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When the Exchange Rate Turns

New Zealand exporters are enjoying a very helpful friend at present: the exchange rate.

We rightly talk about strong returns from dairy, meat, kiwifruit and other exports. Commodity prices and good market demand deserve much of the credit. But sitting quietly behind those returns is the New Zealand dollar. At around US57 cents, our dollar converts overseas earnings into considerably more New Zealand dollars than it would at, say, US65 or 70 cents. That is real money.

As a simple example, US\$1 million of export income converted at US57 cents produces about NZ\$1.75 million. At US65 cents it produces around NZ\$1.54 million. Nothing has changed in the amount sold. Nothing has changed in the overseas price. But more than \$200,000 has disappeared.

That is why we should be thinking now about what happens when the exchange rate turns. New Zealand has been through a particularly brutal economic adjustment. Households and businesses have felt it. Government spending has been under pressure. The Reserve Bank has had to focus hard on inflation and while headline inflation has recently been pushed higher by fuel prices, underlying inflation is much closer to its target range.

The economy is still doing it tough, but there are signs that the adjustment is working and recovery is beginning. Across the Tasman there is a different problem emerging. Australia remains a strong economy, but inflation has again become a concern. The International Monetary Fund recently pointed directly to rising government spending and public debt, particularly among the Australian states and said fiscal consolidation would help bring inflation down.

That is quite a contrast. Australia is dealing with an economy where demand and government spending have remained strong enough to create inflationary pressure. New Zealand has spent several years squeezing excess demand out of its economy.

Why does that matter to our exporters?

Because exchange rates ultimately reflect relative economic conditions. If New Zealand's economy continues to improve, inflation comes under control, government finances strengthen and international investors become more confident about our prospects, there is every possibility that the New Zealand dollar will strengthen.

That may not happen tomorrow. Exchange rates are notoriously difficult to predict. Global interest rates, commodity prices, China, the US dollar and geopolitical events can all move currencies quickly. But assuming today's exchange rate will continue indefinitely would be dangerous.

The Reserve Bank itself is now saying that strong export prices are supporting income and investment across our export economy. That is good news. We should enjoy it. But exporters, growers and farmers need to distinguish between the return generated by their underlying business and the return being generated by currency. Because the two are not the same.

If your business model works exceptionally well at US57 cents but becomes marginal at US65 cents, that is worth knowing now: not after the exchange rate has moved. This is particularly important when making decisions about expansion, land values, capital expenditure and debt.

New Zealand's exporters have always lived with currency volatility. Hedging can provide some protection, but ultimately businesses need to remain competitive through the cycle. But part of today's prosperity is being delivered by an unusually helpful exchange rate.

For contractors, processors and packhouses, this matters just as much as it does for exporters, farmers and growers. If the exchange rate turns, there will simply be less money flowing through the agricultural and horticultural supply chain. That means tighter margins, tougher negotiations and more pressure on costs. I think this needs to be built into your medium-term business planning now, because when the exchange rate turns (not if), it will put real financial pressure across our primary industry sectors.