Mr Brash addresses the subject of the New Zealand dollar and the recent business cycle

Address by the Governor of the Reserve Bank of New Zealand, Dr Donald T. Brash, to the Canterbury Employers' Chamber of Commerce in Christchurch on 29/1/99.

Introduction

Mr Chairman, Ladies and gentlemen,

I am delighted to be addressing you once again, on your first meeting of the New Year. If my memory is correct, this is the sixth occasion on which I have done this, and I appreciate your courtesy and tolerance in inviting me back each year.

Last year, I addressed the subject of New Zealand's balance of payments deficit. Today, I want to talk a little about a related issue, the exchange rate and its behaviour in recent years, because I recognise that, in an export-oriented economy like that of Christchurch, the exchange rate has a substantial impact on the viability of many businesses. I feel relatively safe in Christchurch today, with the trade-weighted measure of the New Zealand dollar around 57, but I felt distinctly less secure when I was here just two years ago, with the TWI up around 69! And certainly the appreciation from around 53 in early 1993 to 69 in early 1997, or an appreciation of some 30 per cent in four years, made life very difficult for many businesses.

Eleven years have passed since the Minister of Finance first gave the Reserve Bank of New Zealand an explicit, quantitative, inflation target, and we have now experienced one full business cycle under that inflation targeting regime, from recession in 1991 to recession in the first half of 1998. For this reason, it seemed like an opportune time for us in the Bank to review that experience to see what we could learn. Accordingly, over much of the last year, we have been doing a careful study of the evolution of the New Zealand economy during the nineties. And to me at least, the results of that review are intensely interesting. Some of them were published just prior to Christmas in the December 1998 issue of the Reserve Bank's quarterly Bulletin, while others will be published in the March Bulletin.

I can't even begin to summarise all of these results, but I want to record a few of them, as they relate to the appreciation of the New Zealand dollar between early 1993 and early 1997. In particular I want to address four questions:

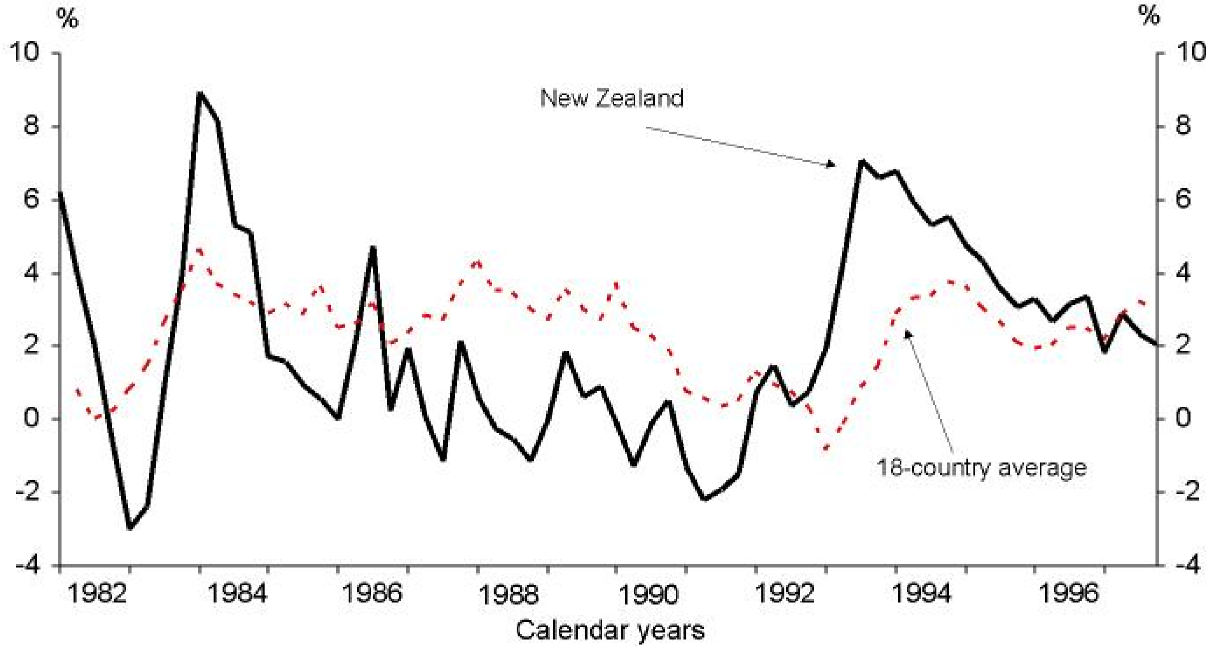
- Why did the appreciation take place?
- Was the appreciation in some sense abnormal or unusual?
- What part did the Reserve Bank play in the appreciation?
- Can large appreciations be avoided in the future?

First, why did the appreciation take place?

When we look back over the last business cycle, from the recession in 1991 to the recession in the first half of 1998, one of the dominant impressions is that the New Zealand economy grew for longer than in either of the two previous business expansions. An even stronger impression is of an economy growing at quite a fast pace, certainly in comparison to growth in most other developed countries. Indeed, in 1993 GDP growth peaked at 7.1 per cent and, while growth slowed from that point on, the slow-down was quite mild by historical standards. The result was that economic growth in New Zealand exceeded the average growth among 18 OECD countries from 1992 to late 1996. By the December quarter of 1997, the New Zealand economy was 25 per cent larger in real terms than it had been at the trough of the recession in 1991. (See Figure 1.)

Figure 1

Real GDP growth: New Zealand and selected OECD countries



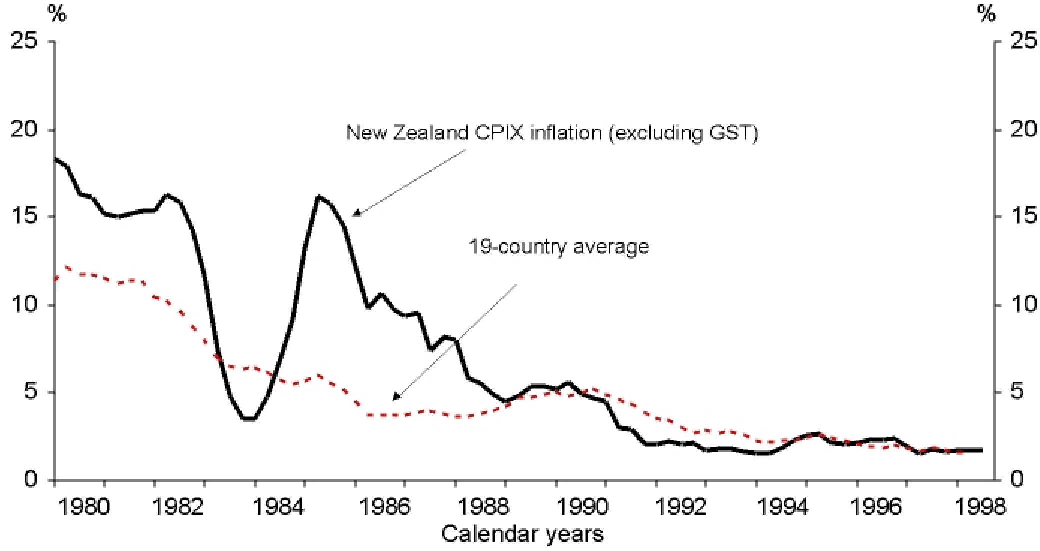
(Sources: Statistics New Zealand, International Financial Statistics, RBNZ calculation)

At the same time as we were enjoying that relatively rapid growth, inflation (as measured by the CPI excluding interest rates) was both low and stable, fluctuating between a minimum of 1.1 per cent and a maximum of 2.7 per cent between 1991 and the present. In the early part of that period, inflation was slightly below the average for these OECD countries, while in the later part of the period, New Zealand's inflation rate was virtually identical to the OECD average. (See Figure 2.)

But although actual inflation was subdued, inflationary pressures were, for several years at least, intense. The New Zealand economy initially expanded more rapidly than several of its major trading partners, fuelled at the outset by rapid export growth but sustained by strong growth in investment and consumption, and, later, by strong inward migration and an expansive fiscal stance. The prices of goods and services not exposed to international competition rose significantly faster than the average increase in all prices. There can be little doubt that our inflation rate would have been appreciably higher – that is, more typical of the seventies and eighties – had monetary policy not been leaning hard against those inflationary pressures.

Figure 2

Annual inflation rates: New Zealand and selected OECD countries

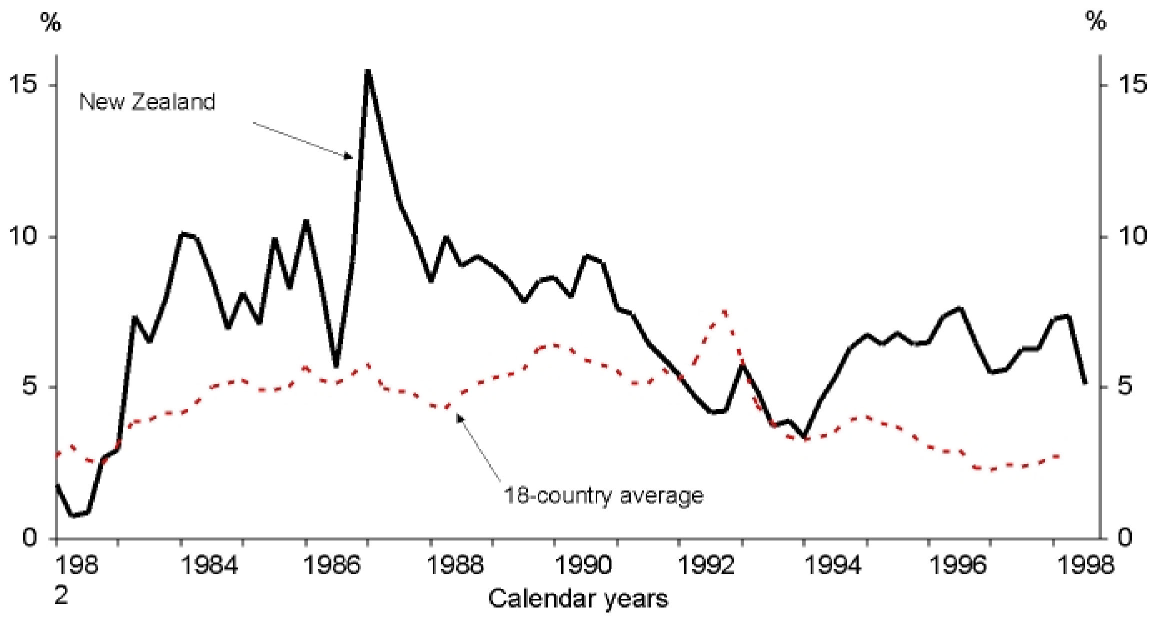


(Sources: Statistics New Zealand, International Financial Statistics, RBNZ calculation)

And of course ‘leaning hard against inflationary pressures’ is a euphemism for pushing up real (inflation-adjusted) short-term interest rates. In 1992, our real short-term interest rates were actually lower than the OECD average; in 1993, they were very close to the average; but from 1994 until some six months ago they were well above the OECD average. (See Figure 3.)

Figure 3

Short-term real interest rates: New Zealand and selected OECD countries



(Sources: RBNZ, International Financial Statistics, RBNZ calculation)

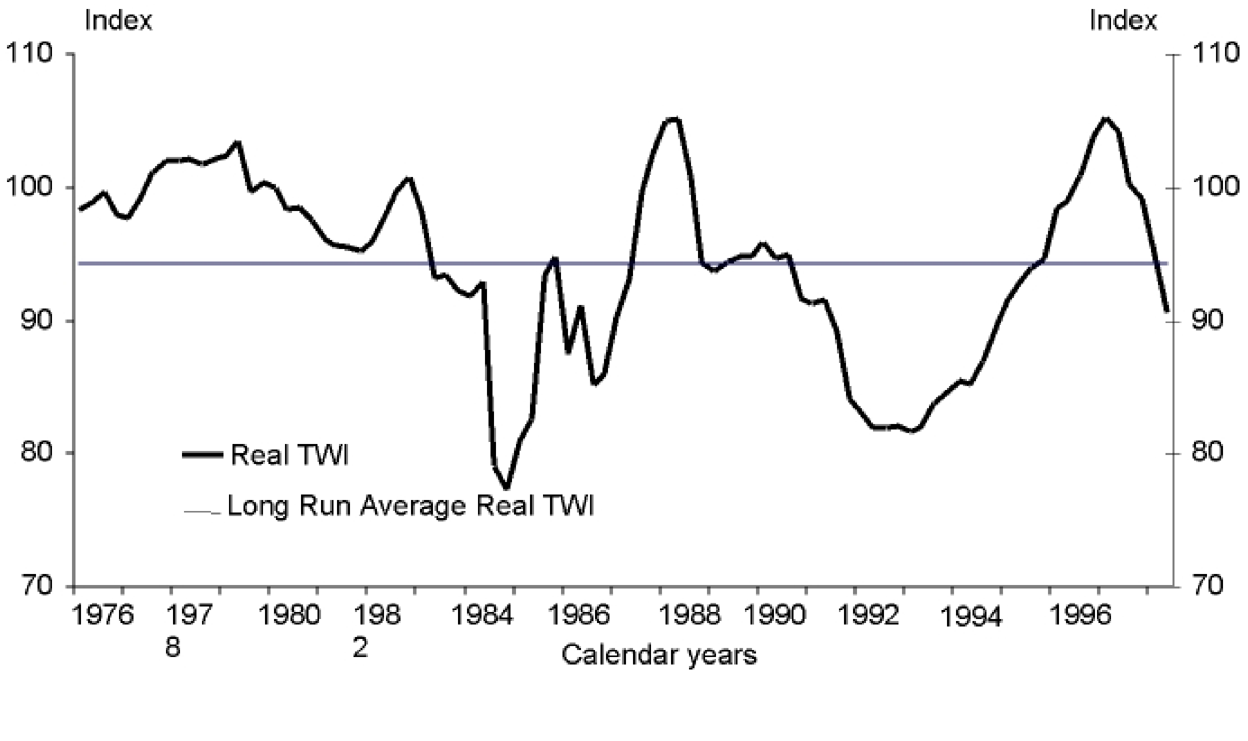
While various factors help to explain why the New Zealand dollar appreciated from early 1993 to early 1997, our research suggests that the dominant explanation is the obvious one, namely the relative strength of the domestic economy and the resulting inflation pressures. Those inflationary pressures necessitated significant monetary restraint, as reflected in the rise in New Zealand's short-term interest rates relative to those in our trading partners. Higher interest rates in New Zealand than elsewhere ensured plenty of demand for New Zealand dollar assets, which is another way of saying that there was upward pressure on the exchange rate. In other words, the strong appreciation of the mid-nineties was the direct result of demand growing to the point where inflationary pressures would have pushed up measured inflation markedly had it not been for firm monetary policy. It was not until the domestic inflation pressures had clearly dissipated that the TWI began to depreciate, around May 1997.

Secondly, was the appreciation in some sense abnormal or unusual?

It is helpful in answering this question to look not at the movement in the nominal exchange rate but at the movement in the real (inflation-adjusted) exchange rate. Figure 4 shows the real exchange rate measured on a trade-weighted basis. What the graph shows is that the real exchange rate rose between early 1993 and April 1997 by 29 per cent, compared with an increase of 36 per cent between late 1984 and mid 1988. So the most recent appreciation was slightly smaller than the one experienced in the mid- to late eighties.

Figure 4

New Zealand trade-weighted real exchange rate



(Source: RBNZ)

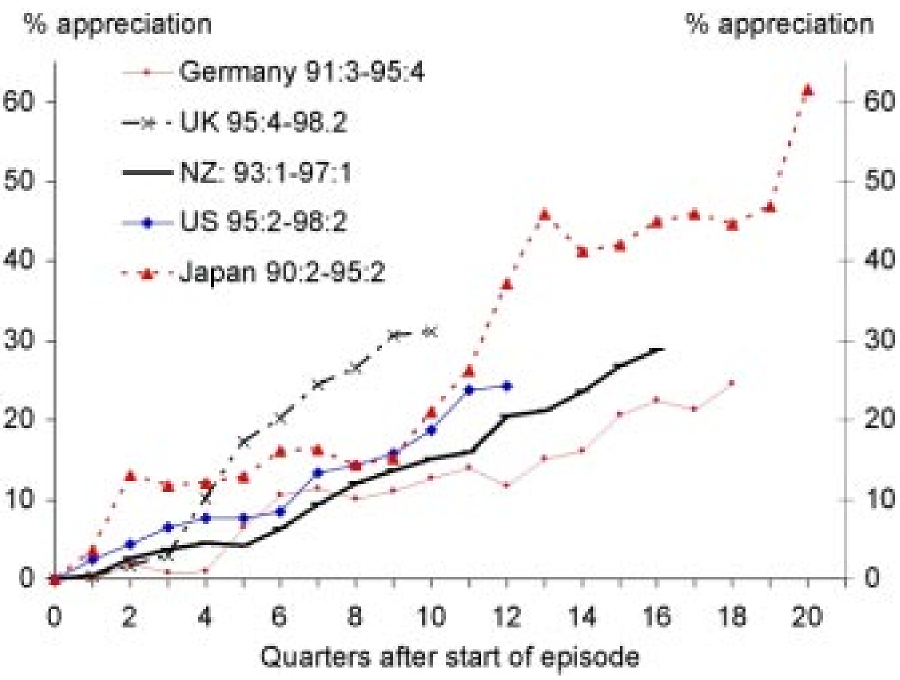
Another important point can be seen in the graph, and that is that, although some exporters are particularly prone to measuring exchange rate appreciations from the very bottom of an exchange rate cycle, it is as unrealistic to imply that the bottom of the cycle is in some way the norm as it would be to imply that the top of the cycle is the norm. The real exchange rate goes through cycles, sometimes appreciating above its long-run average and sometimes depreciating below its long-run average.

In early 1993, it is quite clear that the New Zealand dollar was significantly below its long-run average, and no exporter should have been expecting that the exchange rate would continue indefinitely at those levels. In early 1997, it is equally clear that the New Zealand dollar was significantly above its long-run average, indeed above its long-run average to almost exactly the same extent as had been the case in the middle of 1988 (almost 12 per cent). Today, the real exchange rate again seems to be somewhat below its long-term average level. Given New Zealand's relatively low short-term interest rates, and the size of our current account deficit, I do not myself expect any rapid change in that situation. Indeed, any strong appreciation of the New Zealand dollar at this stage would be surprising. But on the other hand it is no more reasonable to expect the exchange rate to remain below its long-term average indefinitely than it is to expect it to remain above that level for a lengthy period.

But, I am often asked, why do we have to endure these big appreciations at all? Surely other countries have managed their affairs without suffering from such strong appreciations? Well, some may have done so, but it is not at all difficult to find other countries which have experienced similarly strong real appreciations in the recent past, including Japan (an appreciation of 62 per cent from 1990 to 1995), the United Kingdom (an appreciation of 31 per cent from 1995 to mid-1998), Germany (an appreciation of 25 per cent from 1991 to 1995), and the United States (an appreciation of 24 per cent from 1995 to mid-1998). Indeed, Japan's real appreciation was very substantially greater than New Zealand's, while Britain's was somewhat greater and over an even shorter period. And of course none of these countries is small or particularly prone to being buffeted by international shocks. (See Figure 5.)

Figure 5

Recent episodes of exchange rate appreciation

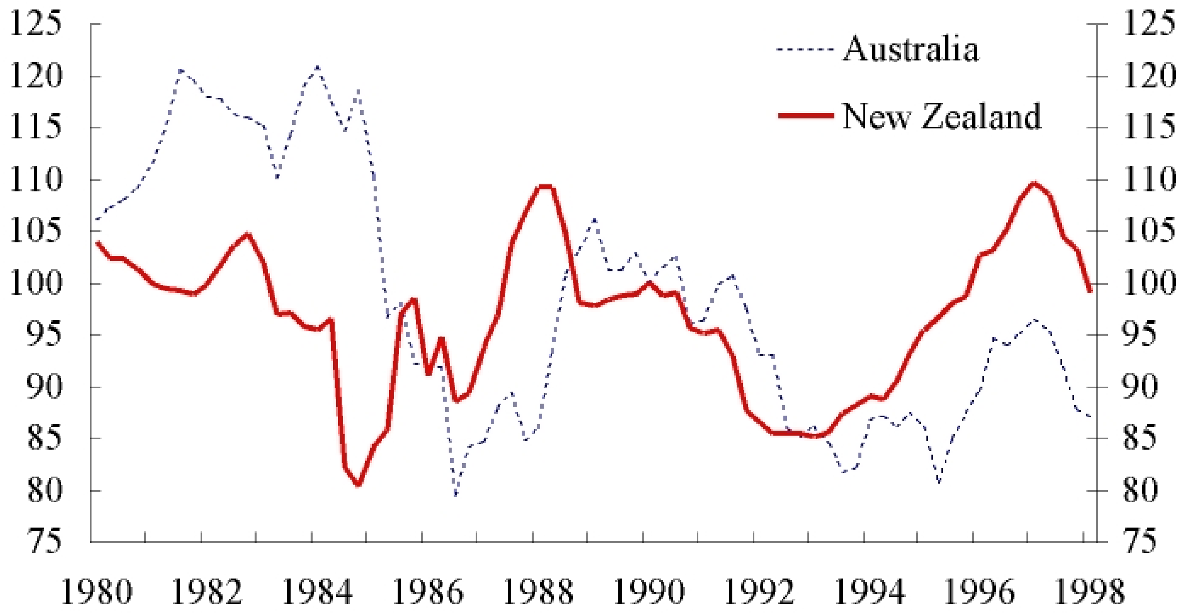


(Sources: RBNZ, International Financial Statistics)

But what about Australia? Surely Australian exporters have not been so badly affected by movements in their real exchange rate as New Zealand exporters were? To be sure, the Australian real exchange rate appreciated rather less strongly than the New Zealand dollar did in the mid-nineties but, as Figure 6 shows, over the whole period since 1980 it is not immediately obvious that the Australian real exchange rate has behaved in ways which have been kinder to exporters than the New Zealand dollar has. Indeed, looking at the volatility of real exchange rates, while the Australian dollar has clearly been through a more subdued cycle than has the New Zealand dollar over the last five years, taking the eighties and nineties together the volatility of the Australian dollar (in real terms) has been somewhat greater than has that of the New Zealand dollar.

Figure 6

Trade-weighted real exchange rates: Australia and New Zealand



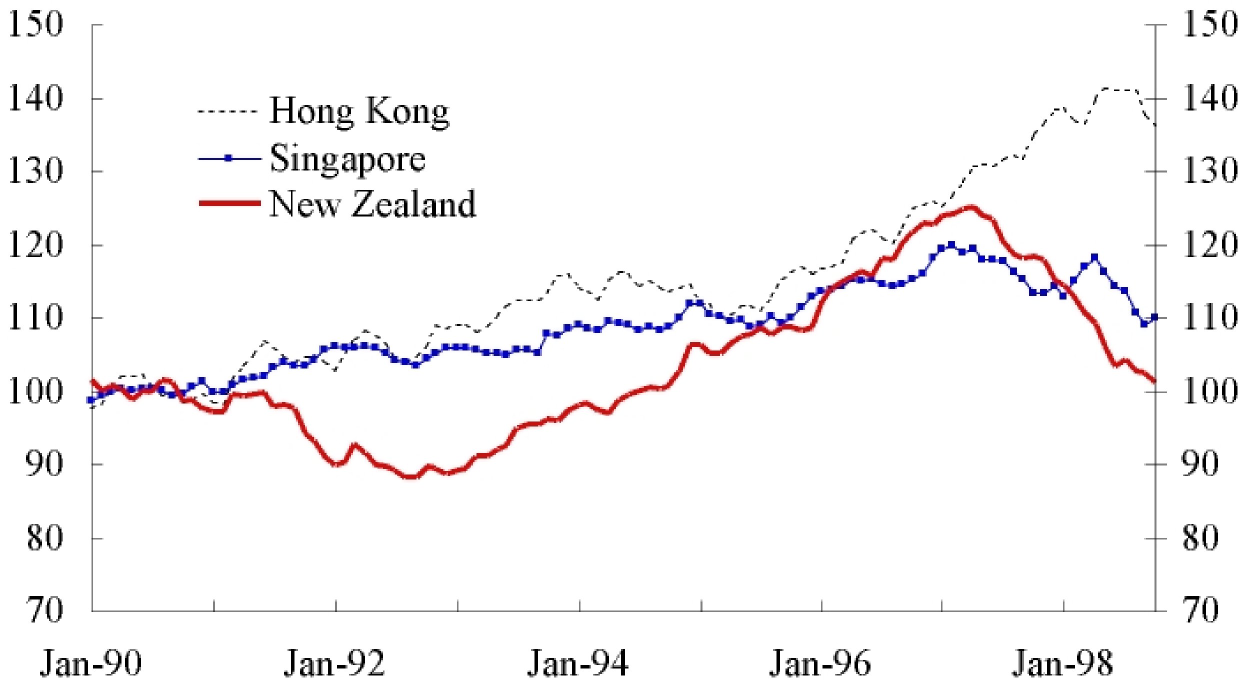
(Sources: RBNZ, International Financial Statistics)

There are various reasons why the Australian dollar appreciated more modestly than did the New Zealand dollar during the most recent business cycle: Australia's commodity prices were weaker than were New Zealand's at various times during the nineties, and more generally Australia had more subdued inflationary pressures, requiring less firm monetary conditions, than New Zealand did. My point is simply that it would be unwise to assume, on the basis of one cycle, that Australia has found some enduringly relevant way of avoiding strong exchange rate appreciations.

A comparison of New Zealand with Singapore and Hong Kong is also interesting perhaps, since they are two small, very open, economies, one of them operating a managed float and the other a currency board peg to the United States dollar. Both economies are often held out as models of economic management, and certainly are economies which have, over many years, achieved strong export growth. If we consider the period of maximum New Zealand dollar real appreciation, from late 1992 to April 1997, we see that the New Zealand dollar appreciated by rather more than did either the Hong Kong dollar or the Singapore dollar over the same period. But if we consider the whole of the nineties, from January 1990 to late 1998, we find that over that longer period the New Zealand dollar ended up at almost exactly the same point as it started in real terms, whereas the Singapore dollar appreciated by some 12 per cent, and the Hong Kong dollar, pegged though it was to the US dollar, appreciated by a very substantial 39 per cent. (Figure 7.)

Figure 7

Real exchange rates: New Zealand, Singapore and Hong Kong



(Source: JP Morgan)

The conclusion we reached from all this analysis is that the appreciation of the New Zealand dollar in the mid-nineties was not unusual, either internationally or in terms of our own history.

Thirdly, what part did the Reserve Bank play in the appreciation?

This may seem a very odd question, since I have already acknowledged that the main factor driving up the exchange rate in the mid-nineties was the need to tighten monetary policy to head off the inflationary pressures caused by demand growing faster than the potential of the New Zealand economy to meet that demand. This pushed up not only the nominal exchange rate, but also the real (inflation-adjusted) exchange rate.

But suppose the Reserve Bank had acted differently. Would matters have been much different? The answer is 'almost certainly not'. Suppose the Bank had not tightened monetary policy. At some point, the rise in the price of houses and other goods and services in the non-tradeable sector of the economy would have begun to spill over into the general price level. Wages and other costs would have started to rise. Other things the same, exporters would have found themselves squeezed by these rising costs. In other words, they would have been squeezed by a rise in the inflation-adjusted exchange rate. So no matter what policy the Bank had pursued, the real exchange rate would have appreciated considerably, and exporters would have been put under pressure. The only issue is whether the real exchange rate appreciation took place alongside low inflation within New Zealand or whether it took place through an inflation blow-out within New Zealand.

It is fair to acknowledge, however, that the way in which the Reserve Bank sees the exchange rate in the implementation of monetary policy has evolved over the years.

In the first years of the fight against inflation, the Bank paid very little attention to the exchange rate. In the years immediately following deregulation, both interest rates and the exchange rate were very volatile. We had very little sense of what ‘normal’ levels for these prices were, and hence put little weight on movements in them when we were thinking about monetary policy and the outlook for inflation. Instead, we paid particular attention to keeping the quantity of ‘primary liquidity’ stable.

By the time I became Governor of the Bank in 1988, we had come to recognise that the very short-term volatility in interest and exchange rates was largely unnecessary, and might well have real costs – if only in obscuring the price signals facing investors and producers in the real economy. As inflation targeting became more formalised, we tended to implement monetary policy by making a careful assessment of all the factors relevant to inflationary pressures, and then working out some internal ‘comfort zones’ for the key financial prices. These were not targets in the sense that we were totally dedicated to maintaining interest or exchange rates within these ranges. But they were designed to shape our own thinking, and to guide us in deciding when it made sense to take some action to limit movements in interest or exchange rates between the periodic reassessments of the inflation outlook.

Over time, the exchange rate band became increasingly prominent. This was partly because we had little formal sense of the linkage between interest rates and inflation, whereas we did have statistical estimates of the direct effect, other things being equal, of a movement in the exchange rate on prices – in other words, the effect of a movement in the exchange rate on the New Zealand dollar price of imports and things like meat and milk which were also exported. Largely because the inflation outlook was still so uncertain during the disinflation period, but also because we thought we had a reasonable handle on the direct price effects of changes in the exchange rate, monetary policy often tended to be focused principally on the inflation outlook over the following 12 months or so.

By the mid-nineties, this approach was becoming increasingly less relevant. Our confidence that a 1 per cent movement in the trade-weighted exchange rate would produce a change in consumer price inflation of about 0.3 per cent within about 12 months began to wane, as first the depreciation of 1991 and then the appreciation of 1993-97 produced a much smaller impact on inflation than previous research had suggested. Indeed, by the end of 1995 reference to ‘exchange rate comfort zones’ had largely disappeared from our monetary policy implementation lexicon. The impact of interest rates on inflation was becoming more evident, and in particular it became clear that the low interest rates of 1992 and 1993 were, with a lag of more than a year, encouraging strong credit growth, rapidly increasing house prices, and inflationary pressures in the domestic sectors of the economy.

More importantly, with inflation having been within the agreed target for 1991, 1992, 1993, and 1994, there was also gradually increasing confidence, within financial markets and, to a lesser extent, in the general public, that the commitment to low inflation was credible. This increased credibility meant that we could afford to be less concerned about the one-off direct price effects of exchange rate movements. Even if we had had a lot of confidence in our estimates of the size and timing of these effects, the risk that they would spill over into higher inflation expectations, creating ongoing problems, was much diminished. While mindful that a change in the exchange rate might in itself be telling us that monetary policy had become inappropriate, we could afford to focus mainly on the medium-term channels by which interest and exchange rates affect the ongoing rate of inflation. In recent years this has meant trying to focus more on the inflation outlook 18 to 24 months ahead.

Keeping that medium-term focus means recognising that monetary policy mistakes take time to correct – that even if we could turn our monetary policy super-tanker very quickly it might not be sensible to do so.

To illustrate, in April 1996, when the Minister of Finance requested an explanation of inflation falling outside the agreed target by 0.1 per cent, I advised him that indications at that time were that inflation might remain outside the target for two or three more quarters. Despite this, I advised him that we did not intend to tighten policy sufficiently to avoid those further breaches since the only way that that could have been achieved would have been through a very aggressive tightening of policy that would have both created a risk of going below the inflation target the following year and considerably exacerbated the exchange rate and interest rate cycle. What we were implicitly recognising is that, while monetary policy can not be used to engineer a sustainably faster growth rate in the long-term, there can be a trade-off between the variability of inflation and the variability of monetary conditions in the short-term.

In late 1996, of course, the inflation target was amended from 0 to 2 per cent to 0 to 3 per cent and, though not requested by the Reserve Bank, this increased the scope for flexibility when faced with the many lags and uncertainties in setting monetary policy.

All of these factors drove us in the direction of being less concerned about the direct price effects of exchange rate movements and more concerned about the medium-term effects of interest rates and the exchange rate. Our focus lengthened from a primary interest in the next 12 months to an 18 to 24 month view.

So in short, over the decade we have moved from a primary focus on the relatively short-term direct price effects of exchange rate movements as a way of reducing inflation, when there was an urgent need to reduce inflation quickly and where the credibility of policy was very low, to a focus on the medium-term effects of interest and exchange rates on the real economy, and therefore on inflation. In large part this change has been made possible by the increased confidence within the community that the Reserve Bank will continue to deliver stable prices, the result in turn of eight years of low and stable inflation.

Finally, can large appreciations be avoided in the future?

Let me say first that a gradually appreciating exchange rate is something to which all countries should aspire. A trend appreciation in the real exchange rate is usually the direct result of a country's relatively superior record of productivity improvement, and that is obviously something to aspire to. A trend appreciation in the nominal exchange rate may arise from that superior record of productivity improvement or it may arise from a superior record of keeping inflation under control. And I think most New Zealanders, including most exporters, would welcome an appreciation which arises from one or both of those factors.

But what we are talking about here is the kind of appreciation which raises the New Zealand dollar by close to 30 per cent over three or four years, faster than any plausible increase in relative productivity or inflation performance. Can that be avoided? Can we even reduce the amplitude of the swings around the long-run average from, say, plus or minus 12 per cent to, say, plus or minus 5 per cent? If I could assure you that the Reserve Bank is confident that it can operate monetary policy without the risk of such large fluctuations in future, I would leave here a much more popular man, and you would leave here feeling very much happier too. Unfortunately, I can give you no such assurance.

In principle, the ways in which large and rapid appreciations might be avoided are of four kinds.

First, to the extent that large appreciations are a function of firm monetary policy, one option might be to resist inflationary pressures less vigorously. Alas, all the evidence from our own and international experience suggests that allowing inflationary pressures to become more embedded in the economy makes the subsequent job of eliminating inflation much more difficult. In other words, when inflationary expectations become more deeply embedded in society, eliminating inflation requires more pressure from monetary policy, higher real interest rates and a higher real exchange rate, not the reverse. And in any event, as already indicated, failing to resist an increase in inflation still leaves exporters facing a loss of competitiveness because of the increase in the domestic costs which they face. The United States, the United Kingdom, Germany, and Japan all approach keeping inflation low in rather different ways, but all have experienced periods of sharp exchange rate appreciation this decade.

The second way in which we might avoid strong appreciations in the future is to avoid, or at least to minimise, the situations where a strong tightening of monetary policy is required. In part, this is a Reserve Bank responsibility, and involves our being quick to spot situations where demand looks likely, 18 to 24 months ahead, to exceed the economy's sustainable capacity to deliver. We are doing a great deal of work to assist us in forecasting but, as I have remarked on several occasions before, no matter how good our research, no matter how good the statistical data on which we make decisions, no matter how good our formal and informal information networks, no matter how good our models, by the nature of the case the future will often turn out very differently to our expectations. Neither we nor any other central bank has a perfect crystal ball. This means that there is simply no guarantee that we will be able to avoid vigorous tightening of monetary policy in the future.

Some have suggested that monetary policy would not have needed to tighten so aggressively in the mid-nineties if fiscal policy – government taxation and spending policy – had not been so expansionary. It is certainly true that, after acting to dampen aggregate demand in the early nineties, fiscal policy became rather more expansionary in the mid-nineties, and this required monetary policy to be tighter than would otherwise have been necessary at that time. To that degree, the stimulatory fiscal policy of 1996 and 1997 must bear some of the blame for the strong appreciation of the exchange rate. Moreover, there can be little doubt that, if strong appreciations are to be avoided in the future, a full recognition of the monetary policy implications of changes in fiscal policy will be imperative.

But it has to be acknowledged that it is not always easy to adjust fiscal policy to take account of cyclical pressures, for reasons which are sometimes technical and sometimes political. Indeed, some would argue that the Fiscal Responsibility Act is based on the premise that adjusting fiscal policy in response to cyclical pressures is neither necessary nor appropriate.

New Zealand's experience in 1996 and 1997 illustrates some of the technical problems well. In late 1995, the Government publicly announced that they would proceed with a reduction in income tax rates in mid-1996 only if the Reserve Bank were satisfied that the tax cuts could take place without putting undue pressure on monetary conditions. We were formally asked if the tax cuts could proceed without creating such upward pressure on monetary conditions, and after careful consideration we formally advised Government that we believed the tax cuts would not create any undue upward pressure on monetary conditions. As Reserve Bank watchers may recall, this was close to the time when we reached the judgement, in October 1995, that inflationary pressures were abating and that some easing in monetary conditions might be appropriate. We in the Bank, others in the Treasury, and many private sector forecasters all felt that the economy would slow down markedly in 1996, and that the proposed fiscal stimulus would not create undue pressure on monetary conditions.

In retrospect, our judgement was incorrect: inflationary pressures in the economy had not eased by as much as we thought at the time and, as it turned out, a firm monetary policy had to be maintained for a further year. And of course, by the time we thought that the outlook was sufficiently subdued that monetary restraint could be eased without inflation becoming a problem, the Asian crisis was about to break. This course of events serves to underscore just how difficult it is to fine tune monetary policy, and why I am reluctant to claim that swings in the exchange rate are a thing of the past.

There may also be difficult political obstacles in using fiscal policy to carry some of the load otherwise carried by monetary policy. In late 1995, the New Zealand public sector was in very substantial operating surplus and, in the absence of tax cuts or increases in government spending, that surplus looked likely to continue indefinitely. Even leaving aside the fact that both the Reserve Bank and other forecasters mis-read what was likely to happen to the economy in 1996, it could well have been difficult to persuade any Parliament in those circumstances to forego tax cuts or increases in government spending. In the end we got both, and part of the price may well have been a continuation of strong exchange rate appreciation for longer than anybody in the export sector enjoyed.

Thirdly, measures might be taken to drive a wedge between New Zealand interest rates and foreign interest rates, so that when monetary policy is tightened in New Zealand to head off inflationary pressures this does not result in an appreciation of the exchange rate, or at least results in a rather smaller appreciation than otherwise.

Various countries try to do this. Some, for example, have tried to cut themselves off from international capital markets by instituting comprehensive controls on capital flowing into and out of the country, of the kind that New Zealand used to have. Few would seek a return to this kind of regime in New Zealand and indeed, even in the countries of Asia which have been most affected by recent turbulence, few have seen the benefits of such controls as likely to exceed their very substantial costs. Those who advocate such controls usually do so only for countries which have not yet got their macro-economic policies in order, or which have serious weaknesses in their financial systems. In other words, controls of this kind are often seen as a temporary or transitional measure, while more fundamental weaknesses are addressed.

Other countries have tried to drive a wedge between domestic and foreign interest rates by instituting a tax on interest income accruing to foreigners, a non-resident withholding tax. In principle, this has considerable appeal because it means domestic interest rates can be pushed up to a level appropriate to the restraint of domestic inflationary pressures while not encouraging a strong capital inflow which would push up the exchange rate. But New Zealand’s own experience suggests that it is in fact quite difficult to make such taxes work effectively, since there are lots of ways in which foreign investors, working in conjunction with locals, can find ways around that tax.

Some academic economists have suggested that countries institute a small tax on all foreign exchange transactions, a so-called Tobin tax after the economist who first proposed it, in order to discourage speculative capital flows. But very few policy-makers give such a tax any chance of being implemented and, if implemented, of actually working as intended. To be effective, it would need to be applied in all countries at the same rate, lest foreign exchange transactions simply migrate to a country where the tax is not applied. And if this substantial hurdle could be overcome, most observers believe that the effect of the tax would be to substantially diminish liquidity in financial markets, so that large 'beneficial' transactions would produce very large movements in the exchange rate. Worse still, there seems little prospect of such a tax deterring large-scale capital flight: who will resent paying, say, a 0.1 per cent Tobin tax if he fears a 30 per cent devaluation?

The only serious contender on the international stage at present as a way to drive a wedge between domestic and foreign interest rates is the so-called Chilean approach. In principle, that involves no restrictions on capital outflow and no restrictions on incoming foreign direct investment, but a requirement that a proportion (initially 30 per cent but later reduced to 10 per cent) of incoming portfolio investment be deposited with the central bank at zero interest for a period of one year. The intention of this measure was to discourage short-term capital inflow while creating no barriers to other forms of capital movement. Whether such a measure would work in the relatively sophisticated financial markets which we now have in New Zealand is at this stage an open question. Indeed, there is intense debate internationally whether the policy has even had a beneficial effect in Chile itself, and Chile has recently reduced the proportion of incoming portfolio investment which must be deposited with the central bank to zero. As I noted in my speech on the balance of payments deficit last year, there would clearly be some real risks in introducing such a policy in New Zealand, not least the longer-term costs of undermining investor confidence in New Zealand's commitment to free and open markets.

A fourth idea for avoiding strong exchange rate appreciations has recently been gaining some media play, namely the idea that New Zealand should irrevocably peg to some larger currency, or even form a currency union with some larger country or group of countries. The New Zealand dollar is simply too small and insignificant to float alone in the turbulent ocean of world financial markets, it is argued, and would be better securely linked to a bigger vessel. Many countries contemplating this possibility see a link to the United States dollar as having huge appeal, while in the past the German mark has also had a number of adherents. No doubt in the future the euro will also attract its strong adherents.

In the New Zealand situation, it is not surprising that most of those who advocate New Zealand becoming a part of a larger currency area argue for a currency union with Australia (although in reality, given the relative size of our two economies, a currency union between New Zealand and Australia would be more akin to New Zealand pegging to Australia than a genuine currency union in the European sense). Australia is our largest trading partner, and there is essentially free mobility of labour and capital between the two countries. This means that two of the key criteria for an optimal currency area would be at least partly met in the case of an Australian/New Zealand currency union.

But while Australia may well be the most logical country for New Zealand to form a currency union with, and this idea may well be worth further exploration for a whole raft of economic and political reasons, it is quite misleading to imply that forming a currency union, with Australia or anybody else, would avoid the problem of strong currency appreciation in the future. As I have already indicated, most of the world's largest economies have within the last decade seen appreciations of a size similar to that experienced by New Zealand in the mid-nineties. The Hong Kong dollar, effectively tied to the United States dollar since the early eighties, saw a huge real appreciation during the nineties in part as a result. Australia did not have such a strong appreciation during the nineties but, as also indicated, the Australian dollar has had rather more volatility over the last 20 years than the New Zealand dollar has.

It is not very long ago that the most common complaint made to me in areas of the country outside Auckland related to the fact that non-Aucklanders were facing real interest and exchange rates which were quite inappropriate to the inflationary pressures in areas outside Auckland. Why, I was often asked, do we have to pay these high real interest rates, and suffer the penalties of the high real exchange rate, when the only inflationary problem is in Auckland? Of course, inflationary pressures were far more widespread than this question implied, but my answer always included the point that, in a single currency area (New Zealand), there can only be one set of interest rates and one exchange rate. Sometimes those monetary conditions will be too loose for some parts of the country and too tight for other parts of the country. But that is the nature of the beast: it simply isn’t feasible to have a different set of monetary conditions in different parts of the same currency area. This means that if we were part of a currency union with Australia and the Australian economy were very buoyant, perhaps because of booming exports of iron ore, gold, and wheat, it is quite possible that New Zealand exporters would be facing a rising (common) exchange rate and all of us would be facing relatively high real interest rates at a time when the New Zealand economy was quite subdued. New Zealand exporters who were concerned about an exchange rate dominated by Auckland conditions can hardly feel confident that Sydney or Melbourne economic conditions will always be more relevant to them.

But surely, if it makes sense for 11 European countries to form the Economic and Monetary Union, with a common currency throughout those 11 countries, it must make sense for New Zealand to link with Australia (or somebody else) also? Not necessarily. Although 23 per cent of our total merchandise trade is with Australia, that is a relatively small part of our trade in comparison to the proportion of trade between members of the new European monetary union. Thus, for example, 45 per cent of France’s total trade was with EMU members in 1997, 46 per cent of Germany’s, and 57 per cent of Holland’s. While Australia is our largest trading partner, and joining a currency union with Australia might well make life easier for those companies trading primarily with Australia, it would not solve any of the problems caused by currency variability for those conducting the other 77 per cent of our international trade. Indeed, I can imagine New Zealand beef exporters might argue for a link to the US dollar, dairy exporters might argue for a link to the euro, and fruit and vegetable exporters might argue for a link to the yen!

Conclusion

So where does that leave us? It has sometimes been argued that developments in monetary conditions in New Zealand were abnormal or unusual in the nineties. Without a doubt, the rise in interest rates and the appreciation of the currency were large. But this tells us little about whether they were, in some sense, too large or inexplicable. I have suggested that monetary conditions were not dramatically out of line with past experience here and abroad, and were broadly what we should have expected given the length and strength of the business cycle.

I also believe that the policy framework has coped well through these testing times. For the first time in many years, we have been through a business cycle without an explosion in inflation expectations and without a large structural fiscal deficit. We have weathered the Asian crisis with our banks in good stead, and we remain well positioned to take advantage of the next international upswing. Given the circumstances, we have also experienced a remarkably orderly shift in the mix of monetary conditions, to one more reflective of the current realities facing the economy.

But clearly it would be a mistake to believe that this is the last time the framework will be tested. What we have learnt from our study is that we need to view these developments in the context of our own business cycle pressures, developments in international capital markets, and the business cycle and inflationary pressures of our major trading partners. Looking ahead, another business cycle upswing will occur at some point, and monetary conditions will again need to be tightened in order to constrain inflation. The extent to which that is reflected in upward pressure on the exchange rate will depend on the strength of the inflationary pressures and the level of interest rates both here and abroad.

Alas, there is no magic bullet which can avoid this situation. Ongoing changes at the Reserve Bank in the way in which we operate policy may, at the margin, slightly reduce exchange rate fluctuations. These changes have included a more flexible approach to inflation targeting by shifting the policy horizon out to 18 to 24 months, assisted in part by a wider inflation band of 0 to 3 per cent.

Over recent years, I think that the Reserve Bank may have slightly reduced the risks of strong exchange rate appreciation by making it unambiguously clear that we have no secret exchange rate floor in the back of our mind. We have an inflation target, not an exchange rate target. For this reason, those buying New Zealand dollar assets with foreign currency always face the possibility that they might lose on their investment. There is no one-way bet in buying New Zealand dollars.

We in the Reserve Bank are committed to doing our utmost to avoid situations where monetary policy has to be tightened aggressively. In other words, we will do our best to tighten in a timely way, so that the tightening can be gradual and moderate. And I hope you will be loud in your support of the Reserve Bank next time we begin such a gradual tightening! But with the best will in the world, it will be necessary to tighten aggressively from time to time to deal with unexpected events.

The message I want all exporters – and indeed those competing with imports – to take from this speech is this. You should assume in your business planning that the current relatively low dollar is not the norm, and will not last indefinitely. As already indicated, I myself do not expect an early appreciation in the New Zealand dollar, given our relatively low interest rates and large current account deficit. Indeed, the New Zealand dollar could well depreciate further. But in deciding how to run your business, especially in a strategic sense, you should look at the historical record, and note that the exchange rate cycle experienced over the last decade was not exceptional, either for New Zealand or by international standards. Exchange rate fluctuations of that magnitude are just part of the rough and tumble of an economy such as New Zealand's. They will happen again.

My plea to you therefore is this: just because the currency is low now, don't sit on your hands and enjoy it. Invest in quality; keep costs under tight control; reduce your vulnerability to exchange-rate-driven price fluctuations; don't pay too much for land (especially relevant to farmer exporters); develop brands that are less price sensitive. As I've said before, a good Canterbury farmer knows that droughts are inevitable from time to time, and plans accordingly. Likewise a good exporter knows that fluctuations in the real exchange rate are inevitable, and plans accordingly. You should be doing this now.

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