

Europe and Global Imbalances

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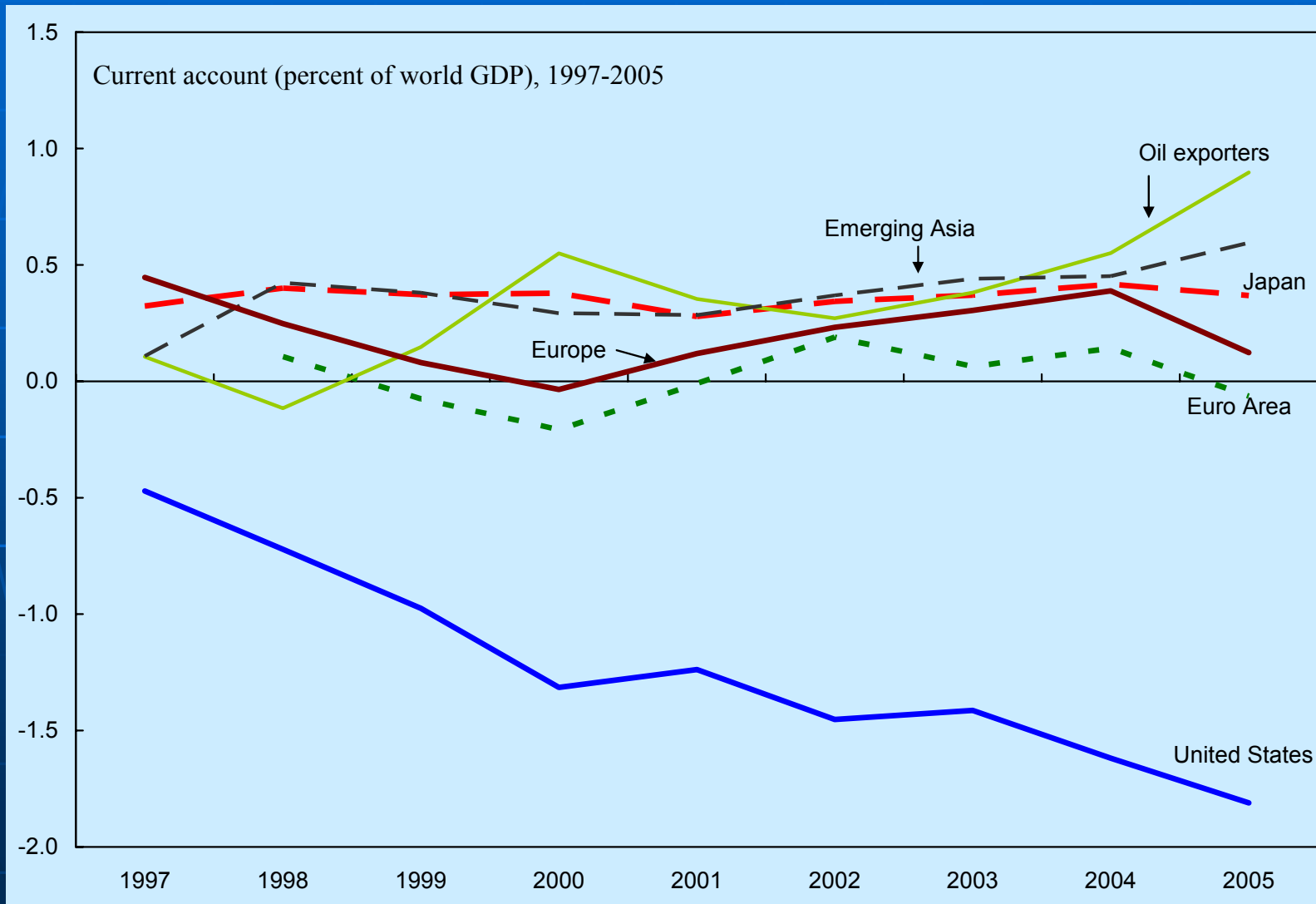
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What We Do

- Large CA imbalances: US deficit; surpluses in Asia and oil exporters...but Europe in broad balance
- How would Europe be affected by reduced imbalances?
 - Stylized facts on Europe's NFA, trade and financial linkages
 - Alternative CA adjustment scenarios simulated with IMF's Global Economic Model (GEM)
 - Add valuation channel, involving quantification of net dollar exposures
 - Address heterogeneity in trade, finance and external positions

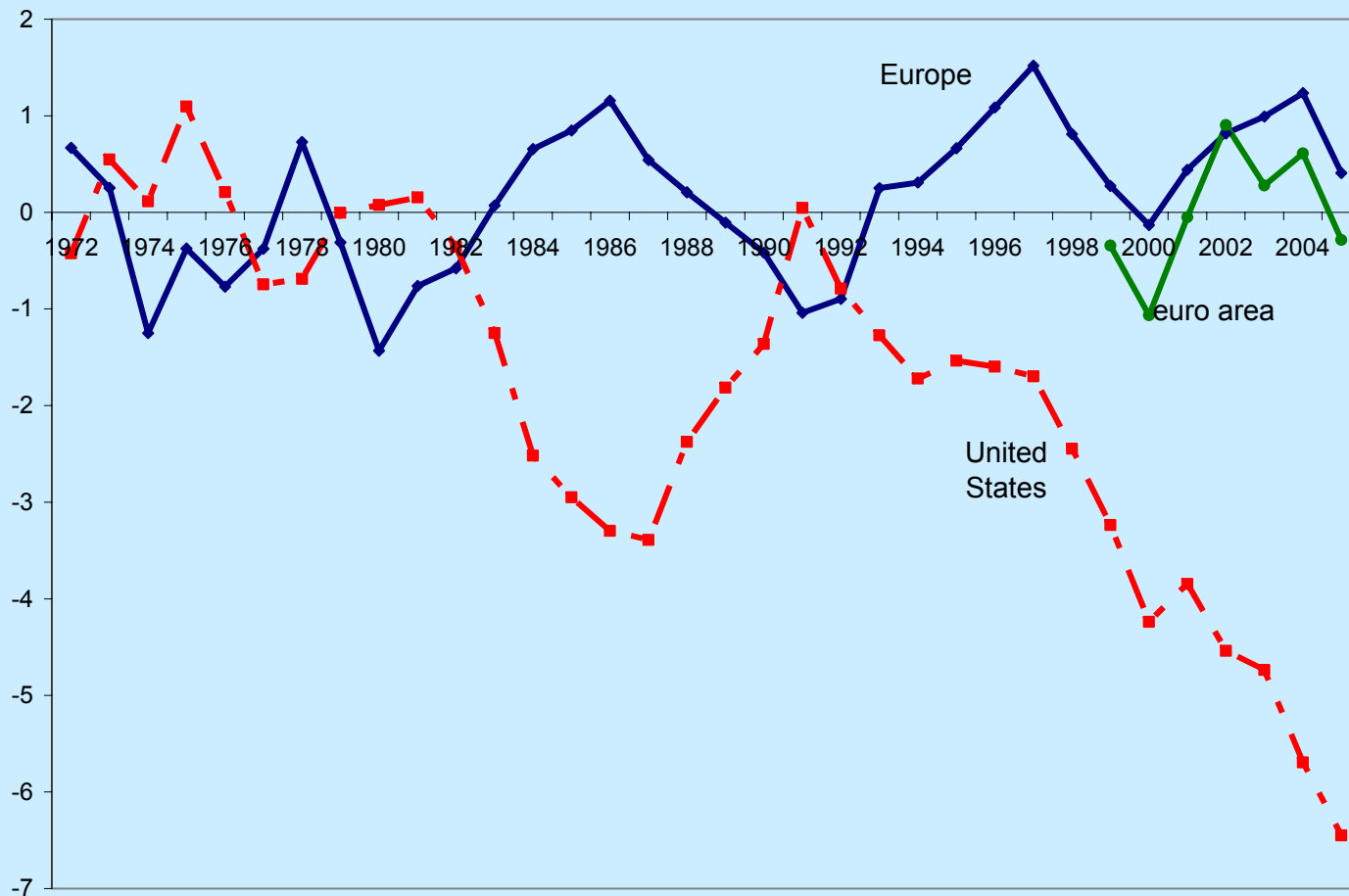
Review: Evolution of Global Imbalances

Europe: a "sideshow" now...



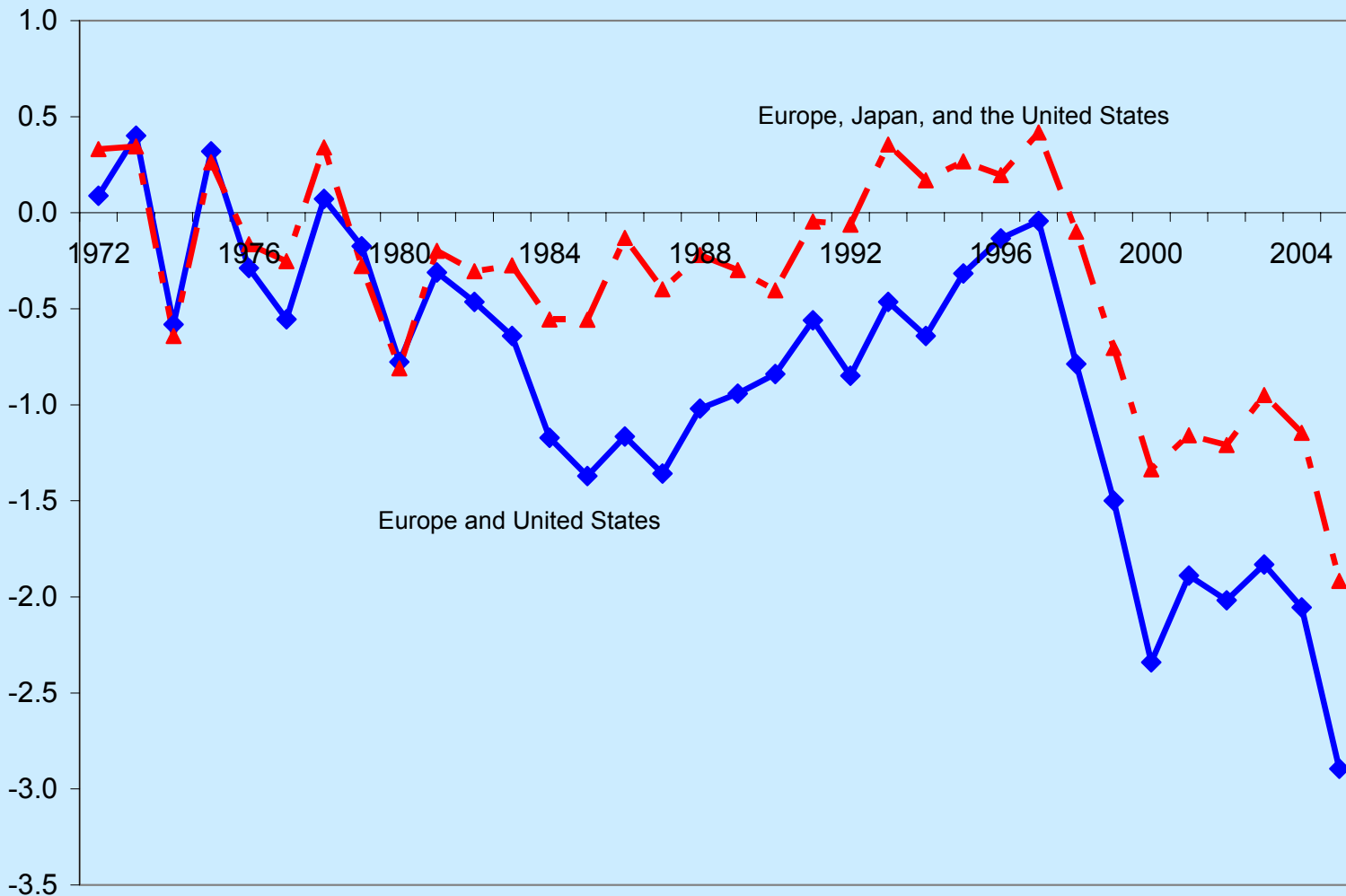
..but it was not always so...

Figure 2. Current account balances: Europe versus the United States (percent of GDP)



The G-3 and imbalances

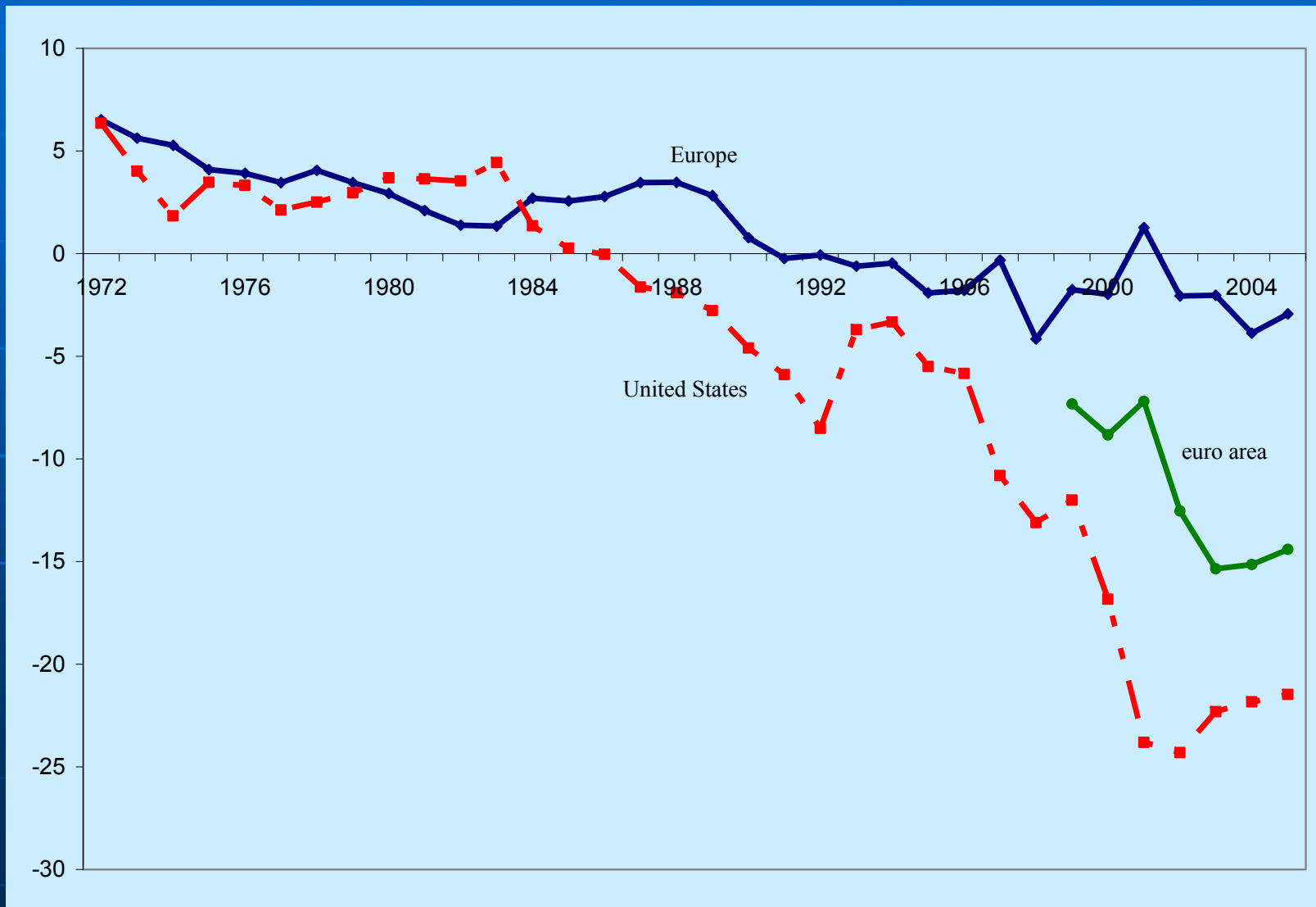
Figure 3. Current account: aggregate balance of Europe, Japan, and United States (percent of GDP)



Trade and Financial Linkages

- Trade links between Europe and US/Asia relatively small (but trade with Asia has grown rapidly in last 20 years)
- CA deficits only one factor in evolution of NFA positions: significant valuation effects over the past 4 years – in part, linked to euro/\$ rate
- Valuation channel increasing in importance, in line with scale of financial globalization

NFA in Europe and the US (pct of GDP)



International Adjustment

- Timing of adjustment open to debate....
- ...but will happen at some point
- Soft-landing scenario: (gradual reallocation in demand and production, smooth exch. rate adjustment)
- Hard-landing scenario: rapid CA reversals; large movements in currencies and asset prices; possible recessionary impact;
- Role of policy action: fiscal policy in US; structural reforms in Europe and Japan; exch. rate flexibility in Asia

The Global Economic Model

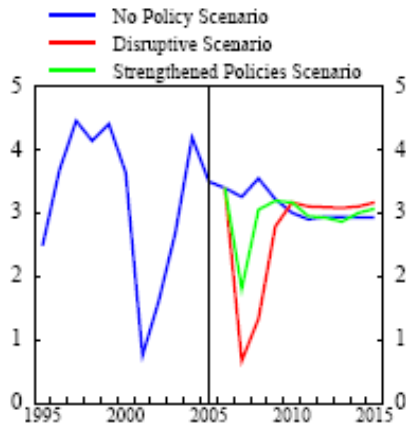
- 4 regions: US; euro area/Japan; Emg Asia; ROW
- Imperfect competition in product and labor mkts; nominal rigidities; adjustment costs
- Internat. bond trade, country risk premium
- Taylor monetary rules, except emerging Asia; fiscal policy stabilizes D/Y in medium-term
- External imbalances reflect different saving rates, plus portfolio preference shock favoring the US

Scenarios

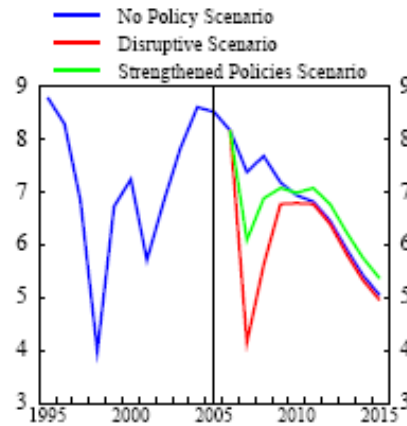
- Baseline scenario: negative shock to US private savings unwinds slowly
- Disruptive scenario: reversal of portfolio shift towards US assets; realignment in Asian currencies; increase in margins
- “Policies” scenario:
 - (i) reduction in US fiscal deficit;
 - (ii) increased exchange rate flexibility in Asia, rise in consumption;
 - (iii) structural reforms in euro area and Japan;
 - (iv) rise in domestic investment in oil exporters

Figure 6. Adjustment of Global Imbalances

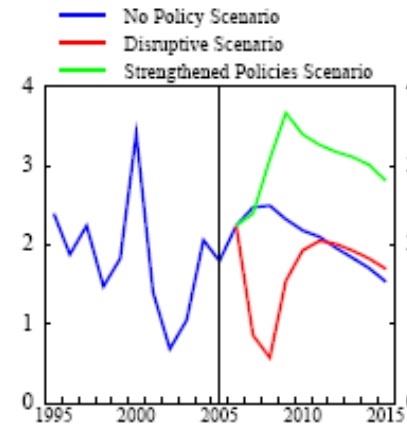
United States
Output Growth
(In percent)



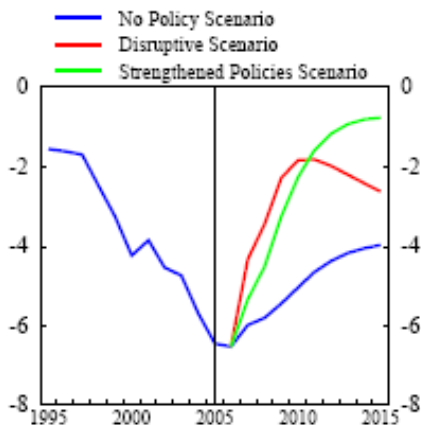
Emerging Asia
Output Growth
(In percent)



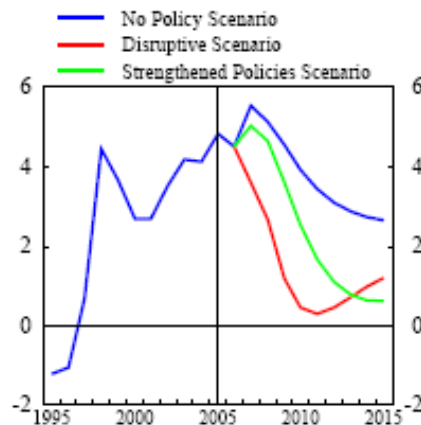
Japan/Euro Area
Output Growth
(In percent)



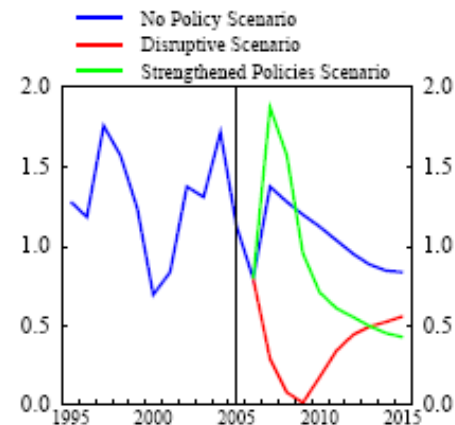
Current Account
(Percent of GDP)



Current Account
(Percent of GDP)



Current Account
(Percent of GDP)



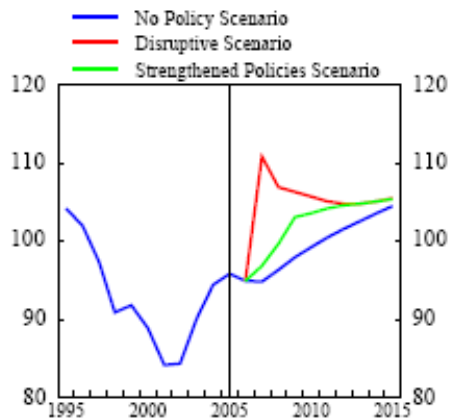
Real Effective Exchange Rate
(Index: 1990=100)

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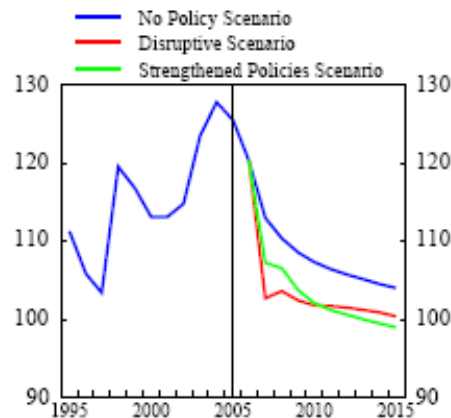
Real Effective Exchange Rate
(Index: 1990=100)

GEM scenarios (II)

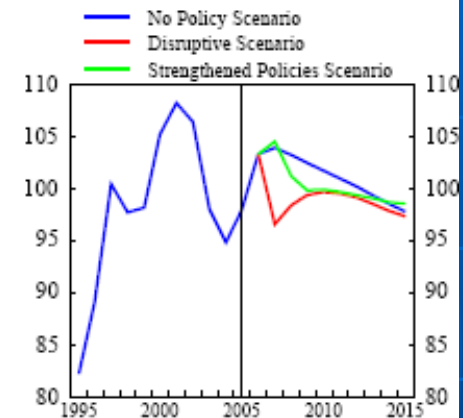
Real Effective Exchange Rate
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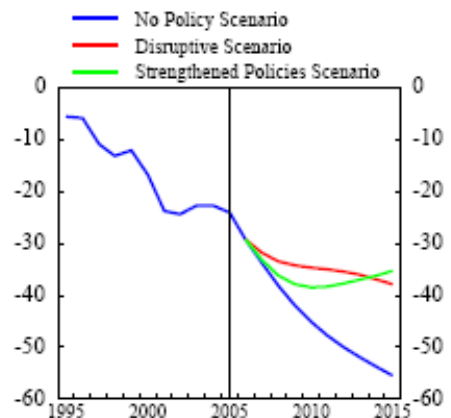
Real Effective Exchange Rate
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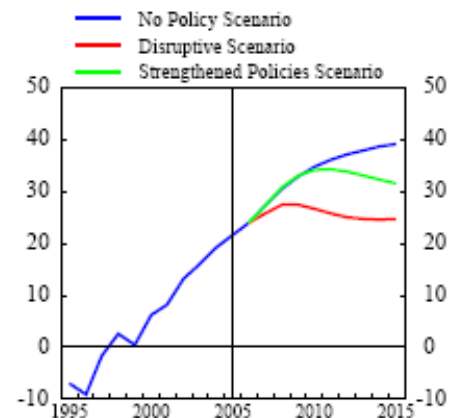
Real Effective Exchange Rate
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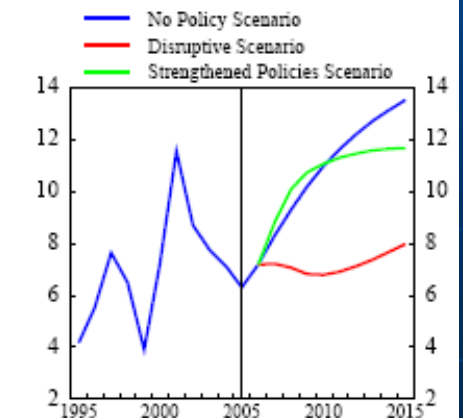
Net Foreign Assets
(Percent of GDP)



Net Foreign Assets
(Percent of GDP)



Net Foreign Assets
(Percent of GDP)



Implications for euro area

- Japan a creditor, euro area a debtor; euro has appreciated in recent years, while yen has depreciated
- Scale of CA and REER adjustment plausibly greater in Japan than in euro area

Valuation Channel

- Not included in GEM analysis
- Require information on currency and asset composition of the international balance sheet for main blocs (in 2005)
- Projections for composition of future gross capital flows, consistent with GEM's prediction for the current account
- Treat Japan and euro area separately; China as key country in emerging Asia

Key assumptions

- Value of dollar-denominated assets changes in line with movements in the dollar
- Value of portfolio equity assets rises in line with GDP growth rate

Net foreign assets and currency composition at end-2005

	Net external position	Net domestic currency position	Net U.S. dollar position	Net other currencies position
China	12.5	-28.3	29.2	11.6
Euro Area	-15.0	-65.5	16.8	34.5
Japan	35.9	-26.9	38.5	21.9
United States	-21.5	(-74.8)	-74.8	53.4

Flavor of quantitative results

- Large capital losses in China and Japan (can be over 10% of GDP over M-T)
- Smaller K-losses in Europe (smaller RER depreciation, smaller \$ exposure)
- Capital gains in United States

Valuation changes: baseline

	China	Euro Area	Japan	United States
Net foreign assets, 2005 (pct of GDP)	12.5	-15.0	35.9	-21.5
Baseline				
Net foreign assets, 2008 (pct of GDP)	24.0	-16.3	34.3	-33.5
PV cap. gains/losses by 2008 (pct of 2005 GDP)	-4.0	-3.5	-8.6	2.1
of which: exchange rate-related capital gains	-3.0	-4.3	-8.1	0.4
Net foreign assets, 2015 (pct of GDP)	26.1	-14.4	38.0	-43.4
PV cap. gains/losses by 2015 (pct of 2005 GDP)	-18.4	-5.5	-16.3	8.4
of which: exchange rate-related capital gains	-12.4	-7.6	-16.0	3.9

Disruptive and Policy scenarios

	China	Euro Area	Japan	United States
Policies scenario				
Net foreign assets, 2008 (pct of GDP)	21.9	-15.8	33.9	-30.9
PV of capital gains/losses by 2008 (pct of 2005 GDP)	-5.2	-3.6	-9.3	3.7
of which: exch. rate-related capital gains	-4.2	-3.9	-8.4	1.8
Disruptive scenario				
Net foreign assets, 2008 (pct of GDP)	15.5	-18.0	23.6	-24.7
PV of capital gains/losses by 2008 (pct of 2005 GDP)	-16.0	-4.1	-17.2	6.9
of which: exch. rate-related capital gains	-15.1	-5.0	-16.1	5.1

Heterogeneity

- Trade linkages: variation in trade with US and Asia
- Financial linkages: variation in dollar exposures (Ireland, euro 'outs')
- External Positions: surplus versus deficit countries (inside and outside EMU)

Table 9: Selected External Positions

	CA	NFA	Net Equity	Net Debt
Norway	16.8	75.0	50.1	24.9
Switzerland	13.8	93.1	6.7	86.3
Sweden	6.1	-9.4	41.2	-50.0
Germany	4.1	12.8	14.3	-1.6
CEEC	-4.7	-51.5	-42.5	-9.0
Spain	-7.6	-49.3	-8.8	-40.5
Greece	-7.9	-79.2	-20.5	-59.0
Portugal	-9.2	-64.6	-29.5	-35.1

Heterogeneity: Policy Issues

- Adjustment as an asymmetric shock, requiring bilateral RER changes
- Inflation differentials within euro area
- Vulnerability of some currencies in CEEC group?
- Key factor: behavior of international financial mkts during adjustment

Conclusions

- Spillover impact on Europe larger than 20 years ago – but still limited
- Trade and valuation effects on Asia much stronger
- GEM simulations: substantial real dollar depreciation
- Open question: currency flexibility in Asia

Conclusions (II)

- Valuation channel
- Risks of a disruptive scenario: policy responsiveness in Europe
- Euro as an alternative reserve currency?

Trade linkages (exports+imports/GDP)

1984

Trading Partner→ Country/Region ↓	Europe 1/	United States	Japan	Emerg. Asia	Other	Total
Euro Area	8.0	4.0	1.1	1.5	12.4	26.9
United States	3.3		2.1	2.1	6.7	14.2
Japan	2.9	6.9		6.1	8.3	24.3
Emerging Asia	5.7	9.3	8.6		9.7	33.3

2004

Trading Partner→ Country/Region ↓	Europe 1/	United States	Japan	Emerg. Asia	Other	Total
Euro Area	8.6	3.9	1.2	4.0	12.1	29.9
United States	4.2		1.6	4.6	9.7	20.0
Japan	3.3	4.2		10.2	4.6	22.2
Emerging Asia	12.1	12.1	11.5		19.2	54.9