

Introduction

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Australia's economic relations with the rest of the world have undergone profound change over the past decade. The floating of the exchange rate opened goods markets to greater international competition and Australia's pattern of international trade changed considerably. Concomitantly, increasing integration into world financial markets saw Australia drawing more heavily on foreign capital. The papers in this Volume aim to increase our understanding of the implications of this process of internationalisation.

1. The Historical Context

In the past 15 years, two broad developments in the world economy have been particularly significant for Australia: financial market liberalisation and the emergence of the newly industrialising countries in Asia. From the late 1970s, financial liberalisation (and, in particular, the removal of capital controls) made financial markets increasingly globalised. At times, these developments were associated with speculative capital flows that undermined attempts to reconcile managed exchange rates with domestic macroeconomic objectives. At the end of 1983, against the background of more general moves to deregulate the financial system, the Australian dollar was floated.

Australia is a small commodity exporting country, subject to significant terms of trade shocks driven by the world commodity price cycle. Once the currency was floated, the nominal exchange rate was able to respond more rapidly to these external shocks, helping to cushion the domestic economy from the inflationary and deflationary pressures to which they gave rise. For example, falls in the terms of trade have been associated with real depreciation which has reduced the negative income effects of the terms of trade decline on exporters and has added a stabilising stimulatory influence to the domestic economy. While movements in the currency have been largely driven by commodity prices, it is widely felt that the depreciation in the mid-1980s went beyond that justified by fundamentals. While the real exchange rate recovered in the second half of the 1980s and fell again in the early 1990s, in line with the behaviour of the terms of trade, the overall trend in the past two decades has been one of real depreciation.

This downward trend in the real exchange rate occurred at a time when Australia also began to cumulate significantly larger external deficits, so that foreign debt was rising as a share of income. This too can be linked to the globalisation of world capital markets. The greater degree of integration of Australia into world financial markets meant that it became easier to attract capital from the rest of the world to

finance investment independently of the level of national saving. There were two major investment booms in the 1980s associated with high real exchange rates and current account deteriorations. The first occurred around the time of the second oil price rise in the late 1970s/early 1980s, and resulted largely from improved prospects for the energy and minerals sectors. The second was associated with the asset price boom later in the decade. Both episodes were accompanied by a build-up in Australia's foreign liabilities and were followed by a world recession and falling commodity prices.

During the 1980s, the second major development in the world economy with strong implications for Australia was the rapid development of the newly-industrialising countries in the Asian region. South Korea, Taiwan, Hong Kong and Singapore set the pace, growing very quickly through export-oriented growth. Indonesia, Malaysia, China and Thailand also recorded high rates of growth. This meant that Australia now had the fastest growing region of the world on its doorstep. It also affected Australia's own policies toward competition, moving them away from inward-looking tariff protection, towards more outward-looking policies conducive to exports.

The combination of significantly reduced protection, the sharp downward movement of the exchange rate in the mid-1980s and the increasing industrialisation of the Asian region have been associated with major changes in the structure of Australia's trade. Both imports and exports have risen significantly as a share of GDP, and a much greater proportion of Australia's trade is now oriented towards the Asia-Pacific region.

Developments in other OECD countries have also been eventful. The rise of the US dollar in the early 1980s and the emergence of a large United States' current account deficit focused attention on exchange rate determination and the process of external adjustment. As the US dollar rose continuously through the first half of the 1980s, it was persistently trading at a discount in forward exchange markets, raising questions about the efficiency of the market. When the currency finally declined, the long lag before the current account responded left many wondering whether the relationships between relative prices and the external account had been significantly weakened by structural change.

While Australia moved to floating rates during the 1980s, European countries were on the opposite track, moving progressively towards fixed exchange rates. While political considerations were an important motivation, there was also a strong emphasis on the perceived economic benefits. It was argued that in the transitional phases, the Exchange Rate Mechanism (ERM) would help to bring about a convergence of inflation within Europe towards low German rates. By accepting the credible policies of the German Bundesbank, other European countries would be able to minimise the costs of disinflation. It was also argued

that there would be strong microeconomic gains for trade and industry brought about by reducing - and eventually eliminating - exchange rate variability.

In the event, the European economies experienced a major real shock. The reunification of Germany saw the need for substantial 'catch-up' investment in the East, and large budget deficits resulted from the need to provide public infrastructure investment and to support the incomes of dislocated workers. Incremental saving had to be attracted towards Germany, and diverted away from other countries. This shift of resources required Germany's current account to move from significant surplus to deficit. To bring this about, while preventing excessive demand from spilling over into inflation, required both upward pressure on German real interest rates and an appreciation of the real value of deutschemark. With nominal exchange rates fixed, these adjustments could only be brought about by higher inflation in Germany, or by deflation elsewhere. Given Germany's commitment to low inflation and the rigidity of European labour markets, financial markets eventually perceived that this scenario would be too costly for most members of the ERM in terms of output and employment losses. One by one, the commitment of various European governments to the ERM was put to the test by speculators, with the result that by the middle of 1993 a number of significant realignments had occurred.

2. The Analytical and Policy Issues

The experiences of a range of countries raise a number of important analytical issues which are addressed in the papers in this Volume:

- Do nominal exchange rate changes cause persistent real exchange rate changes?
- Do foreign exchange markets operate efficiently?
- What impact do exchange rate changes have on the volume of a nation's exports and imports?
- What determines patterns of international trade?

The answers to a number of important policy questions turn on these issues. Perhaps the most important of these is the question of the exchange rate regime itself. Recent historical episodes in Australia and abroad illustrate only too well the need for flexible nominal exchange rates in the face of real shocks in a world where goods prices are sticky. On the other hand, fixing to a low-inflation currency, in the absence of real shocks, is a useful monetary rule, and may help to avoid misalignments caused by misguided exchange market speculation. Whether exchange rates should be fixed or floating depends partly on the nature of the macroeconomic objectives of policy, the flexibility of a nation's goods and labour markets, the types of shocks a country is likely to experience, and the extent of the

microeconomic gains that might be associated with a common currency area. What is relevant for one country in these respects may be inappropriate for another.

If a floating rate is adopted, an important policy issue is the degree to which the authorities can influence the real exchange rate. If prices are perfectly flexible, then monetary policy has no impact on the real exchange rate. In contrast, if prices are slow to adjust, then policy may be able to influence the real rate over an extended period of time. A related policy issue concerns whether sterilised foreign exchange market intervention is a useful tool for influencing the behaviour of the exchange rate. Recent arguments favouring intervention emphasise its role as a signalling device to market participants in circumstances where speculation is driving currencies independently of market fundamentals.

A third set of issues concerns tariffs and other forms of industry assistance. The immediate impact of tariff cuts is to expose domestic industries to greater competition from imports. This may require a lower exchange rate if the trade balance deteriorates in the short run. On the other hand, tariffs act as a tax on exports, particularly for countries like Australia that import much of their capital equipment. Furthermore, increased competitive pressures may bring about dynamic gains and a greater outward-looking export orientation in the domestic economy. Long-run outcomes of competition policy may differ significantly from the short-run effects of such policies.

A fourth issue concerns whether or not policies to promote regional trading 'blocs' - the APEC grouping in Australia's case - are likely to enhance export performance. This will depend on the relative importance of a range of factors, such as resource endowments, political ties and income levels, which affect regional trade flows independently of the overall level of the real exchange rate in individual countries.

Finally, there is the issue of the sustainable level of foreign debt. Borrowing to undertake investment that yields high returns generates increased income and hence the capacity to service the debt. In contrast, if the investment returns are poor, the debt servicing may well require a significant real depreciation. There are also issues concerning the externalities imposed on new borrowers by the fact that there is already a large stock of outstanding Australian debt. Some assessment of the risk and costs of a sharp reduction of capital inflow is also necessary.

3. The Papers

The 'scene-setting' paper by Paul Krugman focuses on some of the major analytical and policy themes of the Conference. He gives his own broad overview of these issues, touches on some of the experiences of OECD countries in

illustrating them, and comments on the problem of choosing an appropriate exchange rate regime.

The papers by Blundell-Wignall, Fahrer and Heath; Bullock, Grenville and Heenan; and John Pitchford, all deal with the Australian experience. The first of these deals with major influences that drive the Australian dollar, focusing in particular on its major cycles and its overall trend in the past two decades. It attempts to sort out which fundamental factors are most important in driving the equilibrium level of the real exchange rate. It also examines the evidence on the impact of inefficient speculation on major swings in the currency. The paper by Bullock, Grenville and Heenan examines how the exchange rate has interacted with other factors determining Australia's imports and exports, including the moves to reduce effective rates of industry assistance in Australia and the rapid industrialisation of the East and South-East Asian economies. It outlines the significant structural changes in trade that have occurred since the middle of the 1980s, and assesses the relative importance of the factors which promoted them. Both papers touch on the issue of whether the real exchange rate and trade performance are evolving in ways that will permit foreign liabilities to be stabilised as a share of GDP. The paper by John Pitchford provides an assessment of Australian policies towards the exchange rate during the 1980s and 1990s. The paper also provides a framework for identifying which exchange rate regime is likely to be most suitable for achieving macroeconomic goals in Australia.

An alternative perspective based on the experience of other OECD countries is provided by Mike Artis. The emphasis in his paper is on the experiences of countries which target the exchange rate. This includes both 'weak form' targeting, such as the Plaza Accord mechanisms, and the 'strong form' target zones implemented within Europe. An analysis of the causes and consequences for policy of the recent breakdown of the ERM is a primary focus of this paper.

Jeffrey Frankel takes up the issue of whether there is a tendency for special regional factors to cause 'blocs' of countries to trade more with each other than is 'normal' in bilateral trading relationships throughout the world economy. He examines most well-known country groupings and, of particular interest from Australia's perspective, he provides some direct evidence about whether the APEC grouping is a 'natural' trade bloc.