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DESKBY 080900Z [coll]

FM CANBERRA 080600Z MAR 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 107 OF 8 MARCH

INFO PRIORITY DOT WASHINGTON TOKYO

FOLLOWING ALSO FOR HM TREASURY BANK OF ENGLAND ECGD

DEVALUATION OF AUSTRALIAN DOLLAR

1. THE PRIME MINISTER ELECT, MR HAWKE, ANNOUNCED EARLY TODAY A DEVALUATION OF THE AUSTRALIAN DOLLAR BY 10%, LOWERING THE MID-RATE AGAINST THE US DOLLAR FROM 94.91 TO 85.49 CENTS. THE TRADE WEIGHTED INDEX MOVES DOWN FROM 81.5 TO 73.3, AND THE STERLING MID-RATE TO 56.60 PENCE.
2. THE LAST TWO WEEKS OF THE ELECTION CAMPAIGN HAD SEEN A LARGE OUTFLOW OF FUNDS FROM AUSTRALIA OFFICIALLY ESTIMATED AT ABOUT TWO AND AN HALF BILLION AUSTRALIAN DOLLARS. THE AUTHORITIES HAD BEEN ALLOWING THE MID-RATE AGAINST THE DOLLAR TO DRIFT DOWN ONLY SLOWLY AT THE COST OF A SUBSTANTIAL INCREASE IN HEDGING COSTS. THIS DID NOTHING TO STEM THE CAPITAL OUTFLOW WHICH REDUCED THE RESERVE BANK'S FOREIGN EXCHANGE HOLDINGS FROM OVER TEN BILLION AUSTRALIAN DOLLARS TO AROUND EIGHT BILLION AUSTRALIAN DOLLARS, A RATE OF DEPLETION WHICH WAS CLEARLY NOT SUSTAINABLE THE MAJOR EFFECT OF THE OUTFLOW WAS A SEVERE SQUEEZE ON LIQUIDITY WITH VERY SHORT TERM MONEY RATES GOING OVER 100 PERCENT AND RUMOURS OF BANKS HAVING HAD TO RESORT TO THE RESERVE BANK AS LENDER OF LAST RESORT. HIGHER INTEREST RATES WERE THREATENING TO FLOW THROUGH TO THE DOMESTIC MARKET.
3. THE MAJOR CAUSE OF THE OUTFLOW WAS THE MONEY MARKET'S WORRIES ABOUT THE ADVENT OF A LABOR GOVERNMENT COMMITTED THROUGH ITS INTERVENTIONIST POLICIES TO A BUDGET DEFICIT CONSIDERABLY LARGER THAN THE LIBERALS' ESTIMATES OF FOUR BILLION AUSTRALIAN DOLLARS FOR 1982/83 AND SIX BILLION DOLLARS FOR 1983/84, AND TO A PRICES AND INCOMES POLICY WHICH, IT WAS FEARED, WOULD FAIL TO RESTRAIN REAL WAGES.
4. IN A PREPARED STATEMENT FOLLOWED BY A PRESS CONFERENCE THIS MORNING MR HAWKE STRESSED THAT THE GOVERNMENT HAD WAITED TO SEE IF THE MARKETS WOULD SETTLE DOWN ON 7 MARCH THE FIRST TRADING DAY SINCE THE ELECTION. WHEN THEY HAD NOT, HE HAD PREFERRED A SINGLE DISCRETE DEVALUATION TO A GRADUAL LOWERING OVER MANY DAYS SINCE, HE CLAIMED, THE LATTER WOULD NOT HAVE GIVEN THE REQUIRED SIGNAL TO THE MARKET. HE HIGHLIGHTED THE SEVERE LIQUIDITY SQUEEZE WHICH WOULD HAVE OCCURRED IN THE JUNE QUARTER, AS TAX BILLS ARE SETTLED, IF THE CAPITAL OUTFLOW WAS NOT ARRESTED. HE RULED OUT ANY FURTHER DISCRETE DEVALUATION IN THE FORESEEABLE FUTURE. THE DEVALUATION DID NOT

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MOVEMENTS WOULD BE BY MEANS OF THE CRAWLING PEG. THE GOVERNMENT'S
VIEW WAS THAT THE FUNDAMENTAL FACTORS UNDERLYING THE EXCHANGE
RATE WERE SOUND: THE CURRENT ACCOUNT DEFICIT FOR 1983/84
WOULD BE NO WORSE THAN IN 1982/83 (ESTIMATED AT AROUND NINE
BILLION AUSTRALIAN DOLLARS), AND COULD BE SUBSTANTIALLY BETTER
IF SIGNS OF GROWTH IN THE WORLD ECONOMY WERE FULFILLED. THE
DEVALUATION RESTORED COMPETITIVENESS ON A UNIT WAGE COST BASIS
TO AT LEAST THE LEVEL OF 1979/80, AND WOULD NOT BE ALLOWED
TO STAND IN THE WAY OF ACHIEVING A CUT IN INFLATION. THE INCOMING
TREASURER, MR KEATING, SAID TREASURY ADVICE WAS THAT THE
INFLATIONARY IMPACT OF THE DEVALUATION WOULD BE MUTED BECAUSE
OF THE CURRENT RECESSION.

5. MR HAWKE RELEASED TREASURY ESTIMATES OF THESE BUDGET DEFICITS
FOR 1982/83 (4.3 BILLION DOLLARS) AND 1983/84 (9.6 BILLION
DOLLARS) UNDER THE OUTGOING COALITION GOVERNMENT'S POLICIES.
THESE ESTIMATES, AVAILABLE TO THE COALITION GOVERNMENT DURING
THE LAST FEW DAYS OF THE ELECTION CAMPAIGN, CONTRAST WITH THE
FIGURES OF FOUR BILLION DOLLARS AND 6 BILLION DOLLARS WHICH
HAD BEEN USED EXTENSIVELY DURING THE CAMPAIGN. HE WAS SEVERELY
CRITICAL OF MESSRS FRASER, HOWARD AND PEACOCK (THE LATTER
TWO BEING THE MAIN CONTENDERS FOR THE LEADERSHIP OF THE LIBERAL
PARTY) FOR HAVING RAISED FEARS OF A DEVALUATION UNDER LABOR
DURING THE ELECTION CAMPAIGN AND FOR HAVING UNDER-STATEd THE
ESTIMATED BUDGET DEFICITS ESPECIALLY FOR 1983/84. MR HAWKE
CHARACTERISED A DEFICIT OF NEARLY 10 BILLION DOLLARS FOR
1983/84 AS UNACCEPTABLE AND COMMITTED HIS GOVERNMENT TO WORK
FOR A DEFICIT OF AROUND 7.5 BILLION DOLLARS (THE FIGURE
ORIGINALLY ARRIVED AT BY ADDING 1.5 BILLION DOLLARS OF ADDITIONAL
STIMULUS TO THE ORIGINAL ESTIMATE OF 6 BILLION DOLLARS), OR
JUST UNDER 5 PERCENT OF GDP, IN LINE WITH OTHER OECD COUNTRIES.
THE NEW GOVERNMENT HOPES TO ACHIEVE SOME OF THIS REDUCTION
BY STIMULATING THE ECONOMY, BUT IS ALSO TO RE-EXAMINE BOTH
CURRENT EXPENDITURE COMMITMENTS AND LABOR EXPENDITURE AND
TAXATION PLANS. MR HAWKE REFERRED TO HIS STATEMENT BEFORE THE
ELECTION (PARA 3 OF MY TEL NO 97) IN WHICH HE HAD HINTED THAT
TAXES MIGHT HAVE TO BE INCREASED IF THE BUDGET DEFICIT PROVED
TO BE GREATER THAN HE HAD BEEN LED TO BELIEVE.

6. THE DEVALUATION WILL BE WELCOMED BY THE MONEY MARKETS, WHO
HAD COME TO SEE IT AS INEVITABLE, BY THE RURAL AND MINING
LOBBIES WHO HAD BEEN URGING A DEVALUATION TO HELP EXPORTS,
AND BY SOME MANUFACTURERS , ESPECIALLY STEELMAKERS, WHO HOPE
TO SEE REDUCED COMPETITION FROM IMPORTS. THIS HAD ALREADY BEEN
REFLECTED ON THE STOCK EXCHANGE WHERE STOCKS OF MINING COMPANIES
HAVE JUMPED. A MAJOR WORRY FOR THE GOVERNMENT IS THE EFFECT
OF THE DEVALUATION ON THEIR PRICES AND INCOMES POLICIES,
BUT MODERATE AND UNDERSTANDING STATEMENTS FROM THE ACTU HAVE
GIVEN THEM SOME GROUNDS FOR OPTIMISM.

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7. MR HAWKE HAS ACTED DECISIVELY AND RESPONSIBLY BEFORE HE IS EVEN OFFICIALLY PRIME MINISTER TO END THE UNCERTAINTY ON THE MONEY MARKETS (AS MR FRASER'S GOVERNMENT IS STILL OFFICIALLY IN OFFICE AS A CARETAKER GOVERNMENT UNTIL THE NEW GOVERNMENT IS SWORN IN, THE FORMAL AUTHORISATION FOR THE DEVALUATION WAS GIVEN BY MR HOWARD). A 10 PERCENT DEVALUATION WAS IN LINE WITH TREASURY RECOMMENDATIONS AND SHOULD BE ENOUGH TO ACHIEVE THIS, AND TO BEGIN TO REVERSE THE CAPITAL OUTFLOW: THERE IS EVIDENCE THAT THIS HAS BEGUN, AND SHORT TERM INTEREST RATES ARE BEGINNING TO FALL. MR HAWKE HAS INEVITABLY LAID THE BLAME FOR THE NECESSITY OF DEVALUATION AT THE FEET OF HIS POLITICAL OPPONENTS, AND WAS CLEVER ENOUGH TO LAY ON THEM PRIOR TO THE ELECTION THE RESPONSIBILITY FOR ANY CHANGES IN LABOR PLANS WHICH, THE BUDGETARY SITUATION MAY NOW REQUIRE.

8. THE EFFECT ON UK/AUSTRALIAN TRADE IS UNLIKELY TO BE DRAMATIC. THE 10 PERCENT DEVALUATION AGAINST STERLING WILL NOT WHOLLY REVERSE THE AUSTRALIAN DOLLARS APPRECIATION AGAINST STERLING WHICH HAS OCCURRED OVER THE LAST FEW MONTHS AS STERLING HAS DEPRECIATED AGAINST THE US DOLLAR. THE MAJORITY OF UK EXPORTS TO AUSTRALIA ARE COMPETING WITH OTHER FOREIGN, NOT AUSTRALIAN, SUPPLIES. ON SPECIFIC UK EXPORTS, ATTEMPTS TO LOWER LOCAL PRICES IN COMPENSATION WILL MAKE IT EASIER FOR THE AUSTRALIANS TO BRING ANTI-DUMPING ACTIONS; ON SPECIFIC UK IMPORTS (MITSUBISHI CARS BEING THE MOST OBVIOUS) WE WILL HAVE GREATER DIFFICULTY IN PROVING PRICE DISCOUNTING.

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