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Australia's Business Cycle Experience, 1963-67

Table 1. Australia: Selected Economic Indicators, 1963-66

Year and Quarter	Manufacturing Employment (1958 = 100) b/	Manufacturing Production a/ (1958 = 100) b/	Gross National Product A $ billions c/	Cost of Living a/ 1958 = 100	Foreign Trade Surplus (+) or Deficit (-) (A $ millions)
1963-I	110	132	3.91	108	+57
II	110	133	3.80	109	+17
III	111	134	4.30	109	+81
IV	112	139	4.96	109	+193
1964-I	114	145	4.17	109	+139
II	115	151	4.29	110	+81
III	117	152	4.88	112	-63
IV	117	151	5.47	113	- 8
1965-I	120	157	4.88	114	-38
II	120	161	4.85	115	-57
III	120	161	5.26	116	-159
IV	120	158	5.80	118	-70
1966-I	121	155	4.96	118	-18
II	121	160	4.98	119	+57
III	121	161	5.44	119	-15
IV	122	n.a.	n.a.	120	+55

a/ Seasonally adjusted.
b/ Final month of quarter.
c/ In current prices, 1 Australian $ = 1.12 U.S. $ at par.

Sources: IMF, International Financial Statistics; and Commonwealth of Australia, Bureau of Census and Statistics, Monthly Review of Business Statistics.

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Australia's Business Cycle Experience, 1963-67

Since 1963 the Australian economy has experienced virtually a complete business cycle -- from expansion through stabilization to a current phase suggestive of a possible revival of business activity. In 1963-64 an investment boom generated inflationary pressures which were successfully restrained by the use of monetary and fiscal policies, at the cost of some recessionary tendencies in 1965-66. This stabilization program relied in good part on the skillful application of flexible monetary instruments, primarily variations in cash reserve requirements which affected the credit base, and greater fluctuations in interest rate levels than had been experienced earlier in the postwar period. Monetary policy actions were supported by appropriate government tax and spending policies during this three year period. The need for restrictive action in 1964 was evident in the emergence of a deficit in Australia's trade account. (See Table 1.) By 1966 inflationary pressures had eased greatly, and the emphasis of government policy was clearly expansionary. The trade account recovered during 1966, and recent press reports suggest strongly that economic activity is regaining momentum.

In retrospect, the Australian stabilization program of 1964-65 was a marked success, particularly compared to the far less satisfactory experience of the 1950's. The improvement is apparent in the much better record of price performance: from 1963 through 1966, the Australian cost of living increased at a relatively moderate average annual rate of 2.5 per cent, compared to an annual increase of 6.5 per cent in the 1950's. There has also been a significant improvement in the foreign exchange position: Australia's total reserves averaged just over \$1.7 billion at the year end from 1963 to 1966 compared with \$1.2 billion in the 1950's.

Over the past decade, the Australian economy has grown rapidly. Between 1955 and 1965, real gross national product increased by 57 per cent, averaging 4.6 per cent per year In addition, the Australian economy has been moving away gradually from its earlier agricultural orientation. In 1956-57, for example, exports of all raw materials (foods, hides and skins and wool, and some metals) accounted for 76 per cent of all Australia's exports, but this share had declined to 66 per cent in 1965-66. In this decade, too, Australian metals production has shown highly satisfactory growth: output levels were roughly doubled in the case of pig iron, ingot steel, and zinc, and there were much larger percentage gains for tinplate and copper. Recently, a major expansion has occurred in the mineral ore deposits; these developments have brought about sizable capital inflows and have brightened prospects for the further major industrial expansion in this sector.

This growth process has been heavily dependent on foreign capital. In recent years, approximately 25 per cent of private industrial investment in Australia has been financed from external sources. About 45 per cent of this money has come from the United States, and an equivalent share from the United Kingdom; Japanese capital accounts for a large part of the remainder. This capital flow has been necessary to finance a chronic deficit in Australia's current account. The Interest Equalization Tax and other U.S. and U.K. restrictions on capital flows reduced Australia's capital account surplus sharply during 1966, and have dampened prospects for capital flows in the near future. In 1966, capital inflows into Australia also declined because Australian interest rates did not rise as much as yields in major foreign markets. Finally -- in common with some other countries which are dependent in varying degree on foreign capital -- fears have been expressed in Australia over the danger of permitting foreign control over an unduly large share of the country's economy.

Australia's balance of payments followed a pattern between 1963 and mid-1966 which was easily reconciled with domestic stabilization. Shifts in the balance of payments were dominated by the trade account, and surpluses resulted when demand pressures in the economy were soft, and deficits when these pressures were strong. Consequently the means employed to stabilize the internal economy were also appropriate for the restoration of external payments balance. After mid-1966, however, a sharp decline in the capital account produced a balance of payments deficit despite continued softness in the economy and an improving trade situation.

This development has produced some complications for domestic economic policy, in that the ability of the Australian authorities to take action to encourage expansion is limited by the prospect of reserve losses larger than they are prepared to tolerate.

Monetary and fiscal policies moderate 1963-64 expansion

The expansionary phase of Australia's recent business cycle experience began in early 1963 and continued through mid-1965. In current prices, Australian GNP increased at an average annual rate of 10.8 per cent in fiscal 1964 and 1965, while the volume of manufacturing output rose at an average rate of 9.2 per cent during the same two fiscal year periods.[1/] The cost of living remained relatively stable until the middle of 1964 but rose by almost 5 per cent during the next 12 months. The overheating of the domestic economy was accompanied by a rapid deterioration in Australia's foreign trade position, as the country's export surplus dwindled in the first half of 1964 and shifted to a deficit which generally persisted over the subsequent year and a half. (See Table 1.)

1/ Virtually all Australian statistics are shown on the basis of the fiscal year, from July 1 to June 30. In the past, this practice probably reflected the overwhelming importance of the agricultural sector in the Australian economy.

The inflationary pressures generated during the expansion of 1964 and 1965 were successfully controlled by the vigorous application of both monetary and fiscal policies. The monetary authorities rely chiefly on a system of variable cash reserve requirements for the Australian trading banks, supplemented by open market operations. In addition, the authorities control commercial bank loan and deposit rates of interest. The fact that there are only eight commercial banks in Australia also means that moral suasion is a relatively effective monetary policy device. Discount rate policy does not exist in Australia, a regularly quoted discount rate having been abandoned in 1959, when the Reserve Bank of Australia was created.

In the period under review, the Reserve Bank of Australia has carried out its monetary policy objectives primarily by fairly frequent variations in commercial bank cash reserve requirements, ranging between 9 and 16 per cent over these four years. Changes in reserve requirements -- which were increased, generally, in 1963-65 and were brought down from mid-1965 to the end of 1966 -- exerted immediate effects on the commercial bank credit base and were reflected in changes in interest rates. (See Table 2.) It is evident that restrictive credit policies were also reflected in 1964-65 in a pronounced slowdown in the rate of growth in money supply, on a seasonally-adjusted basis.

Table 2. Australia: Financial Indicators
(end of period)

	Interest Rates: Treasury Notes	Interest Rates: 2 Year Government Bond	Interest Rates: 10 Year Government Bond	Money Supply[a] (A $ Mill.)	Statutory Reserve Deposits Ratio (Per Cent)
1963 - I	3.64	4.17	4.66	3,476	11.5
II	3.23	3.88	4.37	3,516	11.5
III	3.23	3.81	4.31	3,600	10.8
IV	3.23	3.77	4.29	3,696	10.5
1964 - I	3.23	3.74	4.32	3,818	15.5[b]
II	3.75	4.36	4.58	3,792	15.5
III	3.85	4.48	4.74	3,876	14.8
IV	3.85	4.48	4.76	3,896	15.8
1965 - I	3.95	4.98	5.12	3,902	15.8
II	4.25	4.95	5.15	3,850	13.8[c]
III	4.25	4.98	5.15	3,802	13.8
IV	4.25	4.96	5.15	3,815	12.8
1966 - I	4.58	4.98	5.15	3,807	12.8
II	4.58	4.94	5.17	3,890	9.4
III	4.58	4.96	5.17	3,997	9.4[c]
IV	4.25	4.51	5.01	4,104	8.9
1967 - I	4.26[d]	4.51[d]	5.02[d]	n.a.	n.a.

a/ Seasonally adjusted.
b/ Includes three increases.
c/ Includes two increases.
d/ End of February.
Source: Reserve Bank of Australia, Statistical Bulletin.

Fiscal policy has also been used in the recent stabilization program. The Commonwealth budget deficit was reduced slightly in fiscal 1964 and sharply in the following year. Income taxes were raised by 5 per cent and various excise taxes were increased in the fiscal 1965 budget. An attempt was made to restrain expenditure growth in that budget, and the deficit was reduced by $239 million (60 per cent).

These restrictive monetary and fiscal policies apparently had their intended effects, and demand pressures in the economy eased significantly after mid-1965. Manufacturing output and employment stopped growing at that time, although increases in the cost of living continued through the end of the year. The effects of restrictive policies were reinforced, however, by a drought which had important effects on agricultural output, and demand in the Australian economy softened appreciably late in 1965. Manufacturing employment was constant during the last three quarters of 1965, and rose by less than 1 per cent during the first nine months of 1966. The cost of living rose by 1.7 per cent in 1966, compared with 4.4 per cent in 1965.

Monetary and fiscal policy was eased when it became apparent that the economy had slowed significantly. A series of reductions in reserve requirements began in May of 1965, but interest rates did not fall until the end of 1966. (See Table 2.) The Commonwealth budget became slightly more expansionary in mid-1965 when a small increase in tax rates was more than offset by the growth of expenditures, and the deficit rose by $94 million. (See Table 3.)

In the fiscal 1967 budget, tax rates were not reduced, but expenditures were increased very rapidly, and the deficit rose by $282 million. Tax rates were increased to restrain the economy, and expenditures were increased when expansion was called for. The net growth of the public sector which this pattern suggests has been largely the result of large increases in defense expenditures.

Table 3. Australia: Commonwealth Budget
(A $ millions)

	1962-3	1963-4	1964-5	1965-6	1966-7
Expenditures	3,988	4,389	4,785	5,380	5,930
Receipts	3,566	3,993	4,628	5,129	5,397
Deficits	422	396	157	251	533
Changes					
Expenditures		+401	+294	+595	+650
Receipts		+427	+635	+501	+268
Deficit		- 26	-239	+ 94	+282

Source: Morgan Stanley and Co. The Australian fiscal year extends from July 1 to June 30.

Although it is not yet apparent in the available indicators, press reports indicate that a recovery began late in 1966, spurred by the end of the drought and the expectation of a bumper wheat crop. The continued development of large mineral deposits, and of industries associated with them, is expected to be a further expansionary force. Recent reports suggest, however, that lack of rain is still a problem in some agricultural areas of Australia.

Trade account dominates balance of payments until 1966

During the early part of Australia's expansion, the balance of payments showed a sizable surplus; as inflationary pressures developed in 1964, however, the trade account deteriorated, and losses of foreign exchange reserves followed. (See Table 4.) Restrictive fiscal and monetary policies brought about an improvement of the trade account along with a stabilization of the economy, and the over-all payments returned to surplus in late 1965.

The Australian balance of payments deteriorated after the middle of 1966, however, due to a sharp decline of the private capital account. (See Table 4.) The Australian Government has attributed this decline to U.S. and U.K. restrictions on capital flows, and is disturbed over its inability to gain exemption from the Interest Equalization Tax similar to that accorded Canada. The Government foresees continued reserve losses during the remainder of 1966 as a result of these restrictions.

Movements of interest rates in Australia relative to major foreign markets, however, were probably as important in the decline of Australia's capital account as the U.S. and U.K. restrictions. Australian interest rates reached a peak in early 1966, which was only about 1.3 per cent above the levels of early 1963, and did not rise further during the spring and summer. European and U.S. interest rates rose by considerably larger margins from 1963 to their peaks, and continued to rise during the spring and summer of 1966. Although U.S. and U.K. actions to restrict capital outflows probably caused some of Australia's deficit, the fact that Australian interest rates did not rise after the first quarter of 1966 suggests that it is not reasonable to attribute all of the decline to these restrictions.

Australian exports grew by 6.2 per cent during the last three quarters of 1966, while imports fell by 7.1 per cent in the same period, and the balance of trade improved by $383 million. The continued softness in the Australian economy apparently had appreciable effects on imports, while continued prosperity abroad and the rapid development of various minerals industries in Australia brought about a greatly improved export situation. The deficit on invisibles has grown fairly steadily, however, so the current account improvement in 1966 was not as large as the trade gain. (See Table 4.)

During recent years there has been an important shift in Australia's foreign trade and financial relationships. The U.K. has declined in importance as a trading partner and source of capital, and has been replaced by the United States, and more recently, by Japan. As recently as the early 1950's the U.K. provided approximately two-thirds of Australia's capital while the U.S. provided only 25 per cent; during the mid-1960's they have each been the source of about 45 per cent. The United Kingdom's share of Australian imports declined during the same period from about 50 per cent to 28 per cent. The U.K.

Table 4. Australia: Balance of Payments, 1963-67
(A $, millions)

	Exports	Imports	Net Invisibles	Current Account	Private Capital	Official Capital	Net Official Reserve Change 1/
1963 - I	559	-502	-151	- 94	85	14	- 5
II	570	-553	-136	- 99	171	21	- 93
III	621	-540	-141	- 60	172	-25	- 87
IV	717	-524	-118	75	176	0	-251
1964 - I	700	-561	-123	16	502	-14	- 54
II	696	-615	-168	- 87	149	1	- 63
III	600	-663	-132	-195	167	- 8	36
IV	672	-678	-148	-154	136	- 6	24
1965 - I	640	-678	-156	-194	49	- 5	149
II	663	-720	-178	-235	168	-20	87
III	641	-800	-157	-316	182	23	111
IV	664	-734	-159	-229	194	62	- 27
1966 - I	639	-657	-139	-157	203	-27	- 19
II	692	-635	-185	-128	297	-39	-130
III	693	-708	-152	-167	155	-77	89
IV	705	-650	-192	-137	112	-13	38
1967 - I	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	65

1/ Reserve gains are shown as minus.
Source: Reserve Bank of Australia, Statistical Bulletin.

application for membership in the Common Market suggests that Australia's trade with England may decline further; there is particular fear in Australia that large English markets for agricultural goods may be lost if the application is successful. The Australian Government is consequently making particular efforts to develop export markets in Japan and elsewhere in Asia. The decline in the importance of the

Commonwealth tie with the U.K. has gone far enough to lead to press speculation that Australia's foreign exchange reserves may be moved out of sterling.

Australia's foreign exchange reserves are now about \$1.5 billion (U.S.) (see Table 5); since 1960 they have fluctuated between about \$850 million and \$2 billion, so the current level is not unusually low. Press reports suggest, however, that the Government foresees continuing reserve losses during the remainder of 1967 unless ways are found to revive sagging capital inflows. Australian reserves reached a peak of \$1,973 million at the end of June 1964 and declined to \$1,495 at the end of March 1967, or by \$478 million in this period of almost three years.

<u>Australia's need for external financing likely to continue</u>

Recent press reports have suggested that Australia does not need large amounts of foreign capital because financial markets capable of absorbing major flotations are developing within the country. The recent success of two large issues in Australia has been offered as evidence of the ability of the country to do without external capital. This argument is based on a confusion between two purposes of international capital flows: efficient financial intermediation, and the financing of basic current account deficits. It may be that Australia is developing capital markets which will reduce the need for the services of foreigners as intermediaries.

Table 5. Australia: Foreign Exchange Reserves, 1963-67
(Millions of U.S. $ -- End of Period)

	Gold	Foreign Exchange	IMF Gold Tranche Position	Total	Change from Previous Period
1963 - I	198	1,097	74	1,368	--
II	200	1,172	100	1,472	+104
III	202	1,254	100	1,556	+ 84
IV	208	1,534	100	1,842	+286
1964 - I	211	1,592	100	1,903	+ 61
II	218	1,655	100	1,973	+ 70
III	223	1,609	100	1,932	- 41
IV	226	1,580	100	1,906	- 26
1965 - I	229	1,397	113	1,739	-167
II	230	1,287	125	1,642	- 97
III	231	1,145	125	1,501	-141
IV	231	1,165	135	1,531	+ 30
1966 - I	223	1,181	160	1,565	+ 34
II	222	1,318	170	1,710	+145
III	225	1,216	170	1,611	- 99
IV	224	1,174	170	1,568	- 43
1967 - I	n. a.	n. a.	n. a.	1,495	- 73

Source: IMF, International Financial Statistics.

From this it does not necessarily follow that the recent rate of economic growth in Australia can be financed exclusively from internally generated resources. The current rate of Australia's development implies levels of investment which apparently cannot be financed without some external savings. Australia has had sizable current deficits in all but one of the last 13 years, and it is unlikely that the development of domestic financial markets will appreciably reduce the need for external capital to finance similar deficits in the future.