Closer ties mean sharing our icons
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Australian Financial Review
11 September 2006
P. 20

New Zealand, as a small market-oriented economy well integrated into international financial markets, is showing the strengths and weaknesses of this position.

It has recorded good growth for eight years and unemployment is below 4 per cent. At the same time, New Zealand has drawn heavily on overseas lenders (principally Japan) to fund this growth, which has taken the current account deficit to nearly 10 per cent of GDP.

Monetary policy works partly through higher interest rates, but many borrowers can avoid - or substantially delay - the effect of high interest rates by moving out on the yield curve. Seventy per cent of housing borrowers are now on maturities of two years or longer.

The main counter-cyclical effect of monetary policy is to produce large swings in the exchange rate, which helps to "spill" excess demand into imports.

This might be good policy-making, but is uncomfortable, especially for the (internationally) traded sector, buffeted by the swings in the exchange rate. What might be done to make it smoother?

One answer is to offset the disadvantages of small size by even closer integration with Australia.

Of course we have the benefit of Closer Economic Relations (CER), but its big wins on tariffs and quotas came in its first decade, and it is now nearly a quarter of a century old.

It comes as a surprise that although the two countries are supposedly so linked by geography, culture and migration ties, only a quarter of New Zealand's imports come from Australia.

Full integration will require much more in terms of "behind-the-border" issues of rules and regulations.

The tax systems in the two countries are quite different - for example, New Zealand doesn't have a capital gains tax. Anyone who has bought cheap bananas in New Zealand in recent months knows that the quarantine regulations are different. Airline policy still seems to be a fertile area for differences. There are Trans Tasman Mutual Recognition Arrangements and a Mutual Recognition Agreement, but the Productivity Commission has noted ongoing "inconsistencies and cumbersome regulatory practices". The Australia-New Zealand Business Council sees us as well short of a borderless market.

Remarkably, considering that the banking systems of the two countries are so closely connected that 85 per cent of New Zealand's banks are Australian, the prudential supervision is not just different, but is diametrically opposite in its approach to the possibility of bank failure.

Financial sectors ought to be the easiest to fully integrate, but this has not yet happened. Fund managers still market different funds in the two countries to reflect different rules.

The ultimate measure of financial integration - a common currency - makes a lot of sense on pure economic grounds. Reserve Bank of New Zealand researchers have done a neat test to see whether the two countries are logical partners: given the same monetary policy making rule, would the different circumstances in each country require significantly different settings of policies? The answer is "no".

While this still seems far out of reach politically, circumstances may change. In the late 1990s New Zealand was palpably slipping behind Australia and many of its business community blamed monetary policy implementation. The idea of a common currency was, at least, on the agenda, with active support from many in the business community.

Here in Australia our Treasurer said, correctly, that this decision was largely up to the New Zealanders. He added that if they wanted a common currency, they would have to take the Aussie dollar as is.

That moment has passed, and New Zealand's good economic performance since then has kept the issue on the back burner. But it may come again, especially if the passage of a small economy in an increasingly globalised world gets bumpier still and that impinges disproportionately on particular sectors, such as tourism.

The heavy dependence on foreign capital flows makes New Zealand vulnerable to a change in perceptions in the lending countries. Markets will adjust to a change in flows, even to a "sudden stop", but the adjustment can be painful.

Economists have come to believe that having a common currency makes a big difference to the volume of trade, and New Zealand provides some confirmation: not having a common currency gives you less trade than you might expect.

The Europeans have demonstrated that you can give up your currency while retaining your sovereignty (so the politicians' jobs are safe). A larger currency area would reduce the likelihood of a sudden stop of capital inflow. The Aussie dollar has its own big swings, but these are less than the Kiwi dollar, and Australia draws its foreign capital from more diverse sources.

If the moment comes again, Australia might be ready to be a bit more welcoming to the idea of a common currency. An ANZAC dollar might still be based on the current Aussie dollar, but we should at least offer New Zealand its share of the seigniorage (the profit on currency issue).

More importantly, it would be little sacrifice to us on this side of the Tasman to print a new set of notes with icons that both countries hold dear. Russell Crowe and Mel Gibson have lost their allure in some quarters, but we still have Phar Lap (his skeleton is in Wellington and his heart is in Melbourne) to adorn the notes.

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