1997
+2008

(Treasury, 2011)

4 Impact of exchange rate fluctuations

4.1 The buffering and buffeting role of the floating exchange rate

twp11-01.pdf (317 KB)

Using PDF Files

The flexible exchange rate has played a significant role in buffering New Zealand against external shocks, particularly following the 1997 Asian financial market crisis. The exchange rate also fell significantly at the height of the recent Global Financial Crisis. Subsequently, the exchange rate appreciated as commodity prices recovered and it appeared New Zealand was faring relatively better than a number of other countries.

1997

2009

In determining the buffering versus buffeting role of the exchange rate, it is important to distinguish between the source of the shock, the impact on commodity and non-commodity exporters and the impact on the economy as a whole.

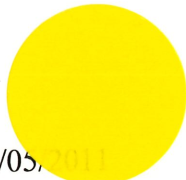
In the case of an external shock to the economy, for example a sudden shift in world demand for New Zealand exports, the exchange rate can move to buffer the economy. A positive shock resulting in higher world prices for New Zealand's exports would typically lead to an appreciation of the exchange rate. This would reduce the amount in New Zealand dollar terms that exporters would have received for their goods or services absent the exchange rate appreciation.

A higher exchange rate also results in cheaper import prices for all New Zealanders. When global demand falls for New Zealand's exports the exchange rate tends to depreciate. By the same process, New Zealand dollar exporting revenues are not typically greatly affected due to the combination of a lower exchange rate and lower world prices. In this case, the adjustment is passed onto the domestic economy which faces higher prices for imports. Thus the exchange rate can act to smooth the revenues that exporters receive. However, this is where the type of exporter becomes important, as the exchange rate does not buffer all exporters.

While commodity exporters are insulated from exchange rate variability to some extent,[9] often the manufacturing sector (both the exporting and import-competing component) loses out. In New Zealand, the real exchange rate tends to follow movements in world commodity prices, reflecting the relatively bigger role commodity prices play in the economy (Westpac, 2009). If world commodity prices increase, manufacturing exporters face a higher exchange rate, yet could still face the same world price for their exported goods. Thus, they do not receive the same extent of the buffering nature of the exchange rate as do commodity exporters.

Westpac (2009) used empirical evidence to support the idea that the exchange rate helps to reduce the volatility that commodity exporters face. Their research showed that the floating exchange rate has substantially reduced price volatility for New Zealand commodity producers. They also found that the New Zealand dollar has tended to move in the same direction as New Zealand commodity prices, which insulates most (but not all) commodity producers from global market volatility. However, this is neither necessary nor inevitable. It depends on the nature of the shock and what else is going on in the world. For example, over 2000 and 2001 the Trade Weighted Index (TWI) was at record lows, world prices were rising, and New Zealand dollar prices for

3rd



exports soared. Hence there was no buffering, and in fact the cyclical increase in prices was exaggerated.

If the source of the shock is domestic, for example a large increase in government spending, the exchange rate will appreciate due to higher relative interest rates in response to the increase in domestic demand. Given the higher exchange rate, the shock is then mostly transferred to the tradable sector, which will receive less revenue for its exported goods.

Overall, the exchange rate tends to "over buffer". While the exchange rate tends to appreciate or depreciate in the wake of a shock as outlined above, it often moves to a level that is beyond what is justified by the economic fundamentals relevant to the medium-term competitiveness of tradable producers. The "over buffering" of the exchange rate is often driven by "trend-following" behaviour. "Trend-following" occurs when the exchange rate is on the rising part of the cycle and it is expected that the currency will appreciate further, increasing the attraction to the currency due to the potential future gains. Another explanation for this "over buffering" is that financial markets are much more flexible than goods and services markets (Dornbusch, 1976; White, 2007).

The role of New Zealand's exchange rate through the Global Financial Crisis

New Zealand's exchange rate can be credited with helping to insulate the economy from a more severe downturn during the recent Global Financial Crisis. When financial turbulence was as its peak at the end of 2008, New Zealand's exchange rate depreciated for a short period of time to a position below its long-term average. This buffered the impact on exporters who experienced a drop in global demand for their goods, allowing exporters to retain more of the revenue they received from overseas. The exchange rate acted as a shock absorber for exporters, thereby helping to mitigate the full extent of the shock. The potential for the exchange rate to depreciate further if necessary may also have helped to support confidence in the economy. However, the exchange rate depreciation was temporary. It began appreciating in February 2009, largely due to the poor economic conditions of other major economies and the recovery in commodity prices.

Notes

[9]Commodities are generally considered to be goods sourced from agriculture and mining.

Page top

The Treasury
1 The Terrace, Wellington 6011, New Zealand
PO Box 3724, Wellington 6140, New Zealand
Tel: +64 4 472 2733 • Fax: +64 4 473 0982 •
info@treasury.govt.nz

© Crown Copyright Disclaimer
Privacy
newzealand.govt.nz