THE GLOBAL SPECULATOR

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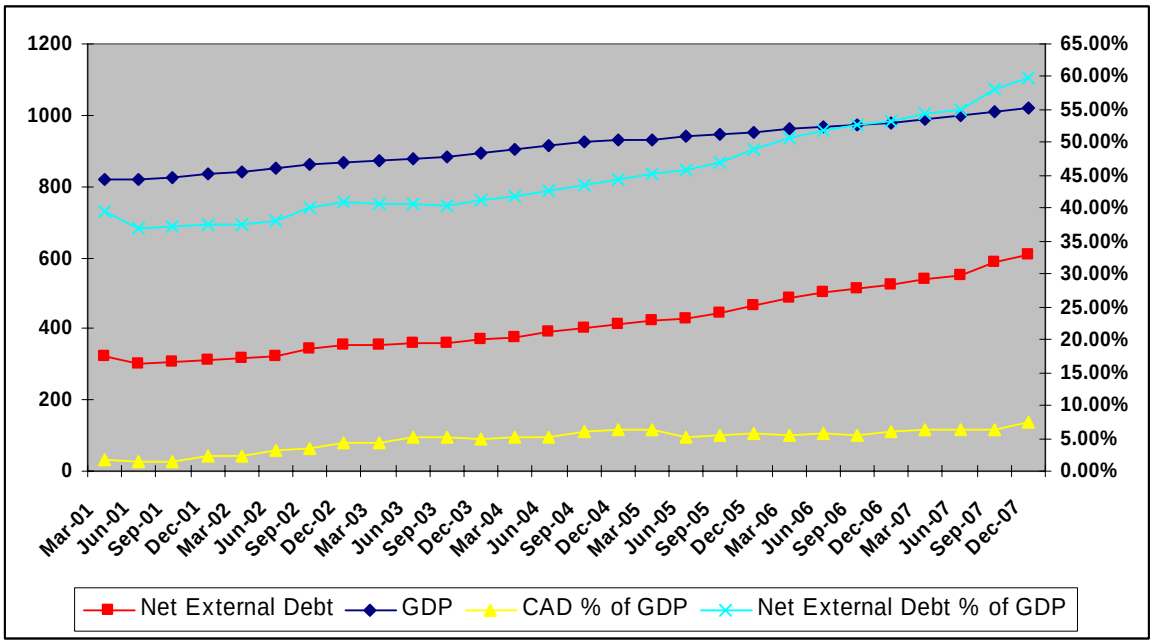
DETERIORATING TERMS OF TRADE

The following is an extract from the March 08 Issue of **The Global Speculator** sent to subscribers on the 10th of April 2008.

The recent release of the trade deficit for February 08 has seen a new record set of B$3.289, primarily driven by a 4% decline in exports. As Australia's current account deficit continues to worsen, it is worth taking a closer look at Australia's deteriorating terms of trade while considering the future implications for the Aussie dollar. In our review we will take a look at the following aspects:

1. **Australia's foreign debt.**
2. **The Reserve Bank of Australia's (RBA) foreign exchange reserves.**
3. **Australia's current account deficit (CAD)**
4. **Australia's exchange rate on a trade weighted basis.**

Net Foreign Debt versus GDP



The chart above looks at:

- **Australia's net external (foreign) debt (in red) versus GDP (in blue) in billions of dollars on the left axis with a look at the proportion of net external debt to GDP on the right axis (in sky blue)**.

- **The current account deficit (CAD) as a % of GDP (in yellow).**

In the last 7 years Australia's CAD has grown steadily from 1.75% of GDP in 2001 to a staggering 7.5% of GDP by 2007 (on a quarterly basis). This presently represents an outflow of capital to the tune of more than $A60B a year. In order to counter this, Australian commercial banks have been borrowing internationally. This has resulted in Australia's net foreign debt climbing steadily, from just 40% of GDP, up to 60% by the end of 2007 (sky blue line). Many economists would argue that this in itself is not that much of a problem provided Australia's access to foreign capital remains uninterrupted. If you ask these same individuals whether rising interest rates will pose a problem for the Australian economy, you have no problem getting them to agree. As I have written in previous articles, the higher the level of Australia's foreign debt, the more Australia is at the mercy of tightening international credit markets. This was clearly demonstrated back in the middle of 2007, when the RBA was forced to intervene in its open market activities to alleviate selling pressure on the Australian dollar. This was facilitated through extensive reversal of its currency swaps. The second chart below clearly demonstrates the drop in foreign exchange reserves (red line), as the RBA swapped foreign currency for Australian dollars.

This chart below looks at

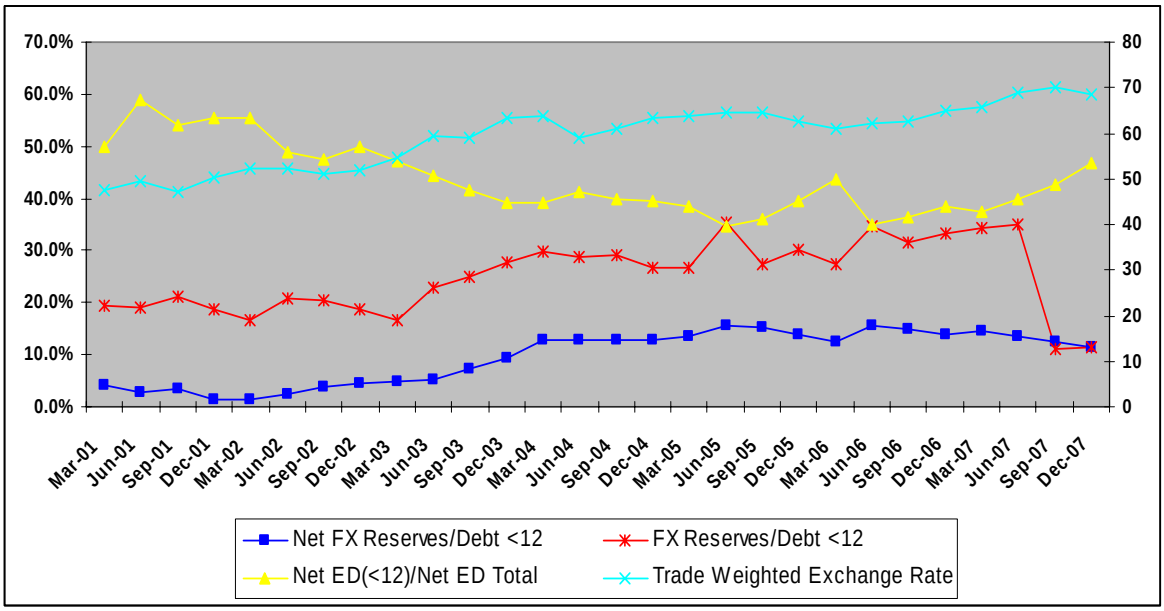
- **Net foreign exchange reserves as a proportion of short term external debt obligations (blue line).** That is**,** foreign debt obligations due within the next 12 months. Since international reserve holdings have been found to be a theoretically and statistically significant determinant of creditworthiness, this ratio of reserves to short term foreign debt obligations is a useful indicator.

- **Foreign exchange reserves as a proportion of short term external debt (red line).** This represents foreign exchange reserves on hand including the funds associated with currency swaps. Currency swaps get netted out when looking at the net foreign exchange reserve figure, because at some point these positions will be reversed as we saw in the September quarter of 2007. The difference between the red and blue lines accounts for these forward commitments.

- **Net external short term debt (due within 12 months) as a proportion of total net external debt (yellow line)**. The higher this percentage, the more vulnerable a country is to short term credit market shocks as a larger proportion of debt has to be refinanced more frequently. The tighter the credit market conditions, the higher the rates of interest that will be charged assuming foreign banks continue their willingness to lend. If they become reluctant, an increasing portion of these funds may have to be financed domestically which will put severe upward pressure on domestic interest rates.

- **Trade weighted exchange rate (sky blue line).** In order for foreign banks to be willing to continue lending to Australian banks, a stable exchange rate becomes imperative. If or when the Australian dollar starts to come under selling pressure (as it did briefly in the middle of 2007 before RBA intervention), there will be a reluctance to lend in Australian dollars and more loans will be domiciled in more stable foreign currencies (such as the Euro). When this occurs, Australian banks will not only face the risk of higher interest rates but will also have to deal with the costs associated with a falling exchange rate.

Foreign Exchange Reserves versus Short Term Foreign Debt Obligations



The trade weighted exchange rate (sky blue) has been rising steadily from its lows below 50 in 2001 to the present highs of around 70. As Australia's terms of trade improved in 2000/2001 (CAD just 1.75% of GDP), our ability to borrow internationally on favorable terms became easier. The proportion of short term external debt to the total (yellow line) was 60% in 2001 and by 2005 this percentage had fallen to just 35%, which was indicative of these favorable terms. Another thing to look at is the net foreign exchange reserves as a proportion of short term external debt (blue line). In late 2001 this was just 1.5%. By 2005 this had significantly improved to 15.5%, as a result of increasing foreign exchange reserves and a smaller proportion of short term foreign debt. A look at the gross foreign exchange reserves as a proportion of short term foreign debt (in red) also demonstrates a similar favorable trend.

Now let us fast forward to 2007. If we look at these same indicators we start to see some disturbing trends emerging. Firstly, the level of foreign exchange reserves on hand as a proportion of short term external debt (in red) has plummeted as a result of the RBA's open market activities in the September Quarter of 2007. Foreign exchange reserves effectively give the RBA ammunition to intervene in the foreign exchange markets to ensure stability is maintained during periods of increasing uncertainty. 2007 saw the RBA burn through more than half of its foreign exchange reserves. The other striking trend change is the proportion of short term net external debt obligations to total net external debt (yellow line) has started trending higher (now over 50%), indicating less foreign willingness to fund Australia's debt on a longer term basis. This is also reflected in the net foreign exchange reserve proportion of short term net external debt (blue line), which has started to trend lower to 11%. The only trend that remains firmly intact is

the trade weighted exchange rate. I want to reiterate my view that I do not expect this to be sustainable going forward. A strong dollar is completely at odds with improving Australia's deteriorating terms of trade, which is a large contributing factor to rising pressure on interest rates. If this massive imbalance is to be corrected the dollar needs to fall, plain and simple. The big challenge for the RBA going forward, will be to ensure that this occurs in an orderly manner. With little in the way of foreign exchange reserves available, this will prove to be difficult.

Any fallout in the Aussie dollar going forward benefits Australians that own gold related investments. To my way of thinking, taking advantage of the present dollar strength to buy gold remains a very prudent strategy for as long as the opportunity remains.

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