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MEMORANDUM FOR Minister of Finance

FROM Adrian Orr
Deputy Governor and Head of Financial Stability

DATE 1/03/2004

SUBJECT **OPTIONS FOR FOREIGN EXCHANGE INTERVENTION**

FOR YOUR Information

Attached is a letter from Dr Alan Bollard, the Governor of the Reserve Bank, which provides the Bank's advice to you on the efficacy of, and options for, foreign exchange intervention. The attached letter should be considered in conjunction with Dr Bollard's February 9 2004 letter.

The Bank's analysis focuses on intervening when the exchange rate is at cyclical extremes in an effort to reduce the peaks and troughs of the exchange rate cycle. The economics literature and the Bank's judgement suggest that intervening to reduce the extremes in the exchange rate cycle offers net benefits to the economy. However, the net benefits are likely to be small. International research and our analysis indicate that sterilised intervention can have small, but not insignificant, effects on the exchange rate, though the effects can sometimes be temporary.

Intervention to reduce the peaks and troughs of the exchange rate cycle can be consistent with the Bank's primary purpose outlined in section 8 of the RBNZ Act, which requires the Bank to conduct monetary policy for price stability purposes. Foreign exchange intervention is also a potentially useful instrument to assist the Bank to achieve its obligations under the Policy Targets Agreement to avoid unnecessary instability in the exchange rate. Another purpose for intervention in some circumstances relates to section 10 of the Act, which necessitates the Bank having regard to the efficiency and soundness of the financial system when implementing monetary policy.

Intervention carries a number of risks which must be managed. The issues include:

- The Bank may generally incur unrealised marked-to-market losses on open currency positions, potentially substantial, and possibly for sustained periods. However, if well managed, intervention should be low-cost or even profitable over the longer term.
- In disclosing marked-to-market currency positions, the Bank would need to manage the reputation risks associated with announcing unrealised losses from time to time. The Bank will also need to manage the reputation risks associated with the difficulty in demonstrating the effectiveness of intervention.
- Intervention will need to be conducted in ways that avoid conflicts with or confusion as to the Bank's monetary policy objectives.
- Intervention will need to be conducted in ways that maintain the incentives for businesses to hedge their currency risks.
- Intervention structures should be designed to avoid compromising the Bank's independence.

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The choice of institutional framework influences the nature of risks and capacity to manage them.

Intervention could occur under section 16 of the Reserve Bank Act 1989 (the Act) under the control of the Bank, and being applied in a manner consistent with the PTA. Under this option, intervention profits or losses would be borne by the Bank. An increase in the Bank's capital would be required for this to be viable, and the Funding Agreement would need to be amended and ratified in Parliament.

Alternatively, the Minister could give a standing direction under section 17 of the Act, giving the Governor an appropriate degree of discretion as to when to intervene. This would result in the Crown indemnifying the Bank for losses and taking any profits, and would obviate the need for an increase in the Bank's capital or a change to the Funding Agreement.

The net economic effect of both options is the same for the Crown on a consolidated basis. However, the section 17 option could reduce the Bank's independence and would increase the risk of interventions being incompatible with the PTA. It would also risk politicising the intervention framework.

We recommend the use of section 16 to provide the Bank legal powers to intervene. We also recommend that this is made operational by a memorandum of understanding between the Minister and Governor, setting out the objectives and parameters of intervention, and providing for an appropriate degree of transparency and accountability.

We suggest that a net open foreign exchange position of around [] to meet the intervention objectives. Given the parameters of extreme shifts in unrealised marked-to-market profits and losses, this would necessitate a capital injection into the Reserve Bank of around NZ\$1 billion.

The Bank's total funding requirement from the Crown to implement such an intervention framework could be as follows:

- a. NZ\$1.9 billion to increase foreign currency reserves to the new NZ\$7 billion minimum level recommended in our letter to you of 9 February 2004. The Bank could draw on this commitment as a NZD liability if and when it decided to intervene at the peak of the exchange rate cycle, or as a foreign currency liability in coordination with the Crown's gross public debt targets.
- b. []
- c. Up to NZ\$1.0 billion of additional capital. We would need this additional capital from the commencement of any intervention.

There are aspects of our advice in this letter that need further consideration and clarification before any decision is requested from you. These issues include legal confirmation, the exact level of capital injection, communication issues, timing around funding, and proposals for a new Funding Agreement. In this letter, it is recommended that we provide final advice for your decision on this matter by no later than end-March, or some other mutually agreed date.

We will discuss this analysis with you on 4th of March 2004.