

Paper 1: The Australian Dollar and the Manufacturing Sector

Paper prepared by the Department of the Treasury for the Prime Minister's Taskforce on Manufacturing

The Australian Dollar and the Manufacturing Sector

Introduction

This paper examines the high and volatile Australian dollar (AUD), which is currently having a significant effect on the Australian manufacturing sector. The paper outlines the recent movements in the AUD, as well as some of the underlying drivers of these movements. It discusses the implications for both the manufacturing sector and the Australian economy more generally. The paper concludes by discussing possible approaches to managing risk associated with currency fluctuations and available advice and support.

The floating of the AUD in December 1983 was one of the major reforms which facilitated Australia's strong, ongoing economic growth in recent decades. A floating exchange rate helps the economy to absorb both positive and negative shocks, alleviating demand pressures during boom periods and providing a boost to the economy during downturns, thereby helping to sustain economic growth over longer periods.

Over the past decade, the AUD has appreciated strongly against the US dollar (USD). This appreciation saw the AUD move above parity against the USD in October 2010 for the first time since July 1982. However, the rise of the AUD has been less pronounced against the trade-weighted index (TWI), which is a better indicator of the effect on trade competitiveness than movements against the USD, reflecting the depreciation of the USD against most other currencies over this period.

This appreciation has been fuelled by two main factors:

- the boom in prices for Australia's mining and energy exports since the mid-2000s, which has resulted in extremely high terms of trade; and
- the strong economic and fiscal performance of Australia in comparison to major advanced economies since the global financial crisis (GFC).

The rise in the exchange rate over recent years is playing an important role in allowing the Australian economy to adjust to the mining boom without generating inflationary pressures. However, it plays this role by reducing the trade-competitiveness of Australian exporters and making imports more attractive to domestic consumers, which adversely affects some parts of the Australian manufacturing sector. Additionally, the volatility of the Australian dollar has made doing business more difficult for some Australian manufacturers.

Measures of the exchange rate

Nominal exchange rates are the relative price of two currencies, essentially the rate at which one unit of currency can be exchanged for another. As the USD is the major global currency, the AUD-USD exchange rate receives most attention.

An alternative measure is the TWI, which is often used as an indicator of the value of the AUD, particularly as the AUD-USD rate can present a misleading picture when bilateral exchange rates exhibit diverging trends¹. The TWI is the weighted average value of the AUD

¹ See RBA 2002

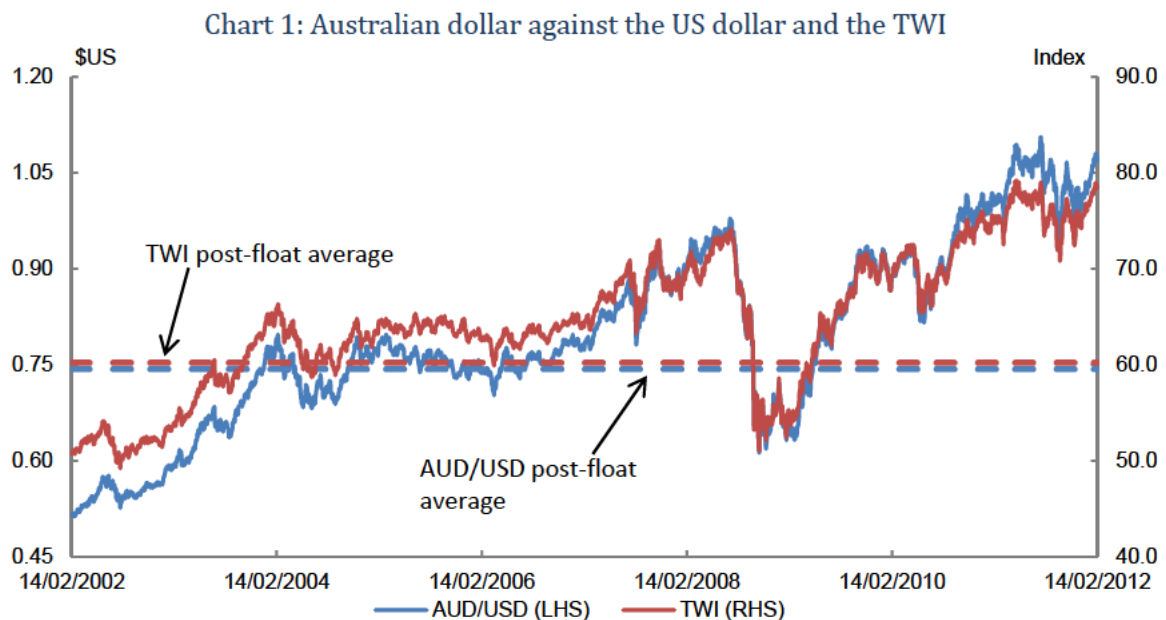
against the currencies of our major trading partners. The weights of each currency in the TWI are equal to each country's share of trade with Australia and are updated by the Reserve Bank of Australia (RBA) annually².

Both the TWI and the USD exchange rate are important measures. The TWI provides a more accurate reflection of overall trade competitiveness, as it includes the exchange rates of all our major trading partners. On the other hand, the USD exchange rate is also important as a significant proportion of global trade is denominated in USDs.

Another measure of the exchange rate is the real exchange rate, which is the nominal exchange rate multiplied by the ratio of price levels in the Australian economy to trading partner(s) price levels. The most commonly used measure of the real exchange rate is the RBA's real TWI, which uses the core CPI measure of price levels (excluding food and energy). It provides a broad summary measure of the prices of Australia's goods and services relative to those of its major trading partners³. The real exchange rate is conceptually the best measure of trade competitiveness, as it takes into account the effects of both changes in nominal exchange rates and relative inflation rates.

Recent trends in the Australian dollar

Since 2001, the AUD has been on an upwards trend against both the USD and the TWI (chart 1), with the notable exception of the GFC period when it fell sharply from July 2008 to February 2009. Since June 2010, the AUD has appreciated by around 25 per cent against the USD to 107 US cents, and by around 16 per cent against the TWI to 78 (to 14 February). To put these figures into perspective, the AUD is now around 45 per cent above its post-float average of 74 US cents and around 31 per cent above its post-float average of 60 against the TWI (as at 14 February).

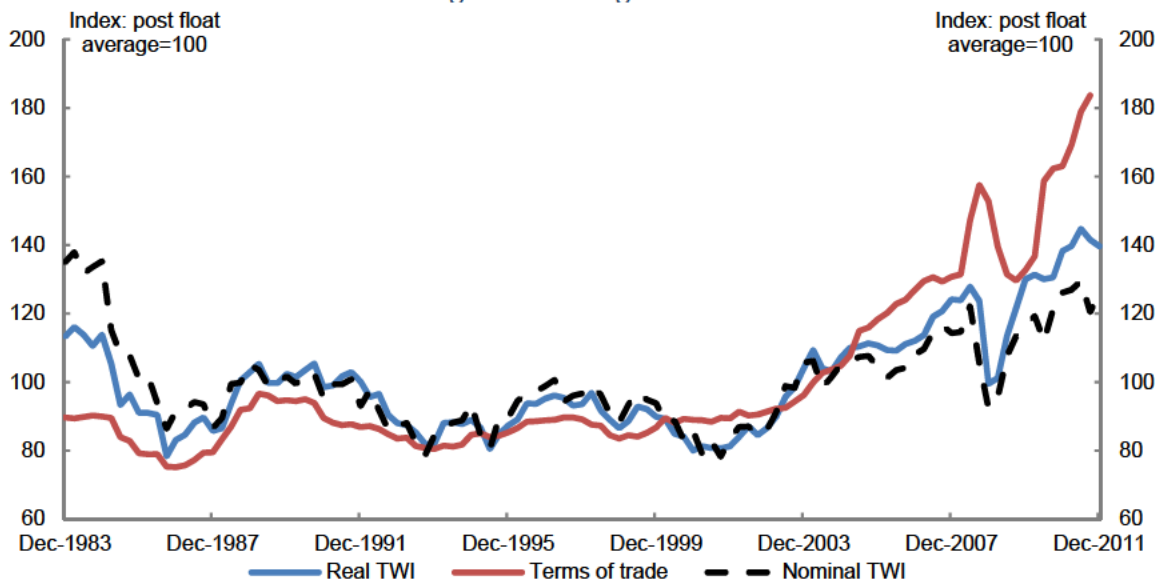


² See RBA 2011a

³ See RBA 2001

Furthermore, over the period since the current terms of trade boom began, the increase in the real TWI has been even more pronounced than the increase in the nominal TWI (chart 2). This reflects higher average inflation in Australia over the past decade than in our major trading partners: in fact, more than one-third of the real TWI appreciation over this period has occurred through higher relative inflation. This mainly reflects unusually low inflation in the rest of the world, as inflation in Australia has remained generally contained. Despite the fact that inflation is well contained, the current level of the real exchange rate suggests that the difference between the price levels of Australia and our major trading partners is at its highest point since the dollar was floated, once again reflecting the unusually low levels of inflation in major advanced economies.

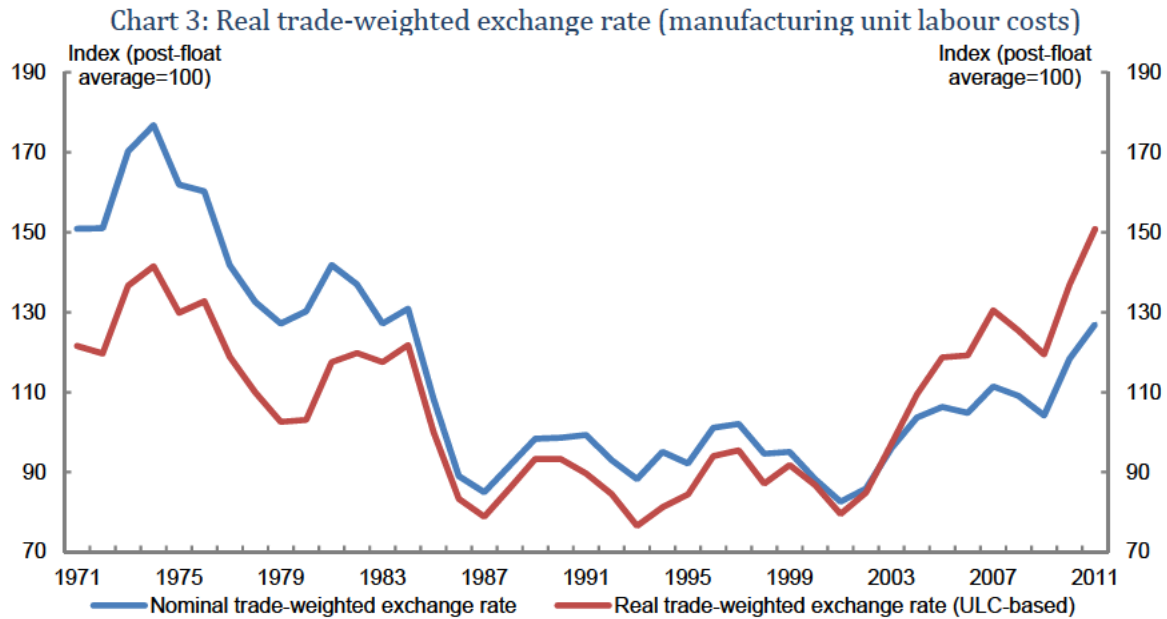
Chart 2: Real trade-weighted exchange rate and the terms of trade



Source: RBA and ABS cat. no. 5206.0 and Treasury.

An alternative measure of the real exchange rate can be calculated based on unit labour costs in manufacturing relative to competitor countries, which provides a more direct measure of changes in competitiveness. The OECD's measure indicates that unit labour costs in Australian manufacturing, relative to our competitors, are now at their highest level since this series commenced in 1970 (Chart 3).

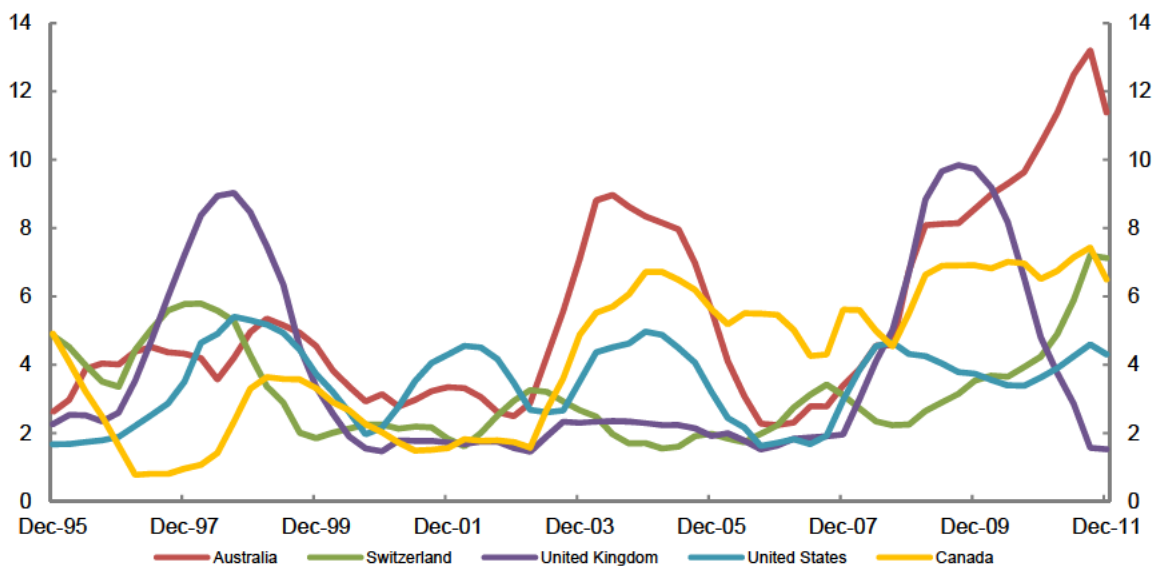
Importantly, this measure suggests that only 60 per cent of the rise in relative manufacturing unit labour costs since the early 2000s can be attributed to the rise in the nominal exchange rate. The remaining 40 per cent can be attributed to domestic unit labour costs growing faster than in competitor countries. This followed a period from the mid-1980s to the early 2000s in which domestic unit labour costs in Australian manufacturing grew at a similar rate to our competitors, as indicated by the fact the real exchange rate measure moved broadly in line with the nominal exchange rate over this period. This underscores the importance of boosting productivity growth as a remedy for the competitiveness challenges faced by manufacturing.



Source: OECD

The volatility of the AUD has also increased in recent years (chart 4). The real trade-weighted AUD has recently been more volatile than at any time since the mid-1980s, and significantly more volatile than other major advanced economy currencies.

Chart 4: Real Exchange Rate Volatility
Three year rolling standard deviation of quarterly average exchange rates



Source: OECD.

Drivers of the Australian dollar

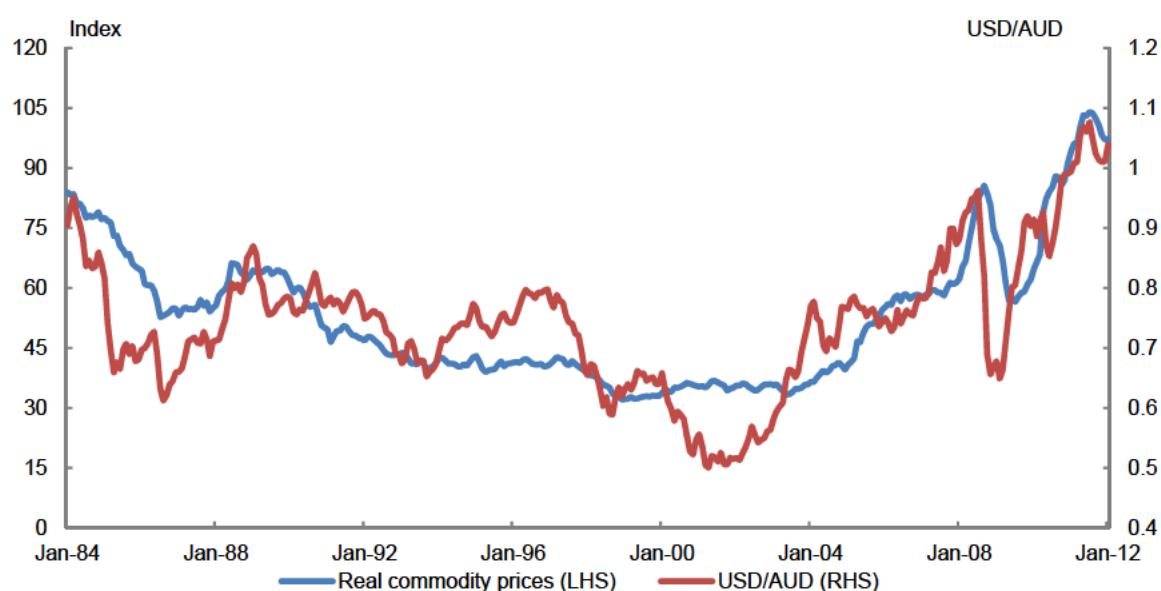
There are a number of variables that can influence the AUD in the short run. However, over the medium term, two key factors - the terms of trade and the interest rate differential - tend to have had the most influence. As such, while it is impossible to predict short run movements in the AUD, it is possible to identify the drivers of longer term trends in the AUD.

Terms of trade

Historically there has been a strong positive correlation between the value of the AUD and the Australian terms of trade, which is an index of the price of Australia's exports relative to imports. Changes in the terms of trade are mainly driven by changes in commodity export prices. A rise in commodity prices generates additional export income as well as capital inflows in response to high returns on investments, both of which increase demand for AUDs.

Since the mining boom began in the mid-2000s, Australia's terms of trade have risen rapidly (Chart 2), excluding a brief period during the global financial crisis. This has placed considerable upward pressure on the exchange rate, although the appreciation of the real trade weighted index has, if anything, been less than might have been expected from the past relationship with the terms of trade. Another perspective is provided by Chart 5, which shows how the exchange rate against the USD has tracked against real commodity prices over time. This suggests that recent movements in the AUD have not been out of line with the past relationship between these two variables.

Chart 5: Australian dollar and real commodity prices



Source: RBA

Note: Commodity prices are in SDR terms and are deflated by the US CPI. For the purpose of medium term fiscal estimates, Australia's high terms of trade are projected to decline by around 20 per cent over a 15-year period from 2012-13, settling just above their 2006-07 level.⁴ The AUD, which is currently around historically high levels, is projected to move in line with the long-term historical relationship between the terms of trade and the real exchange rate. The AUD is therefore projected to remain above historical averages for some time, even as it depreciates in line with the fall in the terms of trade. That said, the extremely uncertain global environment means that there is also a high degree of uncertainty around the level of the AUD in the near term.

The relationship between commodity prices and the AUD means that the currency is sensitive to fluctuations in global confidence, as commodity prices tend to fluctuate with global economic conditions. The link from commodity prices and global confidence to the value of

⁴ 2011-12 Mid-Year Economic and Fiscal Outlook

the AUD also helps to explain why the AUD has been a relatively volatile currency: as global risk sentiment has fluctuated in response to developments in global financial markets, the value of the AUD has also fluctuated.

Monetary policy and interest rate differentials

As reaffirmed by the Deputy Prime Minister and the Governor of the RBA in the September 2010 Statement on the Conduct of Monetary Policy, the RBA aims to keep inflation between two and three per cent on average over the economic cycle. This means that when the economy is performing strongly and inflationary pressure is rising, the RBA will raise interest rates. On the other hand, when the economy is weakening and inflationary pressure is easing, the RBA will lower interest rates.

Movements in Australia's domestic interest rates can affect the exchange rate. When Australian interest rates are high compared to foreign interest rates, capital inflows tend to increase as a result of foreign investors seeking higher returns. This leads to an increase in demand for AUDs and places upward pressure on the exchange rate. Conversely, low Australian interest rates compared to foreign interest rates result in capital outflows and downwards pressure on the exchange rate.

This effect on the exchange rate is an important part of the monetary policy transmission mechanism. Monetary policy (changes in official interest rates by the Reserve Bank) tends to operate with considerable lags, taking a long time to work through the economy and have its full impact on output and inflation. The immediate effect on the exchange rate, via differences in interest rates across countries, enables monetary policy to have a more timely impact on the economy.

The strong economic performance of the Australian economy in comparison to our major trading partners is the main reason why Australian interest rates have tended to be comparatively high in recent years. High commodity prices have a stimulatory effect on the economy, through both higher incomes and increased investment to expand productive capacity in mining. When the economy is close to full employment, this normally requires tighter monetary policy to contain inflationary pressures, as occurred over the period from 2006 to 2008.

More recently, interest differentials have reflected substantial economic weakness and abnormally low interest rates in the rest of the world rather than high interest rates in Australia — Australian interest rates are much lower now than they were preceding the GFC. Since the 2008 global financial crisis, the major advanced economies in the US and Europe have experienced a prolonged period of economic weakness and a substantial rise in unemployment. During the GFC, the official interest rates in the US and Europe were cut to close to the zero lower bound and have remained very low since then. Thus, as the Australian economy recovered and domestic interest rates returned to more normal levels after the GFC, the difference between Australian and foreign interest rates increased accordingly.

The US Federal Reserve's quantitative easing policy also placed additional downward pressure on long-term US interest rates. Quantitative easing refers to the situation where the central bank undertakes large scale purchases of long term government financial assets (government bonds), which increases the price and therefore pushes down the interest rate, or yield, on these longer term assets. As such, the US quantitative easing policy increases interest rate differences from the point of view of US trading partners, resulting in an appreciation of these exchange rates, including the AUD. This USD weakness is the reason

why the AUD has appreciated more strongly against the USD than against the TWI, as the USD only accounts for 9.5 per cent of the TWI.

Relative risk assessments

Another factor likely to have supported the AUD recently is that a number of other advanced economies are now judged to be more risky on account of high levels of government debt, weak economic growth and fragile banking systems. Australia is now one of only eight countries whose national government debt is still rated AAA with a stable outlook by all three major credit rating agencies. The improvement in Australia's relative risk ranking has contributed to foreign investors' appetite for Australian assets.

Since late November the AUD has appreciated significantly, despite reductions in the RBA's cash rate late last year and falls in commodity prices over recent months. This has led some commentators to suggest that the AUD may be becoming a 'safe haven' currency, and that this may work against the stabilising role that the currency has played in the past. However, it is unlikely that the AUD has become a 'safe haven', in the alternative sense that the currency might actually appreciate in response to deteriorating global economic conditions. Indicators of perceived risk in global financial markets have actually improved since the end of 2011. There is no firm evidence at this stage to suggest that the exchange rate will not continue to play a stabilising role in future.

The floating dollar and macroeconomic stability

The floating currency acts as a macroeconomic stabiliser, as its effect on economic activity tends to be countercyclical. That is, when the economy is performing strongly the AUD tends to appreciate, which dampens economic activity. Conversely, when the economy is performing poorly the AUD tends to depreciate, thus stimulating economic activity.

For instance, the current terms of trade boom has boosted aggregate demand in an economy that is close to full-employment capacity. This resulted from higher mining-boom incomes being spent across the economy and from increased investment being used to expand productive capacity in mining. Over the past eight years, real domestic demand has grown by 38 per cent, close to growth in real national income but well in excess of the economy's supply capacity. When the economy is close to full employment, this tends to generate inflationary pressures in the absence of any offsetting mechanism. Compared to a fixed currency, the rising AUD helps to slow the economy and maintain macroeconomic balance in the face of these pressures in several ways:

- directly moderating inflationary pressures by reducing import prices;
- easing domestic demand pressures by shifting spending from domestic to foreign goods and services;
- dampening the extent to which higher commodity prices (which are often contracted in USDs) result in higher domestic incomes; and
- dampening capital inflows into Australia by making AUD assets more expensive.

Movements in the AUD also contribute to macroeconomic stability by being stimulatory during downturns, for instance, during the GFC the AUD fell from around 98 US cents in July 2008 to a low of around 61 US cents in October 2008. This provided a boost to the Australian economy by:

- increasing the competitiveness of Australian exporters and shifting spending from foreign to domestic goods and services; and
- countering the fall in domestic income arising from falling commodity prices (which are often denominated in USDs).

By promoting macroeconomic stability, the floating AUD can be beneficial for all Australian businesses, including manufacturers. For instance, macroeconomic stability:

- assists businesses in making sound investment decisions, by lowering uncertainty;
- underpins the creation of jobs, by encouraging business investment;
- promotes low and stable inflation, which helps to keep interest rates lower; and
- encourages saving by preventing the real value of savings from being eroded by rising prices.

In spite of these considerations, some countries, such as Switzerland, Chile and Brazil, have attempted to reduce upwards pressure on their exchange rates (see Attachment A). However, this does not mean it would be in Australia's interest to follow suit.

In an economy open to capital flows, attempting to fix the nominal exchange rate at a particular level could be achieved, in principle, via two alternative means. The first would be to assign monetary policy to the task, so that domestic interest rates were set to achieve the particular nominal exchange rate level, rather than being set to achieve the medium-term inflation target.⁵ As differences in interest rates across countries are a key influence on the exchange rate, a policy of limiting the rise in the nominal exchange rate in response to the mining boom would require interest rates to be set at sufficiently low levels to achieve this. Over time, this would generate higher inflation, but the RBA would be unable to respond to this by raising interest rates without in turn pushing up the exchange rate. Hence, a policy of targeting the nominal exchange rate would ultimately be incompatible with the RBA's inflation target and would be likely to result in increased macroeconomic instability.

This means that limiting the rise in the nominal exchange rate would not avoid a rise in the real exchange rate over time. Instead of occurring through the nominal exchange rate, the associated reduction in competitiveness would occur, with greater economic disruption, through higher domestic inflation. Increased inflationary pressures have been the experience in countries such as Chile and Brazil when they have attempted to reduce upwards pressure on their exchange rate. Australia's previous terms of trade boom in the early 1970s, when there was a fixed exchange rate regime, was associated with increased inflation and macroeconomic volatility, with lasting adverse effects on economic performance (Gruen, 2011). In contrast, outcomes during the current boom have been much better. Australia currently has an underlying inflation rate close to the mid-point of the RBA's inflation target band, and the economy is close to full employment.

The alternative way of achieving a particular nominal exchange rate level, at least in principle, would be to engage in foreign exchange intervention while, at the same time,

⁵ The RBA's medium-term inflation target is consistent with maintaining an economy close to the 'non-accelerating inflation rate of unemployment'. In this way the RBA fulfils its full employment objective as set out under the *Reserve Bank Act 1959*.

keeping the domestic policy interest rate at a level consistent with achieving the medium-term inflation target. Such an approach is referred to as a sterilised intervention, as it involves offsetting the impact of the exchange rate intervention on the official interest rate. The practical value of this approach is, however, limited because of the large stock of AUD denominated financial assets, held both domestically and overseas. As a consequence of these large holdings, it would be necessary to undertake foreign exchange intervention on a truly massive scale in order to make a material and sustained difference to the level of the nominal exchange rate. Foreign exchange intervention on such a scale would have the undesirable consequence of exposing the RBA to significant balance sheet risks, which would then ultimately be borne by Australian taxpayers. In addition to being difficult to implement in practice, intervening in the exchange rate, even in the case of a sterilised intervention, reduces the capacity of the AUD to contribute to macroeconomic stability.

For Australia, the benefits of having a floating exchange rate far outweigh the costs, particularly as the real exchange rate will move over time even if the nominal exchange rate is held constant. As such, the Government's policy is to let the market determine the exchange rate.

It is sometimes argued that the case for a 'hands off' approach to the exchange rate needs to be reconsidered when a number of other countries are attempting to depress their currencies, either directly or indirectly, resulting in an AUD that is considered too high.

The exchange rate is a key macroeconomic variable, and must be considered in a macroeconomic context. Under Australia's macroeconomic policy regime, monetary policy is normally the primary instrument for managing aggregate demand. As the exchange rate is an important influence on the economy, its impacts are taken into account in setting monetary policy. If the high exchange rate was judged to be having an excessively contractionary impact, we could expect that monetary policy would be eased, which would in turn put downward pressure on the exchange rate.

The Reserve Bank does not take a completely 'hands off' approach to the exchange rate, and does intervene on occasion to prevent the exchange rate overshooting during periods of market dysfunction.⁶ The last such intervention occurred during the global financial crisis, when the Bank intervened to support the AUD in October-November 2008. Its approach has shifted over time towards less active intervention as market participants have become better able to manage currency risks, reflecting its view that exchange rate adjustments play an important role in the economy adapting to external shocks.

Sovereign Wealth Fund

Some commentators have argued that establishing a Sovereign Wealth Fund (SWF), into which governments would invest revenues arising from the resources boom in foreign assets, could be used to limit the appreciation of the exchange rate associated with the boom. The arrangements in place in Norway are often put forward as a model in this regard (see Attachment B for more detail).

In considering how such a policy might affect the exchange rate, it is important to distinguish between two separate issues:

- the effect of investing in foreign assets through a SWF; and

⁶ For a fuller discussion of the RBA's approach to intervention see RBA 2011b.

- the effect of targeting higher budget surpluses when commodity prices are high.

At some stage after the budget is returned to surplus and debt is reduced sufficiently, the Government will once again begin to accumulate financial assets. The Government has indicated that it will consider the use of accumulated financial assets in conjunction with future consideration of the appropriate size of the Commonwealth Government Securities (CGS) market consistent with its objective of maintaining adequate market liquidity.

However, simply establishing a SWF would have little impact on the exchange rate in itself. Investing a given level of budget surpluses in foreign assets, rather than repaying debt or accumulating domestic assets, would affect the AUD only to the extent that it increased the Australian asset share of global portfolios, resulting in a higher risk premium on Australian securities. Such portfolio effects are likely to be small, which means that impacts on the exchange rate would be insignificant for any feasible level of investment.⁷ Investing in foreign assets, rather than repaying debt, would also expose the Government's balance sheet to greater risk.

On the other hand, targeting higher budget surpluses in response to high commodity prices could be expected to have an impact on the exchange rate, to the extent that tighter fiscal policy offsets the impact of the boom on demand, which is the underlying factor driving the real appreciation.

The Government's plan to return the budget to surplus by 2012-13 already entails a substantial fiscal tightening which is helping to relieve pressure on the exchange rate in the near term. Planned increases in compulsory superannuation contributions from 2013-14 onward will also work in the same direction by boosting private saving.

A larger effect on the exchange rate would require a much larger fiscal tightening than currently planned in order to deliver much lower interest rates over an extended period. This is unlikely to be feasible or desirable in the immediate future, particularly as it would risk destabilising the economy in the current uncertain global environment.

Sectoral assistance policies

Some commentators have questioned whether government policies to assist trade-exposed sectors should be linked to the level of the exchange rate. For instance, should various tax or expenditure measures be automatically triggered or made more generous when the exchange rate moves above a certain value?

However, increased assistance to protect one sector of the economy would result in additional pressure on other sectors, making it more difficult for those sectors to attract resources, and slowing growth for the economy as a whole.

The costs of increased assistance would also put additional pressure on the budget, requiring offsetting savings elsewhere, or necessitating an overall easing of fiscal policy which would then place additional pressure on monetary policy to keep inflation in check.

⁷ Debt and equity securities issued by Australian entities comprise around 2.7 per cent of the global portfolio (around US\$150 trillion at the end of 2010). Lifting this share by even 0.1 of a percentage point would therefore require offshore investment of around \$150 billion (over 10 per cent of current annual GDP), with gross government debt remaining commensurately higher as a result.

Furthermore, in order to have budget neutral policies over time, any policy which resulted in higher assistance when the AUD is above a certain point would require the same amount of funding to be 'clawed back' when the AUD falls back to lower levels.

The Australian dollar and manufacturing

Typically, the effect of an exchange rate movement on a sector depends on whether the sector is exposed to international trade, with more trade exposed sectors tending to be more affected relative to less trade exposed sectors. Most Australian manufacturing firms are highly trade exposed and as such bear the full effects of the high AUD.

The high AUD decreases the competitiveness of manufacturers that export goods denominated in AUDs. From the point of view of a foreign customer, the higher AUD makes Australian exports more expensive.

The rising AUD makes foreign imports cheaper for domestic consumers, switching demand from domestically made goods, whose price has not been affected by the exchange rate appreciation, to foreign imports. Lower import prices can also result in lower input costs for those manufacturers that import some of their inputs. Generally, however, this will only partially offset the impact on competitiveness as costs of labour and other domestic inputs are not affected.

In this challenging environment, it is important that the manufacturing sector remains responsive to growth opportunities in the broader economy. In particular, strong growth in the mining and services sectors provides an opportunity for manufacturers to focus their efforts domestically and link into these strongly growing sectors. It also provides an opportunity for manufacturers to extend their business models into these growing sectors (for instance, by providing follow-up, tailored service on manufactured products).

Recent government initiatives recognise the wealth of opportunities currently flowing into Australia and seek to ensure that the manufacturing sector has the resources and know-how to be able to share in these opportunities.

Changes to improve procurement practices will ensure full, fair and reasonable access for Australian businesses to compete for work. Recent measures build on the Australian Industry Participation National Framework and Australian industry participation measures for Commonwealth procurement. Now, stronger rules will apply for large projects under the Enhanced Project By-Law Scheme and for large Commonwealth grants (including to the states and territories) to ensure that Australian manufacturers are considered for major work opportunities.

The Buy Australian at Home and Abroad initiative, announced in the last budget, also seeks to link manufacturers to opportunities in the resources sector. The initiative helps manufacturers to build on existing skills and identify ways to integrate their business into major supply chains.

These measures along with continued responsiveness from manufacturing businesses will help manufactures to weather challenges arising from the high Australian dollar and associated export and trade pressures.

Is Dutch Disease a concern?

High resource prices and the associated high real exchange rate are drawing labour and capital from non-resource parts of the traded sector (including many, but not all, parts of manufacturing) into growth sectors such as mining and construction.

While it is clear that there are losers and winners from this process, such a shift of scarce resources into booming sectors offering rising wages and profits is likely to improve national income overall. Some individuals, given their particular skill set or life circumstances, may not be able to benefit from the opportunities offered by the changing economic structure and may face the risk of unemployment or reduced earnings. Particular communities may also be significantly disrupted. Such challenges point out the need for policy to address these issues and provide appropriate assistance.

There is also some concern that the aggregate gains could be threatened by ‘Dutch disease’, where the reallocation of resources resulting from the commodity boom leads to longer-term detriment for the nation from a loss of spillovers (such as skills, research and development, existing sales relationships, and upstream and downstream employment) from other declining trade-exposed sectors, and from difficulties in re-generating these sectors should the commodity boom be temporary. However reduced spillovers from trade-exposed sectors not benefiting from the commodity boom need to be considered against improved spillovers from the booming sectors.⁸ International evidence also suggests that Dutch disease tends not to apply to advanced countries like Australia. With the right institutions and policy settings, it is possible for advanced countries that experience a temporary surge in their resources sector to manage the associated transitions. They also typically have policy and institutional settings conducive to the accumulation and development of investment, skills and expertise (see IMF 2010 and Statement 4 in Budget 2011-12).

Moreover, it is important not to overstate the link between the commodity boom and the decline of manufacturing in Australia. The strongly rising share of employment in the mining and construction sectors is a relatively recent phenomenon, dating from the beginning of the mining boom, around the mid-2000s. The associated decline in the share of employment in manufacturing is the continuation of a trend that has been evident since the 1950s. It is consistent with the evolution of other developed economies towards services and away from manufacturing, in response to the emergence of developing economies with comparative advantages in the latter. Increasing direct competition from Asia will be an ongoing issue for Australian manufacturing, even in the absence of a commodity boom. Nevertheless, manufacturing output has continued to grow slowly over the long term despite the sector’s relative decline. Short-term fluctuations aside, this trend is expected to continue into the future as manufacturers continue to respond to competitive pressures.

⁸ There is substantial potential for spillovers from the Australian mining sector. Despite mining being 9 per cent of GDP in 2008-09, mining’s share of total business expenditure on research and development was at around 25 per cent. Australia’s mining technology services and equipment sector is recognised as a leading supplier to miners globally. In 2008-09 it employed over 30,000 people and generated \$8.7 billion in revenue, with about 30 per cent of this coming from exports.

Even in the Netherlands, after a decline in manufacturing during an intense period of energy resource extraction lasting until the early- to mid-1980s, manufacturing exports rebounded, reaching nearly 40 per cent of GDP and around 70 per cent of total exports in 1997. This period was also matched by solid long-term per capita GDP growth — matching and, for long periods, exceeding average growth in the OECD.

The services sector in particular has accounted for a rising share of Australian employment over the past couple of decades, currently three-quarters of the total.

As the terms of trade are expected to remain at historically high levels for an extended period, these structural changes are likely to be played out well into the foreseeable future. The commodities boom reflects only the first stage of the global economic shift towards Asia, and will be followed by increased demand for goods and services from the growing Asian middle classes. The changes we are seeing most likely reflect a prolonged shift in Australia's comparative advantage driven by the re-emergence of the Asian giants, that will provide opportunities beyond the mining boom rather than a short-lived disturbance after which we might wish to return Australia to its pre-boom industrial structure.

This shift in our fortunes does not exclude the manufacturing sector. Like other sectors, manufacturing stands to grow from the opportunities that flow from strong Asian growth and strong demand from a growing Asian middle class.

The Government has taken steps to ensure that manufacturers are well placed to take advantage of these opportunities. A number of programs seek to promote Australian manufacturing capabilities overseas and identify opportunities for manufacturers to link into global supply chains. Advice is also available from a number of government sources (and in particular the Australian Trade Commission — Austrade) on export opportunities; and there are also a number of government programs available to boost the business skills and knowledge necessary for exporting.

In spite of the high Australian dollar, disruption in international markets and competitive pressures from overseas firms, Australian manufacturers have proved successful in using exports to diversify into larger international markets and achieve greater economies of scale. The Export Finance and Insurance Corporation has been working with a number of Australian companies who are increasingly utilising their knowledge and expertise developed locally to export high value-added products and services into international markets and supply international production and distribution chains.

Enterprise Connect has also been working with manufacturers (around half of their clientele) to develop the skills necessary for export. A range of Enterprise Connect services, including business reviews, grants, information sessions and study options, provide a comprehensive array of support for manufactures seeking to improve their management capabilities, strategic thinking and on-the-ground expertise. Taking advantage of international developments offers strong prospects for rising employment and incomes over the long term. Policy that promotes economic flexibility, while minimising the immediate costs of structural adjustment, will be fundamental to achieving this.

The Minerals Resource Rent Tax and the extension of the Petroleum Resource Rent Tax, for example, will help create a sustainable economy beyond the mining boom, by supporting investment in infrastructure and industries to grow jobs in the future.

The revenue from these reforms will assist businesses, particularly small businesses that have not benefited from the mining boom, by supporting a cut to corporate taxes and funding new infrastructure across the nation to drive productivity growth. The proceeds of the mining tax will also enable increased superannuation for Australian workers – building national savings for Australia's future.

Through these mechanisms, the profits from the resources boom will strengthen our entire economy, not only indirectly through increased national income, but directly through making available the returns from Australia's common resources for the benefit of all Australians.

How can manufacturers respond to the volatile Australian dollar?

The high level of the Australian dollar and the increased volatility are two separate issues, and are being driven by different underlying factors. There are steps that businesses can take to manage increased exchange rate volatility.

The focus here is on small and medium enterprises. Larger businesses should have greater capacity to deal with the complexities involved in managing exchange rate risks. Furthermore, businesses that operate multinationally, and are thereby exposed to a range of different currency risks in their selling and purchasing decisions, have more scope to benefit from natural hedges.

Sources of advice and support for managing exchange rate volatility

A number of government agencies can help businesses manage risk associated with movements in exchange rates. Austrade provides advice on creating a risk management plan and specialist export advisers are available through Austrade to help build businesses' know-how. The Export Finance and Insurance Corporation (EFIC) lists a number of approaches for businesses to manage payments in foreign currency and avoid foreign currency risk. Business-related State and Territory government websites also provide some high-level advice.

EFIC, in partnership with specialist currency services providers Travelex and HiFX, provides a foreign exchange guarantee facility for exporters to extend their hedging program to more of their export contracts and better protect their export profits.⁹ To be eligible, exporters must have or have approval for a foreign exchange facility with either of the participating foreign exchange specialist and, in the last 12 months, have exported goods and services to at least the value of the foreign exchange facility guarantee. Businesses do not have to provide additional security to access the guarantee and no additional fee is payable.

These government sources provide support to a number of businesses. Common non-government sources of advice and support include foreign exchange specialists, a business's accountant, financial planner or bank.

Approaches to managing foreign exchange risk

There are several approaches to managing exchange rate risk. Banks offer a range of products from which businesses can choose to best suit their needs.

In their simplest form, approaches to foreign exchange risk mitigation involve an agreement to exchange one currency for another on a specified future date, at a rate agreed today (a

⁹ EFIC assists eligible Australian companies to win, finance and protect export and export related contracts through a suite of targeted financial solutions. As Australia's export credit agency, EFIC works alongside commercial banks to provide financial support to Australian exporters where their bank is unable to meet their entire financing requirements. EFIC does not compete with the banks, but strives to support Australian business where there is a gap in the commercial finance market. EFIC operates on a commercial basis and charges fees and costs reflecting EFIC's risk assessment, including the terms and security of a transaction.

forward contract). This offers a business protection against unfavourable changes in foreign currency values.

More complex forward contract arrangements also exist. Some of the more common allow a business to exchange one currency for another on a specified date or dates at:

- the better of the agreed rate or the prevailing spot rate on the day;
- a rate that cannot move beyond an agreed 'worst case' limit;
- the most favourable rate over an agreed period;
- multiple agreed rates for different portions of the transaction; and
- an agreed rate with the right but not the obligation to buy or sell.

Some of these more complex options allow businesses to not only protect themselves against unfavourable exchange rate movements but also enable them to take advantage of favourable currency movements.

Businesses can also reduce their exposure to foreign currency movements by setting up a loan or account with their bank in the foreign currency in which they will be transacting.

Are businesses taking action to mitigate their exposure to foreign exchange risks?

Despite the availability of advice, support and tailored products, surveys indicate that many businesses fail to take any action to mitigate risks associated with foreign currency fluctuations.

A 2009 Australian Bureau of Statistics survey on foreign currency exposure shows that 32 per cent of importers' payments and 25 per cent of exporters' receipts were hedged to some degree. Taking into account the average level of hedging under partial hedging strategies, the actual amounts hedged fall to 25 per cent of payments and 16 per cent of receipts.

These low rates may be partly explained by large exporters having natural hedges without the need to actively undertake hedging activities (e.g. receipts in a foreign currency and payments in a foreign currency offsetting each other to reduce exposure). Discussions with respondents during the editing phase of the survey also suggest that near term payments and receipts are more likely to be hedged, with the level of hedging reducing progressively over the time horizon as the level of uncertainty increases (ABS, 2009). Low rates of hedging may also be explained by the fact that hedging is not free and the cost of hedging activity must be weighed up against the risks and costs posed to the business by movements in exchange rates.

An August 2011 Commonwealth Bank survey suggests hedging by SME exporters is increasing. Over half (53%) of small and medium-sized Australian exporters plan to increase their currency hedging activity in response to the high Australian dollar. Over two-thirds (68%) of importers also said they plan to hedge their USD exposure over the next three months, a significant jump on the results of one year ago (Commonwealth Bank, 2011).

While hedging and similar approaches are important for managing currency volatility, broader factors are also relevant. Experience from Enterprise Connect (an SME advisory program with a strong manufacturing focus) suggests that businesses that are competitive and

well managed are better able to mitigate external changes to their business environment, including currency fluctuations.

Future policy options to help businesses manage exchange rate volatility

In order to further facilitate business access to products for managing currency volatility, there are a number of options that could be further considered by Government

Workshops, Industry Intelligence Networking (WIIN)

Workshops, Industry Intelligence Networking (WIIN) is a competitive small grants element of the Enterprise Connect initiative. WIIN offers grants of up to \$50,000 for eligible organisations to deliver activities to Australian small and medium businesses which help them to improve their performance through better access to new innovations, technologies, expertise, business networks and best practice.

The theme for Round 8 is "Competing in a Global Economy", which clearly touches on some of those issues being discussed. Future rounds could be tailored to specific currency volatility issues.

Business Review

The Business Review is the core service of Enterprise Connect. Conducted by expert Business Advisers, the review works through the operational and strategic position of the firm, and results in a series of recommendations for improvement.

Business Advisors could be encouraged to be more alert for challenges and opportunities around currency volatility.

Leadership21

Leadership 21 is a tailored national small and medium enterprise leadership development program delivered by Mt Eliza Business School, an arm of the Melbourne Business School. The course is aimed at business owners and CEOs of SMEs who wish to develop their personal management skills. Leadership21 is open to all EC clients. Enterprise Connect subsidises 80 per cent of the cost.

Further detail on currency volatility issues could be built into this course.

Managing Foreign Exchange risk

EFIC has developed a Foreign Exchange Facility Guarantee in partnership with specialist currency service providers Travelex and HiFX.

A workshop organised by EFIC with Travelex, or HiFX to discuss effective management of foreign exchange risk and explore financing options available could provide a useful forum to assist exporting manufacturers. Workshops could be organised with other Federal Government agencies such as Austrade and State & Territory Government departments and business associations to help identify appropriate companies and encourage attendance.

Improved links between EFIC and DIISRTE

Under the Market Intelligence Service, Enterprise Connect clients undergoing a Business Review can access tailored export/market intelligence information, sourced through the global Austrade network, on particular markets and opportunities. Further work could ensure that information on existing EFIC foreign exchange management tools is readily available through this service.

EFIC works with eligible Australian based companies – contractors and subcontractors – to win and finance contracts in domestic export focussed projects, including resource export projects.¹⁰ EFIC is working with DIISRTE in the context of the Resources Sector Supplier Advisory Forum and broader Buy Australia campaign. However, greater coordination may be possible between EFIC and DIISRTE across a number of activities, including inclusion of relevant EFIC product information on the Industry Capability Network national database and inclusion of EFIC information on the Buy Australia website.

Conclusion

The floating of the AUD in 1983 was a significant economic reform. As a result of the high terms of trade and the strong economic performance of the Australian economy, the AUD has risen against the USD and the TWI to be well above its post float average. This appreciation plays an important role in promoting the stability of the Australian economy, and dampening inflationary pressures. With the high terms of trade in Australia, the AUD is projected to remain above historical averages for some time. This will mean that conditions for the sector remain challenging and businesses will need to ensure that they continue to focus on improving productivity and grasping new opportunities in order to remain competitive.

Government reforms to support a range of businesses and workers will soften adjustment pressures across the economy, including in the manufacturing sector. The Government has also launched a range of measures to help manufacturers become more competitive such as the Buy Australian at Home and Abroad Initiative and support through the Enterprise Connect network across Australia. Recent action to ensure Australian companies receive full, fair and reasonable opportunity to compete for work in major projects will also be particularly beneficial for the manufacturing sector.

These government actions plus continued action from within the sector will help to provide a sustainable base for the long-term future of Australian manufacturing. A range of options are available to manufacturers to cope with the immediate pressures posed by increased exchange rate volatility. Further information on hedging strategies and managing foreign exchange volatility is available through a number of sources but more information and support could potentially be made available through the Export Finance and Insurance Corporation and through Enterprise Connect.

¹⁰ For EFIC to consider support, the goods or services rendered by a contractor to a project must form an integral part of the overall export project.

Attachment A – Policy actions taken by other countries to reduce upwards pressure on their exchange rates

The Swiss National Bank (SNB) decided last September to set a minimum exchange rate of 1.20 Swiss Francs per euro.¹¹ When the exchange rate moves below this rate (i.e. appreciates), the SNB is prepared to purchase an unlimited amount of foreign currency to drive the exchange rate back above 1.20 Swiss Francs per euro.¹² The SNB is also allowing the money supply to increase by not sterilising its foreign exchange purchases, which would normally risk an increase in inflationary pressure. This decision was based on two special features of the Swiss economy which are not currently applicable to Australia:

- The Swiss Franc is considered a ‘safe haven’ currency, which means that when global risk perceptions increases during periods of global economic turmoil the Swiss Franc tends to appreciate, thus amplifying the adverse effect on the Swiss economy. By contrast, movements in the AUD tend to act as a shock absorber for the Australian economy as the AUD normally depreciates in response to adverse global developments.
- Additionally, the Swiss official interest rate is currently at zero (so that expanding the money supply cannot further reduce the interest rate) and the Swiss economy is going through a period of deflation, thus there is little risk of a break out in inflation. In these circumstances, exchange rate targeting is unlikely to conflict with inflation targeting in the immediate future. In contrast, Australia currently has an underlying inflation rate (through the year) close to 2.5 per cent and the economy is close to full employment.

Some other commodity exporting countries have also undertaken action to alleviate the effects of a high exchange rate:

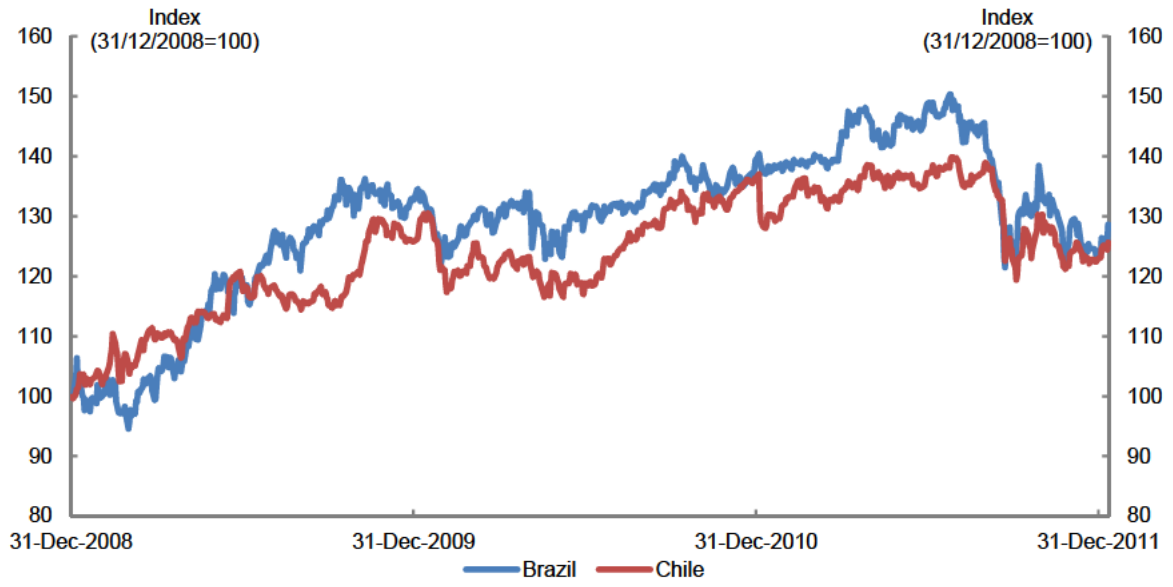
- In January 2011 the Central Bank of Chile announced that it would increase the reserves of foreign currency it holds by US\$12 billion over 2011, through periodic purchases. The monetary effects of the planned intervention were to be sterilised in order maintain the target for the monetary policy interest rate.
- The Brazilian central bank also took action in January 2011, announcing that it would set reserve requirements on bets against the US dollar falling (known as short positions) held by local banks. Starting on April 4 2011, Brazilian banks would need to deposit in cash at the central bank 60 per cent of their short positions in US dollars above US\$3 billion or their capital base, whichever is smaller.

While the currencies of Brazil and Chile have depreciated in recent months, it is uncertain whether the depreciation was a result of central bank action or deteriorating global confidence (chart A1, below). Both countries have also experienced increased inflation. Inflation has risen to 4.4 per cent through the year to December 2011 in Chile and is expected to be around 6.5 per cent through the year in 2011 in Brazil.

¹¹ Note that by convention the Swiss Franc is quoted as the number of Swiss Francs per euro, therefore an increase (decrease) in this rate is a depreciation (appreciation).

¹² http://www.snb.ch/en/mmr/reference/pre_20110906/source/pre_20110906.en.pdf

Chart A1: Brazilian real and Chilean peso



Source: Thomson Reuters

Attachment B – Norway’s Sovereign Wealth Fund regime

Norway’s Sovereign Wealth Fund regime is often put forward as a model for other resource-based economies. This regime comprises two elements:

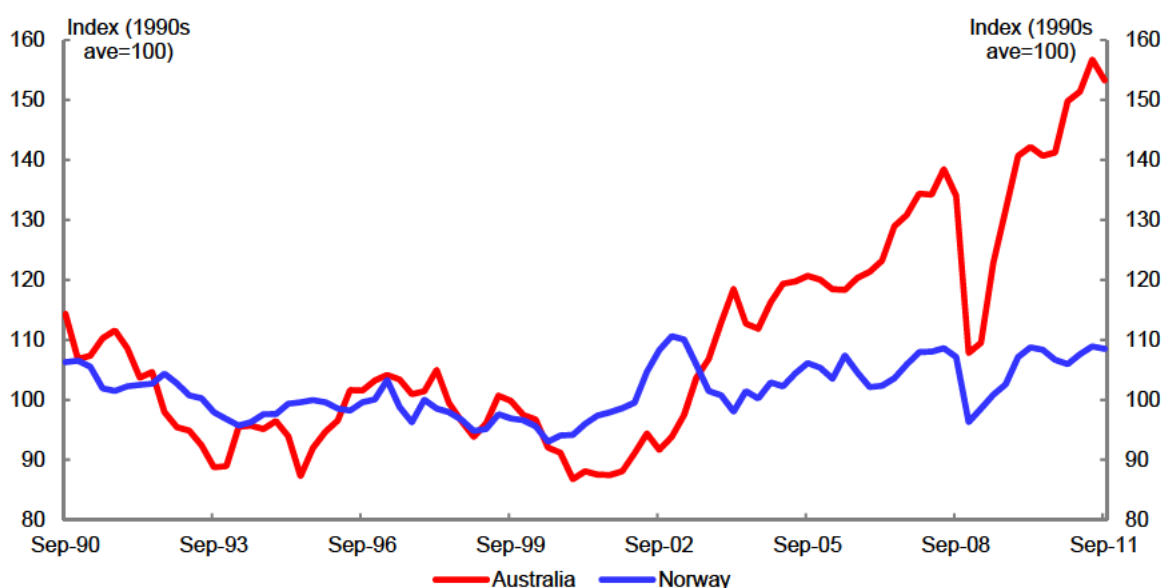
- Since 1996, Government revenues from oil and gas have been hypothecated to a sovereign wealth fund, the Government Pension Fund Global (GPF), which invests solely in offshore financial assets.
- Since 2001, the objective for the non-oil structural budget deficit has been set at 4 per cent of the GPF, which is the Fund’s assumed long-run real rate of return.

Norway’s regime was established primarily to preserve fiscal flexibility against risks to oil prices, and to address long-term challenges arising from population ageing and expected declines in petroleum revenues. In this regard, it is important to bear in mind that:

- The expected lifetime of Norway’s key resources is relatively limited — remaining reserves of oil and gas are estimated to cover only 8 and 26 years of current production, compared to 71 and 98 years for Australia’s reserves of iron ore and black coal.
- Norway is much more dependent on its resource sector — oil and gas account for 20 per cent of Norway’s economy and one-third of government revenues, while mining accounts for 9 per cent of the Australian economy and 6 per cent of government revenues.

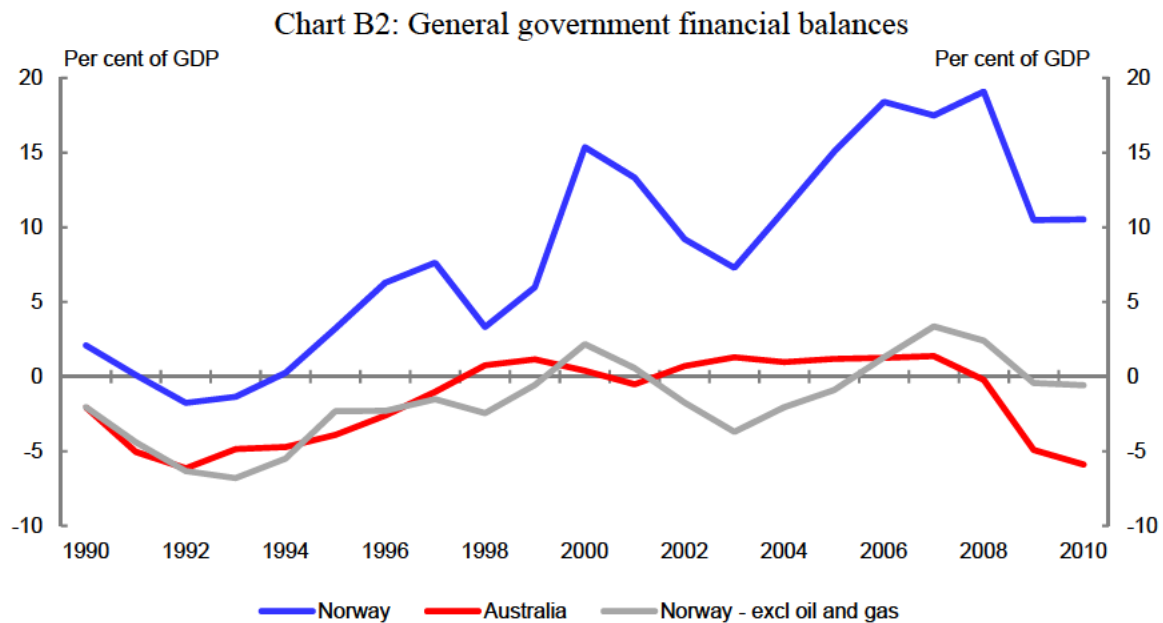
Since the late 1990s, when oil and gas prices surged, Norway’s terms of trade have increased by 160 per cent, compared to a rise of 110 per cent for Australia. Despite this, Norway has experienced comparatively limited real exchange rate appreciation over this period (Chart B1).

Chart B1: Real trade-weighted exchange rates



Source: RBA, IMF

This has been possible because Norway's fiscal objective quarantines petroleum revenues from current spending, resulting in massive budget surpluses averaging 13 per cent of GDP since 2000 (Chart B2). Accumulated surpluses have resulted in a fund now worth almost 130 per cent of GDP. As a result, Norway has been able to limit the impact of the resource boom on domestic demand, thereby limiting the extent to which the real exchange rate has had to appreciate as a consequence. This has been feasible because the Norwegian government captures a large share of the incomes from oil and gas production, partly through its substantial direct financial interests in the petroleum industry.



Source: OECD

Another factor that has limited the impact of the boom on demand in Norway is that it has not experienced a surge in resource sector investment of the same magnitude as has occurred in Australia. Again, this is likely to reflect Norway's relatively limited remaining reserves of oil and gas.

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