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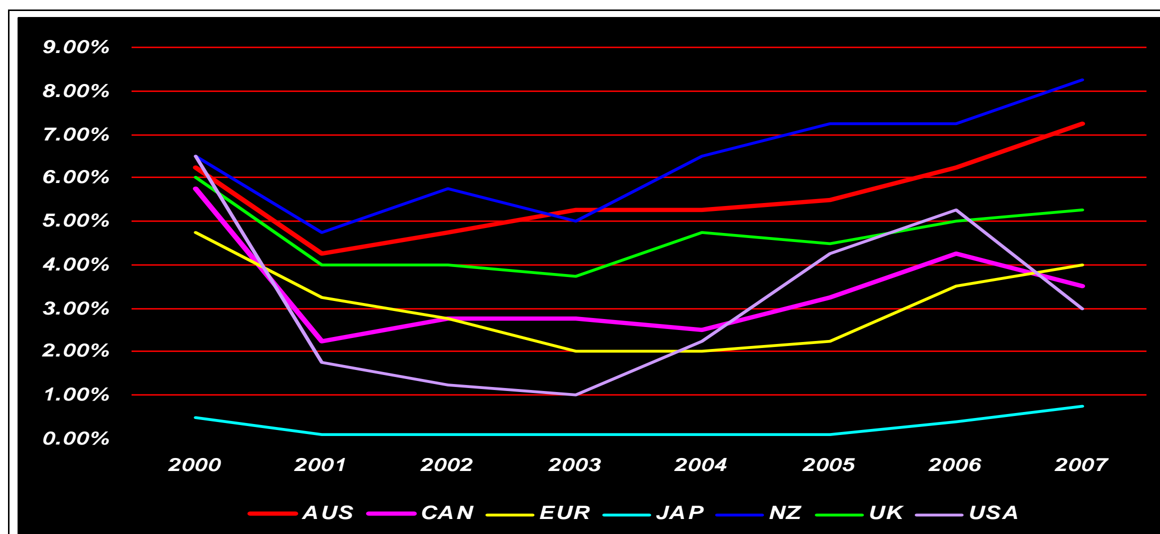
Why is the RBA Lifting Interest Rates?

The Australian dollar has recently strengthened on the back of a widening interest rate differential with most of the developed economies. The USA, Canada and England are presently cutting their interest rates. Europe and Japan are standing firm and Australia and New Zealand continue to raise rates. The charts on the following pages show the trends in interest rates, current account balances (% of GDP) and the respective currency performances across all these economies. One question many disgruntled Australians may be presently asking is: **"Why does the Reserve Bank of Australia continue to increase interest rates while the US Federal Reserve, the Bank of Canada and the Bank of England are cutting theirs?"**

The chart below demonstrates that all these countries, from about 2004/05 onwards, raised interest rates to varying degrees until about the beginning of 2007. The tightening credit markets have adversely impacted on the financial service sector based economies of both England and the USA. Canada has also recently dropped rates 50 basis points to cushion their economy from the recessionary fallout from the USA (one of Canada's largest trading partners). This is despite the continued strength their economy is experiencing from the commodities boom. The Australian economy demonstrates persistent resilience but there are certainly signs that business confidence is starting to wane, especially under the pressure of continuous interest rate hikes.

If we look at the interest rate levels of each country and compare these with their respective current account positions (especially up to the beginning of 2007), we start to see a fairly consistent trend. The worse the current account position, the higher the official interest rate. New Zealand and Australia clearly lead the way with the USA and the UK not far behind. Countries that run large CAD's are dependant on foreign investment flows back into the country to ensure liquid credit markets and a stable currency. The interest rate level generally reflects this degree of dependency.

OFFICIAL INTEREST RATES



CURRENT ACCOUNT POSITION

The USA, like Australia, runs a large current account deficit (CAD) of about 5.7% of GDP. England runs a CAD of 3.5% of GDP which has been deteriorating steadily for the last 4 years. Alternatively, Canada, thanks largely to the commodities boom, runs a current account surplus of close to 2% of GDP. Cutting rates obviously has a negative impact on the respective country's exchange rate, the extent of which is largely determined by the country's terms of trade. If we look at the chart below we can obviously see that the US dollar has been a big looser against most currencies as foreign investment has been drying up. A look at the interest rate chart above shows US rates have nearly halved in the space of 12 months while the CAD remains close to 6% of GDP. If we look at the performance of the British Pound versus the US dollar we can see it has also performed poorly over the last 12 months. Against the cross rates it has been incredibly weak. The reason for the poor performance is the weak terms of trade and the deteriorating levels of compensation being offered to foreign investors. In contrast to the British Pound, the Canadian dollar has performed admirably despite the recent rate cut, as their terms of trade are much more favorable and their dependence on foreign investment is significantly less.

CURRENCY PERFORMANCE AGAINST THE US DOLLAR

In conclusion, we can see that the Australian dollar is potentially very vulnerable. Tightening credit markets have forced the RBA to raise rates in an attempt to keep up with rising market rates (commercial banks are very often raising rates more than the RBA). With a CAD of 5.7% of GDP, Australia's dependence on foreign capital is at critical levels. The rising interest rates simply reflect this risk. In order to retain much of the foreign capital flowing into Australia, foreign investors need to be compensated. Our strong dollar is obviously the present beneficiary. A major problem will occur when the interest rate increases start to negatively impact on the Australian economy (the signs are already there). If the RBA decides to hold rates steady or ease rates at that point, the fallout for the Australian dollar could be immense. Unlike Canada, Australia has been unable to generate trade surpluses from the recent commodities boom and does not have the luxury of rate cuts having a benign impact on the currency. The strong Aussie dollar has played a critical role in the fight against rising consumer prices. If these benefits were to cease, the consequences for Australia's largely consumer based economy will be severe. The Australian dollar gold price will be the major beneficiary from any future fallout.

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