New Zealand's overvalued dollar

by Keith Rankin, 3 April 2012

On 26 April Brian Fallow ("Talk won't cheapen our soaring dollar") voiced the widespread concern, in New Zealand, that the near-record high of our exchange rate is a significant constraint on the sustained recovery of the New Zealand economy. Later that day, Reserve Bank governor Dr Alan Bollard, emphasised this issue, as Fallow predicted he would.

The New Zealand dollar is high for several reasons. One of the most important is the favourable terms of trade, meaning that export prices are historically high relative to import prices. Another is that, with respect to government debt, New Zealand scores favourably compared to most countries.

A further reason is that, historically, New Zealand has been very kind to foreign savers. Consistently since 1985, when the New Zealand dollar was floated, foreign lenders have benefited from both high yields (comparatively high interest rates) and substantial capital gains. New Zealand has come to look like an ideal place for savers to lend to: a source of high returns combined with low risk.

New Zealand - the country, not the government - has not actually paid interest (that is, in goods or services) since 1974. Current account deficits over the last 38 years have meant that New Zealand has borrowed to pay its interest liabilities to the rest of the world. Foreign savers don't actually mind this, because they generally re-lend rather than spend their interest. New Zealand is perceived as a low-risk debtor because it has proved able to attract the credit required to pay the interest bill.

New Zealand's problem has been its willingness to attract and accept more credit from the rest of the world than New Zealand has required. This has mostly occurred by New Zealand banks and monetary authorities paying higher interest rates than required to maintain a stable currency.

Brian Fallow sites John Key claiming that people who think that policymakers can successfully address the exchange rate problem as being in "la-la land", despite the clear evidence (about Switzerland) given by Fallow that successful exchange rate management is possible.

This rhetorical tactic represents the less pleasant side of the Prime Minister, who likes to shut down debates in this way. I recall, a few years ago, that he tried to shut down the welfare debate by suggesting that proponents of welfare reform thought that "pixies in the garden" created money. At that time "pixies" in the US Fed and in the Bank of England were indeed busy creating money, in programmes of quantitative easing that prevented the global financial crisis from becoming a global financial catastrophe.

Foreign savers seeking to optimise their financial returns like to lend to countries with low risk of default or exchange rate depreciation, better yields than alternative countries, and a good chance of capital gain in the form of exchange rate appreciation. A successful intervention requires both reduced yields and a zero expected capital gain.

In 2007, the Reserve Bank of New Zealand attempted to lower an over-valued exchange rate in much the same way that the Swiss are doing now, by creating new NZ dollars and selling them for foreign securities, countering the excess buying of New Zealand securities by foreigners. The problem was that, in creating a fund of foreign reserves that could be sold in the future in the event of a run on the NZ dollar, foreign lenders saw a reduction in the risk of a substantial exchange rate depreciation in the future. So they kept buying NZ dollars.

Much the same thing happened in the United Kingdom in 1931-33 when, after the pound went off the gold standard (and immediately fell sharply in value), an "exchange equalisation account" was created to manage the floating pound. In doing this, the no longer overvalued British pound was now seen as safer than gold-backed currencies. Speculators sold those currencies in favour of the unbacked British currency. While the pound appreciated in 1932-33, the experience of devaluation in 1931 led to Britain's recovery from the Great Depression, just as some other countries were going into it.

The recent Swiss intervention has been successful because Switzerland, in addition to creating and selling its own currency, also has near-zero interest rates.

New Zealand has considerable scope to lower its exchange rate by first reducing interest rates, and, if the problem is not resolved, only then looking to intervene in a more direct way. My belief is that, in the absence of relatively attractive yields on low-risk assets, the exchange rate would fall to the requisite levels. No other intervention would be required.

In capitalist economies, the rate of interest is a price that regulates capital flows. We should let the interest rate do its work. When we face excessive inflows of foreign saving - evidenced by an overvalued exchange rate - then interest rates are too high. Presently we intervene to keep interest higher than it should be. In this case, we could intervene successfully by intervening less.
