Global "Imbalances"

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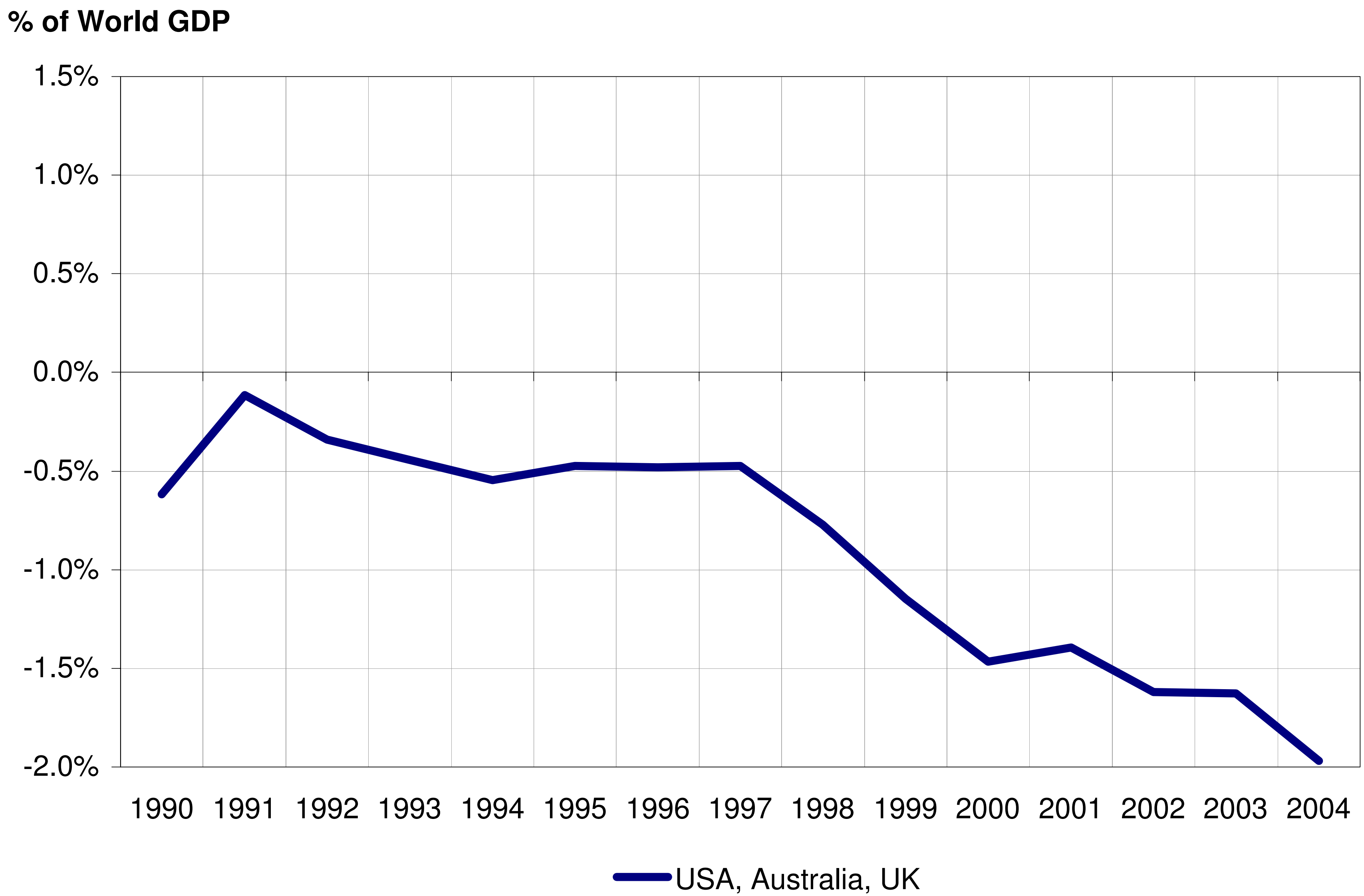
Background paper: "An Equilibrium Model of 'Global Imbalances' and Low Interest Rates"

R. J. Caballero, E. Farhi, P. O. Gourinchas

Current Account by Region



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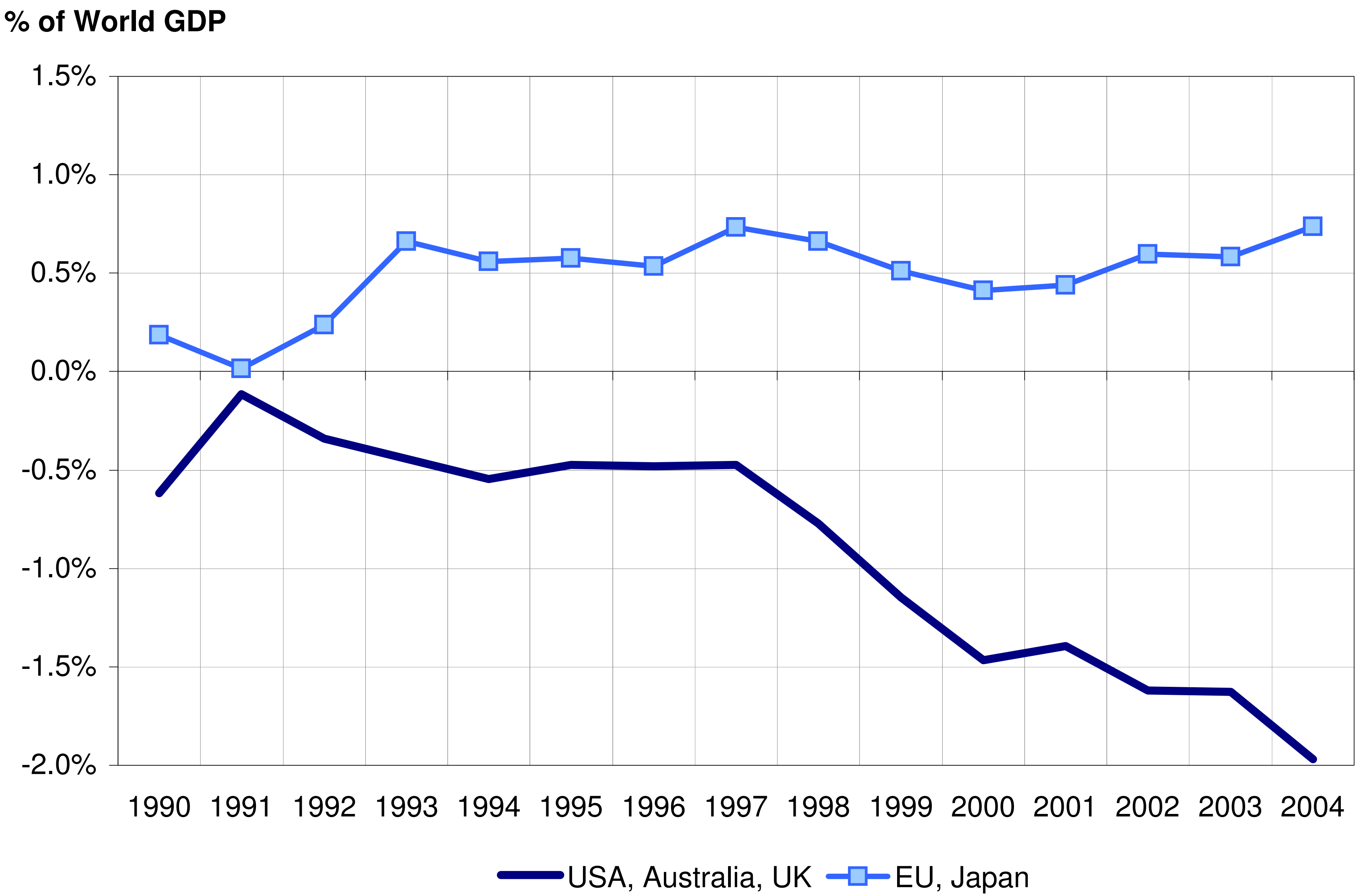

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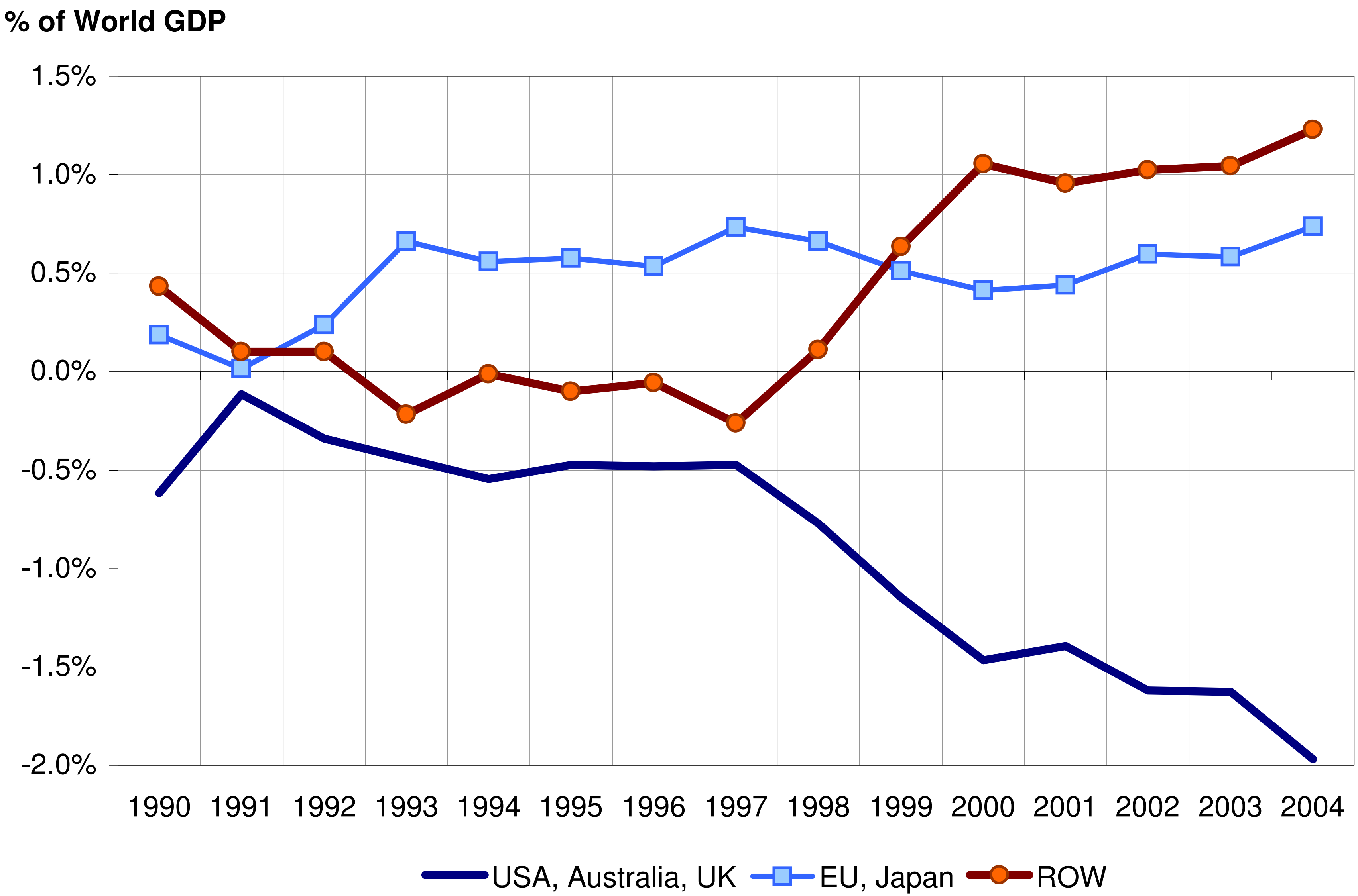
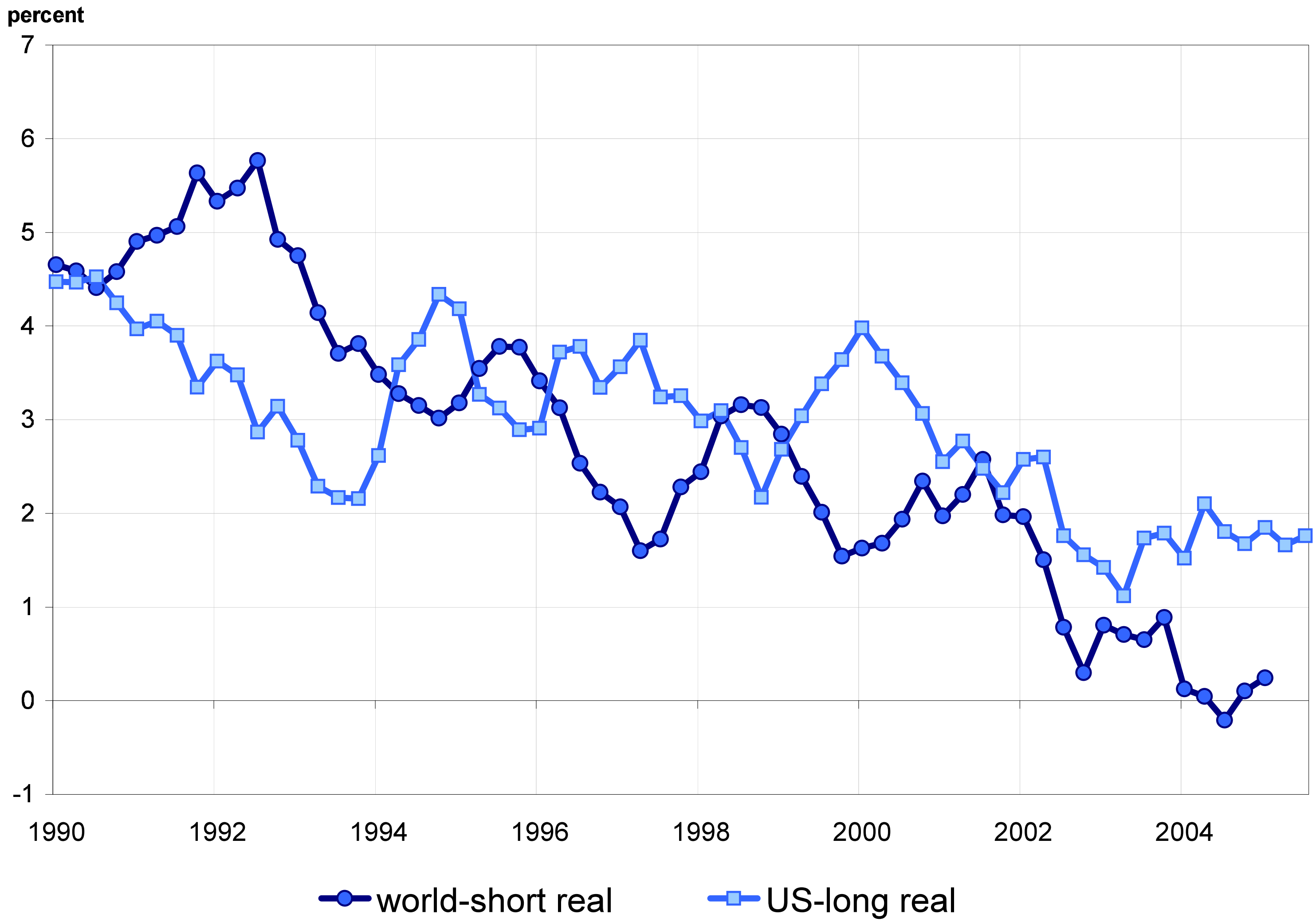


World and US Interest Rates



We need a model!

- The (changing) conventional view: Mostly partial equilibrium or no model. Sudden Stop or 1980s analogy.

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- 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

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    (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

$$K \longrightarrow \{X_{t+s}\} \begin{array}{l} \nearrow \left\{ \begin{array}{l} \delta X_{t+s} \\ \text{financial asset} \end{array} \right. \\ \\ \searrow \left\{ \begin{array}{l} (1-\delta)\, X_{t+s} \\ \text{non capitalizable} \end{array} \right. \end{array}$$

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$$V_t = \frac{\delta X_t}{r - g}$$

Asset Demand

- Long run:

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

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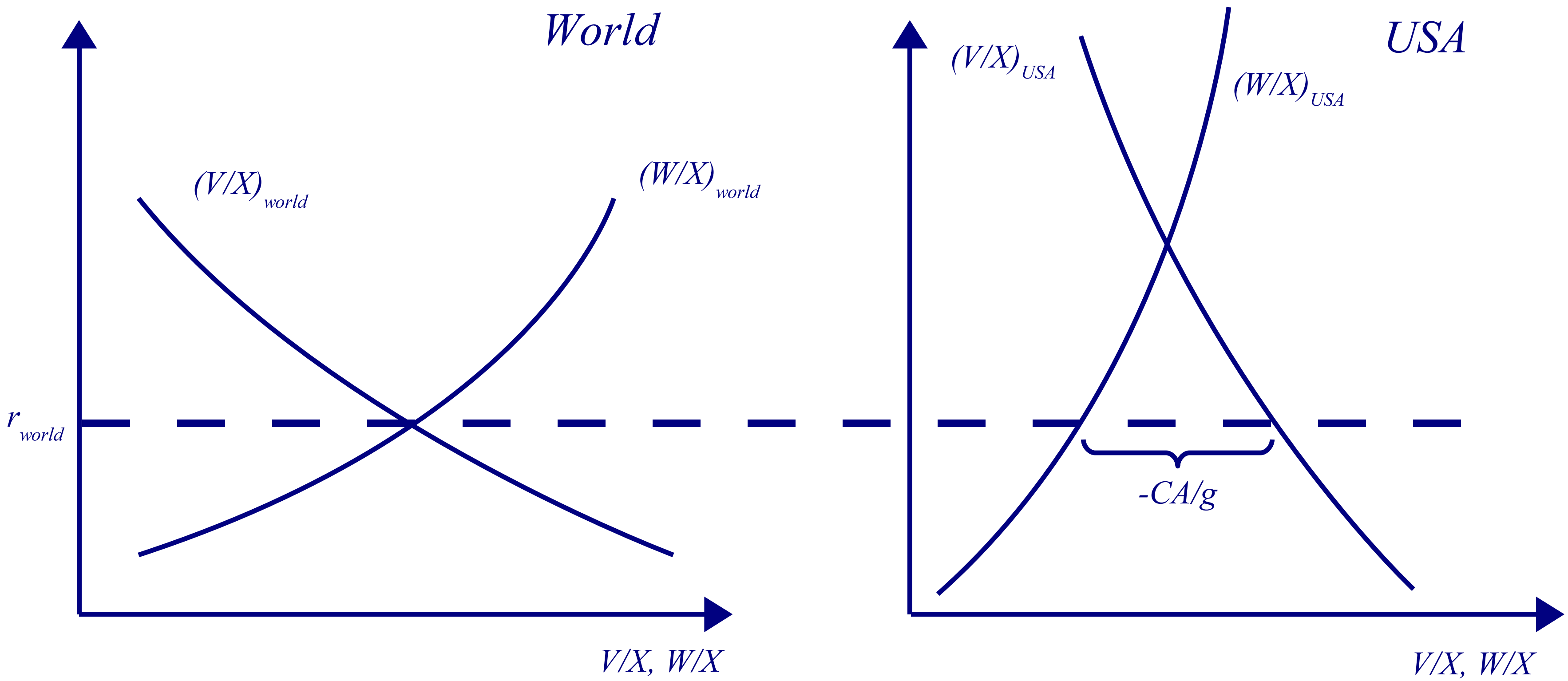
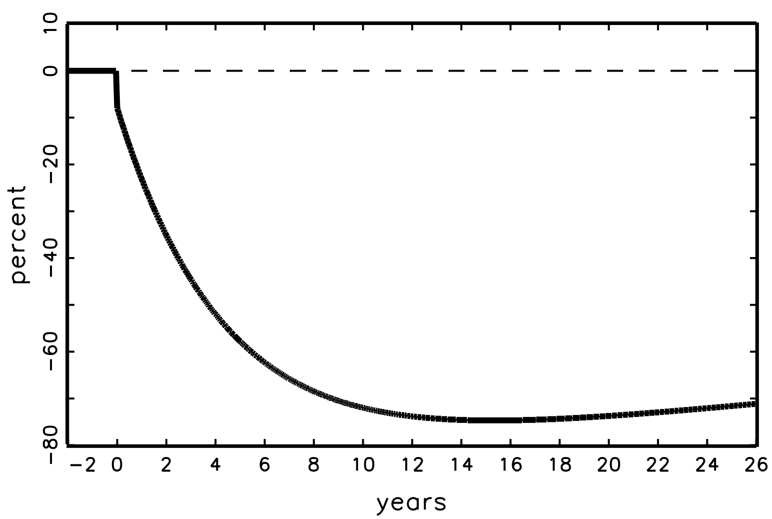
- Short run = Long run plus valuation effects (home bias)

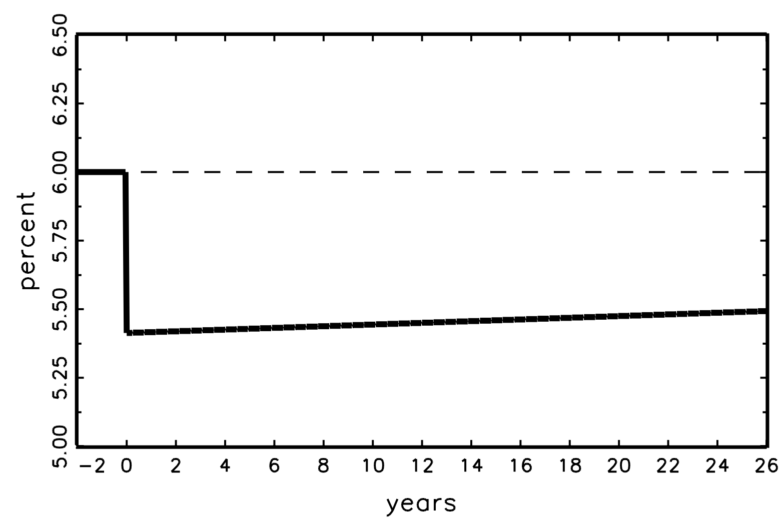
Equilibrium



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: $\delta^R = \delta - \Delta_\delta$

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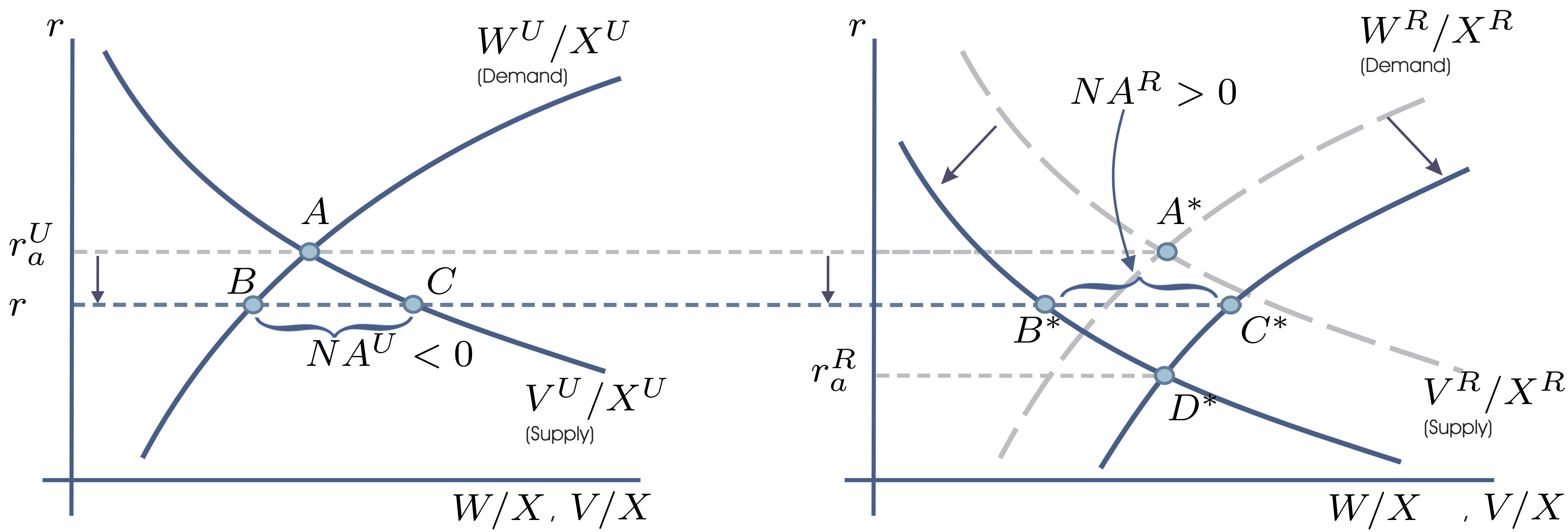
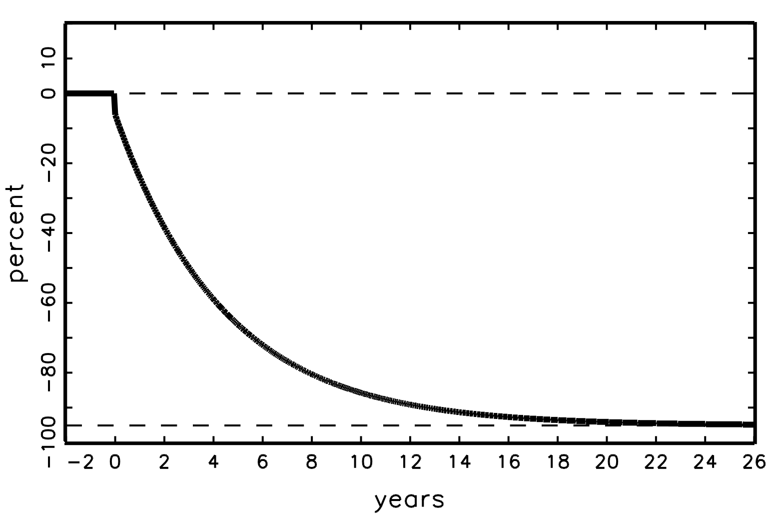
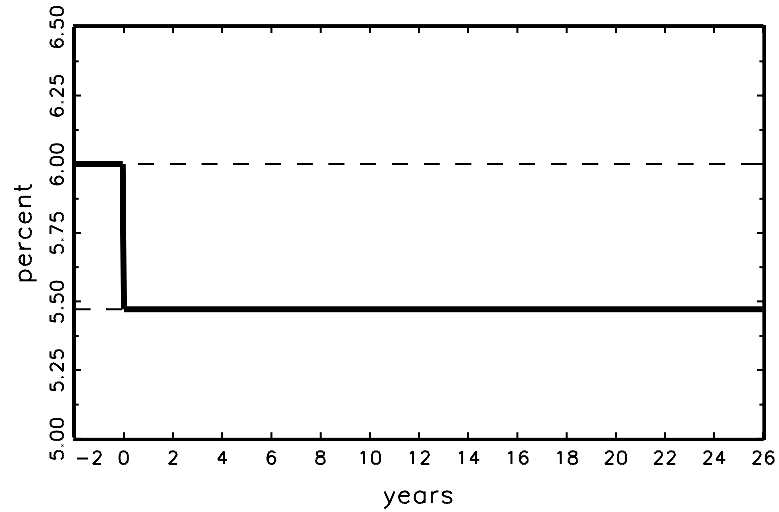
- *Interpretation?* The perception that, in the aggregate, financial instruments are less sound; following, e.g., the collapse of a bubble, corporate governance problems, loss of intermediation capital, decline in property rights protection, increased perception of ‘crony capitalism’.... (factors present in Asian/Russian crises)



The Metzler diagram for a permanent drop in δ^R

A $U - R$ World

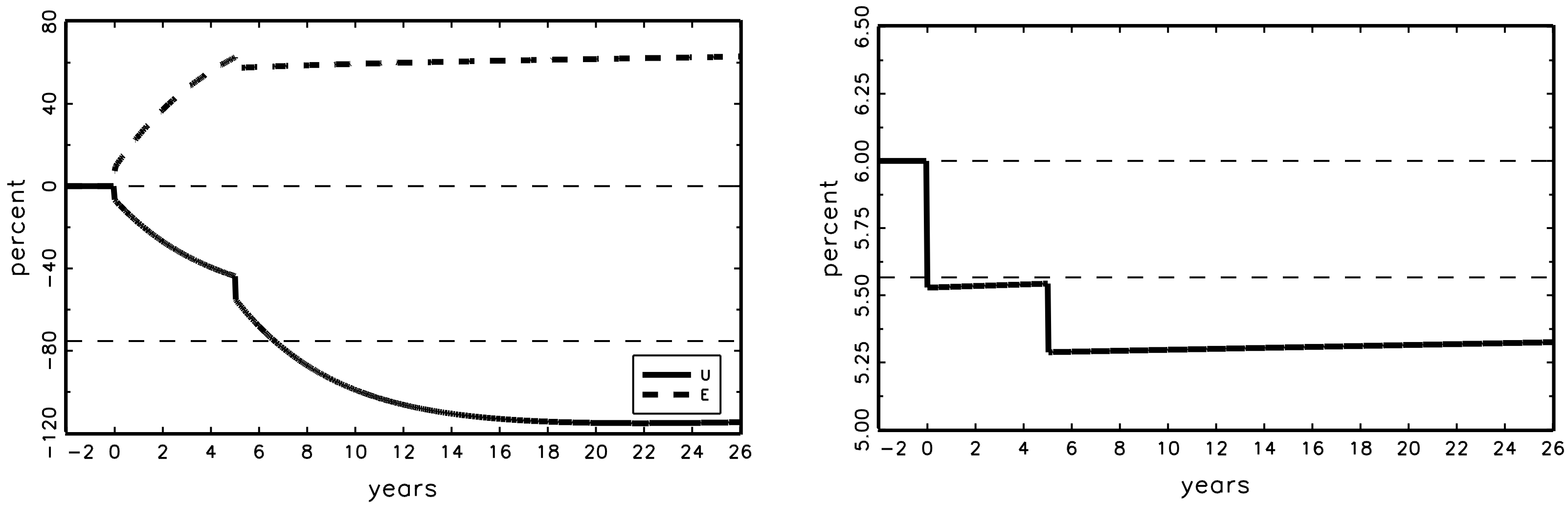




A Collapse in δ^R when $g^R = g$: NFA and Interest Rates

Larger if $g^R > g$!

The Three-Region World



A Collapse in g^E followed by a collapse in δ^R: NFA and Interest Rates

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  - Initial appreciation of dollar and then gradual depreciation of the order of 20-30%.

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  - Financial deepening in Asia...
- Fiscal deficits, savings-glut, and so on...

Final Remarks

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Final Remarks

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- 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.)

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- 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...