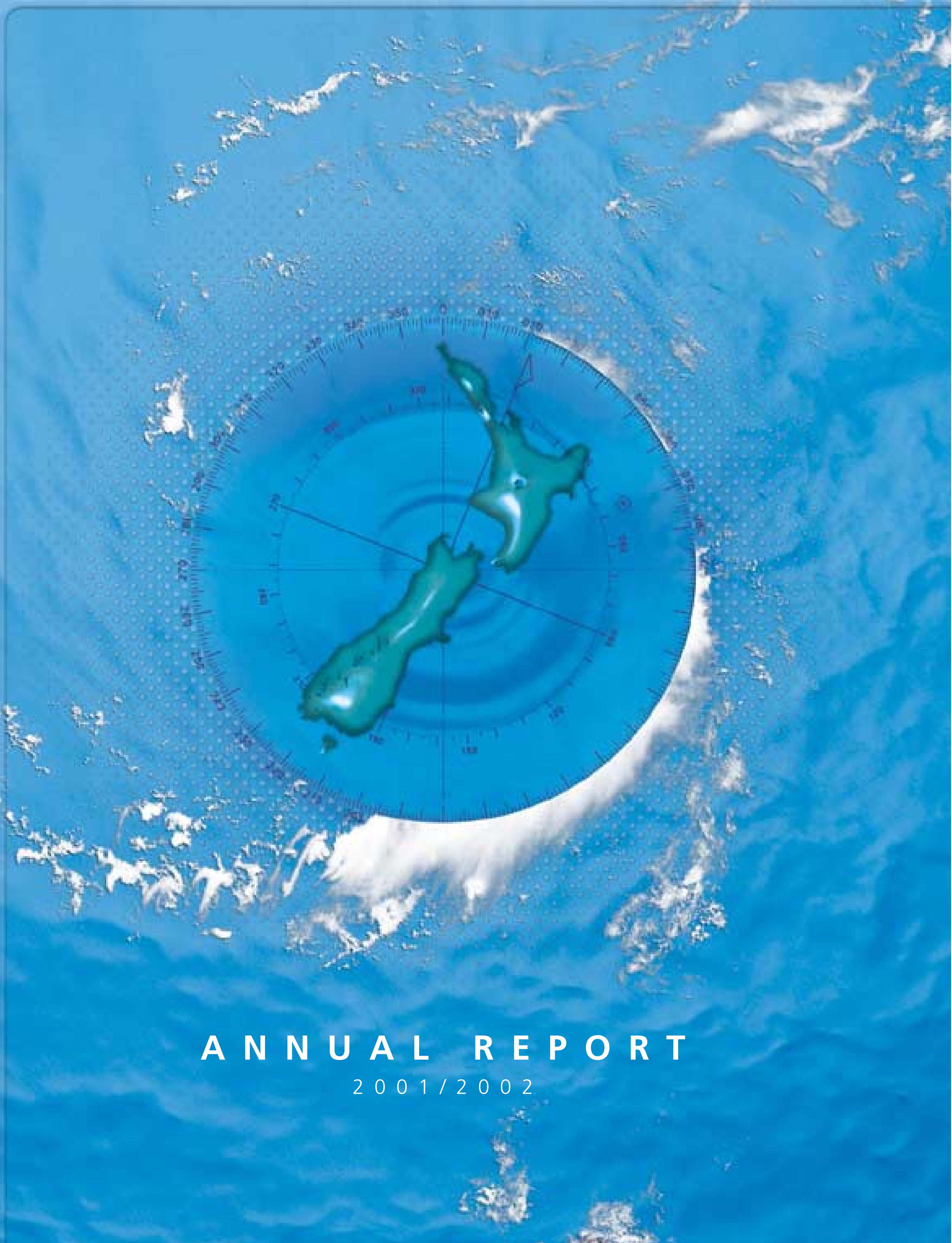
RESERVE BANK
OF NEW ZEALAND



ANNUAL REPORT

2001/2002

Contents

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.

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.

www.rbnz.govt.nz

Reserve Bank of New Zealand *Annual Report* and financial statements for the financial year ended 30 June 2002, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989, published September 2002. ISSN 0110 7070

THE YEAR AT A GLANCE

- For the 12 months to 30 June 2001, Consumers Price Index inflation was 2.8 per cent.
- Following the 11 September terrorist attacks in the United States, the Reserve Bank, in an unscheduled announcement, cut the Official Cash Rate (OCR) from 5.75 per cent to 5.25 per cent. After a further reduction of the OCR to 4.75 per cent in November 2001, the Bank began increasing interest rates again in March 2002.
- As a consequence of the terrorist attacks in the United States, the Reserve Bank reminded banks and financial institutions of their obligations in regard to United Nations sanctions that apply in New Zealand.
- Following the *Independent Review of the Operation of Monetary Policy*, the Reserve Bank engaged two external advisers to contribute to the monetary policy decision-making process.
- In part as a result of that review, the Reserve Bank also assisted in the preparation of amendments to the Reserve Bank Act, which, at the time of writing, were before Parliament.
- Governor Don Brash resigned and the selection process for a new Governor began. Dr Rod Carr was appointed Acting Governor.
- Kiwibank Limited was registered as a bank.
- Discussions were initiated with New Zealand's banks on a new proposal developed by the Reserve Bank by which a failed bank could be recapitalised without a taxpayer bailout.
- Using new software, New Zealand's Exchange Settlement Account System for the first time interfaced directly with the SWIFT global network that facilitates payments and other financial messages between financial institutions.
- The Reserve Bank's building in Auckland was sold.
- A Reserve Bank Email Service was launched, by which subscribers receive Reserve Bank announcements by email as they happen.
- The Reserve Bank spent a net $24.9 million on activities covered by the Funding Agreement, which was 19.7 per cent below the $31 million permitted. The Bank earned a surplus of $175.0 million.

Acting Governor's Statement

The Reserve Bank is charged with preserving stability in the value of money and promoting the soundness of the financial system. In this way, we reduce monetary and financial uncertainty, thereby making our contribution to sustainable economic growth and employment.

Monetary and financial predictability enhances planning and longer-term commitments by people developing skills, by employers taking on employees, and by savers, investors, borrowers and lenders. People making decisions can more readily rely on prices to reflect true costs and know that the mere passage of time will not make them worse off. They also can be more confident that their savings will be there, when required.

Price stability is also laudable because it is fair and equitable. When money loses its value in an unexpected way, those likely to be hurt most are people on fixed incomes, people who rely on bureaucratic processes to set their incomes, people with modest levels of savings, and people on low wages with the least negotiating power to win compensation year after year.

Financial system instability is a source of extraordinary injustice. When financial systems fail, promises are broken, and jobs, savings and trust are destroyed. These may take decades to repair.

So how have we done?

In the year under review consumer prices rose 2.8 per cent. Savers have been rewarded with positive real interest rates, preserving the purchasing power of the money that they set aside in low risk assets, such as bank deposits and government securities. Price stability in terms of expected outcomes, as agreed in the Policy Targets Agreement, has been achieved.

But there is more to this. In line with its broader responsibility for stability, the Policy Targets Agreement requires that, in maintaining price stability, the Reserve Bank must seek to avoid unnecessary instability in output, interest rates and the exchange rate.

In recent months there has been a growing debate about the extent to which the conduct of monetary policy has been consistent with this goal. Monetary policy inevitably faces uncertainty. Shocks, our incomplete understanding of how inflation expectations evolve, and long and variable lags in the impact of monetary policy on inflation outcomes - all call for judgement. Given this, the Reserve Bank must trade off the risks of pre-emption and gradualism against the risks of delay and the potential need for subsequent aggression in the conduct of monetary policy. Inaction now may mean greater instability later on.

Sometimes the Reserve Bank has to move very quickly. The terrorist events of 11 September 2001 required aggressive pre-emption in response, with the Reserve Bank cutting the Official Cash Rate by 100 basis points on top of 75 basis points of cuts earlier in the year. We did this even though headline inflation was outside the inflation target.

As spending power from an extraordinary two years of earnings in the agricultural sector pushed through provincial New Zealand, growth rose to an annual rate of over 3 per cent. Growth was helped along by a recovery in tourism, a rise in immigration and high levels of consumer and business confidence. More people than ever participated in the labour force. Retail sales grew at double-digit rates and activity in the housing market picked up. Stretched resources, headline inflation high in the target range and evidence of persistent inflation resulted in the Reserve Bank beginning to withdraw the stimulus provided previously by low interest rates. This reduction of stimulus was intended to ensure that economic growth continues at a sustainable rate, so as to reduce the likelihood of a more rapid slow down later.

As the year under review drew to a close, the weakening of the US dollar, rising relative interest rates and the rise in our growth prospects relative to some of our trading partners have seen the New Zealand dollar appreciate somewhat faster than we expected, to levels more in line with long-term trends. A weaker US dollar and a smaller US current account deficit are likely to place pressure on the tradable sectors of many countries, including New Zealand.

What of the financial system? The banks operating in New Zealand remain sound, with loan losses and impaired assets at low levels.

Offshore, a significant adjustment is underway in global financial markets, which will affect the real economy in the next few years. While losses to shareholders and bond holders in the US and Europe in particular are likely to be material, it presently appears that the major banks in those countries can absorb their share of these losses without any threat to the functioning of this key element of the global financial system.

The Reserve Bank stands at the hub of the New Zealand payment system, with banks settling over $30 billion a day via the systems that we are responsible for. During the year a significant new interface for these systems was successfully introduced, increasing efficiency while reducing risk and cost. More work remains to be done to further reduce settlement risks faced by banks dealing in New Zealand foreign exchange markets. The expected acceptance of the New Zealand dollar for settlement via CLS Bank, subject to several conditions, will, if achieved, be a material step. Progress by the New Zealand banking industry in agreeing and documenting failure-to-settle rules within the retail payment systems is advancing well.

On 26 April 2002, Dr Don Brash, Governor for fourteen years, resigned to stand for Parliament. It is a credit to both the framework and to Dr Brash that, on the day, the financial markets were confident that the Reserve Bank's processes were robust and transparent. Neither interest rates nor the exchange rate showed instability and the Bank moved swiftly to reassure markets that for the Bank it was business as usual.

Dr Brash's contribution to the flexible inflation-targeting regime, which now underpins monetary policy in New Zealand, has been substantial. Where New Zealand has gone others have followed. Under Dr Brash, New Zealand has led the world in central bank transparency and in harnessing market disciplines to improve the incentives faced by those responsible for the management of financial institutions. The Reserve Bank was an early adopter of polymer bank notes, real-time gross settlement of inter-bank transactions and more flexible human resource practices.

The Reserve Bank is highly regarded among central banks around the world. Reasons include the standard of its annual accounts, the way it communicates and how it organises itself. All current and former Bank staff contributed to this, but Dr Brash deserves a large measure of the credit for the renown of the Bank internationally.

It is also appropriate to acknowledge the contribution made by Murray Sherwin, former Deputy Governor and Deputy Chief Executive of the Bank. Mr Sherwin had been with the Bank since 1976 and served in many roles under various Governors and two distinctly different models of central banking. In recent years he represented the Bank extensively offshore, especially in the Asian region following the period of financial instability. His contribution in the evolution of the Bank into the institution it is today should not be underestimated.

In a year that has had its share of shocks and surprises, as well as the significant demands of routine business, I would like to pay tribute to the dedication and professionalism of all the staff of the Reserve Bank and to express my appreciation for a job well done.

Rod Carr
Acting Governor

RESERVE BANK OF NEW ZEALAND

What We Do

The Reserve Bank of New Zealand is the nation's central bank. The Reserve Bank has three main functions, which 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 to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance. The current inflation target is 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 managing the overnight interest rate, which in turn influences short-term interest rates and thus spending, saving and borrowing by the public and businesses. Decisions on short-term interest rates, along with many other factors, may also influence the exchange rate, and therefore 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 promote a sound and efficient financial system. We act as banker to the banks, providing inter-bank settlement facilities and related payment services. We advise the Government on the operation of the financial system.

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. We also provide secretariat services to the Overseas Investment Commission.

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 governance and management of the Bank, are described on page 8.

RESERVE BANK STRUCTURE AS AT JUNE 2002

Acting Governor
Rod Carr

Departments/Managers	Functions	Internal Services
Economics Department **David Archer** (Assistant Governor and Acting Deputy Governor)	Monetary policy formulation	
Financial Markets Department **Michael Reddell**	Market operations Foreign reserves management	
Banking System Department **Peter Ledingham**	Financial system oversight	
Corporate Affairs Department **Paul Jackman**		Reputational risk management Communications Board secretariat Governors support
Currency and Building Services **Brian Lang**	Currency operations	Property management Security
Financial Services Group **Mike Wolyncewicz**	Settlement services Registry and depository services	Accounting services Treasury services
Human Resources Team **Tanya Harris**		Human resources strategy and services
Knowledge Services Group **Yogesh Anand**		Library services Data services Computer services
Risk Assessment and Assurance Department **Steve Anderson**		Audit services Risk assessment and assurance
Overseas Investment Commission Secretariat **Steve Dawe**	Overseas Investment Commission	

Board of Directors

Executive

Dr Rod Carr
Acting Governor

Paul Jackman
Board Secretary

NON-EXECUTIVE DIRECTORS

Paul Baines
Company Director
Director: Comalco NZ Limited, Fletcher Building Limited, Gough Gough & Hamer Limited, Greenstone Fund Limited, Telecom New Zealand Limited, Upstart Capital Limited, Wrightson Limited. Trustee: Barnardos New Zealand, Enterprise NZ Trust, Institute of Policy Studies, NZ Institute for the Study of Competition & Regulation, Victoria University of Wellington Foundation.
First appointed 1 July 1999 - current term expires 30 June 2004

Hugh Fletcher
Company Director
Chair: CGNU Insurance Australia Limited, New Zealand Insurance Limited, Investment Committee No 8 Ventures. Director: Fletcher Building Limited, Infrastructure Auckland Limited, Rubicon Limited, VCU Technology Limited. Member: New York Stock Exchange Asia Pacific Advisory Committee, United Nations Office of Project Services Advisory Board, The University of Auckland Council, The University of Auckland Trust.
First appointed 10 June 2002 - current term expires 9 June 2007

Dr Arthur Grimes
Economic Consultant
Principal: GT Research & Consulting. Senior Research Associate: Motu Economic & Public Policy Research Trust. Visiting Lecturer: Victoria University of Wellington. Trustee: Reserve Bank Superannuation Fund.
First appointed 1 March 2002 - current term expires 28 February 2007

John Goulter
Managing Director
Chief Executive: Auckland International Airport Limited. Director: HMSC-AIAL Limited. Trustee: NZ Business & Parliament Trust, Auckland Airport Life Education Trust.
First appointed 9 February 2000 - current term expires 8 February 2005

Hon Ruth Richardson
Company Director
Principal: Ruth Richardson (NZ) Limited. Chair: Jade Software Corporation, i-cap Equity Partners Limited, i-cap Mezzanine Limited, ICP Bio Limited, Kula Fund. Director: Canterbury International Limited, Centre for Independent Studies, Jade Direct (UK) Limited, Jade Direct Australia Pty Limited, New Zealand Merino Company Limited, Oyster Bay Marlborough Vineyards Limited, Wrightson Limited.
First appointed 4 February 1999 - current term expires 3 February 2004

Alison Paterson *Chair RBNZ Board of Directors Audit Committee*
Chartered Accountant
Chair: Landcorp Farming Limited, Electricity Complaints Commission. Director: Metrowater Ltd, Tower Insurance Limited, Wrightson Limited. Member: Market Surveillance Panel NZ 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 *Chair RBNZ Board of Directors Non-Executive Directors' Committee*
Company Director
Chair: New Zealand Guardian Trust Company Limited.
First appointed 1 February 1990 - current term expires 31 January 2003


Paul Baines
Hon
Ruth Richardson
Dr Arthur Grimes
Alison Paterson
Non-Executive
John Goulter
Hugh Fletcher
Bill Wilson

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 Minister of Finance and the Governor, which details the monetary policy outcomes that the Bank is required to achieve. The Act requires that a new PTA is negotiated whenever a Governor is appointed or reappointed. The Funding Agreement is a five-yearly agreement between the Governor and the Minister of Finance 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 Crown.

The Act makes the Reserve Bank's Chief Executive - the Governor - accountable for the Bank's actions. In monetary policy, and in most other matters, decision-making authority resides with the Governor alone. The Governor is appointed for a five-year term. The Act sets specific criteria under which the Minister of Finance can dismiss the Governor.

The Reserve Bank's senior management team is made up of the Governor, a Deputy Governor and the heads of the Bank's various departments, as outlined on page 5.

The Governor receives advice from a number of internal committees within the Reserve Bank. These are:

- the Governor's Committee, which meets weekly to consider the management and day-to-day operation of the Bank;
- the Monetary Policy Committee, which meets weekly to advise the Governor on economic and financial developments;
- the Official Cash Rate Advisory Group, which advises the Governor on monetary policy decisions;
- the Financial System Oversight Committee, which meets monthly to consider policy issues relating to the financial system's soundness and efficiency;
- the Risk Management Committee, which meets monthly to consider risk management frameworks for the Bank's activities;
- the Reserves Oversight Committee, which meets quarterly to consider the Bank's foreign reserves activity; and
- the Communications Committee which meets weekly to consider communications issues and the management of reputational risk.

The Reserve Bank has a Board of Directors, as shown on pages 6 and 7. The role of the Board of Directors is different from the Board of a listed company. The Reserve Bank's 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 Governor and the Bank, on behalf of the Minister of Finance. As well, the Board provides advice to the Governor, typically on directors' perceptions of the state of the New Zealand economy and the Reserve Bank's actions.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor, the Minister of Finance only being able to appoint a Governor recommended by the Board. If the Board believes that the Governor's performance, in meeting the inflation target or carrying out his or her other duties, has been "inadequate", then the Board may recommend to the Minister of Finance that the Governor be dismissed. The Board also appoints the Deputy Governor on the recommendation of the Governor.

These duties, and some others, are carried out by a subcommittee of the Board known as the Non-Executive Directors' Committee (NEDC), which includes all the non-executive directors and meets independently of the executive directors. The NEDC provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on page 30.

The Board Audit Committee monitors the internal audit function. The Committee also receives reports from the Bank's external auditor and reviews the Bank's annual financial statements. It is chaired by Mrs Alison Paterson.

The Board as a whole met 11 times during the year under review.

The Reserve Bank's activities are scrutinised by Parliament's Finance and Expenditure Select Committee. Typically, four hearings are held annually, covering quarterly *Monetary Policy Statements.* An additional hearing to scrutinise the Bank's *Annual Report* may be held at the Committee's discretion.

Another important aspect of the governance of the Bank is its transparency. The Reserve Bank Act requires the Bank to issue *Monetary Policy Statements* twice a year to explain its thinking on current monetary policy. In practice, the Bank does this four times a year. The Act also requires the Bank to issue a Statement of Principles on its banking registration and supervision policies.

In addition, the Reserve Bank has a long-standing tradition of making information on its policies and activities available via the Bank's website[1], its quarterly *Reserve Bank Bulletins*, published research papers, brochures and speeches.

Within the Reserve Bank, all activities and expenditure must be authorised and in accordance with a comprehensive set of Bank policies and procedures. The Board receives monthly reports comparing actual outcomes against budget, prepared by the Bank's Financial Services Group. Departments are required to provide quarterly output reports that describe progress to date and explain any significant variances. Quarterly, the expenses of the Governor and Deputy Governor are reviewed by the Chair of the Board of Directors Audit Committee. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are watched closely.

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.

The Reserve Bank is audited by the Auditor-General, who has contracted PricewaterhouseCoopers to assist. In addition, the Minister of Finance is empowered to require a performance audit.

On the recommendation of the Board of Directors Audit Committee, the Board and the Acting Governor have resolved not to engage the Bank's external auditor in any consultancy work, so as to eliminate even the perception of any conflict of interest.

1 www.rbnz.govt.nz

Chronology

4 July 2001
The Official Cash Rate is held at 5.75 per cent.

4 July
A Reserve Bank Email Service is launched so that subscribers can receive Reserve Bank announcements by email as they happen.

7 August
The Minister of Finance announces that he has cross-party support for minor changes to the Reserve Bank Act arising from the Svensson Monetary Policy Review.

15 August
In the August 2001 *Monetary Policy Statement*, the Official Cash Rate is held at 5.75 per cent.

6 September
The Reserve Bank announces the appointment of two part-time external monetary policy advisers, as a follow-on to the Svensson Review.

12 September
Following the 11 September terrorist attacks in the United States, the Reserve Bank states that the banking system and the Reserve Bank's liquidity facilities are operating normally.

19 September
In an unscheduled announcement, the Reserve Bank cuts the Official Cash Rate from 5.75 per cent to 5.25 per cent.

25 September
The Reserve Bank writes to banks and financial institutions reminding them of their obligations in regard to United Nations sanctions against terrorist organisations and nations that sponsor them.

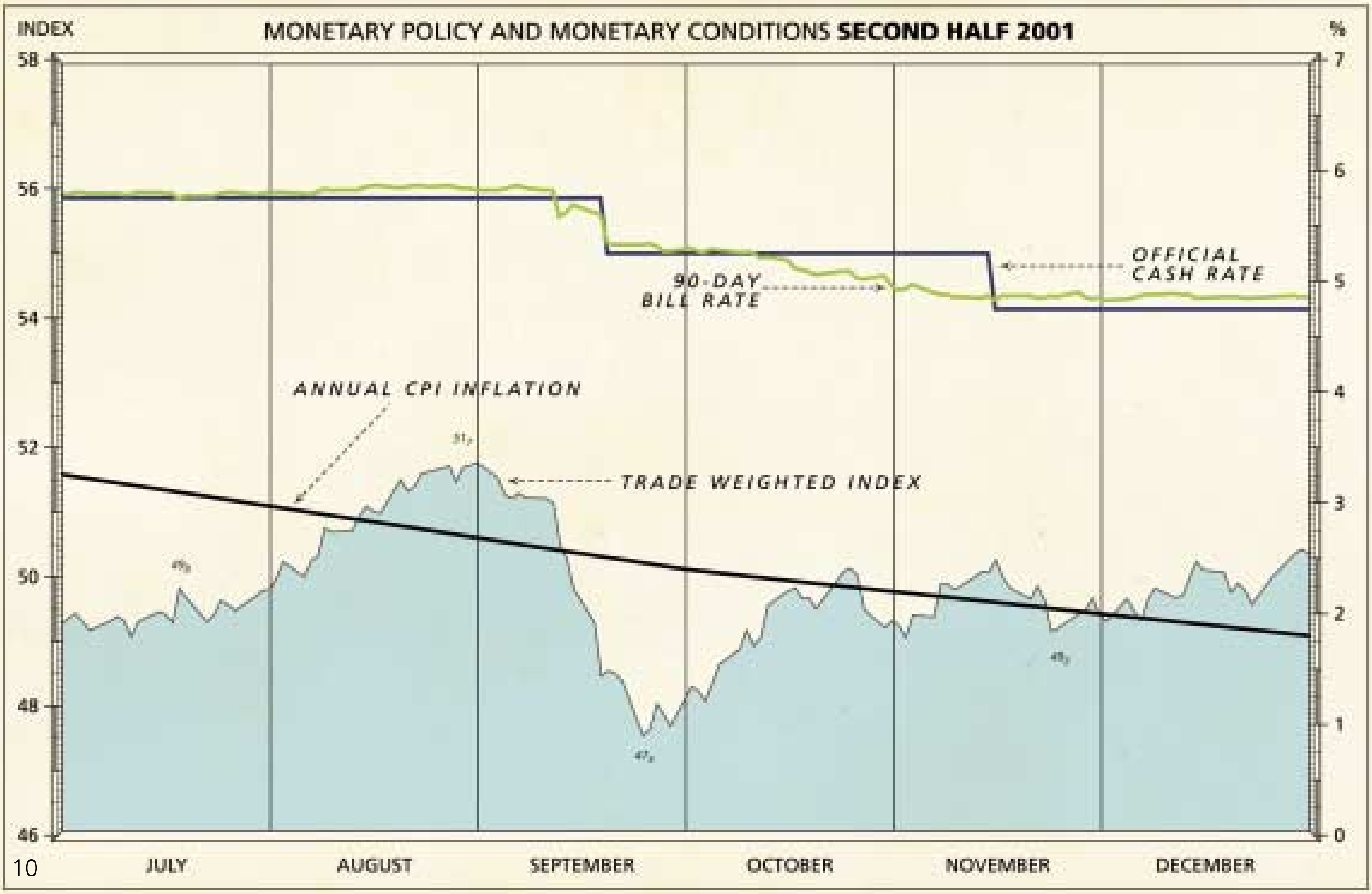
8 October
The new ESAS/SWIFT interface in the payment system goes live.

15 October
CPI inflation for the year to September 2001 is announced at 2.4 per cent.

26 October
The Reserve Bank's building in Auckland is sold.

14 November
In the November 2001 *Monetary Policy Statement*, the Official Cash Rate is reduced to 4.75 per cent.

15 November
The Governor begins a nation-wide roadshow, speaking to 24 meetings.



17 January 2002

CPI inflation for the year to December 2001 is announced at 1.8 per cent.

23 January

The Official Cash Rate is held at 4.75 per cent.

4 February

Kiwibank Limited's registration is completed.

13 March

The appointment of Dr Arthur Grimes to the Board is announced, replacing Professor Viv Hall.

20 March

In the March 2002 *Monetary Policy Statement*, the Official Cash Rate is increased to 5.0 per cent.

27 March

A computer game that simulates monetary policy decision-making is launched on the Reserve Bank's website.

16 April

CPI inflation for the year to March 2002 is announced at 2.6 per cent.

17 April

The Official Cash Rate is increased to 5.25 per cent.

26 April

Governor Don Brash resigns.

29 April

The Board of the Reserve Bank meets to initiate procedures to appoint a new Governor.

8 May

A new support provider for the Bank's Austraclear and ESAS systems is announced.

14 May

The Government confirms Dr Rod Carr as Acting Governor.

14 May

The Government announces the appointment to the Board of Mr Hugh Fletcher, to replace Sir Gil Simpson.

15 May

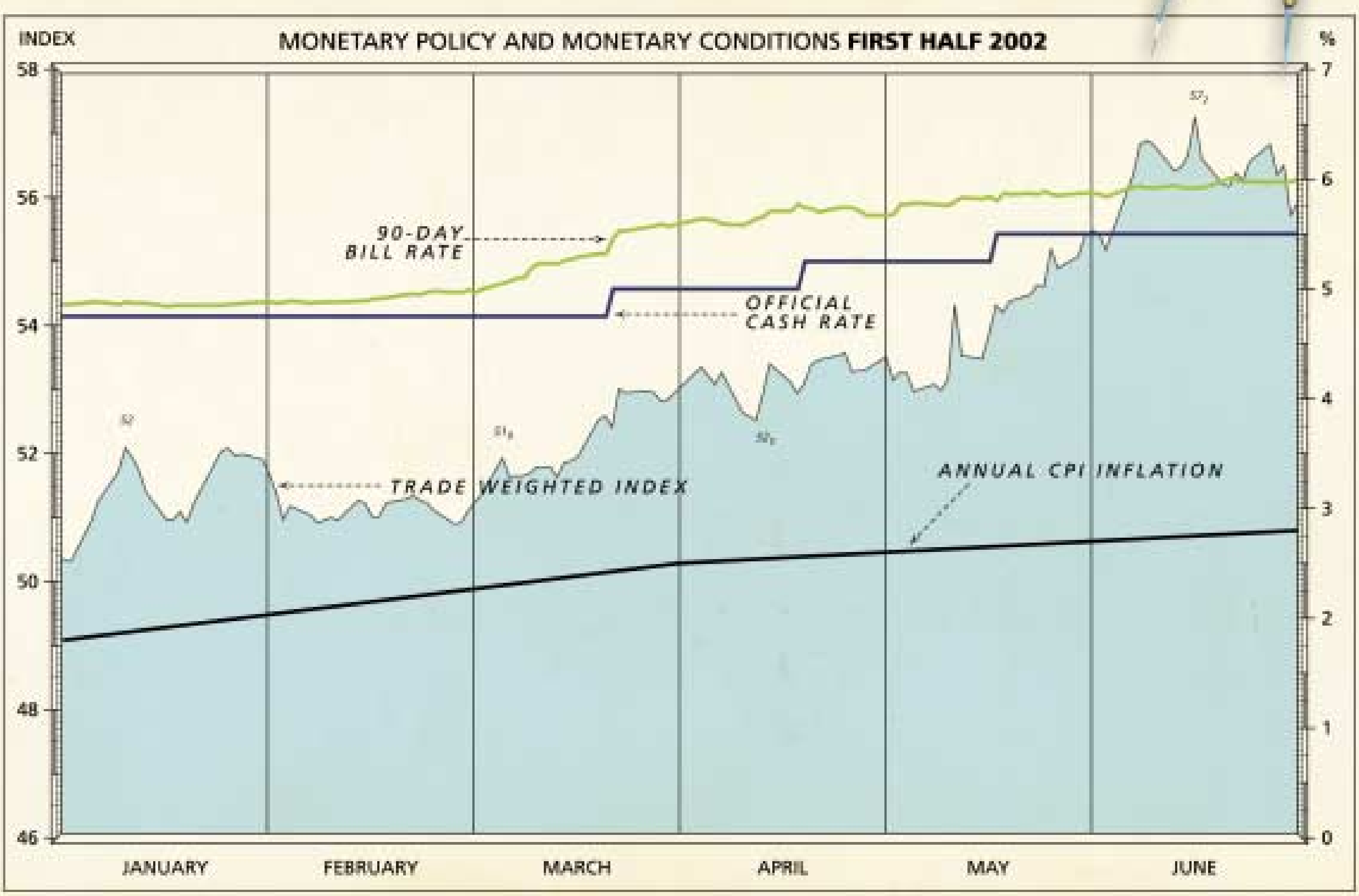
In the May 2002 *Monetary Policy Statement*, the Official Cash Rate is increased to 5.5 per cent.

17 May

Mr David Archer is appointed Acting Deputy Governor.

15 July

CPI inflation for the year to June 2002 is announced at 2.8 per cent.



The Year in Review

Monetary Policy

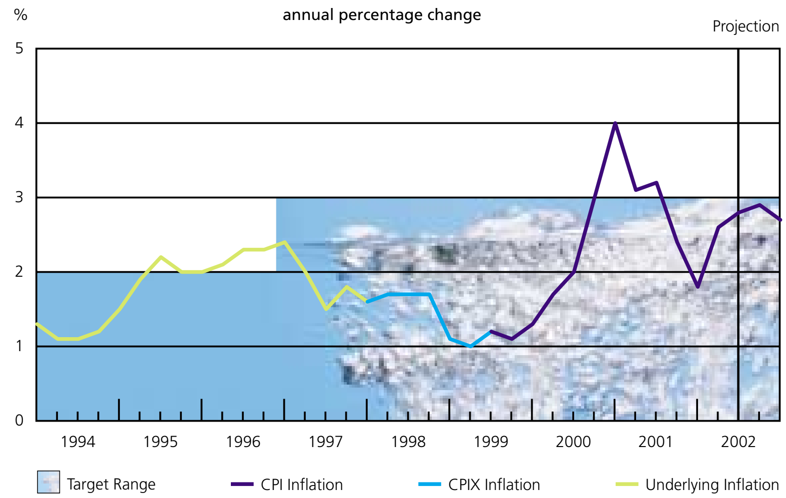
Monetary policy over the review period faced a mix of inflation pressures emanating from the weak exchange rate of recent years, offset by a slowdown in the economies of most of New Zealand's trading partners.

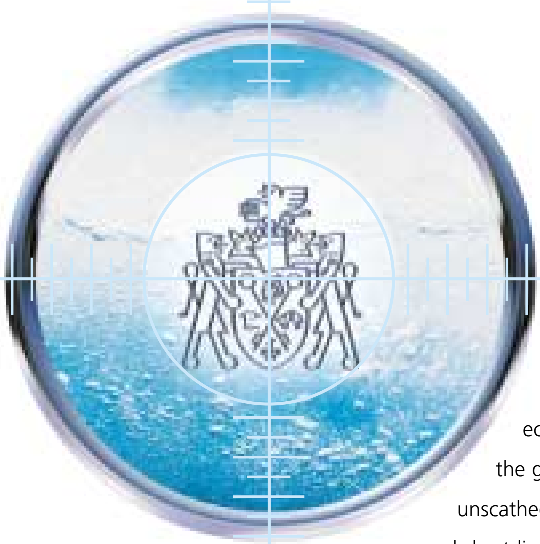
In the first half of 2001, we judged the balance to have tilted towards weaker inflation pressures and, in response, we cut the Official Cash Rate (OCR) by three-quarters of a per cent. The terrorist attacks in the United States in September tipped the balance still further, and the OCR was cut by a further half a per cent in both September and November, taking it down to 4.75 per cent.

Graph 1

Inflation

annual percentage change





However, early in 2002, it became apparent that the economy was coming through the global downturn relatively unscathed. The effects of 11 September proved short-lived, while household spending was still being pushed along by two seasons of very good pastoral export incomes. Large population gains from net immigration added to domestic demand. In response, the Bank began to edge the OCR upwards, starting in March 2002. This was followed by a further quarter of a per cent increase in April which was repeated again in May.

At this time inflation remained at the upper end of the 0 to 3 per cent target zone, leaving limited flexibility to absorb further price pressures without increasing the risk that more persistent inflation would emerge. With three years of above-average growth at home and signs of recovery in the global economy, the Bank judged that a cushion against global weakness, via a low exchange rate and stimulatory interest rates, was no longer required.

Looking ahead, with the exchange rate back to more normal levels and interest rates heading back to more neutral levels, inflation should fall from the upper end of the target range over the next year or so. In the near term, that fall will be assisted by the recent sharp rise in the New Zealand dollar from the very low levels of the past two to three years. This should reduce the risk that inflation expectations, currently anchored at below 2 per cent, will drift upwards to match recent and expected inflation outcomes.

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.

During the year under review, we monitored the development of the new international Capital Accord for banks, and began to assess its application to New Zealand. Proposals for supervising financial conglomerates and for refining restrictions on bank lending to related parties were discussed with the banking sector.

The Reserve Bank assisted in the preparation of amendments to the banking sections of the Reserve Bank Act. The amendments apply to parts IV and V of the Act, which cover the naming and supervision of banks, while a new part covers the oversight of payment systems.

A major international initiative to reduce foreign exchange settlement risk, known as CLS Bank, is expected to commence in late 2002. The Reserve Bank has sought the inclusion of the New Zealand dollar in CLS Bank, and at the time of writing it was expected that shortly the New Zealand dollar would be accepted for inclusion, subject to a number of conditions being satisfied. We hope that inclusion will be achieved by early 2004.

The Reserve Bank continued to participate actively in the Financial Regulators Co-ordination Group, which facilitates liaison amongst the financial sector regulatory agencies in New Zealand. We also co-operated in local and international efforts to combat money laundering, financial crime and terrorist financing.

Kiwibank Limited was registered as a bank.

We continued to discuss implementation issues with the banks affected by our requirement that some overseas banks must operate via locally incorporated subsidiaries rather than as branches. Consultation with banks on the "bank creditor recapitalisation" option for dealing with a failed bank also continued. Bank creditor recapitalisation would see a failed bank recapitalised by using part of the funds of its depositors and other creditors, rather than necessarily relying on tax-payer funding.

In late May 2002, the Bank staged a workshop to discuss banking supervision and the management of a bank failure. The gathering was attended by prominent international academics and central bankers, some of our supervisory counterparts, and several commercial bankers, along with Reserve Bank staff.

Issues covered included:

- how to improve the likelihood that the financial system is sound and efficient;
- desirable levels of bank capital;
- how a regulator can provide incentives to ensure that a bank is well run;
- whether it matters if a foreign-owned bank operates as a branch or as a subsidiary;
- whether it matters if a bank's key managers live in another country or if a bank's computers are overseas; and
- what should be done if a significant bank fails.

The group considered these questions in the context of a banking system comprising a small number of banks that are large relative to the total system and mostly foreign-owned. Our overseas guests commented that the same issues are likely to be confronted by an increasing number of countries in the years ahead, given the way banking is evolving internationally.

In addition, the Reserve Bank is making an increased effort to understand the vulnerabilities of the New Zealand banking and financial system at an economy-wide level. A small section, specifically devoted to this work, has been established in the Bank's Financial Markets Department, generating a regular flow of macro-prudential and macro-financial research. Vulnerabilities arising from New Zealand's unusually high level of dependence on foreign savings were the subject of a keynote speech by the then Governor in January 2002, entitled "An Indebted People".

Box 1 The Reserve Bank's management of risk

The Reserve Bank faces a wide range of risks, some general and others unique to central banks. Of these, the most fundamental risk is of making policy errors in relation to monetary policy or the financial or banking systems, thereby causing damage to the real economy and to our reputation and credibility. We take this very seriously, given the critical importance of credibility to all central banks.

Other more specific risks include:

- credit and interest rate risks associated with our day-to-day liquidity management in domestic financial markets;
- risks associated with holding foreign currency reserves, including credit risk, interest rate risk and exchange rate risk;
- risks associated with processing and storing currency, including risks of theft and robbery; and
- risks associated with being a small organisation, such as the loss of key staff and associated corporate memory.

The Reserve Bank's philosophy in regard to these risks is that risk management is an integral part of the general management task and the responsibility of day-to-day management.

The Bank is a small organisation with a small number of experienced senior executives. To utilise that collective experience, the Bank makes extensive use of committees, the membership of which includes senior staff in addition to those directly responsible for the decisions being made. This is intended to ensure that all aspects, including risk, are considered. These committees are described in detail on page 8.

The Bank also has two units with specific responsibilities in relation to monitoring and managing risk. These are:

- The Bank's Risk Assessment and Assurance Department, which is a specialised unit responsible for providing advice on and monitoring the Bank's risk management frameworks. The internal audit role also resides in this department.
- A 'Risk Unit' within the Bank's Financial Markets Department that provides specialised advice on financial market risk management. This includes recommendations on interest rate risk, credit risk and liquidity risk and the development of specialised measures in this area, such as value at risk.

The Board of Directors Audit Committee also contributes to the Bank's risk management processes.

The key to success in risk management is giving proper thought to both the opportunities and the potential negative outcomes of a course of action and then coming to a balanced view. This is enhanced by the use of structured processes. Strong individual accountability, coupled with the Bank's committee structure and organisational units with specific risk-related mandates, are intended to ensure that this is achieved.

Currency

The Reserve Bank Act gives the Reserve Bank the sole right to issue legal tender bank notes and coins in New Zealand, including determining their design and composition.

The value of bank notes and coins held by the public continues to increase. During the year under review it rose by 8 per cent, to reach $2.7 billion as at 30 June 2002[2]. So far, electronic banking has had little impact on the volume of cash used in New Zealand.

However, the way the Reserve Bank meets the currency needs of the public has changed. The replacement of paper with polymer bank notes in 1999 (see box 2) has enabled the Reserve Bank to re-define its role in the cash distribution process. The greater durability and more effective security features of polymer bank notes mean that we no longer need to machine process bank notes on a regular basis. Since February 2001, we have required the commercial banks to re-distribute bank notes among themselves rather than through the Reserve Bank.

Currency operating expenses, excluding the cost of issuing new currency, have fallen from an average of around $11 million per annum to $8.3 million in 2001/02 and an expected $6 million for 2002/03. These figures include some funding assistance provided to the commercial banks during the transition stage.

As a result, the cost of issuing coins is now significantly greater than for bank notes. In 2001/02 we issued 44 million new coins at a cost of $3.1 million, compared with expenditure of $1.1 million on issuing bank notes. This reverses the usual pattern for central banks.

2 This is excluding the cash holdings of the commercial banks.

Box 2 Performance of polymer bank notes

In May 1999, the Reserve Bank introduced polymer bank notes into New Zealand to replace paper bank notes. By March 2000, all denominations had been converted to polymer and, as of 30 June 2002, approximately 110 million polymer notes had been issued.

The advantages of polymer bank notes are enhanced security features, greater durability, fewer environmental problems with recycling and, over time, cost savings.

Our experience to date has borne this out. Counterfeits detected are well down. During the year under review we discovered just 72 forgeries compared with 156 in 2000/01, 950 in 1999/2000 and 401 in 1998/99. Most forgeries still turning up are of the old paper design.

We are destroying far fewer worn out or damaged polymer bank notes than we did for paper. Annually, we currently destroy just 5.1 per cent of all \$20 notes in circulation, compared with a previous annual destruction rate of 52.3 per cent for the paper equivalent. Of the small numbers of polymer bank notes returned to the Bank as 'unfit', almost all are torn or have suffered other physical damage, rather than being limp or dirty, which were the main reasons for destroying paper bank notes.

The longer life of the polymer bank notes means significant savings. In 2001/02 the cost of issuing new notes was \$1.1 million, compared with \$3.1 million in 1996/97 and \$2.2 million in 1997/98, when all notes were made of paper. This is in spite of polymer bank notes costing more to make and the increase in the number of bank notes in circulation.

Foreign Reserves Management

The Reserve Bank maintains a capacity to intervene in the foreign exchange market to smooth disorderly market conditions[3], though the Bank has not intervened since the New Zealand dollar was floated in March 1985.

To do this, the Reserve Bank holds a diversified portfolio of foreign currency assets which can be realised quickly. These assets are financed by foreign currency borrowings through the Treasury, with additional intervention capability provided by a modest committed credit line with the Bank for International Settlements.

The intended scale of our intervention capacity is determined as a target range by the Minister of Finance, in consultation with the Bank. Since 1998, the target range has been specified in foreign currency terms, as the reserves are held in foreign currencies. As a result, in New Zealand dollar terms both the intervention capacity and the target range move up and down as the New Zealand dollar changes in value. The intervention capacity has generally been close to the mid-point of the target range, as illustrated in graph 2 opposite.

Holding reserves involves costs, as New Zealand generally has to pay more to borrow overseas than can be earned by investing the borrowed money in high quality assets that can be realised quickly. We minimise this cost by carefully structuring the portfolio using a range of instruments, including derivatives such as interest rate swaps and futures. We also minimise interest rate and currency risks by matching the interest rate and currency exposures of our investments with our borrowing. As well, we engage in modest trading in international financial markets.

Over the 2001/02 year, the difference in rates between our average borrowing and investing narrowed. That meant that the existing combination of longer-term borrowings and investments became expensive, relative to what we would have achieved if we had set out to borrow and invest afresh. This is reflected in the $11.7 million marked-to-market[4] loss recorded on the passive benchmark portfolio for the year. This compares with a marked-to-market loss of $19.6 million the year before, which arose from similar movements in interest rates. Note, however, that a reduction in the future cost of borrowing to hold reserves is likely as a result.

Until early 2002, the reserves were held in fully-hedged US dollars, the euro (or deutschmark), and yen. Motivated by our increasing wariness regarding the longer-term credit worthiness of Japan, we have since sold our remaining yen-denominated assets, and reinvested the proceeds in the United States and Europe.

In 2002, we converted part of our reserves from fixed-rate investments into floating-rate and/or short-term investments. We expect this change to reduce the cost of holding reserves, and to reduce marked-to-market losses arising from adverse changes in interest rates.

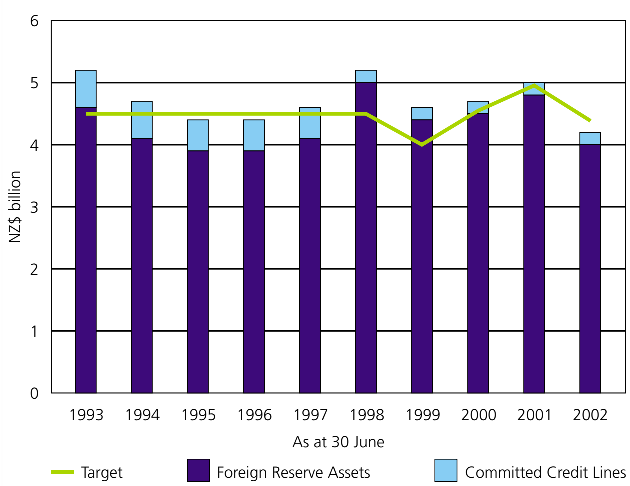
The most significant interest rate risk faced by the Reserve Bank is the possibility of a convergence in the cost of borrowing to acquire reserves and the income that we receive from investing those reserves. In such a scenario, our liabilities would increase relative to our assets, resulting in a marked-to-market loss. In 2000, the estimated marked-to-market loss if this difference reduced to zero would have been $57 million, whereas at the end of June 2002 our losses would have been less than $4 million. This was mainly due to the shift from fixed-rate to floating-rate investments, but also reflects the smaller gap between potential borrowing and investment costs more generally. Note that this number is likely to fluctuate through time, depending on the best choice between fixed-rate and floating-rate borrowing.

Our active management trading activities are aimed at reducing overall costs as well as enhancing our understanding and knowledge of financial markets and instruments. Graph 3 opposite compares the overall net returns or costs of borrowing to hold reserves with a notional benchmark portfolio which excludes the impact of active management.

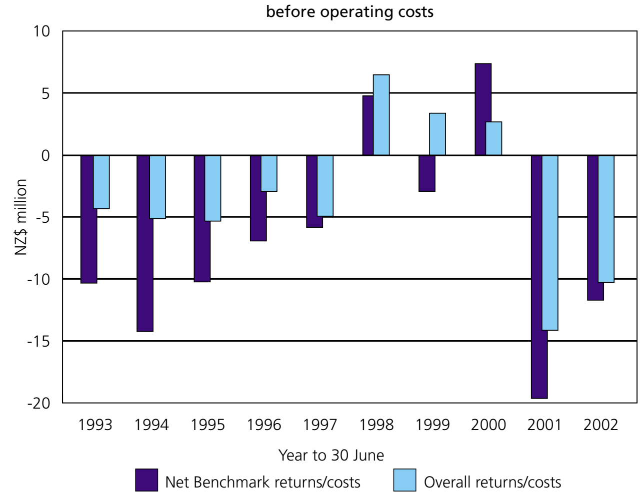
3 Under sections 17 and 18 of the RBNZ Act 1989, the Minister of Finance can also direct the Reserve Bank to intervene in the foreign exchange market.

4 "Marked-to-market" means the revaluation of financial instruments to their current value in the financial markets.

Graph 2 **Intervention Capability**



Graph 3 **Net Returns from Holding Reserves**
before operating costs



Registry and Depository Services

The Reserve Bank provides registry services to issuers of fixed-interest securities, such as bonds and bills. This provides definite proof of legal ownership, 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

	2002	2001
Face value of securities for which RBNZ is registrar	**$63.3 billion**	$65.9 billion
Total value of payments during the year	**$37.6 billion**	$41.8 billion
Number of investors	**24,842**	29,076
Number of investments	**53,355**	60,138

On 9 July 2001, the processing of registry transactions was contracted out to BT Portfolio Services (NZ) Limited (BTPS). On 31 August 2001, BTPS was sold to Computershare Limited. BTPS continues to provide this service under the name Computershare Investor Services (NZ) Limited.

The Reserve Bank also operates the Austraclear New Zealand system, which is a depository that provides the financial markets with a clearing-and-settlement service for high-value debt securities and equities. Once again, its membership fell during the year in review, again reflecting 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 activity for the year under review is described in table 2.

Table 2 Key statistics for depository services as at 30 June

	2002	2001
Value of securities held in depository	**$74.2 billion**	$78.8 billion
Number of members	**230**	265
Number of transactions	**312,500**	302,700

As of 1 January 2003, Datacom Systems (Wellington) Limited will provide software support and software development services for the Austraclear System and the Bank's Exchange Settlement Account System (ESAS)[5].

5 ESAS is a banking service to institutions that need to make regular high-value payments with each other. All the current account holders are banks, who use the system to make large inter-bank payments, though membership is not restricted to banks.

International Liaison

Over the review period, the Reserve Bank again engaged in a wide range of international activities. We participated in regional central banking and finance policy development meetings, contributed to international policy initiatives and maintained relationships with other central banks and international institutions.

The Reserve Bank participated in regional central bank groups, such as EMEAP[6] and SEANZA,[7] and took part in EMEAP central bank working groups on financial markets, payment and settlement systems, and banking supervision.

The Reserve Bank also participated with Treasury in the Manila Framework Group (MFG)[8], contributing to discussions on global and regional economic and financial reforms. In December 2001 in Auckland, we co-hosted an MFG meeting and chaired an EMEAP Deputy Governors' meeting. We continued to work closely with Treasury on a range of issues being addressed in the Asia-Pacific Economic Co-operation (APEC) Finance Ministers' Forum.

The Reserve Bank has been closely monitoring proposals for the reform of the international financial system. We provided related advice to New Zealand's representative on the Executive Board of the International Monetary Fund (IMF). Bank representatives attended the biannual joint IMF/World Bank meetings.

The Reserve Bank represented New Zealand in several meetings of international groups dedicated to combating money laundering. The terrorist attacks in the United States on 11 September focused attention on the Bank's administration of the United Nations' sanctions against Afghanistan.

The Bank made staff available to undertake assignments for the IMF in Asia, Africa, the South Pacific and Europe. Staff gave advice on central bank accounting and financial reporting, establishing government securities markets, the implementation of Basel Core Principles, and assistance with assessments of financial sector stability. We hosted two secondees from the People's Bank of China for eight months.

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

7 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.

8 A regional group of central banks and finance ministries.

Our People

The Reserve Bank employed 192 staff, or 182 full-time equivalents (FTE), as at 30 June 2002. The Reserve Bank's staff turnover rate during the year was 13.5 per cent[9], as shown in table 3.

Table 3 Human resource statistics

	1994 1995	1995 1996	1996 1997	1997 1998	1998 1999	1999 2000	2000 2001	**2001 2002**
Total staff at 30 June (FTE)	293	290	289	281	283	237	199	**182**
Average years of service at 30 June	8.6	8.6	8.7	8.3	8.8	9.4	9.4	**9.2**
Annual staff turnover	9.6%	15.0%	10.6%	8.8%	10.0%	10.4%	14.9%	**13.5%**
Average sick days per staff member	5.3	4.9	5.5	4.9	4.4	4.8	4.7	**4.5**

As in past years, the Reserve Bank again sought to become a more flexible organisation for its staff to work in. To this end, new policies on flexible annual leave entitlements, flexible working hours, and working away from the workplace were adopted. The way staff access the Bank's policies and procedures was enhanced with an intranet facility replacing previous staff manuals.

The Reserve Bank undertook two bank-wide surveys, which looked at attitudes to the Bank as an employer and career aspirations among staff. The information gathered is helping the Bank plan its human resources policies and procedures and is assisting managers to respond to their staff's needs.

The Bank continued to invest in individuals' development of skills and knowledge. Our target of 20 hours of formal training per person per annum was met in most cases. Additional efforts have been made this year to seek secondment opportunities.

The Bank completed a range of equal employment initiatives. They included promoting the Bank as an EEO employer, providing EEO refresher courses for managers and staff, and offering harassment prevention and bicultural awareness training. We conducted 360 degree staff appraisals for the Bank's senior staff as part of a programme of improving the quality of feedback to staff. A two-day meeting of senior staff was held offsite to further develop the Bank's approach to staff appraisals and other human resources and management issues.

Remuneration

The Reserve Bank spent $15.6 million on personnel in 2001/02. 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[10] in 2001/02.

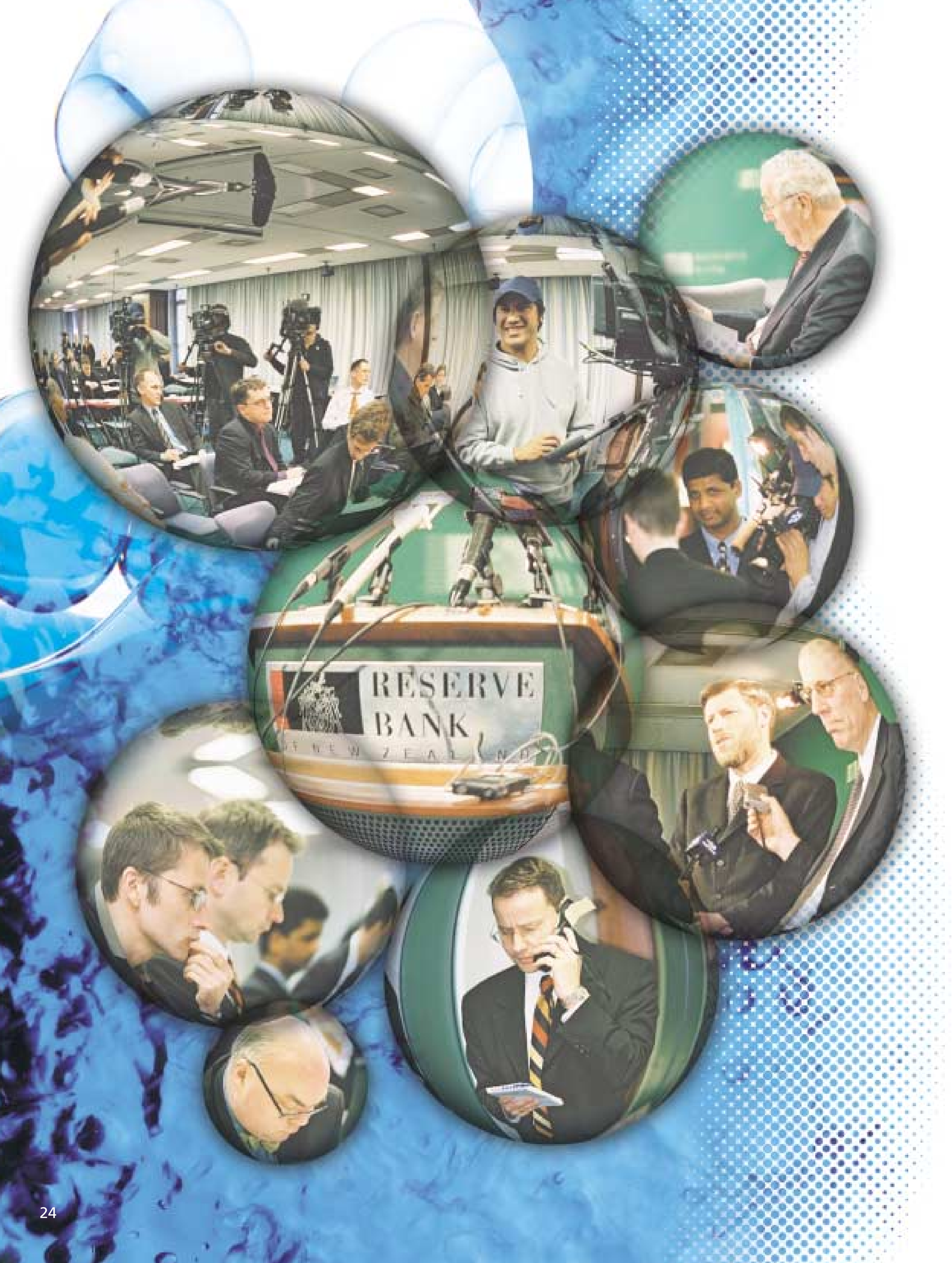
Table 4 Staff receiving $100,000 or more in 2001/02

Total remuneration[11]	Staff numbers
$100,000 to $109,999	5
$110,000 to $119,999	6
$120,000 to $129,999	1
$130,000 to $139,999	5
$140,000 to $149,999	5
$150,000 to $159,999	1
$160,000 to $169,999	1
$180,000 to $189,999	2
$190,000 to $199,999	2
$200,000 to $209,999	4
$220,000 to $229,999	1
$260,000 to $269,999	1
$340,000 to $349,999	1
$430,000 to $439,999	1
Total	36

9 This excludes positions made redundant.

10 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 Minister of Finance on the recommendation of the Board's non-executive directors, who also determine the remuneration of the Deputy Governor. The Bank's remuneration policy is to pay all staff on the basis of performance on the job, while bearing in mind prevailing market conditions based on salary surveys and assessments made by an independent remuneration consultant.

11 This includes payments to one employee who was made redundant during the year.


RESERVE
BANK

Communications

In communications terms, the most significant event during the year under review was the 11 September 2001 terrorist attacks in the United States. On 12 September, the Reserve Bank issued a press statement reassuring the public that the New Zealand banking system was operating normally and that the Reserve Bank's standard liquidity provision was available and operating normally. The statement also said that, in terms of the stance of monetary policy, the Bank was monitoring developments. This set the scene for the unscheduled interest rate adjustment announced on 19 September.

As the 2001/02 period came to a close, monetary policy entered a tightening phase. Set alongside a rapid appreciation of the currency, this generated considerable disquiet among sector groups representing some exporters and manufacturers. The Bank responded by introducing regular briefing sessions for business groups in the main centres, which take place immediately after the release of the Reserve Bank's *Monetary Policy Statements*.

The other noteworthy communications challenge was Dr Brash's resignation, on 26 April 2002. On the same day, Acting Governor Rod Carr issued a press statement saying that for the Reserve Bank it was "business as usual" and all the Bank's functions were being carried out in their normal way. Market reaction was minimal and temporary. On 29 April, the Board of Directors issued a press statement explaining that the process of selecting a new Governor had begun. The statement said that until the Minister of Finance announced an appointment the Bank would make no further comment on the matter.

The Governor's and Deputy Governor's longstanding programme of numerous off-the-record speeches continued, along with a small number of on-the-record speeches. However, when Dr Brash resigned, the decision was made to hold back from on-the-record speeches until the appointment of a new Governor. Likewise, the Bank's usual willingness to respond to its critics in the media was put to one side.

As part of the Reserve Bank's education initiatives, a computer game was put on the Bank's website in which participants make monetary policy decisions and then see their effects simulated, as described in box 3. The game is aimed at secondary school economics students to encourage their understanding of how monetary policy works.

Box 3 Monetary policy in a virtual economy

In March 2002, the Reserve Bank launched a web-based computer game, whereby a player becomes a virtual Governor of a hypothetical central bank and runs its monetary policy. Like the Reserve Bank, the player uses interest rates to control inflation and deflation, though in a virtual economy.

The game is called MoPoS[12], which stands for Monetary Policy Simulation game. It works as a screen with four separate graphs providing data on inflation, GDP, and nominal and real interest rates in a hypothetical economy, plus a point-and-drag bar for adjusting interest rates, as shown.

Every few seconds the player must adjust interest rates to keep inflation between 0 and 3 per cent. When inflation is within the band a smiley face is shown. If inflation goes outside the 0 to 3 per cent target the smiley face quickly turns into a frown. If extreme inflation or deflation occurs the game comes to a halt.

The game replicates many of the challenges faced by a real central bank, including its virtual economy being hit by unpredictable shocks. It is found in the education section of the Reserve Bank's website[13].

12 MoPoS is based on a game developed by the Swiss central bank.
13 www.rbnz.govt.nz

Financial Performance

Operating Expenses

The Reserve Bank's consolidated operating expenditure for 2001/02 was $35.7 million, which was 4.7 per cent under budget[14]. This was also $2.2 million, or 5.7 per cent, below the previous year's actual expenditure. Expenditure was under budget mainly because:

- personnel expenses were $1.5 million less than budgeted, mostly due to unfilled vacancies and lower training costs;
- other expenses were $0.8 million less than budgeted, mostly due to lower computer expenses; and
- administration expenses were $0.4 million less than budgeted, due to lower-than-expected communications expenses.

This was offset to some degree because costs of issuing new coins and bank notes were $1.0 million more than budgeted, mainly due to higher-than-estimated demand for new bank notes and coins. 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 Minister of Finance 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. The current Funding Agreement, starting on 1 July 2000, allows the Reserve Bank to retain agreed amounts for operational expenditure in addition to income from specified activities. During the year under review, the Reserve Bank spent a net $24.9 million on activities covered by the Funding Agreement, which was 19.7 per cent below the $31.0 million permitted for this period in the Funding Agreement.

Operating Surplus

During 2001/02, the Reserve Bank recorded a net consolidated surplus of $175.0 million, against $178.9 million budgeted, and compared to $159.6 million in 2000/01. 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[15], which means the Bank's income varies as interest rates rise and fall. 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 Crown

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 Crown, and the decision rests with the Minister of Finance, after consultation with the Bank's Board of Directors. The amount of this surplus this year was $168.9 million, and it is expected that this will be paid to the Crown. The Reserve Bank Act also provides that any expenditure savings 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

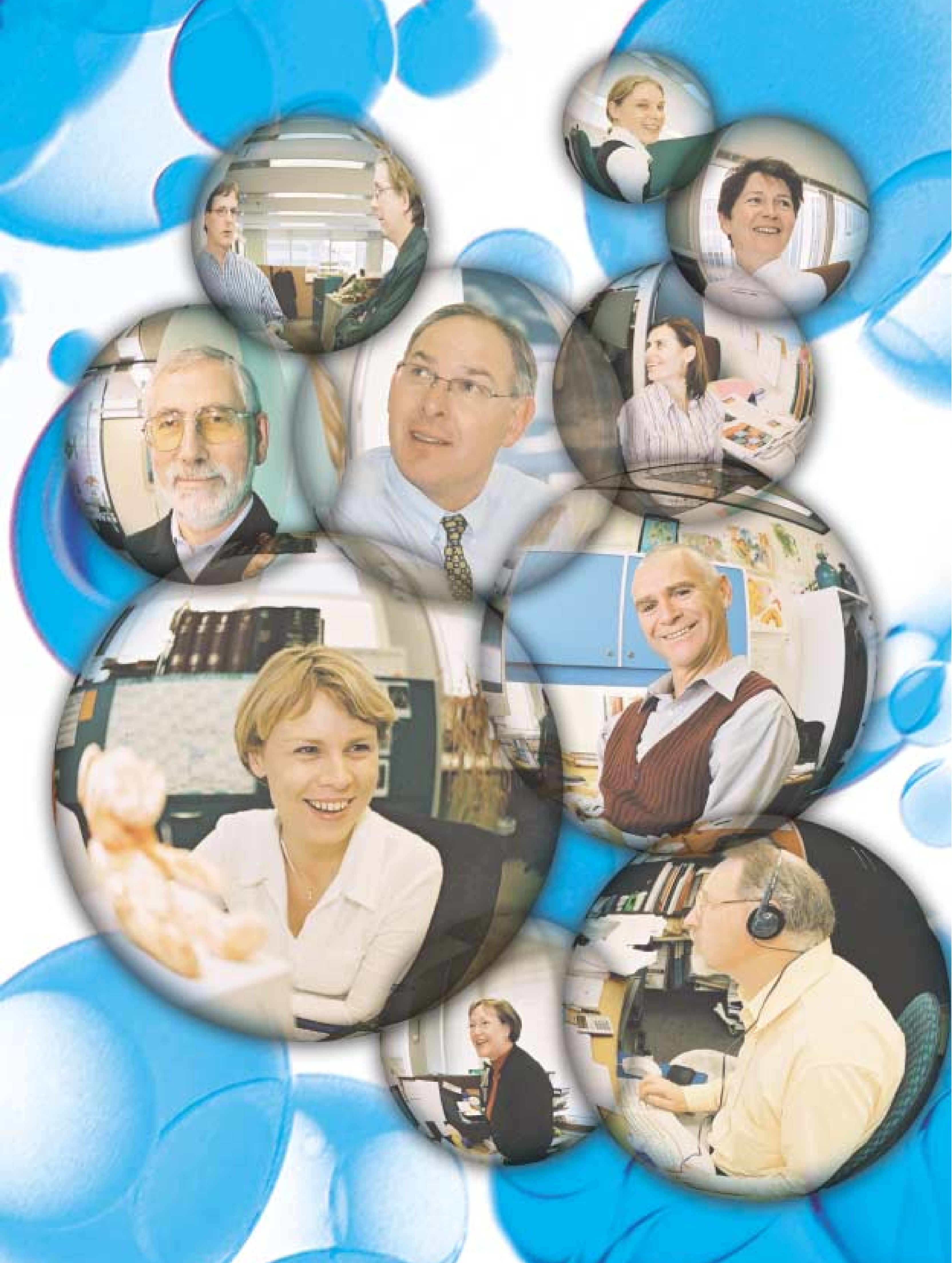
The Reserve Bank's 2001/02 Financial Statements include provision for a transfer to equity of $6.1 million, representing under-spending of the Funding Agreement level for the year together with surpluses in commercial activities such as the registry and depository services. The Bank's consolidated equity at 30 June 2002 was $411.5 million (30 June 2001 $405.4 million).

Budget for 2002/03

The Reserve Bank's budgeted operating expenditure for 2002/03 is $36.4 million. This is 2 per cent above the 2001/02 expenditure of $35.7 million. The Reserve Bank's budgeted net operating expenditure, as defined in terms of the Funding Agreement, is $26.9 million in 2002/03, which is 13.2 per cent below the Funding Agreement level of $31.0 million, and $2.0 million, or 8 per cent, above the comparable net actual expenditure for 2001/02.

14 Consolidated operating expenditure does not include the loss against valuation on sale of the Auckland Property of $0.4 million. Under the Funding Agreement, the Bank retains from its income a sum sufficient to cover any loss on disposal of property.

15 This is known as seigniorage.



Intentions and Outcomes

Each year, the Reserve Bank publishes in its *Annual Report* a list of its priorities for the coming year under the heading "The Year Ahead"[16]. These are specific intended outcomes set through the Bank's planning processes and are in addition to the Bank's normal duties. The following outlines the Bank's priorities as set in the Bank's 2001 *Annual Report* and then the actual outcomes during the year under review.

- **Intention**
  Assist in the preparation of legislation required to implement governance changes announced by the Minister of Finance as a result of the Government's *Independent Review of the Operation of Monetary Policy* and then see that those changes are implemented effectively.
  Outcome
  The Bank assisted in the drafting of amending legislation and at the time of writing the Reserve Bank of New Zealand Amendment Bill was before the House.

- **Intention**
  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.
  Outcome
  The Bank organised visits by a number of leading offshore central bankers and monetary economists who took part in monetary policy formulation and then provided their assessments of the Bank's processes. In addition, two advisers were employed part-time to provide an external dimension to the advice provided to the Governor in respect to Official Cash Rate decisions. The Bank's external consultations that precede each monetary policy decision were extended.

- **Intention**
  Seek legislative amendments in relation to banking supervision and Financial System Oversight.
  Outcome
  The Reserve Bank of New Zealand Amendment Bill included the amendments sought in these areas.

- **Intention**
  Consider the application of the revised Basel Capital Accord to New Zealand-incorporated banks.
  Outcome
  A revised international standard for capital requirements on banks is still being discussed internationally. Its application to New Zealand will be determined when international requirements are finalised.

- **Intention**
  Further develop options for responding to a bank in distress.
  Outcome
  The Bank continued to develop a proposal for recapitalising a failed bank that would not involve a taxpayer bailout. Initial discussions took place with banks.

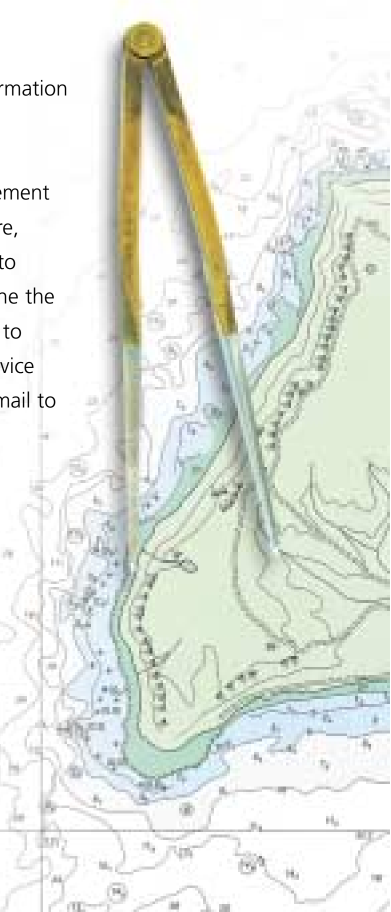
- **Intention**
  Finalise revised arrangements for support of the Austraclear system software, and commence consideration of strategic options for the longer-term future of the Bank's Austraclear service.
  Outcome
  The Reserve Bank awarded a three-year contract to Datacom Systems (Wellington) Limited to provide support services to the Austraclear New Zealand and ESAS systems. The Bank will continue to support the Austraclear New Zealand system until alternative systems become available.

- **Intention**
  Ensure that the New Zealand dollar is accepted for inclusion in the new CLS Bank global payment system.
  Outcome
  Representations were made to CLS Bank. At the time of writing, a favourable announcement, subject to conditions, was expected shortly.

- **Intention**
  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.
  Outcome
  This was done.

- **Intention**
  Upgrade the Bank's internet, intranet and information systems to promote knowledge management.
  Outcome
  The Bank implemented a new contact management system and upgraded its technical infrastructure, including security, to provide improved access to information. Projects were initiated to determine the Bank's future use of internet technologies and to improve electronic records management. A service that sends Reserve Bank announcements by email to subscribers was established.

- **Intention**
  Sell the Bank's Auckland building.
  Outcome
  This was done.



16 For this year's "The Year Ahead" see the page opposite.

The Year Ahead

The Reserve Bank undertakes a formal annual planning and budgeting process to identify goals for the year ahead. The starting point for this is the Governor preparing a list of priorities for the coming year. This is then used as a template against which the Bank's departments must justify their proposed activities in the preparation of their budgets. The priorities set by the Governor[17] for the 2002/03 financial year were:

- examine the relationship between monetary policy and economic growth and any implications for the next Policy Targets Agreement;
- further consider whether there are ways to reduce the size of swings in the real exchange rate;
- complete policy work on foreign exchange market intervention to confirm or otherwise that our non-intervention policy is in fact optimal for the New Zealand economy;
- review the appropriate level of foreign exchange reserves;
- bolster the constituency for low inflation during the monetary policy tightening cycle now underway;
- progress work on bank crisis management and especially the bank creditor recapitalisation proposal, thereby providing an alternative to the Government bailing out a failed bank or liquidating it;
- continue with implementation of the local incorporation policy for overseas banks, where necessary;
- co-ordinate and prepare for the 2003 IMF Financial Sector Assessment Programme mission which will assess the New Zealand financial system and how it is regulated;
- manage the transition to a new support provider for ESAS and Austraclear;
- continue progress on getting the New Zealand dollar into CLS Bank, thereby reducing the risks involved in settling foreign exchange transactions across different time zones;
- find and evaluate an effective and appropriate treasury system, given the diversity and yet low numbers of the Bank's transactions;
- complete a review of the Bank's risk management processes;
- improve the quality of $5 notes in circulation to reduce fading and damage; and
- evaluate and implement a Bank-wide electronic document management system.

17 These priorities were set by Dr Brash before his resignation on 26 April 2002. They were then endorsed by Acting Governor Rod Carr as the Bank's priorities for the coming year.

Reserve Bank Non-Executive Directors' 2002 Annual Report[1]

The Non-Executive Directors' Committee of the Board of Directors (NEDC) considers that during 2001/2002 the Reserve Bank performed its duties well and thus made a significant contribution to the performance of the New Zealand economy. The Reserve Bank's responsibilities were discharged effectively, risks were well managed, and costs were held.

Governor's resignation

The most significant event facing the Reserve Bank and its Board of Directors during the year under review was Dr Brash's sudden resignation on 26 April 2002. The Bank's institutional strength was illustrated by the way it dealt with this event. At the time of writing, the Board is preparing its recommendation to the Minister of Finance on the appointment of a new Governor.

The NEDC can also report that the events that followed Dr Brash's resignation brought credit to the Reserve Bank. On the day of Dr Brash's resignation there was no financial market turmoil. As was made clear very quickly, for the Reserve Bank it was business as usual. Deputy Governor Rod Carr assumed the mantle of Acting Governor and a *Monetary Policy Statement* was presented a few weeks later.

It is important to record the non-executive directors' appreciation of the contribution that Dr Brash made while serving as Governor. New Zealand's inflation record in the 1970s and early 1980s made grim reading. In addition, the economy was enduring major structural changes. Dr Brash became Governor in 1988 and in that very difficult environment his stewardship was decisive. Price stability was achieved in 1991 and Dr Brash's exceptional communications skills were pivotal in building community support for the Bank keeping to its appointed task.

Dr Brash's achievement went well beyond monetary policy. New Zealand now has a banking supervision regime that is unique by international standards. A complex regulatory regime was replaced by a method of bank scrutiny and public accountability that uses market mechanisms and openness.

In addition, under Dr Brash's imprimatur, the Reserve Bank itself was reformed. Staff numbers were reduced from about 700 to under 200, reflecting substantial productivity and efficiency gains. Inside the Bank, Dr Brash fostered a distinctive culture of openness and honest intellectual debate. Professor Lars Svensson, in his review of monetary policy, said "I was struck by the Reserve Bank being the least hierarchical central bank that I have come across ... it shows in the free and informal exchange of views and information between the junior and senior staff, including the Governor."[2]

The NEDC would therefore like to take this opportunity to formally thank Dr Brash for his remarkable contribution.

[1] This report was drafted prior to Mr Hugh Fletcher joining the Board.

[2] Lars Svensson, *Independent Review of the Operation of Monetary Policy in New Zealand*, February 2001, p 40

Amendments to the Act

The Reserve Bank of New Zealand Amendment Bill is currently before Parliament. The Bill follows on from Professor Svensson's report, and, if enacted, the key changes in relation to governance will be that:

- the Governor will no longer act as chairperson of the Reserve Bank's Board of Directors, and instead a non-executive director, elected by the directors, will be chair of the Board;
- Deputy Governors will be removed from the board, though the Governor will remain a Board member; and
- the Board will be required to issue an annual report on the Bank's and the Governor's performance; a practice that was adopted in 2001.

In the NEDC's view these changes remain within the intent of the Reserve Bank of New Zealand Act 1989 and the Bank's governance will be enhanced by the change to a non-executive chair of the Board.

The Bill also makes a number of technical amendments to the banking supervision sections of the Act.

Monetary policy

Throughout the year under review, the NEDC monitored the Reserve Bank's monetary policy performance and reviewed *Monetary Policy Statements* when they were issued. We scrutinised the thinking underlying OCR decisions and the processes used to make these decisions. We are satisfied that the Bank professionally discharged its obligations under the Reserve Bank of New Zealand Act and the PTA and that the Bank maintains decision-making processes that compare well to relevant international best practice.

Inflation, as measured by the year-on-year increase in the CPI, was held within the 0 to 3 per cent target range during the year under review.

The 11 September 2001 terror attacks presented a shock sufficient to warrant an unscheduled interest rate decision. On 19 September, the OCR was cut by 50 basis points to 5.25 per cent. The NEDC believes that this decision was consistent with the requirements of the PTA. The monetary policy framework has built into it the expectation that sometimes the Reserve Bank has to act quickly and, indeed, this was such a case.

The subsequent tightening of monetary policy that began in March 2002 attracted much hostile comment. But as events have unfolded, the balance of evidence so far suggests that it too fitted the requirements of the PTA. For central banks, the risk is that they make their monetary policy decisions too late and too cautiously. If a central bank is able to make a decision early in a business cycle then the amplitude of that tightening or easing is likely to be less than if the same decision is made a few months later. This is in the spirit of the December 1999 amendment to the PTA, which states that "In pursuing its price stability objective, the Bank ... shall seek to avoid unnecessary instability in output, interest rates and the exchange rate."

However, we note that the Bank's May 2002 *Monetary Policy Statement* said that, in terms of the next one or two quarters, "There is a material risk that annual CPI inflation could move above 3 per cent."[3] This is a matter of concern. In retrospect, the March 2002 tightening may prove to have been too late and/or too timid, despite public perceptions. Certainly, the NEDC has seen no compelling evidence to suggest that the Bank was premature or over-reacted in this instance.

The NEDC has come to these judgements via a process of assessment that has been substantially enhanced over the last two years. The Bank typically releases its quarterly *Monetary Policy Statements* on a Wednesday. As soon as the MPS is issued, detailed information about how the decisions were made is provided to all non-executive directors. This includes the written advice received by the Governor on the impending interest rate adjustment. Then on the Friday the Board meets, initially to hear a detailed presentation from the Bank's staff as to how the MPS was prepared and how the OCR decision was made. The NEDC then meets separately to further consider what it has heard. If the NEDC is satisfied that the MPS "meets the requirements of section 15(2) of the Act and is consistent with the Bank's primary function and the policy targets agreed with the Minister", then a resolution is passed to that effect. This is then taken for adoption to a full meeting of the Board that same afternoon.

It is also worth noting, in regard to monetary policy, that the NEDC reaches its view of the Bank's performance in part from direct contact with participants in the New Zealand economy. Each year the Board holds a number of meetings out of Wellington and included in these programmes are consultations with local business people.

Financial system stability

Monetary policy in itself is part of a larger picture, stable money being but one of the building blocks of a robust financial system. During the year, the Board was regularly briefed on the Bank's activities in regard to the registration and supervision of banks and the inter-bank payment system. Noteworthy events included the provision of advice to the Minister on the proposal to establish a state-owned bank, the subsequent registration of Kiwibank and the development of a policy on local incorporation of banks. The Reserve Bank also had discussions with the major banks about how it would manage a failure of a systemically important bank. The Board was briefed on improvements to the settlement services that the Reserve Bank provides to twelve banks in New Zealand. We are satisfied that these activities were consistent with the development and maintenance of a sound and efficient financial system.

Other functions

During the year, the Board also kept under review the Bank's other responsibilities. These included supplying New Zealand's currency and managing foreign reserves. The NEDC is satisfied that these functions were performed efficiently and effectively.

[3] Reserve Bank of New Zealand, May 2002 *Monetary Policy Statement*, page 17

The use of resources and risk management

During 2001/2002, our monitoring of the Bank's use of resources included particular scrutiny of the Bank's risk management, human resource management, and operating efficiency and effectiveness. 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. Financial risk management monitoring is performed by the Audit Committee of the Board. The Audit Committee received regular reports from the Bank's Risk Assessment and Assurance Department on the internal audit function.

The Bank's operating expenditure in 2001/2002 was within budget and within the amount provided for in the Bank's Funding Agreement.[4] The NEDC judges that the Bank has been prudent in regard to the resources used to carry out its work and its management of risks.

Directors

During the year under review, the terms of two directors, Professor Viv Hall and Sir Gil Simpson, came to an end. The NEDC would like to thank them both for their contributions throughout their time on the Board. In December 2001, Mr Murray Sherwin, who as Deputy Governor and Deputy Chief Executive was an executive Board member, resigned. Mr Sherwin served with the Bank for many years in many roles and his contribution was substantial. Our thanks to him for that contribution to the Bank and to the Board's discussions.

Bill Wilson

Bill Wilson
Chair of the Non-Executive Directors' Committee of the Board of Directors
Reserve Bank of New Zealand

1 July 2002

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


SECURITAS ET VIGILANTIA