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Outlook for Interest Rates and the Exchange Rate

Fred Argy*

The theme of my paper is that, provided the terms of trade remain fairly stable, a real exchange rate at about its average 1986–87 level is consistent with a stabilisation of our external debt in 1991; and that the necessary turn-around in our trade balance can occur without requiring a marked slowing down in economic growth. The paper also argues that, if markets accept this view, interest rates will be able to sustain their recent decline.

What is an Equilibrium Exchange Rate?

The issue under discussion is the broad direction of domestic interest rates and the \$A over the next few years. This requires a judgment on whether the present exchange rate is much above or below its underlying equilibrium rate. If it is currently *above* equilibrium, and markets come around to this view, perceived foreign exchange risks will increase, monetary policy will typically be tight and there will be expectations of higher inflation. Nominal and real interest rates will therefore be higher, and the real \$A will be lower, on average than at present. The converse will happen if the current rate is *below* equilibrium. (I am assuming stable real interest rates overseas).

What do we mean by an "equilibrium" exchange rate? An old rule of thumb is to assume that, over time, exchange rate movements will largely reflect inflation differentials (or, to avoid relying on an arbitrary base period, that exchange rates will ultimately be based on absolute differences in price levels). This implies that the \$A will tend to move back towards the horizontal "competitiveness" line in Chart 1. I think, however, most of you would agree that an analysis based on *purchasing power parity* is not particularly useful for projecting trends over the next 3 to 4 years. Given the size of the shocks we have borne in our terms of trade and national wealth, the structural problems we face, and the sharp rise in our net external indebtedness (which needs to be serviced from trade receipts), the real \$A will, over the next few years, need to remain

well below its long-term historical average—*i.e.* below the horizontal line in Chart 1—unless there is a sustained marked turnaround in the terms of trade.

I suggest that a more useful definition of the equilibrium exchange rate for Australia is the rate required to achieve *sustainable external equilibrium*—*i.e.* the rate which can reasonably be expected to generate, over time, a current account deficit capable of:

- (a) stabilising the external debt at an acceptable level (*i.e.* serviceable in the long-run without undue difficulty); and
- (b) being financed on an on-going basis by inflows of capital without requiring (through a tight monetary stance) chronically higher domestic real interest rates than overseas.

A third desirable condition is that:

- (c) the correction to our balance of payments be achievable with a rate of economic growth (during and after the adjustment period) broadly comparable to that of our trading partners (and without abnormal trade restrictions).

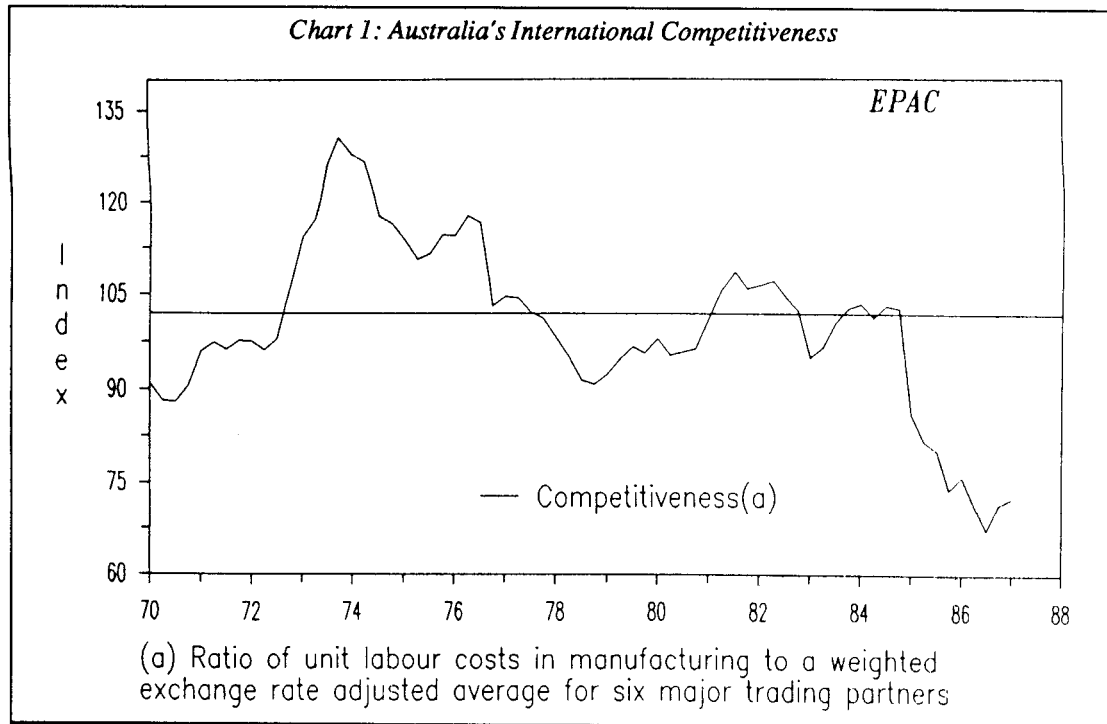
This last condition is no less important than the first two. External balance cannot be secured, on a sustainable basis, at the expense of internal balance. In any case, it is a moot point whether the relative price effects of a devaluation would work effectively in an environment of severe domestic recession.

EPAC Scenario

With such a methodological framework implicitly in mind, the Office put out two Council Papers late in 1986, which argued that the Australian dollar was basically in equilibrium in the sense that the 1984–86 real depreciation was likely, on certain plausible assumptions (*e.g.* appropriate flexibility in the economy), to lead to a gradual reduction in the current account deficit and a stabilisation of the net foreign debt (relative to GDP) early in the 1990s, without requiring a further substantial, sustained depreciation in the Trade Weighted Index (TWI) or a marked slow down in economic growth. We also argued that as markets became more confident that adjustment to external balance was on track, interest rates would tend to fall.

Since the release of the papers, the pace of adjustment has to some extent exceeded our

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expectations [which is ironic, given the prevailing view at the time that our scenario was over-optimistic]:

- the trade deficit has improved more quickly than we envisaged: in the second half of 1986–87 it was running at an annual rate of about 1.25 per cent compared with 3 per cent in 1985–86; in volume terms there was a remarkable turn-around in 1986–87 equal to about 2.5 per cent of GDP (see Table 1);
- the Public Sector Borrowing Requirement (PSBR) has declined at a rate that is fully consistent with our scenario;
- interest rates have fallen sharply, to the point where markets are no longer making much, if any, allowance for the risk of further real depreciation; and
- there appears recently to have been a welcome shift from debt to equity (including direct investment) in the net composition of capital inflow; this has favourable implications not only for the statistically measurable size of our external debt but, more importantly, for Australia's future capacity to service the capital inflow (Chart 2).

However, part of the adjustment has reflected the fact that the TWI has significantly appreciated in real terms, with associated favourable valuation effects on the current account deficit

and debt levels.

Not surprisingly, market psychology is very positive at the present time. However, markets have a notoriously short-term perspective, and the external debt outlook remains a source of public concern. Thus, the basic issue raised in the Economic Planning Advisory Council (EPAC) scenario is still highly relevant: will we be able to stabilise our external debt and maintain a reasonable growth rate without requiring a further major adjustment in the exchange rate? The answer we gave then was yes (although we accepted that there could be a small adjustment in the nominal \$A to allow for relative inflation performance). We still hold to this view.

Necessary Conditions

The validity of our conclusion depends on five propositions—all of them I believe quite defensible.

- (i) that Australia's terms of trade will remain broadly stable over the adjustment period; this is a critical assumption as there is a close correlation between the real exchange rate and the terms of trade.
 - this is somewhat conservative when compared with the kind of medium-term commodity assessments currently being made by the IMF/World Bank, and

Table 1: Selected Trade Indicators

	1984-85	1985-86	1986-87
	Percentage change at constant (1979-80) prices		
Exports:			
Manufactures (a)	6.4	1.1	12.8
STMs (b)	8.8	7.4	-0.4
ETMs (c)	0.0	0.8	26.1
Services	9.9	7.7	11.7
Imports:			
Manufactures	23.6	4.3	-14.1
Services	13.5	-5.3	-4.1
	As a percentage of GDP at constant (1979-80) prices		
Exports:			
Manufactures and services	4.9	4.9	5.4
Goods and services	18.4	18.7	19.7
Balance of trade on goods and services	-1.9	-0.7	1.6
	As a percentage of GNE at constant (1979-80) prices		
Imports:			
Manufactures	7.1	7.2	6.2
Services	4.6	4.2	4.1
	Import penetration ratios at constant (1979-80) prices		
Consumption goods (d)	6.5	6.2	5.6
Capital goods (e)	41.2	45.4	40.1
	As a percentage of GDP at current prices		
Balance on current account	-5.2	-6.0	-5.1
Balance of trade on goods and services	-2.3	-3.0	-1.8
(a)	Metals and metal manufactures plus machinery and transport equipment (Balance of Payments basis)		
(b)	Simply transformed manufactures		
(c)	Elaborately transformed manufactures		
(d)	Endogenous consumption goods imports as a percentage of private consumption		
(e)	Endogenous capital goods imports as a percentage of private investment in plant and equipment		

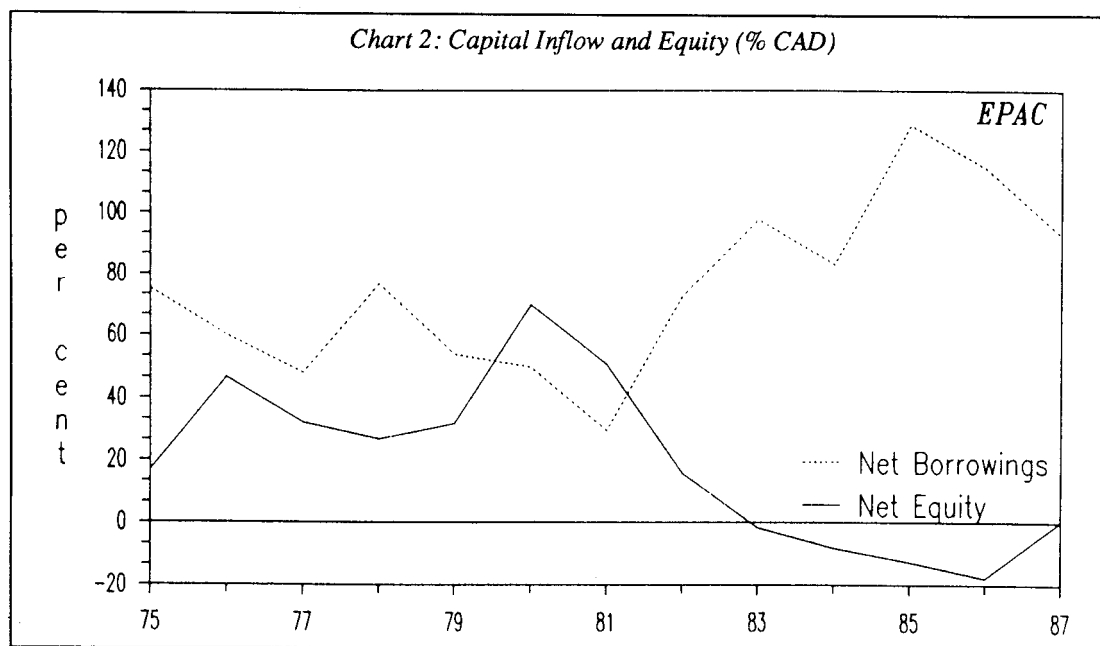
Sources: ABS catalogue no's 5302.0 and 5206.0 June 1987 and the Department of Trade

nothing has happened in recent months to require us to alter our assumption¹; this is not to deny the risk of a further decline in the terms of trade, from the average of 1986-87, but there is an equal probability that it will move the other way. No one has

a crystal ball.

- Treasury is expecting a rise of 2 per cent in the terms of trade in year average terms in 1987-88.

¹ This paper was presented before the world share market collapse.



(ii) that most of the gains in cost competitiveness of the last few years (Chart 1) will be retained. In the absence of appropriate incomes restraint, exchange rate depreciations cannot be sustained in real terms, irrespective of what is happening to the terms of trade, and inflationary pressures bear down on nominal exchange rates;

- although nominal unit labour costs have risen more than in our trading partners during 1986–87, this was allowed for in our assessment, and the medium-term outlook remains much as we envisaged; *i.e.* we expect a slowing down in the rate of increase in unit costs (partly due to improved productivity performance), with cost inflation remaining initially a couple of percentage points higher than in the seven major OECD countries, but the gap tending to disappear over time. Here, as in other elements of the scenario, there are uncertainties, especially as the new wage system has still to be fully tested, but I see no basis for pessimism.
- the rather strong appreciation of the \$A in the last 9 months (by about 8 per cent in real terms), was *not* anticipated in our analysis, but equally the terms of trade turned out somewhat higher than expected at the time of the last Budget.

(iii) that the volume of our imports and exports will respond to the devaluation in a way that

is consistent with the sorts of aggregate trade elasticities often assumed *e.g.* in recent IMF/OECD scenario work;

- there has been an encouraging response to the devaluation so far (Table 1). If the momentum is to be sustained, however, there will need to be an appropriate level of investment in new plant, infrastructure and training in trade-exposed and related sectors.
- there are commentators who feel that the responsiveness of the Australian economy is less than assumed in our analysis, particularly as a relatively large depreciation is involved.
- I do *not* believe market rigidities are so firmly rooted that they will continue to inhibit the necessary supply response for some considerable time; but if this *were* true, then a further real depreciation would (quite apart from the adverse "valuation" effects) achieve little, even if the necessary real wage cuts could be smoothly implemented. We should be seeking to address the market rigidities directly.
- Treasury is forecasting an effective increase of 4 per cent in real private business investment in 1987–88 (with 7 per cent real growth in non-vehicle equipment investment).

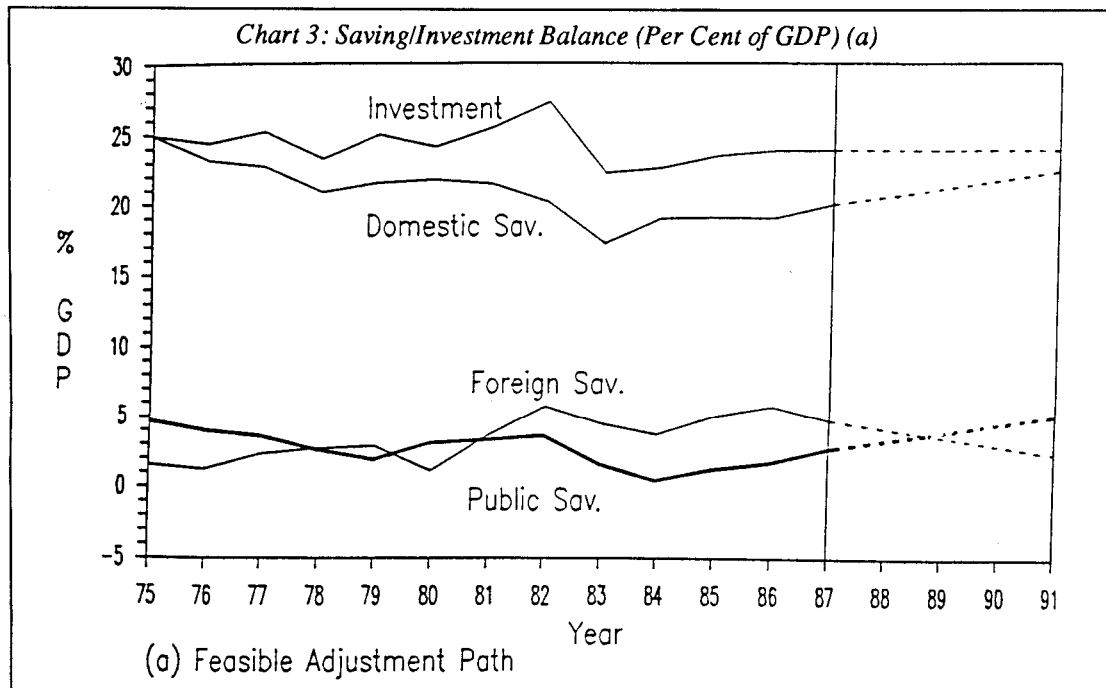
(iv) that, as the level of business investment

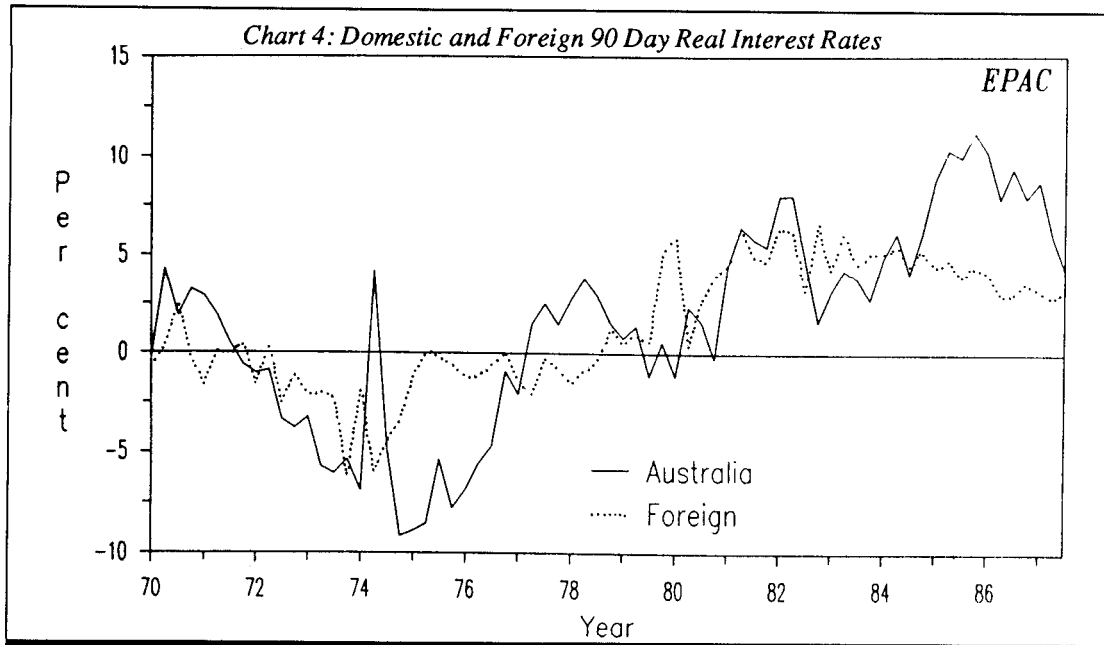
increases and the current account deficit declines (thus reducing the contribution made by net foreign capital), domestic savings will rise sufficiently to make up the gap;

- an increase in domestic saving over the next few years of several per cent of GDP would be required to sustain the outcome envisaged in the EPAC scenario.
 - The Government is primarily looking to increased public sector saving to provide the necessary equilibrating mechanism; given the progress already made, it can fairly be argued that the required fiscal adjustment is well on track (Chart 3).
- (v) that the devaluation since 1984 has not only taken care of the terms of trade shocks but also accounted for any pre-1985 \$A over-valuation;
- The evidence on this point is unclear. I am aware that some models point to a significant over-valuation in 1984 and this may well be true. However, many of these models assume an unrealistically high rate of economic growth and investment in the absence of devaluation. Moreover a casual look at the relevant indicators does not provide an overwhelming impression of over-valuation in 1984.

- cost competitiveness in 1983–84 was more-or-less in line with the long-term average (Chart 1);
- domestic interest rates were not appreciably out of line with overseas interest rates (Chart 4), implying that the market, at least, did not see a risk of significant depreciation. Moreover, in the early 1980s, there were substantial net purchases of foreign exchange by the monetary authorities, implying official efforts to hold *down* the \$A in that period.
- while the current account appeared to be deteriorating in the early 1980s (Chart 5), with marked increases in import propensities, there was a "cyclical" component in this, as Australia's average growth rate in 1980–85, and especially in 1983–85, was well above the OECD average rate.

To the extent that there was an element of over-valuation in 1984, it is arguable that the subsequent depreciation dealt with it to a large extent, as it is clear from Chart 6 that it more than compensated for the terms of trade decline. (On the other hand, Chart 6 should not be seen as suggesting that the \$A is currently *under* valued. There are other factors besides the terms of trade bearing on the equilibrium exchange rate. For one thing, the increase in debt servicing obligations over the last few years has tended to pull down the



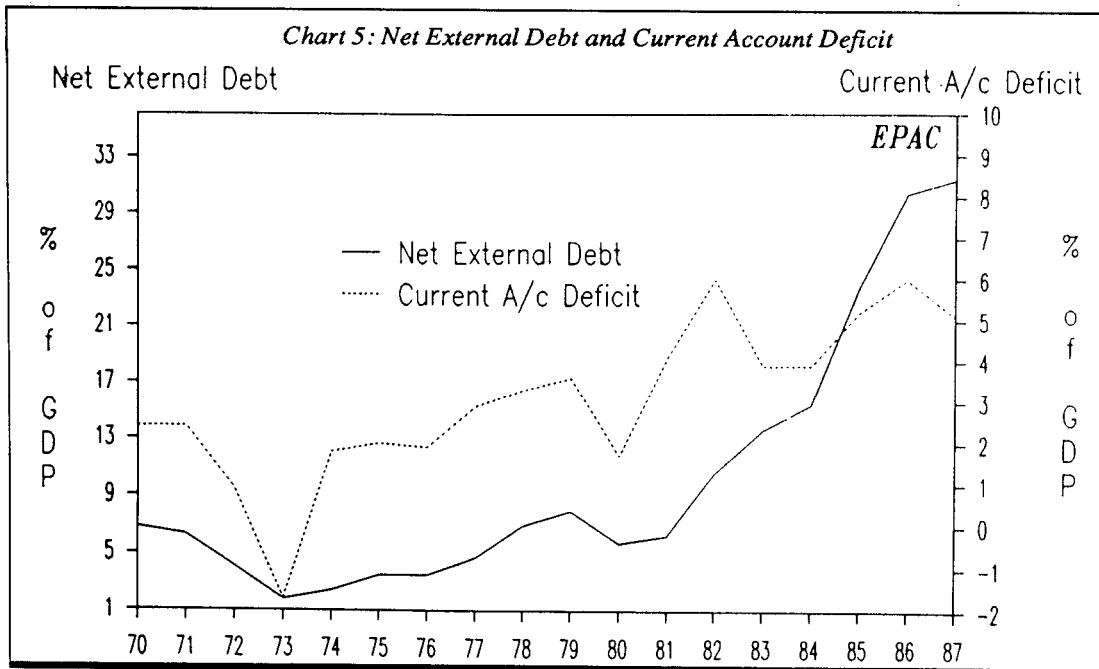


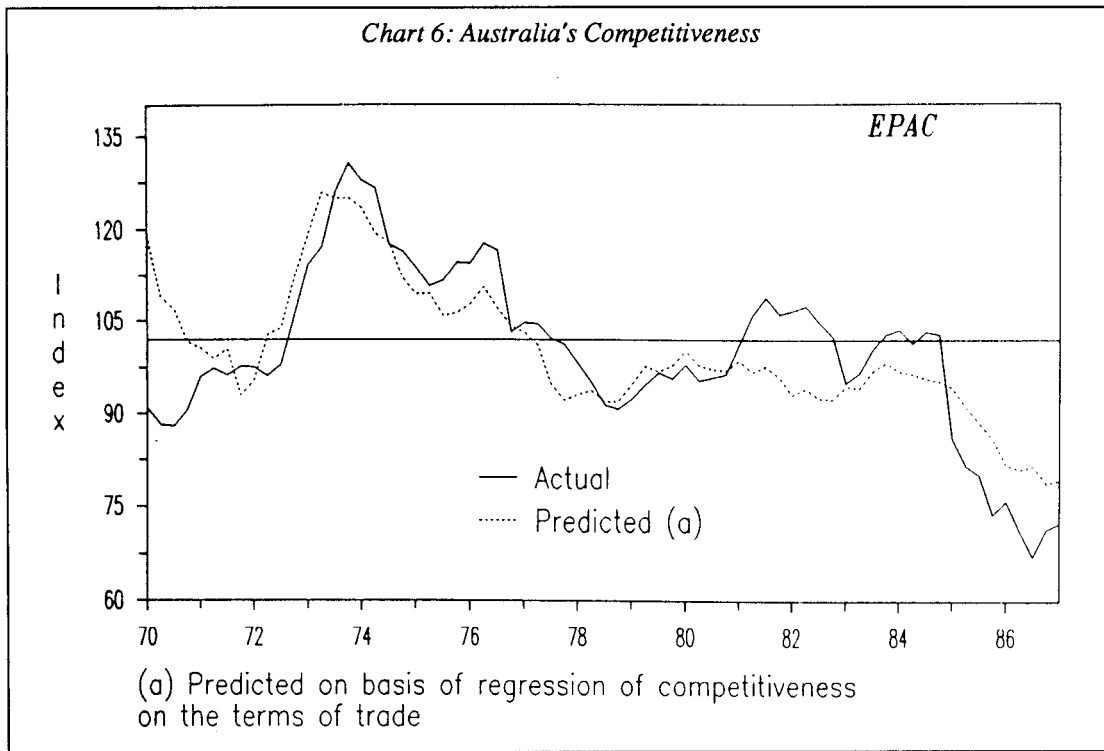
equilibrium level below what would be indicated by movements in the terms of trade.)

Concluding Remarks

If these five propositions are accepted—as I believe they should be for the kind of exercise we are engaged in here—and if financial markets adopt them and are prepared to wait until the turn of the decade to see a stabilisation of the debt/

GDP ratio (clearly the results are sensitive to "end-point" assumptions), I see no reason to expect a large, sustained rise or fall in the *real* TWI over the next few years from the average level prevailing in 1986–87. (As already mentioned, the *present* level of the \$A is higher than assumed in our EPAC papers and may, consistent with that analysis, need to undergo a small *real* adjustment if the recent more





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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