

# thebigpicture

guideposts for the private investor

Week Commencing 6 September 2004

## **Publishing and Subscription Information**

*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## INTEREST RATES: THE PM'S GUARANTEE

**Interest rates "always" go up under Labor governments according to the Prime Minister as he launched his re-election campaign. Has interest rate history been thrown overboard for the sake of politics?**

Despite most people not being allowed to extrapolate past investment performance when offering financial products, the Prime Minister went all the way with the latest fixed interest offering to hit the market. "I guarantee that interest rates will be lower under a coalition government", he said.

Since there is no objective way to test the future, we will have to trust his judgement. However, we can make some of our own judgements about history.

At the outset, we can dispose of the most simple and Liberal-friendly interpretation of history. Interest rates do not begin rising upon the election of a Labor government, peak as it is about to lose office and then fall for the duration of coalition government.

Taking 1960 as a starting point, there have been four changes of government making for five identifiable political periods against which we can assess the Prime Minister's interest rate claims.

Below are six objective tests of how interest rates have moved under the two parties and some verdicts on the lessons to be drawn.

### ***Beginning v End Point***

Cash rates were higher at the end of Liberal I and at the end of Liberal II than at the beginning of those periods. They also rose during Labor I but were lower at the end of Labor II than at the beginning. Rates have also fallen over the duration of Liberal III.

The biggest fall came from the beginning to the end of Labor II; the biggest rise over the course of Labor I.

Verdict: A Labor government could be credited with the largest fall or the largest rise. Apparently, they do not do anything in half measures. Labor could say that a Liberal government is likely (two out of three times) to leave behind higher interest rates than it inherits.

### ***Averages***

The Liberal average has been higher in two out of its three periods in office than in the period prior to it assuming office. Under Labor, the average was higher in both periods than in the period immediately before.

Verdict: Labor has a 100% (i.e. two from two) track record but interest rates are "nearly always" (i.e. two from three) higher under a Liberal government.

### ***Time Weighted Averages***

The average cash rate (weighted by the number of days in office) under the Liberals has been 5.9%. The average under Labor has been 10.4%.

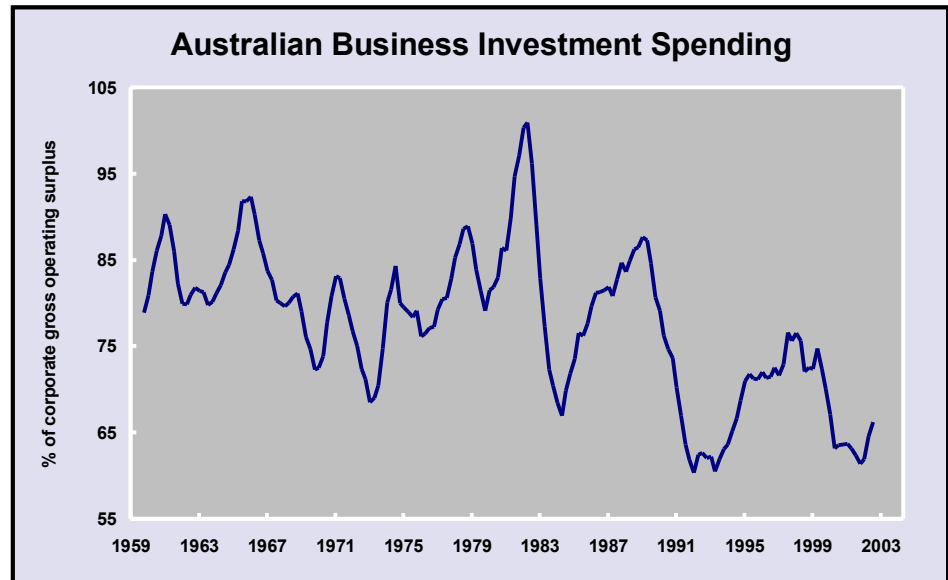
Verdict: Give me the Liberals every time.

### **Five Periods of Government**

Jan 1960 to Nov '72	Liberal I
Dec '72 to Oct '75	Labor I
Nov '75 to Feb '83	Liberal II
Mar '83 to Feb '96	Labor II
Mar '96 to Aug '04	Liberal III

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## THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics and *thebigpicture* Economics

National accounts data for the June quarter released last Wednesday showed business construction activity 5.7% higher than a year earlier and plant and equipment investment up by 11.0%.

However, relative to the profitability of Australian business, spending on capital remained around the record low levels reached in the recession in 1990/91.

Despite a significantly enhanced ability to invest, Australian business appears reluctant to do so. In part, this might be due to it not having got the benefits from its earlier round of investment spending in the second half of the 1990s and a determination to extract more efficiencies from present capacity by working existing assets harder.

However, there seems to be some more pervasive dampening influence. Fed Chairman Alan Greenspan has referred in the USA to the adverse effect business regulation has had on risk taking. There seems to be some evidence in Australia, too, that business might be frightened by the new regulatory regimes being driven in the name of improved corporate governance.

By forcing business decision makers to be more risk averse, the new rules have possibly had a detrimental effect on capital spending, the sustainability of economic growth and the ability of companies to build value for shareholders.

One of the key questions about the Australian economy is whether companies will be prepared to deploy their strengthening balance sheets eventually to prolong the duration of the Australian economic expansion. ■

*“By forcing business decision makers to be more risk averse, the new rules have possibly had a detrimental effect on capital spending, the sustainability of economic growth and the ability of companies to build value for shareholders.”*

## INTEREST RATES: THE PM'S GUARANTEE CONT'D

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- If, on the other hand, you are a Labor supporter, you would highlight how the party “always” inherits policies which have kept rates unsustainably low leading to an election (mostly against the trend of international conditions). Of course, they had to rise afterwards to compensate.

The reality (i.e. my own prejudice) is that interest rates were on a rising trend in Aus-

tralia for thirty years until the early 1990s.

International pressures were partly to blame for the rises just as they have driven the subsequent improvement.

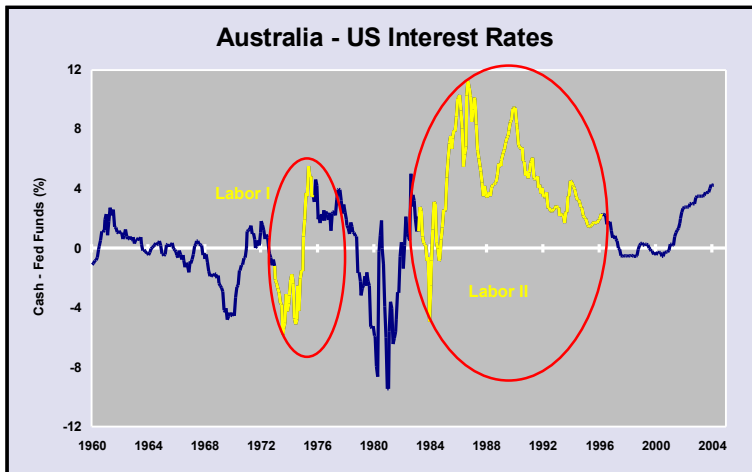
However, monetary policy is notoriously hard to manage and neither party was adept at getting it right. That is why they have both agreed to give up trying and let the Reserve Bank set interest rates without any reference to the political leadership. ■

## INTEREST RATES: THE PM'S GUARANTEE CONT'D

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### Continuing Trends

At the beginning of Labor I, rates had been falling for at least six months (although there was controversy at the time about whether this was driven by politics rather than good economic policy). By the beginning of Labor II, rates had



also been falling, having dropped from over 17% in the prior August. Liberal II and Liberal III also inherited falling interest rates.

Only in this most recent period have the lower rates not been reversed.

Verdict: Except for the last cycle, Australian economic conditions had been so volatile that no-one could maintain control for long.

### Number Up/Down

The five periods divide into 192 months of Labor and 343 months of Liberal rule. Cash rates rose in 74 months under Labor and 134 months under Liberal - 38.5% and 39.1%, respectively, of the number of months they were each in office.

Verdict: Could it be closer? There is a 39% chance of a rate rise under either Labor or Liberals.

### Rest of the World Comparison

Australia is tied closely to the US economic cycle. It is unfair to blame one of the parties for an outcome over which it has no control.

The chart compares Australia's cash rate with cash rates in the USA. A rise in the line indicates that Australia's interest rates are rising faster than interest rates in the USA.

Until the end of 1981, the average difference between US and Australian interest rates at -0.6% favoured Australia and was not significantly different from zero.

However, there was volatility. In the latter period of Labor I, the differential rose from a record low of 6 percentage points to a record high until that time. The differential

subsequently fell, setting another record low under Liberal II but, by the end of this period, the differential was back to where it had been near the end of Labor I.

The mid 1980s, during Labor II, was a period of tumultuous economic change for Australia. Among the changes, new records were set for

interest rates. There was a severe recession but also a prolonged period of low inflation and, with it, the beginning of a trend decline in interest rates.

At the beginning of Liberal III, Australian rates had been falling faster than US rates for four years. The Liberals inherited an ideal interest rate environment for an incoming party.

The momentum did not last long. For the last three years, the differential has been rising as Australia failed to follow US interest rates down and, then, began to raise them more quickly.

Verdict: Should Labor win the upcoming election, unusually, the Liberals would be handing over rates which were on the rise relative to the rest of the world (using the USA as a proxy).

### Overall

The history of Australian interest rates pretty much allows you to draw any opinion to which you might be predisposed.

- It might simply reinforce your cynicism about the use of political rhetoric to weave unrealistic expectations.
- Alternatively, if you are a Liberal supporter, you will probably focus on the mid 1970s and mid 1980s as indicative of the sharp rise in interest rates which "always" happens under Labor.

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## GOVERNMENT: NOT RESPONSIBLE

**Political leadership does not seem to matter to markets any more. The Reserve Bank is the primary economic policymaker.**

Australia has just embarked on an election campaign with two contrasting leaders. One is well known to the financial markets having held senior national political roles for close to thirty years. The other, with a reputation for embracing radical ideas, is a new face who is yet to unveil his first national tax policy.

In years gone by, such a choice of leaders would have created its own tensions about economic policy outcomes. Now, the incumbent is trying to fire the economic debate without great success by creating anxiety over interest rates, budget deficits and inflation.

Neither the choice nor the uncertainty leading to the choice seems to perturb the investment markets.

One reason for the restrained market reaction is that economic policy is now out of the hands of the politicians. While a national leader is being chosen, the markets know that the Reserve Bank is deciding on the nation's economic policy without reference to either of them. Even the Senate does not have a role second guessing these decisions.

The Reserve Bank has acquired sufficient independence for markets to believe that the critical inflation and growth outcomes will not be changed by personality movements at the head of the political process.

Another reason for the absence of investment market interest in the political leadership is a strong policy convergence across parties. Even the conservative side of politics has adopted its own version of 'tax and spend' fiscal policy, a point on which it had long chided its opponents.

The government has set new standards in using rising tax receipts to placate interest groups. This tactic worked very effectively for the government prior to the last national election as it set about restoring its slipping electoral fortunes. Its duplication in this electoral cycle has hardly been sur-

prising.

At the same time, the primary argument for conservative fiscal management remains, namely, the need to build the national savings rate.

Consumption has exceeded household income for over two years according to the national accounts data released on 1 September. The household saving rate was nearly nine percentage points higher ten years ago when this was a more widely discussed matter of public importance.

Fiscal policy had never been free from electoral politics. However, a newly emerging set of fiscal and political principles is being embraced by all parties: use the taxes before your political opponents can earmark them to shore up their own electoral fortunes.

This has been made easier with monetary policy, the primary cyclical economic policy tool, having passed to the Reserve Bank. Politicians have freed themselves, in their minds, from the responsibility of having to conduct economic policy.

To be sure, the façade of good governance requires a budget surplus which everyone is committed to delivering but it can be wafer thin.

That being the case, the temptation to use the expanding fiscal resources from a growing economy to further one's political interests has become overwhelming. There has been a meeting of minds across all parties that potential surpluses will be used tactically.

The emergence of this more pragmatic policy approach has meant little constituency building for targeted long-term fiscal policy outcomes.

Notwithstanding the occasional budget document which dutifully reports the outlook, Budget surpluses as part of a programme to rebuild national savings are no longer a serious discussion in Australia.

Similarly, countercyclical fiscal policy through alternating use of deficit and surplus spending has also been jettisoned. ■

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