

Comment

Tony Makin

If macroeconomic policy has not failed Australia, why else is Australia's unemployment rate still so much higher than the OECD average? And why was the excessively tight monetary policy of the late 1980s (which caused the recent high unemployment in the first place) based on outdated views about a balance of payments constraint? What is really curious is that such questions, and indeed the general question raised in Garry White's paper, have not been asked more often. And if we accept that macroeconomic policy has failed, where has it failed most and what should be done about it?

Why Macroeconomic Intervention?

At the intellectual level, the reluctance to accept the evident failure of macroeconomic policy in Australia can probably be explained by the dominance of the Keynesian macroeconomic paradigm. Keynesian thinking generally presumes that monetary and fiscal policy are indispensable and work well in minimising overall fluctuations in national income. It assumes that private spending on consumption and investment would otherwise be either too low or too high to realise the macroeconomic policy objectives of full employment and low inflation.

A general tenet of microeconomic theory is that markets best allocate finite resources and maximise the incomes of the economic agents participating in those markets. The onus is therefore on policymakers to demonstrate that any public-sector intervention in individual markets is warranted (as it often is whenever externalities are clearly identified). Keynesian macroeconomics, in contrast, holds that policymakers must vigilantly monitor overall economic activity and that frequent macroeconomic intervention is necessary because some markets are inherently unproductive and unstable, especially the financial and investment markets. So whereas in microeconomics markets are, by and large, deemed innocent until proven guilty, in Keynesian macroeconomics markets in aggregate are assumed guilty until proven innocent. This reversal of proof stands out as the single greatest policy inconsistency in modern economics.

One wonders how much sense Keynesian-inspired thinking now makes for an economy that has deregulated and internationalised its financial markets on the understanding that, in general, financial markets efficiently allocate funds between savers and investors. The economy is also now much more closely integrated with interna-

tional goods and services markets, with the proportion of total trade (exports plus imports) to GDP now around 40 per cent. The business cycle is therefore largely determined by external developments, including fluctuations in commodity prices, foreign-investment flows and international asset prices.

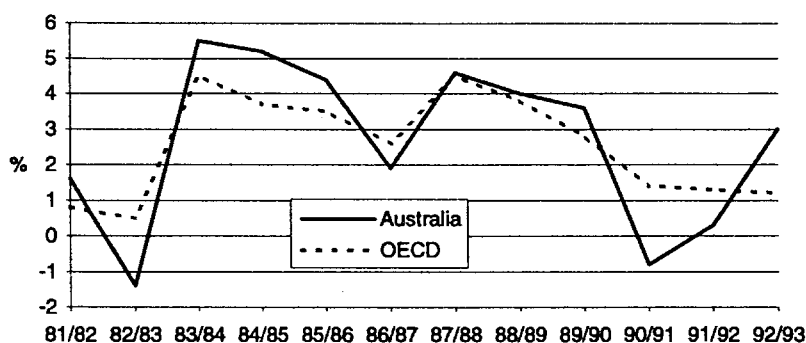
In contrast, the standard Keynesian paradigm was built on the hypothesis of a closed economy which, quite incredibly, left out exports, imports, the terms of trade, exchange rates and international capital flows: the macroeconomic variables at the heart of current economic debate. To make the Keynesian model work properly, it is necessary to seal the economy off from the rest of the world. But in reality, of course, Australia has gone the other way and further internationalised its economy, as have other OECD countries.

Improving Monetary Policy

Despite the Keynesian presumption that macroeconomic intervention is justifiable to stabilise the domestic business cycle, sharp shifts in the stance of monetary policy have not in practice achieved this. White's Figure 1 (p.138), based on a partial measure of economic activity, shows that Australia's business cycle is less variable than the OECD average. However, Figure 4 displays evidence that monetary policy has actually amplified Australia's true business cycle relative to the international business cycle. Activist monetary policy in Australia destabilises rather than stabilises overall economic activity relative to the international business cycle because sharp interest-rate changes can take up to 18 months or so to have an effect on domestic spending behaviour, by which time any downturn or upturn in the cycle may well have reversed itself.

Figure 4

**Australian and OECD business cycles:
annual changes in real GDP, 1981-93**



Source: *Reserve Bank of Australia Bulletin* (various issues).

Interest rates are crucial for the investment process because they affect the cost of capital. Through its discretionary intervention in financial markets to influence short-term interest rates, the Reserve Bank, operating on the basis of incomplete knowledge of economic behaviour, substantially increases interest-rate uncertainty. A risk premium reflecting this uncertainty is then incorporated into interest rates. Such policy-induced uncertainty probably explains why Australia's interest rates are still higher than those of our major trading partners, despite the closely integrated nature of today's international capital markets. Excessive Reserve Bank intervention in money markets also explains why short-term rates are so often out of line with long-term rates. This has given Australia one of the most variable yield curves in the world. The related interest risk premium stymies investment expenditure, which impedes productive activity in the economy.

In addition, habitual monetary policy interventions are based on ever changing forecasts about the future path of the economy; but, as tabulated in White's paper (p.137), such forecasts often prove quite wide of the mark. In light of these failures, it is clearly time for a serious re-think about what monetary policy should be doing and exactly how it should be doing it.

An obvious solution to eliminating the additional interest-rate and inflation uncertainty induced by domestic monetary policy is simply to eliminate Reserve Bank discretion and constrain the Reserve Bank to follow a fixed money-growth rule, as has previously been proposed by many economists, including Milton Friedman (1968). A money-base rule, for instance, has the advantage that the money-base measure represents the total liabilities of the central bank. It is the money magnitude over which the Reserve Bank has monopoly power and should therefore be easiest to control.

A steady money-growth rule would represent a major change in the way monetary policy is conducted and contrast sharply with the severe year-to-year fluctuations in money-base growth over the past decade. Since 1984, money-base growth has varied substantially between 2 and 10 per cent a year. A feasible rate of money-base growth may be somewhere between 2 and 5 per cent a year, in accordance with Australia's average long-term growth of real output. This would not only automatically check domestic inflation but minimise the gyrations in the yield curve and the attendant investment uncertainty.

Fiscal Policy

In discussing the failure of fiscal policy, White relies on the standard textbook (Mundell-Fleming) model of the open economy, which predicts that, under a floating exchange rate and conditions of highly mobile international capital, fiscal expansions crowd out net exports. This model, devised independently by Mundell (1963) and Fleming (1962), also provides a mechanism for understanding how federal budget and trade deficits may be related: the so-called twin deficits hypothesis. Central to this analysis is the behaviour of the floating exchange rate, which is supposed to appreciate after fiscal expansion and depreciate after fiscal contraction.

However, the Mundell-Fleming approach has many specification problems (see Makin, 1994, for further discussion). For instance, in the Keynesian spirit, it assumes

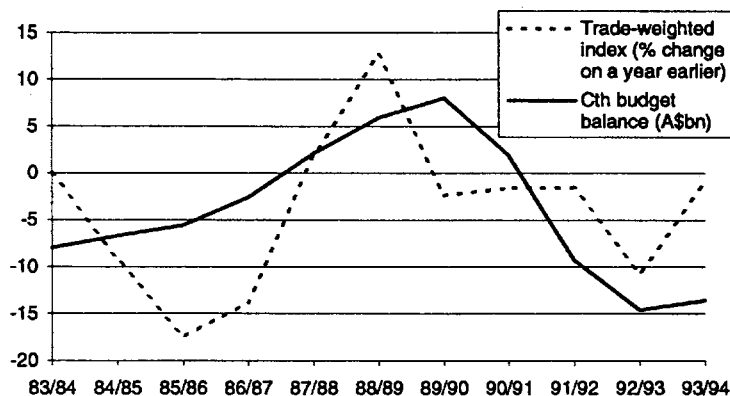
that aggregate output is entirely demand-determined; but this, among other things, fails to allow for any difference between domestic saving and investment. Additionally, there are no variations in the terms of trade, which are central to White's international business-cycle transmission mechanism.

The main practical problem with this model in the Australian context relates to exchange-rate behaviour. In reality, contrary to what the Mundell-Fleming model would predict, the Australian dollar has generally depreciated during periods of fiscal expansion, and appreciated during periods of fiscal contraction. Figure 5 below clearly demonstrates this. For instance, until the early 1980s countercyclical Commonwealth budget deficits were accompanied by a weaker, not stronger, exchange rate. With the subsequent tightening of the fiscal stance (the era of budget surpluses from 1987/88 to 1990/91), the effective exchange rate then regained some of its former strength, but subsequently weakened again following the fiscal response to the recession of the early 1990s (the return to budget deficits).

If fiscal policy had been rendered ineffective as a stabilisation instrument by floating exchange rates (as the textbook model suggests), then it cannot also exacerbate Australia's natural business cycle. However, in my view, fiscal policy still has the capacity to do this, such that it can still magnify peaks and troughs, particularly in national expenditure, relative to GDP. More theoretical and empirical work needs to be done in this area, however.

Figure 5

Fiscal policy and the exchange rate, 1983-94



Source: *Reserve Bank of Australia Bulletin* (various issues).

Conclusion

On balance, it would seem that fiscal policy has in practice been a much less significant source of macroeconomic uncertainty and destabilisation than monetary policy over recent years. In part, this may be due to the constraints imposed by the budgetary process itself. This annual process ensures that changes in the fiscal stance occur only once a year (or twice, when there are mini-budgets), whereas unannounced shifts in the monetary stance can occur at almost any time.

Moreover, because fiscal policy is subject to greater scrutiny, it has been conducted at a higher standard than monetary policy. It is outlined in great detail, and is quite transparent (if one cares to read all nine volumes of the 1994/95 Budget Papers!). By comparison, under existing arrangements, any account of what has been happening with monetary policy (as for instance outlined in the thin annual reports of the Reserve Bank) has to include an element of surmise about both its intentions and its practice. But this may be a deliberate strategy, since the Reserve Bank relies on the element of surprise in order to maximise the impact of monetary policy on the economy.

In sum, macroeconomic policy has recently failed Australia in an overall sense. But this is due mainly to excessively manipulative monetary policy, which has generated unwelcome uncertainty and exacerbated the business cycle.

References

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