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EXCHANGE CONTROLS AND POLICY AUTONOMY - THE CASE OF AUSTRALIA 1983-88

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Introduction

The case for exchange controls under contemporary conditions is simple; they assist national governments in undertaking macroeconomic policies which may diverge from the norms deemed acceptable by international financial markets. Specifically they allow a government committed to expansionary financial policies to limit the extent to which outflows of capital force excessive currency depreciations or interest rate increases. Part of the case in favour of abolishing exchange controls is that such policy independence is actually undesirable; in the context of the current debate in Sweden on the issue Calmfors has put the point particularly sharply:

> ..in my opinion, free movements of capital appear desirable from the standpoint of stabilisation policy. A stabilisation policy that accommadates domestic inflationary disturbances becomes untenable if it rapidly results in capital outflows that threaten the foreign-exchange reserves. As a result, greater discipline is imposed on both monetary and fiscal policy; accordingly, fundamental imbalances need not arise. Thus, currency flows should function as a clear signal that policies need to be changed. (1985, p.91).

In contrast, the starting point for this paper is that capital flows, motivated by expectations in capital markets as to the results of expansionary policies may ensure the failure of such policies, even when they would otherwise stand a good chance of success. If it was the case that only actually unsustainable expansionary packages are judged by the markets to be unsustainable, then a capital outflow which forces the premature abandonment of such a package could be judged to be in the interests of society as a whole. If, however, there is a real chance that growth and employment objectives could be met, perhaps at the cost of a higher inflation rate but without accelerating inflation, then the power of capital outflows to abort such a package simply serves the sectional interests (and reflects the fears) of financial capital.

Consideration of a single example of abolition of exchange controls can never definitively settle such fundamental issues. Nevertheless the case of

Australia is particularly interesting because an extensive set of exchange controls were abolished in 1983 by a Labor government committed to expansionary policies which were out of line with the trend in the OECD countries at large. Australia also represents a case study for the other central question in the exchange controls debate - can they work? If exchange controls are ineffective given current levels of international economic integration (extent of trade and ownership links), then their costs in terms of micro-inefficiencies may well outweigh the benefit in terms of policy autonomy, even assuming that such autonomy is desirable.

Part I of this paper describes the exchange control system operating in Australia in the early 1980's, the arguments for its abolition and the course of events which precipitated its being scrapped. It looks therefore at the effectiveness of control and the political economy of decontrol. Part II charts the course of macro-economic policy under the Labor government, the trend towards restrictionism and the role of the foreign exchange markets in dictating the periodically chaotic pattern of events. The conclusion attempts to draw some broader lessons.

Part I

Control and Decontrol

At the beginning of the 1980's Australia still had an unusually controlled and regulated financial system described, by a foreign critic, as "a rigid structure often unresponsive to market opportunities, market segmentation impeding the flows of capital amongst sectors and administered prices and quantitative controls that failed to clear markets" (Carron, 1983 p.195). The extensive system of controls over foreign exchange was, therefore, part of a wider system of control which came under detailed scrutiny

by the Campbell Committee of Inquiry into the Australian Financial System[1].

The details of domestic financial regulation, and the process of deregulation which unwound it, is beyond the scope of this paper and we shall not attempt any kind of critique of the principles underlying the Committee's deregulatory recommendations. Nevertheless the fact that the abolition of exchange controls and the floating of the dollar took place in this broader context is important. These particular changes were quite widely seen as part of a more or less inevitable process of modernisation of the financial side of Australia's economy. The Australian Financial Review (the respected daily newspaper concentrating on finance, politics and economics) greeted the decision to abolish exchange controls and float the dollar with the banner headline A Brave New World and the claim that "The revolutionary changes implemented today in foreign exchange markets take Australia into the penultimate stage of deregulation of the financial system ...Nine months into office the Hawke Government has achieved much of the brave new world outlined two years ago in the Campbell Committee's report on the Australian Financial System" (AFR December 12, 1983).

The previous conservative government of Malcolm Fraser had instituted a number of important changes on the domestic financial front, including the removal of interest rate ceilings (save for the important home loan sector) and quantitative guidance for trading banks, the relaxation of portfolio controls on savings banks and the introduction of a tender system for Treasury bonds. International financial relations, however, were still heavily controlled. We shall first describe the fixing of the exchange rate and the system of exchange controls before providing some evaluation of the circumstances surrounding their abandonment.

[1] Set up in January 1979 with five members, drawn from the financial sector, its final report was published in September 1981. Its report will be referred to as Campbell.

1. The Exchange Rate

The value of the $A was fixed in terms of a trade-weighted index (TWI) under an adjustable peg system; this had evolved (in 1976) out of earlier attempts to manage a fixed rate first against the US dollar and subsequently against a trade-weighted index (TWI). The rate was fixed each day, with the stated intention of the authorities that "movements in the level of the rate take place by means of frequent small shifts" (Campbell p.115). In the two years prior to the election of the Labor Government, for example, the nominal rate had first moved up steadily by around 10% (over 7 months) and then declined, again rather steadily, by about 12% over the rest of the period. Substantial Reserve Bank intervention took place, and not all "leaning into the wind"; as Argy (1987) recounts the authorities, worried about the current account, were selling Australian dollars in 1982 to edge the exchange rate down in the face of capital inflows.

The Spot Market was operated by the trading banks, acting in effect as agents of the Reserve Bank which limited their foreign currency holdings to "reasonable working balances" (Reserve Bank, 1979 p.5.8). Exporters and importers could cover on the Forward Market. The Reserve Bank effectively set the rates in the market and acted as the underwriter as the banks were required to balance their books with the RB. There was also an unofficial hedge market where risks ineligible for the official market could be matched (see below).

2. Exchange Controls

(a) Trade

Payment for exports had to be received within six months and pre-payment was limited to one month (with corresponding restrictions on

payments for imports) and the Reserve Bank attempted to ensure that reported transactions were at their "true market value" (to limit leads and lags and control surreptitious capital movements through under or over-invoicing). Export proceeds had to be sold immediately to a bank in Australia, although permission could be granted to hold funds outside the country for 1 month if they were to be used for an approved purpose. Forward cover had to be requested within 7 days of the risk being incurred (aimed at limiting to the trade flows currently taking place the swings in the amount of forward cover the authorities would be obliged to provide); forward cover was denied to capital transactions.

There is no doubt that these regulations had a substantial effect in limiting the flexibility of traders in covering their risks. For example, evidence to the Campbell Committee reported of the 7-day rule that "the degree of protest [from companies surveyed] indicates that it has a substantial degree of effectiveness". (Syntec, 1982 p.63). Of course the time period allowed for payments and receipts was quite long (by comparison to some European countries for example), thereby allowing substantial room for the use of leads and lags for speculative purposes.

(b) Australian Investment Overseas

* was banned in short-term fixed interest assets (eg bank deposits) other than certain working balances;

* was limited in long-term fixed interest securities to A$10,000 per individual and $1 million per company per year (these had been banned before 1980);

* was unrestricted in equities and real estate (restrictions similar to those still in force for long-term fixed interest securities were relaxed in 1980 and abolished in 1981);

*direct investment was supposed to meet various conditions such as the

promotion of Australian exports.

Whilst there was a fairly large amount of direct investment overseas (some A$6 billion, over half of which was in ASEAN countries or New Zealand), holdings of overseas financial assets by both financial and non-financial sectors was extremely low (less than A$2 billion). This confirms Syntec's conclusion on fixed interest portfolio investment "the major benefit of this control would seem to be in limiting the potential volatility of short-term capital flows. In this respect these quite rigid controls are considered effective" (p.41).

(c) Overseas Investment in Australia.

* short-term fixed interest (eg bank deposits) was unrestricted except for overseas banks (including Central Banks) which were permitted to hold only working balances;
* portfolio (long-term fixed interest and equities) was unrestricted except that on occasion (between 1972 and 1978) short-term borrowing from overseas was prohibited and a Variable Deposit Ratio (to be deposited interest free with the Reserve Bank) was imposed on longer-term borrowings; timing of drawings on, and repayments of, overseas loans to Australian companies were monitored;
* direct investment in Australia had to meet stringent conditions (connected to concerns about ownership and control).

These regulations had not prevented a very substantial level of overseas investment in Australia, both direct and portfolio (A$ 27bn and A$ 24bn respectively). But the point to emphasise here is that the low level of Australian investment abroad meant that almost all this gross investment in Australia represented net investment - at some 23% of GNP (book values) this net investment reflected Australia's traditional role as a capital importer with relatively little of the capital inflow being re-exported.

3. Campbell's Criticisms Vindicated?

The criticisms and proposals of the Campbell Committee in the field of exchange rate management and exchange controls were undoubtedly influential in framing the outcome. Moreover the bout of speculative pressure which hit the Australian dollar at the time of the March 1983 election seemed to vindicate many of Campbell's observations. This latter episode is important because it forced the Labor Government to devalue by 10% as soon as it was elected, an incident which must have had a very substantial effect on its subsequent policy decisions. Before analysing the post-election devaluation we discuss the Campbell Committee's arguments.

(a) **The Campbell Committee's Evidence and Arguments**

The Campbell's Committee's first conclusion on exchange rate management was that "the degree of flexibility available to the authorities would be greater under a system of managed floating" (p.116), so that the present system of fixing the rate should be abandoned and the "exchange rate should thereafter be determined in the market and the authorities should deal in the market if they wished to promote a particular rate" (p.117). The Committee was careful to point out that this essentially technical decision on having a market-determined rate did not imply any particular level of intervention. Their own recommendation, however, was that "any official intervention in foreign exchange markets (apart from technical smoothing) should be relatively light, infrequent and only for short periods" (p.129). Their preference for a "lightly managed rate" rested on their view that "exchange rate targeting" would "impede the achievement of a stable monetary environment and lead to less autonomy in domestic economic management" and would not "necessarily produce more stable exchange rates over a longer period and may indeed add to instability" (p.121). The latter

argument was based on doubts as to the authorities' capacity to judge equilibrium rates and evidence as to central bank losses on exchange rate interventions.

The Committee accepted that a managed float could "co-exist" with exchange controls. They argued, however, that continued use of exchange controls would be justified only if:

* there are significant macroeconomic benefits to be derived from maintaining an exchange rate substantially different from the free market rate for long periods;
* exchange controls are effective in regulating short-term capital flows, and therefore assist the authorities to manage the exchange rate with less monetary disruption; and
* the macroeconomic benefits of exchange control outweigh the costs (p. 139).

As we have seen the Committee did not accept the first proposition. In the event the Reserve Bank was forced by speculative flows into much more active intervention than Campbell (or indeed the Reserve Bank at the time of floating) envisaged. In any case, the disastrous swings in exchange rates during the 1980's have so shifted the tide of official international opinion in favour of managed rates (as evidenced by the Louvre accord, Chancellor Lawson's conversion to intervention etc.) that the relevant issue now is rather whether exchange controls can make a significant contribution to exchange rate management.

Campbell took the view that the costs of exchange control were substantial, especially in respect of "restrictions on the flexibility of business and its capacity to take initiatives and grasp investment opportunities" (p.143). Not surprisingly the evidence they received emphasised the heavy administrative burdens involved, but it is hard to imagine that these could be of the same order of magnitude as the benefits from a markedly improved macro-economic performance (a possibility Campbell discounted). It should also be noted that such complaints ignore the micro-economic costs of any greater exchange rate instability which could follow

from abolition of controls. The complainants looked at the impact of controls on the costs and flexibility of the foreign exchange transactions they would have liked to undertake in the existing situation, ignoring the additional transactions that they might feel obliged to undertake in conditions of greater instability.

But the issue of the effectiveness or otherwise of exchange controls in limiting short-term capital movements cannot be sidestepped so easily. The Committee's basic conclusion was that:

> in today's world of closely interrelated financial markets, exchange controls could not prevent appreciable movements of capital into and out of Australia in pursuit of interest arbitrage or speculative foreign exchange gains, if the exchange rate is markedly out of line with market expectations. (p.121)

The Committee believed that most studies suggested that "while controls may affect the transactions categories directly covered, they are (after a time) largely or completely offset by compensating adjustments elsewhere" (p.141). Whilst this view was widely held, Argy's recent review concludes "there is no hard evidence on this". He also points to the work of Carland and Valentine (1982) showing that controls did drive a wedge between domestic and foreign interest rates and adds that "from about mid 1978, after controls over inflows were removed, until end 1983 the covered differential significantly and persistently favoured overseas investment" (Argy, 1987 p. 43). The surge in outflows that was observed after abolition of controls (see below) also suggests that the controls had had a very considerable effect.

It would be foolish to write off the almost unanimous view of market participants, both on the official and private sides, that controls had a tendency to erode as the private sector found ways around them and learned how to dress up its applications more plausibly. The Reserve Bank appears also to have relaxed some of its formalities in 1979 (see Syntec, 1982 p.

45). Nevertheless the case for a necessarily fatal erosion of the effectiveness of controls was certainly not convincingly demonstrated by Campbell.

All this is not to claim that the controls then in force could prevent major short-term speculative movements. The Campbell Committee used the obvious fact of gaps in the existing framework of controls as justification for abolishing them. Their reason for advocating the removal of controls on overseas investment in Australian deposits and Australian investment in overseas securities and deposits (the latter described in the Syntec Report as the "lynchpin of the set of controls which are designed to govern short-term outward movements of capital") is instructive:

> The Committee is conscious of the concern of the authorities that these types of accounts could accumulate over time and become a source of potential speculative "overhang". It notes, however, that privately held foreign exchange balances can at times act as a stabilising force in the market. Moreover there is already a large volume of ongoing and accumulated overseas equity and interest-bearing investments in Australia. There can also be substantial 'leads and lags'. These funds can be extremely mobile and can also be viewed as a potential overhang. Finally, it should again be pointed out that under a more market-oriented exchange rate system, the potential capital flows would generally impact on the exchange rate rather than on domestic monetary conditions. (p.148)

Sandwiched between their optimism that destabilising speculation may not happen and their complacency about the domestic impact of exchange rate changes if it does happen, there is a significant argument. This is that controls aimed at preventing short-term capital flows were pointless because such flows could happen quite legitimately under the existing controls. In particular it has been argued, although not emphasised in the Report, that private sector financial innovation was ineluctably increasing the extent of such legitimate flows (in which case the effectiveness of the old controls would be undermined). This line of argument is exemplified by the growth of the private hedge market (for forward transactions) and overseas markets for the Australian dollar. We examine these rather technical issues in the

Appendix, concluding that the effects of such innovations may have been exaggerated.

Our examination of the evidence about capital flows and interest rates and our discussion of the new financial markets leaves a verdict of "not-proven" on the Campbell Committee's judgement, quoted earlier, that exchange controls could not have a sufficient impact on short-term speculative movements. However their view that existing controls were insufficent was clearly demonstrated by the events surrounding the election of March 1983, to which we now turn.

(b) **The 1983 post - Election Devaluation**

The key macroeconomic policies promised by Labour during the 1983 election campaign were:

* the creation of half a million jobs in three years;

* a growth rate of 5% by the third year;

This would involve an increase of the budget deficit of $A1.5 bn, whilst the programme promised that monetary policy would "accommodate the stimulus without crowding out the private sector."

A few days before the poll fears that Labor would pursue expansionary policies and increase controls over the financial system led to capital outflows totalling several hundred million dollars a day. The Financial Review's Editorial sounded the alarm:

> Let there be no mistake. The Labor Party's policy does include greater regulation of the banks than is at present in force and greater federal regulation of the non-bank financial intermediaries....It is true however that the policies of a Labour Government would be more likely to require more regulation than has hithertoo been in place. This is the inevitable result of expansionism with little attention to inflation, to capital outflows and currency fears. (March 2, 1983)

After the election result was known the pressure continued. Two days before it formally assumed office the new Labor Government devalued by 10%. Four days later $2 billion of the $2.5 billion estimated to have left the

country during the election campaign was thought to have returned. Indeed the authorities immediately revalued by over one per cent, a much bigger jump in the managed rate than customary. This had the aim, according to the AFR, of reassuring "the financial community that the 10 per cent devaluation was at least in part a merely political response to a crisis which was not justified by the underlying trade situation, or relative inflation and interest rates" (March 15). The March devaluation, therefore, seems a classic case of a devaluation forced by market expectations of possible adverse effects (on inflation in particular) of the Labor Government being elected. After pointing out that sales of foreign exchange had been $2.3 billion in the first week of March, the Reserve Bank's Bulletin for April 1983 stated that:

> It is difficult to be precise about the nature of these outflows. The key factor was clearly the widely held view that the Australian dollar might be devalued to a significant extent. That prompted many transactors to take action to avoid the possibility of loss and some others to position themselves to profit from a devaluation if it occurred. Exporters sought to delay their receipts from abroad and importers sought to bring their payments forward. These leads and lags were a substantial contributor while another important factor was the extent to which overseas borrowings were repaid and replaced with domestic borrowing.(p.669)

That banks may themselves have been involved is suggested by the fact that the Reserve Bank "reminded" banks that they should not be trading in foreign currencies on their own behalf and there were rumours that rules would be tightened so that Australian borrowers raising money overseas would have to nominate in advance when the loan was to be repaid.

There was surprisingly little discussion at the time of the alternatives to devaluation; reserves were $5 billion, and Australia's credit rating AAA. A tightening up of exchange controls on trade payments and on private sector debt repayments, plus further official borrowing to shore up the reserves was surely a possibility. In a speech reported in the

Monthly Bulletin of the Reserve Bank (May 1985) the Deputy-Governor described the episode thus:

> Despite exchange controls, early in 1983 intense political speculation lead to very heavy capital outflows and the exchange rate was devalued discretely. This episode demonstrated that the prevailing exchange control system was not an effective barrier to short-term flows when exchange rate expectations were strong. (p.726)

The decision to devalue gave the speculators a huge gain and was reported leaving ministers "with the bitter taste of having lost $250 million to currency speculators". It signalled very early how the government would bow to market forces even in a case where it was convinced the pressures were in no sense justified by the underlying balance of payments position.

4. Abolition of Exchange Controls and Floating

There is no doubt that the immediate pressure behind the decision to float the Australian dollar in December 1983 arose from the difficulties for monetary control arising from speculative capital inflows. Argy's review of the decision runs as follows:

> The current account was beginning to show some improvement in 1983; at the same time the interest differential moved more in favour of Australia; moreover, some confidence in the new government was beginning to surface. These forces combined to produce a dramatic reversal in capital flows. In the months that followed inflows became massive; indeed for a while they were almost double the current account deficit. As in 1980/81 the authorities responded partly by allowing the dollar to appreciate and partly by intervening in the foreign exchange market. As in 1980/81 they found it impossible to sterilise the inflow. During these months the money supply was overshooting its projected range (revised upwards by one point in December) (1987, p.34)

But according to an apparently authoritative briefing, the Government's "primary reason" in the decision to float was

> not the effect on the money supply although this was the factor which prompted it to act so soon...Mr Keating and Mr Hawke were firmly convinced a month ago that it was the managed exchange rate itself which was causing the continued speculation against the dollar. Put most vehemently by the Reserve Bank, the argument was that with the Government showing last March that it was prepared to respond to speculation by substantially devaluing the currency, the mechanism of

small discretely managed shifts had been fundamentally undermined....

When Cabinet's Economic Policy Committee met at 3.45pm on Friday after the early morning announcement that the exchanges were to be closed for the day, the decision to float was almost inevitable. Three options were put to the committee. The first was to revalue, the second was to impose short-term currency controls to stem the inflow of capital, and the third was to float.

The first option was rejected on the basis that it would merely confirm that the Government was being manipulated by the market.

The second was rejected because it would undermine business confidence that the Labor Government was innovative and not locked into traditional responses. (AFR, December 12 1983)

The Bank recorded its explanation for abandoning controls rather more technically: "The authorities could have sought to deal with these unwanted flows trhrough direct controls. The Bank saw these as a last resort, prone to create distortions in financial markets and likely to have limited and only short-run effectiveness." (Report 1984 p.3).

This, of course, was not a line of argument which would find favour with the left of the Labor Party and the trade unions. In October 1983 the ACTU's submission to the Martin Committee, set up by the Labour Government to review the findings of the Campbell Committee, had endorsed "the retention of existing arrangements for exchange rate fixing and the retention of controls necessary for exchange rate targeting" (ACTU p.12). The AFR reported that:

> Basically ministers were objecting to a managed system because it was causing speculation against the Government. They believed that if there was to be speculation, let it be among the speculators themselves. This is one argument which will help to sell the decision to the party. (Dec 12, 1987).

Such arguments seem to have been successful. Laurie Carmichael of the Metalworkers Union offered what seems to have been a lone objection: "the Government should have imposed foreign exchange controls to cope with the speculative inflow problem..the float decision was a blow to the solar plexus of the Accord" (AFR Dec 12, 1983).

One very important issue which received little attention was the fact

that the decision to float of itself did not imply the wholesale abolition of exchange controls.[2] Indeed numbers of countries had floated without abolishing exchange controls (for example the UK in 1972). Given the danger of capital flight in the future, and the problems a major depreciation would pose for the Accord with the trade unions in terms of reduced real wages, the decision to abandon controls on capital outflow (short-term fixed interest, long-term portfolio or direct, leads and lags and repayments of borrowing by Australian companies) was of more long-term significance than the decision to respond to the inflows by floating.

The decision to abolish the controls was explained, some two years later, by the Deputy Governor of the Reserve Bank:

> The Government decided to float the Australian dollar. The decision having been taken, there was not a strong case for retaining exchange controls, which were largely directed to protecting reserve holdings and supporting the managed rate system. They were abolished virtually overnight (RB Bulletin May 1985 p.726).

But of course the technical abandonment of a fixed rate does not imply a passive acceptance of whatever rate the market chooses to deliver. Acknowledging that the exchange controls then in force could not prevent severe speculative pressure (as the 10% devaluation had shown), did not entail abandoning the controls which would make potential speculative pressure worse. Whether or not such arguments were put, they clearly did

[2] After December 8, the only serious controls which remained were:
(i) over foreign direct investment in Australia (and it was noteworthy that two weeks after the decision to float it was announced that the ALP's policy of increasing the required domestic participation in mining investment from 50 to 51% and its extension to manufacturing was dropped).
(ii) over holdings of $A by overseas Central Banks, monetary authorities and commercial banks on the grounds that Australia did not want the $A turned into a reserve currency; according to the Reserve Bank this latter restriction was aimed at reducing "short-term flows based on purely "market" considerations" (in which case it was not clear why it applied only to overseas financial institutions.
(iii) although the forward market was freed from official intervention only trade transactions were eligible for cover in the forward market.
The latter two controls were subsequently cancelled.

not carry the day. It is tempting to believe that part of the reason for the conversion of the Treasury and Reserve Bank to the case for abolition of exchange controls (which both had opposed at the time of their evidence to Campbell) was the feeling that the greater openness of financial markets would weaken the ability of a Labor government to behave in an "irresponsible" way. Whilst the move to a floating rate could certainly be seen as enhancing monetary control (see Harper, 1986), abandoning exchange controls would actually reduce monetary control under any circumstances in which speculation made substantial intervention necessary (a possibility hardly to be ruled out). As pointed out in the financial press, however, the freeing of the exchange markets meant that the constraints placed by the financial markets on the government were even tighter:

> The Treasurer argued that by floating the dollar the Government would be forcing the market to determine the value of the dollar on the basis of the strengths and weaknesses of the economy. But inherent in this approach is the acceptance that the Government has an enormous responsibility to keep the economy stable....Accordingly the pressure is now on Mr Keating to keep his Budget deficits closely attuned to the stability requirements of the foreign exchange markets. (AFR December 16, 1983)

The second part of the paper analyses how this pressure was exerted and to what effect.

Part II

Macroeconomic Outcomes and Policies

The years of Labor government have seen substantially faster growth in Australia than in OECD as a whole - just over 4% per year from 1982/3 to 1987/88[3]. Exports, and public expenditure in the first half of the period, provided the main impulses for the rapid growth. Since 1983/4 employment

[3] All data in this paragraph is from Budget Statement 1987-88 No 2, Estimates of Capital Stock 1985-86 and OECD Economic Survey of Australia 1987/88.

growth has been around 3% per year which has kept consumption growing despite the reduction in real wages secured under the Accord[4]. The impact on registered unemployment has been modest (down from 9.3% to 7.8%) because of rapid labour force growth (especially female participation). The current account deficit expanded from an inherited 4% of GNP to 6% in 1985/6. The deterioration in the terms of trade (costing 3.5% of GNP), and deterioration in the balance on property incomes (costing almost as much) as external debt and interest rates rose, wiped out the impact of growing net export volumes. Subsequently the slowdown in domestic demand growth and improvement in the terms of trade reversed this trend so that the Treasurer could forecast a deficit reduced to 3% of GNP for 1988/89. Inflation in the range 8-9% in 1986 and 1987 was far above the average rate for OECD, but began to decline after the middle of 1987.

The outstanding weakness of the macro-economic pattern lay in the stagnant business investment. Only in 1984/5, before the turn towards restrictive policies, did business investment rise strongly. By 1987/88 its level was still no higher than in 1981/2 and the growth rate of the business capital stock had slipped from around 4% per year to less than 3%, no more than the growth of employment; the manufacturing capital stock was virtually static over the whole period. Investment failed to recover strongly despite the rapid growth and a recovery in the profit rate of about one third after 1982/3 t o a rate similar to that of the late seventies. Weakness of investment was reflected in very slow productivity growth - around 1 1/2 per cent per year after an initial spurt in 1983/4.

The Labor Government faced the real constraints posed by the balance of payments of payments weakness, and the necessity to devote substantial real

[4] By 1987 average real earnings were some 4% below the 1982 level; the Award rates handed down by the Arbitration Commission showed a substantially larger fall.

resources to improving it (some 1% of GNP were shifted into net exports in the two years 1985/6 and 1986/7). Under these circumstances rapid employment growth implied either very low productivity growth so that demand for labour rose rapidly in the market sector or rapid reductions in hours of work (which would have the same effect) or big increases in employment in the state sector. Either way, take-home pay had to rise slowly, but with the second or third possibilities real welfare could still grow substantially through increased leisure or improved social services. The Australian pattern corresponds more closely to the first possibility, not at all what the trade union movement had in mind when it negotiated the Accord. The OECD'1987/88 Survey of Australia features a chart showing the very parallel employment record of Australia and the USA in the eighties, but does not point out that both economies have shared the same low wage growth/ low productivity growth route to high employment (see Glyn, 1988).

Thus it is clear that floating the $A and the abolition of exchange controls did not prevent a growth of employment which is impressive by the standards of EEC countries. The role of the Accord is obviously crucial here, but lies outside the scope of this paper (see Archer, 1987). But the impact of floating and abolition on the course of the government's macroeconomic policy, and thus the form of this rapid employment growth remains a central question. We discuss first how policy was influenced by international financial pressures, before looking more broadly at the patterns of fiscal and monetary policy and the course of the exchange rate and capital movements.

1. The Pattern of International Financial Pressures

The outgoing conservative government had presided over a 4 percentage point rise in Australia's unemployment rate, the first year-on-year fall in

GDP since 1952-53, combined with an inflation rate of 13% (about double the OECD average) and a current account deficit of 4% of GDP. In an effort to cope with this uncomfortable combination the conservative government had reversed its commitment to free market principles with a wage freeze and introduced an expansionary budget (see Davis, 1987). It became apparent soon after Labor was elected that the budget deficit was increasing much faster than anticipated; indeed the OECD's calculations (Economic Outlook, various issues) suggest that in 1983 the general government structural deficit increased by 3% of GDP. Paradoxically this allowed Labor both to cut (the increase in) the deficit and still run an extremely expansionary fiscal policy.

In May 1983 a package of measures, including spending cuts of nearly A$1bn, was seen as having "rejected the expansionism proposed during the election campaign" and "the sensitivity of the Government to the reactions of financial markets was apparent" (AFR May 20, 1983). In June, Hawke and Treasurer Keating "made their first official marketing pitch to the New York financial community last week with one clear intention - to put to rest any fears of the Mitterrand factor." (AFR June 21, 1983). When the budget deficit of A$8 billion was announced, the Reserve Bank placed on the record in its Annual Report the view it had put to Keating that "a deficit of that order might conceivably be financed without unmanageable financial pressures." (1983 Report p.8). In his Budget speech Keating said that "unless the structural deficit were to be reduced, strong recovery in the private sector would ultimately bring about a clash of funds between the two sectors and thus put at risk the recovery".

Despite these soothing words the structural deficit increased further in both 1984 and 1985 (by some 0.7% each year according to the OECD) so the small declines in the actual deficit simply reflected cyclical factors.

This was not lost on financial commentators who greeted Treasurer Keating's 1984 budget with some scepticism:

> A Government which placed enormous store on gathering business confidence to underpin a lengthy period in government has jeopardised the fledgling trust afforded to it by influential sections of that community. By using the funds which flow to the Treasury due to strong economic growth to fund additional expenditure rather than cut the deficit or further reduce taxes the Government has tarred itself as a big spender.
>
> Mr Keating's statement that he did not think it wise to have reduced the structural deficit because it would take aggregate activity out of the economy certainly indicated a lack of confidence in the private sector's ability to take further responsibility for recovery from the public sector. (AFR August 24, 1984).

Disquiet about budgetary policy did not coalesce into a serious crisis during 1984, but must have been the explanation for the Prime Minister's "Trilogy" commitment during the successful election campaign at the end of the year: his government would reduce the ratios (to GDP) of public spending, of taxation and of the budget deficit.

Difficulties in interpreting monetary aggregates as deregulation of financial markets proceeded caused the government to abandon its broad money target in January 1985. Nevertheless the trend in the exchange rate was if anything upward during 1984 and it seemed therefore that the Government's perceived pro-market stance[5] was proving very successful in securing room for government led expansion without destabilising the foreign exchange markets. But the lull proved temporary. The AFR reported at the end of the year:

[5] The Government allowed foreign banks authority to operate (16 licences were eventually granted in February 1985), with Keating meeting Labor Party opposition by claiming ingeniously that such institutions had "led the industrial regeneration of Germany and Japan" (reported in AFR July 7 1984). This decision provoked much more discussion than abolition of exchange controls (see the interesting analysis by Harper, 1986). Whilst it contributed to the integration of the Australian financial system into international markets, its significance, from the point of view of the macro-economic concerns of this paper, is rather limited. Such integration was permitted by the abolition of existing controls and would have happened without the direct involvement in Australia of overseas banks.

> Traders and analysts are only now coming to contemplate the impact of the manically depressed commodities market on the Australian economy and question whether as a result the Australian dollar is somewhat overvalued (December 13, 1984).

"Somewhat" was soon to prove a rather dramatic understatement.

Over the next eighteen months the government was buffeted by a series of violent foreign exchange crises, concentrated in particular on the periods: February - April 1985; November 1985; May - August 1986. In these three periods the value of the $A against the TWI fell by 22.4%, 6.2% and 19.8% respectively. By September 1986 the rate was 41.8% below that of December 1984; allowing for relative inflation rates the effective depreciation (as calculated by Morgan Guaranty's World Financial Markets) was 34.2%.

The columns of the Australian Financial Review convey the flavour of these periods of crisis and the perceived impact of international financial markets on domestic policy.

Feb 21 Interest Ratchet Up as $A Slides Further

> If the Federal Government had not discovered the real meaning of the floating of the currency, apart from gongs from international financial magazines[6], the profound shock experienced in the market for the Australian dollar this month must be finally bringing it home...
> general perception that in contrast to the picture widely held 18 months ago of a Government of pragmatic economic managers thought to be running a sound economy, the Government is not prepared to make hard decisions, and despite high nominal interest rates, is running a slack monetary policy....
> A number of factors have been blamed for the currency's decline, including the widening current account deficit, the abandoning of monetary targets, the public service dispute, the Budget deficit and the MX missile crisis.

Public spending cuts, a substantially reduced budget deficit and what was regarded as a moderate wage settlement failed to prevent another selling bout in November and interest rates were hiked up again.

[6] Treasurer Keating had been named Treasurer of the Year in 1984 by Euromoney magazine.

Nov 13 Australia's trade problems worsen..Government admits that growth needs to be wound back...but world markets keep undermining dollar

The Hawke Government's much vaunted clean float of the $A is turning into a nightmare as the foreign exchange market's downhill bandwagon was triggered again by its bearish interpretation of last month's balance of payments figures.

When the $A was floated nearly two years ago, the Federal Treasurer, Mr Keating, declared that "the speculators will now be speculating against themselves rather than against the Australian Government".

But while it can be forcefully argued that there was no alternative but to float, the exchange rate now threatens to undermine the Government's Accord-based economic strategy....

Feb 6 The Aussie dollar is likely to go through similar bouts of apparent recovery and dashed hopes as long as the main support for the currency is unreliable capital inflows attracted by the positive interest rate differential.

Behind the tension over monetary policy is the conflict between the finance sector's demands for moderate economic growth in the order of 2-3% and the Hawke Government's need for 4-5% to make inroads into unemployment.

The influential magazine Euromoney reported, in its generally positive February 1986 special supplement on Australia, the government's determination not to be "railroaded into important changes of policy by economic indicators which it considers of transient importance". It noted however that, should the foreign exchange dealers change their assessments of the $A for the worse on the basis of such indicators, the government would be forced to do "Much the same as it did when the 1985 depreciations happened - only more so. Keep monetary policy tight. Keep fiscal policy tight. And - renegotiate the Accord with the unions to keep wage increases tight as well" (Feb 1986 Supplement p.18). This proved prophetic.

In a notorious interview in May the Treasurer said that lack of discipline over wages and economic policy, in the face of depressed commodity prices, would drag Australia down to the status of a "Banana Republic". Selling pressure built up and in July he was forced into a humiliating retreat over the tax treatment of interest paid overseas, with the AFR reporting that the government was "struggling to maintain some control over the economy." A further rise in interest rates, and cut in the

Commonwealth Budget Deficit to $3.5 billion rapidly followed.

The AFR summarised the situation as some stability was restored:

> Sept 5 The $A crisis of late July/early August forced the Government to undo nearly all its strategy over the first half of 1986 to gradually bring down interest rates, as it tightened fiscal and wages policy. Now, the Government is almost back to where it was when it hiked up interest rates to halt last November's currency crisis. (September 5, 1986)

The financial pressures dramatised in the crises of 1985/86 kept the restrictive trend in policy in place over the succeeeding two years. There were further bouts of selling pressure on the foreign exchanges, notably at the time of the July 1987 election campaign[7] and again after the October stock market crash. But the general trend of the Australian dollar was upwards; by the autumn of 1988 it had regained two thirds of its real depreciation of 1985 and 1986.

In order to assess the overall impact of international financial deregulation, we will analyse in turn fiscal policy, monetary policy, the exchange rate and the pattern of capital movements.

2. Fiscal Policy

As already described the announced cuts in the budget deficit in the early years of the Hawke government concealed a rise in the structural deficit for the general government sector of some 4.5% of GDP between 1982 and 1985, one of the most expansionary episodes of fiscal policy in any OECD country in the 1980's (OECD Economic Outlook). Nevertheless in 1985 the

[7] On this occasion, as well as intervening heavily, the Reserve Bank, took the "highly unusual step of publicly reassuring foreign investors that it was supporting the currency" (AFR July 9, 1987). The Financial Review noted that the authorities feared a repeat of the 1983 election flight of capital when "ironically, investors feared a Labour victory. This year, the money market's bogeymen reside in the Howard [Liberal] camp". This must have been one of the few instances in the history of social democracy that the speculators were frightened of conservative victory !

deficit was only some 3% of GDP, below the OECD average. Australia's ratio of gross public debt to GDP was one of the lowest in OECD countries and it ranked in the bottom half of net debt ratios as well. Moreover, according to the OECD's calculations (Chouraqui et al, 1986) Australia's mid-1980's level of public sector deficit would not lead to a long-term rise in the debt ratio. Accordingly the sustained squeeze on the government spending, which reduced the general government deficit to zero in 1988 (via a 2 1/2% of GDP fall in the structural deficit) cannot be justified on the grounds that the deficit was excessive in relation to other comparable countries. Whilst many of the tax measures (capital gains tax, business expenses, more effective monitoring of evasion etc - see OECD Surveys of Australia 1986/87 and 1987/88) introduced by Labor were of a progressive nature, it is likely that without the pressure of the financial markets they could have been used to fund additional welfare spending rather than retirement of the national debt. In return for extraordinary restraint in bargaining for take-home pay, workers received only modest improvements in the social wage (see Norris, 1987), which in turn meant that the public services contributed little to the expansion of jobs and reduction in unemployment.

3. Monetary Policy

Soon after monetary targeting was abandoned the Reserve Bank announced a "checklist" approach whereby monetary aggregates, interest rates and exchange rates were all assessed. There seems little doubt that the exchange rate has come to assume a major importance in decisions over monetary policy. The strong increases in interest rates when the Australian dollar was under pressure, and downward creep in rates during periods of recovery (early 1986, 1987) are evidence for this. It is also confirmed by the references to the exchange rate in the Reserve Bank's own explanations

of its actions, of which the following is a clear example:

> Monetary policy was tightened sharply on two occasions during 1986/87. In the period leading up to the Budget in August 1986, there was widespread uncertainty and lack of confidence. The exchange rate became the pressure point. A further major fall in the value of the Australian dollar at that time would have been unhelpful both practically and psychologically. The fall in the Australian dollar over the previous 18 months had provided an adequate basis for progressively correcting Australia's external accounts - if other policies were adjusted appropriately and business attitudes responded. Changes in other policy instruments were still to be announced; until they were, options were few. Monetary policy had to be tightened abruptly. The Bank took the unusual step of raising its rediscount rate ahead of the market rate to signal the tightening; market interest rates rose sharply; and large sales of foreign exchange took place out of reserves (RBA 1987 p.12).

The impact of interest rates on investment is as controversial in Australia as elsewhere. What cannot be denied is that real interest rates have been very high in Australia, running about the same as the average for the biggest 7 OECD countries with the long-term real rate being about 2 percentage points higher in 1985. Real investment has been the most signal failure of the government's strategy, with the resultant slow growth in productivity condemning workers to, at best, continuing stagnation of living standards.[5] Moreover the interest rate and exchange rate uncertainty, which has undoubtedly been exacerbated by the abolition of exchange controls and resulting vulnerability of policy to the vicissitudes of international financial confidence, must have further contributed to the weakness of fixed

[5] It is striking that the proportion of corporate profits paid out as interest and dividends is extremely high in Australia. Over the years 1983-84 to 1985-86 net interest and dividends paid by private corporate trading enterprises was an extra-ordinary 73% of net operating surplus. After deducting taxation, this has left undistributed profits making a negative contribution to net investment (in contrast to the postive one in the UK and USA). There are complex problems of inflation accounting involved and shareholders may have benefitted from the high gearing; moreover the fact of negative undistributed income (revealed by the new national accounts which value depreciation at replacement cost) has been a feature of the last ten years so cannot be blamed exclusively on recent interest rate policies. Nevertheless it is hard to imagine that the cash flow implications of this have not been a contributory factor in the weakness of investment (see for example the article by John Brunner, Chief Economist of BHP in the AFR August 12, 1986).

investment.

4. The Exchange Rate

The very fact of interest rate policy being geared towards the exchange rate is itself evidence of the float being "dirty"; as we have already seen. Reserve Bank intervention has also been much more extensive than intended. After the crises of early 1985 the Reserve Bank stoutly maintained that "it did not take a view on where the dollar should settle, nor did it seek to support or produce any particular exchange rate outcome. The main object was to keep in touch with the market, to ascertain the nature and strength of the factors at work and to reduce the degree of voiatility. This approach still resulted in substantial net sales of foreign exchange by the Bank" (RBA 1985 p.8). The estimates they gave were of sales of around US $250 million in both February and April. The November 1985 crisis saw intervention of nearly US $400 million, again with the object of "testing the pressures at work and their strength" (RB Bulletin Feb 1986 p. 10). Intervention was much heavier in the July/August 1986 crisis (some US $1.2 billion net sales over the two months); more concentrated still in January 1987 (US $1.2 billion in a few days) and was estimated at $2 billion in the days after the stock market crash.

Whilst it is true that the external environment has been more turbulent than was anticipated (notably the gyrations of the $US), this heavy management of the exchange rate was obviously a retreat from the extreme free market optimism evinced by the Campbell Committee and more widely at the time of the float. The notion that the market should be free to determine the exchange rate supposed either that speculation would be stabilising or that the exchange rate did not matter much. Optimism as to the former proposition was still being expressed early in 1985 by the then

deputy governor of the Reserve Bank : "so far our experience bears out the advice of the Committee of Inquiry that private sector holdings of foreign assets, and foreign holdings of domestic assets could be factors of stability rather than simply a possible source of speculative flows across the exchanges" (RB Bulletin May 1985 p.726). A couple of years later his successor admitted; "Our market, like other foreign exchange markets, is a highly strung piece of equipment, prone to react suddenly - sometimes violently - to changes in the news, fundamental or otherwise " (AFR Dec 11, 1987).

The problem, as Keating admitted in a speech in London in November 1985 was that : "In today's world, decisions taken in the great financial centres like London and New York significantly affect our very open financial market, and, through that, the Australian economy" (Euromoney Supplement February 1986, p.18).

Although the Bank has firmly denied that it has sought to maintain a particular rate "by the latter part of 1986 however it was generally believed that the clean float had been dirtied - first by the authorities selling foreign exchange to prevent the $A/$US rate going below .60 and later by them buying foreign exchange to prevent it bouncing back above .67. That "ceiling" gradually increased into the 70 cent range in the first half of 1987 (as the US dollar gradually weakened) and further possible increases were prevented by allowing interest rates to fall" (Davis, 1987 p 35). Discussion about the desirability of abandoning the attempt to cap the dollar (by this time around 0.73) was overtaken by the stock market crash and the huge Reserve Bank intervention it provoked.

By March 1988, however, the post-crash fall in the dollar had been reversed. By August 1988 a further 18% real revaluation had taken place, and the Australian dollar's real rate had lost practically two thirds of the

increased competitiveness that resulted from the succession of dollar crises. If the initial fall in the exchange rate was necessary, as many argued, to restore competitiveness to Australia's manufacturing industry, then the subsequent rise during 1988 carried disastrous implications. If the earlier fall was not dictated by longer-term considerations, then it has simply had disorganising and wasteful effects on the pattern of production.

The contrast with Sweden where the early 1980's devaluations, undertaken deliberately, were succeeded by several years of relative exchange rate stability is striking. Whilst Swedish exchange controls have by no means given the authorities complete policy autonomy, they have certainly contributed to the much less erratic pattern than in Australia.

5. Capital Flows

The period since abolition of exchange controls has seen an enormous increase in capital flows. After showing how substantial these have been (table 1) we indicate their implications for Australia's balance of payments and vulnerability to the vagaries of the financial markets.

Table 1 **Investment Inflows and Outflows 1982-3 to 1986-7**

$A bn	Australia's Investment Overseas		Investment in Australia	
	Flows	Flows as % of 1982 stock	Flow	Flows as % of 1982 stock
Official	5.7	73	15.9	262
Direct	9.5	162	12.7	47
Portfolio				
Equities	6.9	3811	4.9	115
Fixed Interest	5.0	725	45.7	326
Trade Credit	1.5	128	0.7	40
TOTAL	28.6	212	79.9	144

memo Current Account Deficit 31.3 (=net investment overseas)
Source: Foreign Investment Australia 1985-86 tables 2 & 4, and Preliminary for June Quarter 1987.

Purged of the revaluation effects in the stocks data, the outflows of capital have been substantially greater in relation to initial stocks than have inflows[9]. A little over one third of the gross inflow has been required to fund the outflow of investment from Australia rather than the current account deficit. Moreover this proportion has been rising, and reached one half in 1986-87. Whilst one fifth of the outflow has been due to accumulation of additional reserves, the rest represents direct and portfolio investment in both equities and fixed interest; the portfolio flows in particular have grown explosively since the abolition of controls. As Hogan (1987) emphasises, the fact that in the absence of exchange controls assets overseas cannot be readily mobilised to repay borrowings overseas means that the gross debt is a relevant measure of exposure. This gross debt, and thus Australia's external financial vulnerability, has been substantially increased to finance Australian investment overseas. The implications of this for monetary policy were underlined by the OECD:

> The structure of net capital inflows has been different from that in the 1970s. The bulk of financing has taken the form of borrowing abroad rather than direct investment inflows. The diversification of portfolios after the lifting of most exchange controls in 1983 has accentuated the pattern, as larger outflows have had to be compensated by increased gross borrowing abroad. A major task of monetary policy has been to attract adequate capital inflows and retain the growing share of short-term funds. (OECD 1988, p.33)

Two further effects of this outflow of capital, permitted by the abolition of exchange controls, are worth considering. Firstly borrowing overseas at fixed interest in order to invest in overseas equities or direct investment will have an immediate deleterious effect on the balance of payments. This is because the interest costs on borrowing are much higher

[9] The data in table 1 add together flow data from different years when different exchange rates were operating; in this sense the data are indicative rather than precise.

than the dividend yield on the shares (or remitted profits on direct investment). In 1985-6 for example the total nominal return on Australian portfolio investment overseas was 2.8%, whilst the average interest cost of Australian borrowing overseas was 9.2% (and the marginal cost probably a good deal higher). Thus every billion dollars Australian portfolio investment, which had to be financed at the aggregate level by overseas borrowing probably cost the balance of payments over $60 million. Including a similar effect for direct investment, the outflows of capital in the five years under consideration must have cost the current account of the balance of payments (as conventionally measured without full accounting for capital gains and losses) at least $1 billion. This figure is rising fast, and has made a significant contribution to increasing the burden of net overseas income payments. The outflow has obviously also contributed to pushing the exchange rate lower on average or keeping Australian interest rates higher, as well as exacerbating the recurrent exchange rate crises. To the extent that the government has used monetary policy to try to manage the exchange rate within the band it has thought appropriate, then the capital outflows have exacerbated the effects on domestic interest rates.

Finally, on the liabilities side of the balance sheet, the fact that the majority of the borrowing necessary to fund the current account deficit has been undertaken by the private sector has meant that the terms have been dictated by private self-interest. Most of the borrowing has been in overseas currencies, but there has been no co-ordination possible of the portfolio of currencies in which the borrowing took place or of its maturity composition. The Australian dollar component of this borrowing, especially the marketable element, represents a dangerous "overhang" which can, and has, put immense pressure on the currency in times of strain. Private borrowing in overseas currencies also creates huge currency risks for the

private sector borrowers, and a rush to cover these risks on the forward market, is a further source of potential pressure on the exchange rate. Moreover the maturity composition of the debt is short - more than 15% of the gross debt being repayable within one year, even leaving out of account the much shorter-term borrowings of the trading banks (Hogan, 1987 table 5). This increases financial vulnerability. The social costs of all these financial transactions can therefore deviate enormously from the private costs. Borrowing overseas seems much too sensitive an activity to be dependent on private market decisions as to how much to invest outside Australia (which affects total borrowing necessary) and as to term structure and currency composition.

Conclusions

(i) The exchange rate/ exchange control system operating when the Hawke Government was elected was not working effectively.

(ii) Whilst some technical changes had to be made to the system of exchange rate fixing then in force, the move to a "freely" floating rate, was naive from an economic point of view and had to be abandoned in favour of heavy intervention.

(iii) Even the decision to freely float the rate did not imply abolishing exchange controls. The result of abandoning controls on outflows, and funding the overseas deficit largely by unregulated private borrowing, has been to substantially increase Australia's vulnerability to exchange rate crises. Whilst the exchange controls in operation in 1983 did not prevent short-term speculative movements, they undoubtedly reduced them, and the case was never made convincingly that the controls could not be tightened up significantly. The subsequent course of the exchange rate has been dominated by capital flows and the succession of downward lurches,

followed by substantial real revaluation, has made economic restructuring much more difficult.

(iv) The decision to float and more especially to abolish exchange controls gave the financial markets enormously enhanced power over the Labor Government's policies. The exchange rate crises which repeatedly buffeted the Government had a significant effect on the course of fiscal and monetary policy. Given the balance of payments difficulties the possibilities for sustained fiscal expansion were limited. But the degree of restriction required by the financial markets and implemented by the Labor Government since 1985 was faster, and went further, than would otherwise have been "necessary", and interest rates have been forced higher. In this sense progress in reducing unemployment has certainly been limited by international financial integration.

(v) The weak investment growth, reflects in part the high level of interest rates, and exchange rate and interest rate uncertainties, for which international financial deregulation (in Australia and more broadly) must take part of the blame. This failure of capital accumulation has condemned the rapid employment growth to take place at the expense of take-home pay, rather than in conjunction with rising productivity and living standards in the broad sense (including improvements to the social wage and reduced hours of work).

Finally, we have not set out to refute the view, widely held amongst Australian observers and officials, that international financial deregulation played a decisive role in fostering the understanding that the Australian economy had to make painful adjustments to meet adverse external circumstances. In this view, the Accord would never have held without the dramatic impact of foreign exchange crises and this fact outweighs their other costs in terms of possibly over-restrictive and panicky policies.

Even if it is correct that the drama of international financial pressure did help to hold down real wages, to conclude that this was the best outcome would imply that rapid employment growth could only be achieved at the expense of stagnation in take-home pay and the social wage. Higher investment would render such a conclusion false. The fundamental weakness of the economy under Labor has been the failure of its orthodox financial policies to engineer the expansion of investment, which is universally agreed to be a precondition for a durable restructuring of the Australian economy. Exchange controls are not a sufficient condition for such an expansion; they may well prove to be necessary components of serious industrial policies in countries with a relatively weak manufacturing base.

APPENDIX 1 Financial Innovations and Exchange Controls

In the unofficial hedge market, transactors ineligible for the official forward market, because their transactions were of a capital nature or because of their failure to request forward cover within 7 days, were able to match their risks with private counter-parties. The bank handling the deal could not itself balance the risk through its own foreign exchange transactions since it could not deal in deposits in foreign currencies.. Syntec found that (in 1978) the hedge market may have reduced the official forward market by about 6%, but it was growing very rapidly and according to the Reserve Bank by October 1983 the official market was accounting for less than 20% of forward and hedge covering[10]. Reliance on directly matching risks left the hedge market (in 1980) very thin with a "tendency to become one-sided when expectations of future movements in the $A/$US exchange rate shift firmly in one direction" (p73). Syntec noted that "the same exchange controls which limit the development of the hedge market [ie banning of foreign currency deposits] are those which also limit speculative capital movements on the spot exchange market" (p73).

Syntec suggested that the banning of non-trade transactions from official forward cover was to some extent vitiated by the hedge-market: it allowed trade-related risks which would have gone to the official market to be matched against non-trade risks. This argument is worth considering because it has been argued that this private hedge market had a decisive influence:

"the scope provided by the market to cover capital risks has made the Australian economy more open to destabilising capital flows which exchange controls could no longer stop. To that extent, the hedge market was perhaps the prime catalyst in the inexorable process of change which culminated in the deregulation of both the forward and spot markets in late 1983" (Lewis and Polasek, 1985 p 385)

The problem caused by the hedge market was that when speculative pressure built up the Reserve Bank was left holding a very one-sided forward exchange book as exporters were tempted by the larger premium (on foreign exchange) ruling in the hedge market to cover their exchange risk there. This drying up of the supply of forward exchange left the RB being obliged to supply importers' needs. The net result was just as though the Reserve Bank was supplying forward exchange for <u>non-eligible</u> risks whilst importers and exporters supplied one another.

The argument seems exaggerated however. It presumes that all the exporters supplying forward cover to the hedge market would otherwise have covered with the RB. In the situation postulated, of widespread fears of a devaluation of the $A, the exporters might very well have kept an open position themselves. In effect the hedge market, by offering a higher premium on forward exchange, allowed exporters to turn an uncertain gain from a possible devaluation (if they kept an open position) into a certain,

[10] In 1978 about half the transactions in the hedge market were ineligible for the official market, the other half tempted out by better rates and (surprisingly) the great majority were apparently linked to trade rather than capital transactions. Unfortunately there seems to be no comprehensive survey of the hedge market for 1983.

but smaller, gain. Those with a capital risk could insure themselves at a cost. The fundamental reason that the RB was left with such a one-sided "book" was the one-sided nature of the "bet" not that all other suppliers of forward exchange were tempted away.

It seems rather inconsistent to stress the importance of leads and lags in generating capital flows (the lags being precisely the actions of exporters to delay their current receipts) and suppose that the same exporters would simultaneously automatically secure forward cover for these receipts. Indeed the very reference to the market becoming "thin" suggests just such a shortage of potential for covering capital risks when exchange rate expectations became one-sided. Of course the hedge market must have attracted some exporters who would otherwise have covered with the RB, thus leaving the RB to cover larger risks, but the extent of this could not be measured by the extent of operations in the hedge market, or even exporters' participation in it. Moreover there is a difference between the Reserve Bank absorbing a higher level of forward commitments on the one hand, and being forced to supply spot currency on the other (as it would have had to do if banks were able to cover the risk themselves). Of course if the capital flight forced a depreciation, the capital loss to the Reserve Bank (and gain to the hedgers/speculators) would be identical. But the loss of reserves and thus immediate pressure to depreciate was postponed, leaving the authorities with the option of taking preventative measures.

Whilst Syntec did not emphasise the private hedge market as a fundamental problem for exchange control, it did point to a parallel problem in the overseas market for $A (the "Euro-$A" in effect). They posited a situation where an overseas bank wanted to provide forward cover for an overseas company with a $A exposure in Australia. Control on fixed interest outflows from Australia would prevent the overseas bank from providing cover by borrowing $A in Australia at the domestic Australian interest rate. Instead the rate on Euro-$A deposits would rise above the domestic rate leading, so Syntec argued, to a greater incentive for Australians and others to evade controls. A particular example cited was that overseas banks could in effect adjust their investments in their Australian subsidiaries (though no convincing argument was given as to why this could not be monitored effectively). Syntec said "We conclude therefore that the continued development of the offshore market for the Australian dollar will tend to erode the ability of the authorities to maintain control of capital flows into and out of Australia". But again it was not the existence of the overseas market for the $A which made it worthwhile to evade controls, but the expected depreciation of the $A; the higher interest rate on Euro-$A simply reflected that expectation. Indeed as has already been pointed out, covered rates consistently deviated from parity, implying that controls still had an effect despite the temptations posed by the Euro-$A market.

Of course the multiplication of financial instruments (in this sense the Euro-$A resembles the private hedge market) may have attracted some additional transactors into the market by parcelling up expected gains and risks in more variegated ways. But the conclusion that this or that innovation was inevitably undermining controls presumed that little could be done in response.

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