INFLATION FIRST:
AN EVALUATION OF RECENT ECONOMIC POLICIES*

K.T. Davis
M.K. Lewis

Working Paper 79-3

Preliminary: Not to be quoted.

* This paper is based upon the final chapter of the authors' forthcoming book
Monetary Policy in Australia,
to be published by Longman Cheshire in early 1980.
INFLATION FIRST: AN EVALUATION OF RECENT ECONOMIC POLICIES

K.T. Davis and M.K. Lewis

Evaluation of macroeconomic policy is a complex task. Comparisons of policy achievements as between the 1970s and 1960s are an invalid approach, for the environment within which policy operates can undergo change. Nor does a comparison with overseas experience, as in Figure 1, necessarily demonstrate poor policy design, since non-policy factors unique to Australia may explain the contrast. This leaves, short of ex post historical judgements of particular policy actions, examination of the consistency and suitability of the design of policy in the light of contemporary economic knowledge.

This is the approach followed in this paper, and two aspects of economic knowledge form its basis. The first is the general principles for the design of policy derived from the theory of economic policy.¹ When combined with the second, knowledge about the economic structure, the consistency of economic policy can be assessed.

The first of these principles is that for every target to be attained there must be at least one effective instrument. With four weapons of economic policy, 'fiscal, monetary, external and wages policies',² it would seem possible to achieve the generally accepted macroeconomic targets of employment, price stability and external equilibrium, with economic growth as a possible fourth target in a medium term strategy. The policy problem would seem to be one of finding a satisfactory mix of the four instruments and tackling all four targets simultaneously. In line with another general principle of policy, each instrument of policy would be employed in this mix according to its comparative advantage in affecting particular targets.
Because of lagged responses, attainment of targets takes time and policy formulation must find a balance between the benefits of rapid achievement and the costs of rapid adjustments - including induced disturbances at later dates. If the instruments are sufficiently specialized in their effects, the dynamic adjustment might be achieved by attaching instruments to the targets they influence most directly (Mundell's principle of effective market classification).

Australian macroeconomic policy formulation since 1975 has followed a markedly different approach. Rather than attack all economic problems together, it has been argued that they need to be tackled sequentially: inflation first, then unemployment and the balance of payments, an approach which has been dubbed the "inflation first" strategy. A second feature of policy formulation has been that instead of seeking to utilize the comparative advantages of the various instruments in a policy package, the emphasis has been upon the 'interrelatedness' of the instruments - of forming them into an 'integrated, coherent and effective whole'. (Lynch, 1976.) Because of this 'interrelatedness' the instruments must be used as if they were one (to achieve price stability in the first instance).

It is difficult to assess to what extent these views are specific ones, prompted by the enormity of current problems, or are new general principles, enunciated for the coming decade. If there were no common elements from one episode to another, then economic theories could not be fashioned. At the same time, no two episodes are exactly alike and theories must be adapted to the peculiarities of each case. The relevant question becomes one of whether the standard set of principles requires amendment in the current environment.
The Inflation First Strategy

Underlying recent policy strategy is a view of the economic structure in which inflation, and the uncertainties it generates, plays a causal role in contributing to other macroeconomic problems. When originally formulated in 1976, the impression was given that reduction of inflation would itself cure the other economic ills. Now, the strategy is viewed as setting the scene for economic recovery by establishing the necessary preconditions of reductions in inflation, interest rates, and real wages, and restoration of traditional financing patterns and profit-wage shares.

At best, the strategy involves neglect of current employment problems for the sake of better employment prospects in the future. Less generously, unemployment is deliberately fostered to dampen wage demands and bear down upon inflation. On either view, the policy involves inefficiencies. Targets, such as unemployment, should not be neglected unless unachievable or unless the cost of achievement is excessive, while transforming a target of policy into an instrument is too costly if other instruments are available.

Government spokesmen have argued first, that an attempt to rectify unemployment problems would, if initially successful, only rekindle inflation and thus eventually be self-defeating. Second, they argue that in current circumstances, the existing policy instruments are unsuitable for correcting the employment position. We consider these in turn.

Within the commonly used framework of the expectations augmented Phillips Curve, the proximate determinants of the rate of inflation are the unemployment position and inflation expectations. To the extent that expectations reflect past inflation rates (and we consider alternative views below) it is the rate of acceleration or deceleration of the inflation rate (not the inflation rate itself) which is related to unemployment. So long as an expansion of demand
leaves some excess supply of labour, the decrease in unemployment would be
accompanied, not by increased inflation, but by a slower transition to
lower inflation rates. Perhaps a faster transition is preferred, but there
is little empirical evidence to suggest that, at current levels of unemploy-
ment, the speed of adjustment is strongly related to unemployment rates.

The claim that existing policy instruments are unsuitable for correct-
ing the unemployment position rests on the grounds that these involve
manipulation of aggregate demand. In contrast, present problems are seen
as largely ones of supply. The "real wage overhang", traceable to 1974 when
the Labor government "lent support to excessive union claims" and "enthusiast-
ically pushed up wages" (Lynch, 1976) is seen to imply that

"... an expansion of demand by itself would still leave real
wages greater than productivity and so would not provide any
incentive for firms to take on extra labour"."

It is frequently overlooked that the real wage overhang is not a uniquely
indigenous problem which can explain the contrasts exhibited in Figure 1.
In 1977, 14 of the 18 O.E.C.D. countries had such an overhang (five of which
were greater than that in Australia), and for most (like Australia) the
overhang began in the early 1970's but widened sharply after 1973. World
wide 'supply' factors, due to the effects of the oil crisis on the product-
ivity of oil-based technology, may in part explain the common unemployment
experience, but demand factors cannot be ignored. The oil crisis has
undoubtedly had effects upon world savings, investment and demand for money,
while domestically, monetary and fiscal restraint has reinforced this
dampening of demand.

Excessive real wages cannot be said to be the sole determinant of
unemployment since a deficient demand for goods can effectively constrain
firms' demand for labour below what it would otherwise be at current real
wage rates. In this case (and similar reasoning is embodied in the Common-
wealth's Submission to the November 1978 National Wage Case), a cut in real
wages need not in itself add to employment. By contrast, if deficient demand
constrains output, an increase in aggregate demand will add directly to
employment although, if real wages are too high any expansion will peter out
short of full employment. "In circumstances such as these, a return to full
employment would require both a fall in real wages and an expansion in demand."5

If we accept that real wages are part of the problem (and we suspect
that the structure of real wages is an important determinant of the distribution
of unemployment), there are some problems in basing policy upon their reduction.
With full indexation, a reduction in real award wages is not possible. For
those who believe in the market mechanism, a reduction in nominal wages is
also made more difficult since one channel through which deficient demand
might bear down upon inflationary pressures is removed. The burden of adjust-
ment is shifted to the direct effects of demand on prices, wage adjustments
outside award agreements, or wage-price interactions which are sufficiently
rapid to occur between indexation hearings.

Suppose, however, that the policy of deflating demand does lead to a
reduction in real wages. If both demand and real wages determine unemploy-
ment, one problem is solved by creating another. It is true that a precondi-
tion for a return to full (and not just higher) employment is thereby estab-
lished, but what is to prevent real wages from increasing again when demand
pressures are reversed? Real wages are ultimately an endogenous variable.
At best, policymakers can influence nominal wages and exert a short run
impact upon real wages. They may not be able to do even this, for with
deficient demand a slowing of nominal wages may be translated into a slowing
of prices with little effect on real wages, as the Budget papers of 1978 acknowledged. Here we run into a fundamental principle that policy should not aim for unachievable goals. Real wages are not an instrument of policy; they are endogenous to the economic system.

In our view these points cast considerable doubt upon the usefulness of the wages arm of current policy. Alternative policy suggestions need to clear two further hurdles. The first of these is the government's view that people would be adverse to conventional 'pump-priming' policies, which would create more uncertainty and rekindle inflationary expectations. Given the amount of misinformation on this point, we might be inclined to agree, although to expect higher inflation at current levels of unemployment may be 'rationally irrational' if the real result is a slower transition to lower inflation, not increased inflation. As for uncertainties, we note that unemployment as well as inflation can create uncertainty (Mallyon, 1977) and that 'stability' at depressed and falling levels of economic activity scarcely encourages a desirable climate for economic recovery. What is at issue is not whether 1940's style 'pump-priming' can work, but whether the policy mix can be altered in such a way as to reduce unemployment without adding to inflation or to inflation expectations. Here we run into the second element of the government's position - the 'interrelatedness' of the instruments of policy.

Policy Interdependencies

(a) Monetary and Fiscal Policies

Those Australian writers who have called for expansionary fiscal policies without relaxing the monetary targets significantly have, in general, been criticised since fiscal and monetary policy can only operate independently of
one another if any excess of government spending over taxation revenues can be financed by issues of securities and the consequences of doing so are of no significance to policy. Government strategy has, in contrast, stressed these consequences. An objective of monetary policy has been to reduce interest rates and the budget has been framed with financial consequences in mind. The aim has been to reduce the size of the budget deficit and thus the financing demands of the public sector.

Given the general rule that the number of targets match the number of instruments, promotion of the budget deficit and interest rates to policy targets must jeopardise the attainment of other targets. We see little reason for doing this.

Contrary to opinions expressed in recent years a budget deficit is not necessarily an economic "bad". Approximately one third of the public sector's contribution to GDP is capital formation and we see no reason why some part of the cost of investment projects should not be shifted to the future by use of loan financing. Attempts to reduce the deficit not only have deleterious demand consequences, but in a number of cases may aggravate the supply side imbalances which policy is attempting to rectify. Restraints on government expenditure have concentrated upon capital expenditures which by providing "social overheads" may be seen as complementary to private capital. Such restraints lead to a reduction in the productivity of private capital and a lowering of private investment expenditure. Increases in both indirect and direct taxes and in charges for government services drive a wedge between real wages paid and received which, given quite natural responses, aggravate imbalances in the labour market.

A major reason for not promoting the budget deficit to the status of a target is that it is an endogenous economic variable whose size will, given
tax scales and expenditure plans, vary with the level of economic activity. It is conceivable (although perhaps unlikely) that fiscal stimulus may lead eventually to a reduction in the deficit as the tax base expands through multiplier and accelerator effects. This is the view of the Melbourne Institute. But suppose we go along with the idea that fiscal stimulus will increase the deficit, at least initially. Conventional wisdom says that interest rates will have to rise to maintain the monetary target, choking off some private expenditures. The result is indisputable, what needs to be made clear is why this occurs.

If the general level of interest rates is set by the interaction of the money stock and the aggregate demand for it, changes in the deficit size, accompanied by an unchanged monetary target, can only affect interest rates via the demand for money. An obvious factor is when the fiscal action succeeds in raising nominal income and hence demand for money. Indeed, any increase in nominal income will raise interest rates irrespective of whether the income expansion comes from fiscal stimulus or a private led recovery. Otherwise, at a constant level of income, there is no reason why interest rates should increase, even if the monetary target is maintained. It is true that the government must sell bonds to finance the deficit and that to effect this sale interest rates must rise, but the sale of bonds is to mop up liquidity which the budget deficit previously injected into the economy, and which would have initially depressed interest rates. Overall the structure of interest rates as between government and private debt may alter, but we should end up with much the same level of interest rates, unless the level of economic activity increases. 6

This account assumes that expectations of inflation are unaffected by the fiscal action. The policy target of lowering interest rates is only consistent with "tight" monetary targets when expectations of inflation are
considered. If monetary policy can lower expectations of inflation and induce lenders to demand smaller inflation premia, a lowering of nominal rates of interest may eventuate. The direction of this process need not be altered by a change in the stance of fiscal policy, as long as the overall thrust of policy continues to leave excess supply in labour and goods markets.

Low interest rates, then, are one of the results of a reduction in inflation but there are dangers in making them a target in themselves. These dangers arise because the initial phase of instituting a lower monetary target puts upward pressure upon interest rates. The idea is for tight money to then reduce inflation expectations and eventually lower interest rates. Until expectations are revised, tight money and the objective of lowering interest rates conflict. This conflict can be avoided, however, if a deflationary fiscal policy leads to a contraction of economic activity and private sector demands for finance.

There is little value in making interest rates an objective of policy if this is the way the objective is achieved. Lower interest rates may stimulate some private expenditures but this benefit will only partially offset the contraction of activity due to fiscal and monetary restraint. More generally, any recovery in the economy, regardless of whether its source is a revival in private expenditures or government expenditures, must, given adherence to a monetary target, lead to an upward pressure on interest rates because of increased demands for money to finance expenditures. If upward pressures upon interest rates are always to be resisted by attempts to reduce the government's demand for finance it is hard to see how economic recovery can occur or, when it does begin, how it can be sustained. The only alternative is to relax the monetary target and allow the money supply to balloon out, as in 1978-79. This has costs in terms of inflation expectations,
which we believe outweigh any benefits from getting interest rates down ahead of time.

(b) Domestic Policies and the Balance of Payments

Figure 1 serves as a reminder that the scope for independent domestic policies in Australia is limited. In framing economic policy, account needs to be taken of the state of the Australian economy relative to other countries and of the likely effects of policy changes upon the balance of payments.

The anticipated effects of policy changes on the balance of payments depend on the form of stimulus and one's view of the linkages involved. Ignoring wages policy, stimulus could come from external policies, monetary policy or fiscal policy (or some combination of these). With the first of these three a deliberate devaluation could be used in an attempt to stimulate export led growth. Because of the price effects of currency depreciation and because of the ambiguity which surrounds the short term response of the trade account to devaluation (the so-called J-curve effect),\(^7\) no-one has seriously suggested this policy. This leaves monetary and fiscal policy which, despite many popular notions, have quite different effects.

Both fiscal and monetary expansion tend to produce a worsening of the likely to current account balance, but are/have quite different effects upon the capital account and hence on pressures on the exchange rate. Monetary expansion, by creating an excess supply of money and by depressing domestic interest rates, leads to capital outflows which, combined with the current account response, leads to either exchange rate depreciation or, if exchange rates are held stable, a balance of payments deficit. The unwanted price effects of the former case, and the fact that outflows of funds negate the monetary expansion in the latter case, seem to preclude any scope for monetary
expansion except in the short run before such adjustments eventuate.

With fiscal policy the immediate effect is an expansion of demand which raises economic activity and pushes up domestic interest rates, as we have already noted. Under fixed exchange rates, higher output levels and higher interest rates attract capital from abroad. This allows the economy to have a deficit on current account, providing resources which act as a cushion to inflationary pressures. With flexible exchange rates the same responses generate an appreciation of the currency if capital flows are sensitive to interest rate differentials. This eventually erodes the initial expansion of output, but as the immediate effect on the trade account could be the other way, some time may elapse before the erosion occurs.

Of the two policies, the fiscal expansion seems the one must suited to the circumstances facing Australia at the end of the 1970's. These results are complicated by the important role of expectations of exchange rate changes and the subsequent behaviour of the capital account. We know little about what governs these expectations, but in the Treasury's eyes they would respond unfavourably to stimulative domestic policies, and there are others who agree with this assessment (notably, Corden, 1978). The Treasury argues:

"'Inflation sensitivity' is not confined within national boundaries. Decisions affecting the balance of payments, particularly through private capital movements, can also be profoundly influenced by the perceptions of decision-makers, whether at home or abroad, of domestic performance and policies. Policies that are perceived as being attuned to the domestic economy's fundamental problems are bound to enhance the likelihood of favourable investment decisions whether by domestic investors or by foreigners. Under current conditions, an attempt to force the pace of aggregate demand growth would tend to result more in a higher price level and adverse balance of payments responses than in enhanced domestic activity."


They may be right, but if the matter is to proceed beyond conjecture
we require answers to the following points. First, there is the extent to which the Australian exchange rate arrangements encourage destabilizing capital flows. Investors have been offered the chance to bet on what the triumvirate will choose or be forced to set. If market forces were allowed to determine the rate, the whole nature of foreign investment decisions would be altered and judgements based on confidence and investment prospects must supplant speculation about triumvirate decisions. Second, there is the question of what motivates foreign investors. Policies also need to be attuned to the economic growth objective and, as Kasper (1976) argues, fiscal spending may do this. Foreign investors may applaud enthusiastically when Australia beats the 'anti-inflation sound-money' drum, but will they invest in a depressed economy? Third, the inflationary consequences of domestic policies depend on the form of the fiscal action and upon the overall mix of policy, not just upon fiscal policy. We now look at the comparative advantage of the instruments and of the policy mix.

An Optimal Policy Mix

In the preceding sections we have examined and, in our view, refuted two of the major principles upon which the inflation first strategy is based. These are, first, that policy goals are interrelated in such a way that the inflation goal must be paramount and, second, that the interdependence of policy instruments effectively precludes any other policy mix. Having also argued against the promotion of intermediate economic variables, such as the budget deficit and interest rates, to the status of targets, we are left with the following list of potential targets and instruments.
In what follows immediately, we shall ignore the objective of growth on the grounds that it is only indirectly influenced by short run macro-economic instruments. Nevertheless, it would be desirable if the policy mix adopted for the three major goals was conducive to the growth objective, and we return to this issue later. As a result, we would appear to have four instruments available to tackle three targets. Such an over-identified system would be a policymaker's delight. However, questions must be asked about the status of wages policy, the scope for exchange rate policy and the nature of fiscal and monetary policies.

Consider, first, the role of wages policy. Two aspects of wages are of relevance: real wages as the "price" of labour for employment policy; the course of money wages as one aspect of the inflationary process. To the extent that a wages policy can exert an exogenous influence on either of these which is not offset by other endogenous responses, some beneficial effects on employment and/or inflation may eventuate. The real point is how this is to be done, and whether it can be effective. On the latter score, the evidence from overseas must raise doubts, while suggestions based on trading tax cuts for wage restraint create an interdependency between the wages policy instrument and fiscal policy which may reduce the effectiveness of the latter.
In the absence of an incomes policy we are left with wages as an intermediate target with the instrument of policy being attempts to "nag" the Commission through submissions for partial indexation or through public criticism of its judgements. While wages policy can be a valuable potential addition to the armoury, we cannot place it on a par with the other instruments, particularly in view of the deleterious effects the somewhat arbitrary rules may have on economic growth.

Second, the scope for use of the exchange rate as an instrument separate from monetary policy is limited. In the long run there is complete interdependence between monetary policy and the exchange rate: if the exchange rate is fixed, monetary policy must adapt to it; if the money supply is fixed, then the exchange rate must adapt. In the short run some independence does exist, particularly if V.D.R.'s and exchange controls are used, and there may be some merit in treating these tools along with the exchange rate as external policies rather than as part of monetary policy.

Nevertheless, the interdependency must ultimately be realized and several courses of action are possible. In a country with a large traded goods sector, the foreign currency prices of which goods are determined in world markets, management of the exchange rate can largely "peg" their domestic price, and to the extent that demand factors lead to stable relative prices between traded and non-traded goods, this course of action "pegs" overall prices. Monetary policy must then be used to influence the capital account and so maintain the exchange rate or induce the desired movement. In practice, while nominally directed at the balance of payments, monetary policy is largely responding to the prices objective for inflationary pressures show up as balance of payments crises (Laidler, 1978). Alternatively, by freely floating the exchange rate, balance of payments concerns are partially removed from the policy arena. This freedom is only partial, since exchange
rate changes can be disruptive and may result from reactions to domestic policy measures.

In our view, an attempt to lead the market by directing the exchange rate to price stability, as the government has sought to do, encourages one-sided speculation and is counter-productive. A choice must eventually be made between a fixed rate and a floating rate, and like many others we would advocate an immediate transition to the second. (Under different international conditions, a fixed rate might be preferred.) A foreign exchange market could be readily established. It would remove the exchange rate from political influence and force transactors to make a responsible judgement about the likely course of market conditions. If the right climate of expectations is to be generated as a backdrop for these judgements, it is necessary for domestic policy instruments to be correctly directed.

Third, we have the view (examined earlier) that for most practical purposes fiscal policy and monetary policy should be seen as one instrument. We have argued that they are two instruments because of differing interest rate effects, balance of payments, expectational, and supply effects and believe that these different characteristics should be utilized.

We believe that monetary policy should be directed at the prices objective as a longer run strategy. It can achieve this objective by slowing the growth of nominal expenditures and by lowering expectations of inflation, thus providing an appropriate climate within which money wage and pricing decisions can be worked out. We concur with Friedman's view and Mundell's view that monetary policy involves the manipulation of nominal variables and should be directed to a nominal goal, in this case, prices. But the corollary holds. Fiscal policy involves real variables (the employment of civil servants and private contractors, the provision of collective
goods and services, the construction of real facilities) and should be directed to a real target - employment in the case of demand deficiency, otherwise to the allocation of resources and economic growth. This is not to deny that fiscal policy cannot alter prices, nor monetary policy affect output; for evidence of both exists. But in the flexi-price world of the 1970's and 1980's, prices should be more responsive to monetary policy, which commensurately loses its power to bite into output and employment. With expectations of inflation attuned to monetary developments, fiscal actions exert a more reliable impact upon employment.

This assignment has been couched in general terms for we see it as a good first approximation which takes account of the comparative advantages of the policy instruments. It is entirely appropriate in the specific circumstances of the late 1970's. In a depressed economy with unused productive capacity, the "Keynesian" prescription is to fix money wages and expand demand. Various proposals have been made to do this by trading tax cuts for wage restraint, and we see no objection to such policies if they work. Unfortunately the track record in other countries is not promising. Our policy essentially borrows from "monetarism" using monetary policy to fix nominal values. A pre-announced and rigidly adhered to monetary growth rate target is used to tie down prices and expectations of inflation. This frees fiscal policy for real targets. Alternatively, this holding down of inflationary expectations will enable a private sector led recovery to expand real output.

The question then becomes one of the form of the fiscal policy. Desirably a fiscal expansion would (a) reduce inflation, (b) encourage economic growth, and (c) create expectations of recovery. Either taxation reductions or capital spending would have beneficial consequences. Taxation
reductions would most aid a reduction of inflation because of the favourable effects upon aggregate supply (Lewis, 1976). Government capital formation which added to the infrastructure of the economy would best encourage complementary private investment needed for economic growth and overcome any recession mentality.

Conclusion

Our assessment of feasible policy options and their comparative advantages has led us to suggest that a preferred policy mix would involve fiscal expansion (directed at the employment goal), maintenance of a monetary target (to tie down longer run inflationary pressures), and a floating of the exchange rate. Our arguments suggest that the poor comparative performance of the Australian economy exhibited in Figure 1 reflects the poor design of policy and not the influence of unique non-policy factors. Inflation is still running in excess of that in other industrial countries and the gain that has been obtained has been at the cost of a slower growth of output.

Throughout our analysis, we have avoided discussion of a number of issues such as technological change and economic growth, generally viewed as outside the realm of macroeconomic policy. We do not subscribe entirely to this separation of responsibilities and, in conclusion, proffer a few comments on their implications for macroeconomic policy.

The effect of rapid technological change on employment has occasioned much concern in popular discussion, but only limited attention from economists. In large part, this neglect reflects the economists' faith in the ultimate influence of the market mechanism, by which changes in relative prices, incomes and patterns of demand can be expected to create new job opportunities for those displaced by technological advances. Of course, these longer run
benefits (of higher living standards due to technological progress) may also involve longer run social costs of changes in income distribution and, in particular, quite disruptive short run adjustment costs.

A major failing of current policy is that by depressing demand, the market forces which are a necessary ingredient of the transition process are disrupted, thus worsening the short run adjustment problems. In an environment in which technological advances have an initial impact of job destruction, it is vital that demand be expanded in line with the increases in potential supply occasioned by those advances. The market forces which economists expect to achieve this expansion of demand may be thwarted by deflationary policies and, in any case, probably need expansionary policies to speed up their sluggish adjustment.

While technological change is an integral part of the economic growth process, the potential growth afforded by such developments can only be translated into actual growth by the process of physical investment. Policies which deflate demand not only provide scant encouragement for this to occur, but may hinder the later recovery. A period of low investment and low demand for skilled labour and apprentices means that bottlenecks are encountered earlier when expansion comes. What might have been desirable output responses instead become undesirable price responses. Workers are denied the prospect of having wages increase in line with productivity, and as unemployment becomes the norm its dampening effect upon wage demands may be diluted. The longer demand is depressed, and recovery is postponed, the more difficult the problems become.
The major theoretical developments have come from Tinbergen (1952), Theil (1964) and Mundell (1962). These are outlined in any major book on macroeconomics.


Readers are referred to Hagger (1978) and to our forthcoming book for an exposition of this framework.


Ibid. Although government spokesmen now admit to the existence of deficient demand, they attribute most of the unemployment to real wages and not to demand. This is largely a matter of judgement. See Johnston, Campbell and Simes (1978) and Jolly (1978) for conflicting estimates of the relative contribution of the two elements.

The total operation does increase the private sectors' holdings of government securities, and this may be perceived as an increase in wealth. Ignoring any minor effects this perception might have upon the demand for money, it is true that by refraining from fiscal expansion, room is left for a private led recovery, financed presumably by the issue of private securities. What reason have we to believe that this gap will be filled by the private sector in the absence of government encouragement? Our argument is based on the premise that a certain government led recovery is better than hoping for a private led recovery.

This refers to the phenomenon whereby a depreciation has an adverse effect on the trade balance in the short term. In the period immediately following a depreciation, a country pays higher prices for its imports before it cuts back on the volume or experiences higher export receipts.
BIBLIOGRAPHY

Corden, W.M. (1978), Wages and Unemployment in Australia, Presidential Address, Seventh Conference of Economists, Macquarie University, Sydney.


* * * * * * *
Figure 1

Output and Prices in Australia and in Industrialized Countries

Yearly Percentage Changes

INDUSTRIAL PRODUCTION

O.E.C.D.

Australia

(Power Strike)

CONSUMER PRICES

Australia

Industrialized Countries