INTEREST RATES WILL FALL BY 2%

DRYSIDE 43

Published 9-9-83

Asked what was Fraser's watershed, my somewhat tentative reply was,"Interest rates will fall by 2 %." Tentative, not because I have any doubts about the significance of that foolish prediction, but because I am sure there was no single event that marked the turn. Important ~~events~~ MATTERS, like the downfall of governments, are seldom so simply explained; tempting though it is to try. Never-the-less the 2% interest rate prediction did have important economic and political consequences that have, in my opinion, received less attention than they deserve. Some of those consequences are still with us. Among other things the event and its sequels serve to show how very long the lags can be in politics and economics.

Campaigning in Queensland in the run up to the 1977 election, and under pressure to be specific, Doug Anthony predicted that interest would fall by 2%. Fraser backed the prediction. I have no idea what passed between them so I have no way of knowing whether Fraser was freely backing his own judgement or reacting to Country Party duress.

What was in fact merely a prediction shared by many informed people at the time quickly took on the status of an undertaking. Nothing was done to deny the impression that the government was promising lower interest. No doubt, in the short run, it suited the government's purpose to have the public believe that it could deliver lower rates. Fraser no doubt comforted himself that he could, if the worst came to the worst, do as he had done so often before - refer to the fine print.

Like every other member I was getting a lot of flac~~k~~ on the interest issue; or at least I thought I was. It was as nothing by 1982 standards. Faced with interest rate criticism at a meeting called by one of the shire councils in my electorate, I argued that, by their very nature, interest rates were unpredictable. I remember adapting a line of Bert Kelly's saying - that if anyone knew tomorrow's interest, he could retire to the South of France and put his feet in a bucket of champagne. This prompted one of the councillors to write to the Prime Minister to tell him what a dreadful member I was because I was opposing the Prime Minister's policy.

(Mainly because of overseas influences, but also encouraged by the need to fund a largish public sector deficit and uncertainty about the future of inflation, interest did NOT fall by 2 %. It did fall a little but then moved up again.)

To make its prediction (now seen as a promise) come true, the government tried to bully interest rates down. The principal means by which the money supply is managed is the purchase and sale of government bonds. The deficit was contributing to money, yet the government tried to reduce the interest at which bonds could be sold to the public. In this as elsewhere, Cabinet had scant appreciation of the laws of supply and demand. They did not seem to realise that it is impossible to control both the price and quantity of anything; money being no exception. By trying to control the price of money the government lost control of the quantity. It was now on a long and slippery slide which ended five years later in defeat.

Money supply management is not a very precise art so that it is quite possible for the best intentioned authorities to get it wrong in the short run; or so I have often been told. (I would be more impressed by the excuse if the wrongness were to show symmetry around the target, but it always seems to be on the high side.) Even if the authorities are allowed a high incidence of error, the consequences need not be serious if they are willing to take corrective action as they get access to each new batch of data.

Money management through the seventies was a very up and down affair. The McMahon government left Whitlam an exploded money supply, which he was slow to correct, resulting in the wild inflation of 1974 and 1975. Money was conservativel managed through 1975, the year Hayden was treasurer, and through 1976 and 1977. By 1977 inflation was falling slowly but steadily. Our position relative to our trading partners was improved and good. Then the government missed its money supply targets for three consecutive years. The "fight inflation first" policy was thrown away. Slowly our inflation rate tended up. The seriousness of what was happening was masked somewhat by falling rates around the world. By feeding into Australian prices,monetary discipline practised elsewhere reduced the extent to which our inflation indices rose but completely reversed the favourable gap with our trading partners. Austtalian inflation is now twice that of our trading partners and by that consideration is worse than 1974.

In view of what happened, those people who now choose to attach a 'monetarist' label to the Fraser government, either in praise or disparagement, are very wide of the mark.

In case any one should be tempted to think that I am only calling on the wisdom of hindsight, it should be known that there were back benchers who saw what was going wrong at the time. Mr. Fraser, Mr. Lynch, or Mr. Howard could testify that we complained repeatedly to them.

The wage explosion of 1981 and 1982 was just one predictable consequence of three years of loose money management. Employees could see inflation rising and had become convinced that their wage bargains would be reflected in rising prices rather than unemployment. Employers had come to expect that government would validate pay rises by printing more money which would enable them to charge higher prices. The government's credibility in a vital area of economic management had been sacrificed to a populist prediction, that by default, was allowed to become a promise.

The coincidence of the wage hike with the need to take money in hand again as Whitlam and Hayden had had to do in 1975, and some bad luck with commodity markets and a drought sent the economy into recession. Loose money management, when it should have been tighter, left the government with no strategy to ease the economy over the period of misfortune. Denied the monetary stimulus that would have been possible if inflation had been at 2 or 3 percent, where it should have been, the government panicked. It discarded all of the economic argument Liberals had employed from the day Fraser defeated Snedden. It brought in a Keynsean budget.

A recession, rising inflation, and a Keynsean budget: its reputation for good economic management was now in tatters and the rest followed with the inevitability of a Greek tragedy.