Panel discussion

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I am very pleased to be here today, and would particularly like to thank our hosts, the Bank of Korea and the BIS, for their excellent hospitality.

Today I would like to talk about the New Zealand experience, and try to draw some broader conclusions based on our experience for the issue of currency internationalisation.

During the conference, we have heard many different views on currency internationalisation, and I feel that to sort out these differences, we need to make a very clear distinction between capital account liberalisation on the one hand, and currency internationalisation on the other. This is the point that Hans Genberg has been making in his comments.

The important thing here is that capital account liberalisation is a policy action, whereas currency internationalisation is potentially a by-product of that policy action, but is not a policy action of its own accord.

The New Zealand dollar: an internationalised currency

The New Zealand dollar is not an international currency in the sense that it is not used broadly in current account transactions, nor is it an international reserve currency. But in line with Professor Kenen's definition, it is an internationalised currency. The factors contributing to that have been:

- New Zealand has had 20 years of open financial markets and capital account convertibility.
- It has had a freely floating currency since 1985.
- New Zealand is very reliant on foreign savings and has a relatively high debt to GDP ratio.
- The hedging of foreign exchange balance sheet risk has become the norm in New Zealand, and this has been underpinned by the Reserve Bank's prudential policy. As a result of these factors, currency internationalisation has flowed on.

Now, in observing the currency internationalisation of the NZ dollar, what have we seen?

First, as shown in Figure 1, the New Zealand dollar punches above its weight when it comes to liquidity. The turnover in the NZ dollar, as a percentage of nominal GDP, is actually higher than for the currencies of most other countries – even currencies such as the Swiss franc and the Hong Kong dollar. As a result, daily turnover, as seen in the figure, has recently been 55% of annual GDP.

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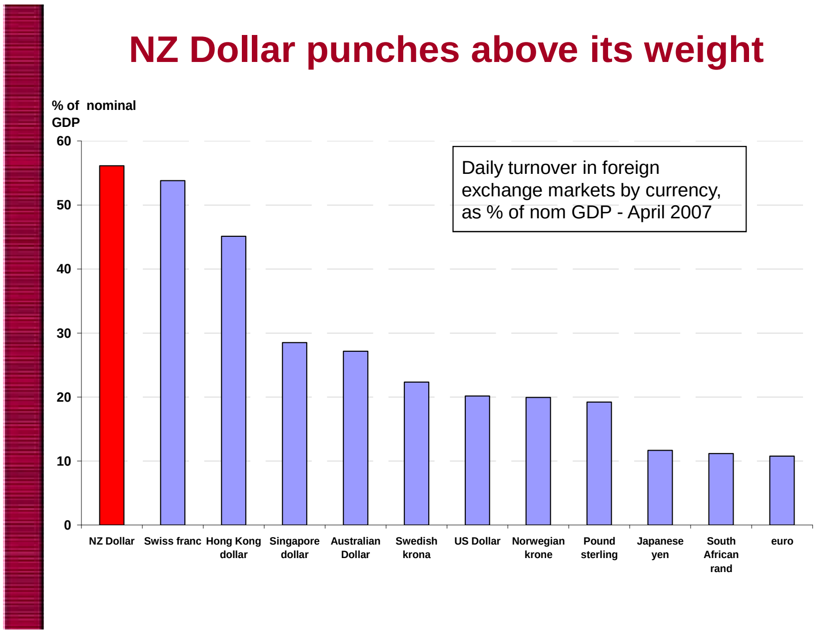
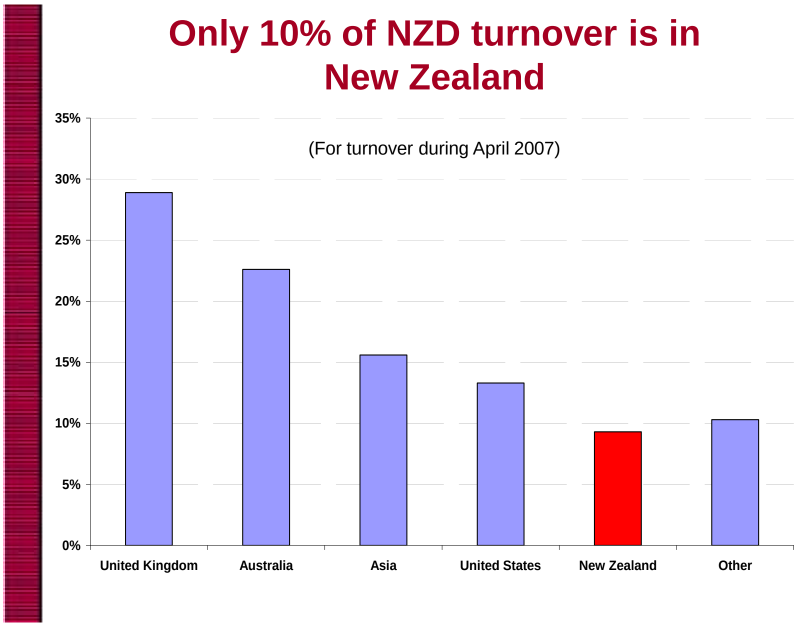
Figure 1



Source: BIS.

We see in Figure 2 that only 10% of this high volume of turnover actually occurs in the New Zealand marketplace itself. Most trading actually occurs in London, followed by Australia, then Asia, etc. This demonstrates that, if a country is hoping to internationalise its currency at some point, it will have to let go of its currency, in the sense that it will need to allow it to be freely traded in global financial markets.

Figure 2



Source: BIS.

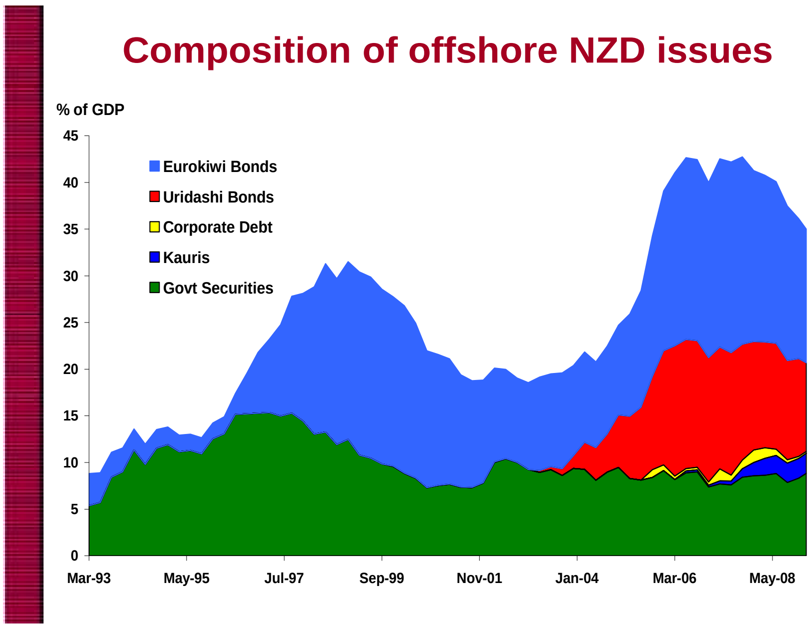
A further characteristic of the NZ dollar as an internationalised currency, as shown in Figure 3, is that a large proportion of NZ dollar debt securities are issued offshore. In fact, only about 35% of NZ dollar debt securities are actually issued onshore; the proportion issued offshore is greater than for all other EMEAP economies including Hong Kong SAR. This is very much in line with Professor Kenen's definition of an internationalised currency.

Figure 3

Source: BIS.

Moving on to Figure 4, we see here the composition of the offshore NZ dollar debt issues. Clearly, this shows an upward trend, but also quite a cycle, so we see that the proportion of NZ dollar debt issued offshore varies greatly according to the credit market cycle.

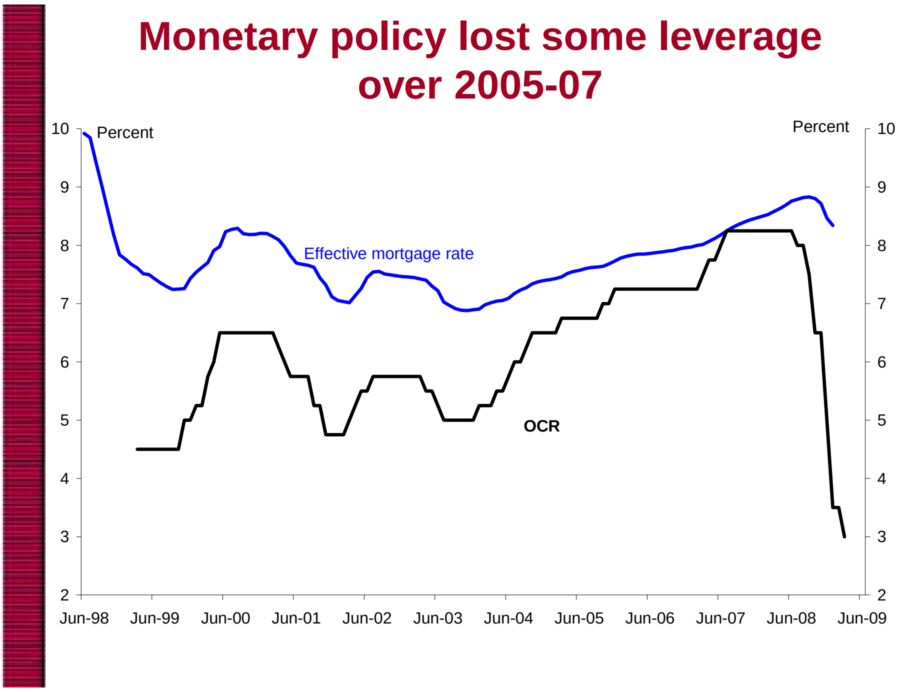
Figure 4



Source: Reserve Bank of New Zealand.

The credit market boom from 2003 to 2007 saw a very rapid growth in NZ dollar debt issues offshore. Since then, due to the international credit crisis, the volume of New Zealand's outstanding debt has been tending to reduce as interest differentials are reduced but, more importantly, risk appetite has diminished among the international investment community.

Figure 5



Source: Reserve Bank of New Zealand.

New Zealand's experience with open capital markets and capital account convertibility

Looking now at New Zealand's experience and the pros and cons of open capital markets and a convertible currency: first, it has been a generally positive experience overall. On the plus side, we have seen that open capital markets and capital account convertibility have facilitated efficient resource allocation in the New Zealand economy. It has promoted adjustment to external shocks and facilitated an independent monetary policy. On the negative side, there is no doubt that the exchange rate can, at times, overshoot in response to shocks. Hence, we do sometimes have unnecessary or perverse adjustments in the traded sector. But, overall, I would say that having an open capital market and an open capital account in New Zealand has been a positive experience, and I don't think that anyone would regret the policy decision that was made in this area back in the mid-1980s.

Experience with the New Zealand dollar as an internationalised currency

Overall, this has been a net positive experience, but it has certainly had some adverse aspects as well.

On the positive side, currency internationalisation has facilitated risk management, particularly the hedging of foreign exchange risk on balance sheets, both of the corporate sector and of the banking sector. It has allowed separate management of foreign exchange and credit risks and has maximised the scope for investors and borrowers to choose options so as to lower the overall cost of capital in New Zealand. This separation exploits comparative advantage in capital markets. On the negative side, the main drawback of currency internationalisation is a lessening of leverage in monetary policy, particularly when risk premia are low, as is the case during a credit market boom. This reduced independence was accentuated by the carry trade phenomenon over 2005–07, which basically meant that, during that period, the exchange rate became more sensitive to shifts in relative monetary policy positions. Of course, what has happened since the onset of the international credit crisis is that monetary policy has become more independent as risk premia have increased; home bias has increased in the investor community; and the carry trade has diminished in importance. Our view is that this change is going to persist for some time – we are not going to have another credit boom in a hurry – so there will be a sustained period where higher risk premia and home bias will promote the independence of monetary policy in a country like New Zealand, even though we do have open capital markets.

Conclusion

Concluding my comments, I would like to make the following points:

- An open and flexible financial system certainly offers significant benefits in terms of economic efficiency and resilience to shocks, and no one in New Zealand or any other country that I am aware of has regretted the move towards capital market liberalisation.
- Currency internationalisation may or may not follow capital account liberalisation, depending on the country's individual circumstances, and in particular whether there is a demand in that country for balance sheet hedging of foreign currency risk.
- Monetary policy may be affected by currency internationalisation when global risk premia are low. The outlook for the medium term, I think, is for greater independence of monetary policy given the trend towards home bias among investors that we are seeing at present.

I will leave it there. Thanks very much for your attention. I look forward to the discussion.