Letters

Why Microeconomic Reform Can Help Reduce Foreign Debt

Peter Forsyth's argument that microeconomic reform won't reduce foreign debt (*Policy*, Winter 1990) is a classic example of throwing out the baby with the bath water.

He is quite right in criticising those commentators — if indeed there are any — who claim that microeconomic reform (MR) will by itself reduce the current account deficit (CAD) and thus the rate of growth of foreign debt (let alone the total foreign debt itself, a much more ambitious objective). He is also right in stressing that reduction in the CAD requires correction of the imbalance between domestic saving and investment; that the primary objective of MR is to raise productivity; and that such an increase, even if it is achieved, will not, of itself, correct the saving-investment imbalance since most of the additional real income will be spent. But none of this implies that MR cannot help reduce the CAD.

At the centre of Dr Forsyth's argument is a logical slip. MR, he says, is neither a sufficient nor a necessary condition for reduction of the CAD. To use an analogy, a pen is neither sufficient nor necessary for writing a letter. It is not sufficient because one also needs paper, and it is not necessary because one can use a pencil or a typewriter instead. But that does not mean that one cannot use a pen to write a letter. Similarly, MR is not a sufficient condition for a reduction of the CAD; it needs to be accompanied by measures to contain aggregate demand. Nor is it necessary because currency depreciation or wage cuts are, in principle, available as alternatives. But that does not mean that MR cannot be helpful in reducing the CAD. Indeed, it may have advantages over the available alternatives.

More serious is Dr Forsyth's faulty economic analysis. His basic mistake is to focus exclusively on one of the two concurrent causes of the CAD and foreign debt — the saving-investment imbalance — and to neglect the other — the inadequate international competitiveness of Australian industry. Since the CAD is identically equal at any time to the excess of domestic investment over saving, in other words to excessive domestic (consumption plus investment) spending, reduction in the CAD requires a corresponding reduction in total spending by means of fiscal or monetary policies. But an across-the-board cut in spending, designed to reduce the CAD, would fall in large part on non-tradables rather than on imports and exportables, and would therefore reduce domestic economic activity and employment; it would upset internal balance before external balance can be restored. That is why expenditure-cutting measures may need to be accompanied by expenditure-switching measures, designed to divert spending away from tradables (imports and exportables) to non-tradables. The appropriate instrument for this purpose (if damaging direct controls of foreign trade and payments are ruled out) is depreciation of the real effective exchange rate, which raises the relative prices of tradables. The necessary change in relative prices can be achieved through a nominal depreciation of the currency (provided it is not offset by domestic wage and price inflation) or through a reduction in the level of nominal and real wages. But the necessary improvement in the international competitiveness of Australian industries can, in principle, also be achieved through increases in efficiency, in other words through microeconomic reform.

This is the role of MR in relation to the CAD and foreign debt that Dr Forsyth neglects. His argument that MR, by raising productivity and incomes will also raise spending is beside the point. We know that any measures aimed at reducing the CAD must do both — contain aggregate demand and improve international competitiveness. Any additional demand pressures that may result from gains in productivity and incomes merely affect the degree of the required macroeconomic restraint.

Although Dr Forsyth does not go so far as Professor John Pitchford in claiming that external balance has ceased to be an appropriate target for macroeconomic policy, he may side with him in arguing that MR is not necessary for this purpose because external balance can be left to the floating exchange rate. But MR has attracted so much government and business attention in the context of the CAD and debt problem precisely because the exchange rate has in practice been rejected as a usable instrument in an economy as small and as trade-union dominated as Australia's. A major motive for high interest rates has been to attract capital inflow in order to 'keep up the dollar' for fear that depreciation would feed into the CPI and set off a wage explosion. In other words, there are strong doubts whether a nominal depreciation can, except briefly, become a real depreciation.

MR is seen as one way of improving the international competitiveness of Australian industries without the politically difficult, and in the medium term impossible, task of reducing real wages. As Dr Forsyth rightly points out, this may well be a forlorn hope. MR which aims to eliminate restrictive practices by trade unions tends to run into as much political resistance as cuts in real wages because it is regarded as an assault on workers' customary rights and therefore living standards. It is the kinds of MR which raise productivity through improvements in technology or management that offer the best prospects of avoiding strong political resistance; but this approach too may be politically difficult because of entrenched habits and the costs

of adjustment.

Dr Forsyth is right to emphasise that Australia's CAD and foreign debt problem is a long-term one of ingrained attitudes and practices that cannot be corrected by quick fixes. 'The ability of macroeconomic policy to produce long term shifts in spending and saving decisions must be questioned' (p.15). But this applies as much to expenditure-switching as to expenditure-cutting measures, to improvement in international competitiveness as much as to the saving-investment imbalance.

Microeconomic reform is not easy. But it will not be made any easier by misunderstanding of its primary purpose. And to denigrate its usefulness is merely to lend support to the vested interests that stand in its way.

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Peter Forsyth responds:

Professor Arndt agrees with the central point of my paper, namely, that MR is not necessary for the CAD and the debt to be reduced, and that it is not of itself sufficient. What he does take up is a separate issue that I treated briefly, namely, whether such reform would be a help in reducing the debt. He asserts that it would be, but even this weaker proposition must be questioned.

For there to be a change in the CAD, it is necessary that expenditure fall relative to production, and also that relative prices change such that net imports of goods are reduced. Far from ignoring this second aspect, I gave it considerable discussion in a longer paper (Forsyth, 1990). Changes in expenditure will tend, when real exchange rates are free to vary, to bring about the warranted price changes automatically. This could come about through changes in the nominal exchange rate, or changes in domestic prices. If exchange rates work, then MR will make no difference: it will not be of any help.

What if exchange rates do not work? Many consider that exchange rates are imperfect instruments and fail to adjust properly. In many cases, they are ascribing the wrong task to exchange rates; there is no presumption that they should vary to achieve a zero, or some desired level, of CAD. Their role is to ensure that the goods flows, i.e. a current account, consistent with expenditure and production decisions come about. Once this is understood, it does not seem evident that they have failed to work in Australia or elsewhere.

But consider the situation where exchange rates fail to adjust. Here, some types of MR may help. If exports become cheaper, and the exchange rate does not alter, the required changes in relative prices will come about. However, there is no guarantee that the exchange rate will remain constant, and in fact the growth in exports will put pressure on it to rise and cancel out the effect of lower export prices. If the exchange rate cannot be relied on to adjust appropriately, it cannot be relied on to stay constant while other changes are effected. To know what is likely to take place, it is necessary to know why the exchange rate is failing to work. At best, some types of MR might help. (If sticky exchange rates are the source of the problem, it would be preferable to address them directly, rather than hope that selective reforms will replace them.)

MR is much broader that just making exports cheaper. In fact, many important reforms are such that, at a constant exchange rate, they would lead to an increased, not decreased, CAD. For example, reductions in protection, increasing road freight charges, increasing railway cost recovery and reducing costs on the waterfront (which would affect imports more than exports, since a large proportion of Australia's exports leave from relatively efficient specialised ports) would all lead to an increased deficit. In addition, MR would extend to non-tradable goods and services industries, and the effects of efficiency improvements in these cases would be ambiguous.

Thus, only if MR is confined to changes that reduce prices in export and import-competing goods could it be of any help in reducing the deficit. The gains from MR are significant, and it would be a costly policy to refuse to undertake such reforms as the Garnaut Report's recommendations on protection, or restructuring the waterfront, because of the adverse effects they might have on the CAD. MR should be implemented for the gains that it can certainly deliver in terms of increasing real income, and it would be inappropriate to pick and choose amongst reforms on the grounds of their questionable effects on the CAD.

To summarise: Some types of MR may help reduce the CAD when other mechanisms, such as exchange rates, fail to adjust appropriately; but even then, such reforms may simply push exchange rates up. Thus, MR in general can be regarded as of little help in reducing the deficit. If the CAD, and the debt, are regarded as problems, then it would be more productive to focus attention on the very difficult task of reducing expenditure relative to production rather than on MR, which is important for its own sake, but which has no clear effects, if any, on the deficit and the debt. As Professor Arndt says, MR is not easy, and it is not made easier by misunderstanding its primary purpose, that of increasing real incomes, and by attributing to it effects that it is highly unlikely to have.

Reference

Forsyth, P. (1990), 'Competitiveness, Microeconomic Reform and the Current Account Deficit', Centre for Economic Policy Research, ANU, Discussion Paper no. 228.