



Asia-Pacific  
Economic Cooperation

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**2007/ASCC/2.4**

Session: Global Imbalances in Financial Flows

*2.4.1*

## **Do Imbalances Matter?**

Purpose: Information

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**Annual Conference of APEC Centres  
Melbourne, Australia  
18-20 April 2007**

The ongoing concern with 'global imbalances' expressed by a host of commentators and officials gives me a tremendous sense of déjà vu. In my 1990 Wincott lecture\* I had examined the case for international coordination to deal with the purported 'global imbalances' of the 1980s, and found it wanting. Though fortunately there is no longer a call for the equivalent of the formal Louvre and Plaza accords of the period which in part led to Japan's decade long slump, there are nevertheless exhortations from the world's great and the good to China to raise domestic consumption and to appreciate its exchange rate; for the US to raise its low savings rate, smother the purported bubble in its housing market and reduce its fiscal deficit; for Europe to reform its inflexible labor markets and to reflate the Eurozone; for Japan to open up its economy to foreign investment, and so on. Though no doubt these purported problems maybe of concern to the citizens of the respective countries being lectured to, should they be of concern to the rest of the world? The discussion of 'global imbalances' implicitly assumes the opposite, because of the supposed spillover effects of these various domestic policies and behavioral outcomes on the global economy. But what are these spillover effects and should internationally coordinated public policy or international moral suasion be used to counter them?

To answer this question it is useful to look upon the global economy as an integrated economy, where governments, central banks, households and firms in each nation are all distinct economic agents acting in their own perceived 'self interest', with their own objectives. The international markets for goods and assets will co-ordinate these myriad decisions into changing relative prices, which at the national level will be reflected in changing macro-economic variables like interest rates, real exchange rates, and savings rates. With both public and private agents maximizing their own perceived interests, this decentralized international system is exactly like a market system. The changes in prices and outputs that arise as a result of the different actions of these agents are exactly like the increase in demand, say, for shoes within a national economy, which *ceteris paribus* raises the price of leather and hence affects the financial circumstances of the purchaser of handbags. The macroeconomic international spillovers are exactly like those affecting the handbag buyer, which (in the economist's jargon) are 'pecuniary' externalities mediated through the price mechanism and of no significance for the efficiency of the economy. They are synonymous with market interdependence and the price system and irrelevant for public policy - in contrast with 'technological' externalities like smoke from a factory which are not mediated through the price mechanism and could require public action. In fact public policy should not attempt to offset these pecuniary externalities as they are the essence of a dynamic market economy. They are not a sign of any 'market failure'. As at the national level, there is no need for any further harmonization or co-ordination at the international level than is provided by the market.

What then are we to make of all the prognostications of various pundits on these 'global imbalances'? They are like the numerous stock brokers reports trying to foretell market trends based on what each claims are 'fundamentals'. But we know that at best they are looking through a glass darkly. No doubt it is a useful intellectual exercise trying to explain a particular macroeconomic conjuncture (like the developing reverse yield gap in the US) by international variables, which will undoubtedly be of interest to punters as they decide on their portfolio choices. These local 'imbalances' may also be of concern to particular economic agents. As a taxpayer in California and the US, I am naturally concerned about their respective fiscal deficits because of their implications for my future taxes. But for the rest of the world these are only of interest if they are holders of the relevant debt instruments financing them. They are not a global concern.

Finally, underlying the discussion of 'global imbalances' is the continuing divide between those who believe that a capitalist economy is inherently unstable, requiring government intervention for stability, and those who argue that despite manias, panics and crashes, a capitalist economy is inherently stable, with these unavoidable and unforeseeable

fluctuations arising from its creative destruction, taking place along a rising overall trend of national income. Government intervention to dampen or eliminate the business cycle will be either ineffective or counterproductive. The latter view reflects what development economists have painfully learnt, that government attempts to smooth income and consumption when an economy is faced by unforeseeable shocks, will either be ineffective, or as in the case of the African marketing boards set up to deal with 'export instability' turn into predatory instruments of taxation. Private agents even in the poorest economies are capable of smoothing these fluctuations in their consumption through saving and investment as was empirically documented for the 1970's coffee boom in East Africa by Paul Collier and his associates..

At the macroeconomic level this consumption smoothing by private and public agents is reflected in the current account of the balance payments, which is given by the difference in domestic savings and investment. That even with the most draconian exchange controls this national consumption smoothing is the determinant of India's balance of payments was documented in a remarkable finding by the RBI that in a simple "intertemporal consumption optimisation model" of India's current account between 1951 and 2002 "the correlation coefficient between the optimal and actual current account balance is close to one. Thus, fluctuations in the current account balance in India are the outcome of residents trying to smooth their consumption paths when the national cash flow fluctuates. The result is noteworthy, given the restrictions on capital flows and the intermittent external shocks experienced". (RBI: Report on Currency and Finance 2002-3). Hence my conclusion that using 'global imbalances' to implicitly justify international dirigisme to stabilize the global economy is as unwarranted as the case for activist national macroeconomic policy has proved to be.

\*"The Limits of International Co-operation", 20th Wincott memorial lecture, IEA, 1990.