SOME OBSERVATIONS ON ECONOMIC CONDITIONS AND POLICY

An Address by

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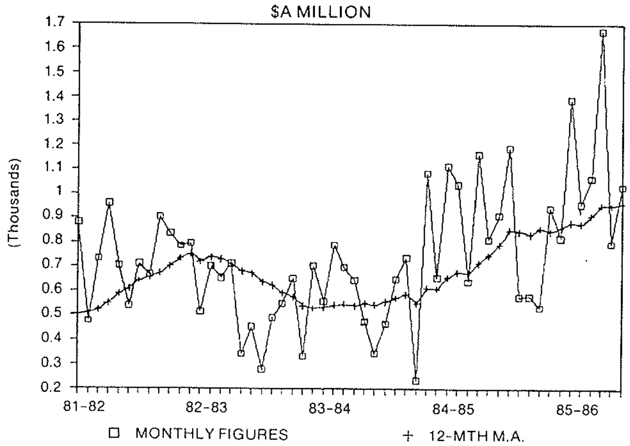
Secretary to the Treasury to the Securities Institute of Australia, West Australian Division on 12th February, 1986

It was suggested to me that I might talk to you about interest rates and exchange rates. There have been, of course, some sharp movements in both in recent times. These have important implications for many people, not least members of this audience, and I will say something about them today.

In a sense, however, *short-term* fluctuations in interest and exchange rates are the froth and bubble of the operations of financial markets, rather than solid indicators of underlying trends in the real economy.It is those underlying trends that we need to focus upon in making assessments about the medium-term outlook for the Australian economy. If the economy overall is performing satisfactorily, and if policies are in place to sustain a reasonable performance, then we should not get to excited about short-term fluctuations in interest and exchange rates.

Over the medium-term financial and foreign exchanges markets will tend to reflect underlying trends in the real economy so that, over that term, interest and exchange rates will also reflect underlying forces. But this is not always the case in the short-term.

GRAPH 1
MONTHLY CURRENT ACCOUNT DEFICIT



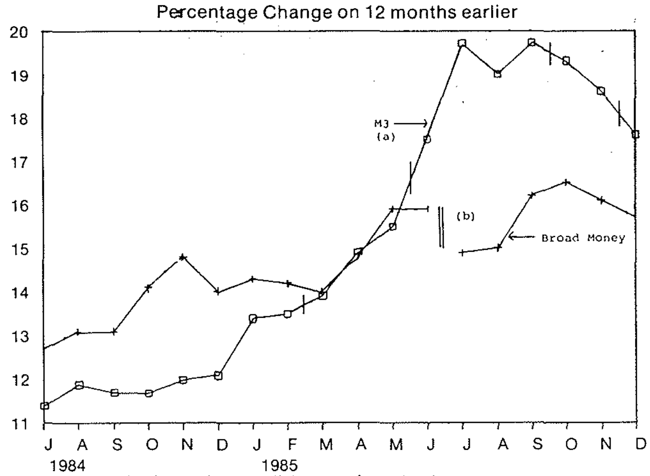
During recent months foreign exchange markets have reacted sharply to, inter alia, monthly current account statistics. In October Australia had a record current account deficit of $1670 million; in November this was halved to $800 million. the former result accentuated the slide in the $A in November while the latter helped it to recover somewhat. The December deficit of $1030 million was in-between and, after a little nervousness initially, the market settled and the $A strengthened.

After falling to 65.75 on 12 November, the rate for the $A against the US dollar recovered to 71.50 at the end of January before coming bach to 69.25 last Friday. Over the same period the Trade Weighted Index recovered from 59.2 to around 63 at the end of January, before coming bach to 61 last Friday.

The monthly current account figures attract much attention but are subject to very wide fluctuations, as Graph 1 indicates. The average deviation of the monthly figures around a 12 month moving average has been equivalent to almost 30 per cent (around $300 million at current levels) of that moving average. It is, of course, the future trend of that moving average that is of most significance. Although there is little evidence of it to date, we expect to see a significant improvement in the current account deficit in the period ahead; more on that later.

The monetary aggregate — M3 and broad money — also have a peculiar capacity in present circumstances to excite many money and foreign exchange market operators. Again we should focus on the underlying trends, not the monthly fluctuations. There are, however, added complications with these series in that the links between movements in monetary aggregates and trends in the real economy are not always straightforward, even in more settled times. The on-going process of financial deregulation which commenced a couple of years ago is changing past relationships in ways which are not yet clear or measurable. Partly for this reason governments, not

GRAPH 2
MONETARY AGGREGATES



(a) Breaks due to the establishment of new banks.
(b) From July 1985 growth rates exclude identified double counting of transactions between NBEIs.

only in Australia but also in the US, UK and elsewhere, have found it necessary to downgrade the role of monetary aggregates and make use of a wider range of indicators for monetary policy purposes.

Graph 2 shows movements in M3 and broad money since July 1984. While too much should not be made of these series (for the reasons just touched upon), it can be seen that the rates of growth in the monetary aggregates have been decelerating in recent months, albeit from high levels. The demand for credit is now slowing and with the effects of the increases in interest rates in November still to be reflected fully in the statistics, some further decelerations in the rates of growth of the monetary aggregates can be expected in the months ahead.

To reiterate, the important question for policy is not how a particular indicator moves in a month but whether the economy is on track, having regard to the pressures which inevitably bear upon it, and whether the mix of economic policies in place represents a practical approach to facilitating necessary adjustments. I would like to offer a few observations on these latter questions.

THE RECENT PAST

It is apparent that good progress has been made on most economic fronts in Australia in recent years. Over the two years 1983-84 and 1984-85:

- real non-farm GDP increased by almost 9 per cent;
- employment increased by 5 ½ per cent (or 345,000) while the unemployment rate declined from 10.3 per cent to 8.5 per cent;
- the rate of increase in prices almost halved, to a little over 6 per cent in 1984-85;
- the rate of growth in earnings also declined substantially, from 11.2 per cent in 1982-83 to 6.9 per cent in 1984-85;
- the profit share increased from under 13 per cent of GDP in 1982-83 to 15 per cent in 1984-85; and
- the All Ordinaries Stock Market Index increased by more than 40 per cent between June 1983 and June 1985, to over 860.

The forecasts presented with the Budget in August pointed to further strong growth in activity and employement in 1985-86. Specifically, non-farm product was forecast to grow by about 5 per cent and employment by 2 ¾ per cent.

There were, however, some important aspects of those budget time forecasts which are worth recalling. In particular:

- The rate of growth of domestic demand was forecast to slow from 5 per cent in 1984-85 to around 3 per cent in 1985-86 and, as a further contrast with 1984-85, private sector demand was forecast to grow faster than public sector demand.
- The sharp depreciation of the $A in the first half of 1985 (20 per cent on a TWI basis) was forecast to provide a significant stimulus to the economy, particularly through import replacement. This increased contribution to growth from net exports was expected to offset the slowing in domestic demand, leading to the forecast of an increse of about 5 per cent in non-farm product for the second year in a row.
- At the same time, the $A depreciaton meant that there would be a significant jump in prices in 1985-86. The CPI was forecast to increase by about 8 per cent through the course of 1985-86, before tapering off.
- The depreciation, together with the slowing in domestic demand, also was seen as facilitating a gradual reduction in the size of the current account deficit relative to GDP, although a further increase in nominal terms was expected in 1985-86.

It is to be noted then that, in the two key areas of prices and the current account, it was anticipated that the numbers would get worse before they got better. That is, the depreciation would provide a valuable fillip to the balance of payments but it would take some time for these benefits to come through and, in the meanwhile, economic policy would have to contend with the adverse short-term effects.

The available indicators for the first half of 1985-86 suggest that demand and employment have remained strong. Domestic demand may in fact have been a little stronger than had been forecast for this period. Employment has been particularly strong, growing by 1¼ per cent in both the September and December quarters.

The increase in the CPI in the September and December quarter of 2.2 per cent and 2.0 per cent, respectively, are in line with the budget time forecast of an increse of 8 per cent over the year to June quarter. The increase over the year to the December quarter was 8.2 per cent.

No precise estimates are available of the direct or indirect effects of the depreciation of the $A on the CPI in 1985. The Australian Statistician has prepared estimates for some items where measurement is practical, namely price movements in "goods and services wholly or predominantly imported", and in "petroleum products". Together they come to 1.73 percentage points over the year to the December quarter.

These estimates by the Statistician do not, however, purport to be a measure of the exchange rate effects on the CPI. His estimate of changes in petrol prices, for example, reflects all the factors bearing on such prices in a particular quarter, and not just exchange rate effects. In the event, other factors such as reductions in crude oil prices and discounting of petrol prices appear to have been such over the year as to offset some part of the exchange rate effect.

Figuring done in the Treasury, which attempts to allow for these various factors, suggests that the exchange rate effect on petrol prices contributed some 0.7 percentage points of the increase in the CPI over the year to the December quarter. Added to the Statistician's estimate of about 1.2 percent points for goods wholly or predominantly imported, the total direct exchange rate effect over the four quarters on this basis would be close to 2 percentage points.

The current account deficit in the first half of 1985-86 totalled $6.9 billion, compared with $5.7 billion in the corresponding period a year earlier. As noted earlier, budget time expectations were that the current account would get worse before it got better and that the 1985-86 deficit would exceed the $10.3 billion recorded last year.

That excess, however, is likely to be greater than had been anticipated at budget time. There appear to be several factors at work here, including:

- a slower and/or smaller than anticipated flow through of increases in import prices as a result of the depreciation which has reduced the expected impact of depreciation on imported volumes in 1985-86;
- stronger than expected domestic demand in the September and December quarters; and
- weaker than expected prices for a number of major export commodities.

A substantial improvement in the current account is still expected. The recent improvement in Australia's international competitiveness and the slow down in the growth of domestic demand should largely ensure that. I note here that while the volume of endogenous imports in the first half of 1985-86 is estimated to have increased by about 5 per cent, much of this increase appears to have been in respect of investment goods, with little if any growth in imports of consumption goods. To some extent the strength of investment imports (about 40 per cent of endogenous imports) probably reflects the bunching of orders for imported plant and equipment associated with the decision to phase out the investment allowance. To the extent that it represents imports of plant and equipment to expand capacity to take advantage of our newly enhanced competitiveness, it is a plus factor for the current account in the medium term.

The main uncertainty surrounding this projected improvement in the current account deficit relates to its timing; no one is able to forecast with any real confidence the lags involved in trade volumes responding to the changes in relative prices occasioned by a substantial currency depreciation. We expect to see a progressive improvement in the current account emerge during the course of the next 6 to 12 months although, given the special factors that can impart substantial volatility to the monthly numbers, we would not expect each and every month's published figure to be "good". (On current plans, for example, the March import figures will be boosted by the delivery of aircraft for Qantas valued at more than $200 million.)

There will inevitably be some changes from the economic forecasts provided with the budget but the overall picture presented at that time remains broadly intact:

- although domestic demand could grow by a little more than the 3 per cent forecast, this implies a significant slowing in the growth of private demand in the current half year;
- with the contribution from net exports now likely to be rather less than the 1¼ percentage points anticipated at budget time, growth in non-farm product could be a little less than 5 per cent;
- given the strong growth to date, the forecast increase of 2¾ per cent in employment is likely to be exceeded; and
- the CPI is expected to increase by a little above 8 per cent over the twelve months to the March quarter, before edging back to the budget time forecast of about 8 per cent over the year to the June quarter.

LOOKING AHEAD

Looking beyond 1985-86, a lot obviously hinges on the effectiveness of economic policy, particularly in maintaining Australia's newly enhanced competitiveness. International economic developments will also be important. On that front the picture is not all bright but nor is it all black:

- growth of around 3 per cent in the OECD countries is forecast in 1986 which, while not spectacular and below what is required to reduce unemployment in most countries, is still a good deal better than the 1 per cent averaged over the period 1980 to 1983;
- rates of inflation in many countries are now at their lowest levels for 15 to 20 years and could go lower if crude oil prices stay around current levels; and
- the volume of world trade is forecast to increase by about 4 per cent in 1986, compared with growth of about 3 per cent in 1985, 8½ per cent in 1984 and virtually no growth at all in the earlier 1980s.

On the other hand, international commodity prices — while mostly above the troughs of 1985 in $A terms — remain at depressed levels. The spread of protectionist arrangements is adding to the pain experienced by Australian exporters of some agricultural and other commodities. International prices for both coking coal and iron ore have been reduced in recent negotiations. While exporters of many of Austrlia's mining and rural commodities anxiously look for signs of improving commodity prices, the depreciation has boosted export returns in $A terms. This has helped what otherwise would have been hopeless situations for many exporters.

The recent sharp falls in crude oil prices are a new and added complication. Assuming they are sustained for some time, lower oil prices should be good news for most countries, particularly in terms of their potential for lowering inflation and stimulating more buoyant levels of economic activity. But there are some qualifications in Australia's case. Australia is currently a net exporter of *petroleum* products, with exports valued at $1.5 billion in the first half of 1985-86 and imports at $1.1 billion. Australia is, of course, a substantial net exporter of *energy* (a surplus estimated at over $3 billion in the first half of 1985-86). It remains to be seen just where crude oil prices settle down but if there were to be a sustained fall significantly below $US20 this could spill over to competing energy sources (especially steaming coal), with adverse effects on our net export income from trade in energy.

To the extent that, over time, lower crude oil prices were to stimulate faster growth in the international economy, Australia could expect to share in the associated expansion of world trade — particularly if, in the process, prices of non-oil commodities of importance to Australia were to be given a kick along.

While governments cannot directly counter international developments of these kinds, they can and must take their implications into account in domestic economic policy formulation. The essence of those implications at this time is that Australia must pursue domestic policies which ensure that the recent substantial improvement in its international competitiveness is maintained.

This consideration underlies current economic policy objectives. In very simple terms, the future growth and posperity of the Australian economy will depend on our ability to produce goods and services of a kind — and at a price — which consumers here and overseas want.

Competitiveness and growth should not be seen as conflicting objectives. Competitiveness is an intermediate policy goal; growth is a more fundamental goal. Competitiveness is necessary for growth but it should not be pushed to the point where it undermines growth. If all that mattered was to correct the current account deficit by, for example, squeezing inflation out of the economy as quickly as possible and cutting back savagely on domestic demand, that might not be too difficult to achieve in a policy sense. But the resultant costs in terms of unemployment and underutilization of other resources are likely to be such that, as in the past, improvements in competitiveness achieved in that way would not be sustained beyond the subsequent recovery phase.

Over the years Australia has performed relatively poorly in terms of restraining wage and other cost pressures. As a result, it has been necessary for the exchange rate to depreciate to permit us to catch up with our competitors. The approach to wages and prices embodied in the Government's Accord with the ACTU is helping to restrain such pressures. In the past also wage and cost pressures have distorted wage and profit shares in ways which have been inimical to growth. The Accord, and the wages pause which preded it, have resulted in more moderate growth in real wages and, combined with increases in productivity, sharp reductions in real unit labour costs:

Real Unit Labour Costs: Non-Farm Sector (a)

	Change %
1981-82	1.9
1982-83	-0.3
1983-84	-5.2
1984-85	-2.2
1985-86 (f)	-2

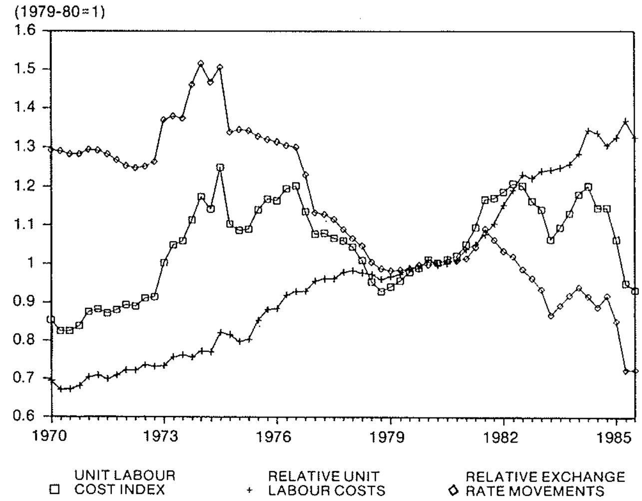
(a) Ratio of non-farm wages, salaries and supplements and payross tax per hour worked by non-farm wage and salary earners to gross non-farm product at average 1979-80 prices per hour worked by all persons employed in the non-farm sector.
(f) Forecast

This recent performance in wages and real unit labour costs is in marked contrast to our experience during most of the 1970s. It lies behind the notable improvements in inflation and profitability during the past few years.

The depreciation of the $A in 1985, in a situation of more moderate wage cost increases, has restored Australia's competitiveness to about the levels of the early 1970s (see Graph 3). Although it has not been the only factor, the Accord has made substantial contributions to these improvements in Australia's fundamentals. It represents a different approach to wage restraint and to the handling of the inflationary effects of currency depreciations compared with the past.

I emphasise this improvement in real unit labour costs and Australia's competitiveness partly because the extent of the changes does not appear to have been widely perceived, and partly because a sustained improvement in competitiveness is critical to the achievement of respectable rates of growth over the medium term.

GRAPH 3
COMPETITIVE INDEX BASED ON UNIT LABOUR COSTS IN AUSTRALIA RELATIVE TO MAJOR TRADING PARTNERS, ADJUSTED FOR EXCHANGE RATE MOVEMENTS; AND COMPONENTS OF INDEX



Some concede that Australia's competiveness has improved substantially during 1985 but are reluctant, for one reason or another, to undertake new investment or in other ways act upon this improvement. There is, for example, a concern that the improvement will not be sustained becasue the Accord will break down and/or the impact of the productivity and national wage cases, combined perhaps with significant wage drift, will cause costs and prices in Australia to increase rather faster than our competitors' economies and therefore whittle away our recent gains.

Assuming that wages are discounted by 2 percentage points in the forthcoming National Wage Case; that productivity superannuation benefits of 3 per cent are spread over a two year period; and that earnings drift continues at the restrained rate of the past year or so, real unit labour costs would increase marginally in 1986-87, following large reductions in each of the three preceeding years. Although increases in prices in Australia are likely to be somewhat faster than in most of our competitors over the next couple of years, the differential should be narrowing.

On this basis Australia would surrender only a relatively modest portion of last year's improvement in competitiveness. That would be a good outcome, both by past Australian standards and compared with the experiences of other countries where large deprecia- tions have occurred.

Current high interest rates are also advanced as a reason for questioning the expected impact of improved competitiveness on the current account.

These are said to be deterring the investment which is necessary in many firms to expand capacity before the potential benefits of improved competitiveness can be exploited. Current interest rates are no doubt a deterrent in some cases although, overall, investment anticipations appear to be holding up.

At the same time, there are signs that the more credit sensitive areas of the economy — housing being the clearest example — are feeling the impact of monetary policy. That is unfortunate but it has also been unavoidable. Moreover, the consequences of the further monetary tightening in November have only just begun to show up in the measured indicators. As suggested earlier, credit and monetary aggregates are likely to slow further in the months ahead. This will obviously weigh heavily in the overall judgements to be made about the stance of monetary policy, along with the other indicators on the "check list" (such as exchange rates and the balance of payments, activity and inflation). Fine judgements are involved.

Finally a word about fiscal policy, the third major element in the Government's macro-economic strategy. After initially providing a significant stimulus to economic recovery, fiscal policy has been tightened since private sector activity picked up and the $A depreciated.

As you will recall, the 1985-86 budget provided for:

- an increase of only 1.3 per cent in outlays in real terms, compared with increases of 6 to 7 per cent in each of the three preceding years;
- a further substantial reduction in the budget deficit (to 2.1 per cent of GDP, about half the comparable 1983-84 figure); and
- because of that reduction in the Commonwealth's budget deficit, a further substantial decrease in the total public sector borrowing requirement.

The budgetary figures for the first half of 1985-86 are on track; they are consistent with the deficit coming in on target, as has been the case in each of the past two years.

Looking further ahead, the Government has committed itself to continuing restraint on the fiscal front. The Trilogy commitments are very clear and very public commitments. The same is true of the Government's tax reform proposals. These are estimated to cost some $1 billion in 1986-87 and close to $3 billion in 1987-88; they are to be funded without additions to the deficit. Implementation of the tax package will therefore place additional pressure on the Government to achieve expenditure restraint. There is also the added complication of declining crude oil prices to contend with.

Continuing fiscal restraint is important for a number of reasons. To the extent that governments — at all levels — increase their demands on domestic savings this will reduce the availability of savings for growth promoting investment, or necessitate increased resort to overseas borrowings. The latter course would moderate the rate of improvement in the current account. The degree of fiscal discipline reflected in government spending and borrowing programs also has implications for the setting of monetary policy.

Over the months ahead the Government will be considering how best to marry together its various trilogy and other fiscal policy commitments. It will, clearly, be taking decisions to restrain the growth in public sector outlays and borrowings.

This must include that State and Local Government Sector, which has bigger spending and borrowing programs that the Commonwealth sector these days.

I know questions are asked as to whether the Government's fiscal policy and other commitments will be delivered — and, indeed, whether the Government's overall economic strategy remains appropriate and on track. Such questions will always be asked. The answers, I suggest, will be found not only in Government pronouncements but, more importantly, in actual performance. The good performance of the Australian economy on most fronts over the past couple of years — years which also called for difficult decisions — and the policy settings which have contributed to that performance, provide a basis for believing that the problems which lie will be resolved satisfactorily.