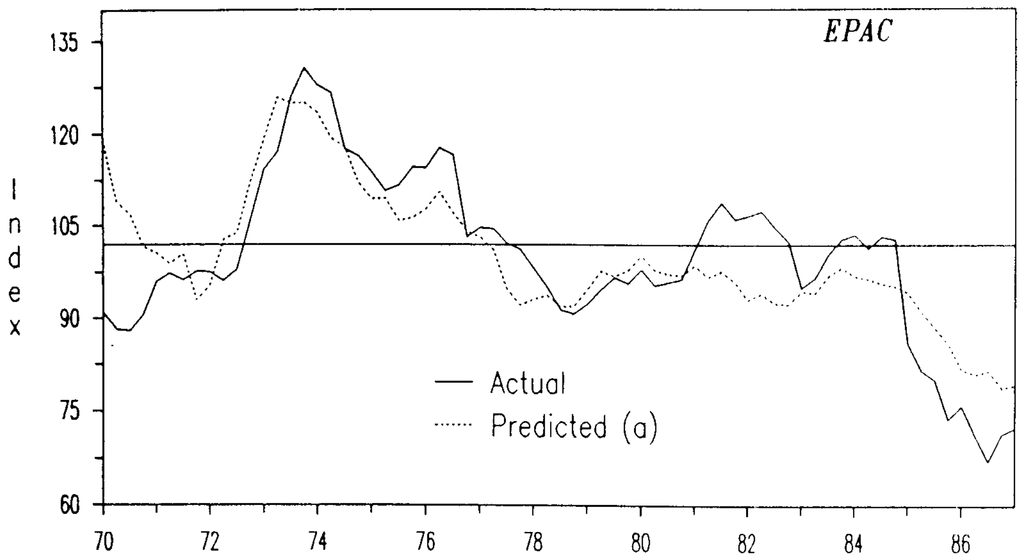
Chart 6: Australia's Competitiveness



(a) Predicted on basis of regression of competitiveness on the terms of trade

favourable trend in our terms of trade were to prove only short-lived. As well, the *nominal* exchange rate would need to reflect the fact that our rate of cost inflation is likely to slightly exceed that of our trading partners in 1987–88, but this influence should gradually wane.)

With real exchange rates stable and our relative inflation performance continuing to improve, the recent fall in interest rates should be sustainable, and there may even be scope for a further easing in domestic *nominal* interest rates over the medium term. If, as well, one were to see a fall in average real interest rates overseas—as the *Economist* was suggesting in a leading article last month—that would provide scope for further downward adjustment in Australian interest rates.

We should however, acknowledge that the underlying forces driving the exchange rate—especially relative inflation, the terms of trade and relative productivity—are subject to considerable uncertainties. There is therefore bound to be a large element of personal judgment involved in any assessments of the exchange rate and interest rate outlook.

In any case, we know that the *actual* exchange rate will frequently diverge substantially, and perhaps for lengthy periods, from the underlying *equilibrium* level, due to expectational factors and market psychology.

In brief, by seeking to identify the equilibrium exchange rate (on which interest-rate trends also depend), we are not only dealing with a moving target but one which seldom corresponds to market reality at any one time. Nevertheless, the question whether the balance of payments will continue to correct itself over the next few years without requiring further real exchange rate or policy shifts, is a key one for policy and financial markets and I commend the organisers of this Forum for throwing it open for discussion.

Australia's Real Exchange Rate: 1985 to 1990

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