THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Reserve Bank Foreign Reserves

Date:	22 June 2007	**Treasury Priority:**	**Medium**
Security Classification:		**Report No:**	T2007/1007

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Dr Michael Cullen)	**Note** the contents of this report. **Agree** to release this report. We will confirm details with your Press Secretary.	For your discussion with Dr Alan Bollard, 10.00am Tuesday 26 June
Associate Minister of Finance (Hon Phil Goff)	**Note**	None
Associate Minister of Finance (Hon Trevor Mallard)	**Note**	None
Associate Minister of Finance (Hon Clayton Cosgrove)	**Note**	None

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
[	**deleted**		**]**	✓
Mark Blackmore	Manager, Macro Policy	**[deleted**	**]**	

Enclosure: **Current foreign exchange intervention policy**

21 June 2007

Treasury Report: Reserve Bank Foreign Reserves

Executive Summary

The Reserve Bank is proposing to adopt a new regime for the management of foreign exchange reserves. What is proposed is consistent with the framework for foreign reserves management established in 2004 when increased funding was provided to enable the Bank to attempt to smooth the peaks and troughs of exchange rate cycles.

The Reserve Bank proposes to:

- Manage a portion of its foreign reserve assets to a benchmark net open foreign exchange position; and
- To vary the aggregate level of the open position with the exchange rate cycle in a way that helps to smooth the peaks and troughs of the exchange rate cycle.

The Reserve Bank would move away from the benchmark position at times it considered intervention could help smooth the peaks and troughs of the exchange rate cycle. Following intervention, the Reserve Bank would look for opportunities to move back towards its benchmark open position and rebuild its intervention capacity.

The proposed approach uses resources currently held on the Reserve Bank's balance sheet and does not require additional funding by the government.

There are some changes in practice as a consequence of this proposal. This report sets out our understanding of how the new regime will operate and the associated economic and financial implications.

A number of elements of this proposal appear likely, on balance, to provide net benefits – for example the proposal to hold some foreign reserves on an unhedged basis **[deleted]** will likely reduce the foreign currency risks, and raise the effectiveness, of interventions to alleviate market dysfunction. At other times, there are additional risks and costs, but we are satisfied that the Reserve Bank's approach adequately accounts for these risks. The Reserve Bank estimates the additional carrying costs to be around **[deleted]** per year, and notes that the foreign exchange exposures will cause additional volatility in its income and in the value of its equity.

The net benefits of other elements of this proposal are less clear – for example whether greater flexibility in the criteria for intervention will successfully reduce the extremes of exchange rate peaks and troughs cannot be answered definitively. There are a range of views on this issue. **[deleted]**.

Overall, the Treasury agrees that the proposed framework enhances the Reserve Bank's ability to stabilise the exchange rate and helps it pursue its price stability objective without unnecessary instability in output, interest rates and the exchange rate [paragraph 4b) of the Policy Targets Agreement refers].

Our expectation is that the Bank's approach will, over time, result in reduced costs of holding reserves, and be reflected in higher dividends on average (although special dividends will likely be lumpy) paid to the government.

Work on this proposal has highlighted some shortcomings in the current statutory provisions determining the calculation of dividends payable by the Reserve Bank to the government. In particular there is no provision for the payment of "special dividends" should the Bank realise gains from its intervention activities. The Reserve Bank and the Treasury are working to address this issue. The proposed Reserve Bank Amendment Bill [EDC Min (07) 11/14 refers], which is proceeding as part of the Review of Financial Products and Providers, may be a suitable legislative vehicle to address this issue.

Section 24 of the Reserve Bank Act requires the Minister of Finance to determine the level of foreign reserves that the Bank holds. Legal advice has clarified that "foreign reserves" includes all foreign currency assets held by the Bank. Currently, only those reserves held for intervention purposes are covered in the Memorandum dated 25 March 2004. When all foreign currency assets are included in the definition the level of foreign reserves held by the Bank is significantly increased.

The Reserve Bank recommends that you sign a revised Memorandum agreeing that it hold a minimum SDR **[deleted]** and a maximum SDR **[deleted]** of foreign currency assets (NZD **[deleted]** –NZD **[deleted]** at current NZD/SDR exchange rate of 0.50). The proposed range allows for the substantial level and variability of the Bank's operations in the foreign exchange market as part of its domestic liquidity management responsibilities. No change to the current minimum level of holdings (SDR **[deleted]** is proposed. The Treasury supports this recommendation.

The Reserve Bank intends to announce agreed changes to the management of foreign reserves, and to publish their report to you. The Treasury seeks your agreement to release this report, subject to the need to maintain a high degree of confidentiality on the operating details.

Recommended Action

We recommend that you:

a **note** the contents of this report; and

b **agree** to release this report. We will confirm details with your Press Secretary.

Mark Blackmore
Manager, MacroPolicy
for Secretary to the Treasury

Media Staff

Referred: Yes/No

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Reserve Bank Foreign Reserves

Purpose of Report

1. You are meeting with the Reserve Bank Governor to discuss proposed changes to the way the Reserve Bank manages the government's foreign exchange reserves.

2. This report sets out the Treasury's understanding of how the new regime will operate and the associated economic and financial implications.

Background

3. In March 2004 Cabinet agreed to provide the Reserve Bank with additional resources to enable it to intervene in the foreign exchange market for the purpose of seeking to reduce the peaks and troughs in the exchange rate cycle, in circumstances where the exchange rate has gone well beyond the levels justified by economic fundamentals.

4. You also agreed that the Bank's foreign exchange reserves held for the purpose of intervening to stabilise the foreign exchange market in periods of market dysfunction be increased by around NZD1.9 billion to a level equivalent to SDR2.45 billion.

5. The Reserve Bank's proposal is to modify the current approach to managing foreign exchange risks associated with foreign reserves held for both insurance and stabilisation purposes. There are two parts to the new strategy:

   - To manage a portion of its foreign reserve assets to a benchmark net open foreign exchange position; and

   - To vary the aggregate level of unhedged reserves with the exchange rate cycle in a way that helps to smooth the peaks and troughs of exchange rate cycle.

6. The Reserve Bank has also reviewed its approach to financing foreign reserves and has decided to move to using its own resources to fund foreign reserves, rather than using foreign currency loans from the government through NZDMO. This approach provides the Bank with greater flexibility in the management of reserves and leads to more efficient use of existing resources.

7. The level of foreign reserve assets held by the Bank is agreed by you pursuant to section 24 of the Reserve Bank Act. Legal advice is that the definition of "foreign reserves" currently applied is too narrow. The level of foreign reserves approved by you should include all foreign currency assets held by the Bank, rather than only those held for crisis intervention purposes.

Analysis

Hedged and unhedged foreign reserves

8. The government has two ways of financing reserves: it can borrow in the foreign currencies we hold reserves in, thus hedging against the risk of exchange rate movements; or it can borrow in New Zealand dollars (eg by issuing debt) resulting in an unhedged or open position (we use the two terms interchangeably). With an open

position exchange rate movements lead to changes in the value of foreign reserve assets, exposing the government to the risk of financial gains or losses.

9. The current approach is to hedge the exchange rate exposures of foreign reserves, so that most of the time our foreign currency assets are matched with liabilities in the same currency. The cost of holding foreign reserves in this case is the interest cost associated with servicing the borrowing. Over recent years the costs of holding reserves have been relatively low (around $2.6 million per year), and in 2005/06 a net return of $20 million was recorded.

10. The primary motivation for holding reserves is to provide a form of insurance in the event that the foreign exchange market becomes dysfunctional (eg participants stop offering two way bid/sell quotes). When a dysfunctional market causes the New Zealand dollar to fall to very low levels there are likely to be advantages from having some portion of the reserves in an unhedged position.

11. With hedged reserves, selling foreign currency assets to support a failing market leads to a position where the Bank's net foreign currency liabilities exceed its foreign currency assets. In some circumstances the Reserve Bank may be required to repay its foreign currency loans and, if the exchange rate has fallen from the intervention level, it may realise a loss.

12. With unhedged reserves, the risk of financial losses can be reduced. From a position where foreign currency assets exceed matched liabilities, the Reserve Bank's actions to sell foreign currency would reduce its foreign currency exposures, and may lead to realised profits. This approach to financing reserves is common practice in other countries.

13. Table 1 below provides a scenario to illustrate how financial risks may be reduced in a crisis. The table uses the SDR[1] limits proposed by the Bank. They are defined in foreign currency as this determines the Bank's ability to buy New Zealand dollars in an emergency. The NZD implications in the table are particular to the exchange rate assumptions noted below.

Table 1

[deleted]

[1] SDR (Special Drawing Right) is the IMF unit of account. The SDR value is based on a weighted basket of countries (US dollar, euro, yen and pound sterling).

14. Maintaining an open position is likely to lead to higher costs and greater volatility in managing the Bank's foreign exchange exposures. The Reserve Bank estimates the additional cost to be around **[deleted]** per annum when it is at the benchmark position. The primary driver of this cost is the higher interest cost associated with borrowing in domestic currency rather than foreign currency. Should the difference between domestic and foreign borrowing costs reduce, the additional cost will also reduce.

15. The foreign currency risk that the Bank takes on will be reflected in movements in its equity position. The Reserve Bank has equity of $1.4 billion and judges this to be sufficient to manage the financial risks associated with the new operating regime.

Varying the level of unhedged reserves

16. The Governor proposes a higher limit on the size of unhedged positions that might be held by the Bank. In 2004 the limit was set at SDR **[deleted]** (equivalent to NZD **[deleted]** at current exchange rates of NZD/SDR=0.50). The proposed limit is SDR **[deleted]** (around NZD [deleted] at current exchange rates), this being the existing capacity with the addition of the proposed **[deleted]** open FX benchmark.

17. Initially the Bank will be looking to build an open position up to the benchmark. The Governor will exercise his discretion in determining how this is best done – he may seek to smooth the peak of the exchange rate cycle, but this would not necessarily be the case.

18. The Reserve Bank would move away from the benchmark at times it considered intervention could help smooth the peaks and troughs of the exchange rate cycle. The existing criteria for intervention would continue to be used as guidelines, but the Reserve Bank would not necessarily meet all the criteria before intervening. The Reserve Bank states that "in general, we will require at least the exceptional and unjustified criteria to be met before moving the Bank's open FX position away from benchmark".

19. The other criteria in the existing intervention policy are that: market conditions are opportune for intervention to impact the exchange rate; that intervention will in all cases be consistent with the Policy Targets Agreement; and that interventions will not attempt to shift the long-term trend of the exchange rate. A copy of the existing guidelines are attached.

20. Following intervention, the Reserve Bank will look for opportunities to move back towards its benchmark open position and rebuild its capacity. Usually this would be done in a way that did not aim to move the market. The aim would be to restore the **[deleted]** capacity from either above if intervening at the peak, or from below if intervening at the trough. Given the unpredictable and volatile nature of the exchange rate it is not possible to say how long the Bank would be away from the benchmark, but it could be so for extended periods.

21. In circumstances when the Reserve Bank had reached the maximum open position at the top of the exchange rate cycle the Governor would seek your agreement before exceeding the limit, as is the case now. At the bottom of the exchange rate cycle, should the Reserve Bank have completely closed its open position, your agreement to sell the hedged reserves will be required. The agreed minimum of hedged foreign reserves SDR **[deleted]** will be available in this circumstance. As above, exceeding that limit requires your agreement.

Financial Implications

22. The Reserve Bank reports estimates of peak mark to market losses of around **[deleted]** with a level of unhedged reserves at the maximum of **[deleted]**. They assess the Bank's existing capital to be sufficient to manage these additional financial risks. The Treasury agrees with the Bank's assessment.

23. Our expectation is that the Bank's proposed approach will, over time, result in reduced costs of holding reserves, and be reflected in higher dividends on average (although special dividends will likely be lumpy) paid to the government.

Reporting and disclosure

24. The Bank provides details of the structure and currency composition of its assets and liabilities to Treasury at the end of each month. These details are included in the government's consolidated financial statements, which are published monthly, and are also published on the Reserve Bank's website.

25. The Reserve Bank also publish a separate data set on the level of our foreign reserves in accordance with the IMF's Special Data Dissemination Standard (SDDS).

26. Changes in financial positions arising from intervention and the consequence of those positions for profit and loss (realised and unrealised) will therefore appear in the public domain within a few weeks of the end of the month.

27. Information on open FX positions in the government's financial statements includes the positions held by other entities. Crown Financial Institutions including the New Zealand Superannuation Fund, ACC and the EQC also maintain open foreign currency positions. The 2004 change to the Reserve Bank's intervention policy also changed the government's policy to maintain net zero foreign currency exposures in its core balance sheet.

28. Such arrangements are fully consistent with the principles of transparent public policy. But there are awkward features of complete transparency in the context of foreign exchange market intervention. In particular, if the market is aware of the limits of the Bank's intervention reserves and where the Bank is relative to this limit, the effectiveness of the intervention policy might be reduced. It is also possible that undesirable exchange rate speculation is attracted.

29. This tension points to a preference for not extending disclosure beyond that currently required by standard practice, and keeping private any net open foreign exchange position limits agreed within the context of a Memorandum or S.17 directive. Although subject to Official Information Act enquiries as to the limit of the intervention capacity and where the Bank is relative to this limit, it would be prudent to withhold disclosure on grounds of protecting commercial interests and ensuring the effectiveness of the intervention policy.

30. A contingent liability or `fiscal risk' is noted, but not quantified, in the government's accounts.

Other financial impacts

31. The proposal to substitute government (DMO) funding of foreign reserves with funding from the Bank's own resources tends over time to reduce the government's borrowing requirements and lowers the projected path of gross sovereign issued debt. There are however no significant immediate impacts on gross debt – the 2007 BEFU forecasts

already incorporate a large proportion of the immediate impacts of these changes, and some of the impacts will only be fully realised over the very long term, out to around 2017.

32. The increased volatility associated with valuation movements in the open foreign exchange position will impact on the government's operating balance. These movements will likely be a small proportion of the total operating balance flows. At times there will be a tendency for the valuation movements to offset rises or falls in the surplus, but this relationship will not be stable overtime. The OBERGAL removes the impact of changes in the value of foreign currency assets.

Legal Issues and Memorandum of Understanding

33. Work on this proposal has highlighted some shortcomings in the current statutory provisions determining the calculation of dividends payable by the Reserve Bank to the government. One issue concerns the volatility of the dividend when calculated under the current statutory formula. The Bank has a process in place to address this issue. Another issue is the absence of a statutory provision for the payment of a "special dividend" should the Bank realise gains from its intervention activities. Changes to the Funding Agreement could be made to address this issue, but in the longer term changes to the Act are seen as desirable.

34. A further issue concerns the definition of foreign reserves that has been adopted under the Act. Section 24 of the Reserve Bank Act requires the Minister of Finance to determine the level of foreign reserves that the Bank holds. Legal advice has clarified that "foreign reserves" includes all foreign currency assets held by the Bank. Currently, only those reserves held for intervention purposes are covered in the Memorandum dated 25 March 2004. When all foreign currency assets are included in the definition the level of foreign reserves held by the Bank is significantly increased.

35. The Reserve Bank recommends that you sign a revised Memorandum agreeing that Reserve Bank will hold a minimum SDR **[deleted]** and a maximum SDR **[deleted]** of foreign currency assets (NZD **[deleted]** – NZD **[deleted]** at current NZD/SDR exchange rate of 0.50). The proposed range allows for the substantial level and variability of the Bank's operations in the foreign exchange market as part of its domestic liquidity management responsibilities. No change to the minimum level of holdings (SDR **[deleted]**) is proposed. The Treasury supports this recommendation.

36. Longer-term, the Reserve Bank considers it appropriate that section 24 of the Act be amended to more clearly reflect the interpretation that has traditionally been applied, that is, to determine the level of foreign reserves held for intervention in a crises.

37. The proposed Reserve Bank Amendment Bill [EDC Min (07) 11/14 refers], which is proceeding as part of the Review of Financial Products and Providers, may be a suitable legislative vehicle to address the issues identified above.

Communication

38. The Reserve Bank intends to announce agreed changes to the management of foreign reserves, and to publish their report to you.

39. The Treasury seeks your agreement to release this report, subject to the need to maintain a high degree of confidentiality on the operating details. We will confirm the details of any release with your Press Secretary and the Reserve Bank.