

## The Big Picture

# The Australian Dollar

The past few years have seen significant movements in the Australian dollar (\$A). Late in 2007 it rose above US 90 cents for the first time since 1984. It has since retreated. Is this good? Is this bad? Why do these movements occur and how has the \$A moved against other currencies?

## The recent strength of the Australian dollar

During 2007 the \$A rose strongly against the US dollar (\$US). It rose moderately against the UK pound and the Japanese yen and held steady against the euro. Why has the \$A performed differently against these major currencies? We will get to that question a little later.

The table below\* shows the performance of the \$A against the major world currencies so far in 2007:

Currency	1st January 2007	30th November 2007	% change
Japanese yen	93.98	98.37	4.7%
European euro	.5978	.6008	0.5%
United States dollar	0.7882	.8834	12.1%
New Zealand dollar	1.1200	1.1574	3.3%
British pound	.40251	.42920	6.6%
Chinese renminbi	6.1677	6.5253	5.8%

\* All data in tables is sourced from Bloomberg.

What if we look a bit further back in time? Is the \$A on an upward trend or are there unique factors at play that have driven the currency in 2007?

Let's start by looking at the performance of the \$A over the past three years.

Currency	1st January 2005	30th November 2007	% change
Japanese yen	79.97	98.37	23.0%
European euro	.5776	.6008	4.0%
United States dollar	.7786	.8834	13.5%
New Zealand dollar	1.0888	1.1574	6.3%
British pound	.40896	.42920	4.9%
Chinese renminbi	6.4437	6.5253	1.3%

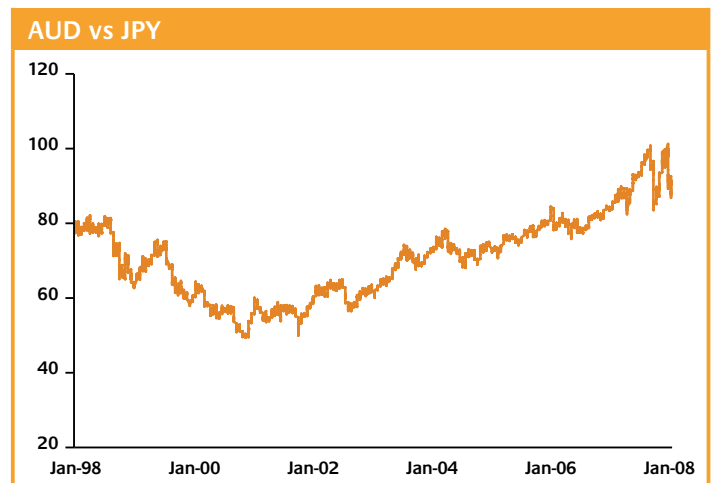
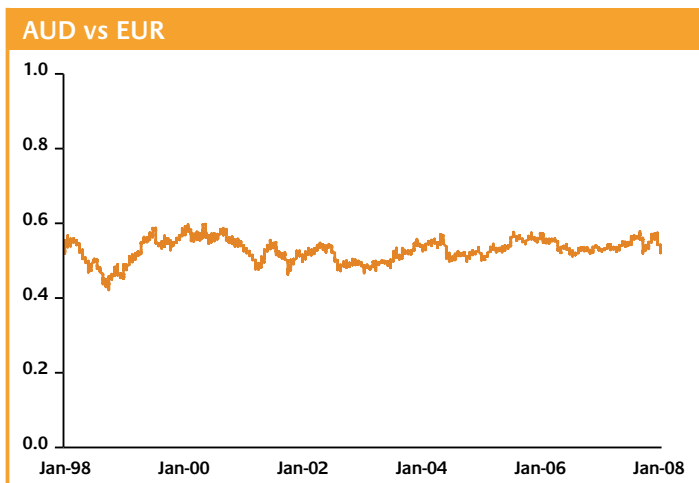
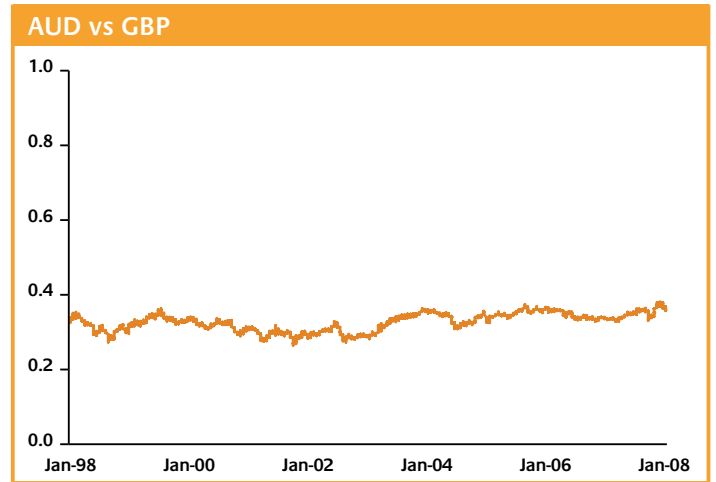
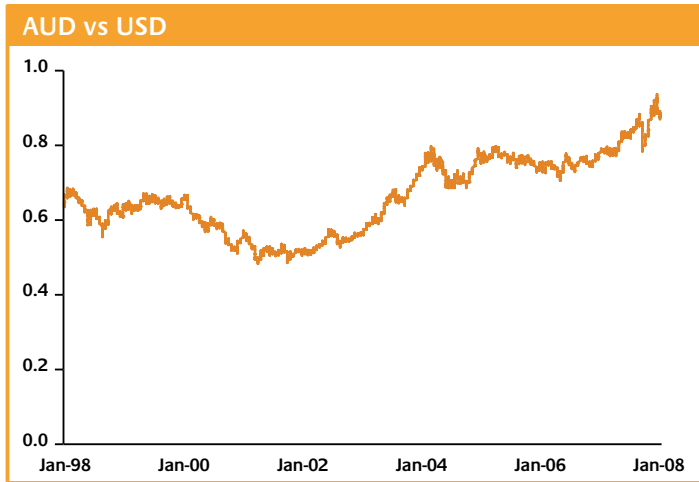
The table above shows that over the past three years the Australian dollar has risen strongly against the Japanese yen, the US dollar and the New Zealand dollar. More moderate gains were made against the pound, the euro and the Chinese renminbi.

But what if we go back still further? Consider a 10 year time frame.

Currency	1st January 1998	30th November 2007	% change
Japanese yen	84.98	98.37	15.8%
European euro	.5921	.6008	1.5%
United States dollar	.6518	.8834	35.5%
New Zealand dollar	1.1212	1.1574	3.2%
British pound	0.39448	.42920	8.8%
Chinese renminbi	5.3908	6.5253	21.0%

Over the past 10 years the \$A has appreciated strongly against the \$US. Gains were also experienced against the Japanese yen, the pound and the Chinese renminbi.

Does this tell us anything about the Australian dollar? Together with the following charts suggest that gains or losses are just as likely over 12 months, 3 years or 10 years. The charts below show movements in the \$A against the euro, yen and pound over the last ten years.



Source: Bloomberg.

The table below shows the highs and lows that the \$A reached against each currency since the late 1990s. The Australian dollar can be quite volatile with strong movements just as likely over short and longer time periods.

Currency	Low	High
Japanese yen	55.99 (Nov 2000)	107.82 (Oct 2007)
European euro	0.4873 (Oct 1998)	0.6636 (May 2000)
United States dollar	0.4828 (April 2001)	0.9366 (Nov 2007)
New Zealand dollar	1.0453 (Dec 2005)	1.3613 (Sept 2000)
British pound	0.3303 (Sept 2001)	0.4468 (Oct 2007)
Chinese renminbi	3.9811 (Apr 2001)	6.9711 (Nov 2007)

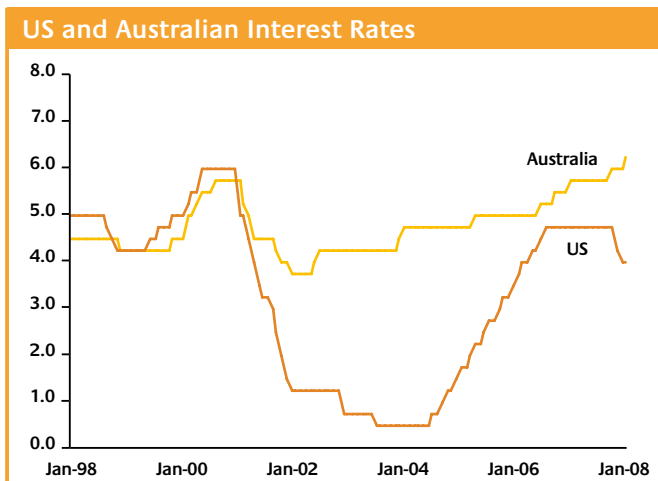
So what drives these moves? And why in particular have we seen the large moves against the \$US and only slight moves against the pound and the euro?

### Some factors that impact upon exchange rates

1. Differences in interest rates between countries and the expectation that these will change.
2. Commodity prices have been important for the \$A over time.
3. Economic conditions. In particular inflation rates, current account positions and economic growth rates.
4. Political factors such as a change of government or industrial unrest.
5. The special case of the US dollar. US dollars are held around the world as a global currency or reserve currency. This extra demand for US dollars has helped keep the \$US stronger than it might otherwise have been.

## So why the recent moves in the \$A?

1. Since 2006, Australia's official interest rates have been rising while in the US they have been stable or most recently, falling. Concerns over the pace of economic growth in the US has seen expectations of further interest rate cuts in the US, while in Australia strong economic growth sees expectations for higher interest rates. This is part of the reason the \$A has risen against the \$US.



Source: Bloomberg.

2. Commodity prices have been rising. The price of gold, lead, tin, coal and iron ore have risen strongly due to strong demand from China. This tends to push up the \$A.
3. Swings in investor confidence. Volatility in the currency markets has picked up due to uncertainty in financial markets flowing from the US sub-prime issue. (Sub-prime mortgages are loans granted to people who may not have the ability to make repayments and those who would not have qualified to borrow money under normal circumstances.) Sentiment can swing on a daily basis making a mockery of currency forecasts.
4. The \$US has weakened against many currencies due its reduced role as a reserve currency, its large current account deficit and most recently, falling interest rates.
5. Why have we not seen similar large moves against the euro and the pound? Firstly, at the time of writing, official interest rates have not been cut in the UK and in Europe. This has reduced the need for investors to go offshore in search of higher yields. Secondly, their economies are still in a reasonable economic shape and they have not had the housing sector weakness seen in the US. Thirdly, oil. The UK has large oil reserves and petrol dollars (dollars earned from oil) are flowing into the UK, propping up the pound.

Before we get carried away with the current strength of the \$A against the \$US we do well to remember that at its peak in September 1973, the \$A reached US 148.75 cents. Even in the early 1980s the \$A bought more than US 100 cents.

## What are some implications of a stronger \$A?

### Potential winners

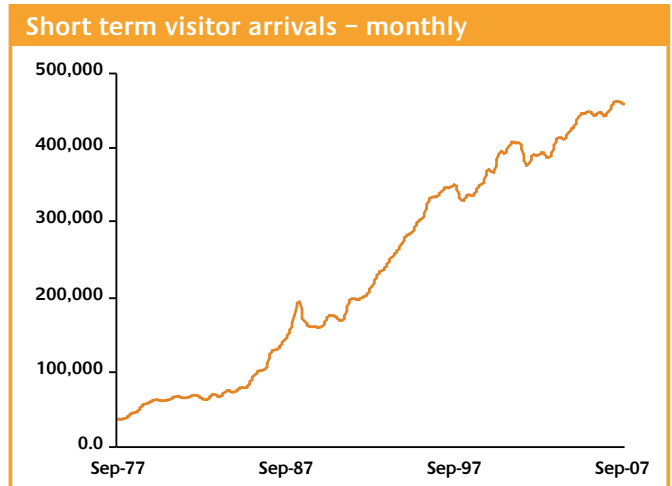
A higher \$A benefits some Australians by:

1. Making imports cheaper. A higher \$A reduces the price we pay for imports. For companies and consumers who purchase imported goods benefit via potentially higher profits and by being able to purchase more goods.
2. Cheaper imports help to keep inflation in check in the short term by reducing price pressures. This has assisted Australia in recent times with cheaper imports from China and the US helping to offset higher prices elsewhere in the economy.
3. Makes overseas travel more affordable to those countries where the \$A has appreciated against their currency.

### Potential losers

A higher \$A:

1. Makes it more difficult to export manufactured goods.
2. Works against overseas tourists planning to visit Australia.
3. Reduces the \$A value of investments in foreign assets such as international shares. To end of November in 2007, global shares\* have risen 8.6% in \$US terms, yet have fallen 3.1% in \$A terms.
4. Companies that earn revenue offshore will receive lower revenue in \$A terms when the \$A rises. This will reduce earnings for the company. We have already seen a number of Australian companies reduce their profit outlook because of the strength of the \$A. This can dampen the share prices for these companies.



Source: Bloomberg.

## Summary

The valuation of a currency is a complex matter. There are many factors at play with different issues being more dominant at different times. This makes forecasting the currency a difficult, if not impossible task. There are both winners and losers from a stronger \$A but on balance a stronger \$A is indicative of strength in the economy.

\* MSCI World Index in \$US terms