MACROECONOMIC POLICY: SOME INTERNATIONAL LESSONS FOR AUSTRALIA*

W. Max Corden
SAIS
Johns Hopkins University
Washington DC, USA 20036-1984

This paper reviews recent macroeconomic experience outside Australia, especially in the United States, the United Kingdom and continental Europe, and compares it with Australian experience. It discusses booms and recessions, inflation (especially the 'credibility' issue), unemployment (cyclical and structural), and exchange rate policy. It also discusses implications for monetarism and rational expectations theories. Two conclusions are that the big remaining problem in Europe and in Australia is structural unemployment, and that Australia was wise to float the dollar and abandon the crisis-prone 'fixed-but-adjustable' exchange rate regime.

1. INTRODUCTION

This paper reviews recent macroeconomic experiences outside Australia. In particular, I am interested in seeing what lessons there are for Australia, and also what the implications are for various fashionable theories. Like a paper presented at the annual conference of the Economic Society in 1988 (Corden, 1989), this one is essentially about comparative economics. It compares Australian experience with that of other countries. The earlier lecture was based on intensive research of Australian experience, but this paper deals primarily with other countries, and any references to Australia are rather casual and not based on recent research. But I hope it will stimulate further comparative work.[1]

2. BOOMS AND RECESSIONS

All the OECD countries have gone through an episode of boom and recession. For the seven largest (the G-7), this is shown in Figure 1. Here three observations can be made.

---

* This paper is a condensed version of a lecture presented at the annual conference of the Economic Society of Australia at the Gold Coast in September 1994. In preparing the revision, I am indebted to Dr Palle S. Andersen.

[1] The principal references are IMF (1994), Bank for International Settlements (1994), and OECD (1994). These are also the sources of all figures.

First, the cycles have not been synchronized. The seven fall into two clear groups. The United States, Canada and the United Kingdom reached their peaks in 1988 and 1989, and the slump began in 1990. Australia also belongs to this group. The United States started recovering in 1992 and Canada and the United Kingdom in 1993. By contrast, the other four reached their peaks later, and in 1993 their negative 'output gaps' were still increasing. The developing countries as a whole did not have a slump at all. The modesty of the slump in the United States is striking.

While a transmission process was at work within continental Europe, more generally the conclusion must be that the international transmission process, if any, is rather weak, if it exists at all. It was beneficial that the slumps in the major countries did not coincide. Contrary to what is often said, there is no virtue at all in 'convergence'. Non-synchronized cyclical movements help to smooth fluctuations in the world economy.

Second, in the late eighties there were asset price booms in many countries, notably the United Kingdom, Japan, the Nordic countries and Australia (and to a lesser extent, the United States). These reflected excessive liquidity. But they were not associated with large increases in the rate of goods and services inflation (i.e. CPI). (Inflation rates are in Table 1.) But, if the booms had continued, they would eventually have led to increased inflation. It is worth noting that the Australian experience was matched in many other countries, notably the United Kingdom. The slowness of CPI inflation rates to react to monetary expansion is probably explained by the decline in inflationary expectations resulting from the slump in the early eighties and by the increased credibility of anti-inflation commitments of governments. In Australia the Accord will have played a role.

Finally, the fact that there was a boom and then a slump, and that this was associated with monetary expansion and then contraction, indicates the difficulty of monetary management. This will be discussed later.

TABLE 1

INFLATION RATES OF OECD COUNTRIES (ANNUAL PERCENTAGE CHANGE OF GDP DEFLATORS)

	Average 1976-85	1988	1989	1990	1991	1992	1993
United States	6.7	3.9	4.6	4.3	3.9	2.9	2.6
Japan	3.7	0.4	1.8	2.2	2.0	1.6	1.0
Germany	3.6	1.5	2.4	3.1	4.7	5.3	3.9
France	9.8	2.8	3.0	3.0	3.0	2.3	2.1
Italy	15.5	6.7	6.2	7.7	7.6	4.5	4.4
United Kingdom	10.8	6.0	7.1	6.4	6.5	4.4	3.4
Canada	7.1	4.6	4.8	3.3	2.5	1.1	0.8
Seven countries above	7.2	3.4	4.1	4.1	4.0	3.0	2.5
Sweden	9.4	6.5	8.0	8.8	7.8	1.3	2.9
Australia	9.2	8.2	7.3	4.6	1.8	1.2	1.1
New Zealand	15.3	7.7	8.0	4.2	2.0	2.1	1.6

Source: IMF, *World Economic Outlook*, May 1994.

The United Kingdom and Australia went through somewhat similar experiences – monetary expansion, asset market boom, then monetary tightness and a severe recession. In both countries there was a move down the short-term Phillips curve which, in the case of Australia, was certainly more than expected. Both the inflation rate and the growth rate fell more than expected. Governments and the public deplored the increase in unemployment, and central bankers claimed credit for the lower inflation rate. Looking at the figures closely (Table 2), one finds that the Australian experience was better than that of the United Kingdom: the slump was less and the decline in the rate of inflation was much more. It would be an interesting research project to inquire why this was so.

TABLE 2

THE UNITED KINGDOM AND AUSTRALIA COMPARED (PERCENT)

	1988	1991	1992
GDP growth rate			
UK	5.0	-2.2	-0.6
Australia	4.4	-0.8	2.0
Inflation (GDP deflators)			
UK	6.0	6.5	4.4
Australia	8.2	1.8	1.2

Source: IMF, *World Economic Outlook*, May 1994.

Inflation rates in all OECD countries other than Germany have been falling, but the Australian experience (as that of New Zealand) is quite remarkable. (This is shown in Table 1.) The average inflation rate figure for the G-7 was 3.4% in 1988 and 2.5% in 1993 – i.e. a modest decline – while the Australian figures were 8.2% and 1.1%.

There is a special story for continental Europe. Germany boomed from 1990 to 1992 because of the fiscal effects of reunification, and this, plus wage demands, caused the inflation rate to rise to over 5% in 1992. As one would expect, this set off panic buttons in Germany, and a monetary contraction followed, which slowed up the growth rate and generated a slump in 1993. The high German interest rates in 1991 and later, worsened the recession in neighboring countries. Owing to the French attempt to maintain the franc-DM rate, France was prevented from monetary expansion designed to counteract its slump.

3. THE DECLINE IN INFLATION

In many countries a decline in the inflation rate has been brought about, not always quite intentionally, at the cost of a severe recession. The precise recession story has differed among countries, and this is shown in Figure 1. This was a painful process, but low-inflation credibility – and hence reduction in wage demands – has been achieved. Some countries, including the United States and Australia, achieved

this result with flexible exchange rate regimes, and others – notably France – with the aid of an exchange rate commitment. The commitment to low inflation can be made in many ways. It certainly helps to have a more-or-less independent central bank that has public support for anti-inflation policies (like Germany).

Given the history of costly inflation-fighting, there is a natural reluctance to risk re-igniting inflationary expectations and so lose the benefits of this experience. Looking at the situation in 1994, in the United States the Federal Reserve is currently very cautious, given that the US economy appears to be back on a normal growth path (and possibly is now at the natural rate of unemployment), and that excessive monetary expansion now would produce its inflationary consequences only several years later. Other countries are not yet in this position. The problem is now that, for the sake of maintaining anti-inflation credibility, there is a reluctance to use monetary policy to bring about a short-term stimulus even when a country is still in a relatively low growth, high-unemployment phase.

The current question is whether the very low 1993 inflation rates of some countries, notably Canada, Australia, and New Zealand (see Table 1), can be regarded as new norms or just the results of the slumps that these countries have gone through. Close-to-zero inflation has been proposed as a target in various countries, especially by central bankers. It is questionable whether this is desirable even if no further or continued recession had to be incurred to achieve or maintain the target. It is much easier to bring about declines in real wages when there is some positive inflation. The reason is that nominal wages are rigid downwards. There may be no need to bring about a general decline in real wages, but wage relativities need to be flexible. Given positive labor productivity growth, some relative wage changes can be brought about without any nominal wage having to decline absolutely, even when there is low or zero inflation. But such productivity growth is not always enough. Real wage flexibility then requires a significant positive rate of inflation, say 2-3%.

4. IMPLICATIONS FOR THEORY

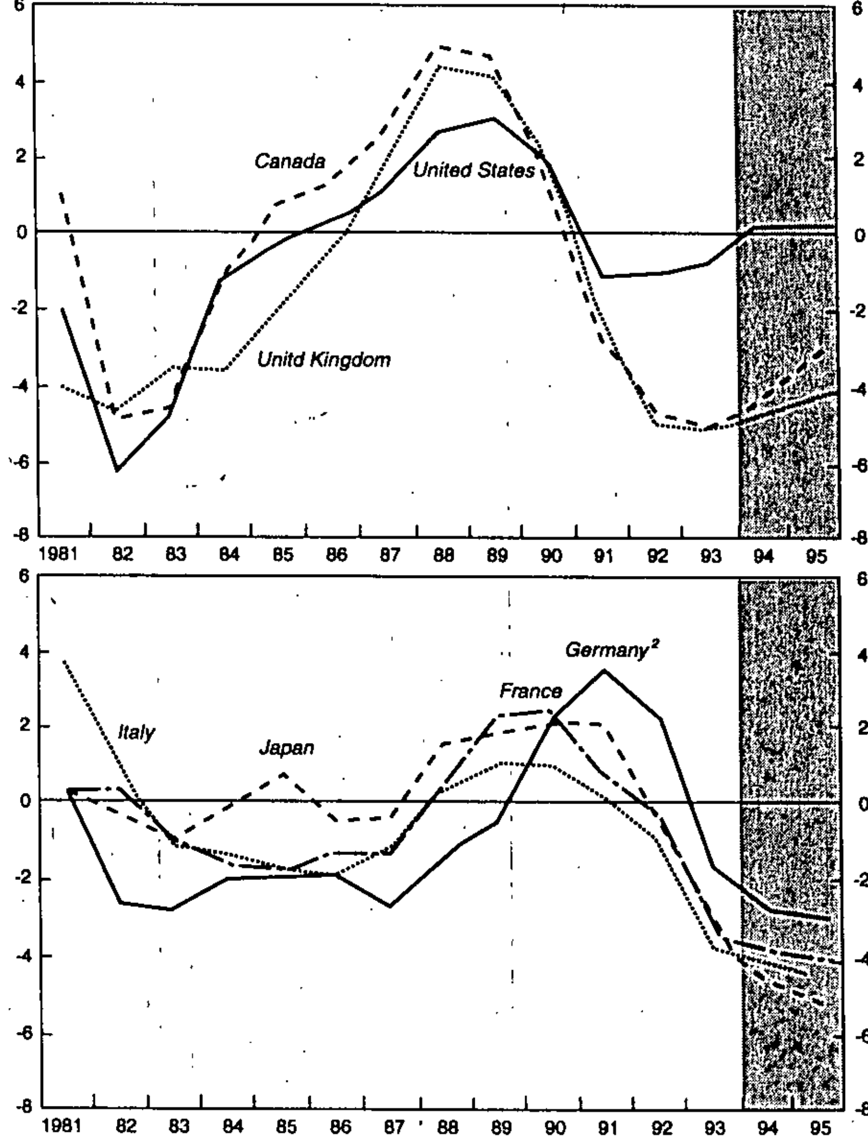
The message of monetarism was that the central bank should proclaim and adhere to a target rate of growth of 'money', and this, if credible, would then establish inflationary expectations. Rules are better than discretion, and the simplest rule is a money growth one. The implication was that a constant money growth rate would also set a constant, or at least predictable, rate of growth of nominal GDP. A constant or predictable rate of change of velocity was assumed in this approach. But financial deregulation, currency substitution (in favor of the US dollar), and other factors led to a breakdown of money demand equations in the eighties. Setting particular rates of growth of M1, M2, M3, etc., did not ensure predictable rates of growth of nominal demand (MV). Furthermore, there was a failure to achieve particular targets in the money growth rate itself. Central banks can determine the money base (to some extent), but they cannot directly determine M3. In any case, the net result is that crude monetarism has been discredited, and most central banks have given up on money growth targets as their principal or only guiding rule.

In the same way, the cruder versions of rational expectations theory have been

FIGURE 1

MAJOR INDUSTRIAL COUNTRIES: OUTPUT GAPS[1]

(Actual less potential output, as a per cent of potential)



Source: IMF, *World Economic Outlook*, May 1994.

Notes: 1. Shaded areas indicate staff projections. For a discussion of the approach to calculating potential output, see the October 1993 *World Economic Outlook*, p.101.

2. Data through 1990 apply to west Germany only.

discredited. Insofar as this theory dismissed short-term Keynesianism (based on the Phillips curve), events simply did not support it. It has never been possible in any developed country (or most developing countries) to bring about a significant decline in the inflation rate through monetary contraction without also generating a recession. The theory said that the policy announcement must be credible, and there is nothing wrong with the theory. But not even Mrs. Thatcher was credible enough. Expectations may be forward-looking, but the only way to look forward in a world where announcements are never trusted, and politicians can never be sure to stay in office or maintain their policies, is to look backward as a guide to the future. Reality is closer to adaptive expectations, which reflect a learning process.

Nevertheless, elements of these two theories have been shown to be correct, and are very influential. Monetary policy does matter, even though the target has to be stated not in terms of a money growth rate but directly in terms of a long-term inflation rate objective. Most important, these theories have led to the emphasis on credibility – which can be established not primarily by announcements but by an actual record of behavior and results. Forward-looking expectations are inevitably formed by looking backwards. This concern with credibility provides the case for making central banks independent of the short-term political process, even though over a longer period a central bank must be accountable.

5. UNEMPLOYMENT AND THE LABOR MARKET

In 1993 the unemployment rate in Japan was 2.5%, in the United States about 6%, and in Canada, France, Italy, the United Kingdom and Australia, over 10%. Chart 2 is interesting, though it aggregates some countries (the US and Canada in North America, and France and Germany in Europe) that have had rather different experiences. There is a large structural element in unemployment, not amenable to short-term demand management, and such structural unemployment has risen sharply in Europe and Australia, but not in the United States.

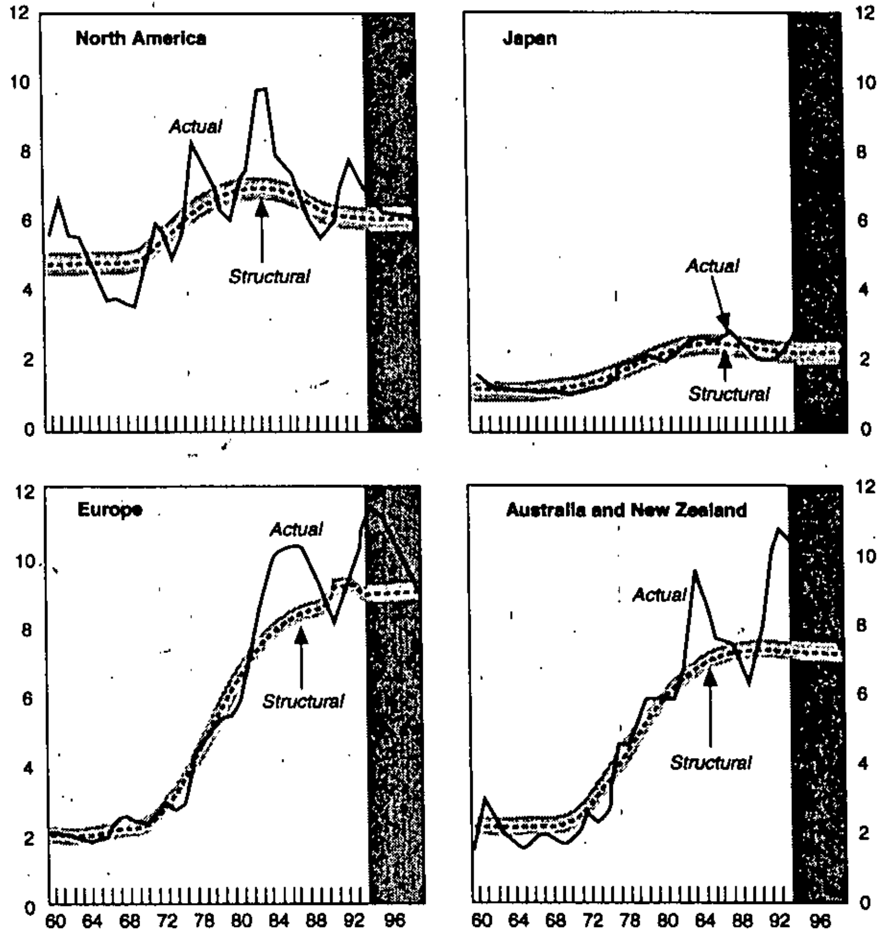
The contrast between the European and the US experience is attracting much attention. Arguably, it can be attributed to two factors: first, labor market rigidities and taxes on employment in Europe that do not exist in the United States, and second, better social welfare provisions and unemployment benefits in Europe. A common view is that it would be desirable for Europe to move to the US situation with regard to the first but not the second. Hopefully, such a move would reduce European unemployment. Probably, tight demand policies in the countries that formed part of the European Monetary System also played a role, combined with a tendency to unemployment **persistence** – i.e. that unemployment persists to some extent even when demand revives.[2]

The contrast between youth unemployment in Germany (5%) and France (25%) is noticeable. Low youth unemployment in Germany is explained, apparently,

[2] The results from extensive research on the causes of high European unemployment, and especially its increase in the eighties, are by no means conclusive. See a comprehensive (and rather negative) recent survey of this research in Bean (1994).

FIGURE 2

ACTUAL AND STRUCTURAL UNEMPLOYMENT RATES
(percent of labor force)



Source: IMF, *World Economic Outlook*, May 1994.
Note: The bands around the structural unemployment rates do not reflect statistically estimated confidence intervals, but merely indicate that there is necessarily considerable uncertainty in the estimates. The actual unemployment rate estimates for the United States are based on the pre-1994 sampling methodology. For Germany, the actual and structural unemployment rates apply to West Germany through 1989 and to unified Germany thereafter. For Italy, the actual and structural unemployment rates use a new series beginning in 1993. These breaks account for, respectively, the uptick in the structural unemployment rate for Europe in 1990, and the downtick in 1993. Shaded areas for 1994-99 indicate staff projections.

by the German apprenticeship system, while high unemployment in France is explained by the very high minimum wage. (Youth unemployment rates, as well as overall unemployment rates, are compared for 1993 in Figure 3.) The share of the long-term unemployed in total unemployment is also much higher in the European Union countries (42%) than in the United States (11%). For Australia, the figure is 34.5%.[3]

The Australian unemployment rate at 11% in 1993 was in the European range – above Germany's, roughly equal to that of France and the United Kingdom, and below that of Spain (22%). As is well known, we also have a labor market rigidity problem. Unlike most countries, we have not just a single minimum wage, but a separate minimum (award) wage for each or most occupations. In that respect we may be the worst case. On the other hand, we do not have the very high social taxes which raise labor costs to employers in continental Europe, and which are surely a major cause of European structural unemployment.[4] Furthermore, in general, our benefit levels are not as generous as in Europe. Nevertheless, the Australian unemployment problem has many similarities with that of European countries, and the discussions going on in Europe are very relevant for us.

Unemployment has both a structural and a cyclical element. One has to face the reality that cyclical variations in unemployment cannot really be avoided. After the event one can criticize the managers of monetary policy for permitting booms and then imposing brakes that create a recession. But it is difficult to judge these matters at the time. A conservative government in Britain (with Nigel Lawson as Chancellor) went through the same kind of experience as a Labor government in Australia (with Paul Keating as Treasurer). In the case of Britain, monetary policy was directed at a crucial time to maintaining a constant sterling-Deutschmark rate, while in Australia the exchange rate floated. But both countries had an asset market boom, followed by monetary tightening and a recession. In both countries financial deregulation helps to explain the asset market boom.

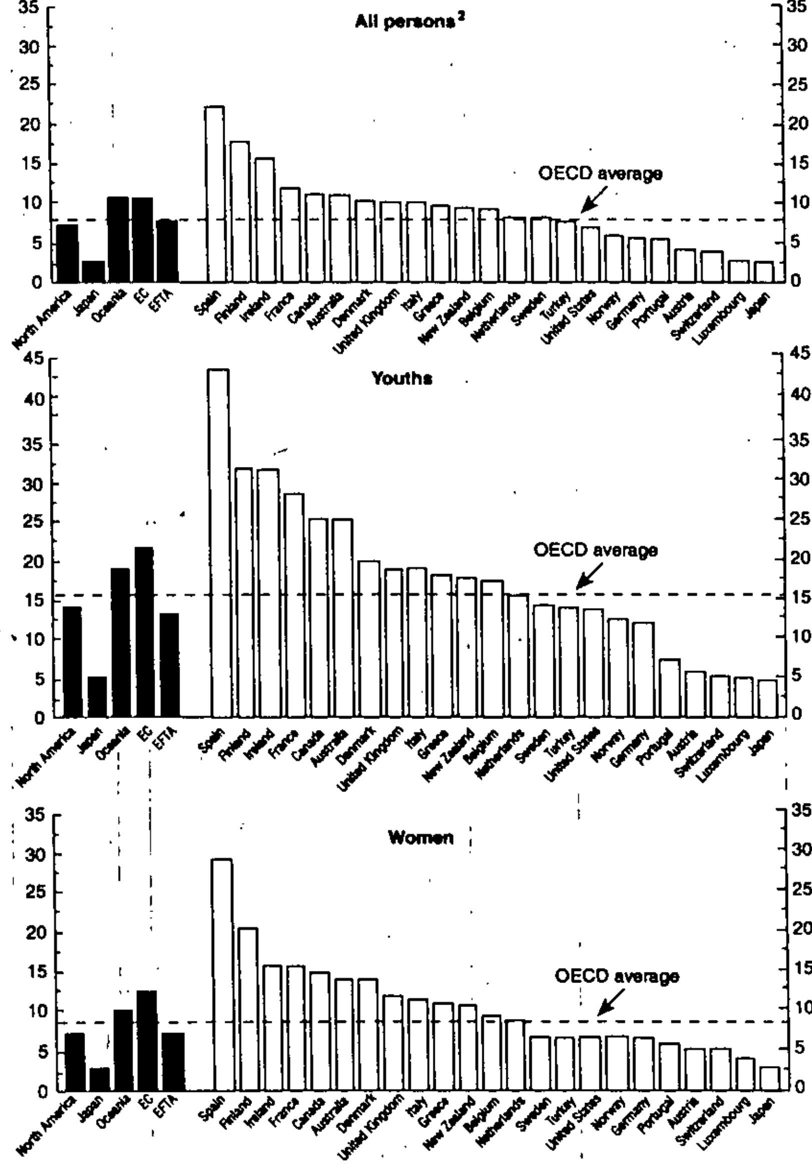
Perhaps the booms should have been moderated earlier with monetary tightness, and the tightening should not have been so severe. But that is said with hindsight. Of course, the authorities should keep on trying to improve their short-term management and avoid euphoria in booms. As the boom develops, monetary policy needs to be tightened. Political pressure to prevent such tightening needs to be restrained, possibly by giving a central bank some independence. But the main policy conclusion, in my view, is that cyclical variations in unemployment cannot be avoided, so that the focus must be on tackling the structural unemployment

[3] These figures refer to 1992 and come from OECD (1994).

[4] This sentence needs to be qualified. Australia, like the United States, Canada and Britain, does impose non-wage labor costs on on employers, but proportionately they are not as high as in continental Europe. The following figures come from the Institut der Deutschen Wirtschaft, Cologne. Non-wage labor costs as a proportion of direct wage costs in 1992 were 86.5% in Germany, 90.5% in France, 103% in Italy, 86% in Belgium, and 82% in the Netherlands. For Australia the figure was 45.5%, and for Britain, 43%.

FIGURE 3

UNEMPLOYMENT RATES – 1993 (PER CENT)[1]



Source: OECD, *The OECD Jobs Study*, 1994

Notes:
1. Countries are ranked in descending order.
2. OECD standardised unemployment rates, except for Austria, Denmark, Greece, Luxembourg, Switzerland and Turkey.

problem. Instead of going from 6% unemployment in the boom to 11% in the slump, we should go from 3% in the boom to 7% in the slump. We must get the average unemployment rate down.

Times have certainly changed. When I was active in the Australian policy debate in the late seventies and urged real wage reductions to raise employment (Corden, 1979), the Australian unemployment rate appeared to have stabilized around 6%. This seemed outrageously high, and I did not think it should be so readily lived with. I used as a reference point the post-war unemployment rate until the early seventies, which was hardly ever above 2%. Now the US unemployment rate of 6% is seen as exemplary. Admittedly, unemployment benefits are better than they were in the sixties and the spread of two-income households has made unemployment more bearable. But surely we can do better.

6. EXCHANGE RATE POLICIES

The most important development in the international economy in the last ten years or so has been rapidly increasing international capital mobility.[5] A major implication is that it is no longer possible to sustain fixed-but-adjustable exchange rate regimes. Managed floating is here to stay. Management consists both of monetary (interest rate) policy directed to influencing the exchange rate at times, and some direct foreign exchange market intervention by the central bank designed to influence the exchange rate in the short run.

Let me first focus on the exchange rate relationships between the major currencies, i.e. the dollar, yen, Deutschmark, Canadian dollar, and sterling. Market-determined movements do not always appear to be rational, and there have been many ups-and-downs. In real terms, the dollar rose about 50% from 1981 to early 1985, and then fell back to where it started by 1987. This was an extraordinary movement, and many proposals for stabilizing exchange rates in some way, for example, with target zones, were inspired by this episode. But since 1988, there has been relative stability. In any case it has become clear that direct intervention has only a short-term impact on exchange rates, and even then not through its portfolio effect (which can only be small in view of the vast stocks of assets involved) but because of its signaling effect with regard to future monetary policies.[6] If the market believes that a currency will depreciate, an immediate depreciation can only be avoided either by dedicating monetary policy to that objective – and usually this will imply a sharp, sometimes inconceivably sharp, rise in interest rates – or by policies that will change expectations.

What it boils down to is that a fixed exchange rate regime – or a regime with narrow margins – can only be maintained if there is a complete commitment to dedicate monetary policy to the exchange rate objective. The major country that has

[5] See Mussa and Goldstein (1994), the annual *International Capital Markets* survey of the International Monetary Fund; and the *Annual Reports* of the Bank for International Settlements.

[6] See Dominguez and Frankel (1993).

come closest to this commitment has been France. Such a commitment could not be made by the United States, Japan, Germany or, for that matter, Australia. The European Monetary System (EMS) crisis of 1992 showed also that the United Kingdom government was not prepared to make that commitment.

The European experience, and especially the crises of 1992 and 1993, shows the undesirability of trying to maintain fixed (or narrow-margins) regimes, when there is still a possibility of adjustment. Monetary policy can be used in a pragmatic way to stabilize exchange rates at most times, while allowing exchange rates to change when there are significant shocks. But a strong exchange rate commitment maintained in the face of market forces is likely to lead eventually to crisis. A finance minister makes a rod for his or her back when making such a commitment. It follows that the decision to float the Australian dollar in 1983 was clearly correct, and indeed inevitable. If it had not been done then, it would have had to be done later.[7]

As capital mobility has spread around the world, many developing countries have been moving in the same direction. Such a policy of managed floating does not exclude an attempt to use monetary policy to maintain a relatively stable exchange rate, provided the relevant fundamentals are also stable. Experience in developing countries has shown that, using a fixed rate (usually fixed to the dollar) as a nominal anchor to discipline domestic monetary policy and to maintain low inflationary expectations, is a risky policy. The costs of failure, either of failure of discipline or of sufficient influence on expectations, are great. The two countries that have been following such a policy relatively successfully lately are Argentina and Mexico, but even here there are problems of real appreciation and there is always the danger of a crisis.[8]

7. FINAL REMARKS

The issues that preoccupy Australia also arise elsewhere in the world. The structural unemployment problem is one that Australia shares with many European countries, though in some respects our situation is not so bad. The proportion of long-term unemployed is less, and we do not have job-destroying social charges to the same extent. On the other hand, we have our unique – and also job-destroying – 'award' system.

The difficulty of short-term monetary management, and of maintaining an expectation of low inflation while also stabilising aggregate demand somewhat, arises everywhere. In this respect the United States has been relatively more successful. This may be because of the relative independence of its central bank, but it must also be remembered that the US experience of the seventies and early

[7] I discuss all these issues in Corden, 1994.

[8] These issues are discussed in Little, *et al.* (1993), and in Corden (1993). Since that sentence was written, the Mexican exchange rate regime has indeed broken down as a consequence of a serious crisis that resulted from prolonged real appreciation and political uncertainties. As so often in other countries, the finance minister had to resign.

eighties – increasing inflation followed by a very severe monetary-policy-induced recession – was different.

On the whole, the exchange rate is not a problem in Australia in the sense in which it is in Europe. On another topic, Australia has a low personal savings ratio, almost as low as that of the United States, and this is one element in the current account deficit. The problem is not the current account as such but rather the likelihood that the community is making inadequate provision for the future because of distortions in incentives and other reasons.

Coming briefly to Australian fiscal policy, relatively prudent fiscal policies combined with the boom yielded a low net public debt to GDP ratio by 1989, namely 12%, which was one of the lowest among the OECD countries. But high fiscal deficits since then brought it to 23% in 1993. While this was still low by international standards (the OECD average was 38%, and the US figure 39%), deficits have to be watched, because they can quickly explode.[9] This relatively favorable Australian situation is, I think, to be attributed at least in part to the power and good sense (rationality!), of the Federal Treasury over a long period. It does not mean that this particular debt ratio is 'optimal', a concept that is difficult to give meaning to when optimality must depend completely on the way in which the funds are spent and on future fiscal commitments, as well as on the extent to which a fiscal expansion raises output rather than crowding-out domestic private investment or ending up in increased foreign borrowing.[10] One can learn from the experience of many developing countries that the key problem is to maintain fiscal control. A firm commitment to a low deficit – and perhaps to balance over the cycle – is one way of doing this.[11]

---

9 The figures come from the Bank for International Settlements (1994, p.29).

10 The Australian government, like those of other OECD countries, has serious contingent liabilities, so that the prospects are not good unless current surpluses as usually measured are now generated. This point was made by Dr. Vince Fitzgerald at the conference in his paper. See Fitzgerald (1994).

11 I have been engaged in a World Bank-supported study of the macroeconomic experiences of eighteen developing countries over the period 1965 to 1990, and this simple lesson clearly emerges. Countries that have maintained fiscal control – usually because of the influence of key technocrats at the Ministry of Finance, and sometimes at the political level – have avoided crises, or dealt with them swiftly. The need for economic rationalism is universal! See Little, *et al.* (1993).

REFERENCES

Bank for International Settlements (1994), *64th Annual Report*, BIS, Basle.

Bean, C.R. (1994), "European Unemployment: A Survey," *Journal of Economic Literature*, 32, June, pp. 573-619.

Corden, W.M. (1979), "Wages and Unemployment in Australia," *The Economic Record*, 55(148), March, pp.1-19. Reprinted in J.W. Nevile (1981) (ed.), *Policies Against Stagflation*, Longman Cheshire, Melbourne.

Corden, W.M. (1989), "Australian Macroeconomic Policy Experience," *The Economic Record*, 65(189), June, pp. 152-63. Reprinted in Philip Maxwell (1991) (ed.), *Macroeconomics: Contemporary Australian Readings*. 2nd edn., Harper and Row Publishers, Sydney.

Corden, W.M. (1993), "Exchange Rate Policies for Developing Countries." In "Policy Forum," *The Economic Journal*, 103, January 1993.

Corden, W.M. (1994), *Economic Policy, Exchange Rates, and the International System*, Oxford University Press, Oxford.

Dominguez, Kathryn M. and Jeffrey A. Frankel (1993), *Does Foreign Exchange Intervention Work?*, Institute for International Economics, Washington, D.C.

Fitzgerald, V. (1994), "Saving, Investment and Growth: A Retrospective on the Debate". Paper presented at the 23rd Conference of Economists, Gold Coast, Australia, September.

International Monetary Fund (1994), *World Economic Outlook*, May 1994, IMF, Washington, D.C.

Little, I.M.D., R.N. Cooper, W.M. Corden and S. Rajapatirana (1993), *Boom, Crisis and Adjustment: The Macroeconomic Experience of Developing Countries*, New York: Oxford University Press, New York, for the World Bank.

Mussa, Michael and Morris Goldstein (1994), "The Integration of World Capital Markets," in Federal Reserve Bank of Kansas City, *Changing Capital Markets: Implications for Monetary Policy*, Kansas City.

Organisation for Economic Cooperation and Development, (1994), *The OECD Jobs Study. Facts, Analysis, Strategies*, OECD, Paris.