

RESERVE BANK NON-EXECUTIVE DIRECTORS' 2001 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 year¹; and
- departures from plan with respect to changes to the Bank’s registry and securities settlement operations.

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

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.

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 2000/2001 was 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 operations²

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.

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.

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.

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

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.

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 published⁴.

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
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>