

Global Imbalances, Exchange Rates and Stabilization Policy

Anthony Makin



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Also by Anthony J. Makin

GLOBAL FINANCE AND THE MACROECONOMY

INTERNATIONAL CAPITAL MOBILITY AND EXTERNAL ACCOUNT
DETERMINATION

INTERNATIONAL MACROECONOMICS

OPEN ECONOMY MACROECONOMICS

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Anthony J. Makin

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Contents

<i>List of Charts, Figures and Tables</i>	ix
<i>Preface and Acknowledgements</i>	xii
1 Introduction	1
Problems with the prevailing paradigm	1
Chapter preview	4
2 The Global Economy and External Imbalances	8
Introduction	8
Asia-Pacific imbalances	10
The Asian crisis of 1997–8	12
China’s rise as a trading power	14
The US current account deficit	19
The global financial crisis 2007–9	21
Sovereign wealth funds	23
Conclusion	23
3 Global Imbalances and Exchange Rates	26
Introduction	26
A two-region balance of payments framework	26
Exchange rates and inter-regional trade flows	27
Trade surpluses, deficits and exchange rate management	29
Monetary implications	31
A two-region output-expenditure framework	33
The real exchange rate, spending and income	34
Global imbalances and exchange rate misalignment	37
Exchange rate protection	39
Should China’s exchange rate be more flexible?	41
Conclusion	42
4 External Imbalances and National Income	45
Introduction	45
Rendering the Keynesian cross diagram	47
Saving, investment and the current account	47

Interest rates and capital flows	50
Fiscal policy and the current account	51
Effective interest rate movements	55
Feasible limits for external deficits and debt	57
Maximum feasible external deficits	59
Feasible external debt limits	62
Benchmark estimates for advanced borrower economies	63
Qualifications	65
Conclusion	66
5 Capital Mobility and National Income	70
Introduction	70
Foreign capital and long-run national income	73
An extended loanable funds framework	75
Capital autarky versus perfect capital mobility	75
Short-run national income gains from foreign borrowing	77
The welfare costs of capital immobility	77
Capital controls	78
Quantitative restrictions	78
Taxes on foreign lending	79
The contribution of foreign capital to national income	80
Estimating national income gains: The Australian case	83
Conclusion	90
6 External Imbalances, Exchange Rates and Interest Rates	93
Introduction	93
The current account, capital account and the exchange rate	93
Output, expenditure and the current account	95
The capital account, expectations and the exchange rate	96
Saving, investment and capital flows	99
Foreign borrowing, lending and interest rates	100
Domestic versus foreign shocks	103
The small economy case	106
Incorporating interest risk premia	107
Domestic versus foreign net savings shocks	109
Conclusion	111

7 Money, Exchange Rates and the Balance of Payments	115
Introduction	115
An alternative monetary model	115
Monetary foundations	116
Monetary shocks under polar regimes	120
Monetary contraction under floating rates	121
Monetary expansion under fixed rates	122
Alternative chain of causation	124
Conclusion	124
8 Macroeconomic Policy, Interest Rates and National Income	126
Introduction	126
Theoretical framework	128
The real sector	128
The monetary sector	132
International capital flows	134
The effectiveness of monetary policy	135
Real sector shocks	136
Public consumption versus public investment	136
Productivity improvement	139
Conclusion	140
9 Monetary Policy and the Real Exchange Rate	143
Introduction	143
Theoretical framework	145
The real sector	145
The monetary sector	148
Monetary shocks	151
Monetary policy, national income and the current account	151
Higher inflation expectations	153
Increased inflation and interest rates abroad	153
Real sector shocks	154
Productivity gains	154
Investment fluctuations and cyclical movements	155
Implications for exchange rate choice	156
Conclusion	160

10 Select Stabilization Policy Issues	163
Introduction	163
Unexpected inflation and interest rates	164
Arbitrary income transfers	164
Estimating redistributive effects	168
Implications for monetary policy	169
Managing public debt	170
Stabilizing public debt	170
Reducing public debt	175
Gains from fiscal consolidation	177
Conclusion	179
Epilogue	181
Introduction	181
Are global imbalances a concern?	182
Gains from international trade in saving	182
Addressing some fallacies	184
Crisis risk factors	186
Excessive public debt	187
Exchange rate risk	188
Inflexible exchange rates and the global financial crisis 2007–9	188
Lessons for Stabilization policy	191
<i>Index</i>	193

Charts, Figures and Tables

Charts

2.1	Global GDP by region, 1980 vs 2007	9
2.2	Global imbalances	11
2.3	Economic growth in China and trading partners	15
2.4	China's gross international reserves	17
2.5	Country shares of international capital inflows, 2007	19
3.1	China's money and credit growth	33
3.2	China's nominal and real effective exchange rates	41
4.1	Feasible external imbalance, USA	64
4.2	Feasible external imbalance, Australia	64
4.3	Feasible external imbalance, New Zealand	65
5.1	Implicit foreign interest rate and cost of foreign capital, 1995–6 to 2004–5	85
6.1	US net foreign borrowing and real ten-year bond rate, 1995–2004	106
6.2	Australian net foreign borrowing and real ten-year bond rate, 1986–2004	111

Figures

3.1	Exchange rates and trade flows for China and its trading partners	28
3.2	The trade balance effects of a pegged yuan	30
3.3	Exchange rates and output – expenditure imbalances	36
3.4	Exchange rate misalignment, imbalances and macroeconomic behaviour	38
4.1	A rendered Keynesian cross diagram	48

4.2	Fiscal deficits, external imbalances and national income	52
4.3	Reduced public consumption	53
4.4	Increased effective borrowing rate	56
4.5	The maximum feasible CAD	60
5.1	International capital mobility and macroeconomic welfare	76
5.2	Macroeconomic welfare effects of unremunerated reserve requirements	79
5.3	Welfare effects of taxes on capital inflows	80
6.1	The current account, capital flows and the effective exchange rate	96
6.2	Current account versus capital account related shocks	98
6.3	International borrowing, lending and interest rates	101
6.4	Increased foreign saving, the external imbalance and interest rates	104
6.5	International borrowing, lending and real interest rates	108
6.6	Domestic versus foreign net saving shocks	110
7.1	Domestic money market equilibrium	118
7.2	An international monetary framework	119
7.3	Monetary contraction under a floating exchange rate	121
7.4	Monetary expansion under fixed exchange rate	123
8.1	General equilibrium	132
8.2	Monetary expansion	136
8.3	Higher public consumption	137
8.4	Increased public investment	139
9.1	General equilibrium	148
9.2	Monetary contraction	152
9.3	Increased interest rates abroad	154
9.4	Productivity improvement, investment boom	155
9.5	Real shocks and exchange rate choice	158

9.6	Monetary shocks and exchange rate choice	159
10.1	Inflation, interest rates and income transfers	166
10.2	The primary budget balance and debt to income ratio	173
10.3	Persistent primary deficits and debt instability	174

Tables

5.1	Estimating the marginal product of capital, 1995–6 to 2004–5	84
5.2	National income gains from annual foreign capital inflow, 1995–2005	86
5.3	Total national income gains from foreign capital, 1995–2005	88
6.1	The current account, the capital account and the exchange rate	99
6.2	Effects of domestic and international shocks	105
8.1	Key results	141
9.1	Key results	160

Preface and Acknowledgements

As economies become more integrated with the rest of the world, the need to better understand international real, monetary and financial linkages becomes ever more important. In particular, more needs to be known about the key determinants of trade and current account imbalances, exchange rates, international capital flows and interest rate differentials, as well as the implications of financial globalization for economic growth and for the operation and effectiveness of domestic fiscal and monetary policies.

The main aim of this book is to advance new conceptual frameworks for interpreting international macroeconomic and financial linkages for globally integrated economies. To achieve this, the work proposes a suite of compatible theoretical approaches, mainly diagrammatic, that provide alternative ways of analysing key issues in the field. As such, it is primarily theory oriented, though on occasion includes illustrative macroeconomic data.

The book addresses perennially important international macroeconomic questions that include the following: What are the macroeconomic causes and consequences of global imbalances? How do exchange rates influence trade and current account imbalances? How does international borrowing and lending behaviour affect domestic and world interest rates? How do international capital flows affect national income? How are monetary and fiscal policy changes transmitted in modern open economies? Are traditional propositions about the effectiveness of monetary and fiscal policies under alternative exchange rate regimes still relevant? What exchange rate regime best suits an economy in light of its macroeconomic characteristics? What is the optimal way to stabilize and/or reduce unsustainable public debt levels? What constitutes best practice for monetary policy? What are the benefits and risks of transnational capital flows? What are the costs of capital controls? Is freer international trade in saving a global economic policy problem or not?

In addressing these questions, this book extends the analysis of my previous Palgrave volume *Global Finance and the Macroeconomy* and can be viewed as a natural and complementary sequel to that work

that further develops the implications of financial globalization and international capital movements for macroeconomic policy. It draws on material published in *Agenda*, *Asean Economic Bulletin*, *Australian Economic Papers*, *Business Economics*, *China and World Economy*, *Contemporary Economic Policy*, *Economic Modelling*, *Economic Issues*, *Economic Record* and *Global Economy Journal*.

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Introduction

Macroeconomic policy debates inevitably revolve around discussion of fluctuations in aggregate measures, such as national income, interest rates, inflation, unemployment, trade imbalances, exchange rates, and various wealth series, such as house price and stock-market indices. Sharp swings in these aggregates most keenly interest economists engaged in analysing their implications for the real sector, the financial sector and macroeconomic policy.

Yet most contemporary theoretical research, particularly in the field of international macroeconomics and finance, appears removed from this reality. Invariably based on microeconomic foundations that assume optimizing representative agents, it underemphasizes standard national accounting aggregates that form the basis of macroeconomic policy analysis.

A major theme of this book is that the dominant prevailing paradigm, known as the representative agent, general equilibrium approach, overemphasizes the importance of micro precepts as a necessary prerequisite for macro model building. As a result, the international macroeconomics and finance field has become overly complex and its lessons for policymakers obscure.

Problems with the prevailing paradigm

The prevailing paradigm (sometimes referred to as the ‘new open economy macroeconomics’) contrasts sharply with the use of aggregative methods and tools that have been long used to great effect in mainstream macroeconomics and international economics textbooks

where microeconomic foundations are simply not deemed necessary to convey key linkages between the important variables in the field.

A sharp divide has therefore emerged between the prevailing research template of international macroeconomics and finance, as characterized in Obstfeld and Rogoff's (1996) monumental text, and the aggregative and behavioural methods used in standard undergraduate pedagogy of the field.

Basing international macroeconomic theory exclusively on microfoundations to the neglect of aggregative and behavioural approaches is unsatisfactory for several reasons. First, proponents of the ruling paradigm assert its superiority over other approaches on the grounds that traditional methods are too *ad hoc* without microfoundations.

Yet, as has been persuasively argued by Gandolfo (2001) and Van Hoose (2004), standard macroeconomic tools, such as the consumption function, are just as empirically verifiable, more realistic, and in principle involve no more *ad hocery*, than the selection of a particular utility function form. Moreover, conventional aggregative methods used in macroeconomics-related areas remain strongly defensible on pedagogical grounds (Romer 2000).

Colander (2007) has also criticized the utility of microfounded macroeconomics as taught at graduate level on the basis that it fails to explain how economies actually function and neglects to equip graduates with the necessary skills for future employment as applied economists.

Due to excessive reliance on microeconomic underpinnings, fiscal and monetary policy prescriptions arising from representative agent, stochastic general equilibrium models are highly sensitive to underlying assumptions, such as utility function choice, which makes them ambiguous and hence impractical for policy purposes.

Second, as a related point, models founded on microeconomic precepts and optimizing representative agents have become overly complex compared to earlier generation models, such as the Mundell-Fleming (MF) model, with its clear policy prescriptions. Models in the spirit of the MF approach continue to be the mainstay of textbook international macroeconomics and remain the most widely used means of analysing the impact of fiscal and monetary policy on exchange rates, the balance of payments and national income.

For instance, the MF model predicts that, if capital mobility is perfect, fiscal consolidation should either have no impact under floating

rates or have a contractionary effect on national income under fixed exchange rates.

Yet unfortunately, the MF paradigm yields numerous results at odds with a growing body of empirical evidence. This is because aggregate models of the short run invariably start from the assumption of aggregate demand side dominance. In contrast, consistent with the precepts of standard long-run analysis, many models in this book start from the alternative assumption of aggregate supply side dominance.

In this way the book presents an alternative approach both to the representative agent-stochastic general equilibrium models of the ruling open economy macroeconomics paradigm with its overly elaborate microeconomic foundations, as well as to the older aggregative approaches. It also relies heavily on much-neglected economy-wide precepts, especially the distinction between aggregate output and expenditure in the absorption sense and the principles of traditional flow-of-funds analysis, to derive a range of new analytical frameworks and results.

Apart from emphasizing aggregates over microeconomic foundations, a subtle assumption underlying numerous models of this book concerns the relationship between aggregate supply and demand. Often, domestic goods and services are treated as originating on the production side via a macroeconomic production function. Within the period, these goods are then made available for sale along with imported foreign goods and services which, in use, are treated as either consumption or investment expenditure.

Hence, the sequencing of macroeconomic activity can be perceived as running from aggregate supply to aggregate demand in the first instance, rather than the other way around, although production by firms is obviously undertaken with prospects of aggregate demand in mind. This has important implications for macroeconomic policy, especially for the effectiveness of fiscal policy.

In sum, by addressing deficiencies in extant models, the aggregate supply-side-oriented frameworks developed in the book provide new perspectives on the determination of global imbalances, the role of capital flows in the growth process, as well as new results about the effectiveness of macroeconomic policy under both fixed and floating exchange rate regimes.

These new results are contrasted throughout with those of extant approaches. Hence, by departing on methodological grounds from

the prevailing research paradigm, the book's innovative frameworks respond to Krugman's (1995) call for practicable guides to address unresolved questions in international macroeconomics and finance.

Chapter preview

This chapter has introduced the key methodological points of difference between the approaches outlined in this book and those of the prevailing research paradigm. Chapter 2 discusses key developments in the world economy since 1980, emphasizing international macroeconomic developments from the Asian financial crisis of 1997–8 to the global financial crisis of 2007–9 with a focus on the growth and significance of 'global imbalances'. The term global imbalances has become synonymous with the simultaneous widening of the current account deficit (CAD) of the United States and counterpart rise in the current account surpluses (CASs) of East Asian (most notably China's) and the oil-exporting economies.

Chapter 3 develops straightforward two-region frameworks for interpreting the effect of exchange rate policy on an economy's trade balance and that of its trading partners in the context of limited capital mobility and discrepant economic growth rates. Recognizing that external imbalances reflect divergent national production and expenditure growth, it reveals that exchange rates remain central to any explanation of global imbalances.

Using the case of China and its trading partners, it reveals how exchange rate misalignment can artificially assist China's output growth and limit its household consumption, thereby slowing the rise in China's living standards. Meanwhile, due to currency misalignment, China's Western trading partners, most notably the United States and the European Union, simultaneously experience larger external deficits, lower output, lower saving and higher investment than otherwise.

Chapter 4 presents an alternative short- to medium-term framework for analysing the simultaneous determination of current account imbalances and the path of national income. Using standard macroeconomic behavioral relationships, it first examines how and why CADs matter by investigating links between domestic consumption, government spending, output, saving, investment, interest rates and capital flows. This rendered Keynesian cross-framework yields results relevant to the 'twin deficits' hypothesis that are contrary to those of standard models. In particular, it shows that increased public

expenditure lowers not raises potential national income over the medium term.

Next it proposes methods for assessing the proximity of CADs and the associated foreign debt to their upper bounds based on the principle that productive investment fundamentally sets the feasible limit for CADs, whereas the capital-to-output ratio ultimately sets the foreign debt to GDP limit.

Chapter 5 centres on the contribution of foreign saving to national income, both in the long and short runs. Using extended loanable funds analysis, it demonstrates how perfect capital mobility contributes to economic development, contrary to a prevalent view that international borrowing is inimical to the welfare of developing economies. As a corollary, the analysis shows that capital controls, irrespective of form, generally reduce development potential and economic welfare by widening real cross-border interest differentials. Using growth accounting precepts and treating Australia as a case study, the chapter also demonstrates how foreign borrowing can contribute significantly to raising an economy's national income.

Chapter 6 introduces new frameworks for analysing the relationship between exchange rates, domestic saving, investment, international borrowing and lending, and domestic and foreign interest rates. It establishes how a range of domestic and international shocks simultaneously determine these key international macroeconomic variables over any given time and derives some general propositions. It then suggests that foreign factors, most notably the rise in net saving in East Asia, have mainly been responsible for the rise in the large CADs of the United States and other borrower economies, such as Australia and New Zealand.

Chapter 7 proposes an alternative monetary model for examining the effects of domestic monetary shocks on the exchange rate and the balance of payments that is consistent with the macroeconomic framework introduced in Chapter 3. Contrary to previous monetary approaches, the approach suggests a new chain of causality that runs from domestic money to the exchange rate to the price level, rather than from money to the price level to the exchange rate. It also shows that under fixed rates, external adjustment is consistent with money market equilibrium and price level stability, and that under floating exchange rates monetary policy in open economies works in the short to medium runs via its impact on exchange rates and aggregate expenditure.