

Discussion

1. David Gruen

John Pitchford has been thinking and writing about the Australian exchange rate and macroeconomic policy for a long time and this paper reflects his longstanding interest in the area. I always find his papers interesting and stimulating. As a good example, I have spent a lot of time in the past few years trying to decide what I think about Pitchford's 'consenting adults' view of the current account. But more of that shortly. Suffice it to say that while I don't always agree with him, his arguments always lead me to think harder about my own positions.

Pitchford's paper on *The Exchange Rate and Macroeconomic Policy in Australia*, covers a lot of ground and in my comments, I can only discuss some of the key ideas. I want to focus particularly on policy issues raised in the paper and, at the risk of oversimplifying, I'll discuss five issues central to this topic. In each case, I'll express the issue as a question, give what I think is Pitchford's answer to the question and then give my reaction to his answer.

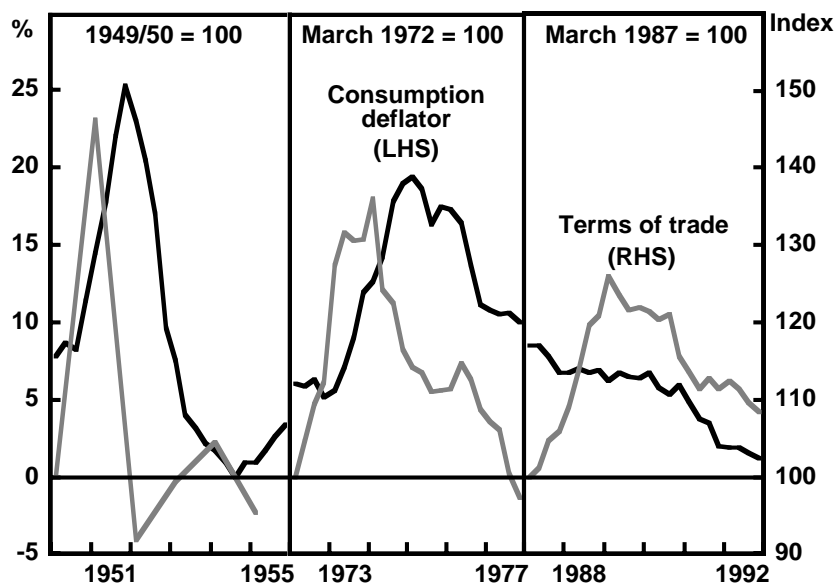
1.1 Which Exchange Rate Regime, Fixed or Floating, is Preferable for Australia?

Pitchford's answer to this question is clearly 'floating'. Being a commodity exporter, Australia's terms of trade are subject to big swings. A floating nominal exchange rate allows the real exchange rate to adjust without big (and costly) changes in domestic inflation. It also allows Australia to insulate itself from general foreign inflation. For Australia, a floating rate is preferable in theory and has worked well in practice.

My response to this view is that I also think a floating exchange rate regime is clearly preferable for Australia, and Figure 1 illustrates one of its advantages. It shows Australian consumer price inflation in the aftermath of three large, but temporary, increases in Australian export prices. As Figure 1 shows, the domestic inflation response was strikingly different in the two earlier fixed-rate episodes than in the final floating-rate one. While the exchange rate regime is not the only difference between these episodes, the capacity of a floating rate to appreciate in response to a favourable export price shock helped the Australian economy avoid a blow-out in domestic inflation in the late 1980s.

1.2 Should Public Policy be Concerned About the Large Build-Up of Australia's Net Foreign Liabilities Over the Past Decade?

I include this question not only because Pitchford discusses it, but also because

Figure 1: Terms of Trade and Inflation

it has been so central to the Australian debate about the external sector and the behaviour of the exchange rate.

Pitchford's answer to the question is most definitely 'no'. While distortions and externalities should be corrected, 'borrowing or lending abroad by the private sector in a world of mobile financial capital is part of a beneficial process of real capital accumulation which is not confined by national boundaries - the timing of any adjustment process depends on the forces underlying the supply and demand for capital and is unlikely to be easily predicted' (see Section 6.2).

My response to this is that I hope he is right. Australia's current account deficit over the 1980s averaged 4.8 per cent of GDP and net external debt increased from under 10 per cent to about 40 per cent of GDP. At the very least, this stock of debt makes the Australian economy more vulnerable to unexpected adverse export price shocks and/or changes in sentiment by the foreign holders of this debt. A sudden drop in foreign demand for Australian assets would normally be reversed by a fall in the Australian dollar (\$A). But asset markets do not always work that way, and it is possible that such a sudden drop would instead require a rapid fall in the current account deficit that would only come about with a severe domestic recession.¹ While it is hard to estimate the likelihood of such a 'hard landing', it is not so implausible that it should be dismissed out of hand.

1. Gruen and Grattan (1993) provide more detail on this and related reasons for concern about the build-up of Australia's foreign debt.

1.3 Does the Floating Exchange Rate Mostly Give Appropriate Relative Price Signals to the Traded and Non-Traded Goods Sectors of the Economy?

Pitchford acknowledges that econometric evidence has been very destructive of *all* theoretical exchange rate models. But even over short time spans (say, a year), he repeatedly argues that exchange rate changes have macroeconomic causes - for example, exogenous changes in investment, saving, fiscal or monetary stance. I conclude that his answer is 'yes'.

My response to this is that, in the long-run, exchange rates do respond to changes in the macroeconomy (e.g., inflation or productivity differentials between countries, terms of trade). But over horizons relevant to the business cycle and to efficient resource allocation in the economy, the evidence strongly suggests that exchange rates are sometimes (often) subject to swings and bandwagon effects that defy explanation even *ex post* as a rational market reaction to macroeconomic fundamentals. The quarter-to-quarter volatility of floating rates also defies explanation and probably has efficiency costs because it induces a significant option value to waiting to invest in the tradeables sector (Dixit 1989). So, I'd change the answer to 'no' - the market sometimes sets the exchange rate at an inappropriate level. It would be nice to know the economic cost of these misalignments.

1.4 Should the Reserve Bank Engage in Sterilised Foreign Exchange Market Intervention?

Pitchford's answer to this is 'perhaps', though I sense that he is uneasy with the idea: 'the clearest case for sterilised intervention would seem to be where the authorities possess superior information to the private sector - where (this) information can be made available, doing so directly, rather than signalling through intervention, would appear far preferable. The alternative involves signals which may be misread' (see Section 5.3).

Pitchford does, however, argue that 'there do not seem to have been any obvious cases in which intervention has been harmful and the process is said to have made money so that the taxpayer has not been required to finance it. If it helps to sustain confidence that the market is reflecting fundamentals, its contribution would seem valuable. In these circumstances there do not seem to be grounds for discontinuing sterilised intervention, provided it is conducted with an awareness of the possible pitfalls' (see Section 6.3).

My answer to the question is 'probably yes'. Pitchford discusses the possibility of rational speculative bubbles, but is sceptical of their relevance. I agree. To quote Michael Mussa (1990, p. 13), rational bubbles require 'not only that (foreign exchange market participants) are sometimes crazy, but that they are systematically,

calculatingly, and fanatically insane' which fits rather uneasily with the idea that they are also rational.

Rather than being justified by the existence of rational bubbles, the strongest argument for sterilised intervention is the apparent importance of foreign exchange participants who trade on noise, on charts or using feedback rules (like 'stop-loss' orders). It is hard to see how these participants' actions have any social benefit and so separating them from some of their money is probably welfare enhancing.

As Michael Artis reports in his paper at this Conference, international evidence on sterilised intervention is still mixed, but some recent evidence suggests that 'since 1984, all but one of the major turning points in the trajectory of the [US] dollar exchange rate coincide with episodes of intervention'. A similar statement is also true for Australia. The Reserve Bank was a net buyer of Australian dollars when the currency was near its all-time low in 1986, and a net seller two years later when the \$A was at its subsequent high point. While this sterilised intervention may or may not have had a lasting impact on the level of the \$A, it was certainly profitable. Since the 1983 float, the realised trading profits from sterilised intervention have been about \$A 500 million.

1.5 Should Monetary Policy be Used to Influence Current Account Outcomes?

I conclude with this question because, like question two, it has been central to the Australian debate. Many, including Pitchford in his paper, argue that tight monetary policy in the second half of the 1980s was at least partly directed at reducing the current account deficit.

Pitchford's answer is 'no'. A current account deficit is not intrinsically bad. Distortions or externalities relevant to private saving or investment should be tackled directly. Similarly, the government fiscal deficit should be judged on its own merits rather than in terms of its impact on the current account.

I agree that monetary policy should not be used to influence current account outcomes. A defense of tight monetary policy in the second half of the 1980s can and should be based on two grounds. Firstly, domestic inflation was more than double the OECD average and, uncontroversially, the Reserve Bank wanted to reduce it. Secondly, Australia was experiencing a tremendous speculative boom with an asset price bubble and a surge in domestic demand which threatened to spill over into higher goods price inflation and a collapse of the Accord with the trade union movement.

Finally, let me apologise to John for putting words into his mouth. But I have no doubt that he'll get a chance to defend himself.

References

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2. General Discussion

The discussion following the Pitchford paper largely focused on the following two issues:

- the benefits of fixed versus floating exchange rates; and
- the rationale and effectiveness of sterilised foreign exchange market intervention.

There was widespread, though not universal, acceptance of the proposition that, for Australia, a floating exchange rate was superior to a fixed rate. The opposing view was that a floating exchange rate did not provide enough discipline on the monetary authorities, who would always deliver too high an inflation rate. This view was held by a very small minority of participants. Given large swings in Australia's terms of trade and investment, real exchange rate flexibility was important. Floating nominal exchange rates permitted rapid changes in real rates, as opposed to their more painful adjustment via relative price levels in goods markets. Because of rigidities in goods and labour markets, real exchange rate adjustments forced through price levels that often entailed large and undesirable output adjustments.

Fixed exchange rates were also seen as undesirable for Australia, because there is no logical currency against which to fix. Even if such a currency could be identified, it was argued that fixing the exchange rate as an efficient anti-inflationary mechanism has generally met with limited success in those countries where it has been tried. Where success has been achieved in reducing inflation, the output cost does not seem lower than in those countries with floating exchange rates which have also reduced inflation.

In the discussion on foreign exchange market intervention, it was noted that, since the floating of the \$A, the Reserve Bank's intervention had generated

considerable profits. These profits stand in contrast to the large losses made by central banks attempting to defend fixed exchange rates. In general, it was thought that informational inefficiencies in the foreign exchange market created the possibility of profitable official intervention. It was, however, important that the central bank not try to defend unrealistic policy settings and maintain an exchange rate away from its fundamental equilibrium value. This would have left open the possibility of large foreign exchange losses incurred by the central bank.

Some participants argued that if the authorities set clear ultimate policy targets, the exchange rate would be self-equilibrating and, as a result, there would be no need for foreign exchange market intervention. On the rare occasions when the market lacked direction or confidence in the ability of the authorities to achieve the ultimate policy objectives, the central bank could reaffirm its intentions by changing interest rates. In most cases, these changes should only need to be short-lived. In contrast, other participants argued that, on occasion, sterilised foreign exchange market intervention could provide some direction to the market that would remove the need for changes in interest rates. This mechanism was viewed favourably by those who thought that participants in the foreign exchange market did not have rational expectations and were predisposed towards fads. It was argued that the 'little stick' of intervention was sometimes superior to the 'big stick' of changing interest rates. It was important, however, that the market viewed the little stick as credible. There was little support for the proposition that sterilised foreign exchange market intervention could alter the exchange rate permanently.

Finally, the history of Australian monetary policy over recent years, and in particular, the link between monetary policy and the current account, was discussed. It was argued that in the late 1980s monetary policy was aimed at controlling the strong growth in domestic demand. This growth threatened to lead to an increase in inflation that was thought to be undesirable. Consequently, monetary policy was tightened. This tightening slowed domestic demand growth and this, in turn, resulted in an improvement in the current account. Monetary policy was responding to domestic demand and potential inflation and not to the current account itself.