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"Is the high Aussie dollar really bad for the Australian and Victorian economies?"

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Messages

Three factors have pushed up the real exchange rate

- High Australian incomes, due to strong terms of trade
- High Australian interest rates, due to domestic demand and macro mix
- High demand for Australian assets, due to global risk attitudes

The high terms of trade are the dominant factor

The real exchange rate has shaped, rather than sped, structural change

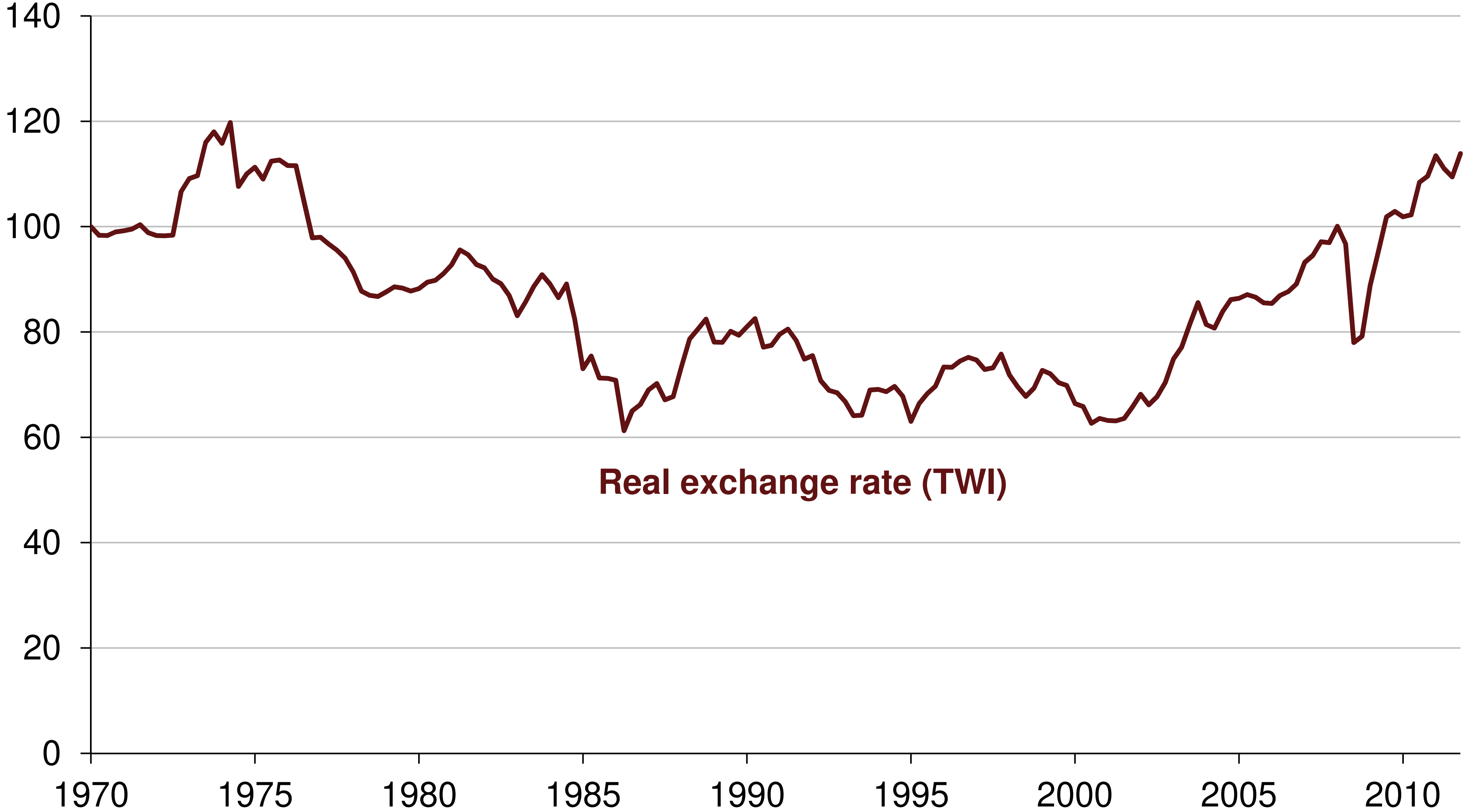
- Real exchange rate has made consumers better off, but has reduced returns for the tradable sector

Policymakers should respond to underlying factors, not to the exchange rate per se

- Policy should not seek to protect industries under pressure
- Policy should seek to ensure *adaptability*: capturing the most from the boom
- Policy should also aim for *resilience*: performing well if conditions change

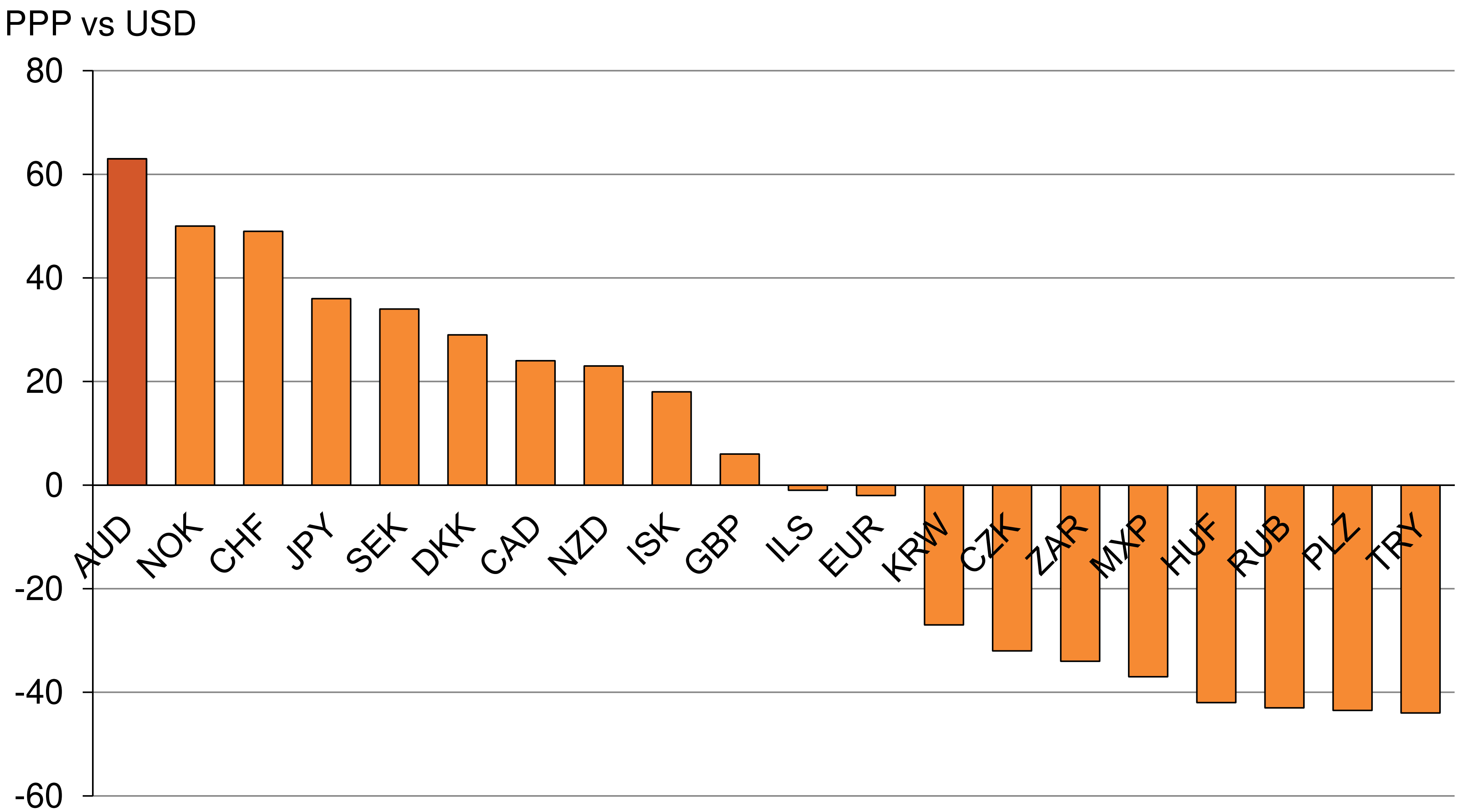
The Australian real exchange rate is at its highest since the 1970s 'wage outbreak boom'

Australian trade weighted exchange rate: Index (June 1970 = 100)



Source: RBA Table F15

AUD is far above purchasing power parity



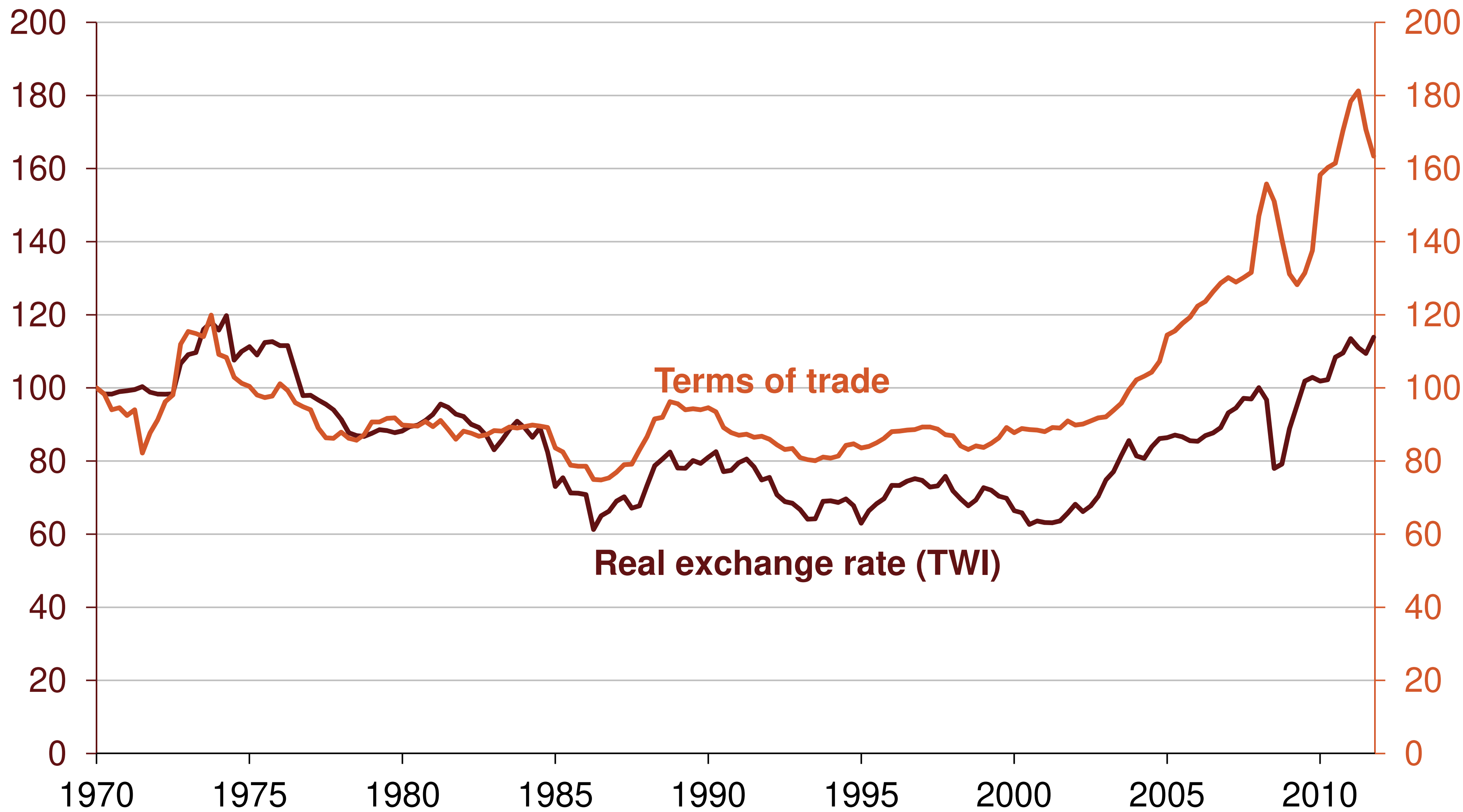
Source: OECD and Pacific FX Service, http://fx.sauder.ubc.ca/PPP.html, retrieved 14/8/2012. PPP reference year 2011.

There are three main drivers of the real exchange rate

1 The income effect from high terms of trade	• Income boost drives up demand for all goods and services • Non-traded sector prices rise, shifting output away from traded goods whose prices are fixed on world markets
2 Australian macro policy mix	• Boom in resources investment requires other sectors to slow • Which sectors slow depends in part on macro policy settings • If monetary policy is the main brake on demand, interest rates higher than rest of world drive up the exchange rate
3 Global asset preferences	• Risk aversion currently high due to Euro crisis and deflation risk • Australian bonds are perceived to be safe • Willingness to hold Australian assets drives up the nominal exchange rate

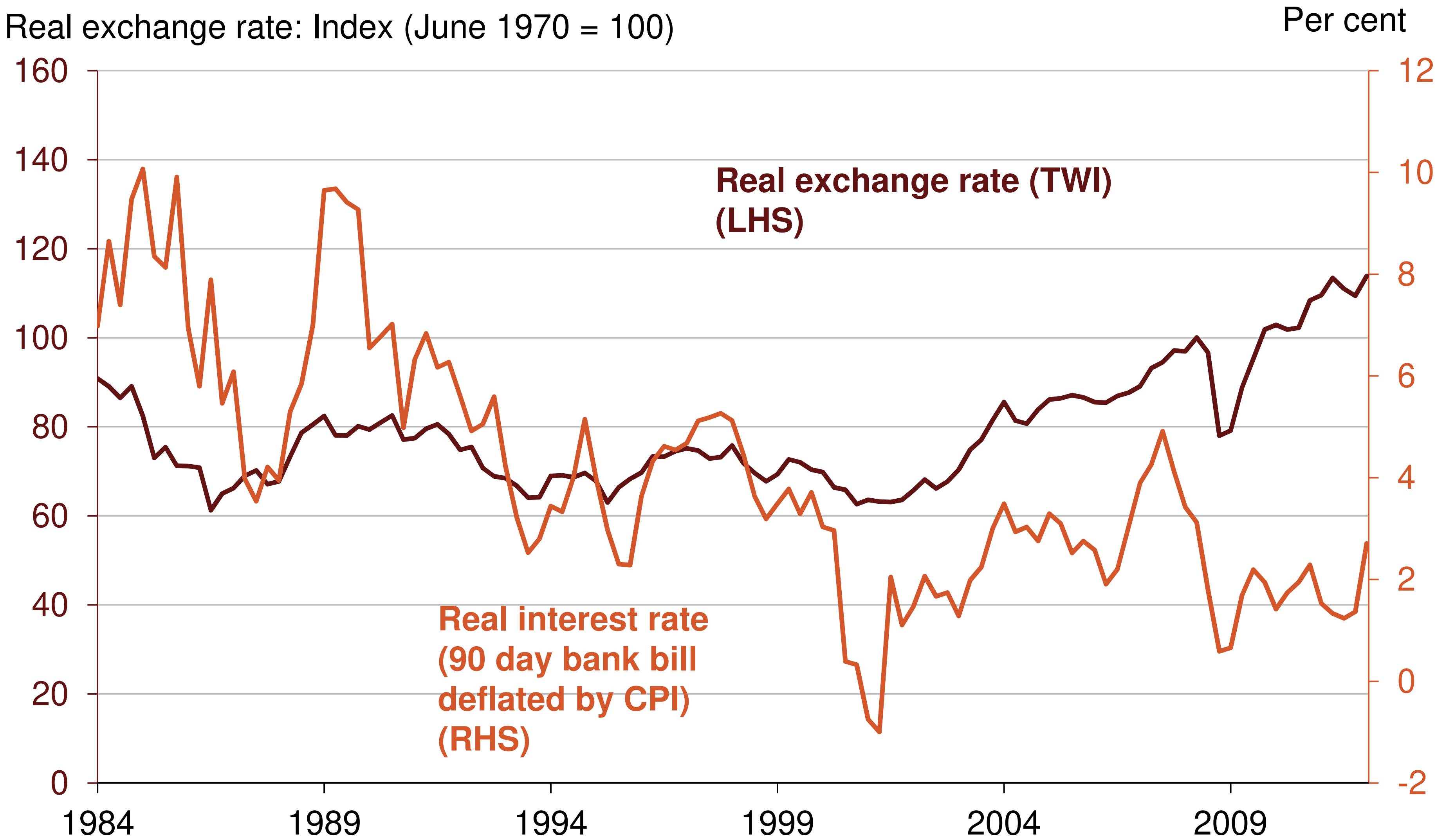
1: Strong terms of trade has pushed up the real exchange rate

Terms of trade and real exchange rate: Index (June 1970 = 100)



Source: ABS 5206; RBA Tables F15 and F1

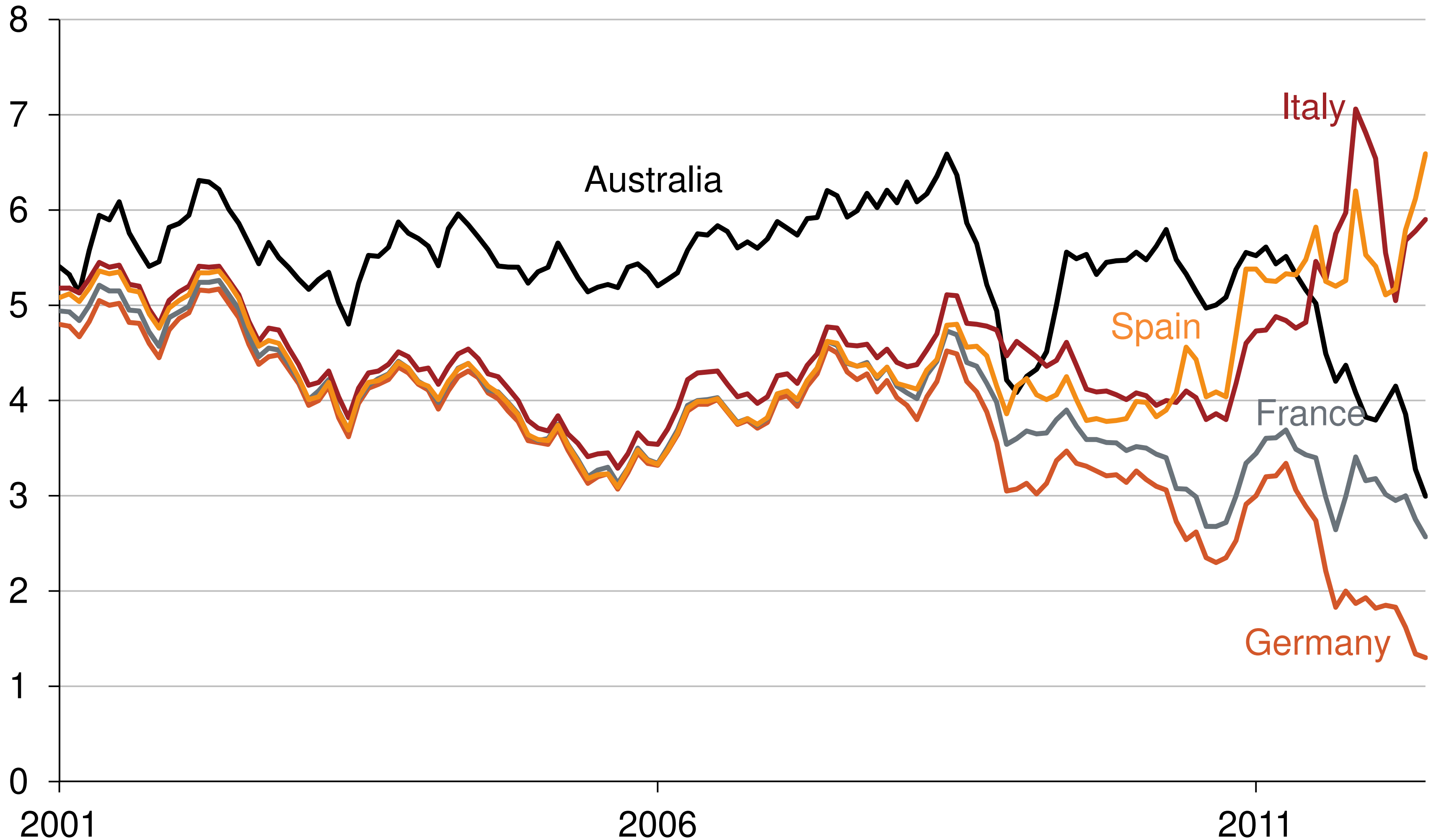
2. Interest rates also affect the exchange rate



Source: ABS; RBA Tables F15 and F1

3. Risk assessments and appetites have shifted

Nominal sovereign yields (per cent)

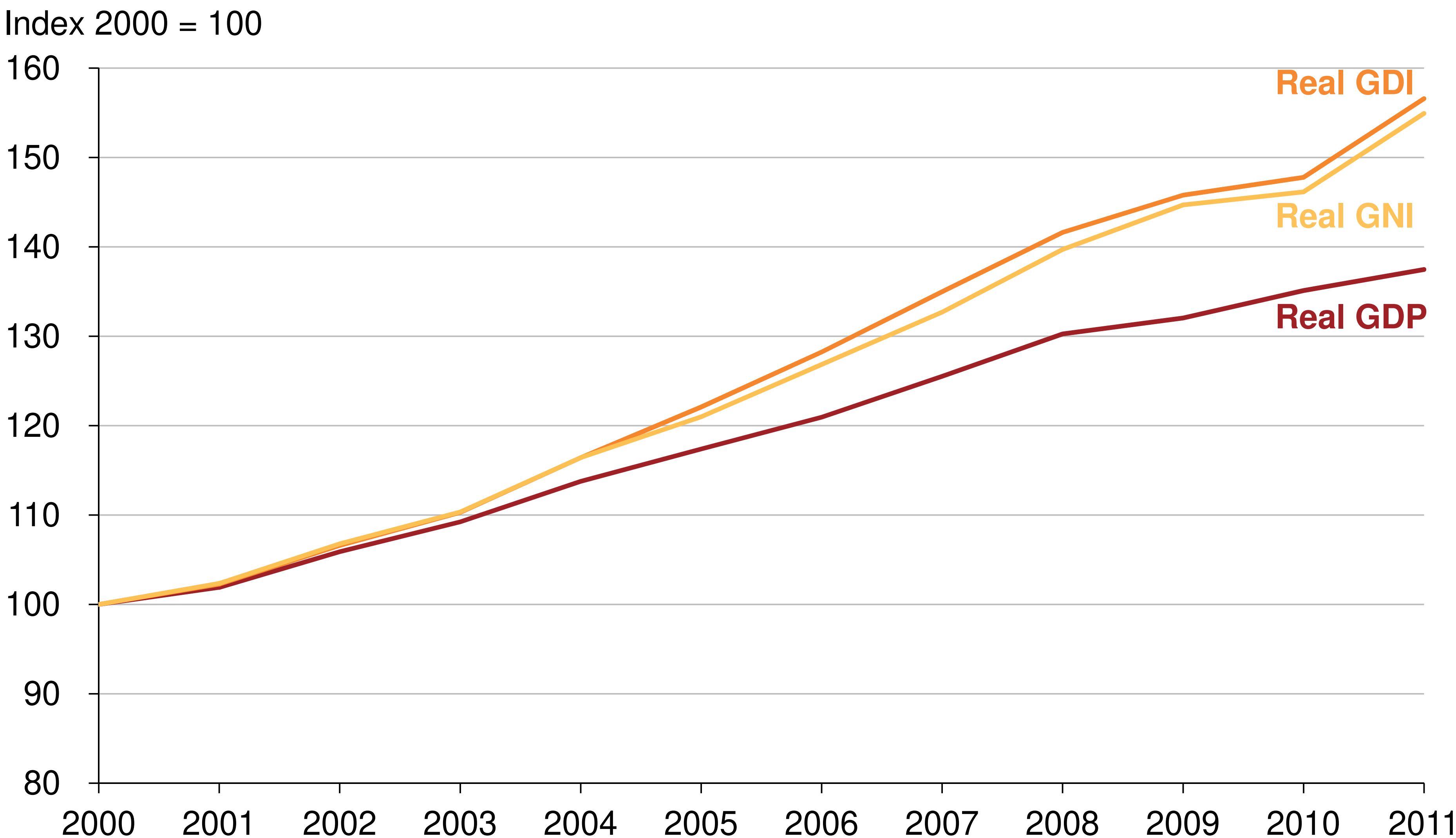


Source: FRED (2012)

The high dollar has shaped the impacts of the terms of trade rather than driven effects in its own right

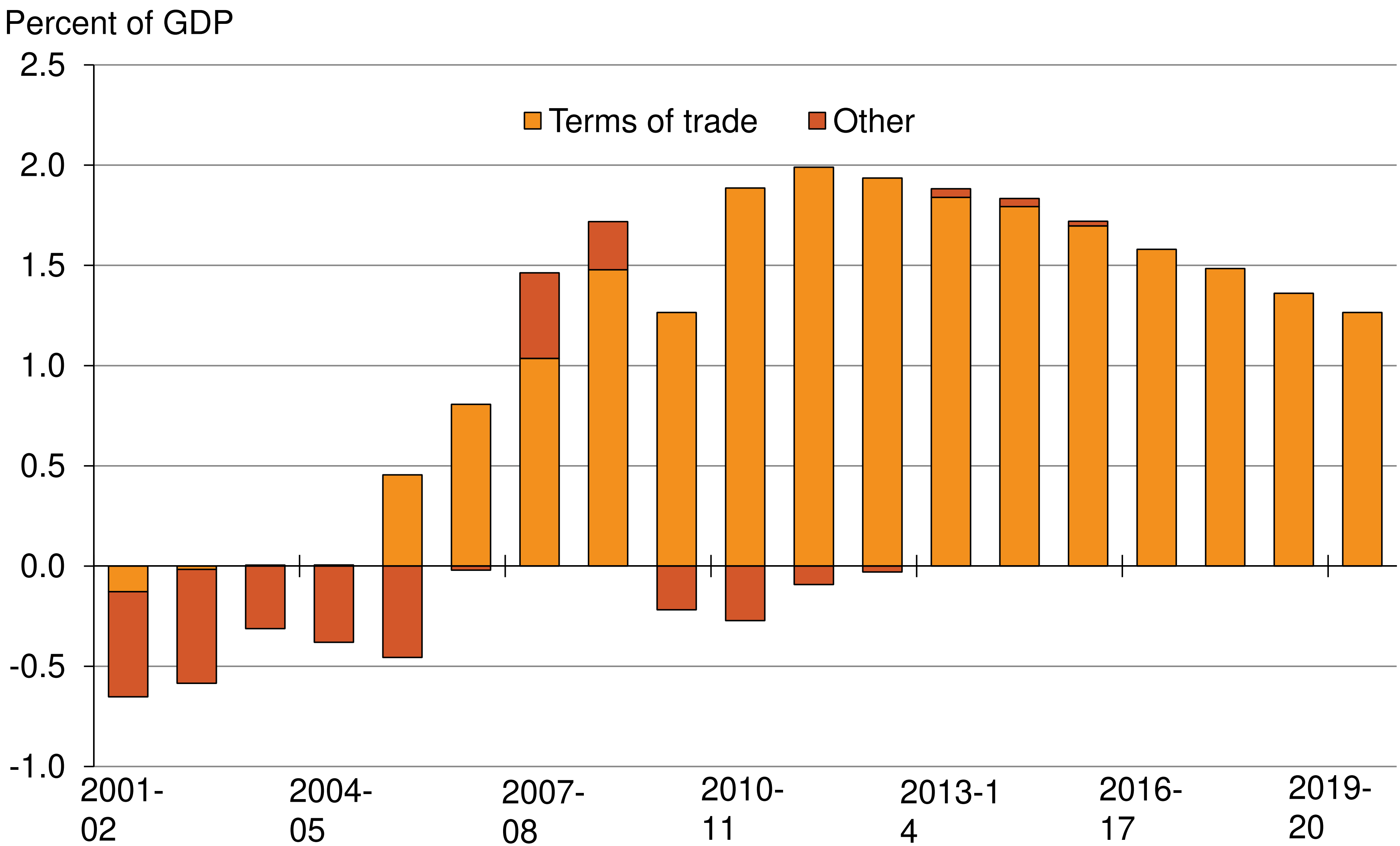
1. High incomes and low prices of of tradable goods
2. Strong tax revenue from high incomes
3. Returns changing across industries
4. Industry mix changing
5. States experiencing different speeds

Incomes have been buoyed by the terms of trade



Source: ABS 5206.0 T30

Tax revenues have been buoyed by the terms of trade



Source: "Estimating the structural budget balance of the Australian Government", Tony McDonald, Yong Hong Yan, Blake Ford and David Stephan. Australian Treasury Economic Roundup, Issue 3, 2010.

Returns to mining have soared, while other tradable sectors are under pressure

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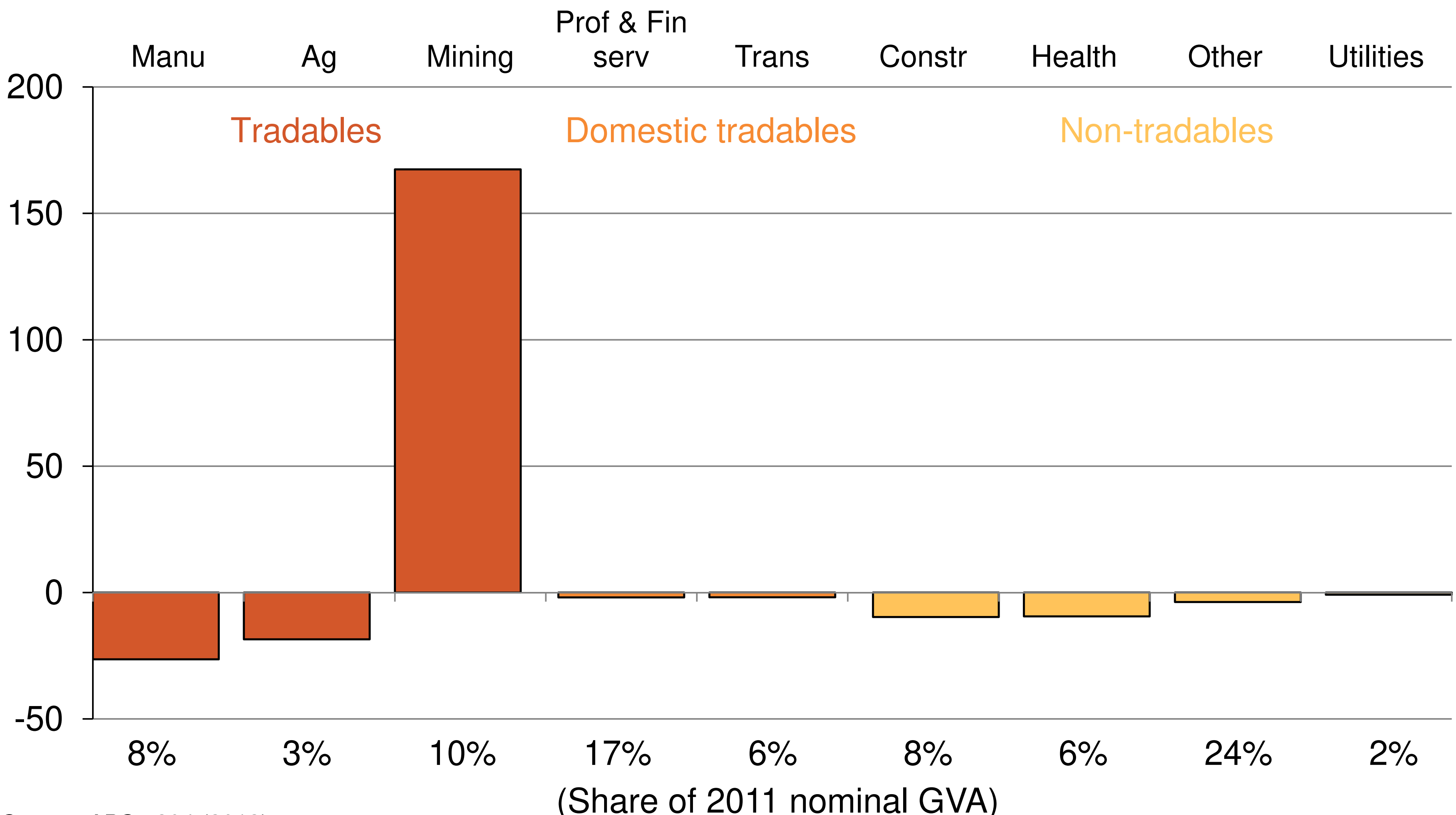
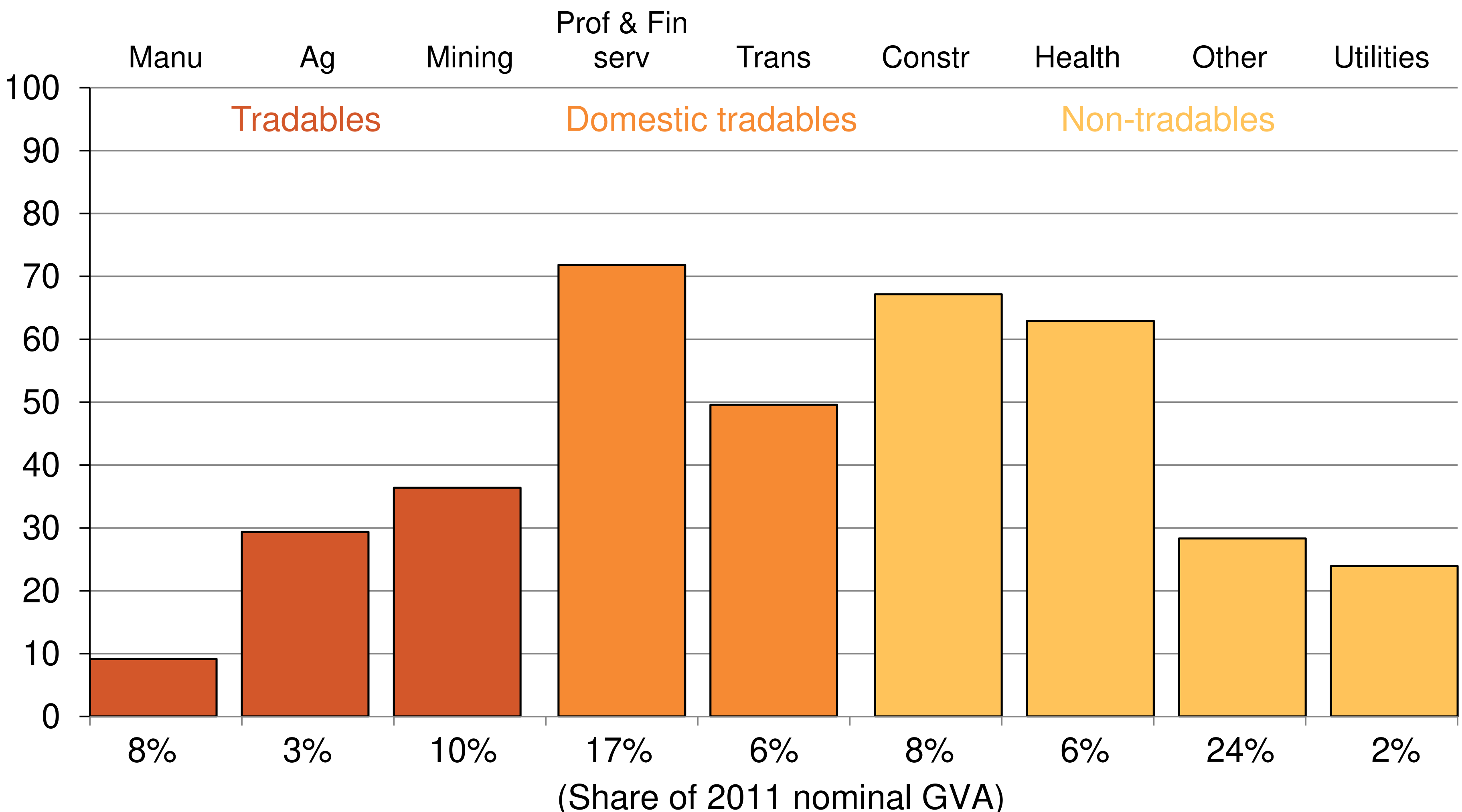
Selected Australian industries, output price growth relative to GDP deflator 2000 - 2011



Source: ABS 5204 (2012)

Non-resource tradables have not kept pace with rest of economy

Selected Australian industries, real value added growth 2000 - 2011



Source: ABS 5204 (2012)

The story is similar in Victoria, with slower tradables but strong domestic tradables and nontradables growth

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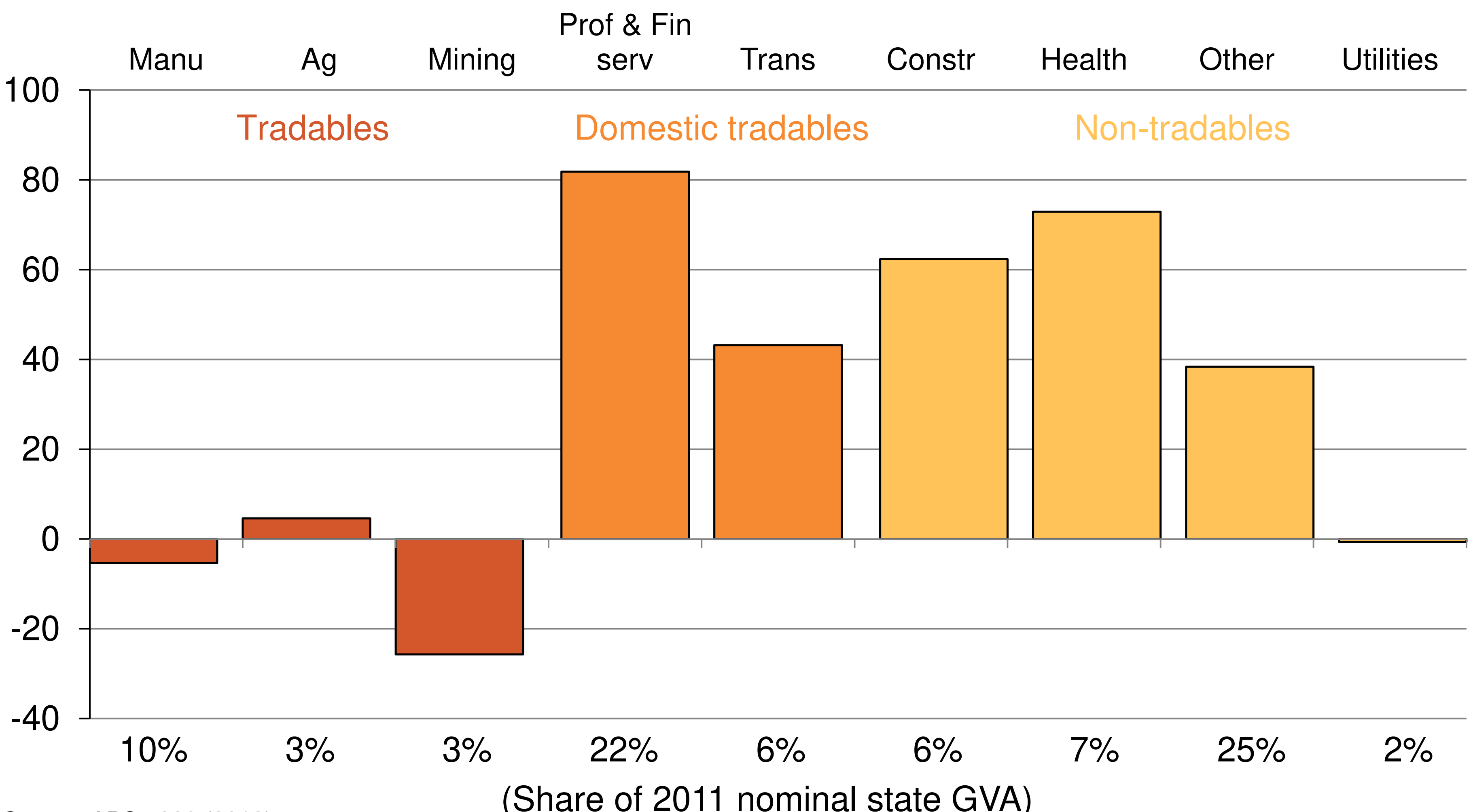
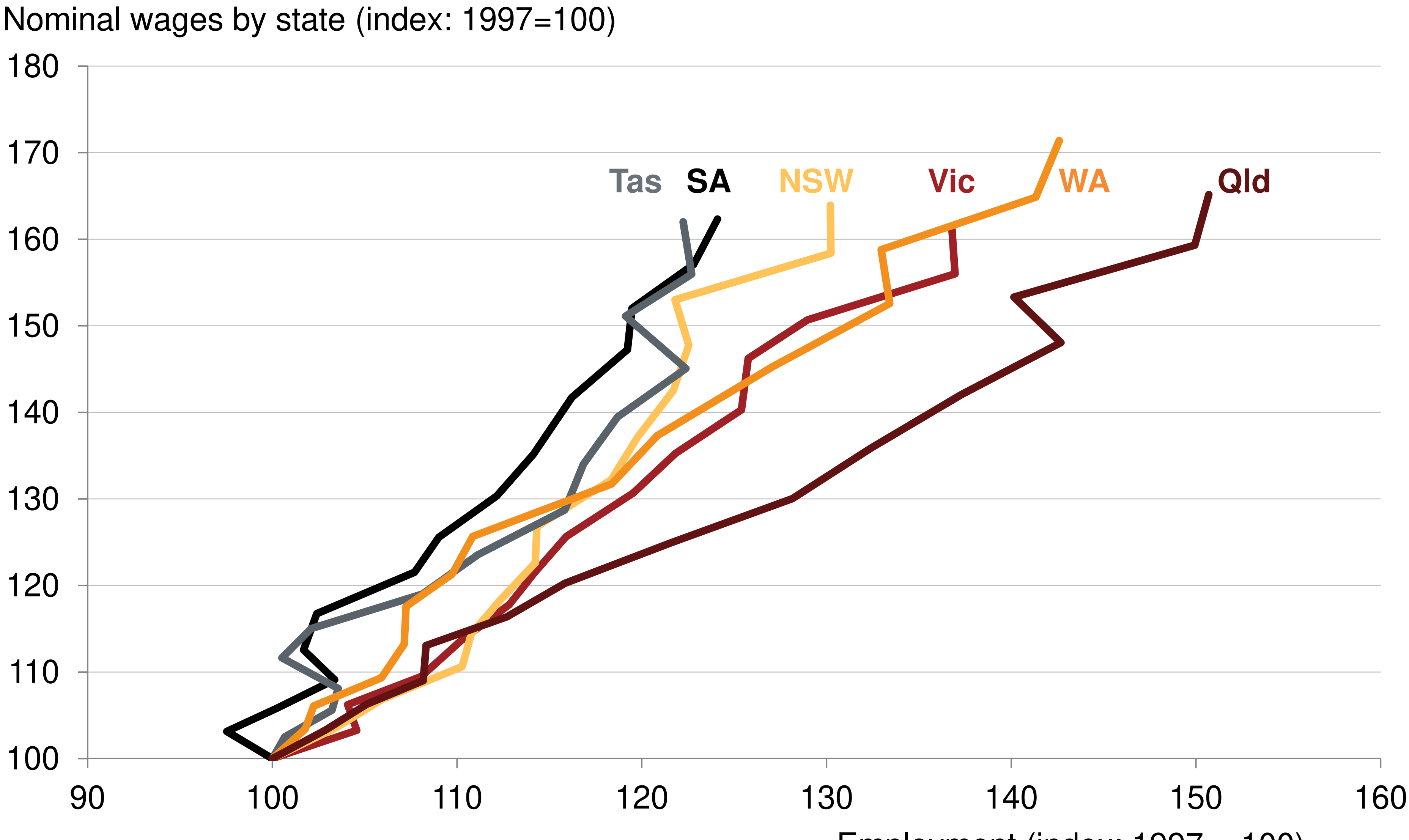
Selected Victorian industries, real value added growth 2000 - 2011



Source: ABS 5220 (2012)

Victoria has still created more jobs than other non-resource states, though wages lag WA and QLD



Source: ABS 6105 & 6345

The market value of production in resource states has risen rapidly, while it has stagnated in Vic and some other states

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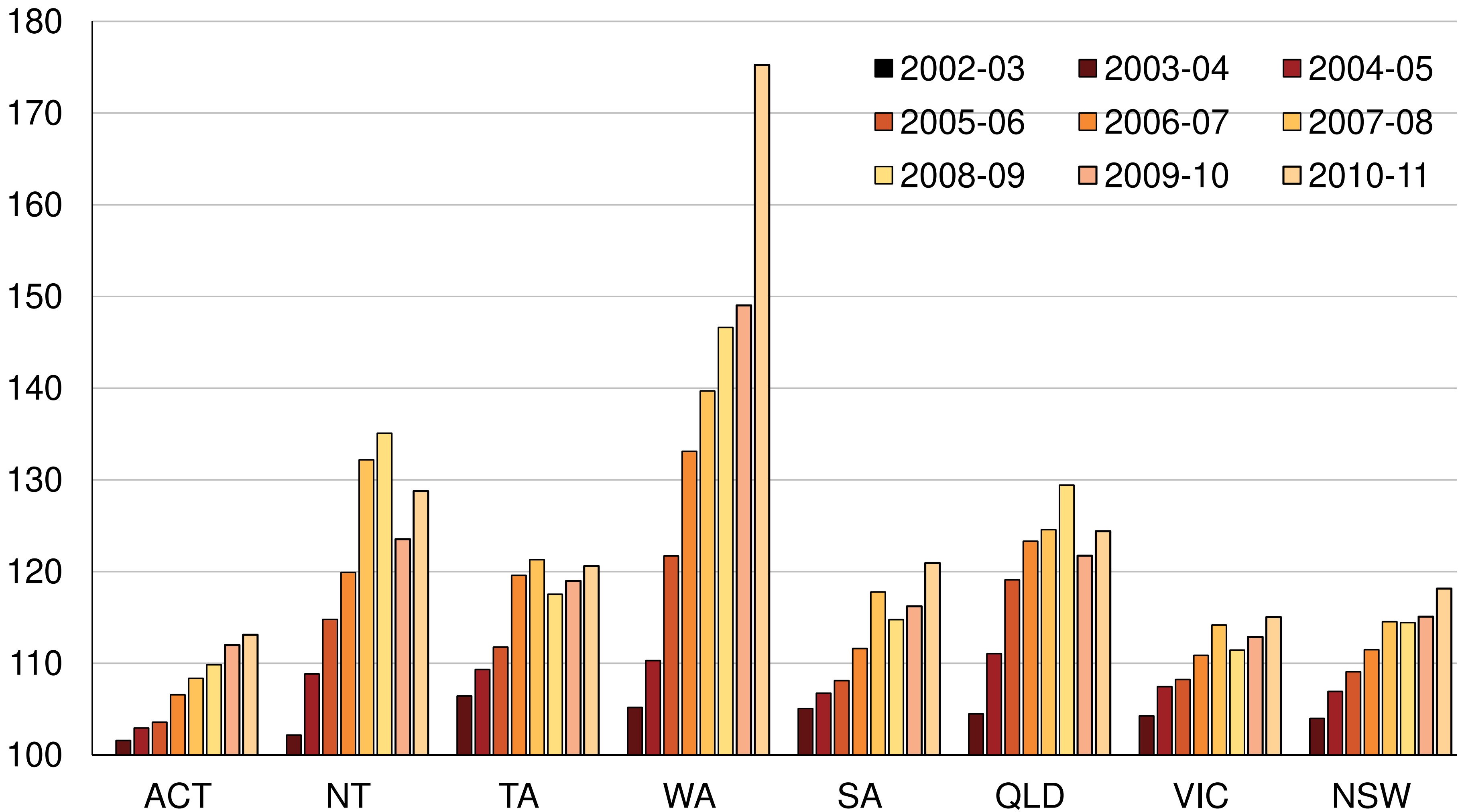
RGDI per capita by state (Index: 2002-3=100)



Source: ABS: Australian National Accounts: State Accounts 5220, 2010-11

Real exchange rate has shaped the impacts of the terms of trade – the only attractive alternative is higher national savings

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Policy stance	Economic variables under each policy stance			
	Tradable prices	Industries	Tax revenue	Income
"Hands off" Permit a high real exchange rate	Low	Resources and nontraded sectors strong; others weak	High	High
"Deny" Lower the nominal exchange rate (eg lower interest rates)	Temporarily high but will be offset fully by inflation	Temporarily strong due to excess demand	Temporarily high due to excess demand	Temporarily high due to excess demand
"Save" Run fiscal surpluses to offset the boom	High	Less pressure on non-resource tradables	Tradables sector revenues perform relatively well	High – but more of it is saved
"Protect" Protect non-resource tradables (eg manufacturing tariffs)	High	Only the protected sectors do well	Lower	Lower due to resource misallocations

See: "The Real Exchange Rate Always Floats", Thorvaldur Gylfason, Australian Economic Papers, 2002

What are the policy imperatives?

Policy should not seek to protect industries under pressure (tariffs, export subsidies)

- Protection is 'effectively inefficient': it reduces income
- It keeps workers and capital in sectors that do not generate valuable output
- It reduces incentives to increase productivity and invites rent-seeking

Policy should seek to ensure *adaptability*: capturing the most from current conditions

- Retrain people on the 'downside of the boom'
- Remove obstacles to industry restructuring
- Remove obstacles to redeploying resources

Policy should also aim for *resilience*: performing well if conditions change

- Invest in assets that will pay off if the boom subsides (*eg* education)
- Continue to prosecute the productivity, competition, and participation agendas
- Exercise fiscal prudence