

# An Anzac Dollar

## Does It Make Sense?

Arthur Grimes

Small countries like Australia and New Zealand are finding money management increasingly difficult in the face of strong—and sometimes apparently irrational—international capital flows. Maybe they should join forces to create a single currency.

**D**ollars: Australia has one, New Zealand has one, Papua New Guinea, Samoa and Fiji all have them (under different names). But California—a larger economic entity than all these economies combined—does not have its own. Is it sensible for a small country such as Australia (or a tiny country such as New Zealand) to have its own currency? Debate on this issue is still only in its infancy in Australia, although it is well underway in New Zealand.

The debate is part of a wider international discussion about the merits of retaining independent national currencies versus moves to regional currency blocs. Analysis of these issues, sparked initially by Mundell's (1961) work on 'optimum currency areas', has expanded to include the merits of a single world currency, as more or less existed under the gold standard.

Mundell, once an advocate of regional currency blocs, now favours adoption of a single world currency (Mundell 1997). Theoretically, the arguments for this option are strong. An individual country, however, cannot opt for a world currency. Small countries must consider whether there is benefit in retaining their own currency versus adopting a joint currency with one or more other countries.

Here we consider the case for an Australasian currency, dubbed an ANZAC Dollar (or 'Zac'). In practice, the behaviour of a Zac would be dominated by the behaviour of the Australian economy, so in economic terms the major issues concerning whether to adopt a Zac or not rest with New Zealand. Before turning to some of the practical issues facing both New Zealand and Australia, however, we must first survey some of the theoretical arguments underlying these issues.

### The case for an independent currency

The strongest argument for retaining an independent currency is that it provides a buffering mechanism against economic shocks, particularly against external shocks such as the terms of trade.

At a macroeconomic level, for instance, a fall in export prices reduces domestic purchasing power and aggregate profitability. If aggregate purchasing power is to be fully or partly restored, an increase in aggregate production is required, facilitated by an increase in profitability.

One method by which this can be obtained is through a real exchange rate depreciation engendered by a nominal depreciation (without full wage adjustment). At a microeconomic level, a fall in export prices causes the marginal revenue product of labour to fall, requiring a reduction in real wages to maintain employment levels. With sticky wages, this can be achieved through an increase in the price of output obtained through an exchange rate depreciation.

However, with perfectly flexible wages, the need for the exchange rate to play this buffering role disappears (Bowden & Grimes 2000). This raises a policy issue: is the promotion of real exchange rate adjustment via the nominal exchange rate beneficial or not?

Grubel (1999), in discussing the potential for Canadian-US currency union, argues that exchange rate adjustment undermines the price mechanism as an allocative device since it obfuscates the need to reallocate

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resources to alternative uses resulting from export (or import) price changes. He argues that faster resource switching will be obtained through explicit domestic price adjustments than through price adjustments facilitated by nominal exchange rate movements. On the other hand, Murray (1999) argues, also in the Canadian context, that exchange rate movements have worked well as a buffering mechanism for terms of trade shocks and that this role enables beneficial price adjustments to occur.

Another argument put forward to support the case for an independent currency concerns the ability of government to maintain an independent inflation rate. At times, when countries are running quite different monetary policies targeted at different variables or at least at different inflation rates, the ability to control domestic inflation gives some weight to the case for retaining an independent currency.

When countries are running similar monetary policies, this argument loses force. At present, central banks in countries as diverse as Australia, New Zealand, the United States, Sweden, United Kingdom, Europe, and even Japan are targeting extremely low rates of inflation. Thus the case for an independent currency based on the need to maintain an independent inflation rate is, for the present at least, diminished.

Then there is the argument that an independent currency enables governments to earn seigniorage, the income generated when central banks issue currency (i.e. issuing interest-free liabilities in place of interest-bearing loans).

This argument has some force if the option is unilaterally to adopt another country's currency. The currency supply in most countries is in the order of 1-2% of annual GDP. A 5% p.a. interest saving on this supply of base money therefore amounts to some 0.05-0.10% of GDP per annum. While not huge, foregoing this amount through adoption of another country's currency is a needless loss of revenue. However, this reasoning collapses in the case of a jointly adopted currency (such as the Euro), in which seigniorage is shared across countries adopting the joint currency.

One further argument in favour of adopting an independent currency is the national sovereignty argument. Money is like a flag: each country has to have its own. In emotional terms at least, the use of another country's currency may be unacceptable to some citizens.

Yet if a joint currency is adopted, especially one with the motifs of each country on the notes and coins (Grubel

1999 and Grimes et al. 2000 discuss options in this regard), then this issue is substantially diminished. There is still a loss of national sovereignty, but if the joint central bank is made up of members from each country and if it is legally independent of each government, then the situation differs little from that of a national independent central bank.

### **The case for currency union**

The arguments for adoption of a common currency are numerous; many are based on a reduction of transaction costs. Modern monetary theories (e.g. Kiyotaki & Wright 1993) emphasise the benefits for trade and exchange of agents utilising a single currency, demonstrating that transaction costs are minimised when agents use the same medium of exchange. It is possible that multiple currencies will emerge, but once a currency becomes dominant there will be no pressure to re-establish multiple currencies since costs are minimised with a single currency (Jones 1976). These theoretical analyses are framed within the confines of a single country, but are just as applicable in a global sense (Mundell 1997).

Related to this analysis are the recent findings (summarised in Coleman 1999) that independent floating exchange rates are a source of shocks to the economy rather than a buffering mechanism. In other words, the value of currencies move in ways that do not reflect economic fundamentals. Importantly, it can also be profitable for foreign exchange market participants to trade

currencies in a destabilising fashion. In such situations, economic costs are increased and the price mechanism becomes less effective in allocating resources efficiently.

The evidence is growing that countries which share a common currency have a higher degree of trade between themselves than can be explained by other factors such as geographic proximity or colonial ties (Rose 1999). Currency integration is thus perceived to be a factor in overcoming a source of trade friction that is only artificially present by virtue of countries issuing their own currencies. Essentially, adopting an independent currency can be viewed as adoption of a non-tariff barrier to trade, with the same costs as for other trade barriers.

A small country may find that adoption of an independent currency raises

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its costs of borrowing relative to those incurred by a large country. Both Australia and New Zealand, for instance, have tended to experience higher real interest rates than has the United States for much of the past two decades. This outcome may be the result of a risk premium applied by international lenders on debt denominated in a small, potentially volatile currency.

Thus adoption of a common currency with, say, the United States may enable both government and private sector agents to obtain lower cost funding, so raising profitability and perhaps increasing investment levels. This is an example of a more general phenomenon in which currency integration may enhance broader economic integration between countries.

### Independent currencies in practice

In practice, almost all the foregoing theoretical issues have been relevant to Australia and/or New Zealand. Take the buffering argument: Australia has experienced a close relationship between its real exchange rate and its terms of trade.

For instance, over the 1986-1998 floating exchange rate period, the correlation coefficient between the two series is 0.87 indicating that the real exchange rate has acted to buffer terms of trade changes extremely effectively.<sup>1</sup> As the terms of trade rise, the real exchange rate appreciates and vice versa. Whether this is beneficial or not depends on one's interpretation of Grubel's point that such exchange rate behaviour may mask the need for resource allocation within the Australian economy.

Unlike Australia, however, the relationship is much less pronounced in New Zealand; the correlation coefficient between the real exchange rate and terms of trade in this case is just 0.32.<sup>2</sup> Interestingly, New Zealand's terms of trade have a slightly higher correlation with Australia's real exchange rate over this period.

Thus, over the floating exchange rate period, the Australian dollar would have provided a slightly stronger buffer against New Zealand terms of trade changes than did the New Zealand dollar. The terms of trade of the two countries have also been moderately correlated as have their real exchange rates and GDP cycles, indicating that the two economies tend to move in tandem.

These results indicate that for New Zealand at least, a joint currency with Australia would not have been

materially detrimental, in a buffering sense, relative to actual experience with a floating exchange rate. Bowden and Grimes (2000) indicate that since New Zealand's adoption of strict inflation targeting in the late 1980s there has been considerable volatility in the real exchange rate, not matched by volatility in the terms of trade. Over this period, exchange rate cycles have been largely driven by monetary policy responses to domestic demand shocks.

### Business attitudes

Another way of assessing the benefits of maintaining an independent currency is to examine the attitude of businesses to maintaining an independent currency versus joining a larger currency union. After all, they are the predominant currency transactors.

Grimes et al. (2000) surveyed 400 New Zealand firms and found that a substantial majority supported adoption of an irrevocable link of the New Zealand dollar to the Australian dollar. Support was widespread amongst small and large firms, exporters and importers, and firms in the manufacturing, agriculture and services sectors. What was particularly instructive—especially in light of transaction costs arguments in favour of currency union—were some of the patterns (as opposed to the overall level) of support for an ANZAC dollar.

Strongest support came from firms with 11 to 20 employees with declining (but still majority) support from firms on either side of this level. The survey indicated that firms of this size tend to be at the threshold of exporting: firms with 6 to 10 staff export 6% of total sales and firms with 11 to 20 staff export 7% of sales. In contrast, firms with 21 to 50 staff export 14% of total sales, and firms with over 50 staff export 23% of sales. Thus there is a substantial increase in exporting at a firm size of about 20 employees. This is consistent with another finding of the survey which revealed that firms with fewer than 25 employees find foreign exchange hedging more costly than do larger firms, and hedge a substantially smaller proportion of their foreign exchange exposures than do larger firms.

The survey<sup>3</sup> indicates that smaller firms without specialist in-house foreign exchange expertise consider foreign exchange risks and associated costs a major impediment to expansion into export markets.

The dynamic impacts of retaining an independent

<sup>1</sup> Annual data for both the real exchange rate and the terms of trade come from the IMF's *International Financial Statistics*. The starting date is dictated by 1986 being the first full calendar year in which both the AUD and the NZD were floating; the final date (1998) is the latest year for which IMF data is available.

<sup>2</sup> Using quarterly data for a similar period, Grimes et al. (2000) find that this correlation is approximately zero, indicating that quarterly noise further disrupts the buffering mechanism.

<sup>3</sup> See Grimes et al. for more detail. A nationwide NBR-Compaq poll also revealed a strong degree of public support: 45% supported adoption of an ANZAC dollar, a further 3% gave it conditional support, with 44% opposed. (*National Business Review* 2 June 2000: 16).

currency may therefore be considerable. These firm-specific costs of maintaining multiple currencies are related to the macroeconomic findings that trade is diminished by the presence of multiple currencies. The findings are also consistent with the results of the microeconomic literature suggesting that multiple currencies lead to sub-optimal search and other costs.

### Weighing up the pros and cons

#### *New Zealand*

The Zac appears to be a realistic option for New Zealand, given its buffering properties and the predisposition of New Zealand businesses towards its adoption.<sup>4</sup> But would such a move inevitably result in even closer union between Australia and New Zealand than envisaged just through currency union?

In some instances where countries have adopted a common currency, other economic policies have been harmonised to a considerable extent. For instance, in the European Union harmonisation has extended not just to free trade, free labour mobility and harmonised competition policies but also to fiscal transfers across countries and agreements under the Maastricht Treaty to limit fiscal and other imbalances within individual countries.

In the Australasian case, free trade and free trade mobility already exist to a high degree and further work is envisaged on harmonising such matters as competition and foreign investment policies. However, at no stage has fiscal harmonisation—arguably a much greater step towards political union—been envisaged. Nor is this an inevitable consequence of currency union.

Moreover, some currency unions or equivalent systems operate without fiscal coordination. Examples include Panama's longstanding use of the United States dollar (USD), and Hong Kong's currency board system, which effectively tied the Hong Kong dollar to the USD.

Hong Kong's experience is particularly insightful. The economy went into recession following the Asian financial crisis as the Hong Kong dollar appreciated substantially against other Asian currencies, given its fixed USD link. It did not receive any fiscal transfers (from the US or elsewhere) to alleviate its adjustment process, and the

resulting recession can be seen as a negative consequence of currency union. However, this experience must be balanced against the previous 15 years of largely beneficial outcomes arising from the fixed USD link. This ensured the economy was sufficiently sound to tide itself over the recession with few long-term ill-effects.

In the New Zealand case, the evidence indicates that adoption of a Zac would on balance be beneficial for domestic producers, even though at specific times the exchange rate may not respond in an optimal manner to New Zealand conditions. Thus there is no need for trans-Tasman fiscal transfers; inter-temporal transfers within New Zealand through temporary fiscal adjustments can compensate for temporary exchange rate misalignments while still enabling the longer term benefits of currency union to ensue.

#### *Australia*

What might be in the Zac for Australia?

Australia and New Zealand formed a free trade agreement (NAFTA) in 1966, which progressed to the current Closer Economic Relations (CER) arrangement.

These agreements have had favourable consequences for both countries, as would be expected from a reduction in trade barriers (see Lloyd 1991 and references therein for empirical evidence).

Reduction of a further trade barrier—separate currencies—can therefore be expected to prove beneficial to both countries, especially if it acts as a catalyst for further harmonisation of commercial policies

across the two countries. The Australian economy is effectively enlarged by 15% as a result of diminishing unnecessary currency and commercial barriers with New Zealand.

The international effect is likely to be even greater. Prior to CER, Australia had an international reputation of having a relatively closed economy (see OECD Country Reports of the period). The adoption of free trans-Tasman trade brought Australia into more of a leadership position in the movement to free up world trade, most notably through Australia's role in the Cairns Group.

With regional currencies now on the agenda for ASEAN and other East Asian countries<sup>5</sup>, early adoption of a Zac would again place Australia in a leadership position in

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<sup>4</sup> Other arguments, such as a reduction in the interest rate risk premium, also favour its adoption.

<sup>5</sup> Leaders from Japan, China, Korea and 10 Southeast Asian nations, meeting in Manila in November 1999 have adopted a vision for a future monetary union amongst themselves (see *Far Eastern Economic Review* 9 December 1999: 22-23).

forthcoming analyses of regional currency proposals: Australia would be recognised as the dominant country in an established currency bloc at a time when larger currency blocs are being discussed. Australia might therefore find adoption of the Zac to its benefit, placing the country at the forefront of debate on a looming issue of significant political and economic importance within the Asia Pacific region.

### Conclusion

An Anzac dollar would seem to be the next logical step in the CER process; it could also help force the pace on other aspects of trans-Tasman harmonisation. Given the strong business support for a common currency area including Australia and New Zealand, the proposal must therefore be taken seriously by all those who seek to boost conditions for economic development in Australasia.

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