WHY THE AUSTRALIAN DOLLAR FELL IN FEBRUARY 1985

by

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Contrary to the expectations of most foreign exchange analysts, the Australian dollar plunged to record low levels during February and early April 1985, both in terms of the US dollar and its effective, ie trade-weighted exchange rate. This article discusses the underlying determinants which contributed to this unprecedented decline of the Australian dollar since it began to float on December 12, 1983.

These factors include economic data, political events and that most unmeasurable of influences, market sentiment. A summary of the theoretical influences is provided in a previous article by this author, "Determinants of Floating Exchange Rates" in *The Australian Banker* of June 1984.

AUSTRALIAN DOLLAR DEMISE: A CHRONOLOGY

The following timetable summarises the main events during recent months.

1984

•	November	Strengthening of A$ expected
•	1 December	Prime Minister's personal authority dented
•	4 December	Poor September quarter national accounts for Australia
•	December	All the above factors led to the unwinding of positions during December
•	December/January	Strengthening US$ as US economic growth surges

1985

• •	14 January	December balance of payments figures for Australia — realisation that current account deficit will exceed A$ 9.5 billion
•	Mid-January/February	Additional liquidity due to public servants' dispute
•	29 January	Treasurer abandons M3 target
•	31 January	Good CPI result for Australia
• •	1 February	New Zealand bans US warship visit; growing furore over Australian MX Missile involvement
•	4 February	US$ soars, begins 9 record days
•	6 February	Hawke reverses MX decision
• •	12 February	January balance of payments figures for Australia — current account deficit revised to greater than A$ 10.5 billion
•	18-20 February	A$ in free fall to then record low
•	21 February	Cash rates rise sharply
•	27 February	Government reaffirms intention to cut deficit; bank licences announced
•	March	Bearish sentiment towards A$
•	4 April	A$ drops to record low of US$ O.6410

For many months after the Australian dollar floated, the Australian/US interest differential has significantly influenced the direction of the US dollar/Australian dollar exchange rate. Since November 1984, this interest differential has increasingly favoured the Australian dollar, which has not only failed to appreciate, but actually weakened. This does not imply that interest differentials are suddenly to be disregarded as an important explanation of short-term exchange rate movements. On the contrary, as the volume of capital transactions in global foreign exchange markets continues to grow in proportion to trade transactions, the prominence afforded to interest differentials, both real and nominal, will intensify accordingly. Therefore, we need to examine the effects which more than offset the influence of interest differentials.

The Australian dollar had been easing against the US dollar from the beginning of December 1984 due to three occurences in as many days. The first was the relatively poor result for the Labor Party in the federal election, which severely dented the charismatic popularity of the Prime Minister, Mr. Hawke. Second, Australia's third quarter GDP data allegedly showed a dramatic slowdown in the economic recovery. Third, the US dollar again resumed its upward path against major currencies in response to the surge in US economic growth in the fourth quarter of 1984. This (unfortunate?) coincidence of events exhausted the confidence which the Australian dollar enjoyed in domestic and international financial markets. From early December 1984 the Australian dollar has been on a downward path against the US dollar, and in terms of its effective exchange rate.

Nevertheless, this decline accelerated sharply in February. The initial influence was a market response to previous declines as Australian exporters began to withdraw from the foreign exchange market. It had been presumed that exporters would sell their foreign currency proceeds prior to the expected appreciation of the Australian dollar during the tax rundown period from late March to mid-May. However, with the relaxation of exchange controls since the floating of the Australian dollar, exporters now have the option of leaving foreign currency receipts offshore indefinitely.

In the event, exporters exercised this option in the expectation of a weaker Australian dollar later in 1985. They effectively vetoed the Australian dollar and, to some extent, precipitated the very depreciation which they desired.

Further adverse economic data emerged in January when Australia's December balance of payments data indicated a significant blowout in the current account deficit for 1984/85 compared with the figures provided by the Treasurer in the Budget. The current account deficit was forecast at about A$ 8.3 billion in the Budget; this was now raised to A$ 9.5 billion. Some private sector economists had been forecasting a much worse balance of payments outlook for some time, but a general realisation of the seriousness of the situation only then pervaded the market.

Domestic liquidity grew quickly during January/February due to a strike by federal public servants which prevented the Commonwealth Government from collecting revenue. Consequently, domestic interest rates eased temporarily and the resultant decline in the Australian/US interest differential further removed support from the domestic currency.

This strike exacerbated a growing problem for the Reserve Bank in accurately measuring the money supply in Australia, especially M3, which was growing far more rapidly than its target range of 8-10 per cent. Rather than revising the range upwards, the Treasurer announced on January 29 that the M3 target would be abandoned.

Newspaper columnists have penned thousands of words about the correctness, desirability or otherwise of this decision. It is not the purpose of this article to discuss this issue but, rightly or wrongly, the foreign exchange market, particularly offshore, took the news badly as implying a loss of control over monetary policy — the Australian dollar began to experience more downward pressure.

In early February, the US dollar began its ascent to a record level against the Deutschemark (since major currencies floated) and this may have been the trigger which initiated the Australian dollar's sudden decline.

A couple of days later, the adverse influence of the domestic economic data on the exchange rate was compounded by the Government's decision not to assist the United States in testing the MX Missile near Australian waters. This followed on the heels of the New Zealand Government's ban on visiting US warships and was greeted in a hostile manner by US institutional investors with funds in Australia. The Australian Government now needed to restore confidence in its currency on both the economic and political fronts.

But more bad news was on the way. The January balance of payments figures resulted in even higher

estimates for the current account deficit. The balance of payments revisions indicate that imports in the first seven months of the financial year were more than 30 per cent above their level in the corresponding period of the previous year. All categories of imports have experienced growth in excess of 15 per cent in this period, reflecting a very substantial rise in import penetration. For the 7 months ended January 1985, the current account deficit was A$ 6.9 billion, compared with A$ 3.9 billion in the corresponding period of the previous year.

The growth differential in favour of imports is unlikely to narrow significantly over the remainder of the financial year. A trade deficit of at least A$2.0 billion is implied. With little change expected in the rate of growth of the invisibles deficit, which stood at A$5.3 billion in the 7 months to January, an overall current account deficit of at least A$10.8 billion is likely. A number of economists consider that capital inflow will not be sufficient to offset a deficit of this size.

In both dollar terms, and as a proportion of GDP, we are facing the second largest current account deficit in the last 30 years, exceeded only the current account deficit in 1981/82 — this was a year in which the Australian dollar fell in trade-weighted terms by around 5 per cent followed by a 12 per cent decline the following year under a managed exchange rate regime.

The Australian dollar went into "free fall" between 18-20 February, depreciating to a then record low of US$0.6580. The Australian dollar effective exchange rate (January 1980 = 100) also recorded a then record low of 82.96 on February 20. Throughout March, sentiment, rather than economic or political events, dominated the foreign exchange market's perceptions of the Australian dollar. Although the authorities tightened domestic liquidity and raised interest rates to support the exchange rate, this was of limited efficacy. At best, it sometimes prevented further depreciation; on other occasions, adverse sentiment overwhelmed the attractiveness of higher returns on Australian securities. The domestic money market also pushed interest rates higher in late March and early April in response to the approaching tax rundown period and in anticipation of further official action to mitigate currency depreciation. Despite this, the Australian dollar slumped to a record low of US$0.6410 on April 4. The effective exchange rate fell to 75.99, a record low for it also.

Much press comment has focussed on the question of the impact of the Australian dollar's depreciation on the rate of inflation. Much of it has been erroneous. Several points need to be made.

- There is undue focus on the fall in bilateral rate against the US dollar when, in fact, it is the smaller fall in the effective exchange rate which is relevant to the rise in the costs of imports.
- Imports of textiles, clothing and motor vehicles — two of the three major components of the Consumer Price Index — are subject to quota restraint. The effect of quota protection, of course, is that prices of these imports to final consumers are set by domestic prices. The rise in fuel costs is, therefore, the *sole* major component leading to a *direct* increase in the CPI.
- Finally, the linkages and lags between a major devaluation and its flowthrough into the CPI have proved historically to be slow, variable and very substantially less than believed at the time of the devaluation.

The fall in the dollar is desirable. The depreciation will, over a 12-18 month period, reduce import growth and stimulate exports. However, it will only improve the current account deficit to the extent that import prices and export prices increase relative to the general price level. Unless the inflationary impact of the depreciation, no matter how small, is discounted at indexation hearings, it will feed into wages and then into local prices.

The course of the Australian dollar over the immediate future will be dictated by whether exporters, banks and overseas portfolio investors choose to speculate further against the Australian dollar. If the Australian dollar is seen as having reached a "sustainable" level, exporters will re-enter the market which will cause a bounce back in the Australian dollar rate.

Sentiment will dominate. Note that the Prime Minister's recent statement ruling out the discounting of wage indexation increases on account of the effects of currency depreciation should be no surprise. The statement reaffirms once again that the Government will maintain the Accord against — if not all costs — at least all reasonable costs. However, market participants, particularly foreign portfolio managers, may well take a harsher view of what constitutes "reasonable" costs.