Current Account by Region

% of World GDP


Global Imbalances
Brunnen, June 2006 – p. 2/17
World and US Interest Rates

percent


world-short real  US-long real
We need a model!

The (changing) conventional view: Mostly partial equilibrium or no model. Sudden Stop or 1980s analogy.
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A simple asset-supply / asset-demand model.
We need a model!

- The (changing) conventional view: Mostly partial equilibrium or no model. Sudden Stop or 1980s analogy.
- A simple asset-supply / asset-demand model.

Conclusion: The current situation is a reasonable and sustainable equilibrium given world heterogeneity in growth potential and financial development. (Note: this is different from saying that it will persist...)
Basic Structure

Split the world: $U - E - R$
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Key: Region’s are heterogeneous in growth potential and financial development
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$U: \delta, g$
Basic Structure

- Split the world: $U - E - R$

- Key: Region’s are heterogeneous in growth potential and financial development

  - $U$: $\delta$, $g$
  - $E$: $\delta$, $g^E < g$

  (note: $E$ competes with $U$ in producing global assets)
Basic Structure

Split the world: $U - E - R$

Key: Region’s are heterogeneous in growth potential and financial development

$U$: $\delta, g$

$E$: $\delta, g^E < g$

(note: $E$ competes with $U$ in producing global assets)

$R$: $\delta^R < \delta, g^R \geq g$

(note: it matters a great deal who is growing faster than $U$)
Asset Supply

\[ K \rightarrow \{ X_{t+s} \} \]

\[
\begin{cases}
\delta X_{t+s} \\
\text{financial asset}
\end{cases}
\]

\[
\begin{cases}
(1 - \delta) X_{t+s} \\
\text{non capitalizable}
\end{cases}
\]
Asset Supply

$K \rightarrow \{X_{t+s}\}$

\[
\begin{align*}
\delta X_{t+s} \\
\text{financial asset} \\
(1 - \delta) X_{t+s} \\
\text{non capitalizable}
\end{align*}
\]

\[V_t = \frac{\delta X_t}{r - g}\]
Asset Demand

Long run:

\[ W_t = \frac{(1 - \delta)X_t}{\theta + g - r} \]
Asset Demand

- Long run:

\[ W_t = \frac{(1 - \delta)X_t}{\theta + g - r} \]

- Short run = Long run plus valuation effects (home bias)
Equilibrium

$\frac{V}{X}$ vs. $\frac{W}{X}$ for the World and the USA.
A $U - E$ World

From early 1990s: European and Japanese slowdown (especially relative to US)

A Collapse in $g^E$: NFA and Interest Rates
A $U - R$ World

Shock: $\delta^R = \delta - \Delta \delta$
**A $U - R$ World**

- **Shock:** $\delta^R = \delta - \Delta \delta$

- **Interpretation?** The perception that, in the aggregate, financial instruments are less sound; following, e.g., the collapse of a bubble, corporate governance problems, loss of intermediation capital, decline in property rights protection, increased perception of ‘crony capitalism’.... (factors present in Asian/Russian crises)
The Metzler diagram for a permanent drop in $\delta^R$
A \( U \rightarrow R \) World

A Collapse in \( \delta^R \) when \( g^R = g \): NFA and Interest Rates

Larger if \( g^R > g \)!
The Three-Region World

A Collapse in $g^E$ followed by a collapse in $\delta^R$: NFA and Interest Rates
Other Topics in the Paper

- Investment and FDI
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  - FDI as a substitute for domestic financial development
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  - A side show
Other Topics in the Paper

- Investment and FDI
  - FDI as a substitute for domestic financial development
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- Exchange rates
  - A side show
  - Initial appreciation of dollar and then gradual depreciation of the order of 20-30%.
Other Topics in the Paper (2)

- Reversals
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- Reversals
- Recovery in Japan, Germany...
Other Topics in the Paper (2)

- Reversals
  - Recovery in Japan, Germany...
  - Financial deepening in Asia...
Other Topics in the Paper (2)

- Reversals
  - Recovery in Japan, Germany...
  - Financial deepening in Asia...
- Fiscal deficits, savings-glut, and so on...
Final Remarks

Is the current situation sustainable?
Final Remarks

- Is the current situation sustainable? Yes
Final Remarks

- Is the current situation sustainable? Yes

- Is it likely to persist for the indefinite future?
Final Remarks

- Is the current situation sustainable? Yes
- Is it likely to persist for the indefinite future? No
Final Remarks

- Is the current situation sustainable? Yes

- Is it likely to persist for the indefinite future? No

- A key distinction: Errors of framework versus shocks
Final Remarks

Is the current situation sustainable? Yes

Is it likely to persist for the indefinite future? No

A key distinction: Errors of framework versus shocks

- Recovery in Japan and Germany
- Financial deepening in Asia
- A sharp decline in the price of oil
- A sharp decline in China and neighbors
- Something we can’t imagine at this time (pandemic, etc.)
Final Remarks

Do I like the current equilibrium?
Final Remarks

Do I like the current equilibrium? No, a leveraged giant is always worrisome...
Final Remarks

Do I like the current equilibrium? No, a leveraged giant is always worrisome... but
Final Remarks

Do I like the current equilibrium? No, a leveraged giant is always worrisome... but

It is an equilibrium, given observed growth and financial development heterogeneity, not an anomaly that has to go away just because it doesn’t fit conventional wisdom...