

The Current Account Debate in Australia: Changing Policy Perspectives

I. Introduction

The debate on Australia's current account deficit presently lies dormant despite a persistent deficit averaging 5 percent of GDP over the 1990s. This benign neglect stands in marked contrast to the earlier debate that took place in the mid-to-late 1980s. A major focus of policy attention was directed towards reducing the sharp rise in the current account deficit and external debt which triggered a debate between economists and policymakers characterised by some observers as a "dialogue of the deaf" (Gruen and Grattan, 1993). Academic economists led by Pitchford (1989a, b; 1990) argued that since a current account deficit reflects the residual outcome of intertemporal, optimising decisions of savers and investors, it is not of direct policy concern. In contrast, business economists aligned with policymakers to view the current account deficit and the accompanying external debt build-up as of obvious danger to the stability of the Australian economy. However, business economists and policymakers disagreed on the question of policy response, especially in regard to the appropriate monetary stance.

How have views on Australia's current account deficit evolved over the past two decades? What factors have shaped and altered policy and market perceptions of the current account? This paper examines these two questions within the framework of the intellectual underpinnings of the debate and the evolving macro policy framework of the past two decades.

Evidence of changing policy views on Australia's current account deficit comes from various sources, including policy statements and empirical work. At the peak of the debate, Keating (then Treasurer) stated: "My main theme today is that economic policy in Australia is, and will continue to be, directed principally at securing further reductions in our current account deficit" (Keating, 1987). A decade later, the policy significance of the deficit is cast in a somewhat different light in Budget Statement 3 to the 1996-97 Budget: "any resulting rise in the current account deficit would not be a cause for concern" (3-16). The Statement provides a retrospective discussion on the current account as a means for explaining a projected rise in the current account deficit to 5 1/4 percent of GDP in 1996-97. The earlier policy preoccupation with the current account imbalance is viewed as a reflection of "various structural weaknesses in the economy, including large public sector deficits and distortions to private savings and investment decisions" (3-3). It is further argued that the government has since adopted a number of effective measures to reduce these structural weaknesses, including fiscal consolidation and micro reform (trade liberalisation, enterprise bargaining and savings initiatives).

Policy preoccupation with a persistent current account imbalance is not unique to Australian policymakers. Several themes identified in an earlier survey of official

views on the current account in industrial countries by Salop and Spitaeller (1980) also recur in Australian policy documents. These features include a concern with short-run adjustment, current account and external debt sustainability and the setting of a country-specific current account target. What is unique to Australia is the debate itself, including reference to the public debate in official documents.

Bayoumi (1990) provides some empirical support for a systematic fiscal policy response to current account imbalances based upon cross-section data for ten industrial countries over the period 1965-86 although his data exclude Australia. A recent empirical investigation by Karfakis and Kim (1995) of market response to Australian current account news (the difference between the actual and expected current account deficit) for the period from mid-1985 to end-1992 offers empirical support for a shift in perceived monetary policy response to current account news. Prior to a structural break identified by the authors in January 1990, domestic interest rates rose in response to larger-than-expected current account deficits accompanied by an appreciation of the Australian dollar against major currencies. This finding is consistent with market expectations of a tightening of monetary stance in response to current account news through sterilised intervention operations in the 1980s and subsequent shift. At the same time, this evidence does not exclude the possibility that policymakers shifted their reaction function, for example from monetary to fiscal policy or, alternatively, that monetary policy was assigned to deflating an overheated economy.

The convergence in positions between protagonists is a surprising outcome in view of the wide gulf between academic economists and policymakers that is claimed to characterise the debate. Does the outcome signify a victory for economists' rhetoric? Not necessarily, as will be demonstrated. Several interpretations of the debate have been offered in the literature. Corden (1997a,b) interprets the debate in terms of a transition period for policymakers caught between changing paradigms of open-economy macroeconomics from the single-period, fixed price Mundell-Fleming model to the intertemporal, flexible price model. Gruen and Grattan (1993) interpret the debate in terms of policy concerns with the magnitude of adjustment costs required to reduce domestic absorption to achieve stabilisation of the external debt-to-GDP ratio and vulnerability of the economy to a sudden switch in market sentiment.

An interpretation of the role of economists in influencing policy outcomes depends upon the assumed underlying policy framework. The mainstream approach is the Bergson-Samuelson framework of a market economy within which policymakers are assumed to maximise a social welfare function subject to economic and technological constraints with the role of the government to correct market failures and achieve an equitable income distribution. At one extreme, are those economists (represented in the debate by Moore, 1989) who argue that markets are generally subject to failure and that the role of the government is to correct failures (and is capable of doing so). At the other end of the spectrum, are those (for example, Pitchford, 1989,1990; Friedman, 1989) who argue that markets perform well and government intervention is

the problem not the solution. In either interpretation, economic argument is assumed to play a critical role in guiding policy outcomes.

A broader perspective on the nature of policy processes and outcomes is offered in Dixit (1997). Dixit interprets policymaking as a process with slow dynamics. A central component in this process is the role of transactions costs, defined as the cost of switching from one structure or policy regime to another. Viewed within this broader framework, economists will not necessarily be a determining factor in policy outcomes. Instead, the determining factor is the removal of economic and political constraints on policy. Nevertheless, economists may influence policy insofar as they are able to exploit these policy “breaks”.

The paper examines the above questions and is organised as follows. Section II examines the intellectual underpinnings of the debate. Section III discusses data and empirical issues relevant to the theory and debate. Section IV looks at alternative policy frameworks for examining and assessing the role of economists in the debate. Section V discusses the main constraints acting upon key macro policy institutions and policymakers and their significance for the debate and its outcome. The final Section brings together the main arguments and concluding comments. Appendices provide more detail on data issues, official views and estimates of debt solvency.

II. Intellectual Underpinnings

This Section examines the intellectual underpinnings of the debate and its role. The policy significance of the new classical paradigm is discussed as well as its implications for related sub-debates on “good” and “bad” deficits, external debt sustainability and the twin deficits hypothesis.

A persistent current account deficit averaging 3 percent of GDP over the 1960s and 1970s in Australia attracted varying degrees of policy concern consistent with the old paradigm under conditions of a fixed exchange rate regime and financial regulation. What is unique to the 1980s is the structural shift in the current account deficit to 4-6 percent of GDP and the elevation of the current account to **the** central policy problem in the mid-to late 1980s.

The debate took place against the background of a major paradigm shift in open-economy macroeconomics from a static (single-period) Keynesian Mundell-Fleming (M-F) model to a dynamic (intertemporal) classical model as discussed in Corden (1997a, b). A basic premise of the M-F model is that **whatever** the exchange rate regime, persistent departures from targets set for internal and external balance necessitate macrostabilisation policy. Corden interprets policy preoccupation with the current account as an outmoded attachment to the pre-1983 environment of fixed exchange rates and restrictions on foreign borrowing. In this special case, a persistent current account deficit is financed solely from a finite stock of foreign reserves.

Hence, policy intervention is justified in order to prevent a speculative attack on reserves and the exchange rate.

The new paradigm of open-economy macroeconomics discussed by Corden offers a possible explanation for the structural shift in external imbalance as well as a theoretical argument for non-intervention. The framework emphasises the national savings-investment identities and their components rather than the older elasticities trade balance or the Keynesian income-absorption identity. This approach highlights the role of the current account as the residual outcome of intertemporal, optimising decisions of savers and investors (see Obstfeld and Rogoff, 1998). In this classical framework with assumed capital mobility, price and real exchange rate flexibility, there is no role for stabilisation policy. Fiscal policy is directed towards the longer-term objective of fiscal consolidation to ensure ex-ante satisfaction of the government's present-value budget constraint and monetary policy is neutral with output maintained at productive capacity. The structural shift in the current account may be explained as a market (optimal) response to the relaxation of liquidity constraint on external borrowing.

Analogous to the free trade debate, an economic case may be argued for policy intervention with the current account if market failures or externalities prevent an optimal outcome being achieved. As in the trade debate, in almost all cases (an exception being a country with market power to influence the static or intertemporal terms of trade), the first-best solution is to remove the distortion at source. Further, micro rather than macro measures would normally be needed and in the process may, by raising investment relative to saving and productivity, widen the current account deficit.

In order to identify and assess the "practical policy qualifications" (Corden, 1997a) to the new paradigm, the conditions that underpin the theoretical benchmark of Pareto dynamic optimality are set out below.

Intertemporal model

Assume a representative agent model of a small, open economy that consumes a single traded good over two periods with unlimited access to borrowing and lending on the world capital market. The agent is assumed to have perfect foresight and maximises a lifetime (two-period) utility function given by (1).

$$U_1 = u(C_1) + \beta u(C_2) \qquad 0 < \beta < 1 \qquad (1)$$

where C_1 is consumption in period 1 and β is a fixed time-preference parameter.

Production is assumed to be subject to diminishing returns as given by (2)

$$Y = F(K) \quad F'(K) > 0 \quad F''(K) < 0 \qquad (2)$$

where Y is gross domestic output and K is capital stock.

The government is assumed to balance its budget each period: the individual's intertemporal budget constraint is given by (3).

$$C_1 + I_1 + C_2 + I_2/1+r = Y_1 - G_1 + (Y_2 - G_2)/1+r \quad (3)$$

where I is investment ($I_i = K_{i+1} - K_i$), r is an exogenous world interest rate and G is government spending.

Maximising (1) subject to (3) with respect to C_2 and K_2 , the first-order optimality conditions are given by equations (4) and (5)

$$\beta u'(C_2) / u'(C_1) = 1/1 + r \quad (4)$$

$$F'(K_2) = r \quad (5)$$

Equation (4) is the intertemporal, Euler equations: at a (dynamic) utility optimum, the marginal rate of substitution between present and future consumption equals the world interest rate. Equation (5) expresses the condition that investment will take place up to the point where the marginal product of capital equals the world interest rate.

Using the current account identities (and assuming net foreign assets (B) are zero at the start of period 1 and end of period 3:

$$\begin{aligned} CA_1 = B_2 - B_1 &= Y_1 - C_1 - G_1 - I_1 \\ &= B_2 \end{aligned} \quad (6)$$

$$\begin{aligned} CA_2 = B_3 - B_2 &= Y_2 - rB_2 - C_2 - G_2 - I_2 \\ &= -B_2 \end{aligned} \quad (7)$$

Diagrammatically, the intertemporal model is shown in figure (1). Without access to borrowing and lending on global capital markets, the economy is constrained to be at the autarkic position A at which saving equals investment and the current account is balanced. Relaxation of the liquidity constraint enables the economy to exploit dynamic welfare gains that arise from a differential between the domestic and world real interest rate. In the diagram, the autarkic interest rate lies above the world real interest rate in which case there are potential welfare gains from borrowing from the world by running a current account deficit in period 1 and importing relatively more expensive present consumption. As a consequence, the economy moves to a higher indifference curve at B . In the following period, the country exports future consumption and runs a current account surplus, repaying debt.

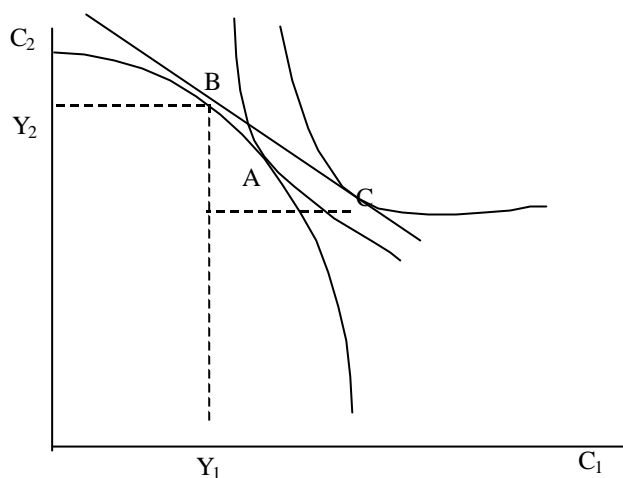


Figure 1. Intertemporal gains from trade.

The basic policy message of the new paradigm is straightforward: since external balances are determined by underlying patterns of savings and investment, neither the size nor direction of a current account imbalance is of policy significance except insofar as it reflects savings and investment distortions. This message is reinforced by the assumptions of maximisation of lifetime utility by private agents and perfect asset substitutability between domestic and foreign assets that underpin the key prediction of optimality of the current account. In particular, the current account performs a “consumption-smoothing” role by allocating intertemporal resources in response to temporary real shocks.

The policy message is also consistent with traditional trade models that explain trade flows as an outcome of changes in relative prices and domestic activity. Such models focus upon the proximate determinants of current account and trade balances. Over the medium term, shifts in savings and investment flows will be reflected in the current account via their impact on relative prices (real exchange rate) and domestic activity relative to trading partners.

Excluding the special case of fixed exchange rates and capital immobility (ruled out in the above model), the message of non-intervention is, however, **not** consistent with a static M-F model. Nor is it consistent with “revisionist trade” models in which the level of imports is determined by trade barriers and exogenous changes in import preferences (see Meredith, 1993). In these models, a policy response to a current account imbalance is required, namely opening market access. However, while trade liberalisation is desirable on static efficiency grounds, it will not eliminate a current

account imbalance as long as fundamentals (demographics, fiscal policy and intertemporal preferences) drive a gap between national savings and investment.

Analogous to the trade debate, an economic case may be made for intervention if the key assumptions driving the prediction of Pareto dynamic optimality fail to be met. But was this case made, by whom and to what effectiveness?

Pitchford (1989a) notes that a theoretical case for intervention could be argued on the grounds of market failure but that the onus is on the government to make it (“those who claim that it is a serious problem have not properly established their case” (p. 2) Even if made, the correct solution is to treat the market failure at source in which case the appropriate policies are micro not macro (“policies which are not at present being considered” (p. 2). He concludes (p. 5): “There may be a case for believing the current account deficits have been excessive, but if so it has not been made”.

The existence of a number of policy and non-policy induced distortions to both private saving and investment in the 1980s in Australia provides an a priori case for interventionist policy although their quantitative importance is less clear. The main policy induced distortions arose from the interaction of inflation (averaging 8 percent over the decade) with the tax regime which allowed full deductibility of nominal interest to business while taxing nominal (rather than real) interest income of private savers. The resulting distortion created a bias towards debt-financed investment and away from private saving, thereby violating the two Euler optimality conditions. The existence of income support under the age pension and weak integration with the social welfare system combined with myopia also mitigated against private saving

Other situations that violate the assumptions of the benchmark model such as “contamination effects” from the spread of risk premia from private to total foreign debt and protectionist pressures related to unequal income distribution between traded and non-traded sectors may also qualify the “non-interventionist” message (Corden, 1997a, b). In particular, the downgrading of Australia’s country risk by rating agencies from 1986 to 1989 lends some support to the existence of market externalities.¹

The government case for intervention did not, however rest upon the above grounds. It presumed rather than argued an economic case for intervention based upon two main grounds: first, concerns about short-run adjustment costs in terms of the reduction in future domestic absorption required to achieve external debt stabilisation within a timely period and resulting vulnerability of the economy to changes in market sentiment and, second, the constraint imposed upon economic growth by the current account deficit. The first argument is not necessarily inconsistent with the new

¹ Moody’s (1993) provides a discussion of the factors behind their ratings and stresses their qualitative nature, being influenced by both economic indicators such as debt ratios and policy settings. Country risk is an attempt to quantify the risk facing investors in terms of the capacity of the country to repay principal and interest on debt in a timely manner without significant influence from adverse shocks.

paradigm, especially in terms of its focus upon longer-term debt sustainability but implicitly assumes that relative price adjustment through real exchange rate depreciation is insufficient and/or subject to long lags. The second argument is embedded in a Keynesian demand constrained framework.

The above two arguments underpinned the government's rationale for a tight macro policy response to external imbalance supported by wage restraint and micro measures. But in both cases, macro policies do not offer clear-cut solutions and open to misinterpretation by private agents, both markets and economists. Since the early 1980s, most industrial countries, including Australia have shifted fiscal policy towards medium -to longer- term objectives of ex-ante fiscal solvency (itself, neither a necessary nor sufficient to reduce the current account deficit, depending upon private sector response).²

As discussed in Section V, the assignment of fiscal policy to medium-term goals and constraint imposed by the Wages Accord left monetary policy as the key short-term stabilisation instrument. However, a tightening of monetary policy has conflicting effects on the current account, depending upon the relative strength of relative prices (exchange rate appreciation) vis-à-vis expenditure reduction. The second argument (external constraint on growth) also has ambiguous macro policy implications. Notwithstanding the emphasis placed in EPAC (1986) on the desirability of growth-orientated policies to reduce the current account deficit, macro measures to reduce the deficit may be perceived as instruments to restrain economic growth.

In sum, a valid a priori argument for current account intervention based upon market distortions did exist in the 1980s with clear-cut micro measures. But this argument was largely ignored by policymakers whose concerns were, instead centred upon the issue of adjustment costs and externally-constrained growth with correspondingly weaker and ambiguous macro policy directives.

Good and bad deficits

A recurrent theme throughout the debate is the distinction between “good” and “bad” current account deficits and attempts to classify Australia's deficit accordingly. Pitchford's interpretation follows closely the theoretical discussion: a bad deficit (or surplus) is defined as one reflecting savings and investment patterns distorted by either fiscal imbalances or market distortions. Thus, a current account imbalance is in itself is neither good nor bad but its causes may warrant intervention. The good and bad deficits story is taken up by, among others, Pitchford (1989b), Tease (1990) and Frazer (1990) with some “creative” modifications in the process

² Ricardian equivalence holds in the (deterministic) representative agent model, thereby ruling out any impact of budget deficits on the current account. An overlapping generations model allows for budget deficits to influence external imbalance through tax timing which can affect present-value income among generations and hence, intertemporal resource allocation.

A middle ground is attempted by Tease (1990). While accepting the above distinction (in which case the policy solution is to correct directly the distortion), Tease uses the dichotomy to justify a potential role for policy as discussed above; to prevent or soften adjustment in anticipation of or in response to shifts in market sentiment. However, he admits the precise policy directive is unclear in this situation. Frazer (1990) also uses the good and bad deficits distinction to justify restrictive monetary policy response; a bad deficit is one in which growth of domestic demand outpaces productive capacity.

More difficult territory is encountered when participants attempt to address the obvious question: can Australia's current account deficit be classified as good or bad? According to Tease, the deficits incurred from the mid-1970s to mid-1980s were bad because the increase in public sector spending was for consumption. In contrast, he argues later current account deficits were good because they financed profitable private investment that could fund debt-servicing without a reduction in future consumption. Moore (1989) goes further, arguing that the observed rise in aggregate consumption as a ratio of GDP implies that the 1980s deficits were bad. However, as is well recognised in public sector economics, the dichotomy between consumption and investment as unproductive and productive is misleading: government consumption may be productive and public investment unproductive. The argument also ignores a justified role for government consumption if, for example it is directed towards maximising the government's social welfare function. It also unclear why distortions to private investment are ruled out given the contemporary debate on the distortionary effects on private borrowing stemming from the interaction of inflation with tax deductibility of nominal interest rate costs.

In sum, while the distinction between good and bad deficits may have some theoretical basis, its operational application in the debate serves to confuse rather than illuminate.

External debt sustainability

At the outset, it needs to be noted that the concept of external sustainability is not well defined in the literature or policy discussion (see Salop and Spitaeller, 1980; Horne, 1991).³ Not surprisingly, the debate is characterised by considerable confusion, in part reflecting different definitions of sustainability. Even if the concept of external solvency is well-defined (see below), developing operational counterparts of solvency and sustainability is a difficult and subjective exercise. Model-free estimates of solvency gaps (the gap between a projected trade balance and that required to stabilise the outstanding debt ratio) assume that projected paths of key parameters (world interest rate, economic growth and trade balance) are independent of each other. Estimates of policy sustainability (identifying whether present policies can continue unchanged without a forced switch) are, however, necessarily model-specific since the expected paths of policy determine private agent response. Neither measure may

³ For example, EPAC (1986 p. 31) prefaces its analysis of external sustainability with the admission "there is no simple definition of what constitutes a sustainable external deficit position".

imply optimality of debt paths unless explicit assumptions are introduced about individual and social welfare functions.

External solvency is defined in the benchmark model in terms of satisfaction of the solvency constraint (the economy-wide intertemporal budget constraint given by equation (8) with the transversality or terminal condition imposed to rule out Ponzi games).

Generalising equation (1) to an infinite horizon:

$$U_t = \sum_{s=t}^{\infty} \beta^{s-t} u(C_s) \quad (7)$$

$$\sum_{s=t}^{\infty} (1/1+r)^{s-t} (C_s + I_s) = (1+r)B_t + \sum_{s=t}^{\infty} (1/1+r)^{s-t} (Y_s - G_s) \quad (8)$$

Rewriting (8):

$$-(1+r)B_t = \sum_{s=t}^{\infty} (1/1+r)^{s-t} TB_s \quad (8')$$

$$\text{where } TB_s \equiv Y_s - C_s - I_s - G_s$$

Imposing the transversality condition on the economy-wide infinite horizon intertemporal budget constraint gives the solvency constraint (equation (8))⁴:

The solvency constraint is the condition that trade surpluses (TB) match in present-value terms the outstanding external debt stock. This requirement in itself is not operationally useful since budget constraints are always met ex-post through one means or another, whether, for example, through a policy shift or debt repudiation. Operationally, the constraint becomes binding when the real interest rate lies above the economic growth rate. If an indebted country has an initial trade deficit, it will need to generate future trade surpluses to stabilise the outstanding external debt ratio. Otherwise, the increase in debt feeds upon itself as the economy borrows to finance interest payments on debt and debt becomes larger relative to other macro variables such as output and wealth. In this situation, lenders become increasingly unwilling to continue financing the current account deficit and may precipitate a forced switch in policies to induce a trade surplus.

Policymakers and business economists shared the common conviction that the current account deficit and external debt were unsustainable (see Appendix II), based largely upon naïve economic indicators (debt ratios) with some support from solvency

⁴ The condition is: $\lim_{T \rightarrow \infty} (1/1+r)^T \beta_{t+T+1} = 0$

measures provided by EPAC (1986). Academic economists, on the contrary argued that the predominantly private nature of external debt (two-thirds of total foreign debt) and the assumed optimising behaviour of private agents negated the claim of unsustainability. Nether argument is correct, as discussed below.

From a policy perspective, the potential usefulness of the solvency condition is that it provides a consistency check on the country's external debt and macro strategy. Equality of both sides of the solvency condition may be achieved by a number of strategies including debt write-off (reducing B); increasing the trade surplus; and an improvement in the global environment through a reduction in the discount (real interest rate less economic growth) or through an improvement in the terms-of-trade.

Estimates of external solvency based upon EPAC (1986) projections of relevant parameters (world real interest rate, economic growth and alternative external debt targets) are given in Appendix III.⁵ The measures suggest that, based upon the actual and projected situation facing the Australian economy in the mid-1980s, external imbalances were unsustainable. Specifically, to meet solvency criteria (defined in terms of stabilising a target net external debt –to-GDP of 40 percent, a trade surplus ratio of GDP within the range of 0.7 to 1.5 percent was required under alternative projections of the discount rate. Since the actual trade deficit from 1980-81 to 1985-86 averaged 2.8 percent of GDP, this means that additional external adjustment of the order of 3.5 to 4.3 percent of GDP was needed to meet the solvency condition. EPAC estimates also suggest that a “sustainable” current account deficit consistent with stabilising the targeted debt ratio was 2.3 percent of GDP, less than one half the actual deficit.

Three anomalies are immediately apparent in attempting to answer the question as to whether the current account and debt-build-up were sustainable as viewed by contemporary observers. First, based upon solvency criteria, the persistence of trade deficits means that Australia was technically insolvent **under any set of plausible projections**. Yet, external lenders continued to be willing to finance the current account deficit. The evidence of country risk and risk premia could be interpreted as a perceived unsustainability by the market. However, equally, risk premia may be interpreted as a sustainability mechanism that ensures ex-post satisfaction of the solvency constraint, assuming unchanged policies.

Second, the widespread reference to historical debt ratios as “warning signals” of unsustainability is misleading. A rising debt ratio need not imply insolvency because it fails to take into account a country's future growth prospects and capacity to repay debt. The popular argument made in the context of the good and bad deficits debate that financing of the current account deficit for consumption purposes necessarily

⁵ EPAC (1986) uses this methodology to compare alternative adjustment paths under “unchanged policies” with those incorporating measures to accelerate adjustment (a similar approach using debt scenarios is adopted in Macquarie Bank, 1989). These projections fail to take into account the fact that if the economy is expected to move along an unsustainable path, some mechanism will happen to ensure ex-post satisfaction of the economy-wide budget constraint (see Horne, 1991).

implies insolvency is also incorrect as discussed earlier. Third, current account and debt paths may be sustainable but not optimal.

In sum, it is not obvious that the structural rise in Australia's current account deficit in 1984 and accompanying foreign debt build-up was unsustainable (however defined).⁶

Twin deficits

The twin deficits hypothesis posits a positive causal relationship between external and budget deficits: budget deficits are at the root of current account imbalances. The hypothesis was triggered in the 1980s in Australia and other countries (especially Canada and the United States) by the positive correlation between movements in budget and current account deficits. Its significance for the debate is dual: first, the hypothesis underpins the premise that the current account is of policy concern and second, it provides an apparent clear-cut policy prescription: reduce the budget deficit as measured by the public sector borrowing requirement.

A causal relationship between budget and current account imbalances is consistent with old and new paradigms, either a single-period M-F model (which rules out Ricardian equivalence) or an intertemporal model such an overlapping generations version that allows fiscal policy to influence the current account by altering the timing of taxes even when private sector decisions are determined by present-value income.

Even if Ricardian equivalence does not hold, movements in the budget deficit may exercise only a weak impact on the current account, depending upon the means whereby the budget deficit reduction is achieved and specific parameters such as import shares of government spending. Conversely, even if Ricardian equivalence holds approximately, the twin deficits prediction may, nevertheless hold, depending upon the stochastic properties of the budget deficit (see Normandin, 1999). For example, a rise in the present budget deficit may signal a future rise in the budget deficits: consumers expect a future rise in their cash flows and adjust upwards their saving, thereby reducing the current account deficit.

The debate is characterised by a general acceptance of the twin deficits hypothesis until the apparent failure of the current account deficit to reverse direction following a shift to a restrictive fiscal stance in 1986/87.⁷ A more critical position is taken by Genberg (1988) who questions the strength of the relationship on the grounds of Ricardian equivalence and the means whereby deficit-reduction is to be achieved. Genberg uses a single-period model to make his argument and fails to provide empirical evidence for Australia on Ricardian equivalence or key parameters such as the share of imports in government spending. A potential opportunity to use the new

⁶ Revisionist interpretation is of interest: 'In the mid-1980s, there were fears that Australia's current account position might be unsustainable...."Looking back, it is clear that the situation was not unsustainable" (MacFarlane, 1999a).

⁷ See Moore (1987) for a contemporary interpretation. Budget Statement 1988/89 (p. 35) refers explicitly to the twin deficits relationship while noting the complexity of linkages between movements in the PSBR and current account deficit.

paradigm to strengthen the argument that even fiscal policy may be an ineffective policy instrument directed towards the current account seems to have been missed.

In sum, while fiscal consolidation may be a desirable medium-term objective, the effect of movements in budget deficits on external deficits within a dynamic framework is not as simplistic as suggested by the twin deficits hypothesis.⁸ The absence of a positive association between budget and current account deficits since the late 1980s has since led to the demise of the twin deficits hypothesis. However, recent empirical tests of the hypothesis for the period 1950 to 1992 for the United States and Canada based upon a stochastic intertemporal model provide strong support (Normandin, 1999) confirming that, indeed, the hypothesis is more complex than interpreted during the period of the debate.

III. Data Issues

This Section examines data and empirical issues relevant to the debate. What inference may be drawn about the Australian current account deficit in the 1980s and 1990s from savings and investment data? Empirical evidence on the optimality of current account balances in Australia is also examined.

In line with the new paradigm, movements in the current account are examined within an accounting savings-investment framework. The focus of the discussion is upon five-year flow aggregates over the period, 1970-74 to 1995-99, as summarised in Table 1. The interpretation of the data is subject to three main qualifications. First, the data are identities and hence no causality is inferred without a specified set of behavioural relationships, especially linking public and private sector savings. Second, the savings data are subject to several measurement errors, including a statistical error, being derived as a residual from national accounts data on income and consumption and the methodology used to adjust for inflation. As a consequence of the statistical discrepancy, the savings-investment gap may not match current account data derived from balance-of-payments data. Third, cyclical effects are excluded although relevant for macro policy and market perceptions of movements in the current account. Further discussion of measurement issues is given in Appendix I.

Period of debate: 1985-90

The most striking feature of the data is the shift in the current account in the second half of the 1980s.⁹ The rise in the current account deficit in the second half of the 1980s is explained primarily on the savings side. But within savings, the story alters dramatically once correction is made for inflation (see Table 1). Once this correction

⁸ One participant subsequently admitted that the twin deficits relationship is less obvious than previously assumed by policymakers (see Dawkins, 1992).

⁹ The structural shift in the current account deficit was accompanied by a shift in the level and volatility of the trade-weighted exchange rate for the Australian dollar (see MacFarlane, 1999a). Both shifts support an interpretation in which deregulation played a critical role by way of relaxing liquidity constraints on external borrowing.

is made, the decline in public sector saving offers a good first approximation of the increase in the current account deficit in the second half of the 1980s.

Table 1. Saving, investment and current account: percent of GDP

	1970-74	1975-79	1980-84	1985-89	1990-94	1995-99
National saving	25.9	22.3	20.0	20.3	17.9	19.4
Unadjusted	25.9	22.3	20.0	20.3	17.9	19.4
Inflation adj.	26.0	22.3	19.9			
Public saving						
Unadjusted	7.8	3.6	2.6	3.1	-0.6	1.0
Inflation adj.	11.3	7.5	5.8	5.8		
Private saving						
Unadjusted	18.1	18.7	17.4	17.2	18.5	18.4
Inflation adj.	14.7	14.8	14.1	14.5		
Household				11.8	9.5	8.1
Enterprise				9.3	8.3	11.7
National Investment	26.1	24.6	24.9	25.0	22.6	22.5
Public investment	7.6	7.7	7.2	6.7	5	4.2
Private investment	18.5	16.9	17.6	18.3	17.6	18.3
Statistical discrepancy	0.3	-0.3	-1.2	0.2	-0.3	1.3
Current Account Deficit	0.5	2.0	3.6	4.9	4.2	4.3

Source: ABS Cat. No.5206.0

In the absence of inflation correction, the data suggest that the rise in the current account deficit reflects a fall in household and private sector saving. However, once appropriate correction is made for inflation, the private saving ratio is stable and the fall in public sector saving is even larger than measured public sector saving. The reason is that the private sector was a net lender to the government with nominal interest income reflecting a real and inflation component. Once the latter is removed, adjusted private sector saving falls below unadjusted or measured private saving with the reverse for the public sector.

The above explanation in terms of public sector behaviour is also consistent with an interpretation based upon a structural shift in the current account in response to the removal of liquidity constraints on external financing. As shown in the table, the fall in public sector saving was accompanied by a rise in private investment in terms of GDP.

Accompanying the persistent current account deficits was a rapid build-up in external debt within a short time span, from slightly above 10 percent of GDP at end-1981 to 42 percent at end-1989, stabilising at around 40 percent of GDP since end-1992 (see MacFarlane, 1999a, p. 8). The debt-servicing ratio rose from below 5 percent of export income (below 1 percent of GDP) to 20 percent of export earnings (3 percent

of GDP) in the 1980s. A further feature of the debt data central to the overall debate and the issue of sustainability was the dominant share of private relative to public external debt with the share of private debt around two-thirds of the total. Other characteristics of external debt such as currency composition and maturity structure attracted relatively less attention although the one-year maturity structure of foreign currency denominated external debt rose from 12 to 30 percent over the period end-June 1983 to 1988.

Post-debate

The structural increase in the current account deficit was maintained throughout the 1990s but the explanation in terms of savings-investment trends alters. Both national saving and investment ratios fell relative to their levels a decade earlier. The national investment ratio fell by 2.5 percent of GDP while the national saving ratio recovered somewhat after a fall in the early 1990s. The major difference from the earlier decade is the structural shift that accompanied budget deficit reduction with both public sector saving and investment ratios falling.

In contrast to the 1980s, the statistical discrepancy dominates the overall change in the deficit over the second half of the 1990s, making interpretation of savings-investment data difficult. A positive discrepancy means that the savings-investment gap is understated but it is unclear whether this reflects too high saving or too low investment (see Appendix I).

In summary, despite evidence of a structural shift in the current account, two features of the savings-investment data in the 1990s differ from that of the 1980s. First, in the earlier decade, the widening of the (negative) savings-investment gap reflects largely a fall in public sector saving whereas the continued negative gap throughout the 1990s is ambiguous in interpretation, owing to the increase in the statistical discrepancy. Second, in contrast to the 1980s, the external debt-to-GDP ratio stabilised in the early 1990s despite a persistent trade deficit, reflecting a temporary negative discount rate (interest rate-output growth differential).

Far from helping resolve the “puzzle” of explaining the shift in policy stance on the current account, the above ambiguities in interpreting savings and investment data suggest that the new paradigm rests upon weak data foundations. Notwithstanding the increase in government consumption driving the rise in public dissaving, stability of private savings in terms of GDP and the rise in the ratio of private investment undermine the “facts” used by, among others, Moore (1988) to argue that the current account deficit financed consumption rather than investment.

Optimality of current account

A growing body of empirical work has investigated the question of optimality of current account imbalances although this work was not available at the time of the debate. Various methodologies are adopted but the main body of work follows the

approach of Ghosh (1995) who uses the representative agent intertemporal model to derive a benchmark consumption-smoothing series. Statistical tests are then performed to test the null hypothesis that the variance in the actual current account over the sample period is not significantly different from that of the constructed series. One shortcoming of this methodology is that the causes of possible rejection of the null hypothesis are difficult to identify because the null hypothesis under investigation is a joint test of capital mobility, rational expectations and auxiliary assumptions (for example, specification of the utility function).

Following the above methodology, Cashin and McDermott (1998) test the optimality of current account imbalances in Australia over the post-regulation period 1984-1998:2. Over the period of the debate (1984-1990:3), the paths of consumption and the current account fail to satisfy optimality criteria but this result is reversed from 1991:1-1998:2. A similar finding of non-optimality of the current account during the 1980s is obtained by Guest and Hicks (1993) although the empirical methodology used by the latter simulates rather than estimates the intertemporal model and defines optimality in terms of maximisation of a social welfare function rather than individual utility.

Empirical findings for other industrial countries are also of interest. Ghosh (1995) finds strong empirical support for the consumption-smoothing intertemporal model for the United States but not for other G-5 economies over the 1980s. In contrast, using a similar methodology, Agenor and others (1999) find that the intertemporal model provides a good statistical fit for France even in a period (1970-96) in which capital controls were imposed.

The above empirical work fills a much-needed gap in an assessment of the new paradigm but also introduces a puzzle. The finding of a switch from non-optimality to optimality of the current account in the 1990s is supportive of the policy position during and after the debate. But it is not consistent with present government position that national savings are inadequate. An explanation for the change in current account pattern is also unclear in terms of the model and interpreting the role of policy. The removal of distortions through micro reform is one explanation but other factors may also explain the earlier rejection of optimality such as risk premia and non-rational expectations.

Optimality of investment.

An issue raised by several contributors (for example, McKibbin and Morling, 1990) in the debate is whether fiscal consolidation was achieved at the cost of lower economic growth through reducing public investment (and indirectly worsening solvency criteria). Otto and Voss (1998) demonstrate that public investment undertaken in Australia over the period, 1959-1992 satisfies the conditions for intertemporal efficiency once account is taken of a falling private-to-public investment ratio. They also suggest that private investment is optimal although sectoral allocation over this period may not be.

Optimality of saving

Optimality of national savings has attracted considerable attention following the shift in policy attention in the early 1990s from reducing the current account deficit to raising national saving. The empirical results are inconclusive, reflecting different methodologies and data problems. Fitzgerald (1993) and McDonald and Guest (2001) conclude that Australian savings are non-optimal. However, the similarity in result appears to be more accidental than by design since Fitzgerald uses an arbitrary benchmark based on trend savings while the latter authors derive an optimal series for saving based upon explicit social welfare function and endogenising aging of population within an intertemporal model.

In summary, savings-investment data provide support for the contention that the current account deficit was associated (but not necessarily caused) by a fall in public saving in the 1980s. However, the data fail to provide a clear picture of the factors behind the continued deficit in the 1990s. Empirical evidence on optimality of the current account and its components suggest that the sources of observed non-optimality in the 1980s is to be found in savings distortions rather than private or public investment. The finding of optimality of the current account in the 1990s, while supportive of present government policy on the current account is not consistent with non-optimality of national saving and present government policy on national saving.

IV. Policy Framework

A number of alternative approaches exist in the literature for analysing policy processes and outcomes, including the mainstream Bergson-Samuelson framework, theory of political economy (Buchanan, 1987), information constrained policy (Stiglitz et al., 1989) and, more recently, transactions cost-politics (Dixit, 1997). This section examines the implications of alternative policy frameworks for interpreting the role of economists in the debate.

The mainstream approach underpins the argument used in Pitchford and other academic contributors (for example, Friedman, 1989) which pits the government against the market. Policymakers are assumed to maximise a social welfare function subject to economic and technological constraints with the role of the government to correct market failures (via taxes and subsidies), correct externalities (through the provision of public goods) and achieve an equitable income distribution.

The above approach forms the basis of a positive theory of government. Its major weakness is that fails to provide a positive theory of how government actually functions once formed. The approach also implicitly **presumes** a key role for economists in influencing policy outcomes, whether through a “passive” role in the provision of information and analysis or an “active” role in attempting to affect directly policy outcomes through participation in public debate. The economic

argument ignores the constraints operating on policymakers that may prevent the implementation of proposed measures even if policymaker accept the underlying logic.

Alternative policy approaches attempt to remedy the above weaknesses. Stiglitz et al (1989) introduce information constraints on policymakers. However, this approach maintains the assumption of a single social welfare maximising principal and assumes that once a policy is found, it will be implemented. A positive theory of political economy is advocated in Buchanan (1987) who analyses outcomes as processes determined with a given set of rules. This approach distinguishes between sets of policy rules (constitution) that govern the policy process and individual policy acts. The theory provides a normative framework for improving rules and hence outcomes.

More recently, Dixit (1997) has developed a theory of transitions-cost politics that provides a synthesis of mainstream and alternative approaches. Dixit's main contribution is to open the social welfare "black box" and admit an explicit role for competing interest groups, including economists, media, legislation, administration and policy institutions. In his analysis, policymaking operates as a process with slow dynamics that is a game between participants who attempt to influence the actions of policymakers. Each policy act is not a choice as in the Bergstrom-Samuelson framework but a play of a game with an existing set of rules and institutions with some freedom to alter future rules. In this framework, the equilibrium outcome is typically not to maximise anything.

A central component in the Dixit framework is the concept of transactions costs, defined as the costs of switching from one structure or policy regime to another. Costs will involve planning, adapting and monitoring alternative structures. In contrast to the mainstream approach, economists will **not** be a determining factor in policy outcomes. This message seems at first sight inconsistent with both the static and dynamic trade debates in which the status quo favours the principle of comparative advantage. The inconsistency disappears once transactions costs are considered.

Role of economists

An alternative interpretation of policy outcomes is in terms of the political process of reducing transactions costs. It is within this process that a potential role for economists arises through their dual passive and active functions. Opportunities to influence outcomes arise at "breaks" in the system when flaws in the present strategy become apparent. How well did economists communicate the new paradigm when viewed within this broader framework?

Academic and other economists used both functions in their attempts to influence policy during the debate. Acting as the undisputed leader of academic economists in the debate, Pitchford's role was primarily an active one, seeking to alter the fundamental policy perception that the current account matters. With few exceptions (see Arndt, 1990), academics supported the Pitchford position largely through

economic analysis. Business economists, notably Moore (1988) aligned with policymakers on the fundamental perception that the current account deficit is of concern.¹⁰ But this group also sought to influence directly policy response, especially monetary policy. A comprehensive report (Macquarie Bank, 1989) set out a specific agenda for policy reforms focusing upon tax reform to increase private saving, stronger wage restraint to increase external competitiveness accompanied by a range of measures to promote industry as well as a reversal of the tight monetary stance.

An assessment of the role of economists in influencing the actual outcome (the subsequent shift in policy perception and clarification of monetary strategy directed towards inflation –reduction and not the current account) is difficult if not impossible since we do not know the outcome in the absence of the debate. Nevertheless, contemporary policy documents suggest the following interpretation.

First, there is evidence of a common framework...savings-investment balances for analysing the current account. However, there is little or no appreciation in policy documents of the key function of dynamic optimality of the current account. Second, there is agreement among the three groups on the desirability of fiscal retrenchment and structural reform to improve structural imbalances and international competitiveness. However, the likelihood that successful micro reform that increased Australia productivity vis-à-vis that of trading partners might not reduce the current account deficit seems to be missed in the policy discussion. The main area of miscommunication lies in the role and functions of macro policy and especially monetary policy in relation to the current account. This issue is taken up in the next section in which it is suggested that the main reasons are to be found in the constraints placed upon monetary policy. There is little recognition of these factors in the arguments put forward by economists.

In summary, a characterisation of the debate in terms of “dialogue of the deaf” or competing paradigms fails to recognise areas of commonality between protagonists. There is also evidence of lack of communication on both sides; a failure by policymakers to clarify instruments and targets in the context of existing policy constraints and an accompanying failure of economists to recognise and incorporate policy constraints in their attempts to influence policy outcomes.

V. Macro Policy Institutions and Constraints

This section discusses the main set of constraints acting upon policymaking in Australia in the period preceding the debate (mid-1970s) as identified in a comprehensive review of the process of policymaking (see Report to the Royal Commission on Australian Government Administration, 1975). It also examines the

¹⁰ Included also is the report of the joint Parliamentary Committee on Foreign Affairs, Defence and Trade (1991) (Langmore Report). The report based upon submissions from different representatives from the community is characterised by the premise of market failure to respond to the current account deficit and hence, the need for intervention (see Makin, 1992).

specific constraints on the two main macro policy institutions (Reserve Bank and Treasury) in the context of the debate.

Constraints on policy

A Royal Commission assigned to the task of reviewing the procedures for policy formulation, implementation and adequacy identified four main constraints on policymaking in Australia in the period immediately preceding the debate. These constraints included: the Constitution (lack of clarity concerning the respective roles of the Commonwealth government vis-à-vis the states); the legislature (including the Reserve Bank Act specifying the relationship between the Reserve Bank, Treasury and Treasurer), international agreements (including binding commitments to current account convertibility and multilateral trade liberalisation by membership of the IMF and GATT/WTO) and social and political interest groups, including economists).¹¹ The Commission also noted the constraints on policy that arose from a lack of understanding of the economy and desirability of improving community understanding of policy ends and means and constraints.¹²

The above set of policy constraints have direct and indirect significance for macro policy settings of the 1980s. The constitutional constraint gives specified parliamentary powers to the Commonwealth government and leaves residual functions to the states. As such, it does not impinge directly upon the effectiveness of monetary and fiscal policy (the latter, defined in terms of the Commonwealth budget) but indirectly influences both because the Commonwealth government lacks the authority to directly control wages and prices. Reflecting this constraint, the Wages Accord of the early 1980s involving a mutually agreed policy of wage restraint between unions and the Labour government was effectively assigned to reducing inflationary pressures, leaving monetary policy as a residual; to maintain a growth in nominal income consistent with the agreement.

In regard to the second constraint, existing legislature as specified by the Reserve Bank Act of 1959 provides power to the Treasurer to override any differences between the Reserve Bank and Treasury. In practice, the government has been reluctant to exercise this power. As discussed by MacFarlane (1999 b), the effective constraint on the independence of monetary policy in the pre-1983 period derived not from the Act but from regulated financial instruments that tied monetary operations to the treasury. The major freeing of macro policy constraints came from deregulation

¹¹ The diversity of various interest groups and their respective influence on the Labour government is discussed in Gruen and Grattan (1993). One factor weakening the overall impact of academics were reforms to tertiary education.

¹² In line with its recommendation of the need for a higher level of informed debate both within the bureaucracy and within the community, the Commission recommended the establishment of an economic advisory body intended to provide an independent and systematic policy assessment resulting in EPAC (Economic and Planning and Advisory Council). EPAC contributed to the current account debate largely through analysis of debt sustainability (see above): its quantitative work underpinned the government's current account target of 2-3 percent of GDP and rationale. However, given its support to the government position, its "independent voice" is questionable as well as its role in the policy process (see, for example, Gruen and Grattan, 1993, p .59 who refer to EPAC as playing a subordinate role in this process).

that in terms of Dixit's framework presented a possible "break" for economists to influence policy strategies and outcomes.

The specific constraints on monetary policy are discussed below, based upon contemporary policy documents including the Reserve Bank Annual Reports, Budget Statements and speeches by the Treasurer and Governor of the Bank. In interpreting contemporary documents, their functions of the policy documents need to be noted. For example, the annual Reserve Bank Reports of the 1980s were intended to provide general and specific (monetary) economic commentary and serve primarily as a means of communicating monetary policy to the ministry and community.¹³ At times, the Report could also be used as a means of indicating specific concerns or the need for a change in approach. However, the Bank's ability to influence market expectations also constrained its contribution to public debate.

Monetary policy and Reserve Bank

Present monetary policy and the institutional framework within which it operates is unambiguously framed in terms of a medium-term objective of reducing annual inflation to 2-3 percent on average as formalised in the August 1996 Statement. The Statement sets out government recognition of Reserve Bank independence and support for an anti-inflation target and provides a well-defined relationship between the Reserve Bank, Government and Treasury. This change in institutional arrangements took place within the existing legal framework.

The above monetary strategy stands in marked contrast to the strategy adopted during the period of the current account debate, as manifested in the checklist approach. The checklist strategy is described by Johnston (1987) as "using all major economic and financial factors - present and prospective". The checklist was a range of economic indicators, including inflation, current account, interest rates, exchange rates and economic activity. Notwithstanding Johnston's claim that the strategy offered the opportunity "for effective monetary policy-making even greater than ever today" (p.13), its main function was to serve as an interim strategy between the breakdown of monetary targeting in 1985 and its eventual replacement by an inflation targeting regime. Not surprisingly, given the lack of clarification between instruments and targets and respective responsibilities of fiscal and monetary policy, monetary tightening during the mid-to- late 1980s was criticised and perceived as a direct response to the current account deficit.

Three broad themes underlie the Reserve Bank Reports and speeches by Bank Governors in the period from 1980-81 to 1991-92. In the first part of the decade, overriding concern is directed towards the stability of the financial system and difficulties of interpreting and controlling monetary aggregates following financial deregulation. In the mid-to-late 1980s, priority is switched to the current account problem and the "burden" placed upon monetary policy vis-à-vis other policy

¹³ This function altered in 1997 from economic commentary to reporting bank operations accompanied by the publication of Semi-Annual Statements

instruments. By the end of the decade, the focus of monetary policy had moved from short to medium term and inflation reduction.

A recent assessment of monetary policy during the 1980s by Grenville (1997) and MacFarlane (1999 b) provides further insight into the constraints acting upon monetary policy and role of economists in influencing policy outcomes. Based upon contemporary Reserve Bank reports and in line with the identified themes, Grenville interprets monetary strategy as “holding the line”, being used as stop-gap measure to buy the necessary time for other policy instruments (fiscal retrenchment and wages policy) to take effect in addressing structural internal and external imbalances. In his interpretation, the perception and criticism of monetary policy arose because monetary tightening was assigned to the symptom (inflation fuelled by nominal exchange rate depreciation) rather than the cause (structural savings-investment imbalance). The checklist strategy further weakened market confidence by sending ambiguous signals about monetary targets and instruments. In the interpretations by Grenville and MacFarlane, the role of academic economists is viewed as marginal. Specifically, the main reasons for delay in introducing inflation targets lay in political constraints: relaxation of these constraints together with the achievement of a reduction in inflation without changing the Reserve Bank Act is seen as the key factors behind the new monetary policy regime (MacFarlane, 1999 b).

Fiscal Policy and Treasury

Two main themes underpin Budget Statements from 1985/86 to 1988/89 paralleled by speeches from the Treasurer (see Appendix II).¹⁴ The themes are: first, the predominance of the current account deficit as the economy’s central problem and, second, the government’s stated policy framework for addressing external imbalances. The shift in policy perspective from the current account to the adequacy of national savings occurs in the early 1990s and is formalised in the 1995/96 Budget.

The identification of the current account deficit as the central policy problem is first stated in the 1985/86 Budget and reaffirmed in three successive years paralleled in speeches by Keating. The rationale for government concern is as earlier discussed, namely debt unsustainability, the slow pace of external adjustment and the constraint imposed on economic growth from the current account deficit (see the 1985/86 Budget Statement). The 1989/90 Budget identifies both external imbalance and the external deficit as the dual economic issues facing Australia, noting that neither is an ultimate policy objective.

The 1987/88 Budget Statement identifies policies directed towards achieving a permanent reduction in the current account deficit, principally through improving external competitiveness via exchange rate depreciation and wage restraint and

¹⁴ The Treasury and Treasurer (Keating) enjoyed a close relationship during the period of the debate (with corresponding influence for the former) as noted by Gruen and Grattan (1993). Whitwell provides a discussion of changing institutional structure of the Treasury: he discusses the shift in philosophy from Keynesian to neoclassical thought which weakens an interpretation of the debate based solely upon old and new paradigms.

through “firm” macro policies to slow down growth in domestic demand. Macro policy mix and settings are elaborated: restrictive fiscal policy to reduce the public sector’s call on national saving; tight monetary policy to restrain domestic demand and inflation and prices and wages policy to improve international competitiveness (see also Keating, 1989). Explicit reference is made to the debate on monetary policy (see also Keating, 1990): the direct assignment of monetary policy to internal balance (reducing domestic demand) is reaffirmed while admitting an indirect linkage with external balance via demand growth.¹⁵, p).

The 1987/88 Statement also provides a discussion on the pace of external adjustment, identifying areas agreement and disagreement in the policy debate. It notes little disagreement in the public debate with policy strategy directed towards enabling resources to be transferred from the non-traded to traded sector. But the issue for debate is adequacy of the pace of adjustment in reducing the trade deficit and whether policies could speed adjustment and thereby lower costs. The risks of faster adjustment (unemployment and disruption to markets) are weighed against the costs of prolonged adjustment and accompanying debt build-up.

In summary, deregulation, itself a factor behind the structural rise in the current account deficit acted as the major freeing of existing constraints on macro policy and especially monetary policy, providing the policy “break” for economists. However, other constraints delayed the shift from monetary to inflation targeting with the checklist approach and resulting mixed signals on monetary targets and instruments forced to act as a transitional strategy.

VI. Concluding remarks

This paper has examined changing policy perspectives of the current account viewed from the debate on Australia’s current account deficit in the 1980s. It addresses two broad questions: how have views on Australia’s current account evolved over the past two decades? What factors have shaped and altered policy and market perceptions of the current account?

The analysis first examined the policy significance and relevance of the neoclassical intertemporal paradigm for interpreting persistent current account imbalances. The basic policy message is that the current account is an optimal outcome conditional upon key assumptions (rational expectations, capital mobility and absence of distortions to savings and investment) being met. Hence, neither the sign nor size of the current account is of policy significance. Analogous to the trade debate, an economic case for intervention may be argued based upon market failures such as distortions to private savings and investment. If argued, the main policy measures are micro not macro and could widen the current account deficit.

¹⁵ “The Balance of payments has been one of the determinants of the stance of monetary policy in the past and will continue to be so in the future” (Keating, 1990, p. 5).

Despite the existence of a case for intervention on the grounds of market failure, the government's case did not rest upon this argument. Instead, it relied upon concerns with short-run adjustment costs of achieving debt stabilisation and vulnerability of the economy to changes in market sentiment as well as the external constraint on growth. The implications for macro policy, especially monetary stance are less clear-cut and open to ambiguous interpretation.

The paper also examined data and empirical issues relevant to the new paradigm and debate. While the structural shift in the current account deficit in the early 1980s was associated with a fall in public savings, its persistence in the 1990s is ambiguous in interpretation owing to the increase in the statistical discrepancy. Far from resolving the puzzle of explaining the shift in policy position on the current account, ambiguities in interpreting savings-investment data and recent empirical evidence on the optimality of national savings and the current account introduce a new puzzle. The finding of optimality of the current account is supportive of present government policy on the current account but is not consistent with the finding of non-optimality of national saving and present policy to raise national saving.

The effectiveness of economists in influencing policy outcomes was discussed and assessed from a broad policy framework that includes constraints on policymaking and transactions costs of altering policy regimes. Policy documents suggest some areas of common understanding between policymakers and economists: specifically, the underlying savings-investment accounting framework and desirability of reducing public saving and micro reform to increase international competitiveness. These areas of commonality weaken popular characterisation of the debate as a “dialogue of the deaf”. However, there is also evidence of misunderstanding on both sides, specifically in relation to the significance of the key prediction of optimality of the current account and impact of micro reform on the current account deficit within the new paradigm and the assignment of monetary policy.

Overall, the debate highlights the complex interactions between changing paradigms and constraints on policy. Deregulation of the Australian financial system in the early 1980s was itself a factor behind the structural rise in the current account and also freed monetary policy from existing constraints imposed by its assignment to an external target and close relationship with fiscal policy. The debate may be interpreted in part as an inability of both economists and policymakers to fully exploit this policy “break”.

Appendix I: Data Issues

This Appendix discusses three main data issues: (1) errors in measurement of savings and the current account: (2) inflation adjustment and (3) disaggregation of savings aggregates.

(1) Errors in measuring the current account

The main statistical error in measuring and interpreting the current account from a savings-investment accounting framework arises because savings are derived as a residual from ANA. As a result, the savings-investment balance derived from ANA data may not match that derived from balance-of-payments data making interpretation in terms of savings and investment trends ambiguous.

Table (1) incorporates a residual statistical error that arises from deriving gross national savings as a residual from income not spent on consumption. As a result, savings will reflect measurement errors in income and consumption. ABS estimates of the size of this error (estimated as the difference between income and expenditure measures of GDP) suggest an annual average error of 0.8 percent of GDP (1959-1987) with a small negative bias of 0.3 percent. Provided the error is random, it is of minor concern. However, McKinnon and Morling (1990) note that the statistical error demonstrates a trend change between 1974-5 and 1982-83 and is inversely correlated with consumption with a rise from 1985-86 to 1988-9 to almost half the current account deficit. To the extent that the deficit reflects unreported consumption, it is understated.

Flynn (1993) discusses alternative methods for deriving gross saving, for example as the difference between gross investment and net borrowing from overseas and based upon flow-of-funds accounts. Neither alternative is appealing: the first because of the problem of measuring capital flows; the second because flow-of-funds data begin in September 1989. However, both provide a consistency check on the ANA method.

As a consequence of the statistical discrepancy, savings-investment balances do not match exactly the current account derived from derived from balance-of-payments data. A recent analysis in Reserve Bank (1999, p.25) shows a widening statistical discrepancy in recent years. For example, in December 1998, the discrepancy was about 1 ½ percentage points above its 1996 average. Since the ratio of investment-to-GDP was only 0.7 percentage points above its average 1996 level with the savings ratio unchanged, it is unclear how to interpret the rise in the S-I balance, whether as a fall in saving or rise in investment.

(2) Inflation adjustment

A further problem of accurate measurement of savings data arises on account of ANA treatment of nominal interest as pure income when a component (expected inflation) represents compensation for a fall in purchasing power under inflation. The inflation-adjusted data account for capital losses or gains which would otherwise overstate income of lenders (government) and understate that of borrowers (private sector). However, the inflation adjustment does not adjust for Australia's overall net position as a debtor.

Actual and expected inflation may also affect savings and investment data in other ways not taken into account: for example, unexpected inflation affects saving behaviour although the net direction is unclear.

(3) Private and household saving

In the post-debate period, policy attention has switched to the issue of inadequacy of national saving, largely triggered by the trend decline in the national saving ratio and dramatic fall in the household saving ratio (see Edey and Gower, 2000). The household saving ratio halved as a percent of GDP (from 15 to 7 percent) over the period 1970 to 1999 and presently stands at around 3 percent of net household income. However, movements in the household savings ratio provide a misleading picture of private savings: the former has been in decline since the mid-1970s while the latter is stable, suggesting a high degree of interaction between household and corporate saving. See also Reserve Bank (1999, p. 24).

Appendix II: Official views on the current account

Several themes emerged from an earlier selective survey by Salop and Spitaeller (1980) of official views in industrial countries on the current account:

1. A predominant concern with the issue of short-run adjustment “the majority of pronouncements refer to the adjustment problem over the shorter-run” (Salop and Spitaeller, 1980, p.123). The countries surveyed shared a common long-run objective of prosperity with the current account playing a subsidiary role.
2. A preoccupation with current account and/or debt sustainability “although the current account is not, and should not be, a principal target in the long-run, its sustainability is considered important” (Salop and Spitaeller, 1980, p.124).
3. Country-specific targets for the current account, based upon a number of criteria ranging from a targeted zero current account balance in France (1980), current account surplus in Germany to no specified current account target in the United states in the 1970s.

The three broad themes are also reflected in contemporary policy documents on Australia’s current account in the 1980s as illustrated below. The predominance of the current account in policy priorities over the period 1986-1989 is unambiguous (see below). At the same time, it also apparent that the current account was not the ultimate objective of policy (see Budget Statement 1989/90). A specific current account target of 21/2 percent of GDP is also stated (Keating, 1989, p.1) as that required to stabilise debt in terms of GDP.

(1) Changing policy perspectives on the current account:

The predominance of the current account in policy priorities in the mid to late 1980s is illustrated by the following policy statements:

“...the most pressing problem facing Australia is how we will confront the challenge of our trade deficit” (Keating, 1986 b, p.1).

“...Economic policy...will continue to be directed principally at securing further reductions in our current account deficit” (Keating, 1987, p.3).

“...The 1987 premiers’ conference is taking place at a time when it is clear that Australia’s balance of payments deficit and associated build-up in external debt remain our pre-eminent problem” (Keating, 1989, p.1).

Present policy position on the current account is illustrated by the 1998/99 Budget Paper No. 1 (Statement 3) as reported in Economic Roundup (1998):

“One of the Government’s key objectives has been to reduce these risks and prevent the current account re-emerging as a constraint on sustained strong economic growth. This has not meant eliminating the current account deficit or maintaining it at some target level. Rather, the strategy has been to address the structural weaknesses that existed and ensure that the economic environment is such that saving and investment decisions underpinning the current account deficit are soundly based” (p.1)

The 1999/00 Budget Paper reaffirms the government position.

“Importantly, the increase in the current account deficit reflects private saving and investment decisions.”...“the fiscal strategy means that the current account deficit is now essentially a product of private saving and investment decisions that reflect market discipline and incentive”.

(2) Debt sustainability and current account target:

“Borrowings have risen to levels that are high by historical standards and raise questions of sustainability” (Budget Statement 1985/6, p.58).

“By 1986 Australia was thus confronted with external accounts which were unsustainable in all but the near term” (Budget Statement 1987/88, p.42).

“We must never lose sight of the fact that the current account deficit and our external debt are unsustainably high” (Keating, 1989).

“We do have to stabilise debt to GDP which we believe obtains with a current account deficit of about 2 ½ percent of GDP” (Keating, 1989, p. 4).

(3) Policy reference to the debate and policy mix:

“I note that there is a view becoming fashionable in Australia that the current account deficit and our debt level do not really matter”...Whatever the theoretical analysts may think, what really matters is what the international markets think-and their message is clear. The Government has in place a set of policies to avoid the eventuality of a change in market sentiment”(Keating, 1990, p.3).

Keating (June 1990) also refers to the debate on monetary policy and the “erroneous” notion that monetary policy is not an effective weapon for correcting the current account deficit. He emphasises that the main role of monetary policy is to reduce excessive demand in the short run.

Budget statement 1989/90 (p.32) notes the increase in debt ratios reflects private investment decisions and “prime facie, there is no reason for policymakers to interfere with such commercial judgements”.

Appendix III. Solvency measures for Australia

(1)	Projected world real interest rate (in percent)	4.5	6.5	4.5	4.5	6.5
(2)	Projected real GDP growth (annual percent)	3.9	3.0	1.0	3.0	3.0
(3)=(1)-2)	Projected discount rate	1.5	3.5	3.5	1.5	3.5
(4)	Stabilised external debt ratio -to-GDP	40.0	40.0	40.0	60.0	60.0
(5)= 3).(4)	Debt-stabilis. trade surplus (percent of GDP)	0.6	1.5	1.4	1.0	2.1

Source: EPAC (1986, Table 10, p.33)

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STRUCTURE

1. INTRODUCTION

Issues

- How have views on Australia's current account evolved over the past two decades?
- What has changed to shape altered policy and market perceptions of the current account?

Purpose: to examine the two questions within the context of the intellectual underpinnings of the debate on Australia's current account deficit and external debt in the 1980s.

Debate characterised as dialogue of the deaf. Outcome and parallels with debate on trade liberalisation.

Sub-debates. Which remain?

- Twin deficits
- Good and bad deficits
- Debt/equity mix
- Fiscal consolidation and growth
- External sustainability
- Savings offsets and superannuation
- Ageing of population and savings policy

2. DATA

- Structural shift in current account and real exchange rate-most striking feature of data when look backwards but not so apparent at the time.
- 5 year averages for main flow and stock aggregates and decomposition. Has story altered?

Main conclusions.

3. CHANGING VIEWS

- Economists
- Academics and business, respective roles.

- Macro institutions
- RBA
- Treasury

- Government

- Market and rating agencies
- Other players (international and domestic institutions, IMF, OECD, EPAC,

4. INTELLECTUAL UNDERPINNINGS

- Static and dynamic modelling of current account.
- Optimality
- Solvency and sustainability

5. POLICY FRAMEWORK

Approaches; Dixit and transactions cost analysis

6. REVISIONISM

Evidence and significance

7. CONCLUSIONS

Main debate and sub-debates; which remain or replaced?

