Vegetable Industry Development Program

What Drives the Economy? Key Economic Variables

This fact sheet provides a brief explanation of four key economic variables, how these variables interact and what you may need to consider in assessing the impact that they can have on your vegetable growing business.

The key variables that are considered are:

- Inflation
- Interest rates and monetary policy
- Exchange rates
- Fiscal policy.

HAL
Horticulture Australia

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

Inflation

What is inflation?

Inflation is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation also reflects erosion in the purchasing power of money over time.

There are many different factors that determine the rate of inflation. Cost-push inflation arises when external factors have an adverse impact on the supply of goods or services. Examples include disruptions to the flow of oil or other important commodities, or the impact of bad weather on the supply and availability of food, which cause prices to rise. Demand-pull inflation occurs in strong or over-heating economies when strong demand for goods and services causes their prices to rise. This is often referred to as 'too much money chasing too few goods'. A strong economy often results in shortages of labour in particular sectors or industries and results in bigger wage increases feeding through into faster inflation.

A sharp plunge in the exchange rate of the currency of a particular country results in higher prices of imported goods and services in that country. That has a direct detrimental impact on inflation and there can be secondary effects if this results in higher wages or increases in the cost of domestically-produced goods as companies may use the reduced price competitiveness of imported goods to raise their own prices in order to build profit margins.

There are a number of data bases that can be used to measure the rate of inflation (price rises) in the Australian economy, but the one that is widely used and reported on in the media is the Consumer Price Index (CPI). In Australia data for the CPI is collected on a quarterly basis. The CPI measures changes in the price of a basket of goods and services purchased by a representative sample of households.

What is the impact of inflation on the price of vegetables? What other relevance does inflation have on business?

As with other goods, the price of vegetables is determined by the interaction of supply and demand. Demand for many vegetables is fairly price inelastic, which means that modest rises in their price do not significantly reduce demand, while lower prices do not generally produce strong increases in demand. In the case of more exotic or unusual vegetables that command high prices then demand is likely to be more sensitive to price changes than is the case with basic vegetables.

The impact of bad weather can have a significant impact on the production and supply of vegetables and such changes in supply are more likely to result in significant fluctuations in the prices of vegetables than changes in demand which usually occur gradually over a longer period of several years or more. Sometimes price rises can be substantial such as in recent instances where severe flooding in Queensland caused major damage to production of a range of vegetables and resulted in substantial price increases.

The main impact of inflation on vegetable growers is in eroding the purchasing power of their income or profit. The real value of their income in terms of the goods and services that can be purchased will decline unless they are able to increase the price of their own produce to compensate for the impact of inflation. This is no different from the impact on other businesses and individuals. If the attempts of businesses to compensate for inflation by raising the prices of their products are successful, and workers are able to secure wage increases that maintain their real income, then inflationary pressures will intensify. The Government and the central bank (the Reserve Bank of Australia) will use fiscal and monetary policy (see below) to curb inflation and, in certain circumstances of rapid and accelerating inflation, may resort to direct controls on prices or wages to bring inflation under control.

In considering demand for their produce, growers of particular vegetables are probably more interested in specific changes in the price of their vegetables relative to other vegetables rather than in the overall rate of inflation. If there has been a general rise in the price of vegetables because of bad weather, but not much change in the price of the particular vegetables they grow in relation to other vegetables, then the impact on demand is likely to be fairly modest. In circumstances where the prices of a few vegetables have risen sharply relative to most other vegetables then the impact on demand for those vegetables is likely to be much more significant.

Another major impact of inflation on vegetable growers is on the cost of labour and other inputs of production. Faster inflation will usually trigger demands by workers for higher wages as they seek to preserve or restore the purchasing power of their income. Vegetable growers will also focus on the detail and causes of inflation paying particular attention to their main costs of production which, in addition to labour costs, include fertiliser, seed, and fuel.

HAL
Horticulture Australia

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

Interest Rates and Monetary Policy

What are interest rates?

An interest rate is the cost that a borrower pays a lender for borrowing a principal sum of money for a period of time. It is usually expressed as a percentage rate payable per annum on the principal borrowed.

There are numerous interest rates with differences in rates reflecting many factors. These include:

- the time period of a loan
- its terms and conditions and flexibility
- whether the loan is unsecured
- if the loan is secured the strength of the security used as backing for a loan
- the risk assessment of the borrower which takes account of financial circumstances and credit history
- the purpose of the loan and viability of any business or investment plans or proposals
- whether the interest rate is fixed for the term of the loan or floats (changes) as economic and financial circumstances change
- the currency of the transaction.

Interest rates (the price of money) on individual loans reflect the level of risk involved. The higher the risk the more lenders will expect for their money. Hence, interest rates are structured with interest rates rising as the perceived level of risk increases. For example banks will charge vegetable growers higher interest rates for unsecured loans such as overdrafts than for loans backed by an asset such as land. In Australia interest rates are structured upwards, depending on risk, from the cash rate set by the Reserve Bank of Australia (see below).

What impact do interest rates have?

A vegetable grower will usually borrow money for working capital expenses, to manage cash flow problems or to expand, develop, or diversify business. Whether the cost of a loan, determined by its interest rate is worthwhile will depend on factors such as the viability of the business plan being undertaken and whether alternative sources of finance are available.

Things to consider

The borrower will need to make a detailed assessment of the viability of their own business plans, assess conditions and whether factors that directly affect their business might change during the term of the loan. It is also important to consider how broader economic and financial changes could affect the interest rate paid and have an impact on the viability and profitability of the business venture.

This sort of detailed assessment will usually also be undertaken by the lender and provides the basis for negotiation concerning the interest rate to be paid, whether it is floating or fixed, and the terms and conditions of the loan. As well as seeking the lowest possible interest rate by comparing the rates offered by different lenders, the borrower should also pay attention to the terms and conditions of the loan, such as whether the loan can be repaid early, without financial penalty. In offering to provide security for the loan, such as a guarantee or mortgage on land or property, the borrower needs to be alert to the consequences, which can be far-reaching if the security is realised by the lender.

What is monetary policy?

Monetary policy is the process by which the central bank or monetary authority of a particular country controls the money supply, often by using its power to change short-term interest rates. The intent is to promote economic stability by aiming for specific economic targets such as a rate of economic growth sufficient to promote employment and ensure low unemployment, and low and stable inflation.

In Australia the Reserve Bank of Australia (RBA) is responsible for conducting monetary policy. It does so independently of government. The RBA's principal role is to control inflation but its charter also specifies that its powers should be exercised in such a way as to contribute to currency stability, maintain full employment, and promote economic prosperity.

Monetary policy decisions of the RBA involve setting the interest rate on overnight loans in the money market (the cash rate). In normal circumstances, the RBA announces its cash rate decisions on a monthly basis (except January) on the first Tuesday of the month. By buying or selling government securities the RBA manipulates the cash rate on a daily basis to the desired (target) level.

Other interest rates in the economy are influenced by the cash rate to a varying degree, with monetary policy having a significant impact on the behaviour of lenders and borrowers in the financial markets. The cash rate has a much more direct influence on short-term interest rates than on longer-term rates on loans/borrowings with a maturity of one year or more.

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

HAL
Horticulture Australia

Exchange Rates

What are exchange rates?

An exchange rate between two currencies is the rate at which one currency is exchanged for the other. There are a myriad of factors that determine the exchange rate of a particular currency and how it changes over time. In most countries these factors include general economic conditions and the economic outlook, the rate of inflation, the level of interest rates, and the balance of payments.

The international competitiveness of the exports of countries with inflation persistently higher than that of other countries will deteriorate, with a detrimental impact on the balance of payments. As a result, the currencies of countries with relatively high rates of inflation are likely to depreciate, or weaken, over the medium term in order to help to restore international competitiveness. However, it is not unusual that there are lengthy periods when the actual exchange of some currencies is out of line with their underlying or fundamental value in terms of purchasing power.

Changes in international commodity prices can have a significant impact on the exchange rates of the currencies of particular countries and this is the case in Australia with its large mining and agricultural sectors having a major impact on economic prospects and the balance of payments. The operation of monetary policy and changes in interest rates has an impact on exchange rates with higher interest rates in Australia relative to other countries likely to prove attractive to foreigners, increasing the demand for Australian dollars and pushing the value of the Australian dollar up.

How do exchange rates influence the Australian economy?

Changes in the exchange rate can have a significant impact on the economy through their impact on inflation, the balance of payments, and growth and employment prospects in different sectors of the economy. These linkages are examined below. Because of the importance of international commodity prices to the Australian economy, swings in the exchange rate of the Australian dollar can be large and there have been periods when the scale of exchange rate movements has exceeded those in many other countries. Since the dollar was floated in 1983 the average yearly movement in the Australian dollar against the US dollar has been in the order of 14 cents.

How do exchange rates influence my business?

An appreciating or strong Australian dollar damages the competitiveness of Australian vegetable exports on world markets, while improving the competitiveness of vegetable imports into Australia competing with domestically-grown vegetables. A weak or depreciating currency has the opposite effect and is favourable for vegetable growers as it has a positive impact on the competitiveness of vegetable exports while making imports of vegetables less competitive against domestic produce.

Recent analysis shows that changes in the external value of the Australian dollar have some impact, after a time lag, on the level of vegetable imports. There are, however, a myriad of other factors at play so it is not possible to measure the scale of the impact of currency movements on overseas trade in vegetables with precision.

Things to consider

The impact of exchange rate movements on the export competitiveness of vegetables is likely to be a significant factor in determining whether vegetable growers seek to sell some of their produce overseas. However, it can take many years to build a successful export business and individual vegetable growers might not have the resources to attempt to do so. They will also take account of the risk that while a decline in the value of the Australian dollar against other currencies may have boosted the competitiveness of their product in overseas markets, the currency outlook is dependent on many factors and sentiment can change suddenly causing gains in competitiveness to be lost.

HAL
Horticulture Australia

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

Fiscal Policy

What is fiscal policy?

Fiscal policy is the use of government spending and revenue (tax) decisions to influence economic conditions and the economic outlook. It is separate from, but used in conjunction and in co-ordination with monetary policy, the other major lever of economic policy.

Spending and tax changes are detailed in government budgets prepared on an annual basis. Individual taxes may be introduced, abolished, or changed in order to improve their efficiency or to assist particular sectors of the economy, but fiscal policy is concerned with overall revenue and spending decisions which, as with monetary policy, have the ultimate objective of creating conditions conducive to economic prosperity and well-being.

A major focus of the annual budget is on the bottom line, that is, the surplus or deficit that is produced from total government revenue and spending. If economic conditions are weak and the economic outlook poor or uncertain then the government may choose to boost its own spending and/or to cut taxes and incur budget deficits in order to provide economic stimulus. This was the course of action implemented by the Australian government to help to minimise the detrimental impact of the global economic crisis in 2008.

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

HAL
Horticulture Australia

Interactions

How do inflation, interest rates, monetary policy, exchange rates, the balance of payments, and fiscal policy interact?

Inflation, interest rates, and monetary policy

The principal objective of the RBA's monetary policy is to control inflation and an inflation target is at the centre of its monetary policy framework. The appropriate target, agreed by the government and the RBA, is to achieve an average inflation rate of 2-3% over the economic cycle. This rate was chosen because it does not significantly distort economic decisions in the community. In other words this level of inflation is seen as providing the basis for a Goldilocks economy – not too hot or not too cold.

It provides a framework for monetary policy decision-making while allowing some flexibility as the RBA decides how to react to changing economic and financial conditions over the economic cycle. In focusing on inflation the RBA pays particular attention to "underlying" inflation. There are a number of measures of the underlying rate of inflation that the RBA considers but basically the difference between the "headline" rate of inflation and the "underlying" rate is that the latter excludes volatile price movements which are a one off such as the sharp rise in vegetable prices following the Queensland floods or the sharp rise in banana prices after Cyclone Yasi. This is because these rises are not determined by general economic conditions and consequently not a reliable indicator of persistent inflationary pressures in the economy.

Monetary policy and exchange rates

In the past, central banks in some countries have used monetary policy to hold the exchange rate of the currency in a particular band against a particular currency or basket of currencies, or to promote exchange rate appreciation or depreciation. In recent years many central banks, including the RBA, have not used monetary policy to directly influence exchange rates, preferring a policy of non-intervention and allowing market forces to determine exchange rates on the basis that changes in exchange rates can themselves help economies adjust to changing economic circumstances.

While not trying to prevent big shifts in the exchange rate of the Australian dollar, the RBA stands ready, like other central banks, to intervene on foreign exchanges if trade becomes disorderly.

The level of interest rates can be a significant factor in determining the strength of the currency. The strength of the Australian dollar against most other major currencies over the past couple of years is mainly a reflection of strong overseas (particularly Chinese) demand for Australia's minerals and some big projects, which are boosting the supply of those minerals. However, short-term interest rates in Australia are significantly higher than comparable rates in the US, Europe, and Japan and this has also been an important factor in contributing to the strength of the Australian dollar.

The exchange rate and balance of payments

One of the main linkages is between the exchange rate and the balance of payments because of the impact that currency movements have on international competitiveness. Market forces would result in an appreciation of currencies of countries running large surpluses on the current account of their balance of payments. The current account is the part of the balance of payments that records a country's exports and imports of goods and services, and transfer payments (such as interest payments and receipts) with the rest of the world. The stronger currency would have a detrimental impact on the competitiveness of exports, but lower the price of imported goods making them more competitive with domestically-produced ones. The overall impact on the economy would be to erode the large current account surplus and bring it back towards balance, but the impact on individual sectors of the economy can be significant. In countries running large current account deficits, the process operates in reverse. The currencies of such countries would, as a result of market forces, depreciate and the weaker exchange rate would bolster the international competitiveness of exports, damage that of imports, thereby reducing the current account deficit.

This linkage does not, however, only operate in one direction. Some countries, for example use monetary policy to prevent large current account surpluses resulting in currency appreciation and eroding the competitiveness of their exports. This is because the export sector is regarded as a crucial driver of economic growth and source of employment and prosperity. Many Asian countries have pursued such policies for many years. The problem of course is that not all countries can pursue such policies, the results of which are to produce major imbalances in the world economy, which eventually can have a major negative impact on global economic conditions.

HAL
Horticulture Australia

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

The exchange rate and inflation

There is also a significant link between changes in the exchange rate and inflation, and again this link can operate in both directions. An appreciating currency makes imports cheaper and thus reduces inflationary pressures. A depreciating currency makes imports more expensive and exacerbates inflationary pressures. There might be a rise in inflation unrelated to currency movements, possibly because large sections of the labour force have been successful in gaining wage rises well above the rate of inflation. If this were to occur there could be a damaging impact on export competitiveness, which could result in downward pressure on the exchange rate. Of course one of the main objectives of monetary policy is to prevent excessive wage settlements that would have a detrimental impact on inflation.

Monetary policy, the exchange rate, and economic growth

The global financial crisis in 2008 produced a sharp slowdown in economic growth and recessions in many countries, which caused international commodity prices to fall sharply and, in turn, put downward pressure on the Australian dollar. The RBA did not use monetary policy to try to slow or halt this decline recognising that the lower exchange rate, through the beneficial impact on the competitiveness of exports, would have a favourable impact on economic growth. Over the past couple of years, strong rises in international commodity prices have caused the Australian dollar to rise sharply on the foreign exchanges. Again the RBA has not used monetary policy to stem the currency's rise despite the adverse effect that the strong currency is having on many sectors of the economy including manufacturing, tourism, and international education.

Monetary policy and fiscal policy

In well-managed economies fiscal and monetary policy are used in tandem, each supporting the other, to create economic conditions conducive to economic growth, employment, low unemployment, low inflation, a stable balance of payments, and currency stability. In order to achieve these objectives and because changes in fiscal policy are rather crude in trying to secure changes in economic conditions in the short-term, economically-responsible governments outline the medium-term stance and objectives of fiscal policy. This allows monetary policy, through changes in short-term interest rates, to play the leading role in meeting specific inflation targets in the short and medium term. Fiscal policy can still be used as a counter-cyclical tool of economic policy, which is to bolster demand when economic conditions are weak or to curb demand at times when it is strong. In the global financial crisis of 2008 the government and the RBA worked in tandem, the former spending money and giving cash handouts, the latter by slashing interest rates, in order to shield the Australian economy from the fall out of the crisis.

Further information

This fact sheet has been produced by Ian James through the Economics sub-program of the Vegetable Industry Development Program. If you would like further information, please contact Ian on 0439 440 023.

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

HAL
Horticulture Australia

HAL
Horticulture Australia

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".