IS MACROECONOMICS DEAD?
Monetary and Fiscal Policy in Historical Context

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I THE CLASSICAL GOLDEN RULES IN THE TIME BEFORE KEYNES

There was no macroeconomic policy in the first 160 years of Economics. The economics of Smith, Ricardo, Mill, Marshall and Pigou was about the allocation of resources between competing uses, the distribution of the incomes derived from that activity, and the welfare associated with that allocation of resources and distribution of incomes. The business cycle was a fact of life, but a temporary disequilibrium that would damage society least if the natural processes of economic adjustment were left to themselves.

In this 'classical' and then 'neo-classical' view of the economy, changes in money supply were determined by the balance of payments through the tried and tested processes of the Gold Standard. Fiscal policy was about balancing the budget; a temporary fall in revenue in recession required a reduction in Government expenditure to match. Any recession would end when the domestic contraction had improved the balance of payments enough to expand the money supply, and when wages and prices had fallen enough to allow the money supply generated through the balance of payments to support adequate levels of economic activity and employment. Any attempt to short-circuit these processes through expansionary fiscal or monetary policy risked inflation, economic instability and side-effects that were worse than the disease.

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For those of us who were students in the first two post-war decades, economics was first of all macroeconomics. Economic policy was first of all macroeconomic policy. The loss of potential welfare associated with unemployment was so large, that its welfare effects overwhelmed those from imperfections in resource allocation. The task of economic policy was first of all to tame the business cycle: to avoid recessions and, when they occurred, to adjust monetary and, especially, fiscal policy to ensure that they were shallow and short. And this was first of all a task of managing aggregate demand so that real domestic demand remained in reasonable balance with the productive capacity of the economy.

Who among us ever forgot Keynes' devastating put-down of his Cambridge colleague Professor Pigou in the opening pages of *The General Theory*? For most of us, from the day we read *The General Theory*, that was all that we wanted to know of the work of that distinguished economist. It was therefore a surprise and a pleasure to stumble upon his work later in life.

In this short paper I am going to ask whether we have returned to a Pigovian world, in which we do not have to worry about maintaining balance between aggregate demand and the supply capacity of the economy; and in which we therefore can safely leave monetary and fiscal policy to the mechanistic application of a couple of simple rules. For determining the money supply, in the place of the Gold Standard, we have a Goods and Services standard, within which interests rates are adjusted so that the rate of increase in a general price index is low and steady. The Goods and Services standard requires a floating exchange rate, which adjusts without intervention to the myriad factors affecting supply and demand for external currencies. For fiscal policy, we simply make sure that the budget is in balance or in small surplus. Any tendency to larger surplus that results, for example, from a large increase in the terms of trade, is given back to taxpayers as a tax cut or benefits increase. Any deficit is anathema. Should the high terms of trade and government revenues go into retreat at some time, the whole process goes into reverse. The exchange rate falls; wages and prices fall to maintain full employment; net exports rise; and for a while real output rises more rapidly than real domestic demand.

One could add that the new Pigovian world would work better if, should institutional rigidities block smooth adjustment, they were removed through reform, as policy-makers tried to do in the lead-up to depression three-quarters of a century ago. Wouldn't this be better than distorting the whole of economic policy to avoid their effects?

There is much that was good about the rules of monetary and fiscal policy as they were understood and practised before the General Theory. Didn't the classical Golden Rules work well enough in Britain for the century between the Napoleonic and Great Wars that saw hugely increased output and incomes in that country? Didn't the Golden Rules work well enough in the United States from the Civil War until the crash of 1929, during which time that country moved to the first rank of economies by virtually all measures? Didn't they work well enough in Australia in the long boom from the Gold Rushes of the 1850s until the Depression of 1891, that gave the seven colonies on that continent, and the neighbouring islands to the Southeast, the highest standards of living in the world? And might they not have worked long after that in Australia if the young democracies there had not tried to block the natural adjustment processes with arbitrated wages, protection and multiple Government interventions in the economy?

II THE RE-EMERGENCE OF THESE CLASSICAL GOLDEN RULES IN TODAY'S WORLD

I was led to these questions by thinking about the current macroeconomic position of Australia. On 17 May 2005 the Treasury Secretary, Ken Henry, gave an important speech on the Australian Federal Budget for 2005 to the Society of Australian Business Economists in Sydney. Henry presented strongly the view that there was no case for the 2005 budget to have been tightened—or have been allowed to tighten automatically—because export prices had unexpectedly risen to unusual heights. He explicitly rejected the case for letting the tax-to-GDP ratio rise when export prices are unexpectedly high. Rather, Henry asserted, with a floating exchange rate, the exchange rate rises with increases in the terms of trade. This causes net exports to fall and allows the expansion of real domestic expenditure to rise above real output growth without increasing inflationary pressures on demand for domestic resources. The rise in the exchange rate may more than compensate for any increased inflationary pressure from the expansion of real domestic demand, perhaps even leading to a reduction in inflation.

In this, the Secretary was implicitly arguing against the views of a number economists. These people, who include myself, have argued that, since the buoyant export revenues of recent years have depended on huge increases in Australia's terms of trade that might turn out to be temporary, it would be prudent to accumulate large budget surpluses for a while, just in case the increase in export prices did, indeed, turn out to be temporary. To expand expenditure immediately to levels that would be sustainable only at high terms of trade, might - we have argued - require painful adjustment, should the terms of trade decline in the short or medium term. We have been putting forward a view - quite different from that enshrined in the classical Golden Rules - that fiscal policy should play an active part in stabilising the economy in the face of important 'imbalances'.

Defenders of the classical Golden Rules, and of how they should be applied to today's economy, are not always entirely consistent. Thus on p.7 of Ken Henry's presentation, quoted above, he says that, despite what has been said above, the task of macroeconomic policy is to keep its eye on the balance between actual output and the economy's capacity to supply output, with an eye on the possible emergence of inflationary pressures. But we have already been told that inflationary pressures, presumably without limit, can be handled by a rise in the exchange rate and increase in net imports. This of course is true, but only if the exchange rate really does move as required, and providing, also, that we are not concerned about the rise in net imports whatever its extent, and providing, in addition, that we would not be worried by the costs of adjustment that would be associated with reducing real demand below output growth, to keep inflation low, if and when the terms of trade fell back, and the exchange rate were to fall, in response, as required.

Let me say at once that nothing has happened yet that would suggest that serious misjudgements were made in the recent conduct of macroeconomic policy in Australia, or, indeed, in the conduct of budgetary policy. We all – including me – know how well things have gone. It is now eight years since I warned that Australians were about to receive a shock: that their country would soon find that it was in the midst of the third period of sustained prosperity since Federation in 1901. This warning of mine was made famous by its serial repetition by Prime Minister Howard. The shock of that warning has been thoroughly absorbed. And things have turned out even better than I imagined they would - the period of unbroken prosperity is now the longest since Federation. Our community would now be shocked more by a disruption of this prosperity than by its continuation.

There is now great confidence in Australia about the likely longevity of the contemporary prosperity. This includes official Australia, as revealed in successive statements from the Treasury and the Reserve Bank. These assert that steady economic growth will be maintained through a combination of (i) a floating dollar (to handle external payments imbalances), (ii) inflation targeting by the Reserve Bank of Australia, using interest-rate policy, and (iii) small and steady fiscal surpluses.

III WHY THE CLASSICAL GOLDEN RULES WERE ABANDONED IN AN EARLIER ERA

The classical Golden Rules worked well for significantly long periods. While they were associated with prosperity, great things were said and thought about them. But they ceased to work well when they were faced by institutional change and internal and external shocks of a dimension that had not previously been contemplated. They then became discredited in the community and the economics profession. Is there some combination of institutional change, and shocks, that could generate unhappy surprises from the current settings of macroeconomic policy? And what might these changes and shocks be?

The shock that unwound the classical system in the inter-war years was increased rigidity in prices and wages. The classical assumption that prices and wages adjust over a reasonable time period to remove unemployment of resources was not facile in most developed countries in the late nineteenth century and early twentieth centuries. But institutional change caused wage and price rigidities to be much greater in the economy to which Chancellor of the Exchequer Winston Churchill returned to the Gold Standard in the middle 1920s than they were in the economy that had been taken to war in 1914: the increased strength of trade unions; the growing assertiveness of democratic polities and its reflection in myriad government interventions in the economy; and the shadow cast by pervasive wartime interventions on post-war economic structure.

A flexible economy, like the classical model, can easily adjust to shocks of many kinds, so that unemployment of resources will be a brief and minor phenomenon after each adverse turn of national economic events. A flexible economy will make ordinary policy look good and good policy excellent. In these circumstances, the most important objective of policy can be to avoid creating shocks of larger dimension. The simple rules of the classical system help with this. They help policy-makers avoid the policy errors that, if they were to be made, would have adverse consequences beyond the normal range of other shocks.

It must be acknowledged, however, that there are limits to the extent of the shocks that can be easily handled even by highly flexible economies. Here the point is best made by reference to the United States economy in the Great Depression. The downward shock to activity delivered by a sharp contraction in the money supply, exacerbated by trade and budget policy, and greatly magnified by a collapse of what Keynes used to describe as ‘animal spirits’ amongst investors, was all too much even for what, then even more than now, was an exemplar of economic flexibility.

IV THINGS WHICH HELP THE RULES TO WORK WELL, AND THINGS WHICH DO NOT

There are several circumstances in which economic performance remains tolerably good independently of the way in which macroeconomic policy is conducted, even where there is relatively little flexibility in wages, prices and allocation of resources. One of these circumstances is when there are few large shocks that need to be managed, either internal, non-policy, shocks or external shocks.

A second circumstance is when the shocks are all in the direction of facilitating the constraint of expenditure within bounds that are reasonably consistent with the supply capacity of the economy. There are a number of ways in which this can happen. The chief amongst these is when productivity is rising faster than expectations of remuneration, either because productivity growth has undergone recent acceleration, or because the economy has recently come through, for whatever cause, a period of slow incomes growth. A variation on this theme is when the ratio of employment to population is growing, because of the age structure of the population, or because of reforms which remove impediments to labour force participation or employment, or because there is unemployment and opportunities for its reduction. The second is when terms of trade are rising, and, if we are concerned about the future as well as the present, are expected to remain high. A third is when, for one reason or another, often to do with the animal spirits of business people, investment is rising. A fourth is when the state of the external accounts and foreign indebtedness allows room for expansion of expenditure relative to production without fear of unsustainable expansion of net external liabilities. And a fifth and final possibility gives Keynes another place in our contemporary story. There is always some degree of stickiness in prices and wages, and that is reinforced by a recent history of lower rather than higher inflation, which leads to an increased degree of 'money illusion'. When this has happened it becomes easier to bring about adjustment, by creating circumstances in which inflation comes out above expectations, leading to reductions, and acceptance of reductions, in real incomes.

These are the various conditions that create the salad days of macroeconomic policy when ordinary macro policy looks good, and good policy looks celestial.

But there are times when each of these conditions can be delivered in reverse. First of all, circumstances may deliver unusually large shocks, from home or abroad. Worse, the shocks may all be in a direction that makes it harder for the authorities to constrain demand within the (appropriately defined and adjusted) productive capacity of the economy. For example, productivity growth may decelerate from high levels that have raised expectations about what is normal in the way of increases in incomes. Or terms of trade may slide, causing income growth to fall behind the expansion of output. Or the animal spirits of entrepreneurs may deliver relatively low and perhaps negative increases in investment for a while. Or inflation may turn out to be lower than expected, sending the benefits from 'money illusion' into reverse. Or unsustainable deficits in external payments or levels of foreign indebtedness may require growth in expenditure to be held below growth in output for a while. These are the dog days of macroeconomic policy, when excellent policy doesn't even look good to the community and polity, and mediocre policy looks appalling.

What does all of this say about the new classical rules, of the Goods and Services Standard of monetary policy; and the steady small surplus for budget policy?

When thinking about how to answer this question, I take Australia as my reference point. But the question is a broad one, of relevance to all countries which have embraced the new classical rules.

V AUSTRALIA IN THE 1990S: A TIME AND PLACE IN WHICH THESE RULES WORKED VERY WELL

Over these past 14 years, the modern Golden Rules of macroeconomic policy have produced marvellous outcomes in Australia. They have supported the longest period of continuous expansion in Australia's economic history, at average rates of growth relative to other developed countries that are higher than over any comparably long period in Australia's history.

It is important to understand the conditions under which recent success in Australia was generated.

The first of the conditions for success in the 1990s was the opportunity to expand the proportion of the population in employment, because, at the beginning, unemployment rates were high and participation rates low.

The second of these conditions was the more flexible wages, prices and resource allocation that emerged from the reforms of the 1980s and early 1990s. This increased the economy's capacity to adjust promptly to shocks, with minimal unemployment of resources. This feature of the modern economy may be enhanced somewhat by the implementation of the more ambitious variants of the current Australian Government's hopes for reform of the industrial relations system.

The third condition was the low expectation of increases in incomes that followed the 1980s Accord between the Labor Government and the trade union movement[2], and then the deep recession of 1990-91. This was reinforced by a big and persistent reduction in inflationary expectations, at first by means of the recession, and then through entrenchment of the inflation targeting regime with tight monetary policy that, for a number of years, kept the rate of increase of prices at or below the lower end of the Reserve Bank's target range.

The fourth condition was the big lift in productivity growth in the 1990s, that followed the trade and financial liberalisation and the partial labour market deregulation of the decade from 1983.

In the presence of these conditions, the new 'inflation targeting' (with a floating exchange rate) and, after the fiscal deficit left over from recession and the Government's response to it had been corrected, the 'steady low surplus' approach to

[2] This was in effect a form of freeze in the growth in money wages, against the background of which the Australian dollar was significantly depreciated, enabling a very significant depreciation of the real exchange rate.

fiscal policy gave Australia its extraordinarily high and stable growth during the 1990s.

My question is: does this record of great success make these rules alone the most likely to generate continuous strong growth in future?

VI AUSTRALIA IN THE 2000s: IS THIS GOOD PERFORMANCE AT RISK?

To answer my question, it is important to see that, by the early twenty-first century, some of the supporting conditions of the salad days for Australia had weakened considerably.

First of all, productivity growth dropped sharply at the beginning of this decade. It is not quite clear why this happened, and it is right to be nervous about the official numbers on recent productivity growth. Nevertheless, it seems that, since around 2000, the rate of productivity growth has been at a much lower level than it was in the 1990s. Over this same period, the economy has not been able to expand so easily the proportion of the people in employment. Employment ratios remain low by the standards of some comparable countries, but their increase now depends on inter-related reforms to labour-market regulation, taxation, and social security. By 2000, the community had grown accustomed to material progress in the form of rising real incomes, capital gains from household assets, and some combination of increased government expenditure and reduced taxation. But the possibilities for meeting these expectations have since then been expanding much less rapidly.

The salad days may have ended there and then. But two remarkable things have happened.

First of all, there has been an extraordinary housing boom, which has led to a release of animal spirits of quite prodigious dimensions. For several years from 2001, growth in the whole economy was maintained by rapid expansion of housing investment, and by private consumption supported by the wealth effects of the housing boom. This compensated for the virtual cessation, from 2000–1 onwards, of what had been very strong growth in exports of services and manufactured goods—for Australia, non-traditional exports—since the mid-1980s. The boom was proximately funded by a rapid growth in household debt. But it was ultimately funded externally, being the other side of the coin to a large increase in the current account deficit.

That housing boom was unsustainable. Its demise, in turn, might well have signalled a period of retrenchment and adjustment, something that would have been difficult even for the flexible modern Australian economy to sustain without a painful decline in activity and employment.

But then a second thing happened. The housing boom was succeeded by an extraordinary lift in prices for several of Australia's major mineral export commodities, deriving to a considerable extent from demands generated by rapid sustained growth in China. The lift in the terms of trade was soon followed by large expansion of investment in the resources sector. The resources boom supported extraordinarily rapid expansion in government revenue which, within the 'steady small surplus' approach to fiscal policy, was applied to rapid growth in public consumption expenditure and reductions in income tax rates. This resources boom is responsible, directly or indirectly, for the whole, and, indeed, more than the whole, of the modest but positive increase in output in Australia since 2003. And it is responsible for the excess of incomes over production that has been an outstanding feature of the national accounts over this period, and which supported continued perceptions of prosperity within the Australian community.

The higher export prices, and the investment associated with the export boom, has so far kept the exchange rate strong enough for inflation to remain within the target range with only small increases in interest rates. But the external deficits and debt, that is the legacy of the housing boom, have kept the external value of the Australian dollar well below the levels to which the terms of trade would otherwise have taken it. There are questions about where the dollar will head next.

The biggest of these questions is whether the China resources boom - already of larger dimension than earlier famous twentieth century Australian resources booms - is a long-lasting feature of the Australian economic environment.

The Chinese industrial expansion of the early twenty-first century has no precedent in scale in global economic history, in absolute terms or relative to the established world economy. It is just possible that, unlike the late 1960s and early 1970s, or the late 1970s or early 1980s, this boom will be with us for a long time. In this case the new Golden Rules will be entrenched by their success.

But that is not the only possibility. Indeed the 2005 budget papers of the Australian Treasury embody the view that the supply response around the world is set to haul minerals prices back towards historically 'normal' levels. It is possible, too, that China's prodigious growth falters, even for a while. If that happens we will find the adjustment process painful in ways of which those very same budget papers give not the slightest hint. Australians will then all wish that they had put aside more of what will then be seen as temporary good fortune for the fisc.

VII FISCAL PRUDENCE AS A RESPONSE TO RISK

How this important story ends will have important implications for the standing of the new Golden Rules, in Australia, and perhaps beyond.

One possibility is that Australia's high current terms of trade, held aloft by continued rapid economic growth in China, and untroubled by any substantial setback to expansion in other major economies, will persist for a considerable period. This would keep government revenues strong, allowing maintenance of the 'no deficits' fiscal strategy without fiscal retrenchment. Private investment would remain strong in the resources sector, as would resources exports. Together these sources of demand for Australian goods and services might, just might, offset a long period of weak housing investment and private consumption expenditure as households absorb and adjust to the consequences of the end of an extraordinary housing boom. The exchange rate may remain strong, so that inflation for tradables goods and services poses not threat to the Reserve Bank's inflation goals. The recent moderation in domestic demand growth might be enough to keep overall inflation close to the target range—most likely, exceeding it moderately for a while, before falling back below 3 per cent per annum. Such an outcome would entrench support for the new rules for a considerable period.

There are other possibilities. The resources boom's contributions to exports, investment and incomes may continue to increase for a while, and the recent easing of domestic demand may give way to some resumption of growth in housing and consumption demand. Meanwhile, the extraordinarily high levels of the current account deficit may continue to place downward pressure on the foreign-exchange value of the Australian dollar, as in the second half of 2005. Both tradables and non-tradables inflation would be contributing to strong upward pressure on inflation—from a starting point in late 2005 at the top of the Reserve Bank's range. The Reserve Bank would need to raise interest rates—perhaps by an amount that would surprise most observers, as in the case of New Zealand in recent times. This would severely test political support for the new approach to monetary policy, which to date has been seen as delivering historically low interest rates as well as stable prices and output growth.

The bigger test would come if the scenario anticipated in the preceding paragraph was followed by readjustment of expectations of global demand for energy and metals, bringing down Australia's terms of trade and investment in the resources sector. It is likely that such developments, in Australia's circumstances of large current account deficits and net external debt even during a period of unusually high terms of trade, would be associated with sharp exchange-rate depreciation. Inflation targeting would require the tightening of monetary policy just as recessionary tendencies were emerging. Inflation targeting and central bank independence would become politically controversial. We would then learn whether recent intellectual and political support for the new Golden Rules was robust, or depended on the favourable environment of the one and a half decades during which they have been applied.

Since we do not know with certainty the end of the story, it might be prudent for Australia to hold back some of its fiscal good fortune, until more of the future has revealed itself. Saving more of the higher incomes and especially public revenues associated with the resources boom would mean less downward adjustment in expenditure and incomes on the easing of the resources boom, should the conditions which generated high incomes and public revenues turn out to be temporary. Such a modification of the contemporary approach to fiscal policy would reduce future pressure on the new approach to monetary policy. Amongst other things, such a prudent course would increase the chances of the Australian polity keeping hold of those parts of the new Golden Rules which would have continuing value, whatever the future may hold.