REAL ECONOMY ASPECTS OF AUSTRALIA-NEW ZEALAND CURRENCY INTEGRATION

The Reserve Bank commissioned David Grimmond of the New Zealand Institute of Economic Research to prepare a report on real economy aspects that might be relevant to any proposal regarding the potential integration of the Australian and New Zealand currencies. The executive summary of that report is reproduced here. The full paper is available from the NZIER as Working Paper No. WP91/1.

This paper provides a preliminary examination of potential real economy impacts of a currency union between Australia and New Zealand. The economic literature suggests that the potential benefits arising from currency integration include:

- the encouragement of **monetary discipline** within the currency union;
- a reduction in the **cost of transactions** between member states; and
- the provision of **large currency** attributes allowing greater exchange rate stability with the rest of the world.

Potential costs include:

- **transitional costs** of converting to a common currency;
- **loss of sovereignty** and independence of economic management restricting member states' ability to respond to unanticipated shocks; and
- exposure to **external shocks** if the currency union imposes an exchange rate that does not reflect the conditions faced by individual members.

Factors concerning monetary policy are not addressed here. The study approached real economy aspects of currency integration under the premise that net benefits of currency union between Australia and New Zealand could increase:

- the more similar are the two countries' economic structures, implying greater compatibility and hence lower transitional costs;
- the stronger the trade links between the two countries, allowing greater scope for currency exchange transaction cost reductions;

- the more independent the postulated joint currency area is, thus increasing the scope for absorbing external disturbances;

- the more diverse external transactions from a joint currency area are, reducing the currency's susceptibility to nominal exchange rate volatility and thus reducing the costs of transactions with the rest of the world; and

- the greater the extent that trans-Tasman goods and factor markets are integrated and adjust rapidly to eliminate disequilibria following exogenous shocks.

Structure

The Australian real economy appears to have performed better in aggregate terms than the New Zealand economy over the past thirty years with evidence that New Zealand per capita incomes are about 80 per cent of those in Australia. The economic structures of Australia and New Zealand have a similar split between aggregate sectors, with both economies having an approximate 10:20:70 split between primary, manufacturing and service sectors. A more disaggregated view highlights fundamental divergences between the two economies, with an emphasis on mining and mineral processing in Australia contrasting with an emphasis on agricultural and forestry production and processing in New Zealand.

Trade

The greater relative importance of trans-Tasman trade to New Zealand suggests that transaction cost reduction gains from currency integration will be relatively greater for New Zealand. A comparison of past trade patterns suggests that currency integration will have little impact in diversifying transactions with other currencies, but should - especially for New Zealand - diversify the mix of traded goods. These two factors would be expected to have a contrasting influence on a joint currency's exchange rate volatility.

In the period since 1985 when both countries have had flexible exchange rates, the Australian nominal exchange rate has tended to be the more volatile of the two. This would suggest that large currency benefits from trans-Tasman currency integration are not likely to be significant.

Commodity exports are important to both Australia and New Zealand, but very few commodities exported are common to both countries. An examination of recent commodity price movements indicates that prices for the typical basket of commodity exports for each country do not behave in a similar fashion. Due to the greater size of the Australian economy, this suggests that a joint currency's exchange rate will respond to prices in a commodity basket that is not representative of New Zealand exports.

Market Integration - Goods

On the assumption that the degrees of quantity adjustment remain unchanged, the absence of flexible exchange rates between Australia and New Zealand would require factor and/or good prices to adjust for exogenous shocks which at present are largely adjusted for by nominal exchange rate movements. A comparison of real exchange rate variability within Australia and New Zealand and between the two countries indicates that over the 1963-89 period price movements were greater between the two countries than within. That is, nominal exchange rates provided a necessary price adjustment process between the two countries. Although this is not conclusive evidence against the desirability of trans-Tasman currency integration - by promoting economic integration, currency integration is in many respects a self-validating process - the evidence suggests that Australasia would be a less desirable currency area than either Australia or New Zealand are currently.

Market Integration - Capital

It would appear that trans-Tasman capital market prices, in the form of interest rates, provide signals which are more responsive to each other than with third countries. It is less obvious, however, whether this apparent efficiency in finance markets has translated into an efficient trans-Tasman allocation of physical capital. The growth in trans-Tasman foreign direct investment in the 1980s suggests that CER has played a role in strengthening capital market integration. This process might continue with currency integration if currency union stimulated further economic integration.

Market Integration - Labour

Despite relatively free trans-Tasman labour mobility, neither country has had ongoing success in eliminating persistent labour market disequilibria. However, the evidence is not inconsistent with the premise that Australia and New Zealand have the attributes of a single labour market. It would appear that persistent trans-Tasman wage differentials have encouraged the net migratory flow from New Zealand to Australia.

There is evidence of aggregate wage inflexibility and of labour markets that respond only slowly to changes in levels of real economy activity. Sources of labour market disequilibria are not examined here, but the findings suggest that labour markets would be an area of concern in the event of currency integration between Australia and New Zealand.