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Australia’s Current Account Deficit:
Past, Present and Future

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Economics, Commerce and Industrial Relations Group
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Australia’s Current Account Deficit: Past, Present and Future
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## CONTENTS

1. Introduction and Summary ........................................... 1

2. Definitions .......................................................... 2

3. Historical Evolution .................................................. 3

4. Forecasts and Outlook ................................................ 7

5. The Policy Debate ..................................................... 10
   5.1 The "Problem" of the Current Account Deficit .......... 10
       5.1.1 The "Risk Premium" Issue .......................... 10
       5.1.2 Currency Depreciation ............................. 10
       5.1.3 Vulnerability to External Shocks ................. 11
   5.2 Policy Responses to the Current Account "Problem" ..... 11
   5.3 Why the CAD may not be a Problem ..................... 12

6. Policies to control the CAD: Simulations with the Murphy Model ............................................. 14

7. Conclusions ......................................................... 16
1. Introduction and Summary

Australia's Current Account Deficit (CAD) is again becoming the subject of intensified attention from the business community, both local and offshore, as well as from the media, economists and political leaders. After falling dramatically, in both absolute terms and as a percentage of GDP, in 1990-91 and 1991-92 it has followed an upward path since then; as well, the trend increase has accelerated in the last several months. There is a widespread view that the Budget Papers' forecast for the CAD in 1994-95 of $18 billion (4 per cent of GDP) will substantially underestimate the final outcome. However, most forecasts indicate that the CAD will not, in the next few years, reach the peaks recorded in the 1980s.

Some do not consider the CAD to be an economic problem at all; this view is often called the "Pitchford line". It argues that the CAD will often reflect sensible private decisions about investment and saving. However, for those who do regard it as a worrying concern, as seen for example in the FitzGerald Report on national saving, this trend has prompted calls for immediate policy action to prevent a recurrence of the mistakes and problems of the late 1980s. This view argues that Australian economic growth can only be sustainable if the "CAD problem" is dealt with. Particular support is given to efforts to increase national saving though reduced public sector budget deficits and higher private saving.

The Federal Government has been resisting calls for an acceleration in its Budget deficit reduction program although monetary policy has been decisively tightened through recent increases in official interest rates. In this context, it is opportune to present an overview of the evolution of the CAD and to discuss some forecasts about its future course. This is followed by some discussion of the policy debates surrounding the CAD.

For those regarding it as a problem to be best avoided, the paper also includes some simulations using the Murphy Model, a macroeconomic model of the Australian economy, which cast light upon alternative macroeconomic policy approaches to containing and reducing the CAD over the next several years. These results indicate that fiscal policy should be the principal weapon if the CAD is to be controlled. They also point to the dangers of repeating the situation of the late 1980s when too much reliance was placed upon the use of monetary policy tightening which operated through higher interest rates.

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1. Macroeconomic policy is that set of policy actions designed to guide the general course of the economy; it includes monetary policy (the manipulation of financial conditions) and fiscal policy (the manipulation of government taxation and spending levels) but can also include wages policy (e.g. the Prices and Incomes Accord) and policies aimed at influencing international transactions (such as interventions in the foreign exchange market or controls on foreign capital flows).
2. Definitions

This paper uses the official definitional framework for the components of the current account as outlined in the Background Paper, *Easy Guide to the Balance of Payments* published by the Parliamentary Research Service².

In summary, the current account records transactions between Australian residents and non-residents in goods, services, income and unrequited transfers. Its major components are as follows:

*The Balance of Trade:* The largest items in the current account are imports and exports of goods; the difference between the value of exports and that of imports is termed the "balance on merchandise trade".

*The Net Services Component:* This consists of revenue from provision of services to non-residents minus spending on services supplied by non-residents; items such as freight and insurance, transport services and tourism are of most importance here.

*The Net Income Component:* This consists of interest, dividends and royalties paid overseas less what is received from overseas.

*The Unrequited Transfers Component:* These are one-sided transactions in the sense that they are not always reciprocated. Examples are the funds which migrants bring with them, the funds which migrants send to family living overseas, funds Australia pays out in foreign aid, pensions to Australian citizens living abroad, and tax revenue received from foreigners.

*The Balance on Current Account* is calculated by summing the balance on merchandise trade, net services, net income, and net unrequited transfers. The "flip side" of the current account, the other side of the balance of payments, is *the Balance on Capital Account*; this shows the corresponding changes in claims on the rest of the world (Australian assets) and obligations to the rest of the world (Australian liabilities). A deficit (or surplus) on the current account will be exactly offset by a surplus (or deficit) on the capital account — with the help of the "balancing item" which takes account of the inevitable measurement errors made over the other items in the balance of payments.

Another important point to note is that the balance on current account can be shown to be exactly equal to the difference between the level of national investment (public plus private) and the level of national saving (public plus private). A CAD arises when national investment exceeds national saving while a surplus on the current account arises when national saving exceeds

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national investment. Public sector saving is defined as the difference between public sector revenue and the sum of transfer payments, public sector interest payments and public sector consumption spending (on wages, materials, property rentals and similar items) while private sector saving is defined as the difference between private income and private consumption, in both the household and business enterprise sectors.

3. Historical Evolution

Table 1 and Graph 1 show the record on the CAD and its components since 1949. Both show the CAD in absolute terms as well as a proportion of Gross Domestic Product (GDP). The latter statistic is considered a very measure especially when making time series comparisons because it takes into account the growth in National Income over time and also allows for inflation.

The data indicates that Australia has experienced a deficit on its current account in nearly every year since 1949. Such an outcome is quite understandable for a nation in Australia's position where our relatively high rate of economic development requires target rates of private and public investment which exceed the nation's saving ability. We expect a CAD since it is, by the way it is defined, equal to the excess of national investment (public and private) over national saving (public and private). Here, foreign saving (through a net inflow on the capital account) needs to be drawn upon to finance the extra investment. However, the substantial increase in the absolute size of the CAD since the mid-1980s is also evident; it is this increase which has preoccupied many commentators and policy makers ever since.

The evolution of the individual components of the CAD over the period 1949-50 to 1993-94 is also of significance in explaining the factors bearing on the size and growth of the CAD:-

- **The merchandise trade balance** has quite often been in surplus in this period. Many might be surprised to learn, for example, that during the 1970s merchandise trade was in surplus in every year; this contrasts with the 1980s when merchandise trade was mostly in deficit. The first three years of the 1990s returned to surplus but 1993-94 registered a deficit; the data that we have on the current financial year shows a continuation of this deficit position.

- **The net services component** has been in deficit over the whole of the period in question and until recently, displayed a rising trend. However, since the late 1980s, there has been some decline in the deficit level. Significant expansion in service exports such as inbound tourism partially explains this turnaround.
<table>
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<td>Net services $m</td>
<td>%GDP</td>
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<td>-1356</td>
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</table>

Source: ABS, Balance of Payments, (5301.0, 5302.0)
GRAPH 1
CURRENT ACCOUNT DEFICIT

Source: ABS, Balance of Payments (5301.0, 5302.0)
• The net income transfers component has shown a long term upward trend which has only been reduced over the past two years by the lower levels of world interest rates experienced in these years.

The fundamental force behind this upward trend has been the rising levels of foreign liabilities used to finance the perennial deficit on the current account; it is this aspect which has attracted the particular attention of some observers concerned about the current escalation in the size of the CAD.

The trends in net foreign debt and net equity liabilities since mid 1986 are illustrated in Graph 2. Increased foreign ownership of domestic companies and assets has been joined in the last decade by rising levels of foreign debt. This generates rising dividend and profit remittances overseas and higher interest payments to the overseas creditors of domestic borrowers.

• In contrast to the net income transfers component, net unrequired transfers have shown a dramatic turn towards surplus since the mid 1980s but an equally dramatic fall in the last two years. This seems to have been largely due to, first, the expansion in the business migration program in the 1980s and then, in turn, the recent restructuring of the program which has reduced the emphasis put upon the requirement for such migrants to bring funds into Australia.

4. Forecasts and Outlook

Graph 3 shows the most recent baseline forecasts for the CAD generated from the Murphy Model by Chris Murphy of Econtech. They forecast the CAD to be increasing steadily as a percentage of GDP until the third quarter of 1995, when it reaches 5.0 per cent, and then to be gradually declining to 3.0 per cent of annual GDP in 2002-03.

This forecast decline in the CAD arises mostly because of a forecast turnaround in public sector saving from -0.4 per cent of GDP in 1994-95 to 2.1 per cent of GDP in 2002-03; it is also based upon an assumption of short term interest rates rising to 9.33 per cent in 1998-99. Without such a projected change in fiscal and monetary outcomes, the forecast CAD would be much larger.

Similar long run forecasts have been made by other groups. Syntec Economics has forecast the CAD to peak at 5.0 per cent of GDP in 1995-96 and then to decline to 4.2 per cent of GDP in 1998-99. Overall, the consensus seems to be that, over the next several years, Australia is unlikely to see CADs of the magnitude of the 1980s when it twice peaked at around 6 per cent of GDP.
GRAPH 2
NET FOREIGN DEBT AND EQUITY LIABILITIES AT END OF QUARTER

Source: ABS, *International Investment Position Australia*, (5306.0)
GRAPH 3
MODEL SIMULATION RESULTS
CURRENT ACCOUNT DEFICITS AS % GDP

- Monetary policy change
- Fiscal policy change
- Baseline forecast
5. The Policy Debate

The increase in the absolute size of the CAD since the early 1980s has generated a lively debate in Australia about, firstly, whether an ongoing CAD of these dimensions is, in any sense, a genuine economic problem and, secondly, if it is a problem, what the appropriate economic policy response to correct it might be.

5.1 The "Problem" of the Current Account Deficit

The first predominant response to the rising CAD in Australia was to argue that it did indeed represent a very serious economic problem and that rapid corrective policy action had to be taken to control it. This viewpoint remains very prominent and vocal today. This view argues that high CADs imply high rates of accumulation of foreign liabilities (i.e. net capital inflow which is the counterpart of the CAD as noted above), especially that of foreign debt, and that such liabilities endanger the economic well-being of current and future generations.

One well-known example of this type of argument can be seen in the FitzGerald Report\(^3\). FitzGerald argued that foreign debt accumulation should be prudently controlled on a number of grounds:-

5.1.1 The "Risk Premium" Issue

With rising foreign debt levels comes a rising risk premium attached to further lending to the highly indebted country by international financial sources. This pushes up market interest rates on further foreign borrowings (with flow-on effects on domestic borrowing as well) and ensures that interest rates will keep on rising as foreign debt levels themselves continue to rise. Eventually, such new foreign borrowings become too costly to undertake so that foreign debt accumulation is no longer possible above a certain limit; investment levels and the growth potential are particularly hard hit by the resulting high interest rate regime. It is much better to take considered corrective action now rather than be forced into emergency action after this financial barrier has been crashed into.

5.1.2 Currency Depreciation

Highly indebted countries are much more likely to experience large and abrupt exchange rate depreciations as foreign financial markets suddenly mark down a currency encumbered by large debt servicing obligations. These exchange rate adjustments can impose very destabilising shocks on an indebted economy,

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especially in terms of inflation control and proper resource allocation, and thus create enormous problems for economic management within the country.

5.1.3 Vulnerability to External Shocks

High levels of foreign debt create large debt servicing obligations; these obligations magnify Australia's vulnerability to external economic shocks such as world recession, falls in our terms of trade or rising world interest rates since the required adjustments to these shocks within Australia become larger and more difficult the larger is the debt servicing burden.

Overall, the central message of the Report is that a concern for the long term national interest requires that the CAD and foreign debt accumulation be restrained to some sustainable level.

5.2 Policy Responses to the Current Account "Problem"

Over the last decade many have argued that macroeconomic policy should be employed to control the CAD; indeed, the most popular policy action put forward to restrain the CAD and foreign debt has been that of fiscal policy tightening to reduce public sector budget deficits and then to achieve budget surpluses. Since the CAD is by definition equal to the excess of national investment over national savings, many have made the simple jump to the conclusion that raising national savings by increasing public sector savings, or reducing public sector dissaving by reducing the budget deficit, must be a central policy contribution to reducing the external imbalance.

This is the well known "twin deficits" argument which essentially attributes the CAD and foreign debt accumulation to public sector budget deficits. The FitzGerald Report advocates public sector budget surpluses as a principal policy action while also advocating policies to raise household savings through increasing compulsory superannuation contributions and the possible use of tax policy changes to raise voluntary household saving.

The Federal Government's policy response to the higher CADs and foreign debt in the 1980s was initially to pursue just such fiscal policy tightening, thus seeming to indicate that it was acting on the view that the twin deficits argument was the correct approach. This policy seemed to work for a period but when the CAD again began to increase in the late 1980s the Government resorted to monetary policy tightening through higher interest rates; the public

justification for such monetary tightening was that it would be necessary for controlling both the CAD and inflation.

This episode generated debate among economists since many argued that in the context of a flexible exchange rate system (which Australia had experienced since 1983) monetary policy would be relatively ineffective in restraining the CAD. This was because higher interest rates would tend to encourage capital inflow and a higher exchange rate; this would reduce Australia's international competitiveness and have the effect of increasing imports and reducing exports. Thus the exchange rate effect would tend to nullify the power of higher interest rates to reduce the CAD directly by reducing the volume of domestic spending, and through it, the volume of import spending.

In the last few years this view that monetary policy is largely ineffective in reducing the CAD has gained the ascendancy. Today, many commentators want to see monetary policy assigned to the task of maintaining low inflation while fiscal policy bears the main burden of controlling the CAD and foreign debt through its capacity to raise national saving levels. Both forms of policy action can also contribute to keeping unemployment at sustainable levels so long as they do not lose sight of their enduring goals on inflation and the current account.

5.3 Why the CAD may not be a "Problem"

By the late 1980s there arose into prominence an even more dissenting view that in the modern global economy the balance on the current account should not generally be a goal of economic policy and that large CADs might not be an economic problem at all. This approach has become associated with the name of its most prominent proponent in Australia, Professor John Pitchford. The Pitchford view is that if public sector budget deficits are set at appropriately moderate levels then most of any CAD recorded will be due to

5. The Government's microeconomic reform programme has often been justified on the grounds that, along with increases in living standards, it can also help to contain and reduce the CAD. However, most economists are of the opinion that its effect on the CAD is ambiguous since it will tend to increase both national investment and national saving; the effect on the CAD will depend on the relative size of these two increases.

6. Indeed, some argued that higher interest rates were more likely to increase the CAD rather than decrease it: "Bewley, Ron and White, Gary, "Do High Interest Rates Improve or Worsen the Current Account?". Economic Papers, vol.9, no.4, December, 1990:19-33.


an excess of private investment over private saving. Now a central part of the argument here is to assume that governments need some good reason for arguing that such private investment and saving actions are not sensible and not in the national interest. If governments cannot come up with such arguments then they should accept these private decisions and the consequent CAD and foreign debt accumulation which are their inevitable macroeconomic manifestation.

Pitchford argues further that while there may be many conceivable reasons for questioning such decisions, these do not relate to macroeconomic policy at all; for example, distortions in the taxation system, which taxes the full amount of nominal interest receipts and allows the full amount of nominal interest payments as business tax deductions, might encourage too much investment, too little saving and thus an excessively large CAD. But here, the correct policy response is to reform the taxation system (to adjust it for the effects of inflation) and **not to employ macroeconomic policy for the purpose**.

Thus, the Pitchford approach suggests that in many circumstances the CAD and foreign debt will not be genuine economic problems because they can reflect proper private decisions on saving and investment. It also implies that even in those conditions where the CAD and foreign debt levels are not "optimal", the best policy response will generally not require the use of macroeconomic policy (so long as public sector budget deficits are not excessive), which should be left to perform its primary, difficult enough role of avoiding recessions, maintaining steady growth in output and employment and of ensuring low inflation.

Even though the Pitchford view has gained substantial support, especially amongst academic economists, the contrary view remains strong with many supporters still arguing that the CAD and foreign debt accumulation must be restrained for fear of the sorts of damaging long term consequences outlined by the FitzGerald Report. This ongoing polarisation of opinion continues to make the CAD a lively point of economic, political and policy discussion. With the CAD set to increase in the short term with strong Australian economic growth over the coming years, we can expect ongoing debate and controversy about its status as a proper goal of economic policy, especially in relation to macroeconomic policy.

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9. These appropriate levels will probably not be zero on average but at some level low enough to achieve sustainable public debt levels while still allowing public investment to be partly financed through borrowings.


11. See, for example, Max Walsh, "Why Bernie is not one in a million", *The Sydney Morning Herald*, 19 July, 1994.
6. Policies to Control the CAD: Simulations with the Murphy Model

It is possible to formally analyse the impact of various macroeconomic policies on the CAD and foreign debt accumulation with the use of a macroeconomic model. Those who regard the CAD and foreign debt as real and major economic problems will be especially interested in such work for obvious reasons. Those who do not regard them as genuine problems might look upon such analyses as at best, irrelevant and at worst, quite dangerous because they tend to divert macroeconomic policy from its proper goals of stabilising domestic economic targets.

However, these analyses also shed further light upon the 1980s controversy about the best policy strategies for containing these external deficits and are thus of relevance to the analysis of current macroeconomic policy as it enters a new contractionary phase.

In this paper, the Murphy Model of the Australian economy is used to study the effects of different monetary and fiscal policies on future levels of the CAD (as measured in terms of its percentage of GDP)\(^{12}\); two policy simulations are considered:-

- **Simulation One** assumes the Government adopts a contractionary monetary policy through an increase in short term interest rates of about 1.2 percentage points in 1995-96 above those assumed in the baseline forecasts of the Model as outlined in Section 4 of this paper, with this increase rapidly tapering back and being eliminated by 1998.

- **Simulation Two** assumes the Government adopts a fiscal policy contraction through a reduction in public sector consumption spending equal to a reduction in the net public sector borrowing requirement of about 1.2 percentage points of GDP in 1995-96 below those assumed in the baseline forecasts of the Model, with this reduction tapering off to insignificant levels by the end of the decade\(^{13}\).

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12. This is a theoretically sophisticated model which combines short run Keynesian properties with long run neo-classical properties. For example, in the short run aggregate demand and real wages affect output and employment in the Model while in the long run the crucial determining variables are factors such as growth in productivity and in the workforce.

13. Both the fiscal and monetary policy changes are forced to gradually "wear off" over several years because of the Model's assumptions about the requirements of sustainable, long run equilibrium solutions for public debt and interest rates.
The size of these monetary and fiscal policy changes seem well within the bounds of the feasible, given the recent policy experience in Australia. However, the fiscal policy contraction does seem "larger" in terms of political and administrative difficulty than the monetary policy contraction.

The results of these simulations are presented in Graph 3. The most significant thing to note is that both types of macroeconomic policy contraction reduce the CAD below the baseline forecast for several years after the policy change. This result for monetary policy is especially interesting because it indicates that, given the Model’s parameters, the direct effect of short term interest rates on domestic demand and imports is larger than the counteracting effect through capital inflow and exchange rate appreciation. These simulation results for monetary policy also agree with Australian economic history since the late 1980s: high interest rates increased the severity and duration of the recession and the CAD also fell in the following couple of years.

However, it should be noted that monetary policy has no long run, enduring effect on the CAD within the Model which contrasts with fiscal policy which does have an enduring effect on the CAD. Thus, the use of monetary policy for controlling the CAD really only makes sense as a short/medium run supporting policy if other policy instruments cannot be further used.

The second issue which is of great interest is the relative power of fiscal and monetary policy to affect the CAD in the short to medium run. Here the problem is that the monetary and fiscal policy changes have different units of measurement so that direct comparisons become problematic. One useful way to compare them is in terms of their relative power to affect various economic targets. If we take the typical targets of inflation and the CAD, then we can inspect the simulation results and arrive at conclusions about the power of the policy instrument to affect the CAD relative to its ability to affect the other target, which in this case is inflation.

These comparisons support the conventional wisdom that monetary policy has far more powerful effects on inflation compared to its impact on the CAD and, conversely, that fiscal policy has far more powerful effects on the CAD compared to its impact on inflation. For example, if we select a year such as 1997-98, then the effect of fiscal policy on the CAD is about one and a half times that of its effect on inflation while the effect of monetary policy on inflation is about four times that of its effect on the CAD. These results support the orthodoxy of the assignment of monetary policy to inflation control and the assignment of fiscal policy to control of the CAD; each policy instrument is assigned to the target it has a "comparative advantage" in controlling.

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14. Personal communication from Chris Murphy.

15. The same sort of exercise can just as easily be performed by comparing CAD control and unemployment control as the two economic targets.
These results show why many of the CAD "hawks" are worried about the current stance of macroeconomic policy. The above analysis shows that, assuming that the CAD is a problem, fiscal policy should now be bearing a large share of the burden of policy adjustment in order to keep the CAD within "manageable" limits during the current period of strong economic growth.

Thus, many perceive that the Government's present Budget deficit reduction strategy is proceeding much too slowly to bring this about. They argue that placing the burden of adjustment on monetary policy will simply repeat the mistakes of the late 1980s. Then, they argue, fiscal policy became immobilised and the inappropriate instrument of tight monetary policy (i.e. high interest rates) was used to restrain the CAD simply because there was nothing else to fight it with; the outcome was a lower CAD and lower inflation but at the cost of severe recession and much higher unemployment. The alternative policy of fiscal policy tightening might have, they argue, held out the possibility of avoiding a deep recession by bolstering net exports of goods and services since the exchange rate would have much lower (and international competitiveness higher) than the levels which actually occurred.

7. Conclusions

Australia is entering a period in which the CAD is likely to rise somewhat although most forecasts indicate that it is unlikely to reach the magnitudes recorded in the 1980s. Given this, there needs to be some resolution of the debate about whether the CAD and foreign debt accumulation are genuine economic problems and, if so, what the best policy strategies might be to attack them.

The central difficulty with the debate about "Is it a problem?" is that the definitive evidence to answer the question will only be likely to be available at some point in the future. Thus, economic historians may be able to answer the question some time in the future but this is little comfort to today's policymakers and economic players who really need the answer now in order to make the right contemporary choices.

If we extrapolate from the recent past to get some idea of the future course of policy, the Federal Government's official policy record from the 1980s seems to indicate that it regards a CAD of less than 5 per cent of GDP as tolerable but outcomes above this threshold as unsatisfactory and requiring policy correction. Since most forecasts do not predict that the CAD will go much over this threshold there may not be much occasion for such correction.

But if the CAD really does "take off", because of a boom in private sector investment or continuing large public sector budget deficits, then the policy correction may be provoked. If monetary policy is again the main vehicle for such an attack on the CAD then economic growth might be again substantially curtailed, and a recession induced, since large interest rate increases seem to
be needed to make much of an impression on the external deficit in the short to medium term.

However, these concerns all hinge on just one possible interpretation of the economic policies and events of the 1980s. There are other interpretations of this policy record. For example, in regard to the episode of severe monetary tightening in 1988 and 1989, despite the rhetoric of the time involving the CAD and foreign debt, it might be alternatively interpreted as being mostly aimed, at first, at preventing a wages "breakout" from the Accord process and then at engineering a substantial, enduring reduction in the inflation rate.

On this interpretation, the CAD and foreign debt are seen as far less important in terms of real policy priorities. If this latter view is correct then we might expect a very different future policy course. Thus, when 1) budget deficit reduction targets to achieve sustainable public debts levels have been met, 2) superannuation contribution targets to increase private retirement incomes have been achieved, and 3) monetary policy has succeeded in keeping inflation within the Reserve Bank’s informal target range of 2-3 per cent, then macroeconomic policy could simply accept whatever outcomes for the CAD and foreign debt which might be generated by private decisions on investment and saving.

On the other hand, the Government may take the FitzGerald Report to heart and seriously set out to achieve some ambitious target for national saving through the use of its fiscal and superannuation contribution policies; here, for example, budget outcomes might be much further into surplus than we would expect from the view in the previous paragraph. Only time will allow us to judge between these rival scenarios!