Submission to the inquiry of the Productivity Commissions of Australia and New Zealand on strengthening economic relations between Australia and New Zealand

Reserve Bank of New Zealand
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The Reserve Bank is pleased to make this submission to the Productivity Commission inquiry into strengthening economic relations between Australia and New Zealand. We confine our detailed comments to Questions 16 and 27, which relate most directly to the Reserve Bank's functions. However, our comments on these questions might also illuminate the considerations and trade-offs relevant to other questions in the Issues Paper, and the debate about the desirability of deeper trans-Tasman integration more generally. Also, we suggest that the consideration of trans-Tasman capital flows (Questions 28 and 29) could usefully take account of the findings of the Capital Markets Development Taskforce and of the Savings Working Group in New Zealand.

What follows deals with Questions 16 and 27 in turn.

Question 16: What would be the advantages and disadvantages of implementing a currency union between Australia and New Zealand?

We focus our discussion here on the economic costs and benefits that might be associated with currency union with Australia. However, it is important to note that the likely economic net benefits for each country would depend heavily on how New Zealand and Australian institutional and political arrangements would change in order to support a currency union. Since Australia's economy is around five times larger than New Zealand's, New Zealand would inevitably be a minority partner in a trans-Tasman union. Institutional arrangements would therefore need to be designed to help safeguard New Zealand's interests. Currency union is therefore an unavoidably political, as well as economic, question.

The recent experience of the European Monetary Union (EMU) demonstrates the need for strong transnational political and economic governance arrangements to maintain stability within currency unions. Imbalances can emerge if union members' individual neutral interest rates differ, yet the members all face the same single policy rate across the union. Adjustment mechanisms in the form of price and labour market flexibility are particularly important to cope with competitiveness differences among members. Another lesson from the EMU experience is that, in the absence of effective limits on government debt or mechanisms for managing a sovereign debt default, fiscal problems in a member can put a currency union under severe pressure.

The Reserve Bank has previously analysed the economic aspects of currency union (Hargreaves and McDermott 1999, Björksten 2001 and Hunt 2005). Similarly to that work, the purpose of the present submission is to inform public debate about currency union.

The rest of this section proceeds as follows. First, we discuss the pros and cons currency union with Australia, drawing on the findings of earlier reviews. Second, we suggest some early lessons from the experience of the EMU.

Economic merit of a Trans-Tasman currency union

A single currency may produce microeconomic efficiency gains such as reduced exchange rate uncertainty and currency conversion costs within the union. Such gains could stimulate trade and investment within the union. Currency union could also expose domestic producers to more competition and thereby increase productivity, and encourage more cross-border financial diversification.

However, although Australia and New Zealand trade substantially with each other,, a single currency would not eliminate exchange rate uncertainty for each country's exporters. Australia's share of New Zealand's total merchandise trade, for example, is only around 20 percent. While a common currency might increase this share, the competitiveness of New Zealand's exports to other economies will be impacted by the value of the common currency's exchange rate. This, in turn, will largely be determined by the performance of the Australian economy. Over the longer term, the international competitiveness of each country's exports will still depend on their cost structures and productivity levels relative to those of the respective trading partners in the rest of the world.

The likely effect of currency union on the stability of each country's effective exchange rate under a common currency is unclear. The New Zealand and Australian dollars are already among the world's highly traded currencies, especially relative to the size of the respective economies. Over recent history, New Zealand and Australia have experienced similar exchange rate cycles and similar exchange rate variability (Mabin 2010). Earlier Reserve Bank work suggests that the volatility of New Zealand's exchange rate in a currency union with Australia would not be lower at high (quarter-to-quarter) frequency, though cyclical (such as 5 year) variability might be slightly reduced (Scrimgeour 2001).

A currency union might deliver lower interest rates for New Zealand over the long term, if the union remained stable and serious imbalances did not emerge. The common interest rate would be expected to be close to the average across the two countries, weighted for the difference in size (and therefore close to Australia's relatively low long term interest rates). But the EMU experience demonstrates that a wedge between the interest rates of members of a currency union might persist, or emerge (perhaps suddenly) if there are perceived differences in credit risk.

An important downside of adopting a common currency is the loss of independent monetary policy to manage domestic inflation when it differs from inflation in other member countries, or to respond to shocks to which other members are not exposed. Regarding the former, common interest rates would be aligned mostly to Australian economic conditions, and may not therefore be appropriate for New Zealand's domestic conditions. Regarding the latter, an independent, floating exchange rate can be a useful shock absorber. In response to negative terms of trade shocks, for example, the currency tends to depreciate, boosting export competitiveness.

Giving up an independent currency implies that domestic prices, wages and fiscal policy have to bear more of the adjustment burden to country-specific macroeconomic shocks. Minimising increases in unemployment and loss of output in response to adverse shocks requires product and labour markets across the union to be flexible, and domestic government debt needs to be low enough for fiscal policy to have the headroom to respond to big shocks. To ensure that member governments have enough borrowing capacity to respond flexibly would require common budgetary rules and mechanisms to ensure compliance. Alternatively, fiscal policy could be constrained through the creation of a common fiscal authority. This option would probably require political union among members (as in the case of the states in Australia, for example).

The economic merits of currency union with Australia therefore depend on the following main factors:

- whether the New Zealand and Australian business cycles tend to move in tandem and the extent to which the economies are exposed to 'asymmetric' shocks (things like a local natural disaster);
- whether prices and wages are sufficiently flexible in the economies and labour sufficiently mobile to act as adjustment mechanisms when asymmetric shocks hit;
- whether New Zealand and Australia are (or are likely to become) sufficiently *economically* integrated to unlock benefits from a common currency;
- whether New Zealand and Australia are, or would be likely to become, *institutionally* integrated, in respect of fiscal policy.

Because the union's monetary policy would be set for the union as a whole, it would be likely that the policy rate would often be quite some way from the price-stability consistent interest rate for New Zealand (the smaller partner), perhaps for quite protracted periods. Several empirical studies have considered the similarity of business cycles to analyse how entry into a common currency would affect monetary policy. McCaw and McDermott (2000) suggested that business cycles in New Zealand and Australia were out of synch about 30 percent of the time between 1960 and 1999 and that export price cycles are not well matched either. This suggests that Australian monetary policy would have been inappropriate for New Zealand during this period.
Using the macroeconomic model in use at the Reserve Bank at the time, Drew *et al* (2001) and Hall (2005) found that adopting Australia's monetary policy in the 1990s would have led to slightly higher output, but that this would have come at the cost of higher inflation. Output and inflation would have been more volatile under common monetary policy, particularly in the presence of external shocks.

Since these studies were undertaken, Australia and New Zealand's terms of trade have diverged as a result of Australia's even stronger terms of trade improvement. Under a common currency, New Zealand producers exporting to Australia would not have been buffered against the weakness in New Zealand's fundamentals compared to Australia's. The external value of the single currency would probably also have been substantially stronger than the New Zealand dollar has actually been over recent years.

Common interest rate settings would probably have been inappropriate for New Zealand over recent years. Had New Zealand been in a currency union with Australia in the run-up to the financial crisis, for example, Australian interest rate settings would have implied lower real interest rates in New Zealand. This would have encouraged firms and households to borrow more, potentially worsening the impact of the crisis on New Zealand. And at present, interest rates would have been higher, weighing on the economy's recovery.

The nature of the shocks faced by the New Zealand economy may also be expected to change with entry into a currency union. A trans-Tasman currency union may cause changes to the types of goods and services produced in each economy. This could increase the asymmetry of shocks and prevent New Zealand's business cycle from converging to that of Australia's.

A common currency would not fully insulate the economy from the adjustment costs associated with macroeconomic shocks. A major potential downside from sacrificing monetary independence is the risk of substantial macroeconomic costs in the event of New Zealand-only economic shocks (such as fluctuations in the prices of our commodity export prices or a large shock like an earthquake). The loss of currency flexibility would imply a much larger real adjustment than with an independent currency.[1] New Zealand-specific shocks appear to be important not only for cyclical differences between New Zealand and Australia (Grimes 2005a), but also for the New Zealand dollar – Australian dollar exchange rate (Grimes 2005b).

In a currency union, significant price and wage flexibility would be needed to help the economy cope with New Zealand-specific shocks. Some flexibility is currently promoted by existing free trade agreements, fairly free labour and capital mobility and ongoing regulatory harmonisation between Australia and New Zealand. Adopting a single currency might enhance flexibility over time. However, the fact remains that without independent monetary policy, adverse shocks will generally require that New Zealand tolerates bouts of falling wages and higher unemployment greater than otherwise, to allow the economy to recover international competitiveness. Likewise, swings in net migration to and from Australia could be larger. The need for real adjustment could, of course, be offset to some extent by the creation of some kind of trans-Tasman fiscal stabilisation mechanism, although this would be likely to require greater political integration.

Available research for New Zealand does not provide conclusive answers about the economic desirability of a currency union with Australia. While currency union with Australia could provide many important benefits, the loss of autonomous monetary policy would expose New Zealand to the possibility of increased inflation and output volatility in general and larger adjustment costs in the event of significant New Zealand-specific shocks. As such, the sustainability of a currency union will depend on the effectiveness of alternative adjustment mechanisms like price and wage flexibility and particularly common fiscal arrangements in helping the economy cope with shocks. Because currency union membership involves the loss of monetary autonomy (and possibly fiscal sovereignty), the decision to enter into a currency union must ultimately be determined within a broader economic and political context. Maintaining effective union-wide fiscal arrangements may be difficult without significant steps toward political integration.

Early lessons from the EMU

Some proponents of currency union argue that it could accelerate business cycle convergence among the member economies (e.g. Frankel and Rose 1998), for example through intra-union trade (Rose 2000, Rose and Stanley 2005) or enhanced labour market flexibility through reinforced incentives for

[1] Haug, Karagedikli and Ranchhod (2003) compare the transmission channels of monetary policy changes for Australia and New Zealand. While there is some evidence that the New Zealand and Australian economies react similarly to monetary policy changes, there are indications that a single monetary policy may exacerbate cycles in New Zealand output.

structural reform (e.g. Blanchard and Giavazzi 2003). Overall, the recent EMU experience casts doubt on the ability of endogenous forces to enhance the compatibility of union members over time.

The ongoing crisis in the EMU illustrates that membership of a currency union can expose an economy to significant risks if adjustment mechanisms are ineffective or the fiscal policy of a member country is unsustainable. The EMU experience suggests that the difficulties in disciplining macroeconomic management in individual member countries, coordinating national policies and addressing emerging macroeconomic imbalances should not be underestimated.

There are clearly serious risks associated with the build-up of internal and external imbalances in economies within a currency union. For some EMU economies, membership brought substantially lower country risk premia in interest rates, which, together with high inflation in some peripheral members, meant that real interest rates in some countries fell to historical lows. This encouraged rapid credit growth in those economies, which saw the build-up of private and public debt and the emergence of asset price bubbles in some southern housing markets.

Growing inflation and unit labour cost differentials within the EMU also saw real exchange rates of members diverge, perhaps more than they would have had the members retained their own currencies. Disappointing productivity growth and slow adjustment of prices and wages eroded the competitiveness of some peripheral economies, worsening their external balances.

Reforms to unsustainable national social security and labour policies became even more important during the downturn, but the EMU experience demonstrates how difficult it can be to achieve such reform. Within a currency union arrangement, internal adjustment processes (that is, prices, wages and labour mobility across the currency union) must be supported by government policies that promote economy-wide flexibility and, in the labour market, ensure that wages reflect labour market conditions. For those entering at a competitive disadvantage, policies that encourage investment and enhance productivity growth are also key to boosting external competitiveness.

Another important lesson from the EMU experience is that mechanisms that effectively discipline national fiscal policy are crucial. Weak enforcement of controls on national fiscal policy allowed the build-up of unsustainable government debt in some peripheral economies. The credibility of the threat of not bailing out a member experiencing difficulties was also weakened by the possible financial spillovers that a sovereign default might produce. In the event of a sovereign debt default, procedures need to be in place to ensure orderly resolution. Without sufficiently low public debt at a national level or effective arrangements for fiscal burden sharing at a supra-national level, governments in the union may not be able to respond to negative economic shocks without putting government solvency at risk.

Question 27: Should Australian and New Zealand banking regulation framework be more closely aligned? If so, how would this best be achieved?

The last ten years have seen significant progress towards further integration and harmonisation in the area of banking regulation. The Single Economic Market (SEM) project was established in 2004. A review of trans-Tasman regulatory arrangements for banks, and an in-depth assessment of different models for closer integration of Trans-Tasman banking regulation, led to the establishment of the Trans-Tasman Council on Banking Supervision (TTCBS) in 2005.

These models ranged from single regulator models to an enhanced home-host model. The former included as an option for the creation of a single new regulator as well as a model in which the Australian Prudential Regulation Authority would become the supervisor for banks operating on both sides of the Tasman. The Government concluded at that time that the risks and costs associated with a single regulator model outweighed any benefits.

One major risk concerns the management of crisis situations. In New Zealand, as in all other countries, a key element of the powers given to bank supervisors and regulators has to do with the management of crisis conditions and bank failures. Prudential regulation is largely about reducing to acceptable levels the probability of failures, but failures may still occur. The global crisis of recent years has again starkly demonstrated that. Choices around the way losses are allocated, even just the choice to allow normal market mechanisms to operate, are often political in nature, especially when they involve taxpayer support. And politicians are elected by, and answerable to, national constituencies, not supranational ones. Much of New Zealand's framework of banking supervision has been built around this recognition.

With the endorsement of successive governments, we have focused on ensuring a clear capacity for New Zealand to manage crises affecting banks with large scale operations in New Zealand, and to ensure in particular that in dealing with the interests of the New Zealand economy and New Zealand customers of banks that national interests can be adequately protected in a crisis when the interests and judgments of New Zealand and Australia (and the respective governments) may well differ. Thus, large banks have been required to incorporate locally and to ensure that they are operationally able to function at arms-length from any parent (see Chetwin 2006 and Ng 2007). A single regulator model would undermine the control and skills we have in terms of crisis management, while still leaving the New Zealand taxpayer and politicians exposed in such an event.

Moreover, the benefits of a single regulator model, which are mainly in the form of further harmonisation of rules and the elimination of unnecessary compliance costs arising from differences between the two regulatory systems, can largely be achieved by a better alignment of our respective sets of rules, where appropriate, without any unnecessary loss of sovereignty. This involves closer collaboration, elimination of unnecessary duplication, and more extensive information sharing between the Reserve Bank of New Zealand (RBNZ) and Australian Prudential Regulation Authority (APRA). That is the enhanced home-host model that APRA and the RBNZ have been operating under these past seven or eight years.

As a result of recommendations made by the TTCBS legislation governing APRA's and the Reserve Bank's mandates, each regulator is required to have regard to the impact of any regulatory action on the financial system of the other country (see DeSourdy 2006). A memorandum of understanding exists between APRA and the RBNZ on sharing information, consultation and setting out a framework for managing crisis situations. Information sharing, crisis preparedness and cooperation between APRA and the RBNZ have all improved considerably. Where sensible, the RBNZ and APRA endeavour to harmonise and align both our regulatory rules and supervisory practices (e.g. the implementation of Basel II and III). For instance, within the Basel II framework banks may apply to their supervisor to use their own models as the basis for determining aspects of their own minimum capital requirements. The Australian owned banks generally use the same or similar models for the purposes of meeting both APRA and RBNZ requirements (although they are often calibrated differently to reflect domestic conditions). APRA and RBNZ regularly share assessments and other information needed for the purposes of supervisory review and in some cases rely on the assessments of the other regulator to some extent. In addition, a key principle that the Reserve Bank has applied in developing our Basel II and Basel III standards is to align with APRA's requirements where possible, subject to New Zealand circumstances.

Harmonising New Zealand's regulatory regimes where appropriate remains an ongoing task as new policies and standards are being developed. It is our view that the present enhanced home-host approach is the correct one. It is consistent with international best practice and provides the right mix between harmonisation on the one hand and flexibility on the other to take account of local differences (see Woolford and Orr 2005, Kane 2006 and BCBS 2010). The benefits of harmonisation in terms of a reduction in compliance costs, better utilisation of economies of scale and its competition-enhancing potential are important but it is equally important to also be aware of the risks and costs associated with this process. As harmonisation progresses the marginal benefit is likely to decline and may eventually turn negative if taken too far.

New Zealand's regulatory approach differs from APRA's in that New Zealand has traditionally placed more emphasis on market discipline and favoured a more light-handed regulatory regime, as opposed to APRA's more intrusive approach. This in part stems from our focus on systemic stability, whereas statutory objectives in Australia are different, and include depositor protection. APRA's objective to act in the best interest of Australian depositors can be at odds with what is best for New Zealand consumers, especially in a crisis, as can be the interests of (mainly) Australian shareholders and New Zealand depositors. The generally smaller size of financial institutions in New Zealand makes some of APRA's requirements and its more intrusive regulatory approach impractical, or at least inefficient, if transposed onto New Zealand. There are also questions concerning the effectiveness of an intrusive approach vis-a-vis a more light-handed and incentive compatible one. Differences in the nature of banks' assets and liabilities reflect the composition of our respective economies and they mean that what is right for one country may not be right for the other.

It is also important to retain certain functions in New Zealand to prevent a hollowing out of skills and functions and for crisis management purposes, when, if there are costs that have to be borne by government, it is the New Zealand taxpayer who would have to fund them (see Hoskin and Woolford 2011).

Finally, the Reserve Bank's regime seeks to maintain a level playing field in New Zealand and to minimise barriers to entry. This is best achieved by cooperation and harmonisation where sensible while retaining regulatory autonomy. In this context, it should be recognised that the majority of New Zealand registered banks are not Australian-owned.

While harmonisation can be efficiency-enhancing, there is a risk that if taken too far the reverse can occur. The home-host model we currently have minimises compliance costs for banks while allowing sufficient flexibility for New Zealand to safeguard its interests. That is why the RBNZ believes that the focus should be on aligning the Australian and New Zealand regulatory frameworks within the existing home-host approach, rather than on other less flexible and more costly and risky regulatory models. The RBNZ looks forward to exploring the scope for further improving the enhanced home-host model with the Productivity Commissions and to any suggestions that might emerge.

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