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Has the Australian dollar disconnected from fundamentals?

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Key points

- Capital flows associated with 'safe haven' demand and central bank reserve diversification have no doubt played a role in the Australian dollar's recent strength. However, the currency's strength also remains consistent with its long term relationship to the terms of trade, high relative interest rates in Australia and an improvement in confidence in global share markets over the last two months.
- At current levels, there is little justification for the Reserve Bank of Australia (RBA) to directly intervene to limit the Australian dollar. A better approach would be for the RBA to continue lowering interest rates.
- The Australian dollar 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 RBA intervention to limit its upside. This call is based on the grounds that it is unrelated to fundamentals. Even the RBA is drawing attention to it with the observation that it 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 line with fundamentals?

What's driving the Australian dollar?

The main concern 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. These flows stem from investors 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 to be playing a role:

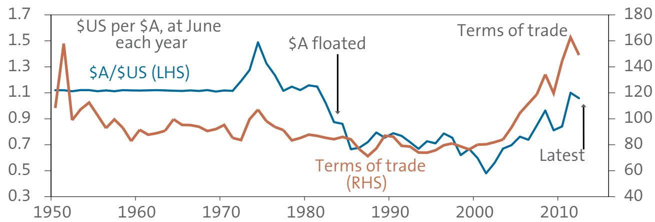
- Australia is now among a diminishing group of seven countries with AAA sovereign ratings and a stable outlook from the three main ratings agencies. As a result, some investor demand that might normally have flowed to US or German sovereign bonds is now likely flowing into this diminishing group of AAA rated countries. This naturally helps fuel demand for the Australian dollar.
- Various central banks, including those in Germany, Russia, Switzerland, the Czech Republic and 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 currency.

Although the Australian dollar 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, in the 1980s and 1990s, the Australian dollar and the terms of trade often moved in different directions from year to year. Furthermore, the recent divergence is not particularly extreme in a broader context. The terms of trade is only down 10% from last year's record high, and the Australian dollar is down 5% from its post-1982 high last year (just above $US1.10). This leaves a 5% discrepancy which is not that 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. The Australian dollar never followed it up to the full extent that might have been expected last year. In other words, the Australian dollar is still catching up to some degree with the terms of trade.

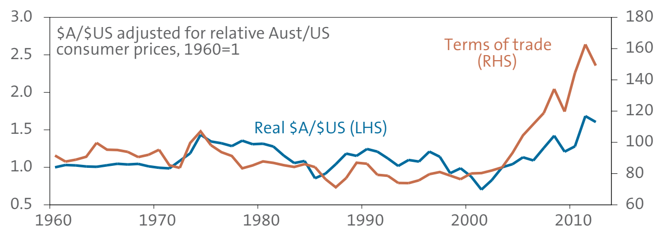
$A versus tems of trade



Source: RBA; Thomson Reuters, AMP Capital

For those who would prefer to look at the 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 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 higher



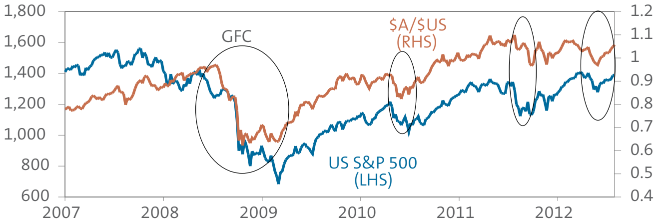
Source: RBA, Thomson Reuters, AMP Capital

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, when reviewing the terms of trade in isolation, we could justify a higher level for the dollar!

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

Finally, in recent years, the Australian dollar 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.

The $A is part of "risk on/off" - looks normal



Source: Bloomberg, AMP Capital

While longer term trends in the Australian dollar and US shares differ, each time shares have taken a decent hit because of worries about the global growth outlook, so too has the Australian dollar. Such concerns have seen investors close down bets in high yield commodity related currencies like the Australian dollar (see circled periods in chart above) only to then rebound as investor sentiment improves. The approximate 9% upswing in the Australian dollar since early June is entirely consistent with an approximate 10% upswing in share markets. This phenomenon explains a large part of why the Australian dollar has appeared to diverge from fundamentals like the terms of trade since early June. Just as the share market can appear to be miraculously rising as profits are still falling, so too can the Australian dollar (which has become more correlated with shares) rise in anticipation of stronger commodity prices. In other words, the recent rebound in the Australian dollar 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 or central bank reserve diversification.

The perils of intervention

Which brings us to the question of whether the RBA should intervene to limit the currency by printing extra Australian dollars? The short answer is: no it shouldn't. A case can be made for currency intervention if temporary 'hot money' capital flows have pushed a currency far away from fair value. However, it is far from clear that this is the case with the Australian dollar at present. Allowing for the high level of the terms of trade, the Australian dollar 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 all well and good. 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 Australian dollar 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 Australian dollar, or any currency for that matter, are far from clear. Also, it's well known from the period before the Australian dollar float in December 1983, that if we try to control the Australian dollar we risk losing control of domestic interest rates. In fact, I would argue that intervention to limit the Australian dollar 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.

The best way to take pressure off the Australian dollar in the short term would be to continue to lower interest rates. In terms of borrowing costs, rates still seem too high to drive a decent recovery in domestic demand, and with 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 Australian dollar

Our assessment is that while the Australian dollar is likely to remain strong over the medium term, the best is probably behind us (the currency has 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. This will result 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 last decade's rate of 10% plus. It is likely to settle 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, although commodity price gains will likely remain strong, the best is probably behind us. On top of this, the damage that the Australian dollar has caused to the trade exposed sectors of the Australian economy 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. While strong global commodity demand is likely to ensure that the currency will remain strong over the medium term, the best is probably behind us.

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