

Exchange Rates

by Dan Nguyen

Exchange rates play a key role in the relationships between individual economies within the context of global economy, because all trade and financial relationships between nations are processed through the exchange rate. With respect to Australia, the exchange rate is simply the price of A\$ expressed in terms of another country's currency, where the conversion of these currencies occur in the foreign exchange markets. The market forces of supply and demand, and all government representatives, in the case of fixed-price currencies determine this price over one country's currency in terms of another. In Australia's case, the exchange rate is determined by market forces, but also "managed" by the Reserve Bank, in order to smooth out fluctuations in the value of the \$A. There are several key factors that influence the supply and demand of the \$A, and therefore, its value, and is directly and indirectly related to the performance of the Australian economy against the global economy. The value of the \$A at any one time is the equilibrium value, however, this equilibrium is subject to continuous changes as buyers and seller of currencies change their preference. Demand for \$A is represented by those wishing to buy \$A, and is affected by several factors including the size of the financial flows into Australia from foreign investors who wish to invest in Australia, which is itself determined by the level of interest rates relative to overseas. Also, the demand for Australian exports creates greater demand for the \$A as foreign currency need to be converted to \$A in order to purchase Australia produce. Similarly, the degree of international competitiveness of local exporters and the level of inflation correlates to the attractiveness of Australian exports, influencing currency demand. Diagram 1 below shows that any increase in the demand of \$A will cause the appreciation of the \$A in terms of another currency, in this case the \$US. On the other hand the supply of the \$A is determined by those people who wish to sell \$A, which is reflected through the level of capital inflow indicating deteriorating confidence in the Australian economy and lower interest rates, discouraging foreign investors. Speculators also have significant influence, where their expectations of a falling \$A in the foreign exchange market usually follows with the offloading of the \$A, contributing to the anticipated depreciation. In addition, the supply of \$A will be affected by the domestic demand for imports, where a high demand for imports, especially during times of strong growth, results in the increasing supply of \$A, as individuals convert more of their wealth into foreign

currency. Diagram 2 below reveals that any increase in supply of \$A correlates to a depreciation of the currency, again in terms of \$US. However a comparison of the \$A against a single currency such as the \$US can create misleading impressions of trends in the value of the \$A. for example during the Asian financial crisis of 1997/98, the \$A appreciated relative to most Asian nations, yet at the same time fell against the \$US. In order to give a clearer indication of how the value of \$A is moving against all currencies, a Trade Weighted Index (TWI) is calculated, through the measurement of the \$A against all the currencies of Australia's major trading partners in a base year. Countries such as Japan and South Korea have a higher weighting, as they are more prominent in trade with Australia.

As with all currencies relying on market forces to determine value, the \$A is subject to the ups and downs of the business cycle. These fluctuations in the \$A impact the economy in a range of ways. Appreciations in the \$A cause Australian exports to become relatively more expensive in comparison to foreign imports, contributing to a worsening CAD. On the other hand, local export industries view depreciations as favourable since a lower \$A translates into more competitive exports on the global market. In relation to the current account, this situation results in an improving CAD. An example of this can be seen in 2001, when the \$A fell to under \$US0.50, export revenue rose 3%, resulting in a trade surplus of \$707 million, due also to falling import expenditure, reflecting the impact of increasing international competitiveness. However, currency depreciation causes several detrimental affects to the economy especially in terms of increasing inflationary pressures stemming from the increasing costs of price inelastic imports, and also in terms of foreign debt, where depreciation translates to an automatic increase in foreign debt expressed in foreign currency. This increases income outflow on the current account in future years and therefore increases the level of the CAD. Although Australia relies primarily on market force to determine the exchange rate, it is because of the variable fluctuations that the Reserve Bank (RBA) intervenes to smooth out excessive changes in the currency relating to short-term factors. This is achieved in the form of monetary policy, and in particular, the

“dirtying” of the float. In order to curb rapid depreciations in the \$A, the RBA may step in and buy large amounts of \$A in order to put upward pressure on exchange rates. However the RBA’s ability to intervene is usually ineffective and limited due to the limited size of foreign currency holdings available. The other method that the RBA may use is the manipulation of interest rates through monetary policy decisions, where interest rates may be raised to increase demand for \$A in order to curb depreciation. Yet the RBA, by buying \$A to increase the exchange rate has to, at the same time, buy an equal amount of government bonds in order to inject this same amount of cash back into the system that it took the \$A from, so as not to affect the monetary policy stance. While initially effective, this method would only be effective for a limited period, and seldom is monetary policy used to directly influence exchange rates. Since movements in the \$A can have both positive and negative consequences on the balance of payments, the RBA and government must determine an appropriate value for the \$A. Theoretically, this value is where the forces of supply and demand cause it to settle, yet in reality, external factors, such as speculation, play a significant role in influencing the value of the \$A, and these speculators, as a group, buy and sell \$A in anticipation of movements in the currency and result in the distortion of the exchange rate; hence the RBA must intervene to avoid excessive shifts in the exchange rates. A problem for the \$A is that due to the high level of financial flows since the 1980s, the currency has tended to be a “hot currency”, subject to extensive volatility dependant on the outlook of the growth prospects in the Australian economy. Due to the increasing fluctuations, the RBA must continue to intervene in the exchange rate in order to maintain relative stability of the economy and its balance of payments flows.