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Should the Exchange Rate be a Target Variable for Government Policy?

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Introduction

It is amazing how fashions in economic policy thinking can change. The 1970s were a period of intense debate about fixed or flexible exchange rates. This debate eventually settled on the great virtues of flexible exchange rates and how governments should keep out of exchange markets. Now, not just only in Australia but overseas, we hear calls for returns to fixed exchange rates.

There have been calls by Helmut Schmidt, former Chancellor of West Germany which is a key player in the original move to flexible exchange rates, calling for a return to fixed exchange rates. And Professor Komiya of Tokyo University calls for a dual exchange rate system for the Yen and US dollar—one rate for merchandise trade and one for financial dealings (*Times on Sunday* 1986). And whereas Australia had one of the cleanest floats in the world, the experience is now for quite excessive intervention by the Reserve Bank to both stop the dollar from falling too low and then stop it rising too quickly.

So, should the exchange rate be a target variable for government policy? This seemingly straight forward question turns out to be quite difficult—not so much for conceptual reasons but for what is really meant by the question. Is it the nominal or real exchange rate that is of interest, and why would we want to be controlling the exchange rate in the first place? Given that we would only want to control the exchange rate for some end in the first place, the issue of whether the exchange rate should be a target variable or not is best addressed by answering the two following questions:

1. What are or what should be the Government's contemporary high priority policy objectives; and

2. What are the instruments available to the Government to achieve these objectives?

These two questions are now addressed in turn.

Contemporary Economic Policy Objectives of the Government

The classic and well known broad economic policy objectives in Australia are full employment, economic growth and price stability. In addition, Australia faces a particular issue in economic management and policy. This issue is the very large run up in our overseas debt and risk that this has imposed for the Australian economy.

Background to this deterioration in trade performance and increasing debt are:

- a succession of current account deficits since the early 1980s exacerbated by,
- a dramatic slump in the terms of trade over 1986,
- a large overseas borrowing to close this large gap between exports and imports,
- a belated realisation by foreign exchange markets that the \$A was grossly overvalued given the income earning power of the economy (diminished in foreign dollar terms by the terms of trade decline) relative to its domestic absorption, leading to a
- sharp and pronounced nominal depreciation of the \$A by foreigners, validated by the government through domestic expenditure and wages policy to ensure a large real depreciation.

Given that the bulk of Australia's debt is denominated in foreign currency terms, a consequence of the depreciation is that the \$A value has increased rapidly relative to our capacity to repay. Our gross overseas debt burden is now over \$100 billion and relative to our capacity to pay—for which the best proxy is mostly taken to be gross domestic product (GDP) or more particularly the net debt to GDP ratio—is some 32 per cent. There are two important aspects here: one is the misconceptions about this proxy measure of debt burden and the other is the role of expectations and dynamics in this process of debt accumulation. On the first point, simple indicators such as the ratio of debt to gross national product or the ratio of debt service to exports are not reliable indicators of servicing difficulties. We even have the situation where undue emphasis is placed on international comparisons of this debt servicing burden. But the important thing about borrowing (and lending) is that both parties expect to benefit—that is what mutual trade is all about. The implication of course is that borrowers have the

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expectation of ability to service the debt.

So the ultimate criterion of whether loans were innately good loans is whether the borrower's rate of return is greater than the interest that has to be paid. That self evident point turns out to be profound—but like most profound things it seems to be the one that most people have missed. The issue is what have our loans been used for and what is our expected rate of return in the Australian economy relative to international interest rates. This is why Hogan (1987) and Dixon and Parmenter (1987) criticise the EPAC scenario (1986) outlining the adjustment required to stabilise our debt by the early 1990s. As Hogan noted, the inheritance of interest charges on existing debt accumulations means that there is going to be a continued passive accumulation of further debt arising from the impact of interest charges and the balance of payments on current account. Hogan points out that the EPAC scenario of stabilisation of the net debt to GDP ratio under the assumption of a current deficit to GDP of about 2.5 per cent requires reducing the current account deficit to about \$A6,000m in 1986–87 prices. As Hogan noted, "that sum and more is already being absorbed by debt service commitments" (Davis 1987). This gives Hogan a figure of a \$10,000m turnaround being required in our external current account balance in a little over three years to stabilise our overseas debt burden.

The second feature is that the dynamics of our debt means we must consider the maturity structure of our loans and the role of expectations. As Dixon and Parmenter (1987) highlighted, the run up in debt leads to doubts in foreign exchange markets of our ability to service such debts, so we look more risky. As we look more risky, we either have to pay an interest premium to continue to attract loans or the exchange rate is lower than it otherwise might be, increasing the total debt repayment burden. One important difference between the EPAC scenario and the scenario of Dixon and Parmenter (1987) is that, given the pessimistic long term outlook for commodity prices, further substantial real depreciation is required to improve our trade balance sufficiently to achieve debt stabilisation.

So the real issue becomes: what is our debt being used for and will our rate of return be sufficient to service the debt? Given the dynamics it comes down to a question of risk—what *exposure* do we really have that is prudent given the volatility of international commodity markets upon which we still rely so heavily?

And it is *not* enough to say, "let the private market do the borrowing because they can service the debt by definition", without first asking the question of whether private investors are targeting the right activities. Private firms can and do unwittingly invest in the wrong activities—mainly they are often given the wrong incentive to invest in certain activities. This happens on a large scale in Australia through protection; we give private firms the incentive to invest in activities that don't give the nation a profitable return, and here I cite clothing, textiles and footwear and motor vehicles as examples. Also, contrary to the message conveyed by effective rates of protection, at least up until a couple of years ago (up until the information base permits), on a more accurate measure of trade distortions, protection for manufacturing measured in terms of the degree to which it restricts trade, was rising quite strongly (IAC 1987).

There is no convincing evidence that the relative price signals which have occurred to date will be sufficient to sustain the recent improvements. Unless someone can come up with some accurate projections showing that the world will not hit an international recession or commodity prices couldn't fall further over the next 3-5 years, all of this suggests that the urgent task of economic policy of government remains to correct the external balance and stabilise and wind back our debt exposure. But, fixing up the external situation is not an end in itself—the real aim is to improve growth and real incomes and employment. So the question really becomes how can we improve the current account by improving international competitiveness in a way which does not unnecessarily impede the long term goal of income and employment growth?

What are the Policy Instruments available to the Government to achieve this?

The effectiveness of some key policy instruments to improve the current account by increasing international competitiveness were recently reviewed in Stoeckel and Cuthbertson (1987) and in Higgs and Stoeckel (1987). The policy instruments chosen were a fall in real labour costs to employers, a fall in real domestic absorption, lowering tariff rates, changing the taxation mix and improving returns from overseas markets. These are described in detail in the paper by Higgs (1987) at this Forum and will not be repeated here. An essential point to note is that each of these policy changes work through

different economic channels. As a consequence, the size of the real exchange rate change to produce a uniform improvement in the trade balance differs between measures. The important point to note is that the real exchange rate changes each time but by differing amounts. And, as Dixon and Johnson (1986) pointed out, an improving current account deficit can be consistent with a rising or falling real exchange rate, as it is commodity defined. That is, the real exchange rate is an endogenous variable. It is possible to have the current account improving and real incomes and employment rising with a rising or falling real exchange rate—all depending on what is happening to other target policy variables. So one issue straight away concerning whether or not the real exchange rate should be a target variable is what are the other targets for government policies.

Real or Nominal Exchange Rates?

Given we ultimately want to improve real incomes and employment, our prime interest is in influencing the real exchange rate. However our nominal exchange rate is of prime concern to many businesses and traders. This is because the nominal exchange rate can fluctuate widely in the short term but cost levels tend to be far more stable. The question of whether we should intervene to influence nominal exchange rates boils down to whether or not the Government should be trying to bear the exchange risk on behalf of private businesses and traders. Risk and expectations do influence real variables such as real investments, but whether the private market or the Government should principally bear this risk burden seems to be open an question.

Can we Control the Real Exchange Rate Directly?

Given we can influence the nominal exchange rate and that the nominal exchange rate can vary much more quickly than can the domestic price level, there can be at times periods of influence on real exchange rates. But the real exchange rate is commonly defined to be (in percentage change terms):

$$R = r - (\text{CPI}_A - \text{CPI}_W)$$

where R is the change in the real exchange rate, r is the nominal exchange rate, and CPI_A and CPI_W are the consumer price index of Australia and the rest of the world respectively.

We have no influence over the inflation in the rest of the world. Also, over time, influencing the nominal exchange rate has an influence on the

domestic cost level and, alternatively, influencing the domestic cost level has an effect on the nominal exchange rate. It is only the net difference that matters and it is not possible to control the real exchange rate directly over long periods of time by direct interventions.

Conclusion

The real exchange rate is essentially an endogenous variable and one we cannot control directly over long periods of time. We can however influence many domestic policy variables such as the macroeconomic setting, taxation mix and the level of tariffs, each of which can have a strong influence on our real exchange rate. The choice of these policy instruments depends entirely on the issues at hand and what is trying to be achieved. One of the most important contemporary economic issues in Australia at the moment is the exposure of risk to the Australian economy to further international shocks given our high debt burden. The single most important domestic policy change we can identify to lower this debt burden, improve our trade performance, reduce inflation, increase growth and increase employment is to lower real wage costs to employers. There are many ways we can achieve this and these have been recently reviewed in Stoeckel and Cuthbertson (1987).

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