

A matter of exchange

A view has been gaining ground in policy circles that low savings have been responsible both for New Zealand's high interest rates and its high exchange rate. The implication is that an increase in saving would provide relief for the export sector and allow lower interest rates. As seductive as this view is for monetary policy, we think it is largely wishful thinking.

Concerns have been mounting around New Zealand's low national saving rate. The worry has been that low savings have made the economy more vulnerable to a funding shock (we'd probably agree) and that low savings are the culprit for New Zealand's low growth (we're sceptical).¹

More recently, it's been argued (both in the recent report by the Savings Working Group, and by the RBNZ) that low savings have contributed to New Zealand's high exchange rate – that raising New Zealand's national saving rate could result in a lower exchange rate as well as lower interest rates, and so take pressure off the beleaguered export sector. In this bulletin we take a closer look at that claim: we think it's based on a number of questionable assumptions, which could lead to both savings policy and monetary policy decisions being made for the wrong reasons.

Global vs local

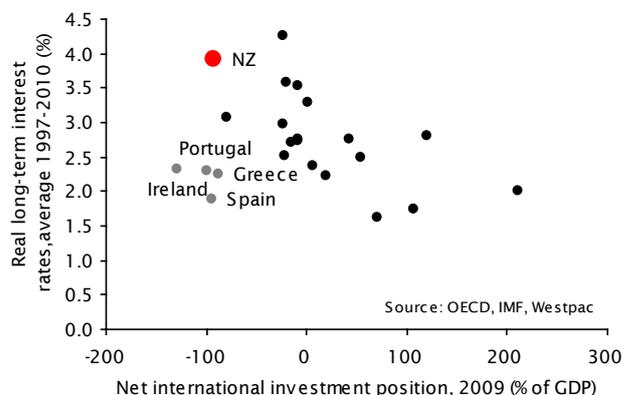
At the heart of the disagreement are two very different explanations for why New Zealand's interest rates have, over time, been so much higher than in most other OECD countries – each of which has very different implications for the exchange rate. The standard economics view – which we share – is that the only way in which interest rates in different countries can diverge over the long haul is through different perceptions of risk or different rates of inflation. For countries with the same riskiness and the same inflation trends, interest rates should converge to the same global level – otherwise speculators could make riskless profits forever by selling assets in the low-yielding country and buying them in the high-yielding

country. (Global interest rates are themselves determined by global saving and investment patterns – essentially by factors such as global growth prospects and global risk appetite.)

For New Zealand the standout risk is credit risk – we aren't that different from other countries (notably Australia) in terms of our inflation rates or the volatility of our exchange rate. What we do have is an unusually high national debt. While our government debt is relatively low by international standards, the net foreign liabilities of New Zealand as a whole, at over 80% of GDP, put us within reach of some euro area basket cases. This would tend to push our interest rates higher than for countries with lower debt (by making us a riskier investment proposition). The chart below, which plots average inflation-adjusted interest rates against net foreign debt for a range of countries, suggests that this broadly holds true (the aforementioned euro area countries are a notable exception, highlighting the extent to which their riskiness was mispriced before the Global Financial Crisis).

We'll call this explanation of New Zealand's high interest rates the 'risk premium' view. Over short periods, of course, interest rates in different countries diverge all the time, for reasons

Average inflation-adjusted interest rates and net foreign debt



¹ See our feature article 'Save our Souls' in the January 2011 *Economic Overview*.

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other than risk. For example, monetary policy tightening in one country might drive up interest rates. When this happens the exchange rate tends to appreciate as well, as investors chase yields. This is called the carry trade. Economic theory says that there is a limit to this carry trade – investors will pile into higher-yielding currencies only up to the point where the exchange rate has become sufficiently ‘overvalued’ for its expected depreciation to offset the prospective interest rate gains.

The alternative account of New Zealand’s high interest rate history – which has been set out most fully in a recent Treasury Working Paper² – builds on the carry trade idea. This explanation – which we will call the ‘excess demand’ view – essentially says that a very long-lived aggregate demand boom specific to New Zealand has kept both interest rates and the exchange rate high. The story goes like this: for a host of reasons New Zealand has suffered from a chronically low level of saving relative to investment, and – as a corollary – persistently strong domestic demand. This has forced the Reserve Bank to keep interest rates above those seen in countries with higher saving rates. A side effect has been the large current account deficit, and our high level of foreign debt. What has allowed these high interest rates, and large current account deficits, to persist over time is a chronically overvalued exchange rate. Essentially, investors have been expecting the currency to come crashing down for 20 years. It won’t happen overnight, but it will happen!

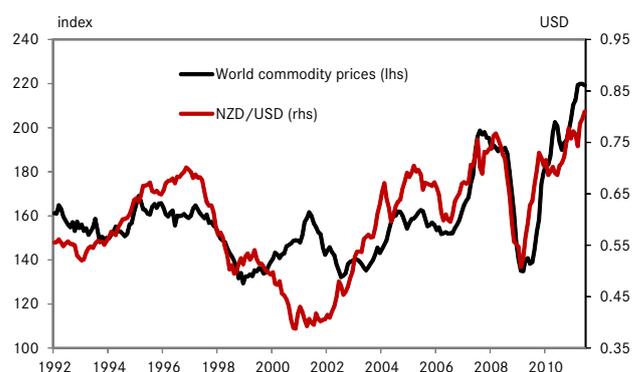
Fair or foul

Both these theories explain the coincidence of high debt and high interest rates in New Zealand, but their predictions for the exchange rate couldn’t be more different. The ‘risk premium’ view suggests that as countries become more indebted, they should see rising interest rate premia and, if anything, a sagging exchange rate (because they need to export more and import less to pay their rising overseas debt burden). The ‘excess demand’ explanation, by contrast, implies that relatively high interest rates should have coincided with an ‘overvalued’ exchange rate.

The Treasury authors argue that the New Zealand dollar *has* been significantly above sustainable levels, and that this counts in favour of their story. We’re not so sure. In other work the Treasury have pointed to research by the IMF and others concluding that the dollar is still well above its long run value.³ But we would argue that what you consider fair value depends crucially on your expectations for the terms of trade, or the price of a country’s exports relative to its imports – higher terms of trade provide an income boost that allows a country to service its debts at a higher exchange rate. For New Zealand, rising global commodity prices have seen the terms of trade reaching record highs, and our view is that they are likely to stay high for a long time to come. In that kind of world, we would also expect the exchange rate to stay above historical averages. The IMF use a variety of approaches

to assess our exchange rate, but only one of those models controls for the terms of trade – and we’re not surprised to see that model concluding that the exchange rate is less than 5% overvalued, well within the margin of error around zero.⁴ Leaving aside what ‘sustainable’ is, we think the IMF’s conclusions are based on some debatable assumptions for New Zealand’s debt outlook. The approach of the IMF’s other two models is to ask what exchange rate would be needed to get our current account and net foreign debt back to sustainable levels – but that’s relative to the IMF’s baseline forecasts. Those

Commodity prices and the exchange rate (inflation-adjusted)



forecasts are for the investment income deficit (i.e. the interest paid on overseas debt and the profits earned by foreign-owned firms) to blow out to 8% of GDP by 2016! Back-of-the-envelope calculations suggest that this would require interest rates, or profits, or New Zealanders’ appetite for debt, to be higher over the next few years than at the peak of the last housing boom.

There is no question that an exchange rate at current levels is painfully high for non-commodity exporters and import-competing manufacturers. But that is not necessarily the sign of an ‘imbalance’ that policy needs to correct, or could easily correct even if it wanted to. It reflects that the world is willing to pay more for what we export, and that as a country, we are able to consume more for what we produce. That is the blessing and the curse of Lucky Countries, also known as Dutch Disease.

Forever overvalued

Not only do we have doubts about how overvalued the exchange rate is right now, we find it very hard to believe that the exchange rate has been overvalued, on average, for decades at a stretch. Over that sort of time span markets adjust and ‘long-run’ drivers look increasingly relevant. It does seem to be true that, as the Treasury paper notes, the ‘carry trade’ can be profitable for extended periods before the exchange rate comes back to earth.⁵ But apart from investors continually expecting an exchange rate depreciation which never comes – which

2 Labuschagne, N and P Vowles (2010), ‘Why are Real Interest Rates in New Zealand so High? Evidence and Drivers’, Treasury Working Paper 10/09.

3 Mabin, G. (2010) ‘New Zealand’s Exchange Rate Cycles: Evidence and Drivers’, Treasury Working Paper 10/10, p. 26.

4 IMF, 2011 New Zealand Article IV Report.

5 See, for example, Burnside, C, M Eichenbaum, and S Rebelo (2008) ‘Carry Trade: The Gains of Diversification’ *Journal of the European Economic Association*, 6(2-3): 581 – 588.

really does not seem plausible to us - there are only two obvious ways in which this could happen. One is that financial markets are 'irrationally exuberant', expecting an overvalued exchange rate to stay overvalued. This is reasonable over an economic cycle, but not over 20 years. The second way would require a whole series of surprise boosts to aggregate demand over that period - what's more, boosts to demand that are specific to New Zealand. One candidate source of these positive demand shocks that we have heard mention is net migration. But New Zealand's net immigration rate has, on average over the past 20 years, been less than that experienced in the US and Australia. Overall, it's this aspect of the 'excess demand' story that just doesn't pass the sniff test.

Is there any evidence, consistent with the 'risk premium' story, that higher debt levels would tend to coincide with a *lower* exchange rate over time? It's mixed - the IMF has done several cross-country studies looking at determinants of exchange rates, including a country's net foreign debt. Some find a small negative effect (higher net foreign debt is associated with a lower exchange rate), some don't. It seems that other factors such as relative productivity and the terms of trade matter more.⁶

Having your cake and eating it

The 'excess demand' account of New Zealand's high interest rates has some very seductive implications. If we could only find a way of getting New Zealanders to save more, we could have both lower interest rates and a lower exchange rate. We disagree. On our preferred 'risk premium' view, higher savings would also be rewarded with lower borrowing costs - but the exchange rate would, if anything, be higher because of a lower foreign debt servicing burden and reduced country credit risk.

But the implications of the two views of the financial world go beyond the exchange rate. As we have set out in our previous work on the post-financial crisis interest rate landscape⁷, they also potentially lead to very different predictions for future monetary policy. Under the 'excess demand' view, borrowing rates might in future be permanently lower (if New Zealand becomes a nation of savers), whereas under our 'risk premium' view, interest rates should eventually return to levels seen over the past couple of decades, and could even rise higher. In particular, what if the required compensation for risk - not just in New Zealand, but everywhere - has shifted higher since the bursting of the 2000s credit bubble? On our view, this inevitably means that NZ lending and deposit rates will be higher, on average, than in the past decade. There will be nothing the RBNZ can do to *persistently* offset the reduced willingness of foreigners to lend to us, without causing higher inflation. Under the logic of the 'excess demand'

view, provided that sufficiently high domestic savings could be engineered, the RBNZ could offset higher international funding costs with a lower OCR for decades (implying, presumably, an undervalued exchange rate over the next 10-20 years!)

Overall, we feel that there is a reluctance on the part of some participants in recent policy discussions to accept the implications of a tighter global funding environment for New Zealanders' standard of living. There also seems to be a widespread desire to search for ways of tightening monetary policy without raising the exchange rate. We suspect a lot of this is wishful thinking. We agree that higher savings have the potential to drive New Zealand's real interest rate premium down. But that would not necessarily lead to a lower exchange rate - which reflects the best export environment that New Zealand has seen in decades. And it is higher interest rates - via a more realistic global pricing of risk - which may help achieve those higher saving rates in the first place.

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⁶ See Edison, H and F Vitek, 'Australia and New Zealand Exchange Rates: A Quantitative Assessment', IMF Working Paper 09/07, table 2, and Ricci, L, G Milesi-Ferretti, and J Lee, 'Real Exchange Rates and Fundamentals: A Cross-Country Perspective', IMF Working Paper 08/13, p. 9.

⁷ 'A matter of interest', Westpac Bulletin, 12 August 2010.