

# WHAT ARE THE COSTS AND BENEFITS OF A FLOATING CURRENCY FOR AUSTRALIA?

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## Abstract

This paper discusses the outcomes that the floating of the Australian dollar has had on that country's economy. First, it looks at the state of exchange mechanism prior to the 1983 float; Second, it looks upon the changing of the monetary frame after 1983; Third, it looks upon the bank deregulation-capital flows-balance of payments since the float and; Fourth, it discusses the stability of the mechanism by looking at the Asian Crisis. The concluding remarks discuss that, overall, the change to a floating mechanism has been a benefit to the country.

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*“In international monetary affairs...I think it is fair to say that the central, canonical issue is that of choosing an exchange regime.”*  
 - (Paul Krugman, 1993, p.19-20).

With the collapse of the Bretton Woods and its Smithsonian Agreement many nations moved directly to a floating currency exchange regime. Like many other emerging markets Australia initially did not follow suit for a number of reasons<sup>1</sup> but eventually in December 1983 the country followed many other industrial nations of the time and the Australian dollar (AUD) was floated: thus to be determined by the forces of supply and demand for it in the foreign exchange market. Early schools of thought (Friedman, 1953)(Kindleberger, 1969) discussed the analytical arguments between a fixed and flexible regime, though in light of the pursuing victor, Friedman’s visionary portrayal of life under a floating system of exchange rate did not mirror international inflation differentials. Instead, what followed in many global circumstances were currency volatilities at far higher magnitudes than most experts had previously anticipated. This reflects the findings of many that there are no simple prescriptions for adopting any particular regime (Mussa et al., 2000). In Australia’s case it is key to look at the question from a before and after objective.

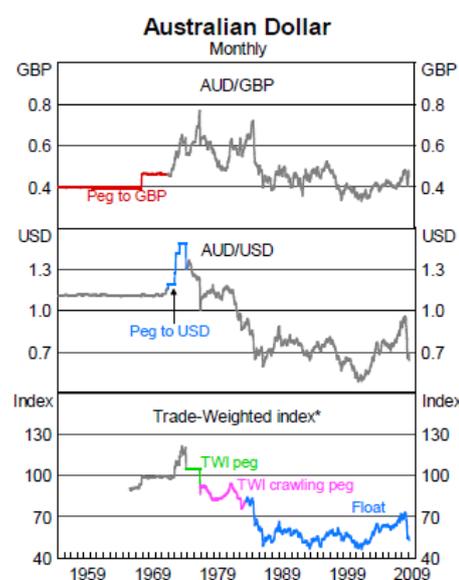


Figure 1: Source Battellino & Plumb (2011)

## 1. Prelude to the Float

Due to the country’s vulnerability and its dependence on trade, constant external actions were continually imposing change on the Australian financial set-up. From the post war period onwards the Australian dollar was initially fixed to the U.K’s pound up until November 1971 which then changed to being set against the U.S dollar. After September 1974, the dollar was pegged, at first, to the trade-weighted exchange rate index and then altered to a crawling peg against the same index. While the emplaced pegs prompted long periods of steady values of currency, occasional realignments, which then became quite frequent, became necessary to respond to balance of payments and monetary pressures. However such action would cause invariably havoc to the economy and the markets. In one particular case in November 1976, the dollar was devalued by 17.5 percent against the trade weighted index, in an attempt to regain control of monetary conditions.

<sup>1</sup> Phillips (1983) in his address to the Australian Business Economists spoke of many of the barriers evolved around: the lack of sophistication and development of the domestic financial system; the time zone difference between Australia and the major markets.

During this period fiscal and monetary policy were seen as being a combination to achieve the broad internal and external balances for the economy (Cockerill et al, 2011: 408). With this, the exchange rate was often used as an instrument to achieve the objectives of internal or external balances but the divergence between these two goals was often the reason for the constant regime changes to the exchange rate. A recurring problem within this was that domestic markets were becoming more integrated with the international markets. Large flows of capital were changing hand and the tight capital controls<sup>2</sup>, were being proven to be increasingly ineffective and readily spilled over into domestic financial conditions, thwarting the efforts of the authorities to set domestic monetary policy effectively (ibid: 418). As Battellino & Plumb (2001: 2) comment upon the eventual decision to float the currency was made, not because authorities had exhausted foreign exchange reserves<sup>3</sup> which is common to most emerging markets, but because of the large inflows of capital that were undermining, the ever-changing, capital controls.

A keynote example of this discouragement was the setup of the foreign currency hedge market in the mid-1970s as a means of managing exchange rate risk. This was a non-deliverable forward market, whose settlements were carried out in AUD, was assembled entirely by private sector markets participants to operate alongside the foreign exchange market (Debelle et al, 2006). As no exchange of foreign currency were being made, no breach to the existing tight controls were made. Such actions led to much of the deregulation of the financial system, which will be mentioned in more detail in section 3.

## 2. A 'leap into the dark'<sup>4</sup>- Monetary policy and the exchange rate under a floating regime

For Australia, the move to a floating rate regime was expected to improve the efficiency of the erratic financial system while giving the RBA a greater control over domestic monetary policy. In an essence the float meant that: banks were no longer required to clear their spot foreign exchange positions every day; reserve banks ceased announcing an indicative midrate for the Australian dollar against the US dollar and; exchange controls were completely removed (Battellino and Plumb, 2011: 2).

But as Stevens (2006) draws upon, the weaknesses of the preliminary framework of the transition was a difficult one to work from and the conditions in the economy became much more volatile. The monetary policy targets at the time were based upon M3 growth but it was becoming less useful as the relationship between money and nominal

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<sup>2</sup>Most of these controls were put in place during WWII and were designed to prevent scarce domestic savings from leaving the country during the war.

<sup>3</sup> Reserve Bank purchased net A\$1.4billion of foreign exchange spot from the banks to revalue the currency in the build up to the float (Cockerill et al, 2011)

<sup>4</sup> 'A leap into the Darkness' was a recurring comment by those sceptical of a floating exchange rate. It appears, albeit infrequently, on blogs referring to the Campbell Committee – the Australian public inquiry into exchange established in 1979.

income growth was becoming unstable (Cockerell et al, 2011). Policymakers 'suspended' this format and replace it with, for what Grenville (1997, p.133) referred to as, a "checklist" of indicators to help guide monetary policy from 1985 onwards. In the build up to the 1987-89 output surge and price boom the indicators evolving around inflation, such as demand and futures expectations of, soon became the central priority of monetary policy. In 1993 the RBA moved to an inflation targeting [IT] framework stating that it would aim for a target of keeping consumer price inflation between 2-3 percent, on average, as following the recession of the early 1990s inflation had evolved around this marker through the tightening of monetary policy.

The exchange rate, which had prior to the float had also been a nominal target anchor for the economy, was now part of the transmission mechanism for monetary policy (Battellino & Plumb, 2011). Very soon into the new regime the exchange rate's fluctuations played an important role influencing the term of trade shocks, which given

Australia's dominance in the market as a commodity producer and raw materials supplier, can be significantly large (Gruen and Wilkinson, 1994). When prices of commodities rose, resulting in a rise in the terms of trade, the appreciation of the dollar would neutralise the expansionary influences on increasing wages and inflations and would stimulate an attractive market substitute in the form of cheaper foreign good. In a recent case, the period between 2003 and the second quarter of 2008 saw net rises in the term of trade totalling to 65%, a 50 year high, whilst supporting strong growth in (Cockerell et al, 2011). In response to this the exchange rate made similar progress with an appreciating volume of 40% in trade-weighted terms whilst only seeing a 4.8% percent inflation at the very end of that period (Beaumont and Cui, 2007). This organic form of restoration to the internal balance would have not been available under the previous fixed exchange rate regime. As Blundell-Wignall and Gregory (1990) point out the rise in the terms of trade, as a result of the Korean War in the 1950s, had led to surge in inflation to a peak of 20% which had to be offset by adjustments to the exchange rate peg but due to the lagging effect of the change in rate it did not successfully cushion the escalation in the terms of trade (Veale, 2008).

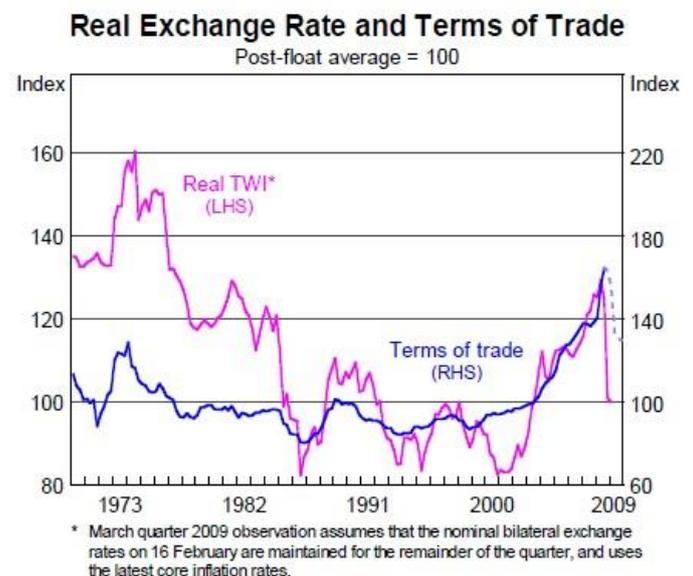


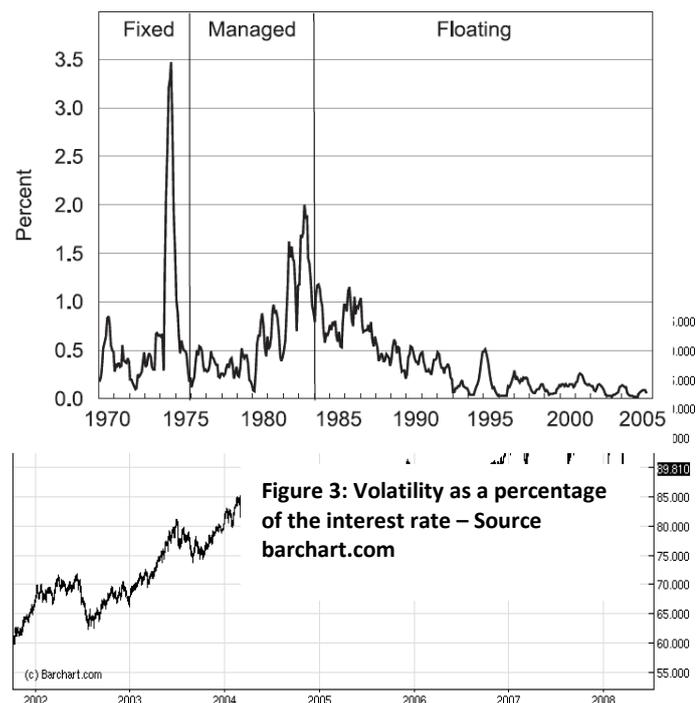
Figure 2: Battellino & Plumb, 2011

Of course it is worth pointing out that the relationship between the floating exchange rate terms of trade, and therefore indirect influence on inflation, is not precise (Battellino & Plumb, 2011). And in addition to this, Battellino & Plumb have pointed out that during the 1990s the direct influence of exchange rates on inflation, in mitigating external shocks, began to diminish in many floating counties including Australia (ibid: 194). Nevertheless the acceptance of a volatile exchange rate has taken much pressure off the RBA and have been less inclined to intervene in the Forex. Of what can be seen from the diagram, the volatility of the interest rate has diminished considerably of the years. This loosening freedom to the Reserve and government has allowed monetary policies, through the outlines of the established *Charter of Budget Honesty*, and fiscal policies to adapt to the medium term inflation while acquiring a high degree of transparency.

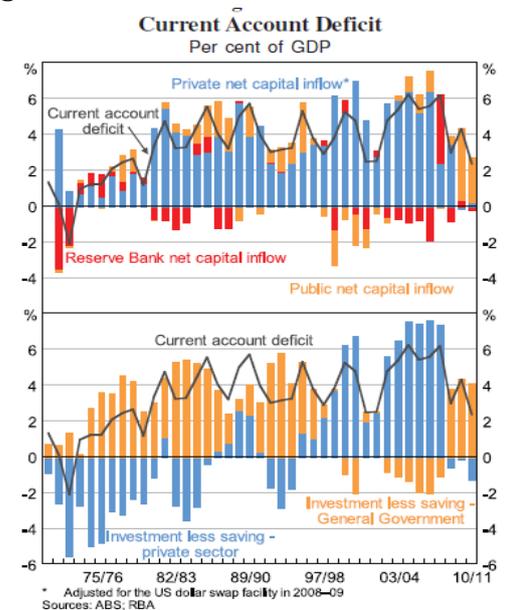
### 3. Bank deregulation, capital flows and the balance of payments following 1983

Prior to the 1983 floating, financial market deregulation had largely taken place encouraging a more market-based environment for banking and this was expected to improve the allocation of domestic capital. The logic of this, which Arteta, Eichengreen and Wyplosz (2001) discuss, is that a preceding stability in financial sector is needed to help allocate the large inflow of foreign capital that might follow the liberalisation of capital accounts following the float of the dollar aiding to avoid financial fragility in the sector.

When capital controls were removed in 1983, at first capital outflows surged but this was soon followed by a higher increase in capital inflows and at the twenty five year mark the regime change net capital inflows had averaged at 4.5% of GDP. Australia's relatively high interest, particularly in the early 2000s leading up to the financial crisis, resulted in the high attractiveness of Australian dollar investments particular in the case for Japanese investors. This in turn, coincided with the appreciation of the AUD against the Yen in that same period (Veale, 2008).



However this vigorous expansion of the financial sector had significant macroeconomic side effects. With the heavy capital inflow, along with banking deregulation, a very rapid expansion of credit was seen in the business and households sectors. Credit rose by up to 150 percent, hugely due to the leveraged corporate takeovers that occurred in the former sector between 1984 and 1987 and by the property boom in the latter sector after 1987 (Veale, 2008). The heavy private investment was matched by a decline in household savings and, despite a substantial movement by the government to save the external deficit rose to an average of GDP between 1985 and 1989 (ibid: 8). In the space of two years the net foreign debt rose to 31 percent of GDP adding to the increasing current account deficits in which the public's concern resulted in a deterioration of consumer confidence (Cockerill et al, 2011). In the face of the credit boom, and its resulting persistent inflation rate, the RBA leaned back by raising the interest rates. The resulting contractions led Australia into a sharp recession which brought to light the unsoundness of financial sector the credit boom had been built on and saw it come considerably close to banking crisis (Gizycki and Lowe, 2000)<sup>5</sup>. In accordance to the previous section, the RBA supported recovery by cut interest rates by 13¼ percentage points over a three year basis in 1990 but the adjustment came with considerable lag of response to the Australian dollar. The provided a salutary lesson to the Australian economy which has seen much reform and modernisation of the financial supervision which reinforced the incentive for a sound risk management (Veale, 2008).



Since the 1860s, Australia has recorded a current account deficit on an almost yearly basis. From the decade prior to the float it averaged around 2½ percent and has seen an increase to an average of 4¼ percent since. Many authors (Pitchford (1990), Belkar et al, 2007) throughout the years have brought up the topic of the potential external vulnerability that could result from major fluctuations in the exchange rate or in case of a sudden stop/withdrawal in the capital given the high levels of external debt in the state at moment. The answer that many follow was under Pitchford's thesis (1990) "consenting adults"<sup>6</sup> view, in which argues, that as long as inflows were put to good use and that the foreign-currency risk was limited, then the deficits would be sustainable (Debelle, 2011). In addition to this, the development of a cross-currency swap market in the latter half of the 1980s was significant as it allowed hedging of foreign currency risk in off shore debt raisings, but 'also encouraged the development of Australian-denominated debt market offshoring' (Cockerell et al., 2011: 420).

Figure 4: Source: Cockerell et al., 2011

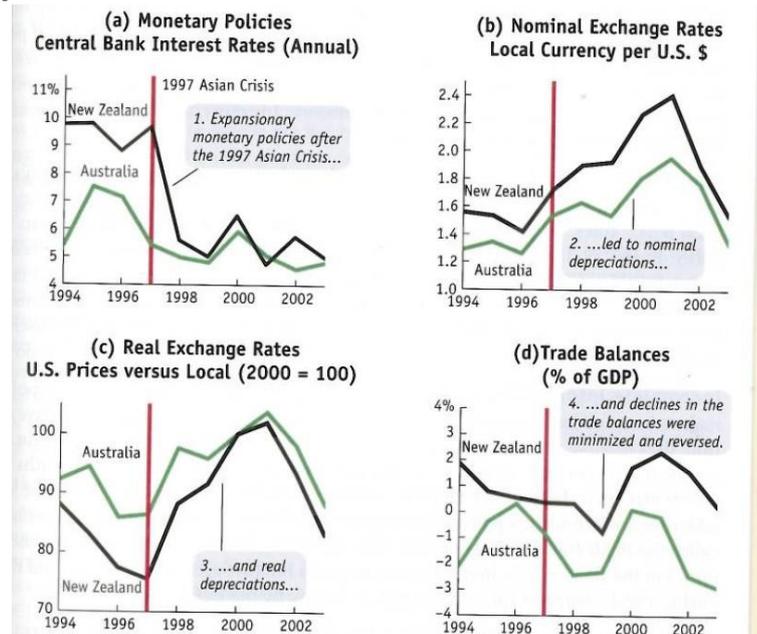
<sup>5</sup> Two of Australia's four largest banks saw major losses-although these were absorbed by the banks' capital-State owned banks were recapitalised, and many non-commercial institutions became bankrupt.

<sup>6</sup> This theory can be traced back to Max Corden, who had expressed very similar views in his 1977 book.

In adding to this, Australia learned the dangers of unhedged currency borrowing in the case of the 'Swiss Loans Affair' in which huge loans denominated in Swiss francs were made by the Westpac bank, principally to farmers. While being carried out to avoid paying a much higher domestic interest rate, the risk in doing so became clear when the AUD consequently depreciated sharply against the Swiss franc resulting in a rise of Australian dollar payments required to service. While the scale of these proceedings were relatively small it has inspired a recent encouragement of extensive hedging of foreign currency loans (Battellino and Plumb, 2011).

#### 4. Economic and Financial Stability

What has probably been the most major beneficial factor of the floating exchange rate in Australia's case has been its resisting aspect during times of significant external shocks. Since 1983, four particular cases stand out: the Asian financial crisis (1997-98); the 'tech bubble' (1999-2001); the ongoing financial crisis (2007-present); and the current commodities boom which represents a positive terms trade shock for Australia (2005 present). Taking the most former case, a large part of Australia's export at the time was



generated by the newly industrialized countries (NICs) of east Asia, particularly Korea, Thailand and Indonesia. When these countries began to see their own economic crisis in 1997, resulting in large economic contractions in each country, and led to substantial decline in demand for foreign goods.

In Feenstra and Taylor's view (2008:683), had the state chosen to ignore the peripheral crisis their own economy most likely would have contracted; home interest rates would have fallen; and have the value of the AUD depreciate. Terms of trade fell by 7 percent during 1998 as commodity prices dropped. Instead the independence of monetary policy allowed the economy to be managed in accordance with the needs of the domestic currency. An expansionary exchange rate lowered interest rates (**a-in the diagram below**) allowing the domestic currency to depreciate (**b**) in the region of 30percent (ibid: 685), in nominal terms. This allowed resulted in the real depreciation of the AUD of the currency to about 20 percent to 30 percent in the short run (**c**) and, as a result, the trade balance moved strongly towards a surplus (**d**), thus leading to the attractiveness of domestic produced goods. As a result, the original decline in the terms of trade was cushioned by an 8 percent decline in the real trade-weighted exchange and overall Australia's real GDP growth remained at 4 - 5 percent during the major

contractions of others in the period of 1998-99 (Beaumont and Cui, 2007).

In a broader sense the stability of the exchange mechanism has seen the magnitude of the country's economic cycles decline. Since the recession of the early 1990s, the standard deviation, of an IMF report, found that the output gap has decline to  $\frac{3}{4}$  percent. This compares to the original results of  $1\frac{2}{3}$  during the pre-float period of 1973-83, and then the first post-float period of 1984-92 with  $1\frac{1}{2}$  percent<sup>7</sup> (ibid: 19). A less volatile external environment may be one of the underwriting factor as declines in output volatility have also been observed in economies whom have established their own similar floating regimes and liberalisation of financial markets (Cotis and Coppel, 2005).

### Concluding remark

Overall, this author finds that country's adjusting to the float has paid off for Australia despite some of its initial problem. It has greatly assisted in the management of the economy and since the early 1990s downturn the macroeconomic performance has been strong seeing real GDP grow on average of  $3\frac{3}{4}$  percent, unemployment fall considerably and has seen inflation average between the 2-3% target of the RBA. Fiscal surpluses have been achieved in the majority of budgets since the implementation of the *Character of Budget Honesty*. The high degree of transparency of the agreement has seen to the lessening use of the interest rate as control mechanism, which in turn, has seen resulted in strong inflow of capital in the country through high values of carry trade. The negative aspects that evolved from the bank deregulation were eventually counteracted through policy changes but, with the growing concern of the recent global climate, the author remains unsure whether the credit boom fiasco has proven as a salutary lesson in the build up to a, probable, housing crisis and the sustainability of the current account deficit will depend on whether capital inflows are largely the result of private decisions and that capital is being put to good use.

Figure 5: Source Feenstra and Taylor (2012)

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<sup>7</sup> Beaumont and Cui (2007) comment on saying that the output gap estimates of the IMF use a Hodrick-Prescott filter on GDP excluding agriculture and mining. Fluctuations in the output of these two sectors are treated as supply shock. Unfortunately, this author could not find the original IMF report, to clarify and to reference on.

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