

EBS/86/213

CONFIDENTIAL

September 11, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Australia - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Australian dollar.

Mr. Tavlas (ext. 6896) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

AUSTRALIA

Real Effective Exchange Rate--Information Notice

Prepared by the European Department and
the Exchange and Trade Relations Department

(In consultation with the Legal Department and
the Research Department)

Approved by L. A. Whittome and Eduard H. Brau

September 10, 1986

The recent evolution of the real effective exchange rate of the Australian dollar, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. 1/ Based on this index, by July 1986 the Australian dollar had depreciated in real terms by about 12 percent since the last occasion on which the Executive Board discussed Australia's exchange rate policy--the Article IV consultation in early March 1986. 2/ This decline in the real effective exchange rate of the Australian dollar, which brought its cumulative fall since December 1984 to 32.5 percent, reflected a nominal effective depreciation of 13.8 percent between March and July 1986. The latter more than compensated for Australia's relatively high rate of inflation, which exceeded the average of its trading partners by an estimated 1.8 percentage points over the same period.

The weakening of the Australian dollar since early 1985 reflected primarily growing market concern about the rapid growth of the deficit on the current account of the balance of payments--from the equivalent of 3.8 percent of GDP in fiscal 1983/84 (year ended June) to 5.9 percent equivalent in 1985/86--and the associated rapid accumulation of external debt. Up to the end of 1985, the strong growth in domestic expenditure contributed to the persistence of the high and rising external current account deficit. In the first half of 1986, however, domestic demand turned downward sharply, declining at a seasonally adjusted annual rate of 3.5 percent compared with an increase of 5.4 percent in the second

1/ The consumer price index in Australia is available on a quarterly basis only. For the purpose of the information notice system, monthly data are derived by interpolation of the seasonally adjusted quarterly series.

2/ "Australia--Staff Report for the 1985 Article IV Consultation" (SM/86/26, 2/12/86). The Chairman's summing up of the Board discussion was circulated as SUR/86/20 (3/12/86).

half of 1985. In addition, trade volumes began to respond favorably to the earlier depreciation of the Australian dollar. Thus, the volume of imports fell by 10.7 percent in the first half of 1986, following an increase of 8.2 percent in the previous six months, while the volume of exports continued to expand notwithstanding the deceleration of growth in some important export markets. These favorable influences on the external position, however, were outweighed by renewed weakness in world commodity prices which contributed to a fall in Australia's terms of trade (on goods and services) of 11.8 percent (annual rate) in the first half of 1986, following a decline of 11.6 percent in the second half of 1985. Thus, the current account deficit remained at a high level in the first half of 1986 and for 1985/86 it reached \$A 13.7 billion ^{1/} compared with \$A 10.8 billion in 1984/85 and \$A 7.2 billion in 1983/84.

As in previous years, the external current account deficit was mainly financed by large borrowings abroad by the public and private sectors, with gross official reserves falling by \$A 0.5 billion (net of valuation changes) during 1985/86. This brought the level of reserves to \$A 13 billion (official valuation) at end-June 1986, equivalent to about four months of imports. Gross external debt rose sharply to an estimated \$A 86 billion by June 1986, equivalent to 37 percent of GDP and 225 percent of exports of goods and services.

In late 1985 monetary policy had firmed sharply in an effort to arrest the weakening of the Australian dollar but, with weakening demand, monetary conditions were allowed to ease perceptibly during the first half of 1986. Indicative of the movements in domestic interest rates, the 90-day bank bill rate declined by 5 percentage points to 14.8 percent during the first half of 1986, after rising by 7 percentage points during 1985. As a result, the differential vis-à-vis the three-month Eurodollar deposit rate fell from 11.7 percentage points in December 1985 to 7.4 percentage points by June 1986, thus weakening incentives to hold assets denominated in Australian dollars.

The rate of increase in consumer prices accelerated to 9.1 percent during the first half of 1986 (seasonally adjusted annual rate) from 3.8 percent during the second half of 1984. This acceleration reflected for the most part the effects of the large depreciation of the Australian dollar. The growth in award wages, which under a centralized wage-fixing system are in principle fully indexed semiannually to past changes in consumer prices, was contained at 3.8 percent in the year to June 1986, as the Government and the trade unions agreed that the national adjustment of award wages in April-May 1986 should be "discounted" by 2 percentage points so as to exclude the effects of the

^{1/} The sharp deterioration in the terms of trade accounted for an estimated \$A 4.5 billion (33 percent) of the current account deficit in 1985/86.

depreciation of the Australian dollar in early 1985 on the consumer price index. In real terms, wage earnings declined by 2.4 percent in 1985/86, following increases of around 1/2 percent in the two preceding years.

Several measures were recently introduced in order to restore orderly conditions in the foreign exchange market and to facilitate external adjustments. In particular, the authorities tightened monetary policy by raising the Reserve Bank's discount rate by 3.4 percentage points in two stages to 18 percent by mid-August. With a view to stimulating private capital inflows, the authorities in late July 1986 removed the 10 percent interest withholding tax on foreign private borrowings, which was imposed a month earlier, lifted the tax on dividends and profits levied on foreign investment, and relaxed foreign investment regulations as well. In addition, the budget for 1986/87, announced in mid-August 1986, provided for a marked reduction in the Commonwealth budget deficit to \$A 3.5 billion (1.4 percent of GDP) from \$A 5.7 billion (2.5 percent of GDP) in 1985/86 so as to limit the public sector's claim on real and financial resources. Outlays were budgeted to remain unchanged in real terms, following large increases in previous years, while revenues were budgeted to increase by 3.8 percent in real terms. The income tax cuts scheduled for September 1986, which represented the first stage of a tax reform package announced in 1985, were postponed by three months. Finally, the Government announced that it will seek to achieve a further "discount" of 2 percentage points in the next national wage adjustment in late 1986 and further restraint in wage increases in early 1987 if economic conditions so require.

Staff Appraisal

In concluding the 1985 Article IV consultation with Australia on March 7, 1986, Executive Directors noted the continued favorable growth and employment performance of the economy, but also pointed to a number of problems that had become evident in 1985. In particular, Directors felt that the current account deficit had reached a level that was not sustainable, and stressed the need for external adjustment, especially in view of the rapid increase in external debt in recent years. To this end, Directors underscored the importance of avoiding an erosion of the competitive position through large wage increases. They also noted that upward pressures on domestic prices had intensified, largely as a result of the depreciation of the exchange rate, and emphasized the need to narrow the inflation differential between Australia and its trading partners quickly.

The recent further depreciation of the Australian dollar appears appropriate in light of the renewed sharp weakening in the terms of trade that has exacerbated the external imbalances. However, in order to promote the required shift of resources to the balance of payments without jeopardizing medium-term growth prospects and aggravating inflation, the depreciation needs to be supported by domestic demand

restraint, improved savings performance and intensified efforts to contain labor costs and preserve external competitiveness. In view of this, the staff welcomes the measures recently taken to foster domestic adjustment, including the intention to cut back sharply the Commonwealth budget deficit for 1986/87, which if achieved together with the authorities' intention to seek further wage restraint should constitute important steps in the desired direction. A thorough review of recent exchange rate developments and of the policy response by the authorities will be conducted in the context of the 1986 Article IV consultation discussions with the authorities, which are scheduled to take place late in 1986.

CHART 1
AUSTRALIA
INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE
(1980 = 100)



¹ Trade weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices, increases mean appreciation.

² U.S. dollars per Australian dollar

Table 1. Australia: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1982						
I	109.2	109.3	99.9	95.4	116.9	116.8
II	109.3	108.7	100.6	92.0	119.8	119.6
III	107.8	105.9	101.8	86.3	123.9	123.8
IV	107.6	104.4	103.0	83.5	127.1	127.4
1983						
I	106.6	102.1	104.4	82.9	130.3	130.2
II	101.5	96.6	105.1	76.7	133.2	133.0
III	105.5	100.2	105.2	77.3	135.3	135.3
IV	109.8	104.5	105.1	79.8	138.1	138.5
1984						
I	111.4	107.8	103.3	81.7	138.1	137.9
II	108.1	105.8	102.2	79.3	138.4	138.2
III	105.5	104.0	101.4	73.5	140.0	140.0
IV	109.4	108.4	100.9	74.2	141.7	142.0
1985						
I	101.8	100.9	100.9	65.9	144.2	144.0
II	89.0	87.8	101.3	58.5	147.6	147.4
III	90.7	88.8	102.1	61.2	150.6	150.7
IV	85.2	82.9	102.8	60.3	153.4	153.7
1986						
I	85.0	81.5	104.3	61.6	157.4	157.3
II	84.7	80.1	105.9	62.6	160.3	160.0
Monthly						
1986						
Mar. <u>3/</u>	84.6	80.6	105.0	62.1	158.4	
Apr.	86.2	81.7	105.5	63.3	159.3	
May	85.8	81.0	105.9	63.8	160.3	
June	82.3	77.5	106.3	60.5	161.3	
July	74.3	69.5	106.8	55.5	162.2	
Percentage change						
Mar. - July 1986	-12.2	-13.8	1.8	-10.7	2.5	

Source: Information Notice System.

1/ Increases mean appreciation.

2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.