RESERVE BANK OF NEW ZEALAND

ANNUAL REPORT

2000/2001

CONTENTS

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.

Reserve Bank of New Zealand *Annual Report* and financial statements for the financial year ended 30 June 2001, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989 and published September 2001.
ISSN 0110 7070

www.rbnz.govt.nz

YEAR AT A GLANCE

For the 12 months to June 2001, CPI inflation was 3.2 per cent.

The Official Cash Rate was held at 6.50 per cent until March 2001, after which it was reduced in three steps to 5.75 per cent.

The Government's *Independent Review of the Operation of Monetary Policy*, by Professor Lars Svensson, concluded that "Monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting."

Following the release of that report, the Treasurer announced his intention that the Governor alone would continue to make monetary policy decisions, but also that the Governor would cease to be the chairman of the Bank's Board of Directors.

The Reserve Bank's programme for sampling the opinions of businesses and sector groups prior to the preparation of quarterly *Monetary Policy Statements* was substantially expanded.

Registered banks were required to publish credit ratings and the circumstances in which foreign-owned banks must be incorporated locally were extended.

Plans to relocate to Sydney the computer hardware for inter-bank settlements were put on hold.

The Reserve Bank's special $10 millennium bank note went into general circulation. Poll results indicated public acceptance of its innovative design and security features.

The Reserve Bank's currency operations shifted to a "wholesale" role, with banks and security companies distributing cash among themselves, rather than via the Reserve Bank.

The Reserve Bank's Auckland branch was closed.

The Reserve Bank's website was upgraded, and an email service to the public was launched.

GOVERNOR'S STATEMENT

2001

The 12 months to June 2001 proved challenging for the Reserve Bank at many levels. During the period, CPI inflation went above the Reserve Bank's target range, reflecting the impact of so-called "unusual events" in terms of clause 3 of the Bank's Policy Targets Agreement with the Government. The Government's *Independent Review of the Operation of Monetary Policy* offered an opportunity to look carefully at the Bank's governance arrangements and the operation of monetary policy. In the area of Financial System Oversight, fundamental policy work was underway assessing new options for dealing with a bank in distress. In the Bank's operational areas, most activities went well, but we did experience some frustrations. The Bank's financial performance was pleasing.

In terms of monetary policy, the period began with business confidence at very low levels, but the world economy very buoyant, the exchange rate at its lowest level ever on a trade-weighted basis, capacity utilisation at a high level, unemployment at the lowest level for a decade and headline inflation rising, partly because of a sharp increase in the excise tax on tobacco products and in international oil prices.

Taken together, these factors suggested that the challenge for monetary policy was going to be restraining inflationary pressures. In December 2000, we foreshadowed the likelihood that monetary policy would need to be tightened early in 2001.

But, as time went by, it became clear that the world economy was slowing much more quickly than seemed likely at the end of 2000, and the outlook for inflation began to seem more benign. Between March and May the Official Cash Rate was reduced in three steps from 6.50 per cent to 5.75 per cent.

Some concern was expressed that we were easing monetary policy too cautiously. However, world prices for many of New Zealand's major exports remained very strong, the exchange rate continued to provide strong stimulus to many parts of the economy, and unemployment was at a 13 year low. Businesses that were increasingly cautious about the future of the economy as a whole were quite upbeat about their own prospects. Some easing in policy seemed appropriate; but a dramatic easing did not.

CPI inflation in fact peaked at 4.0 per cent in the year to December, and increased by 3.2 per cent over the year to June 2001. Nevertheless, the non-executive directors of the Bank reached the judgement that, given the special factors which had pushed up prices during the year - international oil prices, tobacco taxes, and the direct effects of the sharp depreciation in the exchange rate - this did not reflect "inadequate performance" of a kind which might warrant a recommendation to the Treasurer for my dismissal.

In May 2000, Professor Lars Svensson of Sweden was appointed by the Government to undertake an "Independent Review of the Operation of Monetary Policy". The results were released at the end of February 2001. Pleasingly, Professor Svensson was very complimentary about the way in which policy had been formulated during the 1990s, with the notable exception of the way in which we used a Monetary Conditions Index between mid-1997 and early 1999. He also described our present approach to monetary policy as consistent with best international practice.

Professor Svensson did, however, suggest that it was anomalous to have the Bank's Governor chair the Bank's Board, given that the main statutory objective of the Board is to monitor the Governor's performance. He also said that there was too much risk in having monetary policy decisions made by the Governor alone, and recommended that, from the end of my current term as Governor, monetary policy decision-making should be in the hands of an internal committee of five, chaired by the Governor.

In May 2001, the Treasurer announced his intention that the Bank's Board should be chaired by a person elected by the non-executive directors from among their number, but also that monetary policy decision-making should continue to be vested in the Governor.

In other areas of the Bank's operations, we had some successes but also some frustrations.

The Reserve Bank has responsibility for promoting financial sector stability as well as for promoting monetary stability. It does this by registering and supervising banks, remembering that neither the Reserve Bank nor the government guarantees banks or the repayment of their deposits.

This year, after consultation with the banks, we introduced a requirement that all banks obtain and disclose a credit rating, as one important and relatively simple way to help depositors assess the strength of the banks with which they deal. We also introduced a policy requiring systemically-important banks, and some others where depositors are not ranked equally vis-à-vis the assets of the bank, to incorporate within New Zealand. As the financial year ended, discussions were continuing with the two banks most directly affected.

Work continued on two other important initiatives relevant to banking sector stability, these being how we might handle a bank failure and how we can eliminate the settlement risk currently inherent in foreign exchange transactions across different time zones. Progress on both of these projects was pleasing.

Similarly pleasing was progress in stream-lining our currency operations. As a result, the Reserve Bank's Auckland branch closed in November 2000, the Christchurch branch having been closed in June 2000. The Bank's Auckland building is being sold. The scale of our Wellington currency operations was also cut back as we reduced the Reserve Bank's role in the distribution of bank notes and coins around the country.

The management of the country's foreign exchange reserves proved to be slightly more expensive to the Crown this year than we had hoped. The results of our active management, while positive, were less so than expected. A decision to reduce the relatively high proportion of our reserves held in Japanese yen securities also involved unplanned costs. But despite this, the results were reasonably satisfactory in what was a turbulent year for world financial markets. We also completed a comprehensive review of our risk parameters in this area.

Less satisfactory was the outsourcing of the technology required to support our registry operations. Although successfully completed in early July 2001, the process took a great deal more time, energy, and resources than either party initially contemplated. There was, however, no net cost to the Bank as a result of these delays.

We had even more difficulty following our decision in May 2000 to relinquish our licence to operate the Austraclear system in New Zealand. After lengthy negotiations we reached tentative agreement, but at the last minute the party with which we had been negotiating decided not to proceed. While some costs were incurred by the Bank, at no time was customer service adversely affected.

Financial results for the year were very satisfactory. The Bank's operating expenses were, at $37.8 million, 5.6 per cent below budget and 14.6 per cent below those in the previous financial year (when expressed on a consistent basis), in large part because of a sharp drop in the cost of issuing new bank notes and coins. In terms of net costs and income covered by the Funding Agreement, the Bank spent $28.6 million, which was 15.9 per cent below the $34.0 million permitted in the Funding Agreement. The Bank's surplus for the year was $159.6 million, which was slightly up on the previous year, but for a central bank the extent of this surplus is not a good measure of policy or operational performance.

The membership of the Board remained unchanged during the year, but I want to acknowledge the considerable additional work undertaken by the Board on account of the Svensson Review, to which the Board made a substantial submission.

And, of course, I acknowledge the huge amount of good work by staff in all aspects of the Bank's responsibilities. In addition to all our normal tasks, there was the extra work caused by the Svensson Review, down-sizing currency operations, outsourcing registry operations and the prolonged negotiations related to the intended relinquishment of the Austraclear licence. It was a challenging year, but staff rose to meet those challenges enthusiastically and effectively.

Donald T. Brash

Governor

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.

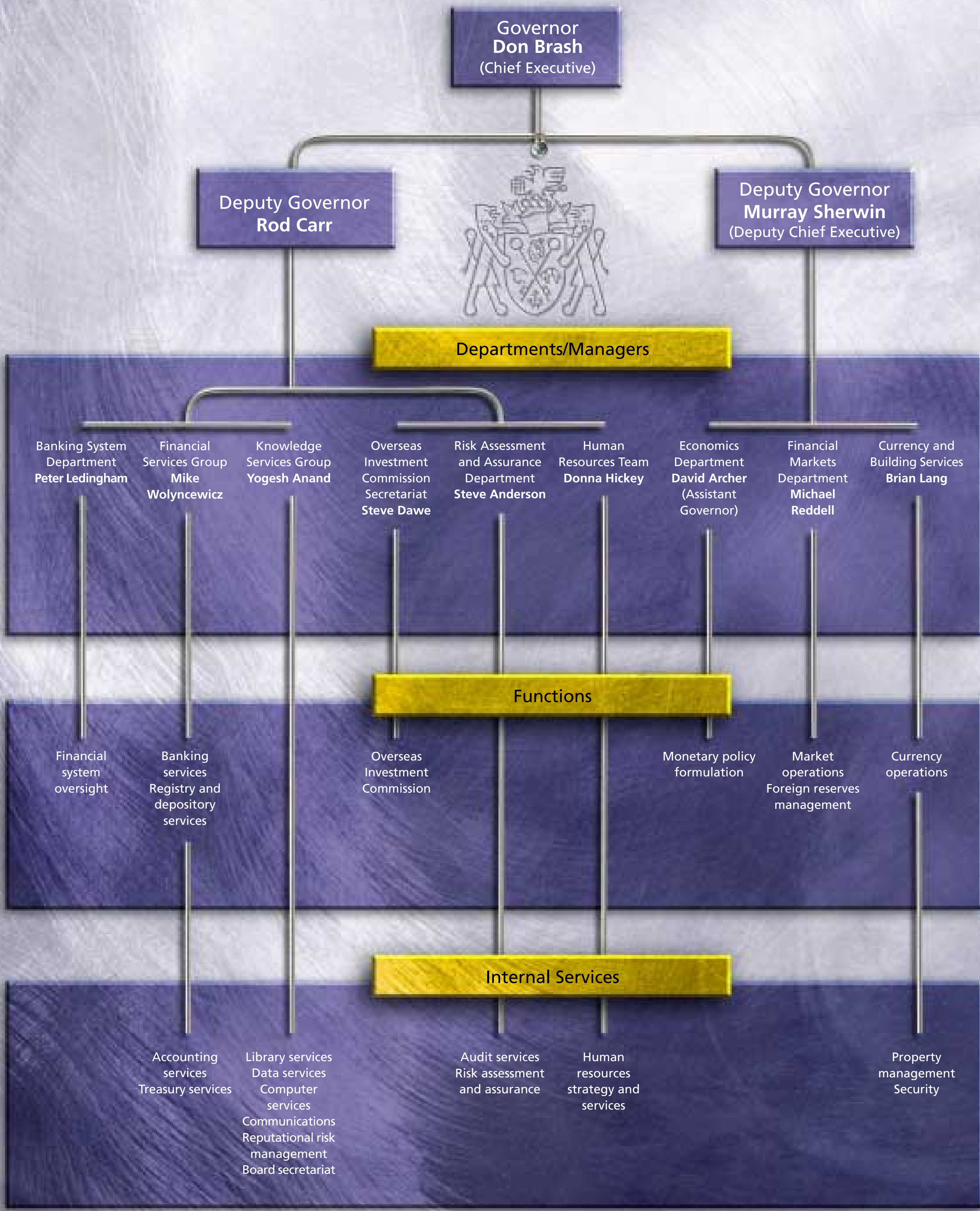
Under the Reserve Bank of New Zealand Act 1989, the Reserve Bank is required to independently manage monetary policy - the supply of money and credit - to maintain overall price stability. Price stability is defined in a separate agreement between the Governor and the Treasurer as annual inflation of 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 thus 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.

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 liquidity- 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 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, four other committees meet regularly to provide the Governor with more specific advice. These are the Monetary Policy and the Reserves Oversight Committees, chaired by Deputy Governor Murray Sherwin, and the Financial System Oversight and Risk Management Committees, 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 Reserve Bank Board of Directors are provided overleaf. The role of the Board and the overall governance of the Bank are described on page 10.



RESERVE BANK STRUCTURE

BOARD OF DIRECTORS

E X E C U T I V E

Governor
Don Brash
Chairman

Deputy Governor
Murray Sherwin

Deputy Governor
Rod Carr

Paul Jackman
Secretary

Sir Gil Simpson

Hon Ruth Richardson

John Goulter

Professor Viv Hall

Paul Baines

Alison Paterson

Bill Wilson

Professor Viv Hall
University professor:
Macarthy Professor of Economics 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 Managed Funds Ltd; Director, Comalco NZ Ltd, Fletcher Building Ltd, Gough Gough & Hamer Ltd, Greenstone Fund Ltd, Telecom NZ Ltd, Upstart Capital Ltd, Wrightson Ltd; Trustee, Barnardos Childrens' Trust, Victoria University of Wellington Foundation; Advisory Board member, Institute of Policy Studies, NZ Institute for the Study of Competition & Regulation; Member, PA Consulting Group Advisory Board.

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

Alison Paterson
Chartered accountant:
Chairman, District Health Boards New Zealand Inc, Waitemata Health Ltd, Landcorp Farming Ltd; Director, Biomed Trading Ltd, Health Benefits Ltd, Tower Insurance Ltd, Wrightson Ltd; Member, Market Surveillance Panel NZ Stock Exchange; Trustee, 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.

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

N O N - E X E C U T I V E

Sir Gil Simpson
Computer programmer:
Chief Executive Officer, Aoraki Corporation Ltd; Chairman, Electronic Commerce Action Team, Christchurch City Mission Foundation; President, The Royal Society of NZ; Director, Waipara Hills Wine Estate Ltd; Member, New Zealand Business Roundtable; Joint venture partner Canterbury Technology Park.

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

Hon Ruth Richardson
Economic policy consultant:
Principal, Ruth Richardson (NZ) Ltd; Chairman, Aoraki Corporation, Cardinal Pty Ltd, Morningstar Pty Ltd, Kula Fund, Icap Equity Partners Ltd, Icap Mezzanine Partners Ltd; Director, Centre for Independent Studies, Immuno-Chemical Products Ltd, Oyster Bay Marlborough Vineyards Ltd, Wrightson Ltd.

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

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

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 three key documents, these being the Reserve Bank of New Zealand Act 1989, the Policy Targets Agreement (PTA) and the Bank's Funding Agreement.

The Reserve Bank Act specifies the Reserve Bank's functions and duties. The 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 Funding Agreement is a five-yearly agreement between the Governor and the Treasurer that specifies how much of the Bank's revenues can be retained by the Bank to meet its operating costs, with the remainder typically going to the government.

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 in 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 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. If the Board believes that the Governor's performance has been "inadequate" in meeting the inflation target or carrying out his other duties, then the Board may recommend to the Treasurer that the Governor be dismissed. The Board also 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. For the first time, the Non-Executive Directors Committee has this year provided the Treasurer with a written annual assessment of the Bank's performance, which is reproduced on pages 28 to 31.

The Board Audit Committee meets regularly to monitor the audit function within the Reserve Bank. The Audit Committee also receives reports from the Bank's external auditor, reviews the Bank's annual financial statements and advises the Board as a whole on the Bank's accounts. Its members are Mrs Alison Paterson (chair), Mr Bill Wilson and Mr Paul Baines.

The Board as a whole met 10 times during the year under review.

The Reserve Bank's activities are 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*.

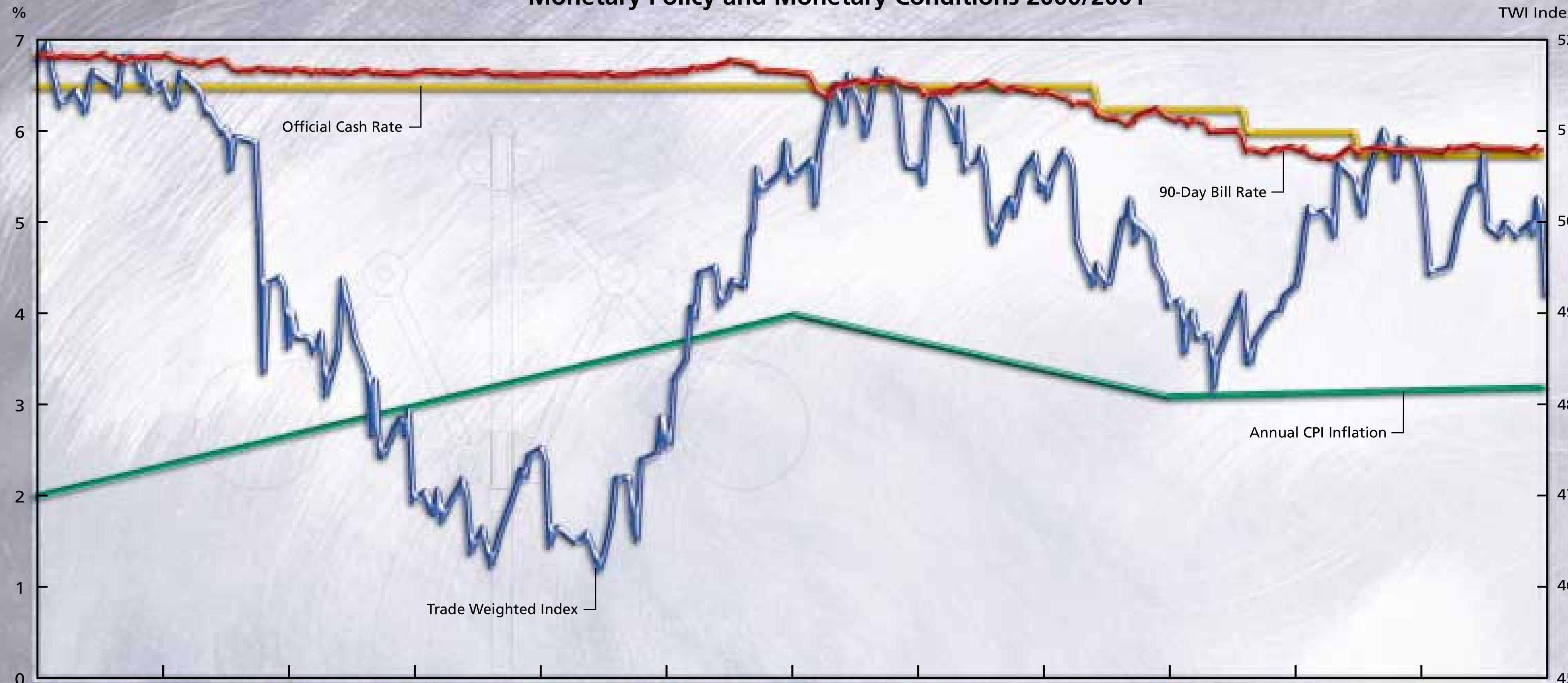
Within the Reserve Bank, all activities and expenditure must be authorised and in accordance with Bank policies. The Board receives monthly reports comparing actual outcomes against budget, prepared by the Bank's Financial Services Group. Also, each quarter, departments are themselves required to report 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 Chair of the Board Audit Committee.

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

As of 2001/2002, the Reserve Bank will be audited by the Auditor-General. In addition, the Treasurer is empowered to require a performance audit.

CHRONOLOGY

Monetary Policy and Monetary Conditions 2000/2001



July

5 July 2000
The Official Cash Rate is announced to be unchanged at 6.50 per cent.

17 July
CPI inflation for the year to June 2000 is announced at 2.0 per cent.

Aug

2 August
A special $10 millennium bank note goes into general circulation.

16 August
In the August 2000 *Monetary Policy Statement*, the Official Cash Rate is unchanged at 6.50 per cent.

Sept

27 September
The Reserve Bank announces its intention to change regulatory rules applying to overseas-owned banks that operate in New Zealand as branches.

28 September
The Reserve Bank makes public its submission to the Government's Independent Review of the Operation of Monetary Policy.

29 September
GDP statistics show that the New Zealand economy contracted by 0.7 per cent in the June quarter, this being revised later to minus 0.5 per cent.

Oct

4 October
The Official Cash Rate is announced to be unchanged at 6.50 per cent.

16 October
CPI inflation for the year to September 2000 is announced at 3.0 per cent.

Nov

17 November
The Reserve Bank's Auckland office ceases handling cash.

29 November
The Reserve Bank announces changes to the format of its *Monetary Policy Statements*, including expressing projected numbers as rounded fractions.

Dec

6 December
In the December 2000 *Monetary Policy Statement*, the Official Cash Rate is announced to be unchanged at 6.50 per cent.

21 December
GDP statistics show that the New Zealand economy expanded by 0.7 per cent in the September quarter, this being revised later to 0.9 per cent.

Jan

17 January 2001
CPI inflation for the year to December 2000 is announced at 4.0 per cent.

24 January
The Official Cash Rate is announced to be unchanged at 6.50 per cent.

Feb

1 February
The Reserve Bank changes its operating procedures for handling cash from banks, which results in the banks largely buying and selling bank notes among themselves.

28 February
The Government's *Independent Review of the Operation of Monetary Policy*, by Professor Lars Svensson, is made public.

Mar

14 March
In the March 2001 *Monetary Policy Statement*, the Official Cash Rate is reduced to 6.25 per cent.

30 March
GDP statistics show that the New Zealand economy expanded by 0.5 per cent in the December 2000 quarter, this being revised later to 0.4 per cent.

Apr

1 April
New regulations permitting the Reserve Bank to require local incorporation of some overseas-owned banks come into effect.

18 April
CPI inflation for the year to March 2001 is announced at 3.1 per cent.

18 April
The Reserve Bank announces that its plans to relocate computer hardware for inter-bank settlements in Sydney are on hold.

19 April
The Official Cash Rate is reduced to 6.0 per cent.

May

16 May
In the May 2001 *Monetary Policy Statement*, the Official Cash Rate is reduced to 5.75 per cent.

30 May
Following on from the Government's *Independent Review of the Operation of Monetary Policy*, the Treasurer announces his intention that the Governor will be retained as the single decision-maker for monetary policy, but he will no longer chair the Bank's Board of Directors.

Jun

29 June
GDP statistics show that the New Zealand economy neither expanded nor contracted in the March 2001 quarter.

4 July
The Official Cash Rate is announced to be unchanged at 5.75 per cent.

16 July
CPI inflation for the year to June 2001 is announced at 3.2 per cent.

THE YEAR IN REVIEW

Monetary Policy

Two significant issues dominated monetary policy throughout 2000/2001.

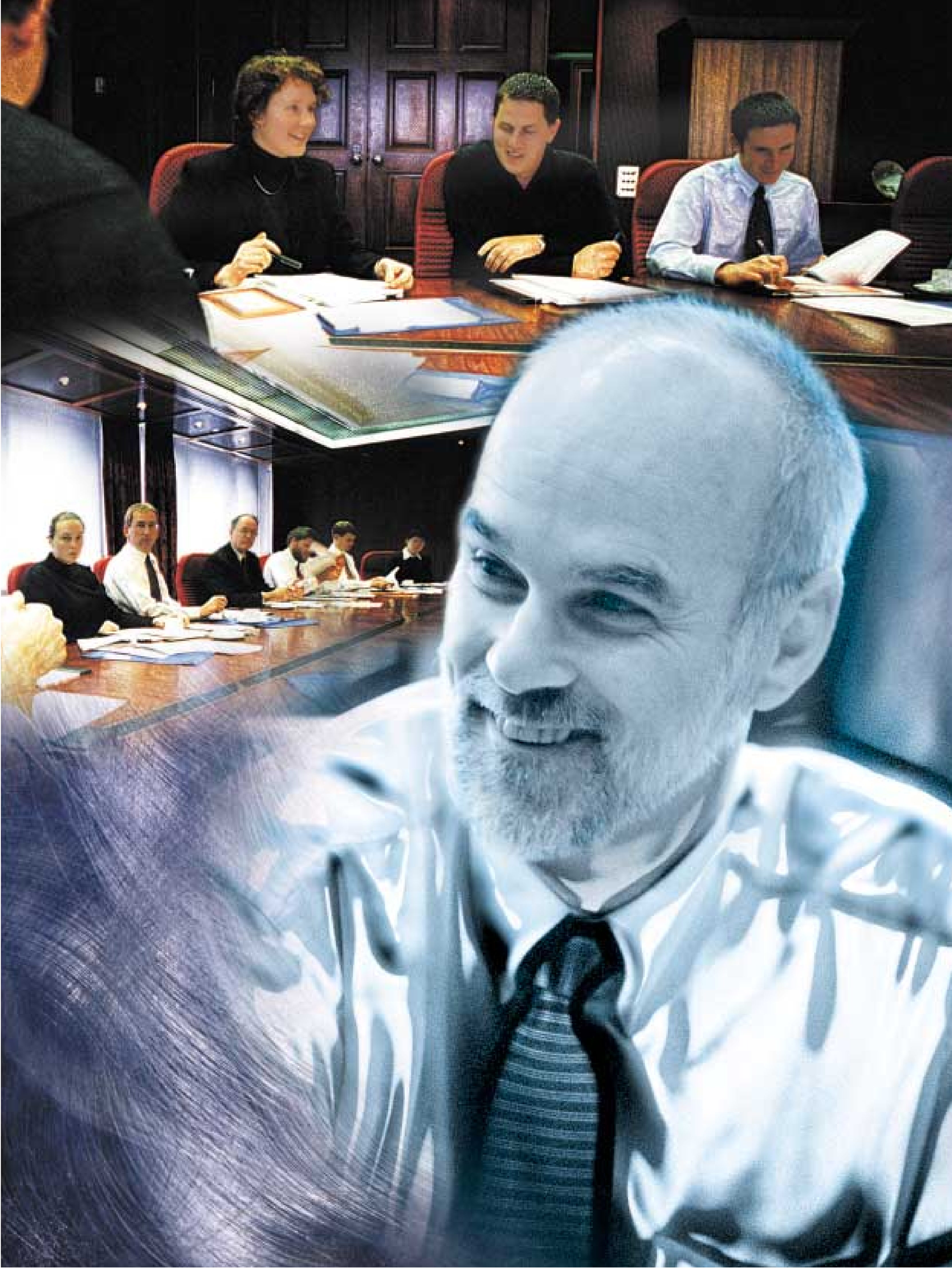
First, inflation spiked outside the Reserve Bank's 0 to 3 per cent target range. CPI inflation reached 4.0 per cent over the year to December 2000, and fell back to 3.2 per cent by the end of the review period, as shown in graph 1. This surge in the CPI was caused by a jump in world oil prices pushing up local petrol prices, increased taxes on tobacco and higher tradable goods prices caused by the low dollar. On the other side, a significant factor with a downward impact on the CPI was the change in state housing rental policy that caused some rents to drop sharply.

Graph 1

The speed with which inflation returns to within the target range will depend, in part, on whether the inflation spike of the recent past has changed price-setting behaviour. Also important will be the cyclical state of the economy and the extent to which demand will put pressure on the economy's productive capacity.

World demand slowed significantly during the year, taking away economic stimulus, but this effect was partly offset by the very low exchange rate, and the ongoing strength of some commodity prices in world markets - dairy prices in particular. The combination of these developments meant that New Zealand's economic performance was patchy, creating the second main issue for monetary policy - difficulty in reading the ongoing state of inflationary pressures.

We nonetheless judged that not only would inflation fall back within the target range relatively quickly, as cyclical pressures on resources ebbed, but also that the risk was that inflation would significantly undershoot the mid-point of the target range. For this reason, despite inflation being above the target range, monetary policy was eased. The Official Cash Rate was reduced progressively by 25 basis points in each of March, April and May of 2001, so that by the end of the financial year the Official Cash Rate was 5.75 per cent.



BOX 1

Monetary Policy Review

In May 2000, the Government established an "Independent Review of the Operation of Monetary Policy in New Zealand" and appointed Professor Lars Svensson of Sweden as reviewer. In setting out the Review's terms of reference[1], the Treasurer said that New Zealand had come through a period of transition to sustained price stability, and it was timely to consider whether the operation of monetary policy was as effective as possible. He also made clear that the price stability goal of monetary policy and the Reserve Bank's operational independence were not under review.

Professor Svensson's Review was released in February 2001 and in May 2001 the Treasurer announced his intentions in regard to the Review's recommendations. Professor Svensson's key conclusions and recommendations, and the outcomes stemming from each of these, are outlined below.

- Professor Svensson said that "Monetary policy in New Zealand is currently consistent with the best international practice of flexible inflation targeting." The main criticism he made of the operation of monetary policy over the 1990s was in regard to the Reserve Bank's use of a Monetary Conditions Index (MCI) from the middle of 1997 to March 1999.

The Bank welcomed Professor Svensson's endorsement of the current operation of monetary policy and accepted his criticism of our use of the MCI as a policy instrument - a shortcoming we acknowledged in our submission.

- Professor Svensson said that, although it had not yet caused a problem, vesting responsibility for monetary policy decisions in an individual was too risky and too dependent on the calibre of that person. He recommended that a formal committee - consisting of the Governor and four other senior Reserve Bank staff - should be jointly responsible for monetary policy decisions.

This recommendation was not adopted. The Government's judgement, shared by the Bank, was that the current framework provides sufficient checks and balances against this risk, given the process for appointing the Governor and the procedures for monitoring his or her performance against clearly stated targets.

The Treasurer noted, however, that "There could be some benefits in exposing the Governor to a wider range of views when decisions are made." He said this could be achieved by appointing external people to advise the Governor on the state of the economy and on monetary policy decisions and "invited the Bank to consider the best way to improve external input into the decision-making process."

In response, the Bank appointed two part-time external advisers, chosen for their broad knowledge of the New Zealand economy, to provide input into the process leading up to monetary policy decisions. As well, prior to the Review's publication, the Bank had expanded its programme of visits to businesses and sector groups, and had begun to invite senior central bankers from other countries to participate in the lead-up to *Monetary Policy Statements* and to provide feedback on this process.

- Professor Svensson recommended that the Governor and Deputy Governors should be removed from the Board, and that the Board should publish an annual account of its monitoring duties.

The Government decided that the Governor should remain a member of the Board, but should no longer chair the Board, given that the Board's prime role is to monitor the Governor's performance. The Government accepted the recommendation to remove the Deputy Governors from the Board.

This *Annual Report* is the first to contain a report from the Bank's non-executive directors, on pages 28 to 31, along the lines recommended by Professor Svensson.

- Professor Svensson also provided the Bank with some suggestions of a more technical nature.

The Bank is following up on these recommendations.

1 The terms of reference of the Review, the submissions to the Review, the Review itself and subsequent responses can be viewed at www.monpolreview.govt.nz.

Financial System Oversight

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

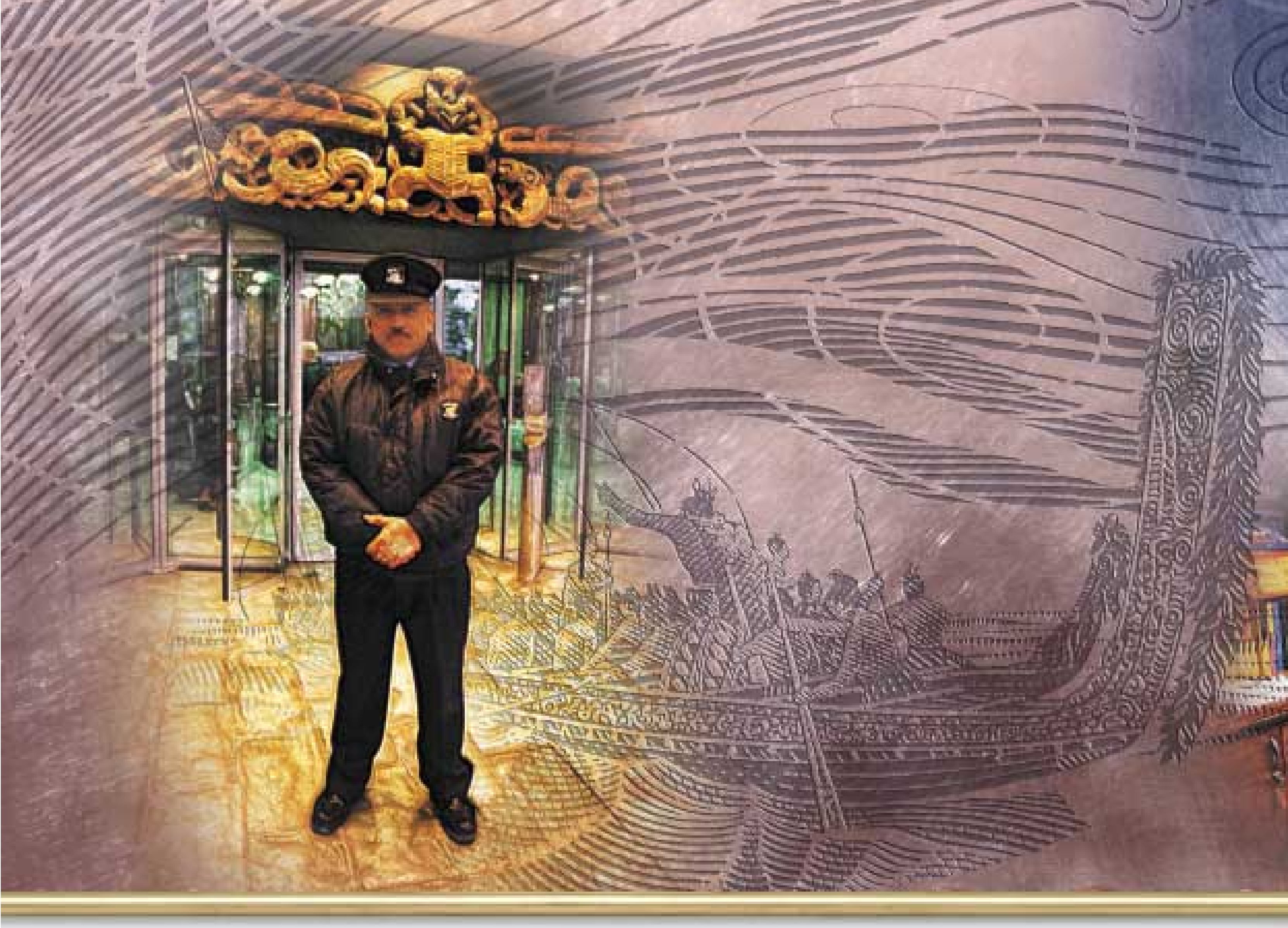
New regulations permitting the Reserve Bank to require local incorporation of some overseas-owned banks came into effect on 1 April 2001. This applies to overseas-owned banks that are either systemically important or come from jurisdictions that either give preference to home country depositors or have a level of public disclosure that is inadequate. Local incorporation means that assets that are part of a bank's New Zealand business can be clearly identified in the event of a crisis, unlike with a branch operation. Also local incorporation means that legislation in a bank's home country giving preference to depositors in that country would not apply here in the event of a failure.

We are continuing to discuss the implementation of this policy with the two banks directly affected.

The Reserve Bank is continuing its policy research and consultation on strategies for managing bank crises. One option, worked on during 2000/2001, would involve recapitalising a failed bank by using part of the funds of its depositors and money owed by the failed bank to other creditors. Locally-incorporated registered banks would be required to have the software in place so that, in the event of a crisis, creditor recapitalisation could be done very quickly. The aim would be to get the bank's doors open again as fast as possible, to avoid the shock of a bank failure to the financial system as a whole. Although depositors, as creditors, would suffer a partial loss, the bulk of their funds would still be available quickly, unlike when a bank actually goes out of business. Creditors, including depositors, might subsequently recover some or all of their "investment" in the resuscitated bank by its subsequent sale.

The Reserve Bank is actively involved in supporting the inclusion of the New Zealand dollar in the operations of CLS Bank, which is a major international initiative to reduce foreign exchange settlement risk. CLS Bank is expected to commence operation early in 2002 and will initially offer services in seven major currencies. A further six currencies are expected to be added to the service in late 2002 and early 2003. The New Zealand dollar is intended to be one of those six currencies.

Technical amendments to Parts IV and V of the Reserve Bank Act have been proposed for inclusion in the Government's 2001 legislative programme. These cover the use of the word "bank", the registration and prudential supervision of registered banks, and the Reserve Bank's powers to gather information on the payment system.



Currency

By statute, the Reserve Bank is required to provide the nation's bank notes and coins. As at 30 June 2001, the total value of currency in circulation was $2.54 billion, which was 12 per cent higher than at the same time the previous year.

Between May 1999 and March 2000, New Zealand's complete range of bank notes was changed from paper to polymer. About 96 million polymer bank notes have been issued and it is now quite rare to find a paper bank note still in circulation.

The introduction of polymer bank notes has been an outstanding success. The public have expressed satisfaction with the change, as reported in box 2.

An additional benefit has been a marked reduction in attempts at counterfeiting. During the review period, we detected just 156 forgeries, compared with 950 for the same period in 1999/2000 and 401 in 1998/1999. Most forgeries still turning up are of the previous paper designs, and to date there have been no serious attempts at forging polymer bank notes.

The polymer bank notes are also lasting much longer. Our expectation is that, though they cost about twice as much to print as paper bank notes, they will last four times as long. The $20 bank notes have now been in circulation for two years, and so far very few damaged bank notes have come back to the Reserve Bank.

The Reserve Bank's role in the daily 'retail' distribution of currency has been greatly reduced. Since the middle of 2000, the banks and security companies have been working together to re-distribute their cash among themselves, rather than using the Reserve Bank as a clearing-house. This change has resulted in the banks holding higher stocks of bank notes than previously, but generally distribution seems to be working well. As a result, our Christchurch and Auckland branches have been closed. We now operate out of Wellington only, in effect as a wholesale supplier, replacing damaged stock and meeting seasonal demands from our cash reserves.

Public Opinion on Polymer Bank Notes

In August 2000, the Reserve Bank's special issue $10 millennium bank note went into general circulation. Then in late October and early November 2000, the Bank commissioned ACNielsen (NZ) Ltd to conduct a poll to find out how the public and retailers viewed the design and special security features of the $10 millennium bank note, the security features on other polymer bank notes and attitudes towards polymer bank notes in general.

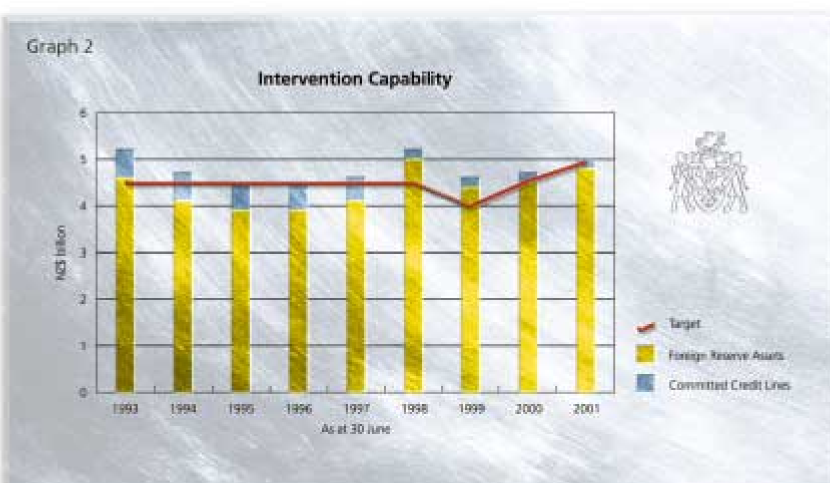
Among the findings:

- Sixty per cent of public respondents and 65 per cent of retailers indicated a preference or strong preference for the $10 millennium bank note over the normal $10 bank note.
- Seventy four per cent of the public and 90 per cent of retailers either preferred or strongly preferred polymer bank notes to paper bank notes. Polymer bank notes were perceived to be superior in quality.
- The special security features of the $10 millennium bank note were less well known than the standard security features of the ordinary $10 bank note. Members of the public were likely to take a suspicious-looking bank note to a bank for verification, whereas retailers were more likely to use the bank note's security features for authentication.

These results indicate that polymer bank notes are well accepted among the public and retailers. They also indicate that people like the bright, innovative design features used in the $10 millennium bank note.

Foreign Reserves Management

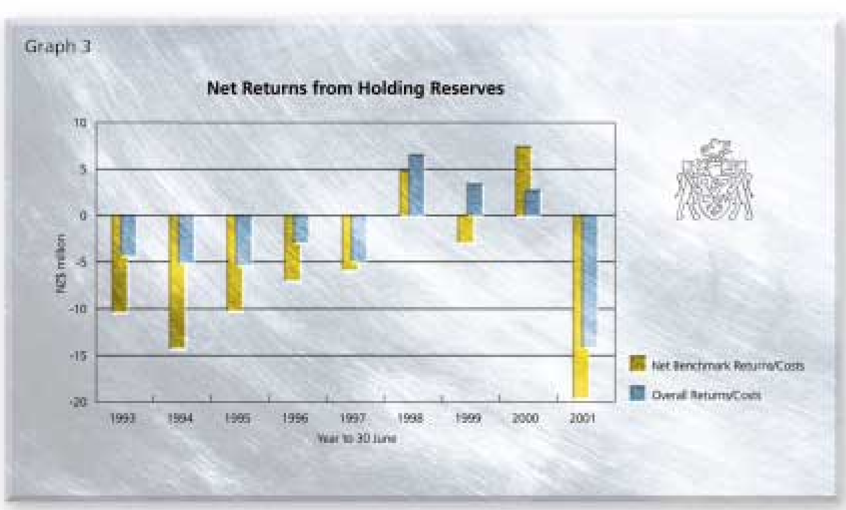
The Reserve Bank maintains a capacity to intervene in the foreign exchange market to smooth disorderly market conditions should they arise, although we have not done so since the New Zealand dollar was floated in March 1985. The Bank holds a diversified portfolio of foreign currency assets, which can be quickly realised if needed. These are financed by foreign currency borrowings through the Treasury. The level of our overall intervention capacity, as determined by the Treasurer, is illustrated in graph 2. Since 1998, the Treasurer's determinations have been expressed in foreign currency terms, given that the resource is held in foreign currencies, and it thus fluctuates when expressed in New Zealand dollar terms, as the New Zealand dollar rises or falls.



Graph 2
Intervention Capability

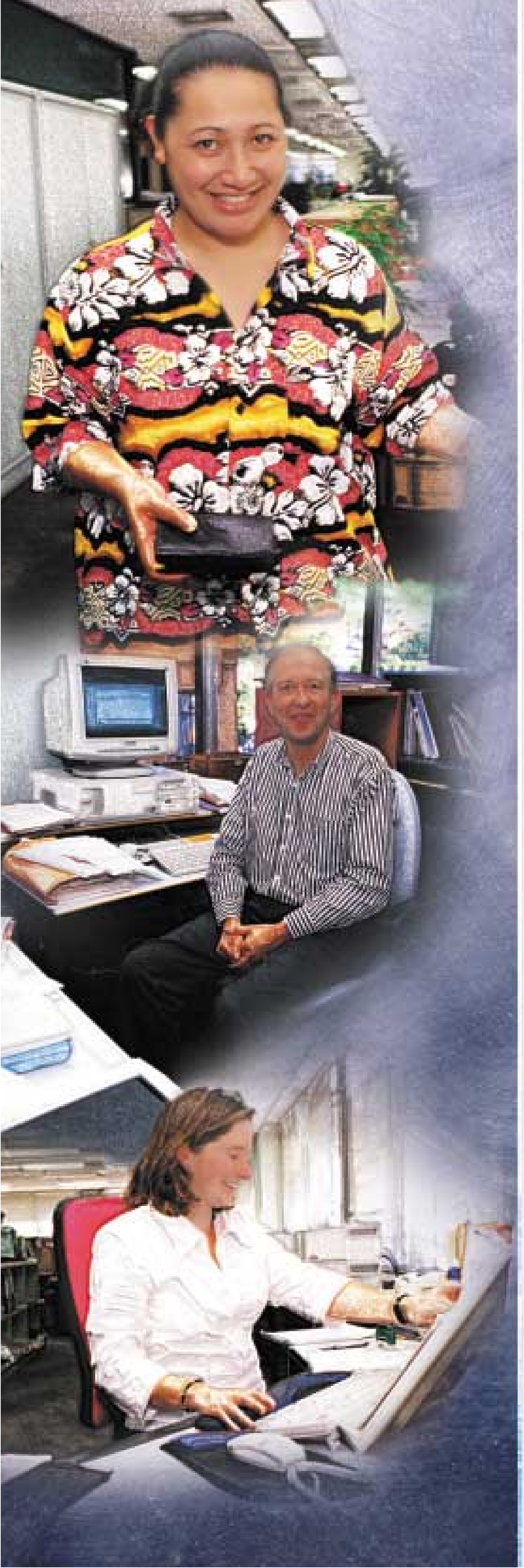
Holding these reserves involves a cost, because we generally have to pay more to borrow overseas than we can earn by reinvesting the borrowed funds in high quality assets that can be realised quickly. This cost can be thought of as an insurance premium, giving us the option to intervene if necessary. We aim to minimise this cost by carefully structuring the overall portfolio, and we supplement this with 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 purely passive "benchmark" portfolio, as shown in graph 3.

To reduce costs on the passive portion of our portfolio we have decreased our holdings of sovereign, largely AAA-rated, instruments in favour of a range of non-sovereign securities. As a result, the difference, or 'spread', between our average borrowing and investing rates has narrowed. This means that, in future, as existing borrowings mature, we can borrow at interest rates closer to our investing rates. This makes our borrowings already in place look relatively expensive, which is reflected in the $19.6 million mark-to-market loss recorded on the passive portfolio. Note, however, that if, as we expect, the portfolio of assets and liabilities is held to maturity, the loss will not be realised, and the amount will increase and decrease over time as the spread between borrowing and investing rates fluctuates.



Our active management activities are also aimed at reducing overall costs, as well as enhancing our understanding and knowledge of financial markets and instruments. As shown in graph 3, over 2000/2001 our active management activities provided a partial offset to the costs generated by the passive portion of the portfolio. On the whole, however, our performance for the year was disappointing, given that a large part of the profit was due to revaluation gains on a medium-term position that was entered into several years ago.

As foreshadowed last year, during 2000/2001 we adopted new working rules for the management of our reserves, giving greater scope to our dealers, although within well-specified limits set by senior management.



Registry and Depository Services

The Reserve Bank provides registry services to issuers of fixed-interest securities such as bonds and bills. This creates a definitive proof of legal ownership of debt securities, and a procedure for changes of ownership. The registry's performance for the year under review is described in table 1.

Table 1

Key Statistics for Registry Services as at 30 June

	2001	2000
Face value of securities for which RBNZ is registrar	**$65.9 billion**	$62.1 billion
Total value of payments during the year	**$41.8 billion**	$50.1 billion
Number of investors	**29,076**	29,606
Number of investments	**60,138**	64,459

This was the first full year in which we outsourced the provision of debt securities registry services to BT Portfolio Services (NZ) Limited (BTPS), though the Bank remains responsible for the services now carried out on its behalf. During that period, BTPS provided services using the Bank's system while customising its Unishare system to operate in the New Zealand environment. Then, on 9 July 2001, the registry was successfully moved to BTPS's system.

The Bank also operates the Austraclear New Zealand System, which provides the financial markets with a depository service for clearing and settling high-value debt securities and equities. The Reserve Bank's depository experienced a fall in membership reflecting both a large number of mergers and take-overs in the financial markets and decisions by many trust funds to have their funds managed on a pooled basis, rather than individually. The depository's performance for the year under review is described in table 2.

Table 2

Key Statistics for Depository Services at 30 June

	2001	2000
Value of securities held in depository	**$78.8 billion**	$79.2 billion
Number of members	**265**	328

During 2000, the Reserve Bank entered into a conditional contract with an external party for the Bank to relinquish its licence to operate the Austraclear system in New Zealand. However, final agreement was not reached and the conditional contract lapsed. This outcome, together with the need to upgrade existing computer software, means that the Bank must now reassess strategic options for the provision of depository services for New Zealand dollar denominated securities. In the meantime, the Bank remains absolutely committed to ensuring that this service continues to be provided to the required standard.

For some years, a wholly-owned subsidiary of the Reserve Bank, RBNZ Registry Limited, was the legal entity through which these services were provided. This arrangement was terminated on 30 June 2001. We decided that, with a significant portion of the registry function now contracted out, the use of a subsidiary company was superfluous. RBNZ Registry Limited will be wound up early in the 2001/2002 financial year.

International Liaison

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

The Reserve Bank has been closely monitoring proposals for reform of the international financial system. During the period under review, we provided advice to New Zealand's representative on the Executive Board of the International Monetary Fund (IMF). Bank representatives also attended joint IMF/World Bank meetings in Washington and Prague.

We continued to work closely with the Treasury on a range of issues being addressed in the Asia-Pacific Economic Co-operation (APEC) Finance Ministers' Forum, including capital account liberalisation, macroeconomic reform, the strengthening of financial markets and a strategic review of the Forum. With the Treasury, we took part in meetings of the Manila Framework Group and participated 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 participation in groups such as EMEAP[2] and the SEANZA[3] group of central banks. Staff took part in EMEAP working groups on financial markets, payment and settlement systems, and banking supervision. We provided technical training on accounting and economic modelling to staff from a number of central banks in the Asia-Pacific region and to Commonwealth members.

We also made staff available to undertake assignments for the IMF in Asia, Eastern Europe and the Middle East. The Governor visited Jakarta to assist the Government of Indonesia resolve a dispute with the IMF. Staff gave advice on operational risks in banking, central bank accounting, the implementation of Basel Core Principles, implementing monetary policy through market operations, and assessments of financial sector stability. One staff member presented a seminar in Kenya on corporate governance in the financial sector under the auspices of the Commonwealth Secretariat.

2 Executives' Meeting of East Asia and Pacific central banks

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.

Our People

The Reserve Bank employed a total of 203 staff (199 full-time equivalents (FTE)) as at 30 June 2001. The Reserve Bank's turnover rate during the year was 14.9 per cent[4], as shown in table 3.

Table 3

Human Resource Statistics

	1993 1994	1994 1995	1995 1996	1996 1997	1997 1998	1998 1999	1999 2000	**2000 2001**
Total staff at 30 June (FTE)	286	293	290	289	281	283	237	**199**
Average years of service at 30 June	8.7	8.6	8.6	8.7	8.3	8.8	9.4	**9.4**
Annual staff turnover	10.9%	9.6%	15.0%	10.6%	8.8%	10.0%	10.4%	**14.9%**
Average sick days per staff member	7.1	5.3	4.9	5.5	4.9	4.4	4.8	**4.7**

During 2000/2001, the Bank worked at building the leadership skills of its senior staff by using "360° feedback" surveys to identify development needs. Senior staff received feedback via these surveys from their peers, staff and managers, and developed individual development plans based on it. This was part of an effort to nurture a culture of open discussion in the Bank that encourages ideas and contributions from all staff.

The way the Bank evaluates jobs, assesses performance, designs development plans and sets remuneration were reassessed. Succession planning, to reduce the Bank's vulnerability to the loss of key "generalist central bankers", was also given attention.

Remuneration

The Reserve Bank spent $16.7 million on personnel in 2000/2001. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 4 shows the number of staff who received over $100,000 in total remuneration[5] in 2000/2001.

Table 4

Staff receiving $100,000 or more in 2000/2001

Total remuneration[6]	Staff numbers
$100,000 to $109,999	9
$110,000 to $119,999	2
$120,000 to $129,999	6
$130,000 to $139,999	4
$140,000 to $149,999	5
$150,000 to $159,999	1
$160,000 to $169,999	1
$180,000 to $189,999	1
$190,000 to $199,999	4
$250,000 to $259,999	2
$310,000 to $319,000	1
$330,000 to $339,999	1
$490,000 to $499,999	1
Total	**38**

4 This excludes positions made redundant.

5 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 bonuses or redundancy payments. The information in table 4 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 on the basis of performance on the job and prevailing market conditions, based on salary surveys and assessments made by an independent remuneration consultant.

6 This includes payments to four employees who were made redundant during the year.

Communications

In communications terms, the highlight of the year was the broadcast of Dr Brash's quarterly *Monetary Policy Statement* press conferences live on Sky Television. The aim was to provide financial market participants with direct access to these critical press conferences, thereby reducing the risk of misinterpretation or confusion, which can occur when financial market participants are reliant on second-hand reports of what's said. Earlier, the Reserve Bank attempted to do this by broadcasting press conferences live on the Bank's website. However, we found that most institutions were unable to access this, because of computer firewalls[7].

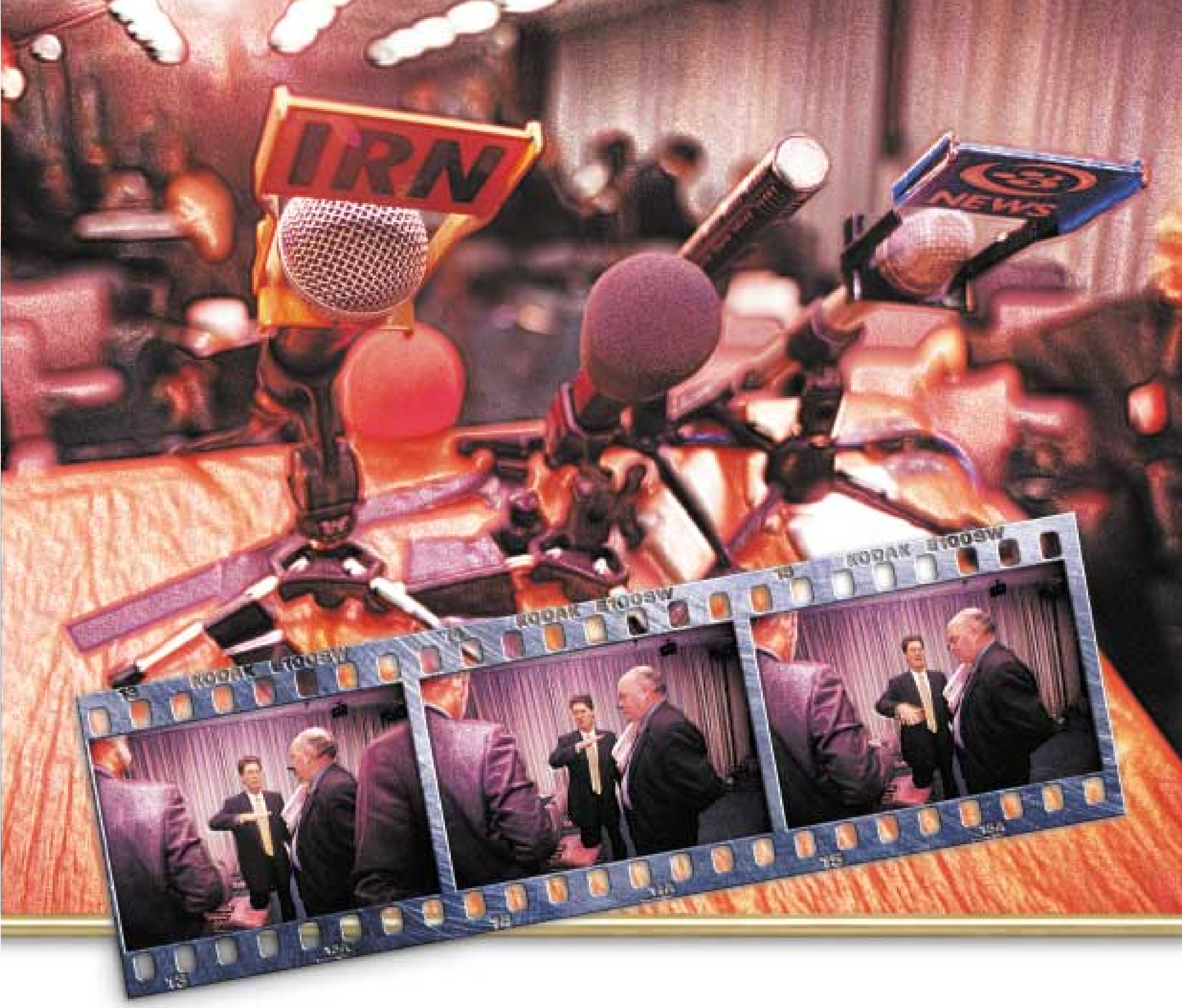
We then turned to television, with Sky Television indicating that it was prepared to accept our press conferences as "live injects" into its CNBC business news channel. This involved employing a production house to produce a 30-minute live broadcast, supplied as it happened to Sky Television. Feedback from bank dealing rooms and others was positive and after two pilot broadcasts the decision was made to continue, for the next 12 months at least.

At year's end, the Reserve Bank began a web-based initiative called the "Reserve Bank Email Service". A facility on the Bank's website[8] allows viewers to enter themselves onto an email mailing list to receive Reserve Bank press statements, speeches and the like, shortly after they are issued to the media.

The Governor's and Deputy Governors' longstanding programme of delivering numerous off-the-record speeches around the country continued, along with a small number of on-the-record speeches. A substantial upgrade of the Bank's website was completed.

7 "Firewalls" are software and hardware systems employed by most organisations to keep their computer systems secure and protected from hackers and viruses. Firewalls allow emails to pass through, but allowing a video stream through a firewall is more complex and we found that few of the target organisations were able to arrange this in time.

8 The Bank's website is at www.rbnz.govt.nz.



BOX 3

A New History of the Reserve Bank

During the year under review, work began on a new history of the Reserve Bank. The principal author is to be Dr John Singleton, Senior Lecturer in Economic History at Victoria University. He will be supported by Professor Gary Hawke, Sir Frank Holmes, and Dr Arthur Grimes.

This publication is intended to focus primarily on the policy issues associated with the development of monetary policy over the past three decades, rather than on the Bank itself. The Bank's only current history, *Between Governments and Banks,* by economic historian Gary Hawke, ends at 1970. The new work is expected to take approximately three years to complete. The Ministry of Culture and Heritage is supervising the project.

Financial Performance

Operating Expenses

The Reserve Bank's consolidated operating expenditure for 2000/2001 was $37.8 million, which was 5.6 per cent under budget[9]. This was also $6.5 million, or 14.6 per cent, below the previous year's actual expenditure. Expenditure was under budget mainly because:

- personnel expenses were $0.6 million less than budgeted, mainly due to lower net remuneration and training costs;
- costs of issuing new coins and bank notes were $0.8 million less than budgeted, mainly due to lower-than-estimated demand for new bank notes and coins; and
- other expenses were $1.1 million less than budgeted, mainly due to the Monetary Policy Review costing less than budgeted and project work not being undertaken.

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

Funding Agreement

Section 159 of the Reserve Bank Act 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. That new agreement changed the way expenditure is calculated, allowing the Reserve Bank to retain agreed amounts for operational expenditure in addition to amounts earned as income from specified activities. During the year under review, the Reserve Bank spent a net $28.6 million on activities covered by the Funding Agreement, which was 15.9 per cent below the $34.0 million permitted for this period in the Funding Agreement.

Operating Surplus

During 2000/2001, the Reserve Bank recorded a net consolidated surplus of $159.6 million, against $150.0 million budgeted, and compared to $159.3 million in 1999/2000. This surplus, however, is not a good indicator of the Reserve Bank's management performance, as it 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 circulation[10], 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 and not to maximise its surplus. For these reasons, the level of the Bank's operating expenditure, as described 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 amount of this surplus this year was $154.1 million and has been paid to the Government. The Reserve Bank Act also provides that any expenditure savings that 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 2000/2001 Financial Statements include provision for a transfer to equity of $5.4 million, representing under-spending of the Funding Agreement level for the year. The Bank's consolidated equity at 30 June 2001 was $405.4 million.

Budget for 2001/2002

The Reserve Bank's budgeted operating expenditure for 2001/2002 is $37.4 million. This is 1.1 per cent below the 2000/2001 expenditure of $37.8 million. The Reserve Bank's budgeted net operating expenditure, as defined in terms of the Funding Agreement, is $27.5 million in 2001/2002, which is 11.3 per cent below the Funding Agreement level of $31.0 million, and $1.1 million, or 3.8 per cent, below the comparable net actual expenditure for 2000/2001.

9 Consolidated operating expenditure does not include the loss on revaluation of Bank properties of $0.8 million and taxation of $0.7 million.

10 This is known as seigniorage.

THE YEAR AHEAD

The Reserve Bank annually undertakes a formal planning process, which identifies goals for the year ahead. During the 2001/2002 year, aside from its normal duties, the Reserve Bank intends to:

- assist in the preparation of legislation required to implement governance changes announced by the Treasurer as a result of the Government's *Independent Review of the Operation of Monetary Policy* and then see that those changes are implemented effectively;
- enhance the credibility and quality of the Bank's monetary policy formulation by undertaking further peer reviews and implementing the Bank's external-input initiative;
- seek legislative amendments in relation to banking supervision and Financial System Oversight;
- consider the application of the revised Basel Capital Accord to New Zealand-incorporated banks;
- further develop options for responding to a bank in distress;
- finalise revised arrangements for support of the Austraclear system software, and commence consideration of strategic options for the longer-term future of the Bank's Austraclear service;
- ensure the New Zealand dollar is accepted for inclusion in the new CLS Bank global payments system;
- install new software to allow New Zealand's Exchange Settlement Account System to interface with the international "SWIFT" settlement account system, this being a precondition for joining CLS Bank;
- upgrade the Bank's internet, intranet and information systems to promote knowledge management; and
- sell the Bank's Auckland building.

Reserve Bank Non-Executive Directors' Annual Report

One of the conclusions from the Independent Review of Monetary Policy ("Independent Review") was that the Board of the Reserve Bank should report annually on the performance of the Governor and the Bank. This is the first such report on the Board's monitoring of that performance.

For this year, the Report is from the Non-Executive Directors' Committee ("NEDC") of the Board, to which the Board has delegated its performance monitoring role. This is pending a restructuring of the Board to be legislated for in 2001/2002. That restructuring, which also follows from the Independent Review, will make a non-executive director the Chair of the Board, in place of the Governor, and will remove the Deputy Governor positions from the Board.

For the NEDC, 2000/2001 has been a busy year. In early 2000 we looked at ways in which we could further enhance our monitoring of the Bank's *Monetary Policy Statements*, and implemented a more structured and intensive approach to assessing those policy documents. For each *Statement* this has involved the NEDC receiving the supporting internal documentation in concert with a comprehensive briefing from the key Bank staff involved. After each briefing, the NEDC has met without the Governors present to formulate and record its assessment of the *Statement*.

All the other key functions of the Bank were also kept under review. The Board received quarterly reports from the Governor on the Bank's performance against its Plan for the year. That Plan was summarised in last year's Bank *Annual Report* (page 31). Material variances from what was planned are addressed later in this Report.

Additionally, the NEDC spent significant time on the issues raised by, and in making a submission to, the Independent Review.

Performance assessment

Overall, the NEDC assesses the Bank to have maintained the high level of performance of previous years. Noteworthy was the observation of Professor Svensson, who conducted the Independent Review, that "monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting, with a medium-term inflation target that avoids unnecessary variability in output, interest rates and the exchange rate". During 2000/2001, the Bank was capably managed. All its responsibilities were discharged effectively, risks were well managed, and costs were well contained.

This assessment has been arrived at after taking into account "exceptions" that arose during the year. The material exceptions concerned:

- CPI inflation, which was at or above the upper bound of the 0 to 3 per cent target range specified in the Policy Targets Agreement ("PTA") throughout the year[1]; and
- departures from plan with respect to changes to the Bank's registry and securities settlement operations.

We elaborate on these matters below.

We wish to record that the high standard of performance of the Bank during the year, though ultimately the responsibility of the Governor, owes much to its staff. Without the efforts of the Bank's staff, the excellent results achieved would not have been possible.

---

1 The Policy Targets Agreement can be found on the Bank's website at www.rbnz.govt.nz/monpol/pta/index.html.

Deviation of CPI inflation from the target

The year-on-year increases in the CPI in 2000/2001 were as follows:

September 2000	3.0 per cent
December 2000	4.0 per cent
March 2001	3.1 per cent
June 2001	3.2 per cent.

The NEDC received extensive briefings at the time these above-target CPI inflation rates were projected and, additionally, reviewed the actual quarterly outcomes in the light of what had been projected. We noted that these outcomes included unusually large increases in indirect taxes for tobacco products and in the international price of oil, partly offset, from March 2001, by some retracement in oil prices, and the implementation of the Government's policy decision to reduce state house rents.

We have been satisfied that these particular price movements fall within the ambit of the "unusual events" envisaged by clause 3(a) of the PTA, that is, events that "can have a significant temporary impact on inflation as measured by the CPI, and mask the underlying trend in prices which is the proper focus of monetary policy". In the absence of the contributions to the CPI from these price movements, inflation is likely to have remained within the target range, albeit narrowly for the June 2001 quarter. We have also been satisfied, as required by clause 3(b) of the PTA, that the Bank's reactions to the above-target outcomes have been directed to preventing general, or in other words, persistent, inflation from emerging. Hence, in our view, although the CPI inflation outcomes for most of the year were outside the quantitative target range, they did not amount to a breach of the PTA.

Throughout the year, the NEDC has also been mindful of the amendment made to clause 4(c) of the PTA following the change of Government in November 1999. That amendment made explicit an obligation that, in pursuing price stability, the Governor should "seek to avoid unnecessary instability in output, interest rates and the exchange rate". Previously that obligation had been implicit. While clearly subordinate to the price stability objective, it does add another, more subjective, dimension to judgements about the Governor's performance in achieving the inflation target. In our view, monetary policy during 2000/2001was implemented in a steady and predictable manner that was conducive to avoiding unnecessary instability in output, interest rates, and the exchange rate.

The NEDC also reviewed each of the *Monetary Policy Statements* released in 2000/2001 for their compliance with the requirements of the Act and the PTA. We are satisfied that each *Statement* met the requirements of the Act and the PTA.

Outsourcing of Registry and transfer of Austraclear operations[2]

The Bank had planned to implement during the financial year significant changes to its operational role in New Zealand's securities settlement and registry systems. The proposed changes involved outsourcing the Bank's Registry operations to BT Portfolio Services (NZ) Limited ("BTPS"), and transferring the Bank's licence to operate the Austraclear securities settlement system in New Zealand back to Austraclear Limited.

[2] The Bank provides a securities registry service for the government and a range of other debt issuers. It also provides, through its Austraclear operation, a securities depository facility (for debt and equities), and a mechanism which enables trades of securities lodged into the depository to be settled on a real time, delivery versus payment, basis.

There was a delay in transferring the Registry operations from the Bank's systems to BTPS's systems, while BTPS's systems were being customised. However, the transfer was successfully completed on 9 July 2001. The risks and the potential for costs to arise from the delay were effectively managed, and there was no disruption to customer service.

The planned transfer of the operation of the Austraclear service did not proceed because the Bank and Austraclear Limited were unable to agree final terms for the transfer. The NEDC is satisfied that, in this circumstance, it was appropriate for the Bank to retain the operating licence and to continue to provide the service for the meantime.

Other functions

During the year, the NEDC also kept under review the Bank's other areas of responsibility. These include maintaining oversight over the stability of the financial system, supplying currency, and managing foreign reserves. We have no "exceptions" to draw attention to in these areas. However, it is worth noting that changes to the Bank's currency distribution arrangements, together with the introduction of polymer bank notes in 1999/2000, are resulting in substantial cost savings of at least $5 million per annum.

Monitoring the use of resources

The Reserve Bank, besides performing important policy responsibilities, is a major financial institution. The Bank's assets at 30 June 2001 totalled $11.3 billion, and in the last year revenue earned was $199.0 million and operating expenses were $37.8 million.

Our monitoring of the use of resources included the monitoring of the Bank's risk management, human resource management, and operating efficiency and effectiveness. During 2000/2001, we received monthly financial reports on revenues and expenditures against budget, and in-depth briefings on the foreign reserves management function and on human resource management.

The Bank's operating expenditure in 2000/2001 was within budget and within the amount provided for under the Funding Agreement between the Governor and the Treasurer.[3] Actual net operating expenditure under the Funding Agreement was $28.6 million against a budgeted amount of $31.6 million. Net operating expenditure provided for under the Funding Agreement in respect of 2000/2001 was $34 million.

Financial risk management monitoring is performed on behalf of the NEDC by the Audit Committee of the Board. The Audit Committee met on three occasions during 2000/2001. It received regular reports from the Bank's Risk Assessment and Assurance Department on the internal audit function, undertook a detailed appraisal of the Bank's 2000/2001 Financial Statements, and met with the external auditors to discuss a range of matters, including the external audit management letter.

---

3 The Funding Agreement can be found on the Bank's website at: www.rbnz.govt.nz/about/whatwedo/0090769.html

Independent Review of the Operation of Monetary Policy

The NEDC made a detailed submission to Professor Svensson, who conducted the Independent Review, and we met with him to discuss that submission. Throughout the review exercise we also provided advice to the Treasurer. Our submission to Professor Svensson and our response to his report were both published[4].

Our key recommendations concerned the governance arrangements for the Bank. In particular, we recommended that:

- the Governor should remain the single decision-maker responsible for monetary policy;
- the chair of the Board should be a non-executive director;
- the chair should be elected by the non-executive directors, rather than be appointed by the Treasurer; and
- the Governor and Deputy Governors should remain members of the Board.

With the exception of our recommendation that those holding the position of Deputy Governor should retain seats on the Board, these recommendations were accepted by the Government in its response to the Review. This has resulted in the institutional structure within which the Bank operates having been very substantially maintained and, in some respects, strengthened. We believe it will serve the Bank and New Zealand well in the future.

Bill Wilson

Bill Wilson

Chair of the Non-Executive Directors' Committee of the Board
Reserve Bank of New Zealand
17 August 2001

---

[4] These can be found at: http//www.rbnz.govt.nz/monpol/review/index.html

Reserve Bank of New Zealand
2 The Terrace
PO Box 2498
Wellington
New Zealand.
Phone: NZ 4 472 2029
Fax: NZ 4 473 8554

For further information write to:
The Librarian
Reserve Bank of New Zealand
PO Box 2498
Wellington
New Zealand.

Email us at rbnz-info@rbnz.govt.nz or visit us at www.rbnz.govt.nz.

Produced by the Corporate Affairs Section of the Knowledge Services Group and the Financial Services Group of the Reserve Bank of New Zealand.

Editor, Paul Jackman; design and production, Cue Design; photography, Stephen A'Court.