

Commercial: Sensitive

17 March 2004

Memorandum to the Minister of Finance

Proposed broadening of foreign exchange intervention capacity - Memorandum to Cabinet

Introduction

1. Attached is a paper for Cabinet on the proposed broadening of the Reserve Bank's foreign exchange intervention capacity. It is proposed that the paper be submitted to Cabinet for consideration at its meeting on 22 March.

Comment

2. The memorandum to Cabinet sets out the rationale for the proposed widening of the Bank's foreign exchange intervention capacity and asks Cabinet to note the key elements required to give effect to the proposal and agree to the additional capital being requested by the Bank. In particular, the memorandum asks Cabinet to:
 - note that the Bank has requested an increase in its holding of foreign exchange reserves for existing intervention purposes (of stabilising the foreign exchange market) of approximately \$1.9 billion and that you plan to agree to that increase;
 - note that the Bank has indicated it will require additional foreign exchange reserves of [] for the new intervention objective of reducing the variability in the exchange rate, and that you plan to agree to that increase, provided that Cabinet agrees to the increase in the Bank's equity by \$1 billion;
 - agree to an increase in the Reserve Bank's equity of \$1 billion, which will require an appropriation from Parliament at the time of the Budget;
 - note that, if the Bank needs to intervene in the foreign exchange market before the increase in its equity has been effected, you would agree to give the Bank an indemnity from the Crown to cover currency losses over that period; and

- note that the Bank's Funding Agreement will need to be amended to make it clear that marked-to-market losses are not included in the allowable expenditure required by the Bank for operational purposes, that you plan to agree to this amendment later this month, and that it will need to be ratified in the House.
3. The dollar figures for increases in foreign reserves are expressed in NZ dollars. The actual NZ dollar value of the increases in reserves may vary depending on exchange rate movements between now and the time that the increases are implemented.
 4. The memorandum to Cabinet sets out the intended process for implementing the new intervention arrangements, based on the timetable given to us by your office. On this basis, we plan to submit to you later this month the proposed amendment to the Bank's Funding Agreement, the letter setting out the policy framework for the new intervention arrangements, and the specific recommendations for the increases in reserves.
 5. The Treasury has been consulted on this memorandum and the attached paper to Cabinet, and supports both papers.

Recommendation

I recommend that you:

- (a) **sign** the attached memorandum to Cabinet, and **agree** that it be submitted to Cabinet for consideration at its meeting on 22 March;
- (b) **note** that the Bank will revert to you later this month with a proposed letter setting out the intended objectives and framework for foreign exchange intervention, the proposed amendment to the Funding Agreement, and a formal request for the increase in the Bank's foreign exchange reserves; and
- (c) **note** that, if the Bank needs to intervene for the purpose of influencing the level of the exchange rate before the injection of additional capital, we will request that you issue an indemnity to the Bank, pursuant to the Public Finance Act, to cover the Bank for all marked-to-market losses that it might incur as a result of intervening for the period up to the time of the capital injection.

Alan Bollard
Governor