EBS/83/64

CONFIDENTIAL

March 28, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Australia - Change in the Exchange Rate

There is attached for the information of the Executive Directors a paper prepared by the staff on the recent devaluation of the Australian dollar.

Att: (1)

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INTERNATIONAL MONETARY FUND

AUSTRALIA

Change in the Exchange Rate

Prepared by the European Department

(In consultation with the Exchange and Trade Relations Department and the Research Department)

Approved by Brian Rose

March 28, 1983

I. Introduction

The Australian authorities have communicated to the Fund (see EBD/83/59, 3/8/83) their decision to devalue the Australian dollar vis-à-vis a trade-weighted basket of currencies by 10 per cent effective March 7, 1983. The value of the Australian dollar in terms of its trade-weighted index was reduced from 81.5 to 73.3 (May 1970=100). The middle rate for the Australian dollar in terms of the U.S. dollar was set at $A 1 = US$0.8549, representing a depreciation of 9.9 per cent, compared with the middle rate set the previous day. The decision was taken at the request of the leadership of the Australian Labor Party, which had won the general elections held on March 5, 1983.

The last staff report on the 1981 Article IV consultation (SM/81/107, 5/11/81) was discussed by the Executive Board on May 29, 1981.

II. Background

After strong growth in 1980/81 (fiscal year July-June), the Australian economy has experienced a sharp downturn since early 1982. Nonfarm activity weakened substantially and farm output was adversely affected by a severe drought. Private fixed investment, which had been buoyant in recent years--especially in the natural resource-related sectors--declined, reflecting a reassessment of export prospects in the light of the world recession and the weakness of international energy prices. High interest rates at home and abroad and an intensification of domestic wage cost pressures accompanied by a sharp fall in profitability led to a deterioration in business confidence.

The slowdown in output was quickly transmitted to the labor market. Total employment was almost stagnant in the year to June 1982, and the rate of unemployment (seasonally adjusted) rose to 6.7 per cent of the labor force from 5.3 per cent in June 1981. As the downturn deepened in 1982/83, the unemployment rate climbed to 9.6 per cent in February 1983.

The momentum of wage increases built up in 1981 and intensified in 1982; average weekly earnings of male employees rose by an estimated 15 per cent in the year ending December 1982. The timing of the wage increases was influenced by institutional developments, including the termination of the wage indexation system by the Conciliation and Arbitration Commission in July 1981, which was followed by a higher rate of industrial disputation and a number of major settlements involving sizable wage increases and reductions in standard working hours. Real wages are estimated to have increased by 4 per cent in 1982, following a rise of 3 per cent in the previous year. In December 1982, the Government declared a "wage pause" under which wages in the public service were frozen for a year and the Arbitration Commission agreed to freeze private sector wages for a period of six months. No significant increases in award wages have taken place since.

Although the rate of inflation in 1981 was comparable with that experienced in the main trading partner countries, a significant differential emerged during 1982, as Australia's rate of inflation remained over 10 per cent while that in the main trading partners decelerated. The rate of increase of consumer prices, which had accelerated from 10 1/2 per cent in the first half of 1982 to 12 1/4 per cent in the September quarter, decelerated to 11 per cent in the December quarter, partly reflecting a slowdown in farm and energy prices. Excluding the food group, however, consumer prices continued to rise at a disturbingly high rate of 11 3/4 per cent.

Unit labor costs in the nonfarm sector rose by an average of 13 per cent per annum in the two years to September 1982 and produced a sizable downturn in profitability. The share of gross operating surplus of companies and financial enterprises in the nonfarm product fell to an historically low level in the six months to September 1982 (Chart 5).

In recent years, the previous Government had assigned a high priority to the objective of bringing down inflation through a policy of financial restraint and had viewed monetary restraint as critical in bringing down inflation and inflationary expectations. The growth of the broad money aggregate, in terms of which the authorities have set their monetary objectives in recent years, increased by 10 1/4 per cent in the year ending January 1983, well within the range of 9-11 per cent set for fiscal 1982/83. During the last two years, the growth of the narrow monetary aggregate has decelerated rapidly, reflecting mainly the effect of deregulation of some interest rates and the rapid growth of nonbank financial intermediaries. Developments in other monetary aggregates such as the monetary base and domestic credit as well as those in the broad money aggregates (M2 and M3) suggest that monetary conditions have tightened significantly during the course of 1982/83. Short-term rates of interest rose strongly in 1981 and the first half of 1982 before declining in the second half. The 90-day bill rate reached a peak of 22 per cent in April 1982, before declining to around 10 per cent by the end of the year. For most of 1981 and 1982, real interest rates remained significantly positive.

Another objective of the previous Government was to bring about a decline in the budget deficit as a proportion of GDP and restrain the growth of public spending. In this aim, it was generally successful until 1981/82. The Commonwealth budget deficit in that year declined to 0.4 per cent of GDP, representing a downward trend in the deficit relative to GDP since 1977/78, when it was 3.7 per cent. Commonwealth budget outlays as a percentage of GDP declined from 29 1/2 per cent in 1977/78 to 28 per cent in 1981/82. The budget for 1982/83, introduced in August 1982, initially projected a deficit of $A 1.7 billion or 1 per cent of GDP. However, the official projection was subsequently revised upward to $A 4.3 billion (over 2 1/2 per cent of GDP), reflecting mainly increased expenditures, including an increase in unemployment benefit payments and drought-related outlays.

The deficit on the current account of the balance of payments increased markedly over the last two years, from less than 2 per cent of GDP in 1979/80 to over 6 per cent of GDP in 1981/82. During this period, the trade balance moved from a surplus of about $A 2.7 billion in 1979/80 to a deficit of over $A 3.4 billion in 1981/82, and the invisible account deficit continued to widen (Chart 4). Weak world demand and lower prices for some commodities sharply curtailed the growth of export receipts and rapid expansion of domestic demand led to a surge in imports. In the first eight months of 1981/82, capital inflows were inadequate to cover the current account deficit, but massive capital inflows in the last quarter of the fiscal year (April-June)--partly in response to favorable interest differentials (Chart 3)--produced an overall surplus for the year as a whole. In contrast to the inflows in 1980-81, which were related mainly to the investment in the resources sector, these recent flows have been more of a portfolio nature, consisting largely of investment by nonresidents in public sector fixed-interest securities, but also including borrowing overseas by governments and public utilities.

The current account deficit in the first half of 1982/83 amounted to $A 4.1 billion, compared with a deficit of $A 4.5 billion in the corresponding period of 1981/82 (Table 2 and Chart 2), reflecting in part the favorable impact of some temporary special factors. In the coming months, with the impact of the drought coming through in the trade figures, the current account is expected to worsen, and, for the year as a whole, the current account deficit is projected to be somewhat larger than in 1981/82. The net inflow of capital was $A 6.3 billion in the first half of 1982/83, of which $A 0.8 billion was on the government account, more than double the inflow recorded in the first half of 1981/82. Private capital inflow more than offset the large current account deficit and international reserves rose by SDR 1,954 million during the six months to December 1982.

The rate of private capital inflow slowed markedly in January 1983, to about $A 360 million, compared with an average of about $A 1.2 billion in the four preceding months. In the weeks preceding the election of March 5, a very large speculative outflow of capital--estimated at $A 605 million in February--took place and international reserves fell by SDR 970 million during February to SDR 5,499 million (with gold valued at SDR 35 per fine ounce)--the first monthly decline in reserves since

June 1982. Moreover, during the first four days of March, net reserves are reported to have declined by almost $A 1 1/2 billion (about SDR 1.3 billion). The capital outflow resulted in a sharp tightening of domestic monetary conditions, with the three-month money market rates rising by about 4-5 percentage points. The authorities felt compelled to devalue the exchange rate principally in order to end the speculative flight of capital and reduce the upward pressure on domestic interest rates that had resulted as a result of the outflow.

The devaluation seems to have stemmed the outflow and in the following days, a sizable reflow of capital is reported to have taken place. The effective exchange rate was revalued in terms of its index from 73.3 to 73.8 on March 9.

Since November 1976, the exchange rate has been determined by reference to a trade-weighted basket of currencies, and is adjusted frequently and in small steps. The effective (trade-weighted) exchange rate appreciated by about 8 1/2 per cent in the two years to December 1981. The real effective exchange rate, defined as relative consumer prices adjusted for effective exchange rate changes, had appreciated by over 10 per cent during the two years ending in the fourth quarter of 1981. The appreciation of the rate reflected the favorable impact of the development of Australia's large mineral and energy resources on the balance of payments. With the worsening of competitiveness as a result of the faster increase in costs and prices than in the main trading partners, and the uncertain prospects for some of the major export products, including those related to energy, the authorities depreciated the effective rate by 8 per cent during 1982. It is estimated to have depreciated in real terms by about 4 per cent during the year to the fourth quarter of 1982 (Table 3 and Chart 1.)

III. Staff Appraisal

Australia's balance of payments situation has become more difficult of late. The deficit on the current account of the balance of payments rose continuously from 1 3/4 per cent of GDP in 1979/80 to an estimated 6 per cent of GDP in the current fiscal year. The deficits reflect partly the adverse effects of the stagnation in Australia's major overseas markets and the weakness in the prices of some of its main commodity exports, but also some deterioration in the competitive position. Australia's rate of inflation, which in 1981 was about the same as the average for all industrial countries, was almost twice the average at the end of 1982. Even after allowance for the depreciation of the Australian dollar since the end of 1981, unit labor costs have since 1979 risen faster in Australia than in the main trade partner countries.

The external deficit has coexisted since early 1982 with stagnant economic activity and rapidly rising unemployment. The rate of unemployment, which at 6 per cent at the beginning of 1982 was already high by Australia's historical standards, had climbed sharply to over 9 1/2 per cent by February 1983.

The weakness of the current account position has been overshadowed until recently by exceptionally strong inflows of capital. These inflows, which initially reflected direct investment in the resources sector, have since the outset of the recession been influenced more by favorable interest rate differentials as well as by the fact that Australia appeared to be a relatively attractive outlet for investment funds in a period dominated by problems of some large debtor countries. In recent weeks, the volatile nature of these capital inflows became evident when a massive speculative outflow of funds took place over a relatively short period. The new Government took an early decision to devalue the currency in order to end the destabilizing speculation and ease the pressures that had built up on domestic interest rates.

The staff's tentative assessment is that there is a prima facie case for the devaluation of the Australian dollar undertaken by the authorities based on the large size--by Australia's historical standards--of the current account deficit coexisting with high and rising unemployment. A restoration of Australia's competitive position had become desirable in view of the uncertain prospects for both the capital account and the current account, which is expected to be adversely affected by the weakening of the prices of Australia's energy-related exports as well as the impact of the drought. More immediately, the sudden and large speculative outflows of funds, which took place notwithstanding a significant tightening of domestic monetary conditions, called for quick and decisive action in order to avert a situation in which speculation could have fed on itself.

The new Government has not yet formulated in detail the full range of its economic policies and does not expect to do so until after an economic "summit" in early April, in which representatives of labor and industry will participate. The staff and the Australian authorities have been in contact with a view to reaching early agreement on a time when it would be convenient to hold Article IV consultation discussions.

Table 1 . Australia: Selected Economic Indicators

	1979/80	1980/81	1981/82	1982/83 Forecast
	(Change in per cent)			
Domestic economy				
Real GDP	1.2	3.8	3.2	-1
Of which:				
Nonfarm GDP	2.1	4.9	2.4	--
Real total domestic demand	-0.3	6.3	5.5	-2
Of which:				
Private consumption	1.9	3.2	4.0	1
Gross fixed capital formation	-0.6	11.6	6.1	-2 1/2
Unemployment rate (in per cent of labor force), average	6.1	5.9	6.2	8 1/2
Consumer prices	10.1	9.4	10.4	10
Wages, salaries, and supplements 1/	11.4	16.1	15.1	10 1/2
	(In billions of $A)			
Balance of payments				
Current account balance	-2.12	-5.29	-9.20	-9 3/4
Of which:				
Merchandise exports	18.	18.87	19.09	20 1/2
Merchandise imports	15.85	19.18	22.45	24
Overall balance	-0.30	1.15	1.35	...
End of period international reserves (in billions of SDRs) 2/	1.65	2.80	4.1	5.5 2/
Financial aggregates				
Commonwealth Government deficit (in per cent of GDP)	-1.8	-0.8	-0.4	-2 3/4
M3 (end of period; percentage growth over previous year)	12.3	12.7	11.3	10.2 3/

Sources: The Treasury, Round-Up of Economic Statistics; Australian Bureau of Statistics, Quarterly Estimates of National Income and Expenditure; Reserve Bank of Australia, Bulletin; and staff estimates.

1/ Nonfarm sector; in current prices.
2/ Including gold valued at SDR 35 per fine ounce, end-February 1983.
3/ End-January 1983.

Table 2. Australia: Balance of Payments--Summary

	1978/79	1979/80	1980/81	1981/82	1981/82 July-December	1982/83 July-December
	(In millions of Australian dollars)					
Exports, f.o.b.	14,072	18,859	18,867	19,094	9,047	10,585
Imports, f.o.b.	13,490	15,853	19,188	22,451	10,755	11,576
Trade balance	581	2,736	-321	-3,357	-1,709	-991
Net invisibles	-4,400	-4,857	-4,972	-5,847	-2,745	-3,118
Balance on current account	-3,819	-2,121	-5,293	-9,203	-4,454	-4,109
Government capital, net	1,357	-80	-67	489	380	771
Total private capital	2,338	1,900	6,509	10,069	2,768	5,562
Net apparent capital flow	3,695	1,821	6,443	10,557	3,148	6,333
Net official monetary movement	-124	-301	1,149	1,354	-1,306	2,224
	(In per cent of GDP)					
Trade balance	0.6	2.5	-0.24	-2.25	-2.3	-1.5
Net invisibles	-3.8	-3.9	-3.8	-3.9	-3.8	-3.8
Balance on current account	-3.2	-1.8	-4.0	-6.2	-6.2	-5.4

Source: Reserve Bank of Australia, Statistical Bulletin.

Table 3 . Australia: Exchange Rate Indicators, 1976-1982

(1975 = 100)

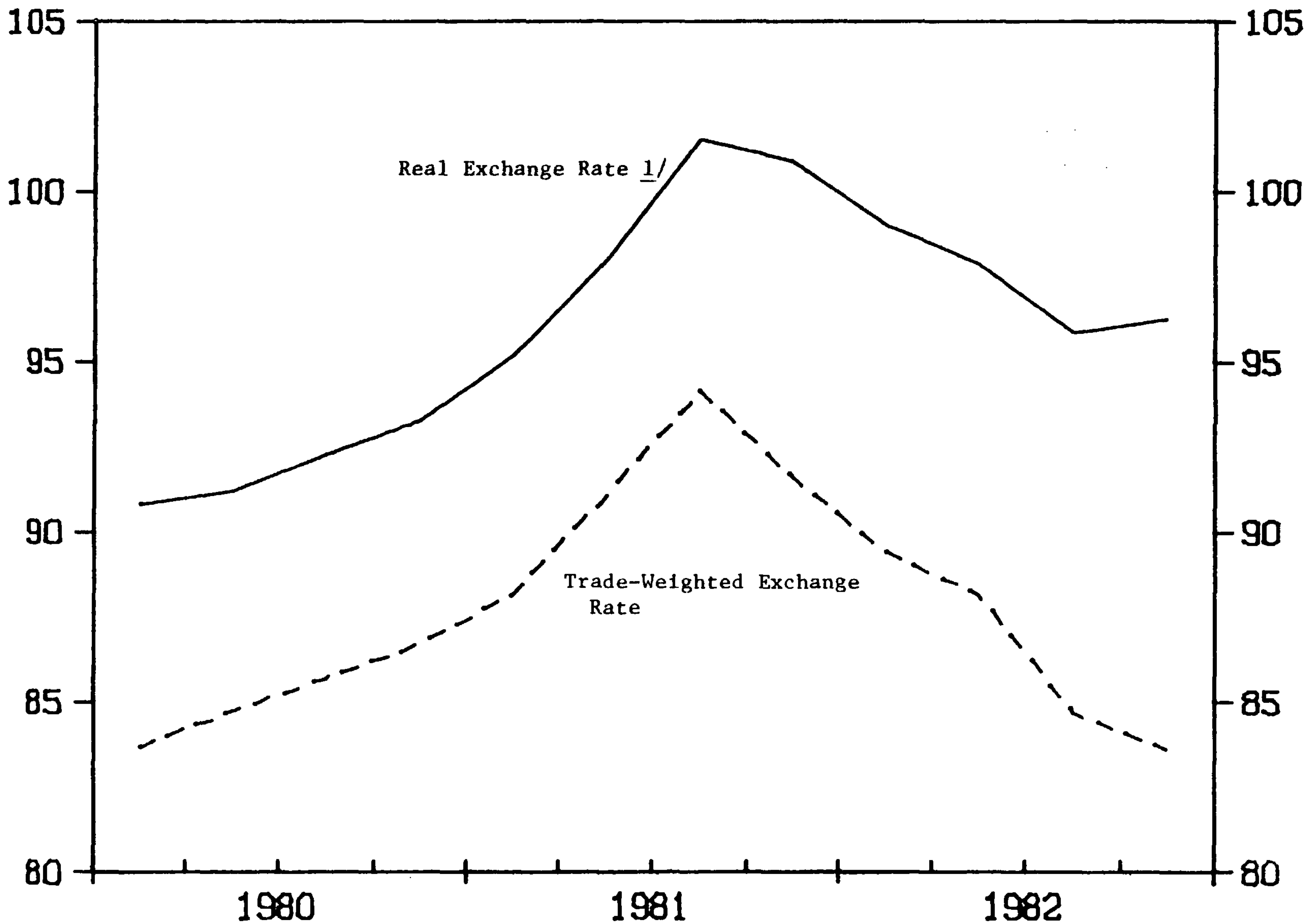
		Nominal Exchange Rates				
		Index of U.S. dollar rate	Index of MERM weighted effective rate	Index of trade-weighted effective rate	Real Exchange Rate vis-à-vis Main Trading Partners	Relative CPI 1/
1976		1.235	97.0	105.3	108.84	1.03
1977		1.1155	87.5	92.5	98.42	1.06
1978		1.1475	85.6	86.2	93.10	1.08
1979		1.1211	81.9	83.1	90.79	1.09
1980	I	1.10	80.9	83.7	90.78	1.08
	II	1.14	82.8	84.7	91.18	1.08
	III	1.16	84.4	85.7	92.27	1.08
	IV	1.17	86.9	86.7	93.29	1.08
1981	I	1.165	89.7	88.2	95.20	1.08
	II	1.145	92.0	91.1	97.99	1.08
	III	1.143	95.2	94.1	101.52	1.08
	IV	1.138	92.9	91.6	100.87	1.10
1982	I	1.074	90.7	89.4	98.96	1.11
	II	1.044	89.4	88.1	97.83	1.11
	III	0.9698	86.5	84.7	95.86	1.13
	IV	0.9574	84.7	83.6	96.27	1.15

Sources: IMF, International Financial Statistics, and Reserve Bank of Australia, Statistical Bulletin.

1/ Australian CPI divided by weighted CPI of main trade partners.

Chart 1. Australia: Exchange Rates

(Units of foreign currency per Australian dollar; index: 1970 = 100)

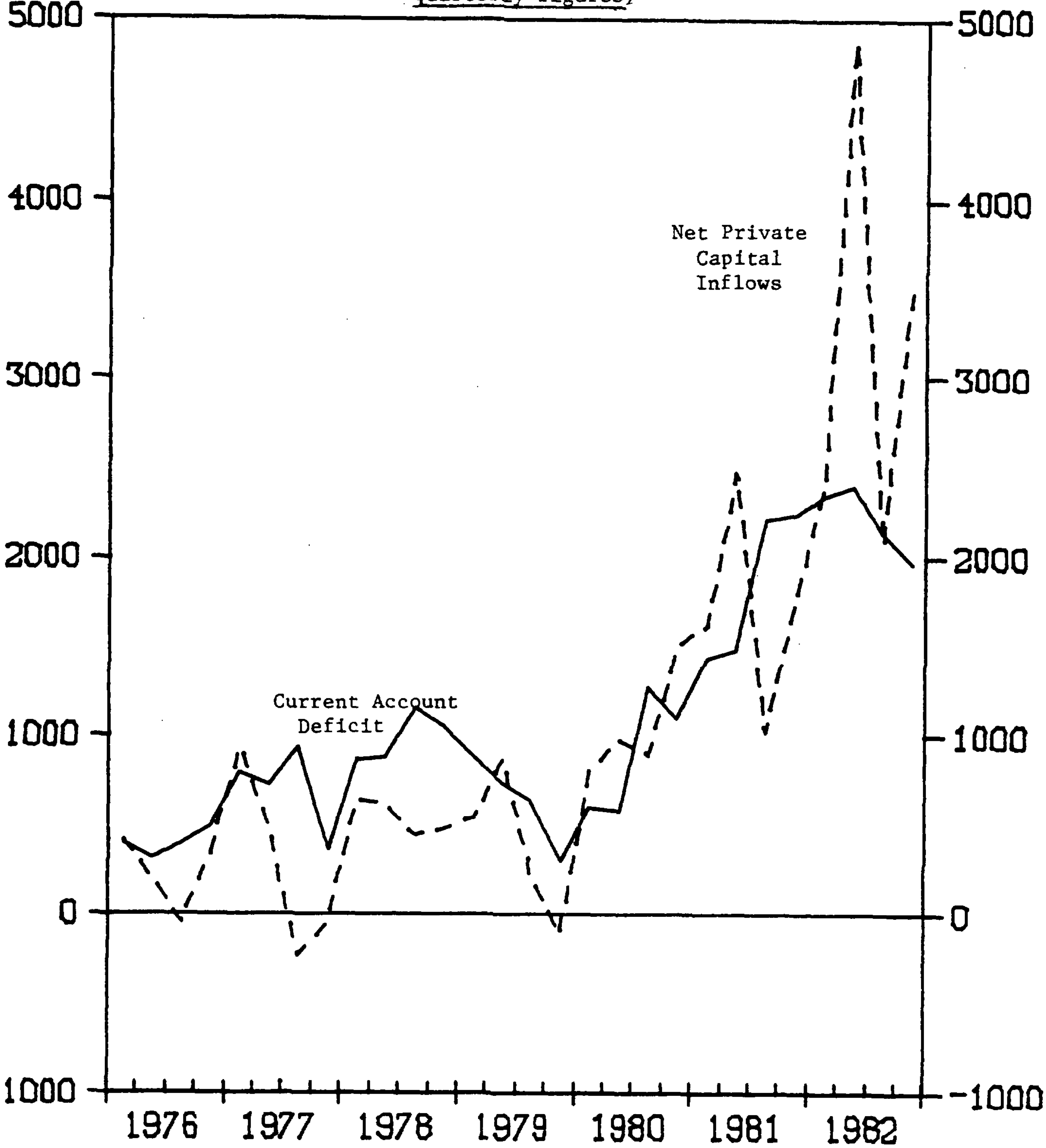


Sources: IMF, International Financial Statistics; and Reserve Bank of Australia, Statistical Bulletin.

1/ Effective rate adjusted for relative consumer prices vis-à-vis main trading partners and competitors.

Chart 2. Australia: Net Private Capital Inflows and Current Account Deficit

(In millions of Australian dollars, quarterly figures)



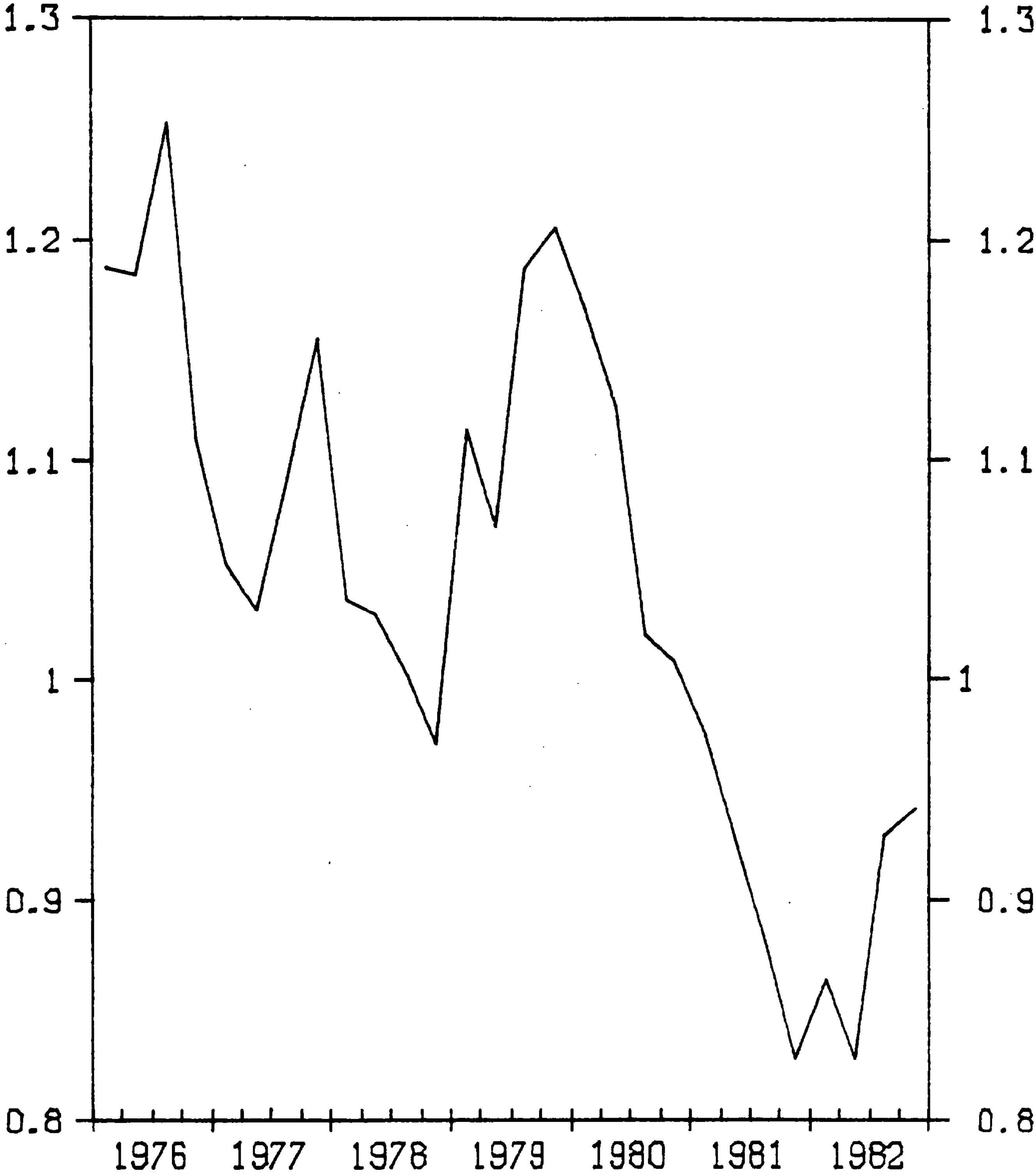
Source: Reserve Bank of Australia, Statistical Bulletin.

Chart 3. Australia: Nominal Interest Rate Differential

Sources: IMF, International Financial Statistics; and Reserve Bank of Australia, Statistical Bulletin.

Chart 4. Australia: Import Cover Ratio

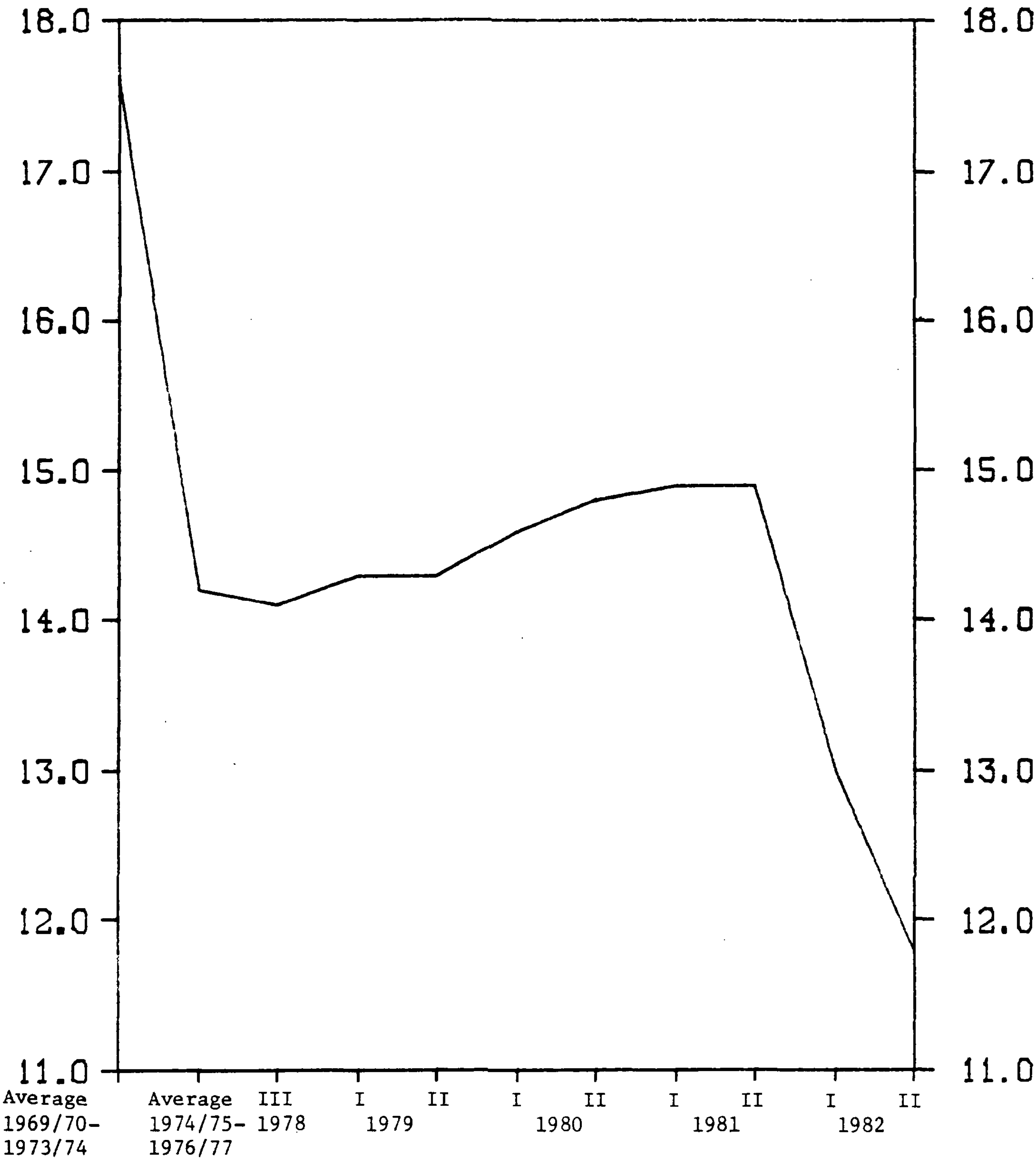
(Exports/imports, f.o.b.; seasonally adjusted)



Source: Reserve Bank of Australia, Statistical Bulletin.

Chart 5. Australia: Nonfarm Profit Share 1/

(In per cent of nonfarm value added)



Source: Australian Bureau of Statistics, Quarterly Estimates of National Income and Expenditure.

1/ Nonfarm gross operating surplus as a percentage of nonfarm value added.