

17 March 2004

Background information on the Reserve Bank's proposal to extend the purpose for which it holds foreign exchange reserves

- 1 On 11 March 2004, the Reserve Bank announced that it had provided advice to the Minister of Finance recommending that, as one of its monetary policy tools, it should have the capacity to intervene in the foreign exchange market to influence the level of the exchange rate. The press statement containing that announcement is attached.
- 2 The following is background information on the Reserve Bank's proposal and what would be required to implement it.

Why is the exchange rate an issue?

- 3 The amplitude of the New Zealand exchange rate cycle has long been a concern. The exchange rate varies across the cycle to a far greater extent than the underlying economic situation warrants. That is, the degree of exchange rate variation goes beyond that which is useful to the economy in terms of absorbing economic shocks and motivating business and household to adjust to lasting changes in New Zealand's external trading situation. Excess exchange rate variation makes engaging in business more difficult, reducing investment and thereby restricting the opportunities for New Zealand's growth. Excessive exchange rate variability can also make the Bank's task of achieving and maintaining price stability more difficult, potentially leading to unnecessary output, inflation and interest rate variability.
- 4 This excess variation is not confined to the New Zealand dollar. It is a feature of floating exchange rates – and indeed the New Zealand dollar is not the most variable exchange rate amongst the developed country group. Nor is it a new issue. But as inflation has been brought down and stabilised around the world, and as a result economies have become more stable overall, exchange rates cycles have not noticeably diminished. Excessive exchange rate variation stands out more obviously in this context as an unresolved issue.
- 5 In response, in the Reserve Bank's *2002/2003 Annual Report* we stated that one of our priorities for 2003/2004 was to “continue to develop and communicate a better understanding of the implications of the exchange rate and its volatility for economic performance, and policy options to affect the exchange rate”. These proposals are a result of that work.

What is the Reserve Bank suggesting?

- 6 The Reserve Bank is proposing that when the New Zealand dollar is exceptionally and quite clearly unjustifiably high, the Reserve Bank could sell New Zealand dollars to buy foreign exchange, in a manner designed to put downward pressure on the exchange rate. Equally, when the exchange rate is exceptionally and clearly unjustifiably low, we could sell foreign exchange to buy New Zealand dollars, in a manner designed to put upwards pressure on the exchange rate.
- 7 Selling and buying New Zealand dollars might initially seem to involve changing monetary policy by altering the New Zealand money supply. However, it is important to note that the intervention would automatically be “sterilised” to undo the effect on the money supply. This is standard practice internationally.
- 8 In principle, any effect of intervention on the exchange rate would have implications for inflation, and therefore for monetary policy. We do not expect to intervene very often or to be able to alter the exchange rate by a sufficiently large amount to make this a substantial issue. But to the extent that we are able to affect the path of the exchange rate through foreign exchange market intervention, that would be taken into account in our interest rate settings.
- 9 To the extent that intervention was able influence the exchange rate, we would have a small amount of additional capacity to fulfil our *Policy Targets Agreement* obligations. Those obligations are to maintain medium term price stability while avoiding unnecessary variations in the exchange rate and the economy in general. Depending on the circumstances, those obligations could be better fulfilled by a slightly smaller exchange rate cycle coupled with a slightly greater inflation cycle, **or** by a slightly greater interest-rate cycle. The essential points are that:
 - a) To the extent that foreign exchange market intervention can successfully alter the path of the exchange rate, we would have an additional instrument at our disposal that might help us better achieve our *Policy Targets Agreement* obligations.
 - b) The choices we would make in each circumstance would be fully consistent with the *Policy Targets Agreement’s* requirement to keep inflation under control.

What the Reserve Bank is NOT suggesting

- 10 There are a number of different types of foreign exchange market intervention that other central banks have used over the years. Some of these justifiably have a very bad name. We are most expressly **not** suggesting that we attempt those kinds of intervention.
- 11 For example, the Bank will not be attempting to stop the exchange rate moving when economic adjustment would be helped by that movement – we will not be targeting or defending any particular exchange rate. Attempts to defend a fixed exchange rate – including New Zealand’s own attempt in 1984 – are very often harmful to the economy, and very costly to taxpayers.
- 12 We will not be attempting to slow or reverse the exchange rate’s movement when a large number of investors and traders are convinced that the exchange rate is going to

continue to move in the same direction. Where large numbers are convinced, it would be harder to conclude that the exchange rate was clearly unjustifiable in terms of the underlying economic determinants. Nor do central banks have enough money compared with the combined position of the market to make such intervention successful.

- 13 Moreover, the Bank will not be trying to smooth out the day to day, week to week, or even year to year movements in the exchange rate. Such volatility is clearly a nuisance, but businesses can and do deal with that by hedging their currency positions.
- 14 What businesses can't easily deal with are the swings over several years from extremely high to extremely low exchange rates, swings that are out of keeping with changes in the underlying economic situation. The distinctive features of the type of intervention proposed are that:
- a) It would be limited to the extremes of the exchange rate cycle, when the exchange rate is clearly unjustifiable in relation to the underlying economic drivers; and
 - b) Intervention would be opportunistic, rather than a "come what may" stand in the market against the odds.

How effective would it be?

- 15 Our general assessment is that foreign exchange interventions as proposed can be effective, but that their impact is usually small and possibly temporary. A well conceived and executed intervention strategy can have some impact if it is consistent with the direction of economic fundamentals and relevant policy settings, including monetary policy in particular.
- 16 The economic costs from exchange rate distortions can be significant at the extremes of the exchange rate cycle. Successful intervention would only ameliorate these distortions to a limited extent, but the benefits from doing so might still be considerable. Our view is that there is likely to be a small benefit from intervention aimed at dampening the exchange rate cycle, enough to outweigh the comparatively small risks of implementing the policy.

What are the costs and risks?

- 17 Interventions involve the Bank adopting an exposure to changes in the value of the exchange rate. Such exposures have financial implications when the exchange rate moves, and attendant financial risks.
- 18 The proposed strategy is in fact likely to be profitable to the Reserve Bank over the medium-term, as long as the exchange rate continues to show a cyclical pattern, and the Bank is not forced to exit its positions prematurely. The reasoning behind this is that if the Bank restricts itself to buying foreign currencies when they are extremely cheap relative to the New Zealand dollar, and selling those currencies when they are extremely expensive, profits should accrue. Because swings in the exchange rate take several years, long periods of time might have to pass before those profits can be realised. A central bank has the advantage of time on its side, as it is not driven by a short term profit motive.

- 19 However, in the interim, potentially substantial unrealised gains and losses in foreign exchange trading are probable and must be accounted for. In a policy sense, the main risk is that the Bank might fail to recognise a structural shift in the exchange rate and try to offset it unsuccessfully, sustaining losses as a result. It would be desirable that any intervention strategy enjoyed multi-party support in Parliament, to minimise the risk that a policy u-turn might cause marked-to-market (accounting) losses to become real losses.

Would this facility have been used in the mid-1990s?

- 20 We have not performed an exercise of re-running history to see whether intervention as proposed might have been used in the past. Such an exercise is, by its very nature, difficult as there are no rules that can be easily applied to tell us when we would have intervened and when we wouldn't have.

What's required to do this?

- 21 Under the Reserve Bank of New Zealand Act 1989 foreign exchange intervention is allowed for in two different forms.
- 22 Section 16 of the Act provides for the Bank to deal in foreign exchange at its discretion for the purposes of performing its functions and fulfilling its obligations under the Act or any other Act.
- 23 Section 17 provides authority for the Minister of Finance to direct the Reserve Bank to deal in foreign exchange for the purpose of influencing the exchange rate. In this case, a written instruction would be required. Section 17 is available to the Minister at any time, irrespective of whether or not intervention is also carried out under Section 16.
- 24 We believe that use of Section 16 should be preferred in most circumstances. The primary reason is that it would co-exist well with monetary policy objectives (as embodied in the *Policy Targets Agreement*), and the Bank's financial stability objectives. Interventions carried out under Section 16 would have many of the same characteristics as monetary policy decision-making currently. The Bank would be operationally independent, and decisions would be made by the Governor.

What are we asking the Minister, and Parliament for?

- 25 Given that we propose to make interventions under the existing Section 16 power, why have we approached the Minister, and why in turn is Parliament to be approached? There are three reasons.
- 26 First, the Bank required additional foreign exchange reserves capacity in order to implement its new intervention policy. Under the Reserve Bank of New Zealand Act, the increase in reserves requires the approval of the Minister of Finance.
- 27 Second, the potential for marked-to-market losses to accrue before profits can be realised implies the need for the Bank to have sufficient financial capacity to absorb

those losses in the interim. A capital injection into the Bank will be required to enable the Bank to absorb unrealised, temporary losses arising from intervention. The capital injection will require an appropriation from Parliament during the Budget process later this year. Further, technically-speaking, marked-to-market losses are counted as “expenditure” under the Bank’s Funding Agreement. A change in the Funding Agreement is thus required, and Funding Agreements must be ratified by Parliament.

- 28 Third, as already mentioned, financial risks are in large part associated with the risk that marked-to-market losses are forced to be realised before the offsetting gains can accrue. One such situation would be the advent of a future government that withdraws support for the financial capacity provided by a changed Funding Agreement. Multi-party support for the changes is an important component of managing such risks.

What happens next?

- 29 The Minister of Finance has said that Reserve Bank should have the capacity to conduct intervention in circumstances it sees as appropriate. He will be discussing the Bank’s proposal with Cabinet.
- 30 Because the Bank would need its reserves and its capital increased the Funding Agreement would need to be amended, and as noted there needs to be ratification by Parliament. A shared understanding on how intervention policy will be conducted would be enunciated in a public letter from the Bank to the Minister of Finance.



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NEWS RELEASE

Capacity to intervene in foreign exchange market proposed

The Reserve Bank has provided advice to the Minister of Finance recommending that, as one of its monetary policy implementation tools, it should have the capacity to intervene in the foreign exchange market to influence the level of the exchange rate.

The Reserve Bank's current stance is to use its foreign exchange reserves to intervene only if the foreign exchange market became "disorderly".

Reserve Bank Governor Alan Bollard said "We have recommended that when the New Zealand dollar is exceptionally and unjustifiably high, the Reserve Bank would be able to use New Zealand dollars to buy foreign exchange, which would put downward pressure on the exchange rate. And, when the exchange rate is exceptionally and unjustifiably low, we would be able to sell foreign exchange to buy New Zealand dollars, putting upwards pressure on the exchange rate. By unjustifiable, we mean when the exchange rate has moved to a level in excess of that readily explained by the relevant economic fundamentals, which occurs only infrequently. This process is similar to that used for some years by the Reserve Bank of Australia.

"By having this intervention tool, we would generally aim to influence the exchange rate in a direction consistent with maintaining our price stability goal. The addition of intervention as an instrument of monetary policy would also better enable the Bank to meet its Policy Targets Agreement clause 4B commitment, which stipulates that "In pursuing its price stability objective, the Bank ... shall seek to avoid unnecessary instability in output, interest rates and the exchange rate." That is, at extreme levels of the exchange rate, intervention may be chosen to supplement monetary policy.

"Importantly, such foreign exchange intervention would not be trying to permanently change the long-run exchange rate. And, the New Zealand dollar exchange rate cycle would not be eliminated. At best, we can influence the exchange rate only by small amounts at the extremes of its cycle when it is a long way from economic fundamentals. In doing this there could be financial risks to the Bank, requiring very careful management.

"In recent days we have put these ideas to the Minister of Finance. There is more work and consultation to be done before final decisions can be made or the setting of operational procedures and capacities," Dr Bollard concluded.

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