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Can Monetary Policy be used to Influence the Real Value of the \$A in the Short or Long Run?

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1. Introduction

This paper tackles a very complex problem and it will be best to approach it in a fairly indirect fashion. The plan adopted in this paper is as follows.

First, we shall consider the history of the Australian dollar (\$A) since it was floated in December 1983. This will be followed by a discussion of monetary policy over that period, a discussion which will consider the extent to which the Reserve Bank has been attempting to influence the value of the Australian dollar. It also considers the difficulties created by the recent strength of the dollar and examines some alternative explanations for this somewhat unexpected development. The third section of the paper will consider whether or not the Reserve Bank can influence the value of the \$A in the short or long run. Most of the discussion mentioned so far will refer to the nominal exchange rate. The final part of this section will consider the implications of the discussion for the possibility of influencing the real exchange rate.

2. The Exchange Rate over the Period 1984 to 1987

Table 1 indicates how the \$A moved against the US Dollar (\$US) and Japanese Yen (¥) over the period 1984 to 1987. It also includes the Trade Weighted Index (TWI) over the same period.

The Table summarises the following developments:

- over 1984 the \$A fell against the \$US but not the ¥ or on a TWI basis;
- in early 1985 there was a sharp across-the-

board fall in the value of the \$A which was caused by a recognition that Australian competitiveness had been eroded by a significant increase in the real exchange rate. This decline was evidenced by burgeoning current account deficits;

- the \$A slipped once again in mid-1986. The extent of this movement is a little obscured in the Table because the major fall occurred in July; and
- The \$A strengthened from that point on although the appreciation was not large in TWI terms.

3. Monetary Policy and the \$A

Table 2 indicates the extent to which the Reserve Bank has bought or sold foreign currency and also includes a short-term interest rate. In order to interpret this Table, it is necessary to make two points about monetary policy in the deregulated environment.

The first point is that the floating of the dollar has given the Reserve Bank control over either domestic monetary growth or short-term interest rates. Individuals or businesses in the private sector can no longer force the Reserve Bank to supply liquidity to the financial system by borrowing offshore. The Bank has chosen to focus on the interest rate

Table 1: Relative Value of the A\$ Over 1984/87

End of Quarter	\$US	¥	TWI
1984 M	0.9350	210.22	82.9
J	0.8613	204.60	79.2
S	0.8330	204.67	80.3
D	0.8728	207.24	81.3
1985 M	0.7051	176.94	69.2
J	0.6655	165.68	65.0
S	0.7077	152.97	64.8
D	0.6809	136.49	60.7
1986 M	0.7119	128.09	61.1
J	0.6772	110.96	56.3
S	0.6274	96.34	51.9
D	0.6648	106.37	55.0
1987 M	0.7053	102.85	55.4
J	0.7203	105.79	56.6

Source: Various issues of the *Bulletin* of the Reserve Bank of Australia

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**Table 2: Reserve Bank Sales of Foreign Currency, Interest Rates
and Changes in the Money Base 1984-1987**

Year	Month	Reserve Bank Sales of Foreign Currency	% Increase in Money Base	11 AM Call Rate
1984	Jan	135	-3.9	9.10
	Feb	258	-1.8	9.76
	Mar	324	0.7	12.45
	Apr	70	3.7	15.15
	May	127	-0.2	14.10
	Jun	345	0.7	12.30
	Jul	128	1.0	12.20
	Aug	21	1.4	11.65
	Sep	259	0.9	11.05
	Oct	136	1.2	11.10
	Nov	27	1.7	11.55
	Dec	246	6.0	12.00
1985	Jan	81	-1.2	11.30
	Feb	293	-1.0	11.65
	Mar	420	1.1	14.00
	Apr	363	2.8	15.40
	May	113	-0.4	15.85
	Jun	397	0.9	19.05
	Jul	118	0.9	15.50
	Aug	349	1.5	16.50
	Sep	233	0.6	16.40
	Oct	279	0.7	16.10
	Nov	601	1.1	18.15
	Dec	463	4.6	19.39
1986	Jan	183	-1.2	18.90
	Feb	162	-1.8	18.60
	Mar	255	1.4	17.30
	Apr	20	1.0	17.15
	May	164	0.3	15.10
	Jun	592	1.2	15.45
	Jul	1060	0.4	14.70
	Aug	862	1.0	17.80
	Sep	341	0.3	17.70
	Oct	-672	0.3	17.70
	Nov	-1316	1.1	16.30
	Dec	-767	3.8	15.41
1987	Jan	2286	-1.6	16.45
	Feb	478	-0.4	16.40
	Mar	-1022	0.5	16.20
	Apr	-2505	2.1	14.75
	May	-227	-0.2	14.10
	Jun	-1202	0.6	13.15

NOTE: RBA sales of foreign currency are the negative of Foreign Exchange Transactions (FET).

SOURCE: Various issues of the Bulletin of the Reserve Bank of Australia.

because the meaning of monetary growth rates has been distorted by deregulation.

The second point is that a sale of foreign currency is only likely to affect the exchange rate if it is unsterilised, *i.e.* if the authorities do not buy government paper to offset the effect of the sale of foreign currency on the amount of cash in the financial system and interest rates. If the sale is unsterilised, interest rates will increase and push up the value of the \$A. If, however, the sale of foreign currency is sterilised, interest rates do not change and there is little reason for the value of the \$A to change after the initial impact of the currency sale.

Most of the sales of foreign currency shown in Table 2 appear to have been sterilised. In fact, a large part of the apparent sales represents the use of foreign currency reserves to finance the Government's offshore budget deficit—transactions of this type are self-sterilising.

The major exceptions to this rule are the sales of foreign currency in mid-1986 which were allowed to drive up interest rates to support the \$A and the purchases of currency in mid-1987 which were allowed to push interest rates down in the hope that this would put a cap on the appreciation of the \$A. Indeed, it appears that the Reserve Bank is currently using the foreign exchange market as the major channel through which it implements monetary policy. Since the Bank has large holdings of foreign currency, this seems to be a sensible approach to the problem.

The recent appreciation of the \$A is somewhat surprising and there seems to be little agreement on the cause. The suggestions which have been made include the following:

- the earlier support of the Reserve Bank. This explanation appears to be quite unsatisfactory now that it appears that the Bank is actually trying to prevent the appreciation;
- earlier values of the dollar were too low because market participants had already factored in a high future inflation differential with our major trading partners (Japan and the US) and with US inflation increasing and Australian inflation steady or falling, these expectations have been revised;
- related to the previous explanation, the movement may be a "speculative bubble" which will eventually burst, leading to another downward adjustment in the value of the \$A;

- there had been an improvement in commodity prices which would justify some appreciation of the \$A. For example, the Reserve Bank's index of rural commodity prices which stood at 70 in June 1986 had reached 85.4 by June 1987; and
- the inflow of capital to purchase Australian shares and property (the latter encouraged by the recent liberalisation of the restrictions on foreign ownership of Australian property) has pushed up the value of the \$A. We have little information on these developments. For example, the most recent data on the composition of Australia's external debt shows a declining proportion of it in the form of equities. The movements discussed here are, however, very recent and we would not expect them to show up in earlier statistics.

Some of these explanations suggest that the appreciation of the \$A is justified. It has, however, raised some fears. It is eroding the competitiveness of industry compared to the level resulting from the lower values of the \$A which prevailed in 1986. This had happened at a time when the current account deficit remains high and external debt is accumulating at a rapid rate.

The final explanation of the appreciation of the \$A raises the spectre of the "Gregory Thesis". An appreciation of the currency is being caused by a sale of assets to overseas investors, but this appreciation is preventing the development of new industries. When the sale of assets slows down, we will not have industries to provide an alternative source of support for the \$A.

If the appreciation is a fluctuation (that is, part of a "speculative bubble"), it creates another problem. Swings of this type will affect the competitiveness of industry and make it unattractive for new industries to set up or for existing industries to expand.

4. Can the Reserve Bank Influence the Exchange Rate?

It was noted in the previous section that the Reserve Bank has attempted to influence the value of the \$A by varying interest rates. There seems to be little doubt that interest rates do have some effect on the exchange rate. Of course, if the Bank chooses to use them in this way, it loses them as an instrument which it can use to achieve other objectives. In effect, we

return to the pre-float situation in which the monetary authorities had little control over domestic monetary conditions.

More importantly, the Bank cannot hold the exchange rate away from the value which would be established in a market free from official intervention. Strong shifts in sentiment outweigh interest rate differentials and the Reserve Bank finds it very difficult to prevent such changes in sentiment from being written into the exchange rate. In general, an attempt to set a value of the \$A which is not justified by fundamentals will result in destabilising speculation which will in the end force the Reserve Bank to give up its support of the exchange rate.

Indeed, the Reserve Bank does not appear to have any ambitions in this direction. Its intervention since the \$A was floated seems to have been of a smoothing nature with the objective of pushing the rate back to a value justified by fundamentals. Even this limited objective may be unobtainable if the market disagrees with the Bank on what the rate should be. The best way to stabilise the \$A would be to adopt domestic policies (particularly wages policies) which are in line with those of our major trading partners.

It has been suggested that the Reserve Bank should intervene to set the real exchange rate rather than the nominal exchange rate. Since this requires a correction of the latter for inflation (relative to that of our major trading partners), it keeps it in line with fundamentals and should not, therefore, give rise to a significant level of destabilising speculation. In effect, the intervention would smooth out the adjustment of the nominal exchange rate to changes in fundamentals. The problems with this approach are:

- it is not clear why the Reserve Bank should be in a better position to choose an appropriate real exchange rate than the market;
- presumably the appropriate real exchange rate will change (for example, as the terms of trade change) and fixing the real exchange rate will be an unsound policy. This problem is complicated by the very difficult problems which are involved in the measurement of the real exchange rate; and
- if the market disagrees with the Reserve Bank's judgement, or if the Bank was to attempt to hold the rate away from the level which the market would establish,

speculation will occur.

It appears from this discussion that it would be best to allow the market determine the real exchange rate.

Conclusion

The Reserve Bank has been using interest rates to affect the value of the \$A since 1983. In mid-1986 it pushed up interest rates to support the \$A, and currently it is reducing interest rates to slow the dollar's appreciation. These changes in interest rates have been achieved by open market operations in the foreign exchange market.

These interventions appear to have the objective of smoothing out adjustments in the exchange rate. There are real doubts about whether the Bank can have any influence on the exchange rate except in this very short-term way. An attempt to influence the real exchange rate may appear to be more feasible, but there are significant problems here as well. For example, what is the appropriate real exchange rate? It would appear to be desirable for the authorities to avoid such an attempt and to focus their attention on developing coherent domestic policies which are consistent with those being pursued by our major trading partners.