

Reserve Bank Non-Executive Directors' 2003 Annual Report

The Reserve Bank of New Zealand Act 1989 charges the Reserve Bank's Board of Directors with the task of keeping under constant review the Governor's and the Bank's performance in carrying out its functions and its use of resources. Included in this task is the role of monitoring whether the Bank's *Monetary Policy Statements* and associated policy actions have been consistent with the Policy Targets Agreement signed under section 9 of the Act.

The Non-Executive Directors' Committee of the Board of Directors (NEDC) considers that during 2002/03 the Reserve Bank discharged its responsibilities in accordance with the requirements of the Reserve Bank Act and the Policy Targets Agreement. Risks were well managed and costs were held.

Appointment of a new Governor

On 23 September 2002, Dr Alan Bollard took up his appointment as the Reserve Bank's new Governor. Given the role of Governor under the Reserve Bank Act, the qualities of the Governor are of particular importance to the success or otherwise of the institution. This means that the process of nominating a new Governor for appointment by the Minister of Finance affords the Board an opportunity to make its most critical contribution to the Bank. This was the first appointment of a new Governor since operational independence was legislated for in 1989. It is thus a particular satisfaction for the NEDC that strong candidates were available for the position and that a person with such an impressive public policy and economics background as Dr Bollard was available to be appointed to the position.

Since his appointment, Dr Bollard has established an excellent working relationship with the Board. In the NEDC's judgement, he has been effective in keeping the Reserve Bank focused on its day-to-day functions, while also initiating carefully considered reviews of the Bank's activities to identify how the Bank needs to evolve in the period ahead.

The NEDC also wishes to record its appreciation for the way that Dr Rod Carr managed the Reserve Bank during his five months as Acting Governor. Inevitably, a transition to a new Chief Executive is difficult for any organisation, yet during that period, under Dr Carr's guidance, the Bank continued to carry out its duties at an exceptionally high standard. Dr Carr has announced his intention not to seek renewal of his current position as Deputy Governor. The NEDC wishes him well for the future and acknowledges formally Dr Carr's exemplary contribution to policy, risk management and broader management during his term at the Bank.

The new PTA

The Reserve Bank of New Zealand Act 1989 requires that with the appointment or reappointment of a Governor a new Policy Targets Agreement (PTA) is negotiated and signed. This was completed on 17 September 2002. Under the Act, the PTA is, in effect, a signed contract between the Minister of Finance and the Governor. The new PTA shifted the lower boundary of the target range for CPI inflation outcomes from 0 per cent to 1 per cent

per annum while retaining the upper boundary of 3 per cent. The 1 to 3 per cent target range is to be achieved “on average over the medium term.”

The Board does not formally take part in PTA negotiations and is not required to endorse a PTA before it is adopted. That said, the NEDC has concluded that the current PTA is consistent with the 1989 Act and, in particular, with clause 8, which states that “The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.” The NEDC also notes that the recent International Monetary Fund “Article IV” report on New Zealand concluded that the new PTA constituted “a welcome enhancement to the inflation targeting framework.”

While the PTA remains consistent with the Act, changes to the PTA over the years have made the Board’s task of monitoring the Governor’s and the Bank’s monetary policy performance more complex. Initially, the PTA required the Bank to deliver price stability subject to some “caveats” relating to major price shocks. This meant that if inflation was inside the range, that outcome was a *prima facie* indication of adequate monetary policy performance. Conversely, inflation or deflation outside the target range was an indication that the Governor’s and the Bank’s performance needed to be examined further. In December 1999, the PTA was amended so that “In pursuing its price stability objective, the Bank ... shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.” This requires the NEDC to make a judgement as to whether any particular instability is “unnecessary”. In addition, the new PTA requires the Bank to deliver price stability “over the medium term.” This requires another judgement as to what constitutes “the medium term”.

In making these judgements, the Board examines the Bank’s monetary policy decision-making and implementation prospectively, retrospectively and on an ongoing basis.

Prospectively, especially at the time of each *Monetary Policy Statement (MPS)* release, the Board examines whether:

- the Bank's forecasts of inflation are such that projected inflation settles comfortably within the 1 to 3 per cent range over the next three or so years;
- these forecasts are reasonable, given current information;
- the projected policy settings are consistent with delivering the projected inflation path; and
- the projected policy settings avoid unnecessary instability in output, interest rates and the exchange rate relative to other potential policy settings that would themselves deliver sustainable inflation within the 1 to 3 per cent range over the next three or so years.

Retrospectively, the Board examines:

- whether inflation has settled within the desired range over relevant time horizons corresponding to earlier *MPSs/OCR* decisions;
- if so, whether this is due to factors consistent with the Bank's projections and, if factors did not evolve as expected, whether the Bank's reactions to those factors were appropriate;
- if not, whether this was due to: (a) identified risk factors evolving in an unexpected fashion, (b) unidentified factors having an unexpected impact or (c) poor judgements by the Bank at the time of the relevant *MPSs*; and

- the appropriateness of the Bank's reactions in response to (a), (b) and (c) above, including the speed of problem identification, the quality and promptness of the Bank's reaction and the Bank's communication of its intended response.

On an ongoing basis, the Board monitors whether inflation on average is within the target range over periods of three and more years. It also monitors trends in inflation expectations and in potential risks to the longer-term inflation outlook that may be influenced by monetary policy actions (e.g. asset price developments). This information provides additional indications as to whether monetary policy is on a path resulting in the sustainable and consistent achievement of the inflation target over the long term.

Monetary policy

CPI inflation for the year to June 2003 was 1.5 per cent, which is inside the target set by the PTA. It is however one of the characteristics of monetary policy that there is a substantial delay between monetary policy decisions and the consequences of those decisions flowing through the economy into inflation. Thus, this inflation result reflects monetary policy decisions made one to two years earlier. The correctness or otherwise of the monetary policy decisions made during the year under review cannot be ascertained as yet.

What the NEDC can say is that during the year under review it carefully scrutinised the way the Reserve Bank made its monetary policy decisions. After each decision, the NEDC sees the written internal advice received by the Governor as well as the advice of the two external advisers appointed by the Bank. At the following Board meeting, extensive briefings are provided as to the judgements that informed the decision. Based on advice from visiting monetary policy experts who have participated in the Reserve Bank's monetary policy setting process and on its own expertise, the NEDC has concluded that the Bank continues to use rigorous and thorough procedures to formulate and implement its monetary policy decisions.

The requirement that the Bank "shall seek to avoid unnecessary instability in output, interest rates and the exchange rate" is inherently difficult to monitor with precision. We note that while interest rates and GDP growth have recently been relatively stable, the exchange rate has appreciated sharply over the past two years, following its substantial depreciation over 1996-2000. The cause of this volatility is an open question, with the determinants of major exchange rate swings being the subject of considerable research and debate internationally. Consequently, the NEDC welcomes the Bank adopting as one of its priority research projects over the coming year an analysis of the relationship between exchange rate variability and inflation variability. A greater understanding of this relationship should be useful in interpreting the policy implications of the trade off (if any) between volatility in inflation, the exchange rate and other economic variables.

Financial system stability

During the year now completed, the Bank resolved to put increased effort into financial stability issues. New Zealand faces increased vulnerability to the consequences of any financial system instability, due to the riskier nature of aspects of the international financial system coupled with this country's high aggregate indebtedness and dependence on foreign savings. The Reserve Bank is assessing aspects of its policy frameworks related to financial system stability issues and is working to further increase its capacity and systems for performing its financial stability functions. This is particularly important given a number of

complex policy issues in this field that the Bank is working to resolve. The Board welcomes the Bank's commitment to these issues, signalled in the Bank's priorities for the coming year, published in the Bank's 2003 *Annual Report*.

The Board itself has increased its focus on financial stability concerns and during the year under review the Board received a number of briefings on these matters. We are pleased to note that the relevant indicators for the banking system point to a system that is in good health and is relatively well placed to absorb economic shocks. Over the coming year, we will take particular interest in the findings of the IMF's FSAP¹ assessment of New Zealand's financial system scheduled for later in 2003 and any matters arising from that assessment.

Other functions

The Reserve Bank has a number of other functions, including supplying New Zealand's currency, and providing and supervising payments systems that are central to the smooth running of the New Zealand financial system. The Board kept these functions under review throughout the year and is satisfied that these functions were performed efficiently and effectively.

The Reserve Bank also manages New Zealand's foreign reserves. This function inherently incurs a cost arising from New Zealand's lower credit rating relative to the countries in which the reserves are invested. Given this cost and the potential risks associated with this function, the Board pays specific attention to foreign reserves issues. We note that the Bank made significant decisions with regard to the trading rules that it adopts in managing the reserves and with regard to its value-at-risk exposures. These decisions were primarily made to mitigate risk. In the view of the NEDC, these decisions reflect an appropriate approach to managing the risks associated with this function without incurring unnecessary costs.

The use of resources and risk management

During 2002/03, the Reserve Bank commissioned an external review of the Bank's risk management processes. The resultant report did not reveal any material risks not being appropriately managed by the Bank. The report did make a number of suggestions for improving some aspects of risk management and these have since been carefully assessed and acted on where appropriate.

More generally, throughout the year the Board monitored the Reserve Bank's use of its resources via monthly financial reports on revenues and expenditure-against-budget and thorough briefings on the Bank's foreign reserves management and human resource programmes. Internal audit and financial reporting were monitored by the Board Audit Committee, which received regular reports from the Bank's Risk Assessment and Assurance Department. No issues of significant concern emerged. We note with pleasure that for the fifth year in a row the Bank's 2002 Annual Report won the Institute of Chartered Accountants Annual Report Awards for Public Sector Entities – Non Trading.

The Reserve Bank's operating expenditure in 2002/03 was within budget and within the amount provided for in the Bank's Funding Agreement. The NEDC judges that the Bank has been prudent in regard to the resources used to carry out its work. The resources allocated in

¹ International Monetary Fund Financial Sector Assessment Program

the Bank's funding agreement are currently adequate for the Bank to carry out its functions. Within this funding, the NEDC has indicated that it supports greater resources being applied to key policy issues, particularly financial system stability and aspects of monetary policy.

The Bank's priorities and projects in policy and operational areas for 2003/04 have been discussed in depth with the Board. Their publication in the Bank's 2003 *Annual Report* provides a basis to monitor the Bank's progress on its priority issues.

Board Governance

At the time of writing, the Reserve Bank of New Zealand Amendment Bill was still before Parliament. If the Bill is enacted, as expected, then the Governor will no longer act as Chair of the Reserve Bank's Board of Directors and a non-executive director elected by the non-executive directors will chair the Board. There will then be no further need to have a Board NEDC. Board processes has been revised to enhance the Board's effectiveness in the context of the signalled changes to the Act.

We note the Government's intention to further amend the Reserve Bank Act to introduce a requirement for the Bank to issue an annual Statement of Intent. We record our understanding and expectation that the amendment will result in no diminution of the Bank's current level of independence.

Directors

During the year under review the previous chair of the NEDC, Mr Bill Wilson, retired from the Board. Mr Wilson served on the Board since 1990 and played a key role throughout his tenure, culminating in the process of appointing the present Governor. The NEDC wishes to formally express its gratitude for Mr Wilson's very distinguished contribution over such a long and sometimes challenging period.

Following Mr Wilson's retirement, the NEDC appointed Dr Arthur Grimes as its Chair, with Mrs Alison Paterson appointed as Deputy-Chair. Mrs Paterson also chairs the Board's Audit Committee. The Board welcomed to its ranks the Rt Hon Ted Thomas as a new non-executive director and Dr Bollard who, as Governor, joined the Board.

Arthur Grimes
Chair, Non-Executive Directors' Committee of the Board of Directors
Reserve Bank of New Zealand

22 July 2003