30 March 2004

Hon Dr Michael Cullen
Minister of Finance
Parliament Buildings
WELLINGTON

Dear Dr Cullen

FOREIGN EXCHANGE MARKET INTERVENTION POLICY UNDER SECTION 16 OF THE RESERVE BANK OF NEW ZEALAND ACT 1989

The Reserve Bank has been provided with the financial capacity necessary to undertake foreign exchange market interventions designed to influence the level of the exchange rate. The Bank has operational independence, under section 16 of the Reserve Bank of New Zealand Act 1989 (the Act), to intervene in the foreign exchange market. This letter sets out the parameters within which those decisions will be taken, and the associated reporting and accountability arrangements.

1 Policy objectives

(a) Foreign exchange intervention under section 16 of the Act is for the purpose of influencing the level of the exchange rate to reduce exchange rate variability when the exchange rate is exceptionally high or low, consistent with section 8 of the Act, as expressed through the Policy Targets Agreement (PTA), and with such other of the Bank’s functions and obligations under the Act as may be appropriate.

(b) (Foreign exchange intervention under section 17 of the Act, for the purpose of restoring liquidity in a period of foreign exchange market dysfunction, is treated separately in a standing directive from the Minister of Finance.)

2 Parameters for the decision to intervene

(a) Interventions should normally only occur when the exchange rate is exceptionally high or low – and when, in the Bank’s assessment, that level is clearly unjustified by economic fundamentals.

(b) Interventions will not attempt to influence the long-term trend of the exchange rate.

(c) Interventions will in all cases be consistent with the PTA.

(d) The Bank will intervene only when it assesses that there is a material prospect of influencing the exchange rate, and in ways that
seek to avoid destabilising speculation.

(e) We undertake that accumulated open foreign exchange positions under section 16 of the Act will be limited to an amount advised to the Minister of Finance. This limit may be revisited, as required, from time to time.

3 Financial and balance sheet implications

(a) Over the medium-term, the Bank would aim to maintain, on average, a net zero open foreign exchange position. (Foreign exchange transactions by the Bank to close out open positions will in general take place when the exchange rate is no longer at exceptional levels, and in a manner designed to avoid influencing the exchange rate, where practicable.)

(b) Gains and losses associated with revaluations of accumulated open foreign exchange positions will impact the Reserve Bank’s net income and hence its capital.

4 Reporting, risk management and accountability

(a) Holdings of foreign currency reserves, open foreign exchange positions, and associated gains and losses (whether realised or unrealised) will be reported regularly in accordance with the Act, the Public Finance Act, and New Zealand Generally Accepted Accounting Practice.

(b) The Bank will maintain risk management systems so as to reliably identify, measure, monitor and control, to the extent practicable, all risks associated with its intervention activities.

(c) The Bank will be held to account against the principles established in this letter and will make available such information as is required to ensure that accountability. However, it is understood that foreign exchange interventions of the kind proposed are likely to have only a relatively small effect on the exchange rate cycle – an effect that may be difficult to measure – and that opportunities to have the desired effect may not always be available.

(d) Full explanation of the Bank’s foreign exchange market interventions under section 16 of the Act will be provided as part of the Bank’s normal reporting practices.

Yours sincerely

Alan Bollard
Governor