

## ANZAC Dollar

*Arthur Grimes and Frank Holmes with Roger Bowden, An ANZAC Dollar? Currency Union and Business Development, The Institute of Policy Studies, Victoria University of Wellington, New Zealand*

*Reviewed by Gordon de Brouwer*

This book provides an excellent and thought-provoking analysis of an important issue for New Zealand, of some consequence to Australia. Arthur Grimes, Frank Holmes and Roger Bowden are widely respected New Zealand economists, and their 130-odd page booklet makes two important contributions to the debate on trans-Tasman monetary union. The first is that it presents clearly and succinctly the reasons why changes in monetary arrangements in New Zealand may benefit that country. The second is that it presents some useful evidence on business perceptions of the costs and benefits of monetary union. But from an Australian perspective, it does not say enough about the other side of the coin — whether currency union would be beneficial to Australia.

Grimes, Holmes and Bowden present three reasons why monetary union, probably with Australia, may be a good idea. The first is that, like Australia, New Zealand is a small open economy which is subject to large terms of trade shocks. Unlike Australia, New Zealand's currency does not insulate the domestic economy from these shocks. The great benefit to Australia from a floating exchange rate is that the Australian dollar tends to depreciate when growth in industrial countries eases and international commodity prices fall. Given that the terms of trade in Australia and New Zealand are highly (though imperfectly) positively correlated, Grimes, Holmes and Bowden argue — persuasively, to my mind — that fixing to the Australian dollar should help stabilise domestic income in New Zealand. They also show that fixing to the US dollar would not stabilise domestic income in the face of terms of trade shocks.

Their second argument is that currency union would eliminate some of the currency risk premium from interest rates, and possibly enable New Zealand to enjoy lower interest rates. They think that this may be greater if the target currency were the US dollar rather than the Australian dollar, but they also note that the putative gain is substantially smaller now than it would have been in the early 1990s when Australian and New Zealand bond yields were several percentage points above US rates. This is the main argument for currency union with the United States, although the authors on balance prefer currency union with Australia.

Evaluation of this argument is less straightforward. On the one hand, European bond yields converged substantially in the lead-up to, and after, the introduction of the euro, despite different country risk and fiscal profiles. On the other hand, countries like Argentina also reckon that they can substantially reduce their long-term interest rates if they 'dollarise', but that can only happen if

international investors have confidence in Argentina's fiscal and political regime. On balance, long-term interest rates may be lower in New Zealand in the event of monetary union, even with Australia (New Zealand bond yields have been an average half percentage point higher than Australia's in the past two years).

Their third argument is stated subtly and is essentially that there are concerns about monetary policymaking in New Zealand, given that the Reserve Bank of New Zealand has made some serious policy mistakes in recent years. In particular, the steadiness of Australian monetary policy and the strong performance of the Australian economy during the Asian financial crisis have left some New Zealanders disappointed with the performance of their own institutions and economy.

Most commentators would argue that the RBNZ was wrong to have raised interest rates so severely to prevent inflation from rising just because Auckland house prices were rising (the rise was essentially the outcome of a shift in asset preferences). This policy mistake lay partly in the excessive formalisation of the RBNZ's inflation target — a looser medium-term focus may have allowed the authorities to accommodate some of the structural shift that was occurring in property prices. Most commentators would also argue that the RBNZ was wrong to have kept interest rates so high for so long in 1997 and 1998, even after it was clear that the economy had suffered a large negative external shock in the form of the Asian financial crisis. This policy mistake lay partly in the RBNZ's excessive formalisation of the monetary conditions index. These policy mistakes may also explain why the NZ dollar does not presently have the same insulating properties as the Australian dollar, as noted above.

But are past policy mistakes a good reason for New Zealand to replace its central bank? If the mistakes are systematic, the answer may be yes. The RBNZ's policy mistakes have not been because of a lack of talent — the RBNZ is staffed by some top professional economists. Rather, it may have been because the Bank has felt it necessary to rigidly and inflexibly formalise its policy framework, and has concentrated policy decision making in one smart person rather than a broadly representative policy board of smart people. This mentality may still not be a reason to replace the central bank, since the New Zealand approach may change and because retaining the option of an independent monetary policy to stabilise income in the face of idiosyncratic economic shocks is important, although it needs to be weighed against the advantages spelled out above.

The second main contribution of the study by Grimes, Holmes and Bowden is that it includes a survey of what business thinks about hedging and currency union. Over 80 per cent of the 400 firms offering an opinion favour currency union. While firms of all sizes are supportive, the most enthusiastic are mid-sized firms — perhaps because they find hedging most expensive and their growth depends on greater access to markets — and firms with investment relations with Australia. The strength of support is informative and suggestive that there may also be genuine trade and investment gains for New Zealand.

From an Australian perspective, the paper is light on the advantages for Australia from currency union with New Zealand. Indeed, the advantages look to

be larger for New Zealand than Australia. The main advantages for Australia would probably be in boosts to cross-Tasman competition and trade. But there are two possible disadvantages to Australia from currency union with New Zealand.

The first is that currency union may increase the exposure of Australia to shocks. In the first place, New Zealand has a higher current account deficit and higher gross and net external debt than Australia — Australia's current account deficit over the past half dozen years has averaged 4¼ per cent while New Zealand's has averaged around six per cent — increasing the vulnerability of the currency to changes in investor sentiment. Given that New Zealand's economy is one-seventh that of Australia, the combined ratios for the two countries are not so different from those for Australia. But what may matter is the susceptibility of Australia's currency to *nominal* shocks sourced from New Zealand. Our two countries' constitutional systems are different and New Zealand is more prone to political and policy idiosyncrasy and instability, which has appeared at times as a political risk premium in New Zealand currency and bonds (like Canada because of secessionist concerns).

The second possible disadvantage is the effect of currency union on Australia's policy institutions, especially the Reserve Bank of Australia. Grimes, Holmes and Bowden argue — rightly — that if currency union is to proceed, it should be with one central bank. It is imperative for 'good' policy in Australia that this not lead to substantial change in policy thinking or formation at the central bank.

Australia learned much from New Zealand's innovation and leadership with inflation targeting but applied this framework with substantially less variability in output because policymakers have retained a pragmatic non-ideological approach. This is Bernie Fraser's enduring legacy as RBA Governor. It is sensible that this approach remain the central bank's cultural norm, and an important way to ensure this is to retain the RBA's current board structure rather than concentrating decision making in the chief executive of the central bank. This is important because central bankers have a tendency to treat inflation above the target as more serious than inflation below the target, and having them explain and persuade other serious people is an important constraint on potential policy asymmetry. New Zealand should, of course, be represented on the Board, although it does not follow that there should be state representation.

New Zealand also has a unique wholly market-oriented approach to prudential supervision. While the authorities genuinely believe that a buyer-beware full-market-disclosure approach is the right policy, this policy is a luxury that New Zealand can afford because its banks are almost wholly foreign, predominantly Australian, owned and supervised. While it goes without saying that market discipline is a necessary condition for stability, it is not a sufficient condition, and currency union should not provide the circumstance for Australia to adopt a hands-off prudential policy.

Drawing all this together, Grimes, Holmes and Bowden present a persuasive case for why New Zealand should pursue monetary union with Australia. The great advantage of a floating exchange rate to a small open economy is that it

stabilises domestic income if the exchange rate moves to offset terms of trade shocks. This happens for Australia but not New Zealand, and it is a good reason for New Zealand to consider currency union with Australia. But from Australia's point of view, the issue needs further careful work and analysis.

There are three other policy issues from the paper that warrant mention. The first is the type of union. For Australians, the least complicated way to proceed would be for New Zealand just to Australian dollarise and replace its monetary authority and policy with Australia's. As the authors argue, this is not politically viable. Australians have to accept that New Zealand is a sovereign nation and cannot simply be treated as another state (unless it decides to become one).

The second is related: currency union between sovereign nations entails a new currency. The authors sensibly say that the conversion rates should be one Australian dollar for one Australian New Zealand dollar, which they call an ANZAC dollar. The problem is with the name. While the ANZAC descriptor has deep emotional resonance in both countries, it is inappropriate as the name of a currency. No other country has 'army corp' or any other such military term in the name of its currency, and it would be unwise to project militaristic sentiment, even by accident.

The third is that some commentators in New Zealand think that currency union should proceed between New Zealand, Australia and the United States. Given the insulating properties of the Australian dollar, this is clearly not an attractive policy option for Australia.

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