

VIEWPOINT

Back to Global Imbalances?

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The crisis has caused the debate on “global imbalances” to unfold in an unexpected way. Previously, many thought that current account imbalances would be eliminated through a drop in demand for US assets, implying a sharp devaluation of the US dollar and higher US interest rates. Instead, the crisis brought an appreciation of the dollar and record high US government bond prices. Will the recovery from the crisis entail a return to the old order?

Large imbalances developed over the last ten years, as the US financed its mounting current account deficits by borrowing abroad. (See figure 1.) This was sustained largely by developing country investments in US government securities—reflecting booming capital inflows, surging commodity prices and growing export volumes. Underlying this phenomenon were high savings rates in Asia and emerging market efforts to self-insure against crises as well as policies to forestall currency appreciation and encourage export-based growth. The resulting equilibrium looked fragile to many since it hinged on an unlimited willingness to buy US assets. To others, it looked more durable, as it enabled high-saving but financially underdeveloped countries to access advanced financial markets. But most expected an eventual unwinding of

global imbalances, implying a shift away from US assets.

Unexpectedly, the crisis strengthened the position of the US dollar. As the crisis went global, the expected shift out of US assets did not materialize. Instead, the increase in risk aversion encouraged a massive shift in global portfolios to US T-bills. The US dollar became the reserve currency of last resort and the US government became both the borrower and creditor of last resort.

To be sure, the resilient attractiveness of US government securities during the crisis was accompanied by some mitigation of current account imbalances. The collapse in gross capital flows and the sharp decline in commodity prices reduced large trade surpluses in emerging economies. The US current account deficit shrank from 6.6 percent of GDP in Q4 2005 to 2.9 percent of GDP in Q1 2009—a much smaller deficit that was in part financed by US residents repatriating their capital. (See figure 2.)

Global imbalances may not fully disappear, however, at least in the short run. The crisis highlighted the effectiveness of self-insurance and this may prompt countries to increase their international reserves going forward. As international trade resumes and commodity prices rise above their recent lows, emerging economies may return to large trade surpluses and foreign asset accumulation. These

funds may be channeled again to the US, provided that US government actions succeed in keeping inflation and depreciation in check. As the US economy recovers, the increase in private consumption, combined with the large fiscal expansion, may halt the decline in the US current account deficit. The resilience of US government bonds during the crisis, and the Fed’s undisputed record as a world leader in managing the crisis, might attract investment into the US that would have otherwise gone elsewhere.

However, other forces could push in the opposite direction. As risk aversion diminishes, investors will pursue higher yields outside the US and international capital flows will resume. The incipient availability of country insurance mechanisms (such as the IMF’s contingent credit facilities) may reduce the appeal of foreign asset hoarding for self-insurance purposes in emerging markets. Stricter financial regulation may undermine the franchise value of US financial institutions, aggravating the adverse wealth effect on aggregate demand. Enhanced safety nets and other expansionary fiscal actions in Asia might decrease external surpluses there. International investors, especially surplus countries, may shift toward currencies other than the dollar. Difficulties in unwinding the US monetary and fiscal stimulus could complicate the debt situation for the US government. These factors would

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Figure 1. US Current Account Balance and the Real Exchange Rate

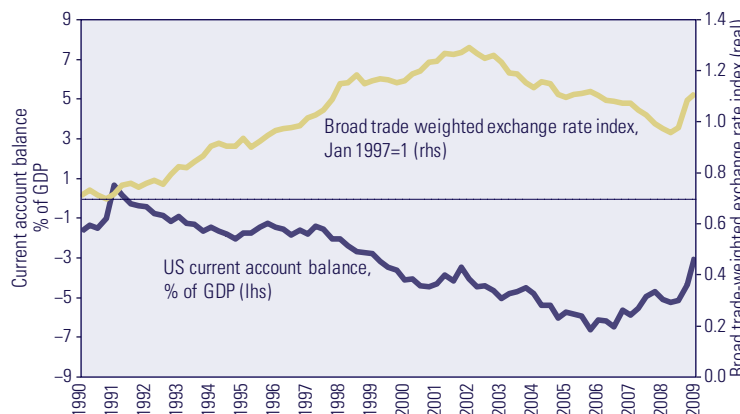
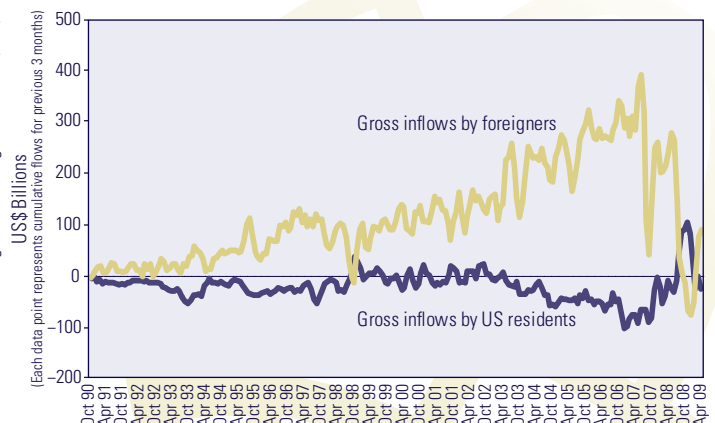


Figure 2. US Gross Capital (Long-Term Security) Flows



Why Don't We See Poverty Convergence?

Does growth or the impact of growth on poverty depend on the initial poverty rate in a way that nullifies the advantage of backwardness?

Developing countries that start out with a high incidence of poverty typically do not enjoy a higher subsequent pace of poverty reduction, measured in proportionate terms. The overall incidence of poverty is falling in the developing world, but no faster than in the poorest countries. In short, we do not see “poverty convergence.”

This is puzzling if we accept two widely-held “stylized facts” about economic development, namely that there is an “*advantage of backwardness*”—countries starting out with low mean incomes exhibit higher growth rates—and that there is an “*advantage of growth*,” whereby a higher mean income tends to come with a lower incidence of absolute poverty. There is ample empirical support for both views, though with qualifications. The advantage of backwardness should mean that countries starting out with a high incidence of poverty and hence a lower mean (given the advantage of growth) should see a higher subsequent growth rate and hence a higher pace of poverty reduction. Indeed, the mean and the poverty rate will have the same speed of convergence in most widely-used log-linear models found in the literature.

In a new paper, Martin Ravallion suggests a solution to this puzzle. Intuitively, the hypothesis is that either the growth process in the mean, or the impact of growth on poverty, or both depend directly on the initial poverty rate in a way that nullifies the “advantage of backwardness.”

To test this hypothesis, a dataset was constructed from household surveys for nearly 100 developing countries, each with two or more surveys over time. These data are used to estimate a model in which the rate of progress against poverty depends on the rate of growth in the mean and various parameters of the initial dis-

tribution—encompassing those identified in the literature—while the rate of growth depends in turn on the initial distribution as well as the initial mean.

The results indicate three distinct consequences of being a poor country for subsequent progress against poverty. The usual neoclassical convergence effect entails that countries with a lower initial mean, and so typically a higher poverty rate, grow faster and hence enjoy faster poverty reduction than otherwise similar countries. Against this, there is an adverse direct effect of poverty on growth, such that countries with a higher initial incidence of poverty tend to experience a lower rate of growth, controlling for the initial mean. Additionally, a high poverty rate makes it harder to achieve a given proportionate impact on poverty through growth in the mean. (By the same token, the poverty impact of economic contraction tends to be smaller in countries with a higher poverty rate.)

The two “poverty effects” work against the mean convergence effect, leaving little or no correlation between the incidence of poverty and the subsequent rate of progress against poverty. In terms of the pace of poverty reduction, the “advantage of backwardness” for countries starting with a low capital endowment (given diminishing returns to aggregate capital) is largely wiped out by the high level of poverty that tends to accompany a low initial mean.

This dynamic “disadvantage of poverty” appears to exist independently of other factors impeding growth and poverty reduction, such as human underdevelopment and policy distortions.

The evidence is mixed on other aspects of distribution. A larger middle class—by developing-country standards—makes growth more poverty-reducing. But this effect is largely attributable to the lower poverty rate associated with a larger middle class.

Controlling for the initial incidence of poverty, there is no sign that a higher overall level of initial inequality, as measured by the Gini index, inhibits the pace of pov-

erty reduction via either the rate of growth or the growth elasticity.

Nonetheless, initial inequality is empirically important, through its bearing on the extent of poverty. While these new findings confirm that initial inequality matters to subsequent progress against poverty, they also reveal that it matters mainly via its bearing on the initial incidence of poverty. There is no sign in this paper’s results that lower inequality among the non-poor, leaving the incidence of absolute poverty unchanged, brings any longer-term payoff in terms of growth and poverty reduction. In the minority of cases in which high inequality comes with low absolute poverty at a given mean, it does not imply worse longer-term prospects for growth and poverty reduction.

Future research should aim at improving understanding of this important handicap faced by poor countries in their efforts to become less poor.

Martin Ravallion. 2009. “Why don’t we see poverty convergence?” *Policy Research Working Paper 4974*. World Bank, Washington, DC.

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tend to weaken the US dollar, increase US interest rates and lower current account imbalances over time.

In sum, to the extent that the US is expected to outperform other advanced economies in the medium term, it might continue receiving foreign capital and the previous pattern of global imbalances might be gradually restored in part. However, with strong forces operating in the opposite direction, the pre-crisis distribution of imbalances is not likely to be fully restored or sustained in the long run. Thus, it would be unwise to dismiss the possibility of an eventual major depreciation of the US dollar and a much higher diversification of global portfolios into non-US assets.