ANZ Research

NZ Insight: Exchange rate a headwind

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The exchange rate is a headwind that shouldn't be ignored

Summary

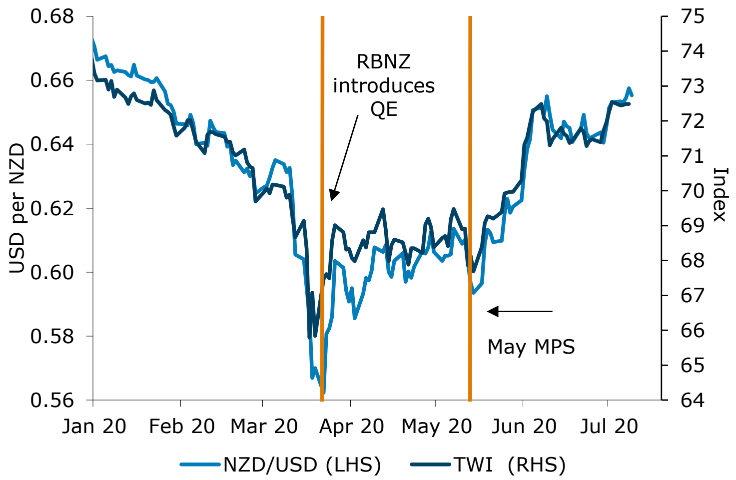
- Although the RBNZ has been easing monetary policy, the NZD has ratcheted higher – leading to tighter monetary conditions than otherwise. While this partly reflects our relatively favourable COVID position and resilient commodity prices, it also reflects the recent surge in global liquidity and the fact that monetary policy here is not as loose as it could be.
- The higher exchange rate may be explainable, but it is not helpful. The elimination of international tourism will mute exchange rate impacts on the economy – but not a lot. And that's not a reason to be complacent in any case. The NZD is an unhelpful headwind to broader exporting and import-competing firms, and will significantly dampen inflation, at a time when an economic boost in non-tourism industries would be welcome.
- With the outlook grim and risks to the downside, the best strategy for monetary policy is to do more. A "go hard, go early" approach is appropriate, including an expansion of QE. The RBNZ is keeping all options on the table for tools it could use, and those that would help dampen the exchange rate (or limit further appreciation) should be carefully considered.

The view

The NZD has increased….

After an initial sharp depreciation in the early stages of the COVID-19 crisis, the NZD has ratcheted higher in recent months (figure 1). On a trade-weighted basis, it is around 10% higher than it was when QE was introduced, with around half of that appreciation occurring since the May MPS.

Figure 1. NZD/USD and NZD Trade-weighted index

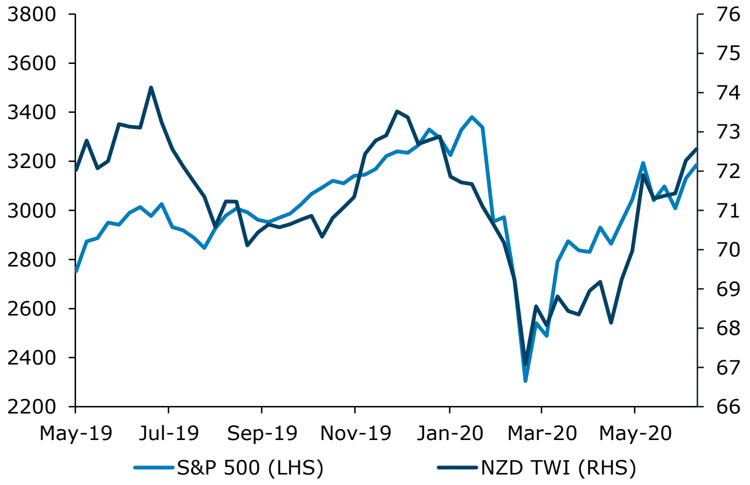


Source: Bloomberg, ANZ Research

Some of the recent appreciation can be explained by better domestic fundamentals: our successful elimination of COVID-19, the vigorous bounce-back in activity and resilient commodity prices. Our ANZ Commodity Price Index has been flat to slightly lower with mixed moves across prices, including an increase in dairy prices recently. But the global downturn may start to weigh on our commodity prices eventually, depending on how supply-side dynamics evolve.

Figure 2 shows that global equities and the NZD are highly correlated. A decent chunk of the recent strength in the TWI (say two-thirds) owes to the fact that other central banks have been easing policy extremely aggressively, and the resulting abundant liquidity has driven portfolio balancing towards risk assets like equities and the NZD.[1] This is controlling for global growth impacts and any positive domestic spill-overs of these policies.

Figure 2. NZD TWI and S&P 500



Source: Bloomberg, ANZ Research

....and is acting as a headwind

The question of what is driving an exchange rate move is critical to how the Reserve Bank views its impacts. If it is justified by domestic fundamentals or a strong exports outlook, then it's likely just part of the package. But if it's a 'portfolio shift' that is largely unrelated to the state of the New Zealand economy, then it amounts to a tightening or loosening in monetary conditions that is less likely to be considered appropriate or desirable, which the RBNZ might therefore look to offset.

To the extent that today's elevated TWI reflects global central bank easing, liquidity injection and portfolio rebalancing (controlling for any positive domestic impacts), then it is a direct headwind that the RBNZ would usually look to offset. Although the TWI can be explained, impacts of portfolio flows on the exchange rate are currently providing a potent economic headwind.

In the good old days, that offset would be a simple matter of tweaking the OCR. Previous modelling from the RBNZ has suggested that a 1% higher TWI that is not explained by stronger domestic fundamentals should see the OCR cut 10-15bp – more if the shock is persistent. If 3-4%pts of the recent appreciation is driven by these sorts of forces, then this would ordinarily be consistent with a 40-45bp reduction in the OCR beyond what would otherwise be deemed appropriate – and much more if the exchange rate move is persistent.

[1] Based on econometric analysis of weekly differences in the log TWI, which finds differences in log global equities, differences in NZ-US 10-year interest rate differentials, and two- and three-week lagged differences in the log Citibank commodity terms of trade as statistically significant explanatory variables. There is no statistical evidence of a structural change in the behaviour of the TWI in response to these factors. This analysis suggests rising global equities can explain 50-80% of the recent appreciation in the TWI. The commodity terms of trade helps to capture the impact of global monetary easing on our external position via better global demand (and proxy New Zealand's relatively favourable position of late).

In the current environment, with inflation set to significantly undershoot the RBNZ's target and the labour market under pressure, a persistently elevated TWI – whatever the cause – is a big problem. The RBNZ needs to achieve their inflation and employment mandates; even if it can be explained, a higher TWI is not helping the outlook for either of these, especially inflation.

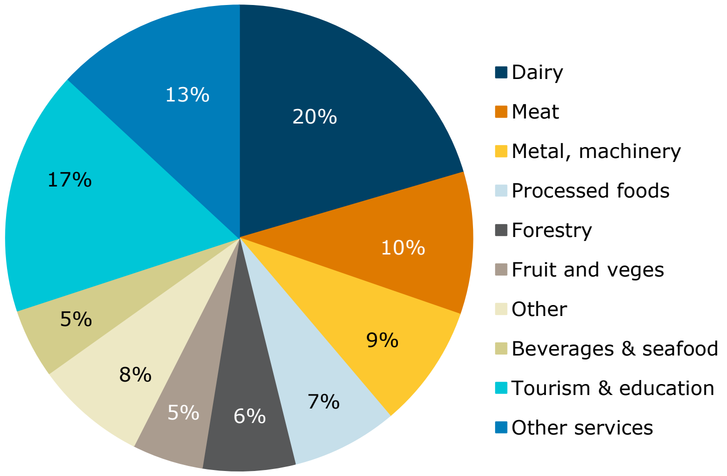
MIA international tourism might mute the impact – but not much

There are reasons to think that the impact of a rising (or falling) exchange rate might be more muted with a closed border, because international tourism spend will not be suffering (or benefiting) from these movements. In addition, New Zealand travellers are not able to substitute between domestic and international travel – exploring your back yard is the only game in town.

There is something in that, certainly. But in a macro context, the impact of the exchange rate is still significant, and we don't expect the pass-through to be significantly smaller.

International tourism and education comprises 17% of exports – a hefty chunk (figure 3). These firms will be pretty indifferent to the exchange rate at the moment, absolutely. But with firms shedding jobs, filling this gap by providing a boost to other industries is beneficial for those who have been displaced. Other exporting firms are good candidates to fill that gap; they tend to be more productive and it's productivity that determines our fortunes in the long run.

Figure 3: Industry share of New Zealand exports



Source: Statistics NZ, ANZ Research

Excluding tourism and education, there is still 83% of nominal exports that will be experiencing the high exchange rate as a headwind right here and now. These firms comprise roughly a quarter of our annual GDP. To be sure, elevated commodity prices are helping some of these industries, but this is being offset by the higher TWI, and for non-commodity exports the impact of the higher TWI will be more severe. Although we are at a seasonal low for primary exports (which typically peak in November/December), most exporters hedge throughout the year and their expectations and budgets for next year will be affected by exchange rate movements now.

Plus, it's not just a headwind for exporters. Import-competing firms in the economy suffer when imports become cheaper, and households and firms are incentivised to buy from offshore. It's true that some additional substitution of international travel towards domestic travel is happening irrespective of the exchange rate. Households and firms are benefiting from higher purchasing power thanks to the higher TWI, and their spending, including on domestic travel, comprises a large portion of GDP. But taking all these forces together, the impact for the economy will be negative on net.

Again, based on the RBNZ's modelling, a 1% appreciation in the TWI that is not explained by domestic fundamentals is thought to have a peak effect on GDP of a little over -0.1% about 12-18 months afterwards. Based on this, the appreciation seen since May could shave 0.4% from GDP, with dampening effects seen for 2-3 years, and flow on effects to unemployment. The impact would be muted by the lack of international tourism, but not an awful lot in our view. Ultimately the impact could be significant.

The impact of a higher exchange rate on inflation – a key part of the RBNZ's mandate – is large too, and much less likely to be muted by the elimination of the international tourism industry. Modelling by the RBNZ has put the peak impact on CPI at -0.1% 6-12 months later. Again, the appreciation since May could subtract 0.4% from inflation at its peak. Relative to our forecast for inflation to be below 1% at the end of this year and stubbornly low for a while, that is very problematic – particularly given the risk that inflation expectations become persistently low, requiring more work from monetary policy in the long run.

A lower exchange rate would help

Although the bounce out of lockdown has been vigorous, the longer-term economic recovery is expected to be slow and risks are to the downside. A lower exchange rate would help. We are a small, open economy. The NZD usually saves the day in a crisis, reliably tanking when times get rough, and that dynamic has not played out this time around. Usually, when we have a global economic downturn even a shadow of the current one, a sharp fall in the exchange rate helps the export sector and encourages households and firms to buy local – helping to drive a net exports recovery. Our get-out-of-jail-free card has failed us, and as it stands any recovery driven by net exports will be due to a weak investment pulse – not a good news story at all.

Monetary policy can play a role. An aggressive, front-loaded approach to monetary policy makes sense given the grim outlook, and the fact that risks are skewed to the downside. The high exchange rate magnifies that fact. We expect the RBNZ will expand QE to $90bn in August, lengthen the timeframe, and leave more tools on the table. We think risks are skewed towards them doing more, and given the need for a "go hard, go early" or "least regrets" approach, that makes sense. Although continued liquidity provision by other central banks may continue to limit any depreciation in the TWI, monetary policy easing here will lower the exchange rate relative to an alternative scenario where the RBNZ did not act.

The question is: what more could or should the RBNZ do? In our view, it makes sense to keep all options on the table, and we think making full use of the current QE programme is the first-best approach. Beyond increasing the programme to $90bn, the RBNZ could take a more front-loaded approach to weekly asset purchases, with a lower run rate later, since the economy needs stimulus right here and now. Providing more yield curve guidance could be an additional way to get bang for buck given the limits of the current programme. At some point, the current QE programme may reach its limits given the size of the Government bond market. Increasing the indemnity cap (which limits QE purchases to 50% of outstanding) is an option, but risks creating market distortion.

So what then?

We think expanding the RBNZ's indemnity to include a broader range of assets, including foreign assets, would make sense. The RBNZ would not necessarily choose foreign asset purchases first, but they should be seriously considered. We are fully aware that there are downsides and risks to foreign asset purchases. But all alternative tools have their downsides – some more than others (table 1). A negative OCR is another option that could have a large impact on the exchange rate, but this has its own potentially significant downsides that make us very wary of going down this path.

Table 1. Alternative monetary policy options – pick your poison

Policy tool	Downside
Increasing QE and using the full force of the current programme – our first choice	At some point the RBNZ owns so many Government bonds the market becomes distorted
Broadening QE to include foreign assets	Fighting the market and perception of currency manipulation
Broadening QE to include higher-risk assets	RBNZ taking on credit risk, disintermediation, mispricing of risk, there's not much to buy
Term lending facility	Useful in times of stress, but not so good at assisting the recovery
Lower and/or negative OCR	Likely to impair the banking system and credit supply
Take no further action after taking QE to 50% of bonds on issue	Potentially lose credibility when it comes to inflation and employment, targets being persistently missed.

Whatever the path from here, the policy response should have regard for the impact that the exchange rate is having. There is no perfect policy option available, and all of the choices have risks, including doing nothing beyond the current QE programme. Given the decreasing palatability of the policy options down the track, an aggressive approach to monetary policy here and now is not a bad strategy, in that it reduces the odds of having to get seriously creative later. But whatever the RBNZ decides to do, front and centre in their deliberations should be the fact that a grim outlook is being exacerbated by exchange rate headwinds. And at the end of the day, the RBNZ have a mandate for employment and inflation. Based on the outlook, doing nothing isn't an option.

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