FINANCIAL MARKETS AND THE REAL ECONOMY

Talk by the Governor, Mr B. W. Fraser, to the National Farmers' Federation Council, Canberra, 12 May 1994.

Introduction

The rural sector is less significant in the overall economy now than in the days when I was growing up in Junee. Forty years ago, farm output represented around 20 per cent of Australia's GDP and contributed over 80 per cent of exports. Today, it accounts for less than 5 per cent of total output but still generates about a quarter of Australia's exports.

These bland figures, however, say nothing about the enormous growth in farm productivity over the decades. And they say nothing of the contribution which farming communities, forged in the flames of fickle seasons and overseas markets, have made to the Australian ethos.

Happily, after the setbacks of recent years, things are now starting to look better than they have for some time. The world economy is showing signs of more life and this is helping commodity prices, including some farm commodities. The recent GATT deal should, over time, boost rural incomes, as the major countries open up their markets and cut back their subsidies. The expanding middle classes in Asia hold the promise of a ready market for suppliers of high quality foodstuffs – and geography is, for once, on our side.

All this you know better than I do. I plan to stick to matters closest to my own turf – matters like bank finance, interest rates and exchange rates, and how they relate to farmers and others in the real economy.

I trust my remarks will not be seen as an exercise in what is sometimes disparagingly referred to as 'jawboning' – the notion that people (and markets) can be talked into behaving in ways which are contrary to their perceived self interests. The success rate with such exercises is probably close to zero, particularly when the message flies in the face of fundamental factors. My aim is more to shed some clearer light on the 'fundamentals' which enter into monetary policy decisions, in the hope that this will contribute to a better understanding of the issues and to better outcomes in various areas.

Bank Lending

Deregulation of Australia's banking system has made it more competitive and boosted the range of products available. This has been to the benefit of depositors, as well as borrowers. It has not meant open slather for the banks; deregulation has been accompanied by a framework of prudential oversight which has been strengthened over recent years.

Credit outstanding to businesses of all kinds has been falling for the past three years. Some suggest this is because banks have restricted their lending to businesses, especially small businesses; bankers, on the other hand, point to a dearth of sound lending proposals. Others have suggested that a good volume of lending is actually occurring but is not yet showing up in loans outstanding because of large write-offs and repayments. I suspect the truth comprises elements of all these explanations.

The Reserve Bank has been endeavouring to get a better handle on lending to 'small businesses'. (We include farmers in this category, although lending to farmers – who are often asset rich but income poor – has its special problems.) An initial progress report was presented in the April edition of the Bank's *Bulletin*. In general, our data confirm findings from other sources that lack of access to bank lending has not been a major problem for most small businesses in recent times.

Our surveys, however, have also confirmed that working relationships between banks and their customers leave a lot to be desired. Many small businesses believe, for example, that loans officers often are not in their positions long enough to get to know their customers, or their customers to know them. Interestingly, this is a greater problem for metropolitan businesses than it is for rural businesses. Perhaps the better personal relationships rural people have with their bankers owe something to the greater efforts made by banks to employ specialists in country branches who have an understanding of farming, as well as banking.

Issues such as cash flow lending, bricks and mortar security and documentation requirements often make for tensions in the relationship. Sometimes unreal expectations are displayed on one side, and excessive caution and insensitivity on the other. These are real problems and it is good to see banks and others taking steps to tackle them. Last week's White Paper also included some measures aimed at improving communications between banks and their customers.

Business demand for credit is expected to grow in the period ahead as new investment in plant and equipment builds up. We believe that banks are both well placed and keen to respond to this demand. Over the past year, many banks have introduced new products to attract small and medium-sized business customers; some of these offer low interest rates capped for several years, and some waive the usual customer risk margins which would normally be added to base rates in determining interest charges.

In this context, questions have been asked about the current rapid rate of lending to housing. Is it occurring at the expense of lending to business (including farmers and other small businesses)? Is it a threat to inflation?

Several points can be made in response to such questions:

- the housing sector has rebounded in a traditional and helpful way during the current economic cycle, providing a good boost to demand when the recovery was slow to get underway;
- we would not wish, however, to see housing overheat to the point where it might ignite asset price inflation and spread into higher inflationary expectations generally;
- so far, there is little evidence of any strong or generalised rises in house prices but that situation could not be sustained if lending for housing were to continue to grow at its current rate of over 20 per cent; and
- so far also, the banks' focus on housing has not been a major problem because of the subdued demand for business loans, but it could become more of an issue as business investment gathers momentum.

It is against this background that the Bank has talked to the banks and pointed out to them – not 'jawboned' or 'threatened' them – that the cause of sustained growth would be assisted if housing lending were to slow as business lending increased. To the extent that does not occur, and lending for housing continued to grow at a pace which threatened to push up house prices and inflationary

expectations, or *aggregate* credit growth threatened to become excessive, the Bank would have to take those considerations into account in framing monetary policy.

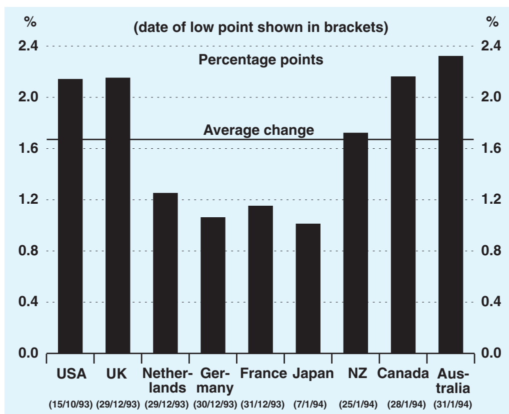
Long-Term Interest Rates

I turn now to interest rates, and look first at long-term rates. These are determined in the market place, and are less influenced by the authorities than short-term rates (to which I will come shortly).

As everyone knows, long-term bond yields have moved up sharply in most countries over recent months, keying off rises in the US. The increases in Australia have been greater than in other countries, with ten-year yields rising by 2 to 2½ percentage points since early February (see Graph 1).

Graph 1

Change in Ten Year Bond Yields Since Most Recent Lows



The decision by the Federal Reserve on 4 February to increase US short-term interest rates by 0.25 percentage points was the trigger. The Fed has followed with two further increases, gradually tightening its previously accommodative monetary policy. Although these increases hardly came as surprises, their arrival caused markets to re-assess the outlook for growth and inflation in the US, and to conclude that the extended period of falling interest rates had come to an end. In short, faster economic growth was seen as leading inevitably to higher future inflation – and hence higher interest rates. As markets often do, they reflected these concerns about the future in financial prices today, even though there is no evidence yet of heightened inflationary pressures (in the US or elsewhere).

They might also have seen the projected stronger world economy, combined with continuing large budget deficits in major countries, as increasing the demand for capital and leading to higher real interest rates. With so much surplus capacity in the world economy, however, those kinds of global pressures seem to be some way off.

In addition to these concerns, part of the momentum behind the recent rises in US bond yields appears to have come from large speculative players selling into a falling market. Some so-called 'hedge funds' were caught with leveraged long positions in bonds and when prices moved against them they were forced to cut their losses, driving prices down further. In this respect, the short-term dynamics of the bond market have resembled what we have seen in share markets in periods of panic, with holders seeking to sell at every opportunity. (Many farmers will know the sinking feeling that comes with having to sell into falling markets!)

Given the dominance of the US capital market, and its strong linkages to other markets in a world where capital moves freely, the pressures in US bond markets were bound to flow through to other markets. When US portfolio managers decide to reduce their bond holdings, they tend to reduce their holdings of foreign bonds, as well as US bonds. Bond markets outside the US, aware of the linkages, are quick to follow the US lead.

The flow-on effects appear to have been accentuated in Australia's case by parallel perceptions of mounting inflationary pressures with faster growth, and by specific concerns about the White Paper and the Budget. This basically reflects scepticism about the ability of the authorities to keep inflation under control over the years ahead.

As I have said before, I believe that scepticism to be unjustified, and I will say more about this in a moment. But first, a word about the implications of the movements which have occurred to date.

Higher long-term bond rates mean, of course, higher borrowing costs for governments with budget deficits to finance. They also mean higher interest costs for private borrowers in countries like the US and Germany where more borrowing is done in long-term capital markets. While this flow-on to lending rates may be helpful in slowing the strong US economy, it will be distinctly unhelpful (assuming it is sustained) in countries like Germany, where recovery is just beginning and unemployment is still rising.

Australia is relatively well placed to absorb the effects of the recent rises in bond yields. The great bulk of banks' business and housing lending is at variable rates, which are based on short-term interest rates, and these have not moved. On the other hand, the weaker share market will make new equity raisings more difficult, while market confidence has taken a bit of a knock. Confidence in the community generally, however, remains strong and the 'real economy' should continue on its way, despite the ructions in financial markets.

Short-Term Rates

What does the rise in long-term bond yields mean for monetary policy in Australia? Does it mean an automatic rise in short-term rates?

The short answer to the second question is 'no'. Monetary policy has to be determined essentially on the basis of Australian conditions. Overseas developments are not irrelevant, but their significance comes through their implications for the domestic economy. They could be quite significant if, for example, there were to be large rises in interest rates offshore which threatened to cause the $A to depreciate to the point where it might undermine continued low inflation. In the present episode, the exchange rate has not come under that sort of pressure.

I mentioned earlier that I thought domestic bond markets, in keying off US developments, had over-reacted relative to actual conditions in Australia. Certainly, the extent of the rises in bond yields in Australia over recent months cannot be explained by any objective evidence of higher inflationary expectations. The recent March quarter CPI confirmed that underlying inflation remained around 2 per cent (where it has been for more than two years now) and most forecasters retain a medium-term prospect of continuing relatively low inflation.

In the past, we have ourselves looked to yield curves for possible clues to inflationary expectations. On this occasion, however, when there is little evidence from other sources to corroborate what they are suggesting, we have to discount them as an indicator of future movements in inflation (and monetary policy).

At this point, I would like to outline our monetary policy framework in a little more detail.

We start with an economy that is in good shape, with real growth of 4 per cent or more, and underlying inflation of 2 per cent. The task is to sustain solid growth with low inflation. The recession has been a factor in producing the good inflation numbers in Australia, just as it has in virtually every other country with low inflation, and the task will become more demanding as the economy moves into the cyclical upswing. With good policies and sensible behaviour, however, we believe inflation can be held in check as the economy grows. Those sceptics who take their cues from past experiences should look to the 1960s, and not just the 1970s or 1980s.

We see advantages in having reasonable flexibility to adjust policies to changes in economic conditions, rather than being pre-committed to certain actions, as we would be, for example, if we had a narrow and precise inflation target. We have said several times, however, that we would like to hold the *underlying* rate to around 2 to 3 per cent over the medium term.

Our favourable starting position will be helpful in achieving that, as will the on-going effects of many of the cultural, institutional and structural changes of the past decade. In particular, price setters – and, by extension, wage setters – are exposed to more powerful competitive forces now than ever before. These are coming from reductions in tariffs and the need to get into export markets to expand production, and from various microeconomic reforms which are helping to shake up the non-traded goods sector (including government services).

Looking ahead, much will depend on how events unfold and how policy responds. Our focus is on monetary policy but other policies have to play their part. In particular, fiscal policy has to do its bit to keep total demands on resources under control while providing scope for business investment to expand.

Given the lags before it affects the economy, monetary policy has to be forward looking. And it has to be adjusted before significant inflationary pressures actually emerge. Against this background, the Bank is continually assessing indicators of potential pressures on inflation a year or two ahead.

For the moment, the indicators are generally favourable. Capacity utilisation is picking up but it is still well short of levels which, on past experience, could be described as 'full'. Labour costs continue to grow by around 3 per cent, which is consistent with relatively low inflation being maintained. High levels of unemployment should keep the lid on general wage pressures in the near term, and enterprise bargaining provides the framework for securing productivity offsets to wage rises.

The exchange rate, which threatened to be a concern during 1993, has traded more firmly of late, and import prices today show no net change compared with a year ago. Growth in the money and credit aggregates is not suggestive of any problems of excessive financial activity or incipient inflation; these readings lack precision but credit growth of around 7 per cent (six months to March at an annual rate) is not out of line with current trends in the economy.

In brief, we expect inflation to remain at levels consistent with our medium-term objectives over the next year or so. Given that, and current interest rate settings, we see no pressing need to be tightening policy and raising short-term rates at this time. At some stage, the recovery can be expected to reach a point where higher short-term interest rates will be needed to contain inflation and keep growth on a sustainable path. At that time, appropriate action will be taken. Barring major unforeseen 'shocks', however, we judge that time is still some way off.

I do not need to sell the benefits of low inflation to this audience. The importance to the whole economy of holding rises in prices and wage costs around the 2 to 3 per cent mark (rather than the much larger numbers of the past) has grown as the proportion of our production sold in overseas markets has increased. Today, about $1 in every $5 of national income is earned in very competitive international markets; for farmers, it is $3 in every $4.

Exchange Rate Policy

I have referred in passing to the exchange rate. I am aware that this has been a bone of contention with farmers on occasions and I would like to go over some issues in a little detail.

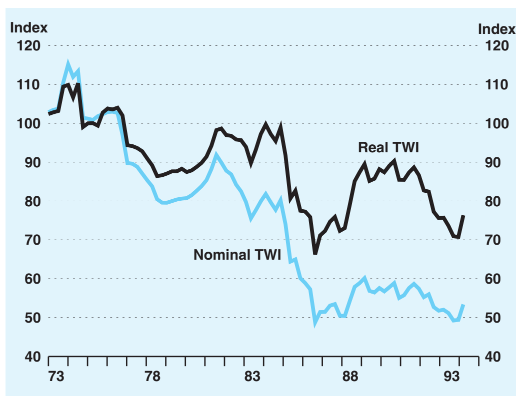
The exchange rate was floated in 1983 not because of any great belief in the perfection of market solutions, but because the managed rate alternative had become unworkable. Floating means that the exchange rate is determined by the interplay of demand and supply – forces which farmers understand better than most. Over the medium term, the market tends to reflect so-called 'fundamental' factors, but over shorter terms other factors can sometimes over-ride the fundamentals, and send confusing signals to investors and producers.

In thinking about the factors affecting the exchange rate, it is useful to look first at

inflation. Countries with relatively high rates of inflation are likely to see their currencies depreciate, to compensate for their higher costs relative to the rest of the world. Adjusting the nominal exchange rate for our relative inflation performance provides a measure of the 'real' exchange rate, which is what matters for exporters. Graph 2 shows that this inflation differential explains the large trend fall in our nominal exchange rate, but it does not explain swings in the real rate.

Graph 2

Nominal and Real TWI



Movements in the real rate reflect developments in both the current account and the capital account of the balance of payments. The current account is influenced by cyclical swings (in both Australia and the world economy), and by structural factors (such as trade protection policies in both Australia and overseas). Trends in productivity and in commodity prices are obviously important; countries with relatively high rates of productivity growth tend to have stronger current accounts and appreciating currencies. Rising commodity prices tend to exert upward pressure on the exchange rate, and vice versa.

Some of these factors like relative productivity performance exert their influence only slowly. Other factors, which operate mainly through the capital account, have a more immediate influence. These are mostly financial in nature, and reflect expectations about interest rates, share prices and exchange rates. We all know that expectations about such matters can form and change quite quickly, and cause volatile exchange rate movements when they do.

In our judgment, the broad sweep of the exchange rate since the mid 1980s is explainable in terms of fundamental factors, such as inflation and interest rate differentials, terms of trade, current account deficits and foreign debt accumulation. This is not to say exchange rates always move in ways we find easy to explain, or that a 'hands off' policy is always appropriate. The exchange rate can be susceptible to sharp changes in market sentiment, which are not always soundly based. In some episodes, speculative flows have moved the exchange rate – in both directions – well away from levels which we judged to be consistent with the fundamentals.

In mid 1990, for example, when the rate peaked at US84.5 cents and a TWI of 63.5, it was clearly overvalued, given that Australia was slipping into recession, interest differentials were moving against us, and the terms of trade were falling. In September 1993, when the rate fell to a low of US64.4 cents and 47.1 in TWI terms on the back of concerns about whether or not the Budget would pass the Senate, it was clearly undervalued. On those (and other) occasions, when we judged that the rate had moved well away from the 'fundamentals', the Bank has intervened.

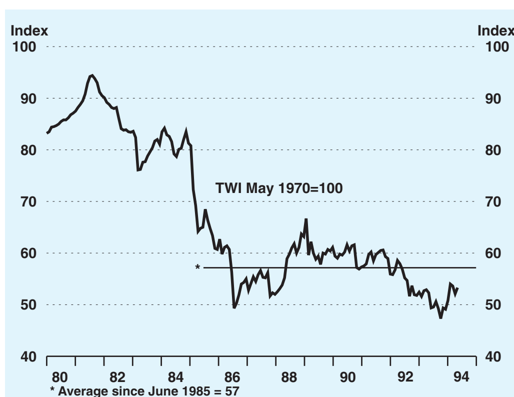
We have, then, been on both sides of the market, selling Australian dollars when the rate was judged to be too high, and buying them when it looked too weak. We have not, however, targetted any particular exchange rate, nor do we believe it would be sensible to try to do so. Our experience suggests that intervention can be effective when it is directed towards returning the rate to a level more in line with long-term fundamentals. Although not an objective as such, the Bank's intervention, overall, has been profitable – which is consistent with it performing a stabilising role.

It is generally understood today that international competitiveness cannot be sustained through artificially depreciating the exchange rate: any short-term advantage will

be lost sooner or later through higher domestic inflation. What the exchange rate giveth, high inflation taketh away! That is why keeping inflation under control and accelerating microeconomic reforms are so critical. Better industrial relations, continuing wage restraint, lower tariffs, financial deregulation, industry restructuring, trade links with Asia, and progressive work and business attitudes are what improves productivity and competitiveness, not attempts to artificially depress the exchange rate.

Over most of the past decade, the trade weighted index has fluctuated around a level of about 57, somewhat above its present level (see Graph 3). During this period, exports – particularly of manufactured goods – have increased dramatically. This suggests that businesses have been competitive at this sort of exchange rate and remain so. It suggests also that exporters have found ways of coping with recurrent bouts of exchange rate volatility.

Graph 3



Over the months ahead, the main influences on the exchange rate are likely to be commodity prices and interest differentials. With the outlook for the international economy looking a little brighter, the tentative improvements in commodity prices we have seen since last September should move further in Australia's favour. This could exert some upward influence on the exchange rate.

As to interest rates, Australia is a little behind the US in the recovery phase so that differentials could move against Australia for a time, as US authorities continue to tighten monetary policy. This factor apart, interest differentials on Australian dollar assets will reflect many factors which are impossible to predict. What we can be more confident about is that inflation in Australia will remain comparable with that in our major trading partners, and so, therefore, should interest rates. This suggests that interest differentials are unlikely to produce anything like the same incentive for capital inflow that they did in the late 1980s.

The Reserve Bank is not in the business of trying to predict the net effect of these and other influences on the exchange rate. But we can be sure that the rate will move about, as it is supposed to in a floating regime. It has remained fairly steady over recent months, notwithstanding problems in the bond markets, and the Bank has not intervened in any significant way since last September. We are happy with that situation. If, however, the rate does 'overshoot' in a major way – in either direction – we stand ready to intervene.

As I said earlier, intervention can sometimes help, but the bottom line, realistically, is that potentially disruptive, short-term capital flows are something we have to live with. They cannot be 'regulated away': we have to play with the cards that are dealt. The main contribution the Bank can make to promoting greater stability is through a monetary policy which keeps inflation in check, while supporting reasonable economic growth. Low inflation facilitates low interest rates, which are more conducive to long-term investment and less prone to attracting the sort of capital that chases financial market volatility and high short-term gains.

Beyond that, the best response to excessive reliance on foreign capital (whether short or long-term) is to reduce our calls on it. This, as everyone knows, requires a better domestic savings effort, which comes back unfailingly to more private and, especially, public saving. On the latter, Tuesday's Budget papers provide

some reassurance. They show, for example, that budget outlays as a proportion of GDP are projected to decline continuously over the next four years; this story holds when the proceeds of asset sales are excluded.

The Budget papers also show that the deficit is now projected to be a little under 1 per cent in 1996/97, and to virtually disappear the following year. That is a comforting medium-term benchmark – especially compared with the more modest goals which many other countries are aiming for. But there can be no certainty that this projected medium-term path will match exactly the dictates of macroeconomic policy and debt management as the economic cycle rolls on. In the past, the Government has demonstrated a preparedness to take tough fiscal decisions, and I would expect the Government to display the same resolve in the future, if that should be necessary.