OUR PRESENT DISCONTENTS
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F.H. Gruen
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OUR PRESENT DISCONTENTS

By F.H. Gruen

1. Introduction

Presidential addresses fall into three categories. Some of the most illustrious consist of learned disquisitions on the author's recent research work. My predecessor's address - some four years ago - belongs to this category. Another type of Presidential address consists of resigned - or not so resigned - head shaking about current trends in the profession. One can find at least half a dozen good examples of this genre in the recent international literature - Galbraith (1973), Gordon (1976), Kaldor (1972, 1975), Leontief (1971), Phelps-Brown (1972), Robinson (1972) and Worswick (1972) coming to mind.

I have been trying to popularise a third category - which can perhaps best be described as resigned - or not so resigned - head shaking not over where the profession is going but over where the economy is going. A decade ago, in a Presidential address to the Economics Section of ANZAAS (Gruen, 1976), I pondered on “What Went Wrong?”. I thought I would return to the theme of deploring where our economy is going, since this seems very much in the spirit of the times.

Presidential Address to the Economic Society of Australia, 27 August 1986. I am indebted to Max Corden and David Gruen for helpful comments on an earlier draft and to Kim Chohan for research assistance.
The main thing which is going wrong at present is, of course, that we - as a community - are spending six percent more than we are earning. This gap is not sustainable in the sense that the rest of the world is going to become increasingly reluctant to go on lending us 6% of our national income for any considerable number of years. Furthermore, recent attempts to reduce this spendthrift attitude of ours have so far been completely ineffective. At a later stage I want to discuss the reasons for this ineffectiveness. At first it seems desirable to look at our problems in an historical perspective. This will be followed by a very broad-brush discussion of current balance of payments theory. We will then examine recent trends in the Australian current account and the various factors which influence it.

Finally I will assess government policies directed towards this problem.

2. An Historical Perspective

My generation of Australian economists - in other words those of us who started professional careers in the decade after World War II - spent a good deal of time discussing balance of payments problems. In fact, according to Max Corden's 1968 survey of Australian economic policy discussion, preoccupation with the balance of payments and "a brooding pessimism about its prospects" were a characteristic of the Australian economic literature in those days. From the vantage point of 1968, Corden's strictures regarding the brooding pessimism about the balance of payments by the profession were well justified. In the second half of the sixties Australia entered a period of large-scale resource development - oriented primarily towards augmenting Australia's net export income. During the 15 years from 1965 to 1980 there were no major worries that we had any serious longer term problems of paying our way in the
world. Admittedly, it might be necessary to restrain the rate of growth of wages so as to render resource development profitable, but no serious longer term fundamental problems of a fuller integration of Australia into the world economy were foreseen. In fact, given the way we can always find a black cloud when the skies are fair, in the seventies we worried a good deal about the so-called Gregory effect - i.e. the possible deleterious effects of an expansion of mineral exports on the rural and manufacturing sectors of the economy.

However, before the mid-sixties, the inability of the Australian economy to generate adequate export revenue was a source of considerable concern among Australian economists. Over the years this concern produced the brooding pessimism about balance of payments prospects which characterised Australian economic policy discussion.

Has the wheel turned full circle? There are, of course, contrasts between the period before the mid-sixties and now. Then our exports were much more narrowly based. Wool and rural exports generally were very much more important. In addition the economy was much more tightly controlled. There were far more restrictions both on the movement of capital and on the movement of goods. Until 1960 general import licensing - applied with varying levels of intensity - restrained import levels to what was "affordable" in the light of changing levels of international reserves, of export prices and of likely rural export volumes. In fact, the application of these restrictions over the longer term actually prevented the economy from finding it's comparative advantage.

However, the brooding pessimism over our balance of payments in the fifties and early sixties was, I suggest, justified by certain peculiarities of the Australian economy.
These peculiarities still exist and affect the speed with which we manage to adjust to rapidly changing external circumstances. Now that the major boost from the resource developments of the last 20 years has taken place, we seem to be back in the position we confronted twenty years ago - when our balance of payments placed very tight constraints on our internal economic growth and on the development of the economy.

3. A Digression on Current Account Doctrine

My task of applying economic principles to our problems would be made easier if there was a clear "received doctrine" regarding the interactions and the causal links between the various economic phenomena we are necessarily concerned about. Unfortunately this is not the case. As Anne Krueger puts it at one stage in her recent survey on Exchange-Rate Determination "It is apparent that many unanswered questions remain concerning current-account/capital-account/exchange rate interactions. Not only do results appear to be sensitive to the specification of asset choices and assumptions about the speed with which various markets clear, but there would also appear to be differences between models in the degree to which a current-account imbalance arises because of the exchange rate as determined in the asset market ..... or because current-account and capital-account demands for foreign exchange ..... simultaneously interact to determine an equilibrium exchange rate."

(Krueger 1983, p.113).

Applied economists obviously cannot wait until theory provides us with a clearer picture; the problems need assessment as they arise. Fortunately some progress is possible, even though many interconnections and causal links remain subject to controversy.
We can start with two ex-post national accounting identities.

\[ \text{CAD} = \text{CIF} = 1 + (G-T) - S \]  

(1)

The current account deficit (CAD) by definition equals capital inflow (CIF) - where changes in reserves are included in CIF. Both these magnitudes must - after the event - equal the gap between domestic savings (S) on the one hand and the demand for such funds arising from both private investment (I) and from the public sector (G-T), on the other. One can therefore decompose the current account movements into those which result from changes in investment, from changes in savings and from changes in the public sector’s demand for funds. However, such a decomposition does not necessarily imply causation. Thus a decline in the public sector’s demand for funds may coincide with - or even induce - either an increase in investment or a decrease in savings and thus leave the current account balance unchanged.

The liberalisation of international capital movements in the seventies focussed attention on the central role of the capital account in affecting either the exchange rate or the level of a country’s international reserves. Until that time the most widely known and used model of the balance of payments was the elasticities-absorption model which focussed on the trade account - i.e. on the factors determining the demand and supply of foreign goods and of services, and on the main equilibrating mechanisms operating in these physical markets. When confronting a current account deficit requiring correction, the elasticities-absorption model focussed on two dimensions. Firstly on the need (at least in a full employment economy) to reduce “absorption” - i.e. real aggregate expenditure - and, secondly on the need to switch economic activity from the non-traded to the traded goods sectors of the economy.
As pointed out by the Krueger quote given above, this model is not as yet fully integrated with the later asset market models though there is an emerging view that "the balance" in the balance of payments tends to be achieved by adjustments in the capital account in the short-run and by adjustments in the trade account in the longer run. Given that markets for goods and services take longer to adjust to changing conditions than financial markets, such a division of labour makes sense - provided there is adequate evidence that markets for goods and services - i.e. the trade account plus services - are moving towards a position of sustainable longer-term equilibrium. The main problem confronting us is that the current account imbalance is showing little evidence of moving in this right direction.

4. Recent Trends in the Current Account and Factors Associated with These Trends

Figure 1 gives Australia's current account balance over the last quarter of a century or so. To provide some intuitive notion of the size of current account balances in a world both of inflation and of real growth in the economy, the current account balance is given as a percentage of Gross Domestic Product. In addition to showing changes in the current account balance, Figure 1 also shows the current account minus net transfers - i.e. the trade account plus services. The major item currently changing net transfers is the net property income payable overseas. Take the current account deficit of almost $14 billion in 1985/86. This means that our net overseas indebtedness has increased by some $14 billion during the last financial year. If all this overseas borrowing takes place at a fixed interest rate of, say 8%, our net transfers in 1986/87 will increase by more than one billion dollars (i.e. $1.12 billion). As a percentage of our current GDP this increase in the debt then adds annual servicing costs of almost
**Figure 1:** The current account and the trade account (plus services) as a percentage of GDP.

**Figures for 1986/7 have been estimated from the monthly Balance of Payments figures.**
1/2% of GDP. 1

If we examine the changes in the current account balance over the last quarter of a century as shown in Figure 1 we notice, firstly, considerable fluctuations in the half-yearly observations, and secondly certain longer-term trends. The most important recent longer term trend is the gradual increase in the size of the current account deficit during the seventies and the eighties. From a current account surplus of 1.7% of GDP in 1972/73, the current account has slipped into increasing deficits over the years - with each trough being deeper than the preceding one and each peak below the peak before.

We can use both our earlier discussion and an examination of the behaviour of the current account to provide some indication of the factors which lead both to this trend and to short term fluctuations in the current account.

(a) Savings/Investment

While it would be desirable to examine the decomposition given in equation (1) earlier, readily available National Accounts data make it more convenient to split the decomposition into two separate parts.

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1 The interaction of the increase in debt and the current account deficit is not as simple as suggested here; it is discussed more fully at a later stage.
The National Capital Account in the quarterly National Income and Expenditure estimates published by the ABS, allows us to examine whether increases in Australia's net borrowing from overseas are associated primarily with increases in gross capital formation or with declines in Australian finance for such capital formation. The finance for such capital formation can be provided in four main ways: firstly, in the form of household savings; secondly, in the form of depreciation allowances and other retained business earnings; thirdly, through government surpluses on current transactions; and fourthly, through borrowing from abroad. Figure 2 provides the relevant data. Substantial increases in investment - e.g. in the late sixties, in 1973/74\(^2\) and during the resource investment boom in 1981 - have usually been associated with increased borrowing from abroad - i.e. with an increase in the current account deficit. However, the most recent growth in the deficit has not been the result of unduly high levels of investment; it has been associated more with subdued savings levels - by households, by business and by government. The current account deficit is then a much more worrying phenomenon - since increases in investment are undertaken with the aim of repaying such investments out of increased future earnings. On the other hand, a decline in savings does not foreshadow any increased ability to repay the extra indebtedness incurred.

\(^2\) In 1973-74 this was largely the result of an increased investment in stocks - probably substantially unplanned.
FIGURE 2* : GROSS CAPITAL ACCUMULATION

PUBLIC INVESTMENT

PRIVATE INVESTMENT

CHANGE IN STOCKS

Finance of Accumulation

NET OVERSEAS BORROWING

GOVERNMENT SURPLUS ON CURRENT TRANSACTIONS

BUSINESS RETAINED EARNINGS

HOUSEHOLD SAVINGS

YEAR ENDING 30 JUNE

*Data is for financial years to 1972-73; and a 4-quarter moving average thereafter.
Sources: Quarterly Estimates of National Income and Expenditure, Australia. ABS Catalogue No. 5206.0.
ABS Time Series Data on Microfiche, Catalogue No. 1311.0.
(b) The Public Sector

Net lending and borrowing raise by sectors of the economy have been compiled recently in the Treasury Round-up (June 1986). Table 1 gives the relevant data for the last 13 years. Here again we find the high overseas borrowing of the last two years associated - not so much with extensive borrowing by enterprises (as they were in 1981/82) but with (i) a decline in household savings from the high levels reached in 1982/83 and 1983/84 and (ii) with historically high levels of borrowing by Australia's public authorities - even though this level of borrowing has been reduced slightly from the record level it reached in 1983/84. In other words, our high current account deficit is not associated with large investment levels, but with low internal savings and with relatively high public sector borrowing.

(c) The Terms of Trade

Both the Prime Minister and the Treasurer have been blaming the recent blow-out in the current account on the deterioration in Australia's terms of trade. The Leader of the Opposition on the other hand argues that, while the decline in the terms

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3 Net lending to Public authorities in Table 1 differs from the better known net public sector borrowing requirements recorded in the Budget papers in a number of minor ways - e.g., differences as between cash and accrual basis, treatment of superannuation, differential coverage of Marketing Boards etc. However, the two series tend to move fairly closely together.
<table>
<thead>
<tr>
<th>Year</th>
<th>Net Lending by Households</th>
<th>Net Borrowing by Corporate &amp; Fin. Enterprises</th>
<th>Net Borrowing by Public Authorities</th>
<th>Net Borrowing from Overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I</td>
<td>II</td>
<td>III</td>
<td>IV</td>
</tr>
<tr>
<td>1973-74</td>
<td>4.66</td>
<td>1.50</td>
<td>1.83</td>
<td>1.14</td>
</tr>
<tr>
<td>1974-75</td>
<td>7.85</td>
<td>2.99</td>
<td>4.43</td>
<td>1.58</td>
</tr>
<tr>
<td>1975-76</td>
<td>4.34</td>
<td>0.91</td>
<td>4.46</td>
<td>1.22</td>
</tr>
<tr>
<td>1976-77</td>
<td>3.30</td>
<td>1.42</td>
<td>4.06</td>
<td>2.30</td>
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<td>1977-78</td>
<td>4.39</td>
<td>1.60</td>
<td>4.78</td>
<td>2.67</td>
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<td>1978-79</td>
<td>4.13</td>
<td>1.21</td>
<td>5.79</td>
<td>2.90</td>
</tr>
<tr>
<td>1979-80</td>
<td>3.02</td>
<td>1.18</td>
<td>3.31</td>
<td>1.06</td>
</tr>
<tr>
<td>1980-81</td>
<td>2.36</td>
<td>2.82</td>
<td>2.83</td>
<td>3.64</td>
</tr>
<tr>
<td>1981-82</td>
<td>2.85</td>
<td>5.82</td>
<td>3.09</td>
<td>5.79</td>
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<td>1982-83</td>
<td>5.31</td>
<td>3.77</td>
<td>5.41</td>
<td>4.51</td>
</tr>
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<td>1983-84</td>
<td>5.54</td>
<td>1.19</td>
<td>6.66</td>
<td>3.73</td>
</tr>
<tr>
<td>1984-85</td>
<td>4.69</td>
<td>2.05</td>
<td>5.71</td>
<td>5.00</td>
</tr>
<tr>
<td>1985-86</td>
<td>4.69</td>
<td>2.48</td>
<td>5.71</td>
<td>5.92</td>
</tr>
</tbody>
</table>

*1984-85 and 1985-86 largely estimated. The differences between columns I plus IV and II plus III equals the Statistical Discrepancy.

Source of Data: Treasury Round-up (June 1986) (from chart 4 p.82).
of trade is of concern, the decline "is not new in Australia. On three occasions during the 1970s (1971, 1974 and 1977) we experienced declines in our terms of trade of a similar magnitude to that which has occurred over the past year. Further, the 1985-86 budget forecasts incorporated "... a marked decline in the terms of trade ...". It was clearly not unexpected."4 In how far our present problems can be attributed to government mismanagement will be discussed at a later stage. An attempt will be made here to put the terms of trade decline in an historical perspective and to examine its effect on the current account.

Figure 3 shows the volatility of Australia's terms of trade over the decades. Mr Howard's office is obviously right when they point out that Australia's terms of trade have declined substantially on three other occasions in the seventies - though on only one of these occasions (in the four quarters ending 1971:1) was the percentage decline as great (13.45) as in the twelve months to March 1986.5 It is also clear that by historical standards, the buying power of our exports is now extremely low - in fact, lower than in the depth of the depression of the thirties and only equalled by the very much lower terms of trade in 1943 - during World War II when a good deal of Australian production of exportables (e.g. wool and wheat) was destined for rapidly growing stockpiles.


5 The percentage declines for the relevant four quarter spans in 1974/75 and 1976/77 being 10 and 11 per cent respectively. This was originally written before the June quarter National Accounts were available. The 12 months June-on-June decline in the terms of trade was 11% and the March-on-March decline was revised downwards from 13.4 to 12.7%.
How much of the recent deterioration in the current account deficit can be attributed to this severe decline in the terms of trade? The estimates of the terms of trade loss produced by the Reserve Bank are substantially lower than those produced by Treasury (and the ABS). This is partly, but not wholly, the result of differences in the base periods used for purposes of comparison. In the time available, I have not been able to resolve the reasons for the remaining differences; they may stem from estimating the effects on the levels and on the changes in the balance of trade respectively.

According to the June 1986 Treasury Round-up "It is clear that the deterioration in Australia's terms of trade since December 1984 has added substantially to Australia's current account deficit". If export price increases had kept pace with import price increases over this period, the March 1986 (seasonally adjusted) quarterly current account deficit would have been little more than half the actual outcome ($1.7 versus $3.3 billion).

The Reserve Bank uses a technique developed by the IMF to decompose the change in the balance of trade and services, as between a volume effect, a terms of trade effect, a price effect and a residual. Table 2 shows this decomposition of the changes in the Australian balance of goods and services for the calendar year 1985 and for the March quarter of 1986.6 The table shows how the deteriorating terms of trade have undermined what would otherwise have been quite healthy improvements in the goods and services deficit of our balance of payments resulting from volume

6 I am indebted to John Veale of the Reserve Bank for these decompositions.
# Table 2

**Contributions to Changes in Current Account**

<table>
<thead>
<tr>
<th></th>
<th>Calendar Year 1985</th>
<th>March Quarter 1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume effect</td>
<td>+1623</td>
<td>+1176</td>
</tr>
<tr>
<td>Terms of trade effect</td>
<td>-2299</td>
<td>-509</td>
</tr>
<tr>
<td>Average price effect</td>
<td>-741</td>
<td>0</td>
</tr>
<tr>
<td>Residual</td>
<td>-36</td>
<td>2</td>
</tr>
<tr>
<td>Change in balance of goods and services</td>
<td>-1454</td>
<td>+669</td>
</tr>
<tr>
<td>Percentage change in terms of trade</td>
<td>-6.31</td>
<td>-4.61</td>
</tr>
</tbody>
</table>

* The base period for the first column is calendar year 1984 and for the second the December quarter 1985. Hence these estimates - apart from being compiled on a different basis to the estimates in the June 1985 Treasury Round-up - use different base periods.

Source of Data: Reserve Bank of Australia.
effects - i.e. from increases in the volume of exports and/or reductions in the volume of imports. 7

A substantial part of this volume effect so far has been the result of a growth in exports. But can the volume effects and the terms of trade effects be treated so separately? Shann has suggested that some (a substantial part?) of the terms of trade decline is the result of the depreciation of the SA and the subsequent growth of Australian exports. He argues that "Australia can and does now influence the world price of commodities such as wool, steamng coal, alumina, iron ore and mineral sands. One could possibly add to that list aluminium, (......) uranium and coking coal. These commodities cover 40% of our exports" (Shann 1986). Shann could have added beef as well, bringing the total up to around 45%.

According to a paper being given at this Conference using the ORANI model for simulation purposes, a 21.5% real devaluation can be expected to turn the terms of trade against Australia by 6.5% over a two year period (Fallon and Thompson, 1986, Table 3.2). Given that ORANI is often regarded as being unduly sanguine about the export elasticities facing the economy, that terms of trade deterioration estimate may be regarded as conservative by some.

7 The "average price effect" given in the table is also of some interest. When imports exceed exports and this produces a depreciation of the currency by, say x% the balance of goods and services will, other things being equal, rise after the depreciation. This will be so simply because both export and import prices will tend to rise by \[\frac{x}{(100-x)}\] (given the depreciating currency belongs to a small economy). Hence the gap will, in the first instance, rise by that percentage - though of course in terms of other currencies, the deficit has not changed.
If the elasticity of demand for exports is less than infinite, it pays the exporting country to impose carefully calibrated export taxes to improve its terms of trade. This has been clearly established in the theoretical literature. Given that we still have a good deal of restriction of imports through tariffs and quotas, we are in fact imposing some implicit rough and ready export taxes - without calibrating them according to the differential elasticities of demand facing different export industries.

However, there are some weighty practical arguments against such taxes. Such export taxes should vary over time - given that the longer-run export demand elasticities are likely to be a good deal greater (in absolute amount) than the short-run elasticities. Further, export taxes could provoke retaliation. They also represent a bizarre policy response at a time when we urgently need all possible export income. But it is worth bearing in mind the possibility of "immiserising growth" as we increase exports - and in the process turn the terms of trade against us.  

(d) The Level of Economic Activity

The last time the current account deficit reached present levels was in the first half of 1982 - when it amounted to 6.3% of GDP. Within a year this deficit had been brought down to 3.7% - a startling reduction of 2.6 percentage points. This substantial improvement was basically achieved by the economy going into a tailspin.

---

8 For a reference to the (extensive) literature on this issue see Corden, (1974, Chaper 7) which also sums up the major issues.
9 When the elasticity of the demand for exports for any product drops below unity, export income can be increased by actually reducing export volumes. Such very low short-run export elasticities are not beyond the bounds of possibility. See BAE (1985).
In 1982/83 manufacturing output fell by 11% and investment in equipment decreased by 14%. Unemployment rose from under 7% in June 1982 to over 10% in the first half of 1983.10

One obvious way of improving our current account then is by deliberately throttling back the level of economic activity. This notion is in the minds of those who accuse the government of pursuing a high growth - high risk strategy. Mr Bob White, the Managing Director of Westpac and Chairman of the Business Council of Australia was speaking for many in the business and financial communities when he said that the Federal Government "might have to help push the Australian economy into recession .... as a long term solution of it's growing trade problems" (reported in The Age, 11 July 1986). One cannot disagree with Mr White that this is a short term option which would be effective; one can disagree strongly with the suggestion that it is a long term solution, it can only be regarded as an effective short term palliative. For one thing, the decline in investment which accompanies a recession tends to postpone the restructuring and re-equipment at least of import-competing sections of the Australian economy - a restructuring and re-equipment which is necessary for us to find our new comparative advantage under the changed and more hostile trading environment we now face.

However, it has to be recognised that a recession can assist the current account quickly. The more such radical trade unions as the plumbers resort to industrial action to obtain large wage increases - wage increases which would necessarily flow on to

10 The whole of this improvement in the current account deficit may not have been the result of our low level of economic activity. The Dixon/McDonald paper - discussed below - suggests that only a small proportion of the improvement was the result of the low level of economic activity. For reasons given later their case seems to me not entirely convincing.
more moderate trade unions - the greater will be the pressure on government to throttle back economic activity in general and employment growth in particular.

(e) **The Changing Competitiveness of Australian Industry**

Changes in the competitiveness of Australian industry resulting from differential productivity, inflation and nominal exchange rate movements can be expected to have substantial longer-term effects on our trade balance. A major difficulty here is that we have very little useful information on the length of the lags involved. There will be a great variety of lags in the different industries - depending on the nature and length of contracts in existence, on the level of stocks, of surplus capacity and of the length of time required to add to capacity - just to mention some of the relevant variables.

Nor have attempts to econometrically estimate lags for aggregate imports (or exports) fared any better. Perhaps one example will suffice. During a 1979 Reserve Bank Conference on a paper by Macfarlane on the Balance of Payments, H.N. Johnston (then of the National Income Forecasting group in the Treasury) argued that "Our econometric work suggests that the lags between movements in our competitiveness and their reflection in the imports ratio are much longer than Macfarlane concludes from his graphical analysis. If our results are correct, the major part of the effect on imports of our improved competitiveness of recent years has still to occur. Our current equation implies that there is a lag of about 2 1/2 years before movements in relative prices have half of their long run effect on the flow of the volume of imports." Macfarlane replied: "The equation has not been put to the test yet. It is really only during 1979-80 that improvements in competitiveness should show up as a fall in the imports ratio according to Johnston's equation." According to later information
fall in the imports ratio according to Johnston's equation. According to later information from Johnston (private communication) when the equation was put to the test it was found wanting! Nor is this an isolated example.

There is a strong presumption that the effect of a real depreciation on the goods and services balance will be larger the longer the real depreciation lasts, while the short-run, or "impact" effects of a depreciation may well be negative. It is also necessary to distinguish between changes in the current account in the depreciating currency and in the other currencies. Arndt and Dorrance (1986) discuss this issue. The perverse negative effect results partly from the price effects mentioned earlier (Footnote 7), partly because of differing currencies used in export and import trade respectively,\(^\text{11}\) and finally because short run elasticities are normally considerably smaller than those ruling over longer periods.

A study being presented at this Conference by Martin and Shaw using the BAE's EMABA model suggests that it will take two years before a sustained depreciation will result in any "real" increase in foreign exchange earnings from Australian agriculture and that a sustained 10% devaluation will raise agricultural $A earnings by a peak of only 12.7% after four years.\(^\text{12}\)

\(^{11}\) This is the current rationale for "J Curve" effects. See Krueger (1983). For some evidence on the currencies used in Australian trade, see Jenny Gordon (1986). See also The J-Curve by H.W. Arndt and G. Dorrance (1986). Arndt and Dorrance label the price effect, RBA's "valuation effects".

\(^{12}\) According to W. Martin and I. Shaw (1986) a 10% devaluation will lead to increases in $A export values of 9.6% (year 1); 10.6% (year 2), 12.4% (year 3), 12.7% (year 4), 12.6% (year 5) and 12.4% (year 10). The model includes wool, sheepmeats, beef and grains and accounts for around three-quarters of Australia's agricultural output.
On the other hand, Dixon and McDonald's recent study of Australia's foreign debt, contains a decomposition of changes in the balance on goods and services over the last eight years, which suggests that changes in the real exchange rate have a substantial effect on Australia's competitive balance of trade performance after about 12 months.13

Whatever the lags involved, the improvement in the competitiveness of Australian industry obviously represents the most important means at our disposal to improve the current account in the longer term.

(f) The Dynamics of Debt Accumulation

Australia's foreign debt has been increasing very markedly in recent years. As a result, debt servicing has become an increasing drain on our export earnings - raising questions of the sustainability of the current debt and in particular of its rate of increase. Existing stocks of domestic and foreign securities need to be willingly held. If the external borrowing requirement keeps growing and shows no signs of correcting itself - either as a result of the operation of market forces or because of an effective change in policy settings - the risk premia required to hold local securities will increase, causing a growing gap between local and overseas real interest rates.

13 "Australia's Foreign Debt: 1975 to 1985" by Peter B. Dixon and Daina McDonald, Australian Economic Review 2/85. See particularly Table 3 and Chart F. While the decomposition of changes in the trade balance is imaginative and useful, I have some misgivings about the small effects shown for the relative growth effect (Table 3, column 7). This could be the result of the assumption that imports grow proportionally with changes in Australia's real GDP growth rate. If the relative growth effect in the decomposition is under-estimated, this will influence the magnitude of the other effects, including that for Australia's competitive performance.
The very large growth in indebtedness in the second half of 1981 was not perceived to raise a sustainability problem - partly because the foreign debt at this stage was very much smaller but also because the indebtedness was incurred largely as a result of a resource investment boom which - it was believed - would more than service the extra external indebtedness.

The situation now is very different. The massive deterioration in our terms of trade, the low levels of savings and high level of public borrowing all increase the risks incurred by those lending to us now. Dixon and Mcdonald's analysis of the growth of Australia's foreign debt/GDP ratio distinguishes between active and passive debt accumulation. Active accumulation occurs when Australia undertakes new borrowing to finance a current account deficit, whilst passive accumulation is the result of interest payable on previously incurred debt plus the increase in the $A denomination of foreign debt resulting from the devaluation of the $A.\textsuperscript{14} Until 1985 Australia's borrowing to finance current account deficits was largely responsible for the growth of the Australian external debt/GDP ratio. In calendar year 1985 - for the first time - the passive increase in the debt-GDP ratio, became the major factor - accounting for almost 70\% of the increase in that ratio. At such a point a substantial improvement in the trade (and services) deficit needs to be on the horizon - otherwise questions about the sustainability of current trends are quite inevitable. In the normal course of events the very large depreciation of the $A would have led to the necessary improvements;

\textsuperscript{14} Devaluation of the $A will increase such foreign debt as is incurred in foreign currency - when expressed in $A - though not the $US or S.D.R. value of such foreign debt.
however, the concurrent massive deterioration in the terms of trade has not only prevented any improvements in the trade account, but has actually led to a further deterioration. Unless there is a pretty substantial improvement in the trade account, continuing questions about our increasing debt are unavoidable.

5. An Assessment of Government Policies

(a) The Benefit of Hindsight

The preceding list of factors associated with our unsustainable current account deficit provides us with both an indication of what can be done to improve the current account balance and also with factors beyond the control of government. Thus the very severe decline in our terms of trade was largely outside our control.

An agricultural trade war between the US and the Common Market was bound to hurt us - as was the breakdown of the OPEC cartel of oil prices - given it's obvious spill over effects on related energy prices. (It remains to be seen how long the very recent re-emergence of OPEC lasts).

While "a marked deterioration in the terms of trade" was forecast in the 1985-86 budget, the dimensions of the actual decline were substantially greater than expected at the time.

To cope with the current account problems perceived at the time of the 1985-86 budget, the government (1) budgeted for a reduction in its net demand for funds (2) through the float of the $A assisted in improving the competitiveness of Australian
industry (3) aimed to convert the nominal depreciation into a real depreciation by negotiating a 2% discount of wage rises with the trade union movement in Accord Mark II. Finally, in response to further falls in the $A in October/November 1985, the government tightened monetary policy with the twin aim of reducing the level of economic activity and raising local interest rates - thus making it more attractive for foreigners to lend to us and for Australians to borrow overseas.

We need to judge these policy settings in the light of what looked sensible at the time. With the benefit of hindsight - that most incisive of all tools of economic policy analysis - it is obvious that the government's fiscal and wage policies have not been sufficiently restrictive. However, that is not how independent observers saw it at the time. Let me just cite two examples. First, let me take that most strident present critic of the government, the Business Editor of the Age, Terry McCrann and his evaluation of Accord Mark II on the day after it was announced - 5th September 1985. In a column headed "Keating's shrewd deal delivers long-term relief", McCrann welcomed Accord II with open arms and such comments as: "the trade off comes close to the best possible solution in the imperfect world in which we live" and "even the productivity deal - at first glance a sizeable additional boost to unit labour costs - is in fact a very shrewd plus".15

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15 Space prevents me from a more detailed paraphrase of the column, which the interested reader can examine in the 5 September 1985 edition of The Age.
Second, let me refer to Max Corden's evaluation of the current account situation in mid-December 1985 - when he wrote three lengthy articles on the Australian economy for the Australian Financial Review (published on the 18, 19 and 20th December 1985). The editors headed the first of these articles "Australia's current account crisis is greatly exaggerated" and the series contains such judgements as "It is quite wrong to say that we have an out-of-control current account or debt level ..... the basic cause is the public sector's borrowing and this is being reined in" and "even more wage moderation and discounting for the depreciation would obviously be even better, but there are blessings to count".

These comments are not reproduced here in any gloating fashion to indicate how wrong informed observers of the economic scene were. I am sure if someone went to the trouble to examine my writings - or recorded interviews - over the period, similar instances of crass over-optimism could be produced. The point is simply that one should judge government policy - not with the great benefit of hindsight - but in the light of what looked reasonable at the time. In that light government actions during the second half of 1985 (including the Budget, Accord Mark II and the tightening of monetary policy later) appeared reasonable and responsible changes to the emerging situation. However, as Fallon and Thompson's paper makes clear, discounting by only 2% did not in fact discount for the full effects of the depreciation the Accord Mark II was designed for.

Until the beginning of 1986, the policy settings seemed not unreasonable. One could expect that the $A depreciation would gradually do its work and the turn-around in the current account deficit would become increasingly marked during the first half of 1986 (as was expected in the 1985-86 Statement No. 2 - p.73). I think the basic blame
which can be levelled at government is the lack of fiscal action during the first six months of 1986 and the lack of recognition (until very recently) that further wage discounting is necessary to turn the current account around. In the absence of such discounting the necessary adjustments have to rely solely on the level of economic activity and of employment.

One can also criticise the Hawke government’s tendency to make long-term commitments - commitments which substantially limit its freedom of action in case of unforeseen (and unforeseeable) changes in circumstances. The rapidly changing external circumstances make it very unwise that the Labor party attempt to fulfill it’s obligations under Accord Mark II; the same may yet apply to the obligations incurred under the trilogy.

(b) *Was the Float A Mistake?*

The large depreciation of the $A has led to inevitable questioning of the wisdom of the government’s original decision to float the Australian dollar. Nor is disenchantment with completely freely floating exchange rates restricted to those normally critical of the free operation of markets. Thus there was the Group of Five countries’ (the US, Japan, Germany, the UK and France) decision to undertake sizeable co-ordinated intervention to appreciate the value of non-dollar currencies against the US dollar during part of 1985.

Again, a recent Working Paper by Atkinson and Chouraqui of the OECD questions “the costs associated with large swings in real exchange rates” which are as likely to result in increasing misalignments as in corrections. “To the extent that
investment and resource allocation decisions, which cannot be easily modified, are taken ... reflecting unsustainable real exchange rate movements, these may entail serious real costs" (Atkinson and Chouraqui 1986).

In spite of these increasing misgivings in some quarters, both the float of the $A and the very substantial depreciation of our currency seem to me to be generally desirable phenomena. The float has probably prevented large speculative profits being made at the expense of the authorities. The float also "buys time" to correct trade (and services) imbalances. On this occasion this time was not well used - or the greater than expected terms of trade deterioration nullified the actions taken. The very substantial depreciation of our currency is desirable because it is providing us with the best opportunity we have had for a long time to discover where our true comparative economic advantage lies.

During the years of successive Fraser governments in Australia, the dominant macro-economic strategy was to "fight inflation first". As Malcolm Fraser put it in April 1985, "We used to keep the dollar value a little higher than the market might have justified, as an anti-inflationary device" (White and Kemp 1988). The maintenance of an over-valued exchange rate bore down, not only on the growth of prices, but also on the level of profitability in exporting and import competing activities with very undesirable consequences for our longer term economic structure.

According to my ANU colleague Adrian Pagan, the overvalued exchange rate of the seventies "cannot be ignored as an important contributing factor to Australia's poor growth performance during the decade - particularly given the much better results achieved elsewhere". The eminent Massachusetts Institute of Technology economist
Rudi Dornbusch - during the ANU-Brookings conference on the Australian economy - expressed the belief that the difference between productivity growth in Australia on the one hand and Japan and Europe on the other may have been due to the fact "that the high-growth European countries and Japan have used a systematic exchange rate undervaluation to get export-led growth throughout the 1960s". Against this background the slide of the Australian dollar does not look like the unmitigated disaster it is so often painted. Rather, it presents Australia with an opportunity to pursue more outward-oriented economic policies; to discover where our true comparative economic advantages lie.

(c) **Import Restrictions?**

At a time when we desperately need reduced import expenditure and expanded export revenue, it is not surprising that those who have resisted the trade liberalisation which has taken place in Australia over the last dozen years or so, should resume the battle. If the measures currently in train - i.e. the massive depreciation of the Australian dollar, the marked slowing down of the level of economic activity, the slow-down of wage growth, the reduction of the demand for funds from the public sector - prove inadequate, the pressure for import restrictions is likely to become even greater. Restrictions could take two forms - non-discriminatory or restrictions on imports of consumer goods only. The latter amount to only 20-odd per cent of total imports. The 1986 budget has taken some further minor actions against luxury car imports.

The main argument in favour of import restrictions would be that they represent a quicker, surer, and less painful method of turning the current account deficit around. They might be regarded as surer. Whether they would really be less painful is very
much open to question. More importantly, they would represent an admission of defeat in the attempt to diversify Australia’s export potential - since it would be the potential new export manufacturing (and other) industries which would be particularly disadvantaged by the excess costs imposed by import restrictions.

As Statement No.2 in last week’s Budget puts it: While the size and urgency of the imbalance might be seen as justifying almost any means to increase exports and reduce imports, efficiency criteria cannot be overlooked. If resources are directed into import replacement or export activities which need to be highly protected or subsidised, living standards in the economy as a whole would necessarily be lower than if the same adjustment to the balance of payments were achieved by the expansion of export and import-competing industries that are internationally competitive.”

The germ of truth in the position of those who want to use non-market solutions to our problems becomes clear when we re-examine the historical terms of trade series in Figure 3. In 1943 Australia coped with worse terms of trade than in the depression - or those ruling now. It did so essentially in a command economy with very tight controls of all kinds - manpower, capital issues, rationing etc.. This is a very different proposition from using only import restrictions.

John Maynard Keynes - not an unalloyed admirer of allowing market forces a completely free rein - put it as follows in his chapter on Mercantilism in the General Theory: “Contemporary experience of trade restrictions in post-war Europe offers manifold examples of ill-conceived impediments on freedom which, designed to improve a favourable (trade) balance, had in fact a contrary tendency. ..... There are presumptions of a general character against trade restrictions unless they can be justified on special grounds ..... a policy of trade restriction is a treacherous instrument
even for the attainment of its ostensible object, since private interest, administrative incompetence and the intrinsic difficulty of the task may divert it into producing results directly opposite to those intended" (Keynes, 1938).

6. Some Concluding Comments - Why Is the Necessary Depreciation so Large
OR Is Australia a Banana Republic?

In conclusion let me return to the brooding pessimism about the balance of payments which characterised Australian economic policy discussion in the fifties and early sixties. I believe there ARE good reasons why the improvement in the competitiveness necessary for a given improvement of the Australian current account may be substantially greater than that for the typical OECD economy. A previous generation of economists used the concept of "the elasticity of the balance of payments" to refer to the changes in the exchange rate required to correct a given deficit.\(^{16}\)

Gottfried Haberler pointed out almost four decades ago "that the danger of international demand being not sufficiently elastic is greatest in the case of highly specialised countries which have a near-monopoly in their principal export goods and are unable to substitute easily and to a large extent home-produced goods for imports. Agricultural countries, especially in the tropical zone, are most likely to be in that category" (Haberler 1949).

\(^{16}\) See Lloyd Metzler (1948).
Basically there are three reasons for Australia's "elasticity of the balance of payments" being relatively low. While we do not have "a near monopoly" in our principal export goods, the short run demand confronting many of our major exports may be fairly inelastic.

Secondly, the relative absence of intra-industry trade and the lack of domestic substitutes for a large proportion of our imports renders the demand for these imports less elastic than for the typical OECD country. Natural protection - in the form of high transport costs - and man-made protection are important reasons for this state of affairs.

Finally, the existence of wage indexation and the rumblings in the trade union movement over the need for continued wage restraint for quite some time militates against any rapid seizure of new investment opportunities - investment opportunities which may prove only temporarily profitable because of subsequent wage breakouts. Many in the business community lack confidence that the current competitive edge which depreciation has given them, will last long enough to recoup any investments made on the basis of the present real exchange rate.

Hence, in a very important economic sense Australia may then be a type of banana republic where large swings in the real exchange rate can perhaps be required to correct balance of payments disequilibria of a given magnitude.
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