

thebigpicture

guideposts for the private investor

Week Commencing 23 February 2004

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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: WHAT IS NORMAL?

History says that Australia's interest rates are too high unless inflation is about to surge from unsustainably low levels. This is a critical call being made by the Reserve Bank. One way or the other, there will be an impact on investment returns.

Last week's edition of *thebigpicture* highlighted how the Australian Reserve Bank appeared to be more aggressive than the US Federal Reserve in pushing interest rates back to what it regards as more normal levels.

There are two issues here. How quickly should the return to normality occur? And, what is normal, anyway?

The authorities in both countries have an idea that the normal rate of interest should be something higher than the rates which prevail. By historical standards they are right. Since 1960, the average Fed Funds rate, the principal US interest rate target for policy, has been 5.8% compared with a current rate of 1%. The average Australian cash rate, the equivalent policy target in Australia, has been 7.5% compared with 5.25% currently.

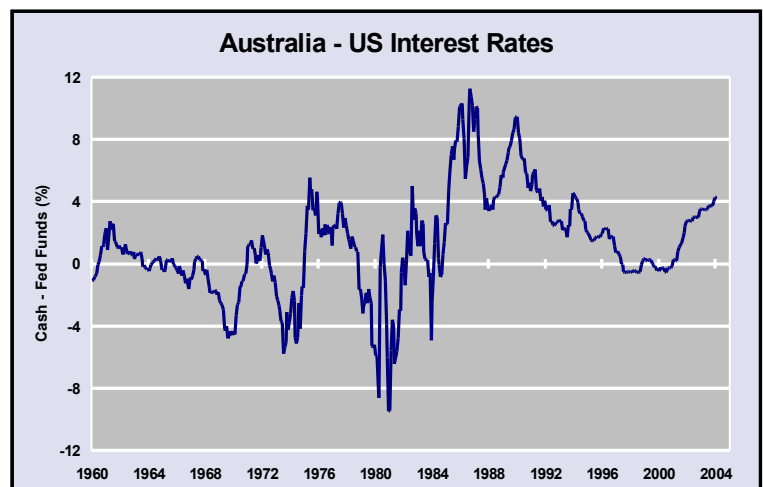
These 44 years of history cover years of boom and recession, oil price shocks and inflation, in Australia's case, as high as 17.5%. Working out what is normal, against this diverse backdrop, is a task full of judgement. The Deputy Governor of the Reserve Bank, when questioned publicly recently about his view of normality, conceded that he did not have a firm number in mind but thought it was something higher than we currently had.

So, as *thebigpicture* has described it on prior occasions, monetary policy is a little like groping in a darkened room. You do not have a clear view of what you are doing. You hope that you will either make out the shapes of relevant objects in time to step aside or that your sense of touch will alert you to any impending danger in sufficient time to avoid destroying the antique vase. In any event, you have to act slowly and deliberately often anticipating things which might not even be a threat.

However, history should be able to offer some guideposts for investors trying to judge what is happening to the investment environment.

The chart on page one shows relative

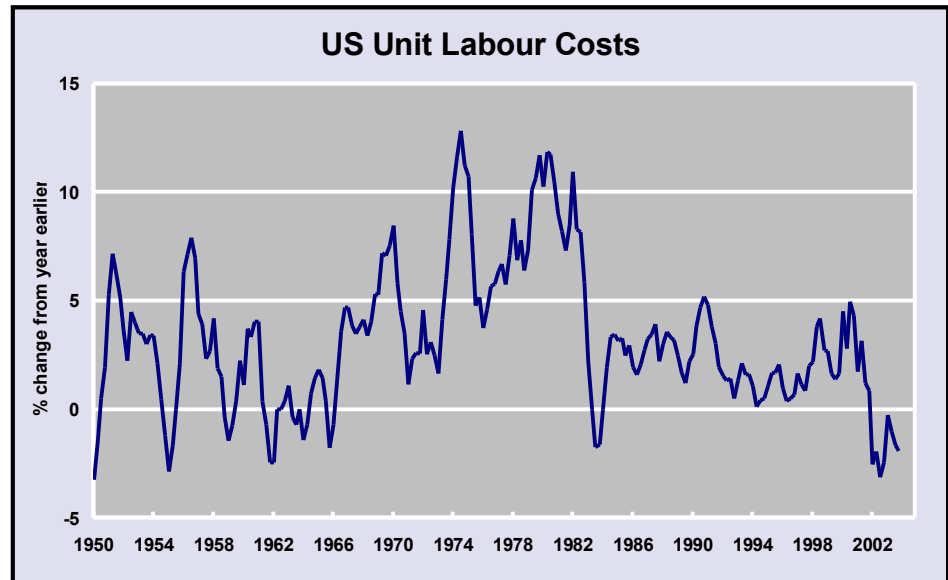
"...monetary policy is a little like groping in a darkened room...you have to act slowly and deliberately often anticipating things which might not even be a threat."



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THE WEEKLY CHART SPOT

“Being more cost conscious has helped business avoid price increases as a way of rebuilding profitability. This has been good for inflation. By helping to reduce the pressure on domestic prices, the surprisingly strong growth in productivity has also encouraged the US Federal Reserve to keep interest rates lower than they might have otherwise.”



Source: US Bureau of Labor

Unit labour costs, a measure of the extent to which labour costs are increasing faster than productivity, are a guide to some of the pressures on business profits. This week's highlighted chart is also linked closely to the discussion of monetary policy in the other pages of this issue.

Other things being the same, firms can accommodate higher wages without any detrimental impact on profitability if the additional wage impost is covered by productivity improvements. Without offsetting productivity support, companies would have to push harder for price rises or face a profit decline.

In the fourth quarter of 2003, hourly labour compensation in the US non-farm business sector was 3.3% higher than a year earlier. This was a moderately significant real rate of increase compared with the 1.4% change in output prices over the same period of time.

At face value, this could have been a considerable burden for US business to bear. However, over the year to the fourth quarter, productivity increased by a massive 5.4%, more than offsetting the higher cost of labour.

The chart shows how unit labour costs declined by 1.9% over the past year and have been falling for nearly three years in a fashion which is largely unprecedented in recent US economic history.

This is no accident. The fall is one manifestation of the so-called jobless recovery which has been occurring in the USA as a result of business pursuing labour shedding policies aggressively in a bid to restore profitability. Alternatively, as demand has grown, business has only reluctantly employed new staff often seeking alternative ways to produce the additional output including the use of new technology for which demand has been rising.

Being more cost conscious has helped business avoid price increases as a way of rebuilding profitability. This has been good for inflation. By helping to reduce the pressure on domestic prices, the surprisingly strong growth in productivity has also encouraged the US Federal Reserve to keep interest rates lower than they might have otherwise.

Economy-wide profit data for the fourth quarter is still to be published in the USA. However, over the year to the September quarter, after-tax US corporate profits increased by 13.9% following a 17.8% gain over the year to the September quarter in 2002, making two successive years of substantial double digit growth.

This mix has made for a relatively benign business recovery in the USA which has underpinned stronger equity market values without tempting the Federal Reserve to undercut the stock market strength with a pre-emptive strike against inflation.

INTEREST RATES: WHAT IS NORMAL? CONT'D

(Continued from page 1)

interest rates. When the blue line is above zero, the Australian cash rate is higher than the Fed Funds rate. A rising blue line means that the Australian cash rate is increasing faster than the Fed Funds rate.

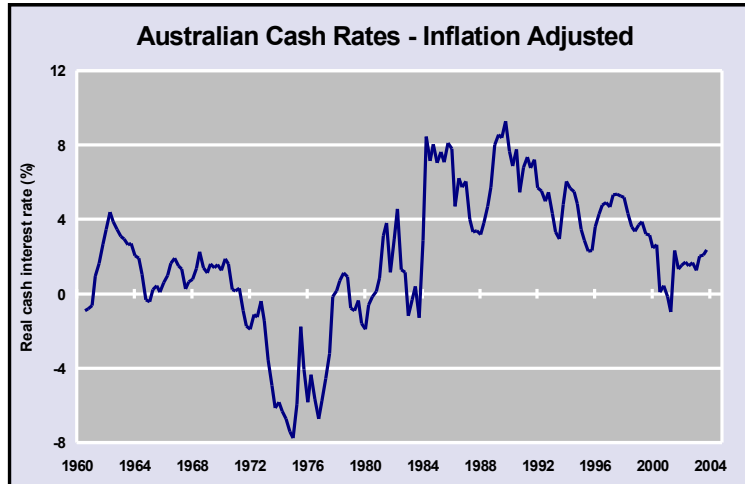
On average over the past 44 years, the Australian cash rate has exceeded the Fed Funds rate by 1.25 percentage points. Until the early 1980s, however, there was little difference. Indeed, the average Australian rate was actually lower than the average US rate by 0.6 percentage points.

During the 1980s, Australia's deteriorating inflation performance, a troubling balance of payments and a steadily depreciating currency caused authorities to raise rates persistently above those in the USA.

Subsequently, during the 1990s, with the threat of inflation subsiding in Australia, rates again converged on those in the USA to the extent that, by early 1998, there was no significant difference.

The current 4.25 percentage point gap began to emerge during 2001 as the Fed moved aggressively to support growth while the Australian authorities were more conservative in their response to perceived global economic and political threats.

The current gap is at the upper end of the pre-1980s range and the lower end of the range which prevailed during the 1980s. And, yet, Australia's economic circumstances appear far more benign than in



the 1980s. In particular, its inflation performance is tracking global inflation closely offering little reason for Australia to have a policy setting diverging sharply from the rest of the world.

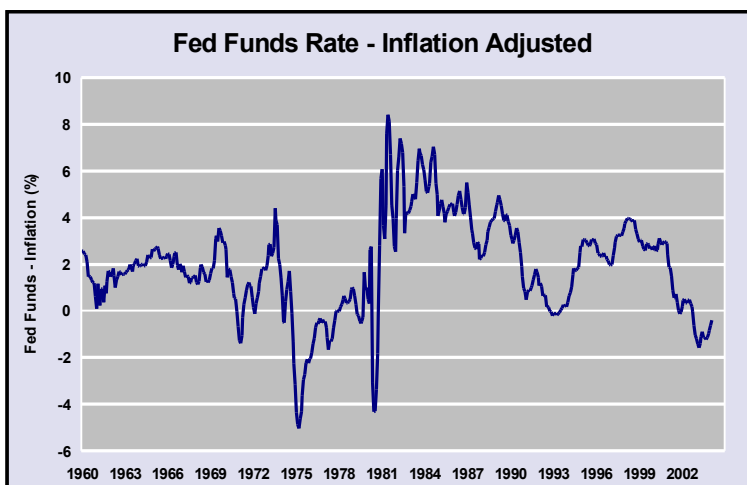
The following charts compare interest rate outcomes with inflation. The first chart on page 3 shows the history of Australia's cash rates adjusted for movements in local inflation outcomes. During the past 44 years, the average inflation adjusted cash rate was 1.9%. However, there were two discrete periods in this history: a quarter of a century prior to 1984 of low real rates followed by a decade of high real rates.

In the second half of the 1980s, real rates were at their peak as the government at the time strived hard to effect some important economic adjustments. However, once this had been done, inflation ad-

justed rates were declining throughout the 1990s.

There was a temporary exaggerated fall with the introduction of the goods and services tax by the Australian government. With the passing of the GST effect, however, real rates have settled mid-way between the pre- and post- 1984 outcomes

“Working out what is normal, against this diverse backdrop, is a task full of judgement. The Deputy Governor of the Reserve Bank, when questioned publicly recently about his view of normality, conceded that he did not have a firm number in mind but thought it was something higher than we currently had.”



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INTEREST RATES: WHAT IS NORMAL? CONT'D

(Continued from page 3)

but consistent with where they were in 1999-2000 when global conditions were far more buoyant than they are today.

Meanwhile, the inflation adjusted rates in the USA, which are shown in the second chart on page 3, continued to decline after reaching a peak in mid-1981. They are now negative and at levels experienced only in rare circumstances during the past 44 years.

Over that time, the average inflation adjusted cash rate was 1.8%, little different from Australia's average. However, in the US, the inflation-adjusted rate is currently minus 0.4% or 2.2 percentage points below its historical average.

Consequently, Australia's real rate measured relative to the prevailing US real rate (shown in the chart on page 4) is pushing toward the upper end of historical outcomes.

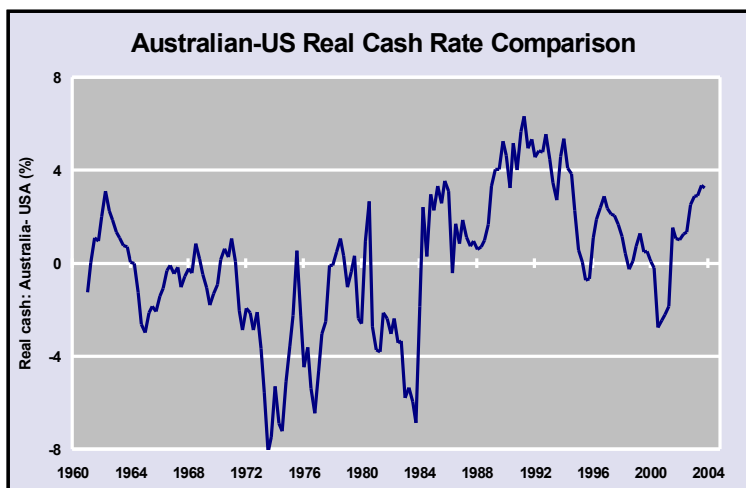
From this historical perspective, Australian rates are relatively high even if US rates were at their historic norm (rather than 2.2 percentage points below).

US average real rate	1.79%
+ current US inflation	1.41%
= implied US 'normal' cash rate	3.20%
+ average Australian-US cash difference	1.25%
= implied Australian cash rate	4.45%
v actual Australian cash rate	5.25%

As the table illustrates, building up from the average US real rate and taking account of current inflation implies that Australian rates are some 0.8 percentage points too high measured against the test of history.

Relative to where US rates actually sit,

Australian rates are some 3 percentage points higher than their average outcomes.



Of course, there is a difference between historical averages and what could be construed as normal given a unique set of economic circumstances.

Nonetheless, the big picture is clear. US authorities are saying that there is cause to be highly accommodating and that an inflation upsurge does not loom large.

Meanwhile, the Australian authorities are saying that policy should be inflation and growth averse in a way which has normally been seen only in periods of strong growth backed by unusually buoyant international economic conditions.

Could there be an argument for significantly different settings between Australia and the USA? History says that there are times when this could be justified. But that is usually the case when Australia is facing a particularly difficult set of circumstances, peculiar to it, in which some form of adjustment must be aggressively forced on the Australian economy.

With the Australian economy now more open to competition and global economic influences than in the 1980s and with the long term decline in the currency seemingly coming to an end, the need for sharply divergent policy seems far less compelling now than in the past.

“During the 1980s, Australia’s deteriorating inflation performance, a troubling balance of payments and a steadily depreciating currency caused authorities to raise rates persistently above those in the USA.”