EXCHANGE RATES - WHERE NEXT?
WILL FLOATING RATES SURVIVE IN THE 1990s?

The 1980s could aptly be described as “the decade of the floating exchange rate”. The move to freely floating exchange rates accompanied a dramatic expansion in international capital flows. Daily foreign-exchange market turnover, for example, increased markedly. Although no figures are available for the early 1980s, daily turnover has more than doubled over the past three years to an estimated US$500 million in April last year. Trading in the Australian dollar now ranks sixth among all currencies. Sydney is the seventh-largest foreign-exchange centre.

The experiment, however, is viewed with increasing scepticism by many as having failed to ensure more stable economic conditions. Thus, pressures have risen for a return to some form of managed exchange rate regime in the 1990s. (In reality, of course, many countries have sought to manage their exchange rates, at least to some extent.)

The shift to floating exchange rates arose partly from the desire to insulate domestic economic conditions from external developments which, under a system of fixed exchange rates, were “absorbed” through the balance of payments and interest rates. But, while volatility in exchange rates has generally increased in the 1980s, it is difficult to find evidence of significantly reduced volatility in interest rates, especially for the smaller economies (see Figure 1).

This partly reflects the emergence of large, and apparently intractable, current account imbalances in the 1980s (Figure 2). Deficits in the US, UK and smaller economies such as Canada, Australia and New Zealand have contrasted with the mounting surpluses of countries such as Japan, Germany and the newly industrialising countries (NICs) of Asia. The need to finance these current account imbalances has resulted in very sizeable international capital flows, which, to some extent, have compromised domestic policy aims, particularly in relation to interest rates.

This trend has also been reflected in the relative strength of the Japanese yen and the deutschmark and the diminution in the role of the US dollar in international payments. This has been associated with the rapid expansion of regional trade; for example, trade between countries in Asia is quite commonly based in yen, and the deutschmark is the dominant single currency in Europe.

What, then, is the outlook for the 1990s?

Whether under a managed or freely floating exchange rate system, economic stability will only be achieved if there is a resolution – or at least a substantial moderation – of external imbalances and greater international co-ordination of economic policies. Some progress on the latter has been achieved among the major industrial nations over the past few years, but it is still evolving. Moreover, additional strains will result from recent...
developments in Eastern Europe and moves to strengthen regional economic arrangements such as through the 1992 unification of the European Community.

Meanwhile, the development of currency (and trading) blocs is likely to proceed. The EMS (European Monetary System), for example, will assume a greater role with the expected inclusion of sterling. A single currency for Europe, however, is unlikely for many years, although the ECU (European Currency Unit) has assumed an increased role in trade and other transactions. Asia could well develop as a yen trading zone in the 1990s, although more formal economic integration is unlikely, given the diversity of economies within the region. Economic integration in North America (the US, Canada and, eventually, Mexico) is more likely, however.

Nevertheless, the return to a fixed exchange rate regime appears most unlikely in the coming decade. The more determined management of exchange rates which emerged in the later years of the 1980s, as a part of international policy co-ordination, will certainly continue and probably become more formalised.

The $A does not fit naturally into any of the currency arrangements likely to develop in the 1990s. Our overseas trade is diversified with Japan, the US, the Asian NICs and Europe all important destinations for our exports. The $A, therefore, should continue to float more-or-less freely. This is also appropriate since most of Australia’s exports are commodities whose prices are determined in international markets.

The outlook for individual currencies in the 1990s will depend on underlying economic conditions and the relative stance of economic policies. Countries with large current account deficits will have depreciating currencies, and vice versa. The $A, therefore, can be expected to remain under downward pressure well into the 1990s. Major structural reforms will be necessary to reduce Australia’s entrenched current account deficit and eventually stabilise our external debt. These will take time to implement.

On the other hand, continued economic co-operation between the industrial economies provides some hope that external imbalances and instability between the major currencies will diminish through the 1990s.

\[ \text{The Australian dollar does not fit naturally into any of the currency arrangements likely to develop in the 1990s.} \]