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MANAGING GLOBAL IMBALANCES: THE ROLE AND DYNAMIC EFFECT OF U.S. INTEREST RATE POLICY

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The current global growth is fairly strong, inflation is low, and financial markets are buoyant. This is despite the recent softness in the U.S. economy that helped accelerate a sell-off on Wall Street in late February 2007, which was already reeling from a plunge in Chinese stock markets. While most analysts scramble to assess the latter, a bigger and more serious trend should not be overlooked: growing global imbalances! Indeed, the recent global equities sell-off and weaker U.S. housing market have made policy makers more preoccupied with increased volatility in the market and higher risk premiums, rather than looking too far out to resolve the current global imbalances, despite the fact that the latter may cause abrupt adjustments that could result in a worldwide recession. True, imbalances are not new, as they had occurred in the past, but the size and composition of the current one is unprecedented, and the trajectory is unsustainable.¹

Resolving the imbalances requires commitments and cooperation from all countries. To be sure, international institutions such as the International Monetary Fund (IMF), the World Bank, and Regional Development Banks could play a leading role.² However, being the world's largest economy and at the same time holding almost two-thirds of the entire global current account deficits, the U.S. holds a key to the resolution. While the problem and direction of required adjustments may be clear, the policy measure is not.

In this chapter, I argue that while standard policy measures seemingly make sense and have been recommended, not all of them are based on a consistent analytical framework that capture the interactions among relevant variables. Consequently, they cannot be used to evaluate the dynamics of exchange rate,

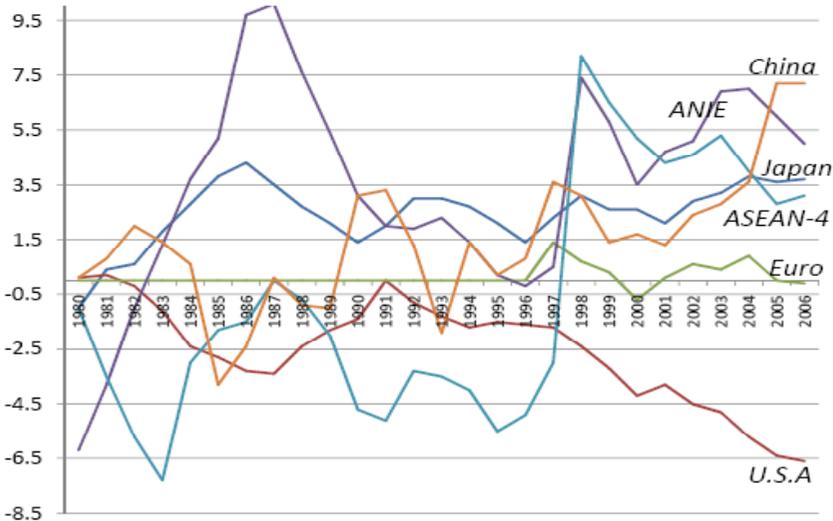
current account deficit, size of debt, and interest payment. By focusing on the analysis of U.S. policy response, it is shown that understanding the dynamic trajectory of these variables is important. Absence of such understanding could lead to policy prescriptions such as raising the interest rates that, in fact, cannot produce an orderly adjustment let alone resolve the problem.

After elucidating the “what” and the “why” of the current global imbalances, this chapter discusses the implications and some policy issues. A more detailed analysis of the policy response is presented in the last section before concluding. The specific analysis is based on a dynamic model shown in the Appendix.

Indications

A prominent feature of the current global imbalances is a large and widening account deficit in the world’s largest and most powerful economy, the U.S., and growing surplus in emerging markets particularly in East Asia (see Figure 1).

Figure1
Current Account Balances (% of GDP)



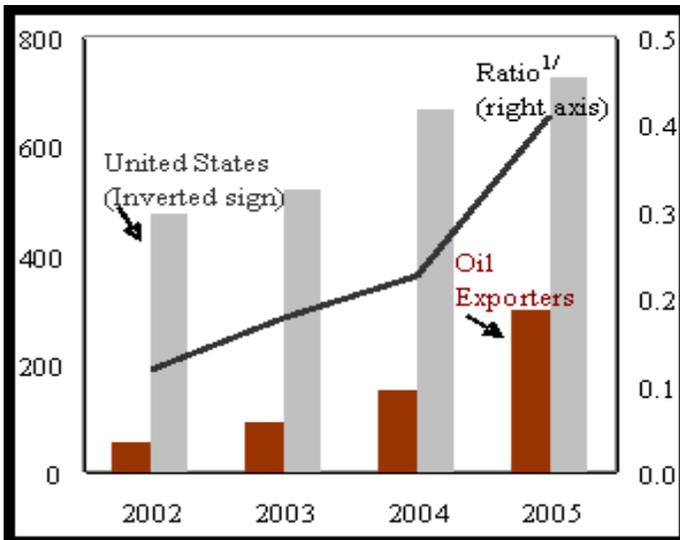
Note: ANIE = Asian Newly Industrializing Economies; ASEAN-4 consists of Thailand, Malaysia, the Philippines, and Indonesia. An alternative chart to demonstrate the imbalances would be one that shows the ratio of each country’s deficit to world GDP; the resulting paths, however, are similar with the one shown above

Source: Author’s calculation based on WEO data base, September 2006.

Reaching at an annual rate of more than \$800 billion, or 7 percent of GDP, the U.S. current account deficit is larger than the “dangerous threshold” of 4-5 percent. What is more dramatic is the fact that this deficit represents roughly 70 percent of the global current account deficits! On the other hand, almost half of the global surpluses is generated in East Asia. No wonder a large portion of the U.S. deficit has been financed by “borrowing” from this region. This suggests that any meaningful efforts to resolve the global imbalances must effectively deal with the imbalances between these two economies.

The surge of oil prices has also made oil-exporting countries a major player on the scene. With the doubling of their surplus within a three-year span, they have become important counterparts to the U.S. current account deficit. As shown in Figure 2, the current account surplus of oil-producing countries represented about 40 percent of U.S. deficit in 2005. This makes recycling oil revenues imperative if attempts are to be made to resolve the imbalances.

Figure 2
U.S. Deficit and Oil Producers Surplus of Current Account

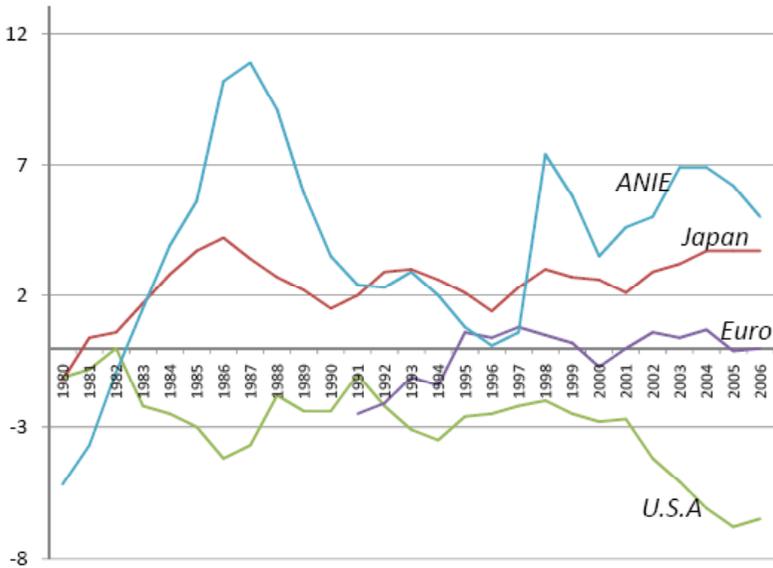


1/Ratio of current account of oil exporters to U.S. current account (in percent, right axis).

Source: Taken from Saleh M. Nsouli (2006, March), Petrodollar recycling and global imbalances. Paper presented at the CESifo’s International Spring Conference, Berlin.

The other side of the “two-gap” is the investment-saving imbalance. As depicted in Figure 3, the investment-saving gap has also a similar position as the current account gap: deficit in the U.S., surplus in Asia. Notice that the imbalance began to widen particularly after the 1997 Asian Financial Crisis that was subsequently followed by a series of crisis in other countries including Russia and Argentina (Azis, 2005).

Figure 3
Saving and Investment Gap



Source: Author’s calculation based on WEO data base, September 2006

Origin

How did global imbalances occur in the first place? Why did the financial system and global institutions fail to prevent such imbalances? The episodes of financial crisis in many countries around the world during the 1990s, and the resulting IT bubble, have a lot to do with it. On the one hand, the up-beat mood that caused over-investment during the pre-crisis period turned into super cautious attitudes among governments and investors that caused investment in emerging markets to fall. On the other hand, accommodative fiscal and monetary policies in industrial countries led to over consumption and a credit boom, including the housing market boom. To the extent that this has widened

their fiscal deficit and reduced savings—especially household savings—they suffered from a classic dual-gap problem (investment-saving gap and trade gap). In the emerging markets, the opposite predicament stands out, i.e., excess current account surplus and under-investment.

Why did the Fed adopt accommodative monetary and fiscal policies at the first place? The end of the cold war followed by a growing number of countries that embraced market system (e.g., Eastern Europe and emerging Asia, particularly China) along with trade and financial liberalization in emerging economies (e.g., East Asia, Latin America), have provided **arbitrage opportunity** for the corporate sector to shift a big chunk of their production to these lower-cost economies. At the same time, fiscal consolidation and economic reforms in countries with a long history of excessive deficit such as in Latin America have allowed budget deficits to decline. All these contribute to a reduction in the world's inflation rates, providing a room for accommodative monetary and fiscal policies.

The dynamics of the process, however, are more complex. Economic reforms and liberalization have made the economies of many emerging markets more flexible, but at the same time their asset markets are also more susceptible to a shock. Witness the Asian Financial Crisis. The open system with insufficient supervision and weak institutions collapsed. As a result, asset prices fell prompting the fear of a deflationary pressure. It is no doubt that the accommodative policy by the Fed is partly influenced by such a fear. The subsequent tech burst in 2000 added to the deflationary fear. **The accommodative policy continued** when the looming Iraq War also exerted further deflationary pressure.

There is also a problem related to low domestic supply elasticity to demand. The Fed's accommodative policy caused not only excessive spending that prompted investment-saving deficit, but it also raised the cost of imports (particularly from China and other emerging markets such as India) exacerbating the U.S.' current account deficit. Flushed with financial resources flowing from the U.S. and other industrial countries, these emerging markets are able to raise investment to stimulate stronger economic growth. Thus, the Fed's accommodative policy has contributed not only to the U.S.' growth but also to the economic expansion in emerging markets including the two large Asian economies. Of all the explanations of the causes of the recent oil price increase, a strong demand spurred by robust growth in these countries is the most compelling one.³ In turn, oil revenues of the major oil-exporting economies reached more than double in a short span of time, i.e., from U.S. \$262 billion in 2002 to an estimated U.S. \$614 billion in 2005. The global imbalances have thus been exacerbated by the oil price surge.

With large and widening U.S. current account deficit, financial markets bet against the dollar. This was translated into increased market expectations for currency appreciation in some Asian economies, particularly in China. With such expectations, capital inflows surged, allowing China to accumulate a huge

amount of foreign reserves. As shown in Table 1, by April 2006, for the first time China's reserve (U.S. \$895 billion) has surpassed that of Japan (U.S. \$841 billion), and according to more recent data by October 2006 China's foreign reserves have passed the U.S. \$1 billion mark. Traditionally, Asian central banks assumed the risk on the dollar value and pumped the money into the U.S. bond market. But with rising expectation of a weaker dollar and continued increase of reserve beyond liquidity needs, diversification is inevitable. Return considerations may become more important. **One strong indication pointing to this direction is the emergence of active government-controlled investment companies in many East Asian countries.**⁴ **The main task of these companies is to manage a portion of official foreign reserves (to adjust the portfolio composition) in order to mitigate the rising costs of holding a huge amount of reserve.**

Table 1
Net International Reserves (US\$ billions)

Country (ranking)	1997	2001	2003	2004	2005	April 2006	Percent of Reserves to	
							GDP	Annual imports
1 China	141	213	404	611	820	895	37	124
2 Japan	209	389	654	826	830	841	18	161
3 Taiwan Province of China	84	123	207	243	254	260	73	139
4 Korea	20	103	155	198	210	223	27	80
5 Russia	14	33	74	122	176	219	23	128
7 India	25	46	98	126	132	154	17	98
8 Hong Kong SAR	93	111	118	124	124	127	70	42
9 Singapore	71	75	95	112	115	127	98	59
10 Mexico	28	44	58	63	73	78	10	33
11 Malaysia	20	29	43	65	69	75	53	61
12 Algeria	8	18	33	43	57	66	55	282
13 Turkey	19	19	34	36	50	60	14	51
14 Brazil	51	36	49	53	54	56	7	69
15 Thailand	26	33	41	49	51	56	30	43
World	1,687	2,334	3,330	4,081	4,698	4,941

Source: International Monetary Fund (2006). World economic outlook: Building institutions. Washington DC: International Monetary Fund.

Discussion

The interplay of U.S. accommodative policy in response to the deflationary pressure following the Asian Financial Crisis—reinforced by the Iraq War—and the resulting strong demand that led to higher oil price have contributed to the current global imbalances.

For some time, observers and policy makers have been concerned with the risk that such imbalances could lead to a worldwide economic crisis. There is also a concern about the failure of the international community to agree on a collaborative response to the problem. Realizing the possible adverse repercussions of global imbalances, discussions are increasingly directed toward the question of how to resolve them without creating abrupt and disorderly adjustments.

Some believe that currency revaluation in Asia would solve the problem, while others emphasize the importance of stimulating savings in the U.S. and

boosting consumption in the rest of the world. In the absence of an exchange rate coordination, emerging markets will unlikely allow their currency to appreciate. They believe that reducing the U.S. fiscal deficit is far more important than currency adjustment. **While it is necessary to understand the origin of the imbalances and what caused them, it is not useful to play a blaming game.** If anything, it could exacerbate the problem. It is much more useful to analyze policy options available in each country by looking at the dynamic trajectory of relevant variables under each of the policy options. Also, to repeat the obvious, a real resolution to global imbalances cannot be reached by a unilateral measure alone.

As far as the U.S.' role is concerned, its policy choice holds a critical position simply by the fact that the U.S. economy is the world's largest and that the country holds 70 percent of the world's current account deficit. Some believe that **tightening the U.S.' monetary and fiscal policy (raising the interest rates and reducing fiscal deficit)** will resolve the problem, others doubt that such policy is sustainable. Although they seem sensible, the dynamic effects of the policy remain unclear.

Implications and Policy Issues

Indeed, policy issues surrounding global imbalances need to be analyzed in a dynamic framework by taking into account the long-term paths of relevant variables, and the analysis should ideally be remote from unrealistic (though standard) assumptions, e.g., perfect substitutability between domestic and foreign assets.

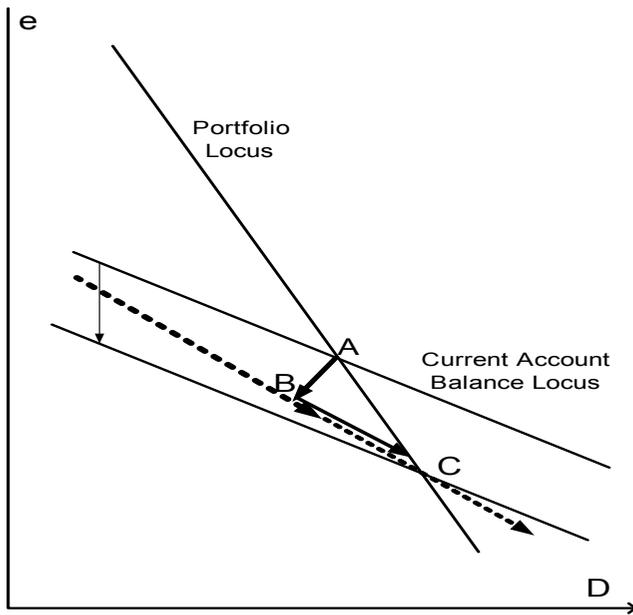
In looking at the trend and long-run equilibrium of current account deficit and exchange rate, country's debt position matters. The interest payment on debt affects the size of current account deficit, and, hence, the extent of exchange rate depreciation. If the U.S. net debt increases, the U.S. dollar value will depreciate more than what is required by the increase in trade deficit, because larger holding of U.S. assets by foreign investors also means larger interest payment in the future.

Since the U.S. gross liability is largely denominated in the U.S. dollar, future debt position is also influenced by what happens with the value of assets (assets revaluation). If the U.S. dollar depreciates, the dollar value of U.S. holdings of foreign assets will increase and the U.S. net debt position falls through improved trade balance and asset revaluation.⁵ These effects will influence the U.S.' future debt position. To be more precise, a dynamic model showing these mechanisms is presented in the Appendix and their policy implications are discussed below.

The debt position (labeled D) is inversely related to the exchange rate (e) as shown in Figure 4. Take the case of accommodative policy by the Fed, along with loosened fiscal policy. This combined policy raised demand, including

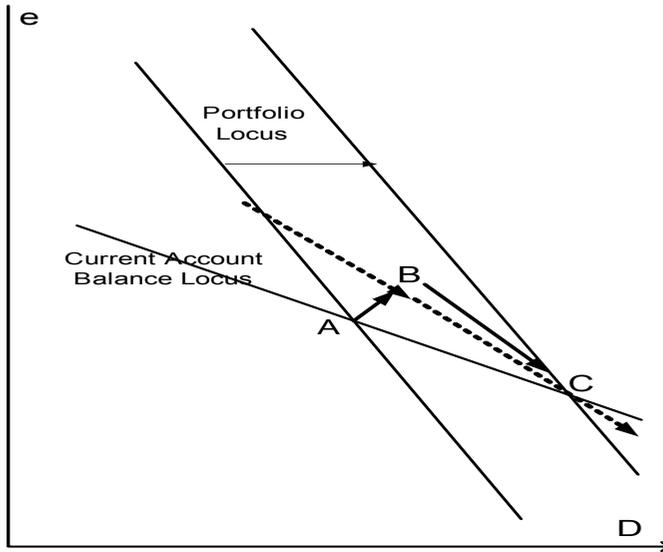
housing demand that caused a housing market boom. But with low domestic supply elasticity, import demand (especially from China) also increased. In the model, this episode is captured by an increase in the shift parameter m (see equation 1 in the Appendix). For any given D , the current account balance locus will shift downward as depicted in Figure 4. The steady state equilibrium moves from A to C through the following mechanisms. The shift in trade deficit due to larger m is shown by the movement from A to B. Initially, this has caused an unexpected depreciation of U.S. dollar. As debt accumulates, further depreciation is inevitable (a shift from B to C). Meanwhile, the current account deficit worsens due to rising m .⁶

Figure 4
Effect of Rising Imports



If the shift is not in the goods market (imports), instead in the asset market, the portfolio balance will play a more important role. As evidenced during the 1990s, there has been a shift reflecting high preferences towards U.S. assets. This is captured by an upward movement of p , a parameter capturing all factors that can cause a shift in the portfolio shares for a given relative returns (see equation 2 in the Appendix).⁷ Graphically, the portfolio balance relation shifts rightward as shown in Figure 5.

Figure 5
Effect of Higher Preference towards U.S. Assets



At a given debt position D , the portfolio balance requires an appreciated exchange rate. Initially, the U.S. dollar will appreciate (the shift from A to B), but as this hurts competitiveness, the current account deficit tends to increase and the U.S. dollar depreciates (from B to C).

What really happened since the mid-1990s was that both m and p shifted upward. An initial pressure of combined depreciation (from rising m) and appreciation (from rising p) led to a smaller than expected depreciation of U.S. dollar. But with the anticipated larger interest payment due to rising debt, the expected depreciation was large. Also, the relatively small elasticity of domestic supply to demand and the low degree of substitutability between U.S. assets and foreign assets has caused the current account deficit to increase rapidly. This is the reason why the actual U.S. deficit has widened despite a not too fast depreciation during the period.

The scenario captured in Figure 5 is similar to a case whereby the Fed raises the interest rate, a policy often recommended by analysts to resolve the current global imbalances. The problem with such a policy is that it overlooks the resulting increase in the net debt position that will cause the expected exchange rate to depreciate further. In order to generate a more orderly adjustment process, it is better if the Fed *reduces* the interest rate. The initial depreciation caused by such a policy is mitigated by improved competitiveness and lower net debt position. The potential overheated economy can be countered by lowering the fiscal deficit. Such a policy mix could help reduce the U.S. current account

deficit—an important step in resolving the global imbalances—without causing disorderly adjustments in the exchange rate.

Thus, while raising interest rates seemingly makes sense, the resulting initial dollar appreciation from such a policy could widen the U.S. current account deficit further due to lower competitiveness. The eventual currency adjustment (depreciation) could be large and less orderly. The shift in preferences toward U.S. assets as a result of higher interest rates is manifested in an anticipated large depreciation due to higher net debt position, hence, higher interest payment. By specifying the relations of two sets of balances, current account and portfolio balances, the analysis clearly shows that a policy mix of lowering the interest rates and reducing fiscal deficit would be more appropriate.

Direction for the Future

Looking at just the size alone, it is hard to imagine that the global current imbalances can be sustained in the future. A scenario of the U.S. borrowing \$7-8 billion per day from foreign investors to finance the current account deficit plus its own outward foreign investment cannot, by any stretch of imagination, be maintained both economically and politically. It is also inconceivable that some 80 percent of all foreign investment by the rest of the world will continue to move into dollar assets.

Some analysts argue that a continued widening of current account deficit will raise the U.S. debt in the future to a point that will cause investors to lose confidence in the economy's ability to service its debt. Once this happens, interest rates must rise or the borrowing country's currency must depreciate to enable the country to continue financing its deficit. I agree with the logic of the arguments, but disagree that the impact is applicable in the near terms. The U.S. net international debt measured as a percentage of GDP is still relatively low, i.e., 13 percent compared to 15 in U.K, 36 in Canada, and 59 percent in Australia. These countries are in no way in any danger of collapse. Also, it is hard to conceive that frictions (or conflicts) between countries will not escalate when the trade imbalance continues to grow.⁸ Indeed, forces that could make the current imbalances unsustainable will not necessarily come from the economic front; the political force is often more powerful. Having said that, however, I do think that heavy reliance on foreign investors to finance the current account deficit cannot and should not be sustained.⁹

Future implications of the current global imbalances can be foreseen by asking the question, what happens if the imbalances are uncorrected? Wide sell-off of U.S. currency could throw the world financial system into damaging disorder that could eventually lead to a global recession. The ballooning U.S. current account deficit will bring down sharply the value of U.S. dollar, which could spark massive capital outflows and lead to rising interest rates. In turn, output will fall. Falling output in the U.S and other industrial countries will

subsequently pose serious problems to the rest of the world. No one is spared. The good news is that such a drastic and non-orderly process will eventually correct the imbalances. The bad news is that the costs of adjustments could be enormous, and it may take a long time for the resulting global recession to recover.

A number of scenarios can be constructed, ranging from a very soft landing, whereby the declines in the U.S. dollar value and investor confidence take place in an orderly fashion, to a scenario of not so soft landing, where the U.S. interest rates will increase significantly and a considerable amount of U.S. asset sales has to take place. Each scenario implies certain policies. The challenge is to find a proper mix of policies that would produce desirable consequences in terms of reducing the imbalances, minimizing the risks of abrupt adjustments, and maintaining the global economic growth. Such a policy mix is also expected to bring about the necessary adjustments in each individual region, i.e., increased spending in Asia (through improved terms-of-trade), euro area, and Japan (through higher productivity) and increased savings in the U.S. that would allow a further fall in the interest rates. Still, some risks remain impending; if structural adjustment in the euro area and Japan worsens investors' confidence, the global growth could be weaker than expected, and the required exchange rate adjustment could be very large.¹⁰

Thus, a more economy-wide analysis exploring alternative sets of policy mix is needed in future study. In addition to the scenario of hard landing, other risks also deserve attention. The impact of an unanticipated shock to U.S. financial markets similar to the one that occurred recently, on global wealth, needs to be studied under each policy scenario. This is particularly important since foreigners have built up extremely large positions in U.S. assets due to ample liquidity and strong investor protection. More importantly, the impact study needs to identify the long-term paths of relevant variables so that the recommended policy is not only based on the short-term and temporary outcomes (the question of sustainability).

Limitation

While the U.S. policy is indeed essential and may hold a key to the overall efforts of resolving global imbalances, it is clear that adjustments need to be made by *all* countries to avoid a "prisoner's dilemma" situation. Each agent must be involved in the process; government or private sector alone cannot resolve the problem. Global institutions (the World Bank, the IMF, WTO, or Regional Development Banks) cannot effectively manage the current global imbalances without full participations and commitments from all member countries, even if the U.S. takes the policy suggested above.¹¹

It is hard enough to find a consensus in each country as to what strategy to implement and what policies to use, let alone managing the imbalances through

global institutions. Even if a consensus is reached, there is no guarantee that the market would react according to what is intended by the policy. Domestic political interventions may further complicate the tasks. There is a risk that individual countries could conduct their policies without regard to global imbalances. They may be aware of the problem, but they either expect others will make the first move or assume that corrective measures taken by others will be sufficient (free riders).

In short, without exploring the range of possibilities regarding the strategic response of other countries (e.g., in a game theoretic fashion), there is still a possibility that the suggested U.S. policy discussed in this chapter will not be able to reduce the global imbalances. Nor will it be effective to mitigate the adverse effect of the imbalances.

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Appendix

In a standard balance-of-payment framework, future debt position (D_{t+1}) is determined by current debt (D) and interest rates (i) plus trade deficit (TB). The latter is influenced by the exchange rate (e) and the shift parameter (m), e.g., rising imports due to greater preference for foreign goods. Thus,

$$D_{t+1} = (1 + i)D + TB(e_{t+1}, m_{t+1})$$

What happens with the equilibrium in the current account? Denote W as the wealth of U.S. investors, W^* is foreign wealth, $EXP(R)$ is the expected rate of return, δ is the share of U.S. assets to which U.S. investors allocate their wealth; thus, $(1 - \delta)$ is a share allocated to foreign assets, and i is the interest rate. If foreign investors invest a share (δ^*) of their wealth W^* in foreign assets and $(1 - \delta^*)$ in U.S. assets, the U.S.' future net debt position can be written:

$$D_{t+1} = [1 - \delta^*(EXP(R), p)] W^* / (1+i) + TB(e_{t+1}, m_{t+1}) - [1 - \delta(EXP(R), p)] W(1+i^*)e/e_{t+1}$$

The last term represents the valuation effect, and p denotes a shift variable capturing all the factors that can shift portfolio shares for a given relative return. An increase in p leads to U.S. and foreign investors' decisions to increase the share of U.S. assets in their portfolio.

The above equation implies that the net debt in the next period equals the value of U.S. assets held by foreign investors next period, plus the trade deficit next period, minus the value of foreign assets held by U.S. investors next period. Note that the value of U.S. assets held by foreign investors next period equals to this period's wealth in terms of U.S. goods, times the share of U.S. assets they are holding, times the gross rate of return on U.S. assets. Meanwhile, the value of foreign assets held by U.S. investors next period equals to this period's U.S. wealth times the share they invest in foreign assets times the rate of return on foreign assets in terms of U.S. goods.

Also note that F, α^* , and α are not independent. Thus, F_{t+1} can be expressed in terms of any two of the three. As described in Blanchard et. al (2005), the above equation can be rewritten:

$$D_{t+1} = (1 + i)D + TB(e_{t+1}, m_{t+1}) + [1 - \delta(EXP(R), p)](1+i) \left[1 - \frac{1+i^*}{1+i} \frac{e}{e_{t+1}} \right] (S - D) \quad (1)$$

This is the "current account balance relation." Thus, the larger the U.S net debt, the greater the probability that there will be a shift of demand away from U.S asset (home bias) and the larger the trade surplus required for interest payment. Eventually this will cause the U.S. dollar to depreciate.

Next is the equilibrium in assets market. In equilibrium, total supply of U.S. assets (S) equals to total demand by both U.S. investors and foreigners.

That is,

$$S = \delta[EXP(R),p]W + [1 - \delta^*(EXP(R),p)](W^*/e)$$

Since by definition $W = S - D$, and, similarly, $W^*/e = S^*/e + D$, we can write the following “portfolio balance equation:”

$$S = \delta[EXP(R),p]W + [1 - \delta^*(EXP(R),p)](S^*/e + D) \quad (2)$$

It is clear from equations (1) and (2) that the net debt position D and the exchange rate e have an inverse relation as shown in Figure 4 in the text. More precisely:

$$\frac{de/e}{dD} = -\frac{\delta + \delta^* - 1}{(1 - \delta^*)S^*/e} < 0$$

In an extreme case of no substitution between U.S. assets and foreign assets, δ and δ^* are independent of the rate of return R , in which case the equilibrium exchange rate is determined solely by the world distribution of wealth or the portfolio preferences not by the current account balance (deficit).

According to the model specification, when foreign demand for U.S. assets increases, the U.S. dollar will initially appreciate and imports will rise. This will cause a rapid increase of the current account deficit. But because of the higher future interest payment, the U.S. dollar will eventually depreciate, slowly but steadily. Indeed, this is what has happened since the mid-1990s. The model is capable of capturing these factual episodes, unlike the standard uncovered interest parity (UIP) model, because it does not assume a perfect substitution between U.S. assets and foreign assets. The lower the degree of substitutability, the higher the anticipated interest payment as a result of an increase in foreign demand for U.S. assets. In turn, this will generate a larger expected depreciation.

Notes

1. For a good summary of the historical perspectives of global imbalances, see Bordo (2005).
2. It is interesting to note that the IMF’s traditional role of crisis fighting has been fading with the absence of financial crises in recent years. This has raised questions about the Fund’s relevance, especially that of middle-income countries in Asia, Eastern Europe, and Latin America have accumulated large amount of foreign reserves (in some cases exceed the IMF’s \$227 billion). The emerging problem of global imbalances may come to an end by allowing the IMF to return to center stage through its multilateral surveillance role.
3. Unlike the oil price increases in the 1970s and early 1980s that were preceded by wars (a pure supply shock) this time the rising oil price was prompted by strong demand, although concerns over future supply related to the Middle East crisis may

- have a role too. At any rate, this partly explains why the recent oil price increase is not followed by a worldwide recession.
4. Noted examples are Singapore's Government Investment Corporation (GIC), Korea Investment Corporation (KIC), and Malaysia's Khazanah Nasional. Capital outflows have also been encouraged, either through national pension funds (e.g., Korea's Pension Fund Association, Thailand's Pension Fund, Japan's Government Pension Investment Fund) or through individual investment (e.g., the 1990s liberalization in Japan, the increased limit of foreign assets holding allowed by the Malaysian government, and China's provision of greater access to individual savers to foreign assets announced in April 2006). In March 2007, China announced that it will create a new agency to invest the country's immense reserves of foreign currency. The new agency will be able to invest some of the money more diversely and aggressively, with the possibility of hundreds of billions of dollars put into acquiring "strategic assets"—mines, oil fields, whole companies—around the world.
 5. The opposite applies to the emerging market where the gross liabilities are mostly denominated in foreign currency. It has been argued that the valuation effect is less important from a longer-term view (the exchange rate adjustment operates mainly through the traditional trade effect). Only in the short run, and particularly from the point of view of emerging economies, could the valuation effect could play an important role. Short-term movements in capital flows could be partially offset by changes in valuation because emerging economies cannot borrow in their own currencies. When the domestic currency depreciates, the return on liabilities increases in terms of local goods, and the burden of liabilities rises. This is precisely the opposite of what happens in industrialized countries, i.e., valuation effect helps the external adjustment; see De Gregorio, J. (2005, June). Global imbalances and exchange rate adjustment. Comments to "From world banker to world venture capitalist: The U.S. external adjustment and the exorbitant privilege" by Pierre-Olivier Gourinchas & H'el'ene Rey, paper presented at the NBER Conference on G7 Current Account Imbalances: Sustainability and Adjustment, Newport, RI.
 6. At a lower degree of substitutability, however, the size of depreciation is smaller although future anticipated depreciation can be large.
 7. The growing preferences toward U.S assets is one of the anomalies observed during the recent years. The other anomalies are a sustained rise in the US current account deficit and a decline in long-run real rates. These anomalies can be rationalized and are actually an equilibrium outcome of two phenomena, i.e., potential growth differentials among countries and heterogeneity in the countries' capacity to generate financial assets from real investments; see Caballero, R. J., Farhi, E., & Gourinchas, P-O. (2006). An equilibrium model of global imbalances and low interest rates. NBER Working Paper No. 11996. National Bureau of Economic Research, Cambridge, MA.
 8. Imagine what happens in Capitol Hill if a growing trade imbalance occurs when the U.S. economic growth is weaker than what we have observed during the last few years.
 9. I do not agree with those who argue that global imbalances are less perverse than originally thought. Such arguments, advanced among others by Caballero, Farhi, and Gourinchas (2006), are based on a static condition and assumption that feeble institutions, e.g., weak property rights, fear of expropriation, and poor bankruptcy procedures, have caused investors in emerging markets (especially China) to buy assets abroad (including U.S Treasuries) either directly or indirectly. The latter is done through the state before the state issues bonds of its own, which are held by banks, companies, and households. Thus, as the argument goes, the risks of a sud-

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den run by foreign investors on U.S assets (the adverse effect of global imbalances) are non-existent. While this may be true in the short run, the argument overlooks the dynamic effects of the imbalances.

10. This is the reason why it has been suggested that “Policymakers and private sector decision makers will need to ensure that national economies and financial and non-financial corporations are resilient in the face of potential changes” (IMF, 2005).
11. With its limited leverage, questions arise as to how the IMF can help steer the big players toward politically painful but necessary steps to reduce the imbalances without triggering a recession.