This is the third in a series of articles on New Zealand, its economy and why it is an attractive investment destination and today we look at foreign currency. What is one of the first things you ask yourself before investing offshore? What is the conversion or FX rate? This is a sensible question because the stronger the Yen the more of another currency you can buy and visa versa.

However, the problem with currencies and being focused on what the current exchange rate is means you may well miss the opportunity. The reason for this is that we as small investors cannot control the currency.

If, for example, winter in Japan is getting colder and colder, the days are getting shorter and darker and you really need a holiday but not just any holiday – you want to go to New Zealand, it is warm, sunny and relaxed – the seasons are the opposite to Japan. You check the FX rate it is 81 JPY to the 1NZD or maybe it is 65JPY to 1NZD. What you really want is the holiday. You could hold off till the FX rate moves in favour of a stronger Yen but maybe in the meantime the airfares have gone up and so have the hotel prices negating the vale you picked up in the FX movement and by now you can't get the time off work so the holiday is lost.

What moves the currency?

Currencies are a factor of interest rates, in normal times, and other factors like fiscal easing, i.e. how much money is available especially when interest rates are low. Of course the credit of a country has an impact as well.

Think of it this way, two people ask to borrow money off you to buy a new car. The first is a person, Yosi, you went to school with. He has a very good job and you have been friends for a long time. In fact you have leant this person money before and had it all paid back. Yosi offers to pay you interest at a rate of 1.0% per year until the money is repaid. The second person, Goro, you don't know him that well but have heard of him through friends. He has his own business but you don't really know much about it. He offers to pay you interest of 5.0% per year.

Who you invest with depends on your risk appetite, you would consider your friend Yosi a good credit risk and are therefore prepared to receive lower interest on the money you lend. However, if you wanted a higher return and were prepared to take more risk you could invest with Goro who will pay you a much higher interest rate.

Five year Government bonds from countries like Brazil (11.3%) and Sri Lanka (11.70%) are able to be bought on high yields relative to a JPY investment. However, New Zealand 5 year Government bonds are able to be bought on a yield of 4.2%[1].

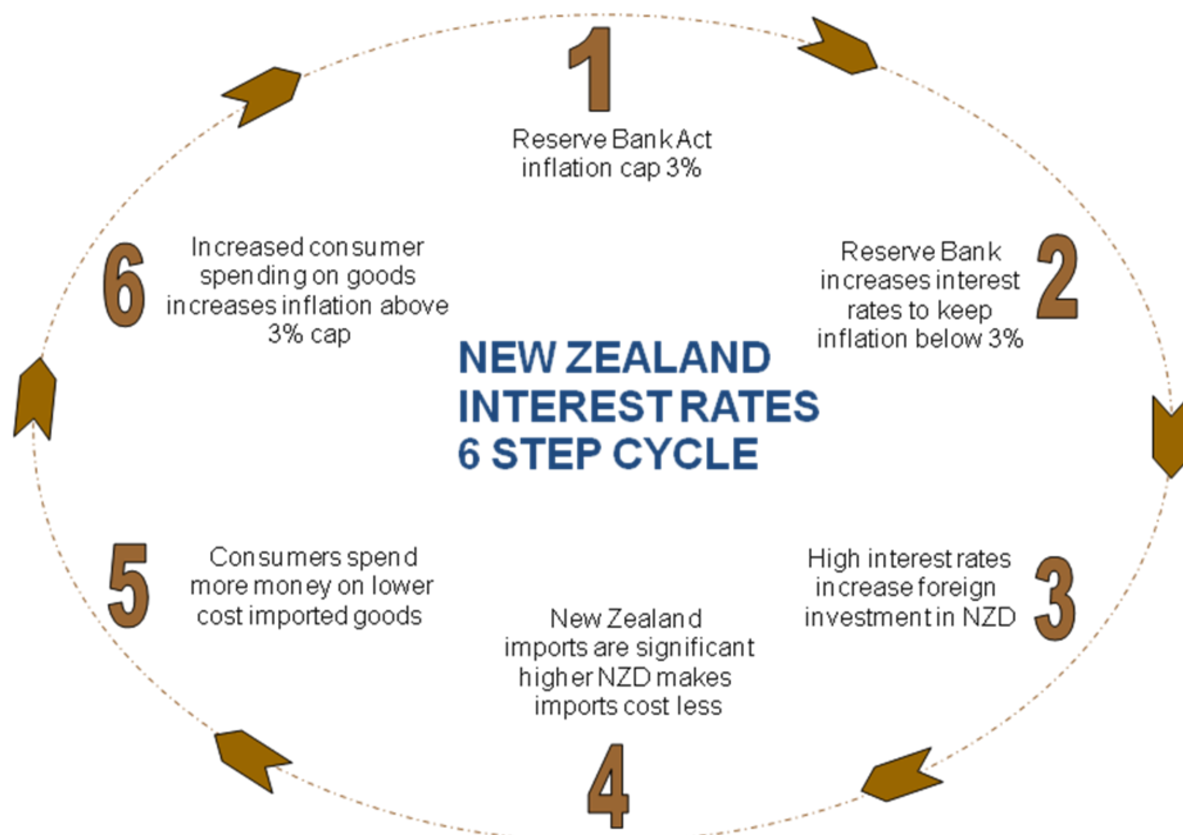
[1] www.interest.co.nz

So interest rates are a function of credit quality. If you are happy with the credit risk you will be happy with an acceptable interest rate. The higher the rate the more demand, the more demand the more it costs effectively reducing the yield. As New Zealand is seen as a good quality credit its interest rates compared with Japan 5 year Government bond rate (0.21%)[2] look like an attractive investment. The more investors that take this view the more demand and the stronger the buying pressure and demand for the currency.

I am sure an economist would suggest that this is far too simple an explanation for all the intricate parts involved in currency calculation and movement but it is a good and understandable guide.

What drives New Zealand's interest rates?

My way to explain this, in a simplified way, is set out in the diagram below. It may well be that I again fall foul of the economists' true view on why rates have been higher but I think it gives a fair and general understanding of the matter.



[2] Bloomberg

Follow the numbers in order clockwise from 1 and you will see the circular spiral of why interest rates in New Zealand climb.

The Reserve Bank in New Zealand has to maintain the medium term inflation rate between 1% and 3%. One of the main tools it has to do this is the bench mark interest rate or Overnight Cash rate "OCR".

New Zealand has a high proportion of home ownership at over 60%[3] and therefore significant mortgage funding. Eventually as the interest rates climb consumers stop spending on anything but essentials to maintain their mortgage, which protects their most valuable asset. In fact landlords who have bank borrowing may have to push up rentals to meet their increased interest costs having the same effect on tenants as owners. When higher interest rates reach this threshold household spending on consumer goods reduces and has a flow on effect of lowering inflation.

As the economy slows, as in a recession, the Reserve Bank seeks to do the opposite by stimulating consumer spending and the economy, and reduces interest rates. The lower interest rates mean consumers have more free cash to spend no longer needing as much to service high interest rates on their mortgage. As consumers spend, the economy is stimulated and begins to grow again.

Needless to say as the New Zealand interest rates rise in this way so does foreign appetite for NZD investment pushing the currency higher.

TWI – Trade Weighted Index

The trade weighted index ("TWI") is another indicator of where the New Zealand currency is going.

The TWI is an index measure of the value of the New Zealand dollar (NZD) relative to other countries currencies. Because there are many other currencies with which the NZD is exchanged, it is necessary, for the purpose of measuring the exchange value of the NZD, to combine those other currencies into some form of composite currency. This is what the TWI is – a weighted average value, expressed in index number form, of a basket of other currencies.

The TWI can be thought of as a weighted average of the prices of a basket of locally available goods and services. The currencies included in the TWI basket are those of the 5 countries which account for the largest share of New Zealand's external merchandise trade. The TWI is a measure of the value of the New Zealand dollar (NZD) against the Australian, US, Japanese, UK and Eurozone currencies.

So about that holiday!

[3] Statistics New Zealand as at 2001; owner-occupied households; www.statistcis.govt.nz 13 July 2009

BANCORP

The NZD is currently at around 80JPY to 1NZD. Will changes to the Japanese domestic tax system and monetary easing in Japan make this look high or low in 6 months time? I am not sure. However, it is currently a nice mild 18oC in Auckland as I write this and the average summer temperatures in Auckland range between 20oC and 30oC with very little humidity. With the long term forecast for Tokyo this winter around 2oC and 5cm of snow fall, I think you should look at booking now!