ECONOMICS MADE EASY

Part 1

7. Exchange Rates

My understanding of the exchange rate has always been rather hazy. But when I read the article written by Dr Bob Gregory, of the Australian National University, which appeared in The Journal of Agricultural Economics *in August 1976, I realized that an important question had been exposed. If it was important then, it is much more important now (1981) when we are teetering on the edge of another mining boom. As this book goes to print, this question looms as one of the biggest economic problems we will face in the eighties.*

It is important to realize that, until the middle seventies, the exchange rate only moved when the government allowed it to move. Governments being what they are, this always meant that the movements were delayed too long and then they had to be too big, with all the traumas that go with big changes. At present, the exchange rate moves in accordance with market forces; at least, we are told it does and I believe them. So now we often have a series of small movements during a week, some up and some down, but all tending to keep the value of exports and imports in balance.

It is clear then, that if the value of exports is to expand because of a mining boom, then the exchange rate will move so as to increase the value of imports. This was the Gregory thesis and it is what Mr Stone says in the last article of this book. It is a fitting end to the book because it opens up a matter pregnant with problems and opportunities.

Gregory Thesis (1) *(December 1976)*

For years Fred and I have preened ourselves because we earn export income. I have often given tongue about this in the House and attracted some nasty comments from my city colleagues when I have compared them unfavourably with Fred and me just because they didn't earn any export income. Fred has occasionally been overcome by his own eloquence to the extent of saying, and even perhaps believing, that he was not farming to make money, but only to provide export income for the country's good. Of course he doesn't really mean it but it has a wonderful ring about it, particularly if he has had a beer or two. So Fred and I have been hitting other less worthy citizens, particularly Eccles, with our export income earning haloes. But now Eccles tells us that the honeymoon is over. He has read an article by Dr Gregory[1] and he keeps pushing it under my nose and telling me that I should read it. But when I found it was about the exchange rate I fought a dogged rearguard action and refused.

Eccles, as usual, wore me down in the end and now I'm glad because the article opens up a startling view of the economy. Gregory's thesis is that the more exports we have, the more the exchange rate will adjust so as to discourage the production of more exports. It will automatically adjust so as to keep exports and imports in balance.

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[1] Gregory, Dr R. G. 'Some Implications of the Growth of the Mining Sector', *The Journal of Agricultural Economics*, August 1976.

At this stage, I complained that I couldn't see where this long-winded argument was leading, but Eccles went on relentlessly. He said that if the export of minerals expands as many think it will, particularly if we start exporting uranium, then there will be an automatic movement in the exchange rate which will discourage our traditional exports, including rural products.

Dr Gregory contends that the expansion of mineral exports in the last ten years has had a very grave effect on the economic health of rural industries by keeping the exchange from devaluing which would have suited rural industry. If Gregory is only half right in his assessments of what has happened in the past and will happen in the future, then a changing world is going to change even faster.

It has been hard work for Eccles to get this economic theory into my modest brain, but he jibbed at telling it to Fred. 'He's your responsibility,' he growled, 'he is your wretched constituent. You tell him yourself and look out he doesn't hit you when you try to take his halo off him. But perhaps you could talk to him as one farmer to another in language he understands. I wouldn't be able to get through to him.'

So I told Fred that, just as the worst enemy of a sheep was another sheep, so, if we have a big expansion in mineral exports, then the worst enemy of an exporter may well be another exporter. When Fred asked me querulously how this would happen, I told him that it was due to the operation of the exchange rate. Fred complained that the exchange rate was a closed book to him and he wasn't prepared to learn about it at his stage of life, but he insisted on recounting a shady story about exchange rates to show that he had heard of them. A Japanese went into a London bank and changed 1,000 yen for £(stg)2.50. Next week he went into the same bank and again put down 1,000 yen, but this time he only got *£2.* He protested but the teller explained that the discrepancy was due to the exchange rate fluctuations. 'Fluctuations, fluctuations,' the Japanese complained bitterly. 'Fluck you plurry Europeans, too!'

Fred's understanding of the way the exchange rate works is hazy as well as coarse, and I apologize for him. But the prospect of Fred and me having to manage without our export income earners' haloes is not a pleasant one, particularly when we have become used to wearing them and they seem to fit us well. But Eccles says that we are not the only sector which will feel the impact of an increase in mining exports. He says that the import competing sector will also find the new environment uncomfortable.

Gregory Thesis (2) *(January 1977)*

Recently Eccles robbed Fred and me of our export income producers' halo by saying that if mineral exports expanded as expected then there would be very strong forces operating through the exchange rate to discourage the export of other products. Then Eccles went on to say that this was not inevitable and one solution was to encourage an expansion of imports. In other words, just as the worst enemy of an exporter would be another exporter, so the best friend of an exporter would be an importer. He then went back to his basic thesis, which is that the exchange rate acts so as to keep exports and imports in balance. If exports expand, the exchange rate moves to discourage exports (and this may be where the farmers get clobbered), but this could be offset by an increase in imports.

And here Eccles referred to the basic paper written by Dr Gregory. Dr Gregory contends that the increase in mineral exports in recent years has influenced exchange rate movements so as to make these far more important than the 25 per cent tariff cut in July 1973.[2]

This made me feel uncomfortable because our side of politics has, for years, been clobbering the Labor Party about the devastating effect of the 25 per cent tariff cut. It was an easy stick to pick up and use to clobber our opponents. Industry leaders could understand a tariff cut, while some of them may have been hazy about the operation of exchange rates. The man in the street could also understand the tariff cut in a hazy kind of way. So we belted the Labor Party with the effect of the tariff cuts on secondary industry when what was affecting it far more were exchange rate movements associated with an expansion in mineral exports. It is a bit like a chap with stomach cancer who thinks his stomach pains are indigestion.

Politicians have been talking nonsense about tariff cuts when the exchange rate has really been making industry sick. Almost behind our backs, the exchange rate has been encouraging an increase in imports so as to bring imports into balance with exports. Gregory says that, for the import competing sector, the mineral expansion has been equivalent to the complete removal of the tariff plus the introduction of an import subsidy!

Now if this has been the effect of an increase in mineral exports in the past, you can imagine what would be the impact of a further explosion in mineral exports in the future. And this many people foresee, particularly if we open the uranium Pandora's box.

Eccles warns that, if this expansion takes place then any action to hold down imports by imposing tariffs or quotas will be at the expense of the exporters in general and is likely to affect rural exporters in particular because they seem to be the most vulnerable.

Fred suggested, in a half-hearted way, that perhaps the best thing to do in the interest of both rural exporters and secondary industry was to prevent the expansion of mineral exports. 'Then we would all be saved', he said. But as soon as he had said it he had the grace to go quite red behind the ears because he knew that he had said something awful. It is indeed serious to consider denying Australia and other countries the advantages that would follow from supplying the world with what it badly needs, in order to shelter particular sections in Australia from the inevitable changes that would follow a big mineral expansion.

But our options are becoming clearer. We can take the dreadful responsibility of stopping the mineral expansion or face up to the inevitable and painful changes which will hit the rural and secondary sections right between the eyes.

Gregory Thesis (3) *(January 1977)*

You will recall that Eccles contends that if there was a large expansion in our mineral exports, then it would affect the exchange rate and so discourage other exports, perhaps rural exports. Eccles says that it is not inevitable that this would follow, because instead we could increase imports. He claims that, in the past, the expansion in mineral exports has had quite a serious effect on the competitive position of import competing industry by its effect on the exchange

[2] The 25 per cent tariff cut has been estimated to have had the same effect as a 4 to 5 per cent exchange rate appreciation. Yet between July 1973 and the middle of July 1975 the exchange rate had appreciated by over 20 per cent. So clearly exchange rate movements were much more important than the 25 per cent tariff cut.

rate. He now says that another way of counter-balancing the expected expansion in mineral exports is for us to export capital.

Eccles explains that exporting money would be a counterweight to exporting minerals, because it is not the export of minerals that causes our exchange problem but the money that comes into the country to pay for mineral exports. 'So any fool can see,' Eccles says scathingly, 'that if money is going out of the country it will counter-balance the money coming in to pay for mineral exports.'

I can see that, but I can't understand why we should send money out of the country if it isn't to pay for imports. But Eccles says we could make gifts to other countries, e.g. overseas aid, make investments in other countries, or send money out of Australia to buy out companies in Australia which are owned overseas. Doing any of these things would not only mitigate the effect of a big mineral expansion but would build up Australia's long-term economic strength and at the same time contribute to world economic development. This is what occurred in the case of the U.S.A. during and after the First World War, and to Great Britain a century ago. But the latter benefits were lost when many of the assets thus built up had to be sold off during the Second World War.

Eccles says that the first solution—overseas aid in the form of gifts—would be a permanent solution because there would be no money coming in later to undo the good done by giving money away. In the awful situation in which the world finds itself with the ever-widening gap between the haves and the have-nots, this solution is not as queer as it appears. I know it sounds odd to say that the way to save yourself from trouble is to give money away but Eccles says that he has seen sillier suggestions.

Another way to absorb our surplus is to invest money abroad. This is becoming increasingly attractive as our high wages make it difficult for us to compete with labour intensive goods made overseas. When the overseas investment starts to be profitable, then the profits would start to come home to roost and in this way the present and future generations of Australians would benefit from using export receipts to build up assets abroad. The return of profits would in time reduce the mitigating effect of investing abroad—but then, who knows what will be happening to our mineral exports by then?

The third solution, using the capital inflow from minerals to buy out overseas firms located here, would be a useful way to make proper use of our mineral wealth. If this was done wisely it would give us more control over our own destiny though this is no guarantee that the new Australian owners would be better or more courageous than the others. All too often, Australian owned companies claim special privileges just because they are Australian.

So the position isn't hopeless, we may yet be able to survive a big expansion in mineral exports. It isn't absolutely necessary to adopt Fred's simple solution, which is to go around shooting miners!

The Last Word *(December 1979)*

Eccles is becoming unsufferable lately; he looks like a cat that has been at the cream. Every now and again he licks his lips or gives a great sigh of satisfaction. When I challenged him as to the source of his unusual state of contentment, he thrust into my hands a copy of a speech given by John Stone, the Secretary of the Treasury Department, to the Australian Institute of Management on 19 November 1979. 'Just read that lot', Eccles said cheerfully and it was almost comical to hear him. Then he went on: 'This is no light-weight speaking. Mr Stone knows what he is talking about. And when you add his comments to those of all the other good and great who have said recently that tariffs must come down, then you must admit that virtue is gradually winning.'

I know that Eccles is inclined to grasp at straws so I took Mr Stone's lecture away and read it carefully. Mr Stone does not spend a lot of time on fancy footwork and I don't think he would make a very good Member of Parliament. The first thing that hits you is his relentless logic. He reminds me of a man crossing a turbulent stream on firm stepping stones, he goes from one known point to the next with measured tread.

Australia is sitting on top of a great opportunity to export. This is because of the impending energy crisis and our con siderable natural advantages as overseas energy gets dearer. But if the opportunity to export is to be grasped then we will have to import more capital. But let Mr Stone speak for himself:

> The development task before us is going to be greater than Australians will be capable of undertaking from their own savings alone .. . There would be nothing particularly novel about that. Since Federation—and most particularly since World War II—we have as a nation been net importers of capital. As a big country, with the 'tyranny of distance' confronting us internally as well as externally, with enormous natural endowments but with a relatively small population to develop them, it has been part of the natural course of events that foreign capital (the savings of others) should supplement our own domestic savings in building the Australian economy.

So to produce the extra exports we will need to import capital. But capital can only come into Australia in the form of imports of goods and services because they (and just not money) are what is required in order to put the capital works in place. So the capital we need must reach us in the form of imports.

If our exports are to increase as we all want them to, and if we are also going to get those extra imports that we need to carry out the capital developments, imports will have to grow at least as fast as exports. But let Stone take the step to the next stepping Stone.

> The more successful, in the decade ahead, we prove to be at exporting, the more successful we are also going to have to be at importing . . . There is no alternative.

The more we increase exports the more we will have to increase imports in order to get our hands on the required capital if development is to proceed. What will be his next stepping Stone? It is that it would be better to encourage those imports by reducing trade barriers than to leave it to inflation, which he rules out as unacceptable, or to the operation of an upward shift in the exchange rate which will be the inevitable result of doing nothing.

> Broadly we have two options: either we act positively to ensure that import growth substitutes for our less efficient producers, or we can allow the economic forces involved to produce the required current account readjustment by affecting our efficient producers (exporters as well as our more efficient import-competing industries) as well as our inefficient ones. The first option implies that, as export income grows (as it is already very strongly doing) we should facilitate the entry of imports by a gradual dismantling of our present import protective regime, including not only tariffs but also quantitative import restrictions and tariff quotas.

I suppose a more menial way of saying the same thing is that, if exports are to increase and foreign capital is still required, then there is no known way of stopping the economic laws working; they will work whether we want them to or not. So we should guide them to reduce import barriers so as to increase imports rather than either altering the exchange rate which will damage our efficient industries or by allowing inflation to damage all of us alike.

I can see now why Eccles looks like a cat that has been at the cream. And that chap who wrote *One More Nail* must also be feeling a bit proud.