
A fresh look at the merits of a currency union

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This article provides an update on the ongoing debate as to whether New Zealand should enter into a currency union with Australia. While the decision to adopt a common currency would ultimately be a political one, assessing the specific economic costs and benefits is important for informed debate. Theoretical developments in the currency union literature and the experience of actual currency unions are both relevant considerations. Experience with the European Monetary Union has focussed attention on the 'endogeneities' of optimal currency areas, where a common currency can be the catalyst for further economic integration between member states. However, the jury is still out on this front. Since our last review in 2001, there has also been some further local research looking at how a common currency might influence the New Zealand economy, but the implications of this research remain inconclusive. The case for a common currency for New Zealand and Australia, at least in economic terms, continues to be open for debate.

1 Introduction

The pace of economic integration between New Zealand and Australia has intensified over the last decade or so, as trade and investment flows deepen and regulatory practices become increasingly harmonised. Trans-Tasman economic integration reflects a regionally specific process of cooperation that began with the New Zealand Australia Free Trade Agreement (NAFTA) in 1966 and more significantly with the signing of the Closer Economic Relations (CER) agreement in 1983. Regional economic integration is also the counterpart to a broader, and more recent process of financial and economic integration embodied in the ubiquitous term 'globalisation'.

A natural question to ask is whether the full benefits of economic integration that have developed between New Zealand and Australia can be realised without a common currency. Indeed a common currency may be a catalyst for deepening the process of economic integration already well underway. Alternatively, one must also be cognisant of the economic costs of giving up one's national currency and the ability to pursue an independent monetary policy that an individual currency provides.

This article is the third in a series of periodic reviews of the currency union debate, following Björkstén (2001) and Hargreaves and McDermott (1999). The Reserve Bank takes no specific position for or against Trans-Tasman currency union per se. Rather, by reviewing both the academic and empirical literature we hope to contribute to an informed economic

debate in the New Zealand context. Ultimately however, any decision to enter into a currency union arrangement with Australia will be a political one, heavily influenced by the government of the day's vision for economic and political cooperation between the two countries.

In the next section we provide a brief overview of exchange rate regimes in general, and the traditional arguments for and against a currency union in particular. Section 3 then examines some of the insights that can be gathered from the first few years of the euro's existence. Europe's monetary experiment has precipitated a rethinking of the earlier literature assessing the costs and benefits of currency unions, while sparking a renewed interest in single currencies at a policy level. The New Zealand specific-context is then discussed in section 4. This is complemented by New Zealand focussed research undertaken since the publication of the last review. The conclusion at that time was that the "existing exchange rate system is viable and successful" (Björkstén 2001, p. 53). There is little reason to depart from this conclusion since the economic 'evidence' for or against a Trans-Tasman currency continues to be far from definitive either way.

2 Costs and Benefits of a Common Currency

At present, approximately three quarters of all independent countries have their own currencies.¹ The remaining 25 per cent either share a common currency via a monetary union, or have adopted the currency of another sovereign country – termed ‘dollarisation’.²

The decision to give up using one’s own currency and enter into a currency union – thereby irrevocably fixing one’s own currency – represents one end of an exchange rate continuum, with flexible regimes at the other. As figure 1 illustrates, in between the polar opposites of fixed and flexible exchange rate regimes lie a variety of intermediate regimes with varying degrees of intervention required to

Table 1

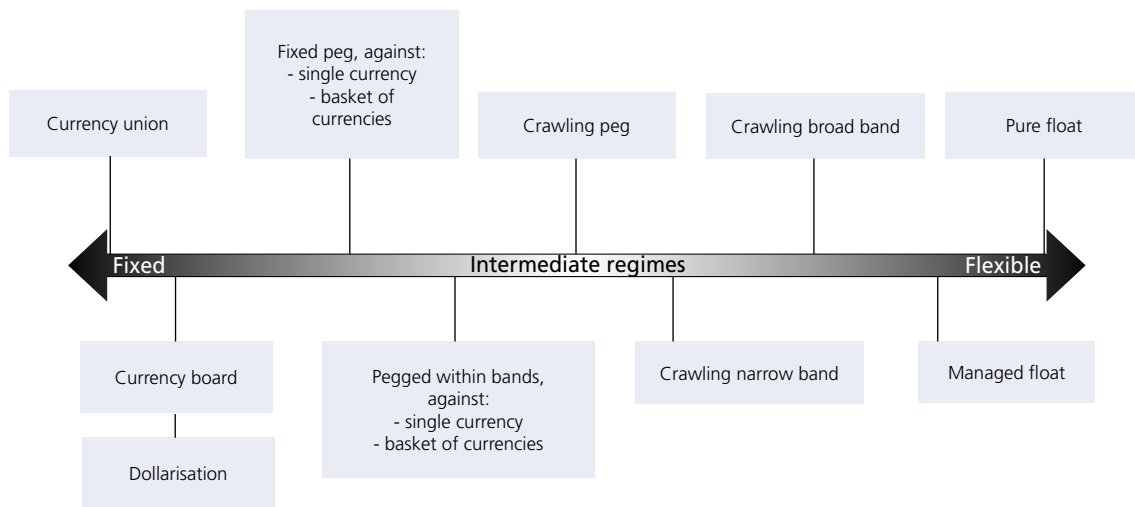
Sovereign Currencies

Sovereign countries with own currency	145	75.5%
Sovereign countries sharing a currency	32	16.7%
Fully ‘dollarised’ sovereign countries	15	7.8%
Number of independent countries	192*	100%

* 191 members + Vatican City

maintain a currency’s value.³ The particular exchange rate regime influences the various economic policy objectives that can be pursued. Economists often speak of the ‘impossible’ or ‘unholy trinity’. This says that a country cannot simultaneously have free capital mobility, a fixed

Figure 1
Exchange rate regimes



¹ An independent country is defined here by membership of the United Nations, plus the Holy See (Vatican City), which although not a member of this international organisation, is generally considered to be the smallest independent nation-state. There are other inevitable definitional grey areas as to what constitutes sovereignty, with Taiwan a prime example.

² At present there are four examples of currency unions using a shared currency – the 8 country Eastern Caribbean Currency Area (ECCA) formed in 1983; the 12 country euro zone; and 2 separate franc zones in Africa comprising 14 countries, both established in 1945. The majority of independent ‘dollarised’ countries use the US dollar. In addition, there are many non-sovereign countries which

may or may not have their own currencies. For example, Hong Kong, which is now part of China, continues to use its own currency the Hong Kong dollar which is fixed against the US dollar. By contrast, the many small overseas territories or dependencies of sovereign states tend to adopt the currency of their sovereign. The Cook Islands, Niue and the Tokelau, for example, all use the New Zealand dollar. The French dependencies in the South Pacific – French Polynesia, New Caledonia and Wallis and Fortuna – all share the CFP franc issued in Paris.

³ See the appendix for a brief description of alternative exchange rate regimes.

exchange rate, and operate an independent monetary policy directed toward domestic goals. A country which enters into a common currency arrangement, for example, gives up the ability to use domestic monetary policy instruments directed toward stabilising inflation or attaining full employment. By contrast, a country which wants to stabilise both the exchange rate and the domestic economy must impose some form of capital controls.⁴

The costs and benefits of various economic policy objectives that are traded off in the respective choice of exchange rate regime, therefore come to define the nature of any given debate. In the context of the common currency issue, this is reflected in debate over the net benefits (costs) of exchange rate stability versus the costs (benefits) of giving up monetary independence. Table 2 below summarises the costs and benefits traditionally ascribed to a common currency. Entering into a common currency arrangement reduces both the uncertainty associated with exchange rate movements vis-à-vis other partner countries, as well as eliminating the costs associated with dealing in multiple currencies. These microeconomic efficiency gains may also be matched by macroeconomic benefits in the form of lower interest rates and lower inflation rates.

But joining a currency union, whether a fully fledged monetary union like EMU, or through dollarisation, comes with a cost. An individual economy no longer has at its disposal tools to manage monetary policy directed at domestic objectives. In this regard it no longer manages inflation, nor can it use monetary policy to respond to macroeconomic shocks it faces. Indeed one of the virtues of a floating exchange rate is that it acts as a shock absorber for terms of trade shocks – that is, depreciating when an economy faces a negative demand shock from the rest of the world for example. However, if all countries within a currency union face the same shock, then the cost of losing domestic monetary policy is less of a concern, since the central bank’s response in terms of changing interest rates will be appropriate for all member states. It is when a member state faces ‘asymmetric shocks’ – shocks that affect it differently from other member states – that the relative costs of giving up an independent monetary policy will be apparent. Asymmetric shocks can occur due to different production and consumption structures across countries, or differences in the degree of exposure to international trade. In addition, a common global shock could still have differential effects on members within a currency union

Table 2
Costs and benefits of a common currency

Benefits	Costs
<ul style="list-style-type: none"> • Ties domestic inflation to partner’s inflation/or targeted currency area inflation rate – establishes an anchor for monetary policy and imports credibility. • Decreases transaction costs. • Improves microeconomic efficiency by increasing price transparency between partners. • Eliminates costs associated with exchange rate uncertainty vis-à-vis partner countries – eg hedging. • Can reduce the risk premium on interest rates in home country – currency and inflation risk. • Catalyst for further economic integration – endogenities. • Protects against domestic lobbies promoting ER manipulation. • Reduces risk of speculative attack on home country currency. 	<ul style="list-style-type: none"> • Loss of ability to maintain an independent inflation rate. • Loss of exchange rate adjustment to terms-of-trade, and other shocks. • Shocks to partner countries can get transmitted to home country. • Loss of national sovereignty. • Weakened accountability of policy makers to national citizenry. • Loss of seigniorage (under dollarisation). • One-off changeover costs.

⁴ In the aftermath of Asia’s experience during the currency crisis of 1997/98 many have questioned the efficacy of intermediate exchange rate regimes. This episode illustrated how economies with fixed but adjustable exchange rates could become more susceptible to currency speculation. In this regard, there is an

emerging consensus on the need for a ‘corner solution’ or ‘hollowing-out’ of exchange rate regimes (Wyplosz 2001, p. 124). Countries should choose either float their currencies or enter into fixed arrangements like currency boards, dollarisation, or monetary union.

owing to differences in the flexibility of product and labour markets or other regulatory differences.

Until 1999 and the creation of the euro, any weighing up of the costs and benefits of a common currency, at least in terms of full monetary union, was largely a theoretical exercise. Neither the two franc zones in Africa formed in 1945, nor the Eastern Caribbean Currency Area (ECCA) formed in 1983 proved particularly illustrative for developed economies such as New Zealand. The European monetary experiment however, has become an important marker in the common currency debate, both in terms of its technical and operational success or failure, and the way in which it influences theoretical discussions of optimal currency areas. Moreover, as Grimes notes in the context of the New Zealand debate, “[t]he economic and political success of the euro might influence the direction in which these matters evolve over the coming decade” (2002, p. 289).

3 Lessons from the Euro zone

EMU: overview

The euro came into existence in 1999 amid much fanfare as the final stage in a somewhat long, erratic and laborious process of economic integration in Europe that began back in the 1951 with the establishment of the European Coal and Steel Community. In many ways economic and monetary union (EMU) represents a pragmatic response to the wider process of economic and political integration, where exchange rate stability came to be viewed as an integral plank in the commitment to increasing trade between member states.

President of the European Central Bank (ECB) Jean-Claude Trichet has recently remarked “...the full benefits of the European common market could not be realised without the single currency”. In other words, a single currency can be seen as the catalyst for further integration - a win-win for all euro zone members.

However, this is certainly not a universally held view. Within Italy for example, there has been a significant groundswell against the euro and even calls to bring back the Italian lira. Much of this dissatisfaction has arisen because monetary

conditions set for the Euro area as a whole appear too have been too tight from an Italian perspective given that Italy is in recession.⁵ Under a currency union, the country no longer has the option to foster a competitive devaluation via nominal exchange rate adjustment or reduce interest rates since these are now set in Frankfurt.

Hence the familiar tension between macroeconomic stabilisation and microeconomic efficiency is clearly apparent in the current rhetoric. But what the ECB president’s remarks also point to is that the relative costs of losing one’s monetary policy maybe lower if a single currency can unleash endogenous forces of deeper economic integration.

Endogeneities of optimal currency areas

The evolution of European economic integration has been shadowed by the development of a theoretical apparatus within which to assess the economic merits of irrevocably fixing one’s exchange rate and entering into monetary union.⁶ This ‘optimal currency area’ (OCA) literature has outlined necessary common properties or conditions among prospective member countries for any proposed currency area to be regarded as economically viable. These properties include:

- Price and wage flexibility;
- Mobility of the factors of production;
- Financial integration;
- A degree of economic openness;
- Similarity of inflation rates;
- Diversification of production and consumption structures;
- Fiscal integration, and;
- Similarity of shocks and some degree of political integration.

According to the OCA, the need for individual floating currencies and independent monetary policies is reduced

⁵ Part of the criticism involves the allegation that when Italy’s exchange rate was irrevocably fixed in 1999 it was set at too high a rate.

⁶ For a useful overview of this literature see Mongelli (2002).

when countries share these properties. For example, if wages and prices are flexible then it is less likely that any disturbance or shock to any economy will result in sustained unemployment or loss of output. When the exchange rate is fixed there is no nominal exchange rate adjustment so the onus is on the real side of the economy to adjust. Significant nominal price and wage rigidity therefore increases the cost of losing the exchange rate as an adjustment mechanism. Financial market integration and fiscal integration both imply risk sharing mechanisms (private and public respectively for negative shocks that might affect one or more members of a currency union. In the former capital can flow more efficiently across members, while fiscal transfers can mitigate the effect of asymmetric shocks via a common supranational fiscal authority.

The traditional OCA literature saw these properties as prerequisites for the formation of a common currency, although the relative importance of each property was hotly debated. By contrast, 'new OCA theory' suggests that these properties should be thought of as characteristics that may well emerge ex post, following the formation of a common currency. In other words, a common currency area may become optimal with the passage of time. According to Mongelli (2002) this notion has shifted the overall balance in favour of currency unions vis-à-vis maintaining an independent monetary policy.⁷

In this regard, initial assessments of the progress of the euro have come to focus on the degree to which the euro area may be taking on the properties of an optimal currency area over time⁸ De Grauwe and Mongelli (2005) state in their overview paper, the evidence points to "moderate optimism" on this front (p. 29). Nevertheless, the authors

acknowledge that the European monetary project is in its infancy preventing firm conclusions on this front.

The catalyst for this reworking of traditional OCA theory came from Andrew Rose and Jeffrey Frankel's research on the relationship between currency unions and reciprocal trade. The 'Rose effect', as it has come to be known, suggested that the mere act of forming a common currency could increase trade between member countries by 200 per cent, or 3 times more than without a common currency. Moreover, the authors posited a positive correlation between trade integration and income growth, which suggests that common currencies are a vehicle for higher standards of living. According to the OECD, a 10% per cent increase in the trade to GDP ratio increases GDP per capita by 4 per cent (Cotis 2004).

Many economists, surprised by the magnitude of the Rose effect, have set about pruning the results, focussing on the nature of the sample countries used to generate the results, and specific econometric issues related to model specification.⁹ In terms of the Euro zone, Baldwin (2005) argues that some form of the Rose effect is occurring, but probably more in the order of a 5-10 per cent increase in intraregional trade (p. 41) – much smaller than the seminal Rose effect, but significant nevertheless.¹⁰ Possible explanations for the effect include the obvious reduction in transaction costs (conversion of currencies and hedging for example) increasing the volume of exports per firm, heightened competition among euro area firms via greater price transparency, and the increased number of firms engaged in exporting within the Euro zone as a result of the elimination of exchange rate uncertainty.

The removal of borders associated with multiple currencies creates other 'endogeneities' including changing the price setting and inflation process, fostering financial integration, greater symmetry of shocks and business cycle

⁷ This point is reinforced by current monetary policy orthodoxy which states there are long run neutralities associated with monetary policy. Monetary policy in the long run can only affect prices and the inflation rate as opposed to real economic variables such as output and employment. Hence the cost of giving up national monetary policy sovereignty is a short run cost at best. In addition there are question marks about the nominal exchange rate as an adjustment mechanism. If for example, the nominal exchange rate becomes a source of shocks rather than a buffer then the loss of this mechanism becomes less important.

⁸ See in particular the collection of papers from the ECB workshop 'What effect is EMU having on the euro area and its member countries', held 16 June 2005. These are available from their website at www.ecb.int.

⁹ See Baldwin (2005), Kenen (2002) and Smith (2002) for discussion of many of these issues.

¹⁰ As de Grauwe and Mongelli (2005) note, it is unclear how much of the purported trade creation effects come from the Single Market programme as opposed to the introduction of the euro per se. In addition, any trade gains are likely to occur over a 15-20 year time frame, so initial estimates may understate the ultimate trade benefits of the single currency (p. 5-6).

synchronisation and promoting product and labour market flexibility.

Price setting and inflation dynamics

By eliminating any differences in the units of accounts between members, the euro potentially makes the price system more efficient and transparent, thereby changing the way prices are set and the behaviour of aggregate inflation over time. By enhancing price transparency and price comparison for example, the euro could be a trigger for promoting price level convergence across the Euro zone, more price flexibility and the reduction of discrepancies in the size and frequency of price changes within some sectors across the Euro zone. (Angeloni, Aucremanne and Ciccarelli 2005, p. 26). Moreover, the ECB's mandate of price stability could decrease the persistence of inflation due to more firmly anchored expectations around a targeted low and stable level. In turn this could reduce inflation differentials between members of the Euro zone.

Evidence of an EMU effect is tentative at best. In terms of the frequency, size and sign of price changes, there is no clear evidence of a change since 1999, when the euro was introduced.¹¹ Similarly there is no evidence of any change in inflation persistence either (which decreased in the pre-EMU years). That said, structural changes in the price formation process that occurred before the euro's introduction could still have been caused by it given private sector expectations and policies designed to prepare each member country for EMU. Similarly, inflation differentials between member countries were significantly lowered over the course of the 1990s, but have increased slightly since the euro was introduced.

Financial Integration

Financial integration encompasses an assortment of financial instruments, financial intermediaries and a market segments. Financial market integration in this sense implies that potential market participants (with the same characteristics), face a single set of rules across the euro zone, have equal access

to a set of financial instruments or services, and are treated equally when in the market (de Grauwe and Mongelli 2005, p. 18). An integrated financial market provides insurance against shocks that affect member countries differently, by improving the interregional allocation of capital, and therefore reduces the costs of giving up national monetary policy sovereignty.

In essence, financial integration facilitates cross-country asset holdings which can act as a risk sharing mechanism. By holding claims to dividends, interest income and rental revenue in other countries of the currency area, residents provide themselves with ex ante insurance against shocks, provided these are imperfectly correlated across the member countries. In addition, an integrated financial market enables better ex post adjustment in response to income fluctuations, where residents can more easily buy/sell assets or borrow/lend in credit markets in order to smooth transitory shocks.

Some progress has been made toward financial integration within the Euro zone, particularly in the bond and money markets.¹² But it is far from a unified market (de Grauwe and Mongelli 2005, p. 22).

Symmetry of shocks and business cycle synchronisation

In the OCA literature the extent to which individual members of a currency union face similar supply and demand shocks is somewhat of a catch-all to encompass the net costs and benefits of monetary policy autonomy. When an economy experiences a shock it can respond in various ways via wage and price changes, changes in the demand and supply of factors of production such as labour or through the nominal exchange rate. As we noted earlier, this adjustment process depends on the degree of wage and price flexibility, labour mobility and the degree of risk sharing or insurance. If an individual country does not have policy autonomy, and these other adjustment mechanisms do not work well, then various shocks impacting the currency area could have a potentially detrimental impact on economic activity in the country concerned.

¹¹ There is some evidence of a cash changeover effect in 2001 however on price adjustment.

¹² For a discussion see Cappiello et al (2005).

The extent to which asymmetric shocks exist within a currency union is determined by the general co-movement of economic activity between member countries. This in turn is influenced by the relative exposure to extra-union trade, the degree of intra-regional trade, the degree of diversification in production of each country and the similarity of consumption patterns across the currency area. If production is diversified - an economy produces a bit of everything - then this dilutes the impact of shocks specific to any one sector. If, on the other hand, an economy specialises in the production of few goods and services, then this accentuates the impact of shocks.¹³

In Europe members states have similar consumption patterns, the diversification of production is reasonably high and business cycles have become more synchronous over time (Giannone and Reichlin 2005, MPC Taskforce 2004). However, the degree of specialisation in the US between states or regions is far higher. As Partridge and Rickman (2005) note, no one questions that the US is not an example of a successful currency union, despite the fact the US regional business cycles have become more idiosyncratic over the last 30 years. So it may be that the role of asymmetric shocks in the debate about the costs and benefits of a common currency has been overplayed (p. 375).

In other words, a common currency could promote more or less diversification (more specialisation) of production structures – and it is too early to prejudge the outcome. As the US example highlights, regions within the US have become more different over time in what they produce and so their business cycles have become less synchronised. All else equal, this would magnify the differential impact of economic shocks. Given that the Federal Reserve does not target monetary policy on a geographic basis, other adjustment mechanisms must operate to ameliorate these asymmetric shocks. These include local and state level fiscal policy, high interregional labour mobility and a highly integrated financial system that provides the insurance function described above. De Grauwe and Mongelli (2005) suggest it is too early to tell whether Euro zone economies will become more specialised over time. However, the

important point to note here is that “[a] common currency could be shared by countries subject to idiosyncratic shocks as long as they ‘insure’ one another through private financial markets” (Mongelli 2002, p. 13). Financial integration may even promote specialisation. This relationship between economic integration and business cycle synchronisation is shown in the figure opposite.¹⁴

Product and labour market flexibility

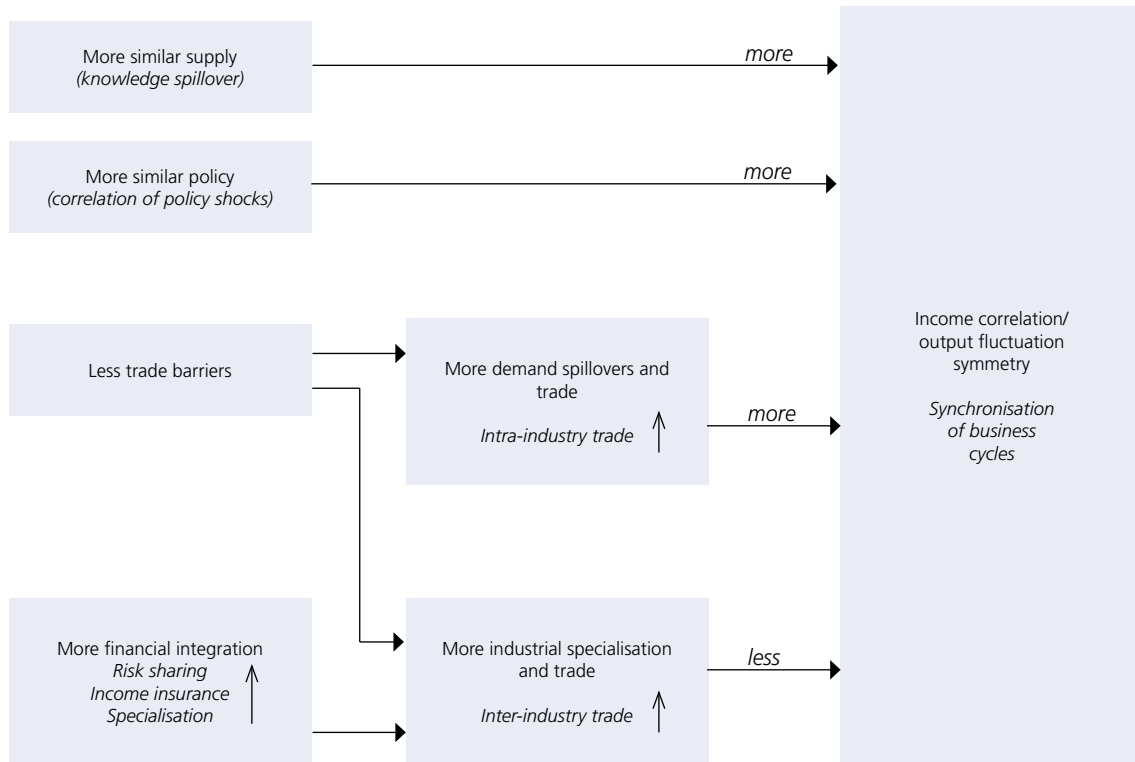
Another OCA property that has been identified as important in reducing the costs of giving up a national currency and independent monetary policy is flexibility in both labour and product markets. The way wages and prices respond to both common and idiosyncratic shocks and how factors of production are reallocated as a consequence, will determine how painful any adjustment process will be for the economy as a whole. The issue of structural reforms is high on the EU’s agenda given persistently high unemployment, weak productivity growth and low labour force participation. Indeed it has been suggested the Euro zone economies have been much less resilient to recent global shocks such as the IT tech crash, terrorist attacks and high oil prices, than a number of other economies such as New Zealand (Duval and Elemskov 2005, p. 3).

A key question is the extent to which EMU will promote or reinforce existing measures directed at structural reform in the area. On this front, Duval and Elemskov argue that, conceptually at least, the euro could be ambiguous for the pace of product and labour market reform. On the one hand, with an independent monetary policy and the nominal exchange rate no longer available to facilitate adjustment, this could act as an incentive to strengthen wage and price responsiveness to changes in demand and supply conditions. This market based adjustment is aided by the transparency created by a single currency where the costs of rigidities are more easily revealed. For example, if this transparency precipitates increased product market competition and lowers associated product market rents, then political opposition to reform may also be lower as there is less rent to be shared. This competition may also reduce the ability

¹³ On sectoral specialisation in the EU see the ECB’s MPC Taskforce publication (2004)

¹⁴ Taken from de Grauwe and Mongelli 2005, p. 23.

Figure 2
Economic integration and business cycle synchronisation



of labour unions to appropriate rents by lowering insider power, hence facilitating reform in the labour market.

On the other hand, EMU could hinder structural reform as it means the upfront costs of structural reforms are large within a currency union - a national government does not have the interest rate or exchange rate depreciation at hand to boost demand as the reform process adds supply capacity. This 'crowding in of added supply' takes longer within a currency union.

For Duval and Elemskov, it is difficult to draw any firm conclusions to-date about the relationship between EMU and the pace of structural reform. The intensity of reforms has softened somewhat since 1999, although the increase in the years preceding could be an expectational effect of EMU. In addition, this deceleration in reform intensity contrasts to non-EMU EU members for whom the pace of reform has remained constant (p. 22).

Euro Enlargement

The prospective enlargement of the euro zone to include the 10 new members admitted in 2004 crystallises a number of

issues discussed above. The 10 new members are obliged by the *acquis communautaire* to ultimately adopt the euro. Based on this agreement they must anchor economic policy with this end point in mind, although the precise timing of euro adoption is somewhat open ended. They must bring down inflation, promote real and nominal convergence, develop their financial sectors and ensure a sound monetary policy and exchange rate strategy.

In relation to the exchange rate stability, adoption of the euro involves a compulsory two year membership of an exchange rate mechanism known as ERM II. To avoid exchange rate volatility and to help anchor inflation expectations, member exchange rates will be allowed to fluctuate within a broad +/-15 per cent band. The philosophy behind ERM II is that it tests policy consistency and the appropriateness of the central parity rate as a permanent rate when the exchange is irrevocably fixed with euro adoption.

One issue that arises is how long the new entrants should wait before entering the final stage ERM II process. How far should these countries go in promoting trade integration with the euro zone and achieving cyclical convergence as

a means of satisfying the classical OCA properties, given the risks associated with asymmetric shocks. Jeffrey Frankel argues that some of these countries might have to wait up to 5 years before they are mature enough to qualify. But we have already noted the endogeneity argument where these countries could qualify ex post. The problem however, as the Chief Economist of the OECD Jean-Philippe Cotis argues, is that EMU has not stood the test of time. So there is a real possibility that these new members could be joining a sub-optimal currency area.

The second issue is how the new entrants will run monetary policy and what exchange rate regime is consistent with ERM II.¹⁵ Essentially monetary policy will be faced with multiple objectives of controlling inflation, keeping the exchange rate competitive and meeting the exchange rate stability criterion. This suggests that monetary policy is not unconstrained since parity against the euro must be more or less maintained for two years.

The recent rejection of a common currency by Denmark, Sweden and the UK, coupled with current dissatisfaction with the economic performance of the euro zone by members itself, clearly points to the fact that the case for a single currency is far from cut and dry. Moreover, with the rejection of the EU constitution by French and Dutch voters, a politics of scale is unfolding in Europe embodying the inevitable tension between national sovereignty and supranational control in an age of globalisation.

4 The Trans-Tasman Debate

The current state of the debate

In the New Zealand context the debate has ebbed and flowed with our own economic fortunes vis-à-vis Australia's. When we last reviewed the issues surrounding a common currency there was heightened public consciousness over a common currency. The Australian economy fared better than New Zealand's in the immediate period following the Asian crisis - which some attributed to differences in monetary policy. Grimes et al (2000) surveyed 400 firms in 2000, and found a majority in favour of an irrevocable link to Australian

dollar, particularly among smaller firms. Similarly a nationwide NBR/Compaq poll showed 45 per cent in favour of an Anzac dollar (but less support for dollarisation - i.e adopting the Australian dollar). Furthermore, comments by the new Labour government at the time hinted at the long-run inevitability of a common currency.

While a common currency is not part of the current Government's policy platform, debate on the merits of a common currency continues to wax and wane over time, partly depending on economic conditions. The basic economic arguments for and against a common currency continue to endure and frame the debate. Lower transaction costs and reduced exchange rate uncertainty from a single currency would enhance greater trade between the two economies, reinforcing existing policy efforts to increase integration. It is likely too that adopting Australian monetary conditions would reduce or eliminate the relative risk premium embedded in the New Zealand interest rate structure.¹⁶ That is, a single currency would eliminate the need to pay a currency risk premium for which international investors demand for holding assets in small, illiquid currencies such as the New Zealand dollar. This could lower the cost of capital facing New Zealand firms and hence boost investment.

On the flip side, higher interest rates could be thought of as the price we pay for independent monetary policy - the premium we pay as insurance against shocks to the New Zealand economy. An independent monetary policy would be useful in relation to a variety of ongoing shocks due to differences in industrial structure between the two economies. Australian exports are mainly hard commodity-based (coal, iron and gold) while New Zealand's continue to be mainly dairy, meat and forestry. So differences in the terms of trade movements between the two economies could see different monetary policy settings as a result. But the true value of an independent monetary policy could well lie in the ability to respond to major shocks. After all, firms and households typically take out insurance for the low probability, but large scale shocks that may significantly

¹⁵ For a comprehensive discussion see Schadler et al (2005).

¹⁶ But remove the chance of New Zealand interest rates ever going below that of Australia's if we consistently kept inflation lower than Australia, or if the fiscal finances were kept in better order over the longer run.

affect them – earthquakes, fire and the like. However, were disease to strike the New Zealand agricultural sector, the option to have a large shift in the real exchange rate via changes in the nominal value of the currency may be invaluable (Brash 2002, p. 193).

In addition, a single currency would not eliminate exchange rate uncertainty. It would eliminate it only for the 22 per cent of exports that currently go across the Tasman. Nominal exchange rate uncertainty would still be a fact of life for the majority of New Zealand exporters, notwithstanding any endogenous trade effects that may develop as a result.

At present there is no formal political imperative from either side of the Tasman to create a genuine single trans-Tasman market, along the lines of the European Union. This partly explains the absence of discussion of a common currency as a logical end point for economic and monetary integration across the region.¹⁷ This is not to deny the progress that has been made over the years on joint regulation (e.g food safety), the increasing harmonisation of some policies and the general increase in trade and cross-border investment.

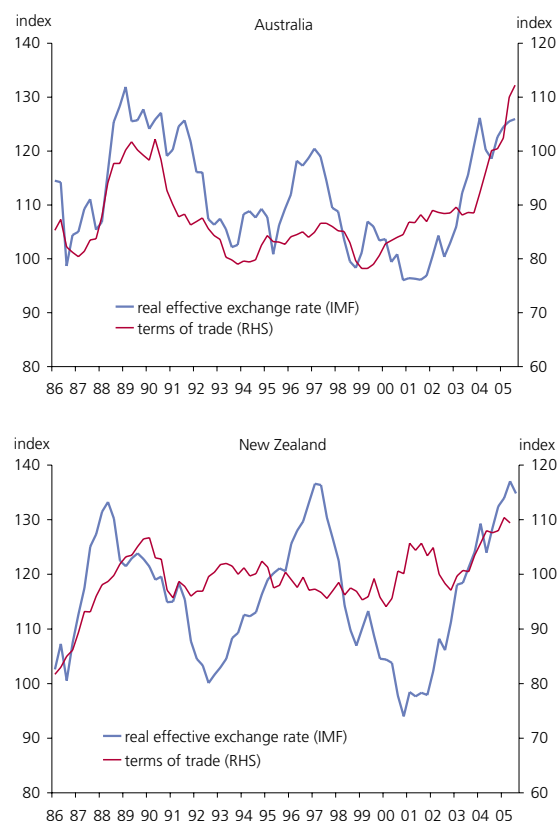
Recent New Zealand Currency Union Research

Since our last review of the currency union debate in the Bulletin in 2001, there have been a number of contributions which have addressed a variety of issues related to the costs and benefits of a single currency.

Grimes (2002) focussed on the necessity of an independent floating exchange rate in relation to its purported buffering properties. For a small open economy like New Zealand for example, one would anticipate a close relationship between movements in the terms of trade and the real exchange rate, as nominal exchange rate movements reflect the shocks coming from changes in the relative price of exports and imports. From figure 5 however, the terms of trade and real exchange rate are much less correlated in New Zealand compared to Australia. This implies the New Zealand

exchange rate acts as much less of a buffer to external shocks compared to Australia's. According to Grimes, an independent exchange rate for New Zealand has been "neither disastrous on the one hand nor necessary on the other" (p. 287).

Figure 3
Real exchange rates and the terms of trade



If an independent exchange rate is not necessary, and if there are the obvious gains from trade coming from lower transaction costs, then there is a prima facie case for a single currency. A single currency may also be optimal if New Zealand experiences similar shocks to Australia and the two economies generally move in tandem. In this regard, research is currently underway at MOTU, led by Arthur Grimes, to examine the relationship between the New Zealand economy and individual Australian states.

If one thinks of Australia as a monetary union, where individual states are possibly subject to idiosyncratic shocks, then it would be interesting to see how different New Zealand is in this respect. The research hopes to "paint a picture of whether New Zealand shares similar economic cycles with all or any of the states, perhaps leading some

¹⁷ For example, a joint Australia-New Zealand Leadership forum made up of community and business leaders was established in 2004 to push the progress towards a single economic market for the region. At the outset they have parked the 'iconic' issue of currency union in the too hard basket, focussing instead on the further work necessary on fostering greater harmonisation. See the statement by the co-chairs, Jackson and MacDonald (2005).

cycles or lagging others”.¹⁸ This work is in its infancy, but early indications suggest New Zealand is not too dissimilar to the Australian states Western Australia, South Australia, Queensland and Tasmania, as opposed to NSW or Victoria. Moreover, any “cyclical differences from Australasia are almost wholly attributable to NZ-specific shocks rather than to industrial structure differences (Grimes 2005, p. 18).

This notion that New Zealand may be little different from an individual Australian state is the premise of Björkstén et al (2004). The authors calculated implied interest rates for individual Australian states and New Zealand, given actual inflation out turns from a target inflation rate and actual output movements from potential output. These Taylor rule recommendations are similar across the individual states and New Zealand. This implies that the “cost to New Zealand associated with abandoning its independent currency and monetary policy may not be substantially greater than the costs associated with the individual Australian states not having independent monetary policies” (p. 19).

Similar in spirit, Coleman (2002) asked whether it made sense for Queensland to adopt its own currency given that shocks hitting this state are not necessarily highly correlated with those hitting the rest of Australia. And if Queensland and New Zealand face regionally specific shocks, why does it make sense for one to be in a monetary union with Australia and the other not. Part of the answer of course lies in the historical development of the Australian Commonwealth since 1901. Related to this is the nature of the institutions that have subsequently facilitated economic adjustment within Australia despite regional differences in shocks and business cycle activity. As we have discussed previously, generically these include factor mobility across sectors/regions, wage and price flexibility and the degree to which private capital markets and government fiscal transfers smooth the adjustment process.

Should New Zealand adopt the Australian dollar, or a shared currency, the question is how important these adjustment mechanisms would be given the loss of the nominal exchange rate and interest rate instruments. A supranational fiscal authority is unlikely, and without a genuine commitment

to a single market for the region the other adjustment mechanisms would not operate efficiently.

In other recent research, Drew et al (2004) perform a counterfactual modelling exercise, and ask how both inflation and output would have evolved over the 1990s had New Zealand adopted the Australian dollar. Using the Reserve Bank’s model and data from 1990-1999, they find that output would have been slightly higher over the 1990s, but at the cost of higher inflation. They also find that adopting Australian monetary conditions would have yielded greater inflation and output volatility. In short, adopting the Australian dollar would not have led to superior monetary policy in New Zealand.¹⁹ These results have been reinforced by Hall and Huang (2004), who perform a similar exercise using the US dollar as the reference currency.

Haug, Karagedikli and Ranchhod (2003) compare the respective Australian and New Zealand monetary policy transmission mechanisms. Differences in the way a single monetary policy works through the respective economies could exacerbate existing cyclical variation. The effect of a single monetary policy would not be known until it became a reality, but some insight might be gained from examining the two existing transmission mechanisms. The authors find qualified evidence that the two transmission mechanisms are similar in terms of the speed and nature of adjustment of inflation and output to monetary policy changes. However, the magnitude of GDP and particularly the exchange rate changes are different. This implies that in a currency union directed to Australian conditions, a given interest change would have a large impact on GDP in New Zealand since the nominal exchange rate is fixed.

In sum, the New Zealand-specific research since 2001 suggests there is no obvious theoretical consensus on the efficacy of a common currency. Abrogating monetary policy in favour of a single currency may make us no worse off than any given Australian state, or it may make the New Zealand economy subject to greater macroeconomic instability – we are no closer to any resolution in this respect. And it is unlikely that resolution can ever be achieved, for this

¹⁸ Media release [www.motu.org.nz].

¹⁹ These results only refer to the specific historical period under examination, and do not assume any endogenous effects of a common currency described in section 3.

would imply unanimity surrounding the economic costs and benefits, and economists are rarely ever of one mind. What we can say with more certainty is that a common currency is ultimately a political decision driven by what is perceived to be in the best interests of the majority of citizens - a route that the Danes and Swedes for example are not prepared to take at this point in time.

5 Conclusion

This article has examined theoretical and empirical contributions to the evolving Trans-Tasman common currency issue since the Bank's last review in 2001. In particular, the early years of EMU provide the natural laboratory experiment to assess many of the arguments surrounding a common currency. Cautious optimism characterises the more considered assessments of European monetary integration. EMU has arguably been a technical and operational success. In addition, the European experience has been the catalyst for a reassessment of the earlier optimal currency area literature. The theoretical literature is now less focussed on the prerequisites of entering an optimal currency area, but rather on the endogenous forces that promote economic

integration following monetary union. These insights arguably shift the relative balance toward a common currency – at least at a conceptual level.

However, EMU has not been without growing pains. The Euro zone economy has been growing below that of its trading partners, and appears less resilient to external shocks. Arguably Europe's problems are a consequence of specific structural rigidities in member countries, rather than a single currency per se. Nevertheless, the euro has been a convenient lightning rod for those who attribute the current malaise to the loss of national sovereignty.

In the Trans-Tasman context, the issue of a single currency has been in hibernation for a while. This can be partly attributable to the robust economic growth New Zealand has experienced relative to Australia over the past 5 years. In addition, the issue is not presently on the political agenda. That said, New Zealand specific research continues into the common currency issue. Perhaps unsurprisingly, this research is far from conclusive – the case for and against a common currency remains an open issue from an economic perspective.

Appendix

Exchange Rate Regime	Main Features
Pure float	ER determined by demand and supply. Central bank does not intervene in the foreign exchange market
Lightly managed float	Demand and supply predominately determine ER. Occasional intervention in FX market
Managed float	Central bank actively intervenes in FX market but not precommitted to any path for the ER
Crawling broad/narrow Band	ER maintained in a broad/narrow band around a central rate that is adjusted periodically at a fixed preannounced rate
Crawling peg	ER pegged to another currency but adjusted periodically
Pegged within Bands	ER allowed to fluctuate within a band around a central peg, either a single currency or basket of currencies
Fixed peg	ER pegged at a fixed rate against single currency or basket of currencies. Rate can be adjusted if major misalignment occurs
Currency Board	Central bank stands ready to convert any amount of domestic currency into foreign currency at a fixed rate
Dollarisation	Official adoption of another currency as predominant or exclusive legal tender. Domestic currency confined to secondary role, usually in the form of coins

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