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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)

Ted Evans to the Rescue

Ian Henderson

When Ted Evans returned to Australia in May 1993 to take up the post of Treasury Secretary after four years in Washington DC on the board of the International Monetary Fund, he found local economists — including policy advisers in his Department and many others with a professional interest in economic policy and analysis — in a mess.

It was a mess largely of their own making, although it had been aided and abetted by widespread superficial commentary, especially from politicians who had absorbed the views of their expert official advisers, promoted them in the public's mind and were thereby seemingly locked into those views, almost regardless of their stupidity.

At issue was the significance of the balance of payments current account deficit (CAD) for policy, including whether policy-makers should, and if so, how they should, attempt to narrow that deficit. As Reserve Bank of Australia (RBA) economists David Gruen and Glenn Stevens (2000:58) put it in a recent description and analysis of the state of play at the start of the 1990s:

> Concern about the current account and Australia's foreign debt probably reached a peak at the beginning of the new decade. At times during the 1990s — especially when the deficit was rising as a proportion of GDP — the debate was again intense, but there were gradual shifts of view and refinements of argument.

The previous decade's obsession with the size of the CAD and with the view that a big CAD was a matter that demanded an urgent public policy response as a matter of high priority had, by the end of the 1980s, been challenged by Tony

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Makin (1989), John Pitchford (1989) and Max Corden (1991) in particular. Putting it succinctly, their alternative argument was that a large CAD was not necessarily either good or bad from an economic perspective, and that neither fiscal policy nor monetary policy should be focused on the CAD.

Fiscal policy-making was also still to some extent bedevilled by the subsequently discredited 'twin deficits hypothesis': That a correlation between public sector and current account deficits — a correlation that became, at least in the public mind, a causal relationship — meant that Commonwealth Budget surpluses were a necessary condition for narrowing the CAD (see, for example, Keating and Dixon, 1989).

Regardless of the disquiet from within the ranks of the local economics profession, for better or worse, it was to be some time yet — as Gruen and Stevens point out — before the policy-makers' obsession with the CAD was overcome. It was to be some time yet before good economics drove out the bad. Indeed, the Pitchford, Corden and Makin challenges initially contributed to the confusion, especially among policy-makers and fringe players in the private sector, many of whom remained wedded to their flawed obsession, despite the power of their critics' case. In the words of Gruen and Stevens (2000:58): 'When these ideas were first presented, they were treated as academic — in the pejorative sense of the word.' There is scant evidence on the public record that either Treasury or the central bank paid any significant amount of attention to the views of the main critics of the officially-sanctioned line.

As if this debate were not enough to keep economists with an interest in public policy fully occupied, during the early years of the 1990s, a second and related, policy debate was also bubbling away largely behind the scenes. The latter debate surrounded the merits or otherwise of the frameworks used and then discarded by the RBA, as its guide to the implementation of monetary policy.

In a valuable account of the evolution of monetary policy between the early 1970s and the late 1990s, RBA Governor Ian Macfarlane (1998:14) noted the failure of the central bank's policy framework during the late 1980s and the consequences of that situation in the early years of the 1990s:

> During this period, a lack of a monetary policy framework that could command widespread support had its costs. It meant that each of the monetary policy easings of 1990 and 1991 were met by the charge that they were done for political reasons. … There was clearly great distrust of monetary policy, the Government and the Reserve Bank.

But when it came to saying just what the problem was with the RBA's framework for monetary policy at the turn of the decade, Macfarlane was, to say the least, discreet — if not a mite disingenuous. The bank, he said, was compelled to keep a low profile in that debate during the period between the 1990 federal election (the one just before the recession hit) and the 1993 poll (the one just after the recovery from recession got, very slowly, under way). The reason for that, he suggested, stemmed largely from the widely-shared perception that the central

bank had not been in charge of its own policy decisions, that it had been little more than the hand-maiden of the Hawke Labor Government and especially of its Treasurer Paul Keating during the second half of the 1980s.

It was little wonder the bank suffered, as Macfarlane said, from a lack of credibility at that time. Keating (1989), fond of boasting publicly that 'they do what I say, I can assure you of that' had ensured that virtually every outsider with so much as a passing interest in the issue would have been convinced that, contrary to the law and contrary to conventional wisdom about what constituted best practice in relation to monetary policy, Australia's central bank lacked operational independence from the government of the day.

But while that situation was embarrassing for the RBA, and while it might very well have made the bank's job more difficult than it already was in the challenging economic circumstances of that time, there was a more important reason why its leaders largely shied away from debate on monetary policy until the early 1990s. As Macfarlane was later to confess, monetary policy had failed during the late 1980s to keep inflation in check. At least with the benefit of hindsight, that was hardly surprising. Monetary policy had been aimed not at inflation, but at the wrong target.

For much of the 1990s, RBA officials were determined, both in public and in private, to fend off any suggestion that the bank had targeted the CAD with monetary policy during the more-or-less recent past. The most they were usually prepared to concede, when pushed, was that politicians took the wrong slant from the economists' advice and used that poorly-understood advice to argue that the RBA was, during the late 1980s, attempting to narrow the CAD by tightening the stance of monetary policy.

Macfarlane did acknowledge, when asked directly whether the RBA took the CAD into account when setting monetary policy, that it had done so in the past but that it did so no longer. After delivering a public lecture in 1999 in honour of the late Chris Higgins (Treasury Secretary in the period 1989-90) Macfarlane was asked whether the balance of payments now entered into the bank's thinking when it came to monetary policy decisions. His answer was, succinctly: No. But he admitted, somewhat circumspectly, that had not always been the case (Macfarlane, 1999).

> I think, even though there were times in Australia when thinking about that was not as clear as it is now, I think by the very late '80s and early '90s — certainly in Chris's time — he would not be at all surprised at that view, that monetary policy cannot be directed at addressing the medium-term structural problem in the balance of payments.

However, it was left to Gruen and Stevens (2000) to finally and frankly bell the cat: Yes, the RBA had in the past aimed monetary policy at the CAD, and yes, that strategy was wrong. During the late and pre-recession 1980s, 'there was … a widely held view that tighter monetary policy was part of the appropriate response

to the external imbalance,' they said, adding in a footnote that 'judged by its statements, the Reserve Bank shared this view at the time'.

It was not until late 1989 and mid-1990 that deputy governor John Phillips argued in public that monetary policy should be targeted not at the CAD but at inflation. For the record, the connection between the CAD and monetary policy, at least in the mind of Treasurer Keating, at about this time is clearly established in a detailed insider's account of the period (Edwards, 1996) and in an earlier account of the period surrounding the 1990-91 recession. (Tingle, 1994)

With policy-makers and other economists confused about how to manage the CAD, it was little wonder that the public, in the form of their parliamentary representatives, was searching through the dustbins of discarded and often discredited explanations and solutions to what was, in some minds at least, a current account crisis. A parliamentary committee (Joint Committee on Foreign Affairs, Defence and Trade, 1991) reported in late 1991 its concerns 'that the current account deficit will again return to high and growing levels as Australia comes out of recession.' The committee reported its uncertainty about the impact of tighter monetary policy on the CAD, and it was forced to reject suggestions from the public that a return to barrier protection offered a way out of the looming CAD crisis.

Into a policy environment shaped by and shaping those deep uncertainties stepped Evans on his return to Australia in early 1993. The incoming Secretary of Treasury enjoyed several advantages over his peers when it came to dealing with the twin dilemmas of how to restore credibility to monetary policy (the Secretary of Treasury was, and still is, ex-officio a member of the RBA's policy making board) and how to deal with the CAD issue, still prominent in public and official discussion of matters economic.

First, Evans had not been in the country when the economy was plunged officially into recession in 1990 — so his advice was relatively untarnished by that experience, even though evidence from an insider later made it clear he had been among the senior Treasury officials promoting tighter monetary policy in 1988, actions that had helped push the economy into recession (Edwards, 1996). Second, Evans had been able to stay in close touch with events on the home front while watching as an interested professional bystander as Australia and many other economies contracted sharply. Third, even Evans' previous high level experience in Treasury (he was the Department's Deputy Secretary from 1984 until 1989), largely in microeconomic reform and taxation, could not so readily be held against his credibility on macroeconomic policy issues.

Evans immediately took full advantage of his situation. In his first month back in Canberra, the new Secretary presented the third Higgins memorial lecture for the Economics Society, and within minutes announced his radical intention: To tell his high-powered audience that he had changed his mind on several key matters during his stint out of the country (Evans, 1993a:15-16).

> I intend to focus upon a few issues of some current interest here on which my own views now differ somewhat from those I held four years

> ago; and differ also from some of what I read in the public debate here: issues such as fiscal policy, saving and investment, and prospects for structural reform.

One matter on which Evans spoke publicly early on in his term as Secretary, with comments which earned him both praise and criticism, was unemployment. When Evans took up his new job, the unemployment rate was just beginning to fall from its post-recession peak of a little more than 11 per cent. To emphasise the point that policy could make a difference to Australia's performance on that front, the new Secretary claimed (notoriously) that the national jobless rate was a matter of choice — choose one set of policies (notably in respect of wages and productivity) and that would permit some labour market outcomes while eliminating others; choose another, and another result was likely to follow.

Evans might well have expressed his point somewhat indelicately, especially during the term of an unemployment-sensitive Labor administration. But his message about the need to make the correct policy decisions in order to see a desirable fall in the unemployment rate would have raised few eyebrows among economics practitioners, even if it did discomfort some in public life. However, Evans' views on the significance of the CAD for policy and the way policy should be used to affect the CAD would have been much more controversial.

Economists had, by the early 1990s, fallen back on the fairly orthodox view that the CAD reflects the gap between national saving and national spending on new investment (Stutchbury, 1992:chapter 5)[1]. That had led many to argue that the CAD would only be narrowed — an aim that many saw as a policy imperative — if national saving were raised sharply and rapidly, in part by the public sector budgeting for fatter surpluses and in part by governments encouraging increased rates of private sector saving.

But Evans saw, and proclaimed openly, that that particular emperor had no clothes (Evans, 1993a:19):

> The issue is not just about saving, but about investment and the balance between the two. Indeed, to my way of thinking, unless we recognise that the issue is basically about investment, then we are unlikely to get our analysis of saving right.

That criticism of the then-current obsession was just the starting point of Evans' powerful critique (Evans, 1993a:19):

> The concern should not be with the current account deficit *per se*, or the call on foreign savings which that deficit represents. Rather, the concern should be with the economic returns that are generated when those savings are put to use.

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[1] This is one example from the time that outlines for informed but not expert readers the saving-investment approach to analysing the CAD.

And that, he added to emphasise the point, was no more or less than traditional Treasury thinking for about three decades — since before he had joined the Department in 1969. The prominence given by the Department in the late 1980s and early 1990s to the CAD, he said, did no more than reflect a judgement 'that the economic returns being generated may have been insufficient to service the debt that arose from those foreign savings' (p. 19). The problem was not the size of the CAD, but the lack of attention given to ensuring that it arose from a soundly-managed economy, one in which savings — both domestic and foreign — were being used efficiently.

Accept that analysis, and it was clear that the obsession with boosting national saving as a solution to the CAD was fatally flawed. Increasing national saving — including by reducing the federal Budget deficit, and turning that deficit into a surplus — would not, of itself, solve Australia's economic problems, despite the hopes of advocates of the twin deficits hypothesis. Evans's aim on that particular point could scarcely have been surer, with the Labor government now led by Keating arguing for higher levels of public and private saving to deal with the CAD (Evans, 1993a:19):

> We should be quite clear about this: that increasing our national saving will not, of itself, solve our economic problems. Reducing budget deficits will not, of itself, solve those problems.

Australia had long been a capital importer, and a higher saving rate would follow, rather than lead, a higher level of national income. Nor would a reduction in the level of investment spending be an appropriate solution to whatever was regarded as the CAD problem. Evans said the 'rather obvious point' was that the entire capital stock, and not just additions to it through investment spending, needed to be used more efficiently if the CAD was to be dealt with — and microeconomic reform was the key to that program (Evans, 1993a:19):

> Australia, traditionally, has not been a low saving or low investing country. Our saving and investment ratios have been relatively high. But our growth performance has not been; and for the simple reason that the economic returns to many or our investments have been low by international standards.

Evans returned to those themes, in various ways, during his first couple of years at Treasury's helm — arguing for example that it was 'how to make better use of national saving' rather than how to boost saving that counted for the nation's prosperity, long-term, and that microeconomic reform had to be the focus of policy to deliver that desired result. (Evans, 1993b)

That policy framework was outlined during the period of Paul Keating's term as Prime Minister. But Evans pushed it further forward (and also continued his

campaign to get the CAD into a proper perspective) under John Howard as PM and Peter Costello as Treasurer.

One of Costello's first public announcements after the Coalition won the March 1996 federal election was that the new Government would embark on a policy of fiscal consolidation, the immediate aim of which was to strengthen the budget bottom line by a total of around $8 billion over the first two years of the Government's first term.

Evans had three years earlier set out his views on such a fiscal objective. He had argued in his first public address as Treasury Secretary that debates about the desirability or not of a Budget surplus, or deficit, or a particular figure next year were essentially outside the realms of economics (Evans, 1993a:18):

> Analyses which call for front-loaded deficit reductions reflect political assessments, not economic analysis. They may well reflect astute political judgement — and they certainly reflect considerable precedent; as such, they are a legitimate part of the total debate. But let us be clear: they do not have a basis in economic requirements, which are for a sustained increase in public sector savings over the medium term.

So, contrary to what might have been expected from past practice — Keating's name as Treasurer springs to mind — Evans in 1996 wanted the public to understand that fixing the saving-investment imbalance, and thereby the CAD, was not a short-term operation. On the day that the Australian Bureau of Statistics released figures showing a roughly $2 billion CAD for the month of April 1996 on 30 May, Evans said that result provided no grounds to support the Coalition's medium-term fiscal consolidation program, nor any grounds to accelerate that program.

The aim of fiscal consolidation, he told a Canberra insurance industry audience little more than two months after the change of government, derived not from any day-to-day, or month-to-month statistics about the state of the economy, but from 'a consideration of the country's savings and investment problems, summarised, usually, in the current account deficit figure' (Evans, 1996:10)

The CAD receives policy-makers' attention because it represents the extent to which Australia is drawing on the savings of foreigners to finance the investment needed to drive economic growth. But, according to Evans, that did not necessarily mean a large CAD was a problem, at least in the eyes of orthodox economists.

When Evans joined Treasury as an honours graduate from the University of Queensland — after a decade working in a blue collar job for the then Postmaster General's Department — the Department's view, shared within the wider economics priesthood, was that 'there were benefits in our drawing upon the savings of the rest of the world,' he told his audience in May 1996. In the longer term, financing domestic investment spending from foreign savings, 'provided we are using that for productive investment' … and provided 'we are indeed

financing investment and not consumption', offered a quicker way to higher living standards than waiting for national saving to rise slowly.

Evans also drew attention to the 'safety valve' case for policy-makers remaining unfazed by some widening of the CAD at times of rapid domestic demand — that rising levels of imports as a consequence of rapid growth in domestic demand offered a valuable alternative to immediately slamming on the monetary policy brakes to slow a temporary rise in the pace of domestic growth. It is a view that RBA economists dare to put privately, rather than publicly, and then only rarely, even after Evans' lead.

But he was quickly back to his long-standing theme (Evans, 1996:12):

> The current account deficit, and that call on savings of the rest of the world, reflects an imbalance (but) it doesn't reflect just a savings imbalance. It is an imbalance between domestic savings and the investment that we see as being necessary in the domestic economy. It is that second point that receives far less attention that the savings point. But it warrants far more.

Evans' point was neither more nor less than this: That the focus of concern when it came to the CAD — the national saving-investment gap, in the conventional accounting framework — should be how to make the existing capital stock (and not just any additions to it by way of spending on new investment) more productive.

The focus should not necessarily be on lifting the saving rate; nor on how bad a relatively wide external deficit was; and certainly not on reining in productive investment spending. And especially not just on rapidly moving the federal public sector to being a net saver, just to get that part of the economy's accounts into the black.

Simply shifting $8 billion from the public sector to the private sector — by cutting federal budget spending by that amount, as was promised in total for the first and second budgets of the Howard-Costello Coalition government — represented, of itself, no great advance in public policy-making. Indeed, it would not necessarily even help to close the saving-investment gap (and thereby narrow the CAD) if it led households to run down their own savings by much the same amount in order to pay privately for services previously financed by the Commonwealth public sector: 'If one finds $8 billion by cutting outlays or by increasing tax revenues in areas where there is an obvious offset to private sector saving, it's a moot point as to whether one has moved very far forward' (Evans, 1996:13).

Evans retired from the Commonwealth public service on 26 April 2001, having served almost eight years as Treasury Secretary and having not sought a further re-appointment to that post.

In assessing his contribution it is appropriate to ask whether, and how far, the making, implementation and analysis of national economic policy has moved forward since Evans' eight year term at the top of the federal government's policy

establishment began in the early 1990s. On the two related matters dealt with here, namely the current account deficit itself and the use of monetary policy to try to narrow that gap between national saving and investment spending, the economics environment has certainly changed.

In his traditional post-Budget address to business economists last year, Evans (1999) was clear and unequivocal on one point at least. With the public sector no longer a net borrower, the 'goal is finally achieved' of correcting the imbalance between saving and investment by the public sector after a decade and a half of effort, he said. But that had not led to, or been associated with, a CAD that could, by any measure, be regarded as narrow.

The 1999 federal Budget estimated the CAD for 1998-99 at $32.5 billion or 5.5 per cent of GDP and forecast the CAD for the following year would narrow only slightly: to $32 billion or 5.25 per cent of GDP. (As it happened, the actual figures were slightly higher, at $32.8 billion and 5.5 per cent of GDP, and $33.5 billion or 5.5 per cent of GDP.) For comparison, the actual figures at previous peaks in the CAD cycle were a little above 6 per cent of GDP in both 1985-86 and 1994-95, and just about spot on six per cent of GDP in 1989-90.

Yet, Evans (1999) made it clear that although the situation was far from perfect from an economic policy-maker's standpoint, it had improved:

> Today, we can be somewhat more relaxed about the CAD than we could in the 1980s, but the proposition could not be put any more strongly than that.

One thing that made the situation more comfortable for policy-advisers and analysts despite the wide CAD gap was that the macroeconomic framework and institutions had been reformed for the better, since the early 1980s and for 'the even better still' since the mid-1990s. And that, Evans suggested, meant that Australian could afford to take the 'consenting adults' view of the CAD — the one scorned a decade previously when it was being advocated by Pitchford and Corden. That is, Evans said, Australian governments no longer bear any exchange rate risk if private sector borrowers or investors make faulty and costly decisions; Australian governments no longer themselves make 'opaque commitments to government-favoured industries' or force local savers and investors to operate in an environment that is fundamentally flawed by favouring inefficient decisions. (Evans, 1999)

The Secretary's warning amounted to an economist's version of the old adage the price of liberty is eternal vigilance there are always some who would turn back the fiscal reform clock if they had the chance!

> Nothing could be better calculated to unwind the superior economic performance that Australia has attained than the attitude that Australia does not need Budget surpluses of the order currently projected.

Just for the record, the surpluses forecast for the current year 2000-01 and the next two — all below the figures estimated just two years ago — tend to confirm Evans' perspicacity. There is a link between that second point and the third that can be drawn about the changes that have taken place since Evans (1999) took his seat at Treasury's top table in 1993.

> A more fundamental and more important reason to be concerned at the prospect of any substantial diminution of the surplus now in prospect arises from the critical role that fiscal consolidation has played in allowing monetary policy to be so well conducted over recent years.

A few months before Macfarlane's somewhat guarded confession that the central bank had, in the past, aimed monetary policy at the CAD, Evans was upfront on that issue (1999):

> If we go back to the early 1990s, for example, there was an expectation that monetary policy needed to be used to help correct the burgeoning current account deficit because there was, at the time, little more that fiscal policy could contribute.

And, the Treasury Secretary made quite clear, using monetary policy to try to rein in the CAD was a strategy the abject failure of which should have been obvious in advance: 'To the extent that monetary policy was tightened on that score, the efforts were counter-productive because the capital account effect of the tightening produced exchange rates that hampered current account correction' (Evans, 1999). In other words, tightening monetary policy (increasing interest rates) led to a stronger Australian dollar, which in turn led to lower exports and contributed to a widening of the CAD. The exact opposite effect to that desired by monetary policy-makers concerned about the CAD.

A history and analysis of the RBA's change of monetary policy framework, from aiming at the CAD to targeting prospective inflation directly, is a subject for another time. And, while Evans' role in that valuable change of approach remains a matter of idle speculation for the time being, one thing is certain: Evans was an active policy player on the central bank board throughout the period when the new approach was being formulated and put into practice.

But, whatever contribution he made to that important change in Australian economic policy-making and implementation, it is certain that Evans was a key player in bringing some economic sense to the debate about the current account deficit, and to the fiscal policy approach (medium-term fiscal consolidation) now being used to deal with the CAD. And, one of the main lessons of that policy change is simply this: That sound policy needs sound economic analysis as a foundation.

Both were missing prior to Evans' stint as Treasury Secretary. Both are now present — an assessment that must include the caveat that things can change for

the worse just as smartly as they can change for the better, unless the minds of insiders remain open.

Evans did not invent, and did not claim to have invented, any fundamentally new insights into the CAD problem. What he did, however, was: take a fresh look at the arguments of economists who had been focussing on the matter; discard the views he and his Department had once held, when it became apparent they were misguided; and adopt and champion views that better reflected sound economics. In so doing, Evans contributed to an improved public understanding of what should be done to deal with the CAD, and what policies should be abandoned in that pursuit.

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