The fall of the New Zealand dollar: why has it happened, and what does it mean?

An address by Dr Donald T Brash, Governor of the Reserve Bank of New Zealand to the American Chamber of Commerce, Auckland on 5 October 2000

Introduction

Over the last few weeks, the most common questions I have been asked at public meetings up and down the country have concerned the New Zealand dollar exchange rate. Why has it fallen so steeply? What does it mean for New Zealand's future? Will it continue to fall from here? Why doesn't "somebody" – by which most people mean either the Government or the Reserve Bank – do something about it? While some of these questions can not be answered with any degree of certainty, it may be helpful to put a Reserve Bank perspective on them.

Why has the New Zealand dollar fallen so steeply?

First, a few facts. Between its peak of more than 71 US cents in November 1996 and its trough of just over 40 US cents at present, the New Zealand dollar depreciated by some 44 per cent against the US dollar, a substantial depreciation over less than four years in anybody's language. Measured against the Reserve Bank's trade-weighted index (TWI), which measures the New Zealand dollar against a basket of five currencies, the fall was somewhat less dramatic, from 69 in late April 1997 to around 47 at present, but that still represented a depreciation of 32 per cent. Whether measured against the US dollar or against the TWI, the New Zealand dollar is currently close to its lowest level in history.

Why has this happened? I think the first point to make is that, at its most recent cyclical peak in late 1996 or early 1997 (depending on which measure is used), the New Zealand dollar was almost certainly over-valued. Inflationary pressures had been strong in 1995 and 1996, and monetary policy needed to be firm in order to deal with those pressures. In part, this was reflected in an appreciation in the exchange rate, to the point where exporters, and those competing with imports, were in many cases under considerable pressure. In other words, some of the fall in the exchange rate over the last few years has simply reversed the over-valuation of 1996 and early 1997.

But that still leaves a lot of the depreciation unexplained.

Once upon a time, it used to be argued that what drove exchange rates was differences in national interest rates, and the strong appreciation of the New Zealand dollar in the mid-nineties was substantially explained in these terms, as I have indicated. Our interest rates were well above those in major capital markets, and this attracted foreign savings into New Zealand, thus pushing up the exchange rate. But in recent times Japanese interest rates have been well below those in, say, the United States, yet the Japanese yen has been one of the few currencies to remain reasonably stable against the US dollar. And over the last six months, central banks in several countries, including both New Zealand and Australia, have seen their currencies fall despite increases in official interest rates which have been broadly similar in magnitude to those in the United States. There is certainly more to it than interest rate differentials.

Once upon a time, it used to be argued that what drove exchange rates was differences in national economic growth rates, perhaps because of a perception that countries with relatively rapid economic growth were more likely to attract investment capital, or to have to push up interest rates to control inflation, both factors likely to encourage an appreciation in their exchange rates. But in recent times, Australia's exchange rate has fallen despite its economic growth being very similar to that in the United States, whereas Japan's exchange rate has *not* fallen despite Japanese growth falling well short of America's. There is certainly more to it than growth differentials.

Once upon a time, it used to be argued that what drove exchange rates was differences in balance of payments positions, with countries having large current account deficits (like New Zealand) tending to have weak exchange rates and countries having large current account surpluses (like Japan) tending to have strong exchange rates. Well, Japan has certainly had a strong exchange rate and New Zealand has certainly had a weak exchange rate in recent times, but New Zealand's exchange rate rose strongly through the mid-nineties despite our relatively substantial current account deficit, and the United States, with a strong currency, currently has the largest current account deficit for many years. Indeed, America's current account deficit, while smaller than New Zealand's relative to our respective GDPs, is now larger relative to America's exports of goods and services than is New Zealand's deficit relative to our exports of goods and services. The countries of the European Monetary Union have a net current account position which is very close to balance at present – neither surplus nor deficit – but the euro has been depreciating more or less steadily since its inception at the beginning of 1999. There is certainly more to it than current account deficits.

Once upon a time, it used to be argued that exchange rate movements reflected financial market perceptions of the political complexion of the relevant governments, with the exchange rates of countries with "left-wing" governments tending to depreciate and the exchange rates of countries with "right-wing" governments tending to appreciate. In recent months, the Australian dollar has depreciated a little less than has the New Zealand dollar, and since Australia has a right-of-centre government and New Zealand a left-of-centre government that could be seen to lend some credibility to this theory. But on the other hand, since last year's election there has been no discernible increase in the margin between yields on New Zealand government 10-year bonds on the one hand and yields on 10-year Australian government bonds and 10-year US Treasuries on the other, suggesting that financial markets in fact see no increase in the risk on New Zealand bonds as a result of the change in government. There is certainly more to it than politics.

There are, of course, lots of other explanations offered for movements in the exchange rate, and it is not my purpose here to offer a comprehensive list of those explanations. I suspect that a whole range of factors explain the recent depreciation of the New Zealand dollar, including our large balance of payments deficit (and large accumulation of external liabilities as a result of running a balance of payments deficit for almost three decades); a perception that New Zealand (like Australia) is an "old economy" where things are made or grown, rather than a "new economy" of bright ideas and high productivity; the absence of any particular "reason" to buy New Zealand dollar assets now that our interest rates are closely comparable to those in major capital markets; and some nervousness on the part of financial markets (whether warranted or not) about the policy direction of the Government.

In part at least, the "fall of the New Zealand dollar" is really a story about the rise of the US dollar. The US economy has been growing strongly, and the US equity market has risen very strongly over the past decade. This has attracted into the US savings from all over the world. Not surprisingly, the US dollar has risen as a result, not just against the New Zealand dollar but against a great many other currencies also. Between the beginning of 1999 and the end of September this year, for example, the Australian dollar and British pound depreciated by about 12 per cent against the US dollar, the Swedish and Norwegian currencies by about 16 per cent, the Swiss franc by about 21 per cent, the New Zealand dollar by about 23 per cent, and the euro by almost 25 per cent. Clearly, the fall in our currency is not just the result of the New Zealand dollar being the currency of a small economy: the currencies of much larger economies have also fallen significantly against the US dollar in recent times.

And over and above all these fundamental factors, there is the possibility – indeed the probability – that some of the depreciation simply reflects the dynamics of the foreign exchange markets: various forms of "reef-fish" behaviour, to use former Prime Minister David Lange's expression, have almost certainly been at play.

In short, the facts make it clear that there is no single, simple, explanation for the fall in the value of the New Zealand dollar over the last two or three years. It follows that exaggerated claims that the fall can be pinned on just one thing – whatever that one thing might be – are almost certainly wrong, and are unhelpful in improving our understanding of the implications. At this time, we need cool heads and rational thinking, not extravagant claims or counter-claims.

What effect will the fall in the exchange rate have on our economy?

Whether the depreciation in the New Zealand dollar has a relatively minor effect on the New Zealand economy or a more substantial effect depends in part on whether the depreciation is in reality just the other side of the strong appreciation of the US dollar – and so likely to be reversed reasonably quickly if the factors which have driven US dollar strength abate; or whether it is in some sense part of a long-anticipated market reaction to New Zealand's specific circumstances, such as our large balance of payments deficit and very large accumulated foreign liabilities – and so likely to be more enduring.

Whatever the real explanation – and it seems to me very likely that there are aspects of both stories in the present situation – the direct and fairly immediate effect of the fall in the exchange rate is that the New Zealand dollar price of the goods and services which we import, and of the goods and services which we export, will go up. (And this includes the New Zealand dollar price of things which *could* be exported, such as milk and meat, because the prices of goods of this kind are also directly affected by the depreciation of the exchange rate.)

These price rises will not happen instantaneously, particularly where importers and exporters have covered their foreign exchange risk in the forward market. To the extent that that has happened, it will take a little while for the New Zealand dollar prices of imports and exports to go up. But go up they certainly will. (Not all of those price increases will reach consumers in full, however, if some of the price increases are absorbed out of the margins of foreign exporters or local importers and distributors. Moreover, a decline in the quality of some goods, difficult to measure accurately in the CPI, may also mask effective price rises.)

The effect of these relative price changes – where the prices of imports, import substitutes, and exportable goods and services go up relative to the prices of things which can only be traded within the New Zealand economy – will be to increase the income of those of us producing goods and services which are exportable, or which compete with imports, relative to the rest of us.

And in that sense the lower exchange rate can be seen as a healthy development. It is the floating exchange rate at work, encouraging the production of goods and services which will reduce our balance of payments deficit and discouraging the consumption of goods and services which are imported or could be exported. To the extent that the low exchange rate persists, and is not negated by higher domestic inflation, this is likely to see stronger growth in exports of goods and services, slower growth in imports of goods and services, and a reduction in New Zealand's balance of payments deficit on current account.

And happily, unlike many of the countries which saw bank and corporate balance sheets devastated when their exchange rates fell sharply during 1997-98, the fall in the New Zealand dollar has had only minimal effect on bank and corporate balance sheets here. Yes, there are a few companies which wish they had not taken out so much forward cover on their export receipts when the exchange rate was higher. But these contracts represent "profits foregone", not the kind of disasters which wiped out so many banks and corporates in Indonesia and Thailand when their exchange rates fell. And the reason for this is that, perhaps because New Zealand has had a freely floating exchange rate for more than 15 years now, banks and corporates in New Zealand tend not to borrow overseas in foreign currency without hedging the exchange rate risk. Indeed, at the end of March last, the Government Statistician estimates that some 97 per cent of all overseas liabilities owed by banks and corporates in New Zealand were "hedged", roughly one-third of it through some kind of natural hedge and the balance hedged through financial markets.

So there appears to be little risk of the depreciation in the New Zealand dollar having any significant adverse impact on the financial strength of the New Zealand financial system or corporate sector, and of course the New Zealand government now has no net foreign-currency-denominated liabilities at all.

But there is one important caveat to this positive story. A currency depreciation does not make the country better off, at least in the short term: it simply redistributes income, or at least the purchasing power of income, from some New Zealanders to other New Zealanders. Some of us are made better off by the depreciation; some of us are made worse off.

But if those of us who are made worse off by the depreciation – those of us, in other words, who face higher prices for petrol, and milk, and meat, and clothing, and TV sets, and cars but get no "offset" through producing higher-priced exports or import-substitutes – fight hard to retain our real income, by pushing up our prices, fees, wages, and salaries, then of course the whole process becomes much more painful.

And this is where the Reserve Bank is relevant. As I said in a speech in Kapiti early in August, the Bank may be able to ignore the initial, direct, impact of a fall in the exchange rate on prices, but our ability to do that "depends on whether we New Zealanders accept that the direct price effects of exchange rate depreciation are not matters which justify our seeking compensation through higher incomes. If we collectively seek such compensation, then the Bank is faced not with a one-off price level adjustment but with the potential for *ongoing* upwards pressure on prices."

And that not only has the potential to produce ongoing inflation, but at least for a time may frustrate the very shift in relative incomes and prices which is required to reduce the current account deficit, and which the depreciation would otherwise produce.

If the Bank were obliged to tighten monetary policy because of *ongoing* upwards pressure on prices, the result would probably be at least a temporary increase in unemployment and a loss of output. On the other hand, if the Bank failed to lean against that inflation, we would almost certainly see not only the economic and social damage of the inflation itself but also a still lower exchange rate – and still a need to tighten monetary policy, indeed by even more, to reign that inflation back in. There can be no doubt that, if we see prices, and fees, and wages, and salaries beginning to suggest ongoing inflation, as distinct from the first round effects of the depreciation, the Bank will tighten monetary policy.

Beyond the direct price effects of the depreciation, over the longer-term the depreciation will, if sustained, encourage people and capital to move out of industries serving a primarily domestic market (such as residential construction and retailing), and into industries producing goods and services for export, or in competition with imports (such as agriculture, forestry, manufacturing, tourism, fishing, horticulture, viticulture, software, and so on).

Thus, to the extent that the exchange rate depreciation reflects the need for a movement of resources from so-called "non-tradable sectors" to "tradable sectors", it is entirely healthy, is consistent with a reduction in the country's balance of payments deficit, and may well lead to a better allocation of resources and thus a somewhat faster rate of economic growth in the medium term. Even so, if the tradable sectors have a very strong demand for people and capital, at some point that has the potential to lead to inflation unless the non-tradable sectors are simultaneously releasing people and capital. The Reserve Bank again makes its best contribution to this process by ensuring that inflation is kept under control, because it is the emergence of inflation which signals that the total demand pressures on the country's resources are beginning to exceed the country's capacity to supply.

To sum up this point, the fall in the exchange rate has the *potential* to produce quite a major change in the structure of the New Zealand economy, to the point where we may see a significant reduction in the size of current account deficits. The Reserve Bank best ensures that that happens, however, by leaning against any attempts by those of us in non-tradable sectors to resist the fall in our real income that that depreciation inevitably means – or in other words, by leaning against any "second-round" inflationary pressures resulting from the depreciation.

Will the New Zealand dollar continue to fall from here?

Let me quickly say that I do not know the answer to this question. Nobody does. If you had asked me three months ago whether the New Zealand dollar would reach 40 US cents, I would have replied that I thought that that was very unlikely. So clearly I can not rule out the possibility that the exchange rate will fall further.

But I do nevertheless believe that over the longer term we will see some strengthening of the New Zealand dollar. Work we are doing at the Reserve Bank using a variety of approaches to the determination of New Zealand's "equilibrium exchange rate" strongly suggests that the "equilibrium exchange rate" is higher than the exchange rate we have today.

One major investment bank which specialises in the analysis of currency trends has recently cut its forecast of the New Zealand dollar exchange rate in three months' time from 52 US cents to 48 US cents, a reduction certainly, but still well above the current exchange rate. Some other commentators are less bullish, but I know of none which is suggesting that the New Zealand dollar should be lower on fundamental grounds.

And if the currently-low exchange rate does in fact produce the reduction in the balance of payments deficit which seems likely, then in due course the confidence of both local and overseas investors in New-Zealand-dollar-denominated assets will return, and some appreciation of the exchange rate with it.

Why doesn't "somebody" do something about the low exchange rate?

Well, rather than waiting for that return of confidence, or for a reduction in the extent to which the US is dominating investors' radar screens, is there anything which might be done to reverse the decline in the exchange rate more quickly, if that were thought desirable? In principle, there are three things that might be done to try to achieve this objective.

First, the Government or the Reserve Bank could try "jaw-boning" the dollar up. In other words, we could make impassioned statements about how much we believe the New Zealand dollar to be under-valued and how strongly we expect the exchange rate to rise. Alas, experience here and abroad with statements of this kind, at least when taken in isolation, suggests that they typically work for about 15 minutes.

Secondly, the Reserve Bank could tighten monetary policy by increasing interest rates. When interest rates are increased in response to an increase in inflationary pressure, tightening monetary policy is seen as a sensible thing to be doing and therefore something which is likely to endure for at least a time. But when interest rates are simply increased in response to a weak exchange rate, in the absence of inflationary pressure, financial markets recognise that higher interest rates are likely to be a temporary phenomenon, followed by lower interest rates. In this situation, not only may an increase in interest rates not help to support the exchange rate, it may actually cause a further *decline* in the exchange rate.

Thirdly, the Reserve Bank could intervene directly in the foreign exchange market, by buying New Zealand dollars with some of the foreign exchange reserves which we currently hold. Many central banks intervene in the market for their currency, and the New Zealand central bank is unusual, perhaps unique, in not having done so in the more than 15 years since our currency was floated in March 1985. We have never ruled out the possibility of intervening in the market for the New Zealand dollar to counteract "disorderly market conditions", but to date we have not been satisfied that "disorderly market conditions" exist. Should we be intervening to reverse the "over-shooting" part of the recent sharp depreciation? So far at least we have not been persuaded that such intervention would be likely to have any large or lasting benefit. At best, it might knock the "tops and bottoms" off the exchange rate cycle, or perhaps arrest a trend where those trading on that trend are the dominant influence on the market. And offsetting those potentially modest gains, there would of course also be some real risks and potential costs to New Zealand taxpayers associated with such intervention.

In short, there appears to be no quick or easy course of action which could be reasonably assured of reversing the decline in the New Zealand dollar, even if there were full agreement on the desirability of that.

What about a currency union with Australia? Would this help? I dealt with some of the economic pros and cons of currency union in a speech some four months ago, and I do not want to add to that at this point. But it is important that nobody think that currency union is a silver bullet, a panacea either for the current weakness in the exchange rate or for the performance of the economy more generally. The Australian dollar is also close to its lowest level ever at present, so that a combined Australian-New Zealand currency would almost certainly be weak at present also. And of course almost nobody on the Australian side of the Tasman is talking about a currency *union*, and almost nobody on the New Zealand side is talking about our simply adopting the Australian dollar. The likelihood of a currency union any time soon therefore seems extremely low, whatever the merits and demerits of such a union.

No, there is no quick or easy way to reverse the recent decline in the New Zealand dollar. We need to recognise that a significant part of the depreciation since early 1997 has simply been the reversal of an over-valued currency at that time, and as such has been desirable. We need to recognise that another significant part of the depreciation is simply a reflection of the strength of the US dollar, and as such may not continue indefinitely. And in part we need to recognise that the depreciation is a market adjustment to our longstanding tendency to spend beyond our means, borrowing the savings of other countries to do so.

Our best course of action, indeed perhaps our only sensible course of action, is to continue doing the things which will make us a prosperous economy – continue to run fiscal surpluses, continue to keep inflation low, continue to improve the flexibility of the economy, continue to remove regulatory barriers to resource mobility, continue to improve incentive structures so that investment goes into those areas with the highest social and economic return, continue to ensure that governance structures in the banking and corporate sectors encourage prudent behaviour, continue to improve the education system, continue to welcome foreign investment, and do everything possible to encourage a culture which values initiative, innovation, hard work, saving and all the rest.

Sound policies across the whole breadth of the economy are the best way of ensuring that the exchange rate recovers over the medium term, and of course the best way of ensuring prosperity for all New Zealanders as well. A prosperous New Zealand, with low inflation, will enjoy a strong currency over the long term, and productivity growth to justify that strength.