



RBA ECONOMICS COMPETITION 2010

*Appreciation of Australia's real exchange rate:
causes and effects*

Best Essay from a First Year Student

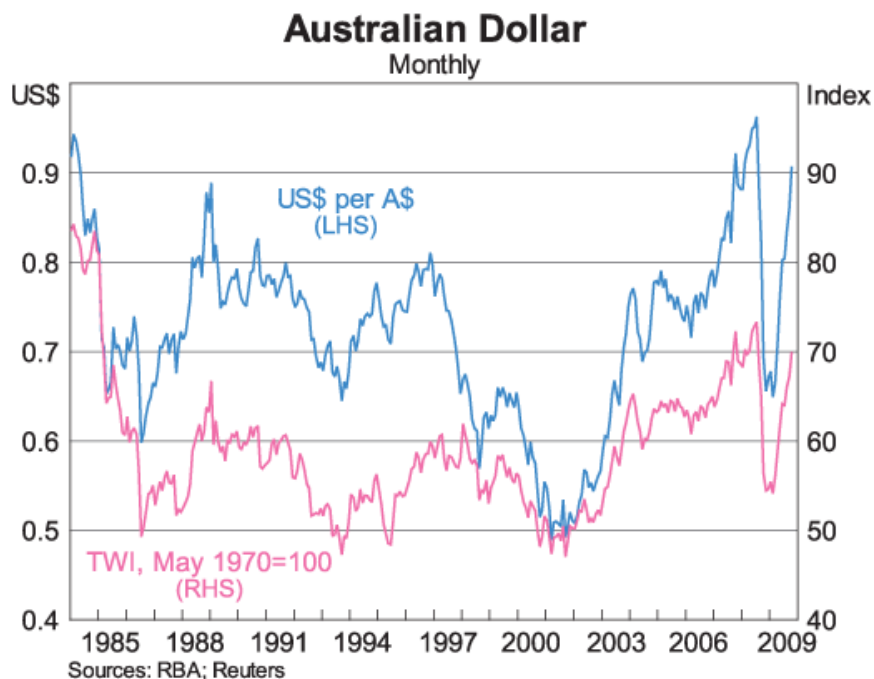
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Appreciation of Australia's real exchange rate: causes and effects

Over the past decade, the strength of the Australian dollar has been a subject of much discussion among economists. The appreciation of the real exchange rate, which refers to the price of the average domestic good or service relative to the price of the average foreign good or service, has occurred in spite of high current account deficits and rising foreign debt. This essay seeks to identify the possible causes of this appreciation and analyse the extensive implications on the Australian economy.

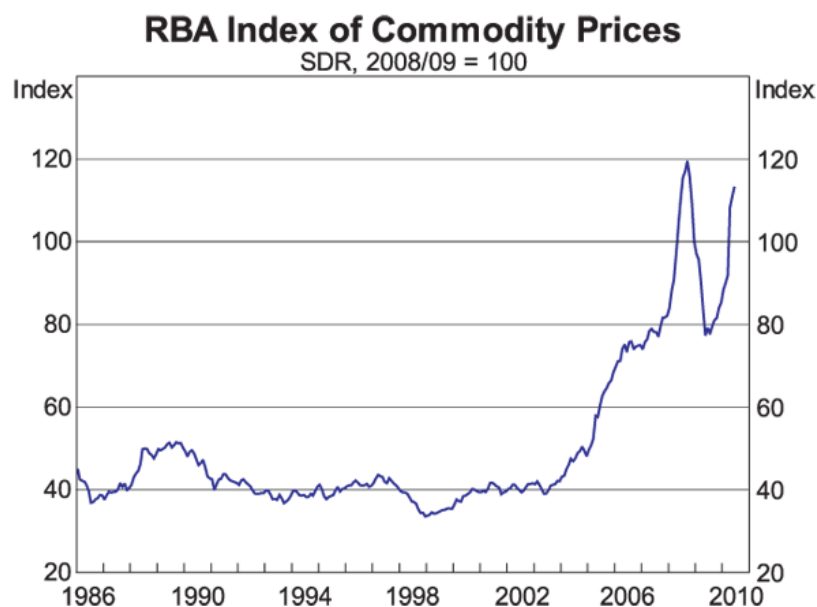
After falling briefly below US50c in the early 2000s, the exchange rate quickly began to appreciate, later triggering speculation among economists that it may again reach parity with the US dollar as it did in the mid-1970s. By July 2008, when Australia was on the brink of the global financial crisis (GFC), the dollar had surged to US98c. However, Australia was soon caught up in the midst of a collapsing world economy, and the exchange rate plummeted to US64c in March 2009. Unpredictably, the dollar made a relatively quick recovery; within seven months it had risen again to US90c (Gittins, 2009). The Trade Weighted Index (TWI), a measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners, weighted according to their significance to Australia's trade flows, has followed similar patterns, both of which are shown in the graph below. Fluctuations in the Australian dollar in terms of US currency are generally larger than that of the TWI, since the TWI gives a measure of whether the Australian dollar is rising or falling on average.



Main causes of the appreciation

The Australian dollar was floated in December 1983, and is thus determined by the forces of supply and demand for Australian currency in the foreign exchange market. In recent years, the main reason for the appreciation of the dollar is the increase in demand for Australian currency associated with trade and financial flows. This increase in demand for Australian dollars results in a higher 'price' of the currency, in other words, an appreciation of the exchange rate.

The Australian dollar owes its strength in large part to the resources boom. This has been the major cause of the appreciating exchange rate over the past decade. Historically, Australia's economic prosperity has been derived from exports of rural and mineral commodities. Extremely efficient in the production of primary products, and endowed with abundant valuable minerals, Australia has been able to capitalise on its competitive advantage in the mining industry. During the mid 1980s and the 1990s, commodity prices were not growing strongly. However, by the late 1990s it became apparent a new resource boom was looming, instigated by the Chinese economy that had been growing rapidly since the late 1970s, with India not far behind (Appendix 1). China's real GDP has increased six-fold since 1990, while India's has tripled (Lowe, 2009). Their efforts to transform their economy required ever-larger amounts of raw materials for investment in infrastructure and export production (Gittins, 2009). The current significance of China in Australia's trade flows is evidenced by the highest weight given to the Chinese renminbi in the TWI (Appendix 2). Other Asian countries were following similar steps in their endeavour to become developed economies, and Australia became the main source of raw materials for the emerging region. This increase in demand for resources led to the dramatic rise in commodity export prices in 2003, which peaked in early 2008, as seen in the following graph.



Source: RBA

In the period prior to the GFC, oil, coal, iron ore and other commodity prices were at an extremely high level, bringing the terms of trade (the ratio of export prices to import prices), to its highest point in 50 years (Gittins, 2009). Higher commodity export prices resulted in foreign countries having to buy larger amounts of Australian dollars in order to purchase commodities, leading to an increase in demand for the Australian dollar and hence an appreciation of the exchange rate. While the GFC was accompanied by a slide in commodity prices and a steeper decline in the dollar, the surprisingly quick rebound of the exchange rate was largely aided by the resurgence of high commodity export prices. China's rapid recovery from the GFC was the main cause, as its government successfully substituted export demand for domestic demand as their main source of economic growth (Gittins, 2009).

Another contributing factor to the appreciation of the Australian dollar is likely to be the level of financial inflows into Australia. Currency must be converted into Australian dollars in order to invest in Australia, and thus the demand for the dollar increases and the exchange rate appreciates. Widely tipped as the fastest growing region of the world, China has attracted the interest of financial investors seeking to earn high returns on investments. However, flexible access to funds is not a feature of Chinese financial markets; investors cannot easily invest or withdraw money as

desired (Gittins, 2009). On the other hand, Australia has been benefited considerably by the growth of China. Also, Australia's financial markets are well developed, including flexible and easy access to investments. Global investors are thus able to indirectly invest in China by investing in Australia.

Australian interest rates are another cause of the high level of financial inflows. Over the past decade, Australia's interest rates have remained above those in major industrialised countries. (Eslake, 2009) Following the GFC, Australia was the first country to raise interest rates. High interest rates offer attractive financial returns on foreign savings, and hence encourage financial inflow into Australia, leading to an appreciation of the dollar.

The causes of the appreciation of Australia's real exchange rate illustrate the purpose of the exchange rate as a buffer against external shocks to the economy. Australia is a relatively small and open economy, and is therefore vulnerable to external shocks. This includes shifts in the terms of trade which tend to create inflationary or deflationary pressures. The floating exchange rate has made the economy more flexible, so that the real exchange rate can rise whilst dissipating the worst of the inflationary pressures.

Implications for the Australian economy

Whilst popular opinion centres on the assumption that an appreciation of the real exchange rate has mostly positive effects on the Australian economy, the impacts are both diverse and extensive. In the short term, a major implication is the improvement in the terms of trade as exports become more expensive and imports become cheaper. This rise in the terms of trade allows a larger amount of imports to be purchased with a given amount of exports; an increase in the real purchasing power of domestic production (RBA bulletin 2005). As a result of relative price changes, there is likely to be an increase in domestic spending on imports, and reduced demand for exports in foreign countries.

The changing demand patterns for exports has further implications. In the short term, the higher export prices resulting from an appreciation will effectively result in the closure of export firms that are no longer able to compete in foreign markets.

Consequently, there will be an initial increase in unemployment, as inefficient export industries contract.

In the long term, the main implication of an appreciating exchange rate is structural change within the Australian economy. Since a strong Australian dollar means that Australian exports become more expensive, export industries will effectively become less competitive in the world market. Export industries other than mining, including farming, manufacturing and tourism, are likely to be impacted by this. Those that cannot compete under the high exchange rate will contract. This results in the release of labour and capital previously utilised by inefficient businesses, which will be reallocated to the expanding mining industry. The reallocation of resources to an area of production in which they are being used more efficiently results in higher productivity growth and increased economic growth. This in turn leads to higher real incomes for Australians, and higher living standards.

The structural change caused by the appreciation of the dollar will create more employment opportunities in expanding sectors, such as the mining sector. The subsequent increase in employment is likely to exceed the initial rise in unemployment. However, a major impact of structural change is the rise in structural unemployment. Workers discover that the skills that were appropriate in declining industries do not match emerging employment opportunities.

A subsequent impact of the appreciation of the real exchange rate is the shift towards a narrow export base as a result of structural change within the economy. Already, exports of mining commodities take up the highest proportion of our overall exports overseas, with China being our major destination for exports (Appendix 3).

Consequently, Australia becomes more vulnerable to external shocks, such as a downturn in the Chinese economy. Australia is also exposed to large fluctuations in commodity prices, which considerably influences export earnings, leading to increased volatility in the current account deficit.

Changes in the real exchange rate have implications for Australia's current account deficit. The current account shows the money flow from trade, income and current transfers for a period of one year. In the short term, an appreciation leads to the valuation effect; a reduction in the Australian dollar value of foreign debt as well as a lower interest servicing cost of debt. Also, the rise in export prices and the decrease in import prices initially triggers an increase in domestic consumption of imports and lower foreign demand for exports. Thus the current account deficit may deteriorate in the short term. The expansion of the mining sector will further deteriorate the current account deficit in the long term. Australia has persistently had a low level of national savings, and thus the high levels of investment spending in the mining industry will require increased borrowing from overseas (Appendix 4), and hence a rising deficit on the current account. While rising foreign debt is widely viewed as a concern, Glenn Stevens (2009) argues that it is not an issue since the imported capital is being used productively.

A strong Australian dollar also presents future challenges for policy makers. It is likely that the recent appreciation of the Australian dollar may lead to structural unemployment due to the contraction of the non-resources sectors of the economy; already a significant issue for the Australian economy (Eslake, 2009). Microeconomic policies should be used to address the problem, for example, education and training programs. This involves retraining those who have lost employment because of structural change. Microeconomic policy may also be required to address supply-side problems related to capacity constraints of the economy. As Treasury Secretary Ken Henry (2010) states, 'the economy [will] struggle to generate the necessary capital, labour and materials to meet strong demand.' These policies can be implemented using the additional tax revenue earned by the government from the increasing profits of mining companies (RBA Bulletin 2005). The government also needs to address the significant environmental impacts of the growth of a highly carbon-intensive mining industry. Increased tax revenue could be invested in more sustainable forms of energy and growth.

The appreciation of the dollar also has the effect of reducing inflationary pressures within the economy through the lower domestic prices of imports. Also, the structural change brought about by the appreciation will also contribute to lowering inflation in the

long term by increasing efficiency in economic production. This will minimise the need to tighten monetary policy in order to address inflationary concerns both in the short term and long term, resulting in lower interest rates.

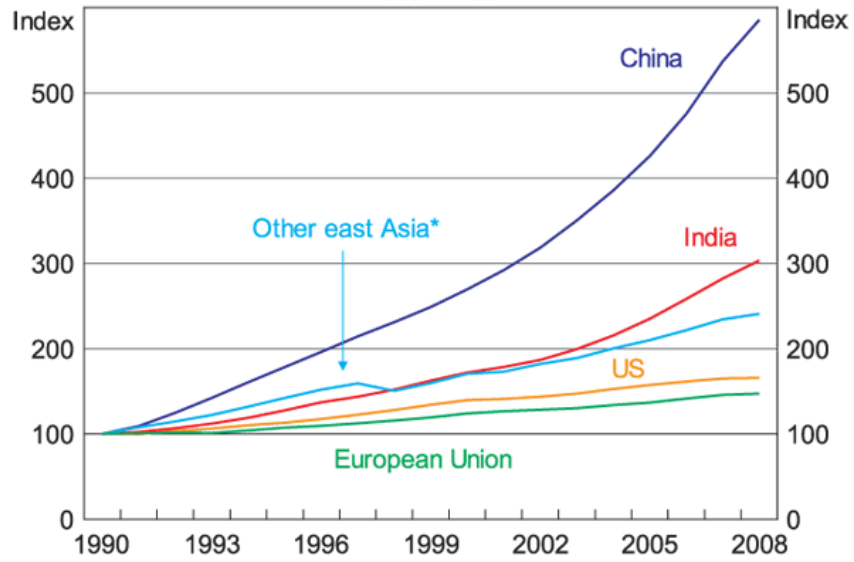
Hence, the main causes of the appreciation of the real exchange rate over the past decade are the resources boom, high commodity prices, Australia's high interest rates and increased financial inflows. While the appreciation of the dollar has many implications for the economy, ultimately, it will have an expansionary effect on the Australian economy in the long term, largely through the instigation of structural change. The higher income flows that will accrue to mining industries will eventually flow to households through wages, which will in turn result in higher expenditure in the economy. This will eventually lead to higher sustained levels of economic growth in the Australian economy. The government needs to consider their response to the risks and environmental impacts associated with this.

Appendices

Appendix 1

Real GDP

1990 = 100



* Includes the ASEAN-4 and the newly-industrialised economies; weighted using GDP shares at market exchange rates
Sources: CEIC; IMF; RBA

Appendix 2

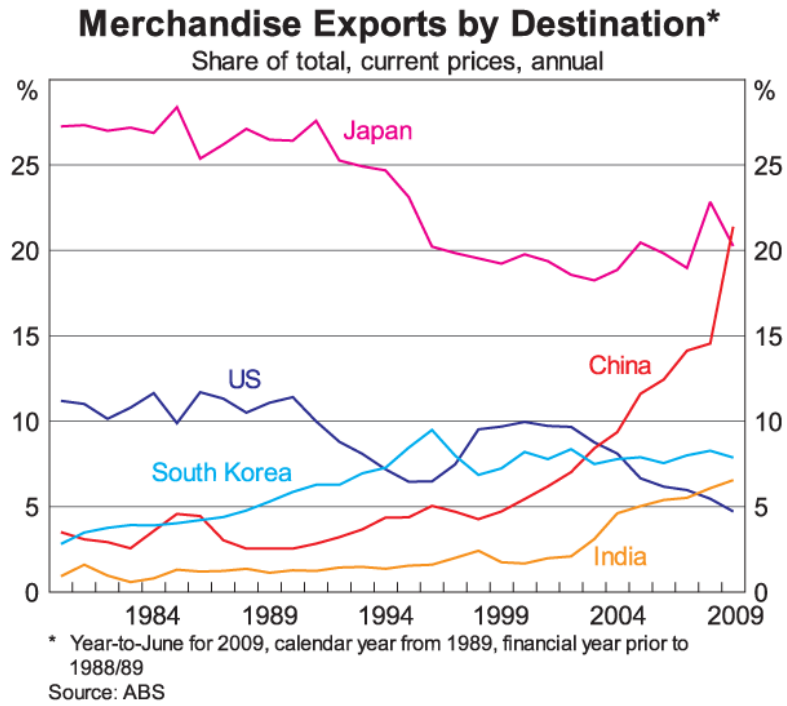
Table 1: TWI Weights

As at October 2009

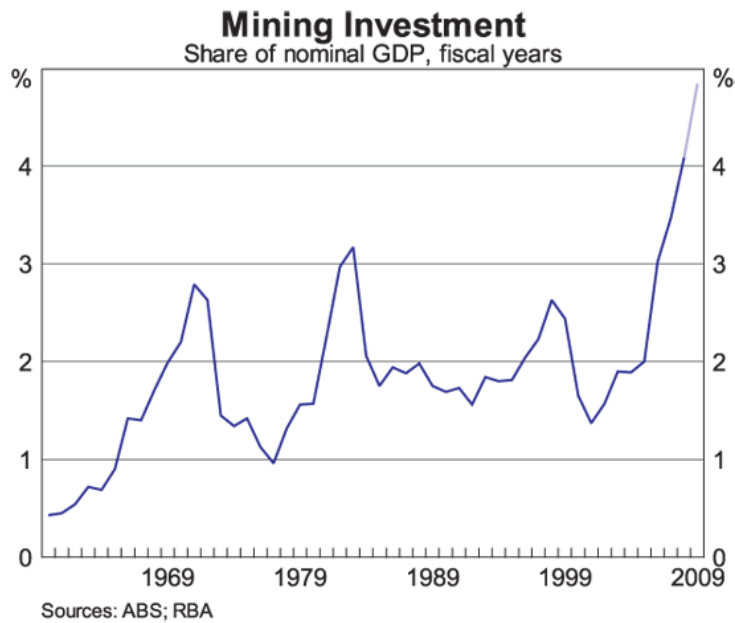
Currency	Weights (%)
Chinese renminbi	18.5621
Japanese yen	17.1230
European euro	10.4411
United States dollar	8.9794
South Korean won	6.2613
United Kingdom pound sterling	4.9916
Singapore dollar	4.6111
Indian rupee	4.2608
Thai baht	3.8159
New Zealand dollar	3.7914
New Taiwan dollar	2.9741
Malaysian ringgit	2.9284
Indonesian rupiah	2.2685
Vietnamese dong	1.3672
United Arab Emirates dirham	1.3446
Papua New Guinea kina	1.1229
Hong Kong dollar	1.1207
Canadian dollar	0.9619
South African rand	0.8056
Saudi Arabian riyal	0.7743
Swiss franc	0.7631
Swedish krona	0.7310

Source: RBA

Appendix 3



Appendix 4



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