

**MACROECONOMIC POLICY AND
STRUCTURAL CHANGE
IN EAST ASIA**

**OPENING ADDRESS TO THE TREASURY
CONFERENCE**

SYDNEY

FEBRUARY 2005

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It is a great pleasure to welcome you to Sydney today, to this inaugural high-level conference for officials from East Asia and the Pacific.

It is almost always the case that the world can look like a dangerous place. Today, there are tensions and imbalances in economic relationships that pose risks for all economies. And some of our economies are transitioning to new regimes on pathways that might not always be smooth. But there are also big opportunities for all economies in increasing openness; opportunities that – as Australia's recent experience shows – can be exploited to very good effect with the right domestic policies and institutional arrangements.

The focus for this conference, then, is an exploration of just what sorts of policies and institutions might prove most productive in East Asia and the Pacific – in securing the gains from increasing openness while reducing its dangers.

Three closely interrelated topics provide the agenda for our discussions – disturbances from the rest of the world; the composition and mix of fiscal and monetary policies; and getting the 'hard' and 'soft' institutions right to deliver best policy outcomes.

The international dimension

There has been a rapid expansion in cross-border economic activity in the past 50 years – including expanding trade and cross-border investment, broad liberalisation and deregulation of domestic markets and institutions, growth of the multinational enterprise and increasing mobility of people. Connections between economies are now wide and extensive; especially so in our dynamic outward-looking region.

I would like to talk a little about two international policy issues that are relevant to our discussion today: first, the policy challenge of maintaining an open global trading system; second, resolving structural imbalances in saving and investment.

An open trading system

The expansion of trade through domestic liberalisation under the auspices of the GATT and WTO has been remarkable. It has been a key driver of economic transformation in many countries – including my own. Given the powerful interests of those who enjoy closed or protected markets, and notwithstanding centuries of theoretical exposition and confirmatory practice strongly supportive of open markets, trade liberalisation has never been easy; indeed, fragility in global trade negotiation rounds has been a constant. And even when trade negotiations are moving apace their motivation can be suspect – all too often

with a mercantilist focus on securing market access for favoured national champions rather than a genuine interest in domestic consumers.

These traditional obstacles to economic liberalisation threaten the achievement of a successful conclusion to the Doha Round. And they present a challenge for those who would want to ensure that the many bilateral and regional preferential trade arrangements currently or prospectively in place do not inadvertently end up increasing burdens in cross-border activity or distorting incentives and choice.

This matters to us as macroeconomic policy advisers because the extent and pattern of international trade can have deep economic consequences, affecting the structure and operation of markets and the flexibility and robustness of the macro economy. Our success in securing the most sustainable growth possible in our economies depends in no small part on efficient and open cross-border trade and investment.

Structural imbalances in saving and investment

The extent of imbalances in saving and investment is also something that should be of interest to all of us here.

Of immediate interest is the extent and nature of saving-investment imbalances in East Asia. The region is a capital exporter; equivalently, the region has an excess of saving over

investment, resulting in current account surpluses. This is not all that surprising for a rich country like Japan, particularly given its demographic profile. But it is remarkable for many of the emerging market economies of the region, including some of the world's most dynamic, with substantial scope for further productive investment, including in the non-traded sector. This matters because inward investment provides valuable support for economic development and growth.

Before the financial crises of 1997 and 1998, East Asia's emerging market economies typically ran modest current account deficits. Obviously enough, this didn't surprise many people. It appeared quite consistent with the differences in expected rates of return on investment. As the World Bank has pointed out, the reversal of capital flows during the crisis is evidenced by a sharp decline in investment as a share of GDP in the affected economies – in some instances by double digit amounts. Saving ratios have also declined, but by much less. The outcome has been a net swing towards surplus on the current account, with the region's emerging market economies exporting rather than importing capital.

Capital exporting has led to concerns about the longer-term sustainability of growth in the region.

And from the perspective of the current account, the pursuit of growth through net exports and not private domestic demand

carries an exposure to potentially disruptive real external shocks.

Policy responses might include a greater focus on improving economic governance generally, promoting the health and stability of financial institutions, and fostering a steady expansion of private domestic demand. I look forward to learning more about these issues in our discussion in this morning's session.

But East Asia is not the only region about which questions might be raised concerning the size and direction of net capital flows. While rather slow to get started, there is now a robust debate about the burgeoning US current account deficit. This deficit has widened sharply over the past four years to its current annual level of around US\$660 billion, or 5.6 per cent of GDP. This is a record in both absolute terms and as a proportion of US GDP. It is a substantial call on world saving.

Viewing the current account deficit in a net lending framework, it is apparent that all of the deterioration since 2000 can be attributed to reduced saving and increased consumption rather than to increased investment. Moreover, in contrast to the situation of the 1990s, this has reflected a turnaround in the public net lending position, as federal, state and local government budgets have moved into deficit.

There is nothing inherently wrong with a highly developed economy running a current account deficit. In fact, a deficit can help stabilise the domestic economy when foreign demand weakens temporarily. Moreover, for an economy the size of the United States, a willingness and capacity to run large current account deficits when world growth is weak provides an important and stabilising source of global demand. In 1997 and 1998, for example, strong US domestic demand widened the US current account deficit but provided substantial and essential support to crisis-affected East Asia.

The issue is the sustainability of such a large imbalance. There is no hard and fast metric by which we can judge what level of current account deficit is sustainable. But there are some reasons for concern.

For one thing, in the absence of a slowdown in the US economy, the current account deficit is likely to grow even further. One reason for this is that imports are now about one and a half times exports. Even if the world economy grows in a balanced manner, and imports and exports grow at the same rate, the US current account deficit will deteriorate further.

Some commentators argue that the situation is worse than this. An empirical regularity in the post-war period is that US imports are more responsive to US income than US exports are to US trading partner income: US trading partners need to grow

substantially faster than the United States – rather than around the same pace – to maintain a constant trade balance (as a share of GDP).

Sustained large deficits lead to a substantial rise in US external liabilities. There are arguments that this is manageable, at least for a while – and maybe a relatively long while at that – but there are attendant risks:

First, non-official sector investors outside the United States want to buy US financial liabilities and real estate, presumably because they offer the best expected rates of return. But what if US growth and returns falter, as they did at the end of the last decade?

Second, the stock of US assets in non-US wealth is relatively small. But can the global portfolio absorb large changes at the margin without substantial price effects?

Third, some countries' monetary authorities are willing buyers of US liabilities, especially US Treasuries, even though they must surely be expecting negative returns. But what if they change their mind because the opportunity and holding costs simply become too high? And what happens when they consider their economies strong enough to bear currency appreciation?

Fourth, dollar depreciation tends to reduce America's net liabilities because its external liabilities are denominated in

dollars while its external assets are largely denominated in foreign currencies. But another way of saying this is that those who are financing the US current account suffer a capital loss – even negative economic returns – when the dollar depreciates. What happens when they demand higher bond yields in compensation?

Serious observers have been arguing since the late 1990s, when the US current account deficit was much smaller than it is now, that the deficit was unsustainable and would come undone in a couple of years. It hasn't. We obviously can't predict these things well. Yet what we are seeing with the cheap debt financing of the US current account deficit is worryingly reminiscent of Fed Chairman Greenspan's warning in 1996 of irrational exuberance in US stocks. The rise in stock prices might have had much further to run but it was still was a bubble. It burst eventually. Is something similar happening now to bond prices?

Whatever happens, the greater the build-up in structural imbalances, the greater is the risk of a large and sudden adjustment to the US economy, global capital and currency markets; and the more likely an adverse shock to all of our economies.

Given the serious consequences of a sharp correction to these imbalances, it is incumbent on us to consider the sorts of

policies that might support their orderly adjustment. It is difficult to see that there is a simple one-dimensional solution. Adjustment of global imbalances is likely to require a mix of: (1) policy adjustment, especially in the US budget deficit; (2) structural adjustment in other economies, including greater openness in trade (especially in services), more effective competition/anti-trust policies and enforcement (as a way to removing a non-tariff barrier to trade), more effective governance (especially in emerging market economies), and freeing up of the labour market (especially in Europe); and (3) some further dollar depreciation to support expenditure switching to US-produced goods and services.

There is general concern that dollar depreciation by itself won't do much to reduce the US current account deficit on a sustained basis; this is the regular outcome in modelling work.

Domestic dimensions to policy and change

Getting domestic policy right is essential in developing resilience to international shocks. There are three aspects that I would like to mention.

The first is the value to policy makers of medium-term monetary and fiscal policy frameworks – for which there is now widespread acceptance. Medium-term frameworks help anchor expectations and reduce uncertainty about the future so long as

the policy framework is credible. In my paper, I provide some detail on Australia's frameworks.

The second is the role of formal and informal review and transparency mechanisms in the policymaking process. A recent Australian example is the way thinking about demographic change has influenced our understanding of the economic consequences of population aging – particularly the consequences for economic growth and fiscal sustainability. Understanding the effects of aging has provided a structure for us to prioritise policy action. It has motivated support for further economic reform to improve incentives for people to enter and stay in the workforce and to improve productivity growth. And it has provided a further measure of fiscal discipline: slower economic growth due to aging slows revenue growth, while rising expenditure on health and aged care services and pensions raises spending growth.

The trigger for our thinking about demographic change was the *Charter of Budget Honesty Act*. Under the Act, the Australian Treasurer is required to produce an intergenerational report every five years, assessing the long term sustainability of current government policies over the next 40 years, including by taking account of the financial implications of demographic change. We produced our first *Intergenerational Report* in May 2002. The novelty of reporting on Australia's fiscal position beyond

the usual four-year forward estimates period attracted strong media and academic interest and, in turn, resulted in Australians becoming more aware of population aging issues.

Policy discussions have converged around the medium-term drivers of GDP – population, productivity and participation – with a concentration on the latter two. At the recent Federal election both the Government and the Opposition acknowledged the importance for Australia of increasing labour force participation and maintaining high levels of productivity growth. The Government has subsequently signalled that these issues will be priorities for its fourth term.

It is now common within government for policy proposals to be evaluated against the benchmarks of increasing productivity and labour force participation. The significantly more rigorous testing of the sustainability of policy proposals is almost entirely due to the publication, less than three years ago, of the *Intergenerational Report*. This is a significant illustration of the way in which a macro transparency instrument may prove effective in focussing attention on the quality of policy at a very micro level, and in building support for microeconomic reform.

The third pillar to support domestic policymaking has to do with the institutions of government. Innovation is a welcome source of dynamism and growth. But it does mean that policymaking institutions either need to be designed to be robust to innovation

or need to be adaptable. And if the legal systems themselves cannot be changed, then the practices around them may need to change to ensure that they remain effective.

The point can be illustrated with our experience, over more than two decades, of financial deregulation and liberalisation. Our regulated systems became progressively ‘leaky’ and – as a consequence – less effective in the 1970s and early 1980s. The authorities at the time decided, sensibly, that just extending legal control would begin a regulatory chase that they could never win. The financial system was liberalised. This directly impacted on monetary policy. It turned out that our monetary policy framework was not robust to market change. The one we have now – of an interest rate-based operational process with a medium-term inflation target – does seem to be robust since it targets the behaviour of people and firms in general and does not depend on particular institutional forms. As this case illustrates, simpler regulatory systems may prove both more effective and more resilient.

Institutions to support policy and change

Making a judgment about what is the desirable policy in particular circumstances is one thing. Being able to deliver that policy is another. As policymakers and their advisers know, advocacy, public support, balancing competing aims, and compromise are essential for successful policy implementation.

I would like here to reflect on some of the ways we can build up our institutions so that they support policymaking and reform.

The first reflection is the importance of nurturing a growing constituency for first-best policy and reform. We all face the onslaught and pressure of self-interested rent-seeking behaviour. To combat this, we need to pragmatically harness existing institutions inside and outside of government to support economic reform.

In Australia, a key role in advancing reform has been played by what is now called the Productivity Commission. The Productivity Commission is an independent government agency with responsibility for assessing policies, markets and institutions as requested by government. It has been around in various forms since the 1920s; originally as the Tariff Board, then the Industries Assistance Commission, the Industry Commission, before emerging as the Productivity Commission. In its original incarnation it was charged with designing forms of protection for Australian industry, especially manufacturing. The cumulative and direct experience of Tariff Board management in confronting rent-seeking behaviour, combined with emerging analytical insight by some key academics on the measurement of the consequences of protection and support by some reform-minded politicians, shifted their view on the value of protection. In the 1960s, they courageously started using

their annual report as a means of making the costs of protection known publicly. Thus began a revolution in policy thinking in Australia about rent-seeking, protection, and international openness. This radical transformation of the Tariff Board from mainstay of protection to independent but government-based advocate of reform and openness took time, effort and personal courage.

My second reflection is a bit closer to home. It has to do with the Australian Treasury's capacity to influence the public policy debate in Australia. We aim to provide our ministers with expert, independent and objective economic policy advice, and to implement the government's economic policy decisions in the most effective and efficient manner possible. We advise and implement; but it is the government that makes policy. At various times in our history as an institution, we have had difficulty in being heard and trusted by the government of the day. At times, when the government of the day has judged our advice and action to be inadequate, it has responded by looking for alternative sources of advice.

One example, in 1983, was the creation of the Economic Planning Advisory Council (EPAC). It was set up under the Department of the Prime Minister and Cabinet to provide the then government with analysis and advice on the medium to longer term economic issues facing the Australian economy. It

was, of course, an example of the pragmatic use of a ‘hard’ institution to influence the public debate. But the fact that it was a specially created institution, separate from the Treasury, was also an assessment that the Treasury was not the right institution to be charged with analysis of all of the economic policy issues important to the government of the day. Significantly, EPAC was merged into the Productivity Commission in 1998.

The point is that we all face the challenge of providing hard-headed advice on economic problems while staying practical and relevant to the government of the day. A useful lesson for institutions like mine is the importance of engaging widely and cooperatively with the rest of the bureaucracy, business, universities, and others in the community.

Within Australia, there are think-tanks, academics, media, lobby groups, market economists, business, other government agencies, political advisers and more who are willing to profess an expert opinion on Australia’s economic policy. And there are, of course, institutions and commentators beyond our borders who have views on Australian policy also. Treasury may be the government’s principal source of economic advice but it is operating in what is now a contestable market. An issue for us, as I am sure it is for you, is how we engage with these diverse interested parties, influence their views, and communicate our views persuasively to the government.

Not engaging is not an option: it results in isolation. We actively interact with this diverse set of interested parties through business and official high-level meetings, a regular and extensive business liaison programme, an active seminar programme, and participation in public forums.

Final comments

Let me now conclude my introductory remarks and allow you to get on with the business of the day. The menu for discussion is a full one. These are important issues and it is timely to share thoughts on them in an informal and private setting, and to consider how we can address them in practical ways that meet our shared aim of securing growth and stability in our region.

Again, I would like to thank you for making the time to come here today.