Adrian Orr: Excerpt on the Reserve Bank of New Zealand's exchange rate intervention proposal

Address by Mr Adrian Orr, Deputy Governor of the Reserve Bank of New Zealand, as part of a presentation to the Meat New Zealand Annual Conference in Whangarei, 25 March 2004.

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I wish to make a few comments about the Reserve Bank's proposal to have the capacity to intervene in the foreign exchange market. These comments relate to what the proposal is, what it is not, and what it implies for business people.

There are two legs to the Bank's foreign exchange intervention objectives which are likely to be used in very different circumstances.

First, the Bank has a long standing objective to restore order to any actual or potential dysfunction in the foreign exchange market. If, for some exceptional and disturbing event, liquidity in the New Zealand dollar exchange rate dried up, the Bank would be prepared to support liquidity until some sense of normality returned. This objective is not about bailing-out speculators, or facilitating 'hot money' flows. It is about ensuring that the foreign exchange market continues to function in an orderly manner and essential transactions can occur. To meet this objective, the Bank currently holds and manages a portfolio of liquid, high quality, foreign currency assets that would be used in exceptional times.

The Bank, last month as part of its ongoing legal commitment to advise the Minister of Finance on foreign exchange matters, recommended that the Bank hold more foreign currency reserves as 'insurance'. More reserves appear necessary because the foreign exchange market globally has grown significantly since 1984 - when the Bank's reserves level was largely set - as has the New Zealand economy. While it is an unlikely event for a well managed economy with a floating exchange rate, the New Zealand economy can not afford to face a situation of a non-convertible currency. Our foreign currency reserves need to be sufficient to ensure such a situation has a very low probability. The Minister of Finance has agreed with our advice and will be moving to increase significantly the level of foreign currency reserves the Bank will manage for such 'insurance' purposes.

In addition, and again as part of the Bank's ongoing legal commitment to advise the Minister of Finance on foreign exchange matters, we recommended having the capacity to intervene in the foreign exchange market to affect the level of the exchange rate in certain circumstances. That is, we would contemplate intervening if the exchange rate is exceptionally and unjustifiably high or low, and we think an opportunity exists that would ensure such intervention was effective.

By exceptionally high or low, we mean when the exchange rate is nearing its cyclical extremes, as has been seen in New Zealand over recent decades on a 3 to 5 year cycle. By unjustifiable, we mean when the exchange rate has moved well in excess of any relevant economic fundamentals, such as relative productivity, commodity prices, growth, or inflation.

It should be noted that most of the time a floating exchange rate, like New Zealand's, performs important economic functions such as acting as a buffer against shocks to the terms of trade or relative business cycle pressure. We believe our floating exchange rate serves New Zealand well.

However, at times, the exchange rate has varied by far more than can be justified by relevant economic fundamentals. It is at these exceptional and unjustifiable levels of the exchange rate that the Bank would consider buying or selling foreign currencies for NZ dollars in an effort to influence the level of the exchange rate. There is no mechanical rule underlying this new objective - such decisions are made in context.

An important part of the Bank's consideration to intervene would be the dynamics of the foreign exchange market at the time and whether we feel our actions will be effective. In other words, the Bank would intervene at opportune times, not when the currency's direction is being dominated by strong international trends or consensus opinions.

We do not intend wasting our reserves by defending a particular exchange rate level, nor do we intend standing in the way of strong market trends or beliefs. We also do not expect to attract speculators who think they can 'take the Bank on'. If we are not defending a particular level of the exchange rate, we have no mechanical rule, and we intervene consistent with our monetary policy objectives at opportune times, then it is unclear what nature of speculator would be attracted by our actions.

By way of example, we are not recommending a Bank of Japan style intervention, where they use significant funds with the aim of influencing the long-term trend of the exchange rate, or by standing in the path of strong trends in the exchange rate. And we are certainly not recommending defending a particular level of an exchange rate that is clearly over or under-valued. This was the case, for example, in many East Asian economies during the late-1990s Asian financial crisis.

Instead, the Bank believes strongly in the virtues of a floating exchange rate within a well managed economy. What we are recommending is intervening when the moment is justified and opportune, with the outcome of, at best, trimming the extreme tops and bottoms of the NZ dollar exchange rate cycle.

Such an intervention strategy would be consistent with the Bank's primary objective of achieving and maintaining price stability. Hence, foreign exchange intervention can be viewed as another instrument for the Bank, consistent with achieving our monetary policy objectives, albeit a very secondary instrument to our most powerful one of the Official Cash Rate. Intervention would be considered in reasonably infrequent circumstances, that is, when the exchange rate level is exceptional and unjustified by economic fundamentals, and when we believe an opportunity to be effective exists.

We do not anticipate having a substantial or large impact on the level of the exchange rate. However, we believe there will be positive benefits that exceed any of the relatively small and manageable risks of such a policy. Given the prominence of the level and cyclical variability of the exchange rate in investment, output, employment, and inflation decisions, even a small impact from intervention on the exchange rate can have widely dispersed economic benefits.

The Bank's advantage in this intervention strategy is not its 'weight of money'. Instead it is the Bank's investment horizon, information, and alignment of policy objectives that brings advantages and opportunities. To be successful, we need to be in the business for the long-term. This is why we have appealed for multi-party political support of the policy.

That said, the Bank already has the ability - legal and operational - to intervene in the foreign exchange market, consistent with achieving and maintaining its primary goal of price stability. What we have requested from the Minister is additional foreign reserves for intervention purposes, over and above the minimum we recommended for avoiding dysfunction. In addition, we have requested that the Government inject additional capital into the Bank's balance sheet so that we can absorb any potential temporary, unrealised, marked-to-market losses in our foreign exchange positions. This is prudent management.

Such an intervention strategy, over the relevant medium-term horizon, should even prove profitable or, at the least, reduce the cost of holding foreign currency reserves for avoiding market dysfunction.

The Bank's intention to buy foreign currencies (sell NZ dollars) when the exchange rate is exceptionally and unjustifiably high, and to sell foreign currencies (buy NZ dollars) when the exchange rate is significantly and unjustifiably low, makes good portfolio management sense - as long as we are in the business for the long-term. On average, over the medium term we would anticipate having no exposure to foreign exchange swings.

The Reserve Bank's management of foreign reserves is a long-term business. It is very common for central banks internationally to manage their foreign currency reserves in such a manner - just as any fund manager or business in the game for the long-term would do.

Our assessment as to the benefits of foreign exchange intervention of the nature outlined is the result of considerable analysis over several years. This includes analysing experiences internationally, and academic and empirical literature. It is not a knee-jerk reaction to the recent level of the exchange rate, nor a response to political pressure. We take our operational independence seriously, and for this reason we have recommended that this new intervention policy operates under the Bank's own legal purposes, so that any intervention decisions are made within the Bank, and are consistent with our primary objective of achieving and maintaining price stability. We have not recommended such an intervention capacity lightly.

As part of our operational independence, we stand prepared to be held accountable for the outcomes, as we do with monetary policy in general.

But, exporters, importers and anybody else dealing with foreign exchange, need to be clear that ongoing and considerable cyclical variability in the exchange rate will continue even if our interventions are successful. Our intervention policy is talking about, at best, knocking the extreme tops and bottoms off the NZ dollar exchange rate cycle. By far the bulk of foreign exchange risk management responsibility remains in the hands of the businesses and individuals within NZ. We are not offering a panacea to these cycle, we are simply saying we think we can make a small positive difference that makes sense.