Foreign Reserves Management and Co-ordination Framework

Between the Reserve Bank of New Zealand | Te Pūtea Matua

and

The Minister of Finance

December 2022

Foreign Reserves Management and Coordination Framework

Contents

1. Introduction of Reserve Bank of New Zealand Act 2021

1.1. This is the first Foreign Reserves Management and Co-ordination Framework (the framework), written in accordance with the requirements under the Reserve Bank of New Zealand Act 2021 (the Act).

1.2. Section 9 of the Act outlines three main objectives for the Reserve Bank of New Zealand (the Reserve Bank), that are to be pursued in a way that furthers the purposes of the Act. These are: the economic objective (price stability and maximum sustainable employment), the financial stability objective and central bank objective.

1.3. The purposes of the Act are to provide for the continuation of the Reserve Bank and to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy.

1.4. The Act sets out the Reserve Bank's functions as a central bank, several of which have a bearing on the Reserve Bank's use of foreign reserves. The Act empowers the Reserve Bank to deal in foreign exchange for the purposes of furthering its objectives.

1.5. The Reserve Bank holds foreign reserves in order to meet its statutory objectives and functions under the Act. Foreign reserves means any foreign exchange held by the Reserve Bank and any financial product denominated in a foreign currency, for whatever purpose.

1.6. The Reserve Bank's functions directly related to foreign reserves include:

1.6.1. s116(a): Formulating (through the Monetary Policy Committee (MPC)) and implementing a monetary policy directed to the economic objectives, while recognising the Crown's right to determine economic policy;

1.6.2. s116(b): Managing foreign reserves and otherwise dealing in foreign exchange for the purposes of the Reserve Bank's objectives; and,

1.6.3. s116(d): Providing liquidity facilities to entities approved by the Reserve Bank in order to manage the liquidity in the financial system and protect the stability of the financial system.

1.7. This framework replaces any understanding (formal or informal), agreement or arrangement between the Reserve Bank and the Minister of Finance (the Minister).

2. Introduction of Foreign Reserves Management and Coordination Framework

2.1. The framework must be agreed by the Reserve Bank and the Minister and the Reserve Bank must hold and manage foreign reserves in accordance with the framework.

2.2. The purposes of the framework are to facilitate the Reserve Bank's ability to meet its objectives and to comply with Ministerial directions. The framework provides a mechanism to co-ordinate the Crown and the Reserve Bank's interests and roles in relation to the management and use of foreign reserves.

2.3. The framework must contain:

2.3.1. s143(2)(a): Requirements and arrangements for the Reserve Bank's management and use of foreign reserves in line with the purpose of the framework (and different requirements or arrangements may be specified for different parts of those reserves);

2.3.2. s143(2)(b): Requirements for those foreign reserves (or for different parts of those foreign reserves) to be maintained at a specified level or within specified levels.

3. Purpose of Reserves

Foreign Exchange Intervention

3.1. The Reserve Bank holds foreign reserves primarily for foreign exchange (FX) intervention for either:

3.1.1. Monetary policy: influencing the level of the New Zealand dollar (NZD) exchange rate when it has significantly diverged from macroeconomic fundamentals; or

3.1.2. Financial stability: stabilising financial markets when foreign exchange markets are dysfunctional, or the convertibility of NZD for foreign currency is impaired.

3.2. It is common practice for central banks to hold foreign reserves. Advanced, open economies, such as New Zealand, hold foreign reserves for extreme scenarios. These are viewed as a type of insurance against large, but unlikely, risks.

3.3. FX interventions are uncommon and are not intended to maintain a fixed level of the exchange rate. These FX interventions are consistent with New Zealand's floating exchange rate regime.

3.4. Section 143 of the Act provides the Minister with the power to direct the Reserve Bank to intervene in foreign exchange markets for the purpose of influencing the exchange rate or exchange rate trends.

Domestic Liquidity Management

3.5. The Reserve Bank accumulates foreign assets from managing liquidity in the domestic financial system. The Reserve Bank is responsible for ensuring there is sufficient liquidity to meet the daily needs of the domestic payment and settlements system and to ensure that short-term wholesale interest rates trade at levels consistent with the stance of monetary policy.

3.6. Foreign assets generated from liquidity management are managed in a separate portfolio from foreign reserves held for FX intervention. The level of foreign assets in this portfolio can fluctuate due to a range of factors. These are not available for FX intervention by the Reserve Bank, nor are they available for use under a Ministerial direction.

Foreign Asset Purchases

3.7. Large scale foreign asset purchases for monetary policy would be managed by the Reserve Bank as a separate portfolio and are not explicitly considered under the level of foreign reserves governed by this framework. Should the MPC initiate large scale purchases of foreign assets, the foreign reserves level in the framework would need to be reviewed.

International Commitments

3.8. A portion of the foreign reserves may be used to meet New Zealand's international commitments to the IMF.

4. Management of Foreign Reserves under the Framework

4.1. The level of foreign reserves that must be maintained by the Reserve Bank is agreed between the Reserve Bank Board and the Minister. The Reserve Bank will maintain the foreign reserves in line with the agreed levels.

4.2. Holding foreign reserves exposes the Reserve Bank to financial risks, including foreign exchange risk, interest rate risk, credit and liquidity risks. The Reserve Bank Board approves the financial risk appetite statement which articulates the degree of tolerance for such risks.

5. Level and Composition of Foreign Reserves

5.1. The level of foreign reserves comprises of foreign reserves for intervention, in pursuit of either monetary policy or financial stability objectives, and foreign assets for domestic liquidity management.

5.2. This framework contains information where release would impact significantly on the Reserve Bank's ability to deal in foreign exchange and where publication would undermine the purposes or objectives for holding these foreign reserves. This information in Schedule A is withheld in accordance with the Official Information Act 1982.

5.3. See schedule A

5.4. See schedule A

5.5. The Reserve Bank's foreign reserves are held in either hedged or unhedged form. Hedged reserves carry no foreign exchange rate risk. Unhedged reserves are exposed to fluctuations in the foreign exchange rate.

5.6. See schedule A

5.7. See schedule A

6. Financial Resources

6.1. The Minister acting on behalf of the Crown is discussing with the Reserve Bank the financial resources necessary for the Bank to support and operationalise the framework. Until such resources are in place, the Reserve Bank will not operationalise the Framework beyond what its financial resources allow for.

7. Foreign Exchange Intervention

Monetary Policy

7.1. The Monetary Policy Committee (MPC) has the ability to intervene in foreign exchange markets for monetary policy purposes, in order to lean against extremes in the peaks and troughs of the exchange rate cycle.

7.2. These FX interventions are not intended to maintain a fixed level of the exchange rate and are consistent with New Zealand's floating exchange rate regime. FX interventions are expected to be rare.

7.3. There are four criteria MPC use to assess the New Zealand dollar foreign exchange rate:

i. EXCEPTIONAL - the exchange rate should be exceptionally high or low

ii. UNJUSTIFIED - the exchange rate should be unjustified by economic fundamentals

iii. CONSISTENT - intervention should be consistent with our monetary policy objectives

iv. OPPORTUNE - market conditions should be opportune and allow intervention a reasonable chance of success

Financial Stability

7.4. Under the Act, the Reserve Bank has an objective to promote and protect the stability of New Zealand's financial system. Holding foreign reserves enables the Reserve Bank to be ready and able to intervene in the NZD foreign exchange market at all times, and to facilitate market functioning during a period of severe market dysfunction or breakdown in NZD trading. The Reserve Bank is solely responsible for intervention in foreign exchange markets for financial stability purposes.

7.5. Such interventions would likely occur during broader crises, could have significant fiscal impacts, and could relate to broader Government decision making or obligations. Where practicable, the Reserve Bank will brief the Minister of Finance prior to an intervention for financial stability purposes. Where appropriate and practicable, the Reserve Bank and the Minister should share information, including market intelligence and intended policy responses, in order to ensure actions are able to best promote financial stability.

7.6. Financial stability events are likely to be sudden and require an immediate response. Where it is impractical for the Reserve Bank to brief the Minister prior to undertaking an intervention for financial stability purposes, the Bank would brief the Minister, as soon as practicable thereafter.

Normalising Foreign Reserves

7.7. Following any significant intervention the Reserve Bank will determine a strategy to normalise the level of foreign reserves, and will liaise with the Minister, where appropriate.

8. Ministerial Directions

Issuing a Direction

8.1. Section 134 of the Act empowers the Minister to direct the Reserve Bank to deal in foreign exchange for the purpose of influencing the exchange rate or exchange rate trends.

8.2. The Reserve Bank and the Minister have agreed that the Reserve Bank will not maintain a specific portfolio of reserves for a specific ministerial purpose or objective.

8.3. The Act sets the power for the Minister to direct the Reserve Bank to deal in foreign exchange within guidelines set out by the Minister in a written notice. Any Ministerial directions will be provided to the Governor of the Reserve Bank**.**

8.4. In accordance with section 174 of the Act, in advance of the direction, the Minister should provide sufficient information and time for the Reserve Bank to consider and comment on the implications for the Reserve Bank's operational (section 136) and monetary policy objectives (section 138). Use or building of reserves to fulfil a ministerial direction may impact the Reserve Bank's ability to conduct an intervention for its monetary policy or financial stability objectives.

8.5. Under section 146 of the Act, the Minister must have regard to this framework before issuing a direction to the Reserve Bank to intervene in foreign exchange markets.

Inconsistent Direction

8.6. If the Minister issues a direction that the Reserve Bank considers to be inconsistent with the <u>operational objectives</u> in the MPC remit, under section 136 of the Act, the Reserve Bank may give notice and advise the Minister that the Reserve Bank will be unable to give effect to those operational objectives under ministerial direction. If notice is given, the Reserve Bank and MPC are not required to give effect to those operational objectives unless, following a notice from the Reserve Bank, the Minister amends the MPC remit (within one month) in order to make the operational objectives consistent with the Ministerial direction.

8.7. If the Minister issues a direction the Reserve Bank considers to be inconsistent with the <u>economic objectives</u> of the Reserve Bank, under section 138 of the Act, the Reserve Bank may give notice in writing that the MPC and Reserve Bank do not propose to give effect to the direction. Under section 139 of the Act, the MPC and the Reserve Bank are not required to comply unless the Governor-General, by Order in Council, provides for different economic objectives, on the advice of the Minister.

8.8. The Reserve Bank may only give notice, in either case, with the approval of the MPC.

Amendments to Framework in Case of Ministerial Direction

8.9. The Minister may issue a direction that is not feasible for the Reserve Bank to fulfil whilst still complying with the arrangements of the framework. If an amendment to the framework is required, then the Reserve Bank and Minister must take reasonable steps to agree on amendments to the framework; however, the Minister may impose amendments on the framework without the Reserve Bank's agreement, under certain conditions specified under section 147 in the Act. These conditions relate to ensuring that the framework is consistent with a foreign exchange direction given by the Minister under section 134, and following unsuccessful attempts to agree with the Reserve Bank on the issue.

9. Publication of Information

Publication of the Framework

9.1. The Reserve Bank will publish a copy of the framework, or a variation of the framework, on its website as soon as practicable after both the Board of the Reserve Bank and the Minister have signed the framework. This framework contains information that if made public would impact significantly on the Reserve Bank's ability to deal in foreign exchange, would undermine the purposes for holding these foreign reserves and the Reserve Bank's ability to meet its objectives in section 9. This information in Schedule A is withheld in accordance with the Official Information Act 1982

Publication of Reserve Bank Information

9.2. The Reserve Bank publishes information on its foreign reserve holdings in regular statistical releases on its website.[1]

9.3. The Reserve Bank conducts activity in a variety of markets, in order to prudently manage its balance sheet, monitor market conditions, and meet its statutory objectives. Changes in the level of foreign reserve holdings can be the result of normal market activities, which are not foreign exchange interventions. This can include the purchase or sale of foreign assets for the purposes of managing liquidity in the domestic financial system.

9.4. The Reserve Bank does not usually comment on its activity in foreign exchange markets. If a FX intervention is undertaken, the Reserve Bank reserves the right to not comment on this activity. Where appropriate, the Reserve Bank may announce that a FX intervention has occurred.

Publication of Ministerial Directions

9.5. Typically, Ministerial directions are published in accordance with the conditions under section 174(2) of the Act; however, it may be necessary for the Minister to defer publication of a FX intervention following a direction in order for the Reserve Bank to be able to meet the direction. FX intervention following a direction may be announced by the Minister when appropriate.

[1] Our foreign currency assets and liabilities (F5); Influences on settlement cash (D10); Standing facilities (D12)

9.6. The Reserve Bank must also defer publishing information relating to a Ministerial direction, if the Minister has deferred publication. The Minister must review the decision to defer publication regularly after the direction is given, and the Minister must publish the direction when the Minister is satisfied the conditions of the deferral are no longer applicable.

10. Monitoring and Reporting

10.1. The Minister and the Reserve Bank must ensure the framework is in force at all times. The Act formalises the Treasury's role to monitor and oversee the Reserve Bank. This includes the Reserve Bank's management of foreign reserves. The Reserve Bank will adhere to the Treasury's monitoring requirements, in line with the Minister's letter of monitoring expectations.

10.2. The Reserve Bank will provide regular progress and performance reporting, and signal any developing issues and emerging risks or opportunities, where appropriate. This may be incorporated with the Reserve Bank's other financial and performance reporting, as appropriate.

10.3. The Reserve Bank will provide reporting on the foreign reserves, including the level and composition. Following an intervention event, the Reserve Bank will provide advice on the implications for financial resourcing, as well as an assessment of that intervention and whether it is desirable to review the framework.

11. Framework Review

11.1. The Reserve Bank and the Treasury must review the operation of the framework within five years of the first framework coming into force, and then subsequently at least every five years.

11.2. The Reserve Bank or the Treasury may request a review of the framework out of the regular cycle, at their discretion. The framework must also be reviewed if the Minister issues a direction.

11.3. The Reserve Bank may request a review of the framework if it believes changes to the economy or foreign exchange markets necessitate a change in the level of foreign reserves.

11.4. The review of the framework will consider any necessary amendments to the framework. The findings of the review must be reported to the Minister.

12. Approval

Monetary Policy Committee Consultation

In accordance with section 143(4) of the Act, the MPC has been consulted on this framework.

Approval by the Reserve Bank and the Minister

In accordance with section 144(1) of the Act, this Framework is dated and signed by the Minister and by 2 members of the Board.

Neil Quigley

Board Chair

Adrian Orr

Governor

For Reserve Bank of New Zealand Te Pūtea Matua

Dated 9th December 2022

Minister of Finance

Dated 11/12/22

Schedule A

Further to 5. Level and Composition of Foreign Reserves:

OIA s 9(2)(d) and 9(2)(i) [redacted]

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