Australian Economics Comment

Paul Bloxham

Chief Economist, Australia & New Zealand
HSBC Bank Australia Limited
+612 9255 2635
paulbloxham@hsbc.com.au

Is the AUD a broken shock absorber?

Driving a car with a broken shock absorber can be quite an unpleasant experience. Every bump in the road can be felt. For Australia's economy, its key absorber of global economic shocks has been the AUD. Without large ups and downs in the AUD in recent years, Australia's economy would not have dealt as easily with the commodities boom or the global financial crisis. But, in a world where central banks continue to use unconventional policy, the AUD may not be the same shock absorber it once was. This issue has once again come to the fore. In the face of recent declines in iron ore prices, the AUD has remained stubbornly high. If this divergence persists, it could frustrate the RBA's efforts to rebalance growth, which could see rates needing to be lower for longer. If the shock absorber is not working, get ready for a bumpier ride.

In the past, the AUD has played a major role in protecting the Australian economy from international shocks. When the commodity prices boom was ramping up, the AUD appreciated to very high levels (USD1.10 at its peak in 2011) to help the economy absorb a strong positive shock to its incomes without excessive inflation. This worked through a number of channels. As resource exports are largely priced in USD terms, the rise in the AUD helped to reduce the impact of the positive income shock on the domestic economy (in AUD terms). The very high AUD also slowed down the non-mining sectors by encouraging more imports, including tourism services, with Australian's travelling abroad in record numbers and doing more of their discretionary retail spending overseas at the same time.

Working in the other direction, when the global financial crisis struck, the AUD fell very sharply (US61 cents at its trough in 2008), which provided support for the economy. Exporters became more competitive, miners' profits were supported (in AUD terms), Australians' took fewer trips abroad and spent more locally (rather than on goods and services from overseas) and imports fell sharply, boosting domestic demand.

The RBA see the AUD as the key price that acts to help the Australian economy adjust to global shocks. This leaves them to adjust the cash rate to, in large part, deal with the domestic cycle. While this is an over-simplification, as interest rate settings affect the level of the AUD (through interest rate differentials) and the AUD also affects local conditions, it is, nonetheless, a useful way to think about the roles of the exchange rate and the cash rate.

As the RBA's own preferred model of the AUD shows, the vast majority of the medium-term historical variation in the AUD can be explained by changes in the terms of trade (read: commodity prices which are determined globally) whereas the interest differential plays a lesser role in determining the AUD. In the medium-term the AUD seems to have played its role as a global shock absorber quite well, given its strong positive correlation with the terms of trade.

The RBA should be quite happy with the role its cash rate setting is playing at the moment. The historically low cash rate setting is already delivering the sorts of effects that might be expected. The housing market is booming, approvals for housing construction have risen and retail sales have been picking up. The lift in the interest-rate sensitive sectors appears to also be driving a pick-up in hiring intentions, such that the unemployment rate has actually fallen in the past couple of months. There would be little reason, at this point, for the RBA to consider cutting rates further, given that low interest rates are having the desired effect. Further cuts could also create risks, if lower rates were to lead to over-inflation of the housing market. Thus, they have a 'neutral bias' and we retain our long held view that the easing phase is done.

But the AUD is not moving to support local growth. Indeed, the price of Australia's major export, iron ore, is currently USD100, having fallen by -25% since the beginning of the year. At the same time, the AUD has risen by +5% to US93.5 cents since the beginning of the year. The further the iron ore price falls without a corresponding fall in the AUD, the more pressure this puts on local income growth (in AUD terms).

This leaves the RBA with a challenge. The low cash rate is doing what it should do -- supporting a domestic upswing -- but the AUD is not playing its traditional role as a shock absorber. This could reflect a range of factors, including Australia's own domestic turnaround, the Federal Reserve's recent dovishness, the likelihood that the ECB will deliver further stimulus next month and the Bank of Japan's ongoing asset purchase programme. In a low interest rate world, Australia's higher interest rates and triple-A sovereign rating look attractive.

Last year, the RBA addressed this challenge by trying to 'jawbone' the AUD lower. Speeches and statements were used to point out that they expected the AUD to fall and that its level was 'uncomfortably high'. The RBA has been reluctant to do this in recent months. In our view, this reluctance reflects that there is now more convincing evidence that growth is rebalancing away from mining to the non-mining sectors, such that there is less urgency to loosen financial conditions. Also, last year the RBA was able to argue that the Federal Reserve's asset purchase programme was clearly distorting currency markets, which is less easily done now that they are tapering. Keep in mind, the USD cross rate is the single most important exchange rate for Australia, given its key role in pricing commodities.

Of course, the RBA could once again choose to start jawboning the AUD lower, if the divergence between commodities and the AUD continues or the RBA starts to get more nervous about the recent slowing in China. But, we see the likelihood that the RBA would consider cutting rates further as very low, given the domestic economy is lifting. Without an easing bias it may also be harder for the RBA to credibly jawbone the AUD lower.

With the AUD at its current level or higher, there is a clear downside risk to our current central case for the RBA to start to lift the cash rate around year-end (Q4). Indeed, watching the AUD over coming months will be of critical importance for determining the timing of the RBA's next move. A higher AUD, particularly in the face of falling commodity prices, is likely to slow the process of rebalancing growth and help to put downward pressure on inflation, which could see the RBA keeping its cash rate lower for longer.

NB. HSBC's central case is for the AUD/USD to be US86 cents by end-2014 and US86 cents by end-2015 (see '*Currency Outlook*', May 2014).

Disclosure appendix

Analyst certification

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Paul Bloxham

This document has been prepared and is being distributed by the Research Department of HSBC and is intended solely for the clients of HSBC and is not for publication to other persons, whether through the press or by other means.

This document does not provide individually tailored investment advice and should not be construed as an offer or the solicitation of an offer to buy or sell any securities or to participate in any trading strategy. The information contained within this document is believed to be reliable but we do not guarantee its completeness or accuracy. Any opinions expressed herein are subject to change without notice. HSBC may hold a position in, buy or sell on a principal basis or act as a market maker in any financial instrument discussed herein.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments (including derivatives) of companies covered in HSBC Research on a principal or agency basis.

Analyst(s) are paid in part by reference to the profitability of HSBC which includes investment banking revenues.

HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Chinese Wall procedures are in place between the Investment Banking and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.

Additional disclosures

1. This report is dated as at 20 May 2014.
2. All market data included in this report are dated as at close 20 May 2014, unless otherwise indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.

HSBC

Disclaimer

** Legal entities as at 8 August 2012*
'UAE' HSBC Bank Middle East Limited, Dubai; 'HK' The Hongkong and Shanghai Banking Corporation Limited, Hong Kong; 'TW' HSBC Securities (Taiwan) Corporation Limited; 'CA' HSBC Bank Canada, Toronto; HSBC Bank, Paris Branch; HSBC France; 'DE' HSBC Trinkaus & Burkhardt AG, Düsseldorf; 000 HSBC Bank (RR), Moscow; 'IN' HSBC Securities and Capital Markets (India) Private Limited, Mumbai; 'JP' HSBC Securities (Japan) Limited, Tokyo; 'EG' HSBC Securities Egypt SAE, Cairo; 'CN' HSBC Investment Bank Asia Limited, Beijing Representative Office; The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch; The Hongkong and Shanghai Banking Corporation Limited, Seoul Securities Branch; The Hongkong and Shanghai Banking Corporation Limited, Seoul Branch; HSBC Securities (South Africa) (Pty) Ltd, Johannesburg; HSBC Bank plc, London, Madrid, Milan, Stockholm, Tel Aviv; 'US' HSBC Securities (USA) Inc, New York; HSBC Yatirim Menkul Degerler AS, Istanbul; HSBC México, SA, Institución de Banca Múltiple, Grupo Financiero HSBC; HSBC Bank Brasil SA – Banco Múltiplo; HSBC Bank Australia Limited; HSBC Bank Argentina SA; HSBC Saudi Arabia Limited; The Hongkong and Shanghai Banking Corporation Limited, New Zealand Branch incorporated in Hong Kong SAR

Issuer of report
HSBC Bank Australia Limited
Level 32
HSBC Centre
580 George Street
Sydney, NSW 2000, Australia
Telephone: +61 2 9006 5888
Fax: +61 2 9255 2205
Website: www.research.hsbc.com

In Australia, this publication has been distributed by The Hongkong and Shanghai Banking Corporation Limited (ABN 65 117 925 970, AFSL 301737) for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). Where distributed to retail customers, this research is distributed by HSBC Bank Australia Limited (AFSL No. 232595). These respective entities make no representations that the products or services mentioned in this document are available to persons in Australia or are necessarily suitable for any particular person or appropriate in accordance with local law. No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. This material is distributed in the United Kingdom by HSBC Bank plc. In the UK this material may only be distributed to institutional and professional customers and is not intended for private customers. Any recommendations contained in it are intended for the professional investors to whom it is distributed. This publication is distributed in New Zealand by The Hongkong and Shanghai Banking Corporation Limited, New Zealand Branch incorporated in Hong Kong SAR. This material is distributed in Japan by HSBC Securities (Japan) Limited. This material may be distributed in the United States solely to "major US institutional investors" (as defined in Rule 15a-6 of the US Securities Exchange Act of 1934); such recipients should note that any transactions effected on their behalf will be undertaken through HSBC Securities (USA) Inc. in the United States. Note, however, that HSBC Securities (USA) Inc. is not distributing this report, has not contributed to or participated in its preparation, and does not take responsibility for its contents. In Singapore, this publication is distributed by The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch for the general information of institutional investors or other persons specified in Sections 274 and 304 of the Securities and Futures Act (Chapter 289) ("SFA") and accredited investors and other persons in accordance with the conditions specified in Sections 275 and 305 of the SFA. This publication is not a prospectus as defined in the SFA. It may not be further distributed in whole or in part for any purpose. In Korea, this publication is distributed by either The Hongkong and Shanghai Banking Corporation Limited, Seoul Securities Branch ("HBAP SLS") or The Hongkong and Shanghai Banking Corporation Limited, Seoul Branch ("HBAP SEL") for the general information of professional investors specified in Article 9 of the Financial Investment Services and Capital Markets Act ("FSCMA"). This publication is not a prospectus as defined in the FSCMA. It may not be further distributed in whole or in part for any purpose. Both HBAP SLS and HBAP SEL are regulated by the Financial Services Commission and the Financial Supervisory Service of Korea. The Hongkong and Shanghai Banking Corporation Limited Singapore Branch is regulated by the Monetary Authority of Singapore. Recipients in Singapore should contact a "Hongkong and Shanghai Banking Corporation Limited, Singapore Branch" representative in respect of any matters arising from, or in connection with this report. HSBC México, S.A., Institución de Banca Múltiple, Grupo Financiero HSBC is authorized and regulated by Secretaría de Hacienda y Crédito Público and Comisión Nacional Bancaria y de Valores (CNBV). HSBC Bank (Panama) S.A. is regulated by Superintendencia de Bancos de Panama. Banco HSBC Honduras S.A. is regulated by Comisión Nacional de Bancos y Seguros (CNBS). Banco HSBC Salvadoreño, S.A. is regulated by Superintendencia del Sistema Financiero (SSF). HSBC Colombia S.A. is regulated by Superintendencia Financiera de Colombia. Banco HSBC Costa Rica S.A. is supervised by Superintendencia General de Entidades Financieras (SUGEF). Banistmo Nicaragua, S.A. is authorized and regulated by Superintendencia de Bancos y de Otras Instituciones Financieras (SIBOIF).

This material is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. This document has been prepared without taking account of the objectives, financial situation or needs of any specific person who may receive this document. Any such person should, before acting on the information in this document, consider the appropriateness of the information, having regard to the personal objectives, financial situation and needs. In all cases, anyone proposing to rely on or use the information in this document should independently verify and check its accuracy, completeness, reliability and suitability and should obtain independent and specific advice from appropriate professionals or experts. HSBC has based this document on information obtained from sources it believes to be reliable but which it has not independently verified; HSBC makes no guarantee, representation or warranty and accepts no responsibility or liability as to its accuracy or completeness. Expressions of opinion are those of HSBC only and are subject to change without notice. HSBC and its affiliates and/or their officers, directors and employees may have positions in any securities mentioned in this document (or in any related investment) and may from time to time add to or dispose of any such securities (or investment). HSBC and its affiliates may act as market maker or have assumed an underwriting commitment in the securities of any companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis and may also perform or seek to perform banking or underwriting services for or relating to those companies. This material may not be further distributed in whole or in part for any purpose. No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. (070905)

In Canada, this document has been distributed by HSBC Bank Canada and/or its affiliates. Where this document contains market updates/overviews, or similar materials (collectively deemed "Commentary" in Canada although other affiliate jurisdictions may term "Commentary" as either "macro-research" or "research"), the Commentary is not an offer to sell, or a solicitation of an offer to sell or subscribe for, any financial product or instrument (including, without limitation, any currencies, securities, commodities or other financial instruments).