

**Commercial: Sensitive**

25 March 2004

## **MEMORANDUM TO THE MINISTER OF FINANCE**

### **Foreign exchange intervention: Proposed amendment to the Reserve Bank Funding Agreement and related matters**

#### **Introduction**

1. Further to the Reserve Bank of New Zealand's (the Bank's) memorandum to you of 9 February 2004 and 1 March 2004, and the paper you sent to Cabinet for its consideration on 22 March 2004, this memorandum seeks your agreement to the proposed increase in foreign reserve assets and the amendment to the Bank's Funding Agreement. It also seeks your agreement to give the Bank a standing direction to intervene in the foreign exchange market in periods of market dysfunction, up to a maximum amount without the need for further approval.
2. Three documents are attached to this memorandum:
  - a letter from me to you, setting out the agreed foreign exchange intervention objectives and principles;
  - a memorandum from you to the Bank that we have prepared, for your signature, reconfirming the existing standing directive under section 17 of the Reserve Bank of New Zealand Act 1989 (the Act) giving the Bank the authority to intervene in the foreign exchange market up to a specified amount without further authority from you; and
  - the proposed variation to the Funding Agreement for your signature (and subsequent tabling in Parliament).

#### **Increase in foreign exchange reserves**

3. In the Bank's memoranda of 9 February and 1 March, the Bank requested that it be given access to an additional NZ\$1.9 billion of foreign reserve assets for the purposes of intervening to combat dysfunction in the foreign exchange market. It was agreed

that the reserves would be increased progressively over the next four years, as market conditions permit and as the Crown's debt programme allows. At current exchange rates, this would increase the Bank's total crisis intervention capacity to around NZ\$7 billion (including reserves held by Treasury and with the IMF). At current exchange rates, this implies that the Bank should work towards maintaining a new minimum intervention capacity of equivalent to a value of 2.45 billion Special Drawing Rights (SDR) over the next four years, in addition to the reserves held by Treasury and with the IMF.<sup>1</sup>

4. In addition, the Bank requested that it be given sufficient scope to intervene in the foreign exchange market for the purpose of reducing exchange rate variability, where the exchange rate is exceptionally and unjustifiably high or low. We requested the ability to hold [ ] of reserve assets beyond those required for combating market dysfunction, this being the maximum net open foreign currency position recommended by the Bank in its memorandum of 1 March. These additional intervention reserves equate to [ ] at the current exchange rate.
5. I recommend that you agree, pursuant to section 24 of the Act, that the Bank's foreign reserve assets be increased to a level equivalent to SDR2.45 billion (in addition to the reserves held by Treasury and with the IMF) and that it have the additional capacity to acquire foreign reserve assets [ ].
6. It should be noted that exchange rate fluctuations mean that the actual value of reserve assets the Bank holds can change even if the Bank has not changed its actual holdings of reserves. To simplify the measurement and monitoring of our compliance with the intervention capacity recommended in this memorandum, the Bank will ensure its compliance with the reserves determination under section 24 of the Act each time the Bank undertakes a new loan or refinances an existing loan invested in foreign reserve assets.
7. [ ]

### **Funding Agreement**

8. In its earlier memoranda to you, the Bank indicated that the Bank's Funding Agreement will need to be amended to ensure that marked-to-market losses incurred by the Bank on any open foreign exchange positions will not be treated as expenditure within the terms of the Funding Agreement. We have prepared an amendment to the Funding Agreement to achieve this outcome, pursuant to section 159(3) of the Act. The principal amendment is a deletion from the Funding Agreement of expenditure related to section 16 activities conducted by the Bank. On this basis, the Bank's allowable funding to meet its expenditure will not include expenditure in connection with any section 16 activities, including any market losses incurred as a result of net open currency positions resulting from intervention under

---

<sup>1</sup> The NZD/SDR exchange rate used for the calculation in this paper is 0.4428.

section 16 of the Act. However, it should be noted that the Bank's statement of financial performance will include any market gains or losses, and the Bank will remain fully accountable for the management of currency positions and other aspects of its intervention activities.

9. The amendment (which I have signed) is attached for your signature. It will require ratification in the House within 12 sitting days after having been signed, pursuant to section 161 of the Act. The amendment to the Funding Agreement has been drafted to come into effect from the date on which it is ratified by Parliament and to apply for the remainder of the current financial year and the year to 30 June 2005. A new Funding Agreement will need to be entered into (on schedule) next year, to take effect from 1 July 2005 for the following five years.
10. The amendment to the Funding Agreement does not alter the agreed level of funding available to the Bank to meet its operational needs. The allowable expenditure remains \$31 million for the year to 30 June 2004 and \$33 million for the year to 30 June 2005.
11. Gains and losses associated with intervention under section 16 of the Act will accrue to the Bank and will not be eligible for payment to the Crown by way of dividend.

#### **Letter confirming foreign exchange intervention arrangements**

12. It was agreed in earlier correspondence with you, and in the memorandum to Cabinet, that I would set out the agreed foreign exchange intervention objectives and reporting and accountability arrangements in respect of intervention under section 16 of the Act. The letter is attached in draft form. I propose to release the letter publicly in the next few days, probably on the same day as you issue your press statement announcing Cabinet's decisions in relation to the foreign exchange arrangements.

#### **Direction under section 17 of the Act**

13. In our memoranda to you, we have noted that foreign exchange intervention to stabilise the market in a period of market dysfunction would generally occur under a direction from the Minister of Finance, at the request of the Bank, pursuant to section 17 of the Act. Since 1990, the Bank has had a standing direction from the Minister of Finance, authorising the Bank to intervene in such circumstances up to US\$250 million without the need for further authority from the Minister. In light of the current changes to the intervention arrangements, we would like this direction re-confirmed by you, as Minister of Finance, with a slight modification to the intervention amount (expressed in SDR and set at SDR175 million, which is approximately US\$260 million at current exchange rates).

14. A memorandum containing the proposed standing direction under section 17 is attached for your signature.

### **Consultation**

15. We have consulted Treasury on this memorandum, including the proposed amendment to the Funding Agreement, the letter setting out the foreign exchange intervention objectives and principles, and the memorandum containing the section 17 direction. The Treasury supports the recommendations made in this memorandum and the attachments to it.

### **Recommendations**

I recommend that you:

- (a) **agree**, pursuant to section 24 of the Act, 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 to a level equivalent to SDR2.45 billion, with the increase occurring over the next four years at times mutually agreed between the Bank and Treasury;
- (b) **agree**, pursuant to section 24 of the Act, that the Bank have the capacity to acquire foreign reserve assets up to a further [ ] (at current exchange rates), for the purpose of intervening in the foreign exchange market to reduce exchange rate variability, subject to the Bank's net open foreign currency position not exceeding [ ];
- (c) **sign** the attached variation to the Bank's Funding Agreement, pursuant to section 159(3) of the Act, and **agree** to arrange for the Funding Agreement variation to be ratified in Parliament within 12 sitting days of your signing it, pursuant to section 161 of the Act;
- (d) **sign** the attached memorandum directing the Bank to intervene in the foreign exchange market, pursuant to section 17 of the Act, up to an amount equivalent to SDR175 million, without the need for any further direction from you, in circumstances where the Bank is satisfied that such intervention is necessary in order to stabilise the market in a period of market dysfunction; and
- (e) **note** my letter to you, attached, setting out the foreign exchange intervention objectives and arrangements, and **note** my intention to sign and publicly release this letter in the near future.

Alan Bollard  
Governor

Recommendations agreed

Hon Dr Michael Cullen  
Minister of Finance