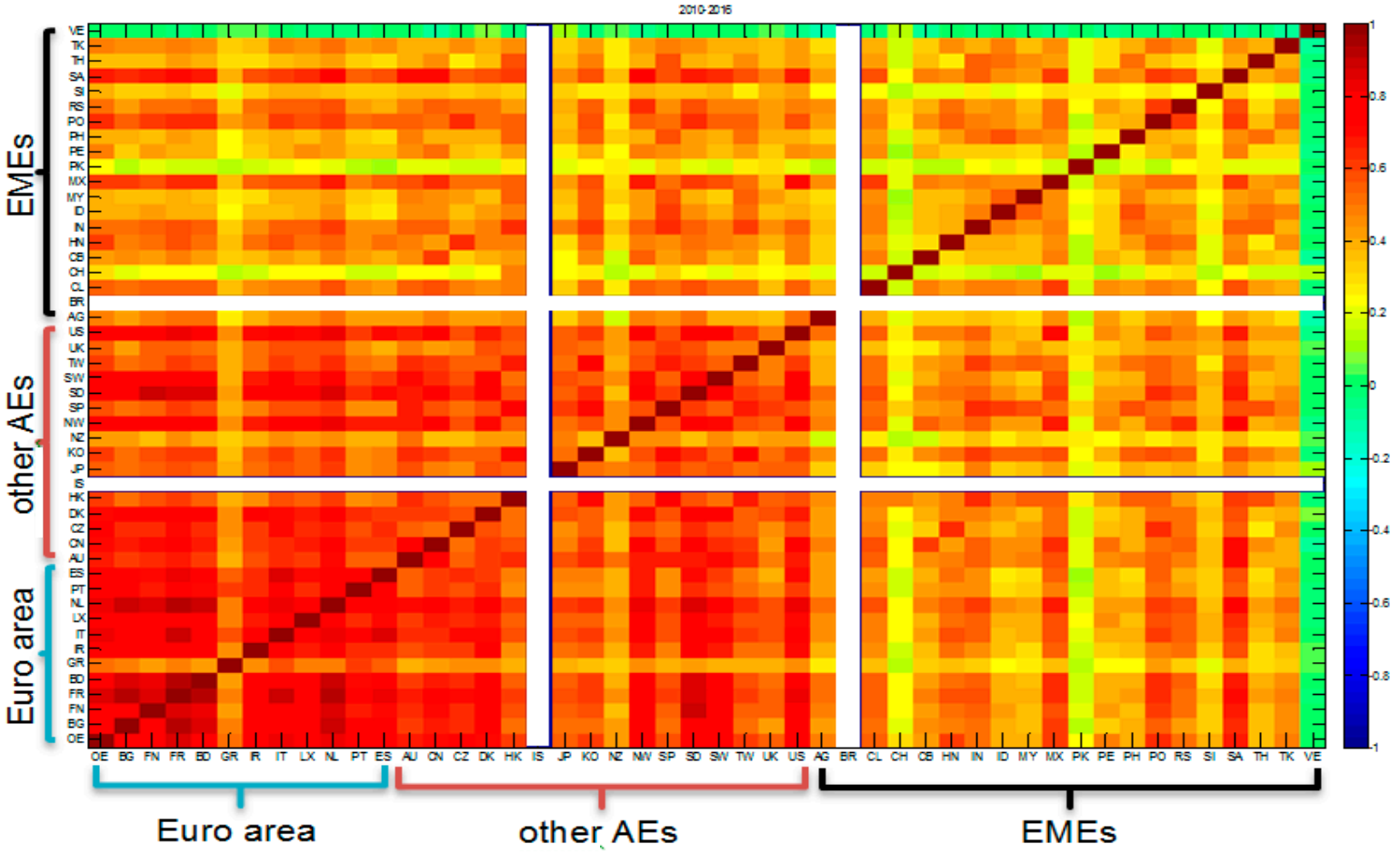
Equity Market Correlations: 1995-2004



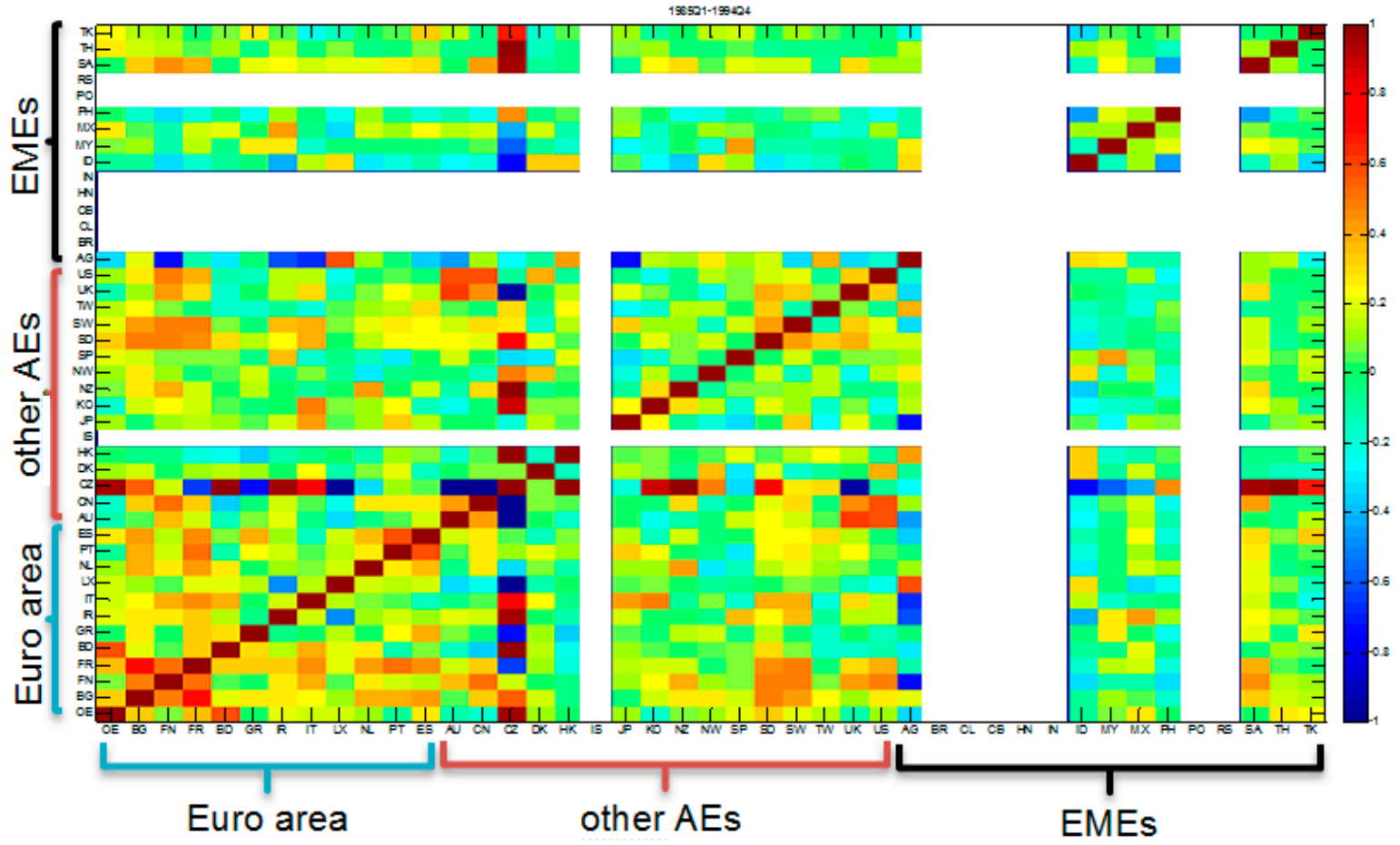
Equity Market Correlations: 2008-2010



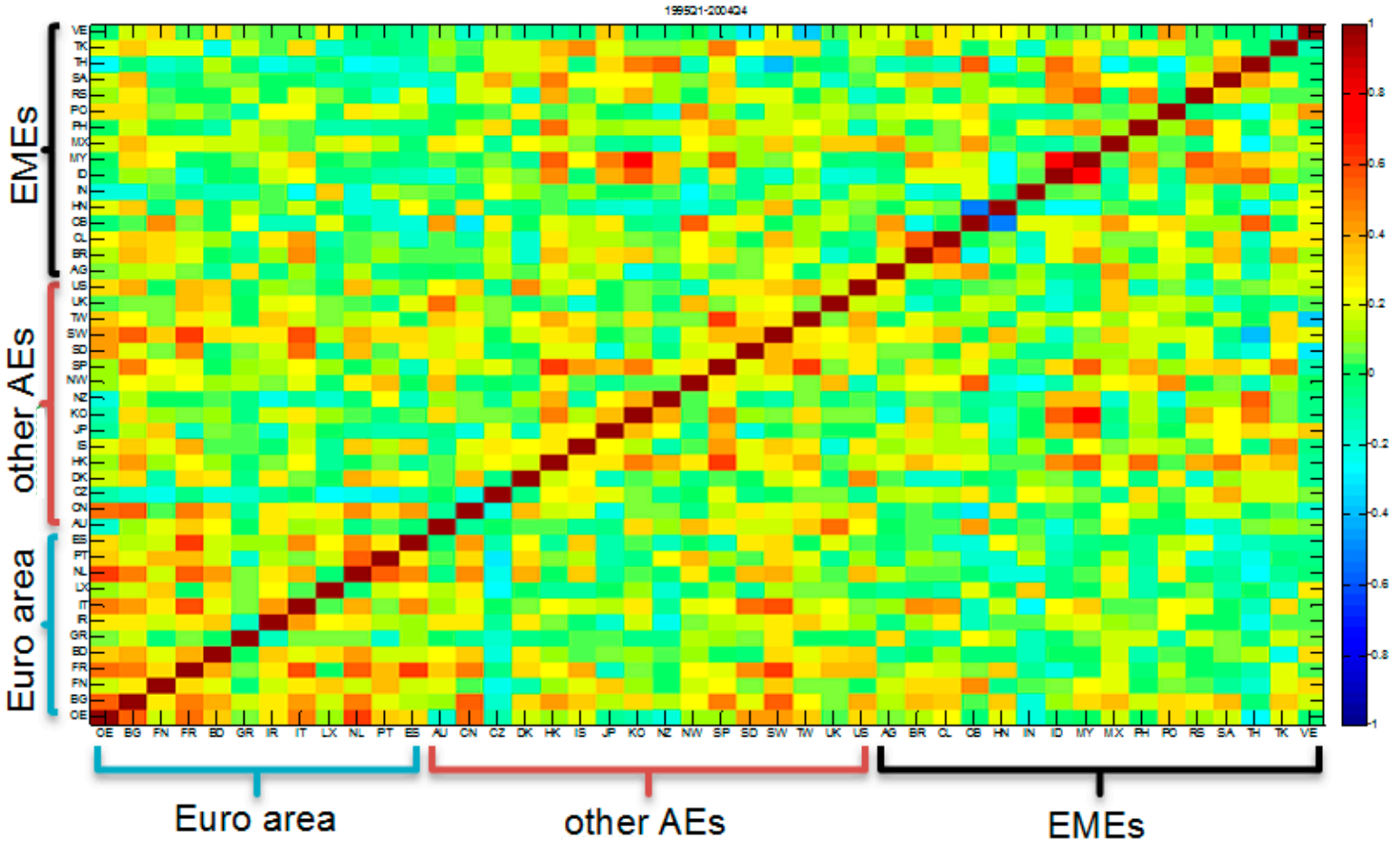
Equity Market Correlations: 2010-2016



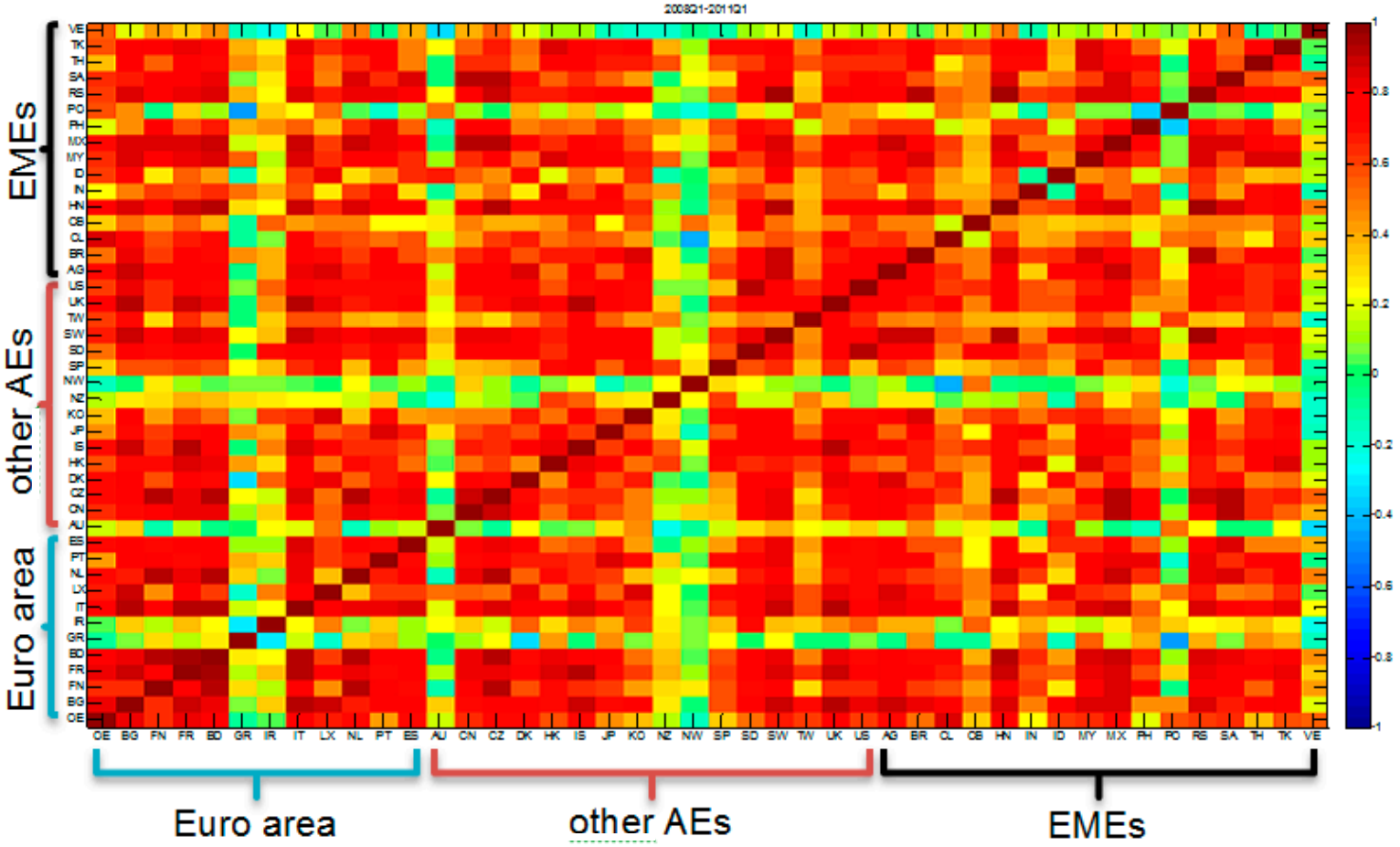
GDP Growth Correlations: 1985-1994



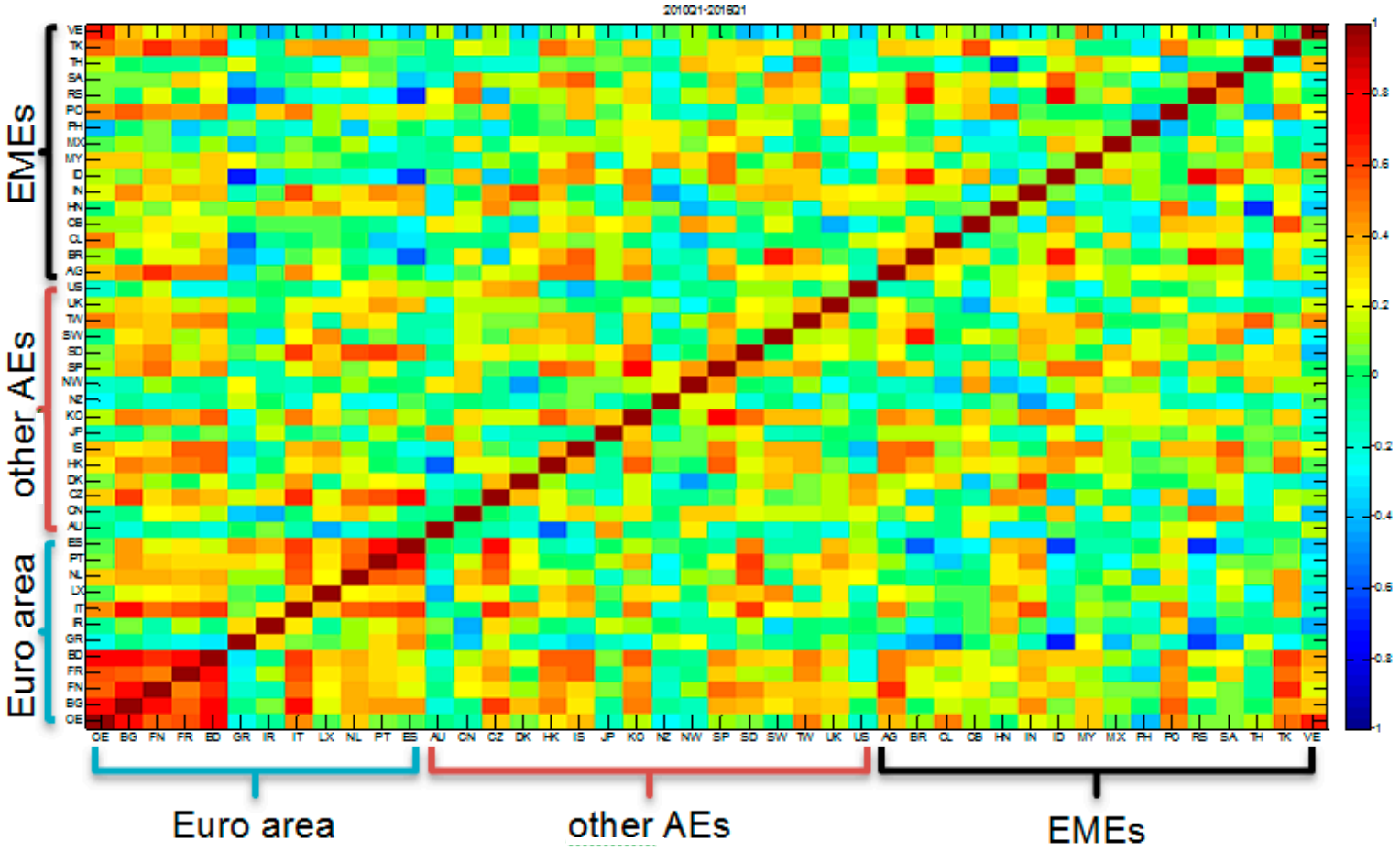
GDP Growth Correlations: 1995-2004



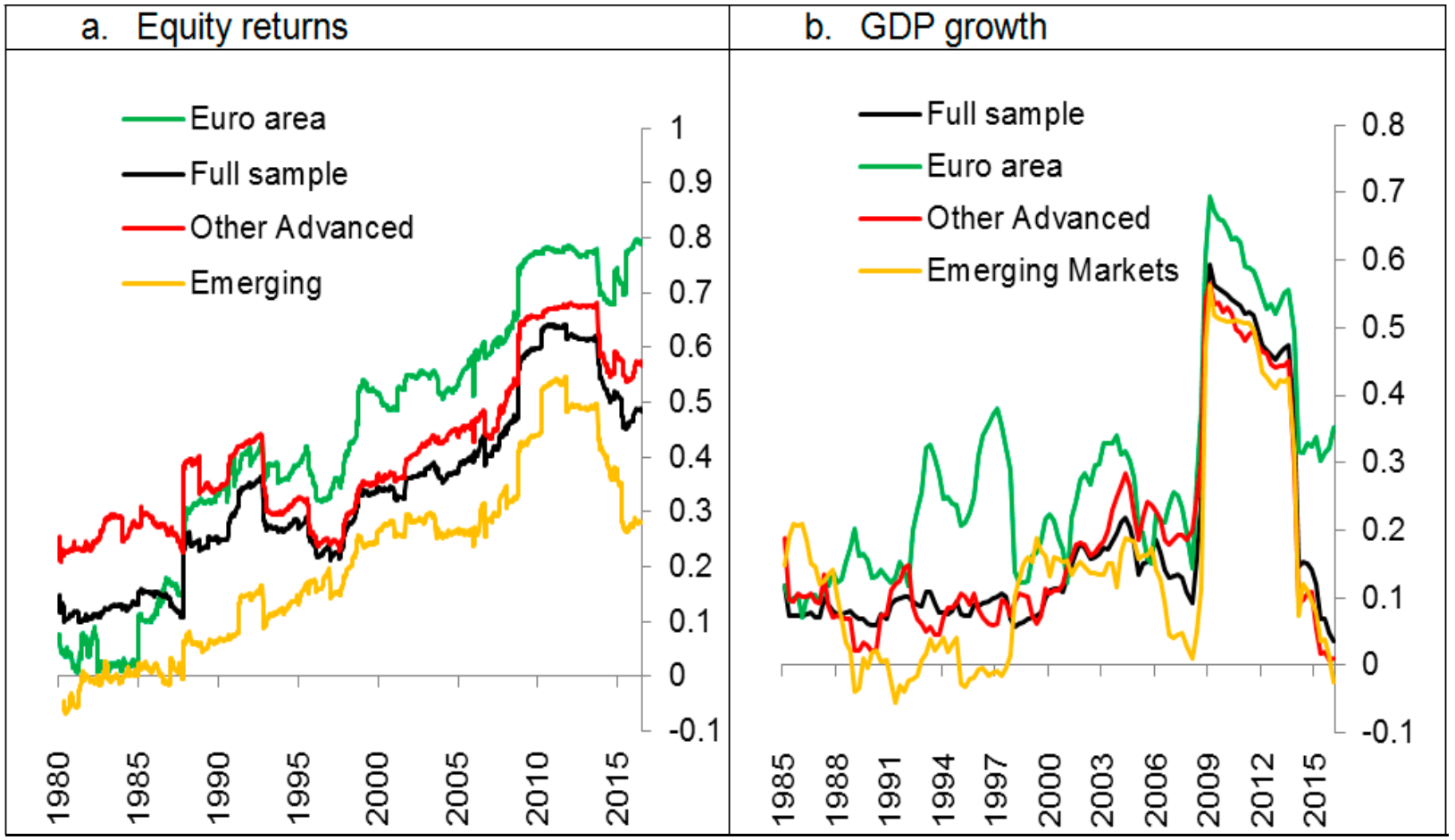
GDP Growth Correlations: 2008-2011



GDP Growth Correlations: 2010-2016



Five-year Rolling Correlations

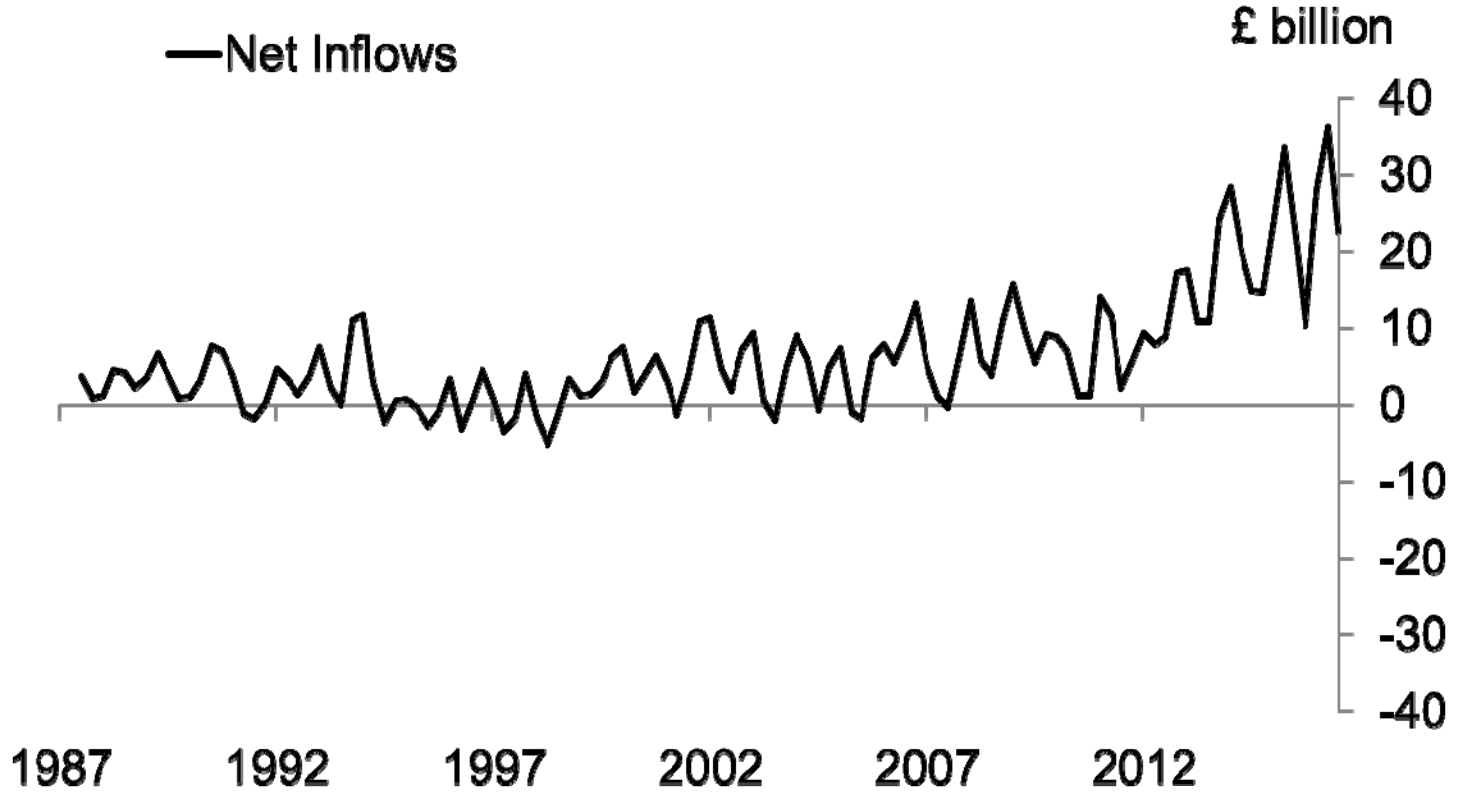


Source: Forbes, "Global Economic Tsunamis: Coincidence, Common Shocks, or Contagion" Speech at Imperial College on Sept. 22, 2016, available on Bank of England website.

Why?
What are the implications?

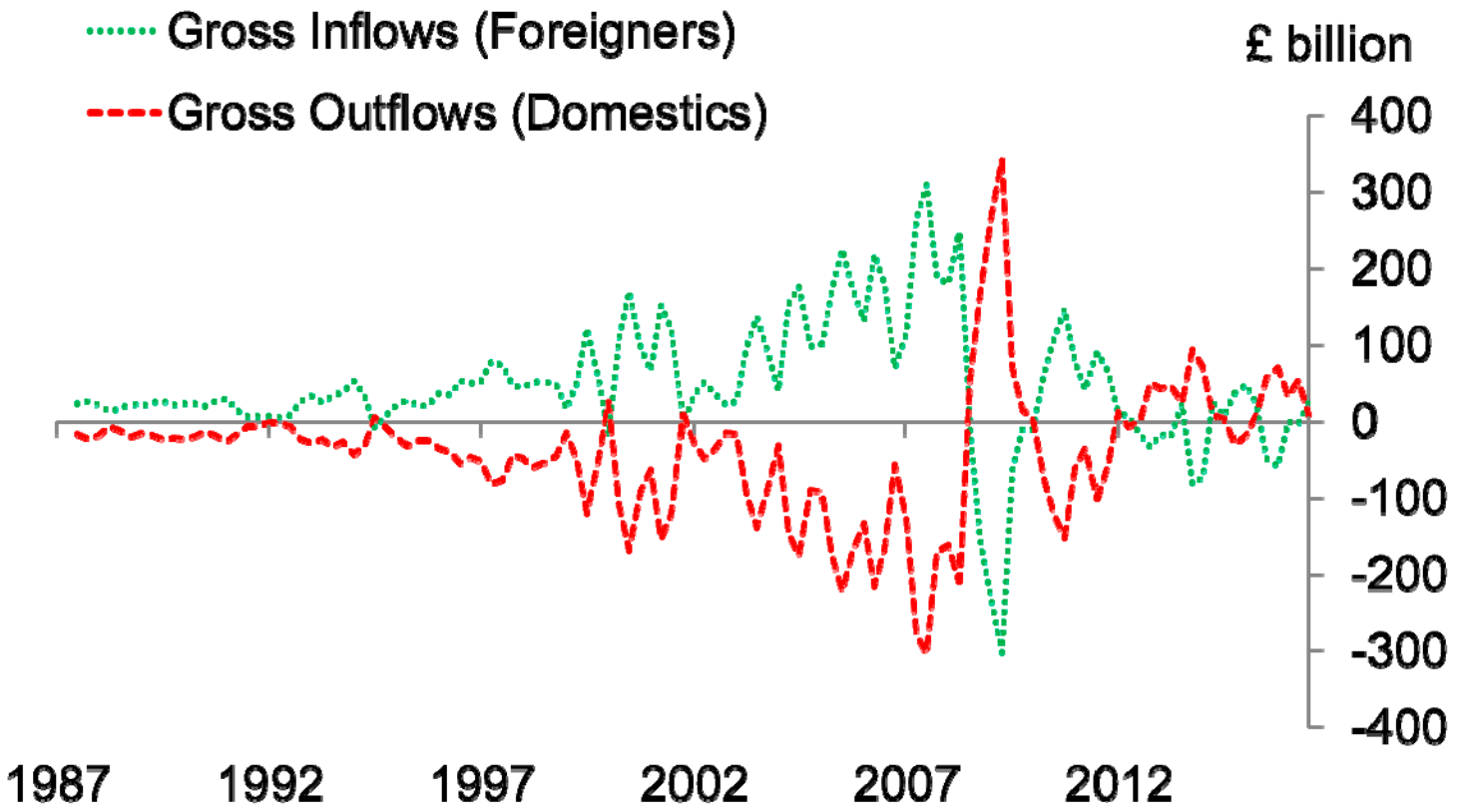
Extra

UK Net Capital Flows (opposite of CA)



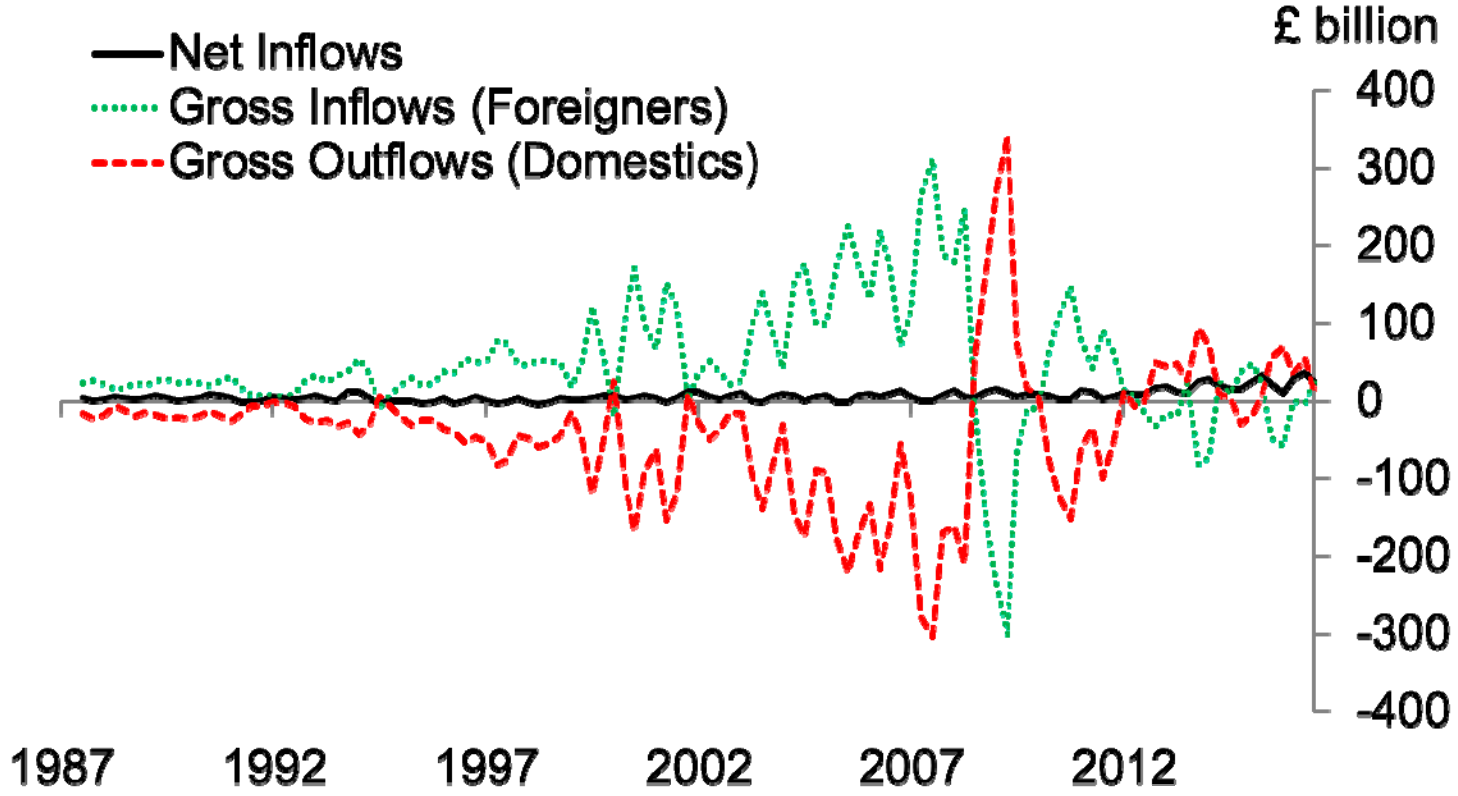
Source: Bank of England, ONS

UK Gross Capital Flows



Source: Bank of England, ONS

UK: Putting the Flows in Perspective



Source: Bank of England, ONS

Framework: Heightened UK Risk

Variables Determining the NIIP Impact	Risk sharing is higher if…	Average of 10 OECD countries with floating ERs	Does this apply to the UK?
Composition of liabilities	…. the riskier are liabilities i.e. the higher is the proportion of equity liabilities relative to debt liabilities	44% share equity in liabilities	27%
Currency denomination of assets	… the higher the proportion of assets denominated in foreign currency	90% of assets denominated in foreign currency	93%
Currency denomination of liabilities	… the lower the proportion of liabilities denominated in foreign currency	43% of liabilities denominated in foreign currency	58%
Hedging ability of ER wrt capital gains on liabilities	…the less does the exchange rate associated with liabilities co-move with their capital gains	26% correlation between ER & foreign currency capital gains on liabilities	52%
Hedging ability of ER wrt returns on liabilities	…the less does the exchange rate associated with liabilities co-move with their rate of return	10% correlation between ER & foreign currency return on liabilities	-14%