# Exchange rate challenges: how should policymakers respond?

## Remarks on the Policy Panel

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The topic for our panel discussion is potential policy responses to exchange rate challenges. The main challenge from my perspective, and I would say for both Australia and New Zealand since the global financial crisis (GFC), has arisen from periods of significant upward pressure on our exchange rates. A high exchange rate puts pressure on export industries, particularly manufacturers, encourages imports and puts downward pressure on price inflation.

How we as policymakers have reacted to this has depended on how we have viewed the causes of the upward exchange rate pressure. In broad terms there have been two alternative explanations: (i) nominal shocks derived from easy monetary policies in the developed countries, particularly from quantitative easing, since the GFC; and (ii) real shocks arising from improving terms of trade as export commodity prices have outstripped the cost of imports, especially manufactured imports.

If the first explanation is most relevant, the policymaker has to assess how firm their domestic monetary policy can realistically be in the face of easy global conditions. For a large relatively closed economy, this scope for monetary policy "independence" may be significant. For a small open economy, there will be less scope for a differentiated monetary policy. This implies an easier policy than warranted by domestic conditions alone, leading to rising non-traded prices relative to traded prices, and rising property prices, potentially leading to financial stability concerns.

Policies to counter such an external nominal shock might include macroprudential policies to reduce financial system risk, restrictions on inward foreign investment (eg into housing) and potentially also FX intervention, resulting in increased holdings of (unhedged and often loss-making) foreign reserves. Essentially it is a story of domestic monetary policy being dominated by the very easy global liquidity conditions, with various other policies trying to compensate.

If the second explanation is more relevant, the policymaker's perspective is very different. A strong terms of trade suggests that the high exchange rate is justified and serves the purpose of distributing the real national income gain across the domestic spending sectors.

Domestic monetary policy easing will be less appropriate due to the positive terms-of-trade income effect on demand. The real appreciation and crowding out of low-return traded sectors (manufacturing) will be more acceptable as resources are diverted to the high-return export sectors. The case for using other compensating policies such as macroprudential measures, foreign investment restrictions and FX intervention will be less convincing. So assessing the drivers of the exchange rate pressure is very important in formulating the right policy response.

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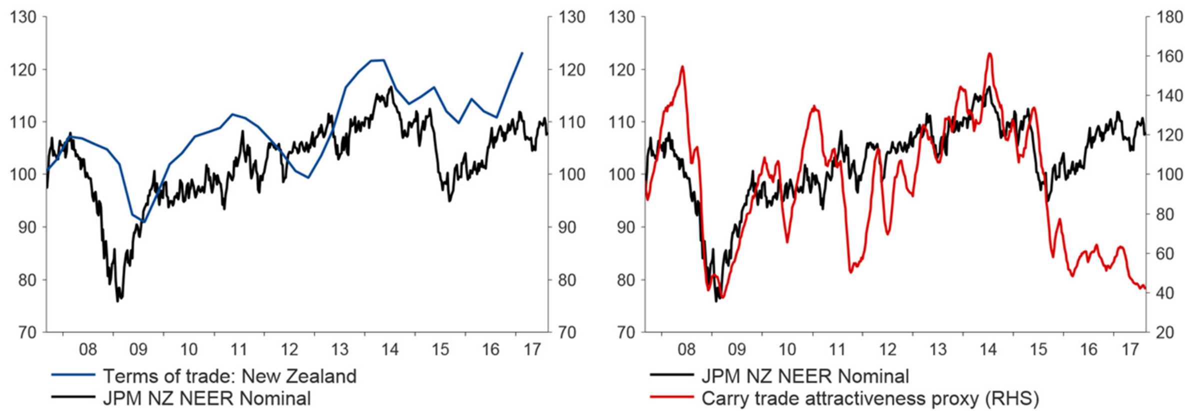
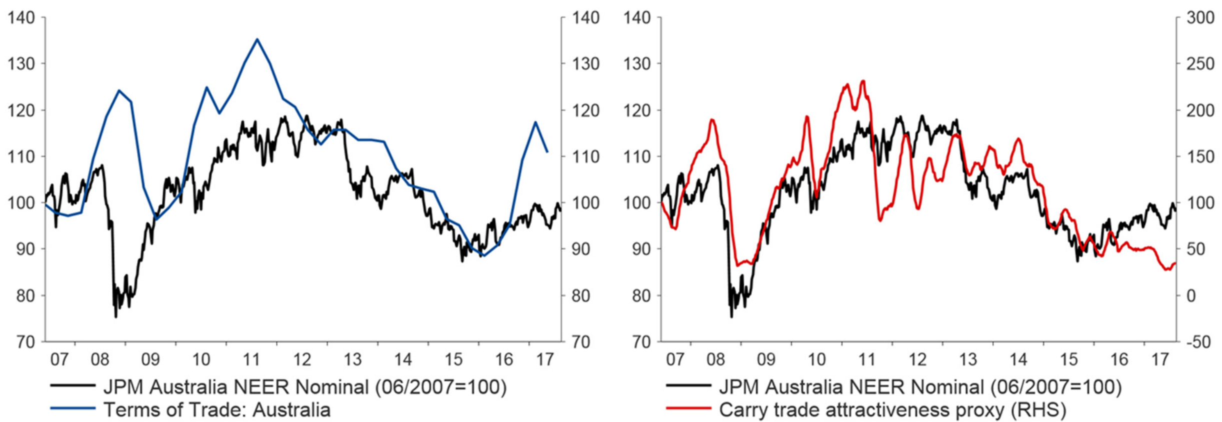
What does the evidence tell us about the relative strength of nominal vs real shocks over the past 10 years? I am not going to answer that, but I will show a few figures below. As we might expect, the figures suggest that both real and nominal shocks have been relevant, varying through time and across countries. The challenge for the policymaker is to continually reassess the drivers, and to modify policies accordingly.

Exchange rate drivers: New Zealand — Figure 1




Source: Thomson Reuters.

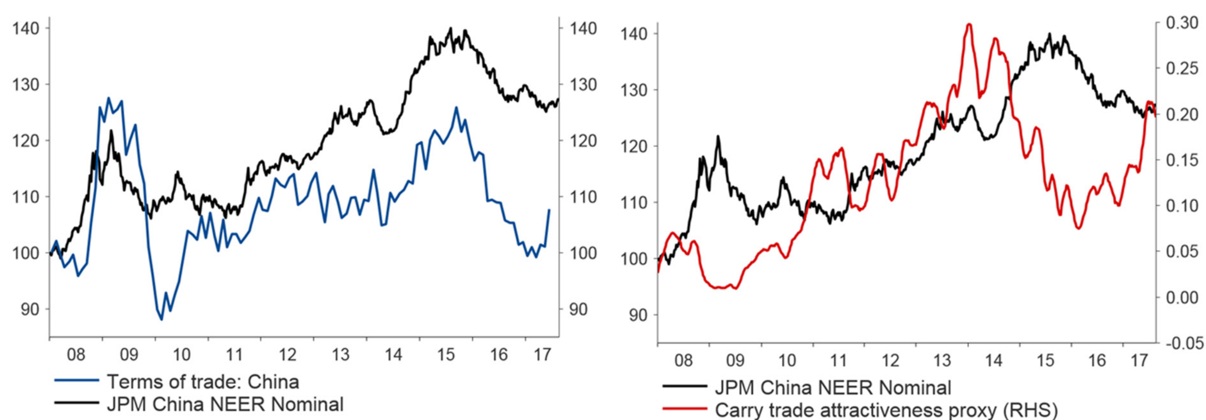
Exchange rate drivers: Australia — Figure 2




Source: Thomson Reuters.

## Exchange rate drivers: China

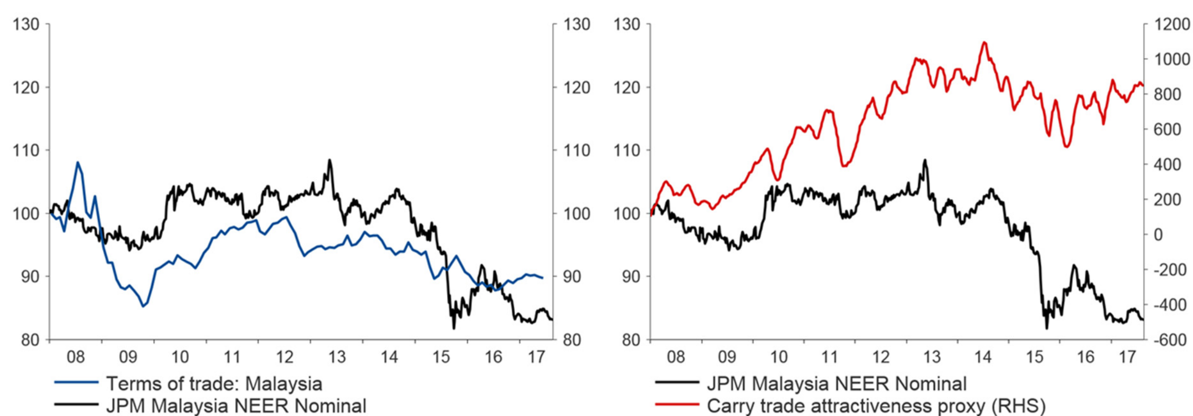
Figure 3




Source: Thomson Reuters.

## Exchange rate drivers: Malaysia

Figure 4




Source: Thomson Reuters.

Note: The carry trade attractiveness proxy is constructed as the local minus the US two-year benchmark government bond rate, divided by the VIX implied volatility index: (two-year local bond rate – two-year US bond rate)/VIX index.