Why the kiwi dollar fluctuates against the Aussie dollar

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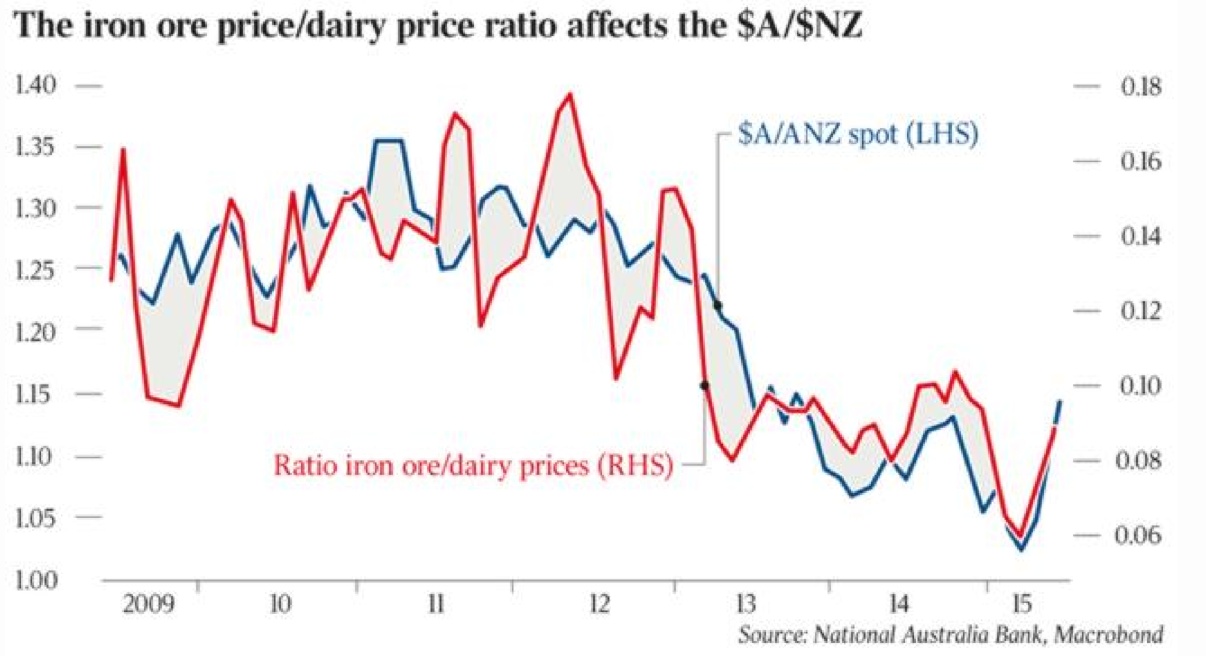

Dollar comparison. *Source:* TheAustralian

The Australian dollar and New Zealand dollar have both weakened against most other currencies in the last year or two. That's because the two countries are experiencing softening demand for, and increasing global supplies of, their key export commodities.

But why does the exchange rate between these nations, given their many similarities, vary as much as it does? A few years ago, an Australian dollar exchanged for one and a third New Zealand dollars; in April, the two currencies traded within a whisker of parity; and last week the exchange rate was 1.12 New Zealand dollars to the Australian unit.

The main factors affecting Australian-New Zealand exchange rate are these:

1. Different commodities. While iron ore accounts for over a quarter of Australia's exports, dairy products contribute almost a quarter of New Zealand exports.

As the chart shows, if you want to understand the trans-Tasman exchange rate, a good starting point is the ratio of the iron ore price to the average price of dairy products.

In recent years, the prices of both commodities have plunged — the iron ore price by 70 per cent and the average dairy price by 60 per cent.

But the moves often came at different times. Dairy prices held up in 2013 when iron ore prices fell — and enjoyed a useful rally in early 2015 before falling sharply in mid-2015 a few months after the iron ore price had slumped.

With iron ore suffering a global oversupply more significant than that facing milk products, prospects are the cyclic recovery in dairy prices will come earlier than for the iron ore price.

2. Differences in the significance of China. China takes a third of Australia's exports and about a fifth of New Zealand's exports.

It's not surprising, then, that important news on the Chinese economy, or big changes in the outlook for China's economic growth, have significant effects on the Australian dollar and a discernible impact on the kiwi currency.

3. Short-term interest rates. In late 2013 and early 2014, cash rates were 2.5 per cent in both countries.

Subsequently, New Zealand raised its cash rate in four steps to 3.5 per cent to cool the economy — and kept the cash rate at that level until last month. The higher level of the NZ cash rate against Australia's cash rate helped to lift the value of the NZ dollar, particularly from February to May of this year when the Australian cash rate was reduced in two moves to two per cent.

The cut in the New Zealand cash rate last month contributed to a weakening in the kiwi currency.

Market talk suggests both Australia and New Zealand may cut their cash rates further — but with the higher probability of such a move in New Zealand, where the cash rate is still more than a percentage point higher than Australia's.

4. Current Account Deficits

Both Australia and New Zealand have persistent shortfalls in national saving relative to capital spending.

As a result, they draw on the savings of other countries and run current account deficits. Currently, those deficits are 2.5-3 per cent of GDP in Australia and 3-3.5 per cent of GDP in New Zealand; a decade or so ago, the two deficits were about twice as large.

Both countries have begun to address their problems of inadequate saving.

Australia is growing private sector saving via superannuation but hasn't restored sustainability in its public finances. New Zealand has reintroduced good discipline to its public finances but has only a modest holding of superannuation assets.

Neither country is likely to experience a big increase in its current account deficit in the next few years.

In brief, the exchange rate between the Australian and New Zealand dollars seems likely to jump about a fair bit over the next year or two — perhaps around a mainly flat trend.

Another question: will the Australian and New Zealand dollars depreciate further against the US dollar?

In my view, that's likely — and will be initiated by a strengthening US dollar against most currencies.

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