Global Imbalances and Spillovers

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*THESE COMMENTS DO NOT REPRESENT THE VIEWS OF ANY INSTITUTION WITH WHICH I AM AFFILIATED
Blanchard’s Insights
Global Imbalances in 2008

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 → 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 $\to$ greater impact of international investment income on current account

• Discussion of risks around imbalances needs to incorporate risks around investment income flows
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*

Spillovers
Equity Market Correlations: 1985-1994

<table>
<thead>
<tr>
<th></th>
<th>EMES</th>
<th>other AEs</th>
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- Red circles highlight significant correlations.
- Color intensity represents the correlation strength.
- Diagram shows the correlation matrices for EMES, other AEs, and Euro area.
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

### a. Equity returns

- **Euro area**
- **Full sample**
- **Other Advanced**
- **Emerging**

### b. GDP growth

- **Full sample**
- **Euro area**
- **Other Advanced**
- **Emerging Markets**

Why?
What are the implications?
Extra
UK Net Capital Flows (opposite of CA)

Source: Bank of England, ONS
UK Gross Capital Flows

Gross Inflows (Foreigners)
Gross Outflows (Domestics)

Source: Bank of England, ONS
UK: Putting the Flows in Perspective

Net Inflows
Gross Inflows (Foreigners)
Gross Outflows (Domestics)

Source: Bank of England, ONS
## Framework: Heightened UK Risk

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