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Australian economy

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The Australian economy has experienced some dramatic changes in economic conditions over the past few years. Low or falling export prices for most of our main exports, greater volatility in exchange rate movements and an underlying depreciation of the Australian dollar, high real interest rates, high inflation rates compared with our trading partners and a burgeoning foreign debt, are all features of Australia's economic situation. This economic environment affects the rural economy and has major implications for the prospects of Australia's rural industries. Therefore it is important to understand not only the main economic conditions facing Australia, as well as some of the causes of the situation, but also to know the implications of these for the prospects facing the agricultural sector.

Current situation

Exchange rates

One of the main macroeconomic developments in Australia of recent years has been the decline in the value of the Australian dollar ($A). The fall in the value of the dollar over the past 10 years is depicted in Figure 1, with movements in the nominal exchange rate, and the real effective exchange rate represented (shown both in terms of the value of the $A against the $US and as a trade weighted index—see Glossary on page 67). There has been an increase in volatility of the $A since it was floated in December 1983 and also a marked fall in its value, due to a number of factors. There are two main reasons for wanting to buy $A. First, buyers of Australian exports need $A to pay for their purchases. Second, some people may want to hold $A as an investment that will make a profit if the dollar goes up.

Changes in our domestic economy compared with the economies of trading partners can therefore alter demand for the $A and cause adjustments in its value. Examples of such changes include decreased demand for Australia's exports and increased import demand, growth in foreign debt, inflation differentials between Australia and its trading partners and differences in governments' economic policies. In addition if investors think the Australian economy is likely to worsen, they will not want to hold $A and their demand for the currency will fall. This causes the value of the currency to fall further.

Fluctuations on the Stock Exchange are a ready indicator of a country's performance.

The dollar has recovered from the record low levels of July 1986, both through support by the Reserve Bank intervention during August and September 1986, and by continuing high domestic interest rates. There has also been a change in the perceptions of operators in the financial and foreign exchange markets as to the improved prospects for the Australian economy, with resultant strengthening of the $A, despite strong selling of it by the Reserve Bank.

World commodity prices

One of the features of world agricultural markets in recent times has been the accumulation of large stocks (Figure 2). This has resulted not only from a decline in the demand by traditional importers because of falls in their incomes, or increases in their production, or both, but also from concurrent over-production of agricultural commodities by major exporters such as the United States of America and the European Economic Community. This over-production arises because of pricing policies adopted by these countries, whereby producers are paid artificially inflated prices divorced from the real prices paid on world markets. The net result has been huge increases in world stocks and marked falls in world commodity prices.
Clearing sales are a chance for farmers to buy less expensive machinery.

Figure 1. Exchange rates.

Figure 2. World stocks of wheat and coarse grains.
The significant difference between real interest rates in Australia and those of our trading partners adversely affects the competitiveness of our exports.

The weakening of the $A, though detrimental to the foreign debt situation and to general price levels in Australia, has had the effect of increasing the price competitiveness of Australian exports on world markets. The fall in exchange rates between 1981 and 1985 has resulted in agricultural product prices rising at a rate nearly equal to the rate of inflation at a time when international commodity prices were falling, though wheat prices in particular have fallen since 1985-86. Offsetting this boost to farm revenue has been the effects of lower exchange rates on farm costs, in particular imported inputs, making them more expensive.

Interest rates
Interest rates, in both nominal and real terms, have undergone significant increases over the past 10 years (Figure 3). This increase has been largely the result of the Federal Government's tight monetary policy. One of the aims of this has been to protect the $A against further depreciation.

There has been some decline in the short-term interest rates recently (as at March 31, 1987) in response to both a strengthening of the $A and an improvement in market confidence. In response to this fall in market interest rates, there has also been a slight drop in prime interest rates. Despite the slight fall, there is a significant difference between real interest rates in Australia and those of our trading partners. This differential is one of the factors adversely affecting the international competitiveness of Australia's exports.

Inflation
Australia's rate of inflation in 1985-86 increased substantially over 1984-85 levels (Figure 4). The relatively high inflation rate in 1986 was due largely to the effects of the depreciation of the $A increasing the price of imported goods and also allowing domestically manufactured goods that competed against imported goods to increase in price. The inflation rate for 1986-87 is likely to moderate slightly in response to a firmer $A.

One of the main concerns regarding Australia's high inflation rate, other than its effect on domestic price levels, relates to the difference between it and the average rate of
inflation experienced by Australia’s main trading partners (Figure 4). The average inflation rate for OECD countries was 4.6 per cent in 1985 and 2.8 per cent in 1986, compared with Australian rates of 6.9 per cent and about 9 per cent for the same periods. The problem with this difference is that it increases Australia’s relative costs of production, further erodes Australia’s competitiveness in export products and puts further pressure on the exchange rate.

Labour costs
Inflation rates and labour costs have been closely related in recent times. Changes in the growth rates of labour costs and rural wages are shown in Figure 5.

Under a system of full wage indexation, increases in inflation are used as the basis for determining the extent of wage increases paid to workers. This nexus was broken during 1985 with wage rates failing to keep up with inflation; as a result, real wages started to decline. With the abandonment of wage indexation in December 1986, it is expected that labour costs will continue to decline in real terms.

The effect of the new two-tier wage system on labour costs is uncertain. This is particularly so since the payment of the second tier increases is subject to the "capacity to pay" criterion. The payment of a fixed money increase in the first round will result in a higher increase in percentage terms for rural workers because of the relatively low level of rural sector wages.

Causes of Australia’s current economic situation
The causes of Australia’s current economic problems are a mixture of historical and recent factors. The historical factors include problems of industry structure, management and labour relations and political impediments to growth.

Industry structure
In the 1950s and 1960s manufacturing industry in particular, and other industries in general, were protected from change and adversity by "made to measure" protection. Such cossetting reduced competition and impetus to innovative management and was a major cause in retarding economic growth in Australia.

Another feature of Australia’s industrial structure that continues to limit growth is that, in general, Australia has specialised in...
the export of goods for which world or trade demand has been growing slowly. Consequently, there has not been a rapid or sustained increase in prices received for many of our major exports.

In addition, Australia’s terms of trade were unfavourable over much of the past 30 years. For that period, it has taken an average 2 per cent more exports each year to pay for the same volume of imports. Over the period 1970 to 1986 our terms of trade have deteriorated further, requiring on average three per cent more exports each year to pay for the same volume of imports. These changes have adversely affected the growth of Australia’s living standards.

Management and labour relations
The protectionist policies of the 1950s through to the 1970s insulated management and labour from adjustment pressures. Protection from competition reduced the need for innovation and entrepreneurship. Conservative management philosophies and occasionally disruptive actions of some labour unions reduced growth prospects. As a result, employment and market opportunities were lost. Also in Australia, labour unions and labour market institutions have sought to maintain real wages. This may have been at a cost of higher unemployment and poorer growth than might have been the case if some flexibility in real wages was possible.

Political impediments
Australia’s economic growth or wider economic considerations sometimes are sacrificed for sectional, regional or political reasons. The Federal Parliamentary system, hostile upper chambers, the fine balance of opposing political parties, and the frequency of elections, all work to increase the relative power of narrowly-based interest groups. Hence, governments have often failed to impose economic change on resistant pressure groups and when governments may succeed (for example, tariff reform), often changes wrought are gradual and subject to rounds of bureaucratic inquiry.

Australia’s problems of industrial structure, management and labor relations and political impediments are some of the long-standing causes of Australia’s economic woes. However, more immediate economic changes also form part of the explanation for Australia’s current poor economic position.

Terms of trade
A feature of Australia’s current poor position is the pronounced decline in its terms of trade since 1984. For example, in 1985-86 the terms of trade declined by 10.1 per cent, compared with a long-term average decline of about 1 per cent per year. The decline in the terms of trade was primarily due to reductions in prices or weak prices for Australia’s main export commodities (for example, iron ore, cereals).

For our main agricultural exports, low growth in the volume of trade, increased food self-sufficiency of our trading partners, the spread of agricultural protectionism and huge stockpiles (Figure 2), in combination have reduced prices or kept them weak. Within non-rural exports, prices of metals, metal ores and coal have remained depressed. A slow-down in economic growth world-wide and continuing technological changes have weakened world demand for some of these commodities.

The deterioration in the terms of trade lowers living standards in Australia. Because a larger volume of national output has to be exported to purchase a given volume of imports, it follows that a smaller proportion of national output is available to fund household expenditure. We therefore tighten our belts and make do.

Figure 5. Rural wages and labour costs.
Current account and devaluation
The adverse movement in Australia's terms of trade has meant Australia has been spending more on imports than it has received from sale of its exports. Low or weak prices for our major exports, including some main agricultural exports, have meant export revenues have risen more slowly than the expenditure on imports. This trade imbalance is a main cause of Australia's current account problems. Record current account deficits have occurred in 1984-85 and 1985-86. Because of Australia's worsening terms of trade and current account situation, the $A has been subject to devaluation (Figure 1). The devaluation of the $A in turn has contributed to a worsening of Australia's current account deficit, for example, by making imports more expensive in $A terms.

Foreign debt
The current account deficits, primarily caused by Australia's poor trade performance, have been financed by foreign capital. For example, the current account deficit in 1985-86 rose to record levels and was financed by capital inflow, 85 per cent of which was in the form of debt. Treasury estimates show Australia's gross foreign debt to have increased from $68 billion in June 1985 to about $86 billion in June 1986.
The expansion in foreign debt has been due to devaluation effects and increased borrowing overseas by both public and private sectors. The private sector in particular has relied increasingly on offshore borrowing rather than seeking overseas partners in business ventures. The preference for borrowing arises from controls over foreign investment and a low rate of withholding tax on interest payments, compared with that on business profits and dividends remitted overseas. The devaluation of the $A has also contributed greatly to our foreign debt. Because a large part of our foreign debt is in foreign currencies, the $A value of our debt (and associated interest payments) has increased due to the $A losing value against these other currencies. It is estimated that about one-fifth of Australia's net debt in June 1986 was attributable to the depreciation of the Australian dollar since June 1984.

Interest rates
Although Australia floated its exchange rate in December 1983, the float has not been free of intervention. Occasionally the Reserve Bank, through its foreign exchange dealings, has lessened the volatility of movements in the exchange rate through buying and selling the $A. The Reserve Bank has also supported the $A by maintaining a tight monetary policy, which has raised real interest rates in Australia and thereby attracted foreign capital inflow and lessened the slide in the current account. Such a chain of events influences market sentiment in foreign exchange markets and causes the exchange rate to be maintained at higher levels than might be the case if real interest rates fell. High real interest rates within Australia, however, reduce incentive for investment and encourage already committed investment to be funded by offshore rather than local borrowing. In part because of the perceived relatively high cost of borrowing locally, investment in Australia's export and import-competing sectors has been slow to pick up. The agricultural sector, for example, needs borrowings for carry-on as well as investment purposes and it faces difficulties because of the high cost of local borrowings. Many farmers also are deterred from borrowing off-shore because of the ruinous experiences of some farmers who borrowed off-shore and failed to insure against the $A losing value.

Concluding comments
The economic climate of the mid-1980s is revealing some weaknesses in the structure of the Australian economy and is causing concern about the state and future of the economy. World prices for many of our major exports are falling, in spite of competitive assistance gained by Australian exporters as a result of a marked devaluation of the $A since 1984. The devaluation has increased the cost of imports, yet the volume of imports has been slow to contract. Domestic inflation has been fuelled by higher import prices at a time when real wages are falling and inflation rates in our competitors' economies are the lowest in two decades. Australia's trade difficulties are compounded by increased overseas borrowing of Australian firms and governments, and by the maintenance of high interest rates in Australia. Australia continues to slip in international rankings of economic growth. Whether or not the performance of the Australian economy will turn around depends on many considerations, some within our control, some not. Those that are include:

• improved entrepreneurial activity in the export and import-competing sectors;
• sustained improvement in management and labour relations;
• accelerated investment in export and import-competing activities, especially in products and commodities with high trade demand growth rates;
• lower inflation;
• greater dependence on internal rather than foreign lending;
• additional commitment to research and development of innovation.

In the next few years it is unlikely that Australia will see an agricultural sector-led recovery, mainly because price and growth prospects for our main agricultural industries are poor or limited. Hence the next few years seem likely to remain difficult years for many farmers engaged in traditional rural industries.
GLOSSARY OF TERMS

Nominal exchange rate is the number of units of a foreign currency that can be bought with one unit of Australian currency. Also called nominal bilateral exchange rate.

Real exchange rate is the nominal exchange rate adjusted for the difference in the inflation rate between the domestic economy and the trading partner.

Real effective exchange rate weights the real exchange rate in accordance with the trade shares of trading partners. It takes into account the movement in the prices of goods in the economies of Australia’s trading partners, and gives an indication of changes in the buying power of the Australian dollar. Usually expressed as an index.

Nominal interest rate is the rate of interest paid on investments or loans.

Real interest rate is the nominal interest rate deflated by the expected rate of inflation. It can be approximated by subtracting the inflation rate from the interest rate. Real interest rates give a better idea as to the real cost of borrowing or investing money because changes in the value of money over time are taken into account.

Terms of trade is the ratio of the index of export prices to the index of import prices. If export prices rise more quickly than import prices, then the terms of trade is said to improve. If import prices rise more quickly than export prices, then the terms of trade deteriorates.

Current account mainly records the value of Australia’s exports and imports of goods and services. It does include some other items affecting Australia’s foreign exchange position, such as property income and transfer payments, which include Government grants to other countries and funds brought in by immigrants. When the current account is in deficit, it means Australia is spending more on imports and other items (for example, transfer payments) than it is receiving from export revenues and other credits (for example, foreign tourism in Australia). Export orientated sectors such as agriculture help reduce current account deficits by generating export income. The current account is one indicator of a country’s economic performance.