9 January 2004

AIDE MEMOIRE – RECENT TRENDS IN THE NEW ZEALAND DOLLAR EXCHANGE RATE

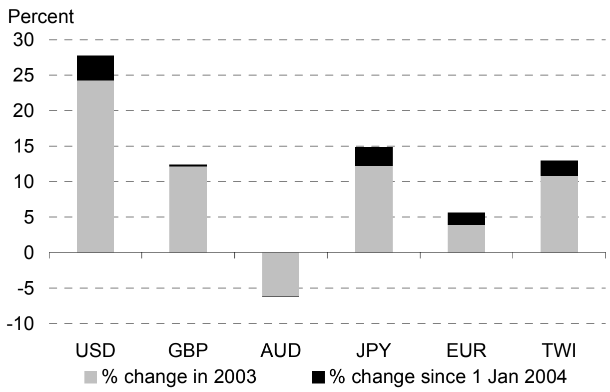
The continued appreciation of the New Zealand dollar has provoked considerable media and market interest since the start of the New Year. This note provides some background information on recent movements in the New Zealand dollar. The note places recent exchange rate developments in a historical context and considers some explanations for current trends. Developments are analysed on both a trade-weighted and cross-rate basis.[1]

1 Recent Trends in the New Zealand Dollar

- Media commentaries have tended to focus on the substantial appreciation of the New Zealand dollar against the US dollar. However, doing so, overstates the extent of the appreciation of the New Zealand dollar. As illustrated in Figure One below, since the start of 2003 the New Zealand dollar has actually depreciated against the Australian dollar and appreciated more modestly against currencies such as the euro.

- Overall, New Zealand's trade-weighted exchange rate (TWI) has appreciated by 13.2% since the start of 2003 and is currently around 44.1% higher than its 2000 low. As illustrated in the graph, most of the appreciation in the TWI during the past 12 months has been a result of an appreciation of the New Zealand dollar against the US dollar (NZD/USD) – a trend that has been particularly pronounced throughout early 2004. Overall, the TWI is currently around 12.8% higher than its post-float average.

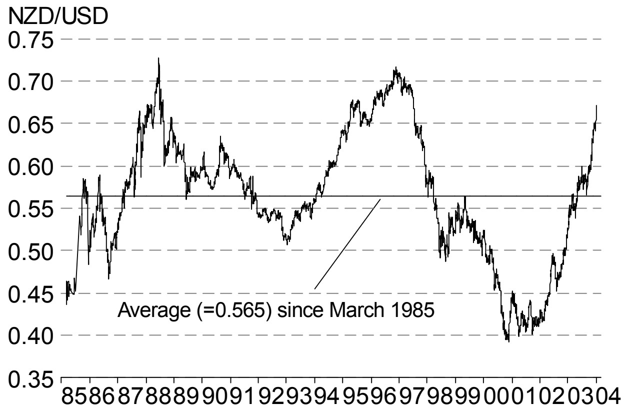
Figure 1: Breakdown of Recent Appreciation in New Zealand's TWI



[1] Please note that the figures in this note are accurate as of 11:10am, 9 January 2004.

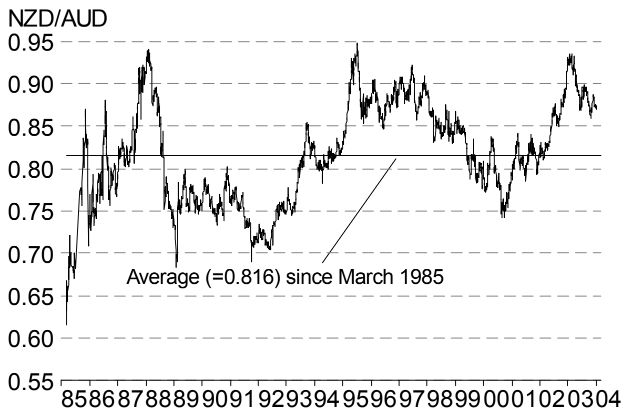
- The NZD/USD exchange rate hit a six-and-a-half-year high of NZ$0.677 today and is currently around 19.9% higher than its post-float average. Notably, the NZD/USD has risen by 5.4% since Christmas Eve.

Figure 2: Historical Movements in the NZD/USD Exchange Rate



- The New Zealand dollar hit a peak of NZ$0.936 against the Australian dollar (NZD/AUD) at the beginning of 2003, but has since depreciated to a recent reading of NZ$0.873. Over the past few weeks, the NZD/AUD has been reasonably stable and is currently 7.0% higher than its post-float average.

Figure 3: Historical Movements in the NZD/AUD Exchange Rate



2 Drivers of Recent Movements in New Zealand's Exchange Rate

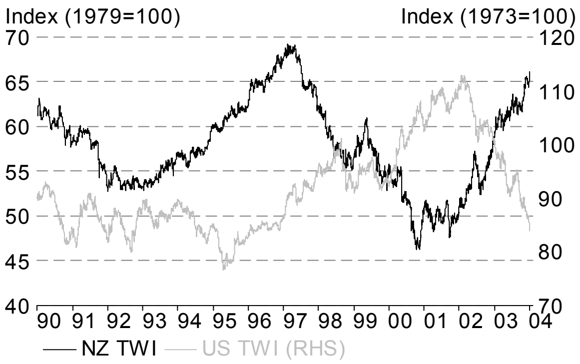
- Two key factors explain most of the appreciation in the New Zealand dollar on a trade-weighted basis from its trough in 2000 and continue to provide an explanation for more recent movements in the currency. They are:

  - generalised US dollar weakness; and
  - the out-performance of the New Zealand economy in world terms.

- Generalised weakness in the US dollar has been the most significant factor in the appreciation of the New Zealand dollar, as has been the case for many other major currencies such as the euro, sterling and yen. In broad terms, the

US dollar trade-weighted index has fallen by more than 25% from its peak in early 2002.

Figure 4: Movements in the US TWI compared to Movements in the NZ TWI



- US dollar weakness reflects a diminished appetite for US dollar assets following the bursting of the equity bubble and, perhaps more pertinently at present, low US dollar interest rates. Recent comments from Federal Reserve officials suggesting that US interest rates will remain near historical lows for the foreseeable future have reinforced this sentiment. In addition, security scares have added to the downward pressure on the US dollar.

- The growth differentials between New Zealand and the rest of the world narrowed substantially during 2003, although in absolute terms New Zealand continued to grow faster than most other countries. The out-performance of the New Zealand economy over the period from 2000 until 2003 has ensured that New Zealand has maintained a positive output gap (in very basic terms, demand exceeding supply) while most other countries are just closing negative output gaps. Encapsulating the relative growth performance of the economy, short-term interest rates in New Zealand remain higher than in most other developed countries and these differentials continue to encourage a healthy flow of funds into the region.

- An improved outlook for world growth has also helped to boost the outlook for commodity prices. Historically, currencies such as the New Zealand and Australian dollars have been heavily influenced by commodity prices. More recently, these currencies also appear to have been supported at the margin by the case of mad cow disease detected in the US.

3 Outlook for the New Zealand Dollar

- During the months ahead, the US dollar is expected to remain the major driver of movements in New Zealand's TWI. Given its significant appreciation post Christmas, some analysts are already revising upwards last year's estimates of the NZD/USD cross rate, largely reflecting a view that the US dollar will depreciate further than had been expected only a month or so ago. Although exchange rates are notoriously difficult to forecast, there are few signs of the fundamental drivers of the New Zealand dollar today reversing in the near term.

- Upward influences for the New Zealand dollar include:

  - continued US dollar weakness, largely as a result of an ongoing deterioration in the US current account and fiscal deficits; and
  - favourable commodity prices as world economic growth strengthens.

- Downward influences for the New Zealand dollar include:

  - a widening of our own current account deficit;
  - slowing net migration trend and its impact on domestic demand; and
  - a further narrowing of New Zealand's growth differential with the rest of the world.

4 Official Cash Rate Review

- The Reserve Bank will review its official cash rate on 29 January 2004. Recent declines in the yields on short-dated bonds suggest that the market's enthusiasm for a January rate hike has diminished, although this is still largely a timing issue rather than a downward revision to the extent of tightening expected to take place eventually. Nonetheless, with interest rates in New Zealand not at the historically low levels seen elsewhere in the world, the Reserve Bank retains considerable scope to maintain or even reduce interest rates should the rising exchange rate show signs of impacting more severely on real economic activity.