

18 March 2004

MEMORANDUM FOR CABINET

Proposed broadening of foreign exchange intervention capacity

Proposal

1. This memorandum explains the proposal to give the Reserve Bank (the Bank) the capacity to intervene in the foreign exchange market for the purpose of seeking to reduce extreme highs and lows in the exchange rate where these well exceed economic fundamentals. It asks Cabinet to note my intention to approve an increase in the foreign exchange reserves the Bank holds for intervention purposes and seeks Cabinet's agreement to provide the Bank with additional capital to enable it to absorb the financial risks associated with foreign exchange intervention. The paper also notes that the Bank's Funding Agreement (between the Minister of Finance and the Governor of the Bank) will need to be amended and ratified in Parliament in the near future.

Executive Summary

2. It is proposed that the Reserve Bank be given the capacity 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. Enabling the Bank to intervene in the foreign exchange market for this purpose will provide potential net benefits for the economy, by giving greater scope for the Bank to reduce uncertainty for the export sector and reduce the economic costs associated with severely over-valued or under-valued exchange rates. The proposed intervention policy will also give the Bank more flexibility to operate monetary policy for the purpose of maintaining price stability, but in ways that reduce the adverse impact of monetary policy on the wider economy. The paper also notes that intervention of the sort proposed brings the exchange rate arrangements closer to those of Australia.

3. Intervention in the foreign exchange market will entail financial and other risks, which will need to be prudently managed. In particular, foreign exchange intervention can expose the Reserve Bank to potentially very large currency losses, though generally of an unrealised and non-permanent nature. In the medium-term, however, I am advised that intervention is likely to be of low-cost or moderately profitable.
4. This paper seeks Cabinet's agreement to an increase in the Reserve Bank's capital of \$1 billion, to absorb any losses that may occur as a result of foreign exchange intervention. This will require an appropriation from Parliament in this year's Budget process. The paper asks Cabinet to note that, subject to Cabinet's agreement to the increase in the Bank's capital, I plan to approve an increase in the level of the Reserve Bank's foreign exchange reserves of [] to enable the Bank to intervene for the purpose of the new intervention policy. In addition, I ask Cabinet to note that I intend to approve an increase in the Bank's foreign exchange reserves by approximately \$1.9 billion to enhance the Bank's capacity to intervene to stabilise the foreign exchange market in periods of market dysfunction (ie the intervention objective that has been in place since 1985). The paper also asks Cabinet to note that I plan to agree to an amended Funding Agreement for the Bank (which sets out the Bank's permitted operational expenditure) as a consequence of the new intervention capacity, and that, under the Reserve Bank of New Zealand Act, the Funding Agreement will need to be ratified in Parliament.

Background

5. The Reserve Bank of New Zealand Act requires the Minister of Finance, in consultation with the Governor of the Reserve Bank, to determine the level of foreign exchange reserves to be held by the Bank for the purposes of enabling the Bank to exercise its powers under the Act. These powers include the ability of the Bank to intervene in the foreign exchange market.
6. Earlier this year, the Bank advised me that it would be desirable to increase the level of foreign reserves, for two purposes. First, work undertaken by the Bank demonstrates that the amount of reserves it holds currently for the purpose of stabilising the foreign exchange market in situations of extreme disorder may not be adequate.
7. Second, the Bank has also been assessing the benefits and risks of widening its foreign exchange intervention policy to seek to reduce the peaks and troughs in the exchange rate cycle. The Bank has advised me that intervening to reduce the extremes in the exchange rate cycle offers potential net benefits to the economy. In order to have the capacity to intervene for this purpose, the Bank would at times require additional foreign exchange reserves, beyond the level required for the purpose of stabilising the foreign exchange market in periods of extreme disorder. It

has also requested an increase in its capital, so as to be able to absorb potentially large, but unrealised and temporary, currency losses.

Comment

8. Since 1985, New Zealand has operated a free floating exchange rate, where the price of the New Zealand dollar relative to other currencies is set in the market by demand and supply conditions. In that period, the Bank has not intervened in the foreign exchange market to influence the level of the dollar – ie the Bank has not bought or sold currencies for the purpose of directly influencing the level of the exchange rate.
9. Reflecting this, the Bank does not hold foreign currency reserves for the purpose of influencing the level of the exchange rate. Its holding of reserves is for the sole purpose of intervening in periods of extreme market disorder, to restore stability to the foreign exchange market.
10. In most respects, the floating exchange rate has served New Zealand's interests very well. It has provided a cushion against external shocks and a basis for stronger and more sustained economic growth. The adoption of a floating exchange rate has also avoided the fiscal risks associated with maintaining a pegged or actively managed exchange rate. However, over the period since 1985, there have been periods when the exchange rate has moved to extreme highs and lows, beyond the levels justified by economic fundamentals. In these situations, the currency poses risks for the economy, including the potential for an over-valued exchange rate to reduce economic output below its potential, and for an under-valued exchange rate to cause the economy to overheat. Exchange rate misalignment of this nature also has the potential to induce a misallocation of resources within the economy, to the detriment of longer term growth prospects. In extreme circumstances, very large swings in the exchange rate can pose risks to the stability of the financial system.
11. Earlier this year, I sought advice from the Reserve Bank and Treasury on exchange rate volatility and the options for dealing with it. The Bank had independently been considering these issues for some years, as indicated in previous briefing material issued by the Bank. The Bank and Treasury have advised me that, in their judgement, and drawing on international practice, there is a case, in limited circumstances, for intervening in the foreign exchange market to reduce the extremes in the exchange rate cycle, where the exchange rate has moved well beyond levels justified by economic fundamentals. Such intervention offers the potential to reduce cyclical pressure on the economy and would provide the Bank with another tool with which to pursue its monetary policy objective of price stability.
12. It is important to note that foreign exchange intervention of this nature would not alter the basic exchange rate cycle; nor would it seek to do so, given that, for the most part, cyclical variation in the exchange rate is unavoidable and often beneficial to the economy. The most that exchange rate intervention could achieve would be to reduce

the peaks and troughs in the exchange rate cycle to a modest, though not insignificant, degree. Although the immediate effects of intervention on the exchange rate are likely to be relatively small, intervention has the potential, if conducted effectively, to influence market sentiment and dynamics, and thereby potentially play a “circuit breaker” role in slowing or even turning around a rising or falling exchange rate in periods where the exchange rate has well exceeded fundamentals. To the extent that intervention succeeds in trimming the peaks or troughs from the exchange rate, it can help to reduce uncertainty in the external sector of the economy, including the risk of reduced export activity.

13. The approach being suggested by the Bank is similar to the foreign exchange intervention that has been conducted by the Reserve Bank of Australia for a number of years, where intervention is part of the overall monetary policy toolkit and where it seeks to take the edges off exchange rate cycles. It is important to note that the proposed intervention is not in any way similar to that associated with Japan or other countries that seek to alter the underlying exchange rate cycle.
14. Intervention is an additional instrument to help the Bank to reduce excessive variability in the exchange rate in ways that are consistent with the pursuit of its price stability objective and with its obligations under the Policy Targets Agreement.
15. The proposed change to intervention policy does not alter the monetary policy framework and will not require an amendment to the Policy Targets Agreement.
16. Although intervention has the potential to bring a number of benefits, it also carries a number of risks, which will have to be well managed. For example:
 - The Bank is likely to incur unrealised losses on open currency positions, potentially very substantial, and possibly for sustained periods during parts of the exchange rate cycle. However, the Bank advises that, over the medium term, intervention should be low-cost and might be profitable, such that unrealised losses are reversed in time.
 - In disclosing its currency positions, the Bank would need to manage the reputation risks associated with announcing unrealised losses, potentially of a large magnitude. The Bank will also need to manage the reputation risks associated with the difficulty in demonstrating the effectiveness of intervention.
 - There is a risk that exporters, among others, may misunderstand the policy intention of intervention and wrongly assume that the Bank will be targeting or defending a particular exchange rate. The Bank has already sought to avoid this risk by making it very clear in its public statements what the objectives of intervention are and what the policy is not seeking to achieve. It will continue to articulate the policy so as to minimise the risk of false expectations being created.

- It is possible that the intervention policy might reduce the incentives for exporters and importers to manage their currency risks by maintaining appropriate exchange rate hedges. I am advised by the Bank that they believe this risk can be minimised effectively by articulating clearly what the intervention policy is seeking to achieve and by making it clear that exporters and importers will continue to have full responsibility for managing their currency risks.
17. The Bank is currently developing the structures and policies to enable it to manage these risks to the extent practicable. It expects to have the appropriate structures in place in the near future, enabling the Bank to become fully operational under the new policy framework. However, if it proved to be necessary, the Bank could operationalise the new intervention policy now, using interim risk management arrangements. In that regard, the Bank has had a long established practice of maintaining the technical capacity and systems to intervene in the foreign exchange market and will be further enhancing this capacity in light of the new policy. It should also be noted that the Reserve Bank Board has responsibility for satisfying itself that the Bank has the structures and systems required to implement the new intervention policy effectively and prudently.
18. Although intervention could be undertaken by either the Bank or Treasury, it is preferable for the Bank to undertake it, given that intervention directly complements the Bank's monetary policy role and its financial stability functions. Moreover, the Reserve Bank of New Zealand Act already makes provision for the Bank to intervene in the foreign exchange market. Under the Act, intervention can occur either at the direction of the Minister of Finance or at the discretion of the Bank under its own powers to deal in foreign exchange. My preference, and that of the Bank and Treasury, is for intervention to occur at the Bank's own discretion, using its powers under the Act, but within broad parameters agreed with me. This has a number of benefits. In particular, it enables the Bank to use foreign exchange intervention as a monetary policy tool to pursue its price stability objectives and to discharge its obligations under the Policy Targets Agreement in a manner consistent with the Bank's independence in implementing monetary policy. It is also consistent with ensuring that the Bank has the necessary accountability for its intervention decisions. And it minimises the risk of intervention being seen as a politically driven decision, and therefore reduces the risk of unfavourable reactions by investors and rating agencies, among others.
19. The Bank's intervention objectives, and the broad criteria for intervening, will be set out in a letter from the Governor to me, and made publicly available. This will provide clarity and transparency to the policy objectives for intervention, assist in managing public expectations as to what can and cannot be achieved with intervention, and provide an accountability structure for the Bank.

Financial Implications

20. The Bank has requested an increase in its existing foreign exchange reserves of around NZ\$1.9 billion to fund the purchase of additional reserves for the purpose of maintaining the capacity to intervene to stabilise the currency market in situations of extreme disorder (ie the intervention objective that has been in place since 1985). This would lift reserves for that purpose to approximately NZ\$7 billion (including reserves held by Treasury). It is intended that these reserves would not be used to intervene for the new purpose of reducing the peaks and troughs in the exchange rate cycle.
21. The Bank has stated that it would require [] in additional foreign exchange reserves to enable it to intervene for the new intervention objective of reducing variability in the exchange rate.
22. The increase in foreign reserves for market stabilisation purposes is likely to occur in phases over the next four years, although it could be brought forward if the need arises. The acquisition of [] of reserves for the new purpose of intervening to influence the level of the exchange rate []. The increase in reserves will add to gross sovereign debt, although the precise impact depends on when the Bank calls on the resources, and the detail of the transaction between the NZDMO and the Bank. However, the government's net debt position would be largely unchanged, as the borrowed funds are invested in foreign currency assets.
23. The Bank estimates the net costs of holding reserves is around \$800,000 per year for every billion dollars of reserves held. []
24. Given the potential for intervention to result in the Bank incurring temporary unrealised foreign exchange losses, the Bank has advised that it is seeking an increase in its capital by NZ\$1 billion to compensate for additional risks on its balance sheet associated with intervening in the foreign exchange market. The capital figure [] and is intended to enable the Bank to absorb currency losses in relatively extreme situations. The increase in capital would involve the government seeking an appropriation from Parliament in the Budget process later this year.
25. The increase in gross debt would reduce the extent that the Government is likely to over-achieve on its long-term debt objective of 30% of GDP, on average, over the economic cycle (assuming the DEFU forecasts as the base). The potential increases in gross debt would need to be taken into account in the review of the Government's debt objectives currently underway. It does not remove the possibility of looking to lower or reconfigure the long term debt objective but it could influence the specifics

(time horizon, gross or net debt target, etc). In addition, the increase would likely have implications for the short term fiscal intentions of having a stated bias for lowering rather than raising debt to GDP.

26. If the Bank sees a need to intervene in the market between now and the time when the new capital is injected, it would do so on the basis of an indemnity from the Crown, executed by me as Minister of Finance pursuant to the Public Finance Act.
27. The proposed intervention objective is unlikely to have a significant impact on the Bank's payment of dividends to the Crown over the medium term, but may result in greater year-to-year fluctuations in the Bank's profits and therefore in its dividend payments.

Parliamentary Implications

28. The Funding Agreement signed by the Governor of the Reserve Bank and me, under which the Bank's operational funding requirements are determined, will need to be amended to take into account the likelihood that the Bank may incur unrealised market losses on open currency positions from time to time. The amendments to the Funding Agreement will be designed to avoid a situation where such losses, if treated as expenditure under the Agreement, would result in the Bank inadvertently breaching the Agreement. On the Bank's and Treasury's advice, I am planning to sign a variation to the Funding Agreement later this month. The Reserve Bank of New Zealand Act requires the Funding Agreement to be ratified by the House.

Consultation

29. The Reserve Bank has consulted Treasury in the preparation of this paper. Treasury concurs with the analysis in the paper and supports its recommendations.

Future process and publicity

30. Following the Cabinet meeting on 22 March, and the Caucus briefing on 23 March, the Reserve Bank and Treasury will complete final preparations required for the intervention capacity to be established, including the preparation of an amendment to the Reserve Bank's Funding Agreement and completion of the letter from the Governor to me setting out the intervention framework. It is my intention to table the Funding Agreement in Parliament on 29 March and issue a press statement on that day. I envisage that the advice given to me by the Bank and Treasury will be released as a package at about the same time. I intend that the debate in the House on the Funding Agreement subject to other house business.

Conclusion

31. I believe that the proposed widening of the foreign exchange intervention objectives is very desirable. It will provide greater flexibility to enable the Reserve Bank to respond to extreme swings in the exchange rate and thereby reduce, albeit to a modest extent, the damage to the economy that can result from excessive peaks and troughs in the exchange rate cycle. Maintaining an intervention capacity along the lines proposed also brings the New Zealand exchange rate arrangements closer into line with those of similar advanced economies, including Australia.
32. In view of these benefits, and the manageable nature of most of the risks associated with the kind of intervention being contemplated, I am satisfied that the proposed increase in foreign exchange reserves, the increase in the Bank's capital and the amendment to the Bank's Funding Agreement are appropriate.

Recommendations

I recommend that Cabinet:

- (a) **note** the proposal for the Reserve Bank to develop and maintain a capacity to intervene in the foreign exchange market for the purpose of reducing the peaks and troughs in the exchange rate cycle, where doing so would be consistent with maintaining medium term price stability;
- (b) **note** that this intervention will entail potential net benefits for the economy, by reducing the economic costs associated with extreme swings in the exchange rate and by providing the Bank with greater flexibility in the pursuit of its monetary policy objectives;
- (c) **note** that foreign exchange intervention carries potential risks, including the risk that the Bank may incur potentially very large, but generally unrealised and non-permanent, market losses as a result of intervening in the market, but that these risks can be prudently managed and that the Bank will be implementing the structures required for that purpose;
- (d) **note** that the Reserve Bank has advised me, and I agree, that it would be desirable to increase the level of reserves held by the Crown for the purpose of intervening in the foreign exchange market to stabilise the currency market in situations of extreme disorder by \$1.9 billion to a total of around \$7 billion (including reserves held by Treasury);
- (e) **note** that the Reserve Bank has indicated that it would require [] in foreign exchange reserves for the purpose of intervening to reduce the variability in the exchange rate, and that I intend to agree to that increase, provided that Cabinet

agrees to the increase in the Bank's capital of \$1 billion (see later recommendation);

- (f) **note** that these proposals have the following fiscal impacts:

	All figures are \$m, GST not applicable				
	2003/04	2004/05	2005/06	2006/07	2007/08 & Outyears
Operating Balance Impact	-	-	-	-	-
Debt Impact of increasing reserves by \$1.9 billion	-	500	500	500	400
No Impact (capital injection)	-	1000			
Total	-	500	500	500	400

- (g) **note** that the capital injection to the Bank will be invested in government debt and has no immediate impact on gross government debt;
- (h) **note** that the timing of the debt impact of increases in foreign exchange reserves is subject to market and fiscal conditions and that the Treasury will report to the Minister of Finance on a regular basis with recommendations on the funding of reserves;
- (i) **note** that the Bank may seek additional reserves funding to enable intervention in the future and that Cabinet will be informed should the Bank do so;
- (j) **note** that a more active intervention policy will have an impact on the Government's operating balance, as realised and unrealised gains and losses, and other associated costs, are incurred, but that it is not possible to estimate these impacts in advance;
- (k) **note** that the total increase in foreign reserves [] is provided under section 23 of the Public Finance Act and does not require further appropriation;
- (l) **note** that the Bank has sought an increase in its equity of NZ\$1 billion, by way of increased equity held by the Crown, for the purpose of enabling the Bank to absorb potential unrealised or realised losses arising from intervention, and that this will require an appropriation from Parliament at the time of the Budget, and **agree** to that increase by way of the following changes to appropriations:

	\$m – increase					
	2003/04	2004/05	2005/06	2006/07	2007/08 & Outyears	GST
Vote Finance						
Non-Departmental capital		1000				n/a

contribution: Capital contribution to the Reserve Bank of New Zealand						
Total Capital		1000				n/a

- (m) **note** that, subject to Cabinet's agreement to (l) above, I intend to issue an indemnity pursuant to the Public Finance Act, should the Bank wish to intervene before the 2004/05 Estimates are passed; and
- (n) **note** that, subject to Cabinet's agreement to (l) above, I intend to move that the House ratify an amended Funding Agreement, pursuant to the Reserve Bank of New Zealand Act.

Hon Dr Michael Cullen
Minister of Finance