Forum
Exchange Rates and Interest Rates: where to now? Implications for Farmers, Miners and Manufacturers

These pages constitute the proceedings of the Policy Forum organised by the A.C.T. Branch of the Australian Agricultural Economics Society, held in Canberra on 30 September, 1987. (Contributions have not been revised following the stock market collapse of October, 1987: see the Forum article on this collapse by John Freebairn in this issue of the *Review*).

Opening Speech

John Kerin*

Thank you for the opportunity to make the opening address to this Policy Forum. You will not be surprised to learn that I am not going to answer the question contained in the Forum title—"Exchange Rates and Interest Rates: where to now?". Forecasting exchange and interest rates is too risky a business. However, there have clearly been some welcome developments in recent months which the Government's policies were designed to achieve and aim to perpetuate.

There has been an appreciation of around 16 per cent against the weakening US dollar over the past year, and of around 10 per cent on the more important trade-weighted calculation. Interest rates are falling and, as the total real depreciation over the past three years is still almost 30 per cent, there has been an enormous improvement in industry competitiveness. It is a matter of arithmetic that the value of the currency critically affects the profitability of the mining, natural resource and agricultural industries, which provide over 80 per cent of Australia's exports, as well as other activities in the tradeables sector.

The overvalued exchange rate of the early 1980s provided the initial impetus to a burgeoning current account deficit and hence overseas debt burden. Despite reasonable terms of trade, the current account deficit reached 5.9 per cent of Gross Domestic Product in 1981–82, before being reduced by the destructive 1982–83 recession. The uncertainty generated by currency gyrations in the 1970s probably replaced protection as the major factor underlying inward-looking industry attitudes in Australia. The depreciations over the past three years have cushioned commodity exporters from the full effects of the world price slump. Rural exports have increased by over 10 per cent in Australian dollar terms, but have fallen by around 20 per cent in terms of special drawing rights of the international monetary fund. It takes enormous changes in domestic cost structures to offset the effects of price or exchange rate changes of this scale. In wheat, for example, a 50 per cent reduction in direct labour costs would only offset a 3 per cent fall in wheat prices.

In the past, two opposite political forces tended to influence the exchange rate policies of conservative governments. The desire of producers of tradeable goods to have the exchange rate set as low as possible led the McMahon Government to set an exchange rate level that, in the absence of supporting policies, was undervalued. In contrast, the fight-inflation-first rhetoric of the Fraser Government and its Treasury led to the over-valued exchange rate of the early 1980s. The float means that the exchange rate is primarily set where it should be—in the foreign exchange market.

The combination of a large current account deficit, the associated build-up in overseas debt, and the terms of trade collapse in 1985–86, led to the substantial currency depreciations we have experienced. Because we have the appropriate support policies, particularly in the wages area, we now have record competitiveness. Consequently, the current account deficit is expected to fall to 4 per cent of the GDP this year. This is back to the 1982–83 level—without a recession, and despite much worse terms of trade.

Nevertheless, there are still those who seek political interference in exchange rate setting. For example, the National Farmers' Federation has advocated relaxing monetary policy with the purported aim of reducing both interest and exchange rates at one stroke. This is in the face of all experience since the float showing that interest and exchange rates are negatively, not positively related. When the exchange rate falls, interest rates go up, not down. There is no evidence that monetary policy is excessively tight—growth in the monetary aggregates has been broadly appropriate and interest rates have fallen. It can

* Minister for Primary Industries and Energy, Canberra

even be argued, as the BAE does in its contribution to this Forum, that the dollar has been undervalued. I would, however, be equally concerned about any attempt by the monetary authorities to push the currency up too far. There is no evidence that this has been the case to date—indeed the Reserve Bank has sometimes acted to hold the value of the dollar down in the short-term. However, the record of the Treasury and the Reserve Bank in the early 1980s was bad enough for us to be never sure that the leopard has changed its spots.

It is also a matter of arithmetic that interest rate levels are important to the profitability of any indebted business. Taken in isolation, it could appear that the primary sector is relatively insulated from domestic interest rate movements. Other sectors tend to have a higher average debt to equity ratio and homebuyers do not have access to tax deductibility for interest payments. However, these things cannot be taken in isolation. Unlike other sectors, the primary production sector has been directly battered by the downturn in world commodity prices, and so has been less able to withstand high interest rates than might otherwise have been the case. High interest rates have led to cash flow and debt servicing problems for some businesses, and depressed investment activity. Households have faced the burden of high mortgage interest payments and other credit charges. The Government has been acutely aware of these costs and the serious consequences for some people. In explaining why these developments have occurred and how our policies have responded, we must also ensure that our policies are appropriate to emerging conditions.

Let me briefly outline the factors which have contributed to relatively high interest rates—remembering that interest rates reflect supply and demand forces in financial markets. Supply factors have included high real interest rates overseas, the inflationary effects of the currency depreciations, falling household savings as a result of reduced real incomes, and the premium paid to foreign investors to cover perceived risks of further currency depreciation. On the demand side, the current account deficit has had to be financed, and there has been some increase in corporate borrowings. While there has also been a substantial fall in the Public Sector Borrowing Requirement, monetary policy has been firm in order to restrain domestic demand. Financial sector deregulation has improved its efficiency, but at some cost to those previously benefiting from regulation.

The appropriate policy response has been to focus on the external current account deficit, which has meant locking in—as far as possible—the competitiveness gains from the depreciations. This required correction of the macro-economic imbalances. The inflationary effects of the currency depreciations had to be insulated from wages and hence the domestic cost structure: this has been done. The fiscal imbalance had to be corrected: it has been completely wiped out. It is not complacency to say this—it is just a statement of fact.

As we predicted all along, as soon as the currency stabilised in the face of incontrovertible evidence that the external current account deficit was being corrected, interest rates fell. All the indications are that this process will continue. We have weathered the terms of trade collapse without a recession—truly an historic achievement. We are now coming to a different set of economic circumstances.

The challenge we face now is managing the second economic recovery since we came to office. Like all recoveries, it must not be allowed to rekindle inflation or a new round of current account difficulties. Stopping the recovery in its tracks is not an option. The Australian people want a return to full employment and rising living standards. That must be our prime objective. The solution to this dilemma lies in further micro-economic reforms to improve the competitiveness and efficiency of the Australian economy. In short, to encourage a productive culture and a more dynamic economy. If we are to lift the constraints on the long-term growth of living standards and job opportunities, this will have to be done at the micro-economic policy level.

This is not to say that there have not been important initiatives in the first two terms of the Labor Government. Freeing up the financial sector has been important in facilitating the process of restructuring. Australia's high level of manufacturing protection is coming down, and the structure of assistance to the rural sector has been rationalised. The two-tier wages system provides the best way—much better than confrontation—to reform restrictive work and management practices.

Senior Ministers, from the Prime Minister down, have set micro-economic reform at the top of our economic agenda in the third term. We have started with perhaps the most far-reaching reshaping of the Federal machinery of government and of public administration in our history. The agenda for further change is wide-ranging, including education and training, transport, industry assistance, and business taxation.

One controversial area concerns the bounds of public ownership—the so-called privatisation debate. If there is to be any policy change in this area there needs to be a rational assessment on a decent information base of the best course of action for the Australian people. To date, I have seen little evidence either way that meets this criterion. The issue is efficient satisfaction of social and economic goals. Neither public ownership no privatisation are ends in themselves. Reform of the primary industry Statutory Marketing Authorities—along with some deregulation where appropriate—has enhanced their commercial effectiveness. Regardless of the outcome of the privatisation debate, this question of organisational efficiency and effectiveness will remain important.

As far as my own portfolio is concerned, I have recently announced a comprehensive Industry Development Review to cover policies and programs for the primary sector. I have a number of objectives for this Review. An immediate objective is to further rationalise the structure of assistance to the sector. While overall assistance is low, there are still, for example, some commodities receiving price support while others do not; some inputs are taxed while others are subsidised; and some industries receive significant consumer transfers while others do not.

But there is also a broader purpose, which is to set the scene for developmental policies and programs for the sector into the twenty-first century. Like the rest of the Australian economy, the primary sector is subject to constraints on its productivity and growth. These need to be identified and remedial action set against the backdrop of the Government's strategy for the sector. The point is not that remedial action will need to be instituted. In virtually every case, such as with work and management practices, workforce training, adjustment assistance and transport services, the Government has a record of activity and achievement extending right back to 1983. Rather, the point is to refine strategies and programs in these areas into a more consistent whole where that might be necessary.

The concept some people have of the exchange rate as a macho image of our standing in the world is not correct. But the exchange rate is critically important to competitiveness. The concept of interest rates as no more than indicators of some people's personal welfare is also not correct. But interest rates are critically important to investment. The true measure of both national economic standing in the world and the economic scope for individual welfare is our national productivity. True national productivity growth includes not only raising measurable output per person employed, but also increasing employment and taking environmental amenity into account. Competitiveness and investment are vital to lifting national productivity. It is because of this that the topic of this Policy Forum is important, and so it gives me great pleasure to declare the Forum officially open.