



FX Daily

Flow fallacies and the AUD

Could 'flows' push the AUD to parity?

In the dozen charts over the page and the text below we break down the capital flows data and show that flows are simply a function of underlying fundamentals. On that basis we conclude that 'flows' will only push the AUD through parity if you believe that: the mining investment boom will return; or the interest rate differential between Australia and the US will return to the levels seen in 2012 (which would require ~100 bps of rate hikes in Australia); or credit growth will accelerate dramatically (or some combination of the above). None of these events are likely in our view.

Decomposing flows

In Figure 1 (all charts are over the page) we show there has been a solid relationship between the basic balance (current account + net FDI and portfolio flows) and the AUD TWI over the past decade or so. Looking at the flows in a little detail we see that inbound FDI flows are the major driver of net FDI flows (Figure 3); while Figure 4 shows that the same is true for portfolio flows. Decomposing the portfolio flows a little more we find that the major driver of inbound flows are inbound debt flows (Figure 5); with the major driver of inbound debt flows usually flows into banks (Figure 6). That said, flows into government bonds did run at higher than average levels over 2010 to mid 2012 - also shown in Figure 6. Figure 7 shows that inbound FDI and inbound portfolio debt flows do indeed account for most of the volatility in net FDI and portfolio flows. So, if we could forecast inbound FDI and inbound portfolio debt flows then we should be able to get a good handle on what trends are likely across net portfolio and FDI flows as a whole.

Underlying drivers of FDI and portfolio flows

In Figures 8 & 9 we show that over recent years there has been quite a tight correlation between business investment growth and inbound FDI flows. (The increased tightness of the 'fit' in recent years reflects the fact that the mining sector is dominating the business investment cycle.) In Figure 10 we show that there is a solid long run relationship between flows into bank debt and credit growth. And in Figure 11 we show that there is nothing mystical about flows into government debt - *they have for about 20 years now simply reflected interest rate differentials*. (As an aside, we have always found it a little odd that flows into government bonds are often seen as having some extra-ordinary ability to put more upward pressure on the AUD than other flows...)

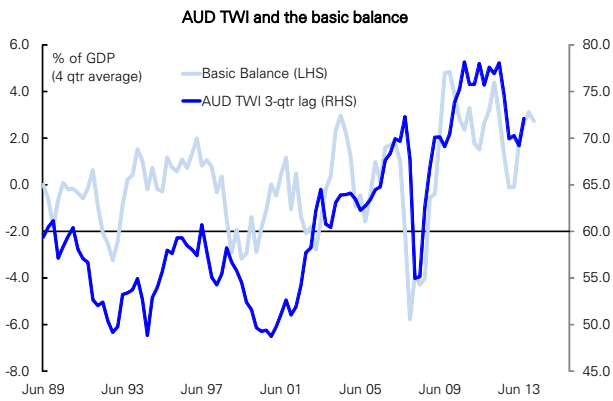
Forecasting flows

Given our expectation that business investment will fall over coming years as the mining investment boom gives way, we think inbound FDI flows are likely to drop (based on the relationship shown in Figures 8 and 9). On portfolio flows, Figure 11 suggests that *less* inflow into government bonds is likely (especially if the RBA tightens after the Fed and the interest rate differential narrows further, as we expect). Finally, Figure 10 suggests that in the absence of a sharp increase in credit growth, an increase in flows into the banking sector is also unlikely.

With these components being the predominant drivers of total net portfolio and FDI flows, it therefore seems unlikely to us that the 'flows picture' will evolve in such a way to push the AUD either to, or through, parity.

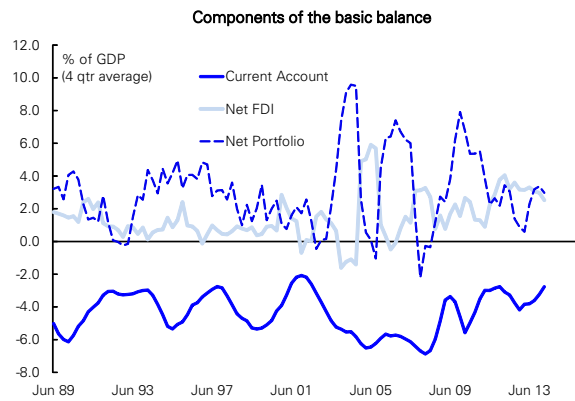


Figure 1: The AUD TWI versus the basic balance



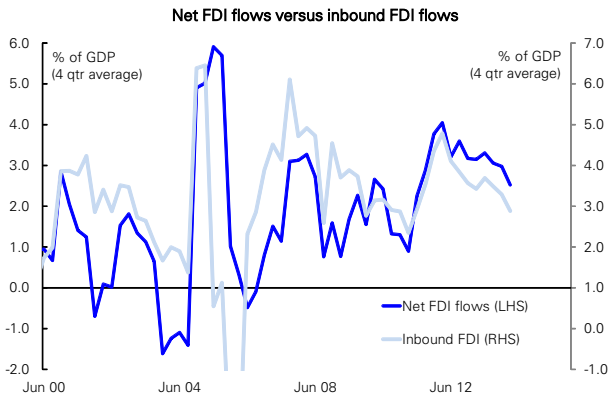
Source: Deutsche Bank, ABS, RBA

Figure 2: Components of the basic balance



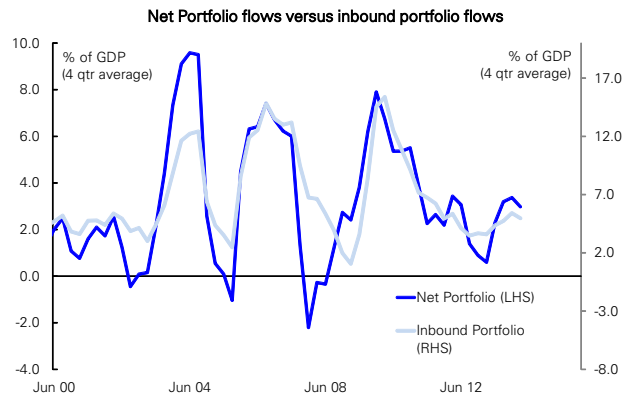
Source: Deutsche Bank, ABS

Figure 3: Inbound FDI flows are the major driver of net FDI flows ...



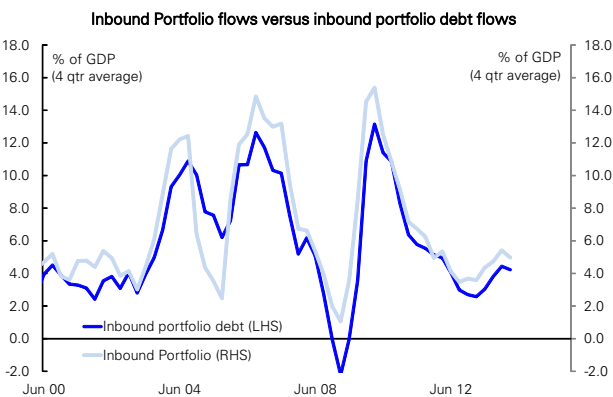
Source: Deutsche Bank, ABS

Figure 4: ... and inbound portfolio flows are the major driver of net portfolio flows ...



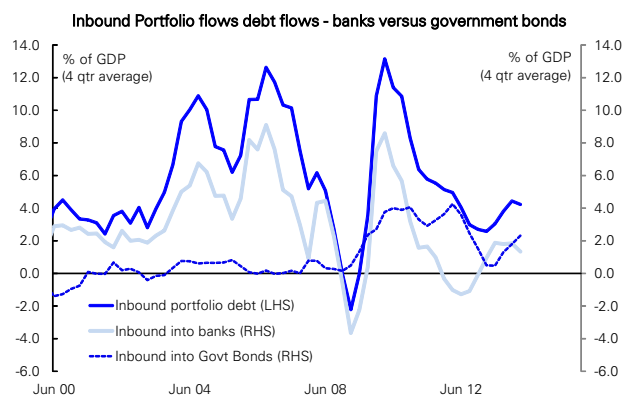
Source: Deutsche Bank, ABS

Figure 5: ... with inbound portfolio flows driven by inbound debt flows ...



Source: Deutsche Bank, ABS

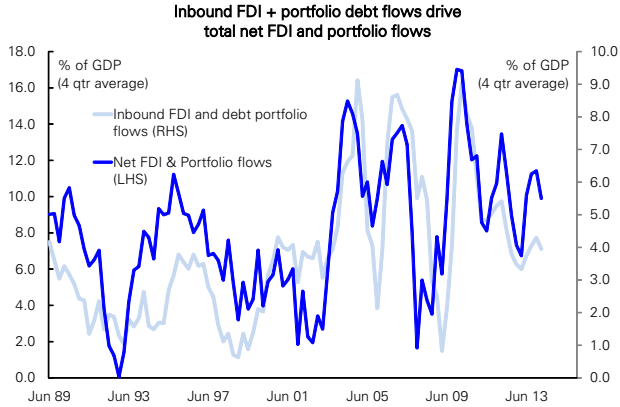
Figure 6: ... reflecting flows into banks, & more recently government bonds.



Source: Deutsche Bank, ABS

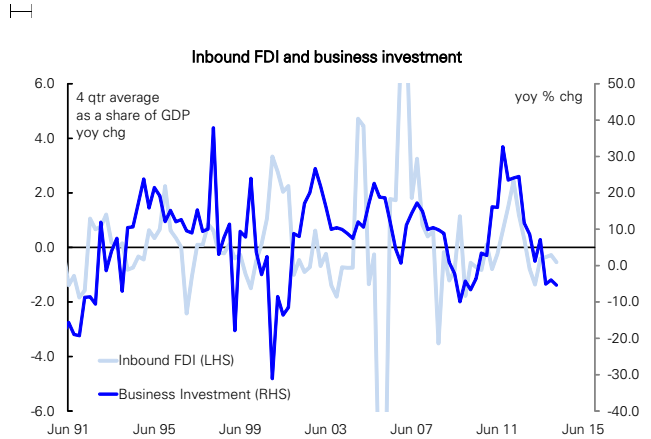


Figure 7: That means inbound FDI + inbound debt portfolio flows drive variations in net FDI and portfolio flows.



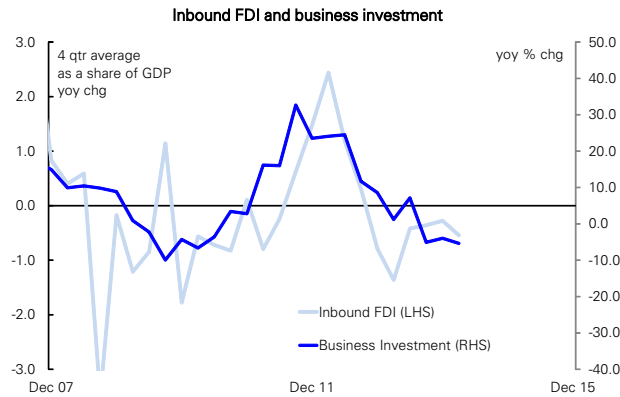
Source: Deutsche Bank, ABS

Figure 8: There is some relationship over the long run between inbound FDI flows & business investment ...



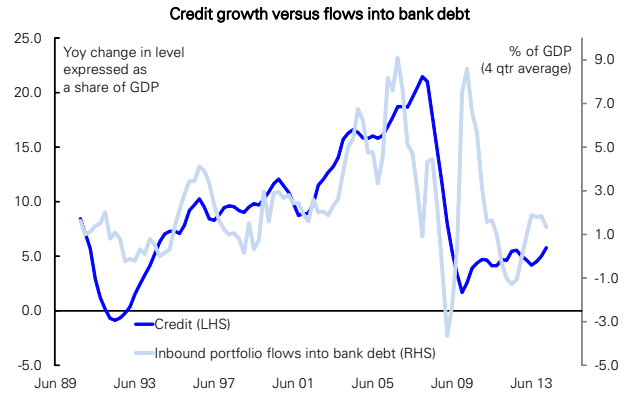
Source: Deutsche Bank, ABS

Figure 9: ... which has become tighter in recent years ...



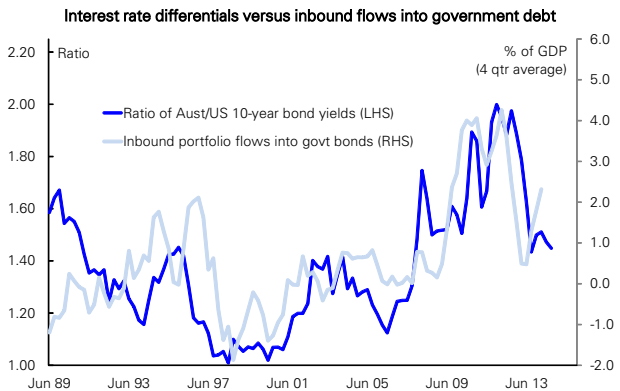
Source: Deutsche Bank, ABS

Figure 10: ... while inbound flows into bank debt have tracked credit growth over the long run ...



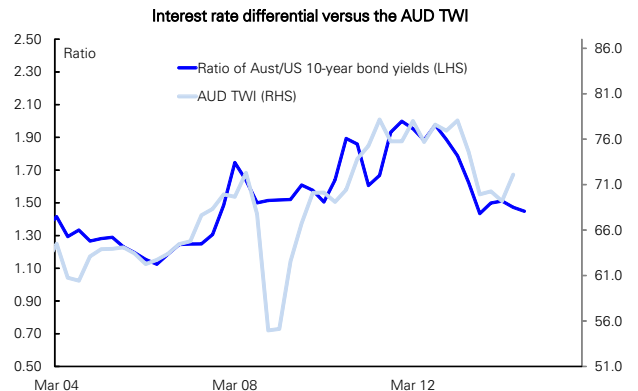
Source: Deutsche Bank, ABS, RBA

Figure 11: ... and inbound flows into government bonds simply reflect interest rate differentials.



Source: Deutsche Bank, ABS, Bloomberg Financial LP

Figure 12: Which invites the question: how much more have flows really told us over the past decade?



Source: Deutsche Bank, Bloomberg Financial LP, RBA