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Dazzling Aussie dollar!

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Last week, it was celebration time in Australia.

It was as if the Christmas season has arrived.

On October 7, the exchange rate of Australian dollar was US99.18¢ - the highest level in 27 years, ever since the currency was floated in 1983.

Traders were happy that prices of imported goods have fallen. Consumers were happy too. With the Aussie dollar soaring to new heights, long-haul destinations in Europe and North America became more attractive. Shopping online from US websites has now become the preferred way.

Floating currency

Before 1983, each day the officials of the Reserve Bank of Australia (RBA) were deciding the value of the currency in terms of the US dollar. Since 1983, market forces of supply of and demand for the Aussie dollar have been deciding each day's exchange rate.

So, if the currency value is rising past the American dollar, is it not something to celebrate?

Rising value of the currency is a reflection of the strength of the economy, indicating the desire of international currency investors wanting a piece of Aussie sunshine.

It is something similar to grabbing all the gold medals at the ongoing Commonwealth Games.

Is Aussie dollar really strong?

That is the question.

In a bilateral relationship of currencies, if one currency is down, the other is up. It is a kind of see-saw.

The US economy is certainly not doing well with 39,000 jobs lost in September, instead of gaining the 18,000, much against the market expectations. So, it is clear that the US central bank would begin a second round of its money printing stimulus, the so-called quantitative easing (QEII) very soon.

That heralds the further weakening of the US dollar.

Last week, Bank of Japan too announced that it would pump in US$ 60 billion equivalent yen to weaken its currency for making its exports cheaper.

On the other hand, the Australian economic growth engine is roaring with its booming mineral exports to China. Since 2001, commodity prices were on the rise due to skyrocketing demand from China. Fearing inflation, RBA has been raising interest rate which improved the investors' risk appetite as well.

Australia is the only developed country which has been raising interest rate in the midst of low interest rates adopted by every other advanced country during the ongoing current worldwide recession.

Although expectations were high on October 5 about a rise in benchmark interest rate by 25 basis points to 4.75% as a measure to fight the potential inflationary pressures fuelled by rising mineral exports to China, RBA decided to hold on to the current rate at 4.5% .

That dampened the hopes of parity with the US dollar. Hot money flowed out. The Aussie dollar went down.

That shows the exchange rate is volatile.

The gyration in exchange rate has cast doubts on Aussie dollar's strength.

Economists argue that economic fundamentals are not strong enough to make the parity of Aussie dollar a reality. The only reason behind the rising Aussie dollar is that other currencies are weak. Consistent stream of bad economic news has made investors seek new havens to lodge their funds.

As I write this on Thursday, October 14 there was a big scramble for gold again. The price of gold shot up to $US1375.60 per ounce, the highest on record. In unison with gold, the Australian dollar, which is a commodity currency, also went up.

The Aussie dollar rose to US99.72¢ eclipsing the US99.18¢ of Oct 7.

Australia is now the safest haven, next only to gold.

Already there are fears of inflation, as the Australian economy is heating up with booming exports. The RBA would raise it to fight inflation any time now or at least in November, which would only encourage further inflows of hot money in search of higher return. That would further strengthen the Aussie dollar.

Big Mac Index

Whether the exchange rate which is determined by the market forces of supply of and demand for the currency, or the officially fixed rate reflects the true value or not, has been the subject of investigation for a long time. The popular purchasing power parity (PPP) theory gives the answer by comparing the prices of a common basket of goods consumed in two countries. The assumption is the goods of the two countries to be compared are of same quality and same specifications. The ratio of prices would then give an idea of the true exchange rate.

Using the theory, *the Economist* of London introduced in 1986 the Hamburger standard. The Big Mac Index, constructed every six months, since then has become a delectable dish for students of monetary economics in universities. Assuming the Big Mac hamburgers at the McDonald restaurants in 41 countries are identical, they can be used for arriving at the "true" exchange rate.

If the prices of Big Mac in the US and Australia are US$ 3.73 and Aus$ 4.35, a comparison of the two prices would indicate the exchange rate of Aussie dollar as US85.7¢. The market rate of Aussie dollar in July 2010 was US88.5¢. If we go by PPP theory, the indication is the Aussie dollar was overvalued in July 2010 by 3.3%.

If we use the exchange rate of Oct 14, namely US99.72¢, the overvaluation of the Aussie dollar is 16.3%.

Double-edged sword

While importers and consumers are pleased with a rise in Aussie dollar, exporters of farm produce, beef and other cattle products and domestic tourist operators are not happy. Their exports would become more expensive to the rest of the world. Tourists to Australia will have to shell out more of their currencies.

The Australian opposition finance spokesman, Andrew Robb announced: "All we're doing is penalizing our manufacturers who export, our farmers who export, our tourist operators."

According to the exporters, the best rate is US60¢ which prevailed during the former Treasurer and Prime Minister Paul Keating's time.

So, what do Japanese Prime Minister Naoto Kan, Chinese Premier Wen Jiabao and the Australian shadow Finance Minister Andre Robb have in common?

They all want a low exchange rate for ever!

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