Alan Bollard: Making sense of a rising exchange rate

Address by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Canterbury Employers' Chamber of Commerce, Christchurch, 24 January 2003.

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My subject today is "Making sense of a rising exchange rate". The exchange rate has risen sharply over the last year or so, and has become the stuff of media headlines in ways not seen for some time, and the concern of exporters which I acknowledge. I'm going to sketch out our broad interpretation of what has been going on, and outline for you something of the way that the Reserve Bank thinks about the exchange rate in making monetary policy.

For several years, of course, the New Zealand dollar fell quite sharply. It settled at levels that, against almost any yardstick, were too low to be sustained. That is so whether measured against the US dollar or in effective (trade-weighted) terms. Little more than two years ago, our dollar was trading at only 39 US cents - 30% below the average for the whole of the last 10 years. Even in trade-weighted terms, our exchange rate spent most of 2001 almost 15% below its 10 year average.

When New Zealanders think about our exchange rate, we tend to think about what is going on here. In fact, that is only half (or less) of the story. The exchange rate is the price of our money in terms of other countries' currencies, so what is happening in other countries, and what investors are thinking about opportunities elsewhere, matters greatly.

In the long run - and, if you are a struggling exporter, that can be a very long time - exchange rates reflect long-term actual economic fundamentals: things to do with the underlying competitiveness of our economy and its firms. If our productivity performance outstrips that of other countries, our exchange rate will tend to rise. If our inflation rate is consistently higher than those of other countries, our nominal exchange rate will tend to fall. And so on. But that is for the long run.

In the shorter-term it is largely a matter of making sense of fluctuations in the demand for funds and in the willingness of the world's savers and investors to supply them. The demand for investors' funds (loosely, the state of the current account of the balance of payments) does not tend to shift very quickly. Instead, changes in the attitudes and perceptions of financial market participants - changes in their willingness to supply funds - tend to be behind most exchange rate changes. To be concrete, in which country and in which sorts of assets do they think that returns will be greatest? Those perceptions and attitudes can be well-founded, or out of line with reality for a number of years. At times, they can shift quickly.

In an ideal world, perhaps, the exchange rate would move simply to reflect actual economic fundamentals - both long-term factors such as structural changes in our relative productivity performance, and medium-term differences in economic cycles. The exchange rate would provide accurate signals to producers, and act as a buffer to temporary pressures. In fact, exchange rates are more volatile than this. Sometimes the moves prove to be well-grounded in economic fundamentals, but by no means always. And exchange rates (like share prices) fluctuate more than the underlying economic fundamentals. New Zealand's exchange rate is a little more variable than most, partly because our economic fundamentals are more variable than those in larger and less commodity-dependent countries. So when it comes to exchange rates we live in an imperfect world - less than ideal, but in my judgement (and we have done a lot of work in this area over the years) still better than the alternatives realistically on offer.

Turning back to our own experience in recent years, the framework I outlined a moment ago does help make sense, broadly speaking, of the exchange rate movements in the last few years. For several years, investors globally were taking a gigantic punt on events in the United States, the leader of the "new economy". They convinced themselves that the United States offered the best returns - the economy was growing rapidly, corporate profits were expected to get ever better, and share prices rose seemingly inexorably.

The enthusiasm of international investors to hold US dollar assets outstripped the American economy's need for those funds. Unsurprisingly, the US dollar rose sharply, to levels too high to be sustained for very long. And it rose against almost every other currency. Even with our OCR at 6.5% through much of 2000, investors just weren't that interested in New Zealand - high tech equity markets were where the good returns were expected. Despite a stellar economic growth performance in the

1990s, markets were just as uninterested in Australia. Both our currency and Australia's fell further than most.

For us, the fall in the exchange rate was something of a mixed blessing. That is perhaps always the case. A falling exchange rate does tend to be good for producers - firms and farmers in Canterbury for example - but it is bad for consumers. It tends to feel better in the countryside than in the cities. It makes our wages look less attractive to prospective skilled migrants, but our beachside houses also appear cheaper to those wealthy foreigners looking for an Antipodean holiday home, and so on. From a macroeconomic perspective, how we feel about these departures from "equilibrium" (and our best assessment of that equilibrium level is somewhere in the range of 54-60 on the trade-weighted index) depends a lot on what else is going on. In this case, the low exchange rate happened to provide a timely buffer when the world economy slowed down sharply: for exporters of manufactured goods and services, in particular, it provided an offset to the impact of the sharp slowdown in world economic activity. But for a variety of reasons, our economic growth proved so robust that New Zealand was one of only a small number of countries that needed to raise interest rates quite a bit last year to help keep medium-term inflation pressures in check. The exchange rate had become too low for too long to really be helpful.

And eventually, as these things do, the exchange rate began to correct - although no one could really reliably predict when this correction would get under way. In trade-weighted terms, our exchange rate has now risen by around 20% since the end of 2001; one of the largest twelve-monthly changes that we have seen in the 18 years since the exchange rate was floated. It is important to put this in context though: even after a striking 30% rise against the US dollar, that exchange rate is still only now around its average level for the last 10 years. On a trade-weighted basis, the exchange rate is now only a few per cent above its long-term average.

As I noted earlier, changes in investors' attitudes and expectations tend to be the main prompts for substantial exchange rate moves. How did those attitudes change last year?

For investors, the US "miracle" has turned sour. Share prices have fallen for three consecutive years, and even US interest rates are unattractively low by international standards. America's need to attract foreign capital - its huge current account deficit - remains as strong as ever. But when the US is no longer flavour of the decade, there was only one way for the US dollar to go. Down. That adjustment was both inevitable (eventually) and healthy.

Pretty much every country in the developed world has seen its currency rise in value against the US dollar. But our currency has appreciated more than most in the last year. While on average, the currency has only returned to more normal levels, against the Australian dollar it has risen to levels that are not far off record highs. While many New Zealanders have been trying to make sense of our currency's sharp rise, many commentators across the Tasman have been grappling with the question of why the Australian dollar has risen so little against other currencies so far. Indeed, in one recent global survey in which financial market commentators were asked which currency was likely to rise most this year, the Australian dollar was the overwhelming favourite.

Two things seem to explain much of the New Zealand dollar's sharp rise. First, our economy has performed very well indeed, surprisingly well in the last year or so. New Zealand is one of the few developed countries where economic forecasts were revised up last year. Amid a rather gloomy world outlook, investors have been attracted to favourable growth surprises. And second, it was a year when solid secure fixed income returns seemed to come back into focus among the investor community. Moody's now rate New Zealand as AAA, and of course New Zealanders' appetite for debt has meant we have long had interest rates that have been somewhat above those of most developed countries. Two of the other strongest currencies last year were the Norwegian krone and the South African rand, both economies with higher interest rates than those in New Zealand.

At the margin, the fact that our current account deficit has been smaller than usual may also have contributed the world has been keen to put money here at just the time when we've needed a bit less than usual. The US, of course, scored poorly all round: it has had a high and widening current account deficit, low interest rates, and a continued disappointing growth outlook.

But what of the rise against the Australian dollar? First, we've had higher interest rates than Australia (and the gap has increased somewhat) in a period when secure fixed income returns have been particularly attractive. Second, validly or otherwise, markets have taken the view that the New Zealand economy is growing more robustly than Australia's at present (the drought, fires, and all that). And

third, when both the New Zealand and Australian dollars are rising or falling, our currency has often gone a little further than theirs: perhaps something to do with our smaller size and less-liquid markets.

It is not my main topic today but can I make just a few quick observations about interest rates. First, our interest rates are currently low by our historical standards (lower than they were when the exchange rate was falling, and only lower than this on three occasions in the last 20 years). Even after adjusting for inflation, interest rates are lower than they have been for most of that time. Second, while the Reserve Bank's monetary policy has a big influence over the level of short-term interest rates over short periods of time, the average or normal level of interest rates over periods of years is mainly determined by New Zealanders' willingness to save and appetite to borrow. For reasons that are not fully understood, over the years New Zealanders have continued to have a higher appetite for debt, at any particular level of interest rates, than do citizens of most other countries we typically compare ourselves with. Only when that changes will our interest rates settle, on average, around the level of those in other countries.

I want to turn now to outline something of how we think about the exchange rate in setting monetary policy.

In setting the Official Cash Rate, we are always very conscious of exchange rate changes, and how those developments will affect the outlook for growth and inflation a little down the track. Those effects have changed through time. For example, not just in New Zealand but internationally, prices seem to be less responsive to exchange rate movements than they were 15 years ago. Suppliers seem to be absorbing more of the impact of cyclical fluctuations in the exchange rate. And as an increasing proportion of our exports are moving up the value-chain, our firms are getting a little more pricing power themselves, and hence are less immediately exposed to the effects of exchange rate fluctuations. And, of course, access to sophisticated financial derivatives gives many firms some breathing space to adjust to changes in the exchange rate. But as a trading nation, exchange rate fluctuations will always be a big influence on the short-term economic outlook, and monetary policy. A rising exchange rate has a very real impact on exporting firms, and those supplying them - here in Christchurch and throughout the country. And it does so particularly when individual cross-rates move rather differently, for reasons that have nothing to do with events in New Zealand: for example, a firm which is sourcing inputs from Australia and exporting to the United States.

What else is going on at the same time also matters critically. Sometimes an exchange rate change will helpfully offset some other development here or abroad, but by no mean always. Making these assessments is very far from being a mechanical or mechanistic exercise. Formal models and estimates of `equilibrium' exchange rates help, and we use them extensively. But they only take us so far. A lot of wisdom, and experience, and informed judgement has to be brought to bear - and a willingness to acknowledge our mistakes and reassess at the next regular review.

And, of course, we had a review of the OCR just yesterday, when we had to work through exactly those sorts of judgements, making sense of the unexpectedly strong rise in the exchange rate since the November Monetary Policy Statement. We put a great deal of effort into understanding both what might have driven the exchange rate, and into assessing what impact the rise might have. We concluded that the recent rise in the exchange rate, if sustained, will dampen economic activity looking ahead - at least as compared to what we were expecting in November. At the same time, we noted that domestic spending appears to have been more robust than we had anticipated - that means that the economy has still been growing strongly. Household spending appears to have remained high, and house sales and construction activity have been very buoyant. It is important to remember that the starting point has been one of quite intense pressure on resources - many of you, for example, are no doubt among the firms who report that they are finding it very hard to get good staff. For the moment, it is appropriate to leave the OCR unchanged, but the balance of risks has shifted. We will need to look closely at the data over the next few months, for evidence that points to reduced pressure on resources and medium-term inflation. If that evidence emerges, and if the exchange rate remains at around current levels, or even rises further, there may be scope for a cut in the OCR later in the year.

Some prices are already falling as a direct result of the rising exchange rate. That, in itself, would not prompt us to adjust monetary policy - any more than the sharp rises in prices in 2000 and 2001 after the substantial exchange rate fall led us to adjust the OCR in response. We focus on the more sustained impact of exchange rate changes; the effects on economic activity and medium-term inflation pressures. Short-term changes in prices can affect people's expectations about inflation, but it has usually been sensible for us to "look through" these effects. If we did not, we would typically be

over-reacting, and pushing interest rates around more than medium-term considerations would warrant - and that might even exacerbate exchange rate fluctuations over time.

Some, of course, would suggest that we should be more active and should adjust the OCR, not just to offset the dampening impact of the exchange rate, but to try actively to reverse, or slow, the rate of increase in the exchange rate. In this case, of course, it is important to remember that the exchange rate has simply recovered to more normal levels, pricing New Zealand assets and products more sensibly, albeit adjusting more quickly than is comfortable. And more generally, we need to be very cautious. We would be the first to acknowledge that monetary policy affects exchange rates, but modest changes in interest rates only rarely do so in a stable and predictable manner over periods that matter to people in the real economy. Understanding, after the event, what has driven the exchange rate is one thing, but reliably forecasting it, or using monetary policy to influence it, is quite another.

What we constantly do, however, is to look behind developments in the exchange rate. We want to understand as well as we can what has been going on and why, and we continually test our reasoning and judgements to ensure that our monetary policy decisions are not unnecessarily exacerbating exchange rate changes. This prudent and sensible approach has in fact been written into our mandate - the Policy Targets Agreement with the Minister of Finance - since 1999. It keeps our focus on medium-term price stability, but requires us to ensure that in pursuing that medium-term goal we avoid unnecessary instability in output, interest and exchange rate. There are no simple answers as to how to apply these provisions to our policymaking; to know just what is "unnecessary", not just right now, but over the medium-term. Sometimes, an OCR rise will exacerbate pressure on the exchange rate, but rises in both will be a necessary response to pressures on output and inflation. At other times, there will be scope for trade-offs, but there are rarely easy or reliable ones.

For us, those choices might come more sharply into focus if we were to see another sharp rise in the exchange rate this year. You will note that I have not said much today about what I think might happen to the exchange rate in the coming year. And that is for a very good reason. However much we can understand, after the event, what has driven the exchange rate, neither economists and central bankers (nor anyone else) has a great track record forecasting exchange rates. And that is especially so when the exchange rate is no longer well away from sustainable long-term levels. Most observers do expect some further rise in our exchange rate, mainly because the US dollar is widely expected to fall further. But a year is a long time in financial markets, and much can change over that time in investors' attitudes to likely returns both here and in other countries.

I would emphasise in closing that the Reserve Bank will never be complacent about the sorts of exchange rate swings we have seen in recent years. We are limited in what we can do to prevent or moderate them, but we recognise the impact they have both on you as business people, and on consumers up and down the country. As I noted at the start of this address, if New Zealand can achieve a superior long-run economic performance that will lead to a trend increase in the exchange rate, but quite marked fluctuations around that trend will be an uncomfortable fact of life for us all. While keeping the goal of medium-term price stability constantly in view, the Reserve Bank will always be asking whether, and how, our decisions and comments can best avoid undue and unnecessary volatility in the economic environment we face - not just today, but over the full course of the economic cycle. The fact that some volatility is inevitable is no excuse for simply being oblivious to it. You cannot be, and we are not either.