Global Imbalances, Exchange Rates and Stabilization Policy

Anthony Makin

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and Stabilization Policy

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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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.