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ON THE DRY SIDE 119 MISSING OUT ON DEVALUATION John Hyde. Published 29.2.85

While regulation and hysteria do modify currency exchange rates, beneath these aberrations is a market which reflects relative inflation rates and the relative abilities of economies to pay their way.

Cross about what I regarded as mismanagement of our potentially vigorous economy, when the Australian dollar fell below parity with the US dollar I penned a terse note about a milestone on the road to penury. I saw the exchange rate as measure rather than cause of failure. But now, if wage indexation is not discounted for price rises caused by the collapse of our currency, these milestones will become millstones.

Perhaps parity below 70 cents US is partly caused by the liquidity surge brought on by the public servants strike, and partly by anticipation of further inflation following the government's abandoned money targets and Hawke's diminished authority. But the long slide from US$1.40 reflects more fundamental changes in the two economies.

The Trade Weighted Index (TWI) is a more relevant measure for many purposes than the US dollar, which has soared away from most currencies. The TWI started at 100 in 1977; it is now about 75.

Forecasters no longer expect to see the US dollar at low levels from which they once expected it to quickly tumble. Its prolonged strength cannot be just a technical aberration, but must also reflect the anticipated relative strength of the US economy. This anticipation makes the United States a preferred haven for mobile capital. Conversely, we do not now expect the Australian dollar to return quickly to US$1.40.

Since the early seventies our standard of living has been maintained and increased by borrowing from abroad but now the cost of servicing the debt thus incurred is catching up with us. Living standards must now be more nearly determined by our production and its terms of trade. To pretend otherwise is futile.

The Khemlani loans, which created quite a stir for their size as well as their peculiar source and lack of Loan Council approval, were to be $4000 million. Since then external government debt has expanded from about $1800 million to about $16000 million at June 1984. In the same time private debt, as opposed to equity investment, has increased from about $4000 million to $28000 million. As most of this $44000 million is denominated in foreign currencies recent devaluation has further increased the servicing burden. Far from trading out of debt we must pay around $4000 million annually in interst and we have a trade deficit of around $5000 million. Recent borrowing has been at real rates of interest of around 6% which is greater than the rate at which we can expect our real gross domestic product or our real exports to grow.

Like firms nations are richer without investments which earn less than interest. It is impossible to say which were the last items on cabinet's shopping list and hence which items were conditional on foreign loans but very little government expenditure earns 6% real interest. In view of subsequent Labor attitudes, it is an irony that Mr. Rex Connor should have wanted the Khemlani money to dam rivers and process uranium - projects which just might have paid their way.

Depressed prices for Australia's principal exports - coal, wheat, sugar, iron ore and wool, and debt servicing are reducing Australian living standards but Australians are reluctant to accept commensurately reduced wages and salaries.

Unless he is prepared to cut outlays a little, for reasons which include a rising interest bill, the Prime Minister needs 4 to 5 percent real economic growth to meet two of his "trilogy" udertakings. The undertakings are that taxes will not rise as a share of the economy, and that the deficit will be reduced in money terms. Mr. Hawke therefore must welcome the devaluation which should make exporting and import competing industries more competitive. However to the extent that increased Australian dollar prices of traded goods are reflected in increased factor costs no competitive advantage, profits or employment is gained. I predict that it is on this rock that "The Accord" is about to founder since the unions will be reluctant to discount indexation for exchange rate effects.

Full indexation at this time of declining economic fortune would be a disaster. In the early days of "The Accord" indexation kept Australian real wages from falling in the face of spiralling unemployment, as real and even money wages fell in other countries. Australian competitiveness and employment were sacrificed to it. Then the medi-fiddle resurrected some of the wounded and unemployment fell a little but not to pre-recession levels. Now The Accord is set to demand a further sacrifice of competivness and employment. It will be argued that because The Accord made no mention of discount for exchange rate movements full indexation is a right, whatever the ultimate cost in employment and reduced living standard. By the next election The Accord would have been thoroughly discredited so now will be seen as the right time to abandon it.

The Hancock Enquiry will provide the means. The report, given the membership of the committee, and given that it will be drafted by paid up members of the IR Club from within the Department of Employment and Industrial Relations will almost certainly not recommend scrapping the system. The committee will however feel it should justify its existence by recommending something - perhaps some flexibility. The recommendations will provide an opportunity to let The Accord slip quietly out of mind.

Initially 'flexibility' might allow some discounting for exchange rate movements. From the standpoint of the unemployed, without a doubt that would be a less bad position than full indexation. After that, however, and beyond the vision of even far sighted statesmen the way this flexibility is interpreted will be important. Next year flexibility might be interpreted as flexibility, for those with the muscle to get it, above a high minimum wage. That would be the worst of all worlds. What is needed, but which I don't believe we'll see, is the gradual adoption of flexibility up and down over a minimum wage defined in terms of full employment - say 1.5% registered unemployed.

Through all this the Arbitration Commission will be worth watching. Their footwork will be splendid; their intention and I suspect accomplishment will be self preservation. Hancock will barely land a blow on this moving target.