Westpac Institutional Bank

Realities of NZD intervention

A primer on the RBNZ's FX intervention policy

- **RBNZ Governor Wheeler's speech this week has drawn the market's attention to the central bank's policy on exchange rate intervention. Here we provide a refresher.**
- **The RBNZ uses four criteria for deciding whether to intervene, with the aim of trimming the peaks and troughs of the exchange rate cycle.**
- **The hurdles to intervention are high but not insurmountable, and it should be considered a possibility in the current environment.**

Reserve Bank Governor Graeme Wheeler received some interesting, though probably not unwelcome, responses to his speech this week on the exchange rate. Media reports largely focused on the statement that "the Reserve Bank is prepared to intervene to influence the Kiwi"; one overseas analyst even declared "New Zealand's entrance into the currency war". The NZ dollar fell around half a cent after the speech was published.

Yet this was no more than a restatement of the RBNZ's policy on intervention that has been in place since 2004. When you examine the policy and its track record, it's apparent that intervention has been a possibility for some time now. In fact we raised this as a risk back in April last year, after the RBNZ stated that "should the exchange rate remain strong without anything else changing, the Bank would need to reassess the outlook for monetary policy settings", which in our view covers both interest rates and exchange rates.

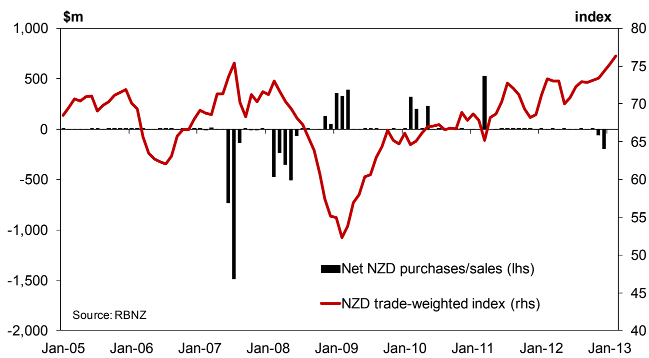
With exchange rate policy firmly on the market's radar at the moment, we provide a refresher on the RBNZ's approach to intervention.

What is the policy on intervention?

The RBNZ developed its current intervention policy in 2004. Decisions on when to intervene are based on four criteria:

- The exchange rate must be at an exceptionally high or low point in the cycle;
- The level must be unjustified based on a range of economic fundamentals;
- Intervention must be consistent with the Policy Targets Agreement (PTA); and
- Market conditions must be opportune, so that intervention has a reasonable chance of success.

RBNZ intervention and NZ dollar trade-weighted index



The RBNZ has repeatedly said that it doesn't expect to have a sustained impact on the level of the exchange rate. Rather, 'success' would be measured on terms such as altering market psychology, disrupting rule-based trading, sending a signal about the desired monetary policy settings, and ideally trimming the peaks and troughs of the exchange rate cycle.

Have these criteria been met?

The criteria are deliberately qualitative in nature – 'constructive ambiguity' is part of the approach, to keep the market on its toes. However, the RBNZ has at times stated that the first two criteria (exceptional and unjustified) have been met, and that's probably the case today. We can also assume that intervention would be consistent with the PTA – at the moment the RBNZ is at greater risk of undershooting its inflation target, so weakening the currency would work in the right direction.

Mr Wheeler noted that the last condition is particularly important. With turnover in the NZ dollar typically in the billions per day, it would be easy for the RBNZ's flow to be swamped by the rest of market. It's telling that the day the RBNZ chose for its first intervention (11 June 2007) was a public holiday in Australia – it's easier to fight the market when a large portion of it is closed. Timing for 'success' has clearly been the major hurdle for intervention in recent years.

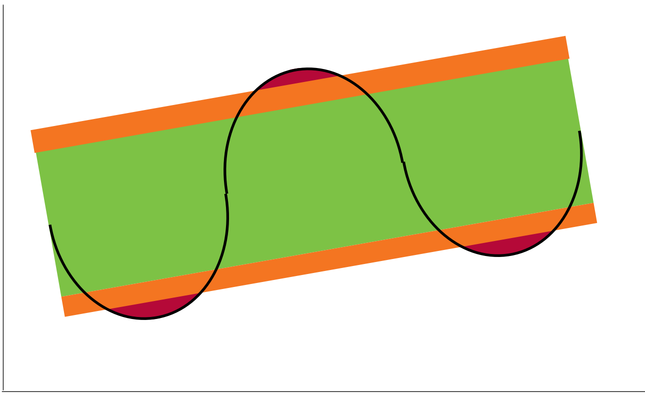
Isn't the RBNZ intervening already?

While the 2004 policy was well publicised, what's less well-known is that the RBNZ introduced a second layer to the policy as part of a broader review of its balance sheet that was completed in 2008.[1] The RBNZ now leaves a 'core' portion of its foreign reserves (about $2bn) unhedged against exchange

1 For more detail see K Eckhold, "The Reserve Bank's new approach to holding and managing its foreign reserves", *RBNZ Bulletin* vol 73(2), June 2010.

rate movements, and varies this portion by buying and selling NZ dollars over the cycle. In this case, intervention only has to meet the first two criteria (exceptional and unjustified) and it only needs to be in the upper or lower ranges of the cycle, not at the extremes. This is modelled on the approach that the Reserve Bank of Australia has taken for many years.

Stylised exchange rate cycle



	Relevant Criterion			
	Exceptional	Unjustified	PTA Consistent	Opportune
Potential squaring up zone	×	×		
Passive reserve building / run down zone	✓	✓	?	
Intervention zone	✓	✓	✓	✓

Source: Reproduced from Eckhold (2010)

It's likely that this secondary policy was the basis for the NZ dollar selling in early 2008 (later 'squared up' after the exchange rate fell during the global financial crisis), and more recently the net $263m that we know was sold in November/December last year. (January figures will be published next week.) In these amounts, we doubt the RBNZ would have any expectation of being able to move the exchange rate. But the fact that they're doing it is a clear signal that the first two criteria have been met, and that the last two may not be too far behind.

How much can the RBNZ intervene?

It depends on the direction. The RBNZ holds foreign currency reserves of around $9bn, which can be used to support the NZ dollar in a crisis situation. In contrast, intervening to weaken the NZ dollar would involve buying foreign currencies, so the amount of foreign currency already on hand is irrelevant. What the RBNZ would need are NZ dollars to sell – and in theory there's no limit to how many of those it can come up with. The main constraint would be maintaining consistency with the PTA, as weakening the exchange rate would add to inflation.

Didn't the Bank of England lose billions by intervening in 1992?

That was a different situation – the Bank of England was trying to defend a particular level of the pound in order to remain within the Exchange Rate Mechanism, a precursor to the euro. Since they were trying to support the currency, not push it down, they were constrained by their level of foreign currency reserves (see above).

How effective is intervention?

The first overseas studies of intervention, using daily or even monthly activity reported by central banks, found no impact on exchange rates. As transaction-level databases became available, later studies found some temporary effects. But the fact that you have to break out the microscope to find an impact doesn't bode well for its usefulness as a macroeconomic policy tool.

Two recent examples – Japan and Switzerland – might suggest that large-scale efforts to weaken the exchange rate can be effective. But neither case is that straightforward. The 16% fall in the yen since last October wasn't the product of direct intervention, which hasn't occurred since November 2011. Instead, it was driven by expectations that the new government would force the Bank of Japan to target a positive rate of inflation, and to loosen monetary policy as much as needed to meet that target. This is hardly a strategy for New Zealand to replicate – we adopted an inflation target 23 years ago.

In late 2011, the Swiss National Bank announced that it would sell Swiss francs in unlimited amounts in order to cap the level of the exchange rate. Since then it has expanded its balance sheet by around 180bn francs, worth 30% of annual GDP (the equivalent for New Zealand would be about $60bn). The policy has been a success in the sense that it has capped the exchange rate against the euro (though the euro itself has been rising in that time). But it has come at the cost of an overheating housing market – the money created as a result of large-scale intervention has to end up somewhere, and in this case it's ended up in property. Indeed, the banking regulator last week raised bank capital requirements in an attempt to stem the rise in house prices and credit growth. So it's hard to argue that FX intervention has been conducive to financial stability.

What would intervention mean for monetary policy?

Successful intervention would amount to a loosening in monetary conditions. All else equal, that would mean higher interest rates than otherwise – either more need for rate hikes or less need for cuts.

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