Antipodean currencies

Waltzing me dollar
Oct 14th 2000
From The Economist print edition

Should Australia and New Zealand form a currency union?

THE plunge of the euro is as nothing beside the drop in two currencies on the other side of the globe. The Australian and New Zealand dollars have both fallen by more than 20% against the American dollar since January, to all-time lows. So fed up are New Zealanders with the kiwi dollar that some are even contemplating currency union with Australia.

Against the American dollar, the kiwi is now 44% cheaper than it was at the end of 1996. The Aussie dollar is 35% cheaper. This partly reflects the fact that both currencies were previously overvalued. But it is also the converse of the current strength of the greenback. Unlike America, both Australia and New Zealand are perceived as "old economies", dependent on resource-based industries (an inaccurate impression, as it happens, since both countries spend more of their GDP on IT than does America). Both also have large current-account deficits, 5% of GDP in Australia and almost 8% in New Zealand, that are even bigger relative to GDP than America's deficit of 4%.

In New Zealand, the sliding currency has put monetary union with Australia on the agenda. A recent study by two leading New Zealand economists reported that more than 80% of 400 firms surveyed were in favour. In recent weeks, Helen Clark, New Zealand's prime minister, has also suggested that a currency union with Australia may be desirable and even inevitable.

One argument in favour is that, by eliminating exchange-rate uncertainty, it would boost trade with Australia and make foreign direct investment more attractive. Also, transaction costs for firms trading between Australia and New Zealand would fall if they no longer needed to convert between the two currencies. And by reducing the currency-risk premium that investors demand for holding kiwi dollars, it would lower real interest rates. Over the past three years real long-term bond yields have been on average 1.4 percentage points higher in New Zealand than in Australia.

Some of these benefits would be modest, however. Although Australia is New Zealand's biggest trade partner, it accounts for only 22% of its exports. New Zealand is even less important to Australia, accounting for a mere 8% of its exports. Linking the kiwi dollar to the Australian dollar would not eliminate the overall risk of exchange-rate volatility facing New Zealand firms. Four-fifths of the country's trade would still be affected.

The main drawback of a currency union is the loss of an independent monetary policy to cushion the economy against external shocks. The likelihood is that interest rates would, in effect, be set for the needs of the Australian economy. The cost of this to New Zealand would depend on how closely the two economies move in step.
On the surface, they have much in common. Both depend on commodity exports, both trade heavily within the Asia-Pacific region and there is (almost) free movement in trade, labour and capital between the two countries. But there are also some big differences, such as the composition of their commodity exports: New Zealand’s top exports are dairy, meat and forestry products, whereas Australia’s top three are coal, iron ore and gold. World prices for these can move quite differently.

A study by Dominic Wilson at Goldman Sachs finds that both interest rates and the exchange rate in New Zealand have tracked those in Australia fairly closely over the past decade; so if New Zealand had adopted the Aussie dollar, policy might not have been radically different over the period as a whole. But the economic cycles of Australia and New Zealand have at times diverged substantially and could do so in future—at a high cost to New Zealand, were its currency tied to the Australian dollar. If the world price of minerals surged, say, but the prices of farm products fell, Australia’s economy would boom, maybe justifying higher interest rates, while New Zealand’s sank, creating a need for lower rates.

Nevertheless, Mr Wilson concludes that currency union would, on balance, bring some small benefits for New Zealand. Any gains for Australia would be negligible. This may explain why there is far keener interest in monetary union in New Zealand.

**Will neighbours become good friends?**

Some of New Zealand’s enthusiasm owes nothing to sound economics. It partly reflects falling business confidence due to the policies of the new Labour government. Trade unions have been given more power in wage bargaining, for instance. Some supporters of currency union think that it would allow New Zealand to grow as fast as Australia. But as Don Brash, governor of the Reserve Bank of New Zealand, has said, “Currency union is not a magic path to substantially faster growth. It is no substitute for domestic policies that promote stronger productivity growth.”

Another popular argument is that currency union would mean better monetary policy. New Zealand’s central bank is widely thought to have pursued an excessively tight policy in comparison with Australia’s. New Zealand has been seen as a model of central-bank independence, and it was the first to introduce inflation targeting. But even model central banks can make mistakes. With hindsight, it held interest rates too high for too long in 1997-98 after the Asian crisis. But you do not need to scrap the central bank to change monetary policy. Indeed, such a proposal raises the suspicion that many who favour currency union see it simply as a backdoor way to looser policy.

The biggest obstacles are political. New Zealanders talk about a union in which the two countries both adopt a new currency. But Australians laugh at the idea of replacing their dollar. If union happens, it will not be a merger but a takeover, with New Zealand adopting the Australian dollar. From an economic point of view this would make little difference, for even under a currency union New Zealand would, in effect, cede control of its monetary policy to Australia, as Australia’s economy is seven times bigger. But politically, adopting the Australian dollar, as opposed to creating a new joint currency, is a tough sell. New Zealanders detest losing to Aussies at anything.