Europe and Global Imbalances

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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...

Current account (percent of world GDP), 1997-2005

- United States
- Japan
- Euro Area
- Oil exporters
- Emerging Asia
- Europe
- United States

..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
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)

Real Effective Exchange Rate
(Index: 1990=100)

Real Effective Exchange Rate
(Index: 1990=100)
GEM scenarios (II)

- Real Effective Exchange Rate
  (Index: 1990=100)
  - No Policy Scenario
  - Disruptive Scenario
  - Strengthened Policies Scenario

- Net Foreign Assets
  (Percent of GDP)
  - No Policy Scenario
  - Disruptive Scenario
  - Strengthened Policies Scenario
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

<table>
<thead>
<tr>
<th></th>
<th>Net external position</th>
<th>Net domestic currency position</th>
<th>Net U.S. dollar position</th>
<th>Net other currencies position</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>12.5</td>
<td>-28.3</td>
<td>29.2</td>
<td>11.6</td>
</tr>
<tr>
<td>Euro Area</td>
<td>-15.0</td>
<td>-65.5</td>
<td>16.8</td>
<td>34.5</td>
</tr>
<tr>
<td>Japan</td>
<td>35.9</td>
<td>-26.9</td>
<td>38.5</td>
<td>21.9</td>
</tr>
<tr>
<td>United States</td>
<td>-21.5</td>
<td>(-74.8)</td>
<td>-74.8</td>
<td>53.4</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
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<th>Japan</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net foreign assets, 2005 (pct of GDP)</strong></td>
<td>12.5</td>
<td>-15.0</td>
<td>35.9</td>
<td>-21.5</td>
</tr>
<tr>
<td><strong>Baseline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net foreign assets, 2008 (pct of GDP)</strong></td>
<td>24.0</td>
<td>-16.3</td>
<td>34.3</td>
<td>-33.5</td>
</tr>
<tr>
<td><strong>PV cap. gains/losses by 2008 (pct of 2005 GDP)</strong></td>
<td>-4.0</td>
<td>-3.5</td>
<td>-8.6</td>
<td>2.1</td>
</tr>
<tr>
<td>of which: exchange rate-related capital gains</td>
<td>-3.0</td>
<td>-4.3</td>
<td>-8.1</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Net foreign assets, 2015 (pct of GDP)</strong></td>
<td>26.1</td>
<td>-14.4</td>
<td>38.0</td>
<td>-43.4</td>
</tr>
<tr>
<td><strong>PV cap. gains/losses by 2015 (pct of 2005 GDP)</strong></td>
<td>-18.4</td>
<td>-5.5</td>
<td>-16.3</td>
<td>8.4</td>
</tr>
<tr>
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<td>-12.4</td>
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<td>-16.0</td>
<td>3.9</td>
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### Disruptive and Policy scenarios

<table>
<thead>
<tr>
<th>Policies scenario</th>
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<th>Japan</th>
<th>United States</th>
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<tbody>
<tr>
<td>Net foreign assets, 2008 (pct of GDP)</td>
<td>21.9</td>
<td>-15.8</td>
<td>33.9</td>
<td>-30.9</td>
</tr>
<tr>
<td>PV of capital gains/losses by 2008 (pct of 2005 GDP)</td>
<td>-5.2</td>
<td>-3.6</td>
<td>-9.3</td>
<td>3.7</td>
</tr>
<tr>
<td>of which: exch. rate-related capital gains</td>
<td>-4.2</td>
<td>-3.9</td>
<td>-8.4</td>
<td>1.8</td>
</tr>
</tbody>
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<td>-4.1</td>
<td>-17.2</td>
<td>6.9</td>
</tr>
<tr>
<td>of which: exch. rate-related capital gains</td>
<td>-15.1</td>
<td>-5.0</td>
<td>-16.1</td>
<td>5.1</td>
</tr>
</tbody>
</table>
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

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

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>1984</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Euro Area</strong></td>
<td>Europe 8.0 United States 4.0 Japan 1.1 Emerg. Asia 1.5 Other 12.4 Total 26.9</td>
<td>Europe 8.6 United States 3.9 Japan 1.2 Emerg. Asia 4.0 Other 12.1 Total 29.9</td>
</tr>
<tr>
<td>United States</td>
<td>3.3 2.1 2.1 6.7 14.2</td>
<td>4.2 1.6 4.6 9.7 20.0</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>2.9 6.9 6.1 8.3 24.3</td>
<td>3.3 4.2 10.2 4.6 22.2</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>5.7 9.3 8.6 9.7 33.3</td>
<td>12.1 12.1 11.5 19.2 54.9</td>
</tr>
</tbody>
</table>