The New Zealand experience of short- and medium-term real exchange rate volatility: drivers and policy implications

Willy Chetwin, Tim Ng and Daan Steenkamp
Reserve Bank of New Zealand
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Key results and conclusions

- e/r cycles longer & larger, and short-term vol. higher, in NZ cf. elsewhere
- real economic developments offer directional explanations for cycle
- economic flexibility and less procyclical policy can help
- monetary and FX intervention policy have some scope, but limited by trade-offs and identification problems
Presentation outline

1. defining and measuring volatility
2. explaining volatility
3. reducing volatility
NZ real effective exchange rate cycles

(Appendix A)
NZ’s upswings larger than most others’
Downswings larger too

(Figure 4)

Mean downswing magnitude (%) vs. Number of cycles for different countries.

Countries represented:
- AT (Austria), BE (Belgium), DE (Germany), DK (Denmark), ES (Spain), FI (Finland), GR (Greece), HK (Hong Kong), IE (Ireland), IT (Italy), JP (Japan), KR (South Korea), MX (Mexico), NL (Netherlands), NO (Norway), NZ (New Zealand), PT (Portugal), SE (Sweden), SG (Singapore), US (United States).
S-t vol also larger than typical
dots: black NZ, yellow AU, red CA, blue NO  (Figure 6)
Explaining exchange rate movements

- exchange rate is an asset price driven by relative risk and returns
- as a highly flexible market, it tends to “jump” in response to economic developments
Cycles are mostly explainable...

Source: McDonald (2012)
... but some “noise” remains

Source: McDonald (2012)
... another cut at noise

Source: McDonald (2012)
What to do?

• Change trilemma choice
• Improve economy’s flexibility
• Non-monetary stabilisation
  - SSI
  - fiscal
  - (macroprudential)
• Monetary policy (4b etc.)
  - no free lunch
• FX intervention

→ There are limits to what can be achieved