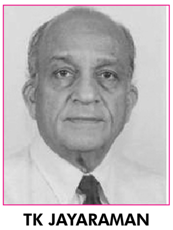
# The rising Kiwi dollar



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On Monday Nov 23, the Kiwi dollar soared to US 76 cents, the highest for the past 15 months. Appreciation of New Zealand (NZ) dollar against the US dollar is a matter of concern to policy makers.

A strong currency helps consumers. It buys more imports. By reducing import prices, it keeps domestic inflation low, which is targeted by Reserve Bank of New Zealand (RBNZ).

On the other hand, a strong currency hurts exports.

Rise in Kiwi dollar is due to the "benign neglect" of the US dollar, which is falling since the global crisis from mid 2008. America's trade deficits are huge. The only way to reduce them, in the light of its own mounting fiscal deficit, is to discourage imports and encourage exports. A depreciating American dollar does just that.

Unlike the Chinese currency, the yuan, which is pegged to the US dollar, NZ dollar is a freely floating currency. In a see-saw of bilateral exchange rate movements, if the US dollar is up, the Kiwi dollar has to be down.

Although along with Australia, NZ is reported to be on its way to recovery from the global recession, it is feared dim export prospects of dairy products would slow down the recovery.

Australian recovery is being speeded up, as its mineral exports are directed to China which is leading the world economic recovery.

Aside from making NZ exports less attractive, the rising Kiwi dollar has been attracting capital inflows into NZ, mostly of speculative nature. Such inflows worsen the situation, by contributing to further appreciation.

### Ways out

At least three: one is simple but not practical; the other is pragmatic but difficult to implement; and the last one is too radical!

One way is to impose controls on capital movements. Remember the successful case of Malaysia during the 1997 currency crisis. It imposed capital controls when capital was taken out fueling the rumour that the Malaysian ringgit would be devalued.

The NZ case is different. Capital is flowing into NZ, as US dollar holders and others are seeking a stronger currency, as people seek higher ground during Tsunami.

Some central banks have powers to levy taxes. Brazil can levy tax at a rate of between zero to 25 per cent on foreign capital inflows for investment in fixed-interest bonds or shares. On October 20, it imposed a 2 per cent tax on capital inflows.

In 1999, Brazil levied 8 per cent tax on capital inflows without success. It could not control the inflow of flood of speculative capital, which simply boosted its currency, the real.

It only showed that underlying issues cannot be addressed by such steps.

Capital controls would be anathema to NZ, which was foremost in liberalizing the economy. NZ was the first country to target inflation. Under a two-decade old rare accord between National and Labour Parties, RBNZ was originally mandated to maintain inflation of not more than 2 percent, which was subsequently relaxed to 3 percent. The government had powers to dismiss the central bank governor, if the latter failed to meet the target. These conditions were cited in the job contract.

### Cuts in spending

The RBNZ is pre-occupied with inflation, raising interest rates, if it is about to exceed 3 percent target under the current policy targets agreement.

The exchange rate would fall only if RBNZ follows an expansionary monetary policy. If the official cash rate (OCR), which signals the monetary policy stance is lower, the exchange rate would depreciate. Given the anti-inflationary bias of RBNZ, there is no likelihood of loose monetary policy stance, unlike in other industrial countries, including US (zero 0.25 percent) or Japan (0.1percent).

The alternative is to follow a "front-loading" of fiscal policy, suggested by a treasury Report. Such a policy would take pressure off monetary policy. In the process, it would lead to a fall in NZ dollar. A Treasury report has recommended that cuts in government spending could result in OCR being set lower than it is now.

"The tighter New Zealand's fiscal policy is, the looser our monetary policy is likely to be and, as a result, the lower the exchange rate," the report said.

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### Radical remedy

Phil Goff of the opposition Labour Party told a Federated Farmers meeting in Wellington last week that he wanted an end to the 20-year bi-partisan accord on monetary policy. He urged RBNZ giving up its anti-inflationary bias.

His arguments were that RBNZ's policy targets did not help exports and growth.

### This is not new.

Two years ago, a Parliamentary committee was investigating whether anti-inflation policy had caused a vicious cycle of "unintended and undesirable consequences". The criticism was that interest rates were raised to higher levels than most countries when the RBNZ made inflation forecasts to be above its target band. As a result, capital inflows rose and caused rise in house prices and big fluctuations in the financial sector.

The Labour Party was then in power. It did not do any thing.

So the ruling party says that opposition is not consistent.

The current Prime Minister John Key had a case to hit back at Phil Goff's criticism of the 20-year old accord. Key says Goff is not consistent.

Here comes the question of consistency.

Did not Oscar Wilde once say: "Consistency is the last refuge of the unimaginative"?

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