

# *thebigpicture*

guideposts for the private investor

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## **Publishing and Subscription Information**

*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## GETTING USED TO A HIGHER DOLLAR

Economic conditions justify a more buoyant Australian dollar. However, the world economy has a vested interest in a strong US dollar and, longer term, upward pressure on its value could well resume. For investors, the stronger Australian dollar is beneficial because it makes Australia a less risky destination for offshore capital.

The Australian dollar has appreciated by over 25% against the US dollar since December 2001 including a 14% gain during 2003. Against the trade weighted index of currencies it has risen slightly less: by 19% and 12%, respectively, over the same periods.

### ***Nationalism: stronger is better***

Most people think of a strong currency in terms of its global purchasing power and national prestige. On these measures, there is little doubt that having a stronger currency is better than having a weaker one.

### ***Exporters: becoming dependent is dangerous***

Exporters are supposed to benefit from currency depreciation. Typically, they dislike any rise in the currency's value. True enough, they achieve a one-off advantage from a fall in the currency but it comes at the expense of anyone who has to import or consume overseas goods or services and can create an illusion about business performance. The effect of continual depreciations may also diminish. In Australia's case, continual drops in the currency were eliciting progressively smaller export boosts.

From a national perspective, improved export competitiveness is better achieved from operational efficiencies rather than an erosion in the international value of Australian assets. Protestations from exporters at a stronger currency should be viewed in this context.

### ***Policy: to help or not***

Desirable or not, an appreciating currency in the short term can cut export incomes. Policy makers will have to decide whether to compensate, perhaps by a drop in interest rates, or simply let the adjustment take its course.

A reduction in interest rates which makes Australia a less attractive destination for short term capital flows might avert a further exchange rate rise. It would also assist the profitability of exporters to the extent that they had borrowed or might need to borrow to carry on their activities. Deciding to take no action might be appropriate if the higher currency is seen as something exporters must adapt to eventually in any event.

Overall, the stronger currency raises the probability of another interest rate reduction or, at least, acts as a restraint on any prospective rise.

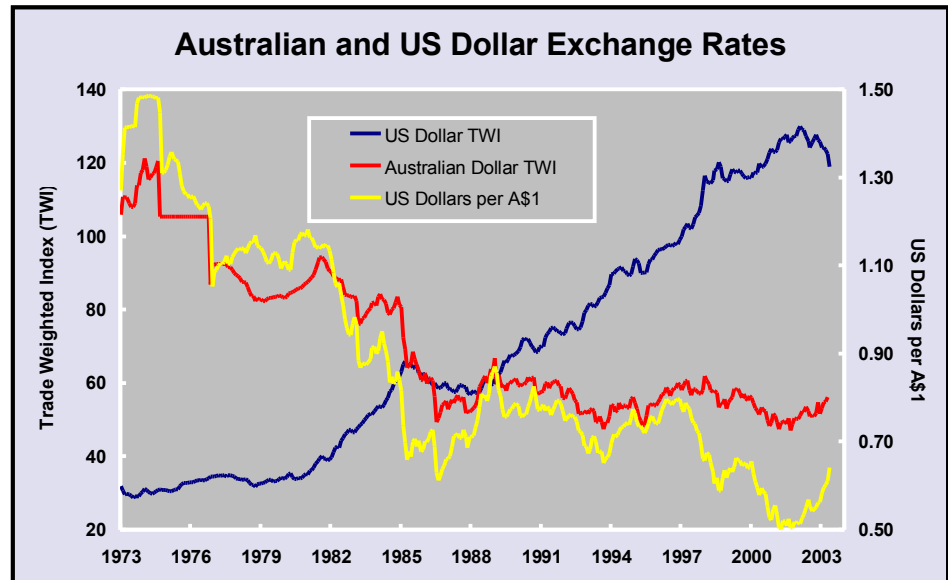
### ***US politics: strong is good***

The US has had a so-called 'strong dollar' policy. This was not necessarily an explicit government decision but the dollar's appreciation did coincide politically with the interests of the White House which has been pleased, whoever the incumbent, to take advantage of the market momentum. Some of this strength did come from the superior performance of the US economy but the monopoly position of the US currency as a global store of value was reinforced as other countries removed many of the barriers to international capital movements.

The US Treasury Secretary was reported in recent days as suggesting that it might no

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## THE WEEKLY CHART SPOT



Source: Reserve Bank of Australia & US Federal Reserve Board

*“Just like for a bank, confidence is critical. There have been other periods of weakness but the dollar has retained its value because people have the expectation that it will retain its value! Importantly, there are no ready substitutes as global stores of value.”*

The US dollar has followed a generally upward trajectory for the past 30 years. The US dollar trade weighted index (the blue line) which is a measure of the currency against the currencies of a broad range of major trading partners has appreciated at an average annual rate of over 4% over the 30 year period shown in the chart.

The US, being the world's largest and most successful economy, has been a magnet for foreign capital. The world's appetite for dollars has been funded through a large current account deficit which has recently been equivalent to about 4% of the US GDP.

With slower US growth, the acquisition of US assets is not as attractive as it had been for the rest of the world. At the same time, a growing balance of payments deficit has meant a continuing ready supply of dollars. So, more recently, the US dollar value has been declining.

Just like for a bank, confidence is critical. There have been other periods of weakness but the dollar has retained its value because people have the expectation that it will retain its value! Importantly, there are no ready substitutes as global stores of value. Over the years, alternatives such as sterling, the yen and more recently the euro have failed to achieve anything approaching the acceptability of the US dollar as a means of international exchange or store of value.

Throughout much of this period of US dollar ascendancy, the Australian dollar (the yellow line) was declining against the US dollar. The period of most intense weakness was during the first half of the 1980s when Australia's relatively poor inflation performance was eroding the purchasing power of the Australian dollar. With more flexible labour and product markets and improved productivity, the currency has been relatively stable throughout the 1990s. This is more evident in the trade weighted index for the Australian dollar (the red line) which is a broader measure of Australian dollar value.

Looking ahead, monetary authorities in the USA and Australia are seeking to have inflation settle at around 2½% a year. No difference in inflation rates takes away one important influence on the exchange rate. However, the US dollar remains the world's currency and the US economy is its chosen safe haven. There is little evidence of this changing.

Also, demographic trends will underpin a superior US economic performance with Japan and Europe likely to experience a population contraction while the US and north American population base (and market) expands enhancing US asset values and providing relatively attractive investment opportunities for the rest of the world.

None of this is a strong argument for betting against the US dollar resuming its upward push in the longer term.

## GETTING USED TO A HIGHER DOLLAR CONT'D

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longer be necessary to maintain a strong dollar. What might have appeared reasonable at first blush subsequently brought forth interpretations about what he really meant to say. Since a weak currency is contrary to maintaining a high degree of national self-esteem, the White House was apparently swift in its repudiation of the suggestion.

From a more analytical standpoint, too, a policy of dollar weakness was criticized. To have the world's largest economy achieve a competitive advantage by deliberately lowering the value of its currency is an aggressive act which could invite reprisals. Some references to the 1930s and the beginning of the depression, as countries competed against one another to give their industries a competitive advantage, have been made to illustrate the folly of this course.

### The Profit Risk

**Recognition that profit sensitivity to exchange rate movements will be affected by how a company organizes its production and sales activities is necessary for effective risk management.**

Case A is a wholly domestic company with all of its revenues generated in the local market and all of its costs denominated in Australian dollars. Examples of this type of company might typically be a service provider, property developer or smaller consumer goods manufacturer. There is no direct exchange rate impact.

Case B is a company whose production is wholly located in Australia but whose entire output is sold in foreign markets at prices denominated in US dollars. This is similar to the typical Australian resources company.

It is the big loser from a firmer Australian dollar. That said, investment markets do not usually accord a profit change from a currency fluctuation the same value as one from an operational or commodity price change. A very weak Australian dollar, for example, has rarely implied a boom in resource stocks.

A strengthening Australian dollar might reflect more favourable international growth prospects which would benefit commodity demand and improve the underlying prospects of a resources com-

### Australian equities: reduced risk

For those whose primary interest is the performance of the stock market, the appreciating Australian dollar should be seen as a positive feature. A rising currency would normally be associated with buoyant capital flows implying a relatively attractive investment environment.

Overseas investors would have seen their returns from the domestic share market eroded by the near halving of the value of the currency which occurred during the 20 years after 1980 and the average annual decline of 2% since 1970. For a country critically dependent upon capital flows having returns undermined in this way was undesirable. The stronger currency takes away one source of risk from an investment in the Australian equity market and, to that extent, should support prices at a higher level than would otherwise be the case.

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A weaker US dollar also tends to mean that US dollar denominated prices move higher. This will also offset some of the effect of the stronger Australian currency on profitability.

Case C is a company with a substantial part of its production and markets located offshore. We assume that it has 40% of its revenue and production costs in an offshore location. Examples of this type of company would include some of the larger Australian firms such as National Australia Bank, Foster's Group and BHP-Billiton.

The relatively small profit sensitivity from geographic diversification of production and sales represents an inbuilt management of risk.

Case D is where all the revenues are generated in the domestic market but a substantial proportion of the costs are in foreign currency. We assume for the example that 60% of the costs are denominated in a foreign currency. Examples of this type of organization would include local manufacturers which import materials for their production processes or companies which have offshore production centres for the fabrication of goods which are to be

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*“From a national perspective, exporters' improved competitiveness is better achieved from operational efficiencies rather than an erosion in the international value of Australian assets.”*

### How a 10% currency appreciation affects profits\* ....

Case A	No change
Case B	Down 67%
Case C	Down 4%
Case D	Up 34%
Case E	Down 10%

\* using a simplified example with revenue of 100, costs of 85 and 30% tax

## THE DOLLAR: ECONOMIC DRIVERS

**Is there a fair value for the currency? An array of economic variables may be relevant but relative inflation is one of the more important in the longer term.**

Among the factors which can influence the currency value significantly are:

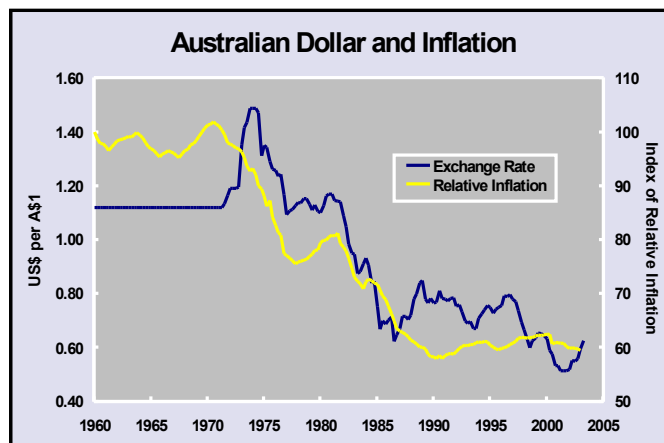
- inflation,
- interest rates,
- balance of payments,
- foreign debt, and
- domestic growth.

How these factors interact will determine the direction of currency movements. At the same time, there is also considerable evidence of overshooting with the level of the currency often driven by speculative activity in global markets. Economic factors might set the direction of the movement but speculative forces might determine its peaks and troughs.

One of the most telling factors over the longer term has been relative inflation performance although some of the deviations from the trend have been significant and prolonged as shorter-term factors have loomed larger.

The yellow line in the accompanying chart shows how Australia's inflation performance compares with that of the USA. When US inflation is lower than inflation in

Australia, as it was through much of the 1980s, the line declines. Australia's relatively poor inflation performance meant that the purchasing power of the Australian dollar was deteriorating faster than



that of the US dollar. That was reflected in the declining exchange rate (shown in the blue line).

Australia's inflation during the 1990s was at least as low as or even lower than inflation in the USA (the yellow line was actually rising gently for much of that time). A more stable exchange rate could have been expected. Even since 2000, a rate closer to 70 cents seemed more appropriate than one below 50 cents. To that extent, the appreciation which has gathered pace in recent months could be construed as a rebound to levels more in line with the longer-term inflation performance.

*“One of the most telling factors over the longer term has been the relative inflation performance ....the appreciation which has gathered pace in recent months could be construed as a rebound to levels more in line with the longer-term inflation performance.”*

## THE PROFIT RISK CONT'D

*(Continued from page 3)*

sold in the domestic market.

Despite being a clear beneficiary of currency strength, the investment market may accord such a windfall a relatively low value if it believes that it might not be sustainable, a reasonable conclusion given such a long history of Australian dollar weakness.

Case E is where the local company has all its revenue and a predominant portion of its costs (say 80%) denominated in for-

eign currency. Some of the biotech companies whose markets are entirely offshore and whose costs reflect the overseas market development activity which is necessary to build alliances and take a product to market could be characterized in this way.

While not apparently great, their sensitivity might be significant enough to be of concern since early stage companies often have limited cash resources and might not have budgeted for a change in currency circumstances.