

[Home](#) » [Opinion](#) » [Ross Gittins](#) » Article

Goodness knows why our dollar's so stable

By Ross Gittins
February 27, 2006

MONDAY COMMENT

THE big news about the Aussie dollar is that there's no news. It's been going nowhere for about the past eight months - which is surprising.

As the Reserve Bank observed in this month's Statement on Monetary Policy, the Aussie has been trading in a narrow range around US75c, a little above its post-float average of US71c.

Against the trade-weighted index, it's been steady around 63, compared with a post-float average of 58. While we depreciated a bit against the US dollar and most Asian currencies from the start of last year, gains against the euro, pound and yen were pretty much offsetting.

All told, last year saw the lowest degree of variability in the Aussie's value in any year since the float in December 1983. And that's surprising when you remember the continuing rise in commodity prices and improvement in our terms of trade during the year. In years gone by, there was a very strong correlation between our dollar and our terms of trade. It appreciated when the miners' prices were high and depreciated when they fell.

Not any more - or, let's not be so dogmatic, not this time - it seems. Why did this old-faithful relationship fail to materialise?

Because, according to the Reserve's theorising, this upward influence on the Aussie's value was exactly offset by a downward influence: the decline in the short-term interest rate differential (the amount by which our official interest rate exceeds the United States official rate) as the US Federal Reserve made 14 consecutive tightenings of 0.25 percentage points.

As a result, the interest differential narrowed from 3 percentage points at the start of last year to 1 percentage point at present, reducing the demand for Aussies.

(It seems there may have been another part of the explanation: some diversion to New Zealand of international funds that otherwise would have flowed to Australia. This was because their official rate is now 7.25 per cent relative to our 5.5 per cent. This is *not* good news for the Kiwi economy.)

But here's another puzzle. This time last year, almost everyone was expecting the US dollar to continue falling. This was obvious, since the US current account deficit was so huge and clearly unsustainable.

The greenback had to fall further to make US exports and import-replacement goods more

internationally competitive and start winding in the deficit.

It may have been obvious, but it didn't happen. Rather than fall, the greenback rose - by 14 per cent against the euro and 8 per cent against the greenback's TWI.

Why? Because the Fed was steadily jacking up US short-term interest rates across the year, making the holding of US dollar-denominated assets ever more attractive and thereby sucking in investment funds.

Do you see the link between the two surprises of last year, ours and the Yanks'? In both examples, people expected that issues concerning *current account* "fundamentals" - rising prices for exports; growing trade deficits - would be the dominant influence over movements in exchange rates.

But in fact it was issues concerning the strength of flows into the *capital account* - how attractive your interest rates were relative to other countries' - that had most influence over movements in the exchange rate.

"In a world of globalised capital markets," the Reserve says, "capital flows seeking to take advantage of actual and perceived differences in rates of return across countries can be more powerful than trade positions for currency markets."

True. Good point. But it's not always that simple. There've been various occasions when the size and direction of the interest rate differential didn't provide a good explanation for the strength of capital flows and what was happening to our dollar.

Consider the latest "Belgian chocolate" theory of exchange rates, as enunciated by Paul de Grauwe, professor of economics at the University of Leuven, in an article in the *Financial Times*.

The prof points to an experiment undertaken by behavioural economists at the Brussels food fair. On the first day of the fair they set up a stall selling Belgian chocolates for 9 euros (\$14.50) a box. They sold quite well.

On the second day they upped the price to €15 a box and demand doubled. On the third day they slashed the price to €2 a box and demand collapsed.

This, of course, was exactly the opposite of what economic textbooks predict. So what was going on? Well, the people at the fair had no way of knowing how good the chocolates were without buying them and tasting them.

So they assumed they could use the chocolates' price as a rule of thumb - a "heuristic" as psychologists call it - to indicate the chocolates' quality. (People do this with cosmetics and bottles of wine all the time.)

The prof's point is that people who trade in currencies have no way of knowing the "fundamental

value" - the quality, so to speak - of those currencies. Each economist who tries to work it out gets a different answer. And the plausible answers cover a surprisingly wide range.

So people in the currency market fall back on using the market price and the direction in which it is moving as a rule of thumb.

"Thus when the [US] dollar goes up for some technical reason, or just by chance, the increasing dollar is a signal for people that there must be some hidden economic strength driving the dollar. And they buy dollars," de Grauwe says.

Here we have a rationale for "momentum trading"- for buying financial assets whose price is rising, and selling assets whose price is falling. And the insidious thing about momentum trading, of course, is that it's profitable - for a while.

The conclusion I draw from this is that, yes, exchange rates are now influenced more by the "hot money" flows of short-term profit-seeking fund managers than by trade- and direct investment-driven flows.

But the likelihood that the world's fund managers' pursuit of short-term profit is often only tenuously related to changes in current-account fundamentals (such as trade balances and commodity prices) or even to observable interest-rate differentials suggests that the standard theories for explaining exchange rate movements no longer work.

The prof's conclusion, however, is that, since financial market economists and other analysts have no better idea of the fundamental value of currencies than the rest of us, but traders are always after justification that their actions are soundly based [and economists need to pretend they know what's going on], analysts have become masters of ex-post (after the fact) rationalisation.

"Thus when the dollar goes up, the analyst goes on a search for variables that move in the right direction and that can be linked to the rising dollar, carefully eliminating from the analysis all the other fundamental variables that move in the wrong direction," de Grauwe says.



The traditional justification for protection is that it saves the jobs of those who work in the protected industry. But now we have the Howard Government happily protecting Qantas from the depredations of Singapore Airlines, while Qantas busily moves jobs offshore in its pursuit of higher profits. Not bad if you can get it.

Ross Gittins is the Herald's Economics Editor.

[Subscribe to The SMH and you could win a \\$26,000 holiday to London](#)

Copyright © 2006. The Sydney Morning Herald.

