

Macroeconomic Policy For Recovery

Ian M. McDonald*

Abstract

The major economic problem from which Australia suffers at the present time is an excessively-high rate of unemployment. Australia also appears to have, at present, an excessively-low rate of saving. In contrast to the views of the "minimalists", who argue that government macroeconomic policy should not be adjusted to offset high rates of unemployment, it is argued in this paper that a policy for recovery is desirable. This argument is based on empirical evidence which suggests that the degree of price flexibility required for the economy to return automatically to full employment does not exist. The appropriate policy for recovery, given the low rate of saving, is an expansionary monetary policy. Indicators of monetary policy do suggest that the current stance of monetary policy is indeed expansionary. It is difficult to say whether an even more expansionary monetary policy should be adopted.

1. The Current State of The Australian Economy

Of overwhelming importance in the current state of the Australian economy is the high rate of unemployment. In June 1993, the (seasonally-adjusted) rate of unemployment for Australia was 11.1 percent. In Chart 1 the pattern of the seasonally-adjusted rate of unemployment from February 1978 to June 1993 is shown¹. From

* University of Melbourne. An earlier version of this paper was presented in a public lecture at the University of Melbourne in 1993, as a lecture in the Dean's Lecture series. The current version has been updated in the light of more recently available statistics.

the rate of about 6 percent in the late 1970's, the rate of unemployment increased to over 10 percent in the recession of 1982–83. This recession was followed by six years (August 1983 to December 1989) of a declining rate of unemployment (with a minor interruption in the period July 1986 to December 1987). However the onset in 1990 of the current recession has pushed the unemployment rate up to exceed 11 percent.

Taking a longer perspective, Chart 2 shows the record of the rate of unemployment for Australia from 1900–01 to 1992–93. The rate for 1992–93 has been exceeded in only five years since 1900–01. These were the five-year period of 1930–31 to 1934–35, the depths of the 1930's recession. The longer perspective reinforces the view that the current rate of unemployment is high.

The current recession has reduced the rate of inflation. In Chart 3 the rate of inflation (using the seasonally-adjusted GDP deflator from the June 1993 Australian National Accounts to construct the quarterly rate of inflation for the period December 1959 to June 1993) shows low rates of inflation for the last 12 quarters. The average rate of inflation over these 12 quarters is 0.3 percent, a rate which is less than the average for the low-inflation 1960's, which was 1.6 percent. The inflation rate over the last 12 quarters shows a smaller variation than the rate in the 1960's. Compared with the 1970's and the 1980's, the current rate of inflation is very low.

The current account of the balance of payments recorded a deficit, for 1992–93, equal to 3.9 percent of GDP. This is slightly greater than the average for the period 1959–60 to 1992–93 of 2.8 percent of GDP. Investment, public plus private, was equal to 19.5 percent of GDP in 1992–93, considerably lower than the average of 24.3 percent for the period 1959–60 to 1992–93.

The costs borne by people in Australia of the current high rate of unemployment are large. A high rate of unemployment indicates a waste of economic resources. Because they do not have jobs, unemployed people are not producing goods and services. In addition to this loss, there is the loss of self-esteem and fulfilment by those unemployed. While these losses fall mainly on the unemployed, they also affect the families and friends of the unemployed and may indirectly affect other people connected to the unemployed by feelings of humanity.

Chart 1
Unemployment, Australia
February 1976 to June 1993

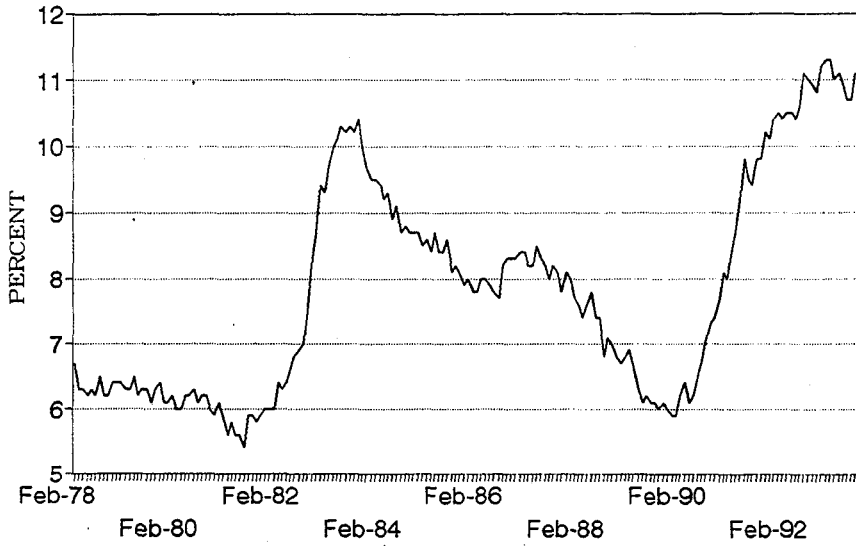
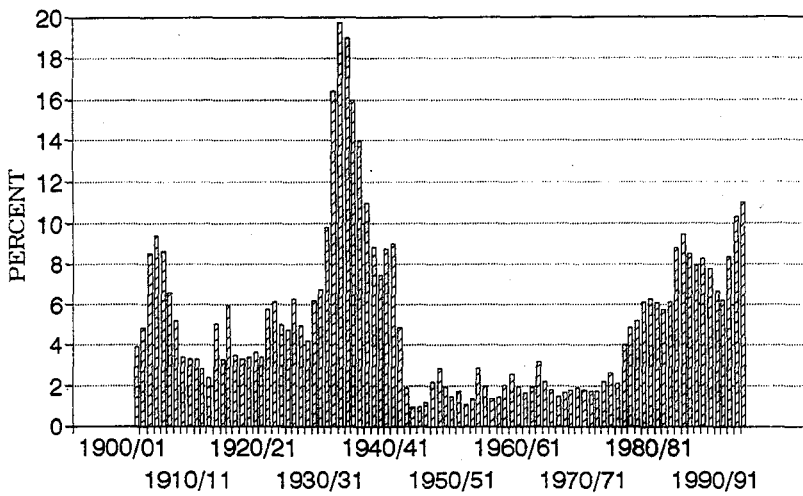


Chart 2
Unemployment, Australia
1900-01 to 1992-93



Given the current situation, what macroeconomic policy should the Australian government follow? That is, what fiscal, monetary and wages policy should be adopted? Before we discuss that question however we will discuss the prior question of whether the government should have a policy for recovery?

2. Should the Australian Government have a Policy for Recovery?

There is an important school of thought amongst economists who argue that the rate of unemployment should *not* influence the government in its setting of macroeconomic policy. A major figure in this school since the second world war has been Milton Friedman. This school of thought argues that fiscal policy should be set by a rule which yields, on average over a number of years, a "satisfactory" outcome, such as a government budget deficit which averages zero, and that monetary policy should be set to yield a nominal anchor. One example of such a monetary policy is Friedman's proposal that the rate of growth of the money supply be set at a constant rate, invariant to the rate of unemployment. Recently another example of a nominal anchor has gained some support. That example is that monetary policy should be set to maintain a fixed value of the exchange rate, again regardless of the rate of unemployment. The UK government adopted such a fixed exchange rate policy when it joined the ERM. In 1992 it abandoned this policy. More recently, France has broken its adherence to a fixed exchange rate policy. Neither country was prepared to tolerate the high rate of unemployment which appeared necessary to maintain the value of their exchange rates.

In this paper the label "minimalist policy" will be used to describe the macroeconomic policies advocated by this school. These policies are minimalist in that they seek to reduce the role of government in macroeconomic policy to a minimum.

The proponents of this school of thought argue that a minimalist policy package will exert a strong control on the rate of inflation. They point out that the post-second world war period, when governments, in setting monetary and fiscal policy, have reacted to the rate of unemployment, the rate of inflation has been generally posi-

Chart 3
Inflation, Australia
December 1959 to June 1993

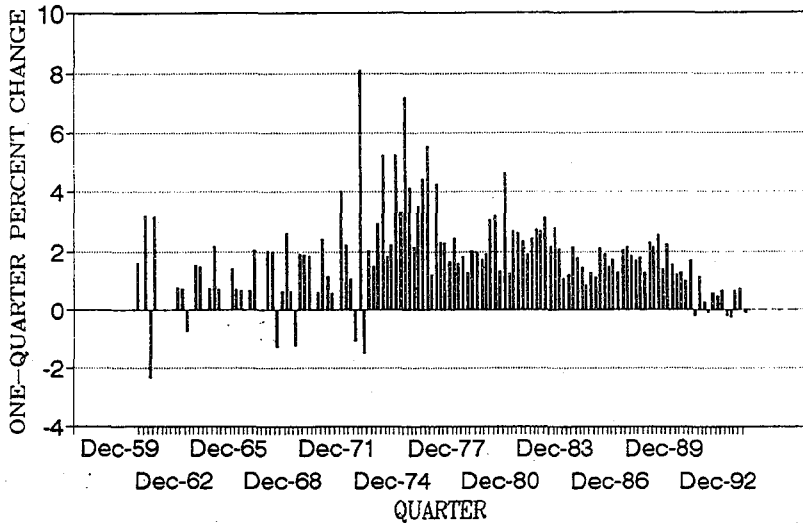
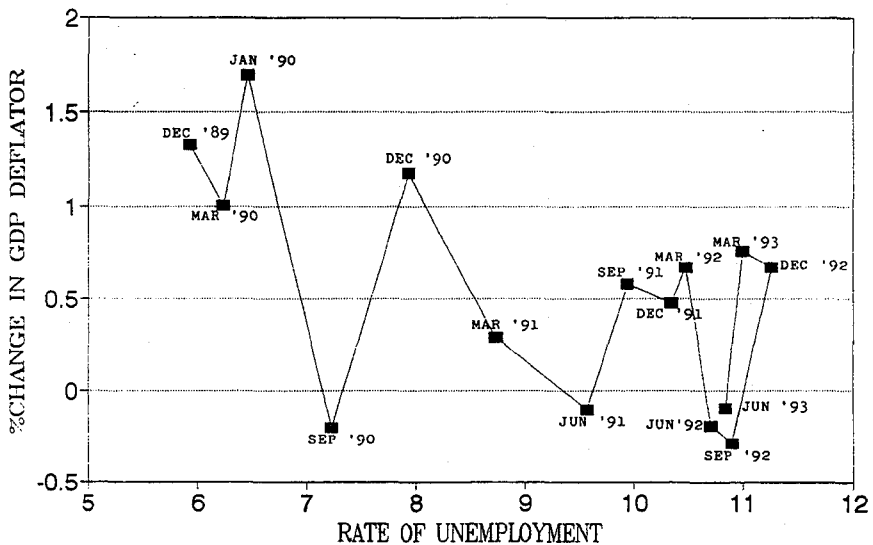


Chart 4
Inflation and Unemployment, Australia
December 1989 to June 1993



tive, in sharp contrast to the experience, as much as is known, for centuries before the second world war. The counter-argument to this school is that a minimalist policy package will lead to generally high rates of unemployment. This counter-argument is disputed by the minimalist school.

In a state of high unemployment, how can a minimalist policy package be expected to reduce the rate of unemployment? Such a package may be expected to reduce the rate of unemployment if there is a tendency for a high rate of unemployment to reduce the price level. To see how, in theory, price flexibility can produce this tendency, consider the fixed exchange rate version of the minimalist policy.

Suppose that the rate of unemployment is high and that this high rate induces declining money wage rates and declining prices. Assume that the government operates monetary policy to maintain the exchange rate. Assume also that the price level in the rest of the world is constant. The declining domestic price level will increase the international competitiveness of the economy. Firms in the export industry will be encouraged to expand output and employment. Their domestic costs will be falling with the domestic price level whilst the prices for their exports remain constant. Thus the profitability of their production is increasing, encouraging the expansion of their activities. The declining domestic price level will also encourage domestic purchasers to switch from imported goods and services to domestically-produced goods and services. This switch will increase output and employment in the industries producing the substitutes for imports. Thus through the expansion of the export industries and the import-substitution industries, employment will increase and unemployment will decline. The increasing expenditure of the people employed in these industries will stimulate output and employment in other industries. In general output and employment will expand across the economy and the rate of unemployment will decline.

If the price level in the rest of the world is declining then, assuming a fixed exchange rate, competitiveness in the domestic economy will be improved if the price level in the domestic economy declines at a faster rate than the price level in the rest of the world. Whatever the given value assumed for inflation in the rest of the world, if high unemployment in the domestic economy produces a declining rate

of inflation then competitiveness in the domestic economy will eventually improve.

An increase in the international competitiveness of the economy is not the only way by which a declining price level or a declining rate of inflation may reduce the rate of unemployment with a fixed exchange rate, minimalist policy. However there is a basic empirical weakness of the argument. That weakness is that, in practice a high rate of unemployment does not produce a persistent tendency for the price level or the rate of inflation to decline. The basic mechanism posited by the minimalist school cannot, in fact, be relied on to work.

To see the empirical weakness of the proposition that a high rate of unemployment produces a declining rate of inflation, consider, first, Chart 4. This chart shows the relation between the rate of inflation and the rate of unemployment for the period December 1989 to June 1993. The rate of inflation is expressed as a quarterly rate in order to give more detail. Unfortunately the variability in the quarterly rate makes it a little difficult to see the trends in the data. The increase in the rate of unemployment in 1990 appears to have reduced the rate of inflation from rates in excess of 1 percent. However in 1991 and 1992 the continuing high (and increasing, albeit more slowly than in 1990) rate of unemployment appears to have had little impact on further reducing the rate of inflation. That is, Chart 4 shows that two and a half years of high rates of unemployment in Australia has not been associated with a falling rate of inflation. Instead the rate of inflation has remained positive and the price level has not been declining.

The evidence in Chart 4, being for a rather short period of time, may be regarded as unconvincing. Maybe a high rate of unemployment for a longer period of time would cause a declining rate of inflation. Maybe the lack of a downward trend in the rate of inflation in 1991 to 1993 is a temporary phenomenon, caused perhaps by special but temporary reasons and that, if the high rate of unemployment continues a downward trend to the rate of inflation will appear. To gain further information consider the period in Australia's twentieth century history when there was the longest period of high rates of unemployment, that is the interwar period. In Chart 5 the relation between the rate of inflation and the rate of unemployment for Australia for the period 1921 to 1938 is shown. From that chart it can be seen that a period of high rates of unemployment of 10 years (1929

Chart 5
Inflation and Unemployment, Australia
1921 to 1938

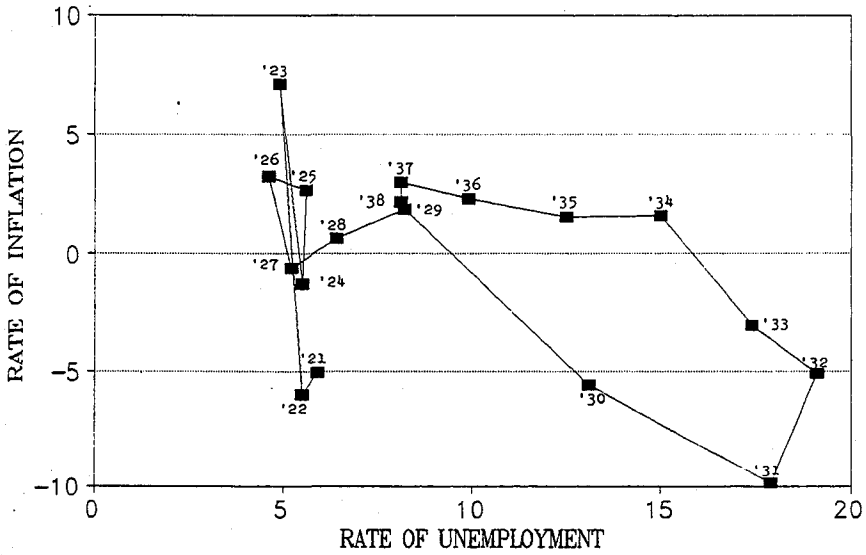
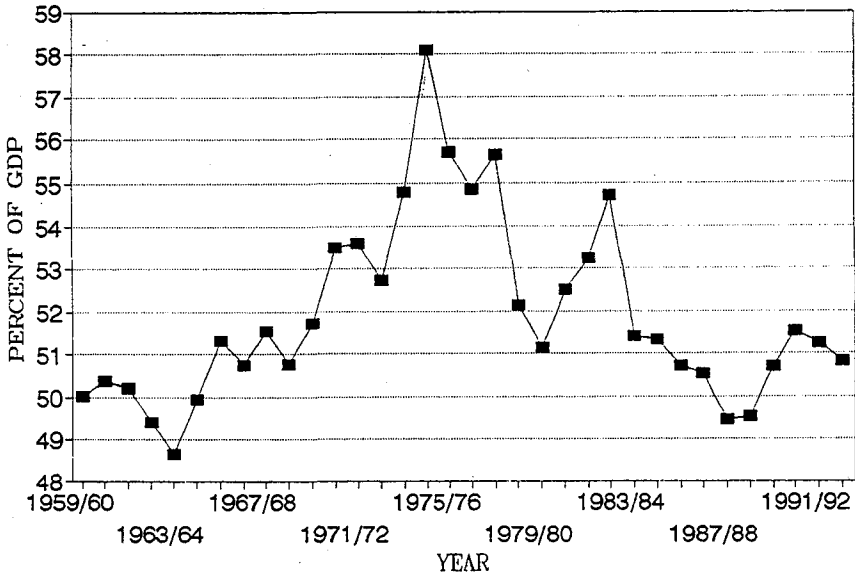


Chart 6
Wage Share, Australia
1959-60 to 1992-93



to 1938) failed to produce a declining rate of inflation. At the end of this 10 year period the rate of inflation was no lower than at the beginning. On the basis of this evidence one would not expect a persistence of the high rate of unemployment in Australia to cause a declining rate of inflation.

The interwar experience of inflation and unemployment in all of the thirteen countries for which Maddison (1991) presents data is shown in McDonald (1993) to resemble the Australian experience in that, in each of these countries the period of high rates of unemployment did not produce a declining rate of inflation. For these countries, the length of the period of high unemployment between the wars varies from 20 years for the United Kingdom to seven years for Germany. Thus they represent a lot of experience in which high unemployment persisted for many years and yet a declining rate of inflation failed to materialise.

With the lack of downward flexibility in the rate of inflation, minimalist policy will not guarantee a recovery from recession. Instead, under minimalist policy a high rate of unemployment will persist for a period of uncertain length. Of course in the past economies have recovered from recessions, even before the second world war when government economic policy was closer to the minimalist policy than it is now; that is before the second world war conscious attempts, when the rate of unemployment was high, to expand the level of aggregate demand through monetary and fiscal policy were not generally attempted. There are other events which, even without downward flexibility in the rate of inflation, will generate recovery, such as the discovery of a new source of gold, the increase of trade following the opening of the New World etc. These events are not directly caused by a recession and so to rely on them is to subject the rate of unemployment to an uncertainly-timed recovery.

3. Policy for Recovery

The lack of downward flexibility of the rate of inflation to high rates of unemployment is a strong argument for adjusting monetary and/or fiscal policy in an expansionary direction when, as at present, the rate of unemployment is high. Of course, such a policy will not reduce the rate of unemployment if the level of real wages is high enough to

be a barrier to expansion in employment. However, the level of real wages does not appear to be a constraint on employment in the Australian economy at present. In Chart 6 the share of wages, salaries and supplements in GDP is plotted for the period 1959–60 to 1992–93. The wage share in 1992–93 is not high by historical standards and is considerably less than the two periods, 1974–75 and 1982–83, when real wages are considered by many commentators to have been a significant constraint on employment. (The wage share compares the average cost of employing labour with the average product of labour. For employment decisions one should really compare the marginal cost of employing labour with the marginal product of labour. However, movements in the wage share may be regarded as a not-unreliable guide to movements in the more relevant marginal concept.)

In moving policy in an expansionary direction, the mix of monetary and fiscal policy has to be decided. By how much should monetary policy be expanded relative to the expansion of fiscal policy. One basis for deciding on the mix of monetary and fiscal policy is the impact the mix has on the allocation of resources between uses for producing current consumption and uses for producing consumption in the future. Expanding fiscal policy by cutting taxes will, by increasing disposable income, induce an increase in expenditure on current consumption and thereby increase the amount of resources used for producing current consumption. Expanding monetary policy will, by reducing interest rates, increase investment and, by lowering the exchange rate, increase exports and reduce imports. The increase in investment will increase the productivity of the economy in the future and thus will enable a higher production of consumption in the future. The increase in exports and reduction in imports will enable an increase in lending to overseas (or a reduction in borrowing from overseas) which will enable an increase of consumption in the future. Thus tax cuts enhance current consumption whilst monetary expansion enhances consumption in the future.

On this basis, to make a judgement on the appropriate mix of monetary and fiscal policy to be used to expand aggregate demand, one should consider the current level of resource usage directed at activities which will enhance consumption in the future. Call the total

amount of such resource usage thrift. For practical purposes define thrift as the sum of expenditure on investment (private and public) plus the current account surplus. (This sum is, by national accounting conventions, equal to national saving). The way in which investment and the current account surplus contribute to consumption in the future has already been described. However, it should be noted that ideally thrift should be calculated to include other types of expenditure, such as expenditure on education and health, which contribute to consumption in the future. Because of the difficulty of assessing the contribution of these categories of expenditure to future consumption, the narrow definition of thrift is used here.

The record of thrift and, as defined here, its two components, investment and the current account surplus, for Australia for the period 1959–60 to 1992–93 is shown in Chart 7. For the period as a whole, thrift averaged 21.5 percent of GDP with investment averaging 24.3 percent of GDP and the current account surplus averaging –2.8 percent of GDP. As can be seen from Chart 7, in the earlier part of the period, 1959–60 to 1974–75, thrift generally exceeded the average for the entire period whilst in the latter part of the period thrift was generally less than the average for the entire period. It would appear that there has been some decline in the provision made by Australian residents for the future. The year of the highest rate of thrift, as a percentage of GDP, was 1972–73, when thrift was 26.8 percent of GDP. The year of the lowest rate of thrift was 1992–93, when thrift was 15.6 percent of GDP. The downward drift in thrift began in 1975–76 and has continued to 1992–93, with some upward movement against the drift in 1979–80 to 1980–81 and 1986–87 to 1988–89.

In 1992–93 thrift, as a percentage of GDP, was at its lowest rate for the entire period 1959–60 to 1992–93. The decline in thrift from 1989–90 to 1992–93 was due to a large decline in investment, which declined as a share of GDP from 24.7 percent to 19.5 percent. The current account surplus moved in the opposite direction to investment but by a smaller amount, from –6.2 percent of GDP in 1989–90 to –3.9 percent of GDP in 1992–93. The tight monetary policy of 1989 has reduced the rate of thrift by a large amount.

Compared with other industrialised countries, the current rate of thrift in Australia is low. In 1991 the rate of thrift for the OECD was 20.9 percent of GDP. However there were considerable differences

Chart 7
Thrifty, Australia
 1959-60 to 1992-93

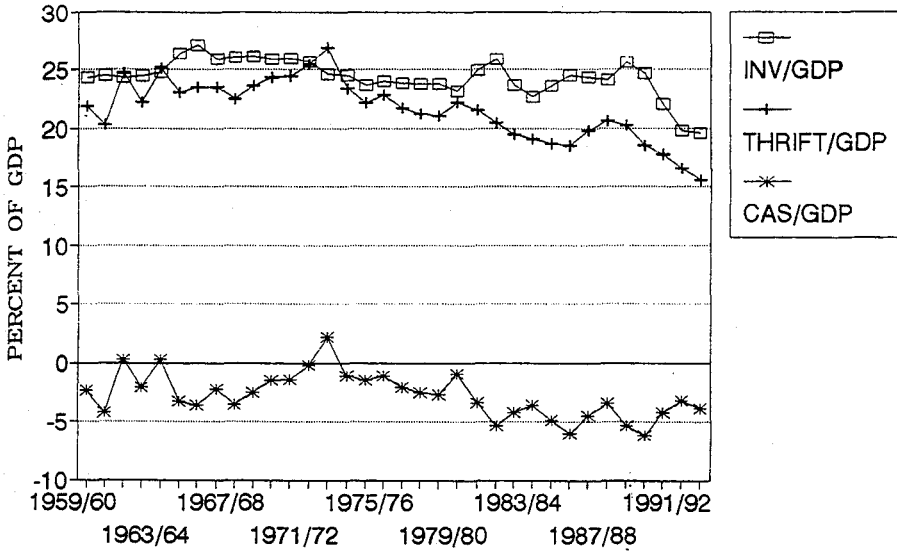
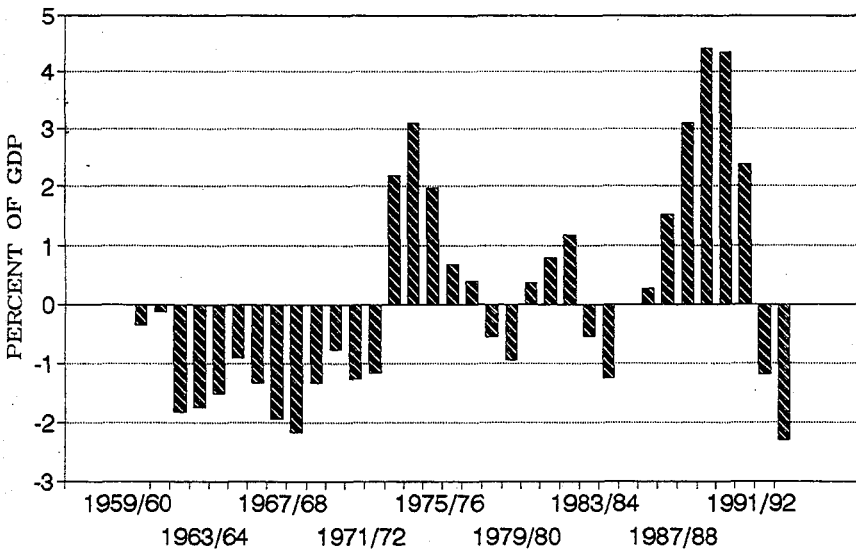


Chart 8
Government Budget Surplus, Australia
 Australia, 1959-60 to 1992-93



between OECD countries, with the lowest rate of thrift being recorded for the USA, a rate of 15.0 percent of GDP in 1991, and the highest rate of thrift, ignoring Luxemburg, being that of Japan, which had a rate of 35.1 percent of GDP in 1991.

Comparisons of the current level of thrift with its level in earlier years or its level in other countries is not necessarily a good guide for economic policy making. There may be good reasons why Australia should have a lower rate of thrift in 1992–93 than earlier years. There may be reasons why Australia should have a different rate of thrift than other countries. An approach which allows for the factors one may think should play a role in determining the optimal level of thrift, factors such as demographic trends and world interest rates, would be desirable. However, because this approach has not been developed yet we will have to stick with judgements based on the historical comparisons and the inter-country comparisons made above. On that basis the rate of thrift in Australia at the present time is low. A recovery in which thrift increases is to be recommended. So the appropriate policy is monetary expansion rather than fiscal expansion.

One drawback in relying on monetary expansion instead of reductions in taxes to reduce the rate of unemployment is that the full effect on the level of economic activity of monetary expansion takes longer than the full effect of a reduction in taxes. It may be that a combination of temporary tax cuts and monetary expansion is desirable.

4. What is the Current Stance of Fiscal and Monetary Policy?

Fiscal Policy

A measure of the contribution of the government's fiscal policy to thrift is the government's surplus on current transactions, as defined in the Australian National Accounts. This surplus, as a percentage of GDP, is shown in Chart 8 for the years 1959–60 to 1992–93. A definition of this surplus from which a series extending back to 1959–60 can be derived is used. The surplus covers the three tiers of government, federal, state and local. It is the surplus of taxes, fees

Chart 9
Real Rate of Interest, Australia
September 1969 to March 1993

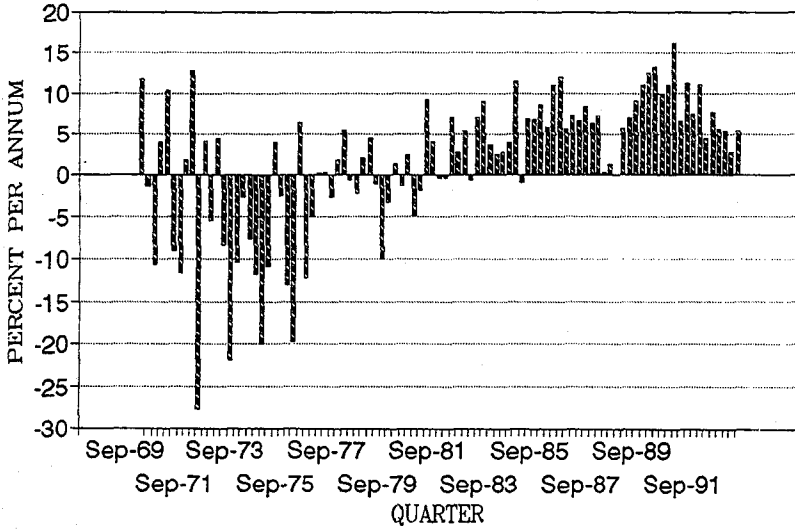
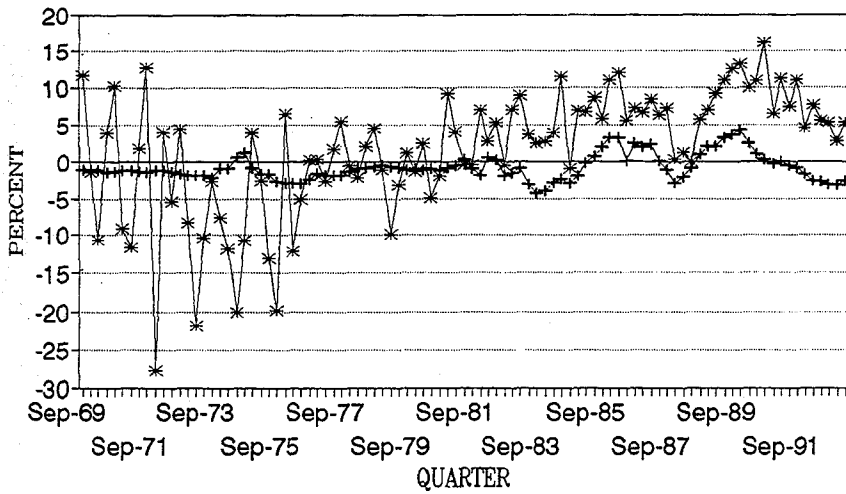


Chart 10
The Short-Long Interest Rate Difference
Australia, September 1969 to March 1993



—*— 3 MONTH REAL INT —+— 3 MON INT-10 YR INT

and fines over final consumption expenditure by general government (which includes the consumption of fixed capital, that is the depreciation of the public capital stock). Excluded from this series is much of the income earned by public trading enterprises, some interest payments and grants and the inflation tax (that is the decline in the real value of government liabilities due to any increase in the price level). The net effect of these exclusions is that the series shown in Chart 8 underestimates the government's contribution to thrift.

In 1992–93 the government's surplus on current transactions was –2.3 percent of GDP. This deficit compares with an average surplus of 0.1 percent of GDP over the period 1959–60 to 1992–93. So the negative contribution to thrift made by the government in 1992–93 was in contrast to the average contribution over the period. Furthermore this contribution is in marked contrast to the large positive contributions of the late 1980's. Indeed in no year since 1959–60 has a deficit of 2.3 percent been exceeded. This suggests that fiscal policy in 1992–93 is relatively expansionary by the standards of the last three decades. This expansionary stance of fiscal policy and the low rate of thrift in 1992–93 imply that monetary expansion rather than fiscal expansion should be used to reduce the rate of unemployment.

Monetary Policy

There are various indicators of the stance of monetary policy. In the 1970's, it became popular to use the growth rates of monetary aggregates, such as M3, as indicators of monetary policy. However, the popularity of using monetary growth rates has declined since the early 1980's.

The real rate of interest is another indicator of monetary policy. (The real rate of interest is the nominal rate of interest adjusted for inflation). Low real rates of interest suggest that monetary policy is expansionary. The current real rate of interest on 3 month treasury notes is not low by historical standards but is much lower than the high rates of the late 1980's. (See Chart 9). An alternative indicator based on interest rates is the rate on short term assets minus the rate on long term assets. At present this difference is low by historical standards, suggesting that monetary policy is expansionary. (See Chart 10). The idea behind using this difference as an indicator of monetary policy is that short term interest rates bear the brunt of

changes in monetary policy since the latter are initiated through the cash market. However, this interpretation may be questioned. In financial markets there is little reason to expect any interest rates to take long to adjust to equilibrium levels. Given this, the negative value of the short/long interest difference that is observed at the moment may reflect an uncertainty that the rate of inflation will remain low in the long term.

With a flexible exchange rate regime, monetary policy has a powerful effect on economic activity through its impact on the values of exports and imports. An expansionary monetary policy will, by lowering the domestic interest rate, put downward pressure on the exchange rate. A lower exchange rate will increase the Australian dollar price of exports and imports. If the increase in these prices exceeds any increase in domestic production costs, then an expansion of production in export industries and in import substitution industries will result. In Chart 11 the index of the trade-weighted exchange rate is plotted for the period September 1970 to June 1993. The chart shows a substantial devaluation of the Australian dollar over this period. To relate this change to the value of domestic production costs relative to overseas production costs, the ratio of the overseas price level (measured by the index of OECD consumer prices) to the Australian price level (measured by the Australian consumer price index) is also plotted in Chart 11. Since 1988 there has been a substantial decrease in the value of the trade-weighted exchange rate and an increase in the ratio of the overseas price level to the domestic price level. The combination of these two changes will stimulate the economy. The increase in the gap between the price ratio and the trade weighted exchange rate shown in Chart 11 to have occurred since 1988 suggests that monetary policy has been expansionary. The expansionary monetary policy has improved the international competitiveness of the Australian economy.

The ratio of the two series shown in Chart 11 is an index of the stance of monetary policy. This ratio is shown in Chart 12. As Chart 12 shows, in June 1993 the stance of monetary policy as indicated by this index is more expansionary than at any time in the period September 1970 to June 1993, with the exception of the September quarter in 1986. This indicator suggests that the current stance of monetary policy is expansionary.

Chart 11
The Exchange Rate and Relative Prices
Australia, September 1970 to June 1993

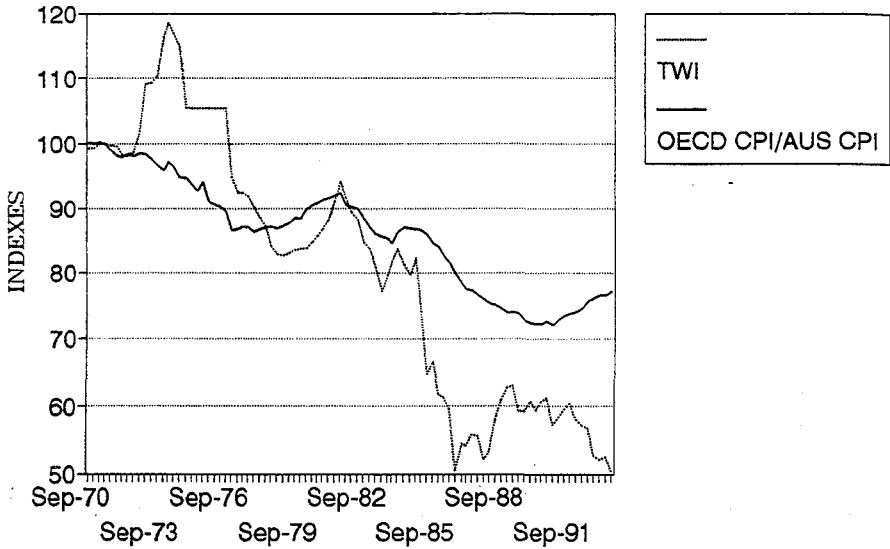
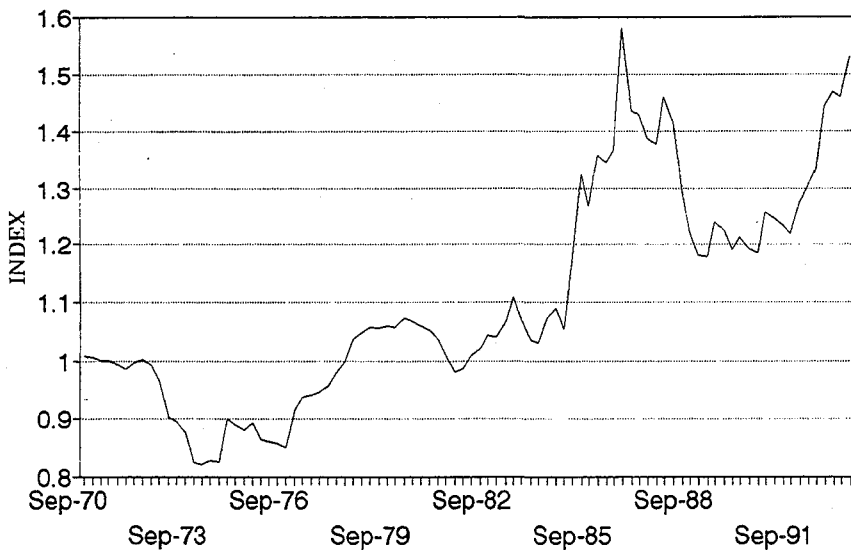


Chart 12
Competitiveness, Australia
September 1970 to June 1993



It would appear from this analysis that the setting of monetary policy is, in the qualitative sense, correct. Whether the Australian economy could take and would respond well to a more expansionary monetary policy is a difficult question.

5. Conclusion

From the analysis of this paper, three points emerge:

- A policy of expanding the level of aggregate demand should be used to reduce the high rate of unemployment in Australia. Minimalist policies should be eschewed.
- In the current state of the Australian economy, the low level of national saving suggests that monetary expansion is a more appropriate policy than fiscal expansion.
- The current setting of monetary policy appears to be expansionary. Whether the economy would absorb a more expansionary monetary policy is difficult to say.

Notes

1. The definitions and services of data used in all charts is given in the Appendix.

References

- Maddison, A. (1991) *Dynamic Forces in Capitalist Development: A Long-run Comparative View*, Oxford University Press, Oxford.
- McDonald, I.M. (1993) "Models of the Range of Equilibria", mimeo University of Melbourne (forthcoming in R. Cross (ed.)), *The Natural Rate Hypothesis Twenty Five Years On*, Cambridge University Press, Cambridge.)

Appendix

Definitions and Sources of Data Used In the Charts

All data was extracted from the databank, Data Express.

Chart 1 Unemployment, Australia, February 1978 to June 1993, ABS The Labour Force, Cat. No. 6203.0.

Chart 2 Unemployment, Australia, 1900–01 to 1992–93, Butlin, M.W. 'A Preliminary Annual Database 1900–01 to 1973–74', Research Discussion Paper 7701, May 1977, Reserve Bank of Australia, Sydney. ABS The Labour Force, Cat. No. 6203.0.

Chart 3 Inflation, Australia, December 1959 to June 1993, Implicit price deflator of GDP, ABS, Australian National Accounts, National Income and Expenditure, June 1993, Cat. No. 5206.0.

Chart 4 Inflation and Unemployment, Australia, December 1989 to June 1993, as for Chart 1 and Chart 3.

Chart 5 Inflation and Unemployment, Australia, 1921 to 1938, Butlin (1977).

Chart 6 Wage Share, Australia, 1959–60 to 1992–93, Wages, Salaries and Supplements as a percentage of GDP, from ABS, Australian National Accounts, National Income and Expenditure June 1993, Cat No. 5206.0.

Chart 7 Thrift, Australia, 1959–60 to 1992–93, Investment is defined as the sum of public and private investment. ABS Australian National Accounts, National Income and Expenditure, June 1993, Cat. No. 5206.0.

Chart 8 Government Budget Deficit, Australia 1959–60 to 1992–93. Defined in text, ABS, Australian National Accounts, National Income and Expenditure, June 1993, Cat No. 5206.0.

Chart 9 Real Rate of Interest, Australia, September 1969 to March 1993, three month Treasury Note deflated by the change in the Gdp deflator. Reserve Bank of Australia, Bulletin. ABS, Australian National Accounts, National Income and Expenditure, June 1993, Cat. No. 5206.0.

Chart 10 The Short–Long Interest Rate Difference. The 10 year government bond rate subtracted from the three month treasury note rate. Reserve Bank of Australia, Bulletin.

Chart 11 The Exchange Rate and Relative Prices. The trade-weighted exchange rate and the ratio of the OECD consumer price index to the Australian consumer price index. Reserve Bank of Australia, Bulletin.

Chart 12 Competitiveness, Australia, September 1970 to June 1993. Definition in text. Source as for Chart 11.