

Asset Bubbles and Global Imbalances

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Abstract:

We analyze the relationships between bubbles, capital flows, and economic activities in a rational bubble model with two open economies. An asymmetry in frictions in the credit markets causes capital to flow upstream from the South to the North. Capital inflows to the North in turn facilitate the emergence of bubbles that further exacerbate global imbalances. The collapse of these bubbles, however, precipitates a readjustment in capital flows, debt deleveraging, and sharp contractions in economic activities. The model can simultaneously explain several stylized features of recent boom-bust episodes.

Keywords: *rational bubble, financial friction, global imbalances, credit boom*

JEL Classification: *F30, F41, E44*