The Treasury

Foreign Reserves Framework Information Release

January 2023

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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

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Treasury Report: The Foreign Reserves Framework Agreement – Policy Decisions and Cabinet process

Date:	Thursday, 22 September 2022	**Report No:**	T2022/1497
		File Number:	MC-1-0

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** to the proposals regarding the level and composition of the foreign reserves held by the bank **Agree** that Treasury provide you a draft Cabinet paper in late October. **Agree** that Treasury and the Bank advise on financial and transparency arrangements in October.	Thursday, 06 October 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 but provided alongside RB 5973

Treasury Report: The Foreign Reserves Framework Agreement – Policy Decisions and Cabinet process

Executive Summary

The Reserve Bank of New Zealand (the Bank) holds foreign reserves to support its financial stability and monetary policy objectives. Because you have an interest in the financial implications for the Crown, and because you may have economic interests in the uses of the reserves, the Reserve Bank of New Zealand Act 2021 requires the Bank and you to agree to a Foreign Reserves Management and Coordination Framework (the Framework). This must be in place by end of 2022.

As a significant policy decision made by you under legislative provisions, we anticipate that you will want to inform and/or seek agreement from your Cabinet colleagues. Treasury proposes to provide you with a draft Cabinet paper towards the end of October for your feedback.

In preparing its proposals for the Framework, and in light of the Bank's new legislation and reframed objectives, the Bank has reviewed the level and composition of the foreign reserves it holds. [29] and [37]

The Bank requires sufficient foreign reserves to fulfil its objectives. These need to be held in advance of any intervention, as the ability to raise reserves during a crisis could be limited. Having sufficient reserves is important, but both holding and using the reserves can cause gains and losses. The amount of risk, and when it arises, depends on the extent to which the reserves are hedged against exchange rate movements. [29] and [37]

As the proposed increase in reserves would increase risk on the Bank's balance sheet, the Bank would need additional financial backing to cover plausible losses through increased capital or an indemnity. This financial backing is not spent to purchase the reserves – the Bank does this by issuing settlement cash – but to offset the risk on the Bank's balance sheet. The provision of financial backing does not change the Crown's net debt – but the activity it enables (holding and using foreign reserves) will give rise to gains and losses that do impact on the consolidated Crown accounts.

The Bank is modelling the additional financial resources required. [37]

It is possible for the Bank to make gains which could be returned to the Crown through the dividend, but the focus is on downsides as this determines the level of financial backing required to bear those risks. This financial backing should be agreed alongside the agreement to the Framework proposals as otherwise the Framework could not operate. Treasury and the Bank will provide you further advice and options for financial backing alongside the draft Cabinet paper in late October.

The Treasury considers the Framework agreement should require the Bank to consult you ahead of foreign exchange interventions that could pose fiscal risks, and be transparent as to the costs and benefits, while maintaining independence and market sensitivity. Agencies will also provide you advice and options on this in October.

Recommended Action

We recommend that you:

a **Note** that under the RBNZ Act 2021 you are required to agree a Foreign Reserves Management and Coordination Framework with the Bank by the end of this calendar year. This must cover the level and composition of the reserves, and may include other matters you and the Bank think fit.

Noted

b **Note** that the Bank has provided you with its proposals as to the levels and composition of reserves required by the Bank to meet its objectives.

Noted

<u>Level and composition of the reserves</u>

c **Agree** with the Bank's proposals that:

a. [29] and [37]

b.

c.

d **Note** unhedged reserves generally have a holding cost which will reduce the dividend payments from the Bank, but will likely be profitable if used in an intervention. Hedged reserves are generally slightly profitable to hold, but may incur costs if used.

Noted

e **Note** that any increase in the foreign reserves for intervention purposes would require additional financial backing for the Bank from the Crown of [37]

Noted

f **Agree** that, alongside the draft Cabinet paper in October, the Treasury and the Bank will provide further advice and options on additional financial backing for the Bank.

Required/not required.

Transparency and consultation

g **Note** that the Treasury considers the Framework agreement should require the Bank consult you on foreign exchange interventions that could pose fiscal risks, and be transparent as to the fiscal impacts, while maintaining independence and market sensitivity.

Noted

h **Agree** that, alongside the draft Cabinet paper in October, the Treasury and the Bank will provide further advice and options on how any consultation and transparency requirements are included in the Framework.

Required/not required.

Process

i **Agree** that Treasury will provide you with a draft Cabinet paper in late October to inform your colleagues of your decisions, with a target Cabinet date of 21 November.

Agreed/not agreed

j **Agree** that this Cabinet paper would seek agreement to the required level of financial backing.

Agreed/not agreed

k **Agree** that subject to any further decisions, Treasury and the Bank will draft the Framework agreement ready for your, and the Board's, agreement in December.

Agreed/not agreed

Renee Philip
Manager

Grant Robertson
Minister of Finance

_____/_____/_______

Treasury Report: The Foreign Reserves Framework Agreement – Policy Decisions

Background

You must agree a Foreign Reserves Managements and Coordination Framework

1. On 5 May 2022 the Bank and the Treasury provided you with information and advice on the Foreign Reserves Coordination and Management Framework – required under section 143 of the RBNZ Act 2021 – which must be in place by the end of the year [RB 5917 and T2022/947 refer].

2. The purpose of the Framework is to facilitate the Bank's ability to achieve its main objectives, comply with directions given by you, and to recognise and coordinate the Crown and the Bank's interest and roles in regard to the foreign reserves. This Framework must specify the requirements and arrangements for the Bank's use and management of the foreign reserves, as well as the level the reserves must be held at. It may include any other matters you and the Bank see fit.

This report seeks your substantive policy decisions on the Framework agreement

3. Since then, the Bank has further developed its analysis on the level and composition of the reserves. It has also considered questions posed by you on potential financial losses, scenarios where the reserves may be used, and use of the reserves to support other central bank objectives. The Bank has provided you with this analysis alongside this report [RB 5973]. The Treasury supports the Bank's recommendations (although we acknowledge there are trade-offs and matters of judgement).

4. Based on your decisions on this report, the Treasury and the Bank will commence drafting the Framework. Treasury will provide a draft Cabinet paper at the end of October for your feedback to inform your colleagues of your decisions regarding the framework, and seek agreement to any financial backing required to operationalise the framework.

The level and composition of the reserves

The Framework is required to set the level or range of the reserves

5. Agreeing the Framework provides an opportunity to ensure reserves remain adequate, especially in light of the Bank's new legislation which provides it a clearer objective and independence to achieve financial stability.

6. [29] The Bank and the Treasury agree that it would be prudent to increase the level of reserves, and that a mix of hedged and unhedged reserves would be desirable.

The Reserve Bank holds foreign reserves to support its objectives

7. The foreign reserves are held by the Bank to support its monetary policy, financial stability, and 'other central banking' objectives. Some are used on a day-to-day basis to manage liquidity in the financial system, which entails little cost or financial risk. Other reserves are held by the Bank to intervene in the financial system for:

   - Monetary policy purposes – to lean against 'Peaks and Troughs'[1] in the exchange rate. This would likely involve the Bank selling NZD to purchase foreign currency, reducing the value of the NZD at the peak of the cycle.

   - Intervention in periods of market dysfunction to support financial stability. Such dysfunction could arise due to natural disaster, a foot and mouth outbreak, or the collapse of a major bank. Such intervention was envisaged for, but ultimately not required, during the Global Financial Crisis and the COVID-19 pandemic. This would likely involve the Bank selling its foreign currency and purchasing NZD, providing access to foreign currency and stabilising the exchange market.

8. Under the previous version of the RBNZ Act, the Bank could only intervene for financial stability purposes at the direction of the Minister of Finance, and such a direction provided financial backing automatically. However, the Bank still held foreign reserves on its balance sheet to provide intervention capacity for financial stability purposes.

9. The Bank currently holds around USD6 billion of hedged reserves and USD2 billion of unhedged reserves for intervention purposes, [29] and [37]
   This level has been largely stable since 2007. The intervention reserves are invested in safe and liquid assets to ensure that they can be available, if needed, in a crisis.

Holding foreign reserves creates both costs and risks.

10. These risks depend on whether the reserves are hedged against movements of the New Zealand dollar:

    - Unhedged reserves have exchange rate risk when held and have historically had an annual holding cost of around 0.75% of the reserves due to interest rate differentials. This holding cost would likely pass through to the Crown in lower dividend payments from the Bank. Unhedged reserves are likely to be profitable if used to intervene, as the NZD is likely to be at a low point when the foreign reserves are sold.

    - Hedged reserves do not have exchange rate risk when held, and have historically been profitable to hold. However, intervention with hedged reserves creates exchange rate risk and is potentially costly.

11. The preferred composition in part depends on the likelihood and form of a crisis, and how much 'insurance' one wishes to pay for. Hedging also changes the effectiveness of reserves to achieve the policy objectives, requiring more to be held.

[1] The 'Peaks and Troughs' framework was agreed in a 2004 memorandum of understanding between the Bank and the then Minister of Finance, partly to support broader economic goals through providing stability to exporters. [29]

[29] and [37]

12. Based in part on a comparative analysis of similar open economies with floating exchange rates, [29] and [37] This analysis compared the amount of foreign reserves held to key economic factors – imports, external debt, GDP, and turnover of that currency in the foreign exchange markets. It also considered the interventions performed by the Reserve Bank of Australia for financial stability purposes as a percentage of AUD turnover at that time. It then considered what New Zealand would need to hold relative to each of these factors to align with the comparable economies. [37]

13. [29] and [37]

This balances the increased intervention ability of unhedged reserves against the increased cost of holding these reserves, and is in line with the existing approach. The exact split would vary over time, depending on management of the reserves, the status of any interventions, and prevailing market conditions.

Treasury supports the Bank's proposals as to level and composition of reserves

14. It is hard to quantify precisely the right level of reserves for financial intervention. Partly, this depends on risk tolerance, and other value judgements. Any crisis where the Bank would be required to intervene for financial stability purposes would be unpredictable and significant. [37] Overall we think there are benefits to the Bank having sufficient capacity to intervene as necessary, including from the market perception that the Bank has that capability.

15. The majority of the immediate costs and risks arise from holding reserves unhedged; hedged reserves only generate this risk when they are used. However, holding a portion of the reserve portfolio unhedged has advantages. It is likely to be profitable in the event of a crisis (when the value of NZD will have fallen) and the loss modelling suggests that a diversified portfolio (i.e. some hedged and some unhedged) helps to limit losses in the most extreme downside scenarios. Having the capacity to hold unhedged reserves is necessary as the swap market (through which hedged reserves are raised) is small and can be illiquid at times. Treasury notes the cost of holding unhedged reserves has historically been higher for New Zealand than for some similar countries due to relatively higher interest rates.

16. Foreign assets held for liquidity management purposes create minimal costs or risks for the Crown's balance sheet, so we are comfortable on this basis.

Additional financial backing will be required

17. Under the old regime, the Bank could only intervene for financial stability purposes with a direction from the Minister of Finance. Such a direction would automatically indemnify any losses resulting from the intervention, and which provide the Bank with the financial backing needed to intervene.

18. Under the new Act, the Bank can intervene for financial stability purposes independently. However the Bank's ability to act is constrained by its resources, and the duty for the board to ensure the Bank acts in a financially responsible manner, and it requires financial backing to hold, manage and use the reserves. [29] and [33]

19. The financial backing could be provided through either additional capital, an indemnity, or a combination of the two. Providing financial backing to the Bank, either through an indemnity or a capital injection, does not have a direct cost to the Crown. This is because it is a transfer of an asset from the Crown balance sheet to the Bank's, and because these are consolidated, the net impact is zero. The gains and losses generated by the activities the financial backing enables however is real, and will impact on the consolidated Crown accounts.

20. The Bank and the Treasury are continuing to consider the best level and form of financial backing, and will provide further advice and options in late October. At this stage, the Treasury preference would be to provide sufficient detail to Cabinet that you can seek agreement to the overall quantum of financial backing and ask for delegated authority to determine further details and establish the financial arrangements. Alternatively, it would be possible to inform Cabinet of the overall quantum of the financial backing required and return to Cabinet early next year to agree the details.

21. The Bank is continuing its broader capital adequacy project and expects to provide a report to you next year, at which time the Bank may seek additional financial backing to support its broader activities.

22. If you and Cabinet do not agree to providing additional financial backing to the Bank, the Bank would be unable to hold the level of reserves set out in its proposal and they may need to work through the implications for the Framework. This would inhibit the Bank's ability to meet its objectives, and could require you to issue an indemnity or a direction during a crisis making you more accountable for the results. As it may impact market confidence during a crisis, and would be a reversion to the pre-existing model, before the Bank was provided a clearer mandate and operational independence in relation to financial stability under the new Act, we would not recommend this.

Your role in relation to intervention with the foreign reserves

23. Both the Bank and you have interests in foreign reserve intervention for financial stability. The Bank is required and empowered by its legislation to pursue its financial stability objective independently. As Minister you have an interest in the fiscal position of the Crown (which includes the Bank within the consolidated balance sheet), and the Government may have additional information on its intended approach to any underlying crisis.

24. The Treasury is considering how the Framework could require you be informed and consulted regarding interventions. For instance, requiring the Bank to assess the fiscal impacts of a potential intervention and consult you, and provide transparent follow up reports. It is important these requirements maintain the Bank's operational independence to support market confidence, allow the Bank to plan and prepare, and minimises uncertainty and overhead during a crisis. These requirements would need to take into account practicality and market sensitivity.

25. The Treasury will engage with the Bank, and provide recommendations and options on these matters alongside the draft Cabinet paper in October.

Next steps

26. Treasury would appreciate your decisions, feedback, and further questions by early October. Based on this, we will work with the Bank to provide any further advice and options alongside a draft Cabinet paper in late October. In particular, we plan to provide you with a recommendation to take to Cabinet to agree the arrangements for providing financial backing for the increased foreign reserves, as well as further advice on transparency and other requirements. These matters will be considered by the Bank board on 19 October. The board will need to agree to the final framework. Financial arrangements are decided by you and Cabinet but may affect the board's ability to agree to, and operationalise, the Framework.

27. If financial backing arrangements are not agreed to in sufficient detail by Cabinet in November to allow the delegation of the details to you and the appropriate Associate Minister of Finance, you will need to return to Cabinet next year to seek agreement to the financial arrangements to allow the Framework to be operationalised.

Indicative timeline	
You provide feedback and decisions in response to these papers	6 October
Draft Cabinet paper and further advice on any options provided to you	27 October
Cabinet paper consultation begins	2 November
Cabinet DEV Committee considers paper	16 November
Cabinet considers paper	21 November
Bank Board agrees and signs the Framework	8 December
You sign the Framework	12 December
Capital arrangements in place, Framework begins to be operationalised	First half of next year