
NON-AGENDA

With the view of causing an increase to take place in the mass of national wealth, or with a view to increase of the means either of subsistence or enjoyment, without some special reason, the general rule is, that nothing ought to be done or attempted by government. The motto, or watchword of government, on these occasions, ought to be — Be quiet. . . Whatever measures, therefore, cannot be justified as exceptions to that rule, may be considered as *non-agenda* on the part of government.

— Jeremy Bentham (c.1801).

Not the Current-Account Constraint Again!

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In the late 1980s, monetary policy aggressively targeted the current-account deficit (CAD) which was then officially interpreted as the gap between national output and national expenditure and as the major macroeconomic constraint on the Australian economy. As a result, short-term interest rates peaked at over 18 per cent in mid-1989; and the subsequent recession saw unemployment rise to 11 per cent, the highest level in decades and well above the OECD average of 7 per cent. The economy suffered far more than it would have if monetary policy had remained neutral, or had itself been constrained by some monetary rule.

The policy reaction occurred despite 'New View' arguments circulating at the time about the changed significance of the external account 'imbalance' under a floating exchange rate and deregulated international financial markets (Makin 1988, 1989; Pitchford 1990; Corden 1991). Among other things, the New View stresses that external imbalances are the difference between domestic saving and investment, to the extent that they reflect private-sector decisions, are no cause for policy concern.

Now that the economy is recovering, we need to remind ourselves that the CAD itself is not really a constraint and that using monetary policy to reduce the CAD probably would not work in any case.

The Exchange Rate and External Adjustment

Under the present floating exchange-rate system, CADs and capital inflow over any period will, in principle, always be equal *ex post*. Yet most analysts still interpret CADs as 'bad', forgetting that the matching capital-account surpluses are 'good' to

the extent that they usually finance extra private investment. As shown empirically in Makin (1993, 1994) and Layton and Makin (1993), extra foreign finance and investment of the 1980s actually made Australia better off in terms of its GDP and wealth to the extent that the value of the capital stock was larger than otherwise. Wealth per head, for instance, rose by over a third in the 1980s.

If at any time the two sides of the external accounts do not match *ex ante*, the nominal exchange rate moves to ensure they do. So concern about the balance of payments ‘constraint’ makes no sense unless the exchange rate itself goes into free fall. But this would happen only in the event that foreigners at once, and en masse, changed their minds about financing any of the additional private investment accompanying higher growth levels. This is unlikely; and it would not, as such, amount to a balance of payments ‘crisis’ for the authorities, but rather an exchange-rate management issue that may not require a heavy handed policy response. If there were a sudden flight of foreign capital that precipitated a sharp exchange-rate depreciation, foreigners would be dumping debt instruments on the domestic market and at the same time forcing down their prices. Not only would part of the stock of Australia’s foreign debt vanish, but lower financial asset prices would raise yields in domestic financial markets. At some point, the higher returns on domestic instruments would attract foreign investors back into the Australian market, so placing a natural floor under the exchange rate. Additionally, a sharp depreciation would raise export values and, over time, improved competitiveness would discourage imports. In general, as David Hume (1752) argued, external disturbances tend to be self-equilibrating.

Do High Interest Rates Reduce the CAD Anyway?

Whether tighter monetary policy actually reduces the CAD is a largely unresolved theoretical issue. The popular Mundell-Fleming approach, favoured for instance by Bewley and White (1990), suggests that tighter monetary policy widens the CAD because higher interest rates cause a higher real exchange rate, which discourages net exports. In other words, monetary tightening could deliver the opposite external account outcome to that intended.

However, this approach ignores certain key linkages between monetary policy and the CAD. For instance, higher interest rates also suppress national expenditure, which lowers imports and possibly raises exports (to the extent that less spending by residents means a greater share of domestic output becomes available for sale abroad). This would tend to narrow the CAD, offsetting the exchange rate-trade account linkage of the Mundell-Fleming model.

Yet the biggest component of the CAD is not the difference between exports and imports of goods and services, but net interest paid abroad on foreign debt, over half of which is denominated in foreign currency. The Australian dollar value of such interest shrinks when the exchange rate appreciates, thus reducing the CAD. But then higher domestic interest rates also raise the amount of interest paid to foreign holders of domestic bonds denominated in Australian currency, thus

raising income paid abroad as debited in the current account. On balance, therefore, the effect of monetary tightening on the CAD is ambiguous.

Conclusion

In view of Australia's macroeconomic performance since the late 1980s, a repeat discretionary tightening of monetary conditions in response to a perceived current-account constraint would amount to policy recidivism on the part of the authorities. Not only could such action reverse recovery and lead to high unemployment, it would again reveal a fundamental misunderstanding of how the external balance is generated and, moreover, would be unlikely to reduce the CAD.

On the other hand, a current-account objective could in theory be assigned to *fiscal* policy. Lower budget deficits may reduce the external deficit to the extent that higher public saving lifts total national saving relative to national investment. Unfortunately, there is then the risk that if foreigners enthusiastically endorse such fiscal restraint by investing more of their funds in Australia, the additional inflow of foreign money would increase the capital-account surplus and thereby reverse any fiscally induced 'improvement' in the CAD!

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