

The Devil or the Deep Blue Sea?

The Reserve Bank in recent weeks has moved again to pre-empt the re-emergence of inflation in the Australian economy by increasing interest rates. This is a fairly predictable decision, given the relatively high average economic growth rate of the Australian economy.

However, some sectors of the economy, including the rural sector, are not experiencing the same growth. Irrespective of their relative situations, it seems these sectors have little choice but to face either higher interest rates, or higher rates of inflation. For rural industries, it is difficult to know which is worse – the devil called inflation or the deep blue sea of higher interest rates.

Monetary Policy and Economic Growth

Economists have a variety of different explanations about exactly how monetary policy, which involves money supply and interest rates, has an impact on economic growth rates. Most, however, seem to agree that monetary policy can be used to curb growth in an economy that is in danger of overheating. And to be fair, history suggests that there can be a variety of different factors operating in an economy as it grows or shrinks, meaning that cast-iron rules about the impact of a particular policy on an economy are elusive.

Nevertheless, there seems to be general agreement that an overheating economy in which demand in a range of sectors exceeds supply will inevitably lead to higher rates of inflation as a result of demand pressures.

The accepted mechanism to prevent inflation getting out of hand is to increase interest rates. Interest rates influence both consumer and business spending and investment decisions, with related affects on output, employment and prices. In addition, higher interest rates are attractive to overseas investors, leading to an inflow of overseas capital and an increase in the value of the Australian dollar. This also dampens inflation by making imports less expensive, and also making Australian import-competing industries less competitive.¹

The question of whether the Australian economy is overheating, and therefore in need of some remedial

measures is the subject of some debate. Mark Paterson writing before the RBA's recently announced interest rate increase, argued that an increase was unnecessary because the economy was already slowing from previous high growth rates.² He also argued that many economic indicators, such as private sector investment rates, public spending, wage growth and lending by financial institutions all remain at subdued levels. He further argued that the main reason the RBA was contemplating an interest rate rise was its belief that unemployment rates of less than 7% would increase inflationary pressures and threaten the RBA's target of 2-3% inflation. In Paterson's view, the RBA was therefore increasing interest rates primarily to retain higher unemployment.

Reserve Bank Governor Ian Macfarlane would probably disagree. He has consistently argued that the RBA needs to pre-empt developments in the economy, rather than to react to them. In explaining the RBA's February 2nd decision to increase interest rates by 0.5%, he cited robust household spending levels, income gains from strong employment growth, a 15% growth in household borrowing, industrial capacity utilisation rates at high levels, and employers experiencing difficulties in finding suitable staff as reasons for the rise.³ He also pointed out that despite a dip in the last quarterly CPI estimate, underlying inflation is running at between 2.1 and 2.4%, and that the CPI measure of inflation is expected to be between 2-3% by mid year. He explained "this tightening ... can be viewed as pre-emptive in that it has occurred before overheating has emerged, and its aim is to prevent that eventuality from occurring."

The fact that Australia is an open economy, closely enmeshed with other international economies where interest rates have risen recently, has also been cited as a reason why Australian interest rates had to rise.

No doubt the RBA has also looked at the probable impact of the GST and related tax cuts on consumer spending, and perhaps decided to move earlier and more decisively on interest rates than they would have otherwise.

Why is Inflation Considered Evil?

The appropriateness of the RBA's two recent increases in interest rates ultimately depends on whether the right indicators of future economic growth have been considered. If the RBA is right, the Australian economy will slow

somewhat during the next 1-2 years, and inflation will remain at the lower end of the 2-3% target range the RBA is required to achieve. The resultant relatively stable economic conditions should allow the economy to continue growing at a more moderate rate for a prolonged period.

However, there is no doubt that as a result of the RBA decision economic growth will be slower than it may have been, business interest costs will be higher, and unemployment will not fall as far as it may have. To many, these would seem to be results that are worse than a moderate increase in inflation, which seems to be a 'liveable' and harmless phenomena anyway. Just why should the RBA have such an inflation fixation – even to the extent of having a charter which sets specific inflation targets as its main focus ?

A 1997 conference convened by the RBA examined this question.⁴ In the introductory notes to the conference proceedings, the RBA explained that “Medium-term price stability is widely accepted as the appropriate ultimate goal for monetary policy. ... high rates of inflation distort decision-making, ultimately leading to slower economic growth. ... monetary policy is the most effective instrument in influencing medium-term inflation outcomes. By pursuing a strategy that ensure that inflation does not distort decisions concerning investment, production and savings, monetary policy is best able to contribute to sustainable improvements in living standards.”

This explanation highlights the fact that in times of inflation, scarce resources such as capital tend to be directed more towards investments where short-term speculative gains are higher, such as real estate and the share market. These may not be the best use of those resources from the perspective of the long-term growth of the economy, therefore less wealth is created in the long term, and all are worse off as a result.

It has been estimated that every 1% decrease in Australia's inflation rate causes real output to increase by one quarter of a percent.⁵ However, economists have also pointed out that policies aimed at decreasing inflation have a cost, in that they also increase unemployment, which has a negative impact on economic output. Over the short-term, a 1% increase in unemployment is predicted to decrease real output by about 1 – 1.2%, which could negate any gain from lower inflation.⁶ Despite this, it is generally believed that the longer-term impacts of lower inflation outweigh the short-term costs, even though not all studies conducted on this question reach the same conclusion.

An additional problem that the RBA faces in administering monetary policy is the recognised lag that occurs between the timing of the interest rate adjustment, and the related response in the economy. This has been estimated to average five or six quarters, which adds weight to decisions favouring early adjustment of monetary policy if the goal is to curb inflation.⁷

It has also been pointed out that inflation becomes self-fulfilling, and that it is many years after a high-inflation period before businesses remove inflation expectations from their budgeting and pricing structures. This perhaps

provides an added reason to stamp out these expectations decisively at an early stage.

Overall, while there is no clear answer to the question, perhaps one commentator summed it up best by concluding that “... now that inflation is down, the best policy is not to let it rise again”.⁸

A Rural Perspective on Interest and Inflation

These considerations, which involve the Australian domestic economy, become somewhat academic to the Australian rural sector which has a strong reliance on export markets. Farmers can be impacted as much by economic developments in Europe, Asia and North America as they can by the Australian domestic situation.

Reliance on export markets is highest for wool (almost 100%), wheat (78%), cotton (88%), sugar (80%), pulses (71%) and beef (62%), although most other rural industries export at least one third of total production.

For these industries, the main impact of Australian domestic economic conditions is felt in the cost of farm inputs, although it is difficult to determine which of increased interest rates or higher inflation have the greatest impact.

The flow-on impact of each of these on exchange rates is also important, given farmers reliance on export markets and their increasing reliance on imported farm inputs such as machinery and chemicals.

Interest rates

A 1997 study by ABARE attempted to quantify the impact on lower interest rates and related \$A exchange rates on farm sector incomes.⁹ The study was based on farm survey data, which revealed that the average farm business debt for all broadacre farms was \$132,700, and that interest costs represented an average 11% of total farm cash costs over a ten year period. The study estimated that a 1% decline in interest rates would also result in a 1.5% fall in \$A exchange rates in the first year. The results of this study are shown below.

While this study examined the impact of a reduction in interest rates and the related exchange rate movements, it is reasonable to assume that an increase in interest rates and \$A exchange rates would have a reverse, though similar scale impact on farm incomes. The impact may in fact be slightly greater, as 1997-98 farm survey data shows average farm debt has increased to \$163,000, about 20% above the 1995/6 debt level.

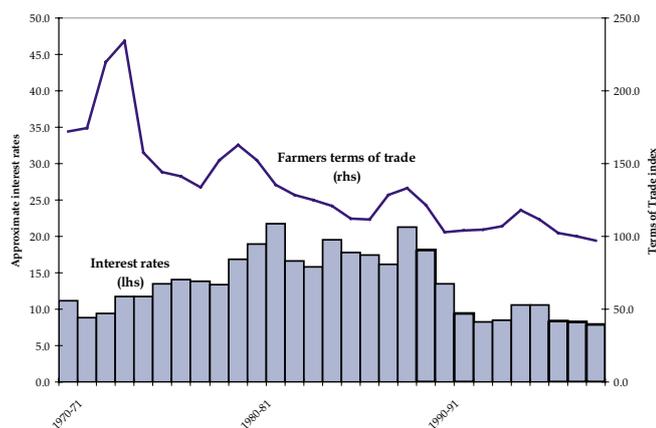
Table 1: Effect of a 1% fall in interest rates, and the related 1.5% fall in the \$A exchange rate on farm cash incomes, 1995-96. * Average totals not necessarily additive

| Enterprise type | Interest rate impact | Exchange rate impact | Total * \$ / farm |
|-----------------------|----------------------|----------------------|-------------------|
| Wheat & other crops | 1,130 | 3,795 | 5,110 |
| Mixed crops/livestock | 1,190 | 1,515 | 2,710 |
| Sheep | 850 | 690 | 1,540 |
| Beef | 680 | 540 | 1,210 |
| Sheep-Beef | 520 | 810 | 1,320 |
| All broadacre farms | 940 | 1,500 | 2,450 |

The two recent increases in Australian interest rates amount to 0.75%, less than the change modelled in the ABARE study, which means their combined impact on farm cash incomes may be slightly less than the amount estimated above.

Figure 1 shows the historical relationship between interest rates and Australian farmers ‘terms of trade’, a statistic that is compiled by ABARE which compares farmers unit costs and unit prices. The graph shows the steady decline in farmers terms of trade since 1970, despite short-lived upturns due to commodity price spikes. The interest rate graph displays estimated interest rates paid by farmers, which Reserve Bank statistics in recent years show have been equivalent to the 90-day Bill Rate plus 3%.

Figure 1: Farmers terms of trade and interest rates.



While there appears to be an inverse relationship between interest rates and farmers terms of trade, it would be too simplistic to attribute all the blame for that decline on interest rates alone. A range of other factors, including high inflation, were all impacting on farm returns at the same time. Nevertheless, this graph and the ABARE study mentioned earlier show that increased interest rates do have a significant adverse impact on farm incomes, and an impact that farmers are unable to pass on in higher prices. Very rough calculations suggest the two recent interest rate rises have cost the average broadacre farmer in Australia around \$2,200 per annum.

Inflation

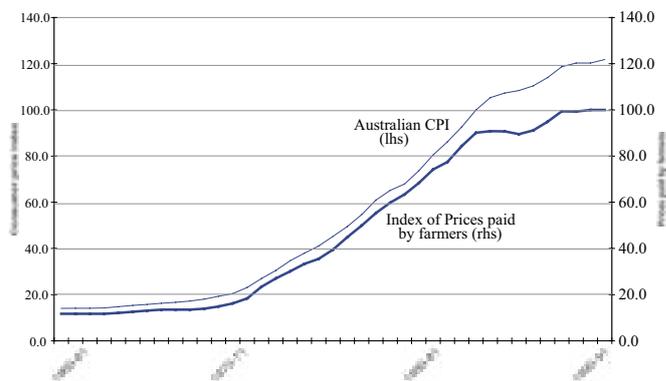
The impact of inflation on farm cash incomes is somewhat more difficult to quantify. The main reason for this is that inflation as it is commonly measured, on the basis of changes in the Australian Bureau of Statistics Consumer Price Index, does not necessarily have a direct relationship with changes in farm prices and costs.

As the ABS recently explained, the CPI is a measure of changes in the price of a weighted ‘basket’ of goods and services, with the prices based on surveys in the eight capital cities.¹⁰ The most recent CPI series excluded mortgage interest payments and consumer credit charges, but includes expenditure on new dwellings.

The historical relationship between the CPI statistic and farm input costs can be observed in Figure 2, which compares changes in the CPI with changes in the Index of Prices Paid by farmers, a statistic collected by ABARE

and used in the calculation of the Farmers Terms of Trade statistic. This shows that since 1991, there has been a substantial divergence between movements in the CPI and farm costs. The reasons for the divergence are complex.

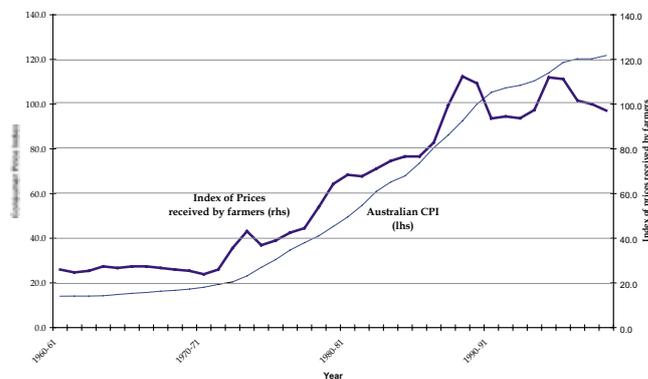
Figure 2: Australian CPI and farm input costs.



The initial divergence between the two index’s occurred at the time of a slump in farm returns, following the boom prices of the late 1980’s. Presumably, lower farm returns led farmers to place strong pressure on their suppliers, and to seek greater efficiencies on-farm. While changes in the value of the \$A would impact on farm costs, there was no major change during this period.

Figure 3 compares changes in prices received by farmers, as expressed by the ABARE index, with changes in the Australian CPI. As would be expected for a sector that is predominantly export oriented, the farm prices received index has moved independently of the CPI at various times.

Figure 3: Farm Prices Received index and the CPI.



The figure also reveals a significant ‘divergence’ in the relationship between changes in prices received by farmers and the CPI in the early 1990’s, which subsequently converged somewhat during the mid 90’s. However the data for recent years shows that farm prices have not increased as the CPI measure of inflation has moved upwards.

Both these graphs show that changes in farm costs and farm prices are no longer closely integrated with changes in the Australian CPI, which is essentially a measure of price movements in Australian capital cities. In fact, while the general economy is experiencing 1-2% inflation, ABARE is predicting that the farm sector will experience deflation in both costs and prices in the next twelve months.

This does not mean that inflation in the Australian economy is irrelevant for farmers. As well as operating farm businesses, farmers also operate family households that face budgetary pressures as a result of inflation. Farmers also compete for investment funding with other sectors of the economy that become more attractive during times of inflation. And in the longer term, inflation washes back into the rural economy in higher costs.

What it does mean, however, is that the farm sector will receive no short-term benefit from measures that aim to keep inflation under control in Australia, especially when inflation is already at such historically low levels.

The Devil or the Deep Blue Sea?

The preceding discussion reveals that while recent interest rate rises will cost the average Australian broadacre farmer in excess of \$2,000 per annum, those farmers are unlikely to gain much short-term benefit from the subsequent lower inflation rates that the interest rate increases are designed to bring about.

Farmers are effectively sandwiched between the devil of inflation, and the 'deep blue sea' of higher interest rates, but the dangers inherent in higher interest rates are more direct, impact immediately, and appear to be much more significant than the impact of inflation.

The fact that the rural economy appears to be operating on a different cycle to the general economy also poses some significant challenges for both Governments and the Reserve Bank in future decisions about monetary and fiscal policy. Monetary policy decisions that are appropriate to modify trends in the general economy may have an adverse impact on regional economies, and these regions may face an extended delay before they share in any subsequent economic benefits that are generated.

An appropriate policy response in these situations may be the use of targeted fiscal measures to stimulate regional economies. No doubt the various State and Commonwealth Treasury Departments would strongly support such measures!

¹ Peter Kriesler. (1995) *The Australian Economy*. Allen & Unwin.

² *Australian Financial Review*, 27/1/00

³ Reserve Bank of Australia. Media Release, 2nd February, 2000

⁴ Reserve Bank of Australia (1997) "Monetary Policy and Inflation Targeting" Proceedings of conference, July 1997.

⁵ McTaggart, D (1992) *The Cost of inflation in Australia*. Reserve Bank

⁶ Kriesler, P (1995). *Op. Cit.*

⁷ Gruen, D et. al (1997) *The lags of Monetary Policy*. RBA paper 9702.

⁸ Norton (1992) cited by Kriesler, P. *op.cit.*

⁹ ABARE (1997) *Effect of interest rate changes on farm sector incomes*. Current Issues 1997(6)

¹⁰ ABS (1998) *Introduction of 13th Series Consumer Price Index*. 6454.0

COMMENTS CONTAINED IN THIS DOCUMENT ARE BASED ON INFORMATION AVAILABLE AT TIME OF PUBLICATION.

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