Simultaneous Internal and External Balance

The achievement of simultaneous internal and external balance is the prime task of macroeconomic policy in most countries. In some countries there may not be a conflict between the achievement of internal balance and balance-of-payments equilibrium. Circumstances may be such that the goals of full employment and a satisfactory growth rate can be achieved without a balance-of-payments deficit emerging. In many countries, however, the potential conflict between internal and external balance, which was discussed in Chapter 2, materialises frequently. In the United Kingdom the conflict between balance-of-payments equilibrium and faster growth has been acute since the Second World War, and in recent years the achievement of full employment has also become problematical.

From the standpoint of theory there are three environments that need to be considered. The first is the case where external balance is defined excluding the capital account, with the possibility of exchange-rate flexibility. The second is the case where external balance includes the capital account and the exchange rate is fixed. The third is the case where external balance includes the capital account and the exchange rate is flexible. A fourth possible case was the situation described in Chapter 2 where balance-of-payments equilibrium is defined in terms of the current account and the exchange rate is fixed. This case presents a severe dilemma for policy-makers because in this situation there would seem to be only the one instrument of monetary and fiscal policy to achieve the two independent objectives of internal and external balance. Meade’s (1951) pioneering work considered the first
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case outlined of the reconciliation of internal and external balance under flexible exchange rates with external balance defined in terms of the current account. Meade showed that the conflict between internal and external balance could be reconciled if monetary and fiscal policy were used for internal balance and the exchange rate used for external balance. But suppose there are limitations on the use of the exchange rate as a policy weapon, as there seemed to be in the 1950s and 1960s. According to Meade's analysis this would leave monetary and fiscal policy to reconcile the two objectives. It was this problem that Mundell (1962, 1963) attempted to explore, investigating the possibility of using monetary and fiscal policy as separate instruments by redefining balance-of-payments equilibrium to include the capital account. Since the capital account of the balance of payments is sensitive to interest-rate differentials between countries, Mundell was able to show that the conflict between internal and external balance could be reconciled by using monetary policy to achieve external balance and fiscal policy to achieve internal balance. Following the earlier argument in Chapter 1, however, about how balance-of-payments equilibrium ought to be defined for the conduct of economic policy, there is a clear difference between the approaches of Meade and Mundell. Meade's analysis is concerned with adjusting the balance of payments to conditions prevailing in the real economy. By contrast, the use of monetary policy to improve the capital account is essentially a policy of financing balance-of-payments disequilibrium which postpones the necessary adjustment and possibly stores up difficulties for the future. The models of Meade and Mundell will be considered below together with a third category of model in which the definition of external balance includes the capital account, and the exchange rate is also variable. The fundamental question in each of the models is which policy to assign to which objective. This is called the assignment problem. As we shall see, the appropriate allocation of policy instruments to objectives becomes very much an empirical matter depending on the relative sensitivity of targets to instruments, or on what Mundell has called the principle of effective market classification. Assume two objectives or targets ($Y_1$ and $Y_2$) and two policies or instruments ($X_1$ and $X_2$) and that each target is responsive to both instruments. There are thus two structural relationships:

$$Y_1 = a_{11} X_1 + a_{12} X_2$$