## COMMENTARY
# Global Imbalances and Global Liquidity

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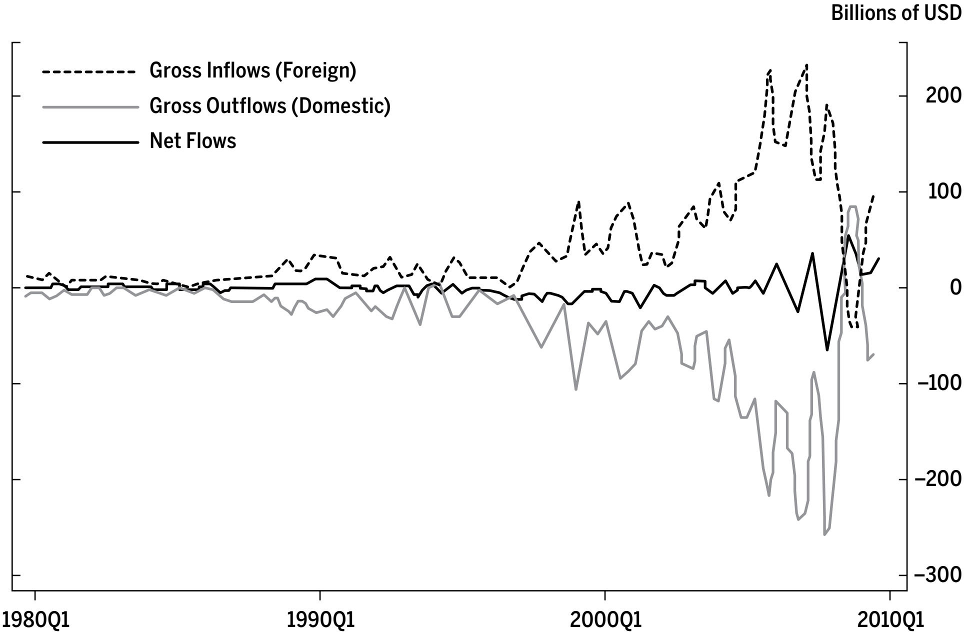
People do not answer direct questions or requests for a number of reasons. They may not understand the question. They may not know the answer—or they may choose not to answer because the correct answer would get them into trouble. Or they may decide that the question isn't terribly interesting, and instead choose to reframe what they are answering.

My reading of this paper by Pierre-Olivier Gourinchas is that he chose the latter strategy. Months ago when paper topics for this conference were assigned, my understanding was that Gourinchas would write a paper on global imbalances that focused on the role of Asia (which was code for a paper on China's current account surplus versus the U.S. current account deficit and related currency issues). Gourinchas starts his paper with a brief consideration of this topic, using the standard approach of focusing on current account balances. He succinctly concludes that global imbalances have fallen since the global financial crisis, and although current account deficits can be a sign of vulnerability, they also can be a healthy indicator and are only weakly correlated with crises. Rather than rehash well-known discussions of the large U.S. current account deficit, the global savings glut, reserve accumulation, inflexible exchange rates in Asia, etc., Gourinchas quickly shifts the focus of the paper to what he believes is the more relevant and timely issue: global liquidity imbalances. I think we should all thank him for not forcing us to sit through another discussion of current account deficits and surpluses and the need for the United States to address its fiscal situation and China to allow more exchange rate flexibility. Instead, Gourinchas quickly shifts the focus to a new and extremely important set of issues related to gross liabilities and liquidity risks.

Gourinchas's argument builds on a fundamental rethinking of imbalances that has been slowly developing over the past few years in a series of papers focusing on gross capital flows and gross asset and liability positions (rather than previous work on net flows and positions). Figure 1 graphs net capital flows for France, and then disaggregates these flows into gross inflows (from foreigners) and gross outflows (by domestics). As shown in the graph, net current account balances—the focus of most previous work on imbalances—have been

FIGURE 1
**Net and Gross Flows for France**




relatively stable compared to the movements in gross capital inflows and outflows over the past 15 years. Most countries around the world—both developed and emerging—show this trend.

Over the past few years, several papers have highlighted why it has become increasingly important to look at gross instead of net positions and flows. For example, Lane and Milesi-Ferretti (2008) and Gourinchas and Rey (2007) show how larger gross positions will cause seemingly minor valuation changes through exchange rates or relative market movements to have substantial reallocation effects in terms of international wealth. Forbes and Warnock (2011) highlight how disaggregating net capital flows into gross flows driven by domestic and foreign investors can significantly change our understanding of what drives extreme movements in capital flows. Bertaut et al. (2011) document how focusing on net capital flows misses the important role played by Europe in channeling financial flows from Asia to the United States before the crisis—patterns only captured by looking at gross capital flows. Shin (2011) also highlights the role of Europe in channeling capital flows—focusing on how European banks intermediate U.S. dollar funds—an exposure missed in measures of current account imbalances.

Gourinchas's paper takes this critically important rethinking of global imbalances by focusing on gross capital flows or positions (instead of net) to a new level. He argues that the key issue is the liquidity of the gross assets and liabilities—not just the magnitudes. More specifically, Gourinchas defines global liquidity imbalances as the liquidity mismatch across countries over time, basically the mismatch between short-term liabilities that need to be rolled over and the country's pledgeable assets. He proposes a specific ratio to measure this—the liquidity coverage ratio (the ratio of the stock of pledgeable claims to maximum short-term funding outlays). Although the details about the measurement and definition are complicated, the concept is clear and important. Rather than focusing on a country's net funding requirements, Gourinchas suggests we should be focusing on a country's gross funding needs. The last few years have shown how quickly markets can freeze up, how liquidity can vanish, how seemingly safe counterparties can be unable to complete their portions of a trade, and how assets judged as low-risk can suddenly become toxic. Just because a country had a reliable source of financing in the past, this is no guarantee that this funding will continue in the future, especially during times of stress. To understand these vulnerabilities, it is necessary to focus on a country's (and its sectors') gross funding requirements and the liquidity of these funds.

Gourinchas outlines some of the challenges in actually implementing his framework for analysis, such as what should constitute short-term financial liabilities. This should be much broader than typical measures (such as short-term external debt) and should include at least M2 (which includes all bank deposits) and possibly even broader aggregates (such as money market funds). This discussion is extremely useful in thinking about a range of issues that are not the focus of the paper. For example, it provides a rationale for many countries to hold reserves that are much larger than traditional models suggest would be needed. One suggestion for this paper would be to push this discussion even further by considering in more detail exactly what should be included in the liquidity coverage ratio and looking at this ratio for different countries. What is included in the ratio will have important implications for how this measure can affect policy.

In the final section of the paper, Gourinchas again chooses to refocus the paper assignment and, instead of focusing on Asia, applies his focus on global liquidity imbalances to the current challenges in Europe. He presents a compelling set of reasons why the situation today may be even worse than the headlines suggest given the liquidity challenges faced in the European banking system. This is not cheery reading. This is especially sobering as the paper stops after a dire assessment of the current situation.

This abrupt and depressing end leads to my main suggestion for the paper—to take these arguments to the next level by discussing what this new approach to understanding imbalances implies for the merits of different policy options. If global liquidity imbalances are a key vulnerability that can lead to crises, what steps should be taken, both during a crisis and a priori? For example, during the recent crisis, the Federal Reserve's swap lines provided a source of liquidity to address some of the challenges raised in the paper.[1] Should these lines be made permanent? Given the assessment of the problem provided in the paper, is there a different approach that the International Monetary Fund (IMF) should be taking to address the types of global liquidity shortages, or are the new lending facilities sufficient? Should there be greater use of American depository receipts to address global liquidity issues? Is this a reason to encourage faster internationalization of the renminbi, as discussed in an earlier session of the conference? Should there be greater regulation of gross liquidity positions and imbalances given the dangers they pose? Given the key role discussed in the paper of the United States as the global liquidity provider, what are the implications if the United States does not address its fiscal challenges and its debt is no longer viewed as a safe haven? Should the emerging world adjust policies so that they are no longer a "liquidity sink"?

Moreover, to answer these questions, careful thought should be given to the multilateral consequences of any policy proposals. One of the lessons that policymakers seem to be learning—albeit too slowly—is that policies targeted at addressing domestic economic conditions often have substantial multilateral effects. The second round of quantitative easing in the United States and exchange rate intervention in China were factors behind the surges of capital inflows to emerging markets in late 2009 and early 2010. Capital controls enacted by Brazil to limit these capital inflows redirected flows to other emerging markets.[2] Numerous papers have shown how banking regulations in one country lead to regulatory arbitrage. International institutions, such as the IMF, are beginning to provide useful analysis of these spillover effects of national economic policies. These considerations should also be included in a discussion of what should be done in response to global liquidity imbalances. Gourinchas's paper suggests that the immediate response to these imbalances may be to provide greater access to funding to reduce these liquidity imbalances. But what are the long-term multilateral implications?

To summarize, this is an extremely useful paper in reframing the debate on global imbalances. Global imbalances matter and are important. What matters, however, is not the traditional focus on net imbalances and current accounts. Instead what matters are gross imbalances, especially with regard to liquidity. This focus, however, suggests that the global economy—and especially Europe—may face even greater challenges than currently understood. Now we need more guidance on what should be done given this critically important reframing of the challenges provided by Gourinchas.

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## NOTES

1 For example, see Rose and Spiegel (2011).

2 See Forbes et al. (2011).