Rejoinder

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Barry Hughes is a true believer in the Keynesian paradigm. Yet, as Tony Makin correctly points out, this view of economics sits uneasily with an economy that is exposed to external shocks and the pervasive influence of international financial markets. In this day and age it is difficult to take seriously the policy prescriptions flowing from an economic framework that takes no explicit account of international capital flows. Getting the paradigm right is important because different economic models can lead to very different policy prescriptions. In particular, the Keynesian model suggests that a fiscal expansion will boost activity, whereas a Mundell-Fleming framework suggests that (in the presence of a flexible exchange-rate regime) a fiscal expansion will be crowded out by an increase in net imports. As well, the ways in which monetary policy might be used to achieve external balance (a misguided policy objective in any case) differ dramatically depending on which paradigm is believed to fit economic circumstances best.

Hughes sees the sharply lower inflation of recent years as a major success for macroeconomic policy and consistent with policy objectives. Lower inflation was indeed a major achievement. However, in the same way that the unemployment outcome which contributed to that lower inflation was rather higher than expected, the fall in inflation was rather greater and faster than the government or its advisers had anticipated. It is notable that the official budget forecasts for 1990/91 anticipated CPI inflation falling to 6.25 per cent (from 8 per cent in the previous year) but the outcome was 5.3 per cent. In the following year inflation was expected to fall to 3 per cent, but again policy (in combination with an adverse external environment) overachieved to reduce inflation to 1.9 per cent.

It is indisputable that lower inflation was an objective of policy through most of the 1980s. However, a review of the record demonstrates that external balance was the major reason for the tight monetary policy of the late 1980s and that inflation was a secondary priority until inflation began to fall faster than expected. The following quote from the then Treasurer provides a typical defence of the high interest rates of the period:

> high interest rates are associated with our trade circumstances . . . this is the only policy prescription to get that demand under control and to get the imports under control and it's only then that we'll see any prospect of interest rate relief. (Keating, 1989)

Hughes seems to have joined the revisionists who wish to retrospectively overemphasise the relative weight placed on those policy objectives that happen to have

coincided with policy outcomes. The only other explanation is that the public was purposely misled by the official commentary in order that the lack of a public constituency for low inflation could be overcome.

Hughes repeats the argument that monetary policy was the only policy instrument available to deal with a 'demand boom' in the late 1980s. The then Treasurer made clear his reliance on monetary policy at the time: 'monetary policy in the last couple of years had a role as a balancing instrument, and while ever we had GNE outstripping GDP by a factor of 2 to 1 obviously it did have a role' (Keating, 1990). This reliance was unavoidable because fiscal flexibility was constrained at the time by the wages policy. However, the extent of that boom was grossly overstated. It is true that, when measured in constant price terms, demand was growing at twice the pace of output during 1988/89. However, the relativity of the growth rates of demand and output was distorted by a rise in the terms of trade. In current price terms, demand was growing no faster than output. Australians had done no more than spend the additional income that a rise in the terms of trade had provided. In any case, if the concern was excessive demand growth relative to output, then tighter monetary policy was not the correct prescription as this would increase net capital inflow (as it did) and thereby increase demand relative to output (White, 1991).

If demand was growing no faster than output in 1988/89 (when correctly measured), why were the Keynesians so determined to reduce economic activity? (Or did they look at the wrong tables in the national accounts in developing their policy prescriptions?) Demand and output growth in Australia were both strong because the international economy was expanding strongly. As the world economy (inevitably) slowed, so did activity in Australia. Similarly, the asset-price inflation experienced in Australia followed closely the pattern observed in most major economies. Were the high interest rates of the late 1980s really justified if offshore developments were going to see a slowing of activity and asset-price inflation anyway? It remains a real possibility that all that was achieved was an exacerbation of the inevitable downturn.

Both commentators raise the issue of exchange-rate determination. The Mundell-Fleming model is based on the assumption that interest-rate differentials dominate the course of exchange rates. However, like most pervasive economic relationships, this assumption must be interpreted in any practical situation under *ceteris paribus* ('other things being equal') conditions. If the terms of trade fall and cause the exchange rate to depreciate, then is not unreasonable to expect that any crowding out of a fiscal expansion will occur at a lower exchange rate than that observed in the previous period. Makin's Figure 5 (p.154), indicating that the Australian dollar has generally depreciated during fiscal expansions, is easily explained. Australian fiscal expansions generally occur during periods of falling terms of trade and, therefore, a weakening exchange rate. If the impact of the external environment through the terms of trade is generally more important that the change in the fiscal balance, then a falling exchange rate should be expected. The point is that the exchange rate would have depreciated further if the fiscal balance had not decreased by as much as it did.

Fiscal policy is not something that can be set in terms of a given fiscal balance. Economic conditions (inflation and activity) have a pervasive impact on both revenues and expenditures with no explicit policy changes. The budget balance will vary with the economic cycle and result in redistributions of income that are often undesirable. The issue is whether the government actually achieves anything more than popularity by being seen to be doing something to promote growth. Hughes must admit that the multitude of economic statements and associated spending initiatives of the early 1990s achieved less growth than the government had hoped. Unjustified faith in the impact of greater spending would have been a key reason why GDP growth was over-estimated in 1990/91 and 1991/92 (see Table 2, p.137).

Makin suggests that monetary policy should be put on auto-pilot by use of a fixed money-growth rule. A problem with this prescription is that the relationships between the growth rates of any of the available measures of money supply and nominal output are highly variable. For example, the ratio of original quarterly nominal GDP to the money base has risen from around 3 in the early 1970s to around 5 in recent years. In the past three years this ratio has fluctuated between 4.8 and 5.4. As well, in all major economies monetary policy is conducted through the targeting of short-term interest rates. The targeting of interest rates has evolved because the monetary aggregates have been found to be of little practical use. What is needed is a simple decision rule based on the level of short-term interest rates (for example, the yield on short-term rates could be set in relation to bond yields or a measure of inflation).

Makin is correct in identifying the disparate approaches taken toward the onus of proof when it comes to macroeconomic policy and microeconomic policy. Macroeconomic policy decisions should be subjected to the same sort of rigorous cost-benefit analysis usually applied to microeconomic policy. Any resulting inaction would be to the benefit of the nation.

References

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