November 4, 1982 - 82/201

Statement by Mr. Prowse
on Australia's Proposed BSFF Purchase
Executive Board Meeting 82/142
November 5, 1982

Australia has requested a purchase of SDR 32.463 million in connection with its obligation to accumulate special stocks of sugar under the International Sugar Agreement. Australia previously made a purchase under the BSFF to finance obligatory sugar stock accumulations in 1979.

The proposed purchase is, in amount and form, typical of purchases under this special facility which is designed to assist and encourage primary producers to participate in buffer stock arrangements (and to accept related constraints on their exports), which are seen as beneficial to the industry as a whole through reducing volatility in prices and supplies to the market. In the present depressed and uncertain markets for primary exports - including, of course, sugar - it is more important than ever that this special facility should operate effectively, be seen to operate effectively, and be available to producers as they need it and as they meet its requirements.

The BSFF is a highly specialised facility with very restrictive special conditions on eligibility. It is evident from the staff paper - EBS/82/183 - that the Australian request meets the special conditions for eligibility under the BSFF.

Apart from the special conditions of the BSFF itself, purchases under the facility must, of course, be consistent with the Fund's general policies and requirements. These requirements include that of balance of payments "need". In view inter alia of the unusual formulation the staff has used in its paper to assist the assessment of "need" in this case, it seems that it might be helpful, perhaps even necessary, to comment - even if only briefly - on the concept of need and its application under the BSFF and also on the facts of the present case.

The concept has been much discussed, defined and re-defined over the years, both generally and specifically in relation to the BSFF. Both in the broad and in the particular, it was intensively considered by the Executive Board in the later part of the 1970s; important relevant papers are SM/76/197 and SM/76/197 Supplement 1.

The staff, in EBS/82/183, make the following statement, which is something of a summary of comment on page 9 of SM/76/197: "Judgments about what constitutes a weak reserve position in this context are made on a case-by-case basis, taking into account a wide variety of factors, including inter alia the volume of foreign trade, (variability of exports and imports), past behaviour of reserves, (size of gross and net reserves), prospective developments (in them), the traditional level of reserves, and seasonal factors (and the size of short-term foreign liabilities)." I note that I have added the words in parentheses on the basis of the statement in the original documents, because I think they are also important elements in any assessment including in the present case.

It would no doubt be very tedious for the Board for me to explore in detail, on this occasion in relation to this relatively small purchase, the whole history of this matter of "need" but I do want to make a few other brief references to the important basic papers noted above. Thus (in discussing another special facility, the Compensatory Financing Facility) SM/76/197 says: "The balance of payments is a flow concept that does not refer to a moment in time, and no basis exists in the decision on compensatory financing for fixing either the length of the period of balance of payments need or the date of its termination in relation to the time of the drawing." Moreover, it is evident from that paper and others that subject to certain exceptions, the Fund's policies may make distinctions on the basis of the character or origin of need for the purposes of establishing special facilities, for example, the Oil Facility, the Compensatory Financing Facility, and I think it may be added, the Buffer Stock Financing Facility.

The requirement of need is generally seen in the Fund's deliberations as having three separate aspects, each of which is to be appraised separately and any one of which can justify the balance of payments "need" requirement, as indicated by the use of the conjunction "or" in the Articles. That is, need may be "assessed on the basis of the member's balance of payments position, or its reserve position, or developments in its reserves."

Since emphasis has been placed by the staff on the question of balance of payments deficit in determining the existence of "need", a subject for consideration, and one which is still controversial and evolving, is how payments deficits are to be measured. As SM/76/197 has it: "The concept of payments deficit that is most relevant in evaluating need is undoubtedly the one covering net autonomous transactions, i.e., transactions undertaken for their own sake, for which the central authorities have provided the financing, either by drawing on their reserves, by engaging in official borrowing, or by deliberately inducing other residents to borrow. That is, the items below the line that reflect the financing of the imbalance will comprise official reserve assets and the liabilities that qualify as official financing . . .". The purposes and effects of official balance of payments financing are to maintain reserves at a level higher than they would otherwise be, or to maintain an exchange rate higher than it would otherwise be, or a combination of both. These purposes serve to distinguish balance of payments financing from the other major category of capital transactions, those associated with capital formation, and the paper notes: "Borrowing that takes the place of the use of reserves clearly does not belong above the line as a factor contributing to a payments surplus or to the reduction of the deficit that would have existed in the absence of the borrowing." In the Australian case it is to be noted that the Government has undertaken very substantial overseas borrowing to maintain its reserves, and additionally has encouraged semi-governmental bodies to seek financing abroad where they otherwise have sought it domestically. Further, the painfully high level of interest rates in Australia has served to attract substantial inflows of capital which may very well be extremely sensitive to interest rate differentials.

The matter of "need" specifically in relation to purchases under the BSFF was discussed in 1973 when a proposal before the Executive Board was that the criterion should not apply to this special facility. This was not generally accepted but there was some support for the suggestion of the staff that the requirement should be interpreted more flexibly in this context, and that view is further recorded in 1975.

Again, the "Report of the Executive Directors on the Proposed Second Amendment" comments as follows: "Under the concept of need in Article V, Section 3(b)(ii), a member will be able to purchase the currency of other members of the Fund if its balance of payments position or its reserve position is unfavourable or if there is an unfavourable development in its reserves, . . . even though it does not have a deficit on its balance of payments according to accepted definitions of the balance of payments." It was recognized that one important consequence of the separateness of the aspects of "need" is that the requirement does not bar a member with adequate or even high reserves from using either Fund resources or SDRs. In the papers referred to above it is suggested that a clear-cut recent instance of this principle is that participants in the European common margins arrangement, some of them with high reserves, routinely draw on the Fund and use SDRs for the settlement of deficits in connection with intervention. Finally, as SM/76/197 Supplement 1 states: "As determination of need almost always entails a judgmental element, a judgment about the need of a member to draw because of its reserve position might be influenced somewhat by the country's balance of payments experience and prospects. A certain use might thus be considered justifiable on the basis of reserves that were on the low side, though not extremely low, in conjunction with a payments position that was not particularly strong, though perhaps not clearly in deficit."

Balance of payments need in the Australian case

Against this background, what is the position in the present case. As the staff paper notes, "The interpretation of recent developments in, and the short-term outlook for, Australia's balance of payments and reserves position is not entirely straightforward". Appraisal is difficult because the present situation in respect of Australia's balance of payments is not only uncertain but also largely unprecedented. The current account deficit is, for Australia, extraordinarily high, at about 6.2 per cent of GDP. It is especially important in these circumstances to look beyond month-to-month movements in the reserves and payments position and to look at the "fundamentals". Some relevant points are:

- It is not conclusive to assess Australia's (or indeed any other country's) balance of payments "need" simply on the basis of three, or in effect, one month's movement in reserves. The growth in Australia's reserves in September was attributable essentially to unexpected capital inflow (unexpected in terms of the established adverse seasonal pattern), and this disguised the underlying balance of payments position.

- There was a positive swing of $A1.45 billion in the September 1982 balance of payments outcome as compared with September 1981, but some $A1.39 billion of this was attributable to the capital account.

- A considerable portion of this increased capital inflow appears to have comprised short-term flows prompted by very favourable interest rate differentials as between Australia and other developed countries, notably the US and Japan. On November 3 the yield on Australian Government 26-week Treasury Notes was 15.2 per cent. The influences underlying these recent flows seem basically "financial" and these influences and the direction of the flows they induce could change quickly, possibly stimulating an outflow of similar magnitude. In particular, the strong capital inflow of recent months seems not to be the result of any increasing demand for investment in industry in Australia, or to any recovery in commodity markets or mineral prices, or any pick-up in the demand for capital to invest in resource development in Australia. In that respect there has been no improvement in basic economic conditions, such as might be expected to reflect in longer-term balance of payments prospects.

- Australia's <u>current account deficit</u>, as a percentage of GDP has expanded from 2 per cent in 1979/80 to about 6.2 per cent in 1981/82: its highest level for 30 years. A similar figure is expected for 1982/83.

- The 1981/82 deficit as a percentage of GDP (6.2 per cent) is 2-1/2 times the arithmetic average for the past 25 years as a whole.

- Underlying this weak current account position has been an adverse and widening inflation differential between Australia and its trading partners. Over the year to the September quarter, Australia's Consumer Price Index rose by 12.3 per cent, compared with weighted average increases of 6.5 per cent in its major OECD trading partners (US, West Germany, Japan, UK, France, Canada, Italy and New Zealand) and 7.8 per cent in all OECD countries over the year to August.

- In Australia, average weekly earnings rose by 15.2 per cent over the year to the June quarter, considerably above the rates being recorded in many other developed countries (e.g., 5.3 per cent in US, 3.5 per cent in Japan, 2.5 per cent in Germany, 7.8 per cent in UK). The longer term balance of payments outlook reflects this basic economic problem of deteriorating competitiveness in Australian industry. Correcting this will take time. Indexes purporting to measure international competitiveness on the basis of unit wage costs suggest a decline of around 13 per cent over the two financial years 1980/81 and 1981/82.

- The outlook for the Australian balance of payments in the period ahead has been further damaged by the current severe drought - crop production is expected to be down 28 per cent in 1982/83. Taking into account depressed overseas market conditions, and rising costs, the net value of rural production is expected to be down 44 per cent in current prices in 1982/83 - and in real terms by 49 per cent.

- Foreign exchange reserves currently represent 2-1/2 months' imports of goods and services. This is much lower than throughout the 1960s and most of the 1970s and, given Australia's position as an exporter of primary commodities to volatile markets, leaves no margin for safety. The following table illustrates the position:

Foreign Exchange to Imports (Australia)

	Months of Imports
1961-65	6.0
1966-70	3.9
1971-75	7.5
1976-80	1.9
1981-82	1.7
1982 Sep.	2.5

- Clearly the ratio has been deteriorating. It has picked up to around 2-1/2 months recently. But the ratio needs to be considerably increased. Australia has survived in recent years with an even lower ratio of reserves to imports through approaches to the BIS for cover, by drawing on its IMF reserve tranche, by substantial compensatory overseas borrowing, and so on. But it is clear that there is a need for a more comfortable level of foreign exchange than 2-1/2 months' imports represents.

- Nor does it seem that this level has been regarded by the Board in other cases as an indication of reserve ease. For recent BSFF drawings the average has been around 1.9 months. Rather similar results are obtained for recent CFF drawings. The average level of reserves in terms of months of imports has again averaged out at 1.9 months with some countries drawing with reserves (not limited to foreign exchange) as high as four and six months' imports. Australia supported those drawings, as did the Board, and the reference here is only to illustrate the point.

The exchange value of the Australian dollar

- The Australian dollar has depreciated substantially over the past 15 months (approximately 11 per cent in terms of the trade weighted index and 17 per cent against the US dollar). Over the latest four months these depreciations have been 4.8 per cent and 8.1 per cent, respectively. Such depreciations do not suggest that the Australian authorities have been satisfied with the balance of payments position. Indeed they are symptomatic of the underlying weakness in the fundamentals.

Government borrowing overseas

- The Australian Government has been borrowing overseas to support the balance of payments. Recent borrowings have been a pounds sterling 100 million loan and a yen 20 billion loan in July, a US$400 million loan in September and yen 15.5 billion and DM200 million loans in October. These amount to about $A800 million. Importantly, if Government borrowing is excluded, net monetary movements in September increased by $A555 million, but did not fully offset the losses in July and August, $A704 million. This is, of course, relevant to the staff comment about September offsetting July and August results.

It is evident that the Australian authorities are concerned at the balance of payments situation. The preceding considerations suggest that if the Australian authorities had done nothing they would have a clear-cut balance of payments need of major dimensions. But because Australia has been moving its exchange rate down and undertaking large-scale Government borrowings overseas and maintaining its interest rates at (painfully) high levels, it cannot be deemed in any common sense of the words not to have a balance of payments need.

For the information of Directors I attach three tables:-

(1) Australia: Official Reserve Assets and Imports
(2) Australia: Current Account of the Balance of Payments as a Percentage of GDP
(3) Australia: Australian Dollar Exchange Rates

I commend to the Executive Board the proposed purchase by Australia under the BSFF.

Attachments

Table 1. Australia: Official Reserve Assets and Imports

(In millions of Australian dollars; end of period)

	Foreign Exchange	Months of Imports	Total (gold at SDR 35 per ounce)	Months of Imports
1971-72	3,146	10.0	3,382	10.7
1972-73	3,684	11.6	3,904	12.3
1973-74	3,051	6.4	3,260	6.8
1974-75	3,010	4.7	3,251	5.1
1975-76	2,145	3.3	2,384	3.6
1976-77	2,164	2.5	2,444	2.8
1977-78	1,708	1.8	2,003	2.2
1978-79	1,565	1.4	1,885	1.7
1979-80	1,355	1.0	1,672	1.3
1980-81	2,223	1.4	2,501	1.9
1981-82	4,074	2.2	4,370	2.3
1982				
September	4,733	2.5	5,011	2.3

Table 2. Australia: Current Account of the Balance of Payments as a Percentage of GDP

	Current Account Balance (in $A mlns.)	Current Account Balance as Percentage of GDP
1971-72	-338	-0.9
1972-73	711	1.7
1973-74	-842	-1.6
1974-75	-957	-1.6
1975-76	-1,072	-1.5
1976-77	-2,073	-2.5
1977-78	-3,056	-3.4
1978-79	-3,805	-3.7
1979-80	-2,071	-1.8
1980-81	-5,225	-4.0
1981-82	-9,097	-6.2
1982-83 1/	-10,000	-6.0

1/ Forecast.

Table 3. Australia: Australian Dollar Exchange Rates 1/

	TWI of Value of $A (May 1970 = 100)	US$/$A Mid-Rate
1980		
June	85.0	1.1576
1981		
June	92.9	1.1480
July	94.2	1.1356
August	94.4	1.1508
September	93.8	1.1414
October	93.0	1.1350
November	91.2	1.1514
December	90.5	1.1279
1982		
January	90.1	1.0994
February	89.2	1.0740
March	88.8	1.0503
April	88.2	1.0608
May	88.0	1.0482
June	88.2	1.0223
July	86.1	0.9958
August		0.9643
September		0.9493
October 14	83.7	
October		0.9367

1/ End of month (except second last entry).