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ASIA/PACIFIC

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Downunder Daily

Canary Down 2 Coal Mines

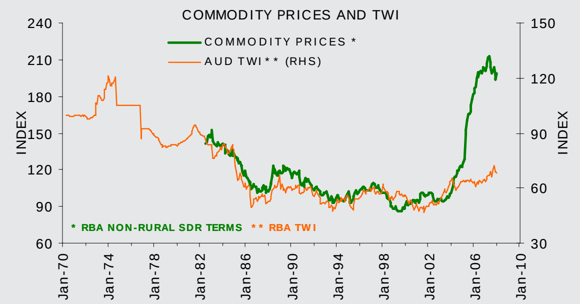
I expect two bearish trends to intensify this year: The growth slowdown will likely go global, and the credit crunch will intensify. Many financial variables will be affected by one or the other of these trends, but there is one financial variable that looks particularly vulnerable to both: the A$.

Historically, the A$ has been viewed as a barometer of global growth, and has been correlated with industrial commodity prices. That correlation has fallen in recent years (Exhibit 1), but the link – actual or perceived – remains important within currency markets.

It certainly remains the case that the A$ does well when risk appetites are expansive. As noted by Stephen Jen, our global head of FX research, this is also when the US$ tends to under-perform as investors seek higher returns elsewhere. The flip side, however, is that when risk appetites contract, the US$ does better – and the A$ tends to suffer. The inverse link between the A$ and the US$ is obvious from Exhibit 2. (The US$ is measured by the DXY index, which is a basket of six currencies. Note that the A$ has a beta of around 1.2 relative to the DXY index – so when the US$, on this measure, falls by 10%, the A$/US$ cross rises by 12% on average.) In a year of diminishing risk appetite, Stephen expects the US$ to strengthen. This is a setting where the A$ will fall.

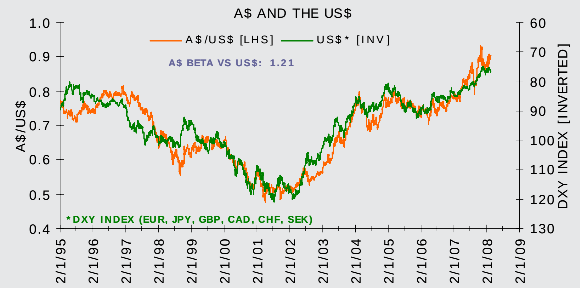
The second risk factor is the global credit crunch. Why should this affect the A$? Remember that Australia has a current account deficit of almost 6% of GDP, despite the boom in commodity prices and the terms of trade (export prices relative to import prices) hitting a 50-year high. The external deficit is overwhelmingly funded by foreign purchases of Australian debt. Foreign portfolio debt inflows were 7½% of GDP over the year to September (latest available data).

Exhibit 1
The A$ Follows Commodity Prices…



Source: RBA; Morgan Stanley Research

Exhibit 2
…And Goes the Other Way to the US$

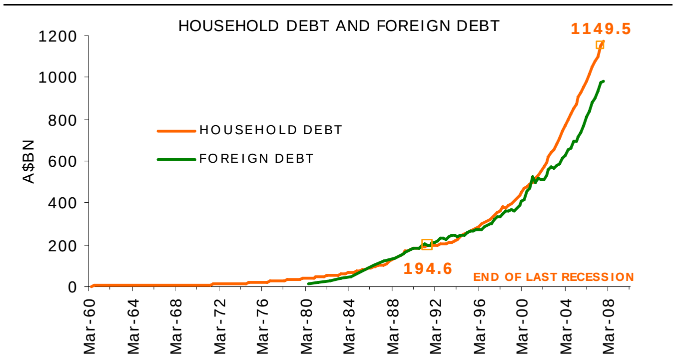


Source: Bloomberg; Morgan Stanley Research

Money is fungible, but the principal end-user of this largesse is clear: the Australian household sector. Australia's households are significantly more leveraged than America's: The debt/income ratio in Australia is 196%, versus 138% in the US. The escalation in household debt over the past 15 years has broadly matched that in Australia's foreign debt (Exhibit 3).

Exhibit 3

Households Borrow, Foreigners Lend

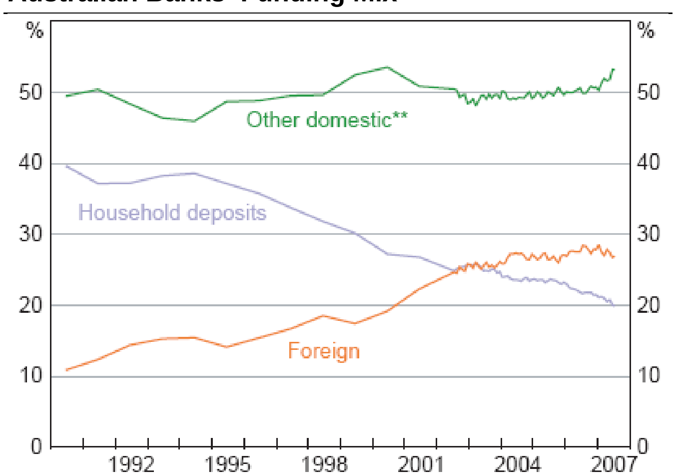


Source: ABS; Morgan Stanley

Australian households don't borrow direct from overseas; they borrow from the banks. Australia's banks now rely heavily on capital markets for funding. As Exhibit 4 shows, households' deposits have fallen from 40% of banks' funding in 1990 to 20% now. Much of that decline has been matched by a rise in foreign-sourced capital. In fact, financials now dominate the stock of Australian bonds held by foreigners (with a large part of the rest being asset-backed securities) (Exhibit 5).

Exhibit 4

Australian Banks' Funding Mix*

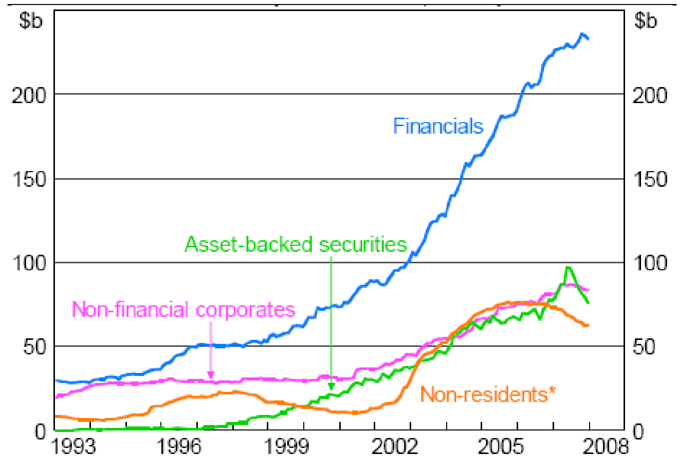


* All banks (domestic operations, on-balance-sheet). Annual data up until June 2002, monthly data since. ** Mainly debt securities and business deposits
Source: ABS, APRA, RBA; Morgan Stanley Research

The heavy reliance on foreign capital for bank-issued debt is, in the midst of a global credit crunch, a key risk for the Australian dollar. For now, banks have faced a moderate increase in costs, but are able to continue issuing paper.

Exhibit 5

Australian Bonds On Issue Offshore*



* All currencies, except for non-residents, which is A$-denominated issuance only.
Source: RBA, ABS; Morgan Stanley Research

The same is not true of asset securitisers. Securitisers' foreign debt outstanding fell in the September quarter. The A$ fell sharply mid-quarter, declining 10 cents against the US$. The funding shortfall was largely made up by a decline in Australia's foreign reserves, from A$64.9bn to $44.0bn at quarter-end, reflecting an unwinding of FX swap positions. (The RBA has disputed this interpretation, and did so again in yesterday's *Monetary Policy Statement*. The Bank argues that FX swaps have no impact on FX rates. It says it uses currency swaps as a replacement for domestic repos in managing domestic liquidity and rates. The Bank's argument therefore boils down to this conclusion (which we consider illogical): An interest rate repo affects interest rates, but an FX repo doesn't affect FX rates. In any case, the key point is that foreign demand for A$ debt dried up in Q3, so someone must have funded the capital because the accounts always balance.)

The A$ has since recouped the lost ground. But the A$ now faces two clear risks: a global slowdown weakening commodity prices and global capital markets' demand for financial-sector debt moderating. The catalyst for the decline may be when domestic financial markets begin to price the prospect of RBA rate cuts – something I expect to see (the prospect, not the actual cut) before year-end.

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