

John McDermott: Understanding the New Zealand exchange rate

Speech by Dr John McDermott, Assistant Governor and Head of Economics of the Reserve Bank of New Zealand, to Federated Farmers, Wellington, 22 November 2013.

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Whenever presenting on the economy, the first question I get almost always relates to the elevated level of the New Zealand dollar. People are often concerned that the exchange rate is too high or too volatile and believe that these problems could be addressed by running monetary policy differently.

Concern about the exchange rate is understandable. Movements in, and the level of, the exchange rate can have substantial impacts on the performance and structure of the New Zealand economy and on people's livelihoods. The exchange rate is important and the Reserve Bank devotes a great deal of resources to understanding it.

Today I want to summarise the Bank's thinking on the types of questions we get about the exchange rate. Given time constraints, it will be necessary for me to skip over many of the complications and nuances behind these questions. For those who would like to know more, I invite you to visit the Reserve Bank's website. It has a large volume of analysis on the exchange rate – presented both in lay terms and in as technical a form as you could ever wish.¹

Before I begin though, it is worth noting, what I think everyone now accepts, that the solution to a high and variable exchange rate is not higher inflation. International and historical experience has shown that if a central bank runs monetary policy looser than is required it will generate inflation. Such future inflationary problems would be very costly to resolve in terms of growth and employment.

Is the exchange rate high?

An initial question is whether the exchange rate is high. The answer, currently, is most certainly yes: the nominal exchange rate is at historically high levels against nearly all of our trading partners².

Here it is important to introduce the concept of the real exchange rate. The real exchange rate, as well as being influenced by the nominal exchange rate, also takes account of relative inflation rates so is a better measure of overall competitiveness. An exporter's competitiveness is determined not just by the nominal exchange rate, but also by their cost of doing business relative to their foreign competitors.

Unfortunately for New Zealand's tradable sector, just like the nominal exchange rate, the real exchange rate is also high. Figure 1 shows the real exchange rate over the past 50 years, and the current rate is well above its historical average since 1964.

When the New Zealand dollar is either high or low, it tends to remain high or low for longer than the exchange rates of other countries. So in the current situation, not only is it clear that the real exchange rate is high, it is also likely that this elevation will persist for some time.

¹ A relatively accessible example of the Bank's research on the exchange rate was a conference we held (jointly with Treasury) earlier in the year. Copies of all the papers from this conference are available at http://www.rbnz.govt.nz/research_and_publications/seminars_and_workshops/Mar2013/programme.html.

² On a trade weighted basis and against the major currencies involved in New Zealand dollar transactions (other than the Australian dollar), our exchange rate is currently in the top decile relative to historic experience.

Figure 1:

New Zealand's Real Exchange Rate



Source: Bank for International Settlements

What are the drivers of the real exchange rate?

We can think about what drivers the exchange rate in a couple of ways. One is the cyclical dimension of the exchange rate and the other is the long term level.

The Reserve Bank has models that are able to explain a good proportion of cyclical fluctuations in the exchange rate.³ These models typically highlight the correlation between the exchange rate and a few key variables, such as the terms of trade, interest rate differentials, relative house price inflation, and measures of risk. Of course, one should never confuse these correlations as causal explanations of the exchange rate. Figure 2 illustrates how the cyclical movements in the three most important variables used in one of these models can explain a large proportion of exchange rate fluctuations.⁴

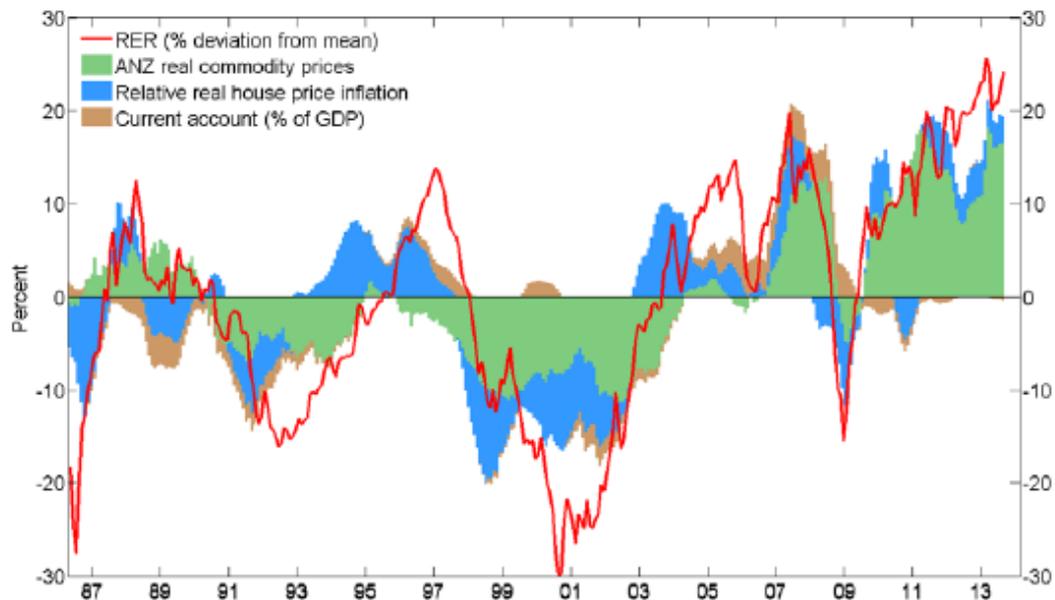
Even though we can explain the cyclical movements in the exchange rate these movements may not be welcome by the tradables sector because, among other things, it adds uncertainty to decision making. That said, short term exchange rate volatility can be effectively countered through the use of forward exchange rate contracts, but it remains true that longer term exchange rate cycles are more difficult to handle for many exporting firms.

³ For examples see McDonald, C (2012) "Kiwi drivers – the New Zealand dollar experience" AN 2012/02 and Cassino E and Z Wallis (2010) "The New Zealand dollar through the global financial crisis" RBNZ Bulletin September 2010.

⁴ For specific details see McDonald, C (2012) "Kiwi drivers – the New Zealand dollar experience" AN 2012/02.

Figure 2:

Contributions to Real Exchange Rate deviations from mean



Source: RBNZ

More important issues relate to the long term drivers of the exchange rate and the implications of the exchange rate being overvalued. When the Reserve Bank talks about an overvalued exchange rate we usually mean that the exchange rate is too high to achieve desired economic outcomes such as an appropriate allocation of resources. In this sense the exchange rate can be overvalued even if its strength can be explained by factors such the terms of trade.⁵

An important issue when it comes to determining the exchange rate in New Zealand has been the persistent gap between savings and investment. Over the past 40 years New Zealand has demanded more capital for investment in housing, infrastructure and other assets than its domestic saving rate could finance. This has meant an on-going reliance on foreign saving and capital inflows. This saving shortfall has also put upward pressure on interest rates and the exchange rate.

The resulting higher exchange rate has surely affected the tradable sector's profitability and its decisions about investment, employment, and market strategy. These decisions may well have led to a misallocation of resources resulting in a tradables sector that is smaller than is desirable. International experience certainly suggests that countries that sustain fast growth tend to do so with a strongly growing tradables sector, tapping the potential of a global market and the productivity prospects that creates.

Could the high real exchange rate be addressed by running monetary policy differently?

A range of suggestions aimed at solving the overvaluation problem have been provided by a number of commentators, such as:

⁵ Sometimes people use overvalued to mean a value of the exchange rate higher than indicated by economic fundamentals. This is not the meaning being used here but rather it means the effects of the exchange rate are undesirable from an economic perspective.

- Keeping interest rates low;
- Currency intervention;
- Quantitative easing;
- Capping the exchange rate;
- Targeting growth and employment, and
- Changing the focus of monetary policy.

As much as we would like it otherwise, many of these suggestions are either unlikely to have a significant lasting effect, or have unpalatable trade-offs such as much higher inflation, or are simply not feasible. The limitations and problems associated with these suggestions have been well covered in Governor Wheeler's speech *Manufacturing decline not just a dollar story* so I will not repeat them here.⁶

There are some things the Reserve Bank has been doing that, at the margin, may avoid the exchange rate being higher than is currently the case.

The Bank does intervene in the foreign exchange market from time-to-time. But evidence from the past, here and elsewhere, suggests foreign currency intervention is unlikely to have a sustained impact in lowering the exchange rate.⁷ This is because daily foreign currency transactions in New Zealand dollars swamp any practical intervention capacity, averaging around \$100 billion per day with more than 80 percent of the transactions taking place offshore. At best the Reserve Bank can attempt to smooth the peaks and troughs of the exchange rate. Of course, reasonable people can differ on what is the appropriate scale of intervention used to smooth some of the volatility. But the old economic saying that there is no free lunch still applies: the greater the scale of intervention, the greater the financial risk carried by the tax payer.

More active macro-prudential policy has been undertaken recently to help reduce the build-up in systemic risk in the banking sector resulting from imbalances in the housing sector. The current low interest rates, although appropriate for the current inflationary environment, are contributing to those financial stability risks. In such circumstances one might consider using monetary policy more aggressively to lean against house prices.⁸ While this would mean inflation would take longer to rise to the mid-point of the target band it would reduce the risk of a future crash in the housing market.

However, using monetary policy to reduce the financial stability risks of a booming housing market would put additional upward pressure on the exchange rate. Instead, we have used macro-prudential policy, in particular the loan-to-value ratio limits, to help moderate the risks in the housing market. This addresses the financial stability issue more directly and reduces the need for monetary policy to put pressure on interest rates and the exchange rate.

What, other than monetary policy, will remedy the real exchange rate?

Saying there is little monetary policy can do about the exchange rate, is not the same as saying there is little that can be done. The Reserve Bank undertakes a great deal of research and analysis on the exchange rate. One example of this research was an Exchange Rate Forum jointly hosted by the Reserve Bank of New Zealand and the Treasury earlier in the

⁶ See http://www.rbnz.govt.nz/research_and_publications/speeches/2013/5150125.html.

⁷ Chetwin, W and A Munro (2013) "Contemporary exchange rate regimes: floating, fixed and hybrid" paper presented to Exchange Rate Policy Forum.

⁸ Borio C and P Lowe (2002) "Asset prices, financial and monetary stability: exploring the nexus" BIS working papers No. 114.

year. One of the objectives of the forum was to generate ideas for reducing the harm caused by the exchange rate.

The harmful effects of exchange rate cycles can potentially be addressed partly through improved microeconomic policies, especially those that promote greater competition. Such policies need to be structured to make the economy more flexible, thereby reducing the need for the exchange rate to carry the burden of absorbing economic shocks. An example here could be increasing the responsiveness of the building industry to housing demand.

Likewise, reducing the magnitude of domestic demand cycles would reduce the pressures that monetary policy needs to lean against. Avoiding pro-cyclical changes in fiscal policy such as tax cuts or increasing public spending when resources are already stretched. Similarly, banks could avoid excessively relaxing credit standards when demand for financing is strong. Such actions would ease cyclical exchange rate pressures.

Since the savings and investment gap plays a prominent role in New Zealand's exchange rate story, it seems reasonable to suggest that it will be necessary to tackle our reliance on foreign savings to finance our consumption and investment. The dependency on foreign savings means that we have persistently needed interest rates above those in most developed economies. Addressing the residential investment needs of a growing population and increasing the incentives for private sector savings, such as the tax treatment of investment income and issues around the long-term design of public and private pension systems, are the sorts of issues that need to be debated to see what would work best in New Zealand.

Conclusion

The exchange rate plays an important role in a small open economy like New Zealand and generates many questions and concerns. The persistently high exchange rate is out of line with what looks to be necessary if New Zealand is to achieve its economic aspirations of catching up with the rest of the OECD's income levels.

The Reserve Bank spends a great deal of time on this issue because it is important. In so doing we have developed a number of models that can explain the exchange rate. But explaining the exchange rate is not the same as saying it is fairly valued.

The New Zealand dollar is overvalued from the standpoint of its effects on the economy and we would like to see a lower exchange rate. A key conclusion of our work is that this overvaluation stems, at least in part, from the persistent savings and investment imbalance.

Therefore to address New Zealand's overvalued exchange rate the underlying imbalances themselves must be addressed. Raising domestic savings relative to our investment needs appears the best way to sustainably lower New Zealand's real interest rates and take the pressure off the real exchange rate.