Plotting the course for currency's fall against greenback not so easy

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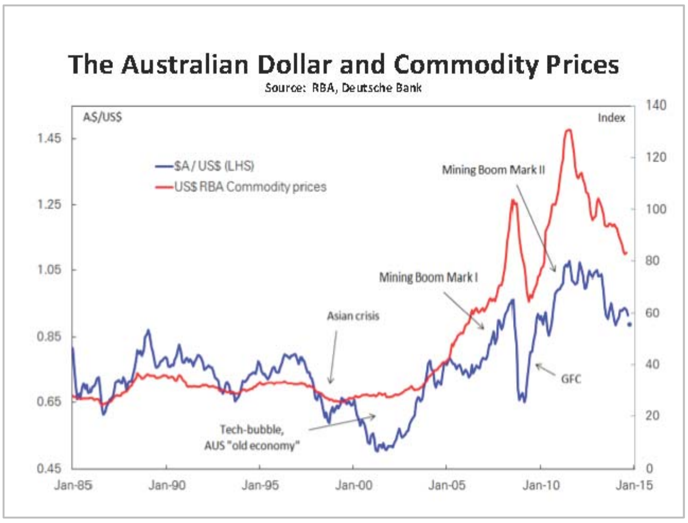

IN recent weeks, the Australian dollar has weakened against the US dollar and market sentiment towards the Aussie currency remains strongly negative. But just where our currency will settle and the course it will take to get there are highly uncertain. Also, the benefits for Australian shares from a lower dollar can take a while to come through.

One reason why exchange rates are hard to predict is that they often overshoot.

Fifteen years ago, Australia was deemed to be an "old economy" that would be left behind in the dotcom world — and the exchange rate plunged to two dollars to the US dollar.

Market sentiment soon shifted to focus on our benefits from China's growth; our dollar moved quickly higher.

During and after the global financial crisis, the Australian dollar again fell out of bed and then surged.

The Australian dollar used to be seen as mainly determined by commodity prices. And, from the introduction of the float in 1983 to the late 1990s, that was a fair call. But the relationship between commodity prices and the exchange rate weakened during the global dotcom boom; and (thankfully) the currency didn't keep pace with commodity prices when, with buoyant demand from China, our commodity prices started their steep climb in 2004.

Our current account deficit has about halved, to 2.5 per cent of GDP, in recent years. As a result, relatively small swings in net inflows of capital now have a bigger effect on the exchange rate and the leverage of the dollar to commodity prices has somewhat lessened.

Currently, the dominant view in foreign exchange markets is that the Australian dollar will fall further against the US dollar. That's in part because the US central bank is expected to raise its cash rate in 2015 (due to stronger growth and a tightening labour market) while our cash rate is more likely to be held at its current level (soft economy). Also, the consensus view is that the Chinese economy will slow markedly, causing further big declines in prices of our bulk exports.

The Aussie dollar is also expected to slip a little against the pound (the British economy is rebounding) but hold against the yen and euro (weak economies and money-printing). Our exchange rate to the New Zealand dollar is seen as depending on how export prices for their major export, dairy products, move relatively to the prices of iron ore, our dominant export.

I share the view that, more likely than not, the Australian dollar will decline further against its US counterpart. But I'd emphasise again the difficulties in predicting exchange rates. And I'd add three further thoughts.

First, sentiment in foreign exchange markets will probably continue to focus on the prospective slowing in China's growth and at times will exaggerate the resulting slump in Australian commodity prices. On occasion, the Aussie dollar could be friendless — and take a cold shower or two.

By contrast, in the medium term, the trend level of our exchange rate could be higher than is generally supposed — as export revenues are boosted by shipments of gas, iron ore prices are boosted from the closure of high-cost iron ore mines abroad, and net capital inflows, including for infrastructure financing, add to the demand for the Australian dollar.

When our dollar falls in value against the US dollar, investors with US shares benefit immediately — whether their US shareholdings are held directly or in managed funds including exchange-traded funds. As our currency weakens, the earnings of many Australian-listed companies with US dollar revenues are likely to be upgraded. However, if the outlook for the Aussie dollar remains negative, international investors would be discouraged from participating in our market; the better profits in Aussie dollars may not translate quickly into higher share prices.

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