Peterson Institute for International Economics

Global Imbalances and Policy Spillovers: New Approaches at the IMF

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September 18, 2012

New Approach to Policy Surveillance

- New principles and framework very sensible
- Policies have large spillover effects
- Countries cannot be assessed in isolation
  - Their policies affect everyone else
  - Everyone else's policies affect them
  - This includes domestic policies
- Agree with IMF's assessment of US fiscal cliff effects
  - Agree with QE analysis in first spillover report

New Approach to Policy Surveillance

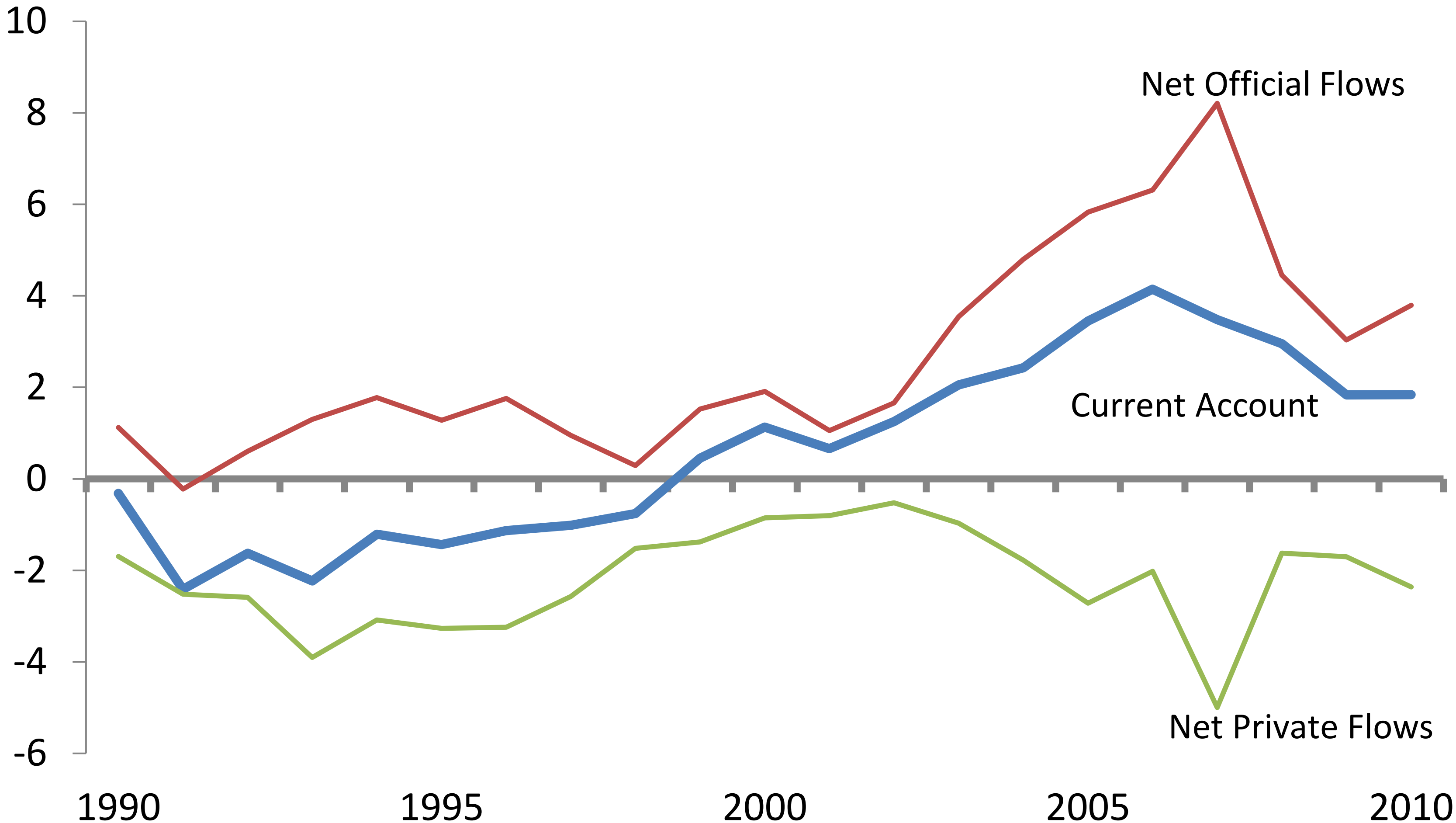
- Statistical analysis needs to be done jointly over all countries to account for spillovers
  - External Balance Assessment is a good start

- However, a technical statistical issue has thrown off the initial EBA conclusions in an important way
  - The error is understandable but correctable
  - It does not invalidate the overall approach

- EBA analysis includes exchange rate policy
  - accumulation of FX reserves
- But it greatly understates the importance of reserves and other official financial flows
- Net official flows are the most important driver of global imbalances
- Although surveillance must consider all policies, external and domestic, exchange rate policy is the one area in which IMF members have obligations
- "A member shall avoid manipulating exchange rates … to gain an unfair competitive advantage"

External Accounts of Non-Industrial Economies

(percent of GDP)



Source: IMF *International Financial Statistics* and Truman (2011) for SWFs.

Correlations, All Countries and Years, 1986-2010

(percent of GDP)

	Current Account	Net Official Flows	Net Private Flows	Volatility (Std. Dev.)
Current Account	1.0			11.0
Net Official Flows	0.5	1.0		10.8
Net Private Flows	0.5	-0.2	1.0	7.8

Note: Official flows include estimated SWF flows based on oil exports and Truman (2011). FX reserves are allocated to recipient countries based on IMF COFER data.

CA = NOF + NPF

CA = α + β NOF + *exogenous factors*

(not exchange rate, which is endogenous)

<u>Pure floating exchange rate</u>

β is <u>un</u>biased if NOF reflects reserves target, SWF saving, development loans.

<u>Fixed or managed exchange rate</u>

β is biased <u>up</u> if CA shocks dominate.

β is biased <u>down</u> if NPF shocks dominate.

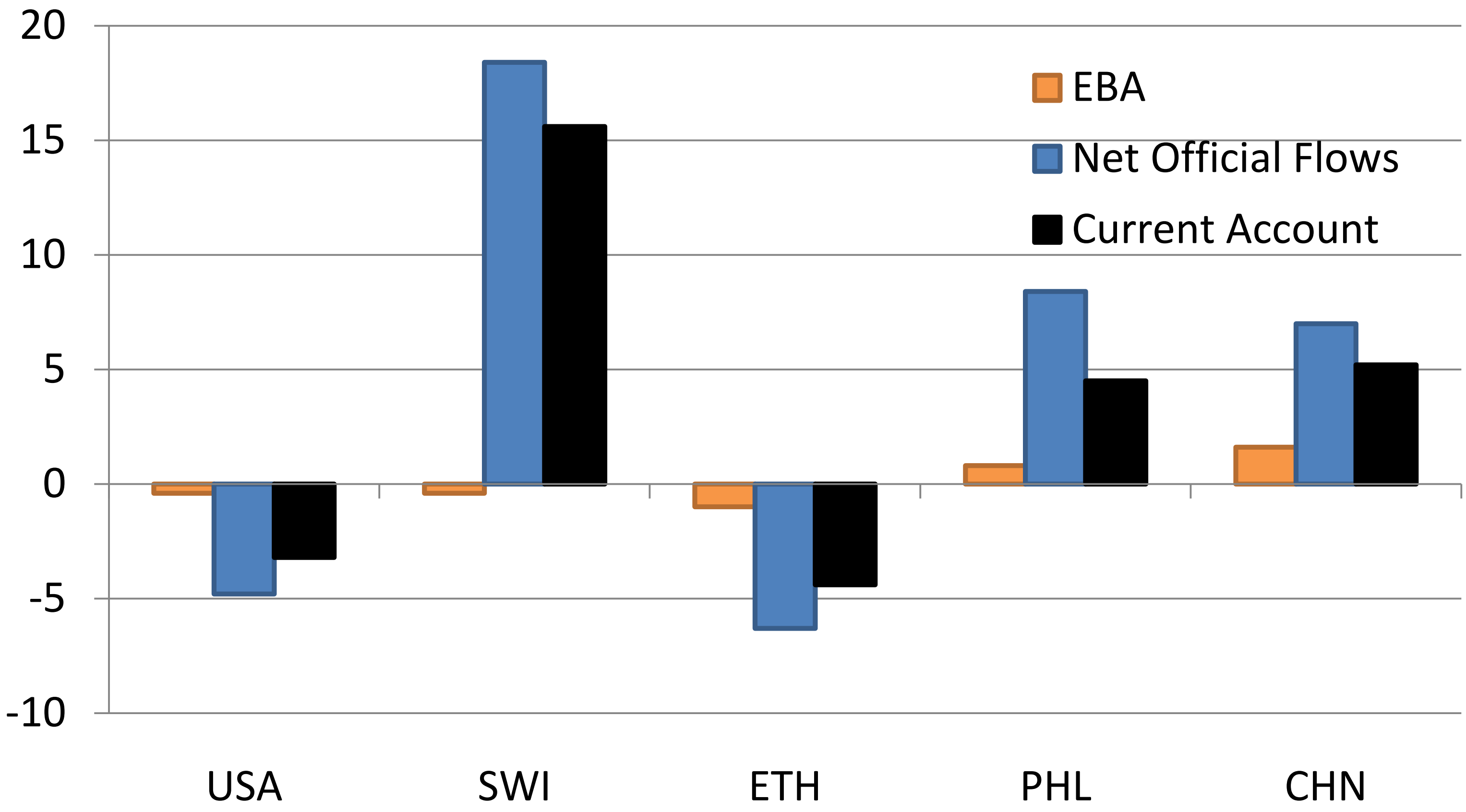
Instruments for NOF

- EBA uses lagged NOF and current VIX in separate regressions by country
- I use
  - lagged 5-year moving average of NOF
  - lagged 5-year moving average of oil exports (if over 10% of GDP)
  - lagged net foreign assets
  - lagged FX reserves divided by goods imports
  - current fiscal balance
  - country fixed effects in panel regression

Other Statistical Issues

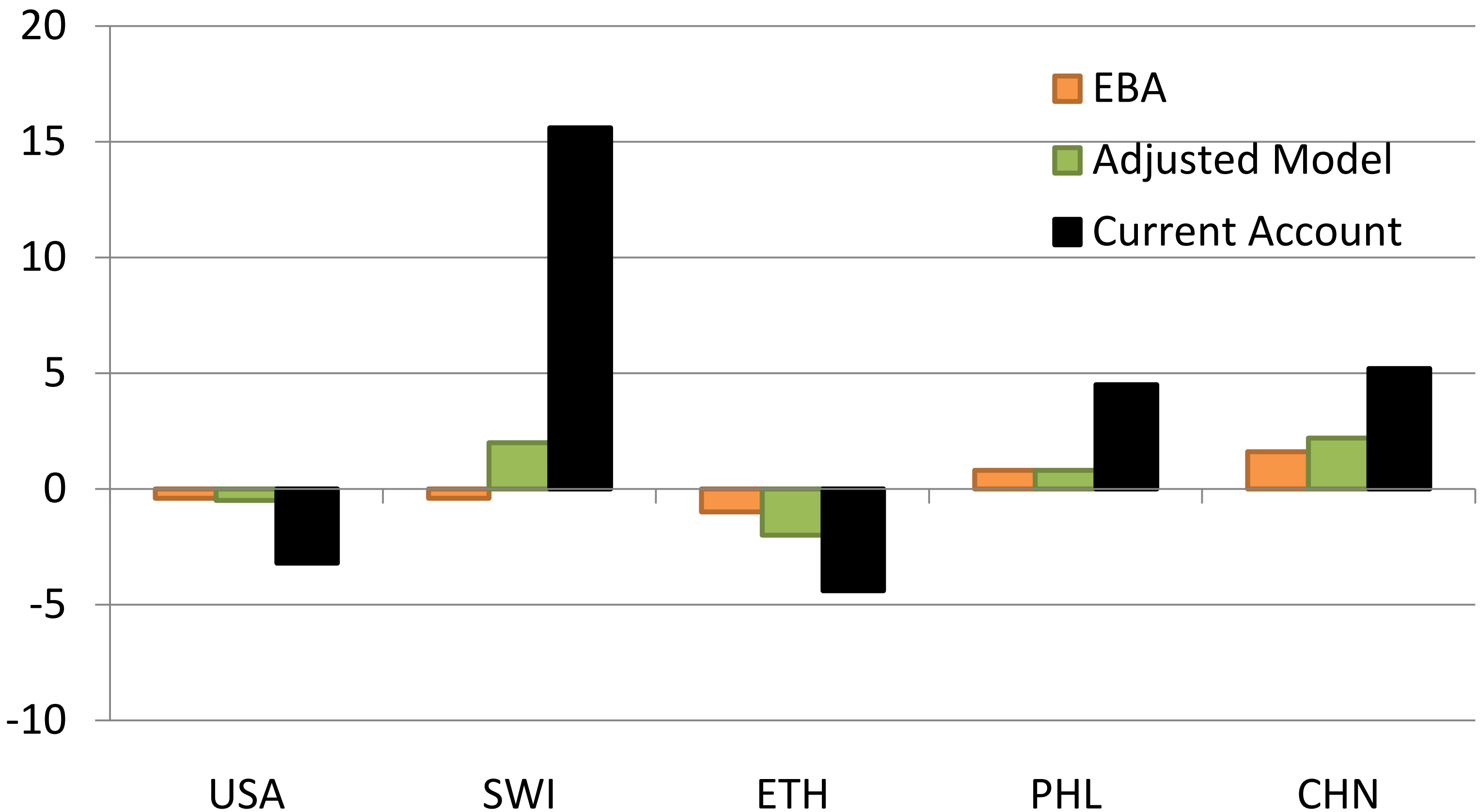
- Some variables in EBA regression may be proxies for net official flows (NOFs)
  - large oil exports are driver of SWF flows
  - net foreign assets include reserves and SWFs
  - financial centers have large NOFs
  - currency share in world reserves indicates recipients of NOFs
- Capital controls
  - are poorly measured
  - may affect other variables inversely

Contribution of Official Flows to Current Accounts (percent of 2010 GDP)



EBA is IMF estimated effect of FX reserve accumulation on current accounts.

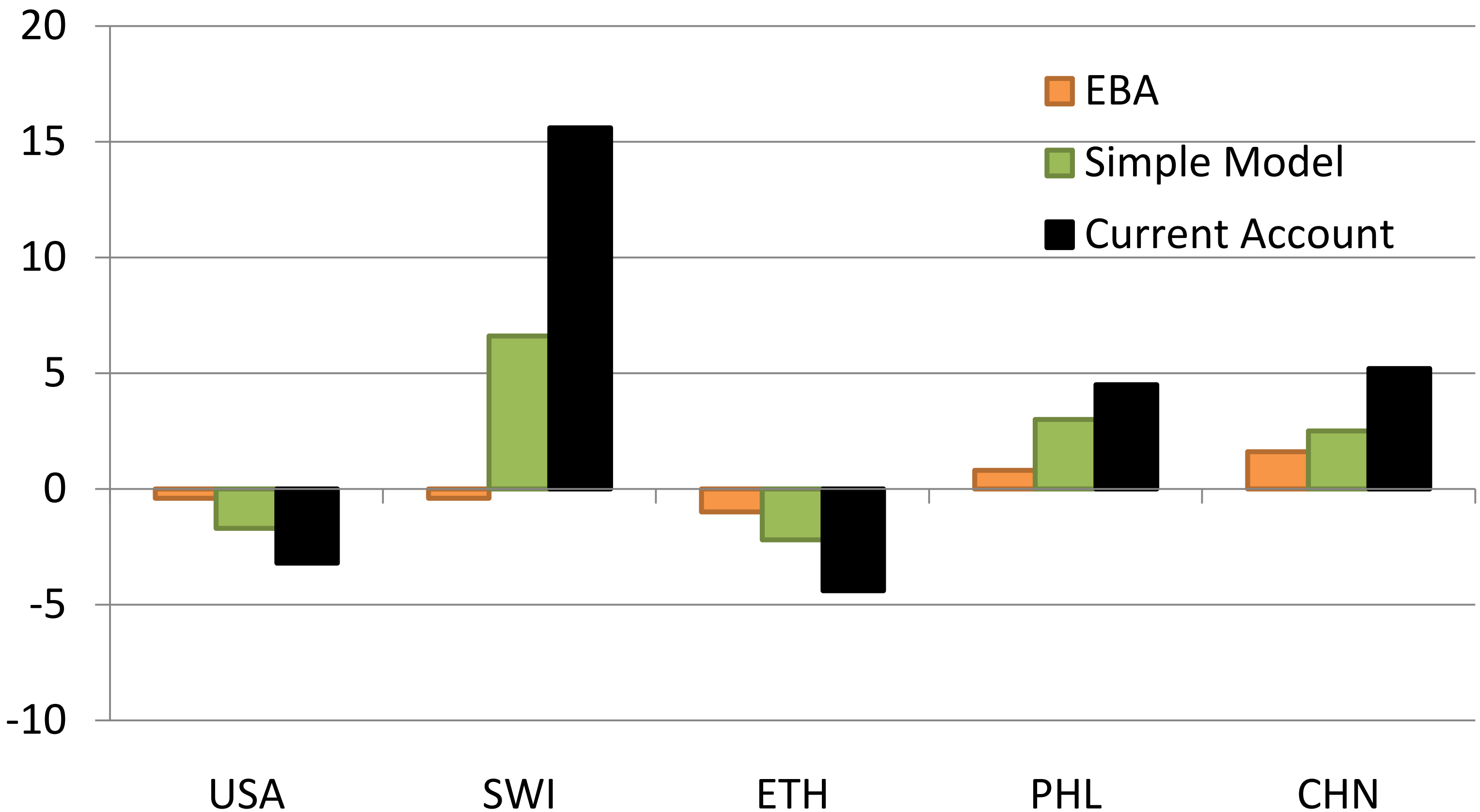
Contribution of Official Flows to Current Accounts (percent of 2010 GDP)



EBA is IMF estimated effect of FX reserve accumulation on current accounts.

Adjusted model is based on IMF model with adjusted official flows (not instrumented, both with and without capital control interaction), more countries, and Chinn-Ito capital mobility data.

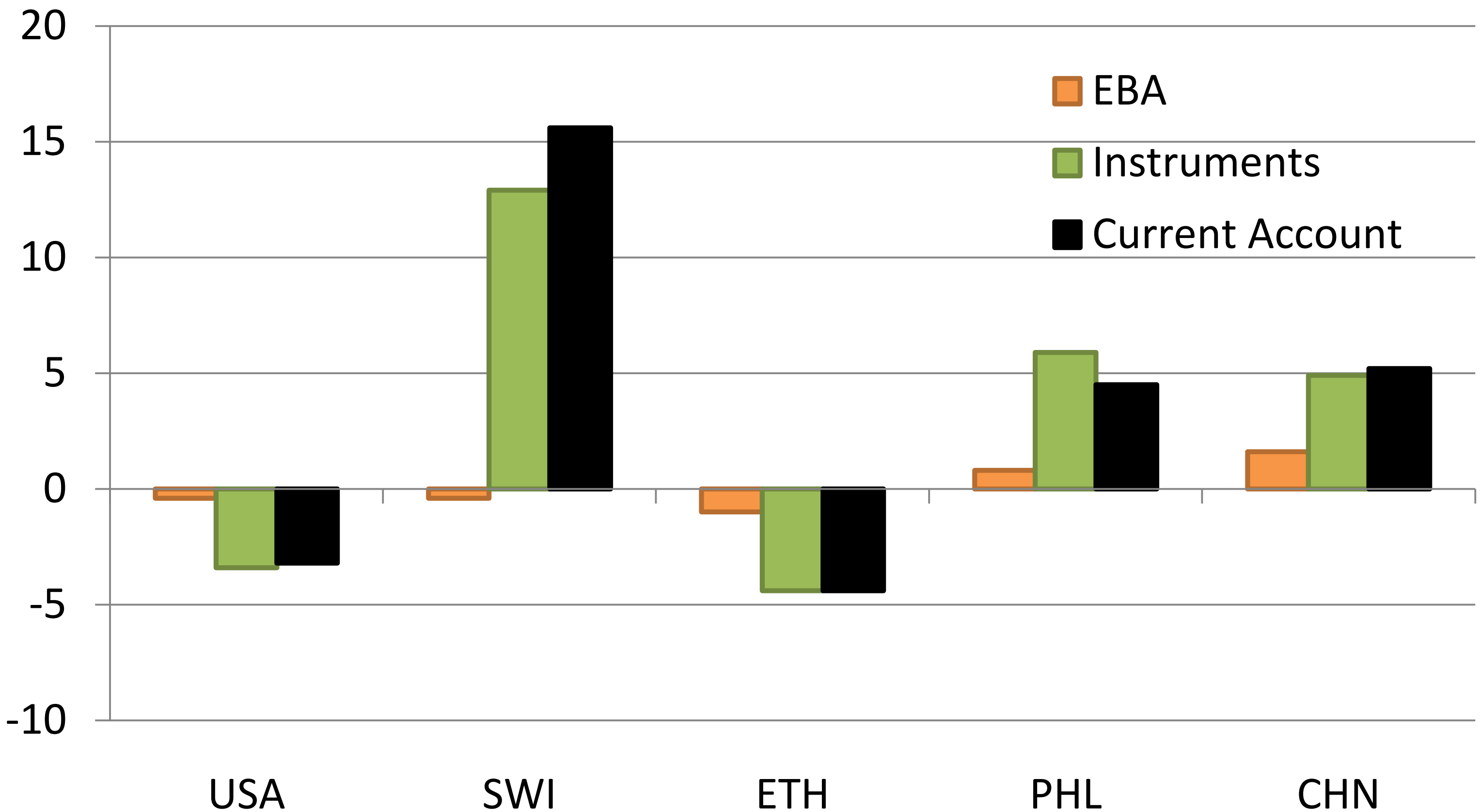
Contribution of Official Flows to Current Accounts (percent of 2010 GDP)



EBA is IMF estimated effect of FX reserve accumulation on current accounts.

Simple model is based on adjusted flows, more countries, no instruments, and only 2 explanatory variables: net official flows and fiscal balance.

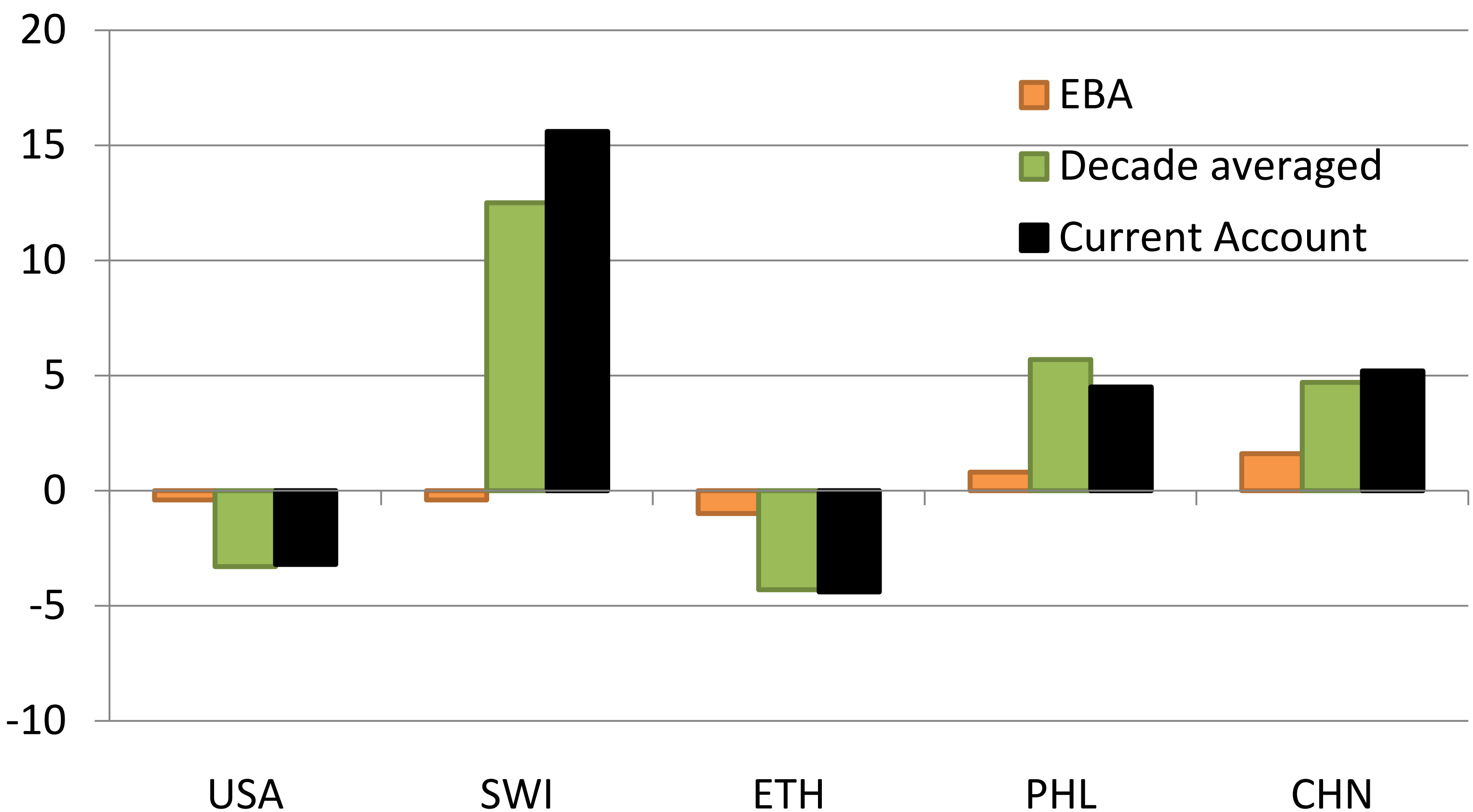
Contribution of Official Flows to Current Accounts (percent of 2010 GDP)



EBA is IMF estimated effect of FX reserve accumulation on current accounts.

Instruments is based on simple model with instruments for official flows.

Contribution of Official Flows to Current Accounts (percent of 2010 GDP)



EBA is IMF estimated effect of FX reserve accumulation on current accounts.

Decade averaged is the simple model using non-overlapping decade averages of country data and weighted by country GDP as in Gagnon (2012).

FX Reserve Adequacy

- IMF overstates adequate FX reserves
- Too much credence to what countries do
- Too little attention to more important policies:
  - Better monetary frameworks
  - Less foreign-currency debt
- Ridiculous to assert that China's $3.2 trillion of reserves is only 25% above an adequate range
- For many emerging markets, FX reserves are now essentially unnecessary except as mercantilist tool