Macroeconomic Policy Analysis

---- The Case of Australia during the Asian Crisis

By

Sean Ehrlich     David Liu     Shunyao Jin

April 17, 2002

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In 1997, Thailand was faced with a devastating economic crisis as a fall in investor confidence led to mass selling of the Thai Bhat, large depreciation of the value of the currency, and serious economic recession. The problem was not confined to Thailand, though, as it rapidly spread to Malaysia and then other Asian countries like South Korea and Indonesia. It had become known as the Asian Financial Flu when its repercussions had started to affect distant countries like Russia and Brazil. As the crisis spread from one country to the next, Australia had to be concerned for their own economic well-being. Although a developed economy when all the other primary victims were still developing, Australia still had much to fear. Their economy was closely linked to many of the Asian economies that had suffered as well as Japan, whose recession was only worsened by the Asian Financial Flu. Although Australia was probably safe from the economic devastation that befell their neighbors, a serious recession was not out of the question if a fall in investor confidence in Australia resulted from these crises. However, although the Australian dollar did depreciate against the U.S. dollar, British pound, and, the Japanese Yen, this depreciation was minor and, in fact, benefited the Australian economy. This paper will first demonstrate how closely linked Australia was with the Asian economies who suffered crises and present some basic economic indicators for the past seven years. Then it will present a model demonstrating how Australia’s depreciation led to
lower interest rates and higher output. Lastly, the paper will discuss the wider economic implications of the Australian non-response to the depreciation and offer policy suggestions.

Australia’s position in Asia and its recent economic performance

The Australian economy is very closely tied to the economies of Asia. APEC countries account for about 70% of both Australian exports and imports. If one excludes those APEC members that are part of the Americas, like the United States, Canada, and Mexico, as well as Russia, then APEC trade still accounts for 46.3% of imports and 59.7% of exports. Japan is Australia’s second largest trade partner and accounts for 14% of imports and 11% of exports. South Korea is Australia’s fifth largest trade partner and the countries that were particularly hard hit by the crisis, such as Thailand, Singapore, Indonesia and Malaysia, each accounted for over 2% and as much as 4% of Australia’s exports and imports. As can be seen, it would be almost impossible for an economic crisis across Asia to not effect the economy of Australia.

In order to begin to see how the Australian economy reacted to the financial crises, the data in Table 1 show the recent macroeconomic performance in Australia. Two significant points stand out in this data: In 1997, the interest rate dropped and the value of the Australian dollar depreciated significantly against both the U.S. dollar and British Pound and slightly against the Japanese Yen. In addition, inflation fell slightly soon thereafter while economic growth continued. The confluence of these economic changes with the start of the Asian financial crisis is unlikely to be coincidental, but the fact that, taken together, the data suggests that the
Australian economy was, at worst, not harmed by the Asian financial crisis and may even have been helped by it is certainly surprising. The next two sections will show why these economic changes occurred and what they meant.

**Analysis of Australia’s Monetary and Fiscal Policies**

As previously demonstrated, Australia’s economy is closely tied to the Southeast Asia regional economy. It is a major player in the Pacific region because significant portion of its imports and exports come from and go to that region. However, Australia came out almost unscathed during the Asia financial crisis that occurred in the mid of 1997. Many factors contributed to its survival during the crisis. Particularly, Australia’s economic fundamentals have remained strong because it has stable prices, a sound fiscal position, a low current account deficit, and healthy employment growth. This, together with a very competitive exchange rate and expansionary monetary and fiscal policies, has partially insulated the country from the impact of the Asian financial crisis. All of these are the result of Australia’s sound macroeconomic policies and structural reforms that have been gradually put in place over time. The policy which we are going to examine is the monetary measures that Australia took prior to and during the Asia financial crisis.

The Reserve Bank of Australia has the primary responsibility for the conduct of monetary policy. The formal objectives of monetary policy require the Reserve Bank Board to conduct monetary policy in a way that will best contribute to price (currency) stability, the maintenance
of full employment, and the economic prosperity and welfare of the people of Australia. Price
stability is regarded as a precondition for achieving the last two objectives and, in pursuit of this
goal, the Reserve Bank has agreed to a commitment with the government to hold inflation to
between 2 and 3 percent over the economic cycle. The commitment was formalized when it
issued the *Statement on the Conduct of Monetary Policy* in August 1996.

To achieve this goal, the Reserve Bank of Australia has applied effective monetary policy
through adjusting the money supplies to set the target for the cash rate, which is the interest rate
on overnight loans made between institutions in the money market. Most remarkably, it acted
preemptively against inflationary pressures in July 1996, reducing the cash rate by half percent
from 7.5 percent to 7.0 percent. It then did cut the cash rate four more times, each time a half
percent, within a year, in which the Asia financial crisis occurred, and brought down the rate to
5.0 percent. Each of these cuts in the cash rate represented a monetary expansion.

The aggressive rate cut by the Reserve Bank of Australia achieved its goal; the inflation has
decayed sharply to average about 2 percent since the mid-1990s, comparing with an average
inflation rate of over 8 percent during the 1980s. Meanwhile, because of the interest rate
decline, Australia’s currency has depreciated sharply against U.S. dollar in 1997 (by 6.0%) and
1998 (by 14.8%). Figure 1 illustrates an economic model that explains this process: A
monetary expansion lowers the interest rate because, with more money available to lend, banks
cannot charge as much for their money. This lower interest rate leads to a depreciation in the
currency because it lowers the return on the Australian dollar, thus making it less valuable than
foreign money. This should be contrasted with the reasons for depreciation in the Asian
countries afflicted by the Financial Flu: there, the loss of investor confidence resulted in a change of the foreign expectations curve, which led to a depreciation, lower interest rates, and a change in the demand for money.

The depreciated Australian dollar has partially offset the impact of the depreciations of several other Southeast Asia currencies due to the financial crisis, and in turn dampened the deterioration of its current account deficit. This enabled Australia to continue its macroeconomic growth. The AA-DD diagram in figure 2 helps illustrate the mechanism: In order to depreciate the currency, the monetary expansion which shifts out the AA curve also leads to higher output, i.e. economic growth. Because of the Australia’s sound economic fundamentals, there was no change in aggregate demand during the Financial crisis. Thus, the DD curve remained stable. In many other Asian economies, the capital flight that marked the crisis reduced investment, which led to lost jobs as capital projects were halted, which led to reduced demand. Thus, there the DD curve shifted inward, canceling out the output gains from the depreciation, and leading to a reduction in output and deep recession. Because the Australian depreciation flowed from domestic macroeconomic policy and not from foreign investors pulling out capital, these consequences did not follow there.

**Evaluation of Australia’s Macroeconomic Policies**

Generally speaking, Australia’s performance compared well when faced with the increasingly difficult international environment during the Asian Crisis. The Australian economy recorded a favorable combination of good growth and low inflation in 1997. Real non-farm
GDP expanded by 3.75 per cent, led by strong private-sector domestic demand. Underlying consumer price inflation was 1.5 per cent, influenced by declining prices for imports but also containment of domestic costs.

Financial markets in Australia, although not directly caught up in the financial turmoil that engulfed the region, had nonetheless been affected by the actual and expected economic consequences of the crisis – notably by weakening export demand and falling commodity prices. This had led to a fall in the exchange rate of the Australian dollar and lower bond yields; the share market, while rising, had underperformed markets in most other industrial countries. These adjustments in financial prices had taken place over a period of nearly a year.

The worsening external economic conditions were out of the control of Australian policymakers. The task for domestic policies, rather, was to support the economy’s capacity to adjust to changing circumstances. In this regard, at the macroeconomic level at least, past policy actions payed off. Public finances were in good shape, inflation was low, and the balance sheets of businesses and financial institutions were strong. We can find that the current account deficit widened in 1998; however, a short-term widening of this nature does not reflect inadequacies in current economic policies and, in itself, is not an issue of direct concern for monetary policy. This widening current account deficit is unusual, though, as usually depreciation should lead to improving current accounts as Australian goods would be cheaper for foreigners to buy and, thus, they should have purchased more while imports would be more expensive for Australians to buy and they should have bought less.

**Recommendation in line with Australia’s Policies**
Certainly, the single most effective step countries can take is to pursue sound and sustainable economic and financial policies. And given the ease with which contagion can spread, even countries with ostensibly strong fundamentals may, at times, need to change their monetary and fiscal policies to guard against spillover effects.

At the same time, since such crises are often provoked by problems in the financial sector, or intensified by them, much more needs to be done to strengthen domestic financial systems and the policies and institutions needed to underpin them. In particular, domestic financial systems must be strong enough to allow governments to change monetary policy as needed, without fear of provoking a domestic banking crisis or rampant inflation. While this undoubtedly calls for more effective prudential regulation and supervision, it also calls for better accounting and disclosure rules, an end to government-directed lending, more effective national bankruptcy laws, and other reforms to reinforce market discipline over owners and managers.

More broadly, the Asian crisis underscores the fact that there is a wide range of institutional factors that can have an important bearing on countries’ economic performance. Certainly, sound domestic financial systems are one of them, but there are many others, including the transparency of government policy, a level playing field for private sector activity, a legal system that protects property rights and allows assets to move to their most productive uses, and a properly sequenced opening to capital inflows. Appropriate measures to boost domestic demand are surely needed, but so are steps to accelerate deregulation of the economy, and strengthen the domestic financial system. Because of Australia’s institutional
factors and underlying economic performance, they were able to survive the financial crisis where so many other countries did not.

Cited Sources: