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## **REVIEWS**

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### **Determining the Current Account**

*A. J. Makin, International Capital Mobility and External Account Determination, Macmillan, London, 1994*

*Reviewed by Warwick J. McKibbin*

**A**t a time when Australia's current-account deficit is again a matter of public concern and likely again to be a focus of economic policy, Tony Makin, an economist at the University of Queensland, has published a very useful analysis of the determination of the current-account balance. The issue of large current-account deficits and surpluses is not just a periodic focus of Australian economic commentators but is also an important policy issue in the global economy. One example is the American emphasis on the Japanese current-account surplus. Another example is the debate about fixing exchange rates between the major economies to prevent the large overvaluations and undervaluations of currencies that result from large movements of financial capital and lead to large current-account imbalances. If more economic commentators and policy-makers in Australia and overseas had a copy of this useful book, debate on the issue of the current account would at least be better informed.

The book has a clear message: current-account deficits are not a problem in themselves but merely reflect the underlying saving and investment position of an economy. Indeed, the high capital mobility that allows countries to run current-account deficits enhances welfare because it facilitates the efficient allocation of scarce capital. Open capital markets allow countries to trade savings efficiently. Countries that choose to consume more than current income or to invest more than economy-wide saving can pursue these objectives by borrowing from global capital markets. Similarly, countries with the opposite preferences can lend to global capital markets.

This analysis adds up to a strong case for not treating the current-account in itself as a target of macroeconomic policy. But readers who disagree with this policy conclusion should not ignore the book. Dr Makin has produced an excellent overview of the determination of the current account, covering in depth and with clarity the issues of measurements, theoretical approaches to the current-account determination (both old and new), and clearly espoused policy implications. It is essential reading for economic commentators and students because it so effectively challenges common positions taken in the public debate on the current account. Makin makes a clear and convincing theoretical case why the current account probably doesn't matter on a set of explicit and reasonable assumptions. However,

the book does not go quite far enough to be the conclusive treatment of the topic because it doesn't delve sufficiently deeply into the body of empirical evidence that is available to support the theoretical insights.

The book's five chapters contain an excellent overview of the theoretical literature of current-account determination and the policy implications. The critical issues are clearly expounded and covered in depth, in the context of the debate on the current account in the literature. Chapter 2 gives a useful overview of the accounting concepts required for an informed understanding of the balance of payments, and gives a clear exposition of the relationships among income, expenditure, saving and investment, changes in wealth and asset flows.

I particularly liked Chapter 3, which is an insightful and very readable overview of the alternative approaches to the theory of external account determination. This chapter is as good an overview and history of ideas in this area as I have read. Proceeding from the mercantilist view that it is better for a country to sell more than it buys, it introduces David Hume's Price-Specie Flow mechanism, to show that the partial approach of the mercantilists is flawed because it ignores the asset flows that accompany any given trade position. These asset flows, in the form of either gold or foreign reserves, would change wealth stocks and therefore relative demands for goods, and so act to reverse automatically the initial trade position. Makin then proceeds to introduce the other main approaches, including the 'elasticities', the 'absorption', the 'monetary', and the Mundell-Fleming approaches. Each body of theory is criticised and the key deficiencies are discussed. The main weakness I found with this chapter was the lack of coverage of extensions to the theoretical literature that have been undertaken in a number of global simulation models that attempt to address the problems that Makin raises. The key problem is that incorporating a more realistic treatment of asset accumulation and real capital formation is not analytically easy. The alternative in recent years has been to move to simulation techniques in large-scale theoretically based multi-country models. Ignoring this substantial emerging empirical literature (aside from a small footnote) is a deficiency of an otherwise excellent chapter.

Chapter 4 also nicely integrates intertemporal models with the more traditional approaches. This chapter naturally incorporates the role of capital flows (both direct investment and speculative flows) into the analysis. Despite the clarity of treatment of the purely theoretical literature, the chapter again does not proceed to introduce the more recent empirical applications that have extended the theoretical approaches. The intertemporal modelling approaches have necessarily moved outside the realm of tight analytical techniques towards numerical simulation techniques. Despite the application of numerical techniques, I believe that these new approaches should still be classified as theoretically valid and could have been incorporated into this chapter.

Chapter 5 focuses on the role of capital mobility in the global economy. This chapter is more empirical than earlier chapters; it outlines some important empirical debates in the economics literature related to current-account determination, such as whether or not capital is internationally mobile. It then gives a discursive

overview of a range of issues from the empirical relevance of covered interest parity to the determinants of investment and saving. The coverage in this area could have been more substantial and empirical in the sense that there are many estimates of policy multipliers and key elasticities in the literature. Nevertheless, for the general reader this chapter neatly summarises the main issues. My concern is that many of the issues remain theoretically ambiguous and ultimately become empirical questions.

This is a useful book for a range of students, from those taking advanced undergraduate courses to policy-makers and economic commentators who need to catch up with recent developments in the theory of current-account determination. In some places the use of mathematics increases the complexity for a general audience, but it is kept to the minimum necessary to clarify the key points of the analysis. The clear presentation of complex issues is particularly appealing. But, as in most areas of economics, the theoretical ambiguities require more empirical clarification, especially when policy prescriptions are required.

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