

A Decade of Keating: Prospects for External Recovery?

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Abstract

Government policy has sought to counter a deteriorating current account deficit by a regime of high interest rates. This paper analyses this policy prescription and argues that less reliance on monetary policy is essential for containing external debt.

1. Introduction

Faced with a worsening current account deficit (CAD) and external debt throughout the second half of the 1980s, Government policy response had two distinct phases. Initially, the problem of external trade imbalance was to be resolved by the real exchange rate mechanism (the J-curve). The massive depreciation of 1985-86 did have some effect in addressing the rising CAD, but, because the exchange rate soon appreciated, the experience was a failure of the CAD to respond adequately to the exchange rate.

The reason for the currency appreciation was a recovery in commodity prices and higher interest rates.

When the exchange rate mechanism fails to deal with the external problem in the given policy time frame, alternative approaches are sought. Tradition-

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ally, deficit countries contract their economies with high interest rates to choke import demand. This was the path chosen by the Hawke-Keating Labor Government after 1987.

The inadequacies of these policies, and the inappropriateness of the latter, are discussed below in the context of econometric models of the CAD, the exchange rate and a survey-based study of the problems facing exporters. The models are used to determine the impact of these policies on the external account.

This paper analyses economic outcomes and potential policy directions. It is argued that less reliance on monetary policy and the need for a stable and lower valued dollar are essential for the required structural change.

2. Current Account Forecasts

Owing to seasonality and the extreme volatility of the monthly releases of the provisional CAD, it is unwise to place any emphasis on a simple comparison of consecutive provisional CAD releases. However, it is extremely important to have good up-to-date information about the external balance if associated policy is to be successful in slowing the economy without overshooting the target. For these reasons it is necessary to have a formal model of the CAD so that the effects of provisional data on the forecasts can be assessed.

It is important to note that it is not necessary for an econometric model to incorporate all of the determinants of the CAD when it is used for policy analysis. While forecast accuracy may be enhanced by incorporating all such factors, the omission of a relevant instrument from a model implies that when that instrument is varied, the forecasts will be biased. Therefore, the effect of interest rates on the CAD can be evaluated by comparing actual data with forecasts from a model that does not include interest rate effects. If high interest rates are, indeed, having an effect on the CAD, a persistent bias should exist in such a model.

The model selected for this study is that reported in Bewley, Fisher and Parry (1988a, hereafter BFP), which is a cointegrated VAR (Vector Autoregressive) model based on the theory developed in Bewley, Fisher and Parry (1988b). This model expresses eight components of the CAD in SDRs and allows for seasonality and the number of working days in each month. Forecasts are then transformed back to the \$A denominated series at the rate of exchange prevailing at the forecast origin.

BFP (1988a) reported that the CAD model has a high degree of accuracy in predicting the direction of the cumulative 12-month ahead CAD. Longer

term forecasting properties of this model have not previously been analysed.

In order to focus on the trend of the CAD, rather than the accuracy of point forecasts, the actual CAD data has been smoothed with a 3-point moving average in Figure 1. The similarly-smoothed 24-month ahead forecast, with an origin of December 1986, has been superimposed on Figure 1. Since forecast errors from a single origin are autocorrelated, it is inappropriate to apply standard statistical techniques to analyse this relationship, but certain points can usefully be made.

In the run up to the election in 1987, Mr Keating argued that the J-curve effect was at work and in the September 1987 budget speech stated: "We have turned the corner and the big gaps in the trade accounts have begun to close." However though the rising trends in the model's predictions were at variance with official forecasts, they turned out to be in broad accord with outcomes.

Figure 2 repeats the exercise from a base of December 1987 and again, given the opinions of the Treasurer quoted above, actual and predicted CAD outcomes turned out to have been reasonably informative. These predictions, together with one made in June 1987, are brought together in Figure 3. The only major departure between actual and predicted outcomes was during the commodity price boom in early 1988. The fact that forecasts with origins six months apart coincide, and are acceptably accurate, implies that no new information external to the model had any significant effect on the CAD. This principle can be used to assess the effects of economic policy. That is, if policies are working to change the CAD, bias should be present in the forecasts.

These forecasting experiments have been extended in Figure 4 to cover most of the CAD crisis period. It can be seen that forecasts with an origin of December 1985 produced a systematic bias throughout 1987. Since the dollar fell dramatically in May 1986, it can be implied that much of the difference between the December 1985 and the December 1986 based forecasts is a measure of that currency depreciation. However as mentioned above, the exchange rate effect requires a longer period than the given policy time frame allows. Furthermore, the mechanisms may be hindered as the inflationary effects of higher import prices cause real wages to fall. If this fall is resisted, the exchange rate process is blunted.

Throughout the period between late 1986 and the end of 1989 the current account deteriorated, the only exception being a brief improvement during the period of lower interest rates associated with the response to the October 1987 share market crash (see Figure 5). By late 1987 it was generally

accepted by the public and Government that the external problem remained and the government acted to raise interest rates. Unfortunately, the rate of deterioration in the current account then increased.

3. Current Interest Rate Policy

Since January 1988 there has been a successive tightening of monetary policy. This is supposed to bear down on the external accounts via domestic demand. The positive relationship between imports and income is long established. However, experience questions the appropriateness of this policy as the effect on domestic demand is slow, and the stability of the relationships between monetary policy, aggregate demand and net exports since deregulation is questionable (see for example, Bennett and Dippelsman, 1989). However, the effect on relative prices (making imports cheaper) is more rapid (see Figure 6). With rising interest rates, the \$A rose throughout 1988. Over 1987-9, imports worsened dramatically. In fact, the most inaccurate Government forecasts were for imports, but this has been attributed by government to strong demand, not relative price effects. However recent Reserve Bank research (Wilkinson and Horton, 1989) showed that the most important determinant of import growth over the period 1986-9 was the relative price effect.

Figure 7 presents a comparison of the endogenous imports forecasts based in December 1988 with the actual data. The latest forecasts based in March 1990, are also included in Figure 7. It is concluded from this section of the analysis that import forecasts have been on track. There is yet no news to suggest that the trend in imports has altered; the slight drop in the recent forecast is well within normal month to month variation.

In Figure 8, six sets of forecasts made at various times during 1989 and 1990 are superimposed on the same axes. It can be noted that towards the middle of 1989 the forecasts were worsening. Since that time, the forecasts have lowered but only to the trend established more than a year ago. It must follow from this analysis that interest rates have not yet had any restraining effect on the CAD. If and when they do, the forecast paths will begin to lie consistently under the previous forecast paths.

The current forecast for the CAD is presented in Figure 9. It can be seen that the CAD has stalled at just under \$2bn per month. The annual forecasts for the present and previous fiscal years are compared to treasury forecasts in Figure 10. For the second year in succession it appears that the Treasury has been too optimistic in its projections. In both years, as in previous cases,

the CAD model has performed well with reasonably stable cumulative forecasts.

Both the Government's initial forecast based on the J-curve response and subsequent forecasts based on the slowing of domestic demand in response to high interest rates were both too optimistic. So, in keeping with the short-lived exchange rate depreciation policy, tight monetary policy was an inadequate response. It is further inappropriate as high interest rates rapidly flow through to put pressure on the exchange rate, which in turn flows through to damage the competitiveness of import competing and export industries.

The economy must grow at a certain rate to maintain a stable rate of unemployment. The Australian economy has found this rate of growth impossible for structural reasons as it cannot finance the associated import demand. The external problem requires structural change to alter import propensities and/or export receipts. Unfortunately, tight monetary policy effects aggregate demand - investment and consumption. So this policy has prohibitive effects on structural change. It is an extremely expensive and inappropriate method of dealing with the CAD.

4. The Real Exchange Rate

Purchasing Power Parity (PPP) is a theory of exchange rate determination that insists on the dominance of trade in real goods and services. As shown in Figure 11, the relationship between the exchange rate and relative prices for the Australian-US situation has changed markedly since the float.

Adam and Bewley (1990) found weak evidence for PPP in the form of a stable relationship between the exchange rate and relative prices over the whole sample but a much stronger relationship was evident pre-float. While Figure 11 might indicate that the post-float period has been characterised by the exchange rate and relative prices moving in opposite directions, the situation is also consistent with the same positive linear relationship but with a much greater variance.

The exchange rate and its (derived) long run value computed from the model reported in Adam and Bewley (1990) are reported in Figure 12. Clearly the oscillations have increased in amplitude since the float. Substantial deviations have occurred and, as is popularly suggested, the \$A overshot its long-run mark both in the downswing after the May 1986 commodity price collapse and in the upswing of the ensuing commodity price boom.

The current deviation of the \$A from its long run value is highlighted in Figure 13. The \$A, at the time of writing around 76c, is approximately 18 per

cent above its equilibrium suggesting that when interest rate policy is eventually eased the \$A may have a long way to fall, particularly if it again overshoots.

It is stressed that even though the brief real depreciation in 1985/6 failed to give the desired result in the short term, the exchange rate must be part of any solution. Clearly the \$A is too high to give the required signals to prompt reallocation of resources to the traded goods industries. This mechanism must have some effect irrespective of whether the exchange rate is fixed or floats. Flexible exchange rates have proven to be extremely volatile, given mobility of international capital flows. This creates a hostile environment for exporters.

5. Export Potential

The analysis contained in the Hughes (1989) report on Australian exports, with reference to the performance, obstacles, and issues of assistance, highlights two major problems facing exporters.

Typically, an exporting firm goes through various stages to maturity. That is, in the earlier export years, the return on export promotional expenditure is relatively low as the exporter seeks to generate market acceptance. Since such an export plan might take 3–4 years, the exporter must not only predict its potential sales at current prices but must build in a factor for future exchange rate risk.

Since much of the burden of exchange rate fluctuations falls on the exporter, it is possible, indeed likely, that a number of exporters who begin their export exposure in typical fashion find that exporting is no longer viable when the exchange rate appreciates. If an exporter, faced with this scenario, exits from the market, most of the effect of the promotional expenditure is lost and the whole promotional plan must start all over again if the exchange rate subsequently depreciates. It is for this reason that exchange rate valuation and volatility affects mature exporters while new exporters simply do not attempt to enter a market when the product is not viable.

The implication for this entry/exit behaviour for exporters is that on re-entering a market, there is some delay before the previous levels of exports are attained. In the current context, increasing strength of the \$A may have a depressing effect on aggregate exports for several years to come, even if the dollar were to fall to its long-run sustainable levels.

The current circumstance of the Australian Wool industry provides a graphic example of how changes in the exchange rate can alter export

volumes markedly in the short-term (see Figure 14). Wool prices are supported by a floor price established in \$A and consequently the price to foreign buyers is largely determined by the exchange rate (see Phillips and Bewley, 1990). As the Australian dollar strengthened through the latter half of 1989, the proportion of wool purchased by the Australian Wool Corporation (AWC) increased from less than 40 per cent to more than 60 per cent. The subsequent decline in the exchange rate saw the proportion purchased fall to 30 per cent and the subsequent appreciation has again increased the level of AWC purchases.

Import Replacement

Traditionally import volumes have been regarded as relatively fixed due to the long lead times required for ordering, transport and typical delays on Australian wharves. But over recent years, there has been a major technological revolution, particularly in the cost and availability of air freight. Currently some 23 per cent of the value of Australian imports arrive as air cargo (see Figure 15). Together with more efficient shipping services, these developments have allowed importers to respond quickly to opportunities created by fluctuations in the exchange rate.

6. Conclusion

Under any scenario the medium term prospects for the economy are bleak, given current policy settings which emphasise the role of monetary policy. The deficit is still not recovering. The \$A, although it has fallen since the election, is still overvalued and monetary policy is working in the wrong direction by propping up its value. We are now armed with adequate information to eliminate the real exchange rate (in isolation) and monetary policy as feasible approaches.

As the next electoral term's policy debates unfold, there must be increased emphasis on untried approaches. The general proposition of some optimal policy set for rapid remedy of Australia's external problems is dubious, but some points may be made on a couple of policies designed to take the weight off monetary policy and reduce the volatility and valuation of the exchange rate. A consumption tax is one such policy.

Unlike monetary policy, a tax on consumption can manage demand without distorting the relative prices of domestic and imported goods. The argument for a consumption tax is that it would generate a larger pool of savings than the same level of revenue generated by income taxation.

A stable, appropriately (lower) valued dollar is required as a minimum to establish an export led recovery. A consumption tax could take the burden off monetary policy, hopefully allowing the \$A to fall to a level more conducive to restoring external balance. A major criticism of moves to reduce interest rates is that Australia also faces inflationary pressures. The most appropriate way of overcoming this policy conflict is to speed up the pace of microeconomic reform so as to increase domestic and foreign competition.

Microeconomic reform should reduce prices of some goods and services and may be desirable for other benefits it can create directly. However, as the impact of microeconomic reform on overall competitiveness is ambiguous, it should not be put forward as an approach to rectify the current account deficit.

The high level of Australian interest rates, compared to almost all other countries, has contributed to exchange rate volatility. Relatively high interest rates attract speculative capital flows from investors wishing to gain from high rates during periods when they judge that the risks of currency depreciations are low. When those risks increase, capital outflows accelerate, only to reverse after the consequent period of currency decline. An easing of monetary policy could remove some of the excess volatility from the exchange rate.

Prospects for Recovery?

Prospects for the economy given by current policy settings are dominated by the extent of damage caused by tight monetary policy. We are optimistic about the ability of the Australian economy to recover quickly given a major switch in policy approach before the next election. Never has Australia experienced a recession in the absence of either a collapse in commodity prices or a drought, suggesting that the economy should be able to rebound quickly.

Unfortunately, the Treasurer seems committed to his election stance on the consumption tax. There is much rhetoric but little action on microeconomic reform. The March current account deficit has caused a reaffirmation of the need to keep interest rates high (!) until the current account improved.

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Figure 1: December 1986 Base

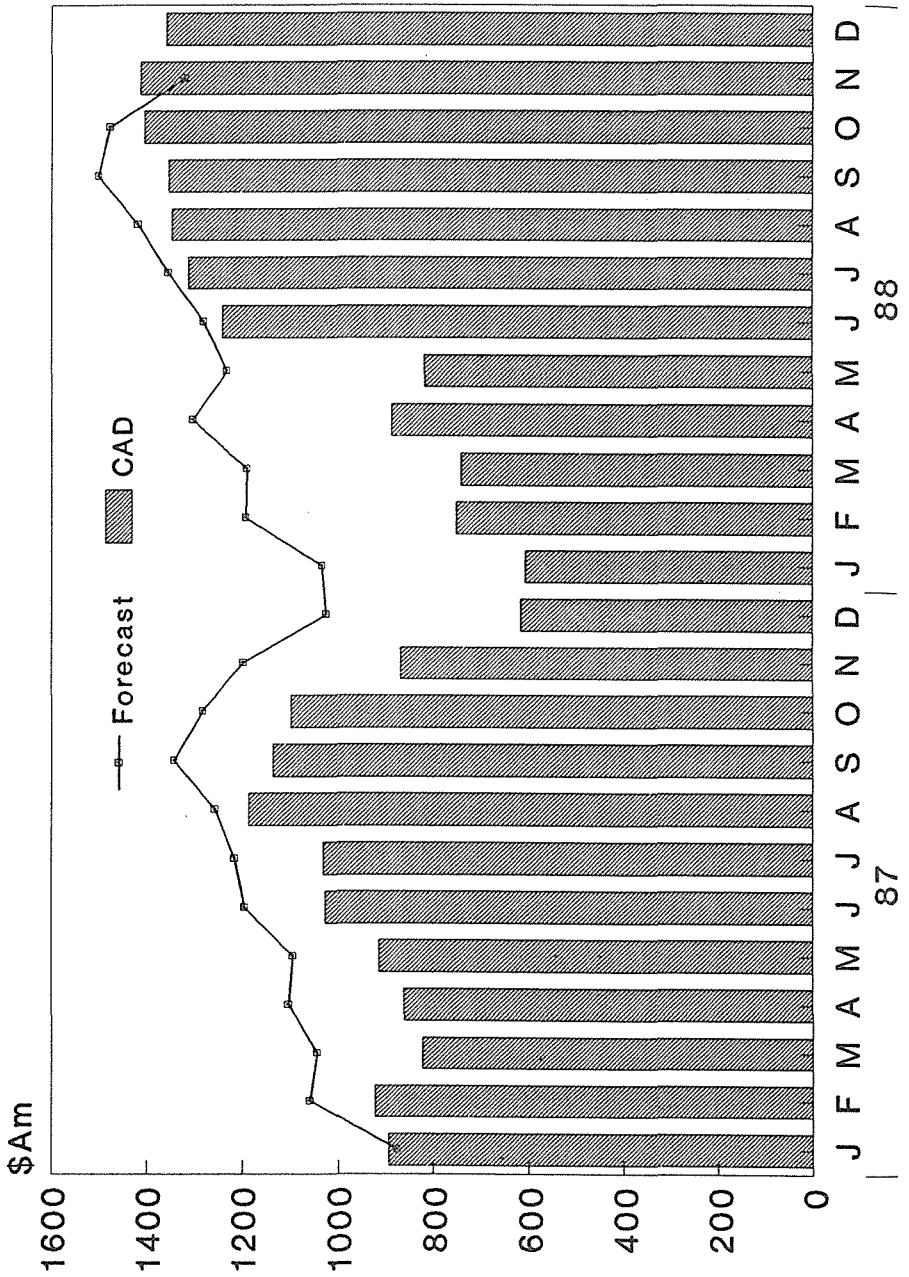
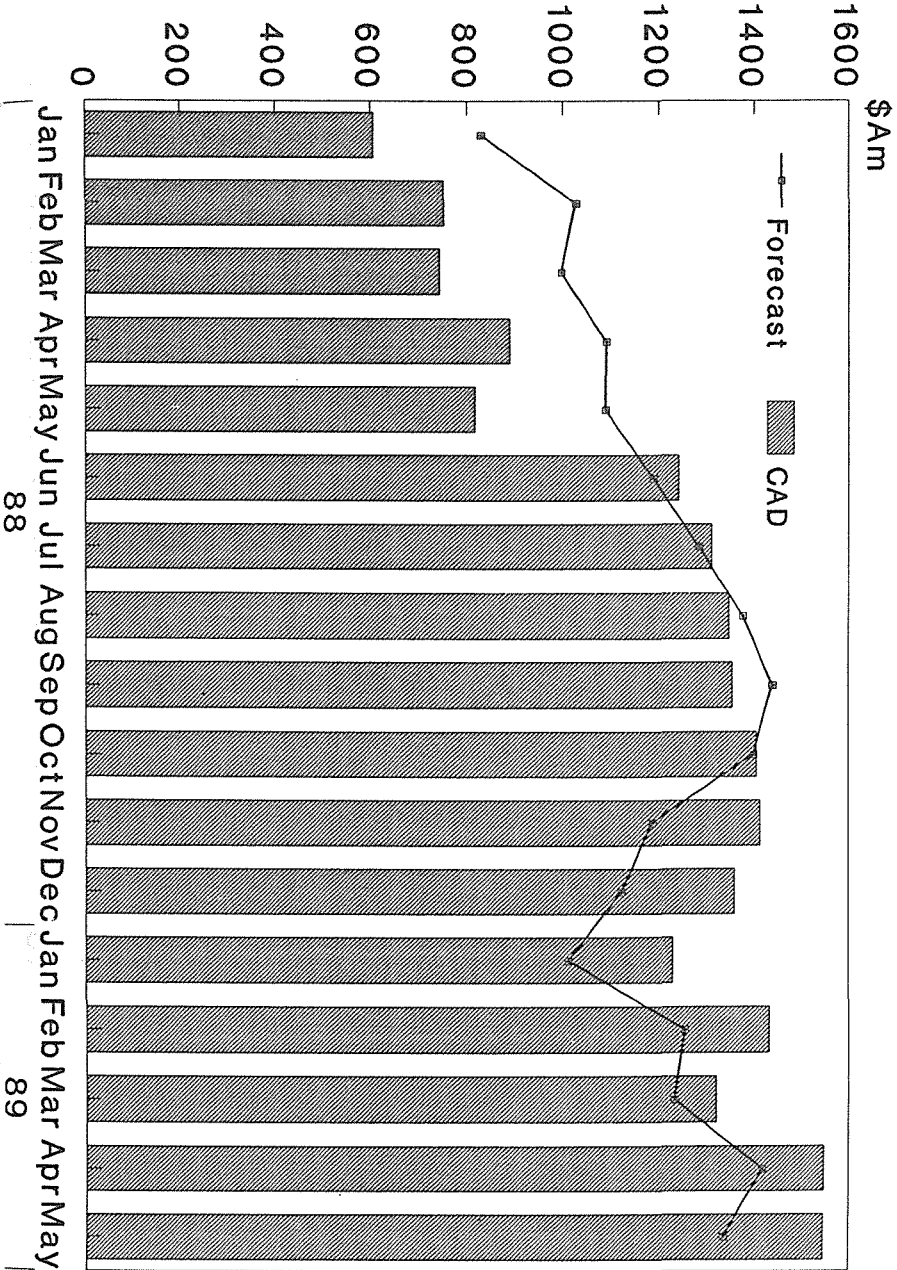


Figure 2: December 1987 Base



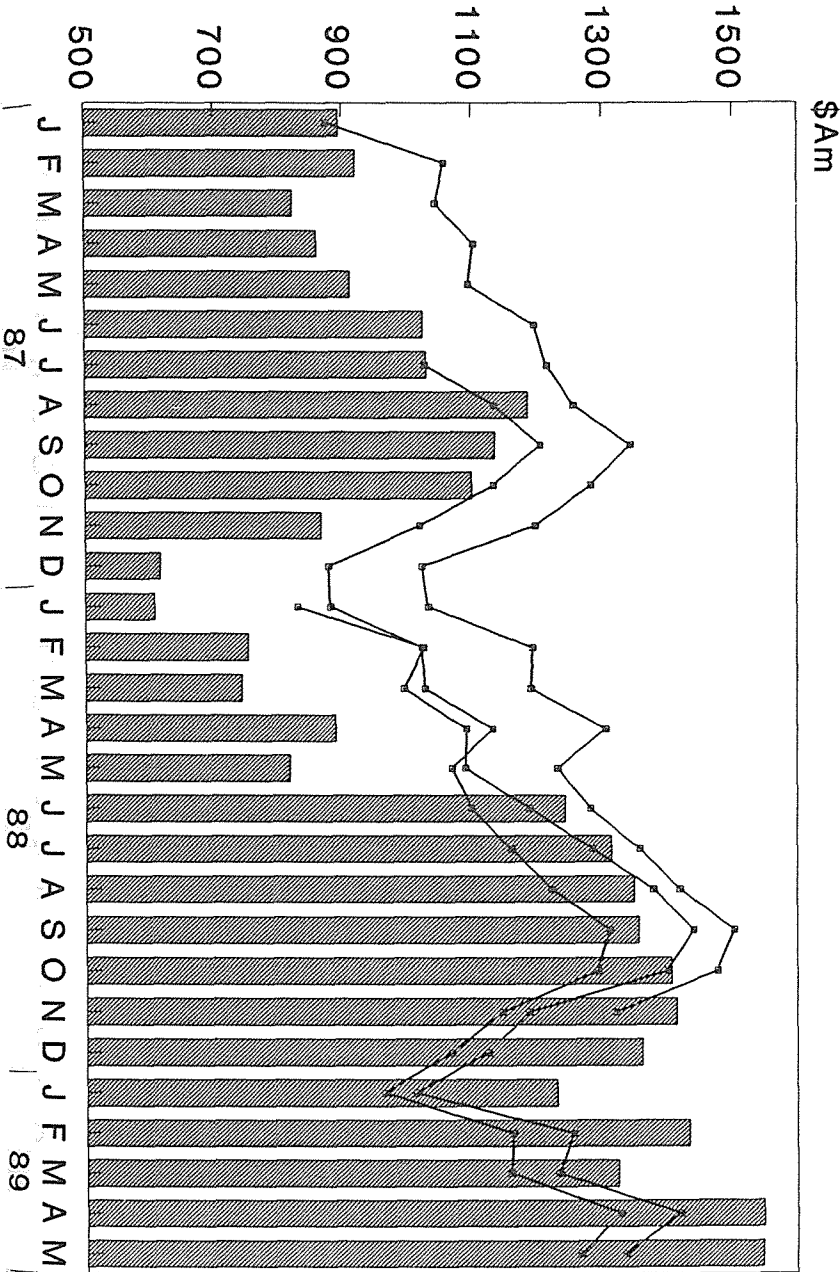


Figure 4: J-Curve and the Commodity Price Boom

Figure 5: CAD and Interest Rates

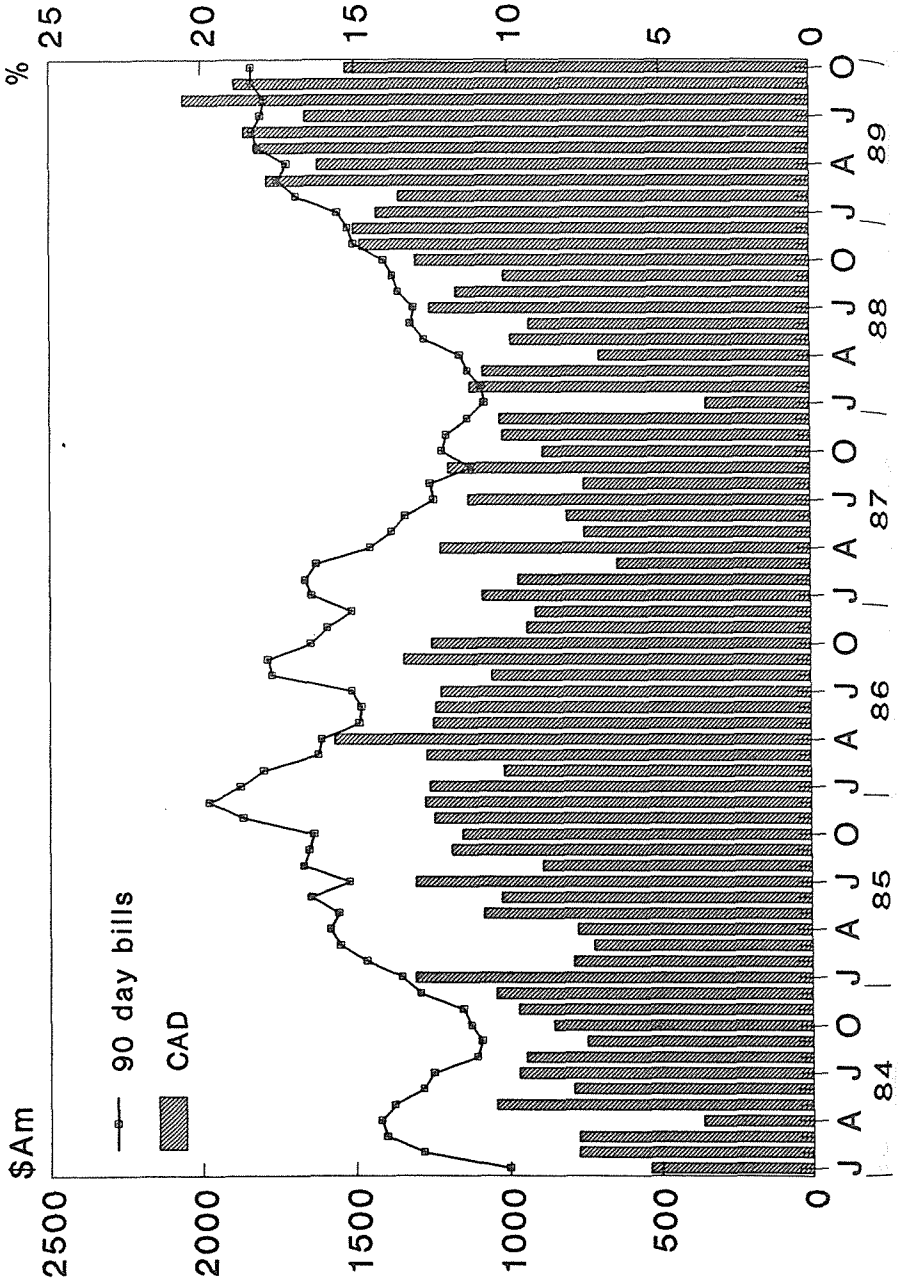


Figure 6: Imports and Relative Prices

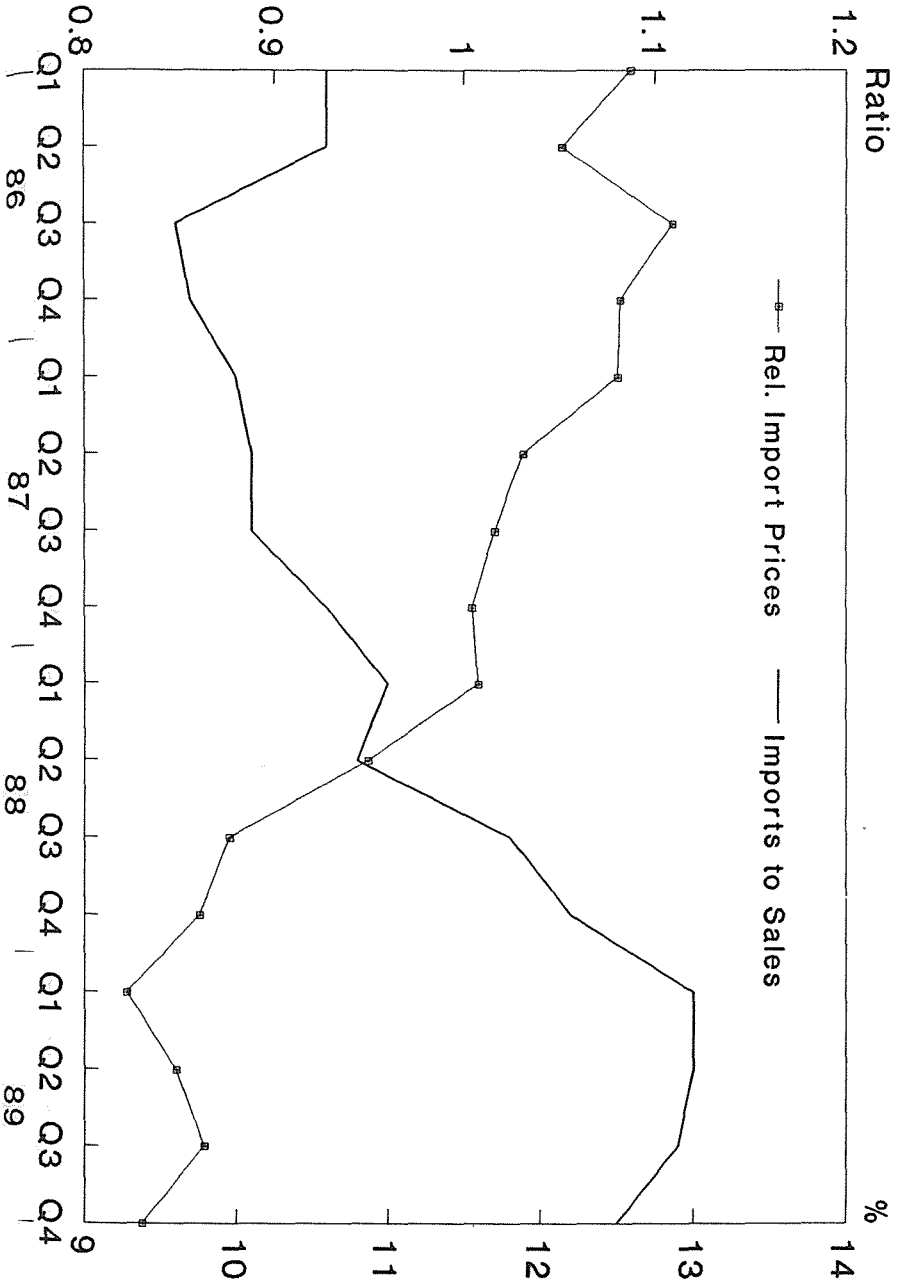


Figure 7: Endogenous Imports

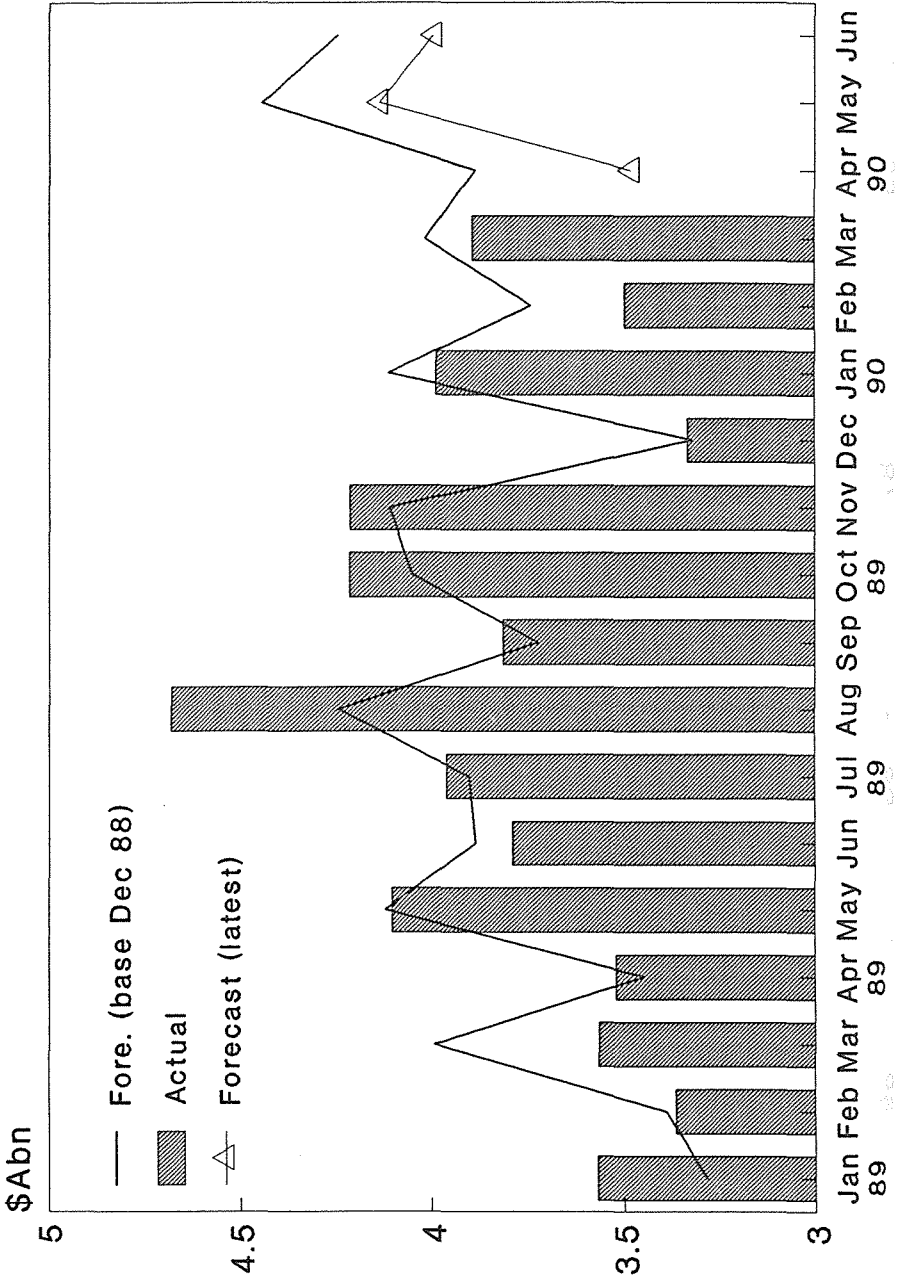


Figure 8: CAD Forecast Updates

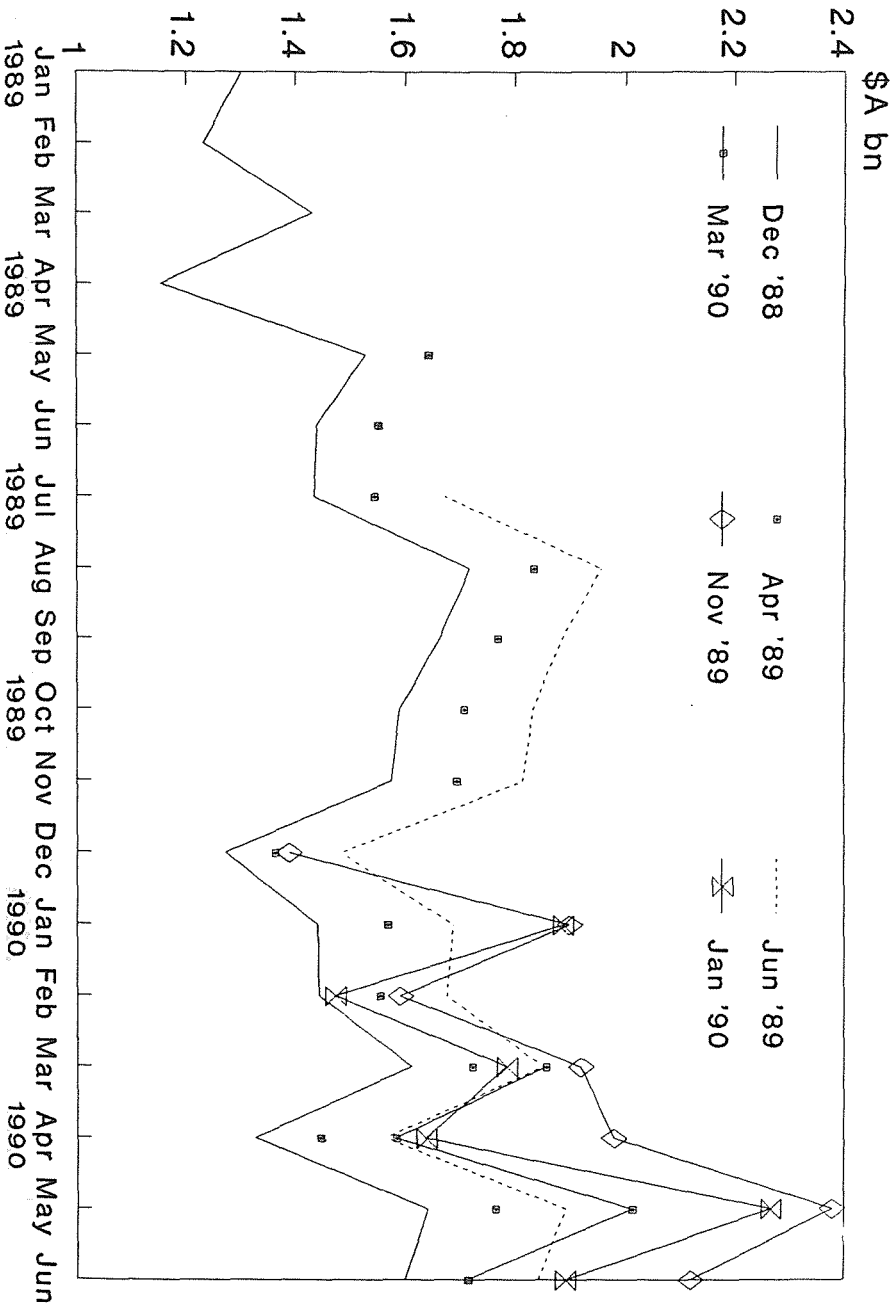


Figure 9 : Current Account Forecasts

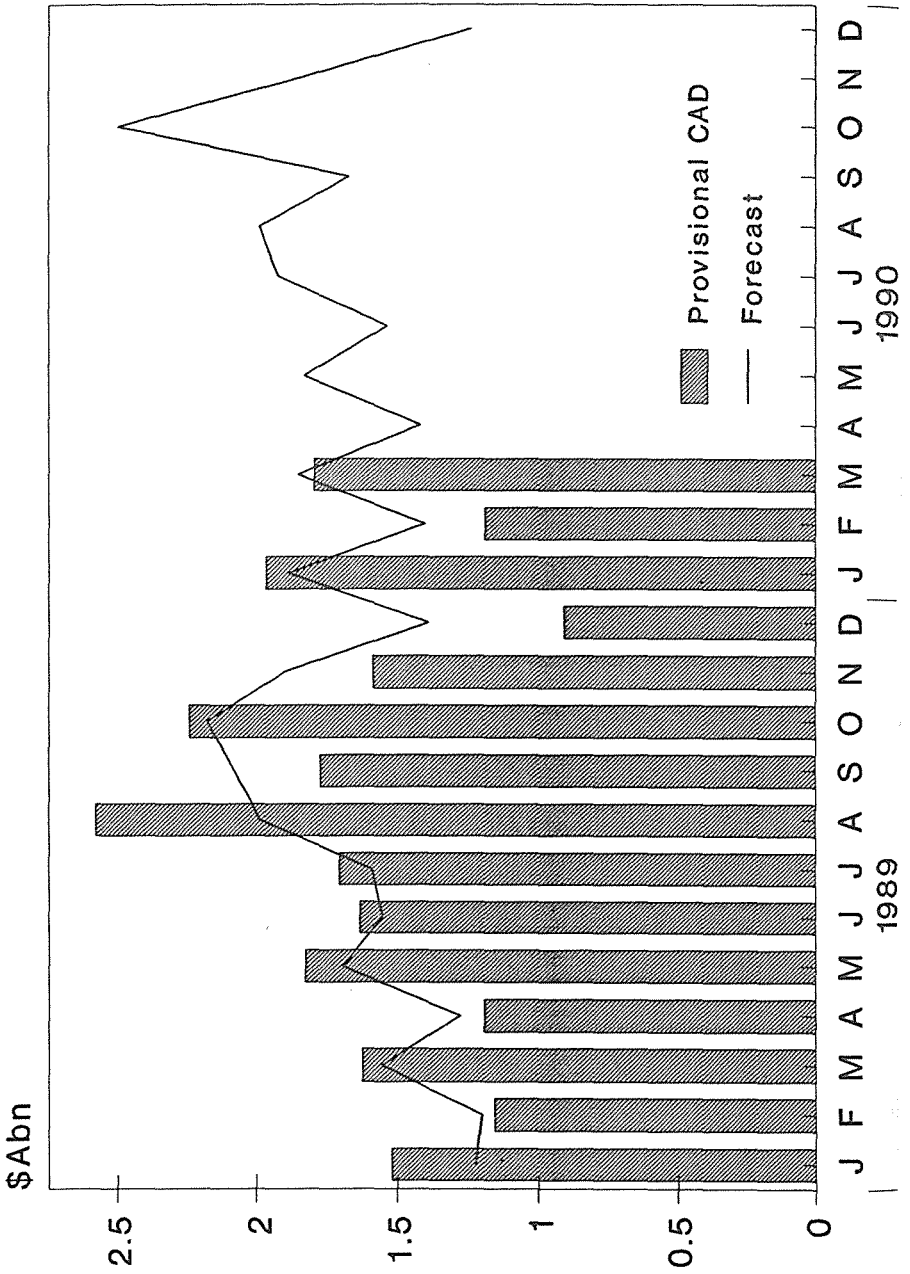


Figure 10: Annual CAD Forecasts
Updated Cumulative 12-month Forecasts

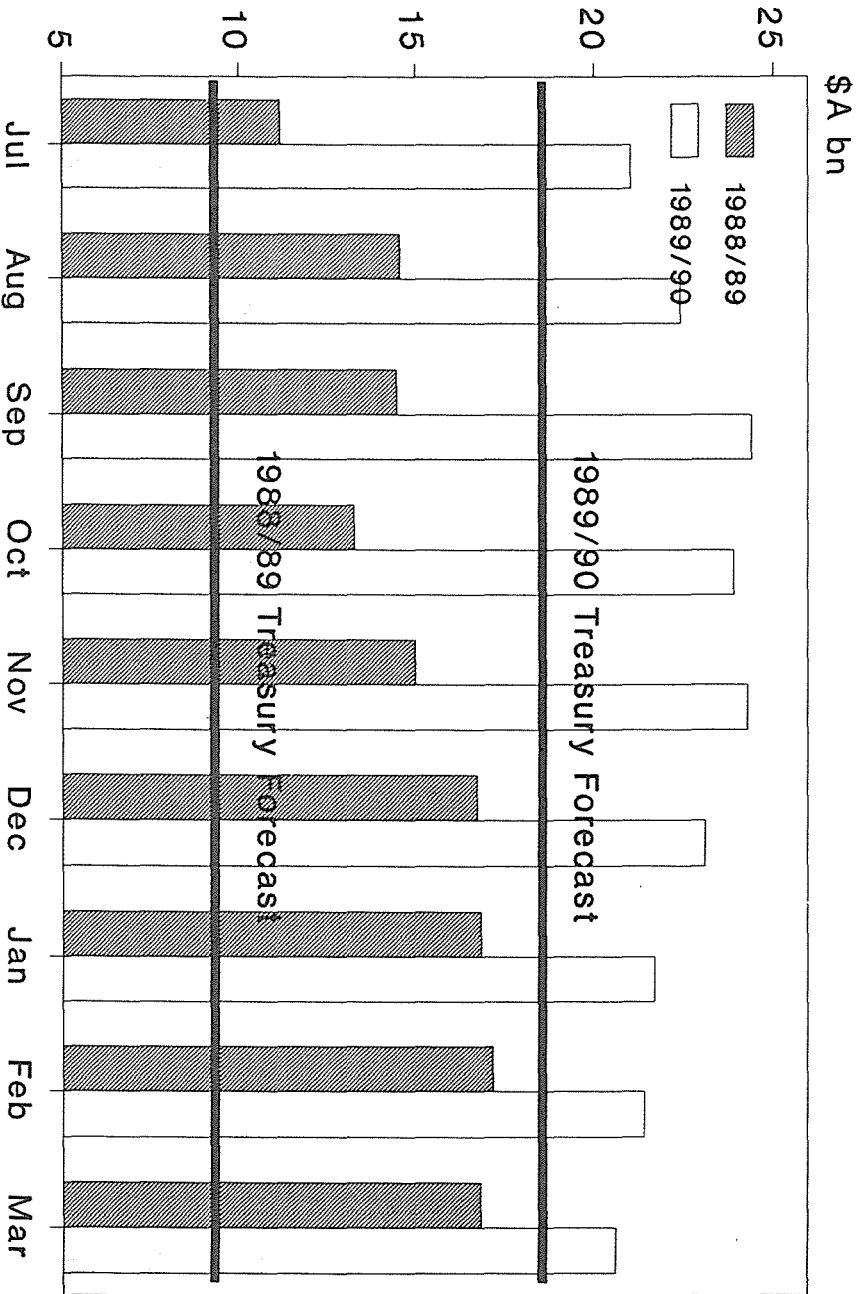


Figure 11: Purchasing Power Parity

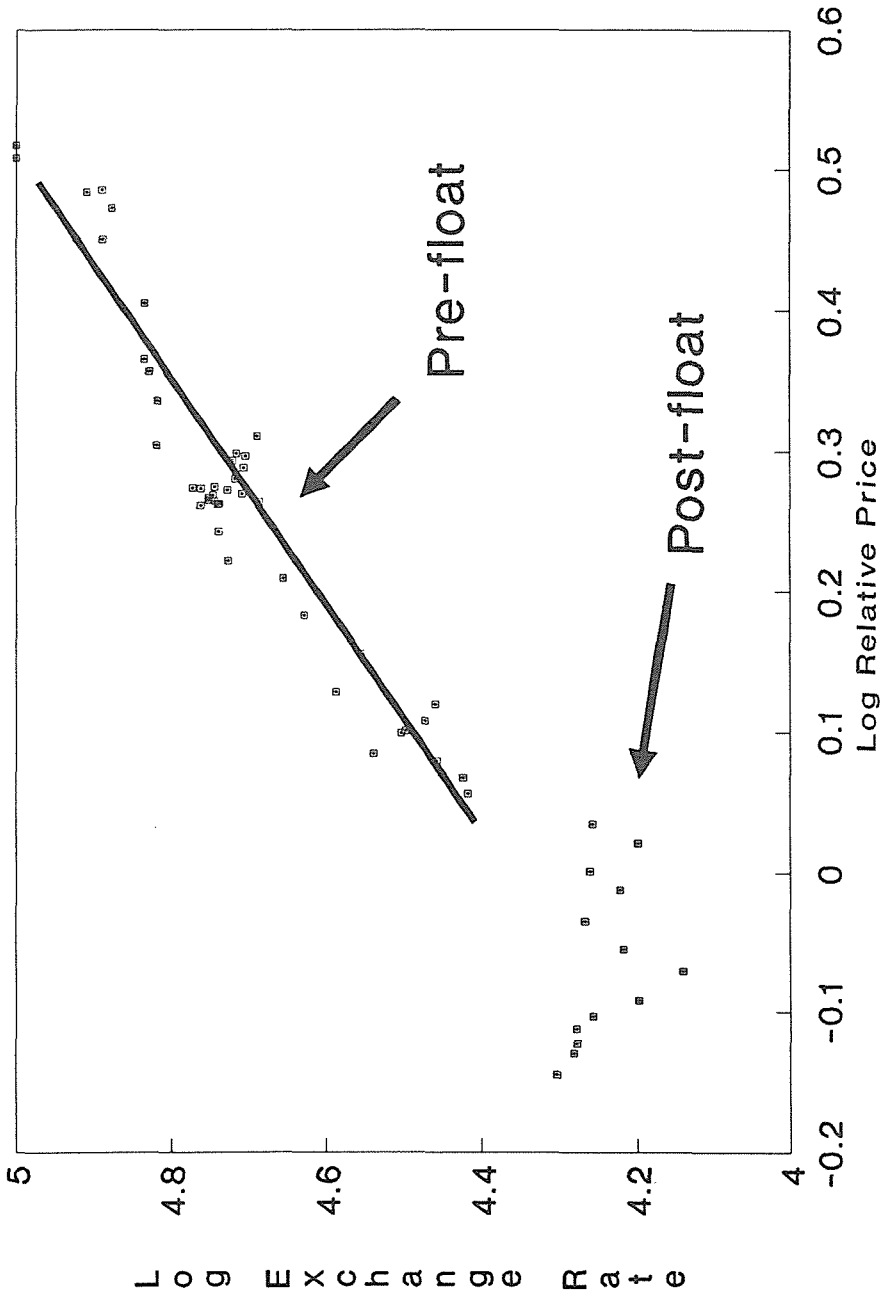


Figure 12: Real Exchange Rate

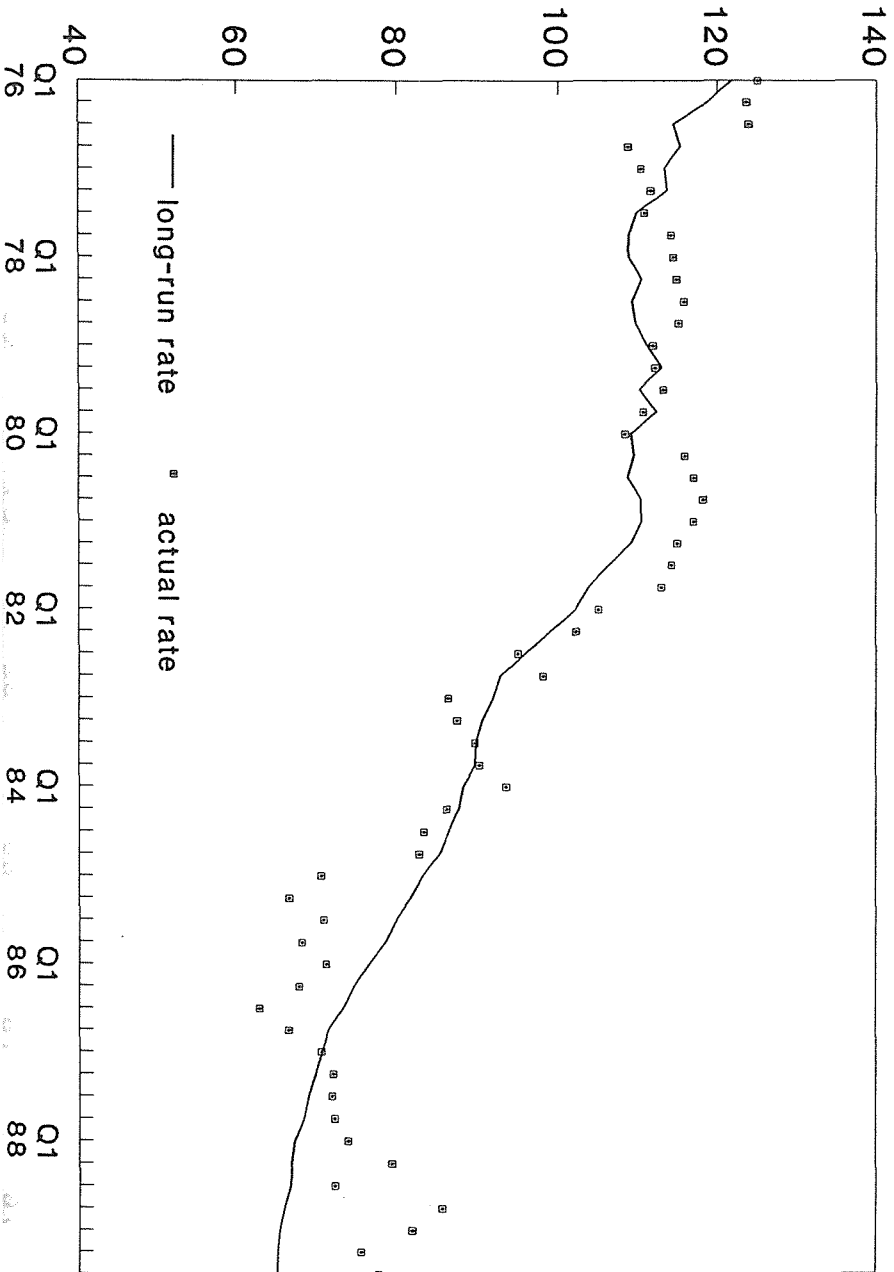


Figure 13: Valuation of \$A

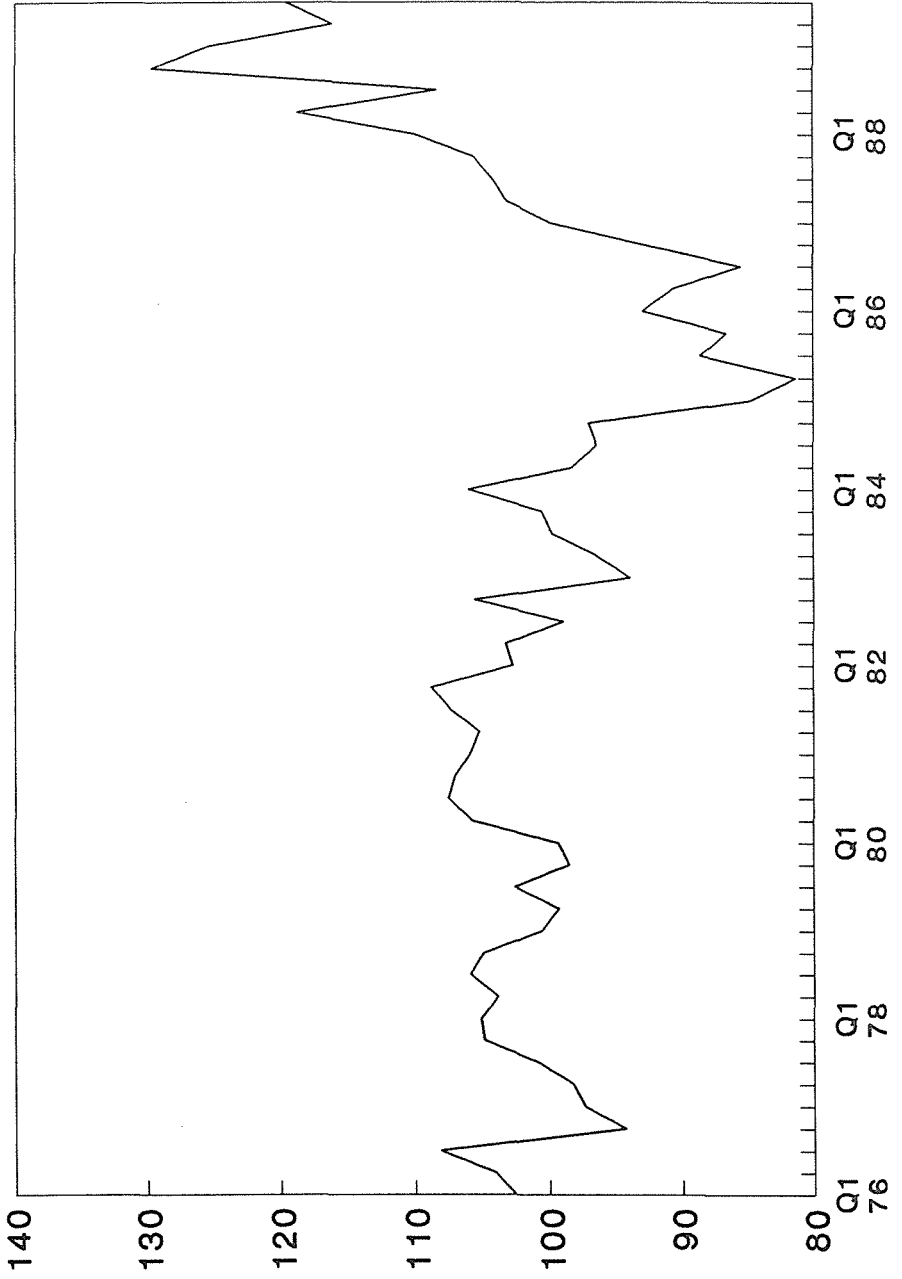


Figure 14: Wool Corporation Purchases and the Exchange Rate

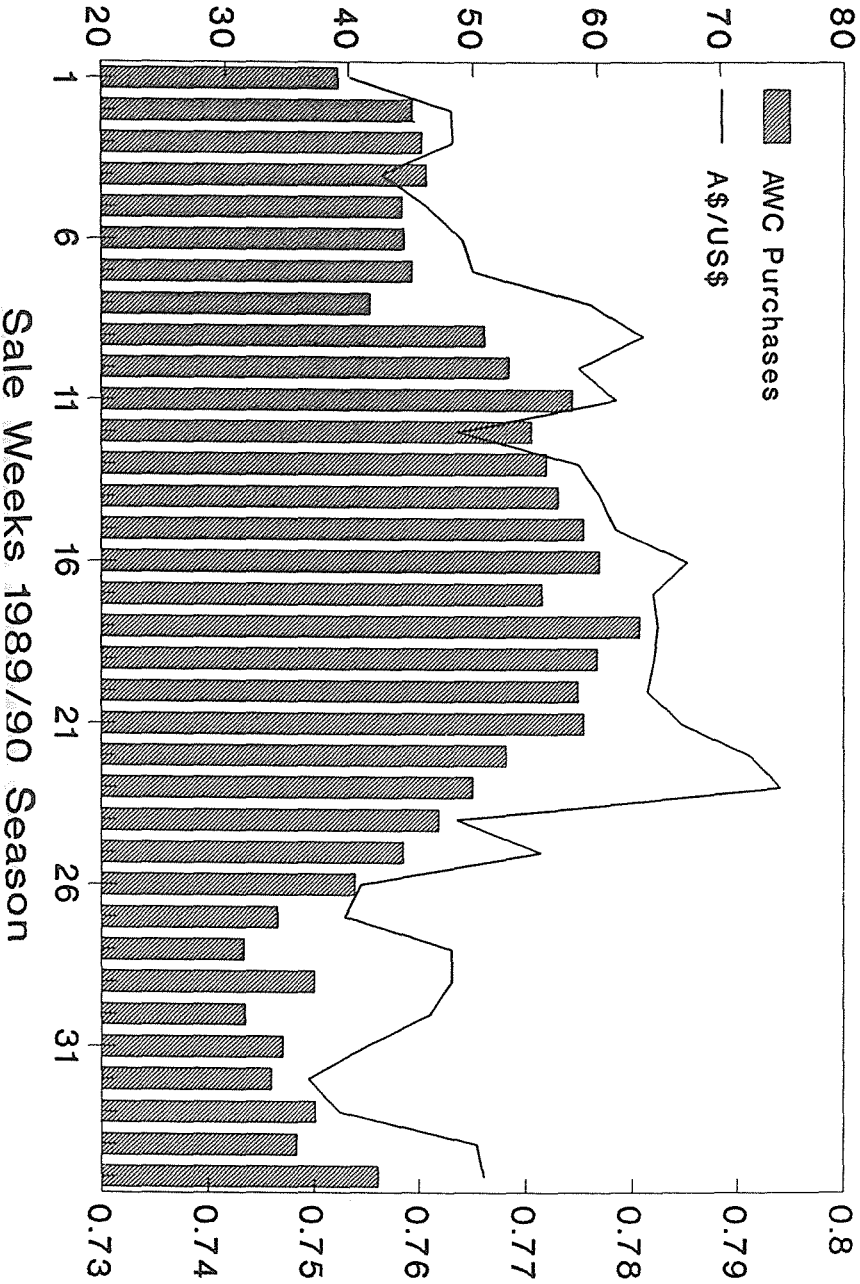


Figure 15: Air Cargo
Share of Trade by Value

