

Meade's Analysis and Today's Global Imbalances

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I am greatly honored to have been invited to contribute this lecture to commemorate the life of one of the outstanding group of economists to whom I have argued (Worswick and Trevithick 1983, p. 91) we owe the prosperity of the postwar years.¹ It was not inevitable that the economic history of the post-World War II period would be so dramatically different to, and better than, the experience of the 20-year interregnum between the two bitter conflicts of the twentieth century. As a matter of historical fact, the leading economist of that day, the creator of the set of ideas of combining microeconomic liberalism with macroeconomic management that laid the basis of the postwar prosperity, had during the war years toyed with a reversion to mercantilism that would have doomed hopes of a liberal world order. His decision to abandon, at least conditionally, these ideas is recorded in his *Collected Works* (vol. XXVI, p. 284) in the following terms:

if all the other countries of the world agree to fall in with the stipulations of the Commercial Union (which, in my judgement, is extremely unlikely), we shall gain more on the swings than we shall lose on the roundabouts. That we shall lose something on the roundabouts is, in my judgement, indisputable. Nevertheless, I am ready to be persuaded not to oppose the scheme, on the ground that our discretion is only restricted if others also are conforming to a strict code, and that the latter, if by a miracle it does come about, may be to our very considerable advantage.

The Commercial Union, which evolved into GATT and ultimately the WTO, was of course the brainchild of James Meade. He, along with outstanding colleagues in the British wartime economic service like Marcus Fleming, Roy Harrod, Lionel Robbins, and Dennis Robertson, remained faithful to Keynes's interwar vision of economic policy even when the master hesitated. We should all be profoundly grateful that he and his colleagues stood up for what Samuelson subsequently dubbed the "neoclassical synthesis" against the doubts of Keynes himself. Without their steady good sense, the world might well not have experienced the 60 years of unparalleled growth that it has subsequently enjoyed.

Although I overlapped with James Meade when I was an undergraduate at the London School of Economics and he was a professor, I did not get to know him personally until the 1960s when I had finished graduate work in the United States and become an academic at the then-new University of York. But it was impossible in England in the 1950s for even an undergraduate not to be influenced by the analysis that Meade had made famous through his opus *The Theory of International Economic Policy*. This was among the finest expressions of the orthodoxy of that day, almost the ultimate refinement of Keynes's international economic analysis in an era when Keynesian thought was everywhere dominant. Most of my remarks today will be related to that analysis.

¹ Distinguished Lecture in honor of James Meade delivered at Christ's College, Cambridge, on November 20, 2006. The author expresses thanks to his colleagues Michael Mussa and Edwin Truman for helpful comments on a draft and several members of the lecture audience for pertinent questions. Copyright Peterson Institute for International Economics: All rights reserved.

Doubtless the most important parallel between the intellectual position of James Meade and me is that I find it easy to subscribe to his famous aphorism that “I have my heart to the left and my brain to the right.” I too believe that governments should try to reduce income inequalities as well as internalize externalities and regulate monopolies where they are unable to introduce competition, but otherwise leave the microeconomy to the market, while managing the macroeconomy. It is the latter subject that I am going to discuss today, asking in particular whether the analysis that he developed can help illuminate what some of us see as the dominant economic issue of the moment: adjusting the global imbalances without throwing the world economy into recession in the process.

Meade’s Analysis

The most famous part of Meade’s analysis, the focus of my remarks, concerns the macroeconomic management of an open economy. This was developed in volume I of his opus, on *The Balance of Payments*. That volume started with a careful definition of the concepts he used that is all too rare today. He distinguished autonomous from accommodating capital flows, where the former are instigated by economic agents for welfare-maximizing reasons, while the latter would not occur without payments disequilibria which need to be financed. Of particular note is his concept of a “neutral economy” in which interest rates (called “monetary policy,” which in this postmonetarist age again sounds rather modern), wage rates, and the exchange rate, as well as fiscal and commercial policy, were all assumed constant. It was in this context that he first examined the impact of an exogenous increase in expenditure on income, the balance of trade, the balance of payments, and the terms of trade. The differential impact on the balance of payments as opposed to the balance of trade arises from the changes in capital flows that would be induced by increased expenditure. The forces that govern capital flows are “very complex” (p. 61), but include the impact of higher saving on outward investment, the impact of a change in the profitability of investment, and so on. He went on to analyze the impact of other shocks: increased productivity, shift of expenditure between home and imported goods, a capital transfer to the foreign country, reparations payments, new investment opportunities, and tariffs.

The core of his analysis came in Parts III and IV, where he analyzed how policies should be deployed in order to achieve the key objectives of macroeconomic policy. The first objective stipulated was internal balance, defined as “maintaining a level of total demand for all the products sufficiently high to maintain full employment, but not so high as to lead to a continuing inflation of money prices and costs” (p. 106). Meade recognized that employment and inflation might be in conflict, but then internal balance should be thought of as whatever is considered on domestic grounds as giving the best combination. The second policy objective postulated was external balance, which never received a similarly careful definition, it merely being assumed that the reaction to a shock should be to restore the balance of payments to what it was before, with the implicit assumption that this was an equilibrium situation.

At the beginning of chapter 8, Meade notes that an expansion in either fiscal or monetary policy (a lower interest rate) could be used to raise income, but that they would have different effects on capital flows. Monetary expansion would induce (what we would now call) a stock outflow of short-run funds, and a flow outflow that would primarily impact long-term investments. But he never pursued this line of thought to develop the idea that an appropriate mix of fiscal and monetary policy could achieve both internal and external balance. That idea was left to Robert Mundell (1962) to argue a decade later.²

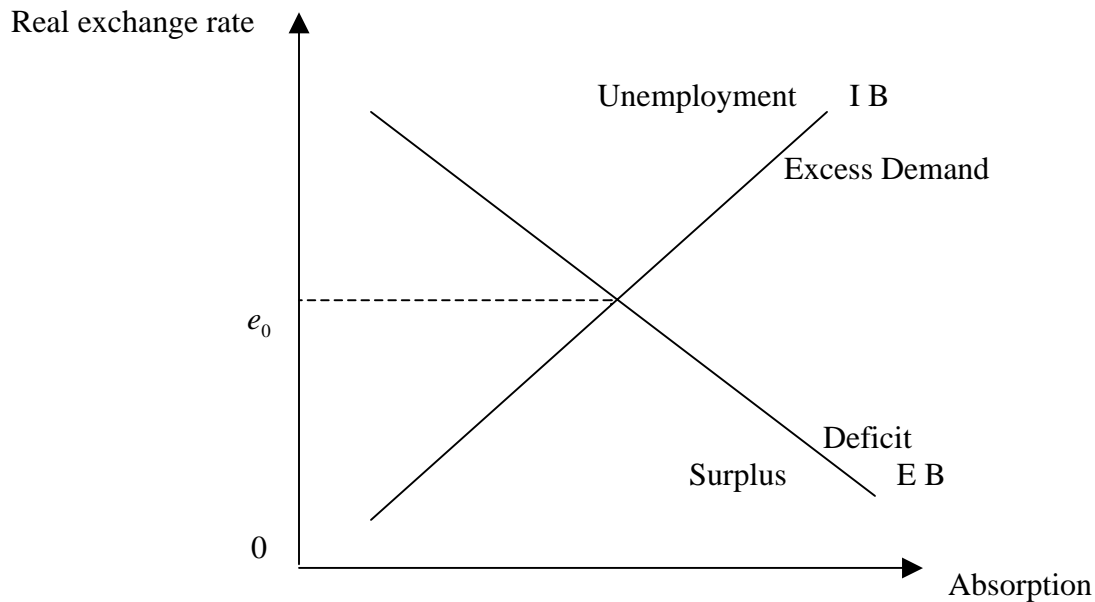
Rather Meade in practice regarded both financial policies (i.e. fiscal and monetary policy) as having essentially similar effects, affecting primarily absorption (domestic demand). Hence they would often be unable to achieve both objectives simultaneously, and so one would get what were later dubbed “dilemma cases,” where an expansionary fiscal or monetary policy might be needed for domestic reasons, but would

² Actually I think the idea is fallacious, at least if one takes a longer-term view: see Williamson (1971). Starting from equilibrium, an exogenous shock that requires raising interest rates to preserve short-run internal and external balance will imply a progressive worsening in the external balance over time.

make the balance of payments situation worse. His solution was to introduce a “price policy,” meaning either an exchange rate change or a general change in the price level. Nowadays we would take for granted that the latter could not be effected by fiat but would require a possibly prolonged period of deviation from internal balance, so that the practical form of price policy we would be willing to consider is a change in the exchange rate. A country suffering from deficient demand and a balance of payments deficit was therefore advised to adopt an expansionary fiscal-monetary policy and to devalue its currency. Figure 1 illustrates the relationship between the two objectives and the two policy instruments as graphically portrayed by the Australian economists W.E.G. Salter and Trevor Swan.

There was of course much more analysis in Meade’s opus, but this is what I regard as the core. Harry Johnson (1958, ch. 6) subsequently generalized Meade’s financial policies to “expenditure changing policies” and his price policies to “expenditure switching policy,” but in that form the analysis is still what most policymakers use when they discuss global adjustment or national balance of payments problems.

Figure 1. The Salter-Swan diagram of Meade’s analysis



Before moving on, let me mention the practical policy inference that James Meade drew from his analysis. This was of course the need to reintroduce exchange rate flexibility into the arsenal of practical policy tools. He wrote at a time when the Bretton Woods system was widely regarded as having legislated essentially fixed exchange rates.

True, they could be devalued (or in principle revalued) in the event of a “fundamental disequilibrium,” but this was widely conceived to describe a pathological condition that self-respecting countries would not find themselves in, except possibly in the aftermath of a major war (as in 1949). His analysis told him that this was a disastrous constraint, and so he became one of the two pioneers in advocating the adoption of flexible exchange rates (Meade 1953). The other pioneer was the late great Milton Friedman (1953), whose passing we lamented only last week. But there was a major difference between the Meadean vision and the Friedmanian vision of a system of flexible exchange rates. Friedman advocated freely floating exchange rates, with the market determining the rate unaided (perhaps he would prefer to say unimpeded) by the government. Intervention is regarded as something dirty. James Meade, on the other hand, wanted the government to be able to set the rate at e_0 in Figure 1. In this it should be unimpeded both by the market and by the constraint of an inherited parity. The two versions of flexible exchange rates are as different as chalk and cheese.

Internal Balance

As noted above, James Meade gave a careful definition of internal balance. When the Phillips curve came along in the late 1950s, we rather naturally came to see his definition as implying the socially optimal point on the Phillips curve. Society could buy a little less unemployment by accepting a somewhat higher rate of inflation. When the left controlled the political process, it would tend to want a low rate of unemployment even if this cost rather more inflation. In contrast, the right would want to be tough on inflation and willing to accept rather more unemployment. So internal balance might depend on political preferences, but given political reality it was well defined at any point in time.

Then in the late 1960s came the Phelps-Friedman revolution, which argued that the Phillips curve was unstable in the short run and vertical in the long run. If society tried to pick any point on the Phillips curve other than the natural rate of unemployment, inflation would accelerate/decelerate due to the fact that inflation expectations would adapt to reality. It followed that internal balance was pinned down by hard facts, at the natural rate of unemployment, rather than that there was an element of political choice. The Lucas rational expectations revolution did not change this conclusion; it merely argued that what had previously been regarded as long-run inevitabilities might be realized in the short run. A few economists have tried to resist the hard conclusion that there is no scope for pushing unemployment below a “natural rate” without courting disaster, but most of the profession were convinced by the evidence, especially after the acceleration of inflation in the early 1970s.

The policy rule that follows naturally from this diagnosis is inflation targeting, which has been adopted by more and more central banks since the beginning of the 1990s. The central bank tightens monetary policy if inflation is projected to exceed its target rate, which tends to raise unemployment above the natural rate. Conversely, low inflation induces a monetary stimulus, which lowers unemployment. Internal balance might then be interpreted not as the level of demand consistent with the unchanging natural rate, but as incorporating whatever modification is being pursued by the central bank in the interest of inflation targeting.

Thus I do not believe that the concept of internal balance has undergone any fundamental modifications in recent years. Since about 1970 it has been understood to mean something close to the output level when the natural rate of unemployment, or NAIRU³ if you prefer, prevails with small and temporary modifications to push inflation to its target level. There are plenty of econometric estimates of what this implies, starting with those produced by every inflation-targeting central bank. This bedrock of Meade’s analysis rests on firmer ground than when he first proposed it.

External Balance

While James Meade was very careful to define the meaning of internal balance, one cannot say the same about his definition of external balance. The index refers one to p. 105 for the definition, but all one finds there is the following:

Secondly, the authorities may bring about a change in domestic expenditure in order to offset the secondary effects on the *balance of payments* of any primary change in the foreign demand for home products or in the home demand for foreign products or in the volume of net transfer payments to or from foreign countries. This we may call a policy of “external balance.”

Later (on p. 116), he refers to “an existing disequilibrium in the balance of payments,” and a footnote explains that in a two-country world such as he was analyzing external balance in one country implies external balance in the other “if we ignore the possibility that an accommodating payment (or receipt) to A (or B) may be an autonomous receipt (or payment) to B (or A).”

³ The nonaccelerating inflation rate of unemployment.

I can conceive of two defenses for James Meade's failure to offer a clear definition of external balance. The first is that the element that makes for all the difficulty, namely capital flows, was relatively small when he wrote. Reserves changed primarily to finance trade imbalances at a fixed exchange rate, and reserve changes are clearly accommodating payments and receipts. If exchange rates were fixed, and the balance of payments accounts contained only trade and reserve changes, then there would be no problem in defining external balance.⁴ Ignoring the two complications noted in the footnote, external balance would prevail when reserve changes were zero, so that trade (including invisibles) was balanced. Meade's first defense would presumably have been that these were reasonable approximations to reality in 1951.

The second defense is that it is at best tough and at worst impossible to give a satisfactory definition of the appropriate capital flow that would characterize external balance. I know, because I am among those who have been brave (or foolish) enough to try (Williamson 1983, pp. 22–26). I argued that the appropriate concept was the “underlying” capital flow that reflected “thrift and productivity.” A first attempt to measure this was to take actual average capital flows over some period of time (or to take their obverse when reserves are unchanged, current account imbalances). However, where there was some reason to expect a change in actual capital flows, like a debt crisis, then one would try to make reasonable allowance for that and not insist on using past actual figures. Another approach was to try to consider what capital flows would maximize the welfare of domestic residents.

Critics labeled this a normative concept of what one would like capital flows to be, and argued that it was more appropriate to base estimates of equilibrium exchange rates on actual capital flows rather than what one wished they were. This is the basis of the distinction between a fundamental equilibrium exchange rate (FEER) and a behavioral equilibrium exchange rate (BEER). I still contend that if one has reason to expect a change in capital flows then it must be rational to allow for that. I would also point out that in practice the BEER will vary depending on what time period the analyst chooses to measure capital flows over, and perhaps also on which capital flows he chooses to include (e.g. only foreign direct investment, which implies a judgment that the basic balance should be equilibrated). But some concept of external balance is implied, and so we are still in the same universe as James Meade.

However, an even more fundamental challenge to his way of thinking is provided by the analysis of those who are complacent about the global imbalances. Let me quote an e-mail last summer from one of my colleagues, Adam Posen:

As for external balance...I do not buy that being a primary or even major concern for policy of a large developed country with flexible exchange rates, stable government, and sustainable fiscal policies, under conditions of largely free global capital movement. So far we have seen little fire from the US imports of capital, despite you and CFB [Fred Bergsten] and many other eminence grises and statesmen of the immediate post-Bretton Woods generation thinking about capital inflows with the mindset of that period—and despite all the benchmarks including Rogoff-Obstfeld's of what was supposed to be unsustainable deficits not proving to be calamitous. If the US continues on a terrible irresponsible fiscal binge, then that could indeed spark a sell off in US[-dollar] denominated assets, but then the cause is fiscal irresponsibility not international imbalances.

It is appropriate to appraise the analysis of the next section in the light of this alternative view, which might actually be right. But if the contention is wrong, then the world could end up with a calamitous recession. That is why I still find it interesting to pursue a Meadean analysis of the global imbalances.

However, one point needs to be made about the terms in which even supporters of the concept define external balance nowadays: We think of seeking a given change in the current account balance, or at the most basic balance, rather than in terms of a defined change in the overall balance of payments (change in reserves). This is because within wide margins capital flows adjust in order to finance changes in current

⁴ Even that is not quite true for two reasons. The first is that gold is an internationally traded commodity that is an autonomous export to the countries that produce it but was bought inter alia by monetary authorities to add to their reserves in transactions that were clearly accommodating. The second arises, because many countries desire a secular increase in their reserve holdings.

account imbalances, in contrast to the stickiness of the latter. In terms of James Meade's concepts, capital flows usually accommodate current imbalances. In fact, we search for current account balances (or conceivably basic balances) that do not threaten to precipitate a situation in which capital flows will not be accommodating. There is unlikely to be a unique set of current account imbalances that satisfy this criterion, which makes the analysis unconvincing to skeptics. That does not make it wrong to try to employ it.

Global Imbalances

The latest *World Economic Outlook* (September 2006) forecasts a US current account deficit of \$869 billion (6.6 percent of GDP) for 2006 and significant surpluses by fuel-exporting countries (\$395 billion)—excluding Russia. Fuel exporter Russia alone has a surplus of \$120 billion, and the following denotes surpluses in nonfuel exporters Japan (\$167 billion), China (\$184 billion), and the Asian newly industrialized economies (\$79 billion). Thus a big part of the global imbalances stem from the fact that the oil exporters are still accumulating reserves rather than spending the proceeds from the latest oil price increase. (One can argue that this is a perfectly sensible way for them to behave.) The rest is that there is a large deficit in the United States and large surpluses in East Asia.

Why worry about these imbalances? The principal concern is sustainability. We have been told repeatedly in the past that we live in a brave new world of capital mobility where markets will finance deficits indefinitely, only to be rudely disappointed when the crisis came. We were told it about the capital-importing developing countries, especially in Latin America, as late as 1981.⁵ Then the debt crisis broke. We were told it about Mexico in the early 1990s. Mexico in the 1990s was different to Latin America in the 1970s, because it had implemented a whole host of reforms (the “Washington consensus” reforms, actually). Then in late 1994 the Mexican crisis broke. We were told it about East Asia in the mid-1990s: The situation in East Asia was quite different to that in Mexico, because capital inflows were financing high levels of investment rather than low levels of saving. Then in 1997 came the East Asian crisis (the most traumatic economic event I have witnessed in my career). We were told it about Argentina, which faced no danger of a crisis because it had embraced the pole of a truly fixed exchange rate. Then the Argentine crisis broke. The one common feature of these crises is that before the crisis the countries involved had large current account deficits that were being voluntarily financed by private capital inflows.

Ah, but these incidents all concerned emerging economies, not the center of the international monetary system, the United States. This time it is going to be different because the circumstances are so different. There will be no crisis. Let's hope this time that will be right. But forgive me if I remain a follower of that statesman of the Bretton Woods generation, James Meade, and not play with fire by completely trusting the markets.

Why is this “playing with fire?” By their nature, crises are rarely forecastable; if they can be forecast, then it is a fair assumption that some policymaker will organize evasive action. So let me present a possible scenario rather than pretend that this is the way a crisis is likely to develop. Imagine that the United States elected a president who worried about the current account deficit and listened to the advice that he got from institutions like mine. He would be advised to eliminate the cyclically adjusted budget deficit, which means in practice that he would have to raise taxes. Maybe he would decide that the increased taxes should be paid by the people who can best afford to pay them. These happen to be the people who could send large sums abroad if they were so motivated. The motivation might be provided by the threat of increased taxes on what they invest in the United States (since income generated abroad is less likely to be known to the tax man). The resulting capital flight would initiate a depreciation of the dollar, which might feed on itself. American economists are mostly incapable of conceiving of a shock to spending driven by something that is not in the models, like a loss of confidence in the dollar, but that does not mean that it could not happen. It could drive a US recession in the short run, but at least in the United States one would expect the demand from increased

⁵ I recall vividly a conference in Santiago in early 1981 where the overwhelming view was one of complacency toward the large current account deficits then being run by Latin American countries. Markets were financing them, weren't they, so there was no need to worry.

exports to come on stream in the medium term. In contrast, in the rest of the world the expenditure reducing effect of a US recession and the expenditure switching effect of appreciation would reinforce one another to nurture a contractionary impact. Given how weak the rest of the world has proved in expanding domestic demand in recent years, the result could be a recession that was not only deep but also prolonged.

What does the analysis laid out earlier imply would be necessary in order to limit this threat of a global crisis? To begin with, one has to decide some rough pattern of global payments positions at which one should aim (Meade's external balance). The main consideration is that this must not imply too high a level of the international debt, or a secular increase in the international debt position (net debt deflated by GDP, as a measure of the capacity to service debt) of any country, meaning in practice the United States. A reasonable figure for the maximum safe level of the net international debt has conventionally been taken as about 40 percent of GDP, but the recent experience of Australia and New Zealand and the older precedent of Canada suggest that this may be too low for a developed country with good growth prospects. 60 percent might be more appropriate. A reasonable figure for the future growth of US nominal GDP is 5 percent per annum, consisting of about 3 percent real growth and 2 percent inflation. Five percent of 60 percent of GDP is 3 percent of GDP, which is the sort of figure that many of us have used as a target for the US current account deficit.⁶

One then has to decide how to distribute this improvement in the US position in "deteriorations" that come to the same sum over the rest of the world. It would be really nice if James Meade had left us with a definition or statistical measure of "external balance" that could be applied mechanically and that everyone would accept, but of course he didn't, for the good reasons already outlined. There is bound to be an arbitrary element in how this exercise is done, but I see only one way in which the need for such an exercise can be avoided, which is to take the optimistic view attributed to Adam Posen above. However, there are several criteria that seem natural candidates to guide the allocation of current account "deteriorations," namely:

- 1) The classical forces of thrift and productivity. Could a country increase intertemporal welfare by raising its level of investment or reducing its level of saving, because of high returns to investment or because current levels of consumption are repressed?
- 2) Keynesian considerations of effective demand. If a country's trade balance is eroded, will the resources that flowed into it go to waste or could demand be stimulated so that the resources are redeployed elsewhere?
- 3) The impact on growth. Would the growth rate suffer from either a withdrawal of export demand, as the expositors of "Bretton Woods II" assert, or overvaluation induced by Dutch disease?
- 4) The speed of change. If a country has had a very unbalanced position in the past, it may be unrealistic to expect it to achieve a position equal to that of other countries (e.g. in terms of a similar ratio of surplus or deficit to GDP) in the short or even medium run.

Perhaps a gifted theorist could combine these criteria in a way that would carry conviction and avoid the possibility of conflicting signals from different criteria. My approach is very low-tech, merely asking whether any of the criteria rule out adjustment by particular players.

Let us start by considering how much adjustment to expect of the oil exporters. The answer is, I think, not very much. Surely there is a lot of adjustment already in the pipeline, as countries start to spend something closer to their new, increased permanent income. What I doubt is the appropriateness of asking them to do more than this. Countries will not raise their intertemporal welfare by increasing investment (or consumption) at a forced pace. Trying to force the pace of adjustment would be highly likely to expose countries to Dutch disease and thus have an adverse impact on growth. These countries should take time to

⁶ Note that this calculation is unaffected by the empirically important fact that dollar depreciation reduces the net international debt of the United States, because many US assets are effectively denominated in foreign currencies while almost all US liabilities are denominated in dollars (Gourinchas and Rey 2005). The reason is that the dollar will not be depreciating in the new steady state of a 3 percent deficit. However, what this fact does imply is that the path to that new steady state will be easier than it would be without the asymmetry in denomination.

raise their level of spending, even assuming that high oil prices are here to stay, rather than a transitory phenomenon as in 1973–85 that should be mainly financed rather than adjusted. Many of the other oil countries should be exhorted to follow the examples of Kuwait and Norway, which save and invest a substantial part of their income for the long-term future after the oil has run out.

Japan has been the world's largest surplus country for many years and still runs a large current account surplus (forecast by the IMF at 3.7 percent of GDP this year). Until recently I regarded the Keynesian argument of dominant importance in the Japanese case. Forcing Japan to cut its current account surplus would simply have meant allowing resources to run to waste, because Japan lacked effective policy instruments with which it could expand demand elsewhere to compensate for reduced net foreign demand. The recent recovery in Japan has begun to erode this argument. I still think that Japan should be cautious in the speed with which it runs down its surplus, but the fact that it is now in a position to do that without wasting the resources seems clear. Over the next several years I would regard a reasonable interpretation of external balance for Japan as implying a substantial reduction in the current account surplus.

Another large surplus country is China, with a 2006 current account surplus forecast by the IMF at \$184 billion (over 7 percent of GDP even on the IMF's reckoning, and some of my colleagues believe this to be an understatement). The basic balance is in even larger surplus, for China has about \$60 billion per year inflows of FDI. The idea has gained currency that this reflects China's clever strategy of export-led growth (see Dooley, Folkerts-Landau and Garber 2003 for an influential statement of this view). I find this analysis a reflection of the worst tendency for opinion to swing from one absurd extreme to another with no consideration of the possibility that a sensible middle position may have been right all along. Export-led growth originally⁷ meant not discriminating against exports, so as to use export expansion rather than import substitution to solve the balance of payments constraint that has so often brought growth to a standstill. A successful policy of export-led growth typically resulted in the international capital market being willing to lend to the country in question, as a result of which the country could and often did go into current account deficit. All the East Asian crisis countries—examples of export-led growth par excellence—were in current account deficit in the years before 1997. Unfortunately Thailand overdid it, and the resulting contagion plunged the whole region into crisis. Now one is told that the answer is to run an export surplus. This may have been necessary in order to reestablish confidence after the crisis and build safeguards against a repetition. And it certainly increases demand, at least for tradables. What it neglects is the supply-side. A current account surplus involves investing a part of savings in low-yielding US Treasury bills (or some other low-yielding foreign asset). This preempts resources that might have been invested or consumed at home, and in that way boosted either growth or living standards or both. To ignore this aspect is as foolish as it was to ignore the danger that an excessive deficit financed by short-term inflows would precipitate a crisis.

It is of course utterly wrong to expect a big reduction in the bilateral imbalance between China and the United States. The analysis here should concern multilateral, not bilateral, balances. The relevant questions are:

- 1) whether China could expect to increase intertemporal welfare by reducing its very high level of savings;
- 2) whether it could stimulate domestic demand so that resources that no longer flow into a multilateral surplus could be redeployed elsewhere;
- 3) and whether such a redeployment would reduce its likely growth rate?

So far as (1) is concerned, the high savings in China reflect not just saving by the rich but high levels of precautionary saving by desperately poor families. They are afraid that they will have nothing to fall back on in the event of adversity in an era when the state has withdrawn most of its safety net and families no longer provide security in the traditional way in the increasingly likely event of surviving to old age. Plausible government commitments to a future safety net could be expected to reduce saving for a modest, and affordable, level of current government expenditure. In regards to (2), the idea that China, with its high growth rate, modest government debt, and small fiscal deficit could not afford to expand demand, if

⁷ E.g., in the writings of Bela Balassa, such as Balassa (1993).

necessary by fiscal expansion, is unconvincing. Yes, there are some contingent debts out there because of the parlous finances of many state-owned banks, but even the realization of these would not make China a highly indebted country. So far as (3) is concerned, there is no reason in the world why a replacement of foreign by domestic demand should reduce the growth rate, unless it went so far as to threaten a balance of payments crisis. This is not a threat that is currently on the horizon.

China itself could therefore benefit by a policy aimed at reducing the Chinese current account balance by something of the order of at least \$200 billion a year over the next several years. The idea that defining Chinese external balance as implying a \$200 billion swing in its current account toward deficit would serve American but not Chinese interests is misguided: China would be the primary beneficiary of deploying more resources at home.

The remaining area that was noted as a major surplus area at the start of this section is the newly industrialized Asian economies (Hong Kong, Korea, Singapore, and Taiwan). The IMF forecasts these to have a current account surplus of \$79 billion, some 5 percent of GDP, in 2006. Some of these, like Singapore and Taiwan, have long had big surpluses, and it is difficult to conceive of these being eliminated quickly. A reasonable target, i.e. definition of external balance, might be a reduction of \$50 billion in their collective current account surplus within three years. It is becoming increasingly difficult to find reasons for treating these countries differently to other traditional surplus countries, like Germany, Japan, and Switzerland.

Doubtless there are other areas that might reasonably target a change in their current account balance, but these seem to be the major ones. Including a likely reduction in the oil exporters' surplus, which one might expect to come out as at least \$100 billion per year, it is not difficult to identify possible counterparts to a \$450 billion reduction in the US current account deficit. I see no evidence of payments objectives that are inherently inconsistent.

Given the targets for internal and external balance, application of James Meade's analytical framework is rather straightforward. Achievement of the targets requires a mix of expenditure changing and expenditure switching policies in both the surplus and deficit countries.

In the main deficit country, the United States, there is a need for both deflationary financial policy and depreciation of the dollar, given that the economy is essentially at full employment. It would be preferable for the deflationary financial policy to take the form of fiscal contraction rather than higher interest rates so as not to discourage the desired correction of the dollar. Much as some of us would like to see spending on certain causes slashed, overall the United States is a low tax country where public goods are underprovided relative to private goods. Hence the desirability of a large US tax increase as one component of the adjustment. The United States does not have a policy of active management of the dollar so it would be in no position to engineer a dollar devaluation, but one should expect at least "oral intervention" in support of an appropriate depreciation of the dollar. In practice, this would amount to a requirement that the Treasury Secretary stop averring his love for a strong dollar when the dollar is overvalued.

Conversely, in the East Asian surplus countries (including some that do not fall in the main surplus areas identified in the IMF statistics cited above) the need is for both an expansionary financial policy and currency revaluation. In a few cases there may be scope for lower interest rates, but in most cases the main way of engineering expansion will involve more government spending and/or lower taxes. Japan will have to be cautious because it now suffers from a high level of government debt, but most of the other countries do not face binding fiscal constraints. It is critically important that they expand demand, not only to contribute to payments adjustment but also because if domestic demand does not expand in this part of the world then successful adjustment would involve resources running to waste. Neither consumption nor investment would benefit, and growth would decline. But these results are not inevitable—they can be avoided by following Meade's prescription!

Expansionary demand policies need to be accompanied by currency revaluations if they are to lead to payments adjustment rather than inflation. This is the essence of the Meade analysis.⁸ Calculations made by

⁸ This is always denied in the articles of Ronald McKinnon. In his models the exchange rate (the bilateral dollar rate, not even the effective rate!) determines inflation while savings and investment determine the trade balance. The composition of expenditure is apparently insensitive to relative prices. I have sometimes called his theory that adjustment can be affected without changing real exchange rates "the theory of the immaculate adjustment."

some of my colleagues (Goldstein 2004 and Cline 2005) suggest that the currency changes would need to be quite large. For example, the “optimal” percentage exchange rate revaluations⁹ from the March 2005 average exchange rate were as follows for the East Asian countries for which Cline (2005, table 6.2) made calculations:

	Against dollar	Effective appreciation
China	45	21
Hong Kong	71	33
Indonesia	35	9
Japan	39	18
Korea	14	-8
Malaysia	59	29
Philippines	7	-1
Singapore	79	54
Taiwan	38	10
Thailand	33	6

While some of these changes (such as those for Hong Kong and Singapore) presume a current account objective that the governments in question could be expected to challenge, two general conclusions seem difficult to avoid. First there needs to be a very general, and generally large, appreciation against the dollar if adjustment is to embrace East Asia. Second in most cases the effective currency appreciation would be less than half as large as the appreciation against the dollar, for the obvious reason that the East Asian countries are important trading partners of each other so that if they all appreciate together the effective appreciations of each will be mitigated.

While several of the East Asian currencies (most notably the Japanese yen, the Korean won, and the Philippine peso) float, if with occasional intervention, several of the other currencies are heavily managed even if not de facto pegged. Government policy in these countries could orchestrate an appreciation. Even in the countries with floating currencies it would be important for the governments to accept rather than resist appreciations against the dollar. Hence one would look to most East Asian countries to undertake both components of the Meade policy prescription: to expand demand and to revalue.

However, we live in an emphatically multicountry world, rather than a world with the two countries A and B about which James Meade wrote. The question therefore arises as to what role should be played by countries other than the United States and East Asia: Europe, English-speaking countries other than the United States, Latin America, and the developing countries of South Asia, the Middle East, and Africa. In general these are countries without embarrassingly large payments disequilibria one way or the other. Europeans are fond of saying that since they are not part of the problem they should not be part of the solution. This is only partly true. While they should not be expected to engineer a real effective appreciation or to expand demand, it would be important for them to understand that it is their effective exchange rate that should remain pretty much where it is, while they need to welcome rather than resist a further appreciation in terms of the dollar, so long as it comes in parallel to the correction of the Asian currencies.

James Meade’s prescription for dealing with the global imbalances thus implies a contraction of demand in the United States, an expansion of demand in East Asia, and Asian action to secure substantial currency appreciations (or, at the least, not to resist market moves to appreciate their currencies). It seems to me very unfortunate that in some circles this policy advice is being libeled as special pleading by the United States. Apart from the fact that it includes advice to raise taxes that will hardly be welcomed by the Bush

⁹ Cline’s criterion of “optimality” for the East Asian countries was that the sum of GDP-weighted, squared deviations of changes in the current account as a percentage of GDP from the target changes be minimized, subject to the condition that the dollar depreciation be adequate to secure the desired adjustment, where the target should be a 40 percent cut in its surplus for any economy with a surplus of over 1 percent of GDP.

administration, the primary beneficiaries of this action would be those who live outside the United States, and particularly Asians. For it is non-Americans who will suffer the most if in the end the global imbalances lead the world into recession, while even in an ideal adjustment it is the United States that will have to curtail its absorption of real resources and Asians who will get the main benefits of increased absorption. Perhaps the silliest mistake of the age is to describe these as costs and not benefits.

One task remains: to appraise this analysis in the light of the view of Adam Posen presented earlier. It will be recalled that he argued that it is mistaken to direct policy to securing external balance. If an industrial country has a floating exchange rate, access to the international capital market, a stable government, and responsible fiscal policies, then it should concentrate policy on controlling inflation and avoiding unemployment, and allow the balance of payments to emerge as a residual.

Without adjustment, the United States is currently on course to see its debt/GDP ratio¹⁰ expand without limit. Even if the trade deficit has now stopped expanding (which assumes that exports will from now on grow 50 percent faster than imports and that the demand elasticities for exports and imports are effectively equal, contrary to the finding of Houthakker and Magee 1969), debt will grow increasingly rapidly as a result of the cost of servicing debt. Transversal conditions tell us that it is not possible for debt to grow forever relative to everything else. At some point adjustment must occur. What Posen is arguing is that, provided governments maintain their existing policy regime and responsible fiscal policies, the market can be relied on to secure a crisis free adjustment at some point. That may possibly be right, though I am not willing to bet the house on it, and if it proves to be wrong I fear the consequences will be disastrous. But that we can seriously discuss such a proposition seems to me a mark of just how far the world has come from the age in which James Meade wrote his great work, and at least in this dimension change, has been for the better.

¹⁰ Strictly speaking, its net international investment position divided by GDP.

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