

GLOBAL IMBALANCES AND LOCAL RISKS

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Outline of Presentation

■ THE US DEFICITS

- Twin Deficits?
- Who is picking up the bill?
- What if Asia floats?

■ LONG-TERM INTEREST RATES

- Déjà-vu all over again?

■ RECENT CRISES IN EMERGING MARKETS

- Central lessons

■ CHINA

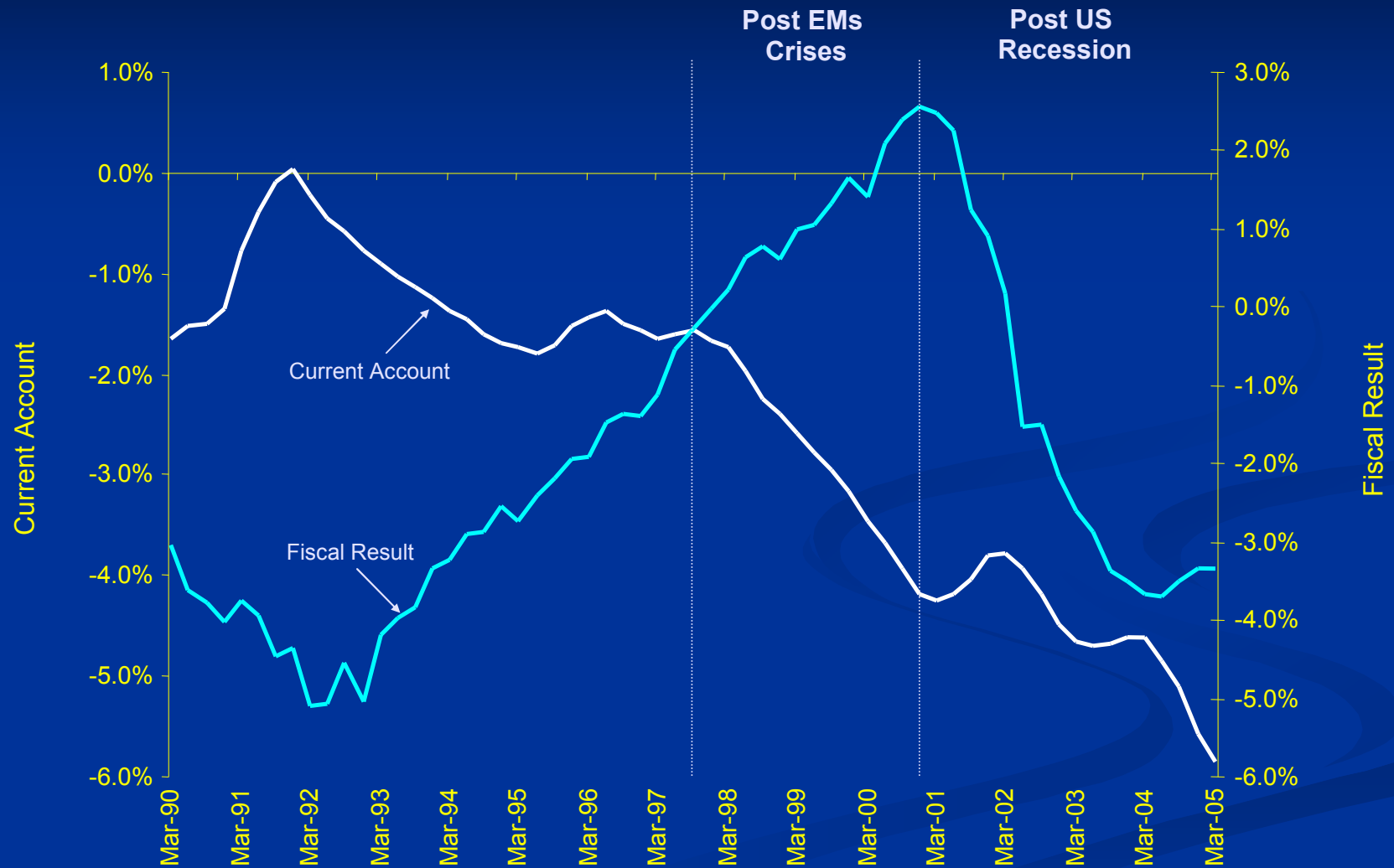
- Financial vulnerabilities

US External Deficit: Anatomy

- The US current account deficit (CAD) exceeds 5 percent of GDP.
- Before 2001, CAD increased because of larger expenditure by US private sector, even though US fiscal deficit vanished.
- After 2001, CAD increased as a result of larger US fiscal deficit, even though the private sector stopped dissaving.

US Twin Deficits

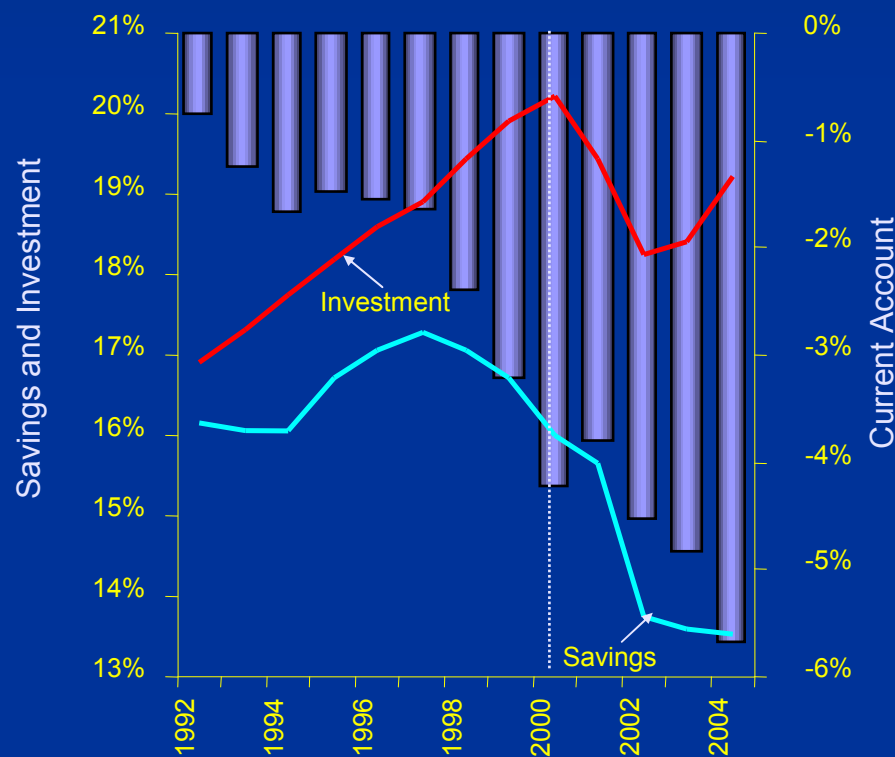
(In % of GDP)



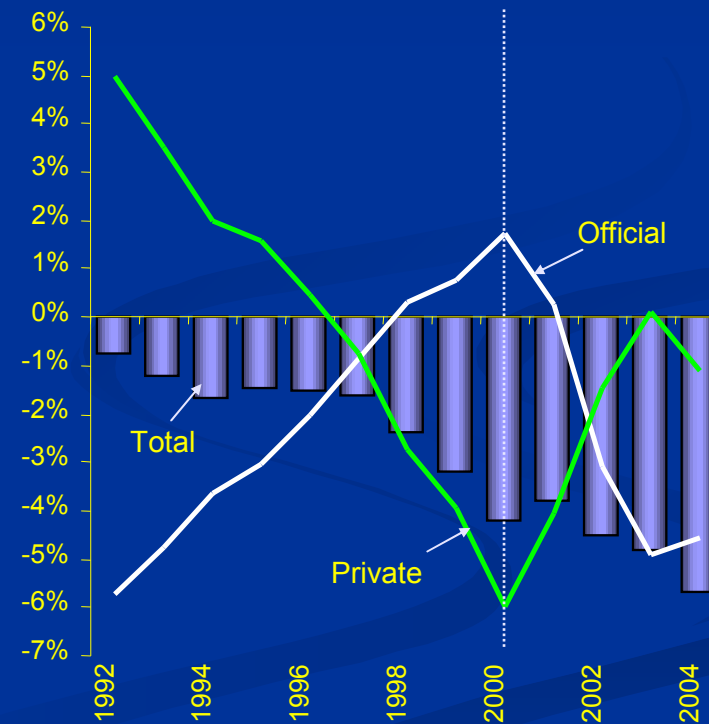
The Changing Anatomy of the US External Imbalance

(% of US GDP)

Savings & Investment

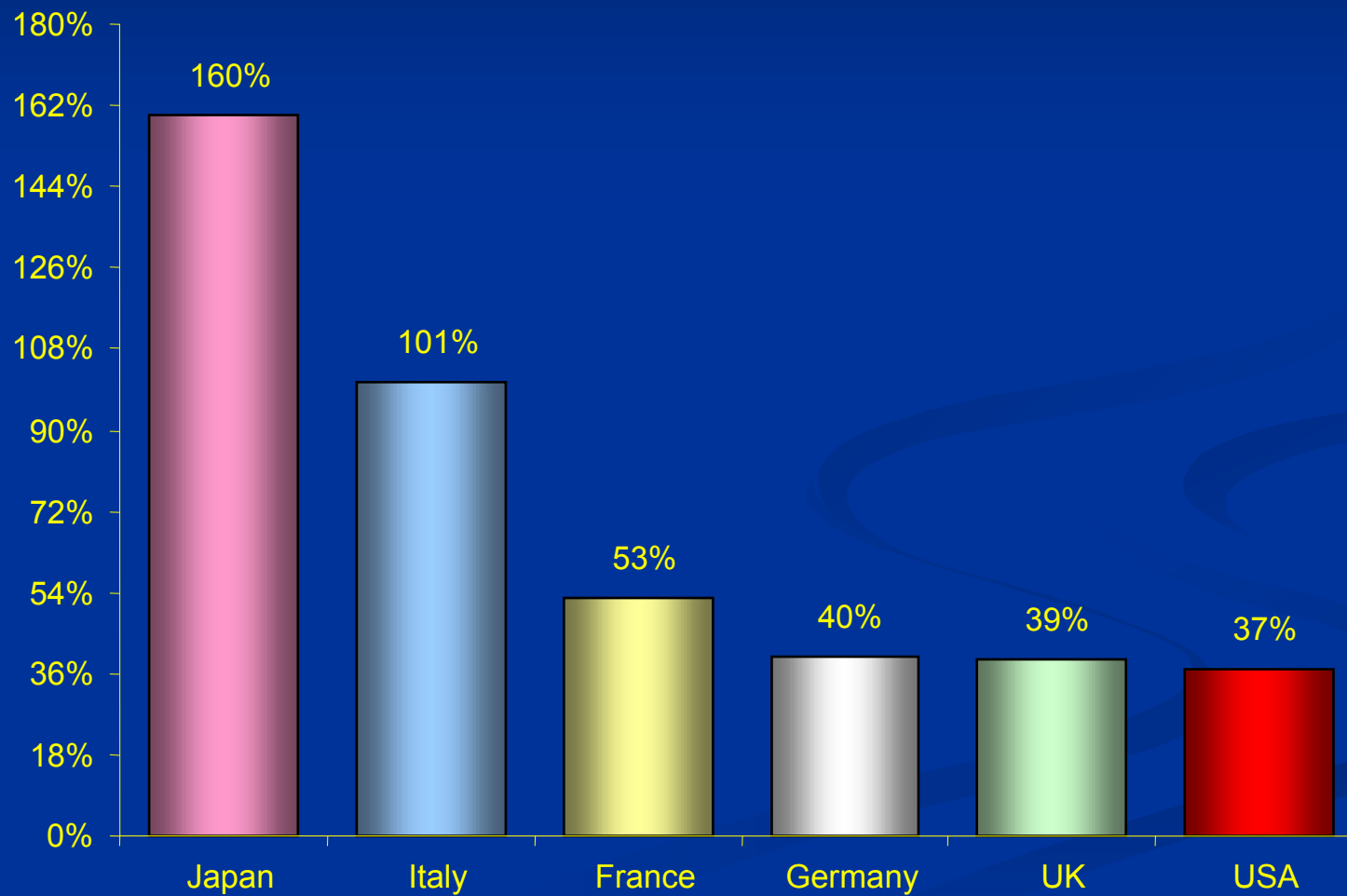


Private and Official Current Account



Public Debt in Industrialized Countries

(Central Government, in % of GDP)

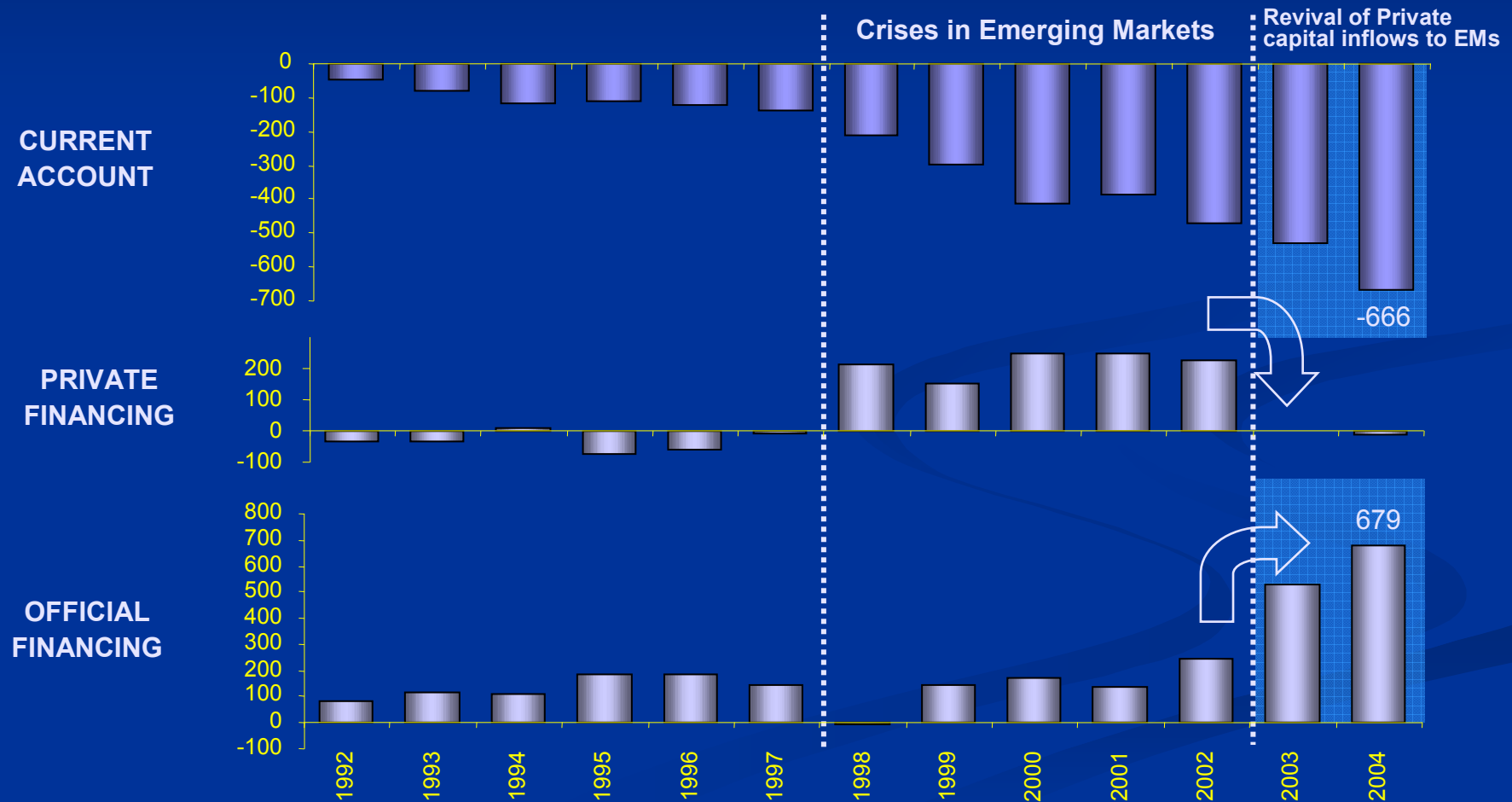


US External Deficit: Financing

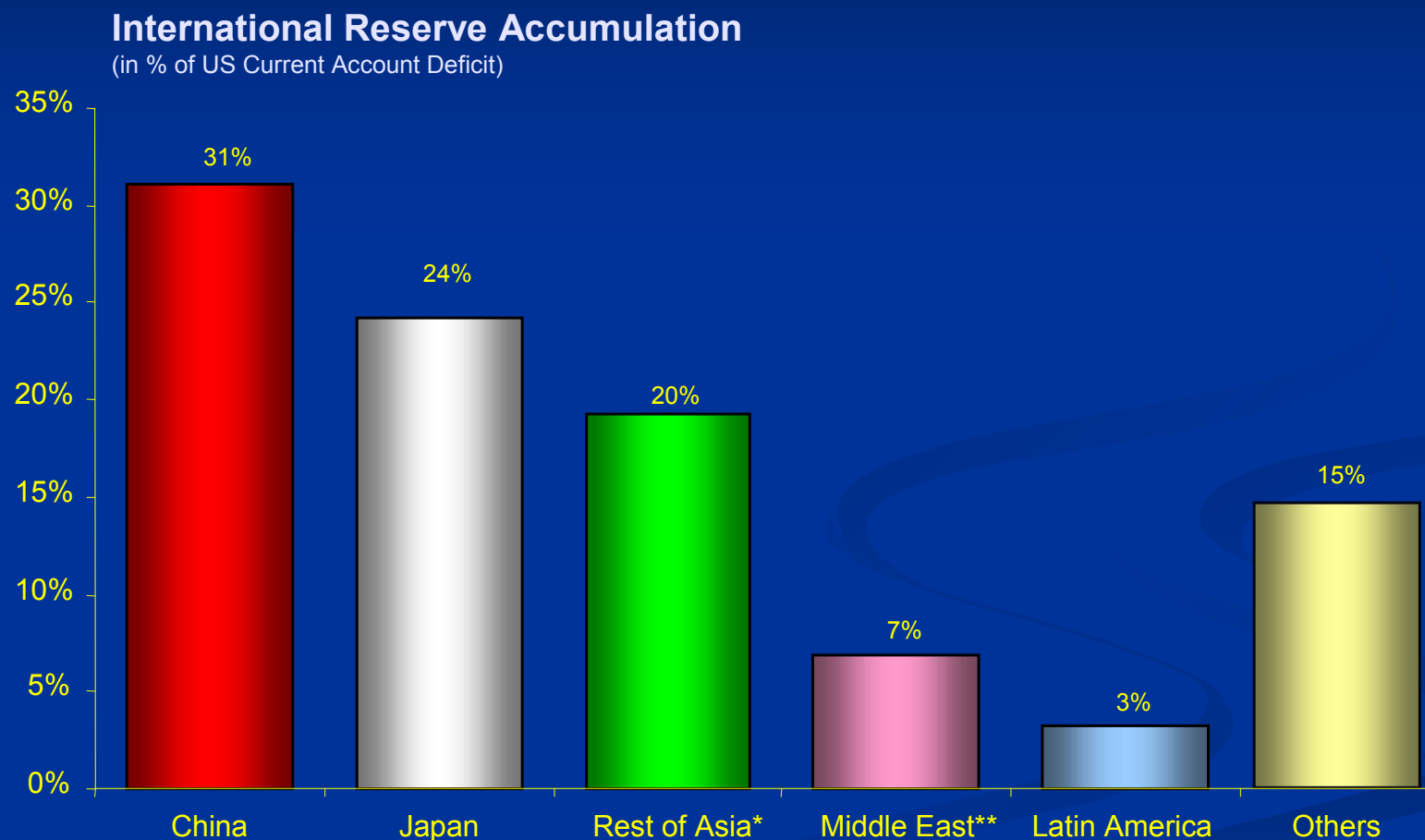
- Before 2001, it was partly financed by the private sector.
- After 2001, it is mostly financed by non-US central banks.
- In 2004, China alone finances more than 30 percent of US Current Account deficit, or about 1.8 percent of US GDP.

Financing of the US External Deficit

(in billions of USD)



Who Financed the US Current Account Deficit in 2004?: Non-US Central Banks



*Includes: Korea, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, Taiwan and Thailand.

**Includes Oil Producers: Bahrain, Iran, Kuwait, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen.

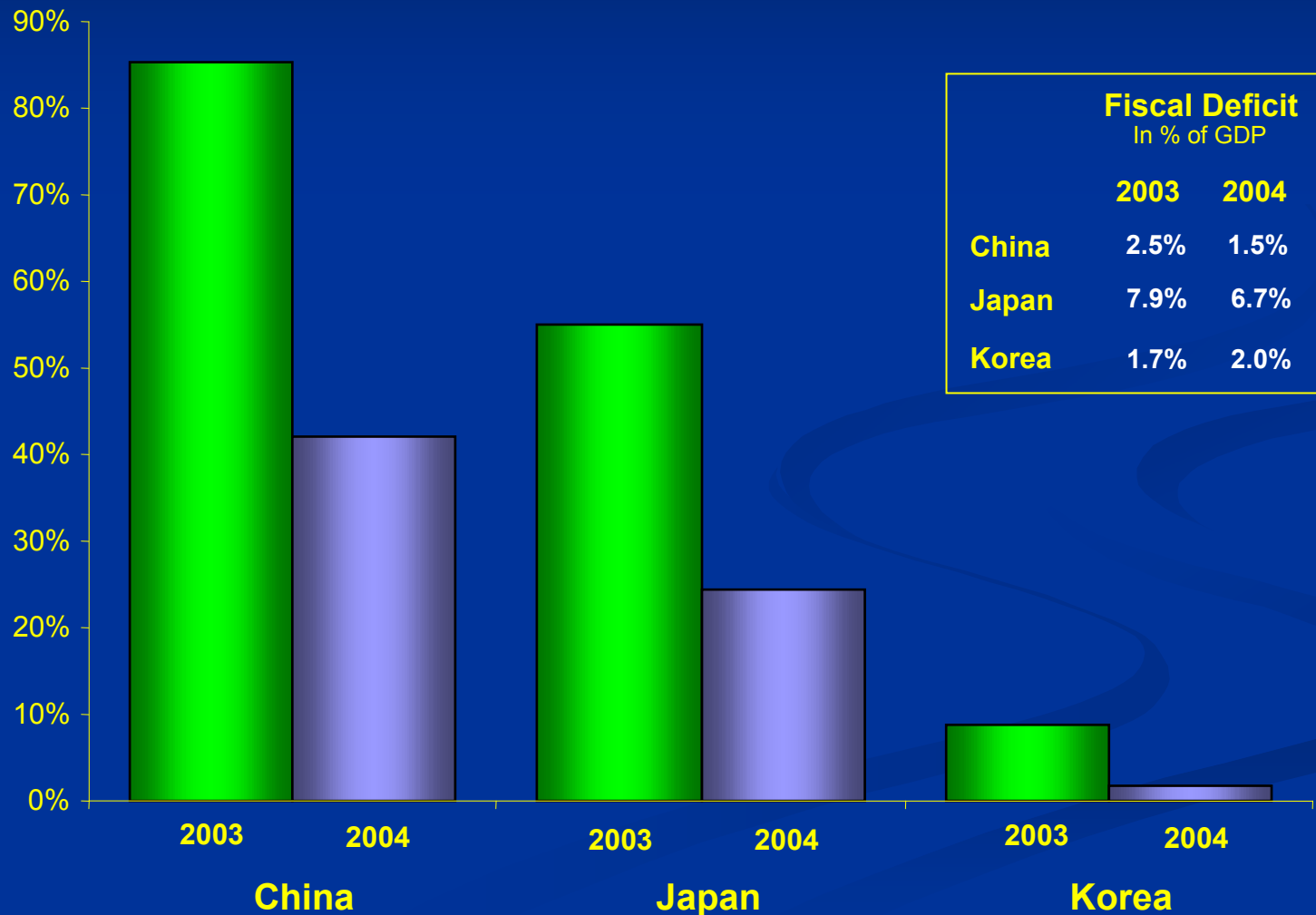
**But Non-US central
banks have no capital
to buy US debt . . . !!**

How Do They Do It?

- Non-US central banks buy US Treasury bonds by issuing their own debt obligations (including high-powered money) to:
 - Private sector, or
 - Other banks who fund their purchase by higher private sector deposits.
- Thus, directly or indirectly, private investors lend to non-US central banks who, in turn, lend to US government!!

How was International Reserve Accumulation Financed?

Seniorgage Revenues in % of International Reserve Accumulation



What If Asia Floats?

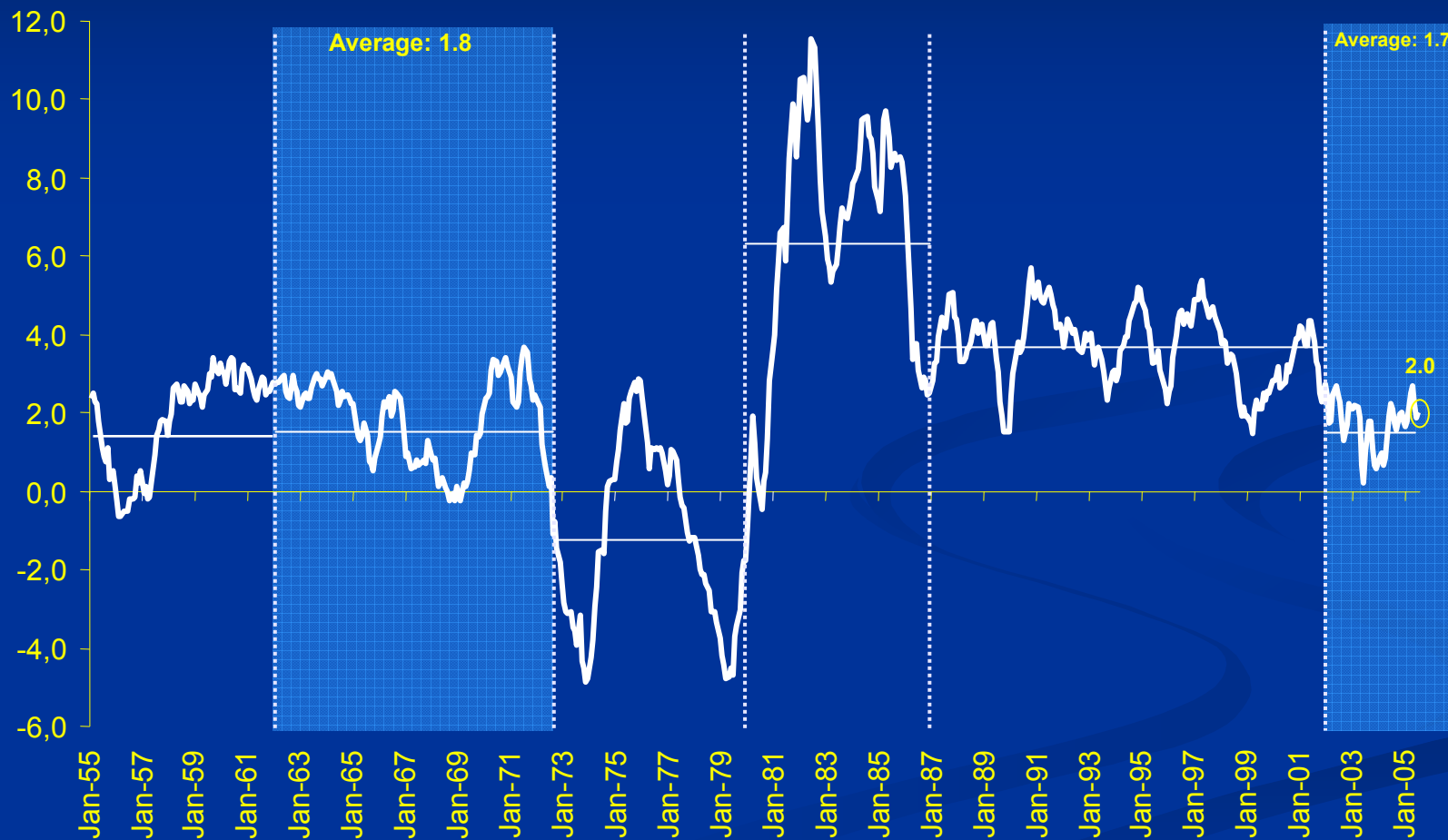
- This means that Asian central banks stop buying US public debt obligations,
- and, therefore, the private sector will buy US public debt obligations directly,
- instead of indirectly, as before.
- Thus, if private sector propensity to buy public sector bonds remains about the same (a reasonable assumption), the impact of Asia floating against the USD on interest rates and exchange rates need not be large. . .
- Unless, of course, political and other considerations generate high market volatility.

US Long-Term Interest Rates

- Interest rates started to fall after the 1998 “flight to quality” prompted by the Asia/Russia crises.
- But rates continued falling even after the “flight to quality” reversed course, and US CA deficit got larger in 2002.
- This appears to be due to:
 - a sharp contraction in loans to the US corporate sector (about 4 percent of US GDP, relative to 2001), and
 - larger saving by Emerging Asia + China (about 0.7 percent of US GDP, relative to 2001).

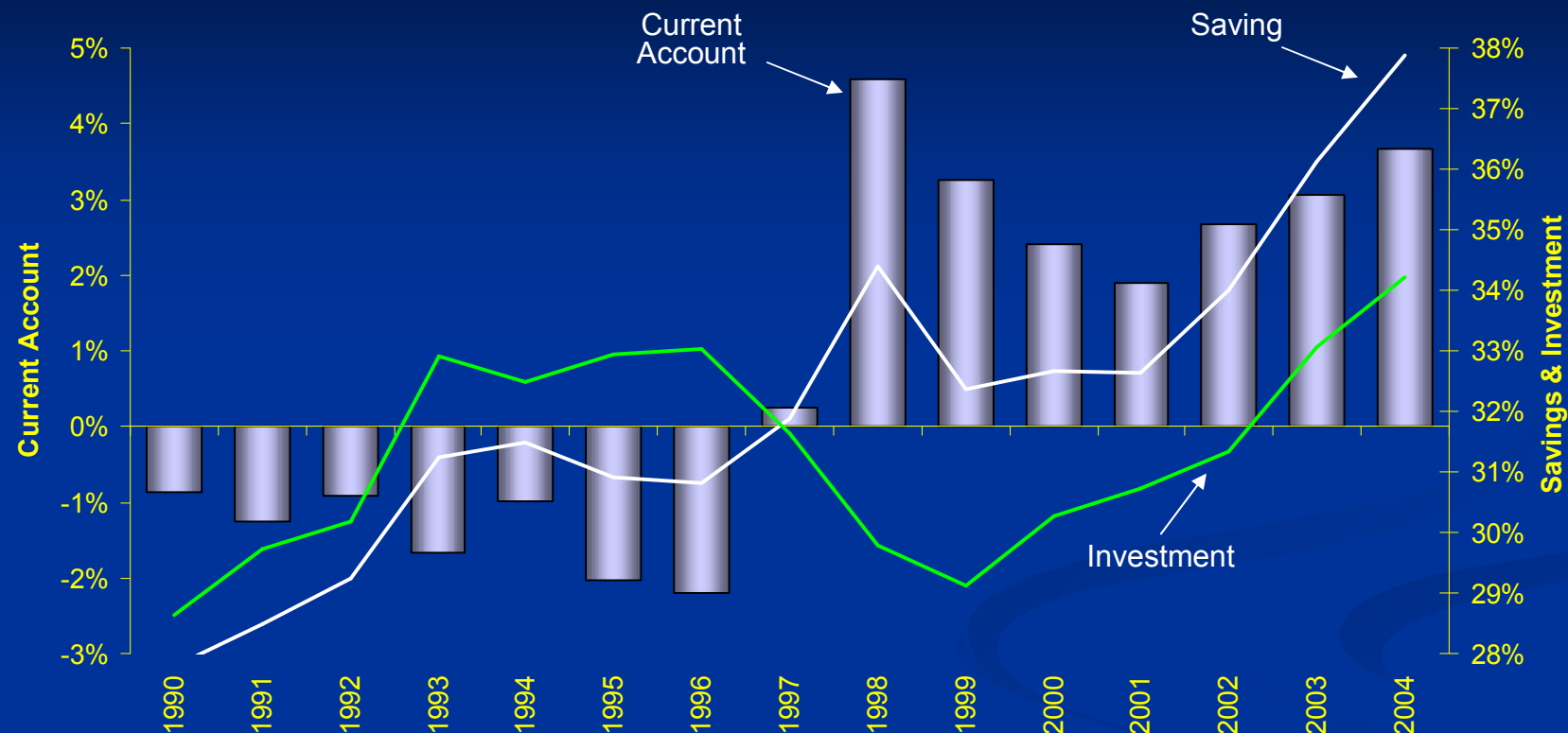
US Interest Rates: A Long Run View

(real interest rate, 10-year US Treasury Bond, Jan-55 – Jun-05)



Saving and Investment in Asia-7*

(In % of GDP)



	1990-1997	1998-2004	Change		2001	2004	Change
Saving	30.2%	34.0%	3.8%	Saving	32.6%	37.9	5.3%
Investment	31.4%	31.3%	-0.2%	Investment	30.7%	34.2%	3.5%
Current Account	-1.2%	2.7%	3.9%	Current Account	1.9%	3.7%	1.8%

*Includes China, India , Indonesia, Korea, Malaysia, Phillipines and Thailand.

Assessment

- The current imbalances are sustainable, even if non-US central banks stop buying US public debt obligations, *if private sector propensity to buy public sector bonds remains largely unchanged.*
- Given current low interest rates, Emerging Markets, and China, in particular, will become magnets for capital flows.
- This may give rise to higher investment and growth in EMs but
- given their small size compared to the US, this trend will likely have little impact on interest rates,
- unless the US fiscal deficit shows no downward trend

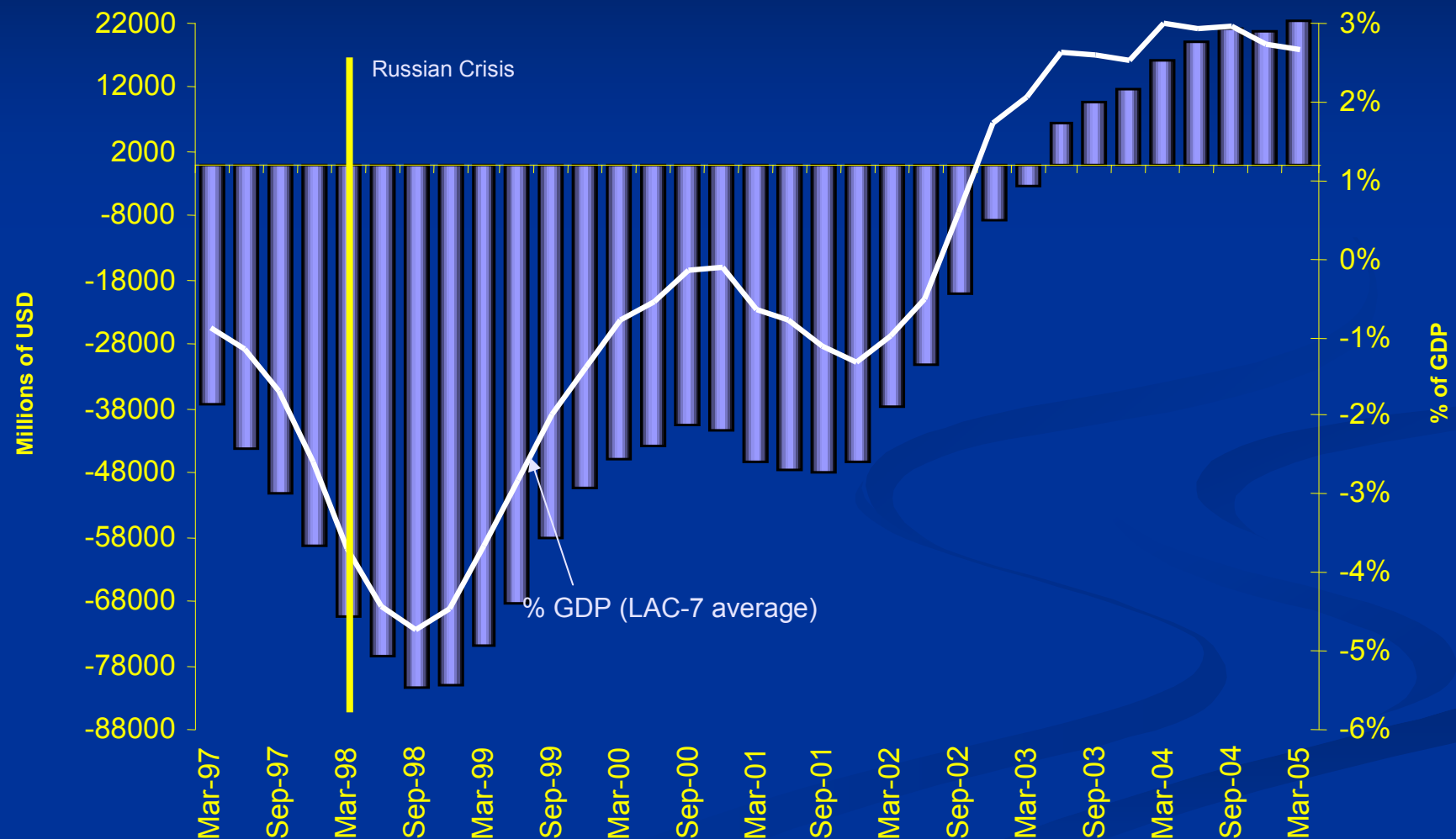
***LEARNING FROM RECENT
CRISES IN EMERGING MARKETS***

External Factors

- Financial crises are associated with Sudden Stops of capital inflows.
- Sudden Stops happen to several economies at about the same time,
- suggesting that factors external to individual EMs play a key role.
- The Asian 1997 and, especially, the Russian 1998 crises, which caused a liquidity crunch in global markets, are prominent examples.

LAC-7: Current Account Adjustment

(last 4 quarters quarters, millions of US dollars & % of GDP)



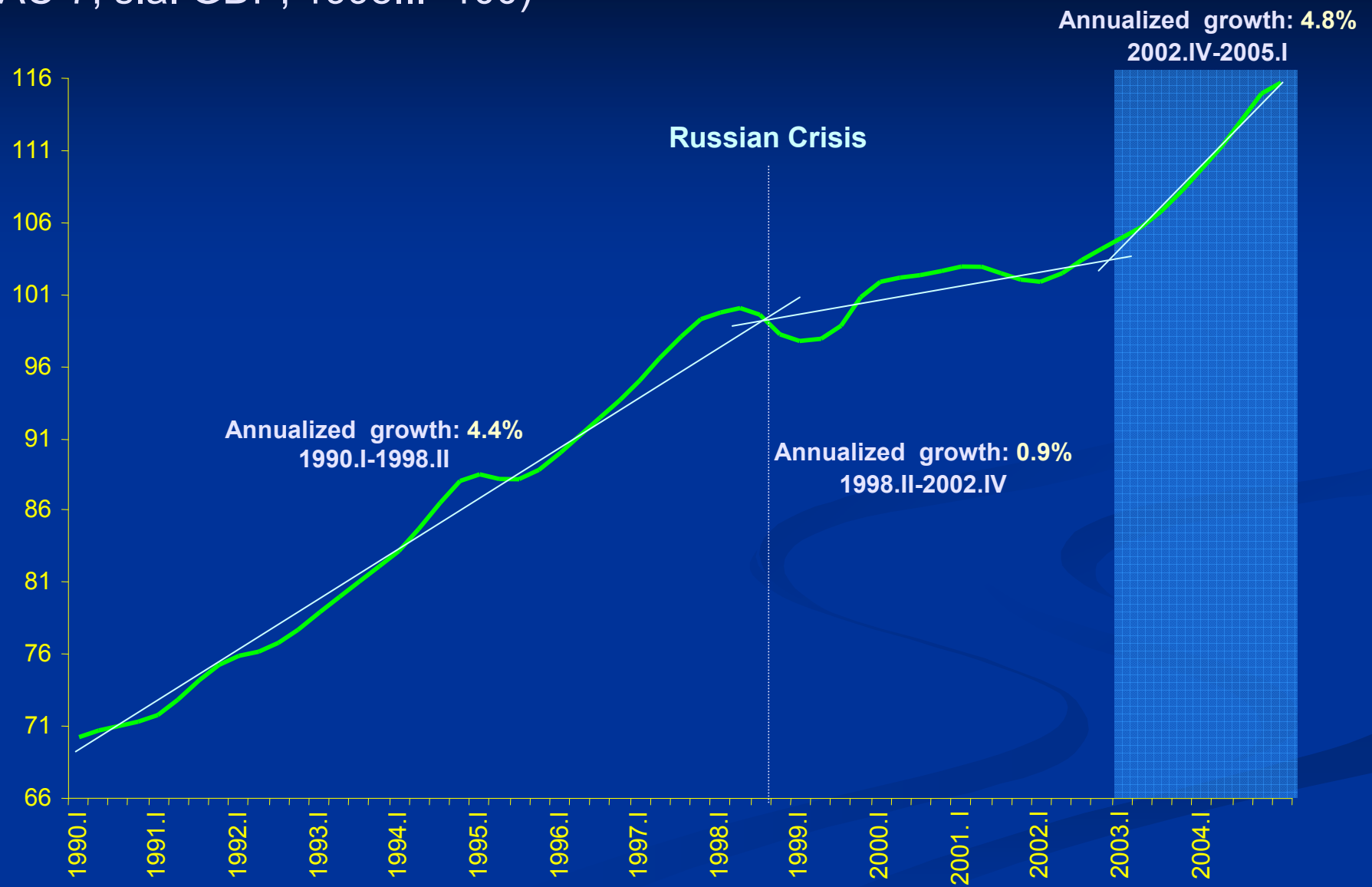
LAC 7: INVESTMENT

(LAC-7, s.a. Investment, 1998.II=100)



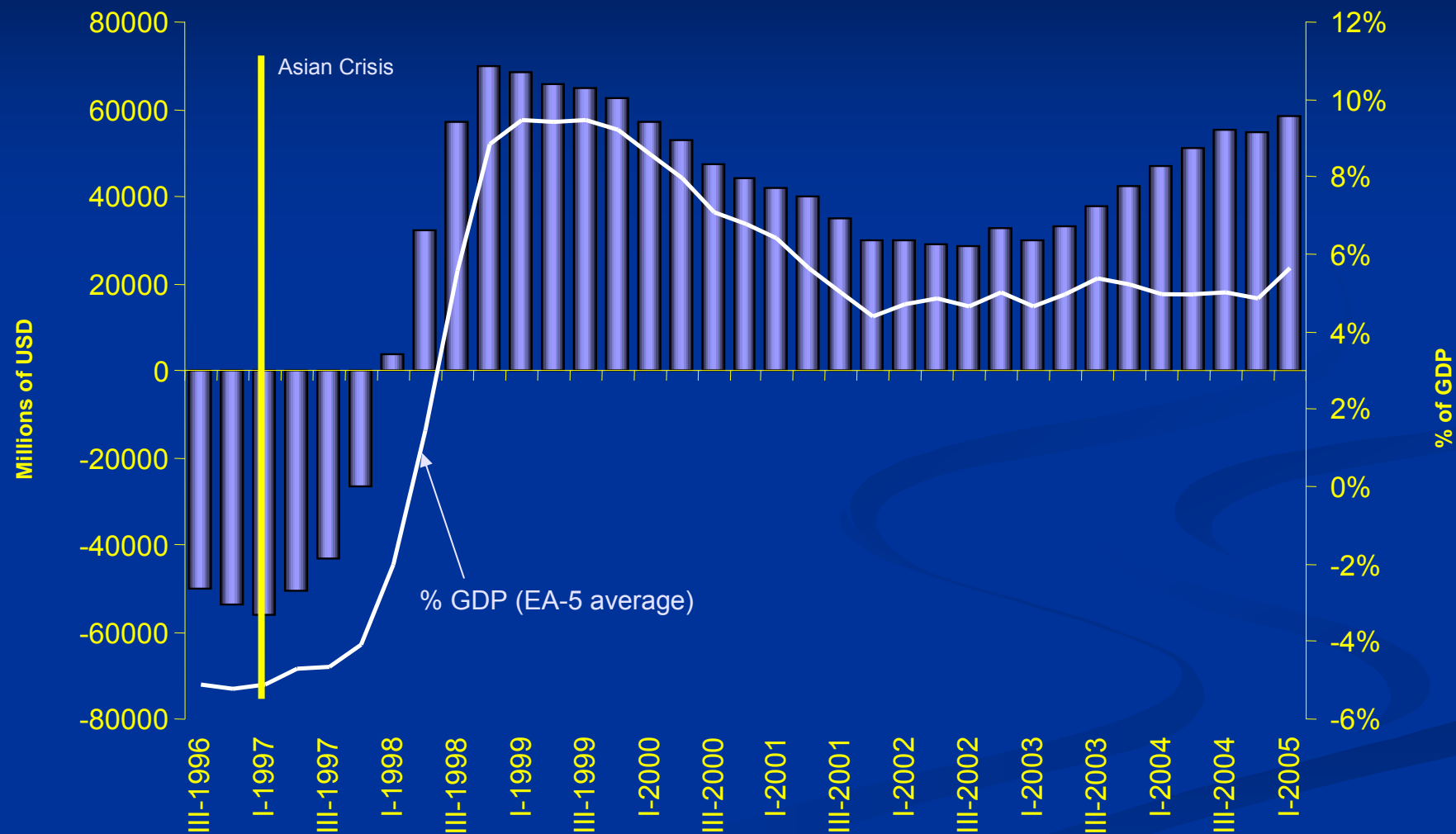
LAC 7: GROWTH

(LAC-7, s.a. GDP, 1998.II=100)



Emerging Asia: Current Account Adjustment

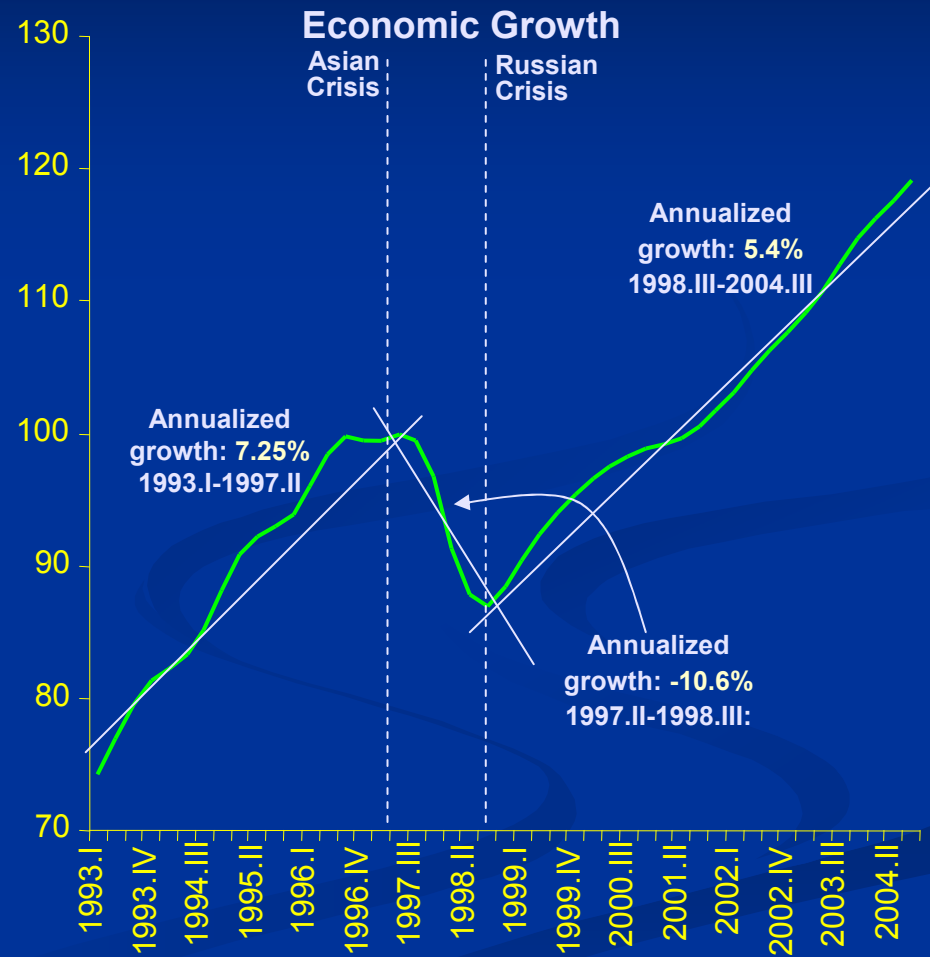
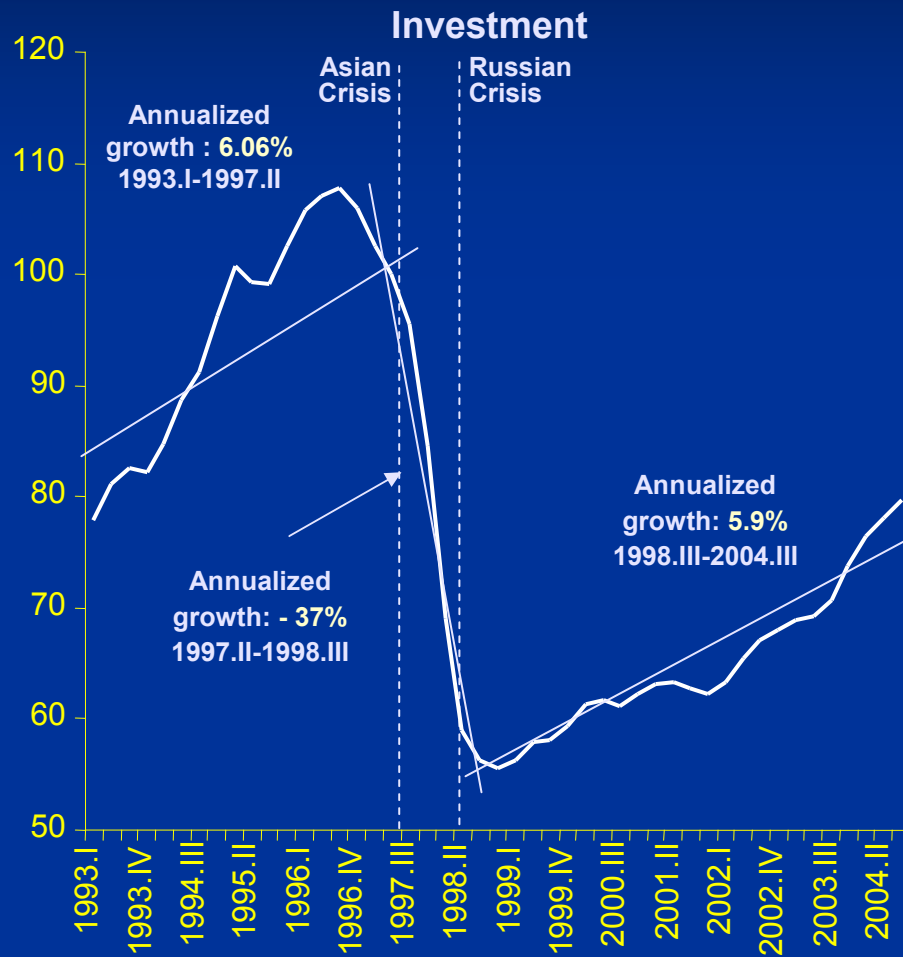
(last 4 quarters quarters, millions of US dollars & % of GDP)



Includes Indonesia, Korea, Malaysia, Philippines and Thailand.

Emerging Asia: Investment and Economic Growth

(s.a. Investment and GDP, 1997.II=100)



Includes Indonesia, Korea, Malaysia, Philippines and Thailand.

Domestic Factors

- Domestic factors are also relevant.
- Our research suggests that
 - External (Current Account) Deficits, and
 - Domestic Liability Dollarization, i.e., foreign-exchange denominated loans by domestic banks as a share of GDP, increase the probability of a Sudden Stop.

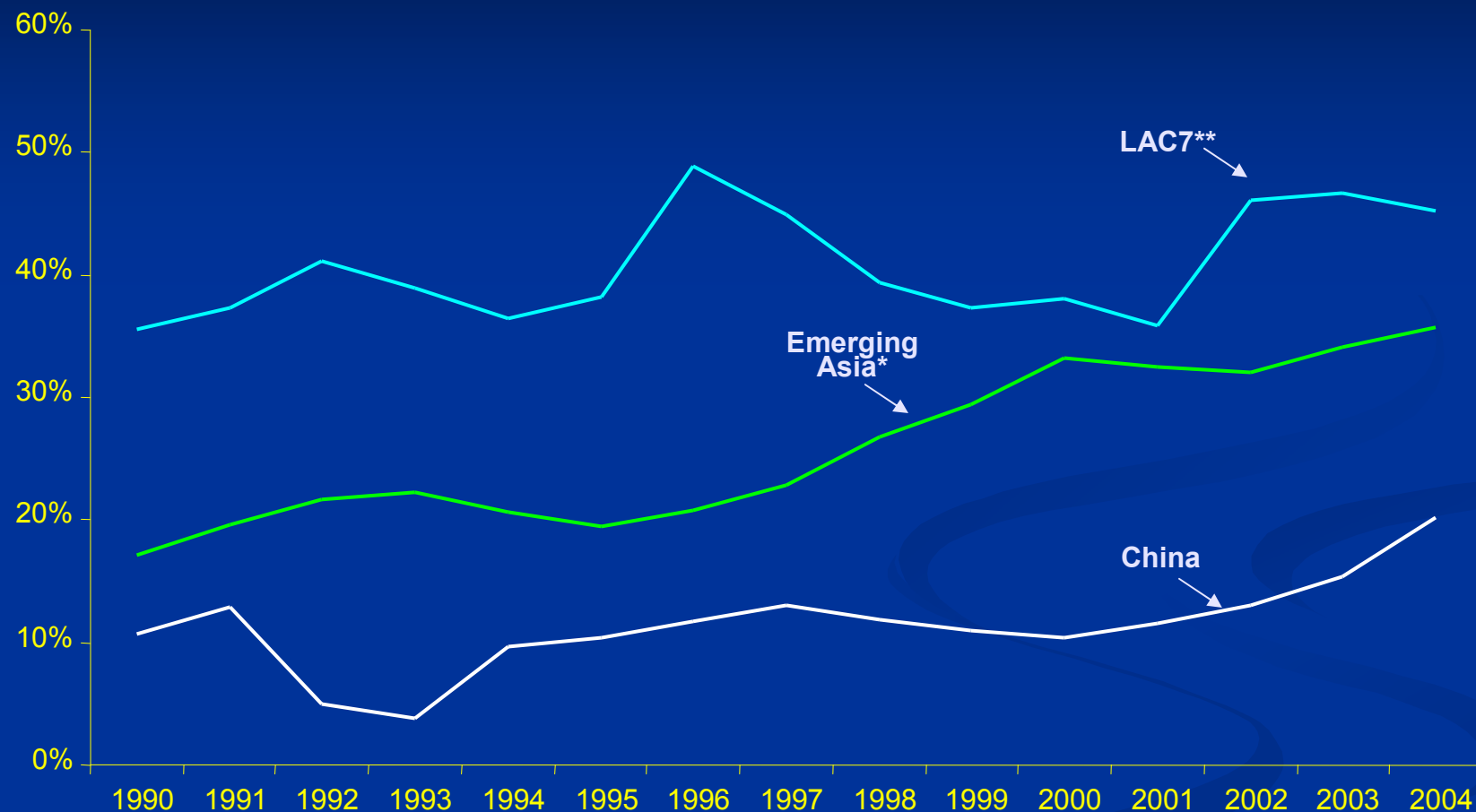
CHINA

Banking Sector

- By international standards, stock of International Reserves is not large relative to M3.
- Hot money is becoming more and more prominent, although total stock is probably modest.
- Central bank sterilization has not succeeded in substantially increasing the ratio International Reserves/M3.

International Reserves: China vs. Other EMs

(% of M3)



Source: IMF World Economic Outlook.

*Includes Indonesia, Korea, Malaysia, Philippines and Thailand.

** Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Financial Flows and Issuance of PBC Bonds

(% of GDP)



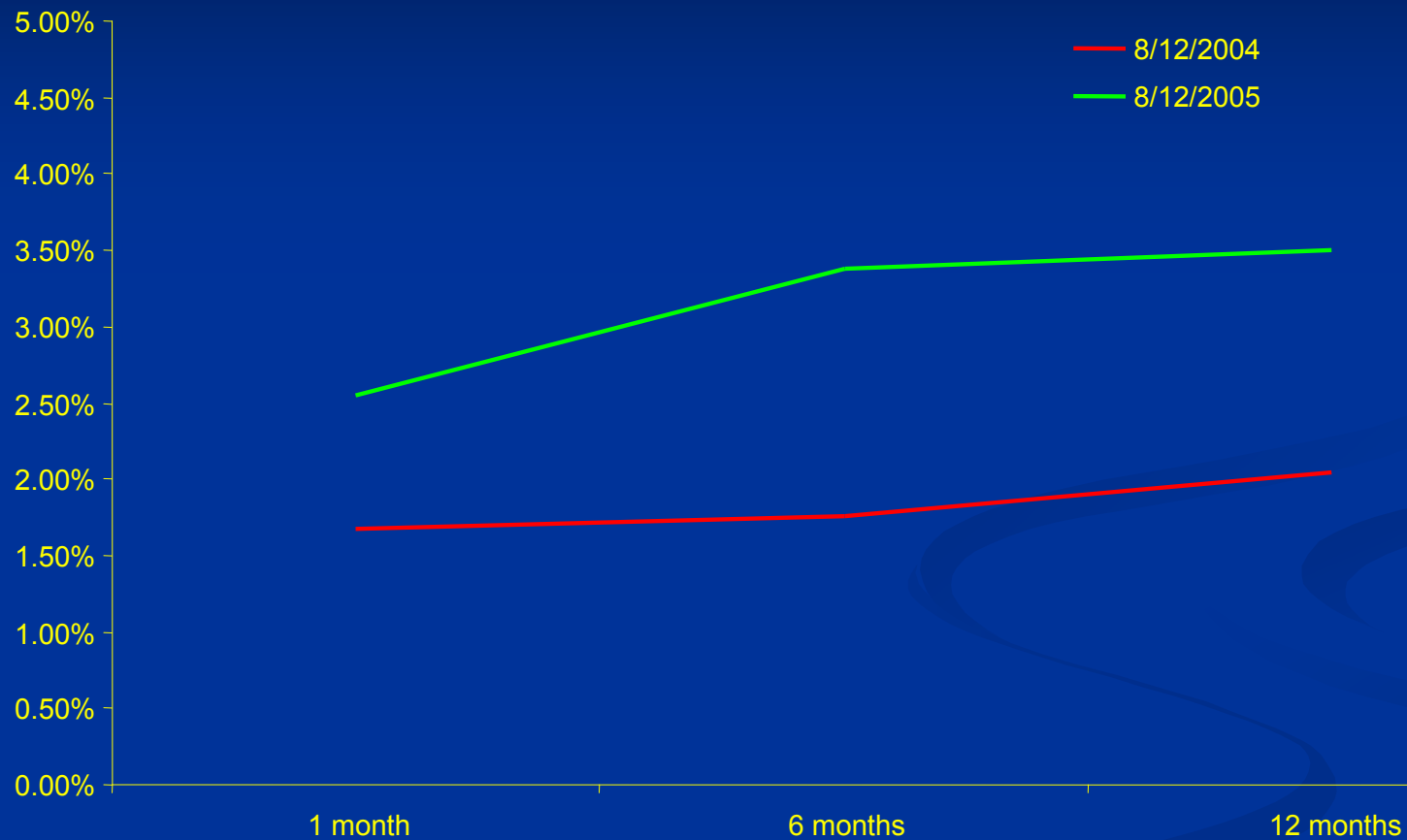
Source: IMF – international Financial Statistics.

Hot Money: Prospects

- RMB Non-Deliverable-Futures show that **expected returns** (from RMB appreciation) **are less than 4 percent** per year.
- However, expected returns have been rising,
- and may keep rising if market believes that the China's authorities will bow to US pressure for further RMB appreciation.
- For instance, if market expects that RMB will be revalued 5 percent against the USD in 1 month, then the USD return on holding RMB for 1 month would be equivalent to 80 percent per year!

Yield Curve of the Renminbi

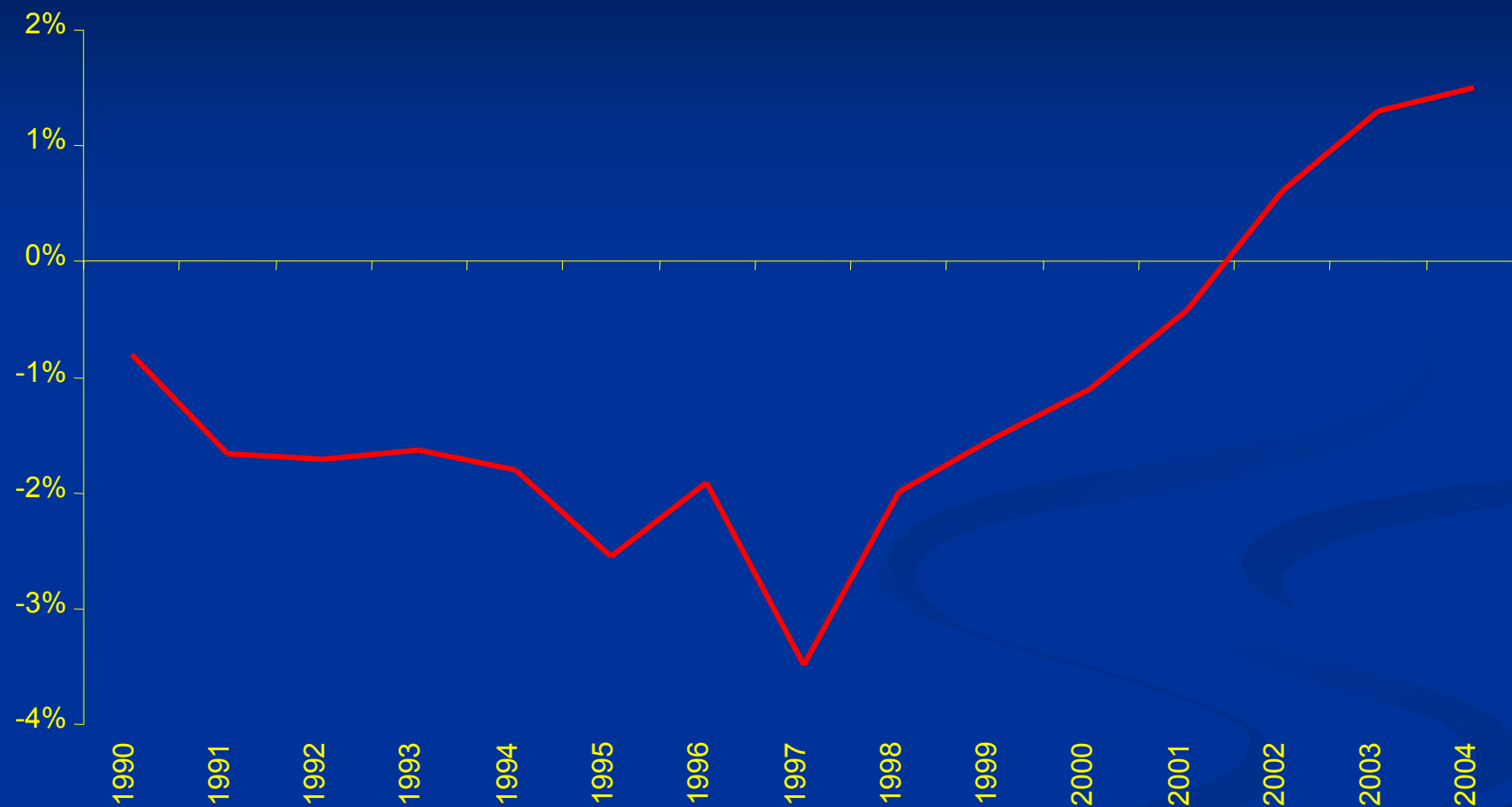
(NDF RMB per USD, annualized return)



Source: Bloomberg

Net Errors & Omissions

(% of GDP)



Source: IMF World Economic Outlook.

Thus, capital inflows under present conditions may increase the vulnerability of the financial sector to Sudden Stops.

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