

EBS/85/161

CONFIDENTIAL

June 26, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Australia - Real Effective Exchange Rate - Information Notice

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

Mr. Belanger (ext. 8671) 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 Brian Rose and J. T. Boorman

June 26, 1985

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. <sup>1/</sup> Based on this index, the Australian dollar had depreciated by April 1985 by more than 10 percent since the last occasion on which the Executive Board discussed Australia's exchange rate policy--the Article IV consultation in February 1985. The depreciation is estimated to have amounted to 13.9 percent during this period.

Australia adopted a floating exchange rate on December 12, 1983 and at the same time eliminated virtually all exchange controls. From that date to January 1985, the real effective exchange rate remained relatively stable, some slight nominal appreciation (3.1 percent) being offset by a lower rate of inflation in Australia than in its main trading partners. Against the U.S. dollar there had been a depreciation of nearly 10 percent, reflecting the dollar's general strength. Throughout most of this period, the short-term interest rate differential had been in Australia's favor. Monetary growth, however, as measured by developments in M3, had been running beyond the range of between 8 and 10 percent adopted by the authorities as a "conditional" projection for the period June 1984 to June 1985; M3 grew at an annual rate of 15.4 percent between June 1984 and January 1985. In addition, fiscal policy remained strongly expansionary with a total public sector borrowing requirement equivalent to 7 percent of GDP projected for 1984/85 (fiscal year ending June).

In February 1985, the Australian dollar came under heavy pressure in foreign exchange markets, declining against the U.S. dollar by 12 percent from end-January to end-February. After a short period of stability, this pressure re-emerged in late March, and in April the average value of

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<sup>1/</sup> 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.

the Australian dollar vis-a-vis the U.S. dollar was nearly 20 percent below the average January level. In nominal effective terms, the depreciation also amounted to about 20 percent over the same period.

Several factors appear to have contributed to this sharp decline in the value of the Australian dollar. The deficit on the current account of the balance of payments in the first seven months of 1984/85, i.e., through January 1985, widened by some \$A 3 billion (annual rate equivalent to 2 1/4 percent of GDP) compared with the same period of 1983/84. On January 29, the authorities announced that the "conditional" projection range for the growth of M3 for the year to the June quarter of 1985 was being abandoned because recent measures of financial deregulation were judged to have rendered M3 an inaccurate indicator of monetary conditions. Although M3 growth had been significantly above the specified range, the authorities viewed monetary conditions as having remained quite firm, as reflected, in particular, in the continued abatement of inflation and the increase in short-term interest rates toward the end of 1984 and in the early part of 1985. The growth of M3 at an annual rate since June 1984 remained equivalent to 15.4 percent, on average, in February and March 1985. At present, representative money market rates are at around 15 1/2 percent, some 10 percentage points above the inflation rate. Nevertheless, financial markets may have perceived the abandonment of the projection range as a weakening of the Government's resolve to pursue appropriate financial policies, particularly against the background of an expansionary budget. There was also concern that the Prices and Incomes Accord between the Government and the unions which was a key element of the Government strategy was coming under strain. These developments may have cast doubt on the Government's ability to sustain the recovery in economic activity without pressure on costs and prices and strains on the external position.

Recently, the authorities have reaffirmed their determination to reduce both the Commonwealth budget deficit and public spending as a proportion of GDP in 1985/86 and over the Government's term of office. In support of this objective, they announced in May 1985 a package of measures aimed at reducing the projected level of expenditures in 1985/86 by \$A 1 1/4 million or about 1 1/2 percent. The Australian dollar has since firmed somewhat in the exchange markets.

#### Staff Appraisal

In their discussion of the 1984 Article IV consultation with Australia on February 20, 1985, 1/ Executive Directors generally welcomed the authorities' decision to float the Australian dollar and abolish virtually all exchange controls, particularly as it would enhance the effectiveness of monetary control. Directors were, however, concerned

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1/ EBM/85/26, SUR/85/17 (2/25/85).

about the excessively expansionary fiscal policy. They underlined the need to take early steps to restrain government spending, and emphasized that without firm financial policies the success of incomes policy ran the risk of being short lived. Directors also noted that the deficit on external current account, which was expected to reach 4.5 percent of GDP in 1984/85, was large. They felt that the external position had to be watched carefully and that developments in it further underlined the need to pursue firm domestic macroeconomic policies. Recent developments as regards the exchange rate lend further support to these conclusions. In this context, the measures announced last month to lower projected government expenditure in 1985/86 are a significant and welcome step.

Table. Australia: Real Effective Exchange Rate and Related Series

(Indexes: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies) <u>2/</u>	Exchange Rate in terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1979						
I	99.6	96.1	103.6	99.3	87.5	87.3
II	99.5	96.3	103.2	97.3	89.6	89.7
III	99.3	96.9	102.4	99.0	91.8	91.7
IV	99.1	97.1	102.1	96.8	94.3	94.5
1980						
I	98.7	97.7	100.9	96.7	96.7	96.6
II	99.7	99.4	100.3	98.7	99.2	99.3
III	100.5	100.6	99.9	102.0	101.3	101.1
IV	101.2	102.3	98.9	102.6	103.0	103.2
1981						
I	103.3	104.6	98.7	102.5	105.7	105.6
II	106.8	108.5	98.4	100.4	108.1	108.0
III	111.8	113.9	98.2	100.3	110.4	110.2
IV	110.7	111.5	99.3	100.2	114.5	114.8
1982						
I	109.2	109.3	99.8	95.4	116.9	116.8
II	109.4	108.7	100.7	92.0	119.9	119.6
III	107.9	105.9	101.9	86.3	124.0	123.8
IV	107.5	104.4	103.0	83.5	126.9	127.4
1983						
I	106.5	102.1	104.4	82.9	130.2	130.2
II	101.6	96.6	105.2	76.7	133.4	133.0
III	105.5	100.2	105.3	77.3	135.4	135.3
IV	109.8	104.6	105.0	79.9	137.9	138.5
1984						
I	111.3	107.8	103.2	81.7	137.9	137.9
II	108.1	105.8	102.2	79.3	138.6	138.1
III	105.6	104.0	101.5	73.5	140.1	140.0
IV	109.3	108.4	100.8	74.2	141.4	142.0
1985						
I	101.5	100.9	100.6	65.9	144.0	144.0
Monthly						
1985						
Feb. <u>3/</u>	101.0	100.2	100.7	65.1	144.0 <u>4/</u>	...
March	94.8	94.4	100.5	61.1	144.7	...
April	87.0	86.7	100.3	57.9	145.3 <u>5/</u>	...
Percentage change						
February- April 1985	-13.9	-13.5	-0.4	-11.1	0.9	...

Source: Information Notice System.

1/ Increase means appreciation.

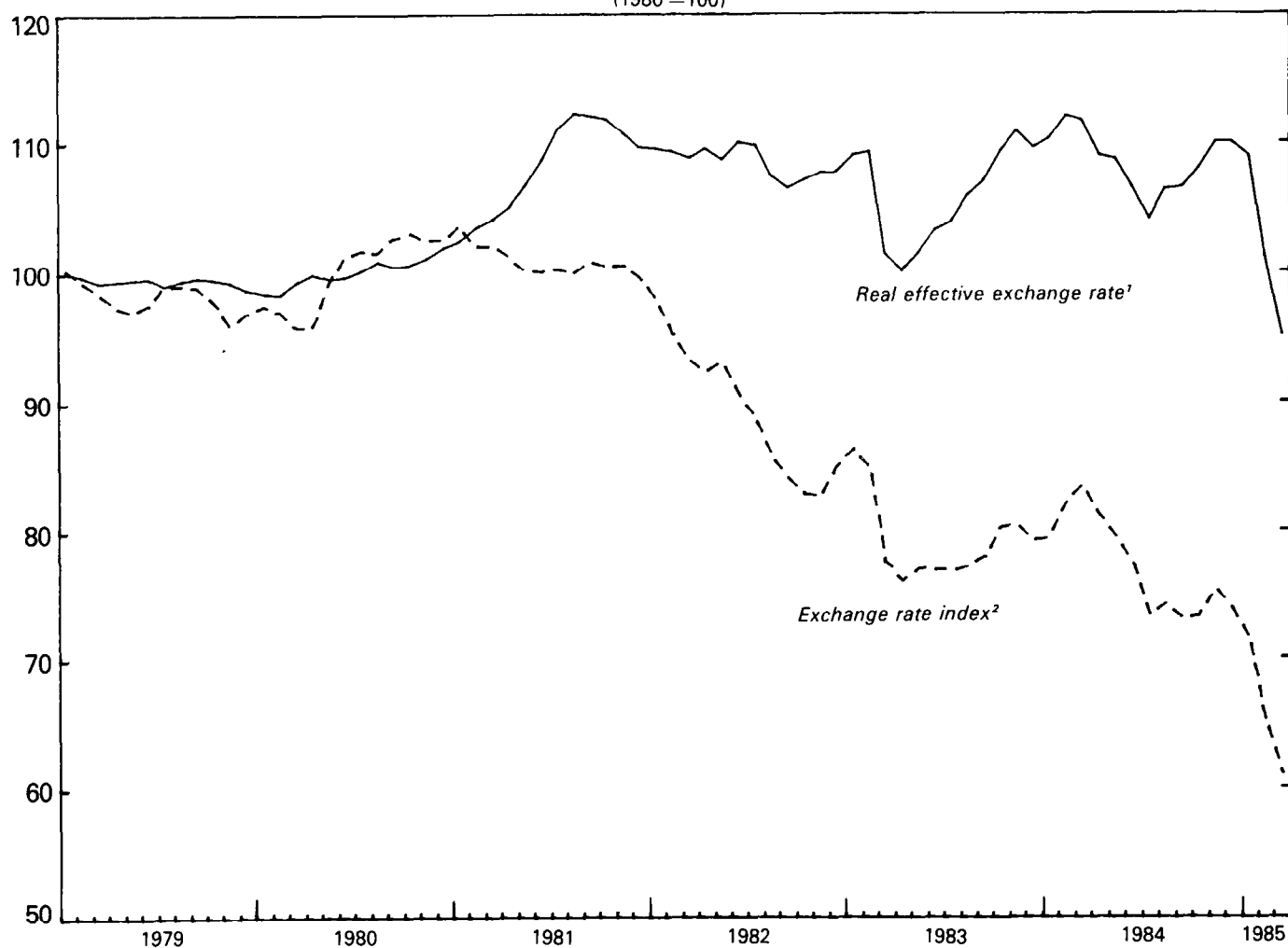
2/ Using seasonally adjusted consumer price indexes.

3/ Date of latest consideration by the Executive Board.

4/ Monthly data derived by interpolation of seasonally adjusted quarterly series.

5/ Estimate obtained through extrapolation of the rate of inflation over the previous six months.

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



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

<sup>2</sup>U.S. dollars per Australian dollar.