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RODNEY'S RAVINGS

Offering importers, exporters and investors quality NZD/USD insights

EXECUTIVE SUMMARY

The NZD/USD is the most important exchange rate for many importers, exporters and investors. Despite this, there is a serious lack of quality analysis of what drives the NZD/USD. Without a good understanding of what drives the NZD/USD many importers, exporters and investors are making hedging and other currency-related decisions in the dark.

This Raving goes in search of quality insights into what drives the NZD/USD. It reviews what the RBNZ, the bank economists and some of the currency-related service firms have to offer in terms of helping educate people about what drives the NZD/USD. Being a bit old fashioned I believe that a well-founded understanding of what drives the NZD/USD is a prerequisite to people making informed hedging and other currency-related decisions. The search turned up assertions, platitudes, abstract academic reports and the occasional useful insight. I didn't look under every stone, but I searched enough to be reasonably confident that there isn't anyone offering quality insights into what drives the NZD/USD.

To fill this void we have launched the **Economic Literacy Programme**, which includes educational NZD/USD workshops. The following link has information on the first two NZD/USD workshops we will be running in Auckland - <http://www.sra.co.nz/pdf/NZDUSDWorkshops.pdf>, while the next link has information on all of the workshops - <http://www.sra.co.nz/workshops.html> - and details on why I am qualified to run the workshops.

One importer client recently told me that he gained more than an 8000% annual return from his investment in our twice monthly reports on the NZD/USD. This is partly a testament to how competitively-priced our reports (and workshops) are, is partly a testament to the quality of the framework we have developed for assessing NZD/USD prospects and partly reflects a bit of luck. Exchange rates can be fickle things, so even armed with our framework things will not always go smoothly.



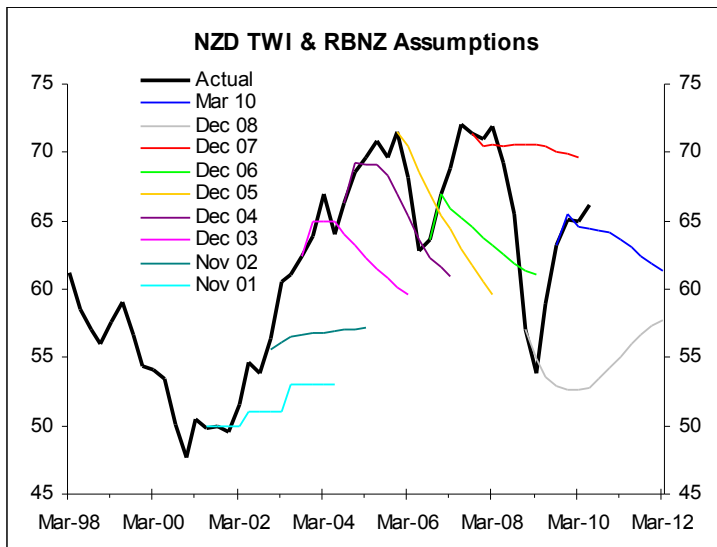
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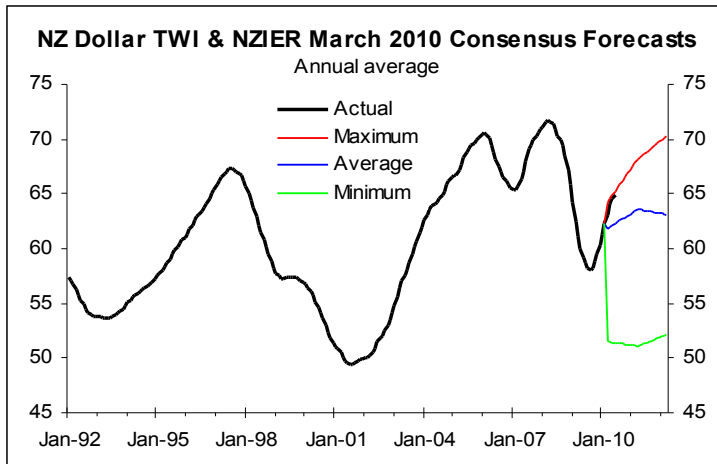
The dilemma faced by importers and exporters in search of enlightenment

To appreciate what it is like for many importers and exporters searching for enlightenment about what drives the NZD/USD, so they can make more informed hedging and other currency-related decisions, I searched to find what was available.

The first port of call was the Reserve Bank. The Reserve Bank not only produces quarterly forecasts but it also controls short-term interest rates that are often thought to play a major part in driving the exchange rate, so where better to start?!



The RBNZ's quarterly forecasts are presented in the Monetary Policy Statements and contain "assumptions" rather than forecasts. The coloured lines in the chart show a selection of the assumptions the RBNZ has made about the NZD TWI (i.e. the value of the NZD against the currencies of largest trading partners), which generally revert to the average. The dates relate to when the "assumptions" were released. A monkey armed with darts and a dart board could make better "assumptions". In the RBNZ's defence, it doesn't promote the assumptions as predictions, but even allowing for that one is left wondering why it bothers at all!



The next port of call is the economic forecasters; the bank economists and the like. NZIER do a useful job of surveying 10 of the economic forecasters each quarter, including the main bank economists. To see these visit NZIER's website - <http://www.nzier.org.nz/> - and select "Publications" from the main menu. The adjacent chart shows the average predictions for the NZD TWI based on the most recent survey (the blue line), the maximum forecasts (red line) and the minimum forecasts (green line). The average prediction is for little change over the next two years, but the 10 forecasters

have all bases covered currently with a massive spread between the maximum and minimum predictions. Based on the consensus forecasts – the blue line - the best guess is that the NZD won't change much, which seems pretty unlikely given the historical behaviour of the NZD and the fact that it is already well above the blue line. However, as a fallback position what I take away from the survey of economists' forecasts is that if the NZD doesn't remain reasonably stable it could either appreciate significantly or collapse. Now that is stating the obvious!

The NZIER Consensus Forecasts aren't designed to provide insight into why the economists are predicting what they are predicting, but rather to provide a useful summary of what they are predicting. So to see whether the bank economists offer valuable insights into what drives the exchange rate in the more in-depth reports they produce, I accessed the latest relevant reports from the websites of the four major banks. I read the reports with as open a mind as possible.

For exporters, importers and investors to have any faith in exchange rate forecasts, I believe the forecasters need to be able to demonstrate that their predictions are well-founded: (1) correctly identify



the key drivers of the exchange rate, preferably including evidence showing the roles the key drivers play; and (2) present researched and well-reasoned views on what will happen to the key drivers and what this implies for the NZD. That doesn't seem too much to ask?!

I wasn't so much interested in what the economists were predicting, but more I wanted to discover whether they had spent the time and effort to develop a robust/quality framework for making exchange rate predictions. As an aside, the following were the predictions I found, which are consistent with the chart above that had all bases covered.

"At this juncture we believe the NZD is biased lower over the year ahead, before structural forces support over the medium-term."

"Our forecasts see the New Zealand dollar rising through this year, then easing back slightly in 2011"

"All up, we suspect some consolidation is due for NZD/USD. While Friday's cautious improvement in risk appetite bodes well for further recovery in NZD/USD, we suspect a push through 0.7000 will be a bridge too far in the near-term given the headwinds from still fragile sentiment and negative momentum." [This bank didn't seem to have medium-term currency forecasts, but focused on trying to assess near-term movements, which could be a good idea.]

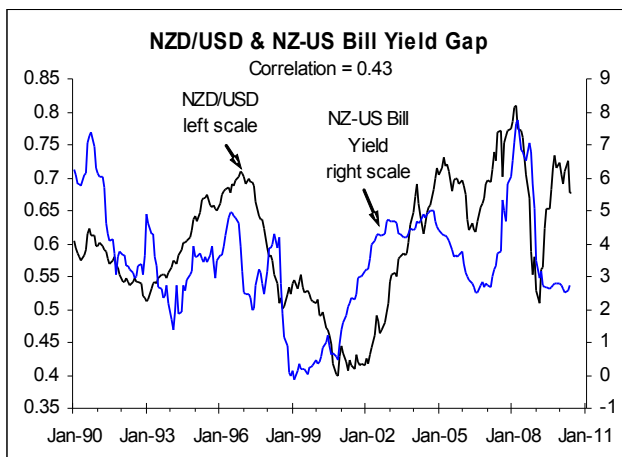
"We expect the NZD to hold up around current levels in the near term ... The slightly earlier timing of a rate hike in NZ would give the NZD a slight short-term boost. ... But later in 2010 we expect a mild depreciation in the NZD. ... However, the extent of that depreciation is likely to be modest."

What I was really looking for was evidence that the forecasters understand what they were talking about. I was after insights that would help me understand the puzzle of exchange rate behaviour and make me more confident in their predictions. Did their reports show that they had developed robust frameworks for forecasting the exchange rate? Was the logic of their arguments sound? Or were the reports full of the sorts of vagaries and platitudes normally used by people to cover up their lack of understanding?

The relevant comments in one of the reports are as follows.

"NZD to fall slightly in the coming years. We expect the NZD to hold up around current levels in the near term, underpinned by interest rate differentials. We expect the RBNZ will start to increase its policy rate a little ahead of the Federal Reserve, and well before the main European central banks. The slightly earlier timing of a rate hike in NZ would give the NZD a slight short-term boost.

"But later in 2010 we expect a mild depreciation in the NZD, as monetary policy tightening by the Federal Reserve provides some broad-based support for the USD and as European central banks follow suit. However, the extent of that depreciation is likely to be modest. NZ's economic prospects have fewer structural clouds hanging over them (particularly relative to the UK and Europe), and local interest rates will be higher. Against the USD and the Pound, in particular, the NZD is likely to linger above its respective averages of the past 10 years."



In explaining what would drive the NZD the focus in this report was mainly on interest rate. The adjacent chart shows the historical relationship between the NZD/USD and the interest rate gap between NZ and the US. The 90-day bank bill yield gap is used as a proxy for the gap between official interest rates that is focused on in this report. This is necessitated because the NZ OCR was only born in March 1999.

The chart shows a correlation of 0.43 between the NZD/USD and the interest rate gap, which is like a D grade or fail in old-style school marking. Personally I wouldn't bet a dime on a currency view based predominantly on interest rates.



One of the other reports had the following to say.

“Our forecasts see the New Zealand dollar rising through this year, then easing back slightly in 2011. As always, this is highly dependent on the US dollar’s performance. As a rule of thumb, the US dollar tends to follow a non-linear path: it strengthens when the economy is weak, as investors look to the USD as a safe haven; weakens when the economy is doing moderately well, as investors look for more growth-sensitive markets; and strengthens again when the US economy is outperforming and the world sees it as a genuine investment destination.”

This report didn’t provide any evidence of this “rule of thumb”, which appears to rely heavily on the most recent experience with the financial crisis, with the USD initially appreciating – the NZD/USD depreciating - even though the US economy was at the epicentre of the financial crisis. Even a half-baked analysis of the historical behaviour of the NZD/USD would show that the NZD/USD appreciates (i.e. the USD/NZD depreciates) when the US economy is weak vis-à-vis the NZ economy. If exporters and imports were to run with this rule of thumb (i.e. expect the NZD/USD to depreciate whenever the US economy is weak) they would surely go bankrupt at some stage in the future.

The financial crisis has fundamentally changed the relationship between the NZD/USD and US economic growth, and the same applies to the relationship between the NZD/USD and relative NZ-US economic growth, which is the critical one. The most important issue to address going forward is when or whether the old relationship will be restored, at which point “rules of thumb” can be rolled out again, but hopefully not the dubious rule of thumb presented in the report in question. This report did, however, have a good section on the relevance of the boom in commodity prices to the sustainable level of the NZD, but even with this useful insight it didn’t fill me with confidence in the authors’ understanding of what really drives the cycles in the exchange rate.

A third report by economists at one of the major banks had the following to say.

“We have laid out a fairly safe central track for the NZDUSD over the forecast period. Technically, the NZDUSD is already below our February 2010 forecast. But the danger with currency forecasting is in chasing trends. We prefer to focus on the spirit of the forecasts, rather than on the precise numbers. Our NZD view is somewhat tempered by the house view for the major currencies. We have the NZD gradually declining from current levels towards the low to mid-0.60s area by the second half of next year, as NZ’s relative growth underperformance relative to other countries become apparent and the USD firms slowly. During that period, the interest rate differential that the NZD currently enjoys will have narrowed. The NZD then recovers towards our estimate of structural fair value of around 0.66 by the end of the forecast period.

“Our bias, however, is towards a much bigger cycle, with an earlier move towards the low to mid-0.60s by the second half of this year as recent global jitters extend, and risk assets are repriced as major economies around the globe embark on their exit strategies. A shakeout of the EURUSD towards 1.20 is a key feature. This is followed by a rebound in the NZDUSD towards the 0.70 area once again, as points of differentiation are sought by the currency market. In this respect, the NZD will stand out amongst other currencies, a large net external liability position notwithstanding.”

This report at least spoke explicitly about the most important economic fundamental – relative growth between NZ and our trading partners – but it wins the award for the most platitudes and contained little more than assertions. For a long time the public has been fed a diet of economic reports that contain 95% assertions, with only 5% of the conclusions drawn from quality research of how the economy actually works. So the public can be forgiven for not knowing what quality, research-backed analysis looks like. In my experience, warning bells start ringing when reports use terms like “a fairly safe central track”, “our view is tempered by the house view” (this tells you the forecasts are a “political” compromise), “gradually declining” (the NZD does not gradually decline), and “estimate of structural fair value” (it is only economists who think the exchange rate will head back to some arbitrary assessment of fair value).

Even if in my most generous mood I had to conclude that none of the economic reports I read left me much more the wiser about what really drives the exchange rate. Again, assertions are not the same



thing as insights! And platitudes are a poor substitute for the simple language generally used by people who understand what they are writing about and have an interest in helping others learn.

My next port of call was the academic economists. Surely they could help exporters and importers understand what drives the exchange rate, even if from a somewhat academic perspective. I used google to search for academic-type reports on the NZD and the following were the first two I found. If you can already imagine the abstract stuff the academics are focusing on, skip to the next page.

“New Zealand’s Foreign Exchange Market and the Nature of Expectations

“Why do high interest rate currencies tend to appreciate? Standard economic theory predicts the precise opposite. Arbitrage should ensure that expected returns are equal across all countries, in which case currencies with high interest rates should be expected to depreciate. What you gain on the high interest rates you can expect to lose by the currency moving against you. The fact that markets don’t behave like this has been dubbed the ‘forward premium puzzle’. Hundreds of studies have verified the anomaly across most currencies and most time periods (see Engel 1996 for a survey).

“The ‘standard economic theory’ mentioned above is the risk-neutral rational expectations hypothesis. So the puzzle, and the related failure of uncovered interest parity, can be blamed either on the presence of a risk premium or on expectations not being rational, or more precisely failing to appear rational ex post.”

Source:

<http://www.questia.com/googleScholar.qst;jsessionid=MGGMzjvKQ9zvLH5w2FwsSDFm7K2hG9l4VhmpwYLyf6r58nG12fJm!1748356985!-2083947951?docId=5002380709>

This research report appears to teach us that at least some “standard economic theory” is off with the fairies, while some academic studies produce more questions than answers.

“The Relative Size of New Zealand Exchange Rate and Interest Rate Responses to News

“This paper examines the relative size of the effects of New Zealand monetary policy and macroeconomic data surprises on the spot exchange rate, 2 and 5 year swap rate differentials, and the synthetic forward exchange rate schedule. We find that the spot exchange rate and 5 year swap rates respond by a similar magnitude to monetary surprises, implying there is little response of the forward exchange rate to this type of news. In contrast, the spot exchange rate responds by nearly three times as much as 5 year interest rates to CPI and GDP surprises, implying that forward rates appreciate to higher than expected CPI or GDP news. This is in contrast to standard theoretical models and US evidence. Lastly, we show that exchange rates but not interest rates respond to current account news. The implications of these results for monetary policy are considered.”

Source:

http://www.motu.org.nz/publications/detail/the_relative_size_of_new_zealand_exchange_rate_and_interest_rate_responses

The Reserve Bank produces economic research reports on a range of topics, so I had a look at what was on offer from the RBNZ’s research archives. The following was broadly representative.

“Order flow and exchange rate changes: A look at the NZD/USD and AUD/USD

“In this paper, we apply a series of empirical microstructure tests to the NZD/USD and AUD/USD. In contrast to a more traditional macro approach to explaining exchange rate changes, microstructure studies focus on the role that transactions play in helping the market aggregate information on individual market participants expectations of economic fundamentals and risk preferences. ... We find that there is a strong contemporaneous relationship between net order flow (the net of buyer-initiated and seller-initiated transactions) and changes in the NZD/USD and AUD/USD at frequencies from one minute to one week, similar to studies on other currencies.”

Source: http://www.rbnz.govt.nz/research/discusspapers/dp09_03.pdf



Having myself authored a few Reserve Bank research papers many years ago I am walking on thin ice, but most importantly I know firsthand how removed from reality this sort of research often is. The focus is often on testing some obscure issue when the big, really important questions go unanswered.

It is possible that some of the firms specialising in currency-related services run courses that provide quality insights into what drives the NZD/USD, but I am not aware of anything like what we are offering with our NZD/USD workshops. Tuatara (www.tuatara.co.nz) and Asia-Pacific Risk Management (www.asia-pacificrisk.com) have been the two main players in this area, but do not seem to run the sort of workshops we are running. LatitudeFX offers seminars, but they only seem to have a focus on teaching people how to become traders (see http://www.latitudefx.co.nz/about_us/trade_shows.php). Anthony Byett, my ex-colleague and former Chief Economist at ASB, provides regular comments on the exchange rate on his website and has some useful links (see <http://fxmatters.co.nz>), but Ants doesn't appear to be running any educational seminars or workshops.

What is needed is a no-bullshit explanation of what really drives the NZD/USD so importers, exporters and investors can learn something and subsequently apply this learning to their currency hedging and other currency-related decisions. This is what our NZD/USD Workshops do. Click on the following link for information about the first two workshops - <http://www.sra.co.nz/pdf/NZDUSDWorkshops.pdf>.

The workshops will provide unparalleled insights into what drives the cycles in the NZD/USD, including the impact of shocks. The strength of the workshops will be the use of real world examples, plain English and our unique insights into what drives exchange rate cycles. The workshops will offer the opportunity for rapid and quality learning. They will short-circuit and supplement the normal trial-and-error learning that can take years and can be painful and expensive.

The workshops will provide much more than an update of near-term prospects for the NZD/USD. They will provide invaluable insights into the underlying reasons for cycles in the NZD/USD, including covering the following:

- The roles interest rates, economic growth, the housing market, commodities prices and the like play in driving the NZD/USD.
- What motivates the behaviour of the large investors and currency traders who play the major part in driving the NZD/USD.
- The role shocks and random events can play, and how these events can be used to make more profitable decisions. This will include the major role the international financial crisis is currently playing.

The workshops will touch on what drives the cycles in the NZD/AUD, NZD/JPY, NZD/EUR and NZD/GBP, but the focus is very much on the NZD/USD.

Why am I qualified to run the workshops? The following link will take you to the part of our website that presents information on all the workshops we are running and gives my biased view on why I am uniquely qualified to run the workshops - <http://www.sra.co.nz/workshops.html>.

Using the framework presented in the workshops we have helped our importer and export clients. One importer client recently told me that he gained more than an 8000% annual return from his investment in our twice monthly reports on the NZD/USD. This is partly a testament to how competitively-priced our reports (and workshops) are, is partly a testament to the quality of the framework we have developed for assessing NZD/USD prospects and partly reflects a bit of luck. Exchange rates can be fickle things, so even armed with our framework things will not always go smoothly. However, much better to have a framework that works well most of the time as a starting point for making hedging and other currency-related decisions than be bounced around by the assertions and platitudes of people who don't seem to have developed a coherent framework.