Why our dollar refuses to fall back to earth

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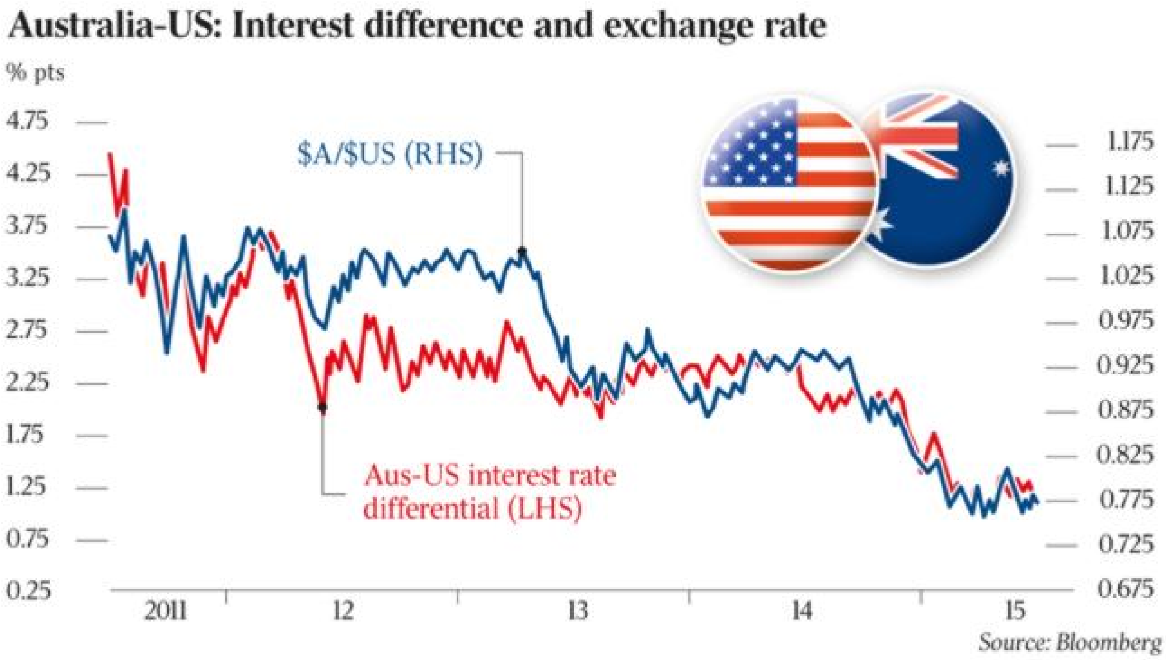

Source: TheAustralian

For many years, monetary policy had greater potency in Australia than in other countries.

That’s because most of our borrowing for housing, or to fund small businesses, carries variable interest rates. As a result, moves in the Reserve Bank’s cash rate (usually) affect existing borrowers as well as would-be borrowers.

Also, the Australian dollar is a fairly “clean float” — by which I mean we didn’t raise our cash rate to defend the exchange rate during the Asian financial crisis in the late 1990s, and we avoided recession.

Separately, the exchange rate was allowed to soar in the resources boom of 2011 — and contained the inflationary effects of the “once in a century” surge in commodity prices.

But some now argue our ultra-low interest rates won’t lift the economy out of its lacklustre state — or even achieve the “further depreciation” in the Australian dollar the RBA says has “seemed both likely and necessary”.

Certainly, the monetary easing has boosted asset prices — for shares, bonds, commercial property, and Sydney and Melbourne houses.

But effects on the economy and our exchange rate are often seen as unacceptably mild. And were the RBA to follow up by cutting interest rates further, Sydney and Melbourne house prices could shift from boom times to an unpleasant bubble.

Glenn Stevens, the RBA's governor, offers a good explanation of why the economy is sub-par despite our record low rates: "History tells us that recovering from a financial crisis is an especially long and painful process, and more so if other countries are in the same boat."

In my view, the rate cuts will have a useful effect in boosting the overall level of demand — but after very long lags.

The problem is the slow rebuilding of confidence.

Many non-resource businesses are using their improved cashflows to pay dividends or buy back shares — borrowing and spending on new capital has lower priority.

In a similar vein, many households with mortgages are reacting to the marked drop in rates not by reducing monthly repayments and spending more but by paying off debt more quickly. As a result, the average Australian household with a mortgage has built up a repayment buffer of 26 months. The effect, notably ironic, is households are using low rates to reduce debt. Low rates are also forcing many self-funded retirees to cut back on their outlays on goods and services.

So why hasn't the Australian dollar done what many businesses and investors expected and fallen further against the US dollar?

As the chart shows, our exchange rate traded at high levels to the greenback in late 2012 and early 2013, relative to the difference in interest rates between the US and Australia.

But that discrepancy was corrected in the June quarter of 2013 and has not reappeared. The Australian dollar seems to be about where relative interest rates suggest it should be.

For our dollar to decline usefully against the greenback, we may have to wait for expectations the US will soon raise its cash rate — or cut our interest rates and live with a housing bubble in the two biggest cities.

Even then, the Australian dollar may not move as low as many people now wish for. Our current account deficit, which isn't given much attention these days, is running at between 2.5 and 3 per cent of GDP — or about 40 per cent of where it has been at this stage of earlier commodity price cycles.

Given the prospective flows of capital from China and Japan into physical assets, the Australian current account deficits in prospect seem likely to be financed readily and comfortably.

What's the takeaway for investors? Low interest rates aren't ineffective in boosting spending in Australia. But with many businesses and households behaving cautiously — and strengthening their balance sheets — the impact from even ultra-low rates is more delayed and drawn out.

We can reasonably expect a lower Australian dollar, particularly when expectations build up for an early increase in the US cash rate. But we may not see our currency trade down to, and stay at, the much lower level many are hoping for.

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