Building a balance sheet to support financial stability

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Introduction

E ngā mana, e ngā reo. E ngā karanga maha o te wā.

Tēnā koutou, tēnā koutou, tēnā koutou katoa,

Good morning. It's wonderful to be here in Sydney representing Te Pūtea Matua, the Reserve Bank of New Zealand. I want to thank UBS for hosting this event and for inviting me to speak.

As an Assistant Governor with responsibility for financial markets, I spend a fair amount of time thinking about the RBNZ's balance sheet, its size, composition and the risks associated with it – and that is what I would like to talk about today. This speech might be considered the third in a trilogy on the RBNZ's balance sheet, following on from Christian Hawkesby's in 2020 and Vanessa Rayner's in 2021.

Central bank balance sheets are garnering significant interest these days, which is understandable given their growth in size. With increases in size largely due to their use as tools of monetary policy post GFC, any change in central banks' balance sheets are commonly viewed as either a form of monetary easing or "quantitative tightening".

It is correct that a central bank's balance sheet is an instrument of policy, not an instrument of profit and therefore any time there is a change in the size or composition of the balance sheet, it will be in support of policy. When we consider policy, however, this includes financial stability and is not the exclusive domain of monetary policy.

Today my focus will be on the RBNZ's balance sheet as a tool to support financial stability and I will outline some of the recent steps we've taken to strengthen the RBNZ's balance sheet for that purpose. In particular in the area of foreign reserves.

The role of the central bank balance sheet in financial stability

Financial stability is often thought about in terms of prudential regulation – which aims to support the stability of individual deposit takers which in turn strengthens the financial system.

In their traditional "lender-of-last-resort" role, central banks can also provide funding or liquidity, lent against good collateral, and typically at penalty rates of interest, to support the stability of individual entities.

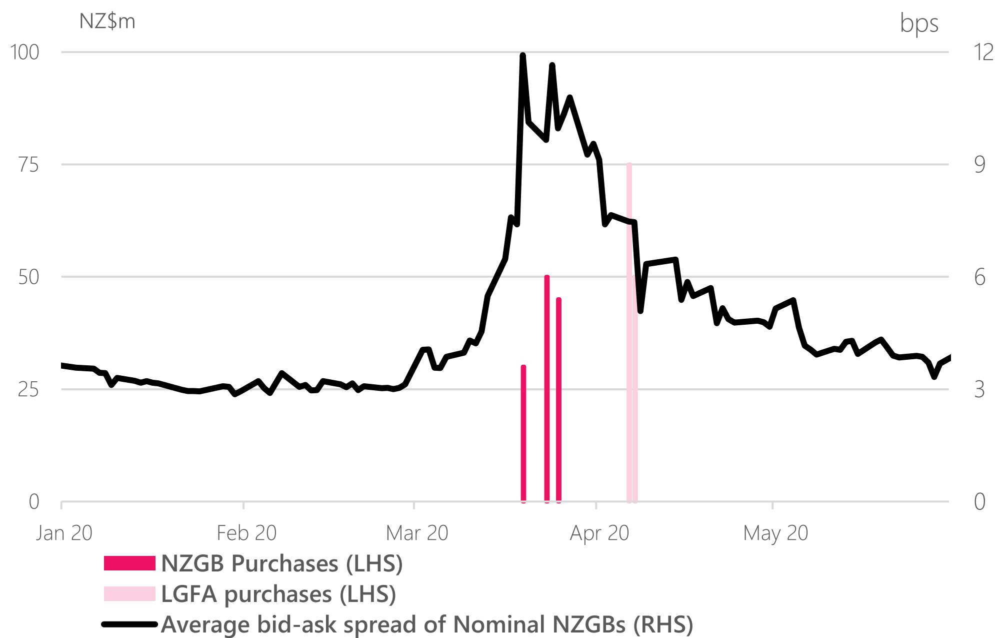
Central banks also play a critical role in the provision of market liquidity in the normal course of business supporting objectives related to efficient payments and settlements across the financial system and effective monetary policy transmission. For instance, the RBNZ regularly transacts in the FX swap market to ensure that the implied NZD overnight interest rates in that market remain close to the OCR.

The functioning of financial markets more broadly is also important for financial stability. Market dysfunction erodes confidence, impedes transmission of monetary policy, and can quickly transmit via the financial system to the real economy.

Central banks in this context can also play a role as "market-maker-of-last-resort", providing market liquidity through facilities designed to provide targeted and temporary liquidity where it might otherwise be absent, largely in times of stress or crisis. For example, the RBNZ has a Bond Market Liquidity Support (BMLS) facility which we can use to make outright purchases of government bonds during periods of market stress – something we did during the most acute phase of the COVID-19 crisis.

Figure 1

Bond Market Liquidity Support



Source: Bloomberg; RBNZ

The role of market-maker-of-last-resort is largely an unavoidable one given the importance of market functioning, both for financial stability and as a channel for the transmission of monetary policy.

But that doesn't mean there aren't important questions to ask about how and when central banks should play this role. How dysfunctional do markets need to be before central banks step in, who should have access to central bank facilities and on what terms, are live policy issues across many jurisdictions today. The Bank of England has recently announced its intention to provide liquidity facilities to non-banks[1] and the Federal Reserve's response to banking stress earlier this year included a facility which took collateral at par, rather than at market value[2].

While circumstances at a given point in time may dictate variation in response to crises, guidelines for the provision of support can also support appropriate expectations of self-sufficiency with market participants. To that end, as part of our current internal Liquidity Management Framework Review, we are developing our crisis "playbook" to support a clear understanding of the purpose, scope and entry and exit conditions for crisis facilities between ourselves and market participants.

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[1] Hauser, A. (2022, November). *Thirteen days in October: how central bank balance sheets can support monetary and financial stability* [Speech]. Presented at the ECB's 2022 Conference on Money Markets. Retrieved from https://www.bankofengland.co.uk/speech/2022/november/andrew-hauser-keynote-speech-at-the-european-central-bank-conference-on-money-markets

[2] Bank Term Funding Program. (2023, September 11). Retrieved from www.federalreserve.gov website: https://www.federalreserve.gov/financial-stability/bank-term-funding-program.htm

Foreign Reserves Coordination Framework

Like most central banks, RBNZ holds foreign reserves on its balance sheet that can be used to intervene in the foreign exchange market to support both financial stability and monetary policy objectives. This could include intervening when market functioning is impaired, and liquidity is limited – or when the level of the exchange rate is at extreme and unjustified levels relative to economic fundamentals and thereby working against the desired stance of monetary policy.

In the case of the RBNZ, the level and use of foreign reserves had historically been agreed with the Minister of Finance under ad hoc Memoranda of Understanding, with the last one agreed in 2007. The introduction of the new Reserve Bank Act 2021 required the RBNZ and Minister of Finance to agree to a new 'Foreign Reserves Management and Co-ordination Framework' (FRCF) setting out expectations around the management and use of foreign reserves in New Zealand and the respective roles of the RBNZ and Minister of Finance. The FRCF was agreed in December 2022 and published in January 2023.

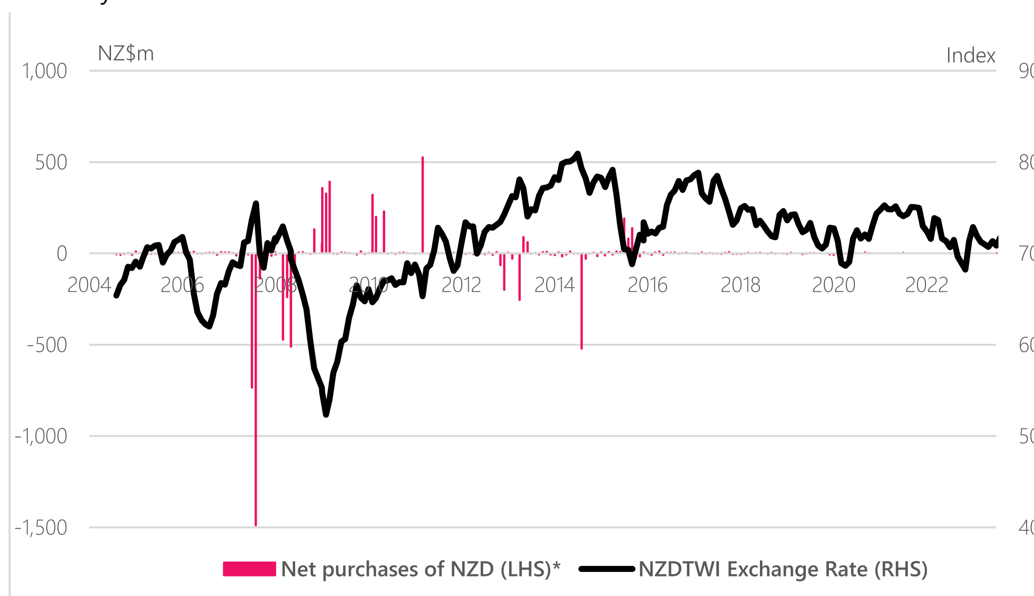
The introduction of the new framework does not fundamentally change the approach to foreign exchange interventions. Periods of intervention are still expected to be rare, and we remain committed to maintaining a free-floating exchange rate, with this being reflected in the internal decisioning frameworks we apply.

For example, in assessing the appropriateness of FX intervention for monetary policy purposes, the Monetary Policy Committee (MPC) utilise four key criteria that set a high hurdle for intervention to occur with all four required to be met. These include: 1) Exceptional – the exchange rate should be exceptionally high or low 2) Unjustified – the exchange rate should be unjustified by economic fundamentals 3) Consistent – intervention should be consistent with our monetary policy objectives 4) Opportune – market conditions should be opportune and allow intervention a reasonable chance of success.

Figure 2

NZDTWI and RBNZ Foreign Exchange Activity

Monthly data to June 2023



*Includes all RBNZ activity in the foreign exchange market including business as usual operations

Source: RBNZ

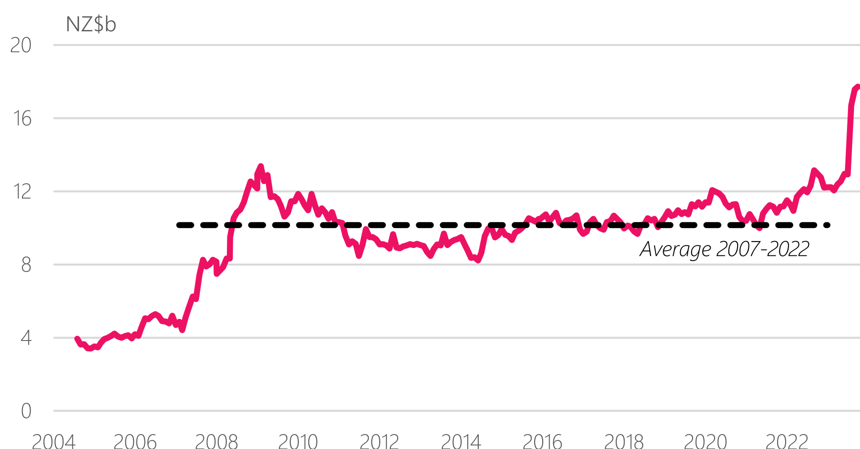
A well-functioning foreign exchange market is critical to New Zealand's economy and is relied on every day by exporters, importers, borrowers, and investors. In extreme circumstances, such as financial crises, it may also be necessary for the RBNZ to intervene for financial stability purposes, providing liquidity and confidence to the market. In order to do so the RBNZ must already hold foreign assets which requires a prepositioning of the RBNZ balance sheet. In these situations, the RBNZ will consider whether market dysfunction is sustained, systemic and could be reasonably addressed by intervention.

Under the new FRCF, agreement was reached with the Minister of Finance to increase the RBNZ's holdings of foreign reserves for this purpose. The agreement acknowledges the time since last review, growth in size of the economy and scale of FX markets in the intervening period and therefore the need for increased capacity to support intervention.

Figure 3

Foreign Currency Intervention Capacity

Monthly data to September 2023



*Foreign reserves that are readily liquefiable less foreign currency liabilities that fall due in the next 12 months.
Source: RBNZ

As episodes of intervention are rare there is no clear answer as to what the right level of foreign reserves is. In determining what an appropriate level of foreign reserves for New Zealand might be, we considered a range of metrics, including import volumes, debt outstanding and FX turnover, as well as international central bank comparisons, and scenarios including previous interventions in New Zealand and overseas. We will not be commenting on the target level of reserves agreed as that information is considered market sensitive but will note that achieving it is a process that will occur over a number of years. This is because we seek to avoid undue risk to market liquidity from our actions in reaching agreed levels.

Increasing the level of foreign reserves – all else equal – results in the size of the RBNZ balance sheet increasing. The raising of reserves, and their subsequent investment in foreign currency assets, is funded through the RBNZ increasing the level of settlement cash in the system. This also means that the initial cost of funding the foreign reserves reflects the Official Cash Rate (OCR) – the rate at which settlement cash within the system is remunerated by the RBNZ. This cost of carry is partially offset

by the return generated on the investment of the foreign reserves into assets such as foreign currency government bonds.
The RBNZ holds two main portfolios of foreign reserves, hedged and unhedged, with the distinction between the two simply reflecting how the NZD is converted into a foreign currency.

Unhedged reserves are raised by selling NZD in exchange for foreign currency in the spot foreign exchange market. This transaction results in us owning foreign currency, and the value of these assets will fluctuate in line with increases or decreases in the exchange rate.

The hedged reserves are raised by lending NZD in exchange for foreign currency, generally in the cross-currency basis swap market. We effectively borrow foreign currency under long term contracts and are not exposed to movements in the exchange rate, because all the foreign exchange rates are agreed at the start of the contract.

Historically the RBNZ has chosen to hold a mix of both unhedged and hedged reserves. In addition to the different exchange rate exposures, there are other considerations taken into account when determining the mix. These include the relative costs, risk appetite, refinancing risk and intervention needs. While we will not comment on what the composition will look like in the future, we expect the mix of portfolios to carry flexibility and be influenced by market conditions over time.

Under the Foreign Reserves Management and Co-ordination Framework the RBNZ is also responsible for managing the investment of the foreign reserves. Like most central banks, the primary considerations when looking to invest our reserves are safety and liquidity. This ensures that when they are needed our reserves maintain their value and can be easily converted into cash. Subject to satisfying safety and liquidity requirements, return is then considered and optimised and like other central banks around the globe, the RBNZ is also evaluating alternatives for the incorporating sustainability considerations in our investment criteria. While the purpose of the reserves will always require safety and liquidity as primary criteria, risks such as those posed by climate change will impact upon those over time and transition and mitigation likewise may add to investment opportunities.

A Review of Financial Resources

Central banks, including the RBNZ, are unique in that they can operate under negative equity – the value of their liabilities can exceed the value of their assets – without impinging on their ability to fulfil their policy objectives. However, there is a risk that periods of deep and persistent negative equity could erode confidence in a central bank and therefore its ability to fulfil its' policy objectives. The RBNZ has a legislatively mandated obligation to operate in a financially responsible manner and aims to have sufficient financial resources to support its core operations, manage exposure to financial risks associated with its balance sheet activities, and enable a reasonable range of policy interventions for financial stability and monetary policy that may be needed in the future.

Holding and using foreign reserves, for example, exposes the RBNZ balance sheet to a range of financial risks, including market, credit, liquidity and counterparty risks. In the normal course of operations, this would require access to an appropriate level of financial resource, i.e. capital or like instruments, to accommodate exposure to those risks on their balance sheet.

RBNZ, together with the NZ Treasury, have reviewed the RBNZ's financial resources and determined that in addition to those required to support the agreed increase in foreign reserves holdings, there are current and potential future balance sheet activities (such as interventions for financial stability) that carry a degree of financial risk and would also benefit from additional pre-positioned financial resources.

Pre-positioned financial resources, in this case capital and indemnities, provide several benefits beyond mitigation of risks to credibility. It can support the Crown's ability to manage overall Crown exposure to financial risk well in advance of a crisis, support fiscal and monetary policy coordination, provide clarity around decision-making structures to enable quick action in a crisis, and support the RBNZ's operational independence, which is critical for our credibility in achieving our objectives.

Following the review, the RBNZ has received an additional $1.8 billion in capital plus additional indemnities from the Crown.

Indemnities provide financial backing for the RBNZ and transfer financial risk to the Crown in relation to specific activities undertaken by the RBNZ. Unlike capital, indemnities are not fungible – they can't be exchanged for anything else – and cannot be used to support general balance sheet volatility.

An example of an indemnity that you may be familiar with is the indemnity the RBNZ received for potential losses on the Large Scale Asset Purchase Programme (LSAP) deployed in response to COVID-19. Provision of this indemnity has meant that accounting losses from the LSAP programme have not impacted the RBNZ's capital position. As part of the review this indemnity has now been terminated for new purchases (although it remains in effect for existing bonds purchased under LSAP that remain on our balance sheet).

Central banks around the world have taken varied approaches to address accounting losses from bond purchase programs undertaken during and before COVID. Some central banks (like the RBNZ) have opted for indemnities while others have gone into negative equity. Since central banks around the world are publicly owned and their balance sheets are consolidated within overall government balance sheets, the overall effect on government balance sheets remains the same.

Since the RBNZ balance sheet is a subset of the Crown balance sheet, accounting losses on LSAP have to some extent been offset by fiscal benefits to the rest of the Crown. The IMF has explored the net benefits of the LSAP programme in New Zealand as part of their independent Article IV report, and has found that the LSAP programme had favourable effects on the Crown's fiscal stance.

Following the review two new indemnities have been provided. The first indemnity specifically supports foreign exchange interventions related to the FRCF. The second indemnity relates to losses that may be incurred on bond purchase programmes, in the future. As discussed previously bond purchase programmes, which can be useful in supporting financial stability, may be needed in instances of market dysfunction, such as that we encountered at the onset of COVID-19. It is important to note that interventions will not necessarily lead to losses, and in some cases, can be profitable.

Larger risks, for example for bond purchase programmes intended to provide ongoing monetary policy stimulus on the scale of the COVID-19 LSAP, may require additional financial resources, beyond that currently provided. However, we expect that in such situations, there would be more time to formulate policy and seek additional financial resources once immediate crisis concerns have been alleviated. As such, we have not sought pre-positioned financial resources to enable interventions of this scale. We have a Memorandum of Understanding (MOU) on Additional Monetary Policy (AMP) tools with the Minister of Finance which lays out a process for seeking an indemnity beyond our existing financial resources if needed. This MOU further provides the Crown with a role in promoting fiscal and monetary policy coordination. As previously discussed, the RBNZ also retains the ability to operate under negative equity.

Conclusion

In conclusion, central banks can use their balance sheets to support not just monetary policy, but also financial stability objectives. In all cases though, the balance sheet is an instrument of policy and not profit. Interventions for financial stability might happen at the same time as monetary policy interventions, for example during COVID-19, or they may occur independently, in fixed income or currency markets.

The foreign exchange market is very important for New Zealand, as a small open economy. In conjunction with Treasury and the Minister of Finance, the RBNZ determined through the Foreign Reserves Coordination Framework that a higher level of foreign reserves holdings was appropriate. We are building towards that now.

Risks related to this higher level of foreign reserves holdings, combined with risks associated with other current and possible future balance sheet activities in pursuit of our objectives have necessitated a higher level of financial resources. We now have a greater level of pre-positioned financial resources in the form of capital and indemnities, which enable us to intervene in markets to support financial stability, if and when needed. We have agreed processes to seek additional support if required, and like other central banks retain the ability to operate under negative equity.

Central banks are sometimes accused of fighting the last crisis. Our aim in undertaking reviews of our reserves, resources and intervention playbooks is to not continue to fight the last crisis, but to learn from it, and position ourselves to be prepared (as far as one can be) for the next one.

Thank you.

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