



Currency Impact on Exports

**A paper prepared for
The New Zealand Trade and Enterprise**

by Infometrics Ltd

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Introduction

The recent rise in the New Zealand dollar has been an important factor behind the 8.6% fall in export receipts over 2003, and threatens to stunt future export and economic growth.

Infometrics has been asked by New Zealand Trade and Enterprise (NZTE) to look at what impact the rising currency is having on exporters. We have undertaken 20 telephone interviews with a range of manufacturing and service exporters throughout New Zealand. The points made in this paper are based on comments, observations and experiences of these companies as well as Infometrics knowledge and analysis of 30-40 successful manufacturing firms interviewed over the past decade as part of biennial studies conducted on behalf of The Treasury.

It is relatively easy to establish the impact of the appreciating currency on individual businesses. However, their circumstances and experiences vary considerably making it difficult and possibly dangerous to draw conclusions about the aggregate consequences for the economy.

Conclusion - the economics of appreciation

The currency is a powerful and indiscriminate price setting mechanism. Changes in the currency have little or nothing to do with individual market conditions and they translate into higher or lower returns irrespective of the attributes of firms or their products.

In practice the transmission mechanism is that exporters and importers absorb the currency-induced price changes in their margins. Ultimately competition or survival will force them to either abandon unprofitable product lines, or alter final selling prices. The latter then produces the price signals that customers respond to (the demand response).

Over the short-term firms generally absorb currency fluctuations within their margins – they hold their selling prices stable for their customers and consequently there is little if any change in sales. Forward cover, as well as specific commercial contracts, assist or compel companies to keep selling prices constant in the short term. Furthermore, companies tend to “look through” currency movements either because they think the movements will be temporary, or because they do not want to jeopardise the investment they have made in establishing export markets.

Thus, in the short-term (at least a year) the macro-economic impacts of a rising currency appear to be confined to reduced incomes for exporters. This conclusion is consistent with the responses from the firms interviewed for this paper. In some cases the financial consequences are substantial, but the majority of firms have not changed their export volumes. In a number of cases volumes have continued to increase despite (possibly because of) thinner margins.

The longer and more substantial the rise in the currency is, the more likely the financial pressures faced by exporters will translate into changes in production, investment spending, employment and business strategy. These changes in business behaviour are the real threat to future export and economic growth.

Although there were few definite examples of firms making such fundamental changes to their businesses, a number were under pressure to do so. One manager conceded that his board wants him to shift production to China, another is contemplating laying off staff as a particular product line is likely to be abandoned, and others are reconsidering expansion plans.

The business case for investing in additional export capacity in New Zealand is now more difficult to make, but not impossible – one firm is still attracting activities from its US parent because they can still do the work more cost competitively in New Zealand than in the US.

The large and unpredictable cycles in the value of the \$NZ increases the risk associated with investing in export market development. Exporting is already a formidable challenge for most New Zealand firms. The current surge in the value of the \$NZ will dissuade more firms from investing in exports, and will persuade some to abandon recent attempts to establish export markets. The strength of the domestic economy and the increased competition from imports, as a result of the higher dollar, are also factors that undermine the case for exporting.

Our conclusion is that currency volatility is an important reason why New Zealand's unimpressive export performance is likely to persist over the medium term. That implies that the balance of payments current account will also remain a constraint to economic growth. The currency will eventually depreciate, but its level is probably less important to exporters than its stability. Some companies appear to be managing the volatile currency by focusing on differentiated, high margin products, shifting production to cheaper Asian manufacturers, or importing more of their inputs and final goods. There is a small group of exporters who have virtual control over their pricing and therefore are largely unaffected by currency movements.

Currency movements in perspective

Although the currency has appreciated dramatically over the past two years, the rise began from a particularly low level – in fact the lowest point for the TWI since the dollar was floated in 1985. The dollar, as measured by the TWI over the three months ended January 2004, is now around 10% above its post-float average (around 18 years).

The twists and turns of the TWI

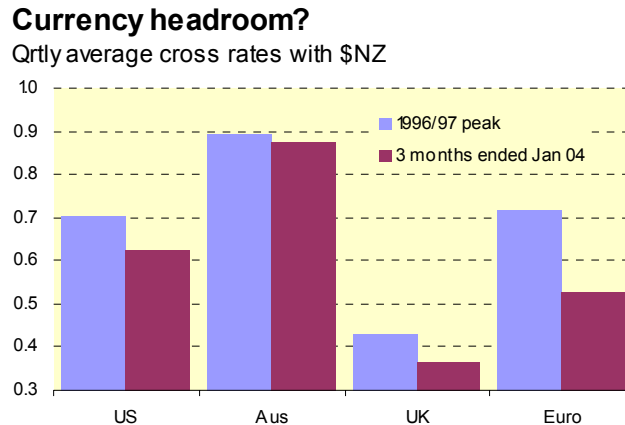
New Zealand's TWI, monthly averages



Graph 1

The upswing in the exchange rate has been more severe than during the mid-1990s, mainly because of the low starting point. The TWI over the past week (ended 12 February) has all but reached the peak recorded in early 1997.

The biggest change in the cross exchange rate has been against the \$US, which has weakened considerably over the past year. On a TWI basis, the \$US has fallen by around 22% over the last two years. However, the \$US/\$NZ cross rate has yet to reach the quarterly peak of \$US0.706/\$NZ recorded in December 1996.



Graph 2

The effect by sector

Figure 1 provides a useful, though simplistic, indication of the likely impact of a rising currency on particular export industries. There are a number of factors that affect the vulnerability of industries to a rising currency, but two of the most important are:

- pricing strength, which encapsulates the size of margin an industry/business works with, and;
- the degree to which the business/industry is hedged, both naturally and via forward cover contracts.

Those industries that have little or no pricing power (relatively thin margins) and have very little imported content are the most vulnerable to a rising exchange rate. In other words the full effects of any change in the currency will flow through to these businesses reasonably directly.

At the other end of the spectrum there will be businesses that export products/services that are sought after in overseas markets and have a relatively high import content. Under these conditions the firm is reasonably well hedged, probably has good margins, and is in a strong position to change its foreign prices in response to currency movements. Some niche manufacturers are in this position.

Impact of currency appreciation

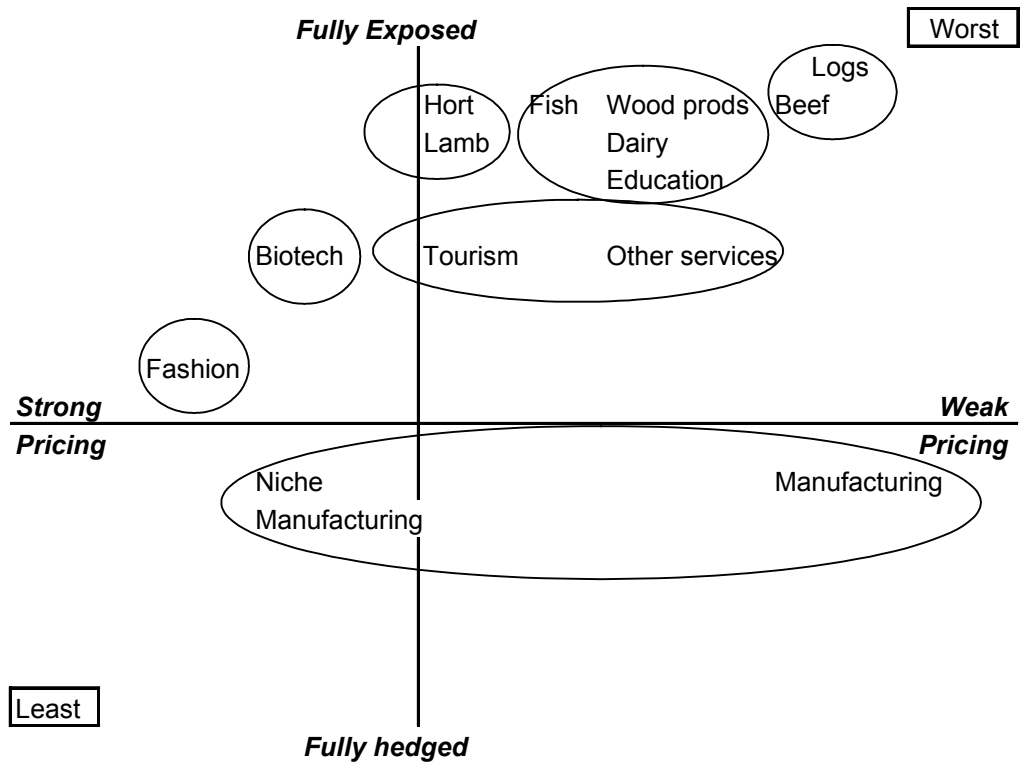


Figure 1

The squeeze on returns from an appreciating currency can vary considerably between companies even in the same industry. Fixed price contracts, forward cover, different markets/customers, sourcing of inputs and cost structures all contribute to the resilience or otherwise of individual businesses.

The length of time an industry/business has been involved in exporting can also have a bearing on how well they cope with currency gyrations. Some of the difficulties the export education sector is now encountering can be attributed to a lack of experience amongst providers in dealing with adverse market conditions.

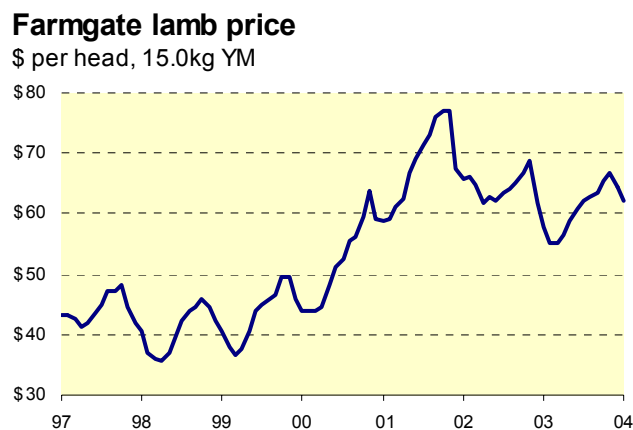
Agriculture

Primary industries (directly and indirectly) account for around half the country's total export receipts. Most are likely to suffer the squeeze on their returns without significantly altering production and export volumes. Apart from forestry and wool the major primary exporters are driven by natural cycles and have little choice but to continue producing and therefore exporting, irrespective of returns. Climatic conditions probably have a bigger impact on agricultural output than the currency.

Fonterra, the country's largest single export business has forward exchange rate cover at an average of \$US0.52 for the current season. Infometrics estimate that the average forward cover rate for the 2004/05 season will be around \$US0.61 (based on covering receipts 15 months ahead) and \$US0.65 over the 2005/06 season. Fonterra calculate that for

every one cent rise in the currency against the \$US the payout falls by 10c. That implies that if world prices remain constant dairy farmers could see their returns fall from around \$4.15 this year to under \$3.00 by the 2005/06 season.

Meat production looks as if it will remain relatively stable. Lamb returns have been largely maintained despite the higher currency, while beef prices have come off around 17% over the past year.



Graph 3

Forestry

The combination of a rising currency and markedly higher (100%+ increases) shipping costs has virtually eliminated margins in the log export trade. As a consequence log shipments have declined – Port of Tauranga, which accounts for around 50% of all log shipments, has experienced a 25% decline in log tonnages (December quarter 2003 compared to the same period in 2002). The decline in log production and exports is more of a delay than a complete loss – the trees are still available for harvest at some future date, when (if) market conditions improve.

Although margins in the pulp and paper industry have been reduced by the rising currency exports, volumes are likely to be maintained as companies continue to run their plants to optimum capacity. Furthermore, Carter Holt Harvey have a reasonable amount of long term forward cover against the \$US at a favourable rate.

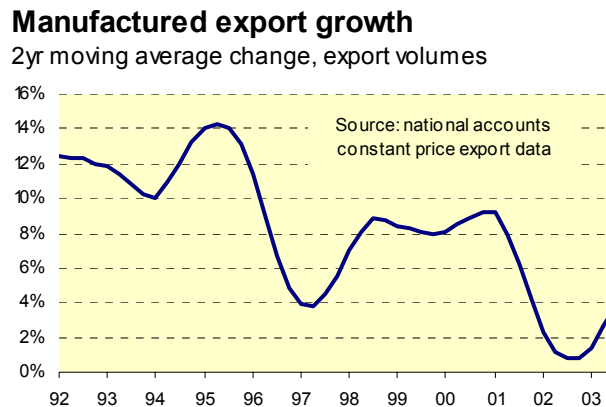
Manufacturing

Manufacturing export businesses have been buffeted by a number of economic events/trends over the past five or so years:

- The emergence of China as the world's most competitive producer of manufactured goods has encouraged New Zealand exporters to outsource production to lower cost Chinese plants. (We discuss the consequences this in more detail below.)
- Increased competition in Australia from Asian manufacturers, especially in the aftermath of the Asian crisis.

- Large swings in the currency and therefore returns – over the past decade the currency has, on average, changed by around 7.4% each year, compared to 5.7% for Australian exporters.

Manufacturing export growth has definitely slowed over the past five years (see Graph 4). Non-food manufactured export volumes as measured by Statistics New Zealand’s overseas trade volume index grew on average by 6.3%pa between 1985 and 1995. Since then the average annual growth rate has slowed to 4.4%pa.



Graph 4

As we indicated in Figure 1 above, the impact of the rising currency varies considerably. Interviews with around 15 manufacturing firms simply confirm the wide range of circumstances and therefore consequences.

Those with reasonably good natural hedging (a high imported content in their finished products), a good spread of well established markets and relatively high margins indicated they would stick with their export plans for at least the coming year. In other words export volumes from these firms will be maintained or increased over 2004.

Those exporters with low margins and little pricing power are being squeezed with some contemplating having to abandon some products/markets. Such firms are scattered through the manufacturing sector, including ICT and biotechnology, and are likely to record a reduction in export sales (in constant prices) over the coming year.

A number of points emerged from the interviews that help build a more comprehensive picture of the business and economic ramifications of the rising dollar.

Forward cover – although more exporters are utilising forward exchange rate contracts to cover future export receipts, many are still relatively inexperienced and lack a formal strategy. Two or three companies indicated that they were running out of forward cover because they had assumed that the currency would have peaked by now. That backs up other company responses to NZTE.

Naturally hedged – a significant number of exporters have a high degree of natural hedging implying that changes in the exchange rate have a relatively small effect on their export business. It also suggests that some exports add very little to overall GDP.

Ability to set prices – those firms with little ability to determine their foreign selling prices are particularly vulnerable to a rising currency. Such firms tend to be into high volume manufacturing and/or compete in markets with a wide range of competing products. Those exporters that specialise in producing a small number of customised products (machines, boats, specialised components) appear to have more pricing power (prices are negotiated for each sale).

One significant exporter had price escalation clauses in sales contracts that enabled them to lift prices if the exchange rate moved above a certain level. However, as they pointed out, any price increases would eventually reduce demand for their products.

Margins – high margin businesses clearly have more ability to withstand the impact of a rising currency than those businesses operating with low margins. Margins vary considerable, even within an industry, and often reflect the degree to which a business has invested beyond the basic manufacturing operation – R&D, distribution, licensed products, branding, etc.

One company observed that local firms with a heavy investment in R&D can ease the pressure on margins and profits of a rising currency by amortising development costs over a longer period – extend product life cycles. It is a practical response given the expected temporary nature of the deterioration in returns.

Maturity – more mature companies are likely to be able to withstand currency fluctuations better than young exporters because of their management/market experience, stronger relationship with customers, possibly greater product and market diversification.

Investing in exports – it is generally recognised that getting started as an exporter is one of the biggest challenges a New Zealand business faces. The current rise in the currency is likely to convince a number of firms to delay any commitment to developing export sales and may well cause some new exporters to abandon their investments.

Any actual or perceived increase in the risk of investing in export market development will discourage such investment and ultimately stunt export growth. In our view this process is one of the most serious consequences of the current rise in the \$NZ, but it will only become obvious in the longer term.

Established exporters have little alternative but to continue servicing markets given the investment they have made in them and the importance of exports to the growth of these firms. Some companies that are currently under severe pressure from the high exchange rate are still committed to exporting – in some cases they have little alternative given that exports account for the bulk of their sales.

Chinification – over the past decade a significant proportion of the developed world's manufacturing capacity has been shifted to emerging economies, particularly China. Many New Zealand manufacturers have been compelled to outsource their production to lower cost Asian factories in order to remain competitive in their foreign markets as well as in New Zealand. The rise in the \$NZ simply reinforces the trend to outsourcing production. Some companies spoken to for this paper

admitted that without their Chinese-sourced products their financial position would be even more dire than it is, given the rise in the dollar.

Interestingly some companies have seen a marked improvement in their margins by marrying much lower cost production in Asia with their well-established/ premium brands selling into high value markets. It raises the prospect, though, that eventually few New Zealand manufacturing export companies will actually produce goods locally. Exports of manufactured goods will continue, but the firms involved will be brand/ marketing/ distribution companies (for example, Icebreaker) rather than manufacturers.

On the face of it, shifting manufacturing output to Asia will lower net exports and therefore detract from overall GDP growth. However, if, by outsourcing, firms increase the margins they generate from their exports, then it is possible that GDP will rise as the higher margins are measured as value added.

Demand versus the currency – for many companies demand conditions in foreign markets are more important than the currency. So long as an exporter is achieving a positive margin on sales, the more it sells the higher its aggregate profits will be. One way of maintaining income when margins are squeezed is to produce and sell more.

Service exporters

Service exporters tend to price their output in \$NZ and therefore the consequences of a rising dollar first show up as a weaker demand.

Pricing consulting contracts, academic courses or holidays in \$NZ simply translates into higher foreign currency prices. Potential customers must choose whether to meet the higher price or go with some other supplier.

The impact of the rising currency on student numbers appears to have been relatively muted in some areas of the education sector (mainly well-established institutions) and quite substantial for providers of undifferentiated services – English language schools.

Consulting firms have seen themselves rapidly priced out of many of their high value markets by the rising \$NZ. As a result these firms simply have less work and in some cases must scale back their business. The longer term consequences of any retrenchment include a reduced ability to hold/ attract highly skilled people. That compounds the loss of competitiveness for such businesses.

Young exporters

We noted above that well established exporters are probably more likely to survive the current sharp lift in the currency. The implication is that less mature exporters would be more vulnerable. From conversation with a number of young exporters it seems that experience is less important than the characteristics of the product and the way it is sold.

High margin products can withstand major shifts in the currency. Moreover, such products tend to be highly differentiated and therefore the exporting firm has some ability to set prices. One small firm that had been exporting for less than two years was struggling with one product line that was essentially an ingredient with little to differentiate it from other

suppliers. Volumes had declined and employment had been reduced. However, it had another export product – a finished good with a clear brand – where margins were high and there was an ability to set prices. The contrast, even within this one small exporter, highlights the vastly different outlooks for different export recipes.

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