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Annual Report

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Our Values

Excellence: We pursue excellence in all that we do and we achieve it by actively challenging, reviewing and improving the way we work.

Our People: We value the talents of our people and enhance those talents by providing encouragement, support and opportunities for growth and development.

Our Reputation: We strive to inspire public confidence by acting with integrity, exercising sound judgement and using public resources responsibly.

Working Together: We respect and encourage both open communication and diverse contributions aimed at achieving the Reserve Bank's goals.

Our Commitment to New Zealanders

As New Zealand's central bank, we will do everything in our power to build national and international confidence in the stability and integrity of New Zealand's money and monetary system.

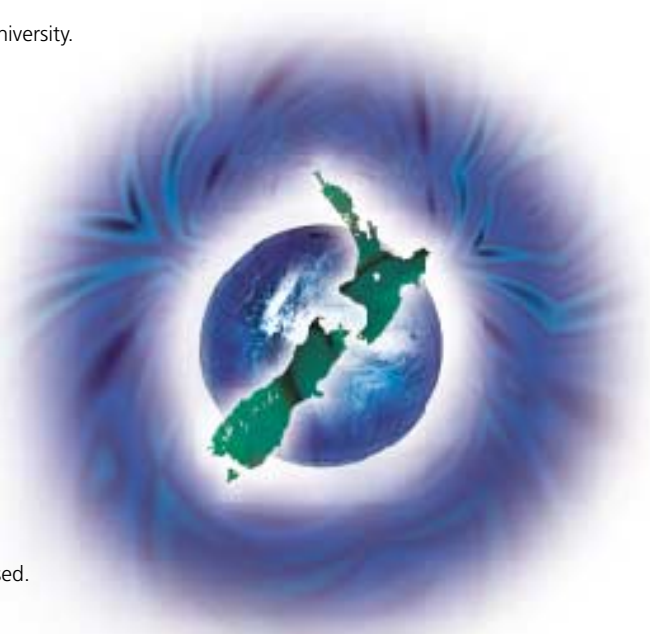
We will do that by:

- operating monetary policy so as to maintain price stability;
- promoting the maintenance of a sound and efficient financial system; and
- meeting the currency needs of the public.

We will critically review our performance regularly and will aim to ensure that we use tax-payers' resources efficiently and effectively.

Year at a Glance

- For the 12 months to June 2000, CPI inflation was 2.0 per cent.
- The economy grew very rapidly during the second half of 1999, before slowing in the first half of 2000.
- A new Policy Targets Agreement required the Reserve Bank, in delivering price stability, to “seek to avoid unnecessary instability in output, interest rates and the exchange rate”.
- Statistics New Zealand took interest rates out of the Consumers Price Index, allowing the Reserve Bank to target CPI inflation instead of the CPI excluding interest rates.
- The Government announced the terms of reference for a review of the implementation of monetary policy, to be undertaken by Professor Lars Svensson of Stockholm University.
- Two new banks were registered.
- The banking sector got through the Year 2000 date change without difficulty.
- A special commemorative \$10 millennium bank note was issued.
- The introduction of the full range of polymer bank notes was completed.
- The Reserve Bank’s Christchurch branch was closed.
- The Reserve Bank’s registry processing was contracted out.
- The Reserve Bank decided to relinquish its licence to operate the Austraclear New Zealand system.
- The Reserve Bank’s operational departments were restructured.
- Feedback training was provided to most staff.
- The Reserve Bank’s operating costs, where covered by its Funding Agreement with the Government, were 3.5 per cent below the limit specified in the Agreement, and 1.4 per cent below actual costs the year before.





Governor's Statement

The twelve months to June 2000 were a demanding time for the Reserve Bank. During that period, monetary policy entered a tightening phase, which always engenders stress. We also weathered the Year 2000 date change, completed the introduction of polymer bank notes, and undertook a significant internal restructuring. The Reserve Bank faced these challenges well.

In particular, for most of the year to June 2000, consumer price inflation remained around the middle of the 0 to 3 per cent target, although at the very end of the year annual inflation picked up moderately. This pleasing result overall was, for the most part, the result of monetary policy decisions made prior to the year under review. The consequences of the decisions made in the 1999/2000 period will not be known for some time yet.

When the 1999/2000 year began, the Official Cash Rate (OCR) was 4.5 per cent. By November, it was clear that demand in the economy had expanded strongly and that the highly stimulatory monetary conditions of the previous 18 months were no longer appropriate. In response, we increased the OCR to 5.0 per cent. When GDP statistics were finally available, it was apparent that in the second half of 1999 the economy grew even more strongly than we had thought at the time, indeed at an annualised rate of almost 10 per cent. Alas, as things stand, this is a much faster growth rate than the New Zealand economy can sustain in the longer term without inflation, suggesting that the November OCR increase had been fully warranted.

We continued to increase the OCR during the first half of 2000. However, with the exchange rate remaining well below historical averages, and indeed weakening over the year as a whole, monetary conditions continued to be quite strongly supportive of growth. This was notwithstanding an OCR of 6.5 per cent by the end of the year under review.

The weakness of the exchange rate over the past year or so has posed some challenging questions, both for the conduct of monetary policy and for the longer-term evolution of the New Zealand economy. In real terms, the currency has remained near the lows of previous cycles despite rising commodity prices.

Over recent years, the Bank has argued that, at some point, New Zealand's persistent current account deficit and growing ratio of external debt to GDP would begin to weigh on investor sentiment. We have noted that such a change in investor sentiment might be reflected in diminished capital inflows, leading to a weaker currency and a higher risk premium in New Zealand interest rates. This could be part of a process by which our current account weakness would be remedied, since a shift in monetary conditions of this kind would encourage stronger export performance and higher savings, while leading to more subdued growth in domestic consumption. We hoped that, if such a transition could be achieved without significant economic disruption, New Zealand's prospects for enduring prosperity would be enhanced. At the time of writing, the question before us was whether a positive scenario of that sort was under way.

Shortly after the present Government was elected in November, the Treasurer and I negotiated a change in the Policy Targets Agreement (PTA) which guides monetary policy within the legislative mandate to "achieve and maintain stability in the general level of prices". Dr Cullen proposed that the PTA be amended so that, in delivering price stability, the Bank should "seek to avoid unnecessary instability in output, interest rates and the exchange rate". I had no difficulty in agreeing to this proposal, and indeed the Bank has been operating in this way for some time. The amendment confirms that the Bank should be willing to accept some short-term variability in the inflation rate, if smoothing out such variability might produce unnecessary variability in output, interest rates and the exchange rate.

But neither Dr Cullen nor I imagine for one moment that the amendment implies that the Reserve Bank can, or should, seek to avoid all movements in output, interest rates and the exchange rate. Such an objective would be completely beyond the Bank's powers to deliver. Indeed, there is some evidence that moving short-term interest rates in a firm and pre-emptive manner, before inflationary or deflationary expectations become entrenched, is more likely to keep output growing at close to its sustainable trend, compared to adjusting interest rates slowly.

In May, the Treasurer also announced the terms of reference for an independent review of monetary policy, to be conducted late in 2000 by Professor Lars Svensson. The terms of reference make it clear that the price stability objective and the Bank's operational independence are not on the table for discussion. That said, I welcome the review, as an opportunity to get some fresh thought from outside the Bank on how we do things.

2000

The Reserve Bank has responsibility for promoting financial sector stability, as well as for keeping inflation under control. The year under review saw further work on policy development in this area, most particularly on the new policy of requiring local incorporation of systemically important banks and of some banks with substantial retail deposit business. Work also continued on contingency planning for a bank failure, remembering that in New Zealand neither the government nor the Reserve Bank guarantee banks or bank deposits. The financial system continued to be in good health, having coped easily with the mild recession during 1998, the steep depreciation in the exchange rate over 1999 and 2000, and the Year 2000 date change.

Like other central banks, we were concerned that Year 2000 fears might lead to a strong increase in the demand for cash over the end of the calendar year. In response, we stockpiled paper bank notes as they were withdrawn from circulation. We also sought to assure the public, via the media, that the banking sector was well prepared. In the event, the extra demand for cash was modest. The reserves of old paper bank notes were destroyed early in the New Year.

The Reserve Bank began the introduction of new polymer bank notes during the 1998/99 year, and introduced all the remaining denominations during the year under review. That process went smoothly.

Polymer bank notes last much longer than paper ones. In part for this reason, the Bank decided some time ago to scale down its note-processing operations. Our Christchurch branch closed in June, and our remaining branch, in Auckland, is scheduled to close in November this year. Our Wellington note-processing operations have also been reduced.

With this substantial scaling down of our note-processing operations, and the decision during the year to outsource the operations involved in our securities registry business, we decided late in 1999 to restructure our operational departments, to make them more appropriate to the Bank's current needs. The total staff of the Bank will have declined from some 270 full-time equivalent positions at the end of 1999 to less than 200 positions by the end of 2000.

Notwithstanding this reduction in staff numbers, 1999/2000 was the second year since I became Governor in 1988 that the Bank's operating expenditure somewhat exceeded the amount we had budgeted for the year. This was due to the unexpectedly high costs incurred in meeting the public's demand for currency, particularly for additional coins, and higher than expected personnel expenses arising from the costs of restructuring the Bank's registry operation. All other categories of expenditure remained close to budget. More importantly, the Bank continued to operate within the limit specified in the Funding Agreement signed with the Government in 1995. In May, a new five-yearly Funding Agreement was signed with the Government, as required by legislation, covering expenditure to 30 June 2005.

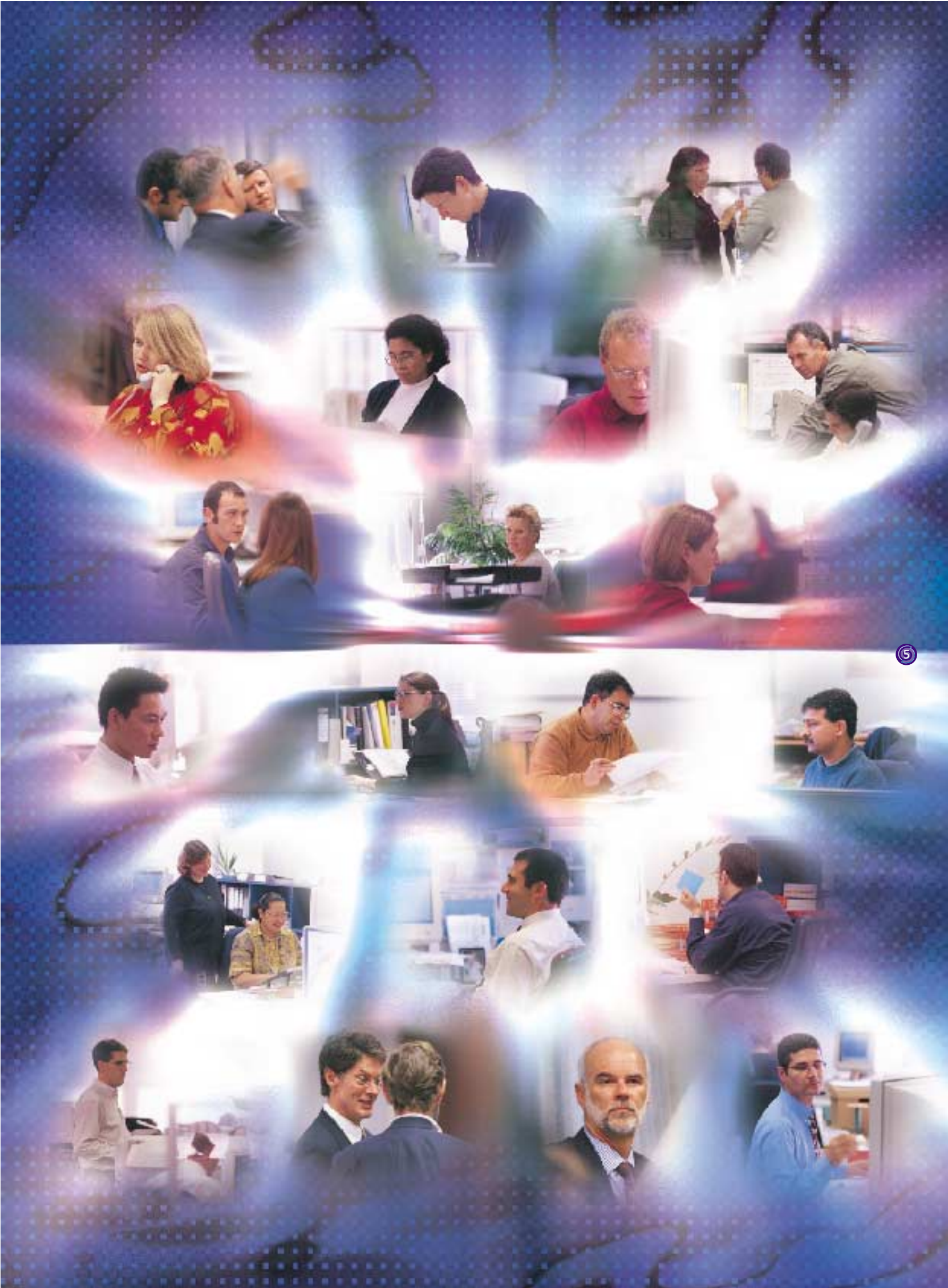
At the end of January, the Board appointments of Mr Lindsay Fergusson and Mrs Alison Paterson came to an end. Mr Fergusson did not seek re-appointment and I record my thanks to him for his contribution to the Bank since his original appointment to the Board in late 1988. His replacement was Mr John Goulter, and I welcome him to the Board. Mrs Paterson was re-appointed for a further term.

It is customary to end statements of this kind with perfunctory remarks about how well staff have worked during the year. I want to thank the staff of course. But in this case it is important to record that the Bank's employees have worked with loyalty and commitment during a very difficult time, facing a major internal re-organisation and the Bank attracting considerable public criticism for tightening monetary policy. Such times are never easy for staff, and I am particularly grateful to them for their "dedication to duty under fire".



Donald T. Brash

Governor



The Reserve Bank of New Zealand-What We Do

The Reserve Bank of New Zealand is the nation's central bank, and, as such, it acts as banker to the government and registered banks.

The Reserve Bank has three main functions. These are:

- operating monetary policy to maintain price stability;
- promoting the maintenance of a sound and efficient financial system; and
- meeting the currency needs of the public.

Under the Reserve Bank of New Zealand Act 1989, the Reserve Bank is required to independently manage monetary policy - the supply of money and credit - to maintain overall price stability. Price stability is defined in a separate agreement with the Government as annual inflation of between 0 and 3 per cent, measured by the Consumers Price Index, as calculated by Statistics New Zealand.

This is achieved through influencing short-term interest rates, which in turn influence longer-term interest rates and spending, saving and borrowing by the public and businesses. Decisions on short-term interest rates influence the exchange rate as well, and therefore the prices of imports and exports as measured in New Zealand dollars.

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The Reserve Bank is responsible for the registration and prudential supervision of registered banks, to help ensure a sound and efficient financial system. We act as banker to the banks, providing inter-bank settlement facilities and related payment services.

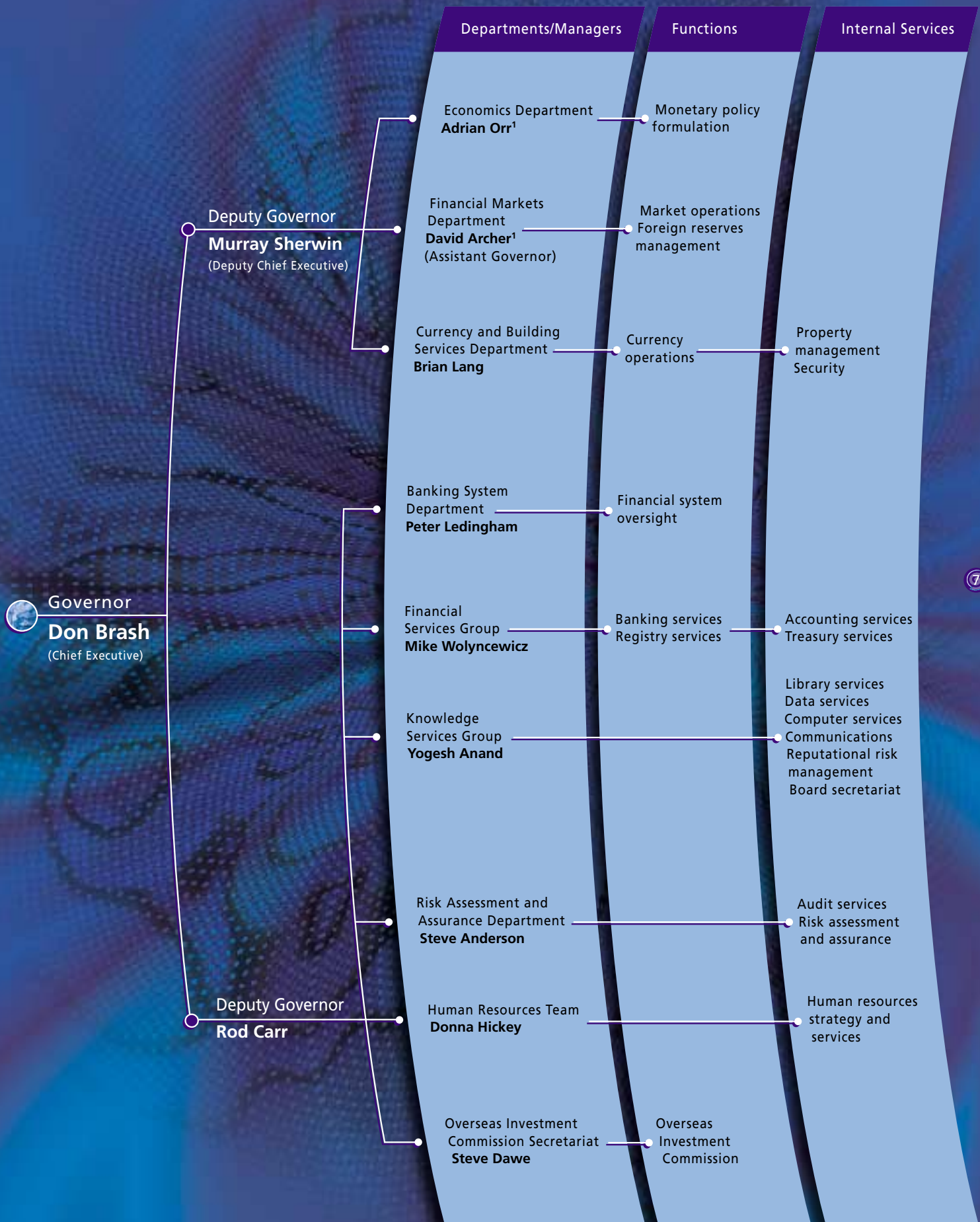
The Reserve Bank issues New Zealand's currency and manages foreign exchange reserves to enable intervention in the foreign exchange market, if ever required. The Bank provides cash and debt management services to the government, and secretariat services to the Overseas Investment Commission.

At the Reserve Bank's head is the Governor, assisted by the two Deputy Governors and an Assistant Governor. A Governor's Committee meets weekly to consider policy and management issues. It is chaired by the Governor, and consists of the Deputy Governors and all department heads.

In addition, three other committees meet regularly to provide the Governor with more specific advice. These are the Monetary Policy Committee, chaired by Deputy Governor Murray Sherwin, and the Financial System Oversight and Risk Management Committees, both of which are chaired by Deputy Governor Rod Carr. By statute, the Governor is ultimately responsible for all decisions.

The Reserve Bank's internal organisation is illustrated in the chart opposite. Details of the current Reserve Bank Board are provided overleaf. The role of the Board and the overall governance of the Bank are described on page 10.

Reserve Bank Structure




¹ At year's end, Adrian Orr resigned, David Archer was appointed Chief Manager Economics Department, and Michael Reddell was appointed Chief Manager Financial Markets Department.

Board of Directors

Executive Directors



Governor
Don Brash
Chairman



Paul Jackman
Secretary



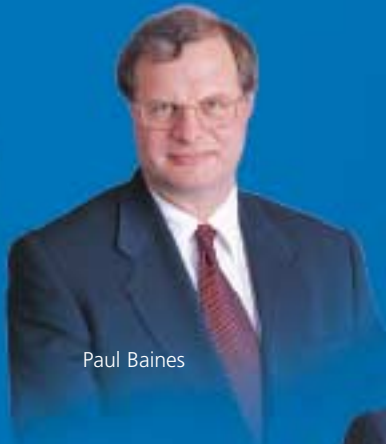
Deputy Governor
Murray Sherwin



Deputy Governor
Rod Carr



Professor Viv Hall



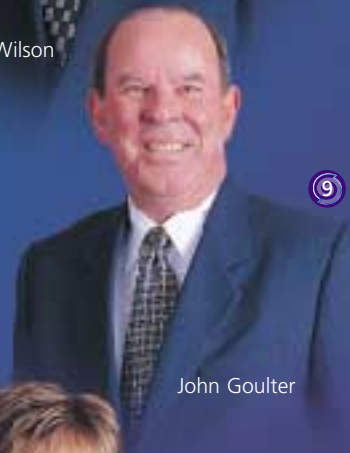
Paul Baines



Alison Paterson



Bill Wilson



John Goulter



Hon Ruth Richardson



Sir Gil Simpson

Non-Executive Directors

Professor Viv Hall

University professor: Macarthy Professor of Economics, School of Economics and Finance, Victoria University of Wellington; Board member, New Zealand Institute of Economic Research (Inc).

First appointed 1 March 1992 - current term expires 28 February 2002

Paul Baines

Company director: Chairman, Enterprise NZ Trust, Tower Investment Savings Ltd; Director, Comalco NZ Ltd, Fletcher Challenge Ltd, Gough, Gough & Hamer Ltd, Greenstone Fund Ltd, NZ Post Ltd, South Eastern Utilities Ltd, Telecom NZ, Wrightson Ltd; Trustee, Barnardos Children's Trust, Victoria University of Wellington Foundation; Advisory Board member, NZ Institute for the Study of Competition & Regulation.

First appointed 1 July 1999 - current term expires 30 June 2004

Alison Paterson

Chartered accountant: Consultant, Beattie Rickman; Chairman, Crown Health Association, Waitemata Health Ltd, Land Corporation Ltd; Director, Biomed Trading Ltd, Health Benefits Ltd, Tower Insurance Ltd, Wrightson Ltd; Member, Market Surveillance Panel New Zealand Stock Exchange; Trustee, Barnardos Children's Trust, Donny Charitable Trust, Wrightson Retirement Plan.

First appointed 1 February 1995 - current term expires 31 January 2005

Bill Wilson

Company director: Chairman, Property Leaders Australia Ltd, Property Leaders New Zealand Ltd, Property Leaders Australia and New Zealand Ltd, New Zealand Guardian Trust Company Ltd, New Zealand Guardian Trust Funds Management Ltd.

First appointed 1 February 1990 - current term expires 31 January 2003

John Goulter

Managing director: Chief Executive Officer, Auckland International Airport Limited; Director, HMSC-AIAL Ltd Trustee, NZ Business & Parliament Trust, Auckland International Airport Life Education Trust.

First appointed 9 February 2000 - current term expires 8 February 2005

Hon Ruth Richardson

Economic policy consultant: Principal, Ruth Richardson [NZ] Ltd; Chairman: Cardinal Pty Ltd, Morningstar Pty Ltd, Kula Fund; Director, Aoraki Corporation Ltd, Centre for Independent Studies, Immuno-Chemical Products Ltd, Oyster Bay Marlborough Vineyards Ltd, TransAlta NZ Ltd, Wrightson Ltd.

First appointed 4 February 1999 - current term expires 3 February 2004

Sir Gil Simpson

Computer programmer: Chief Executive Officer, Aoraki Corporation Ltd; member, New Zealand Business Roundtable; joint venture partner in Canterbury Technology Park; Chairman, Christchurch City Mission Foundation.

First appointed 9 June 1997 - current term expires 8 June 2002

Governance

The Reserve Bank of New Zealand is wholly owned by the New Zealand government. The Reserve Bank's authority and accountability are based on two key documents, these being the Reserve Bank of New Zealand Act 1989 and the Policy Targets Agreement.

The Reserve Bank Act specifies the Reserve Bank's functions and duties. The Policy Targets Agreement (PTA) is a written contract between the Treasurer and the Governor, which details the inflation target that the Bank is required to achieve. The most recent PTA was signed on 16 December 1999.

The Act makes the Reserve Bank's Chief Executive - the Governor - accountable for the Bank's actions. In monetary policy matters, all decision-making authority resides with the Governor. The Governor is appointed for a five-year term. The Act sets specific criteria under which the Treasurer can dismiss the Governor.

The Reserve Bank has a Board of Directors, as shown on pages 8 and 9. The role of the Board of Directors of the Reserve Bank is different from that of a listed company. The Board has no involvement in directing Reserve Bank policy, monetary or otherwise. Rather, the Board's primary function is to monitor the performance of the Bank and the Governor, on behalf of the Treasurer. As well, the Board provides advice to the Governor, typically on the consequences of the Bank's activities for the commercial community.

When required, the Board makes recommendations to the Treasurer on the appointment or reappointment of the Governor, the Treasurer only being able to appoint a Governor recommended by the Board. The Board appoints Deputy Governors on the recommendation of the Governor. These duties, and some others, are carried out by the Non-Executive Directors Committee of the Board, which comprises Non-Executive Directors only. The Non-Executive Directors Committee is chaired by Mr Bill Wilson and, for these purposes, meets independently of the Executive Directors. Another committee of the Board meets regularly to monitor the audit function within the Reserve Bank. The Board as a whole met 11 times during the year under review.

If inflation goes above or below the Reserve Bank's 0 to 3 per cent target, or if the Board believes that the Governor's performance in meeting the inflation target has been "inadequate", then the Board is required to provide the Treasurer with a written explanation. In that situation, the Board may also recommend that the Governor be removed from office.

The Reserve Bank's activities are also scrutinised by Parliament's Finance and Expenditure Select Committee. Typically, five hearings are held annually, covering four *Monetary Policy Statements* and the release of the Bank's *Annual Report*.

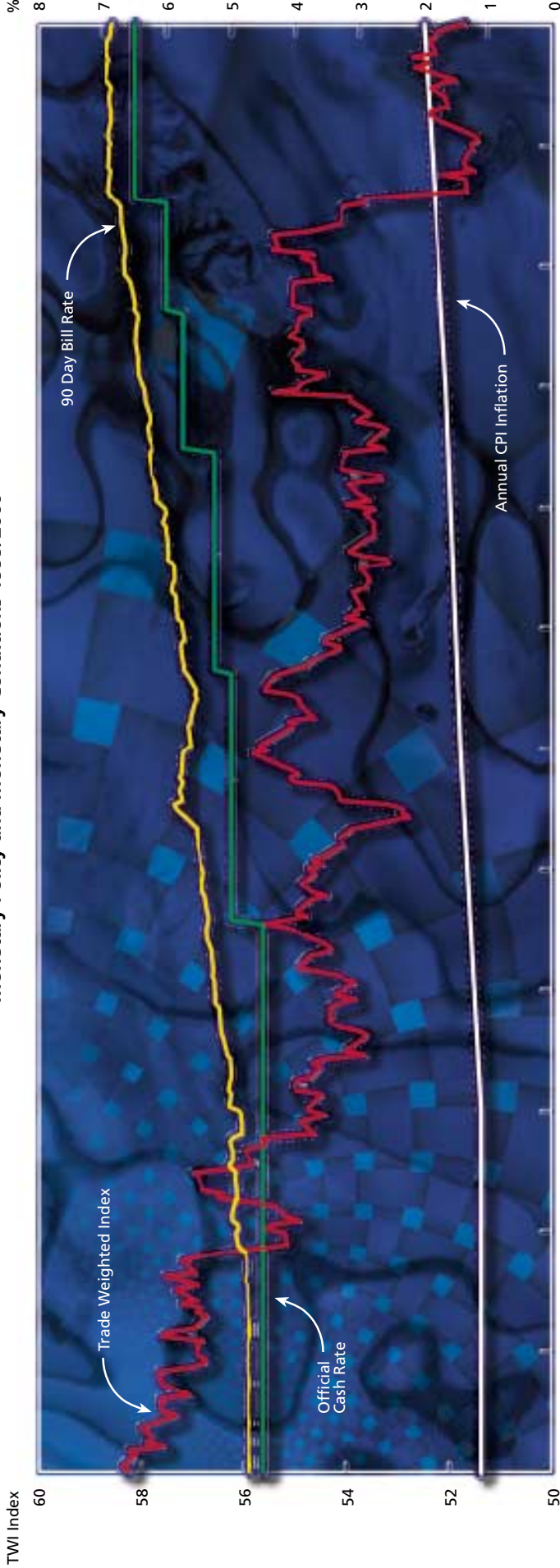
Within the Reserve Bank, all activities and expenditure must be authorised and in accordance with Bank policies. The Board and the Governors receive monthly reports comparing actual versus budgeted outcomes, prepared by the Bank's Financial Services Group. Also, each quarter, departments are themselves required to report actual versus planned and budgeted outcomes to the Governors and to provide explanations for significant variances. Quarterly, the expenses of the Governor and two Deputy Governors are reviewed by the chairperson of the Audit Committee of the Board, currently Mrs Alison Paterson.

The audit function within the Reserve Bank is part of the work of the Bank's Risk Assessment and Assurance Department. Its wider brief is to ensure that the full range of operational, financial and reputational risks faced by the Bank are properly managed.

The Reserve Bank is subject to external auditing, the auditor being appointed by the Treasurer. In addition, the Treasurer is empowered to require a performance audit.

Chronology

Monetary Policy and Monetary Conditions 1999/2000



2000

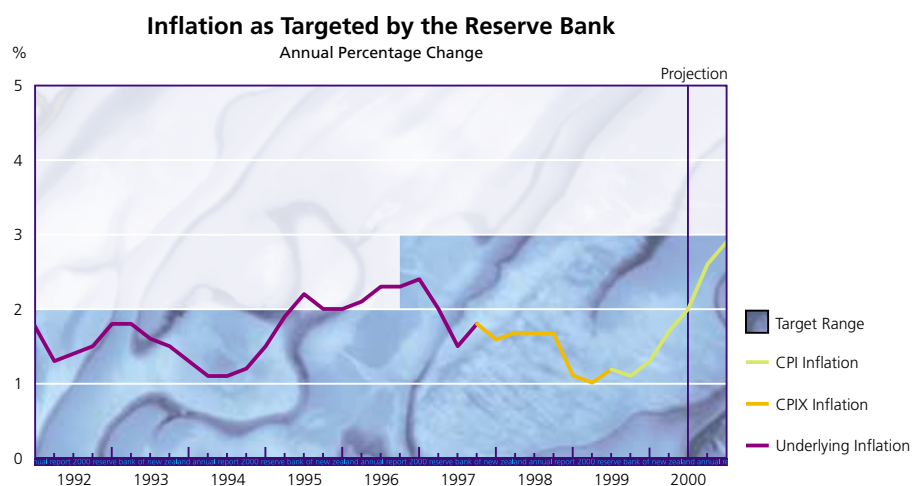
Month	Event
July	<p>7 July 1999 Rabobank New Zealand Limited is registered as a bank in New Zealand.</p> <p>15 July CPI inflation for the year to June 1999 is announced at 1.2 per cent.</p> <p>26 July \$100 polymer bank notes enter circulation.</p>
Aug	<p>18 August The August 1999 Monetary Policy Statement keeps the Official Cash Rate (OCR) at 4.50 per cent, but foreshadows that monetary policy will need to tighten soon.</p> <p>15 September The design of a commemorative \$10 millennium bank note is unveiled.</p> <p>17 September The Reserve Bank announces that it is investigating requiring local incorporation of some banks currently operating in New Zealand as branches.</p>
Sept	<p>15 September The Reserve Bank announces that it will target CPI inflation, instead of CPI excluding interest rates (CPIX), following Statistics New Zealand taking interest rates out of the CPI.</p> <p>29 October CPI inflation for the year to September 1999 is announced at 1.1 per cent.</p>
Oct	<p>17 November The OCR is increased to 5.0 per cent.</p> <p>16 December A new Policy Targets Agreement requires the Reserve Bank, in delivering price stability, to "seek to avoid unnecessary instability in output, interest rates and the exchange rate".</p> <p>20 December The contracting out of the bank's registry operation is announced.</p>
Nov	<p>1 January 2000 Overtight banking systems get through the millennium date change without difficulty.</p> <p>5 January Shredding begins of \$2 billion in paper bank notes, which had been retained in case of Year 2000 needs.</p> <p>6 January The first full day of banking in the new millennium is completed without difficulty.</p> <p>19 January The OCR is increased to 5.25 per cent.</p> <p>19 January CPI inflation for the year to December 1999 is announced at 1.3 per cent.</p>
Dec	<p>15 March The OCR is increased to 5.75 per cent.</p> <p>20 March \$50 polymer bank notes go into circulation, completing the polymer range in New Zealand.</p>
Jan	<p>17 April CPI inflation for the year to March 2000 is announced at 1.7 per cent.</p> <p>19 April The OCR is increased to 6.0 per cent.</p>
Feb	<p>9 May The Government announces the terms of reference of its review of the implementation of monetary policy.</p> <p>17 May The OCR is increased to 6.5 per cent.</p> <p>24 May The Reserve Bank announces that the Bank intends to relinquish its Austraclear operating licence.</p> <p>30 May The Government announces that Professor Lars Svensson of Stockholm University will undertake the review of the implementation of monetary policy.</p>
Mar	<p>23 June The Commonwealth Bank of Australia is registered as a bank in New Zealand.</p> <p>17 July CPI inflation for the year to June 2000 is announced at 2.0 per cent.</p>
Apr	<p>9 May The Government announces the terms of reference of its review of the implementation of monetary policy.</p> <p>17 May The OCR is increased to 6.5 per cent.</p> <p>24 May The Reserve Bank announces that the Bank intends to relinquish its Austraclear operating licence.</p> <p>30 May The Government announces that Professor Lars Svensson of Stockholm University will undertake the review of the implementation of monetary policy.</p>
May	<p>9 May The Government announces the terms of reference of its review of the implementation of monetary policy.</p> <p>17 May The OCR is increased to 6.5 per cent.</p> <p>24 May The Reserve Bank announces that the Bank intends to relinquish its Austraclear operating licence.</p> <p>30 May The Government announces that Professor Lars Svensson of Stockholm University will undertake the review of the implementation of monetary policy.</p>
Jun	<p>23 June The Commonwealth Bank of Australia is registered as a bank in New Zealand.</p> <p>17 July CPI inflation for the year to June 2000 is announced at 2.0 per cent.</p>

The Year in Review

Monetary Policy

Inflation remained near the centre of the Reserve Bank's 0 to 3 per cent target for most of the year to June 2000, although it climbed to 2.0 per cent by the end of the period, as in graph 1. This increase reflected diminishing dis-inflationary pressures, as the economy grew strongly through 1999, and temporary factors that should have few ongoing implications, such as a tobacco tax increase and higher oil prices.

Graph 1



In line with abating dis-inflationary pressures, and the possibility of inflationary pressures emerging again, monetary policy was adjusted to reduce the stimulus that it had previously provided. The Official Cash Rate (OCR) was increased incrementally from 4.5 per cent in November 1999 to 6.5 per cent in May 2000.

Growth eased in the middle of 2000. However, at the time of writing, growth was expected to increase again over the next couple of years, encouraged by the very low exchange rate and continuing growth in our trading partners. Consequential mild upward pressure on inflation was also expected, but inflation was still projected to be well within the target range, once the temporary effects from petrol and tobacco price increases passed through.

Throughout this period, the exchange rate remained at or near historical lows. Assessing the degree of stimulus being provided to exporters and those competing with imports was important for determining how quickly the previous interest rate stimulus needed to be withdrawn.

Overall, the year under review illustrated many of the issues that are raised in managing monetary policy in an economy such as New Zealand's. A premium was placed on the Reserve Bank explaining its actions well, key issues being:

- why the time delay between monetary policy actions and their effects meant that OCR increases were required before inflation moved above the mid-point of the target band;
- how OCR increases that took interest rates up to "normal" were consistent with removing policy stimulus as distinct from a policy contraction; and
- why, as a general principle, OCR increases or decreases are not required to offset inflation or deflation caused by temporary factors, so long as inflationary or deflationary expectations are not increasing as a result.



Box 1

Business Visits and the Reserve Bank's Economic Forecasts

The Reserve Bank draws on many sources of information when making its interest rate decisions. Aside from the formal data available publicly, the Bank also holds one-on-one discussions with businesses throughout New Zealand, to get a first-hand feel for the “flavour” of economic activity.

Roughly six weeks before the publication of quarterly *Monetary Policy Statements*, staff from the Bank's forecasting team visit senior executives of around 50 businesses and business organisations across the country. Our sample is chosen to broadly reflect the different sectors and industries that make up the economy. We visit a mix of large and small firms, industry leaders, Chambers of Commerce and industry federations.

At these visits, we discuss current trends and the outlook over the next year or so, as they relate to individual firms. We seek insights into sales, output, capital expenditure, employment, costs and pricing, as seen in recent months and as expected or planned over the coming year or so. We especially seek out whether recent outcomes have matched budgets or expectations, and whether the factors driving prospects are specific to the businesses visited, or to their industries generally.

These business visits add richness to the context within which we interpret the official data, and they assist us to discern the relevant economic trends in the data. We also gain insights into how the business sector is responding to changes in economic conditions, including monetary conditions.

Monetary Policy Implementation

1999/2000 was the first full year in which the Reserve Bank implemented monetary policy using the Official Cash Rate (OCR), following its introduction in March 1999. The OCR system continued to work well and deliver much reduced volatility in short-term interest rates.

The Year 2000 date change was a major focus for the Reserve Bank's liquidity management. In April 1999, we made public our plans to supply additional liquidity over the date change period and, in addition, to provide liquidity "on demand" to individual banks. This liberal approach helped banks prepare, and, in liquidity management terms, Y2K passed without incident.

Over the course of the year, there was potentially a persistent shortage of liquidity in the banking sector due to the pattern of government cash flows. To offset this, we made greater use than normal of foreign exchange swaps as a means of injecting liquidity.

The Reserve Bank made a number of changes to its guidelines for the pricing of open market operations, becoming more open with the markets and bringing our minimum and maximum rates more closely into line with market rates.

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Box 2

Monetary Policy Review

On 9 May 2000, the Government announced the terms of reference for a review of the operation of monetary policy². They stated: "The review will consider:

- The way in which monetary policy is managed in pursuit of the inflation target. The review will examine the way the Reserve Bank interprets and applies the inflation target set out in the Policy Targets Agreement, with a view to ensuring that this approach to achieving medium-term price stability is consistent with avoiding undesirable instability in output, interest rates and the exchange rate.
- The instruments of monetary policy. The review will assess whether the Reserve Bank has an adequate range of instruments and is using its current instruments effectively in altering monetary conditions in the desired direction.
- The information used by the Reserve Bank in its decision making. The review will consider the range of sources, availability, type and timeliness of data, and the impact of these variables on forecasting and decision making.
- The monetary policy decision making process. The review will consider whether the decision making process and

accountability structures promote the best outcomes possible.

- The co-ordination of monetary policy with other elements of the economic policy framework, including an evaluation of the relationship between monetary policy operations and other Reserve Bank functions such as prudential oversight of financial institutions.
- The communication of monetary policy. The Reserve Bank's communication of monetary policy decisions will be reviewed to ensure that these decisions are explained to the public and financial markets in the simplest, clearest and most effective way possible."

The terms of reference also said that the single goal of monetary policy - stability in the general level of prices - and the Reserve Bank's operational autonomy and accountability for inflation outcomes would not be reviewed.

On 30 May 2000, the Government announced that Professor Lars Svensson of Stockholm University would undertake the review, to be completed by the end of February 2001.





Financial System Oversight

The Reserve Bank Act requires the Reserve Bank to promote a sound and efficient financial system. We do this by registering banks, by developing banking supervision policies, and by monitoring banks' compliance with those policies.

In terms of the Reserve Bank's Financial System Oversight function, the Year 2000 date change was a critical event for the Bank, as it was for the banking sector. As described in box 3, a smooth transition was achieved.

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Work continued on developing more comprehensive policies and strategies to minimise the potential costs of a bank failure and the impact of such a failure on the financial system. A major focus was on policy options for responding to a bank in distress. We continued to consult with banks on proposed criteria for requiring systemically important foreign banks and some banks taking substantial retail deposits to incorporate locally.

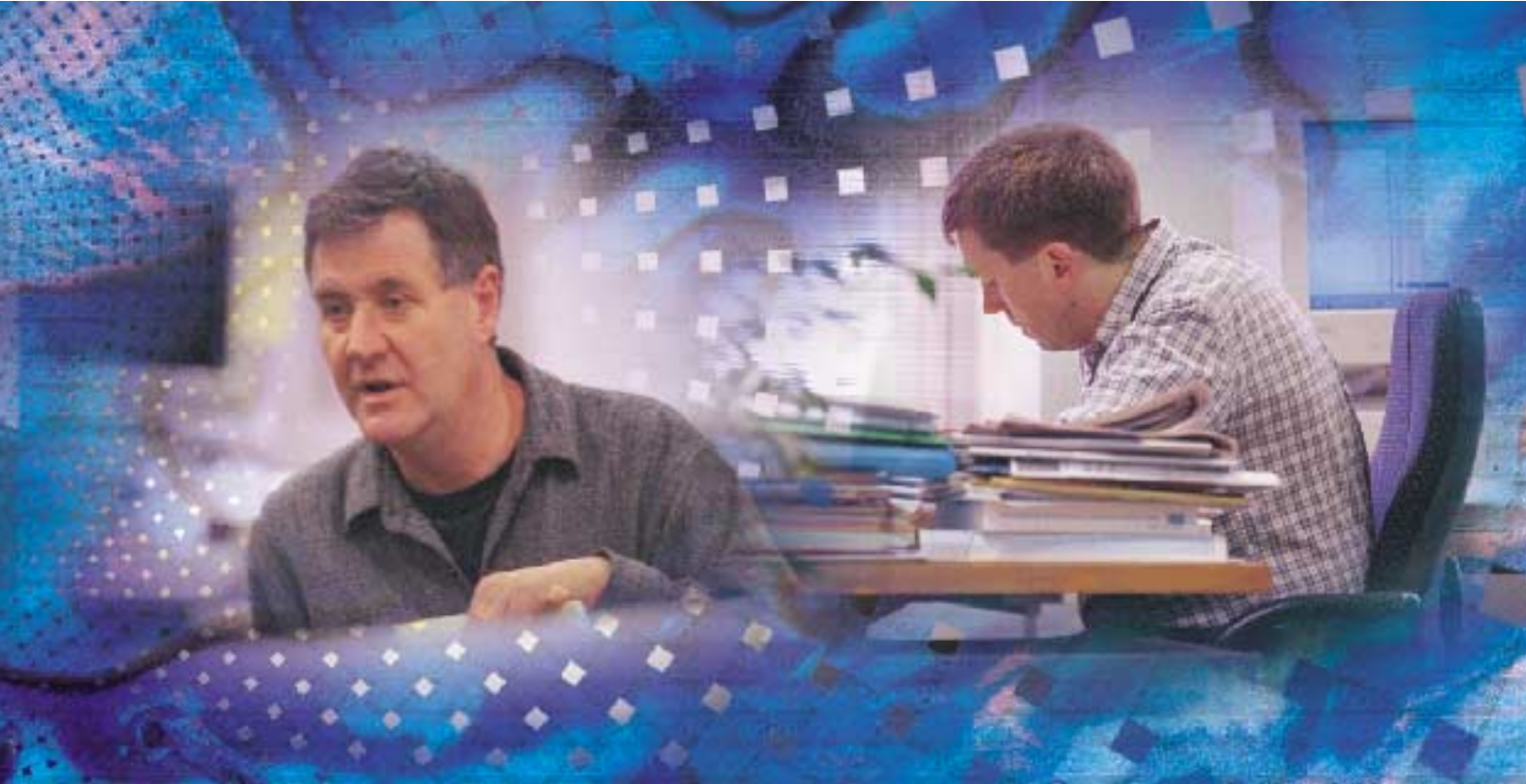
In conjunction with the banking industry, we began work on a project which, if successful, will allow the New Zealand dollar to be included in an international initiative for settling foreign exchange transactions in real time, known as the Continuous Linked Settlement Service (CLSS). This would markedly reduce the risk to banks in New Zealand of being caught by the default of a counter-party to a foreign exchange transaction. For this to occur, CLSS would need to be connected to the settlement accounts that New Zealand banks have with the Reserve Bank.

Legislation in April 1999 provided greater legal certainty to the netting of payments transactions, netting being the pooling of financial obligations, so that only the difference between two gross amounts needs to be paid. As a result, we approved recognition of the Austraclear system in New Zealand as a multilateral clearing-house. Austraclear is a wholesale operation for the clearing and settlement of high-value debt securities and equities.

During the year under review, the Reserve Bank actively participated in regional discussions on bank supervision and payments system issues. We made submissions on the work of the Basel Committee on Bank Supervision. We also hosted and chaired a meeting of the SEANZA³ Forum of Bank Supervisors in Auckland in November 1999 and chaired a meeting of the Governors of South Pacific central banks in December 1999.

Two new banks were registered in the 1999/2000 year, these being Rabobank New Zealand Limited and Commonwealth Bank of Australia.

3 SEANZA includes central banks from Australia, Bangladesh, China, Hong Kong, India, Indonesia, Iran, Japan, Korea, Macau, Malaysia, Mongolia, New Zealand, Nepal, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka and Thailand.



Box 3

The Year 2000 Changeover

The Year 2000 date change presented the financial sector with two fundamental risks, one being a matter of operational reality, and the other involving public perceptions potentially generating problems regardless of the facts.

The most obvious risk was that computer difficulties would cause problems for banks. To ensure that this did not happen, the sector undertook extensive programmes of testing and upgrading software during 1999.

The Reserve Bank kept a “watching brief” on preparations by financial institutions, and we tested and upgraded our own systems. Contingency arrangements were also prepared.

Come the date change, 24-hour computer systems - ATMs, EFTPOS and credit cards - functioned as normal. Other systems, including those for handling large value transactions, were thoroughly tested over the changeover weekend and opened for business without difficulty, as scheduled, on 5 January 2000, the first business day of the New Year.

The other risk was that, in the run-up to the date change, members of the public would become alarmed and, *en masse*, withdraw their savings from banks.

As a contingency, we increased markedly our reserves of cash and ensured that these reserves were distributed around the country in case of sudden need. We also undertook a public education programme to explain that there was no reason for panic withdrawals. This was done initially by providing confidential briefings to talk-back hosts and others in the news media who might have to deal with alarmed members of the public. Our message to the media was that they had a particular responsibility not to “spook the horses”.

This responsibility was well understood and well met by those briefed.

Dr Rod Carr was designated the Reserve Bank’s Year 2000 spokesperson, and he gave numerous interviews to the news media in the last few months of 1999. His key message was that in the New Year people’s money would be just as safe in the banks as ever it was, while conversely making large cash withdrawals involved risks, such as loss or theft. A brochure with the same message was provided to banks to display in their branches.

As events unfolded, public demand for currency was moderately higher than the normal seasonal peak, but the extra demand was easily met.

The Year 2000 date change also created international responsibilities for the Reserve Bank. Given that New Zealand was one of the first countries in the world to enter Year 2000, there was international interest in events here. In this regard, the Bank’s website was important. During the critical period, we participated in information sharing with several international agencies.

Uncertainty regarding the date change also had the potential to create disruption and liquidity pressures in financial markets. In response, the Reserve Bank implemented temporary measures to ensure that banks could be confident that sufficient liquidity would be available. Financial market participants in New Zealand were comfortable with the state of the markets in the lead-up to the changeover. There were no signs of distress or last minute transactions involving New Zealand assets. Financial markets re-opened on 5 January without incident.

Currency

Providing the nation's currency is one of the Reserve Bank's key statutory obligations. As at 30 June 2000, the total face value of bank notes and coins held by the public was \$2.25 billion⁴, which was a 15 per cent increase over the previous 12 months.

During the 1999/2000 financial year, most paper bank notes in circulation were replaced with new polymer bank notes. The design of these polymer notes was largely unchanged, but their security features were significantly upgraded.

In the 12 months to 30 June 2000, over 80 million polymer bank notes were issued and we detected only one attempt at counterfeiting a polymer bank note. In comparison, over 900 forged paper bank notes were identified in the same period.

Traditionally, the Reserve Bank has played a central role in the re-distribution of cash between commercial banks. This provided an opportunity to check bank notes for quality and authenticity. The introduction of polymer bank notes, with greater durability and better security features, means that there is now less need for us to continually check bank notes.

The Reserve Bank has been encouraging the banks to develop their own procedures for checking and distributing bank notes. As a result, our Christchurch branch was closed at the end of June 2000 and the Auckland branch will cease operations on 17 November.

The Reserve Bank will continue to have prime responsibility for the supply and integrity of bank notes. New bank notes will be issued to replace damaged bank notes and to meet peak demand periods, such as at Christmas and Easter. Suspect and unfit bank notes will be identified by banks and security companies and returned to the Reserve Bank in Wellington for checking or destruction. To assist this process, the Reserve Bank is leasing to security companies the processing machines that were located in our Christchurch and Auckland branches.

These changes will in time provide cost savings for all concerned.



⁴ The difference between the totals shown here and the amount shown under Currency in Circulation in the Consolidated Statement of Financial Position (page 48) relates to \$87.7 million of coin issued by the Treasury prior to 1989, which remains in circulation but which we treat as a contingent liability (see note 30(b) Contingent Liabilities on page 81).



Box 4

The Millennium Bank Note

On 15 September 1999, the Reserve Bank unveiled the design of a special \$10 bank note commemorating the new millennium. This was initially sold to the public as a collector's item. Then in July 2000, we released a variant of this special bank note into general circulation to gauge the public's reaction to its new security features.

Modern scanning technology means that some traditional security features in bank notes are less effective than in the past. In particular, scanning technology means that faces and other visual details traditionally used as security features can now be replicated sufficiently accurately to deceive the eye.

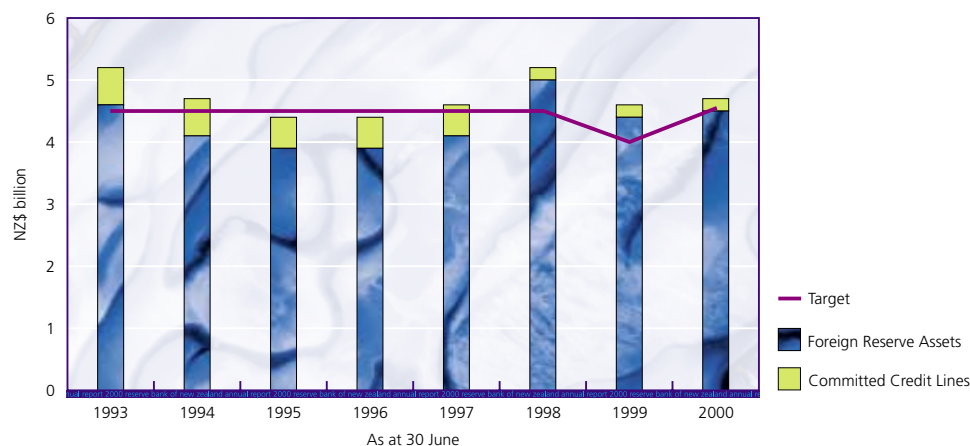
In response, the millennium \$10 bank note incorporates two new security features that are world firsts and cannot be replicated by scanners. The bank note has a 'diffraction optically variable device', which is an aluminium coating in the shape of two silver ferns within the "window area". This feature reflects rainbow colours when the bank note is tilted to the light. In addition, when the bank note is folded, so that the window is placed over the image of New Zealand on the back of the bank note, then the letters "Y2K" become visible.



Foreign Reserves Management

The Reserve Bank has not intervened in the foreign exchange market since the New Zealand dollar was floated in March 1985. Nonetheless, the Bank holds a diversified portfolio of foreign currency assets, which can be used to intervene to smooth disorderly market conditions, should they arise. A modest committed credit line with the Bank for International Settlements (BIS) provides additional intervention capability. The level of our overall intervention capacity, determined by the Treasurer, is illustrated in graph 2.

Graph 2 Intervention Capability



The Reserve Bank's reserves are deliberately structured so that, under almost all market conditions we can rapidly transform our investments into cash at little cost, if needed. The reserves are mostly AAA rated assets and are financed by foreign currency borrowings through the Treasury at New Zealand's AA+ credit rating.

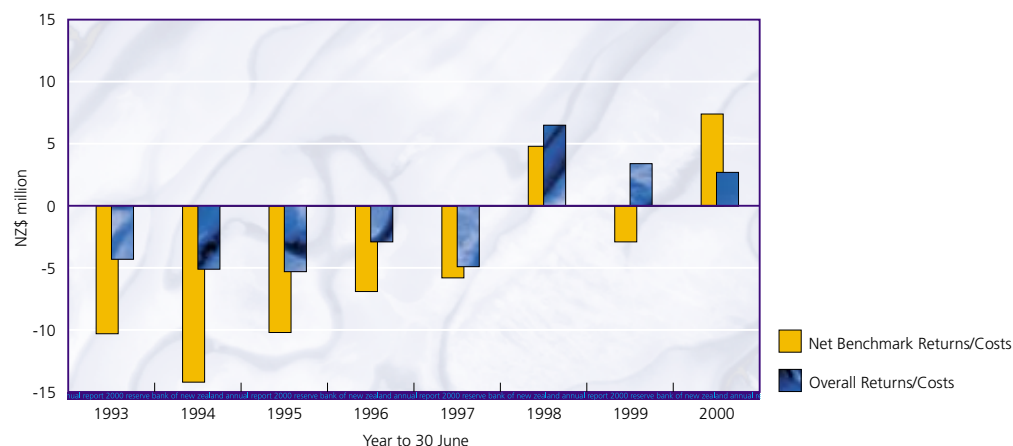
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Holding reserves in this way involves a small net cost, because New Zealand generally has to pay more to borrow overseas than the sums borrowed can earn when invested in high quality assets that can be realised quickly. We aim to reduce that cost through carefully structuring the overall portfolio, supplemented by modest trading in international financial markets. We measure the overall cost reduction by comparing the net cost to the cost that would have been incurred from holding a passive "benchmark" portfolio.

As shown in graph 3, during 1999/2000, for the first time in several years, our active management activities did less well than our benchmark would have done. This was due in part to the poor performance to date of a large medium-term position that has a fixed profit over its life. In other words, this paper loss will reverse by the time the position matures. In addition, we have experienced losses on some activities affected by changes in global bond markets during 1999. On the positive side, the discretionary trades undertaken by our portfolio managers generated good income over the year. At the end of the financial year, we were close to adopting new working rules for the management of our reserves.

In recent years, annual variations in the net income from holding reserves have generally been in a -\$10 million to +\$5 million range, which is around -0.2 per cent to +0.1 per cent of the value of the reserves. Potential variances are much larger, as discussed in box 5.

Graph 3 Net Returns from Holding Reserves



Box 5

Holding Foreign Reserves – the Risks

By its nature, holding a portfolio of foreign currency reserves involves risk.

The Reserve Bank funds its reserves by borrowings in the same currencies as it invests in. This provides a natural hedge or protection against exchange rate changes.

We are, however, exposed to other risks. Around 15 per cent of our asset holdings are rated less than AAA, spread across a range of AA and A rated issuers. In the extreme, assuming that we had invested fully to our internal limits in the debt of a defaulting issuer, we could lose \$350 million in the case of an AA+ rated issuer, and \$50 million in the case of an A rated issuer. This would be before any recovery was attempted.

The Reserve Bank is also vulnerable to the risk of interest rate changes between the cost of borrowing to acquire reserves and the earnings we receive from investing those reserves. Our liabilities are typically AA+ rated, while our assets are typically AAA rated. Ordinarily the interest rates attached to these assets and liabilities move approximately in tandem, but, in extreme circumstances, wide divergences can occur.

If a marked “flight to quality” occurred, the difference in interest rates between AA+ and AAA rated financial instruments might widen significantly, delivering large revaluation gains on our portfolio, as happened in August 1998 following the Asian/Russian crises. Conversely, large revaluation losses could be incurred as any such crisis abated and these interest rates

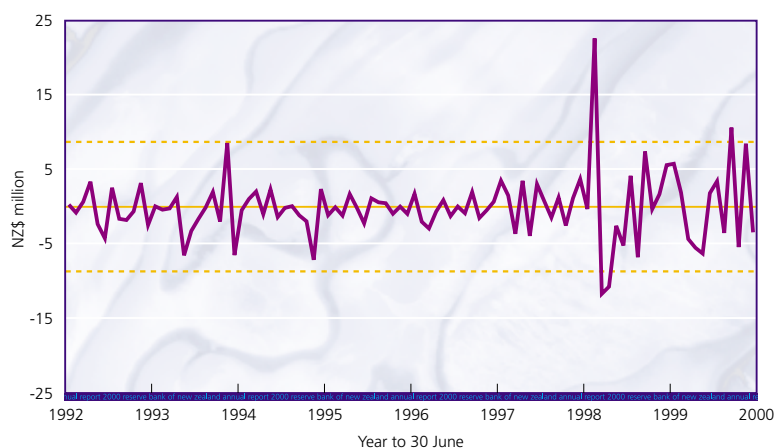
reverted to their prior levels. Similarly, if market participants actively sought lower credit-quality financial instruments, then interest rate differences could narrow sharply, causing revaluation losses. If the interest rate difference between AA+ and AAA rated financial instruments converged from current levels to zero, then we would record a paper loss of around \$57 million.

Our active management trading activities also involve risk beyond that which is inherent in merely holding reserves. Markets, interest rates and credit costs may not behave as we expect them to. Overall, we structure our activities in order to keep worst-case losses from adverse interest rate movements to around \$100 million. We seek to minimise risk through diversification and set tight constraints on how much interest rate or market risk we are willing to accept.

To put this in perspective, as illustrated in graph 4, for 95 per cent of the time since 1992 monthly gains and losses have been in the +/- \$8.5 million range, as depicted by the dashed lines, on a portfolio of around \$5 billion of assets and matching liabilities. There have been no losses from defaults of issuers over this period. In relation to the overall portfolio, the expected variance in returns is extremely low at -0.2 per cent to +0.1 per cent of the total value of the reserves. This is much smaller than the expected variance of a typical, well-hedged, private sector funds manager.

Graph 4

Net Income from Holding Reserves





Registry Services

The Reserve Bank provides registry services to issuers of fixed interest securities (e.g. bonds and bills). This creates a definitive proof of legal ownership of debt securities, and a procedure for changes of ownership. The Bank also operates the Austraclear New Zealand System, which provides the financial markets with clearing and settlement services for high-value debt securities and equities. This is done through a wholly-owned subsidiary, RBNZ Registry Limited.

At 30 June 2000, RBNZ Registry Limited was registrar for securities with a face value of \$62.1 billion, compared to \$63.5 billion at 30 June 1999. We provided services for just over 29,606 investors, holding over 64,459 separate investments. The total value of payments made during the 12 months to 30 June 2000 was \$50.1 billion.

At 30 June 2000, Austraclear New Zealand had 328 members and securities held on their behalf of \$79.2 billion, compared to 303 members and \$83.0 billion 12 months earlier. Members' securities are held by New Zealand Central Securities Depository Limited, which is a custodian trustee wholly owned by the Reserve Bank.

On 15 May 2000, the Reserve Bank outsourced the processing of debt securities to BT Portfolio Services (NZ) Limited, though the Bank remains responsible for the services now carried out on its behalf.

The Reserve Bank also decided to relinquish its licence to operate the Austraclear New Zealand System, subject to reaching final agreement with the Australian licensor Austraclear Limited. If an agreement with Austraclear Limited can be concluded, then that company will operate the Austraclear New Zealand System.

Both these decisions were driven by assessments of the need to invest heavily in upgraded systems over the next couple of years, and the ongoing business risks associated with these activities. In both cases, we felt that New Zealand's financial markets would gain increased competitiveness and efficiency by our decision to step back from direct operational involvement.

The Reserve Bank will, however, continue to operate the Exchange Settlement Account System (ESAS). This is a banking service to institutions that need to make regular high-value payments, all the current account holders being registered banks. At present ESAS processing is dependent on the Austraclear New Zealand System, and the Reserve Bank will have to ensure that it can operate ESAS independently of that system.



International Liaison

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The Reserve Bank's international activities continued at a high level in 1999/2000. The Bank contributed to international policy initiatives, participated in regional groupings and liaised with other central banks and international institutions.

The Reserve Bank has been closely monitoring progress in proposed reforms of the international financial system, arising from the international financial difficulties of 1998/99. During the period under review, the Bank provided advice to New Zealand's representative on the Executive Board of the International Monetary Fund (IMF). We made submissions on the Basel Committee's Core Principles for Banking Supervision and draft Core Principles for Systemically Important Payment Systems.

The Reserve Bank continued to work closely with the Treasury on a range of policy issues for the Asia-Pacific Economic Co-operation (APEC) Finance Ministers' Forum, including policies relating to capital account liberalisation, macroeconomic reform and the strengthening of financial markets. We participated with the Treasury in the Manila Framework Group, attending two meetings over the year and participating in discussions on global and regional economic and financial reforms.

Links were maintained with other central banks, particularly those in the Asia-Pacific region, through groups such as EMEAP⁵ and the SEANZA⁶ group of central banks. Staff took part in EMEAP working groups on financial markets, payment and settlement systems, and banking supervision. In November 1999, as chair of the SEANZA Forum of Banking Supervisors, the Reserve Bank hosted a 2-day conference for Forum members. The conference marked the end of New Zealand's 2-year term as chair of the Forum.

Reserve Bank staff provided briefings and technical assistance to a number of central banks in the Asia-Pacific region. This included hosting secondments by two staff from the People's Bank of China.

5 Executives' Meeting of East Asia and Pacific central banks.

6 See footnote 3, page 16.

Our People

The Reserve Bank employed a total of 244 staff (236.8 full-time equivalents (FTE)) as at 30 June 2000. Of those, 220 staff were based in Wellington, 18 were at our Auckland office and 6 were at our Christchurch office⁷. The Reserve Bank's staff turnover rate was 10.4 per cent, excluding redundancies, as shown in table 1.

Table 1

Human resource statistics

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000
Total staff at 30 June (FTE)	286	293	290	289	281	283	237
Average years of service at 30 June	8.7	8.6	8.6	8.7	8.3	8.8	9.4
Annual staff turnover	10.9%	9.6%	15.0%	10.6%	8.8%	10.0%	10.4%
Average sick days per employee	7.1	5.3	4.9	5.5	4.9	4.4	4.8

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Following decisions to outsource the registry business and to close the Christchurch and Auckland branches, the operational departments of the Reserve Bank were restructured to better meet the Bank's requirements. Staff in the departments affected helped design the new structure.

In total, during the year under review, 39 positions were made redundant. Extensive support was provided to those affected, including counselling through the "Employee Assistance Programme", career transition training and retraining.

A 1998 staff satisfaction survey suggested that more effort was needed to promote open communication and encourage diverse contributions in the work place. As a result, in 1999 training was provided for most staff in the giving and receiving of feedback. A second staff satisfaction survey afterwards showed a significant improvement in interpersonal communication and feedback throughout the Bank.

In November 1999, a substantial meeting between the Reserve Bank's senior management and staff reviewed options for improving the Reserve Bank's work place culture. Ideas from that gathering included enhancing the Bank's leadership capabilities, improving employee training and continuing to promote a family-friendly work environment. These were incorporated into the Bank's Human Resources Strategic Plan for 2000/2001.

⁷ The Christchurch office closed at the end of June 2000.

Remuneration

The Reserve Bank spent \$20.1 million on personnel in 1999/2000. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 2 shows the number of staff who received over \$100,000 in total remuneration⁸ in 1999/2000.

Table 2

Staff receiving \$100,000 or more in 1999/2000

Total remuneration ⁹	Staff numbers
\$100,000 to \$109,999	4
\$110,000 to \$119,999	5
\$120,000 to \$129,999	5
\$130,000 to \$139,999	5
\$140,000 to \$149,999	3
\$150,000 to \$159,999	2
\$160,000 to \$169,999	2
\$170,000 to \$179,999	1
\$180,000 to \$189,999	1
\$190,000 to \$199,999	1
\$200,000 to \$209,999	1
\$220,000 to \$229,999	1
\$290,000 to \$299,999	2
\$490,000 to \$499,999	1
Total	34

8 Total remuneration includes the annual cost to the Reserve Bank of all elements of contracted remuneration (salaries, any benefits provided, fringe benefit tax, superannuation), plus any annual bonuses or redundancy payments. The above information sets out the amount unconditionally earned during the financial year. The remuneration of the Governor is set by the Treasurer on the recommendation of the Non-Executive Directors of the Bank, who also determine the remuneration of the two Deputy Governors. The Bank's remuneration policy is to pay all staff who are performing well the market median, based on salary surveys and assessments made by an independent remuneration consultant.

9 Includes payments to 3 employees who were made redundant during the year.



Communications

The communications highlight of the period was the Year 2000 date change. The Reserve Bank's strategy was to defuse public concerns by talking openly about the risks well in advance of the Year 2000 date change. The final "non event" in terms of withdrawals by depositors suggested that the Bank's communications strategy was correct.

The Reserve Bank sponsored a Journalists Training Organisation course in economics for mid-career journalists and, for that, a text book entitled *Reporting Economics: A New Zealand guide to covering the economy*. The Bank was also a part sponsor of the Financial Literacy in Schools programme organised by the Enterprise Trust, which provides resources to secondary schools to teach personal financial management skills.



The Reserve Bank also extended its external communications by broadcasting Dr Brash's *Monetary Policy Statement* press conferences live on the Bank's website. However, after two "webcasts" we discontinued this, as we found that most institutions were unable to watch, due to difficulties getting the signal through their own internet security systems. We suspect that in a few years time this will be worth revisiting, as technology and software improve. Providing market participants with the nuances of Dr Brash's press conferences as they happen remains a very desirable goal.

The Governor's and Deputy Governors' long-standing programme of delivering numerous off-the-record speeches around the country continued, along with a small number of on-the-record speeches. At year's end, a substantial upgrade of the Reserve Bank's website was underway.

Financial Performance

Operating Expenses

The Reserve Bank's consolidated¹⁰ operating expenditure for 1999/2000 was \$44.4 million, which was 3.2 per cent over budget. This was also \$0.2 million, or 0.4 per cent, above the previous year's actual expenditure. This excess of expenditure over budget mainly occurred because of:

- the cost of issuing new coin being over budget by \$1.1 million, due to higher than expected demand for new currency, particularly over the Year 2000 period; and
- higher than expected personnel expenses arising from the costs of restructuring the Bank's registry operation.

Almost all other categories of operating expense were within 10 per cent of budget.

Funding Agreement

Section 159 of the Reserve Bank of New Zealand Act 1989 requires the Governor to sign a Funding Agreement with the Treasurer every five years. The intention is to constrain the Reserve Bank's expenditure, whilst ensuring that the Bank has sufficient funds to carry out its responsibilities free from political interference. A new Funding Agreement, starting on 1 July 2000, was signed on 16 May 2000, as explained in box 6.

During the year under review, the Reserve Bank spent \$38.8 million on activities covered by the Funding Agreement, which was 3.5 per cent below the \$40.2 million permitted for the period in the Funding Agreement signed in June 1995.

Operating Surplus

During 1999/2000, the Reserve Bank recorded a net consolidated surplus of \$159.3 million for the year, against \$140.8 million budgeted, and compared to \$153.0 million in 1998/99.

This surplus is not a good indicator of the Reserve Bank's management performance. The Bank's surplus is highly dependent on interest rate levels. The principal source of income for the Bank is interest earned on the financial assets backing currency in circulation¹¹, which means the Bank's income varies as interest rates move up and down. Also, the Bank deals in financial markets to achieve policy goals, not to maximise its surplus. For these reasons, the level of the Bank's operating expenditure (see above) is a better indicator of its stewardship of public resources.

Payment to the Government

The Reserve Bank Act requires the Bank to calculate the amount by which its income exceeds the level of operating expenditure agreed in the Funding Agreement. This surplus may be added to the Reserve Bank's equity or paid to the government, and the decision rests with the Treasurer, after consultation with the Bank's Board of Directors. The Reserve Bank's surplus this year was \$157.7 million, excluding the surplus attributable to the Registry Services function, and has been paid to the government.

The Reserve Bank Act also provides that any expenditure savings the Reserve Bank makes against Funding Agreement levels may be added to the Bank's equity. Any over-expenditure against Funding Agreement levels must be deducted from equity.

The Reserve Bank's Equity

The Reserve Bank's 1999/2000 Financial Statements include provision for a transfer to equity of \$1.4 million, representing under-spending of the Funding Agreement level for the year. The Bank's subsidiary company RBNZ Registry Limited also recorded a surplus of \$0.2 million, which forms part of the Bank's consolidated equity. The Bank's consolidated equity at 30 June 2000 was \$400.1 million.

Budget for 2000/2001

The Reserve Bank's budgeted operating expenditure for 2000/2001 is \$40.1 million on a consolidated basis. This is 10 per cent below the 1999/2000 spending of \$44.4 million.

The method for calculating expenditure for Funding Agreement purposes was changed in the Funding Agreement covering the five years starting on 1 July 2000. The change allows the Reserve Bank to retain for operational expenditure agreed amounts in addition to amounts earned as income on specified activities.

10 The Reserve Bank's registry services function was excluded from the Funding Agreement that applied in 1999/2000. The term 'consolidated' is used where the figures include those of the registry services function.

11 This is known as seigniorage.

Defined in terms of the new Funding Agreement, the Reserve Bank's net budgeted operating expenditure is \$31.6 million in 2000/2001, which is 7.2 per cent below the Funding Agreement level of \$34.0 million, and \$1.1 million, or 3.4 per cent, below the comparable net actual expenditure for 1999/2000.

The budgeted decrease over the actual expenditure in 1999/2000 primarily reflects the one-off additional expenditure in the 1999/2000 year, as described above.

Box 6

Funding Agreement

On 16 May 2000, the Governor and the Treasurer signed a new five-year Funding Agreement for the Reserve Bank. The Funding Agreement specifies how much of the Bank's revenues can be retained by the Reserve Bank, to meet its operating costs, with the remainder going to the government.

The method for calculating expenditure under the Funding Agreement has changed. Previously, the Reserve Bank retained a given sum of money from its income to pay for its operating expenses. Now the Bank retains a smaller sum of money plus the income from some specified revenue-generating activities. This is to encourage the Bank to undertake activities that produce returns. Previously, all revenue earned went to the government, while the Bank carried the costs, which was a disincentive for the Bank to undertake some activities that would provide income. That contradiction is now resolved. Also, the new Funding Agreement for the first time includes the Bank's registry services.

In addition, the Reserve Bank can now retain income to compensate for any loss recorded from the revaluation or sale of the Bank's land or buildings. This means funding of the Bank's primary activities is not adversely impacted by changes in property values. As previously, any under-spending accrues to the Bank's reserves, while any over-spending is paid for out of the Bank's reserves.

Under the new Funding Agreement, the Reserve Bank retains from its income:

- \$34,000,000 for the year commencing 1 July 2000;
- \$31,000,000 for each of the years commencing 1 July 2001, 1 July 2002, and 1 July 2003; and
- \$33,000,000 for the year commencing 1 July 2004.

In addition, each year the Reserve Bank retains income earned from:

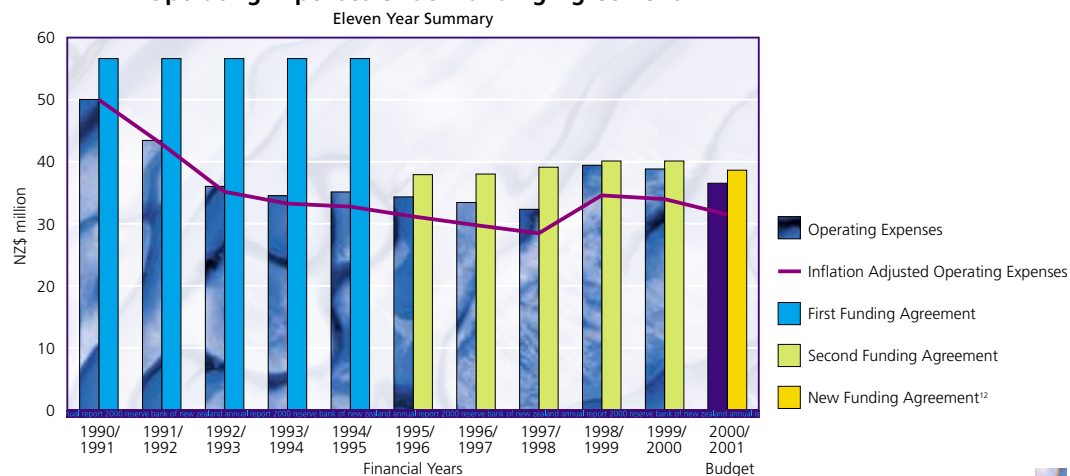
- settlement account services (ESAS);
- renting Reserve Bank properties;
- sales of collectors' currency;
- scrapping obsolete coins;
- registry services; and
- the Overseas Investment Commission secretariat.

The Reserve Bank expects to earn total revenue of around \$4 million per annum from these activities.

Currency expenses are expected to decline over the next few years, due to the longer life of polymer notes and the closure of currency processing operations in Auckland and Christchurch. This is reflected in the lower Funding Agreement levels for the three years from 2001 to 2003. The small increase in the 2004/2005 Funding Agreement level is largely due to an expected re-investment in the nation's currency.

The Reserve Bank's performance against the previous two Funding Agreements and budget for the first year of the new Funding Agreement are illustrated in graph 5 below. The Bank achieved substantial cost savings over the last 10 years, progressively reducing its operating expenditure, while still performing the same range of functions and reshaping its operations. Higher operating expenses in 1998/99 and 1999/2000 were mainly due to the introduction of polymer bank notes and one-off costs associated with the reorganisation of our currency operations.

Graph 5 Operating Expenses Under Funding Agreement



12 \$34 million for 2000/2001 as in the new Funding Agreement, plus estimated income of \$4 million, as described above.



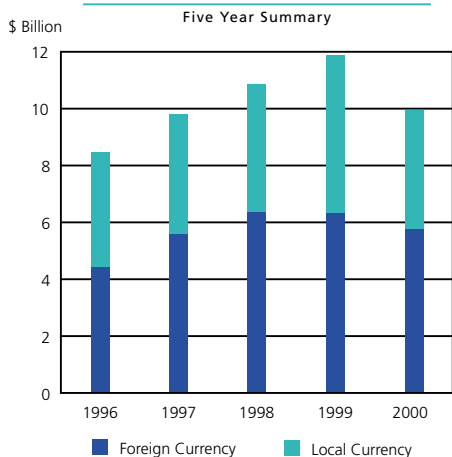
The Year Ahead

The Reserve Bank annually undertakes a formal planning process, which identifies goals for the year ahead. During the 2000/2001 year, aside from its normal duties, the Reserve Bank intends to:

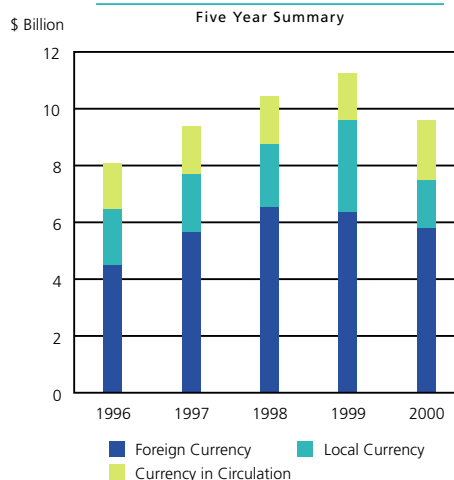
- co-operate fully with the Government's review of the implementation of monetary policy;
- research how inflation and economic cycles are likely to be affected by different inflation targeting strategies, especially where it is difficult to be certain of outcomes;
- begin using the Bank's government bond portfolio in repo¹³ operations for day-to-day liquidity management;
- complete an evaluation of proposed revisions to the international capital adequacy requirements for banks and develop proposals for revisions to the requirements applying to banks in New Zealand, and then consult on those proposals;
- finalise a policy requiring local incorporation of registered banks that are systemically important or do not meet other minimum criteria;
- continue to investigate options for responding to a bank in distress to minimise the potential costs of a bank failure;
- make further progress on reducing or better managing payment system risks, notably foreign exchange settlement risks;
- adopt new processes for managing the Bank's foreign exchange reserves, to provide greater flexibility and manage assets and liabilities together, rather than just assets against a benchmark;
- relinquish the Bank's licence to operate the Austraclear New Zealand System and establish Austraclear Limited as the replacement system operator;
- develop the Exchange Settlement Account System (ESAS) to accept payment instructions via the SWIFT communications system and to provide the infrastructure necessary to apply to have the New Zealand dollar admitted to the Continuous Linked Settlement Service;
- withdraw from the daily re-distribution of circulating bank notes and coin;
- prepare the Bank's Auckland building for sale;
- outsource the marketing and administration of the collectors' currency function;
- implement strategies for coaching and mentoring staff, so as to encourage team development and enhance the Bank's leadership capabilities; and
- review the way the Reserve Bank collects, stores and provides information to internal and external users.

13 A "repo" in this context is a transaction in which the Reserve Bank takes liquidity out of the financial system by selling securities to financial market participants in contracts in which the Bank agrees to repurchase those same securities later on.

Composition of Assets

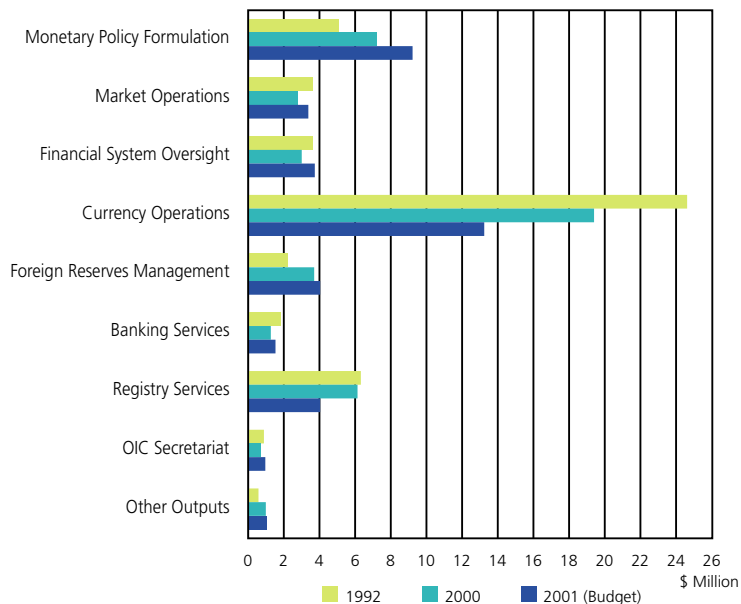


Composition of Liabilities (Excluding Equity)



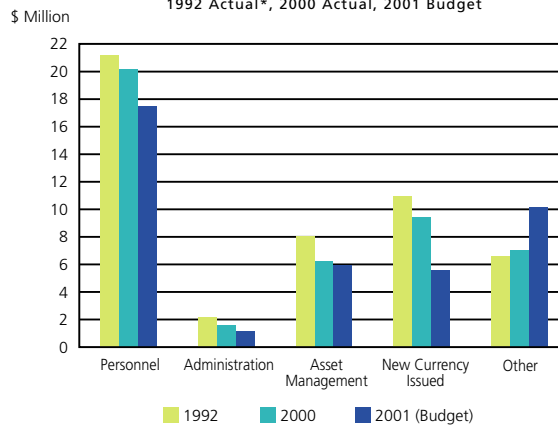
Operating Expenses by Function

1992 Actual*, 2000 Actual, 2001 Budget



Operating Expenses by Type

1992 Actual*, 2000 Actual, 2001 Budget



*1992 is used in these graphs as a benchmark, given that in the early 1990s the Reserve Bank underwent substantial restructuring that resulted in savings and new priorities.