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Davidson on Keynes: the open economy dimension

Abstract: This paper reviews the treatment of open economy issues in Paul Davidson’s book, John Maynard Keynes. Davidson aptly summarizes Keynes’s criticism of the international monetary system for the asymmetric “burden of adjustment” it places on deficit countries compared with surplus countries, which imparts a contractionary bias to the world economy. Davidson also updates Keynes’s proposals for global monetary reform and extends his analysis of international trade. However, Davidson’s arguments about mainstream views of international finance and the ineffectiveness of exchange rate adjustments are on less solid ground. This paper suggests reformulations of Davidson’s interpretations on the latter two points.

Key words: General Theory, international finance, international trade, John Maynard Keynes, open economies, Paul Davidson.

Among its other virtues, Paul Davidson’s book John Maynard Keynes (2007) puts strong emphasis on the international dimensions of Keynes’s economic thought. Contrary to the myth that Keynes’s theory was intended only for a “closed economy,” Keynes was acutely aware of the challenges posed by international trade and financial flows for the formulation of economic policy in the national interest, and accordingly, he frequently addressed “open economy” issues in both his theoretical and policy writings. As Davidson writes,

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many believe that Keynes’s *General Theory* analysis is not applicable to economic problems of nations integrated into the global economy of the 21st century. Nothing can be further from the truth. The principles underlying Keynes’s *General Theory* analysis have a direct applicability for discussing the operations and problems of any open economy. (ibid., p. 118)

In this volume, Davidson devotes 3 out of 12 chapters, or approximately one quarter of the book, to elucidating Keynes’s contributions to the analysis of open economies and their implications for current global economic problems.

As Davidson rightly notes, Keynes’s principal concern was that the international financial system contained a contractionary bias in the way it imposed most of the burden of balance-of-payments adjustment on the deficit countries, rather than the surplus countries. Davidson outlines Keynes’s vision of a global financial system that would reverse this contractionary bias and instead impart an expansionary thrust to the global economy by forcing the surplus countries to take up more of the adjustment burden. Along the way, Davidson provides a breathtakingly rapid and characteristically provocative discussion of the following points: how Keynes developed his proposals for a post–World War II monetary system, how the actual system that emerged out of the 1944 Bretton Woods conference differed in key respects from Keynes’s proposals, why the Bretton Woods system worked relatively well for about two decades but eventually failed, what has come after the demise of Bretton Woods and why it is worse, and how a modified version of Keynes’s proposed international monetary system could be adapted to the conditions of the twenty-first century. In addition, Davidson provides Keynes-inspired critiques of conventional theories of international trade based on comparative advantage and the traditional argument for flexible exchange rates as a means of curing global trade imbalances.

In the remainder of this paper, I first highlight a number of areas in which I think Davidson is absolutely right in his assessment of the direction in which Post Keynesian analysis of the international economy should proceed. Then, I turn to two areas in which I would take issue with parts of Davidson’s arguments: first, his characterization of what the mainstream of the economics profession believes today; and second, his unduly negative assessment of the potential contribution of exchange rate realignment to rectifying global payments imbalances. In both of these areas, I will suggest reformulations of Davidson’s arguments that I think are more defensible. Finally, I will conclude by agreeing with Davidson’s fundamental conclusion that we could do better than relying
on flexible exchange rates to solve global trade imbalances, while also noting one surprising omission from Davidson’s discussion.

**Contractionary biases and Keynesian remedies**

Davidson ably documents Keynes’s constant concern with the potential for liberalized financial flows (or what used to be known as “capital mobility”) to undermine the expansionary macroeconomic policies that he saw as the cure for the Great Depression and the guarantor of postwar prosperity. Because “free movement of capital funds across national boundaries” leads to “a tendency to equalize interest rates across nations,” Davidson writes, a country with liberalized financial flows “cannot unilaterally try to reduce its interest rate to stimulate investment and employment” (ibid., p. 119). However, Keynes believed that control of a country’s interest rate by its own monetary authority was an indispensable component of a full employment policy:

> It is the policy of an autonomous rate of interest, unimpeded by international preoccupations, and of a national investment programme directed to an optimum level of employment which is twice blessed in the sense that it helps ourselves and our neighbours at the same time. (Keynes, 1936, p. 349, quoted in Davidson, 2007, p. 121)

Therefore, as Davidson notes, Keynes thought it desirable that countries should regulate financial inflows and outflows—that is, to use what are commonly known as “capital controls.”

Keynes also pointed out that if countries are unable to lower their own interest rates in order to promote full employment, they will be tempted to pursue full employment instead via mercantilist policies aimed at securing a trade surplus. Such a policy approach, however, can lead to what he called a “senseless international competition for favourable [trade] balance which injures all alike” (Keynes, 1936, pp. 338–339, quoted in Davidson, 2007, p. 120). Or, in Joan Robinson’s famous reiteration of Adam Smith, a policy that seeks to achieve high employment via a trade surplus in one country at the expense of low employment and a trade deficit in other countries is a form of “beggar-my-neighbour” trade policy (Robinson, 1947, pp. 156–170).1 Thus, contrary to the conventional wisdom, Keynes believed that a world of open capital markets was likely to be a world driven by international conflict over employment opportunities, not a harmonious world with full employment for all nations.

1 For discussions of Robinson’s views on international economics and trade policy, see Blecker (2005b) and Rima (1991; 2003).
Furthermore, Keynes highlighted the fact that the international monetary system of his time contained a significant contractionary bias in the way that it imposed the burden of adjustment on the countries with balance-of-payments deficits. Whereas a surplus country can sustain its surplus by accumulating gold or foreign exchange reserves almost without limit, as long as it can sterilize the possible inflationary effects, a deficit country will eventually run out of international reserves and hence can be forced to adjust—more rapidly, if the country is subject to a financial crisis (e.g., as a result of capital flight by domestic residents, a speculative attack on its currency, and/or a default on its international debt). In Keynes’s words,

It is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is in the debtor position on the international balance of payments—that is, on the country which is (in this context) by hypothesis the weaker and above all the smaller in comparison with the other side of the scale which (for this purpose) is the rest of the world. (Keynes, 1980, p. 27, quoted in Davidson, 2007, p. 148; emphasis in original)

If a deficit country has to reduce its payments imbalance through its own adjustments, it is forced to take measures such as fiscal cutbacks (spending reductions or tax increases), interest rate hikes (to attract foreign capital, if financial markets are open), and currency depreciation or wage reductions—all of which can have contractionary effects on the domestic economy. Moreover, if the country is large enough to have an appreciable impact on its trading partners (and deficit countries need not be small, as the United States has recently demonstrated), the impact of these policies can help to drag down the rest of the global economy. Especially, if one nation’s devaluation leads to competitive devaluations by other countries, the result is a situation in which no one gains.

To remedy this bias in the operation of the international monetary system, according to Davidson,

Keynes concluded that an essential improvement in designing any international payments system requires transferring the onus of adjustment from the debtor to the creditor position. This transfer would substitute an

2 In conventional models of the Mundell–Fleming variety, a currency depreciation is normally expansionary. However, there are many well-known reasons (not incorporated in those models) why depreciations may be contractionary. These reasons include reductions in real wages and increases in profit markups, which tend to diminish consumer demand, and the higher costs of imported producer goods (capital and intermediate goods) and of servicing foreign currency-denominated debt. One classic reference is Krugman and Taylor (1978); see also Razmi (2007).
expansionist, in place of a contractionist, pressure on world trade (Keynes, [1980], pp. 29–30). . . . [Therefore] Keynes recommended combining a fixed, but adjustable, exchange rate system with a mechanism for requiring the nation “enjoying” a favorable balance of trade to initiate most of the effort necessary to eliminate this balance, while “maintaining enough discipline in the debtor countries to prevent them from exploiting the new ease allowed them (Keynes, [1980], p. 30).” (2007, pp. 148–49, italics in original)

Following Skidelsky (2003), Davidson acknowledges that part of Keynes’s thinking about global monetary reform originated with his reading of the proposals for a postwar financial system designed by two of Hitler’s financial advisers (Hjalmar Schacht and Walter Funk). In spite of this dubious origin, Keynes borrowed the German’s idea of seeking to maintain balanced trade via exchange controls rather than currency depreciation. However, Keynes went beyond the Schacht–Funk plan by envisioning a mechanism that would prevent the hoarding of liquid assets (foreign exchange reserves) by the surplus countries, and which would instead encourage those countries to “spend any excessive trade surplus earnings by buying producibles from deficit nations, thereby permitting the deficit nations to work their way out of debt” (Davidson, 2007, p. 123). To this end, Keynes famously proposed his International Clearing Bank (ICB), a supranational central bank that would emit a new international reserve asset known as the “bancor” and could utilize the excess bancor deposits of creditor countries to provide liquidity to debtor countries.

As is well known, the international monetary system that emerged at the 1944 Bretton Woods meeting followed the less ambitious (and more U.S.-centric) plan of Harry Dexter White, rather than Keynes’s vision. The Bretton Woods system included convertibility of the U.S. dollar into gold at a fixed parity for foreign central banks, and adjustable pegs for other currencies relative to the dollar. The Bretton Woods conference also established the International Monetary Fund (IMF), a more modest body than Keynes’s ICB, with more limited powers to make short-term loans to countries that encountered balance-of-payments deficits. As it evolved, the IMF typically imposed conditions on borrowing nations which closely resembled the automatic adjustment mechanisms of the gold standard days, including currency devaluations and monetary and fiscal contractions that often imposed harsh austerity on debtor countries.

Nevertheless, Davidson observes that the Bretton Woods system fostered two decades of global prosperity between the mid-1940s and mid-1960s. Even though this system did not incorporate rules that obligated
the surplus countries to bear the burden of adjustment as Keynes had recommended, the United States effectively supplied enough liquidity to the global economy in the postwar period that the 20 years following the end of World War II became known as the “golden age” of capitalist growth. The United States began to play this role through its Marshall Plan aid, which not only helped to rebuild war-torn economies but also helped to avert a postwar depression in the late 1940s. Then, as a large creditor nation, the United States was able to increase its import purchases and foreign investments to a degree that significantly bolstered the global boom of the 1950s and 1960s. For two decades, other countries accepted dollars as if they were “good as gold,” and the global economy had no shortage of liquidity.

However, by the late 1960s, U.S. payments surpluses were shrinking and turning into deficits, while the newly emerging surplus countries—especially West Germany and Japan—refused to step into the role of providing adequate demand and liquidity to sustain global economic growth (and, although Davidson does not mention it, they also refused to revalue their undervalued currencies). Moreover, by the 1960s, several western European countries had accumulated a large “overhang” of dollar reserves and began to cash in some of their dollar assets for gold, as they were permitted to do under the rules of Bretton Woods. As U.S. gold reserves dwindled, President Richard Nixon closed the gold window, devalued the dollar (relative to gold), and finally abandoned the entire Bretton Woods system in a series of moves between 1971 and 1973.

Although the story of the shift to floating exchange rates is well known, Davidson (2007, p. 146) emphasizes a point that has received insufficient attention in discussions of the post-1973 international monetary disorder: the fact that, from that time forward, none of the surplus countries was generally able or willing to provide the liquidity necessary to sustain global prosperity as the United States had done in the aftermath of World War II. It is not surprising, therefore, that most of the period since 1973 has been one of slower global growth, and that the one exception—the global commodity-led boom of roughly 2004–7—was stimulated in large measure by a major new surplus country (China) imparting a significant demand stimulus to the entire world economy.\(^3\)

\(^3\) Since the early 2000s, rapidly growing Chinese demand for raw materials and energy products has driven up primary commodity prices globally and benefited developing nations that export these goods, while simultaneously imposing severe costs on other nations (both developed and developing) that import these commodities. However, China has amassed an enormous hoard of foreign exchange reserves in its effort to limit the appreciation of the yuan. China’s foreign exchange reserves
In light of the dismal economic performance during most of the period since 1973, Davidson offers an updated version of Keynes’s ICB-bancor plan for the twenty-first century. This plan, versions of which have been published previously (e.g., Davidson 1992–93), abandons the idea of a world central bank, and in its place substitutes a somewhat more modest international clearing union that would issue “international monetary clearing units” (IMCUs) that would be held by member countries’ central banks and would be convertible into their respective domestic currencies. Although there are many interesting features of Davidson’s proposal, perhaps the most significant and unique aspect is his idea of instituting “a trigger mechanism to encourage any creditor nation to spend what is deemed (in advance) by agreement of the international community to be ‘excessive’ credit balances [of IMCUs] accumulated by running current account surpluses” (Davidson, 2007, p. 155). The balances could be spent either on imports of goods and services, foreign direct investment (FDI), or unilateral foreign aid (transfers). Davidson’s vision is that such a mechanism—and the penalty of having excessive credit balances confiscated by the clearing union if not spent—would effectively shift the burden of international adjustment onto surplus nations, thereby imparting an expansionary rather than a contractionary thrust to the global economy.

Although Davidson considers his plan less ambitious than Keynes’s original plan (largely because the clearing union falls short of being a true global central bank, as most central banking functions are left to national monetary authorities), nevertheless any plan for creating a new supranational institution with significant power over national governments is still too ambitious to be considered politically realistic in the present situation. The virtue of this proposal, therefore, lies less in the prospect of its adoption in the foreseeable future than in putting front and center the key idea of inducing the surplus nations to take up more of the burden of adjustment in the international payments system. Minimally, one might hope that the major nations (for example, the G-8 plus China, India, and other large developing nations) might be able to negotiate a cooperative framework in which stimulus policies by the surplus nations would help to maintain global prosperity as the United States and other deficit nations try to adjust their way out of debt. Sadly, it could take a

increased by more than 10 times from about $160 billion in January 2000 to more than $1.6 trillion in February 2008 (data from International Monetary Fund, International Financial Statistics, online database). This is exactly the kind of “excessive” hoarding of international currency reserves that Davidson’s proposed international clearing union would be charged with preventing, as discussed in the next paragraph.
global economic crisis of a magnitude not seen since the 1930s to make something like Davidson’s scheme politically feasible.

**Absolute versus comparative advantage**

Keynes’s views on international trade theory were less well formed than his views on international financial arrangements. Therefore, Davidson extrapolates considerably from Keynes’s scarce writings on the topic to apply his principles to contemporary trade issues in the early twenty-first century. Nevertheless, what emerges from this effort is a coherent albeit brief statement of the Post Keynesian approach to international trade (see Blecker, 2003a, for a survey). Among other things, this approach is characterized by a refusal to separate trade theory from international monetary theory, as is conventionally done in the orthodox approach. The traditional theory of comparative advantage treats trade as an act of barter, on the twin assumptions of balanced trade and full employment. Under these idealized conditions, the only function of trade is to increase efficiency by allowing each nation to specialize in those products that it can produce with the relatively lowest opportunity cost. The model of comparative advantage assumes that countries have inherent differences in their “production possibilities” due to inherent differences in their “resource endowments,” technological capabilities, or both. This assumption is essential for the implication that every country is better off exploiting its given advantages rather than trying to improve its productive powers.

Post Keynesian economists, including Davidson, have long criticized this theory on two grounds. First, based on Keynesian macroeconomic principles, Post Keynesians doubt the efficacy of the automatic adjustment mechanisms that are supposed to maintain balanced trade with full employment. If there is not full employment, then demand-side stimulus policies may be more important than supply-side efficiency considerations for promoting national economic welfare. If trade is not balanced, then surplus countries are exporting some goods in which they do not have a true comparative (i.e., efficiency) advantage, but instead are exporting based on absolute cost advantages—and, correspondingly, deficit countries are importing some goods in which they actually do have a true comparative advantage, but lack an absolute cost advantage at the prevailing wages, prices, and exchange rates (see Blecker, 2005a). Second, Post Keynesians have long criticized the assumptions of immobile capital and given technological capabilities that are essential for
trade to follow comparative advantages. In a world of mobile capital and technology, it is evident that most of the competitive advantages in modern international trade are created, not “endowed.” Keynes was quite prescient in this regard when he wrote, “[e]xperience accumulates to prove that most modern mass-production processes can be performed in most countries and climates with almost equal efficiency” (Keynes, 1982, p. 238, quoted in Davidson, 2007, p. 131).

Under the more realistic assumptions that trade need not be balanced, less-than-full employment is possible, and capital and technology are mobile, trade follows absolute monetary cost advantages rather than inherent comparative efficiency advantages (see Brewer, 1985; Milberg, 1994). Davidson’s articulation of this view is worth quoting at length:

given the existence of multinational firms and the ease with which they can transfer technology internationally, any differences in relative costs of production in any particular industry are more likely to reflect national differences in money wages (per same hour of “real” human labor) plus the costs of providing “civilized” working conditions (measured in terms of a single currency) such as limiting the use of child labor, plus the costs to the enterprise of providing health insurance and pension benefits for employees, etc. In other words, in a laissez-faire system today, global industrial-trade patterns are more likely to reflect differences in nominal wage, occupational safety, and other nominal labor expenses that the enterprise must bear, than real costs associated with either national differences in climate, or difference[s] in the availability of natural resources. (Davidson, 2007, pp. 131–132)

Davidson concedes that traditional principles of comparative advantage continue to apply in natural resource-based products, “where productivity is related to climatic conditions or mineral availability” (ibid., p. 133). In many manufactured goods, however, production is likely to be located wherever multinational firms can obtain the lowest unit money labor costs—that is, money wages adjusted for productivity and measured in a common currency. Therefore,

international production and trade patterns will be determined by [the] absolute advantage of having a large supply of low money wage workers available and not by the law of comparative advantage. Consequently, in the West production and employment in the tradeable goods industries will decline substantially, if not completely. (ibid., p. 136)

4 For example, Pasinetti (1981) argued that the dynamic gains from international technology transfer and “learning” are much greater than the static gains from specializing according to existing comparative advantages.
Davidson goes on to discuss the application of these principles to various current issues, such as the controversy over “outsourcing” and displaced workers in the United States (on this point, he cites the excellent book by Uchitelle, 2006). Among other things, Davidson refutes the facile notion that the United States could address the problem of displaced workers simply by supplying more education and training. If the jobs have moved elsewhere, even highly educated or retrained workers will not find employment commensurate with their skills. Somewhat pessimistically but perhaps realistically, Davidson concludes as follows:

Unless the governments of developed nations take deliberate action to secure and maintain full employment in their domestic economies despite their lack of absolute advantage competitiveness in industries producing tradeable goods and services, free trade has the potential to impoverish a significant portion of the population. (Davidson, 2007, p. 137)

What mainstream economists believe

Davidson is on less firm ground when he makes the following claim:

Every well-trained mainstream economist whose work is logically consistent with classical theory knows that the claimed benefits of free trade with a freely flexible exchange rate are:

1. that it is impossible for any nation to experience a persistent (unfavorable) trade imbalance where the value of imports exceeds that of exports;
2. that each nation can pursue monetary and fiscal policies for full employment without inflation, independent of the economic situation of its trading partners; and
3. that the flow of capital will always be from the rich creditor (i.e., developed) nations to the poor debtor (i.e., less developed) nations . . . capital should flow from where it [is abundant and] earns a lower return to where it [is scarce and] earns a higher return, i.e., capital should flow from rich nations into the poor nations until the return on capital is equal in each country. (ibid., pp. 126–127.)

Admittedly, Davidson puts a few key qualifiers in this statement when he refers to “well-trained” economists “whose work is logically consistent with classical theory” (thus leaving open the possibility that there are mainstream economists who are not well trained or whose work is not consistent with classical theory) and when he refers to “claimed benefits” (thus acknowledging that mainstream economists may understand that these benefits are not being realized). Nevertheless, I think claims 1 and 3
in this list are out of date as a characterization of what most mainstream international economists believe, and even claim 2 is no longer maintained in such a strident fashion today.

It would be more accurate to say that these three claims were believed by most mainstream economists up to the early 1970s, and that they were cited as justifications for the shift to flexible exchange rates and open capital markets at that time. However, much ink has been spilled since then on why these predictions did not come true. It would also be accurate to observe that many undergraduate textbooks continue to teach such ideas, even after they have been abandoned by serious scholars in the field (a fact that, in itself, is a sorry commentary on the current state of undergraduate economics education). The better textbooks at least specify the assumptions required for these conditions to hold (for example, claim 1 requires immobility of financial capital, and claim 3 ignores risk premia and technological differences). Most importantly—and I will return to this point below—economists should believe in some version of claim 1 (i.e., an automatic adjustment mechanism to maintain balanced trade) if they want to assert the “classical” doctrine of comparative advantage as the basis for supporting free trade. If this is what Davidson means, then he has a valid point. Nevertheless, most mainstream economists have long since abandoned the first and third claims, while heavily qualifying the second.

On the first point, mainstream open economy macro models show numerous cases in which there can be persistent trade imbalances, provided that financial capital is mobile and a nation reaches an “equilibrium” with sustainable net financial inflows or outflows. In models with mobility of financial capital, balance-of-payments equilibrium is typically defined in terms of the overall balance, not the current account or trade balance alone. In the most au courante neoclassical models, the current account is driven by the capital (or financial) account, and the latter is determined by “intertemporal optimizing behavior,” which entails lending by nations where saving exceeds investment (consumption is less than income) to nations where investment exceeds saving (consumption is greater than income). These models generally contain “intertemporal budget

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5 What used to be known as the “capital account” in the balance of payments is now called, in the officially accepted jargon of the IMF, the “financial account” (and the term “capital account” is reserved for certain special types of capital transfers). Financial account is probably a better term, because the lion’s share consists of transactions in financial assets (bank deposits, loans, bonds, equity, etc.) and what might be considered investment in “real” capital (FDI) is a relatively small portion, some of which is merely merger and acquisition activity anyway—and sales of capital goods across national borders are recorded in the current account, not the financial account.
constraints,” according to which net lending must be balanced by net
borrowing (or net repayments) and vice versa in the very long run. Post
Keynesian economists should be critical of such models for their many
unrealistic assumptions, especially in regard to superrational agents who
possess unbelievable amounts of information about the future. Never-
theless, modern neoclassical models do allow for “persistent” surpluses
or deficits on current account (and in the trade balance) for significant
periods of time (on the order of decades or longer)—and in some such
models, “permanent” or “equilibrium” current account imbalances are
possible (see, e.g., Caballero et al., 2008).

On the second point, even though the general idea is still maintained,
there is increasing recognition that national policymaking can be signifi-
cantly constrained especially if free mobility of financial capital is also
allowed. Without going into the technicalities of the various models, one
simple device commonly used in mainstream analysis is the idea of the
impossible trinity or “policy trilemma”: no country can simultaneously
have more than two of the three goals of autonomous monetary policy,
control of its exchange rate, and open financial (capital) markets. Es-
pecially, once countries have opened their financial markets, they must
give up either control of their own interest rates or management of the
exchange rate, and any country that tries to violate this risks a financial
crisis. Of course, it is not at all clear why having liberalized financial
markets should be considered a goal of economic policy on the same
plane as having autonomy in regard to monetary policy and the exchange
rate (see Palley, 2009)—unless one believes in the third point, which
is the alleged benefit of open capital markets (see also Blecker, 1999).
Nevertheless, the trilemma concept—along with the many more specific
models that underlie it—effectively makes the point that contemporary
mainstream economists do not believe that every country with free trade
and a flexible exchange rate has complete policy autonomy.

What perhaps does underlie point 2 is the notion that flexible exchange
rates function as a “shock absorber” that helps countries to mitigate the
impact of external “shocks”—whether the shocks are supply-side (e.g.,
oil price increases), demand-side (e.g., a foreign recession), or financial
(e.g., a rise in the world interest rate). In the simplest textbook models,
there are situations in which adjustments of flexible exchange rates can
completely offset the effects of such shocks on the real economy. But
mainstream analysis has long since advanced over those simple models,

I am indebted to Ann Davis for suggesting this reference. See also the discussion
of this article in note 8.

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and no one today would seriously claim that having a flexible exchange rate completely insulates, for example, the United States from an adverse oil price shock or Canada from a U.S. recession. Among other things, it is now widely recognized that flexible exchange rates can be driven by financial market forces (such as interest rate differentials, volatile expectations, herd behavior, and speculative bubbles) that can move them in different directions from what would be helpful for keeping trade balanced or nullifying external shocks (see the sources cited in Blecker, 1999).

On the third point, mainstream economists are acutely aware of the fact that most global financial flows are not moving toward the poorest, most capital-scarce countries, and instead (rather “perversely”) have been flowing mostly to the world’s richest nation—the United States. Even if one focuses on FDI, most of it flows among the industrialized nations and to a small number of upper-middle-income or rapidly growing nations (e.g., China and Vietnam), but relatively little goes to the broad majority of low-income nations. But rather than continue to assert a prediction that is blatantly false, mainstream economists have devoted much energy to explaining why capital is not flowing into the capital-scarce, less developed countries, and in fact there is now quite a large literature on this topic. This literature includes numerous explanations that are perfectly compatible with mainstream economic reasoning, including inferior technology, complete specialization, increasing returns, institutional failings (e.g., corruption or inadequate rule of law), and a lack of complementary inputs (e.g., human capital and infrastructure). Essentially, these explanations allow for variations in some of the factors that are held constant in the ceteris paribus assumption of the traditional model, and when these factors are variable, then the poorest countries do not necessarily offer the highest expected returns to capital, their “scarcity” of capital notwithstanding.

Although all these explanations have some merit, they focus on the “supply side” and ignore the “demand side” emphasized by Keynes. There are other explanations that emphasize the demand side and are therefore more consistent with Keynesian theory. For example, to the extent that FDI is directed toward sales in domestic markets, then low-income countries with small consumer markets make relatively unattractive locations for FDI. If developing countries try to attract export-oriented FDI (e.g.,

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7 One seminal article is that by Lucas (1990). More recently, Batista and Potin (2007) add a trade-theoretic twist (they allow for complete specialization along with technological differences) and also note the difference between financial and real rates of return. The latter study also cites much of the previous post-Lucas literature.
for low-wage assembly operations), they may be subject to a “fallacy of composition” in the simultaneous efforts of so many such countries to attract foreign capital to promote exports of similar types of goods to the same industrialized country markets (see Blecker, 2002; Razmi and Blecker, 2008). In this case, it is perfectly logical that most would-be exporters among the developing nations will not attract large amounts of FDI, even though a few of them succeed in doing so. Thus, there are Keynesian as well as neoclassical explanations for the fact that most capital does not flow toward the poorer countries. Nevertheless, most mainstream economists today no longer believe in the simple-minded prediction that capital will always flow toward the poorer countries where it is more scarce.

However, as noted earlier, there is one important sense in which Davidson’s statement about the first claim is accurate, namely that mainstream economists should believe in some sort of automatic macroeconomic adjustment mechanism to maintain balanced trade if they want to uphold the comparative advantage model of free trade. Ricardo (1951) was cognizant of this issue and devoted most of chapter VII in his Principles to outlining a monetary adjustment mechanism that would maintain balanced trade under a gold standard. To the extent that modern mainstream economists have abandoned any serious notion of automatic adjustment to balanced trade (as opposed to equilibrium in the overall balance of payments), there is an intellectual incoherency in their use of a “pure” trade theory that assumes the existence of such an automatic adjustment mechanism while their international financial models no longer imply one. In most international economics textbooks, balanced trade is assumed in the trade half, but there is no serious effort to justify this assumption in the finance half (since only the simplest models that assume capital immobility imply automatically balanced trade).

It is important to stress that this argument is not an esoteric intellectual exercise; real people’s livelihoods, occupations, and incomes depend on

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8 Although few contemporary neoclassical analyses even bother to address the issue of automatic trade balance adjustment, some implicitly seem to claim that trade deficits are irrelevant because a country may (to put it crudely) have a comparative advantage in selling assets (i.e., borrowing). Implicitly, this suggests a broader conception of “trade” encompassing assets as well as goods and services (essentially, the entire balance of payments), which is superficially appealing but ignores the vital distinction between goods and services (which employ labor in their production) and financial assets (which do not). One recent model of this sort portrays the present set of global trade imbalances (U.S. deficits, Asian surpluses) as a sustainable equilibrium situation, assuming that the United States has a superior ability to “generate financial assets from real investments” (Caballero et al., 2008, p. 358, abstract).
the trade policies that their governments adopt. In the real world, trade imbalances on the order of 5 percent of gross domestic product (GDP) or higher have not been uncommon since the advent of flexible exchange rates and open capital markets in the 1970s. In such situations, some jobs are transferred from one country to another based not on intrinsic efficiency advantages, but on absolute competitive advantages due, for example, to wage repression, undervalued currencies, and other mercantilist practices. For example, as of 2007, total U.S. imports exceeded total U.S. exports by a ratio of 1.7:1, and in U.S. bilateral trade with China, the import–export ratio was about 5:1. In the presence of such lopsided imbalances, the displaced workers whose travails are chronicled by Uchitelle (2006) did not all have their jobs sacrificed on the altar of greater efficiency; rather, many of them lost their jobs due to mismanaged exchange rates as well as macroeconomic and trade policies that do not serve the national interest.

The efficacy of exchange rate adjustment

In the course of his discussion of exchange rate adjustment, Davidson makes the following, eminently reasonable statement:

In the real world, trade between nations does not always involve the large gross substitution effects presumed by classical theory. Income effects can have major impacts on a nation's international payments balance. Sole reliance on changes in exchange rates to solve persistent trade imbalances can be misplaced even in the long run. (Davidson, 2007, p. 137, emphasis added)

As long as the qualifiers in italics are maintained, I have no quarrel with this statement.

Nevertheless, in parts of this discussion, Davidson appears to forget the qualifiers and implies that exchange rate changes are rarely effective (or are generally ineffective) for rectifying trade imbalances. For example, he claims that the reduction in the U.S. trade deficit in the late 1980s was caused mainly by a drop in prices of imported oil and the economic slowdown that culminated in the recession of 1991, not by the large dollar depreciation of 1985–87 (ibid., pp. 141–143).


10 The oil price explanation is particularly dubious, because petroleum and related products accounted for only about 10 percent of U.S. imports of goods (and an even
what used to be called “elasticity pessimism”—that is, the view that the Marshall–Lerner elasticities sum to about one or less, so that a depreciation of a nation’s currency fails to improve its trade balance (because the increase in the quantity of exports and decrease in the quantity of imports together are insufficient to offset the increased domestic currency cost of the imports). Davidson admits that these elasticities are low mainly in the short run, and may rise over time as contemplated in the “J-curve” concept of trade balance adjustment (where the trade balance first worsens, but later improves, in response to a currency depreciation, as it takes time for companies involved in international trade to change their contracts, place or receive new orders, produce goods, and send or receive shipments). However, he then asserts that the long-run improvement may never take place, claiming that “the initial short-run J-curve worsening in the trade balance can induce expectations of a further fall in the exchange rate that might generate a new J-curve that signifies a further immediate decline in the value of net exports (ibid., p. 140, emphasis added). Of course this “can” happen, but Davidson provides no evidence or citations to support the implication that it is a typical result. On the contrary, numerous studies have verified that trade balances often respond positively to currency depreciation, albeit after some initial lag—especially in the industrialized countries (less so in developing nations).

To clarify where I agree and where I disagree with Davidson, the data in Figure 1 may be helpful. This figure shows the correlation between the Federal Reserve’s broad index of the real value of the U.S. dollar and the U.S. trade deficit measured as a percentage of GDP, where the latter is expressed as a positive number for convenience. There is certainly some positive correlation between these two data series, although the correlation is far from perfect. This suggests that there is a relationship between the value of the dollar and the U.S. trade deficit, but the latter smaller percentage of imports of goods and services) during the late 1980s. See U.S. Bureau of Economic Analysis, National Income and Product Accounts, table 4.2.5, Exports and Imports of Goods and Services by Type of Product, available at www.bea.gov. The slowdown argument is more valid, as discussed below, but does not imply that the dollar depreciation had no effect.

11 The one situation in which Davidson’s outcome is likely to occur is in a developing country with high import dependency, in which a currency devaluation exacerbates domestic inflation (by making imports more expensive), thereby nullifying the competitive benefits of the nominal devaluation and, often, leading to another round of devaluation. However, this outcome is rarely observed in industrialized nations (or any nations) where inflation is under control. For example, when the U.S. dollar fell in 1985–89 and again in 2002–8, the United States did not experience an outbreak of significantly higher inflation such as was observed in, for example, Mexico following the massive devaluations of 1982 and 1986 during that country’s debt crisis.
is also strongly affected by other factors—and I agree with Davidson that “income effects” (i.e., fluctuations in U.S. national income relative to other countries) are chief among the other factors. Furthermore, there are clearly long and varying lags in the effects of the exchange rate on the trade deficit, but until recently, the lags were no longer than about two years. For example, when the dollar soared in 1981–85, the trade deficit increased with about a two-year lag (rising from 1983–87). Then, when the dollar fell in 1985–87, the trade deficit came down about two years later (1987–89)—with a further fall in 1991 due to the income effects of the U.S. recession (and, because the U.S. received large transfer payments from its allies in the Persian Gulf War, the current account swung briefly into a surplus in that year).

The trade deficit rose slightly in 1993–95, primarily as a result of the recovery from the 1991 recession (this was an income effect on which Davidson and I would fully agree). Subsequent to that, the rise in the dollar in the late 1990s contributed to an even larger increase in the trade

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**Figure 1** The value of the U.S. dollar and the trade deficit, quarterly, 1973-I to 2008-I

![Graph showing the value of the U.S. dollar and the trade deficit, quarterly, 1973-I to 2008-I.]

deficit, again with about a two-year lag (the trade deficit accelerates after 1997, about two years after the dollar started rising in 1995—although 1997 was also the year of the outbreak of the Asian financial crisis, which led to a negative foreign income effect as well as further appreciation of the dollar). As before, both exchange rate and income effects were clearly at work, but the former were certainly not negligible.

The real mystery in the data shown in Figure 1 is why the U.S. trade deficit did not begin to decline until 2007, fully five years after the dollar peaked and began to fall in 2002. Why was the J-curve lag so much longer in this most recent episode? I think there are two main reasons: (1) from 2002 through 2006, the dollar fell only relative to the flexible rate “major” currencies of the other industrialized nations, but not with respect to the largely managed “other” currencies of the developing nations that now supply the United States with most of its imports (see Figure 2); and (2) the prolonged overvaluation of the dollar in the 1997–2002 period (shown in Figure 1) caused a significant and persistent reduction in the investment rate and capital stock in the U.S. manufacturing sector, which produces most tradable goods (see Blecker, 2007).

Factor 1 meant that while U.S. exports did begin to rise as a result of the lower dollar—since U.S. exports compete mainly with products from other industrialized countries—imports also continued to grow, especially from developing countries whose currencies did not appreciate until after 2006. Thus, exchange rate effects were at work, but one needs to disaggregate the data by country and currency to see how they operated (and why they were so limited). Factor 2 meant that U.S. capacity to produce tradable goods was significantly diminished during the prolonged period of dollar overvaluation, which implies that the U.S. economy no longer has the capacity to produce many of the goods that it now imports (especially the intermediate inputs that were “outsourced”). Here, Davidson would be right to say that there is a lack of “substitutability” between U.S. and foreign products, but only because domestic capacity was destroyed—and that capacity can be rebuilt, or new capacity created. If the dollar remains low for a similarly prolonged period, and especially if the dollar falls more vis-à-vis the currencies of the developing nations (as it was starting to in 2007–8), the United States will restore some of its capacity to produce tradable goods (partly, though not entirely, because the cheap dollar will lure foreign companies to invest in U.S. production).12

12 There is already evidence that this is starting to happen. The business press is reporting significant foreign investments in U.S. production, partly as a result of the
Nothing I have said here is intended to imply that exchange rate adjustments should be expected, by themselves, to entirely eliminate trade imbalances. For the reasons indicated earlier, in a world with open capital markets and flexible exchange rates, currencies often move in exactly the “wrong” direction for rectifying a trade imbalance. For example, as Figure 1 shows, in several instances, the U.S. dollar continued to rise for several years after an increase in the trade deficit meant that the dollar “should” have fallen (this was true in 1983–85 and again in 1998–2002; see Blecker, 2003b). These “perverse” movements in exchange rates low dollar and partly in response to high transportation costs due to the rise in energy prices. See, for example Mui (2008), who reports investments in Virginia by IKEA (in furniture) and by Rolls Royce and Canon (in high tech). The role of high energy prices in driving some production, such as steel, back to the United States is also discussed by Rubin and Tal (2008).

Figure 2 Alternative indexes of the real value of the U.S. dollar, monthly, February 2002 to June 2008


Notes: The major currency index includes the floating rate currencies of the industrialized countries; the other currencies index includes developing countries’ currencies. The all currencies index is a trade-weighted average of the other two indexes, and is the same as the broad, real index of the dollar’s value shown in Figure 1.
are driven by international interest rate arbitrage and currency market speculation ("bubbles"), not by the underlying “fundamentals” of trade balances (Blecker, 1999). In this respect, Davidson is entirely right that a system of freely flexible exchange rates cannot be expected to automatically eliminate trade imbalances. However, I think the main reason for this conclusion is that exchange rates do not always move in the right direction to eliminate those imbalances, not because exchange rate changes do not have significant effects in reducing trade imbalances when those changes are in the right direction (and after allowing for suitable lags).13

Finally, I would point out that there are two aspects of Davidson’s analysis that implicitly acknowledge a greater role for exchange rate adjustment than he acknowledges. First, in his analysis of trade following absolute monetary cost advantages, Davidson (2007, p. 136) makes it clear that he means unit labor costs (or other costs of production) measured in “a single currency.” For nominal costs in foreign currencies to be converted into one single currency (such as the U.S. dollar), they must be converted at prevailing exchange rates. Thus, Davidson implicitly admits that exchange rates can affect absolute competitive advantages and, ipso facto, trade balances. But if an undervalued currency can give a country an absolute competitive advantage resulting in a trade surplus, it stands to reason that revaluing that country’s currency could help to eliminate that advantage, thereby reducing the surplus.

Second, in designing his update of Keynes’s international monetary system, Davidson explicitly allows for adjustments in nominal exchange rates of the national currencies with the IMCU in response to “permanent increases in efficiency wages” (2007, p. 156). In other words, if a country becomes less competitive because of a rise in its unit labor costs (wages adjusted for productivity), it would be allowed to devalue its currency. This suggests that some degree of exchange rate adjustment is not only feasible but even desirable for maintaining balanced trade relations among nations. In this respect, what is objectionable about freely floating exchange rates is not that they adjust at all, but that their movements are often excessive in magnitude or perverse in direction relative to what would be necessary for reducing trade imbalances.

13 Davidson (following Keynes) is quite right to point out that exchange rate adjustment is often costly, because it raises the cost of living for workers and thereby implies a cut in the real wage. But, this is a type of “income effect,” and it reminds us that exchange rate adjustment often works through income effects as well as substitution effects.
Conclusions

Davidson’s devotion of one quarter of his book on Keynes to open economy issues goes a long way toward rectifying the neglect of Keynes’s views on international economics in many other appreciations (and critiques) of the latter’s work. Davidson shows not only that Keynes placed a great deal of emphasis on international concerns but also that Keynes’s analytical framework and policy views remain relevant in the twenty-first century. In spite of the reservations expressed above on a few aspects of Davidson’s arguments, I fully agree with him that properly managed exchange rates would be better than freely floating ones for avoiding large trade imbalances and for curing them when they occur. Thus, I concur with Davidson’s conclusion: “Keynes’s general theory analysis implies there should be a better way to resolve international payments imbalances than leaving the matter to a freely flexible exchange rate market” (2007, p. 144).

Nevertheless, I was surprised at one omission in Davidson’s otherwise comprehensive account of Keynes’s views on international economics. In his essay on “National Self-Sufficiency,” Keynes famously argued: “let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national” (1982, p. 236). This argument was partly, but only partly, motivated by a desire to enable countries to maintain autonomous macroeconomic policies to sustain full employment, as emphasized by Davidson. In addition, Keynes (ibid., p. 239) observed that many countries were seeking “new modes of political economy” (including what we would now call development and industrial policies) that would only be feasible if they were, to some extent, freed from the constraints imposed by liberalized trade and financial flows. Therefore, Keynes argued that “the policy of increased national self-sufficiency is to be considered not as an ideal in itself but as directed to the creation of an environment in which other ideals can be safely and conveniently pursued” (ibid., p. 240)—ideals that included, but were not limited to, full employment. Thus, a more complete Keynesian view of international relations would include freedom for countries to pursue different kinds of economic policy regimes—which many authors now call “policy space”—rather than the one-model-fits-all concept enshrined in today’s “Washington consensus” in which all countries must adopt the same policy framework.
REFERENCES


