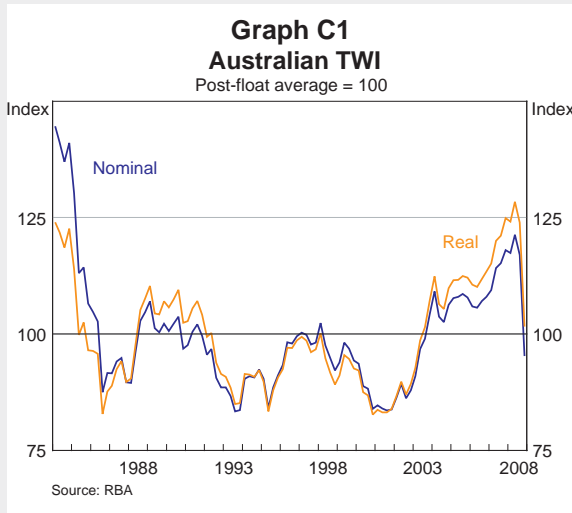


## Box C: The Exchange Rate and the Economy

The exchange rate has depreciated sharply since the August *Statement*, with the Australian dollar depreciating against all major currencies. The trade-weighted index (TWI) has fallen by 20 per cent since August, amongst the largest change in any three-month period since the currency was floated in December 1983 (Graph C1). The level of the real TWI is now at a five-year low, and is around its post-float average. This large depreciation reflects a range of factors, including the recent rapid deterioration in the outlook for world growth, the sharp fall in commodity prices, the narrowing of the interest rate differential between Australia and the rest of the world, and the generalised scaling-back of international investments (see also the ‘International and Foreign Exchange Markets’ chapter).



The depreciation of the exchange rate will have significant implications for the domestic economy, with the effects flowing through several channels. First, the depreciation will boost the prices of imported goods and services and (holding other factors constant) will put upward pressure on consumer price inflation, feeding through rapidly into the prices of some goods, such as petrol, but more slowly for many others. Traditionally, estimates of the extent of the aggregate exchange rate pass-through into the CPI were quite large, but recent experience

suggests the exchange rate effect on inflation has become more muted and protracted over time.<sup>1</sup> For example, the large cycles in import prices in recent years appear to have been reflected in much smaller swings in tradables inflation at the consumer level (Graph C2). Of course, any upward pressure on inflation in the current episode will be offset somewhat to the extent that the depreciation has been associated with a general slowing in the world economy and falls in global commodity prices (including oil).

Second, the depreciation can have effects on businesses with foreign-currency-denominated assets and liabilities and foreign-currency income streams or servicing obligations. Australian financial institutions and many large corporates with foreign currency borrowings typically

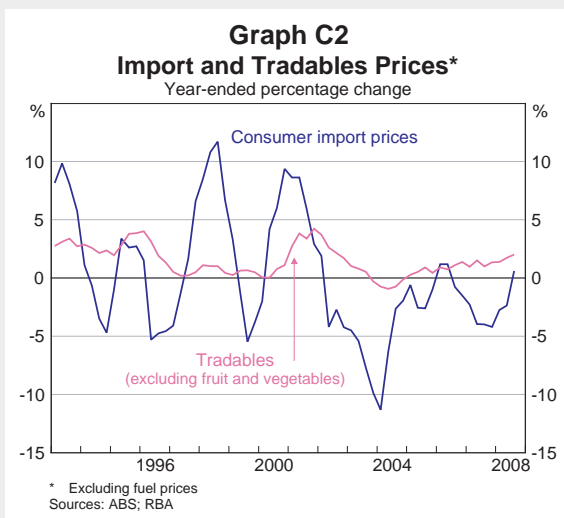
<sup>1</sup> Recent empirical work suggests that, holding other effects constant, a 10 per cent increase in import prices boosts consumer prices by around 1 per cent, with the effect spread over about three years. For further discussion of this issue, see Heath A, I Roberts and T Bulman (2004), ‘Inflation in Australia: Measurement and Modelling’, in C Kent and S Guttmann (eds), *The Future of Inflation Targeting, Proceedings of a Conference, Reserve Bank of Australia, Sydney*, pp 167–207.

hedge their exchange rate exposures, largely insulating themselves from the effects of exchange rate changes on their balance sheets.<sup>2</sup> However, non-financial companies follow a range of policies regarding hedging of foreign revenues and expenses, and based on experiences in previous episodes we can expect that some companies will report hedging losses or gains in their accounts.

Third, holding other factors constant, the depreciation will benefit import-competing and export industries, which will experience an improvement in their international

competitiveness. Exporters that are price-takers in international markets (for example commodity exporters with prices denominated in US dollars) will benefit from higher profitability and will have an incentive to increase supply. Exporters such as the tourism and education industries where prices are set in Australian dollar terms will benefit from increased foreign demand, given that their prices will have fallen relative to suppliers in other countries. By themselves, these effects will be stimulatory for growth and will show up in the national accounts as an increased contribution to growth from net exports (and a reduction in the current account deficit). Of course, it must be remembered that the depreciation is occurring in an environment of slowing world growth, lower commodity prices, and a reduction in Australia's income and growth prospects, which will work in the opposite direction to the stimulatory effects of the depreciation.

More generally, during the post-float period the exchange rate has acted as a form of shock absorber for the Australian economy. The recent depreciation follows a period when the exchange rate appreciated substantially, in line with the historically large run-up in the terms of trade. That appreciation was contractionary for the economy, but helpful in that it contributed to holding down inflation and reducing pressures on resource utilisation at a time of strong growth in domestic incomes. During the Asian crisis in the late 1990s the depreciation of the currency was a key part of the adjustment mechanism that helped the economy to continue to weather that storm, despite a sharp decline in growth in a number of our key trading partners. The recent large depreciation will also be helpful in reducing the impact of the marked deterioration in the outlook for world growth and the associated fall in global commodity prices. ❧



2 See Becker C and D Fabbro (2006), 'Limiting Foreign Exchange Exposure through Hedging: The Australian Experience', RBA Research Discussion Paper No 2006-09.