

## Who Cares Where the Buck Stops?

**A**fter what seems like just a few brief months of 'low interest rate' sunshine, once again the stormclouds are gathering. On four successive occasions, the Reserve Bank has acted in markets to increase interest rates, with Australia apparently locked in step with similar rate rises in the US.

**Initially, the need to cool off economic growth and avoid inflation were the main reasons cited for the increases, but now many commentators claim that the RBA will need to further lift rates in order to prop up the \$A, which has been falling in value against its US counterpart.**

**Somewhat curiously, many obviously regard a lower \$A as undesirable, a view not shared by most farmers and exporters. Just why the Reserve Bank should be called on to prop up the \$A, and why it should use interest rates to do this is a matter of considerable confusion.**

Since November 1999, the Reserve Bank has acted to increase Australian interest rates four times, an approach to monetary policy that many commentators have referred to as a 'few light taps on the brakes'. In total, the increases to date have amounted to 1.25%, and pundits are tipping the possibility of further rate rises of up to 0.5% in the next few months. The consistent message from the Reserve Bank in relation to the earlier rises has been the need to stave off potential inflation, by cooling demand and thus growth in the Australian economy.

However, in more recent weeks there has been a growing chorus of commentators all pointing to the 'precarious' state of the \$A, and suggesting that it is essential that Australian interest rates are lifted in order to defend the Australian dollar. Headline after headline has suggested that the only way that the value of the \$A could be maintained was for the RBA to raise interest rates, and many referred to the size of the differential between Australian and US interest rates as the critical factor in making interest rate decisions in Australia.

The underlying message has been that a further decline in the value of the \$A against the \$US will somehow presage a disaster of enormous proportions, and that it must be avoided at all costs.

Such comments raise a number of important questions. Firstly, it is necessary to question whether a fall in the value of the \$A compared with the \$US is in fact a disaster for the Australian economy. Secondly, there is a need to seriously question whether adjusting interest rates is the appropriate mechanism to use to try to manage exchange rates. Related to this is a need to critically examine whether Australian – US interest rate differentials are as critical as has been suggested.

### Is a Lower \$A a Disaster?

For exporters such as farmers, miners and the tourism industry, a lower \$A has generally been welcomed. Time and time again, a fall in the Australian dollar coincides with an increase in the price of wool or beef or grain.

There are sometimes claims made that the net result of a lower \$A is simply that Australian farmers have to produce more wool or beef in order to be able to pay for an imported tractor, which of course increases in prices as a result. Such claims ignore the full impact of exchange rate movements, as has been pointed out in some analysis conducted by ABARE.<sup>1</sup>

That analysis reported that a 1% depreciation in the value of the \$A produced a 1% increase in the farmgate price of grains, a 0.82% increase in the farmgate price of beef, a 0.9% increase in the price of sheepmeats, and a 0.88% increase in the price of wool, all other things being equal. These increases occurred over a relatively short timeframe, and are driven by the significant export orientation of these industries.

These farm-gate price increases are partially offset by increases in the cost of some farm inputs, especially those, such as chemicals and machinery, which are imported. In general, a 1% decrease in the value of the \$A translates directly into a 1% increase in the cost of imported farm inputs, as Australia is a relatively small market for these goods in global terms.

However, imported goods represent only a proportion of total farm inputs. Many farm input costs, such as labour, professional services, interest payments, contractor

charges, repairs and maintenance, Government charges and sharefarmer costs remain largely unaffected by changes in exchange rates, especially in the short to medium term.

When all these are factored into total farm input costs, and offset against the increases in farmgate prices, the net result calculated by ABARE is a \$1,000 average increase in cash incomes for broadacre farmers as a result of a 1% drop in the value of the Australian dollar. In some sectors of agriculture such as the grains industry, the increase in cash income is as high as \$2,500 per annum.

Such a result indicates that a drop in the \$A is clearly beneficial for some sectors of the economy. However, the economy is obviously much bigger than just the farm sector, which, despite its export significance, only represents about 2.8% of total GDP.

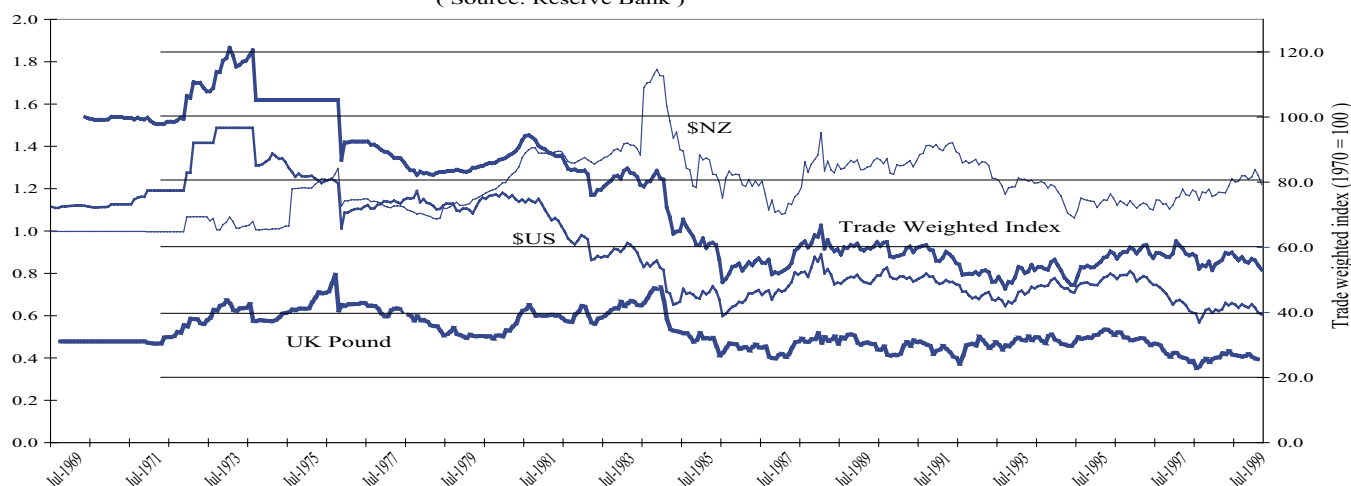
on a Trade Weighted Index basis, the \$A has traded in a band between 50 and 60 points since about May, 1986, which is where it settled after a steady drop over the three year period post the floating of the \$A in December, 1983.

From a short-term perspective, the movement of the \$A against the TWI has been negative over the past twelve months, but viewed from a longer-term, the movement has been within a normal range, and hardly seems to warrant heightened concern from the markets.

Leaving these qualifications aside, it is apparent that whatever their significance, movements in the \$A have tended to be downwards rather than upwards over recent months, and this clearly creates some concern in financial markets.

At the simplest level, this is a reflection of the fact that the sellers of Australian dollars exceed the number

Figure 1. Value of the \$A against major overseas currencies.  
( Source: Reserve Bank )



Even so, in looking at other sectors of the Australian economy, it is not immediately obvious why such a fuss is made when there is a modest decline in the value of the \$A, - especially if that decline is in \$US terms, and especially if it represents a short-term phenomena.

For a start, the \$US has been one of the strongest currencies globally, on the back of sustained growth in the US economy. Measured against a broad basket of US trading partner currencies, the \$US increased from an index value of 100 in January 1997 to around 120 by the third quarter of 1998.<sup>2</sup> It stabilised between late 1998 and the present day, although a lot of that apparent stabilisation is accounted for by a sharp depreciation against the Japanese Yen, the currency of one of the main US trading partners. In comparison with the Euro, for example, the \$US has appreciated by about 20% in the past 18 months. Given the strength of the \$US, which has appreciated by up to 40% against some currencies over the past three years, it is hardly surprising that the \$A has fallen in relative terms. Most other world currencies have done exactly the same!

Secondly, simply measuring the \$A against the \$US does not provide a comprehensive picture. It ignores the changes in the value of the \$A against the currencies of the main countries that Australia does business with. When measured

of buyers. Sellers of Australian dollars (or conversely, Australian buyers of overseas currencies) are Australians who purchase foreign goods, services, or assets, or who need to pay interest on overseas borrowings. Buyers of Australian dollars are obviously the reverse – that is, overseas buyers of Australian goods, services, assets or borrowers repaying interest on Australian-sourced loans.

Simplistically, this balance between buyers and sellers of Australian dollars is reflected in the Current Account statistic, which is normally a deficit in Australia's case. About 80% of Australia's CAD figure is a deficit in income – that is money being paid by Australians to non-Australians. About half is repayments of debt, and the balance is dividends and profits being distributed to overseas investors.

If Australia experiences strong economic growth and there is relatively greater demand for imported goods or internationally-sourced finance, this deficit is likely to increase, especially if demand for our exports does not increase to the same degree. This is precisely what happened during the recent Asian-crisis, commencing in 1997.

Such a situation places downward pressure on the value of the \$A, as dollar sellers outnumber buyers. As a result,

imported goods and services increase in price in \$A terms, and demand for imports into Australia will be reduced. Eventually, all other things being equal, the cycle reverses and the value of the \$A again increases. The involvement of Government can, of course, distort these movements. In Australia's case however, only a relatively small amount of the deficit in income is attributable to Government, so these movements largely reflect changes in the private sector.

The conclusion from this somewhat simplistic analysis is that the value of the Australian dollar is determined by the state of the Australian economy relative to that of its trading partners. As such, it is largely an indicator of relative economic health, and it appears to make little sense for Governments or Reserve Banks to take action to change it. That would be treating the symptom, rather than the cause!

### Can Interest Rates Modify Exchange Rates?

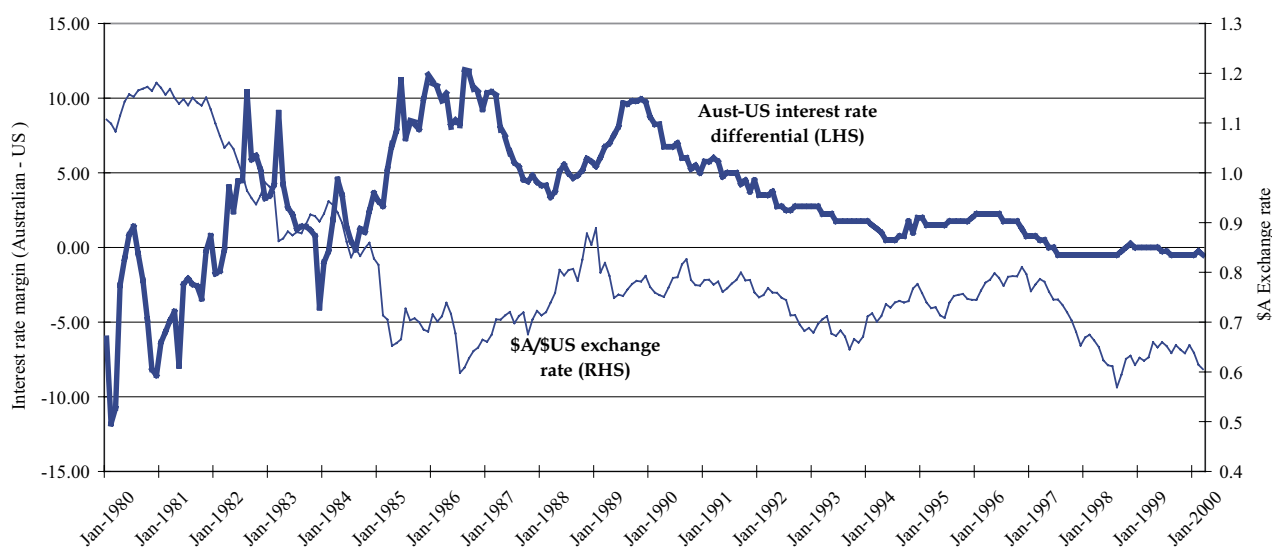
However, irrespective of the theory, the recent history of the Australian economy is the reverse of this situation. Commodity prices over the past six months have been increasing, and the value of exports across most sectors has increased faster than the value of imports. In fact, the recovery of some Asian markets has resulted in a 30% increase in export sales to Asia in the second half of 1999. In theory, this should lead to an appreciation in the value of the \$A, as overseas traders need to purchase Australian dollars to pay for the Australian products and services they purchase.

At a superficial level, there appears to be some logic to this sentiment. Relatively higher interest rates in the US would certainly be more attractive for those in a position to quickly move large amounts of money internationally. If there was a rush of overseas investors taking funds out of Australia, there would certainly be more sellers of \$A than buyers, driving the value of the \$A down.

Unfortunately for the theory, it does not always translate into practice, as can be observed in Figure 2. It is perhaps necessary to disregard the period before about 1986, when the \$A was either fixed by Government, or adjusting to the current free-floating regime. However, since that time there has been periods when Australian indicator interest rates have been up to 10 per cent above US indicator rates (in 1987 and again in 1990) while the \$A was relatively low. Conversely, there have been periods when Australian interest rates have been quite close to US rates, yet the value of the \$A has been relatively strong (such as the period between 1994 and 1997)

Obviously, the short-medium term relationship between the US-Australian interest rate differential and the value of the \$A is much more complex. As the Reserve Bank Governor recently commented "... there is, of course, no certain or mechanical relationship between interest rates and the exchange rate, but it is assessed that instability will be reduced by the pursuit of policies which engender confidence among domestic and foreign investors that Australia will remain a low inflation economy."<sup>3</sup>

Fig 2. Australian and US interest rate margins and exchange rates.  
Australian interest rates are RBA official cash rates. US rates are Fed. Res. of NY Maximum target rates.



Some participants in financial markets are obviously of the opinion that it is interest rates that play a big part in the value of the Australian dollar. More specifically, the focus recently has been on the differential between Australian and US interest rates. As one commentator explained "If the (US) Fed does raise rates by half a per cent, the interest rate differential between Australia and the US will widen, and increase pressure on the (Australian) dollar."

### What is the RBA's Real Objective?

An innocent bystander could be justifiably confused by the current situation. Almost daily, there are media reports about the state of the \$A, and the dangers inherent in any further drop in its value. Repeatedly, comments are made to the effect that the Reserve Bank will simply have to raise interest rates yet again to support the \$A.

Yet close analysis reveals that moderate falls or rises in the

value of the \$A are to be expected, and are in fact as much a symptom of the state of the Australian economy as they are a causal factor. Not only that, but significant sectors of the economy (especially those such as agriculture, mining and tourism which earn the bulk of the nation's overseas income) actually benefit from a lower \$A.

Seemingly, at least in relation to the most recent rate increase, the RBA has acted in accord with the sentiment or expectation of the markets, yet at the same time is admitting that interest rates and exchange rates are not linked. It is almost as if the Reserve Bank is prepared to respond to the sentiments or expectations of the financial markets, however irrational they may be.

In the game of 'chicken' between the markets and the RBA, it looks like the RBA has backed down.

But perhaps the last few words of the Reserve Bank Governor's recent statement reveal the true intent of the RBA's recent actions. The Charter of the Reserve Bank is focussed heavily on managing inflation within a range between 2 and 3%, and current inflation expectations (even ignoring the impact of the GST) are above that range. In addition, there is generally a belief that in the short-term a declining \$A adds to inflationary pressures – although this is by no means certain. As the Reserve Bank recently stated "There is considerable uncertainty in assessing the likely impact of this currency depreciation on inflation. The longer-term history of the relationship between exchange rate and import prices would suggest that, were the exchange rate to remain around these levels, there would be some significant upward pressure on inflation during the year ahead."<sup>4</sup>

What appears to be emerging is that the RBA has decided on this most recent rate rise on the basis that a further interest rate increase will be necessary to reduce the risk of inflation emerging later in the year. Whether or not this risk becomes a reality as a result of the \$A remaining at its current level or continuing to fall is not the major issue – the exchange rate risk is just one of a number of factors that combine to create an inflation risk profile, and at present more of these factors are positive than negative. Hence the RBA decided to move.

The fact that the RBA moved in a direction that accorded with the 'markets' expectations, even though the reason for the RBA move was different to what the markets believed, creates its own problems.

Whatever the reality, there is now a perception that the RBA's move was motivated by the depreciation in the \$A. By inference, this reinforces the notion that a lower \$A is something that is bad, and that steps should be taken to avoid any further depreciation. Recent daily moves in the value of the \$A, apparently on the back of comments from the RBA or politicians about interest rates, confirm this perception has taken hold in foreign exchange markets.

Perhaps the RBA felt that the smokescreen of 'defending the dollar' was as good a way as any to sneak through another rate rise without facing strong criticism from industry, and especially some export sectors. Nonetheless, there will now be heightened expectations that Australian interest rates can and will be used to prop up the \$A. If this perception is allowed to persist, it will significantly complicate future decisions by the RBA about interest rates.

- <sup>1</sup> ABARE (1997) Effect of interest rate changes on farm sector incomes. ABARE Current issues No. 6.
- <sup>2</sup> US Federal Reserve (2000) Monetary policy report to the Congress. February 2000.
- <sup>3</sup> RBA (2000) Statement by the Reserve Bank Governor, May 3, 2000.
- <sup>4</sup> Reserve Bank (2000) Semi-Annual statement on Monetary Policy. May 2000

**COMMENTS CONTAINED IN THIS DOCUMENT ARE  
BASED ON INFORMATION AVAILABLE AT TIME OF  
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