# The Treasury

## Foreign Reserves Framework Information Release

## January 2023

This document has been proactively released by the Treasury on the Treasury website at:

**https://www.treasury.govt.nz/publications/information-release/foreign-reserves-framework-agreement-proactive-release**

### Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [29] appearing where information has been withheld in a release document refers to section 9(2)(d).

### Copyright and Licensing



### Accessibility

The Treasury can provide an alternate HTML version of this material if requested. Please cite this document's title or PDF file name when you email a request to information@treasury.govt.nz.

TE TAI ŌHANGA
THE TREASURY

# Treasury Report: The Foreign Reserves Framework Agreement – background, issues, and process

| | | | |
|---|---|---|---|
| **Date:** | 5 May 2022 | **Report No:** | T2022/947 |
| | | **File Number:** | MC-1-0 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| **Minister of Finance**<br>(Hon Grant Robertson) | **Note** for the Framework to be in place by 2023 you must agree the level, composition, and uses of the foreign reserves. The Reserve Bank expect to provide further advice and seek your agreement to substantive matters in July.<br><br>**Agree** to the proposed timing and work-plan and **indicate** if you wish further advice on specific matters before then. | Friday 27 May 2022 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone | 1st Contact |
|---|---|---|---|
| Jack Starrett Wright | Senior Analyst, Macroeconomic and Fiscal Policy | [39] N/A (mob) | ✓ |
| Renee Philip | Manager, Macroeconomic and Fiscal Policy | [35] | |

## Minister's Office actions (if required)

**Return** the signed report to Treasury.

| | |
|---|---|
| Note any feedback on the quality of the report | |

**Enclosure**: No

# **Treasury Report:** The Foreign Reserves Framework Agreement – background, issues, and process

## Executive Summary

The new Reserve Bank Act requires the Minister and the new Board of the Reserve Bank of New Zealand (RBNZ) to agree a 'Foreign Exchange Management and Coordination Framework' (the Framework). The Framework is intended to replace various existing directions and understandings as to the use of the RBNZ's foreign reserves. It is anticipated that most of the existing arrangements will be incorporated into the new agreement. Two areas of likely change are:

- The uses of foreign reserves will be updated to reflect the RBNZ's new ability to independently use foreign reserves to intervene for its financial stability objective, for example if there is market dysfunction following a severe shock. Previously the RBNZ could only intervene for financial stability purposes on the direction of the Minister of Finance.

- In preparing for the new framework, the RBNZ has taken this opportunity to review the level and composition of the foreign reserves, as these have not been reviewed since 2007. As foreign reserves can have fiscal costs and risks, any changes may have subsequent implications for the financial backing required by the RBNZ.

The RBNZ has provided you with a report with its analysis to date which is indicative of the likely view of the RBNZ's Board when it is in place from 1 July. The RBNZ and the Treasury expect to provide you with further substantive advice in July. You do not need to make substantive decisions at this point, but you will need to decide the level and composition, management arrangements, and objectives for the foreign reserves and then agree this with the new Board of the RBNZ in time for the Framework to be in place by the statutory requirement of 1 January 2023.

The Treasury agrees with the RBNZ that the Framework agreement provides a good opportunity to review the foreign reserves, and the RBNZ's analysis seems reasonable. However, there is significant judgement required in these matters. Relevant considerations include:

- The risks of not holding sufficient reserves;

- The cost of holding reserves;

- The cost and risk of using reserves to intervene;

- Implications for the RBNZ's required financial backing, and independence of the RBNZ; and

- The viability of other options.

We expect other elements of the Framework to remain largely unchanged. This includes:

- The other purposes of foreign exchange interventions. In particular, we are assuming that you would not direct the RBNZ to intervene for purposes other than monetary policy or financial stability.
- The 'peaks and troughs' framework for interventions over the cycle, which aims to reduce exchange rate cycles.

At this stage, Treasury and the RBNZ are seeking your indication of whether you are comfortable with the direction of travel in this work. If you indicate any areas where you require further information or analysis, this will be undertaken between now and July, at which point the RBNZ is likely to seek your decision on some of the key aspects of the new agreement.

## Recommended Action

We recommend that you:

a **Note** that you and the Board of the Reserve Bank of New Zealand (RBNZ) will need to agree to the Foreign Reserves Framework (the Framework) by the end of this year.

b **Note** that the RBNZ has provided you with its initial analysis on the substantive matters to be included in the Framework, and expect to seek substantive decisions mid-year. Treasury and the RBNZ will provide you with advice in July regarding these decisions.

c **Agree** to the process and timeline set out in the next steps below.

*Agree/disagree.*

d **Indicate** whether you would like further information on this, including on:

a. the uses of the foreign reserves;
b. the level of the reserves;
c. the composition and hedging approach; and
d. the financial backing required.

*Required/not required.*

e **Meet** with officials to discuss if necessary

*Required/not required.*

Renee Philip
**Manager, Macroeconomic and Fiscal Policy**

Hon Grant Robertson
**Minister of Finance**

# **Treasury Report:** The Foreign Reserves Framework Agreement – background, key issues, and process

## Purpose

1. The Reserve Bank of New Zealand (RBNZ) has provided you with a report on foreign reserves to update you on their analysis and work towards the newly legislated Foreign Reserves Framework agreement. This Treasury report provides you with a high-level summary of the RBNZ's analysis, sets out the central issues, and provides a framework for thinking about the trade-offs before you need to agree to substantive issues in the middle of the year.

2. The table annexed sets out the RBNZ's view on the substantive matters at this point, as well as the Treasury's comments.

## Background

3. The RBNZ, like most central banks, holds foreign currency reserves on its balance sheet to support its objectives. Foreign currency reserves may be used independently by the RBNZ to intervene to support financial stability or to meet the economic objectives. In your capacity as Minister of Finance, you also have an interest in the reserves as they may pose risks and costs to the Crown finances, and you have the ability to direct the RBNZ to use the reserves for intervention (as covered below).

4. To reflect the different interests between the RBNZ and Minister, the new Reserve Bank Act requires the Minister and the new Board of the RBNZ to agree the 'Foreign Exchange Management and Coordination Framework' (the Framework). The Board may focus on ensuring it can achieve its objectives and manage its risk tolerance for the RBNZ's capital position whereas you might focus on the financial costs and risks to the Crown, as well as ensuring the RBNZ is able to meet its objectives.

5. The Framework is intended to replace various existing directions and understandings as to the use of the reserves. The RBNZ must comply with any duties specified in the Framework, and must have regard to the Framework when dealing with foreign reserves. The agreement also sets the level or range of reserves held by the RBNZ, which limits what it can do and affects the potential fiscal costs and risks. The Framework must be in place by the end of this year. You can also affect the level of risk taken on through the Bank's financial banking, and statutory directions.

6. Because the RBNZ has a new independent objective of financial stability and because the level of reserves has not been considered for some time, the RBNZ believes the current level is insufficient and should be reconsidered. They have provided you with a report setting out their analysis, as well as the mechanics and purposes of the foreign reserves in more detail.

## Use of the foreign reserves

7. The Act allows the RBNZ to use foreign reserves to achieve its objectives of financial stability, the economic objectives of price stability and full employment, and its objective to act as New Zealand's central bank in a way which furthers the purpose of the Act. The focus of the current set of advice is on the reserves held to support the financial stability purpose.

*Financial stability*

8. The new Act allows the RBNZ to independently use its foreign reserves for the purpose of its financial stability objective, previously done only on ministerial direction. In the event that the market for New Zealand dollars (NZD) becomes dysfunctional (for example, in the event of a global or national financial crisis or natural disaster) the RBNZ could step in to provide liquidity, support a functioning market, and ensure international obligations are met. This would likely entail the RBNZ selling foreign assets to purchase NZD. Although the market for NZD is very liquid, and it is unlikely that intervention would be required (it was not during either the global financial crisis or during COVID-19), the RBNZ is responsible for meeting its objectives in extreme or unlikely circumstances.

9. There are alternatives to holding reserves on the balance sheet for financial stability intervention. For instance, 'swap lines'[1] with other central banks such as the Federal Reserve provide access to foreign currency. The RBNZ sees reliance on a swap line as unsuitable as New Zealand does not have a standing swap facility with the Federal Reserve System (the Fed), and reliance on one would inhibit the RBNZ's ability to immediately and independently act in foreign exchange markets. The extension of a swap line would be at the Fed's discretion, and there is no guarantee one would be made available, or if it was, the terms and conditions under which it would operate.

*Monetary policy*

10. The RBNZ may intervene for monetary policy purposes, likely by selling NZD to influence the exchange rate and meeting its economic objectives. There is an existing 'peaks and troughs' framework under which the RBNZ is able to lean against particularly high and low values of the NZD with the aim of reducing price volatility for exporters and importers. The 'peaks and troughs' principles would be included in the Framework, and at this point we are not advising they be reconsidered.

11. The RBNZ also holds foreign assets for its day-to-day monetary policy implementation to manage liquidity. [29]

    These assets, and the operations they support, will need to be reflected in the agreement.

*Other uses*

12. In addition to holding reserves for the financial and economic objectives, the RBNZ is proposing it hold [29] and [37] for its objective to act as New Zealand's central bank. This will likely be for, but is not limited to, achieving climate related goals through investment in green bond funds in cooperation with other central banks. These funds could be used to intervene, but not as 'first line of defence'.

13. The Act retains the ability of the Minister to direct the uses of the reserves for any other purpose. One unlikely (and not contemplated) example would be to peg the value of the NZD to another currency. Although such direction serves to automatically indemnify the RBNZ for any related loss, this might still limit the use of reserves for other purposes. The Treasury does not think such a direction is likely, but if a ministerial direction is contemplated it would be advisable to raise the level of reserves before it is needed.

[1] Agreements between central banks to exchange currencies.

## The level and composition of reserves

*The Minister and the Board must agree the level of reserves to be held by the RBNZ*

14. Reserves may be costly to hold and require financial backing for the RBNZ due the additional risk. However, sufficient reserves allows for intervention in the event of a crisis, and having that capability provides market confidence (possibly reducing the likelihood they will be needed). The level of foreign reserves required is largely determined by the financial stability objective, as intervening for monetary policy purposes will tend to involve buying foreign currency and selling NZD. Reserves are expected to be funded through the RBNZ increasing its settlement cash – essentially creating NZD to purchase foreign assets.

15. The RBNZ currently holds around USD 8.5b in reserves for intervention purposes. The RBNZ believes this level is inadequate to satisfactorily perform its new statutory objectives and is overdue to be reviewed. The RBNZ analysis has compared New Zealand with other small open countries with their own currency (Canada, Australia, Sweden, and the UK). Factors considered were relative GDP, domestic currency trading volume, imports, external debt, as well as the Reserve Bank of Australia's experience intervening for financial stability purposes during the global financial crisis. The GDP or intervention scenario comparisons would suggest a relatively lower level, but the external debt or NZD trading volume comparisons would suggest a higher level of reserves. [29] and [37]

16. The Treasury agrees that the Framework agreement provides a good opportunity to review the level, composition, and use of the foreign reserves – especially in light of the new legislative framework and objectives of the RBNZ. However, these questions are a matter of judgement with no absolute answer. You may be comfortable taking risk and cost onto the balance sheet now to avoid future costs in the event of a financial crisis. You may also wish to provide the RBNZ with more capacity and more independence to intervene to pursue its objectives. The Treasury view is that deciding the appropriate level or range will not be precise. The RBNZ's comparative analysis seems a reasonable approach [29] and [37]

*The agreement may also include a range for the reserves*

17. The RBNZ feels it is appropriate to set a range rather than a specific level for the foreign reserves for practical and risk management purposes. [29] and [37]

18. Treasury has some reservations about these 'add-ons'. Some should have been captured in the initial comparative analysis, future growth can be considered when the Framework is reviewed in five years, and there is a genuine choice for the Minister whether to endorse the RBNZ using New Zealand's foreign reserves for climate change purposes. We would like to see further analysis and justification from the RBNZ on these points, in particular the other central banking activities some of it which is relating to climate objectives, before supporting the proposed approach.

## Foreign reserves can be hedged or unhedged

*Hedged and unhedged reserves have different costs and carry different risks*

19. Reserves are unhedged when the USD asset is funded by an NZD liability. This exposes the RBNZ to currency risk, as the value of the USD may fall relative to NZD. The RBNZ needs to hold sufficient capital against this risk. In addition to foreign currency risk, unhedged reserves have an annual holding cost of around 0.75% because NZD interest rates have historically been higher than USD interest rates. If intervention in the market was needed, the USD assets would be sold and, as this would take place when the value of the NZD is low, we would expect the intervention itself to be profitable.

20. Reserves can be hedged by swapping the NZD liability for a USD liability. This removes the exchange rate risk, and usually locks in a small profit (due to the pricing in the hedging market). However, at the point of intervention, using hedged reserves brings risk on to the Crown balance sheet. The USD asset is sold but the USD liability remains – exposing the RBNZ to exchange rate risk, and would result in losses in the event that the NZD falls further following the intervention.

21. The trade-off is that unhedged reserves have a higher carrying cost[2] (due to interest rate differential) and require capital to be held against mark-to-market losses[3], but are more likely to be profitable in the event of an intervention. Hedged reserves are generally profitable to hold and require minimal capital to hold (as the currency risk is hedged) but may result in fiscal losses in the event of an intervention. The actual likelihood you give to different situations determines what you should hold to be most fiscally efficient. If the likelihood of intervention is low, hedged reserves are more attractive than unhedged.

22. Historically New Zealand foreign reserves were hedged. A smaller pool of unhedged reserves was created when the 'peaks and troughs' framework was adopted in 2004, but the reserves for financial stability purposes remained fully hedged. Unhedged reserves have been relatively more expensive for New Zealand compared with similar countries due to persistently higher interest rates, and our low usage. Hedged reserves have historically been profitable for the RBNZ to hold, but may result in losses in the event of an intervention.

[2] [29] and [37]
[3] 'Mark-to-market' accounting reflects the current market price.

**Table 1: Comparison of unhedged and hedged reserves**

| | **Unhedged** | **Hedged** |
|---|---|---|
| **Asset** | USD | USD |
| **Liability** | NZ | USD |
| **Carrying cost** | -<br>About 0.75% p/a due to interest rate differentials | +<br>Historically profitable |
| **Capital** | Requires capital to be held against mark to market losses | Minimal capital required - except against risk when intervention happens |
| **Risk and profitability in event of financial stability intervention** | ++<br>Profitable in all likely scenarios | -<br>Profitable if NZD rises after intervention, but if NZD falls post intervention and doesn't recover before the USD liability matures, would make potentially significant loss. |

23. [29] and [37]

24. The Treasury has some reservations about the proposed composition of the reserves. Historically the RBNZ has not held unhedged reserves for financial stability intervention purposes and unhedged reserves introduce greater cost and risk to the balance sheet than hedged reserves. New Zealand may not be entirely comparable with other countries because our persistently higher interest rates means that unhedged reserves are relatively more costly. The main benefit of unhedged reserves is the 'insurance value' of a profitable intervention. Because we consider an intervention to be very unlikely, and because interventions would still be possible with hedged reserves (but with a risk of losses), we are leaning towards a greater proportion of reserves to be hedged, but we have not reached a firm view on the specific composition. We will provide further advice on this in July.

## Reserves create risk on the balance sheet, requiring financial backing

25. Additional reserves create risks on the RBNZ balance sheet – due to exchange rate swings while holding unhedged reserves, or at point of intervention for hedged reserves. In order to incur this risk the RBNZ will want additional financial backing from the Crown, alongside the Framework agreement. You would need to agree to any additional financial backing.

26. This financial backing could be implemented either by providing additional capital directly for example through writing down the Crown Settlement Account or reducing dividend pay-outs as the RBNZ builds its position, or through a contractual or statutory indemnity. Because the RBNZ balance sheet is consolidated with the Crown the

provision of additional financial backing itself would have no immediate cost to the Crown. The gains and losses on the underlying activity – holding reserves and intervening in the market – are real gains and losses for the Crown.

27. An indemnity might be best suited to covering the risk associated with hedged reserves – as financial backing would only be necessary if the Bank was to intervene. This could be automatic, or could provide for ministerial discretion depending on the level of control you wish to have, and the level of operational independence you think appropriate. Treasury will provide you further advice on the possible approaches and trade-offs in July.

## Next steps and process options

28. The Framework must be agreed by the Minister and the Board of the RBNZ within 6 months of the relevant section of the Act being brought into force by order in council on 1 July 2022. This gives a final deadline of 1 January 2023. The RBNZ must consult the Monetary Policy Committee (MPC) on the Framework. Treasury and the RBNZ must review the operation of the Framework at least every 5 years.

29. The RBNZ is aiming for substantive content on the level and composition of reserves, and anything the RBNZ should have regard to in using these Reserves, to be agreed by you and the new Board by July to allow for Framework drafting to begin, implementation considerations to be assessed, legal review, and in case any other matters arise. The RBNZ is also required to consult the MPC, and has been working with the Transition Board. The RBNZ expects to provide you with further information in July, and aims to have substantive content agreed around that time. Treasury will provide advice alongside this providing our own views and recommendations.

30. From July to September 2022, drafting of the Framework would commence as the RBNZ will work towards the Board seeking your agreement to the Framework in November, ahead of the December 2022 legislative deadline.

31. You do not need to make substantive decisions before July, but you may wish to form a view on your comfort with the proposed level of reserves, the level and timing of risk associated with the hedging strategy, the level of control in terms of Crown balance sheet and the preferred levers you might exercise. These are matters of judgement. You could request further information from the RBNZ or the Treasury, or meet with officials. You may also wish to discuss this with the new Board following its establishment.

32. You might also request further information from the RBNZ on the additional buffers for other central banking activities and what these would be used for in practice, as well as the trade-offs of holding a higher ratio of hedged to unhedged reserves.

33. Treasury and the Reserve Bank are not considering some issues at this point in depth, as change is unlikely and further work would require significant commitment. These issues include the underlying principles for the 'peaks and troughs' framework, shared reserves with New Zealand Debt Management, or seeking a commitment to swap lines from the Fed. We are also not considering other uses for which the reserves could be used under ministerial direction. We are seeking your indication of whether you are interested in receiving advice on any additional matters. This may require reconsidering the timeline outlined above.

## Annex 1: Key issues

| | Reserve Bank view | Treasury comment |
|---|---|---|
| **Appropriate level of reserves** | The RBNZ's assessment is that current reserve levels for intervention are inadequate [29] and [37] | Treasury agrees it is timely to review the level of foreign reserves held for this purpose, and this level seems justifiable. |
| **Additional range of reserves** | [29] | The Treasury view is that some of these factors should have been captured in the comparative analysis, and we would like to see further justification for the other central banking objectives. We would like to see further analysis to support these additions. |
| **Composition of reserves** | [29] and [37] | The Treasury has some reservations about the RBNZ's proposal. This would introduce greater cost and risk to the balance sheet. The main benefit of unhedged reserves is the 'insurance value' of a profitable intervention. Because we consider an intervention to be very unlikely, and because interventions would still be possible with hedged reserves (but with a risk of losses), we are leaning towards a greater proportion of reserves to be hedged, but we have not reached a firm view on the specific composition. We will provide further advice on this in July. |
| **Uses of reserves** | The Reserve Bank does not propose to incorporate additional reserves to account for potential ministerial directions and is not planning to review the peaks and troughs framework for monetary policy intervention. | Treasury agrees that it does not see any likely use of the ministerial direction power, and it is not necessary to reconsider the peaks and troughs framework at this juncture. |