RESERVE BANK OF NEW ZEALAND

ADDRESS BY THE GOVERNOR RESERVE BANK OF NEW ZEALAND TO THE AUCKLAND MANUFACTURERS' ASSOCIATION

30 NOVEMBER 1992

THE EXCHANGE RATE AND MONETARY POLICY

In this speech, delivered to the Auckland Manufacturers' Association on 30 November, Dr Brash addresses current issues relating to the role of monetary policy and the exchange rate. Dr Brash focusses on the real exchange rate - that is, competitiveness - and concludes that this is influenced largely by decisions made by producers. In particular, competitiveness will be affected by decisions affecting productivity and wage settlements vis-a-vis international competitors.

Ladies and gentlemen, I am sure I do not need to remind most people in this audience that New Zealand is a small open economy. Our future prosperity is very much dependent on our ability to trade successfully, and that in turn is very much dependent on the competitiveness of New Zealand producers *vis-a-vis* producers abroad.

It has been a recognition of this indisputable fact that has led many people, including many in the manufacturing sector, to focus on the need for New Zealand to have a 'favourable' exchange rate, or sometimes a 'competitive' exchange rate.

Recognising that the exchange rate is indeed one of the most important price signals in the economy, I thought it would be helpful if I set out our views on these issues as clearly as possible.

Some people have expressed concern that the Reserve Bank is 'targeting' the exchange rate, while others have expressed concern that we are not. Some are worried about comments, made by the Reserve Bank and others, that over the long term there is likely to be some appreciation in the New Zealand exchange rate against the currencies of our trading partners.

I want to make six main points by way of reply, but before I do that it may be worth recalling briefly a little bit of history.

Figure 1 shows how the New Zealand dollar has moved since the early seventies, measured against the basket of five currencies in the Reserve Bank's Trade Weighted Index (TWI). As you can see, there has been a trend depreciation over that whole period - amounting to a total depreciation of over 50 per cent between 1972 and the present - punctuated by two brief periods of appreciation during the disinflation of the mid-eighties. Reflecting back on our poor record of economic growth over most of that period, it isn't difficult to recognise that, on its own, a depreciation of the exchange rate is no guarantee of economic growth and prosperity.

Figures 2-6 show the New Zealand dollar against the individual currencies in the TWI over the same period. Unsurprisingly, the same trend depreciation is visible in all cases with the exception of the New Zealand dollar against the Australian dollar: against the Australian dollar (AUD), the New Zealand dollar has followed no clear trend, but rather has fluctuated quite widely.

Figure 1
Nominal Exchange Rate (TWI)

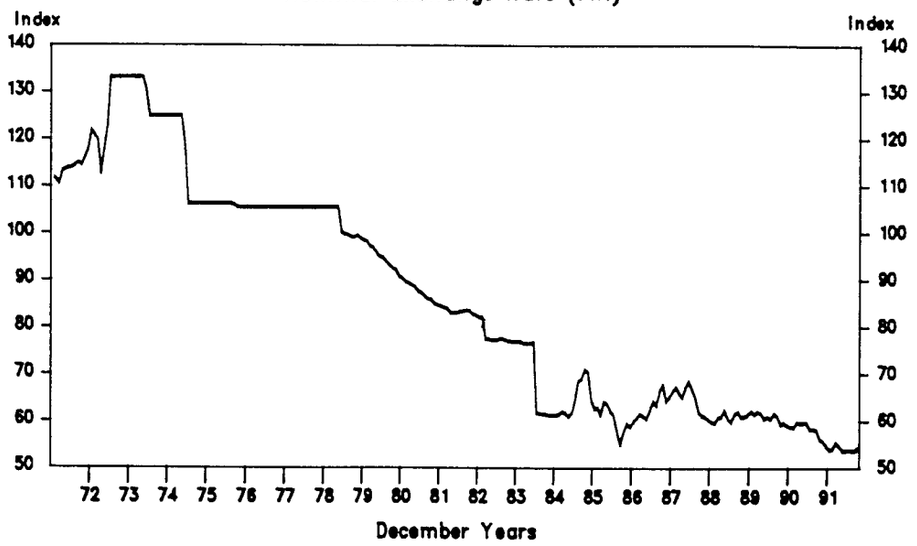


Figure 2
US/NZ Exchange Rate

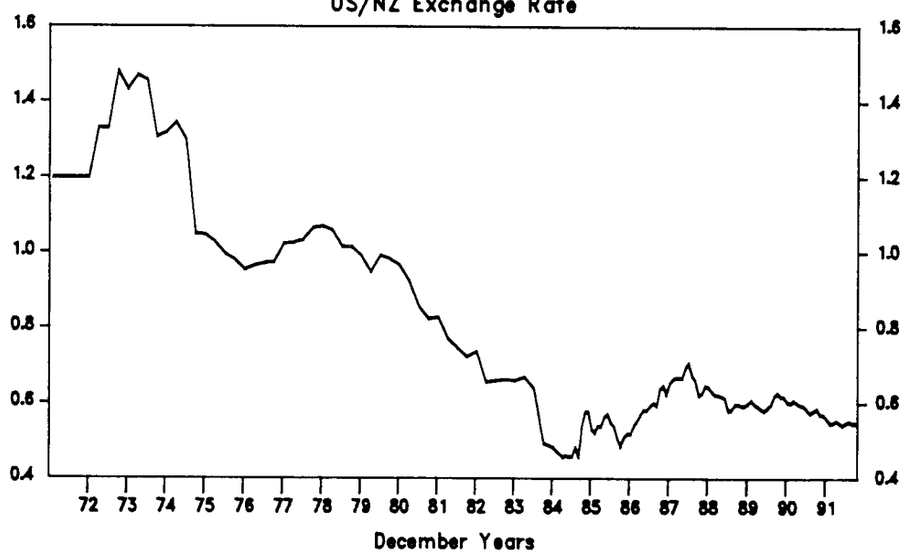


Figure 3
YEN/NZ Exchange Rate

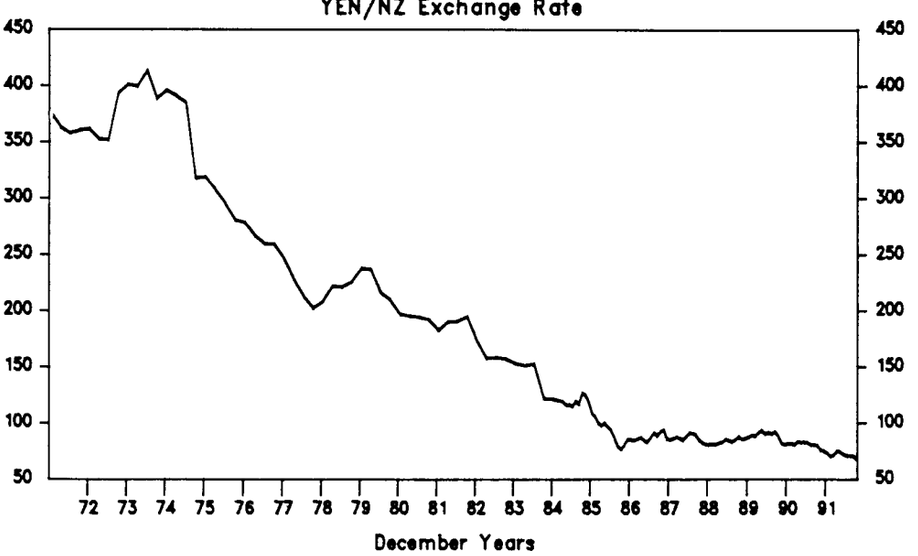


Figure 4
STG/NZ Exchange Rate

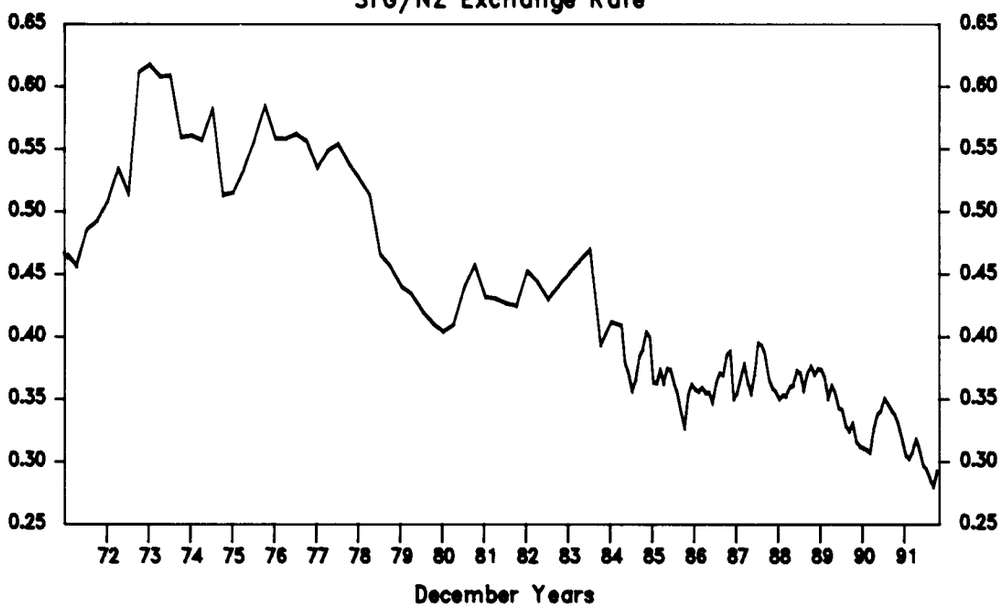
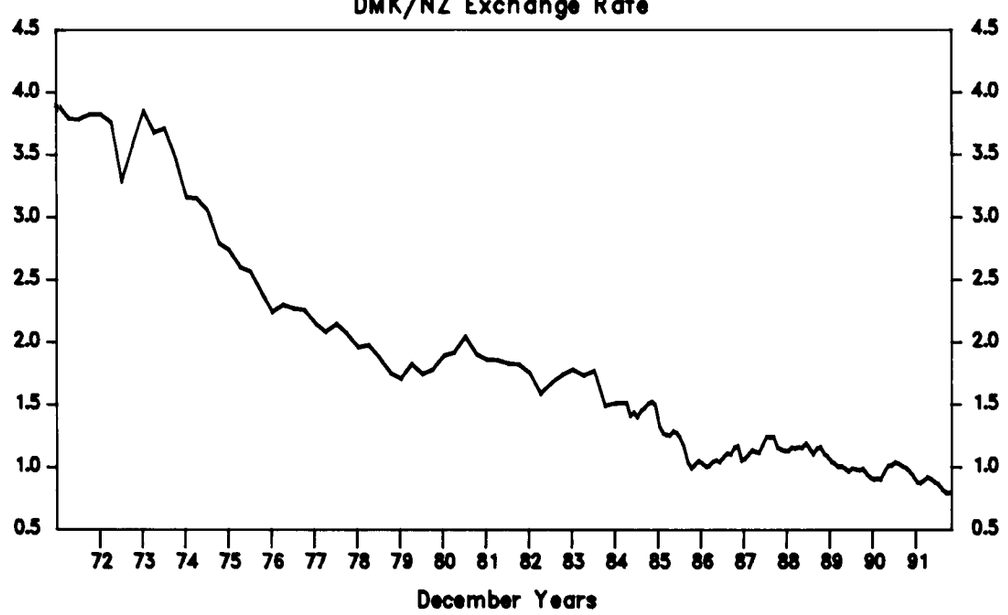


Figure 5
DMK/NZ Exchange Rate



This past volatility against the AUD has no doubt been a problem to some of you in the manufacturing sector. It may also be a surprise to some in the financial market, who tend to regard the AUD and the kiwi dollar as closely related at all times. That has clearly not been the case over most of the last 20 years.

Incidentally, it is interesting to note that, after a period of considerable volatility in the New Zealand dollar in the years immediately after the currency was floated in March 1985 - to say nothing of the occasional precipitous movements under the previous

Figure 6
AUD/NZ Exchange Rate

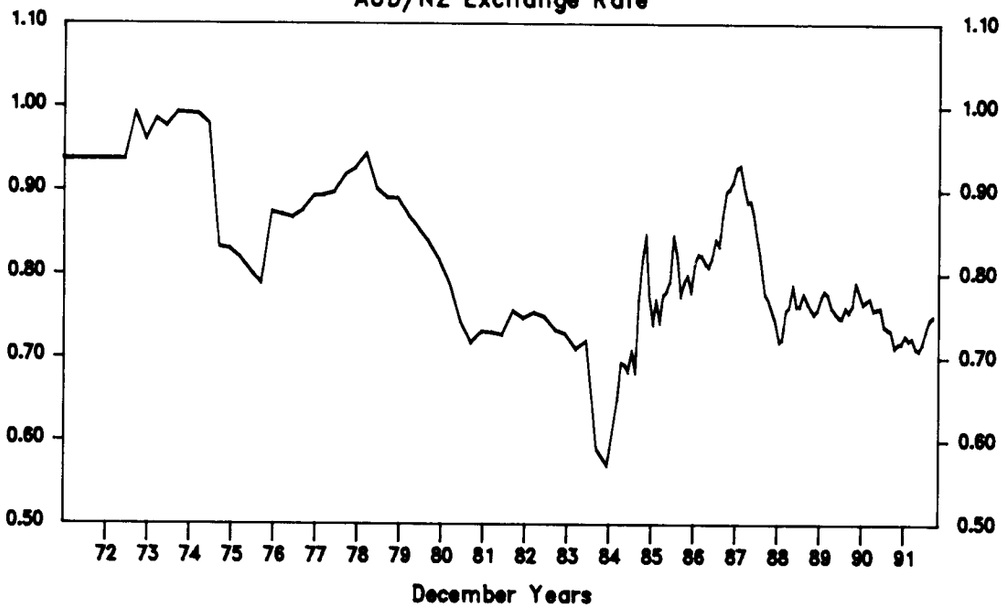
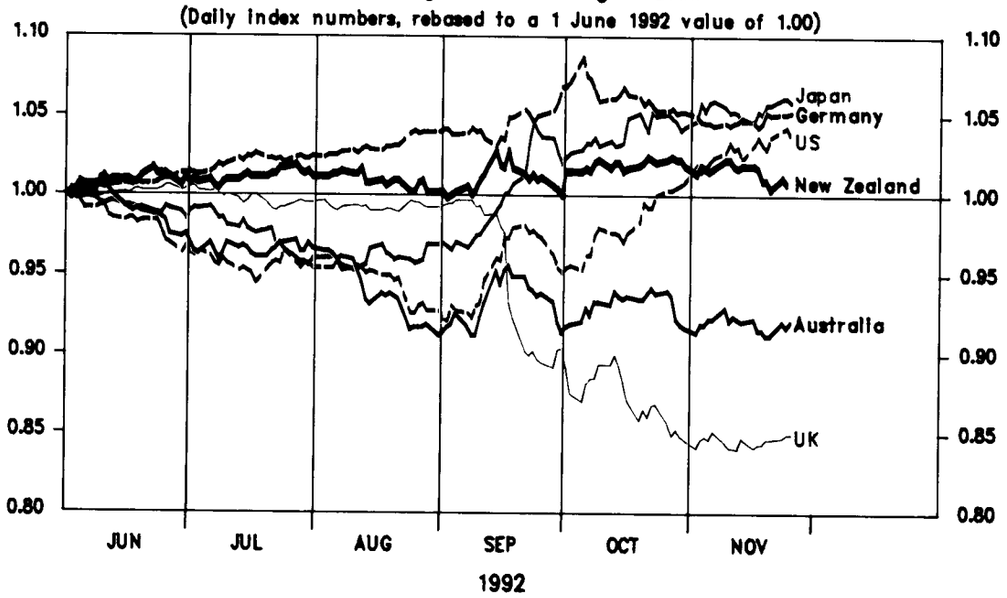
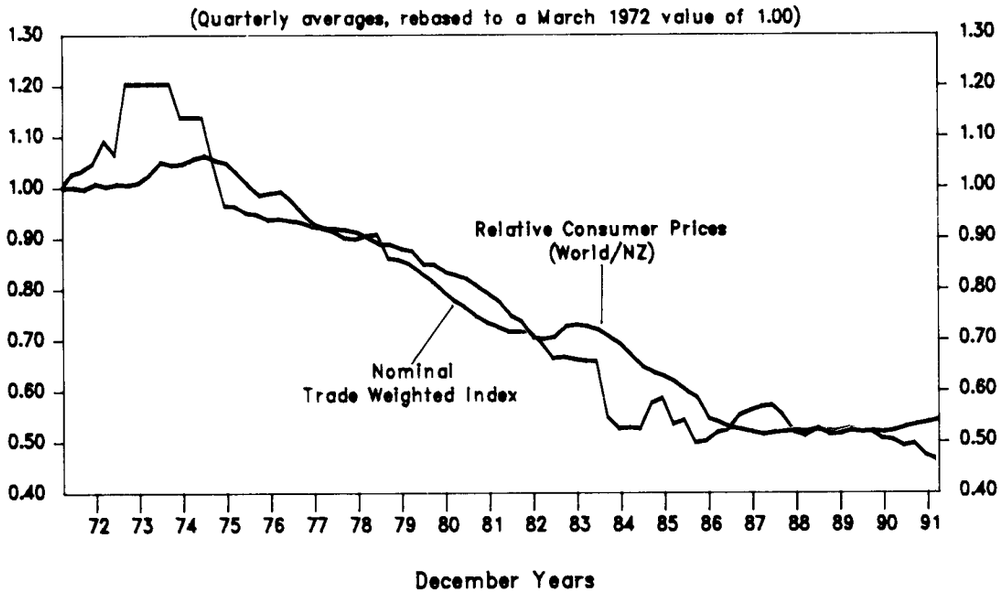


Figure 7
Trade Weighted Exchange Rates
(Daily index numbers, rebased to a 1 June 1992 value of 1.00)



'adjustable peg' arrangements - the kiwi has in recent times been one of the most stable floating currencies in the world. This is particularly so for recent months, as shown in Figure 7, where the New Zealand dollar is measured on a trade-weighted basis and compared with similar trade-weighted exchange rates for the UK, the US, Australia, Germany, and Japan. And as you know, unlike the central banks of the other countries shown in the graph, New Zealand's central bank does not intervene in the foreign exchange market by buying and selling currency.

Figure 8
Relative Consumer Prices and Nominal TWI
(Quarterly averages, rebased to a March 1972 value of 1.00)



Over long periods of time, the exchange rate tends to reflect two things: our inflation rate compared with inflation elsewhere in the world; and real factors, such as real wages and productivity compared with the same factors abroad. This second group of factors collectively make up a large part of an economy's competitiveness.

One can get a rough sense of the balance of these two types of influence on the exchange rate by stripping out the relative inflation component. In economists' jargon, this means calculating the ' real' exchange rate, just as stripping inflation out of nominal interest rates gives the 'real' interest rate. Since 1972 most of the reduction in the nominal exchange rate - the TWI - is explained by the difference between inflation in New Zealand and inflation in our trading partners, as shown in Figure 8.

Armed with this history, let me now turn to the six points I want to make this evening.

First, in an open economy, the exchange rate has a very important impact on prices in the local economy, and as a result no central bank with an interest in containing inflation can be indifferent to it. Thus, a sharp fall in the exchange rate would tend to increase New Zealand prices, while a sharp rise in the exchange rate would tend to depress local prices. If the target for inflation set by Government is 0 to 2 per cent, the extent to which the Bank can tolerate sharp movements in the currency is limited, whether those movements be up or down. A sharp *depreciation* could drive the inflation rate above 2 per cent. A sharp *appreciation* could drive the inflation rate below 0 per cent. Given the present Policy Targets Agreement between the Minister of Finance and myself, both outcomes would be equally undesirable.

Secondly, when the Reserve Bank looks at the exchange rate to assess whether or not it is broadly consistent with the maintenance of price stability, what we look at is the Trade Weighted Index (TWI). This way of measuring the exchange rate, as its name implies, involves valuing the New Zealand dollar not against any one currency but rather against

the currencies of our major trading partners, weighted according to the importance of our trade (imports and exports) with those countries. At the present time, the weights are Australia 33.79 per cent, the United States 25.23 per cent, Japan 25.26 per cent, the United Kingdom 10.52 per cent, and Germany 5.20 per cent. The weights are revised from time to time, and are publicly known.

Various people have criticised our use of the TWI. Some critics simply complain that it does not reflect the movement of the New Zealand dollar against the single currency which particularly affects them. (Some companies in your own sector, for example, complain that it does not describe adequately the exchange rate which most affects them, namely the kiwi/AUD cross rate.) We would immediately concede this point: by definition, the TWI values the New Zealand dollar against a *basket* of relevant currencies, not against a single currency. It does not purport to describe the impact of the exchange rate on any one company or industry. We monitor the TWI, rather than the value of the New Zealand dollar in terms of a single currency, because New Zealand prices are affected by prices in a *number* of countries, not just in one country.

A more sophisticated criticism of the TWI is that, because it weights currencies by the importance of New Zealand's trade with particular *countries*, not by the currencies in which our trade is *denominated*, it seriously understates the importance of the relationship between the New Zealand dollar and the US dollar. This view is often stated by people in the agricultural sector, because a high proportion of our agricultural exports are invoiced in US dollars, irrespective of destination.

We have looked very carefully at this argument, and accept that, in the very short-term, the currency in which trade is invoiced is important. In the longer-term, however (and it is this longer-term in which monetary policy has an impact, and therefore an interest), it is domestic currency prices in our trading partners, and not the currency in which invoices are expressed, which has the greatest effect on New Zealand inflation. For this reason, we are at this stage satisfied that the TWI is the most relevant measure of the exchange rate for monetary policy purposes. Let me acknowledge, however, that this is an issue which is always being monitored, and there is certainly nothing immutable in the present TWI.

As an aside, may I also say that, whatever the flaws in the TWI, it is for most purposes a better measure of the behaviour of the New Zealand dollar than is any individual cross-rate. I find it surprising to read media headlines proclaiming that the 'New Zealand dollar sees new 5-year low', or 'New Zealand dollar falls again', when what is actually happening is that the US dollar is rising against virtually all currencies, including the New Zealand dollar, and the TWI is unchanged. There have been a great many such misleading comments on the New Zealand exchange rate in recent years, and I am glad to see that Radio New Zealand, at least, as well as some of the print media, are beginning to focus more on the TWI. Individual cross-rates are *of course* important to many people. But as a measure of what is happening to the New Zealand dollar they are frequently misleading.

My third point is that it is indeed quite likely that, in the long term, there will be a tendency for the New Zealand dollar to appreciate against the currencies of our trading partners to the extent that inflation in New Zealand runs at a rate below that in our trading partners. The depreciation of the *past* 20 years reflects the fact that, through most of that period, our inflation rate was above that of our trading partners. The appreciation which may

well occur in the future will be a result of the better relative inflation performance which can be expected to flow from the Reserve Bank Act of 1989 - and indeed the framework established by that legislation has already contributed to New Zealand's having one of the lowest inflation rates in the OECD.

I can understand why the prospect of an appreciating exchange rate fills many companies with foreboding. But in fact this tendency for the New Zealand dollar to appreciate in the long term should not give any New Zealand producer grounds for concern, because what is relevant to the ability of a New Zealand producer to compete on international markets (or against imports on the New Zealand market) in the long term is not the nominal exchange rate but the second group of factors that I mentioned - those aspects of competitiveness that go into the measure of the real exchange rate, such as real wages and productivity compared with the same factors abroad. If our inflation rate is below that of our trading partners, the nominal exchange rate can appreciate by the extent of that inflation differential without disadvantage to New Zealand producers.

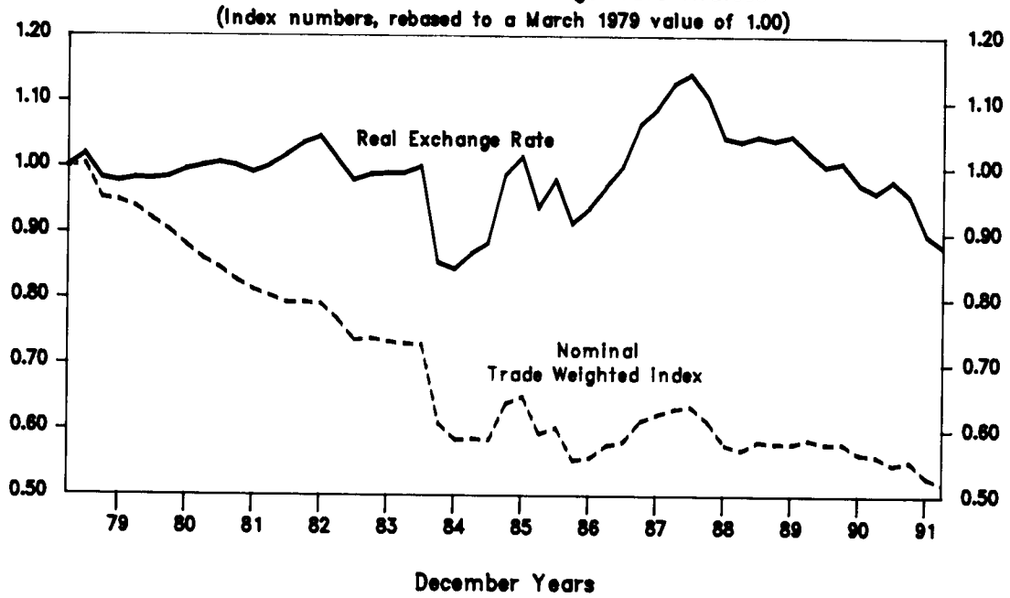
Fourthly, and I can't stress this point too strongly, none of the points I have made - about how no central bank concerned with restraining inflation in an open economy can be indifferent to the exchange rate, about how it is the TWI that we monitor when looking at the exchange rate impact on domestic inflation, and about the likelihood that, in the longer term, the nominal exchange rate may well have a tendency to appreciate - none of these points means that the Reserve Bank has a fixed target for the exchange rate which is unchanging over time. The appropriate level of the nominal exchange rate from the Reserve Bank's point of view is that level which, taking into account all the various factors affecting domestic prices, is consistent with the maintenance of price stability.

Given the uncertainties and imprecision in any economic forecast (which is reflected in the fact that we target an inflation band), this is never a single exchange rate, but always a range. Moreover, it is not even an unchanging range: it will vary depending on what other factors are feeding into the inflation rate. This is amply demonstrated in recent New Zealand experience, where the exchange rate which seemed consistent with price stability when wage settlements were running at around 5 per cent was quite a bit higher than that which seems appropriate with wage settlements running at much lower levels. If wage settlements were suddenly to revert to much higher levels without similar increases in productivity, the monetary conditions, including the exchange rate, which would be consistent with price stability would be much firmer than at present.

Conversely, if wage settlements were to fall further, the monetary conditions, including the exchange rate, which would be consistent with price stability would be somewhat easier than at present. (For this reason, it is not appropriate to suggest that New Zealand uses the exchange rate as an 'anchor' for its inflation rate, in the way that countries which are members of the Exchange Rate Mechanism of the European Monetary System do.)

I mentioned early on in my remarks that the real exchange rate, or the nominal exchange rate adjusted for inflation differentials, is relevant to exporters' long-term competitiveness (and indeed to the long-term competitiveness of those competing with imports) whereas the nominal exchange rate by itself is not. Before making my fifth main point I want to comment briefly on the importance of the real exchange rate - in other words, the importance of the extent to which New Zealand producers are able to compete with overseas producers.

Figure 9
Nominal and Real Exchange Rate Indices
(Index numbers, rebased to a March 1979 value of 1.00)



In my view, the real exchange rate is one of the most important price signals in the economy. Too high a real exchange rate will harm the competitive position of New Zealand producers and will tend to discourage investment in the production of exports and import substitutes, so contributing to balance of payments deficits and, probably, unemployment. Too low a real exchange rate (or, put another way, too low a level of real wages) will tend to depress living standards by making many consumption goods (including food) artificially expensive, and will tend to lead to under-investment in domestic sectors, such as housing and infrastructure. I have had no difficulty arguing from a great many platforms over the last few years that, with large balance of payments deficits and rising unemployment, there was a prima facie case for believing that our real exchange rate was, until recently, overvalued.

On the other hand, I would not want anybody in this audience to get the impression that I believe that getting relative cost structures right is all there is to a successful export strategy. As we are increasingly being reminded by many people with experience in successful exporting, a reputation for supplying a quality product, well adapted to market needs, on schedule, with appropriate after-sales support, is in many situations at least as important as price in winning and retaining export markets.

Turning to my fifth main point, I want to say that, regardless of how important the real exchange rate is, it isn't something which monetary policy can sustainably influence.

To be sure, monetary policy can affect the real exchange rate in the short-term, by moving the nominal exchange rate temporarily away from the level consistent with relative inflation rates. Figure 9 shows New Zealand's real exchange rate since 1979. It is undeniable that the disinflationary monetary policy initiated in the mid-eighties produced an appreciation in the real exchange rate; while the policy easings of August 1988 and September 1991, made possible by the substantial progress which had been achieved in reducing inflation, produced a depreciation in the real exchange rate.

But the position in the longer term is quite different. To illustrate this point, let us imagine that in 1972 (the beginning point on Figure 8) the Reserve Bank had been asked to depreciate the real exchange rate by 10 per cent to improve competitiveness and, though this is not usually stated, reduce the purchasing power of New Zealand consumers. Using the only tool available to it, the Bank would probably have eased monetary policy, to induce the TWI to fall. Initially, a gain in competitiveness would have been achieved, but subsequently domestic inflation would have risen, aided both by higher import prices and by easier monetary policy. That rise in costs facing domestic producers would have eroded the early competitiveness gain, leaving New Zealand businesses without anything like the improvement sought, and with higher inflation to boot.

In order to recapture the initial competitiveness gains, the Bank might have been tempted to ease monetary policy further, and push the TWI down further. (The sound of calls for a *further* 10 per cent fall in the exchange rate has a familiar ring!) This time around, the initial competitiveness gains would have lasted less time, as wages and other prices responded more quickly.

Eventually, we might have ended up with a picture not unlike the early 1980s, with the nominal exchange rate much lower, few competitiveness gains, and an inflation problem to deal with.

The key message is: important though the real exchange rate is, it is not something which the Reserve Bank can influence over the long haul.

Finally, I want to emphasise the point that whereas the Reserve Bank cannot engineer a sustainable improvement in the economy's competitiveness, collectively you can. Competitiveness comes from real cost structures that compare well with those abroad; from quality of design, product, and service; and from adaptability, to keep in touch with ever-changing market conditions. All these are in your hands. The best thing that the Bank can do is not confuse the picture by allowing inflation to wobble away from price stability.

Let me illustrate, in particular, the point about real cost structures, because it is extremely important. It is the movement in real cost structures in New Zealand compared with those in our trading partners that is reflected in the 'real' exchange rate calculation that I referred to earlier. If New Zealand costs rise faster than those abroad - perhaps because of increases in wages not supported by increases in productivity - the real exchange rate will have a tendency to rise even when the TWI remains absolutely steady. More rapid increases in New Zealand costs than the costs facing our trading partners spell a loss in competitiveness, as you will all recognise - and this is what the appreciating real exchange rate shows.

Moreover, if the Reserve Bank remains true to its mandate to maintain price stability, monetary policy would have to be tightened to offset any inflationary pressures associated with more rapidly rising costs. As a result, the nominal exchange rate would have a tendency to rise also, thus pushing the real exchange up even more, to the further disadvantage of New Zealand producers.

But the converse is also true. If New Zealand real costs fall compared with those abroad -perhaps because of productivity gains that are not fully absorbed by higher wages and

profits - there is an improvement in the ability of New Zealand producers to compete internationally, even if the TWI remains steady. In this case, the real exchange rate measure falls (that is, depreciates).

Moreover, because the Reserve Bank is charged with maintaining price stability and not with engineering an absolute reduction in prices, the reduction in inflationary pressures may well be accompanied by an easing in monetary policy. That would tend to reduce the TWI, and give a further boost to competitiveness.

In other words, and this is the point that I want to get across, ultimately it is those who determine movements in our real cost structures - employers and employees - who collectively determine the real exchange rate. It is not monetary policy.

This may sound somewhat obvious, but it used to be a constant source of amazement to me how often I received comments which suggested that the relationship was not understood: the meat company executive, for example, who told me at length that his company could not survive at the then current exchange rate, but who then mentioned casually at the end of the meeting that he expected most of his staff to get a 5 per cent wage increase that year. (This incident took place some three years ago.)

If you propose to increase wages, you are by implication saying that you can continue to compete against imports, or compete on the export market, at the current exchange rate, and indeed can continue to do so even if wage rates increase. If you want a depreciation in the exchange rate, you are by implication saying that you want to *reduce* real wages. You can't say you want both a reduced exchange rate and higher wages - or at least, you can't with a straight face.

Recent governments have acknowledged this relationship between wage behaviour and monetary conditions. In their different ways - recognising their different approaches to labour market structures - they have sought to make wage settlements consistent with the price stability target, in order to facilitate easier monetary conditions.

As wage settlements have in fact become consistent with the price stability target, the Bank has been able to tolerate easier monetary conditions and a lower nominal exchange rate. And the combination of stable domestic cost structures and a lower nominal exchange rate has produced a very significant improvement in the competitive position of New Zealand producers.

So my message to New Zealand producers today, be they manufacturers, or farmers, or tourist operators, or whomever, is that the real exchange rate is largely in your hands. If you want to improve your competitive position *vis-a-vis* international competitors, then make decisions on improving productivity and settling wages which are consistent with that objective. By so doing you will further enhance your competitiveness, and bring closer the day when we can, as a nation, ensure that there is productive work for all.