Discussion

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The issue that Susan Collins addresses in her paper is whether the buildup of net foreign indebtedness from current account deficits requires a policy response to eliminate these deficits. I am an outsider to this debate with my area of expertise focussing on issues of how monetary policy should be best conducted. In the past, I have committed in print to the proposition that the two main goals that a central bank should pursue are price stability and financial stability. One question raised by Susan's paper is whether a central bank should pursue a third goal in the conduct of monetary policy: the elimination of current account deficits. Susan's answer for Australia is no, although she does hedge her bets a little bit by indicating that in some situations, as in the case of Japan during the postwar adjustment years from 1953-1964, using monetary policy to manipulate the current account may not have been a bad policy. I, on the other hand, want to come down much stronger against the use of monetary policy to manipulate the current account: under no conditions should the monetary authority focus on the current account as a target of its policy.

Before I go on to discuss how policy makers should respond to current account deficits, I do want to discuss some methodological issues about the approach used by Susan in her paper.

The Case Study Approach

Susan's paper uses the case study approach to look at whether persistent current account deficits for other countries in Asia have created serious problems for their economies. The evidence in Susan's paper indicates that the answer is no. Her studies of Asian countries, particularly South Korea and Indonesia, show that current account deficits are often necessary to keep domestic investment high, even when there is a shortfall in domestic savings, and can therefore be an important part of a virtuous cycle which promotes investment and growth.

I found Susan's case study evidence to be extremely informative and useful, and I think that it convincingly demonstrates that current account deficits do not have to lead to problems. My only criticism of her analysis is that by focussing on Asia, she only has looked at countries that have been a success story. To fully assess what problems might arise from persistent current account deficits, we would also want to look at countries with high deficits who eventually ran into difficulties. Specifically, it would have been worthwhile for the paper to have contained some discussion of the Latin American experience. As we know, Latin American countries incurred large current account deficits in the 1970s, but were unable to repay their foreign debt in the 1980s, leading to severe dislocations for their economies. The Latin American episodes suggest that there is not always a happy ending when a country has a large buildup of its foreign indebtedness.

My impression is that the key element of the Latin American debt problem was that the foreign debt was incurred by the government and not the private sector. Thus the incentives

to borrow only for productive investment opportunities were not strong and, at least on an *ex post* basis, over borrowing resulted. Since Australia's foreign debt has been primarily incurred by the private sector, it is not at all clear that Australia's situation is at all comparable to that in Latin America. Nonetheless, I would have liked the paper to contrast what happened in Latin America with what occurred in Asia, thereby helping us to see when persistent current account deficits might get a country into trouble.

Are Current Account Deficits a Problem for Australia?

Many economists, politicians and members of the media have a knee-jerk reaction that current account deficits which lead to substantial net foreign indebtedness must be bad. However, taking the view that foreign indebtedness is bad is like taking the view that any indebtedness is bad. Clearly borrowing can be a bad thing if there are the wrong incentives (bad tax policy, government guarantees, etc.) encouraging individuals and firms to borrow too much. Nonetheless, it must always be remembered that borrowing helps drive economic growth. The key role of financial markets in a successful economy is to promote borrowing: that is, financial markets move funds from those with a surplus to those with a deficit who have productive investment opportunities. If the borrowing channel were to be cut off, these productive investment opportunities would never see the light of day, thus making for an inefficient and slow growing economy.

This view of borrowing leads me to the following position. In order to make the case that current account deficits are a problem, you must demonstrate which incentives are wrong that either promote too much investment or too little saving. The standard criticism of current account deficits is that the net indebtedness they create will have to be paid back by lowering standards of living in the future. However, if foreign borrowing was used to make a productive investment, the result will be that output will grow so much that consumption in the future will rise even after the loans are paid back. Susan's discussion indicates that this seems to be the case for South Korea. However, current account deficits may be a problem for Australia. Susan finds that, in contrast to South Korea, net foreign indebtedness for Australia is associated with a future real depreciation of the Australian dollar. Because, in contrast to the Latin American countries who experienced a debt crisis, Australia's foreign debt has been incurred by private firms rather than the government, it is not obvious that there are distortions that have promoted overborrowing and over investment. Indeed, looking at the recent figures for Australian investment, it seems far more likely that there is a problem of under investment rather than over-investment.

However, there is reason to be concerned that Australia is undersaving. Australian savings rates are well below the other countries in Asia that Susan has looked at and there are reasons to believe that government policies have not given consumers the right incentives to save. For example, while the Australian government pension scheme may be highly justifiable on equity considerations, because it is given to old people only if they do not have enough income or assets, it discourages private saving. Also the reliance on income tax rather than a consumption tax to raise revenue also produces disincentives for private saving. There is also concern that Australian government budget deficits may remain high even after the economy strengthens, thus leading to government dissaving which also contributes to undersaving.

Implications for Policy

The key conclusion from Susan's paper and from the above discussion is that current account deficits do not automatically indicate that there is a problem that requires changes in government policy. Yet, this does not mean that current account deficits should be ignored because they might signal that incentives to save and investment may be incorrect, requiring a change in policy. The key point for policy making is that once a government's fiscal house is in order, the solution to a problem of an inappropriately high current account deficit is to create the right private incentives for savings and investment. This requires focussing on what distortions in private markets might be leading to non-optimal amounts of savings or investment, and then deciding how these distortions can be eliminated or, alternatively, offset by other microeconomic policies.

For example, evaluation of the incentives for dissaving arising from the Australian government pension system might indicate that superannuation contributions should be raised in order to get people to save the appropriate amount for retirement. By using superannuation to compensate for the distortion created by the government pension system, private saving would be closer to the optimal level and the current account deficit would shrink. Forced savings for retirement indeed has been part of the policy package in Singapore which raised savings rates and helped reduce current account deficits. An important point about this kind of policy response is that it does not focus on the current account deficit *per se*. Instead it identifies a distortion in the market and then tries to correct the distortion with microeconomic policies.

An inappropriate policy response to current account deficits is one which assumes that all such deficits are bad and thus require policies to either directly lower investment or raise savings to hit a target for the current account deficit. The use of monetary policy to hit current account deficit targets is exactly one such inappropriate policy response. Susan points out that using monetary policy to eliminate current account deficits wouldn't work very well for an open economy with flexible exchange rates like Australia. The usual story is that a tighter monetary policy reduces the current account deficit by raising saving and lowering investment. However, in an open economy with flexible exchange rates, the tighter monetary policy leads to an appreciation of the domestic currency which has offsetting effects on the current account. The result is that it is not clear whether a tightening of monetary policy will lower or raise the current account deficit.

I want to make the case against using monetary policy to deal with current account deficits even stronger. Under no conditions should monetary policy be used to eliminate current account deficits. The case against using monetary policy to reduce current account deficits applies equally well to closed economies with fixed exchange rates like Japan in the 1953-64 years as it does to an open economy with flexible exchange rates. Indeed, I feel that Susan gives too charitable a view of Japanese monetary policy in this period.

The idea that monetary policy can be used to deal with current account deficits is based on an old Keynesian fixed-price framework which is now thoroughly discredited. In this framework, tight money raises both nominal and real interest rates (because prices are fixed) which lead to a decrease in investment and an increase in savings that lowers the current account. However, in a world of flexible prices, although monetary policy can control real interest rates in the short run, it cannot control real interest rates in the long run.

The inability of monetary policy to control real interest rates in the long run is just an implication of long-run monetary neutrality in most standard flexible price macro models. Since monetary policy cannot control real interest rates in the long run, it cannot be used to correct a long-run structural problem of an imbalance between savings and investment.

The attempt to use a policy which only works in the short run but not in the long run only results in a stop-go policy like the one pursued by Japan in the 1953-64 period. It should be said that although Japanese monetary policy was based on inappropriate principles, it did not do too much damage to the economy. Luckily, Japan developed high savings during this period so that there was no large structural imbalance between savings and investment which required a permanent contraction of investment and the economy in order to satisfy the current account target.

Although I have criticised the use of monetary policy to reduce current account deficits, I want to be careful to point out that inappropriate monetary policy which produces inflation may create distortions in the economy which lead to large current account deficits. Thus, I am wholeheartedly in agreement with Susan's conclusion that prudent macroeconomic policies are an important element in keeping current account deficits from becoming a problem for a country. Keeping its fiscal house in order and not running large budget deficits is one element of prudent macroeconomic policies. The other elements are maintaining price stability and financial stability so that financial markets function properly, with the result that private investment and savings are optimal. Thus I am left holding to my earlier position that the monetary authorities should not focus on the current account but should stick to preserving price and financial stability.

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2. General Discussion

The discussion centred on various aspects of Australia's current account experience, but also touched on some of the examples from Asian countries discussed in the paper.

For Australia the focus was on two related issues. The first was whether the size of the current account deficit, and the level of foreign debt, were problems. The second concerned the causes of the imbalance between savings and investment.

One participant argued that Australia's level of foreign liabilities, and its continuing current account deficits, represented a serious problem. If the international market becomes reluctant to continue financing investment in Australia, the low level of Australian savings was thought to condemn future generations to declining relative, and perhaps absolute, living standards. Even if Australia continues to attract foreign savings, the increased foreign debt will cause the real exchange rate to depreciate in order to generate the trade surpluses necessary to service the foreign liabilities.

This pessimism was not universal. One participant argued that Australia typically devotes a higher share of GDP to investment than many OECD countries. While Australia's relatively fast population growth accounts for part of its high investment, it does not account for it entirely. This investment is being used to create the productive capacity to service the debt without the need for real depreciation. In addition, the process of internationalisation is probably increasing the economy's growth rate, so that there is

little reason to believe that the current foreign debt is going to saddle future generations with stagnant or declining living standards.

Most participants suggested that the current imbalance between domestic savings and investment was probably not optimal. Three reasons were cited. First, some saw government savings as too low. An increase in the structural budget deficit may have been warranted in the early 1990s, but there was a feeling that the government was not winding back the budget deficit quickly enough. However, it was also remarked that it might be difficult to maintain the quality of government spending, while reducing the deficit, so that there was a trade-off between quality and size. Nevertheless as investment levels rise, the failure of government savings to increase significantly may lead to a substantial increase in the current account deficit.

Second, when taking account of opportunity costs, the private savings rate can be too low. Even if this is not caused by policy-induced distortions, it is a policy problem. The existence of policy-induced distortions affecting private saving was seen as the third reason why the savings-investment imbalance may not be optimal. While one way to increase total savings was to remove the distortions, in some cases the distortions were important tools of social policy. Here, the pension system was seen as very important. By guaranteeing payments from the government after retirement, the pension system discouraged individuals from saving sufficiently. Given that removing the social safety net was undesirable, the discussion turned to other policies that could be used to prevent the pension system from unduly distorting the aggregate savings outcome. Here, compulsory superannuation was thought to be particularly important. Changes in taxation were generally seen to be less effective in generating additional saving, as most saving was done for retirement. Given the continued existence of the safety net, changing incentives through taxation was thought to be inferior to compulsion. However, not all participants were in favour of compulsion, as it restricted individuals' rights to make their own decisions. There was no disagreement with the proposition that monetary policy was an inappropriate tool to target the current account deficit.

In reference to the Japanese experience, it was argued that the combination of a fixed exchange rate and a lack of access to world capital markets forced the authorities to use monetary policy to keep the current account in balance. There was also some discussion as to whether increased growth led to higher savings, or higher savings led to faster growth. A number of participants made the case that various countries experienced high investment rates and high current account deficits initially but then, as the growth dividend from the investment began to be realised, savings rates rose. In addition, in a number of countries, policies designed specifically to increase savings were initiated. There was some question as to whether these schemes did in fact increase savings rates. The example of Singapore was given where the Central Provident Fund appears to have contributed to the national savings rate of over 40 per cent of GDP, though it is not the only policy. In Malaysia, savings may have also been strengthened by policy measures, while the effects of such measures in Thailand were said to be uncertain.