Supporting Paper A9
Foreign exchange intervention

The Reserve Bank has long been responsible for being prepared to undertake intervention in the foreign exchange market in crisis conditions, when there is extreme disorder in the foreign exchange market, to help maintain a functioning market. We hold substantial foreign exchange reserves as a precaution against this sort of low-probability high-impact event. At times, liquidity in the foreign exchange market has come under stress, but we have not had to undertake such intervention in the 22 years since the New Zealand dollar was floated. Intervention of this sort is undertaken on behalf of the Government, and all financial gains and losses accrue to the Crown (sections 17 and 21 of the Reserve Bank Act).

Following the float of the New Zealand dollar in 1985, the Reserve Bank's policy was not to intervene in the exchange rate for monetary policy purposes. However, over a period of several years, dating back to the mid-1990s, the Reserve Bank had been reassessing its position as to whether foreign exchange intervention might also be a useful option to have in the toolkit in periods of extreme over or undervaluation of the New Zealand dollar, to support monetary policy. The Reserve Bank of Australia's policy and practices in this area had been particularly influential in shaping our thinking.

The value of the real exchange rate over the medium to long run is determined by real economic fundamentals, over which monetary policy cannot have much influence. Over shorter time frames, cycles in the exchange rate can be quite marked and troublesome. Although floating exchange rates tend to move in the broad direction suggested by fundamentals, they are prone to overshooting. That is, exchange rates can and often do move well above (and well below) what the medium-term fundamentals would warrant. Even what might appear to be quite large shocks – such as the current sharp rise in dairy prices – do not tend to lift estimates of the sustainable medium-term exchange rate by very much.

Exchange rate overshoots can obviously have real consequences, especially in periods when excess demand pressures, which are often the trigger for a sharp rise in the exchange rate, have their roots in the domestic economy rather than in the export sector.

In 2004, the Minister of Finance endorsed a new policy under which the Reserve Bank would have the capacity to use foreign exchange intervention, in relatively rare circumstances, to influence the level of the exchange rate. The new approach allowed for intervention to take place at the extremes of the exchange rate cycle, when the Reserve Bank judges that the exchange rate is at levels unjustified by medium-term economic fundamentals. All interventions must be consistent with the Policy Targets Agreement, in the sense that intervention must not threaten the achievement of the medium-term inflation target.

Foreign exchange intervention provides the Reserve Bank with an additional supplementary monetary policy tool. The Official Cash Rate (OCR) is the primary instrument, but in some circumstances, foreign exchange intervention can be a useful, but distinctly secondary, supplementary tool. By taking advantage of periodic opportune conditions in the market, and by sowing additional seeds of doubt among some participants in the market, intervention may at times help trim the peaks and troughs of the exchange rate cycle. The intervention framework is consistent with the requirement on the Reserve Bank, in the Policy Targets Agreement, to seek to avoid unnecessary instability in, inter alia, the exchange rate. Of course, any sustained effects are likely to be difficult to measure, partly because one can never know with certainty what would have happened in the absence of the intervention.

Foreign exchange intervention for monetary policy purposes is undertaken at the Reserve Bank's own financial risk. The size of any positions the Reserve Bank takes is disclosed in tables published on our website around the end of the month following the intervention. Because of the relatively demanding criteria for intervening, and because the Reserve Bank is able to hold its position for prolonged periods (unlike most speculative market players), we would expect intervention to be profitable even if it had only limited influence on the exchange rate itself.

Until June this year, the Reserve Bank had not used these new intervention powers, even though for much of the period since early 2004 the exchange rate has been exceptionally high by historical standards. The threshold for intervention explicitly designed to influence the exchange rate had deliberately been set quite high. In June, however, with the exchange rate moving towards post-float highs, the Reserve Bank judged that all the criteria had been met and intervention occurred. The intervention led to an immediate fall in the exchange rate. But the main objective was to send a strong signal that, in the Reserve Bank's view, the level of the exchange rate was out of line with the medium-term economic fundamentals. By creating some additional uncertainty, about the possibility of the Reserve Bank being active in the market selling the New Zealand dollar, we hoped that those speculating in the New Zealand dollar would put more weight on the idea that the exchange rate is not necessarily a one-way bet.

In July 2007, after a long-running review of the Reserve Bank's balance sheet management, undertaken to ensure that our practices and procedures were best-suited to meet our diverse policy responsibilities, some further modifications were announced.

With the endorsement of the Minister of Finance, the Reserve Bank's guidelines for operating in the foreign exchange market have been modified. Intervention intended to affect the exchange rate directly may still occur from time to time, but is likely to remain quite a rare event. However, in addition, the Reserve Bank will now be able to accumulate or reduce foreign exchange positions when the exchange rate is at extreme levels and unjustified by medium-term economic fundamentals. Such transactions will not necessarily be expected to affect the exchange rate. However, they will allow the Reserve Bank to give concrete signals regarding the extent to which the exchange rate is seen as being over or under valued and, hence, at unsustainable levels. Such positions could also be expected to be profitable over time. The overall scale of our ability to alter our foreign exchange position (adding to our reserves when the currency is strong, and running them down when it is weak) is not publicly disclosed but is the subject of an agreement with the Minister of Finance.

Overall, we believe that these foreign exchange guidelines provide us with a flexible instrument to help supplement the OCR in conducting monetary policy. But foreign exchange intervention is no panacea.

As part of the July package, it was also announced that, in future, we will hold some portion of our foreign reserves outright. For the last 20 years or so, the Reserve Bank's foreign currency assets have been fully matched by foreign currency liabilities. That was an unusual approach by international standards and we are now moving in the direction of a more internationally conventional approach. This approach will be somewhat more costly, but should leave us better-positioned to cope with the risks associated with severe foreign exchange crises. In crises of that sort, access to borrowed funds can be jeopardised precisely at the time when certainty about ongoing access to funds is paramount.