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WHAT DETERMINES AUSTRALIAN INTEREST RATES?

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The interest rate played a major role in the last Federal election. Playing on the fears of an electorate whose indebtedness had risen precipitously since the previous ballot, the government undermined the opposition's credentials as a trustworthy economic manager. The opposition gave the government little trouble because a new generation of Labor politicians was oblivious of the economic forces that had shaped interest rates under previous Labor governments. Therefore, the debate on the interest rate was decided mainly on authority. The electorate went with the elder statesman who saw no need to engage in a genuine argument with an inexperienced challenger who failed to take the offensive by pointing out the basic economic principles that determine the interest rate.

Economists distinguish between the nominal and real interest rate. The Fisher equation on the interest rate, which was introduced by Irving Fisher (1867-1947), defines the real interest rate as the nominal interest rate minus the inflation rate. Clearly, it makes a great difference if one borrows at 15 percent interest when the inflation rate is 12 percent, or when the inflation rate is only 2 percent. In the first instance the borrower pays only 3 percent in real terms (15-12), whereas in the second the real interest rate is a crushing 13 percent (15-2). During the election campaign, the debate on the interest rate concerned the real rate because most economic decisions, including the decision to save and invest, depend on the inflation-adjusted real rate. The following

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arguments apply to the real interest rate, although the adjective 'real' is often dropped for brevity.

The real interest rate was high in 1984-85 and in 1989-92, during the premierships of Robert Hawke (1983-91) and Paul Keating (1991-96), and negative during Gough Whitlam's premiership (1972-75). During the first episode of high interest rates under Labor, the short-term real rate peaked at 8.8 percent and the long-term rate at 10.7 percent, and during the second episode the short-term rate reached 10 percent and the long-term rate 8.7 percent. Despite Whitlam's tumultuous tenure, real interest rates dropped to minus 9.1 percent (short-term) and minus 8.1 percent (long-term) during his premiership. The failure to explain these drastic movements in the interest rate, which all occurred when Labor was in charge of economic policy, doomed the opposition's election campaign.

The close connection between Australian and international financial markets ensures that the real return on Australian investments stays close to what can be earned on similar investments abroad. International investors direct capital to the country where it earns the highest real return at a given risk. As can be seen in Figures 1 and 2, Australian real interest rates have traced American interest rates fairly closely since the 1970s. A statistical analysis shows that a change in the American interest rate by 1 basis point (0.01 %) moves the Australian interest rate by the same amount. This relationship holds both for the short-term and long-term rate. Overall, changes in the American short-term rate account for 32 percent of the variation in the Australian short-term rate, and the American long-term rate explains 55 percent of the variation in the Australian long-term rate.[1]

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1 These statistical findings are based on least-squares regressions of the Australian short-term (long-term) interest rate on the corresponding American rate, using the Newy and West estimator for autocorrelated disturbances with four lags. The time period runs from the first quarter 1971 to the fourth quarter 2003. The real interest rate is the nominal rate minus the inflation rate in the preceding year. All data are from the IMF International Financial Statistics.

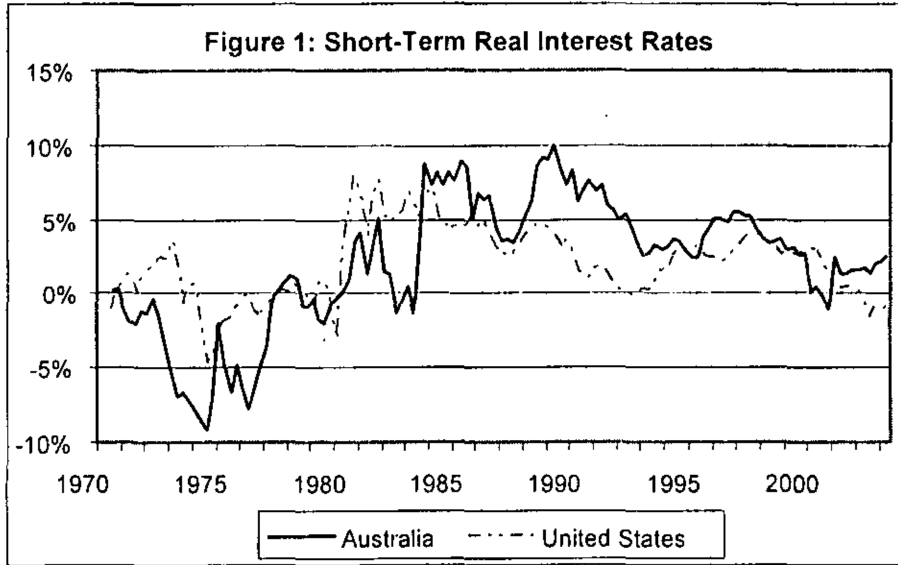
Figure 1: Short-Term Real Interest Rates
15%
10%
5%
0%
-5%
-10%
1970
1975
1980
1985
1990
1995
2000
Australia
United States

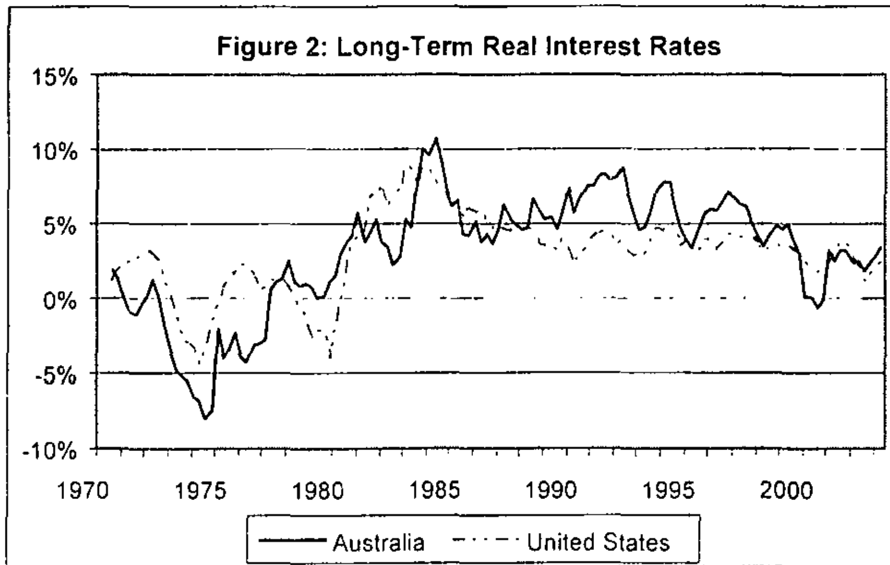
Figure 2: Long-Term Real Interest Rates
15%
10%
5%
0%
-5%
-10%
1970
1975
1980
1985
1990
1995
2000
Australia
United States

Economics students are often surprised to discover that the real interest rate can be negative. They find it hard to believe that consumers wish to save when they lose money on their savings. However, Irving Fisher paid close attention to negative real interest rates in *The Theory of Interest*, his most famous work which appeared in 1930. Indeed, saving that yields a negative expected return is common; it all depends on how much subjective value a consumer attaches to future spending. For example, the expected return on an insurance contract is negative because the insurance company must cover its administrative cost and it earns a profit. Nevertheless, consumers buy insurance because it promises a payout in a future emergency when extra money is particularly valuable to them.

The same principle explains the negative real interest rates in Australia and the United States in the 1970s. During the oil crisis, consumer confidence fell because consumers became more pessimistic about their economic prospects. These fears were well founded, as the oil crisis was followed by high unemployment and low economic growth. Since people expected a decline in personal consumption, they attached a high subjective value to money spent in the future. For this reason, they were willing to save even if the direct return on saving was negative. The motive to save was to maintain consumption in the face of an expected decline in income. Despite the negative real interest rate, the share of saving in disposable income actually increased. Thus, a fall in consumer confidence explains the negative real interest rates in Australia and the United States during the oil crisis. Consumers who anticipate harsh economic conditions save and their saving drives down the real interest rate, possibly below zero.

Irving Fisher's model applies to a frictionless economy in which consumers respond to changes in economic conditions. The effect of monetary policy on real economic variables, including the real interest rate, cannot be adequately analysed within this framework. Monetary policy affects the real interest rate only if rigid wages or prices prevent an immediate return to the old economic equilibrium that existed before the policy change. An expansion in the money supply by the Reserve Bank reduces the real interest rate as long as there is no flare-up in inflation. But prices will eventually catch up with the change in monetary

conditions. Therefore, the monetary authorities can control the real interest rate only during a limited time period.

In October 1979, the new chairman of the Federal Reserve, Paul Volcker, announced that monetary policy would be used to curb American inflation, which exceeded 10 percent at that time. The deliberate monetary tightening sharply increased American real interest rates. The short-term real rate soared from minus 3.1 percent in 1980 to 8 percent in 1981, and the long-term rate jumped from minus 4 percent in 1980 to 9 percent in 1983. Volcker's enduring legacy is a low American inflation rate, which had dropped to 3 percent by 1985. Disinflation was achieved at the cost of a severe recession, during which 2.8 percentage-points of GDP were lost for each percentage-point reduction in inflation (Mankiw, 2003: 369-70). Given the dominance of the US in international financial markets, the high American interest rates spilled over into Australian credit markets. The Australian short-term real interest rate rose from minus 2 percent in 1980 to 4.1 percent in 1981, and after a short reversal in 1982-83 peaked at 8.7 percent in 1984. Similarly, the long-term rate moved from nil in 1979 to 5.6 percent in 1981, and to 10.7 percent in 1984.

The short reversal in Australian interest rates in 1982-83 highlights the Reserve Bank's limited control of the real interest rate. During the last year of the Fraser government (1975-83), the Reserve Bank, which did not yet have the power to conduct monetary policy independently, resisted the upward pressure on domestic interest rates that emanated from the United States. The Hawke government, which gained office in March 1983, continued the easy monetary policy for several months. As a consequence of the monetary expansion, Australian inflation remained high and the current account worsened. In December 1983, the Hawke government bit the bullet, removing exchange controls and floating the dollar. Thus, in the twilight of exchange controls and strict financial regulation, Australia had been able to keep the domestic real interest rate below the international level for only one and a half years. Since then, the removal of exchange controls and financial deregulation have further weakened the Reserve Bank's power to influence the real interest rate independently of foreign economic conditions.

The inflation that had emerged during the oil crisis lasted longer in Australia than in the United States. Australian inflation still averaged almost 8 percent in the second half of the 1980s, and by the end of the decade it was again rising. In 1989-90, the Hawke-Keating government brought inflation under control by slashing the money growth rate and raising the real interest rate.[2] Australian short-term interest rates rose more than 5 percent above American rates, and Australian long-term rates exceeded American rates by about 3 percent. The unfavourable spread between Australian and foreign real interest rates lasted for several years because international investors added a risk premium to Australian investments, until Australia had established its credentials as a low inflation country. The tight monetary policy triggered a severe economic recession that broke the ingrained inflationary expectations in the price setting process. From 1991 to 1994, Australia lost about 2.3 percentage-points of annual GDP for each percentage-point reduction in inflation.[3] Although the recession was painful in terms of unemployment, Australia overcame inflation with a smaller sacrifice in output than the United States.

Previous Labor governments did not cause the large fluctuations in Australian interest rates, which were either due to foreign factors or to the necessity to combat inflation. The worsening economic outlook during the oil crisis, which accounted for an increase in the propensity to save, explains the negative real interest rates in Australia and abroad during the Whitlam government; high American interest rates during the Volcker disinflation spilled over into Australia at the beginning of the Hawke government; and Hawke and Keating brought inflation under control with high interest rates. A policy mistake occurred at the end of the Fraser government, which started a futile attempt to keep Australian interest rates below foreign rates. It may also be thought that Labor put up with inflation for far too long in the 1980s. However, the Labor government was right to give precedence to microeconomic reform over disinflation. The deregulation of the Australian economy would have

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2 Weber (1994) analysed Australian monetary policy during the recession in the early 1990s.

3 The loss in Australian output was calculated with the same method as the one used by Mankiw (2003: 369-370) for the United States.

been derailed if, at the same time when domestic markets were subject to foreign competition, a monetary tightening had given rise to a severe economic recession. It is also likely that the reduction in inflation was less costly in terms of output lost in the more flexible economic environment after microeconomic reform than it would have been earlier.

The Howard government won the debate on the interest rate because the Labor party kept Bob Hawke and Paul Keating conspicuously at arm's length during the election campaign. This strategy badly misfired because it created a big blank in Labor's economic policy record. Although Labor had no real reason to run from its past, it let the government hijack the debate on the interest rate under previous Labor governments. This lack of appreciation of the forces that shaped macroeconomic policy during previous Labor governments weakened Labor's economic policy platform during the 2004 Federal election.

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