Donald T Brash: The pros and cons of currency union - a Reserve Bank perspective

Address by Dr Donald T Brash, Governor of the Reserve Bank of New Zealand, to the Auckland Rotary Club, Auckland, on 22 May 2000.

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Introduction

In recent years, there has been a huge increase in interest in exchange rate regimes, both within New Zealand and internationally. Should countries maintain their own currencies, or adopt the currency of some other country or group of countries? If countries maintain their own currencies, should they “float”, or attempt to “peg” to the currency of some other country?

As you know, New Zealand has had its own currency for many decades, and since March 1985 that currency has been floating against other currencies, with its value determined day to day in the financial market. But through the mid-nineties as our exchange rate appreciated strongly, many people became concerned about whether this was the best arrangement for New Zealand (between early 1993 and early 1997, an inflation-adjusted trade-weighted measure of the New Zealand dollar appreciated by some 29 per cent, putting considerable pressure on exporters and those competing with imports).

Interest in the subject has become even more widespread in the last couple of years, with 11 of the countries of Europe abandoning their own currencies and forming a currency union, and with the growing interest in several Latin American countries in adopting the United States dollar. Last month, Sir Frank Holmes and Dr Arthur Grimes, two highly-regarded economists, released a study they had undertaken for the Australia New Zealand Business Council entitled ***An ANZAC dollar?***, and this has further intensified public and political interest in the matter. It is clear that there is strong interest in the subject on the part of the business community.

So today I want to make some comments from a Reserve Bank perspective.

But at the very outset I want to make it clear that any decision to abandon our own currency is fundamentally a political issue. Currency unions are generally formed as part of a larger strategic push to integrate the countries entering the currency union, often in combination with free trade agreements, harmonisation of legal standards, and liberalised migration laws. Viewed in this way, entering a currency union is a major foreign policy decision, and thus a matter for elected politicians. It is not a matter on which a central banker should express an overall opinion, and I will not be doing so.

But the choice of currency regime does have important economic implications which need to be carefully assessed, and I believe it is appropriate for me to comment on those.

One other point should be clarified at the outset. There are some differences between “currency union” (implying a new central bank and a new currency to cover a range of countries and currencies, as in the case of the European Monetary Union) and “dollarisation” (implying the simple adoption of the currency of another country, whether in New Zealand’s case that be the Australian dollar or the United States dollar). And the most important of those differences for us is whether New Zealand would have any part in making the decisions about the monetary policy which would affect us. In a currency union, all the countries included in the union ***in principle*** have a say in forming monetary policy for the area covered by the union. All countries have a voice at the table, even if that is only a single voice among many. In the case of dollarisation, however, only the country whose currency is adopted makes the decisions about monetary policy.

The study by Sir Frank Holmes and Arthur Grimes suggested that a currency union with Australia (involving a new central bank for both countries, and a new currency) could have some useful benefits for New Zealand. And they suggested a currency union, rather than New Zealand’s adoption of the Australian dollar, largely for reasons of political acceptability in New Zealand.

Whether such an approach would meet the political acceptability test in Australia, of course, is a bit debatable. Preliminary comments from Australia suggest no interest whatsoever in abandoning the Australian dollar in favour of a new trans-Tasman currency. But whether currency union with Australia, or the simple adoption of the Australian dollar by New Zealand, the outcome would in substance be very similar. With the exception of who gets the seigniorage income, on which I will comment in a moment, both options would involve New Zealand's relinquishing any effective control over monetary policy in New Zealand.

In the case of the United States dollar, currency union is not even being raised as a possible option. The only possibility in that case would involve New Zealand's adopting the United States dollar. And that too, of course, would mean relinquishing any control over our own monetary policy. Since the term "currency union" has been widely used in New Zealand to include both currency union as properly understood and the simple process of adopting another country's currency, I will for the most part use the term "currency union" in the balance of my comments, while recognising that for all practical purposes we are talking about "dollarisation", be it "Australian dollarisation" or "US dollarisation".

Some myths about currency union

Before I comment on some of the economic advantages and disadvantages of currency union, it might be helpful to dispose of a few of the myths that have become rather prevalent.

The first myth is that the Reserve Bank is opposed to currency union, perhaps because "Don Brash would lose his job". Certainly, if we "dollarised", using either the Australian dollar or the US dollar, there would be no need for anybody to be employed by the Reserve Bank of New Zealand and those now employed by the Bank would lose their jobs. If we went into a currency union, presumably with Australia, it is also likely that many existing Reserve Bank staff would lose their jobs (though I must admit that the European precedent perhaps suggests that job losses would not be great in that situation!). But I can assure you that neither the Reserve Bank nor Don Brash is opposed to currency union. Nor are we ***promoting*** currency union. As indicated a moment ago, the Bank's responsibility is to advise Ministers about the economic implications of currency union, both the pros and the cons, and to foster informed public discussion on the issue.

The second myth is that small countries are in some ways just too vulnerable to have their own currencies in the modern world. This is sometimes expressed in terms of the metaphor of a tiny rowing boat, tossed around in a turbulent ocean, with the turbulence arising from the vast flows of capital which every day wash backwards and forwards at the click of a mouse. But there are some extremely successful small countries with their own currencies - Singapore and Switzerland spring immediately to mind - and, contrary to popular mythology, the New Zealand dollar is ***not*** a particularly volatile currency.

Not a particularly volatile currency? No. The Reserve Bank has looked at this issue both in terms of short-term volatility and in terms of the big exchange rate swings which are, I suspect, of rather greater concern.

Looking at short-term volatility (measured as 30 day volatility against the United States dollar), the New Zealand dollar was more volatile than the Australian dollar, the British pound, the Japanese yen, and the German mark between the time of the float in March 1985 and August 1988. But for most of the period since September 1988, and indeed on average over that whole 12 year period, the New Zealand dollar has been somewhat ***less*** volatile than any of those currencies.

Looking at the big exchange rate swings which made life difficult for exporters and those competing with imports at some stages during the last decade, we compared the size of the exchange rate appreciation from trough to peak for each of the same currencies. We found that the maximum appreciation which the New Zealand dollar experienced during the decade (measured on an inflation-adjusted, trade-weighted, basis) was, to be sure, at 29 per cent rather greater than that experienced by the Australian dollar (at 20 per cent), but was closely similar to the maximum trough-to-peak appreciation experienced by the German mark (27 per cent), the United States dollar (also 27 per cent) and the British pound (31 per cent), and very substantially smaller than that experienced by the Japanese yen (62 per cent). In other words, as I have indicated on other occasions and contrary to much current mythology, the big exchange rate swings experienced by the New Zealand dollar during the nineties were not in the least unusual by the standards of other currencies.

This suggests rather unambiguously that, while currency union would eliminate nominal exchange rate uncertainty for New Zealand traders trading within the currency union, there is no currency which we could adopt which would eliminate big exchange rate swings against countries outside the currency union. And since New Zealand's trade with Australia amounts to little more than 20 per cent of the total, a currency union with Australia would still leave most of our exporters facing currency uncertainty. In other words, currency union with Australia would buy nominal exchange rate certainty for those handling little more than 20 per cent of our trade (perhaps especially those in the manufacturing sector), while leaving those handling the other 80 per cent of our trade still facing such uncertainty.

And I say currency union would buy some traders "nominal exchange rate certainty" to make it clear that currency union would not buy anybody ***real*** exchange rate certainty, or in other words, certainty of a constant exchange rate after inflation has been taken into account. This is something which Hong Kong has discovered over the years. Although it has had a currency which has been tightly tied to the US dollar since the early eighties, its real, or inflation-adjusted, exchange rate has appreciated quite strongly, both because the US dollar has appreciated against most other currencies and because Hong Kong's inflation rate has been markedly higher than that in the United States. This has led to the steady erosion of the competitive position of Hong Kong's manufacturing sector, and indeed has been one of the factors leading to a move of manufacturing out of Hong Kong into southern China.

The third myth is that a currency union with Australia would greatly increase competition in the New Zealand banking sector, to everybody's benefit. I find it very hard to see why this might be the case given that all of the large Australian banks are already actively involved in the New Zealand market. Moreover, New Zealand already has an open and contestable banking sector. There are few regulatory obstacles to foreign banks entering New Zealand, provided that they meet certain minimum qualitative criteria. It is clearly not necessary to enter a currency union in order to derive the benefits of foreign competition in the banking sector. In this regard, I was struck by the figures released by KPMG earlier this month, which suggested that the net interest margin earned by the major banks in New Zealand has been falling steadily in recent years, and is now markedly lower than the net interest margin earned by Australian and US banks.[1]

The fourth myth is that currency union with Australia would somehow suddenly enable the New Zealand economy to grow as quickly as the Australian economy, or enable New Zealanders to be instantly richer. That perception appears to drive quite a lot of the public comment on this matter. But of course that is nonsense. The fundamental driver of living standards in New Zealand is the rate at which we can improve productivity. Currency union may have a modest bearing on our productivity performance, as I will argue in a moment, but fundamentally productivity is about the quality of our education system, the quality of New Zealand management, the incentives provided by the tax and benefit system to work and acquire skills, attitudes to work and leisure, the pace of innovation, and so on. Currency union would have little effect on these matters. Currency union within Australia itself has certainly not guaranteed that economic growth in Tasmania and South Australia will match that in Queensland - any more than currency union within New Zealand has guaranteed that Southland will enjoy Auckland growth rates. And Panama's adoption of the US dollar in 1904 has not enabled Panama to perform as well as the US economy. Other factors, and other policies, are very much more important for our long-term growth than whether we are part of a currency union.

And my final myth is the argument that, because other countries are forming currency unions, or dollarising, New Zealand should do the same. But the reasons why other countries are forming

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[1] Financial Institutions Performance Survey 2000, KPMG.

currency unions or dollarising have very little relevance to New Zealand. The countries of the European Monetary Union formed a currency union, involving a new central bank and a new currency, in a situation where intra-union trade flows were a high proportion of the trade of most of the member countries (certainly a much higher proportion than is the New Zealand/Australia situation), and where currency union was simply one part of a very much wider agenda of political, economic, and regulatory integration. The countries of Latin America have, in some cases, locked themselves to the US dollar, and in some cases are thinking of full US dollarisation, after decades of extremely poor money management and hyper-inflation. Neither of these situations has any relevance to New Zealand.

Moreover, in the last few years a large number of countries, particularly but not exclusively in Asia, have moved away from tying their currencies tightly to some other currency, in favour of a floating exchange rate. Certainly there has not been a generalised international move towards currency union or dollarisation.

The real economic pros and cons of currency union

But there are some valid arguments why a currency union might have economic advantages.

To begin with, a currency union seems certain to reduce the transaction costs incurred now by traders and travellers exchanging New Zealand dollars for other currencies. This would probably not produce a huge saving in a currency union with Australia - although there would be worthwhile benefits for tourists in both directions - but, because so much international trade is conducted in US dollars, the savings would be rather greater if we were to adopt the US dollar as our own currency.

Second, a currency union with Australia might reduce average New Zealand interest rates a little. Over the last decade or so, Australian long-term interest rates have been pretty similar to those in New Zealand, but for much of that period (though not currently) Australia’s short-term interest rates were appreciably lower than those in New Zealand. Adopting the US dollar would currently reduce interest rates in New Zealand by rather more. Although the differences are much less now than they were a decade ago, US interest rates are currently lower across the entire range of maturities than those in New Zealand. By adopting either the Australian dollar or the US dollar, we would avoid the need to pay the currency risk premium which savers currently demand for holding New Zealand dollar assets. (There could well be on-going differences in interest rates between New Zealand on the one hand and Australia or the United States on the other, of course, arising from credit and liquidity risks, but the differences would be smaller than currently.)

But it is also the case that a currency union would remove any chance of New Zealand interest rates falling ***below*** those in Australia (or the United States, if it was the US dollar we adopted). While it might seem unlikely that New Zealand interest rates would ever fall below those in Australia and the United States, it is worth recalling that New Zealand’s long-term interest rates were somewhat lower than those in Australia through the first half of the nineties and slightly lower than those in the United States for a time in 1994; and that most interest rates in Canada, Singapore, Switzerland and the European Monetary Union are below those in the United States today.

The main reason why New Zealand interest rates have been so high in the last decade is that through much of that period we have been coping with the hang-over of high inflationary expectations, especially in the property market, the result of two or three decades of high inflation bingeing. The United States had very high interest rates in the early ***eighties***, as it grappled with high inflationary expectations. If New Zealand continues to keep inflation well under control, and continues to maintain the confidence of financial markets by following a prudent fiscal policy, it seems entirely reasonable to expect that in time New Zealand interest rates could fall below those in both Australia and the United States. In forming a currency union, we would in effect be betting that, no matter with whom we formed that currency union, their policy performance would be better than our own could have been for the indefinite future.

Third, while currency union, with Australia or any other single country, would not ***eliminate*** the exchange rate uncertainty which New Zealand exporters face, it would clearly eliminate the nominal exchange rate uncertainty for trade with the country or countries forming part of the currency union (and probably reduce the real exchange rate uncertainty also). As indicated earlier, a currency union with Australia would eliminate nominal exchange rate uncertainty on only a relatively small part of our total trade, but it is quite an important part of our trade in a qualitative sense. A much larger part of our manufactured exports go to Australia than to any other single destination, and the Australian market is particularly important as a "testing ground" for small companies just getting into the business of exporting.

As a result of this reduction in exchange rate uncertainty within the currency union, it seems very likely that currency union would stimulate trade with other parts of the currency union. Empirical research on the effects of currency uncertainty on trade is, unfortunately, not very conclusive, with some studies suggesting that the effects of currency uncertainty are actually pretty small and others suggesting that they are quite significant. My own rather subjective view is that a currency union would indeed increase trade between New Zealand and other parts of the union, and that seems to be the view of the business community also. If that is correct, then a currency union, with Australia or the United States, would stimulate trade within the currency union, and to that extent could produce some worthwhile productivity gains, as New Zealand producers moved into areas of greatest comparative advantage. This is probably particularly true of a currency union with the United States. There is already substantial trans-Tasman trade, and for that reason arguably less scope for increasing it through the creation of a currency union.

On the other side of the ledger, there would be one potentially major and one more minor disadvantage of a currency union.

The potentially major disadvantage would be the loss of an independent monetary policy, and hence loss of a very important way of moderating demand shocks and of any ability to influence our own inflation rate. And this loss would seem to apply whether the currency union was with Australia or the United States, and whether it involved the creation of a new central bank (possible in the case of Australia) or simply dollarisation. (Clearly, in the event of New Zealand's entering a formal currency union with Australia, involving a new central bank with representatives from both countries and a new currency, New Zealand would have some say in the formulation of monetary policy, but realistically that say could only ever be a small voice alongside the much larger voice of the Australian economy.)

Views will differ on how important that loss would be. But we can see from recent international experience that the loss ***can*** have very substantial and sometimes very adverse implications. And those implications would potentially be more significant if we were to form a currency union with the United States than if we were to form a currency union with Australia, given the broad similarity between the New Zealand and Australian economies.

There seems little doubt that the fact that Argentina has had a more prolonged recession over the last few years than have some of the other major countries of Latin America has been largely a result of the fact that Argentina has been tightly tied to the United States dollar through its currency board arrangement. As a consequence, the Argentine currency has been pushed upwards, along with the US dollar, against the currencies of many of Argentina's trading partners. Similarly, Hong Kong seems to have had a more prolonged recession than many other Asian economies for the same sort of reason. (Interestingly, during the nineties the trade-weighted real appreciation of the Hong Kong dollar, tied tightly to the US dollar, was much greater than the maximum appreciation of the New Zealand dollar during the nineties.) Conversely, it seems clear that within the European Monetary Union some of the smaller economies such as Ireland have been over-heating rather dramatically recently, with monetary policy determined by the new European Central Bank in the interests of the whole currency union almost certainly too easy for those smaller economies. While that may create prosperity in the short-term, it may create considerable difficulties down the road.

I well recall the mid-nineties, when the most common complaint I encountered speaking to audiences outside Auckland was that they were suffering from high real interest rates and a rising real exchange rate even though there was no inflation (so at least it was claimed!) in those areas, the only inflation being confined to Auckland. Even had these claims been true, the reality was that all parts of New Zealand formed then, and still form, a currency union, and there is only room for one interest rate structure and one exchange rate within a currency union. Were we to join Australia in a currency union, our interest rates and the exchange rate we faced would be influenced by the common central bank (in the case of a genuine currency union), or by the Reserve Bank of Australia (in the case of Australian dollarisation). In practice, it would be the needs of the Australian economy which would dominate the monetary policy decisions in either case. And of course, adopting the US dollar would mean accepting whatever monetary policy seemed appropriate for the US economy.

This would probably tend to increase the magnitude of New Zealand business cycles, and the variability of New Zealand's inflation rate. With no ability to use New Zealand monetary policy to deal with these cycles, it would be necessary to use fiscal policy more actively, and to encourage more flexibility, both up and down, in prices and wages, to moderate these cycles.

The minor disadvantage of dollarising, and at this point I need to make a distinction between dollarising and forming a currency union where a new currency is established for the countries forming part of the union, would be the loss of what central bankers call seigniorage income. This is the income which a central bank generates by issuing little pieces of paper, or in our case little pieces of plastic, and calling them money. What happens is that we issue these little pieces of plastic in exchange for good value, and we invest that value in government securities at the going market interest rate. The interest income earned is called seigniorage income, and in New Zealand it amounts to about $130 million each year (a currency on issue of a little over $2 billion, invested in government securities to yield somewhat over 6 per cent per annum). If we were to join a currency union modelled on the European Monetary Union, we would retain a share of the seigniorage income appropriate to our relative size in the new currency union. But if we were simply to adopt the Australian dollar or the US dollar, it is very likely that we would lose the benefit of that income to the country whose currency we adopted. Not a huge loss perhaps, but $130 million each year, growing gradually, should not be given away without some thought!

How to weight the pros and cons?

As I indicated at the commencement of my comments, joining a currency union, or adopting the currency of another country, has potentially important implications which go well beyond economic issues. But even focusing on the economic issues, weighting the various pros and cons is not easy.

It is sobering to note that Canada, a country doing almost 80 per cent of its trade with the United States, has nevertheless chosen to retain its own currency. And a recent article by a senior economist at the Bank of Canada argued that, given the way in which Canada's terms of trade behave relative to those of the United States, having a separate Canadian currency was very much in Canada's national interest.[2]

It seems clear from the survey conducted for the Holmes/Grimes study by the National Bank of New Zealand that a substantial majority of the New Zealand business community - or at very least a substantial majority of those who responded to the survey - are in favour of a currency union with Australia.

But I am not myself entirely sure what to make of this strong support for currency union with Australia. ***Of course*** businesses are in favour of less currency uncertainty. I suspect if the business community were asked if they were in favour of lower taxation they would also register a strongly favourable reaction. The real question is not whether less currency uncertainty would be helpful but whether less currency uncertainty would compensate for the ***costs*** of a currency union, such as the risks of greater variability in output and domestic inflation. And the answer to that question is much less clear.

To illustrate, let's suppose there is a sharp fall in New Zealand export prices. ***With*** our own currency, this is quite likely to lead to a fall in the New Zealand dollar, as it did in the second half of 1997 and

[2] Murray, John (1999), "Why Canada needs a flexible exchange rate", Bank of Canada working paper 99-12.

1998. This fall in the currency cushions New Zealand exporters to some extent from the adverse impact of the fall in world commodity prices, effectively by spreading the “pain” of that fall across the rest of us, who find that our New Zealand dollars can now buy fewer imports than before. ***Without*** our own currency, on the other hand, there is an increased risk that a fall in New Zealand export prices leads to no fall in our (new) currency, our exporters have to suffer the full pain of the fall in international prices, and may well be forced to lay off staff and reduce output. That has an indirect effect, of course, on the rest of the country, but those who are not closely associated with the export industries may be relatively little affected.

In the final analysis, the choice of exchange rate regime is mainly a choice about the ***nature*** of the pain we prefer to experience as a consequence of international shocks. It does not provide an opportunity to ***escape*** the pain inevitably caused by those shocks.

Conclusion

It would be nice to conclude my comments today with a clear conclusion, or an on-balance judgement. I don’t propose to do that, partly because the decision about currency regime is, as I have indicated, finally a matter for elected politicians not for central bankers, and partly because even the economic pros and cons do not point to a clear conclusion.

Moreover, it may well be appropriate to widen the range of options somewhat, and to think more laterally before we reach any conclusions at all. For example, might it be possible to negotiate a comprehensive free trade agreement with the United States as part of a package involving our adoption of the US dollar and surrender of the relevant seigniorage income? Losing the seigniorage income might well be a worthwhile concession in return for a free trade agreement with the US.

Clearly, there are lots of potential options. There can be little doubt that this issue will be a matter for public discussion and debate for a considerable time to come. I believe the Reserve Bank has already made a constructive contribution to that discussion, through the publication of a number of papers relevant to the issue.

But it is crystal clear that currency union is not a magic path to substantially faster New Zealand growth. It is no substitute for domestic policies that promote stronger productivity growth. It is not an issue which should be decided in haste. And it is not an issue on which the Reserve Bank will be taking sides. Anybody who accuses me of promoting a currency union, or for that matter of opposing a currency union, has not read this speech!