Grant Spencer: Recent intervention by the Reserve Bank of New Zealand in the foreign exchange market

Opinion article by Mr Grant Spencer, Deputy Governor of the Reserve Bank of New Zealand, 27 June 2007.

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On 11 June, the Reserve Bank confirmed that it had intervened in the foreign exchange market to sell New Zealand dollars. This was the first such intervention since the exchange rate was floated in March 1985.

The Bank's 11 June announcement has prompted a lot of discussion and commentary around the objectives and impact of FX intervention. It is useful to clarify a number of issues around this subject.

Foreign exchange intervention is an ongoing process and the Bank will not be commenting publicly on its specific intervention activities. We will, however, continue to release our financial accounts, which show the accumulated impact of the Bank's intervention activities. These accounts are posted on the Bank's website at the end of each month, with a lag of one month.

Under the Bank's Policy Targets Agreement with the Minister of Finance, the Bank seeks to avoid unnecessary variability in interest rates, output and the exchange rate as it goes about maintaining low inflation. The Bank's primary monetary policy instrument is the Official Cash Rate (OCR). The foreign exchange intervention framework provides an additional tool for the purpose of trying to moderate the extremes of the exchange rate cycle.

Intervention operates at the margin, affecting the balance of demand and supply for the New Zealand dollar. It can have an immediate downward impact on the exchange rate as it did on 11 June. That can help to moderate the "peaks" in the exchange and the length of time we spend at peak levels. It does not attempt to defend a particular level of the exchange rate. Rather it sends a signal that, in the Bank's view, the exchange rate is out of alignment with the economic fundamentals. Those speculating in the New Zealand dollar need to be aware that the exchange rate is not a one-way bet; they need to be cautious.

The Bank's policy is to intervene only when the exchange rate is at exceptional levels; when it is unjustified by medium term economic fundamentals; when intervention is seen as consistent with the Policy Targets Agreement; and when market conditions make intervention opportune.

In recent times, the New Zealand dollar has been at levels that the Bank regards as both exceptionally high and unjustified by the economic fundamentals. Many businesses would agree. The high level of the exchange rate is creating challenging conditions for large parts of the tradables sector, particularly for those not directly benefiting from the recent rise in world commodity prices. With New Zealand's current account deficit sitting around 9 percent of GDP, it is our view that the exchange rate cannot be sustained at current levels over the medium term.

Does trying to lower the New Zealand dollar run counter to monetary policy and the Reserve Bank's low inflation objective? We do not believe so. Intervention is about seeking to moderate the trend in the exchange rate and rebalancing monetary policy pressure. It does not fundamentally alter monetary policy and does not signal a future easing of conditions. The direct liquidity impact of FX interventions is always offset via the Bank's money market operations.

The mechanics of foreign exchange market intervention are quite simple. The Reserve Bank acquires foreign currency reserves by selling New Zealand dollars. This activity may be limited by the amount of foreign reserves we are prepared to accumulate; but is not limited by the Bank's ability to supply NZ dollars. In this sense, intervention to lower the NZ dollar is less restricted than in the reverse situation where intervention is working to support the NZ dollar by running down reserves.

Many countries around the world have policies which allow foreign reserves to be built up as the exchange rate rises and reduced when their currencies come under pressure. Unlike many commercial traders, the Reserve Bank has the scope to hold additional foreign reserves for an indefinite period. When the exchange rate eventually falls to a more sustainable level, the holding of foreign reserves should become profitable as their value will increase in New Zealand dollar terms. Claims by some observers that the Bank has somehow "thrown away" taxpayers' money by intervening simply do not stack up.

FX intervention is a supplementary monetary policy tool and is considerably less potent than the central OCR instrument which has an important influence on the trend of the exchange rate. As noted in the Bank's June *Monetary Policy Statement*, the outlook for the OCR will depend on how inflation pressures evolve over the months ahead. Evidence that inflation pressures are abating will be an important step in seeing the exchange rate return to more sustainable levels.