SPEECHES

Comments by Dr Don Brash, Governor of the Reserve Bank of New Zealand on: *Three perspectives on an Australasian Currency Union*

By Andrew Coleman, The University of Michigan, Future Directions for Monetary Policies in East Asia. At a conference hosted by the Reserve Bank of Australia, HC Coombs Centre for Financial Studies, Kirribilli, Sydney on 24 July 2001.

At the outset, I would like to thank Andrew Coleman, not only for this very interesting paper, but more importantly for his personal contribution in opening out the issue of New Zealand joining a currency union.

Without Andrew's contribution, I don't think that the discussion would yet have developed as far as it has, or reached into the territory that it has.

New Zealanders from all walks of life are currently trying to work out what drives economic success. As a topic of dinner table discussion, New Zealand's economic performance – both absolutely and relative to other countries, especially Australia – is starting to rival rugby and politics!

This is the territory into which Coleman has taken the discussion of currency union. Do the current monetary arrangements – which feature a floating exchange rate and an inflation target to tie down the independent monetary policy that results – maximise growth?

My standard response when asked what monetary policy can do to help maximise economic growth is to say that maintaining price stability is the best contribution that monetary policy can make. However, that contribution is a small one and more akin to removing an impediment than being an active accelerant or a catalyst for transformation.

I do not resile in any way from that answer when I say that it is incomplete. My standard answer addresses the mostly macro-economic question of whether the long-run Phillips curve is vertical. But there are other, more complete, aspects of the question. What monetary arrangements would best support growth, and is what we currently have the best?

One might note at the outset the irony of asking this question now. We have recently learned how to deliver price stability, and thereby how to remove the impediment to growth that comes from an unstable pricing mechanism. So why are New Zealanders not satisfied?

We are not satisfied because as we have progressively removed various impediments to growth, we have found that the gains have fallen short of expectations and desires. Macro-economic and structural policy reforms almost certainly delivered an improvement in economic performance in New Zealand, but not sufficient to begin the process of clawing back New Zealand's four-decade long decline in relative living standards. So we are now looking for the deeper reasons for under-performance.

The case for the current monetary arrangements being perhaps a part of these deeper reasons for under-performance comes from four interconnected lines of thinking. Many of these points have been made by Andrew Coleman in this and earlier papers. Let me comment on each of them.

1 Floating exchange rates aren't what they were cracked up to be

This is the argument that the current monetary arrangements do not deliver the benefits that we used to think they would. In particular, floating exchange rates are not as good at insulating open economies from external shocks, or at keeping open economies close to equilibrium, as we previously believed.

Andrew Coleman has referred to a very significant body of work that goes to show how much "noise" there is in market-determined exchange rates, and how difficult it is to relate exchange rate movements to economic fundamentals. I have a good deal of sympathy with the point he is making. Having been on the receiving end of much criticism about exchange rate developments that have not been justified by economic circumstances, and about which I could do nothing, that sympathy is heart-felt. I am sure that Ian Macfarlane likewise accepts the force of the point, especially in the context of the Australian dollar sitting at historic lows after a decade of truly outstanding economic performance and an unusually small degree of structural imbalance.However, we should be careful not to get carried away with the idea that foreign exchange markets are imperfect. By and large, over the history of floating exchange rates, they do reflect relative economic circumstances. And that seems to be more true for smaller economies than the large, relatively closed, economies for which much of the research has been undertaken. International commodity prices do seem to have been very important determinants of both the Australian and New Zealand dollars (notwithstanding the Arthur Grimes' results that Coleman cites, which relate the exchange rate to very odd looking — albeit official — terms of trade data). And I well recall the episode from early 1997 through 1998 when the New Zealand exchange rate fell rather faster than we could explain at the time, only to find that the fall was well justified by the gathering Asian financial crisis.I think it is probably true to say that real exchange rates are more volatile, and "unreasonably" so, for floating exchange rate economies than for regions within currency unions. The point is far more true at short-term frequencies than at business cycle frequencies, where for regions within a currency union the scale of real exchange rate change can also be very large, but it is also probably true at business cycle frequencies.

2 Exchange risk is a significant non-tariff barrier to trade

Second, it is argued that the current exchange rate arrangements create a barrier to the kinds of activities and enterprise that would contribute to faster growth. In particular, the existence of exchange rate risk inhibits trade, and hence economic integration with external markets, to a greater extent than we previously believed.From my perspective, this is getting to the nub of the issue. It is one thing to argue that floating exchange rates aren't as useful as we previously thought. Once one allows for the point that real exchange rates sometimes have to adjust, whatever the monetary arrangements, one is trading off one imperfect monetary arrangement for another, and we don't know exactly how large the costs and benefits of such a trade-off actually are. But if one monetary arrangement adds a barrier to trade that the alternative does not, there is an important issue to be addressed.To be frank, I don't know what to make of the evidence that others have presented and that Andrew Coleman has cited. Logically, I would expect that the introduction of transactions costs would constitute a barrier. And I would expect that the introduction of risk would also constitute a barrier. But how big of a barrier, given the increasing efficiency and growing accessibility of financial markets? Past research has struggled to show that exchange rate volatility makes any difference to trade. The new research, such as that generated by Andy Rose, shows that currency unions have a very big effect on trade above and beyond the effects of volatility – so big that I am left wondering about the plausibility of the results. For example, do we really think that trade between the Cook Islands and New Zealand is large because we have a common currency? Or are there other more important reasons?

3 Gains from trade with a larger region really matter for growth

It is one thing to argue that separate currencies inhibit trade. It is still another to argue that that inhibition to trade damages growth. Interestingly, in the recent thinking about growth that has been going on in New Zealand, economic integration with the rest of the world figures large. Our distance from markets, our relative scale, our relative lack of diversification, and the limited extent to which our potential risk-takers rub shoulders with more entrepreneurial types, all figure in the discussion. If greater trade with a larger area can break down or overcome these kinds of constraints, the growth gains might well justify giving up one's currency and monetary independence.Again, however, I don't know what to make of the arguments. I am convinced that there are gains from trade that New Zealand hasn't yet exploited. We often describe New Zealand as a small open economy, but with exports now accounting for a little over one-third of total activity we are far from being as open as many economies of comparable size. To be sure, we are not located in the middle of Europe, but nor is Singapore or Malaysia or Hong Kong. Leaving aside the question as to whether the existence of a separate currency is a significant barrier to further openness, are the kinds of gains that *might* come with greater trade likely to be highly relevant to how fast New Zealand can grow? Or instead are such gains mostly relevant to the *level* of productivity and real incomes in New Zealand? Tariff barriers can make an economy poorer, but do they usually hamper growth?

4 Economic adjustment doesn't need the help of a floating exchange rate

Those of us in countries with a floating exchange rate regime normally suppose that, as circumstances change, the process of economic adjustment will be usefully smoothed by a changing nominal exchange rate.Andrew Coleman asks some pointed questions about the standard analysis of adjustment to region-specific shocks. How prevalent are region-specific shocks? Are they big enough, and frequent enough, to make business cycles behave very differently? For the countries and regions that we are concerned about, how different is the mobility of factors between different regions within currency blocks and between the currency blocks themselves? And how much of such mobility differences as do exist is a product of the very existence of separate currencies? How important is a single fiscal authority, once one allows for the ability of separate fiscal authorities to smooth out income shocks by borrowing? And one might add some other equally pointed questions. Do we want adjustment to be "smoothed" by floating exchange rates or fiscal transfers in the first place? If the region-specific shock is temporary, won't individuals smooth consumption anyway; and if the shock is permanent, shouldn't we just get on with the adjustment process?One of the more intriguing (and if correct, compelling) arguments in favour of currency union that I hear these days is that the floating exchange rate favours the "wrong" kind of entrepreneur. An exchange rate that buffers swings in commodity prices makes commodity-based activities more attractive, and commodity-based activities are a less dynamic base for growth. And an exchange rate that is volatile and discourages potential entrepreneurs from engaging via trade with other entrepreneurial types also hampers dynamism.These arguments about harm to the dynamism of the economy are important ones to get to grips with, and we are only just starting to scratch the surface of the issue. Interestingly, if these arguments turn out to be valid, it probably points to the desirability for New Zealand of currency union with the United States rather than Australia.Again, I'm not sure of the answer to these very important questions. One sense I have is that we haven't yet posed the question properly. It seems to me that we tend to analyse the issue of region-specific shocks as if the issue was adjustment to shocks within the "normal" range of events that different regions are exposed to. For common-garden variety shocks, there's not much of an adjustment issue. The real question is whether one would desirably have a buffering mechanism available when a truly large region-specific shock hit. What if some disease took out New Zealand's dairy industry entirely, for several years? If we pose the question this way, we are asking about the scale of the premium we might be paying – if indeed we are paying a premium – in order to preserve the option to have a massive shift in the real exchange rate occur partly through a change in the nominal exchange rate.Ladies and Gentlemen, I have spent too much time already telling you how little I know about the answers to these questions. I am, however, quite certain that the questions are much more important than we have allowed up until recently. Our understanding of the importance of the issue, and the growth-dynamic frame within which the issue should be set, has been greatly helped by the innovative contributions of people at this conference, such as Andrew and Andy Rose. For that we owe a debt of gratitude.