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# The $A – has it disconnected from fundamentals?

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## Key points

> While capital flows associated with safe haven demand and central bank reserve diversification have no doubt played a role in terms of recent $A strength, it is also easily consistent with the long term relationship to the terms of the trade, high relative interest rates in Australia and an improvement in confidence in global share markets over the last two months.

> As such, there is little justification at current levels for the RBA to directly intervene to limit the $A. A better approach would be for the RBA to continue lowering interest rates.

> The $A is likely to remain strong over the medium term but the best of the gains are probably behind us.

## Introduction

The strength of the Australian dollar since early June has generated much interest of late, with some calling for Reserve Bank intervention to limit its upside on the grounds that it is unrelated to fundamentals and even the RBA itself drawing attention to it with the observation that "the exchange rate…, has remained high, despite the observed decline in the terms of trade and the weaker global outlook." But is the Australian dollar really so out of whack with fundamentals?

## What's driving the Australian dollar?

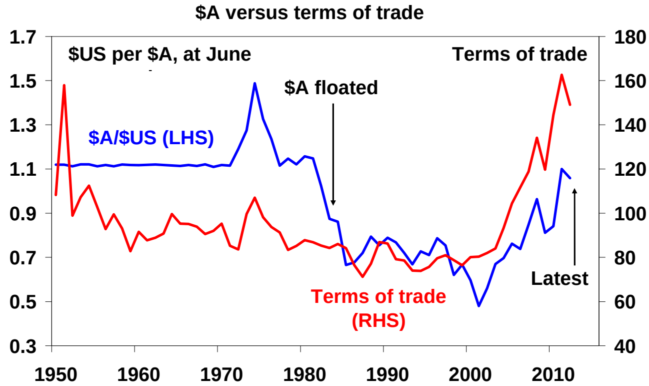
The main concern recently is that the Australian dollar has seemingly become detached from fundamental drivers, such as the terms of trade, and is being driven by capital flows looking for a safe haven and central banks diversifying their reserves away from the US dollar and euro. To be sure safe haven demand and currency diversification are likely playing a role:

- Following ratings house Moody's decision to put Germany's AAA sovereign rating on negative credit watch, Australia is now amongst a diminishing group of 7 countries with AAA sovereign ratings and a stable outlook from all three major ratings agencies. As a result some investor demand that might normally have flowed to US or German sovereign bonds is now likely flowing into this diminishing group of safe AAA rate countries like Australia. This naturally helps fuel demand for Australian dollars.
- Various central banks, including those in Germany, Russia, Switzerland, the Czech Republic and in the Middle East are reported to be buying the Australian dollar in order to diversify their foreign exchange reserves.

However, the significance of these flows is not known with any precision. And more importantly the strength of the Australian dollar can be explained in terms of fundamentals and the normal behaviour of the Australian dollar.

Firstly, **while the $A and commodity prices as reflected in the terms of trade – which measures the ratio of Australia's export prices to import prices – have seemingly moved in opposite directions in recent months, the divergence is not that unusual**. As can be seen in the next chart, the Australian dollar and the terms of trade often moved in different directions from year to year in the 1980s and 1990s. What's more, the recent divergence is not particularly extreme in a broader context with the terms of trade only down 10% from last year's record high and the $A down 5% from its post 1982 high last year of just above $US1.10, which leaves a 5% discrepancy which is not very unusual at all. What's more while the terms of trade is down 10% from last year's high this was from a record level with the $A never following it up to the full extent that might have been expected last year. In other words there is an element of catch-up – with the $A still catching up to some degree to last year's surge in the terms of trade to a record high.

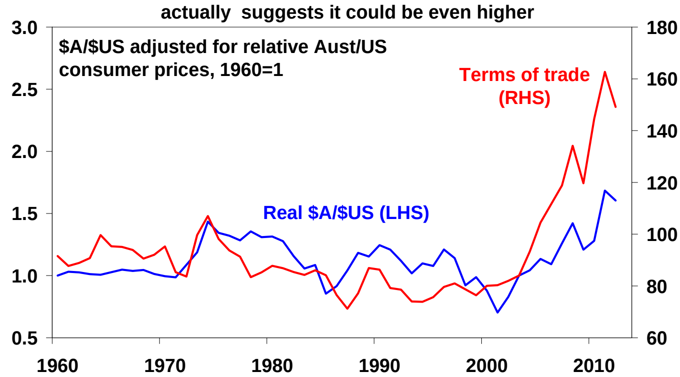
**$A versus terms of trade**




Source: RBA; Thomson Reuters, AMP Capital

For those who would prefer to look at the $A exchange rate in real terms, ie adjusted for relative prices between Australia and the US, it's a similar story. In real terms the Australian dollar is at the highest it's ever been over the past 50 years, but the still near record terms of trade suggests that it could be even higher. See the next chart.

**The $A is high in real terms, but the terms of trade actually suggests it could be even higher**

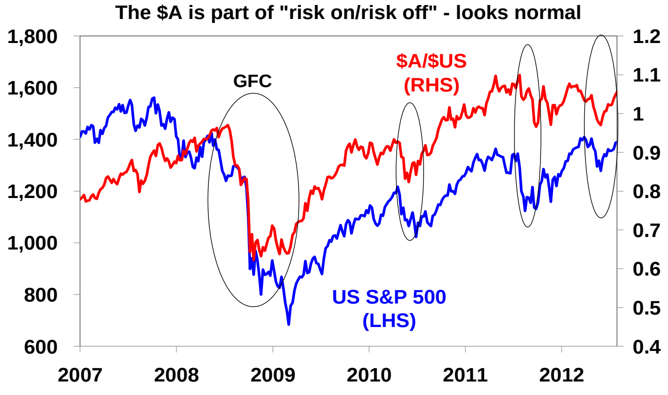



Source: RBA, Thomson Reuters, AMP Capital

In other words, the value of the Australian dollar is not particularly unusual relative to its long term relationship with the terms of trade. If anything the terms of trade looked at on its own, might be seen as justifying a higher level for the Australian dollar!

Secondly, while Australian interest rates have fallen since last November, they look like remaining high relative to US, European and Japanese interest rates at a time when the later countries are all engaging, or likely to engage, in more quantitative easing which has the effect of increasing the supply of their currencies relative to the Australian dollar which in turn reduces their relative value.

Finally, the Australian dollar in recent years has swung very much in line with a phenomenon that has become known as "risk on/risk off". Short term swings in the Australian dollar have become highly correlated to other growth oriented assets like shares. This is clear in the chart below which shows the Australian dollar against the US share market.




Source: Bloomberg, AMP Capital

While the longer term trends in the $A and US shares differ, each time shares have taken a decent hit because of worries about the global growth outlook so too has the $A as such concerns have seen in investors close down bets in high yield commodity related currencies like the $A – see the circled periods – only to then both rebound as investor sentiment improves. **The roughly 9% upswing in the $A since early June is entirely consistent with a roughly 10% upswing in share markets since then**. This phenomena can explain a big part of why the $A has appeared to diverge from fundamentals like the terms of trade since early June. Just as the share market leads earnings and coming out of the downturn can be appear to be miraculously rising as profits are still falling so too can the $A (which has become more correlated with shares) be rising in anticipation of stronger commodity prices. In other words the recent rebound in the $A may simply be telling us of better global economic conditions, and hence commodity prices, ahead.

The bottom line is that the recent strength in the Australian dollar does not appear to be particularly unusual relative to fundamentals such as the terms of the trade, relative interest rates and monetary policy and a return to "risk on". There appears to be much more to the Australian dollar's strength than capital inflows on the back of safe haven demand or central bank reserve diversification.

## The perils of intervention

Which brings us to the question of whether the Reserve Bank of Australian should intervene to limit the $A by printing extra Australian dollars? The short answer is, no it shouldn't. While a case can be made for currency intervention if temporary "hot money" capital flows have pushed a currency far away from fair value, it is far from clear that this is the case with the $A at present. Allowing for the still high level of the terms of trade, the $A is unlikely to be far from fair value. If the RBA could neatly separate foreign central bank buying of Australian dollars and supply them with the required level of Australian dollars then well and good as they would simply stash it away in their reserves and it wouldn't affect domestic monetary policy or economic activity. The reality though is that we don't know whether capital inflows influencing the $A are temporary or permanent and to what degree they reflect foreign central bank buying or private sector flows.

More broadly fair value levels for the $A or any currency for that matter are far from clear and its well known from the period before the December 1983 $A float that if we try to control the $A we risk losing control of domestic interest rates. In fact I would argue that intervention to limit the $A risks sliding us back into the economic mediocrity that prevailed prior to the currency being floated. Strong countries have strong currencies – we should learn to live with it and focus on boosting productivity.

Rather than via direct intervention in the foreign exchange market, the best way to take pressure off the $A in the short term would be to continue to lower interest rates, which in terms of borrowing costs still seem too high to drive a decent recovery in domestic demand and given inflation running at the low end of the target range there is still plenty of scope to ease. We remain of the view that the cash rate will fall to around 3% by year end even though the RBA may leave rates on hold for another month in September.

## The longer term picture for the $A

Our assessment is that while the Australian dollar is likely to remain strong, over the medium term the best is probably behind us with the $A having risen 120% from its low point of $US0.48 in 2001. On the one hand commodity demand from emerging countries is likely to remain strong as they continue to industrialise resulting in ongoing strength in infrastructure spending and a step up in demand for consumer durables. Against this though China's growth rate is unlikely to return to the 10% plus of last decade, likely settling around 8%, and the supply of commodities is set to rise strongly over the years ahead following recent global mining investment. This probably means that the best in terms of commodity price gains is likely behind us, albeit they will likely remain strong. On top of this the damage that the $A has caused to the trade exposed sectors of the Australian economy as it has moved beyond the parity level to the $US suggests that it is at or around the limit of its sustainable strength. Consequently I am now more inclined to see it sustained in a range around $US0.95-$US1.10 in the next few years.

## Conclusion

Summing up, the recent strength in the Australian dollar is not particularly unusual and is certainly not extreme enough to warrant any direct intervention in foreign exchange markets by the RBA to limit its value. A better approach is to continue focusing on boosting productivity and lowering domestic interest rates a bit further. More broadly while strong global commodity demand is likely to ensure that the $A will remain strong over the medium term, the best is probably behind us.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