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Interest Rates Are Not Doing the Job

John Hyde

The worse than expected August current account deficit of $2.58 billion is further evidence that the government's high interest rate policy is not working. The budget forecast is for a record $18.5 billion current account deficit. It now appears as though even that figure will be exceeded.

The Government and its 'independent' monetary authority, The Reserve Bank, are not of the deficits-don't-matter school. They are so convinced that deficits matter very much---so much that they have housing rates of 17% and commercial interest rates over 20% as they try to mop up excess liquidity to slow the economy and get imports down. For two years, at least, we have been told that the policy is about to work soon, but the deficit keeps on growing. Isn't it about time we questioned this over reliance on high-interest-rate policy---it may have worked in the past but it is not working now.The aim of high interest is to remove spending power from the likes of you and I, because our propensity to spend is demanding more than is produced in Australia and is, therefore, being satisfied by imports. Last year, in spite of interest rates which were supposedly ruinous, gross national expenditure rose by a real 7.7%. The forecast was only 4%---further evidence that interest rates are not doing what is expected of them.

If only because it has always been the case in the past, we must still presume that some interest rate---25%, 30%, who knows---will cause as recession. We might also presume, because it always has in the past, that the recession will reduce our expenditure on consumption and investment by even more than it reduces our production, thus taking the pressure off imports and leaving more unconsumed product to export. This has been described, somewhat derisively, as the theory of the recession led recovery!

In these columns I, with others, have argued that micro economic reform, by increasing production, will eventually turn the balance of payments around. Dr Peter Forsythe took me to task, pointing out that it will only do so if the increased production is, in fact, used for that purpose. And there is no reason to assume that it will be so used.

If the incentives to save, invest and consume are unchanged, we are likely---because we have done so in the past---to continue to consume more than we are producing, and invest more than we are saving. A government that is worried about the current account must work on these two ratios.

To change the first it might change the way each of consumption and investment are taxed. Income tax when combined with inflation is a deadly disincentive directed against people who save and it subsidises those who borrow. Mr Peacock has seen this anomaly, but his solution to it is unworkable and will be abandoned. A broad-based consumption tax in lieu of income tax is a workable solution---perhaps the only workable solution.

Government saving can be achieved either by raising taxes and by reducing outlays. Both are required. At least $5 billion of cuts are needed. Sir William Cole, a former head of the Department of Finance writing for the Australian Institute of Public Policy listed $4.2 billion of cuts, without doing anything too Draconian and concentrating mainly on major items. Surely a party in power, with the resources of the civil service at its beck and call, could find another $800 million in small amounts. To repay government debt and reduce domestic demand in a way that is less damaging than interest rates which belong on a another planet, taxes should be increased to produce an even bigger Commonwealth surplus and an overall government surplus. Present policy will increase the tax take automatically.

Finally, although it is dreadful politics, a capital gains tax on housing---which should be seen as a trade off for lower interest rates---would divert resources from houses and land to investment in farms, factories and mines.

When it is no longer necessary to rely on interest rates to kill demand, the inflow of foreign funds will dry up somewhat. At present foreign investors are prepared to accept the risky Aussie dollar, for rates of return they can get nowhere else in a country with our credit rating, even at its lower level. Then the A$ should fall making it easier for our industries to compete, thereby increasing exports and reducing imports---i.e. reducing the current account deficit. The catch is that as the A$ falls the A$ value of the interest rate bill payable to those overseas creditors whose debts are denominated in foreign currency rises. To pay it, domestic consumption will have to fall. This drop in consumption demand is induced by the tax and government expenditure changes already described.

After the debt has been serviced, productivity is the ultimate determinate of our living standards. If, at the same time as the above, a rapid program of micro-economic reform is instituted, foreign investors may see that the Australian economy is so well run that they quickly return the A$ to current levels and higher. This is, in fact, what usually happens to the currencies of countries which deregulate, cut tariffs and privatise---the best known case being that of post-war Germany.

Anyone got a better idea?

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