



**RESERVE
BANK**

O F N E W Z E A L A N D

2003-2004 **Annual Report**



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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.

THE YEAR AT A GLANCE

- For the 12 months to 30 June 2004, Consumers Price Index (CPI) inflation was 2.4 per cent.
- During the review period, monetary policy completed a modest easing cycle and then began a tightening cycle.
- The Reserve Bank Act was amended in a number of ways, refining the Bank's governance arrangements, including adding a requirement that the Board of Directors have a non-executive chair, the first elected chair being Dr Arthur Grimes.
- The Reserve Bank became a shareholder in the Bank for International Settlements.
- The Reserve Bank consented to the ANZ Banking Group (New Zealand) Limited acquiring and then amalgamating with The National Bank of New Zealand Limited.
- The IMF Financial Sector Assessment Programme (FSAP) reviewed the New Zealand financial system.
- The Reserve Bank gained additional capacity to intervene in the foreign exchange market to influence, at the margin, the level of the exchange rate.
- Mr Adrian Orr was appointed Deputy Governor/Head of Financial Stability, and Dr Don Abel was appointed Assistant Governor/Head of Operations.
- The Reserve Bank spent a net \$27.6 million on activities covered by the Bank's Funding Agreement, which was 11 per cent below the \$31 million permitted. The Bank generated a surplus of \$195.1 million, of which \$191.7 million was paid as a dividend to the Crown.



The Reserve Bank Act requires the Bank to maintain price stability and to promote a sound and efficient financial system. Both these tasks are important for New Zealand, and hence they are the main focus of this introduction to the Reserve Bank's 2004 *Annual Report*.

Monetary Policy

We are required by law to maintain price stability, and, by agreement with the Minister of Finance, to aim to keep future Consumers Price Index (CPI) inflation between 1 and 3 per cent on average over the medium term.

During the second half of 2003, the Official Cash Rate (OCR) was held at relatively low levels by New Zealand standards. However, by the end of 2003 it became clear that, contrary to most economists' forecasts, New Zealand's strong economic growth was not slowing. Moreover, domestic inflation remained significant. At that stage, its impact on overall CPI inflation was held in check by a very strong New Zealand dollar, but this could not be relied upon indefinitely. Therefore, in the first half of 2004, monetary policy began a tightening phase, to ensure that any future increase in inflation would be temporary. Handling the underlying strength in inflation will be the main policy challenge during the year ahead.

We have this year reviewed our thinking about the relationship between monetary policy and economic growth. To summarise, good monetary policy allows an economy to grow at its average sustainable rate, but no higher, whereas poor monetary policy can either restrict growth or trigger inflation. For the Bank, a crucial question now is calculating New Zealand's potential growth rate, and assessing whether the high growth rates of recent years are sustainable.

It has also been a year of high and volatile exchange rates. We have done a lot of background work on exchange rate issues to help inform our monetary policy decisions. This includes a fresh look at the impact of monetary policy on the exchange rate and the effects of the exchange rate on the economy.

In the light of the pressures on the New Zealand dollar, we also reviewed our policies on foreign exchange intervention. Under our Act, we have long had intervention powers. During the review period, we gained additional capital and reserves to enable us to extend the purposes for which we might intervene. These now include supporting monetary policy by influencing the extremes of the exchange rate cycle, if ever required. We have made public some of the principles that we would apply to making and implementing a decision to intervene.

Financial Stability

The Reserve Bank Act requires us to supervise banks to promote the maintenance of a sound and efficient financial system. It has been a significant year in this area.

Among the highlights has been a major inspection of our approach to financial surveillance by the IMF Financial Sector Assessment Programme (FSAP) Team. They pronounced it broadly healthy, and made some suggestions which we are now working on.

During the year, we conditionally approved New Zealand's biggest corporate acquisition so far – ANZ Banking Group (New Zealand) Limited's acquisition of, and then amalgamation with, The National Bank of New Zealand Limited. This involved a very large amount of work and has provided an opportunity for us to restate our regulatory requirements for systemically important banks operating in New Zealand. As part of this, we expect that they organise their retail operations through local subsidiaries, with New Zealand boards and with chief executives who report to their New Zealand boards. An outsourcing policy is also being developed to ensure that the systemically important banks have enough technical functionality to run their core operations on a standalone basis, if necessary. Our aim is to avoid high compliance costs, and to retain our efficiency-based approach to regulation, while still ensuring that we can have control over New Zealand's financial system should a crisis ever arise.

Westpac Banking Corporation has this year made a formal proposal to remain exempted from our requirement that systemically important banks here are locally incorporated. We are now considering the merits of their bolstered branch proposal.

All of New Zealand's large retail banks are now Australian-owned. We have been working with The New Zealand Treasury in an endeavour to design an integrated regulatory system that takes into account Australian methods of bank regulation, while still meeting New Zealand's particular needs. These are that we have a banking system that offers good returns to depositors and investors, meets the needs of borrowers, and can be managed effectively by the relevant New Zealand authorities, including in a crisis.

We have taken advantage of two international investment opportunities this year. The Reserve Bank has become a shareholder in the Bank for International Settlements, and we have joined East Asian nations to participate in the newly formed Asian Bond Fund.

I am also pleased to report that this year we have built up our staff resources in the financial stability area, taking on senior people with experience in commercial banking.

Other Operations

The Reserve Bank carries out numerous other functions that help keep the New Zealand financial system in good shape.

Highlights during the review period included acceptance in principle of the New Zealand dollar as a currency for the international 'Continuous Linked Settlement (CLS)' foreign exchange clearing system; a technology upgrade for our real-time gross settlement system; partial implementation of a decision to exit the provision of registry services; investment in a new state-of-the-art treasury system; and production of the Lord of the Rings commemorative coin series. This list shows how varied our work can be.

The Overseas Investment Commission, which is housed and staffed by the Reserve Bank, was reviewed, and on 20 July 2004 the Minister of Finance announced his intention that the Commission would be disestablished and its work done by a dedicated unit within Land Information New Zealand.

People

The Reserve Bank Amendment Act, passed during the review period, requires that the Reserve Bank Board elect its own non-executive chair. In September 2003, Dr Arthur Grimes was elected to that position. In December 2003, Dr Marilyn Waring was appointed to the Board, replacing the Hon Ruth Richardson whose term had expired. I wish to thank Board members for their continuing advice and support, especially Chairman Dr Arthur Grimes, and Deputy Chair and Chair of the Board Audit Committee, Mrs Alison Paterson.

Staff throughout the Bank worked enthusiastically and energetically to achieve the outcomes described in this *Annual Report*. I thank them all for their dedication and effort. It is a privilege to lead an institution of this calibre that is helping make the economy and the financial system work better for the benefit of all New Zealanders. I could not carry out my duties without the extensive support that I receive.

Alan Bollard
Governor

The Reserve Bank's Senior Management Team



Alan Bollard
Governor



Mike Wolyncewicz
Chief Financial Officer



Yogesh Anand
Head Knowledge Services Group



Tanya Harris
Head Human Resources Team



Don Abel
Assistant Governor
Head of Operations



Brian Lang
Head Currency and Building Services



David Archer
Assistant Governor
Head Economics Department



Paul Jackman
Head Corporate Affairs Department



Steve Anderson
Risk Assessment and
Assurance Department



Adrian Orr
Deputy Governor
Head Financial Stability Department

Governors		Departments/Heads	Functions ¹	Internal Services
Governor Alan Bollard	Assistant Governor Head of Economics David Archer ²	Economics Department	Monetary policy formulation	
	Deputy Governor Head of Financial Stability Adrian Orr	Financial Stability Department	Market operations Foreign reserves management Financial system surveillance	
		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
		Knowledge Services Group Yogesh Anand		Library services Data services Computer services
		Human Resources Team Tanya Harris		Human resources strategy and services
		Assistant Governor Head of Operations Don Abel		
		Corporate Affairs Department Paul Jackman		Reputation management Communications
		Risk Assessment and Assurance Department Steve Anderson		Audit services Risk assessment and assurance
		Overseas Investment Commission Secretariat Steve Dawe	Overseas Investment Commission	

¹ For accounting purposes, the Reserve Bank also includes among its functions a classification called 'Other Outputs' which spans a number of departments, and includes the provision of economic policy advice and overseas representation and liaison.

² After year's end, Mr Archer took leave to take up an appointment with the Bank for International Settlements, and Mr Grant Spencer was appointed Assistant Governor/Head of Economics.

BOARD OF DIRECTORS

Executive

Non-Executive



Dr Alan Bollard
Governor

Paul Jackman
Board Secretary

Paul Baines
Company Director

Hugh Fletcher
Company Director

Director: EDS (New Zealand) Pension Fund Limited, Fletcher Building Limited, Gough Gough & Hamer Limited, New Zealand Institute of Economic Research Inc, Telecom New Zealand Limited; Council Member: Barnardos New Zealand.

Appointed 1 July 1999 - current term expires 30 June 2009

Chair: Advisory Board of No 8 Ventures; Director: Fletcher Building Limited, Ports of 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.

Appointed 10 June 2002 - current term expires 9 June 2007



John Goulter DCNZM JP

Company Director

Chairman: Advance Whangarei Limited, Contract Management Board Auckland Regional Council Rail Project, New Zealand Lotteries Commission; Director: United Carriers Group Limited; External Adviser: ABN-AMRO New Zealand Limited; Trustee & Board Member: NZ Business & Parliament Trust.

Appointed 9 February 2000
- current term expires 8 February 2005



Dr Arthur Grimes

Chair RBNZ Board of Directors

Economic Consultant

Principal: GT Research & Consulting; Senior Research Associate: Motu Economic & Public Policy Research Trust; Adjunct Professor of Economics, University of Waikato; Trustee: Reserve Bank Superannuation Fund.

Appointed 1 March 2002 -
current term expires 28 February 2007



Alison Paterson qso

Chair RBNZ Board of Directors Audit Committee and Deputy Chair RBNZ Board of Directors

Chartered Accountant

Chair: BPAC NZ Limited, Electricity Complaints Commission, Landcorp Farming Limited; Governing Board: National Research Centre for Growth and Development (University of Auckland); Director: Abano Healthcare Group Limited, Metrowater Limited, Nga Pae o te Maramatanga (National Institute of Research Excellence for Maori Development and Advancement - University of Auckland), Wrightson Limited; Council member: Barnardos New Zealand; Trustee: Wrightson Retirement Plan.

Appointed 1 February 1995
- current term expires 31 January 2005



The Rt Hon Edmund Thomas DCNZM PC QC

Retired Judge of the Court of Appeal of New Zealand

Member: Privy Council; Visiting Fellow Wolfson College Cambridge UK; Distinguished Visiting Fellow School of Law Auckland University.

Appointed 1 March 2003 -
current term expires 29 February 2008



Dr Marilyn Waring

University Professor

Professor of Public Policy, Massey University

Appointed 4 February 2004
- current term expires 3 February 2009

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 in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement (PTA).

The current inflation target is annual CPI inflation of between 1 and 3 per cent on average over the medium term. Typically, this is achieved through managing the Reserve Bank's overnight interest rate, which in turn influences short-term interest rates, and thus spending, saving, and borrowing. Our decisions on short-term interest rates sometimes also influence the exchange rate, and therefore the New Zealand dollar costs of imports and New Zealand dollar earnings of exporters.

The Act also directs the Reserve Bank to promote the "maintenance of a sound and efficient financial system" and to avoid "significant damage to the financial system that could result from the failure of a registered bank". To achieve these requirements, all banks in New Zealand have to be registered, and the Reserve Bank operates a banking supervision system designed to encourage banks to manage their risks carefully. This regime includes a combination of self, market, and regulatory discipline. There are no restrictions on the number of banks allowed in New Zealand, though for systemically important banks we require local incorporation.

The Reserve Bank does not underwrite or guarantee individual banks, and it does not provide a safety net for depositors in the case of a bank failure. There is no government-based deposit insurance or government guarantee of deposits or banks in New Zealand.

The Reserve Bank acts 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.

We manage foreign exchange reserves to enable intervention in the foreign exchange market, if ever required. We could do this either because the continuing operation of the foreign exchange market is at risk, or to influence extremes in the exchange rate cycle. We would do the latter to assist monetary policy to deliver price stability and avoid unnecessary instability in other macro-economic variables.

The Reserve Bank issues New Zealand's currency. As required by statute, we control the design and printing of the nation's currency. We then issue currency to banks, which they in turn provide to their customers. We also withdraw from circulation and destroy damaged or unusable currency.

The Reserve Bank provides cash and debt management services to the Government. We have also provided secretariat services to the Overseas Investment Commission, although, as noted earlier, the Minister of Finance has announced his intention that the Commission's work will be taken over by a dedicated unit within Land Information New Zealand.

Our internal organisation is illustrated on page 5. Details of the Reserve Bank Board of Directors are provided on pages 6 and 7. The role of the Board, and the governance and management of the Bank are described on pages 9 to 11.

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**, which specifies the Reserve Bank's functions and duties;
- the **Policy Targets Agreement (PTA)**, which is a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve; and
- the **Bank's Funding Agreement**, which is a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Bank's income can be retained by the Bank to meet its operating costs, with the remainder typically being transferred to the Crown.

The Reserve Bank also subscribes to a mission statement and a statement of its values that can be viewed on the front inside cover of this document.

The Governor

The Reserve Bank 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 for the appointment, reappointment, and dismissal of a Governor. The current Governor, Dr Alan Bollard, took up his appointment in September 2002.

Management Structure

The Reserve Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Operations, and the heads of the Bank's various departments, as on page 4. The posts of Governor and Deputy Governor are required by statute, the current Deputy Governor also being the Head of Financial Stability. In addition, two other members of the Bank's senior management team are designated 'Assistant Governors', these being the Head of Economics and the Head of Operations.

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, typically eight times a year;³
- the Financial System Surveillance Committee, which meets fortnightly to consider policy issues relating to the financial system;
- the Assets and Liabilities Committee, which meets monthly to consider balance sheet management and related risks; and
- the Communications Committee, which meets weekly to consider communications issues and the Bank's reputational interests.

These committees generally include a wider membership of senior bank staff than is strictly necessary. This reflects a deliberate policy to ensure that important decisions are subject to additional scrutiny and risk identification by experienced staff not directly involved in managing the task at hand. This approach provides an offset to the Reserve Bank's reliance on the Governor alone for key decision making.

The Reserve Bank does not publish the minutes of any of these committees, given that they are all in-house, ad hoc in their membership, and advisory, as opposed to being decision-making committees.

³ This group also includes the Bank's two part-time external monetary policy advisers, who provide outsiders' perspectives to mitigate the risk of 'groupthink'. At year's end, the two external advisers were Mr Terry McFadgen and Mr Malcolm Bailey.

Board of Directors

The Reserve Bank has a Board of Directors, the membership of which is shown on pages 6 and 7. Under the Act, the Board of Directors must comprise not less than five and not more than seven non-executive members, who are appointed for five-year terms by the Minister of Finance. In addition, the Governor is a Board member, but the Chair must be a non-executive member, the current Chair being Dr Arthur Grimes.

The role of the Board of Directors differs from that of the Board of a listed company. The Board has no involvement in directing Reserve Bank policy, monetary or otherwise. The Board's primary function is to monitor the performance of the Governor and the Bank, on behalf of the Minister of Finance. The Board does this by holding regular meetings at which it receives extensive briefings on the Bank's activities, decisions and policies. At these meetings, the Board also provides advice to the Governor, typically on governance issues.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. If the Board believes that the Governor's performance, in meeting the requirements of the PTA, or in 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. The Board provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on pages 40 to 43.

The Board of Directors 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. Directors on that committee are Mrs Alison Paterson (Chair), Mr Paul Baines, Mr Hugh Fletcher, and Mr John Goulter.

The Board of Directors met 10 times during the year under review.

Parliamentary Scrutiny

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

Transparency

An important aspect of the governance of the Reserve Bank is its transparency.

The Bank publishes an *Annual Report*, an annual *Statement of Intent*, and quarterly *Monetary Policy Statements*, which explain current monetary policy and provide detailed economic projections. On our website⁴ a *Statement of Principles* summarises our bank registration and supervision policies.

We also make information on our policies and activities widely available via speeches, brochures, media interviews, quarterly *Reserve Bank of New Zealand Bulletins*, published research papers and discussion papers, and an extensive website.

Risk Management

The Reserve Bank faces a wide range of risks, some general and others unique to central banks. Of these, the most fundamental risk is making policy errors in relation to monetary policy, or the financial or banking systems, thereby causing damage to the real economy and to the Bank's reputation and credibility. 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, interest, and exchange rate risks;
- 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.

The Reserve Bank sees risk management as an integral part of the general management task and the responsibility of day-to-day management. However, to ensure that all aspects of risk are considered properly, the Bank makes extensive use of committees, whose membership includes senior staff in addition to those directly responsible for implementing the decisions being made. These committees are described on page 9.

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

In addition, succession planning is a management priority. Knowledge management strategies have been developed to institutionalise knowledge.

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

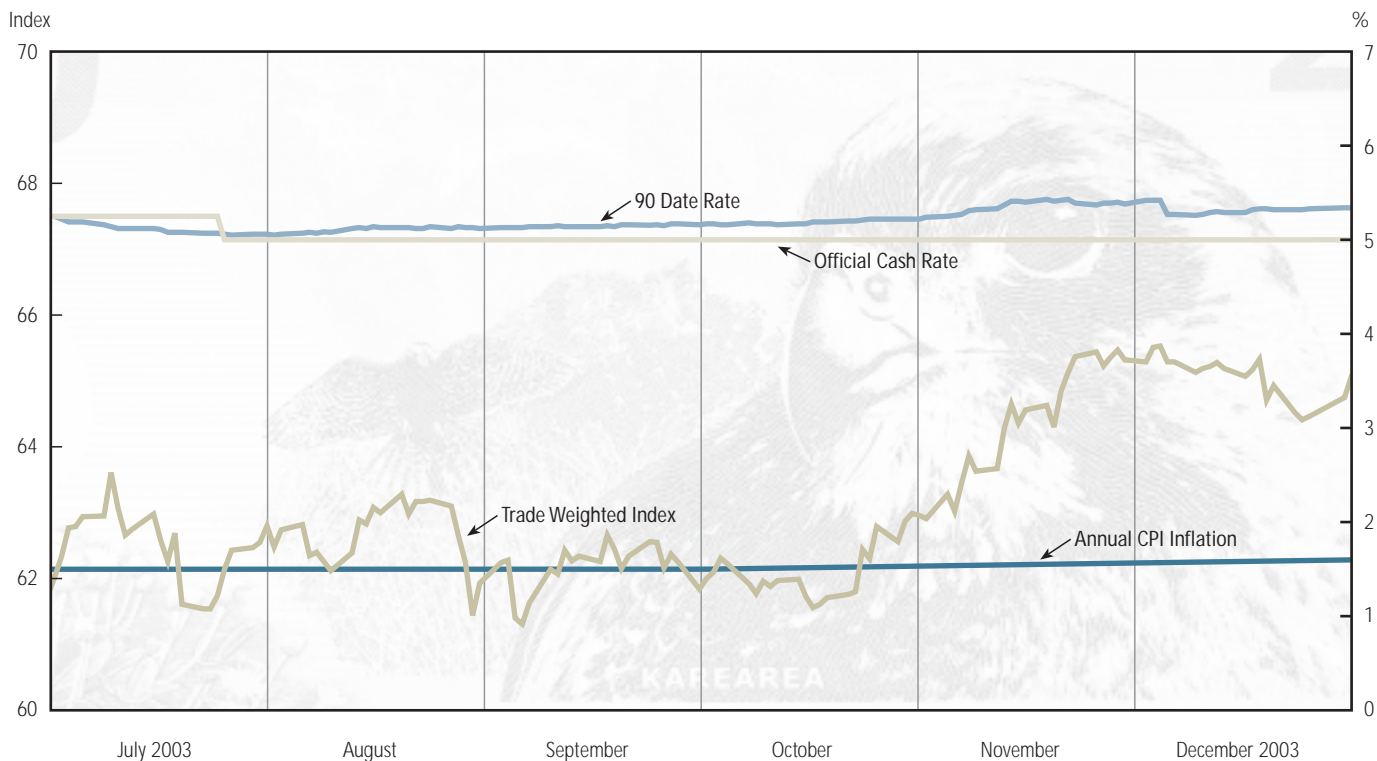
Authorisations and Audit

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 regular reports that describe progress to date in outputs and projects, and explain any significant variances. The expenses of the Governor and Deputy Governor are reviewed by the Chair of the Board of Directors Audit Committee each quarter. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are watched closely.

The internal audit function within the Reserve Bank is performed by the Bank's Risk Assessment and Assurance Department. The Reserve Bank is audited externally by the Auditor-General, who has contracted PricewaterhouseCoopers as his agent. In addition, the Minister of Finance can order a performance audit.



Monetary Policy and Monetary Conditions 2003



22 July

Adrian Orr is appointed the Reserve Bank's Deputy Governor/Head of Financial Stability.

24 July

The Official Cash Rate (OCR) is reduced from 5.25 per cent to 5.0 per cent.

14 August

Reserve Bank Act amendments require that the Bank's Board of Directors has a non-executive chair and ownership changes of 10 per cent or more of registered banks must have the Reserve Bank's consent.

19 August

The Reserve Bank announces that it has become a shareholder in the Bank for International Settlements.

4 September

The OCR is left unchanged at 5.0 per cent.

18 September

Dr Arthur Grimes is elected Chair of the Bank's Board of Directors.

23 October

The OCR is left unchanged at 5.0 per cent.

24 October

The Reserve Bank announces its consent for ANZ Banking Group (New Zealand) Limited to acquire The National Bank of New Zealand Limited.

31 October

The IMF Financial Sector Assessment Programme team is in New Zealand undertaking a review of the financial system.

10 November

The Minister of Finance announces a review of the Overseas Investment Commission.

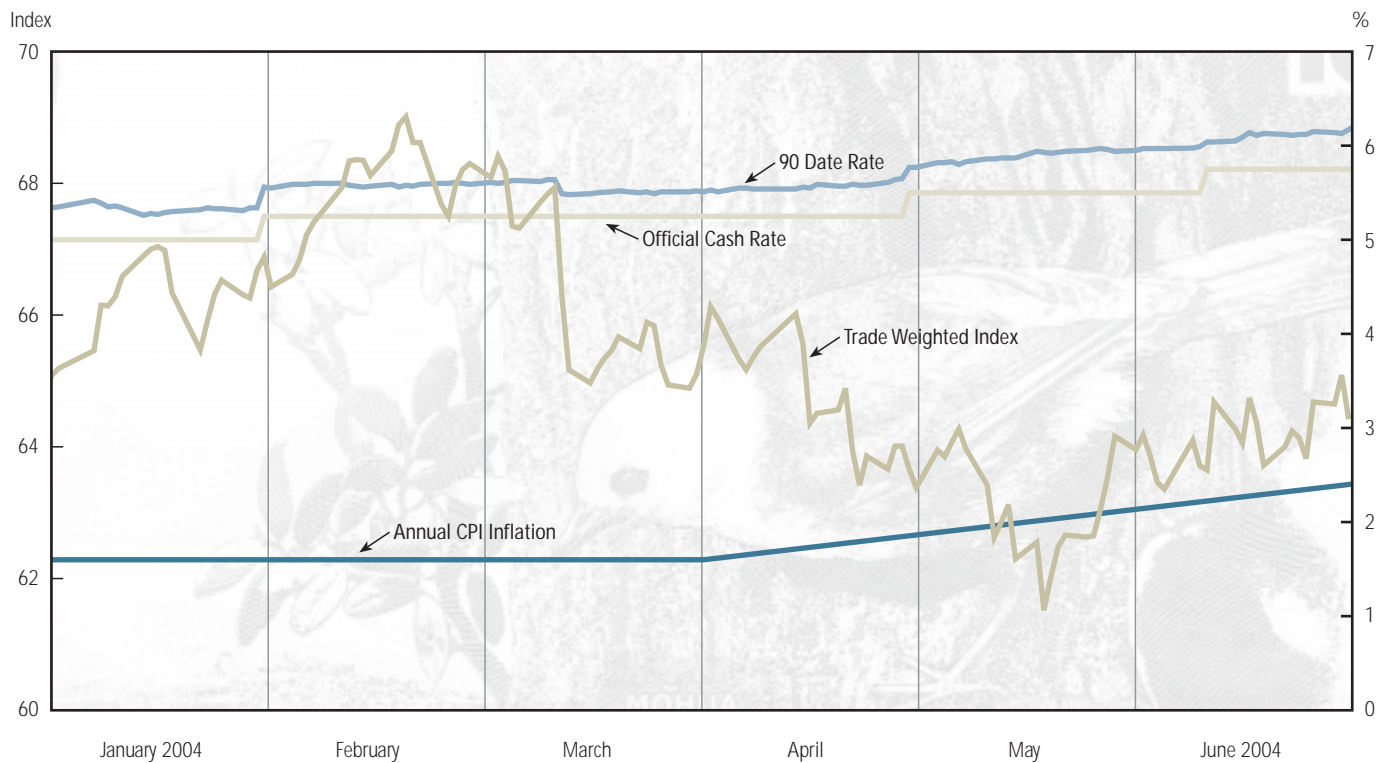
4 December

The OCR is left unchanged at 5.0 per cent.

18 December

Dr Marilyn Waring is appointed to the Board of Directors, replacing the Hon Ruth Richardson whose term expires.

Monetary Policy and Monetary Conditions 2004



29 January

The OCR is increased to 5.25 per cent.

30 January

The Reserve Bank advises that in rare circumstances it would adjust monetary policy to constrain extreme asset-price bubbles.

11 March

The OCR is unchanged at 5.25 per cent.

11 March

The Reserve Bank announces that it is seeking an additional funding capacity to be able to intervene in the foreign exchange market to influence the exchange rate.

24 March

Dr Don Abel is appointed as the Bank's Assistant Governor/Head of Operations.

30 March

The Reserve Bank issues a letter to the Minister of Finance outlining how it intends to undertake foreign exchange interventions to influence the exchange rate.

6 April

Parliament ratifies changes to the Reserve Bank's Funding Agreement required to enable the Reserve Bank to undertake foreign exchange interventions to influence the exchange rate.

29 April

The OCR is increased to 5.5 per cent.

6 May

The IMF FSAP review of the New Zealand financial system is made public.

10 June

The OCR is increased to 5.75 per cent.

25 June

The Reserve Bank announces its consent to the amalgamation of ANZ Banking Group (New Zealand) Limited with The National Bank of New Zealand Limited.

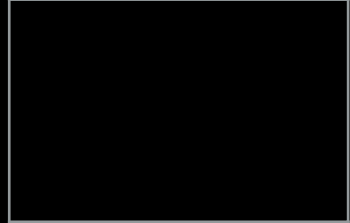
1 July

Additional capital of \$1 billion is received from the Government and invested in New Zealand Government securities.

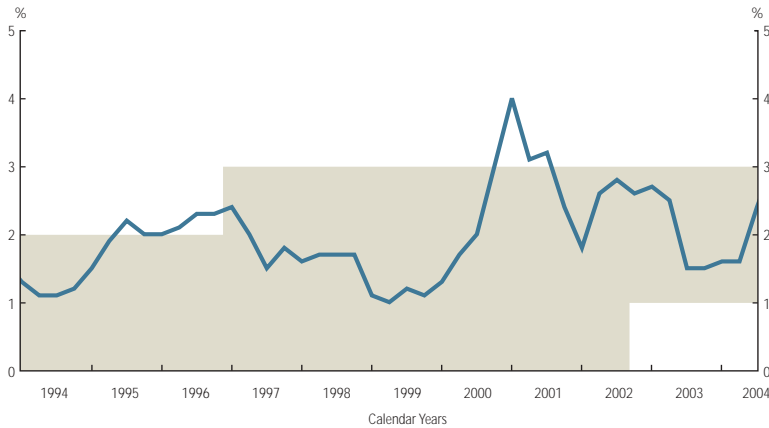
15 July

CPI inflation for the year to June 2004 is announced at 2.4 per cent.

THE YEAR IN REVIEW



Graph 1 Inflation⁵ Annual Percentage Change



5 The inflation series shown in the chart differs slightly over time, depending on what the Reserve Bank targeted at the time. Thus, from 1989 to 1997, the Bank targeted 'underlying inflation', which was CPI inflation minus interest rates and minus various temporary influences on inflation. During 1998 and up to the June quarter 1999 our target was so called 'CPIX inflation', which was CPI inflation minus interest rates. We did this because from 1998 onwards the PTA required that temporary influences on inflation were dealt with by way of explanation after the fact. Then, in 1999 Statistics New Zealand excluded interest rates from CPI inflation, so that CPI inflation unmodified became the target from then on.

Monetary Policy Formulation

During 2003/04, the New Zealand economy grew more strongly than expected, mainly due to robust household consumption and residential building. Export volumes grew moderately, and export prices in overseas markets lifted markedly. The Trade Weighted Index (TWI) exchange rate rose sharply and then settled again, though at year's end it was still above its long-run average.

At home, growth stronger than expected saw capacity and labour constraints continue to intensify, and domestic inflation pressures increased. However, the rising exchange rate during 2003 helped push import prices lower. Annual CPI inflation for the review period was 2.4 per cent.

Anticipating stronger domestic inflation, the Reserve Bank raised the Official Cash Rate from 5.0 to 5.75 per cent in three steps between January and June 2004. We did this to keep inflation within the requirements of the Policy Targets Agreement (PTA) and to constrain inflation expectations.

Nonetheless, we projected a temporary rise in CPI inflation above 3 per cent over calendar 2005, as import prices stop falling and begin rising. This would not be a breach of the Bank's PTA, as the Bank is now required to keep inflation between 1 and 3 per cent "on average over the medium term". As this inflation outcome is expected to be short-lived, trying to fully offset it using monetary policy would be inappropriate, as to do so might unnecessarily increase instability in other macroeconomic variables. However, we will be alert to any warning signs of changes to the medium-term path for inflation.

Looking back, an earlier increase in interest rates might have further reduced inflation risks, but it could also have fuelled the rising exchange rate, possibly creating an unnecessarily sharp downturn later on. Our monetary policy decisions throughout the period reflected judgements about the balance of the risks that we faced.

Box 1: New Foreign Exchange Intervention Capacity

During the review period, the Reserve Bank gained an additional capacity to intervene in the foreign exchange market.

The Reserve Bank's long-standing objective of its intervention policy has been to restore order in the foreign exchange market, if in a crisis liquidity in that market ever dries up. This is being retained. However, the Bank now has an additional objective for intervention, that being to help implement monetary policy. This is to help ensure that, in delivering low inflation, we also avoid "unnecessary instability in output, interest rates and exchange rates", as per clause 4b in the PTA, in this case by aiming to reduce the extremes of the exchange rate cycle.

Interventions are likely to be rare, as before intervening the Bank will require that four specific conditions are met, these being that:

- the exchange rate is *exceptionally* high or low, which is likely to be when the New Zealand dollar is nearing its historical extremes;
- the exchange rate is *unjustifiably* high or low, ie, in excess of economic fundamentals;

- intervention would *not be inconsistent* with the PTA; and
- the *opportunity* exists for a successful intervention, ie, there is a material prospect of influencing the exchange rate, given market conditions.

Intervention is likely to involve the Reserve Bank taking positions against prevailing market trends, implying that short run marked-to-market losses may occur. The Bank has received a capital injection from the Government to manage the balance sheet implications of this risk. Longer term, as intervention will generally involve 'buying low' and 'selling high', it is likely to prove profitable.

If intervention is successful, the benefits may be considerable, but it's important to emphasise that, even so, the exchange rate cycle will continue, and intervention won't have a large impact on the overall level of the exchange rate. Normal foreign exchange risk management will still be sensible for those exposed to exchange rates, such as exporters and importers.

Market Operations

The Reserve Bank interacts with financial markets daily to stabilise liquidity,⁶ implement monetary policy, and maintain a capacity to intervene in financial markets, if required.

Maintaining liquidity in the banking system requires us to offset the injections and withdrawals of funds caused by the Government's activities, ie, taxing and spending. A relatively stable level of banking system liquidity ensures that the market cash rate settles at a level consistent with the Official Cash Rate. We do this through a daily open market operation, and the use of other tools, such as foreign exchange swaps and the early repurchase of soon-to-mature government bonds.

During the review period, the Government accumulated, by New Zealand standards, very large sums of money for later transfer to the New Zealand Superannuation Fund. This strained liquidity management within the New Zealand financial system, in the sense that it became difficult for banks to obtain enough bonds and treasury bills to sell to the Reserve Bank to secure liquidity. When necessary, other liquidity instruments were used to manage this. By year's end, the Government had begun contributing to the New Zealand Superannuation Fund and enough government bonds had been repaid that the imbalances, as described, corrected.

Financial System Surveillance

During the year, the financial system remained sound. The dominant players, all registered banks, reported good profitability, low levels of impaired assets, sound capitalisation, and robust investment grade credit ratings. The payment system operated smoothly.

In October and November 2003, a team led by the International Monetary Fund (IMF) assessed first-hand New Zealand's financial system, as part of the IMF's Financial Sector Assessment Programme (FSAP). Their report,⁷ published in May 2004, concluded that New Zealand's financial system functions well, and short-term risks to it appear low. The report also found that the New Zealand banking supervision framework is broadly in line with international standards. The report made a number of recommendations that largely matched policy work already under way.

The New Zealand banking system changed substantially with ANZ Banking Group (New Zealand) Limited acquiring and then amalgamating with The National Bank of New Zealand Limited. This created the largest bank in the country and increased the overall Australian ownership of New Zealand banks, The National Bank of New Zealand Limited previously having had a British owner. Both the acquisition and amalgamation required the approval of the Reserve Bank.

We granted these approvals subject to the requirement that the primary duty of the new bank's board of directors and senior management must be to the New Zealand bank. We also required that the new bank has unambiguous access to the technical and management capacity necessary to stay in business if any of its outsourced service providers fail, including its Australian owner.

During the review period, a working group of the Australian and New Zealand treasuries and central banks, and the Australian Prudential Regulation Authority, was formed to develop policy options for closer integration of trans-Tasman banking regulation.

Westpac Banking Corporation delivered their proposal for continued exemption from our local incorporation requirements. They are suggesting that they operate in New Zealand under a 'buttressed branch' alternative to local incorporation for systemically important banks. The Reserve Bank will make a decision during 2004/05.

During the review period, we also developed a new policy for assessing the suitability of banks' directors and senior managers.

Recapitalisation using creditors' funds is one of a number of options being considered for dealing with a bank failure. During the review period, we worked with a large bank to develop and assess a prototype of this model. Further work is planned.

The Reserve Bank Amendment Act introduced provisions by which the Reserve Bank can recommend to the Minister of Finance that a payment system be 'designated', which confers legal certainty on the finality of payments made through the system. We expect to process the first applications for designation in the 2004/05 year.

⁶ By liquidity we mean the total amount of money in the financial system.

⁷ www.imf.org/external/country/NZL/index.htm

Preparation continued for New Zealand dollar foreign exchange transactions to be in the Continuous Linked Settlement (CLS) system by the end of 2004. The system is operated by CLS Bank, which is an international agency for settling foreign exchange transactions in real time, thereby reducing the so-called Herstatt risk of foreign exchange settlements not being completed due to time zone differences, and different legal jurisdictions and operating procedures. CLS links central banks' settlement systems, and for making New Zealand dollar transactions CLS Bank will utilise the Reserve Bank's Exchange Settlement Account System (ESAS).

Work also continued with the New Zealand Bankers' Association to improve failure-to-settle arrangements in retail payment processes.

Box 2: Assessing Financial Stability

Later this year, the Reserve Bank will publish the first of a regular series of *Financial System Reports*, which will assess the soundness and efficiency of the New Zealand financial system.

This begs the question of how a sound and efficient financial system is defined. The Reserve Bank interprets financial system soundness and efficiency as meaning:

- the financial system, and especially the banking system, is capable of maintaining essential functions in the face of economic and financial shocks, including the failure of a large bank;
- the financial system does not cause instability in the wider economy, eg, it is not a source of poor credit allocation, is not prone to fraudulent activity or criminal misuse, and is not a source of inherent instability in its own right;
- individual banks have a low probability of failure;
- if a bank does fail, then the failure can be managed in an orderly manner, with minimal disruption to the financial system as a whole;
- the financial system meets the financial needs of the community at reasonable cost; and
- the financial system is innovative, and adapts to changing economic circumstances and the changing needs of the community.

In assessing the sector's soundness and efficiency, the Reserve Bank looks at:

- indicators of the strength of the banking system, such as banks' profitability, impaired assets, provisioning for bad debts, capital ratios, diversification of loan portfolios, large credit exposures to single or closely related borrowers, exchange rate or interest rate risk, and exposures to related parties;
- the capacity of the banking system to withstand economic and financial shocks, such as a major fall in the exchange rate, increases in interest rates, falls in asset prices, or a sharp weakening in the wider economy;
- the capacity of payment systems to function at all times, including in the face of technical breakdowns and disturbances in the financial system; and
- the overall health of the non-bank financial sector, although here we have no regulatory powers.

We pay particular attention to whether or not our interactions with the financial sector encourage prudent management and yet also avoid excessive compliance costs or interference with banking as a business. Note also that there is no government or Reserve Bank deposit protection or guarantee of banks, if and when a bank fails.

Foreign Reserves Management

The Reserve Bank maintains a capacity to intervene in the foreign exchange market.

This intervention capacity consists of a diversified portfolio of foreign currency assets that can be realised quickly. These assets are financed by foreign currency loans from The Treasury. In addition, we maintain a committed credit line with the Bank for International Settlements (BIS). The Minister of Finance, in consultation with the Reserve Bank, determines the amount of foreign reserves required, specified as a range denominated in foreign currency terms. Thus, in New Zealand dollar terms, the level of reserves moves up and down as the New Zealand dollar changes in value, as illustrated in graph 2.

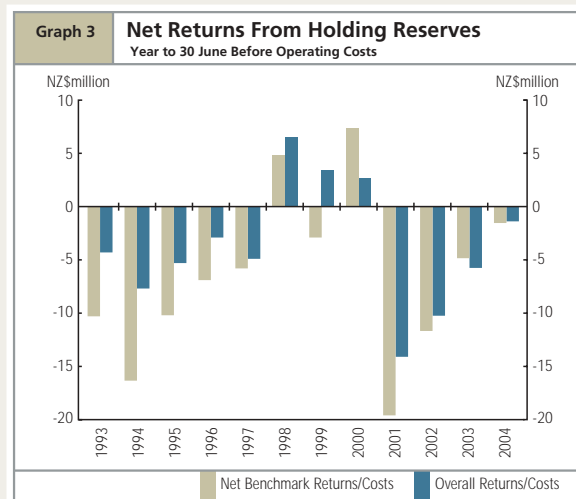
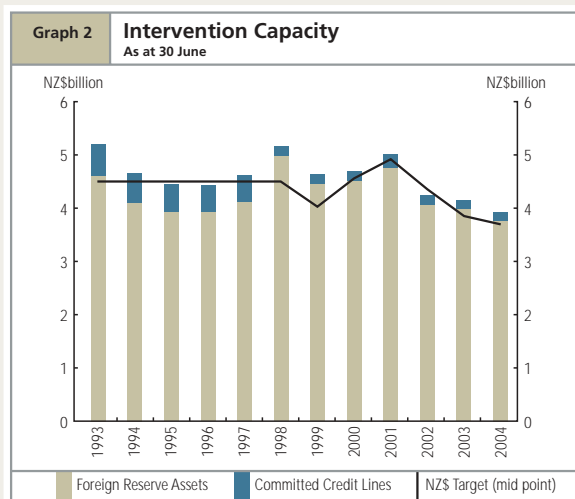
In March 2004, the Minister of Finance approved an increase in the Bank's foreign reserves. Over the next four years, the Bank's intervention capacity will increase to about NZ\$7 billion.

Holding reserves involves a cost, as the interest that the Reserve Bank pays to borrow foreign currency is generally higher than the interest that we earn reinvesting the

borrowed money. This is because our investments have to be high quality and able to be converted to cash very quickly in an emergency.

We seek to minimise this cost by maximising our investment returns, subject to prudent exposures to liquidity and credit risk. Some of the Reserve Bank's reserves are actively managed through discretionary trading in international financial markets. During the year under review, the exposure – potential gains or losses – from our discretionary trading was about the same as from our passive strategies. We also match the maturity and currency denomination of our investments with those of our borrowings to minimise our exposure to movements in interest rates and exchange rates.

Graph 3 compares our actual overall returns/costs of holding reserves with what would have been the returns/costs of adopting a purely passive strategy. During 2003/04, actual costs were slightly lower than for a purely passive approach. This reflected our traders generating profits from discretionary trading in global fixed income and foreign exchange markets.





Currency Operations

The Reserve Bank supplies the nation's currency. We do this by selling bank notes and coins at face value to the banks, which the banks then issue to their customers. In addition, whenever we process bank notes, we check for forgeries and replace bank notes that are damaged or of an unacceptable quality.

As at 30 June 2004, 103 million bank notes and 1.1 billion coins were in circulation (ie, held by the public and the banks), with a total face value of \$2.9 billion, which is up 4 per cent on the previous year. However, during the same period, the value of currency held by the public increased by 8 per cent. The reason for the 4 per cent difference is that the amount of cash being held by the commercial banks declined, despite increased public usage. At the end of June this year, the cash held by the banks was 12 per cent below the same time last year. Commercial banks are now managing the distribution of cash within the community more efficiently than previously.

During 2003/04, we machine processed 66 million bank notes, which is 64 per cent of the total in circulation, destroying 14.8 million as unfit and detecting just 28 counterfeits. The cost of replacing unfit bank notes and meeting growth in demand totalled \$1.3 million in 2003/04, compared with \$2.2 million the previous year. The lower cost was primarily due to the issuance of fewer new \$20 bank notes at Christmas. This was because we had available higher stocks of used bank notes. The quality of our polymer \$20 bank notes is holding up remarkably well. In the year to 30 June, we destroyed just 16 per cent of \$20 notes in circulation, compared with an annual destruction rate of close to 60 per cent when we had paper bank notes.

Demand for coin continues unabated. During the year we issued 55 million coins, at a cost of \$4.1 million, of which 87 per cent were lower value 'silver' coloured coins. As mentioned in the 2003 *Annual Report*, we are reviewing our silver coinage both in terms of their size and cost.

Box 3: Other 'Currency'

Aside from providing the bank notes and coins that New Zealanders use day-to-day, the Reserve Bank also provides small numbers of special commemorative coins that typically are of interest to collectors. These coins have their own special designs and often are made of precious metals. Their marketing and promotion has been outsourced to the Stamps Division of New Zealand Post, as there are significant synergies in the production and marketing of collectors' stamps and coins with linked themes. However, the Bank still retains the final say on the theme and design of the coins.

During the past year, New Zealand Post has marketed a number of commemorative coins, the highlight being a Lord of the Rings series. Income from commemorative sales exceeded expectations.

In addition, from time to time, the Reserve Bank has to deal with commercial interests wanting to use reproductions of bank notes or take images from currency to promote their products or services. Mostly this does not cause problems, but sometimes reproductions are sufficiently similar to genuine bank notes or coins that consumers might mistake them for real money. When that happens, the Reserve Bank is required to intervene to protect the public.

Rather than imposing blanket or ad hoc restrictions, we specify in detail what we are prepared to allow, the details of which are available on our website. Anyone intending to make or issue anything that looks like a bank note or coin should check these requirements very carefully and get legal advice.

Settlement, Registry and Depository Services

The Reserve Bank provides a number of services to the financial markets. These contribute to the soundness and efficiency of the financial system, though it is not inevitable that they have to be provided by the Reserve Bank.

Registry Services

For many years, the Reserve Bank has provided a registration and payment service for debt securities, such as bonds, bills and notes, issued by the Government, local authorities and others in the public and private sectors. However, during 2002/03 the Reserve Bank announced its intention to exit this business, and during 2003/04 implementation began. By June 2004, most customers had transferred to private sector registry providers. All are expected to transfer before December 2004. At that time, the Bank's outsourcing arrangement with Computershare Investor Services for processing registry transactions will end.

The Reserve Bank has, however, commenced provision of a registry service for securities held by institutional investors. This is a limited service available only to members of the Austraclear New Zealand system. These securities are registered in the name of New Zealand Central Securities Depository Limited, which is a wholly-owned subsidiary of the Bank. This restricted service reduces manual intervention and duplication in the registration and holding of securities by institutional investors, enhancing market efficiency and reducing operational risk.

Austraclear

The Reserve Bank provides electronic clearing and settlement services using the Austraclear New Zealand system. This provides real-time delivery and payment services for debt and equity securities. Members can also use this system to transfer cash. All securities in the Austraclear New Zealand system are held on its members' behalf by New Zealand Central Securities Depository Limited. In recent years, the value and volume of transactions have been relatively stable, as shown in table 1.

Exchange Settlement Account System

The Reserve Bank's Exchange Settlement Account System (ESAS) is a banking service for financial institutions that need to make high-value payments with each other. ESAS operates in real time, so that individual transactions are settled electronically as they happen. All current ESAS account holders are registered banks, though membership is not restricted to banks.

During the review period, the Bank successfully upgraded the hardware and operating systems of Austraclear and ESAS. Also, in October 2003, ESAS introduced an additional queuing algorithm known as 'auto offset'. This allows simultaneous settlement of transactions between account holders, which is more efficient and reduces daily liquidity requirements.

Table 1: Key Austraclear New Zealand Statistics

Year ended 30 June	2004	2003	2002
Average daily transaction volumes	1,124	1,183	1,196
Average daily transaction values	\$10.1 billion	\$9.9 billion	\$9.9 billion

Table 2: Key ESAS Statistics

Year ended 30 June	2004	2003	2002
Average daily transaction volumes	3,693	3,271	2,862
Average daily transaction values	\$35.26 billion	\$32.6 billion	\$30.1 billion
ESAS system availability during core hours	99.92%	99.94%	99.41%

Continuous Linked Settlement (CLS) Bank⁸

By the end of 2004, the New Zealand dollar is expected to be included in the Continuous Linked Settlement (CLS) system for settling foreign exchange transactions. This will eliminate the risk of non-settlement for foreign exchange transactions across different time zones. Otherwise, there can be extensive delays between a transaction being initiated and completed, during which the party that started the process is at risk of the other party defaulting.

CLS removes settlement risk by settling foreign exchange transactions only when both parties can exchange currencies simultaneously. CLS settles foreign exchange transactions on a payment versus payment basis on the books of CLS Bank. To do this, CLS members hold multi-currency accounts with CLS Bank, which in turn has real-time gross settlement accounts with the central banks of CLS currencies, of which there were 11 at the time of writing.

For the New Zealand dollar to be traded in this way, CLS Bank must become an ESAS account holder. In addition, the Reserve Bank must provide operational and technical support for the ESAS system during the daily CLS settlement window. This will require evening work, and new staffing arrangements are being implemented to provide this.

Internal Services

During the year, the Reserve Bank entered into a contract with OpenLink Financial, Inc. of New York for the purchase of a new treasury system. The system, which is scheduled to go live late in the 2004/05 financial year, and will deliver 'straight through processing', reducing operational risk attached to the Bank's financial management activities. 'Straight through processing' means a transaction needs to be entered into the Bank's treasury system only once, as opposed to many times as at present.

Other Outputs (International)

For accounting purposes, the Reserve Bank has an output classification entitled 'Other Outputs', which we use as a collect-all for some outputs that span departments. The main 'Other Output' is our international activities. These were more extensive than normal over the period under review.

In August 2003, the Reserve Bank became a shareholder in the Bank for International Settlements (BIS). The BIS is an international financial institution owned by about 50 central banks and based in Switzerland. It provides financial services to central banks, international financial institutions, and governments. The cost of the BIS shareholding was approximately NZ\$100 million, which was financed by the Reserve Bank. This delivers increased access to foreign currency funding, and stronger connections with the international central banking community, both of which could be very useful in a crisis.

The Bank invested US\$25 million in the newly created Asian Bond Fund. The Bank also continued to work with EMEAP⁹ to develop a second Asian Bond Fund dedicated to investing in less developed bond markets in the East Asia region.

During the review period, the Reserve Bank was a member of a Trans-Tasman Officials' Working Group which examined the pros and cons of further integration of trans-Tasman banking regulation. We were also the co-ordinating agency for a visit to New Zealand of the IMF Financial Sector Assessment Programme (FSAP), held over late 2003 and early 2004, to assess New Zealand's financial system.¹⁰ Bank staff 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.

Maintaining and developing links with other central banks, particularly those in the Asia-Pacific region, was helped by our participation in regional central bank groups, such as EMEAP and SEANZA.¹¹ Staff took part in EMEAP working groups on financial markets, payment and settlement systems, banking supervision, and information technology. The Reserve Bank represented New Zealand in several meetings of international groups dedicated to combating money laundering.

Staff undertook assignments for the International Monetary Fund, the World Bank, and other international agencies in Asia and the Pacific region, though fewer than in the past. Advice on monetary policy, broader economic policy and information technology, and assistance with assessments of financial sector stability were provided.

⁸ www.cls-group.com

⁹ Executives' Meeting of East Asia and Pacific central banks.

¹⁰ See page 16.

¹¹ SEANZA includes central banks from Australia, Bangladesh, China, Hong Kong, India, Indonesia, Iran, Japan, Korea, Macau, Malaysia, Mongolia, New Zealand, Nepal, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka and Thailand.

Our People

The Reserve Bank employed 216 staff or 210 full-time equivalents (FTE), as at 30 June 2004. Staff turnover during the year was 13.5 per cent, as shown in table 3.

The Reserve Bank continued to work on ensuring that it has the right people, systems and structures in place. In contrast to previous years, recruiting additional staff has become a priority, as a number of significant new projects have been initiated.

A new Human Resource Management Information System (HRMIS) was purchased to automate processes, provide easier staff access to information, and allow better reporting on the Bank's human resources. We have set ourselves the task of enhancing the capabilities of our managers, and the HRMIS will assist us assess our managers' capabilities and needs.

In the coming months, the Bank will commence live processing of the New Zealand dollar in the CLS system. This will require extended working hours, and over the past six months, through consultation with staff and selected recruitments, a new team has been put in place.

Remuneration

The Reserve Bank spent \$17.8 million on personnel in 2003/04. 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 remuneration¹² in 2003/04.

Table 3: Human Resource Statistics

	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Total staff at 30 June (FTE)	210	193	182	199	237	283	281	289	290	293
Average years of service at 30 June	8.8	9.2	9.2	9.4	9.4	8.8	8.3	8.7	8.6	8.6
Annual staff turnover	13.5%	11.3%	13.5%	14.9%	10.4%	10.0%	8.8%	10.6%	15.0%	9.6%

Table 4: Staff Receiving \$100,000 or More in 2003/04

Total remuneration	Staff numbers
\$100,000 to \$109,999	5
\$110,000 to \$119,999	6
\$120,000 to \$129,999	7
\$130,000 to \$139,999	1
\$140,000 to \$149,999	4
\$150,000 to \$159,999	6
\$160,000 to \$169,999	4
\$170,000 to \$179,999	2
\$180,000 to \$189,999	1
\$200,000 to \$209,999	1
\$210,000 to \$219,999	2
\$220,000 to \$229,999	1
\$230,000 to \$239,999	1
\$290,000 to \$299,999	1
\$350,000 to \$359,999	1
\$450,000 to \$459,999	1
Total	44

¹² 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 having regard to prevailing market conditions based on salary surveys and assessments made by an independent remuneration consultant.



Governors' Interests

The Governors note the following related interests. In each case, appropriate steps have been taken to ensure that no conflicts arise.

- Dr Abel: None.
- Mr Archer: None.
- Dr Bollard: The interests of his wife, Jenny Morel, in Morel and Co and No 8 Ventures Ltd.
- Mr Orr: Director Lake Taupo Funds Ltd (LTF) (LTF is wholly-owned by the Lake Taupo Forest Trust (Tuwharetoa Tribal Trust). Mr Orr cannot be a member of LTF's investment committee); Chairman Institute for the Study of Competition and Regulation.

More generally, the Reserve Bank maintains policies and practices to avoid or manage conflicts of interest among Governors and Bank staff. The Bank's Conflicts of Interest Policy requires that staff act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy also states that staff must avoid situations where their integrity might be questioned, and that their best protection is full disclosure of any potential conflicts. The full policy is available on the Bank's website.

Communications

During the review period, the Reserve Bank's external communications were in transition, reflecting new challenges facing the Bank.

The Reserve Bank has a long-standing tradition of transparency in relation to monetary policy. This is most notable in the way the Bank publishes the economic projections on which, in part, its interest rate decisions are based. This approach continues unchanged.

However, a new element has been added, in that the Reserve Bank has gained an additional capacity to intervene in the foreign exchange market to reduce the extremes of the exchange rate cycle. At year's end, details of how such an intervention would be managed were being worked on, and one of the issues was how an intervention would be communicated. When seeking to influence inflation expectations, the Bank's communications style has been simple, direct and forthright. However, the communications requirements of an intervention may well be more complex, and our initial thinking is that in this area at times the Bank will have to be more guarded.

The Reserve Bank's wider work on financial stability issues also presented the Bank with new communications challenges, as complex policy questions came to the fore, in some cases involving a number of government agencies and a trans-Tasman dimension. These demands can be expected to increase in the coming year. Again, these are areas where at times the Bank has to be reticent in what it says, although at times the Bank still will need to actively explain the difficult policy judgements that it will need to make.

Bank Priorities and Outcomes 2003/04

Through its annual planning and budgeting process, the Reserve Bank identifies a list of specific or one-off priorities and projects for the coming year, in addition to the Bank's day-to-day activities. This is then used as a template against which the Bank's departments must justify their proposed activities in the preparation of their budgets. Table 5 outlines the Bank's priorities, as set in the Bank's 2003 *Annual Report*, and the actual outcomes during the year under review.

Table 5: Bank Priorities and Outcomes 2003/04

Bank Priorities	Outcomes
<p>Price stability and growth</p> <p>Develop and communicate a better understanding of any impact that our current approach to pursuing price stability may have on sustainable economic growth. This includes understanding the relationships between monetary policy, inflation outcomes and growth.</p>	<p>A theoretical review of the issue was completed, and, at year's end, empirical tests were being developed. Results will be published later in 2004.</p>
<p>Exchange rate implications</p> <p>Continue to develop and communicate a better understanding of the implications of the exchange rate and its volatility for economic performance, and policy options to affect the exchange rate and its volatility.</p>	<p>A research programme was completed, and the results were reviewed in the June 2004 <i>Bulletin</i>.</p>
<p>Compliance with Basel Core Principles/international standards</p> <p>Determine the merits of full compliance with the Basel Core Principles of Banking Supervision and decide what, if any, further measures will be taken to more fully comply with these international standards.</p>	<p>The IMF FSAP report found New Zealand to have a good level of compliance. Their recommendations to improve our compliance further are, in broad terms, being implemented.</p>
<p>Financial Sector Assessment Programme (FSAP)</p> <p>Prepare for the October 2003 IMF FSAP assessment of the New Zealand financial system and how it is regulated, including codifying New Zealand's compliance with international standards and codes and coordinating with other agencies.</p>	<p>The IMF FSAP review of the New Zealand financial system was made public in April 2004, the results being positive.</p>
<p>Organisational form for foreign-owned banks</p> <p>Determine a policy on the organisational arrangements that the Reserve Bank requires of foreign-owned banks, including examining an 'enhanced' branch structure. This will include evaluating New Zealand incorporation, branch and different formulations of 'enhanced' branch structures, from a systemic stability perspective.</p>	<p>At year's end, the Reserve Bank was assessing a detailed proposal for a bolstered branch structure put forward by Westpac Banking Corporation.</p>
<p>Integration with Australia</p> <p>Determine the extent to which the New Zealand financial system and regulatory frameworks should be integrated with those of Australia versus pursuing a more autarchic approach. This will include discussions with the Australian authorities, The New Zealand Treasury and others.</p>	<p>A joint Australia/New Zealand working party reported to their relevant ministers in both countries at the end of June 2004.</p>
<p>Bank creditor recapitalisation (BCR)</p> <p>Further develop policy options for managing financial institutions in distress. This will include working with one or more registered banks to determine if the concept of BCR is feasible, as well as developing alternative and related prudential policies.</p>	<p>Pilot work on the BCR concept was completed, indicating that it is technically feasible. At year's end, work was underway on related failure management issues that need resolution before a formal policy position can be promulgated.</p>

Bank Priorities	Outcomes
<p>Failure-to-settle and governance arrangements Promote the implementation by registered banks of robust failure-to-settle arrangements in payment switches.</p>	Work on this issue with the New Zealand Bankers' Association continued.
<p>CLS Bank Implement systems required for the New Zealand dollar's acceptance by CLS Bank. This will require close cooperation and coordination with CLS shareholder banks in New Zealand.</p>	CLS Bank has scheduled testing and trialling for the New Zealand dollar's inclusion to be completed by November 2004. The New Zealand dollar is expected to be in the system by the end of 2004.
<p>Electronic document and records management system (EDMS) Upgrade or replace the Reserve Bank's EDMS system, ensuring that the system meets legal and statutory obligations and effectively manages the Bank's corporate knowledge.</p>	A contract to replace our existing document management system was entered into. At year's end, implementation had begun, which is expected to be completed in the 2004/05 year.
<p>Bank Projects 2003/04</p>	
<p>Treasury system Conclude an evaluation of treasury systems and substantially progress implementation of a new treasury system.</p>	A contract was entered into with a supplier to replace the existing treasury system. At year's end, implementation had begun, which is expected to be completed in the 2004/05 year.
<p>Liquidity management system Review and refine liquidity management related systems. This will include advice on possible new liquidity management tools and systems to replace the current use of outdated operational spreadsheets.</p>	An initial review of the requirements for this project was completed. However, the project was delayed due to resource constraints associated with the treasury system project. It is intended to recommence in 2005, when the treasury system project is completed.
<p>Austraclear/ESAS system Upgrade the technology base used for core payment systems (ie, Austraclear and ESAS).</p>	In April 2004, the technology underpinning the Austraclear and ESAS systems was successfully upgraded.

Financial Performance¹³

As well as being a statutory agency, the Reserve Bank is also a financial institution.

The Reserve Bank receives no funding from the consolidated account. Instead, income is generated, mainly by investing the proceeds from issuing currency. Registered banks pay the Reserve Bank the face value of currency being issued to them. The Reserve Bank invests the funds in New Zealand Government Securities, from which it receives income. The income directly associated with issuing currency is referred to as 'seigniorage'. The Reserve Bank retains a proportion of the seigniorage to pay for its operating costs and the rest, typically, is passed to the Government. The amount of seigniorage that the Bank may retain to pay for its operating costs is set in a five-year Funding Agreement with the Government. If the Reserve Bank does not spend the amount specified, the savings are retained and transferred to Equity.

The May 2000 Funding Agreement¹⁴ entitled the Reserve Bank to retain from its income the following amounts in order to meet the costs of carrying out its functions under the Act:

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

This is in addition to income earned from other specified activities for each of the relevant years.¹⁵

Table 6 shows the relationship between the assets and liabilities of the Reserve Bank, and their approximate values.

Table 6: The Financial Position of the Reserve Bank as at 30 June 2004

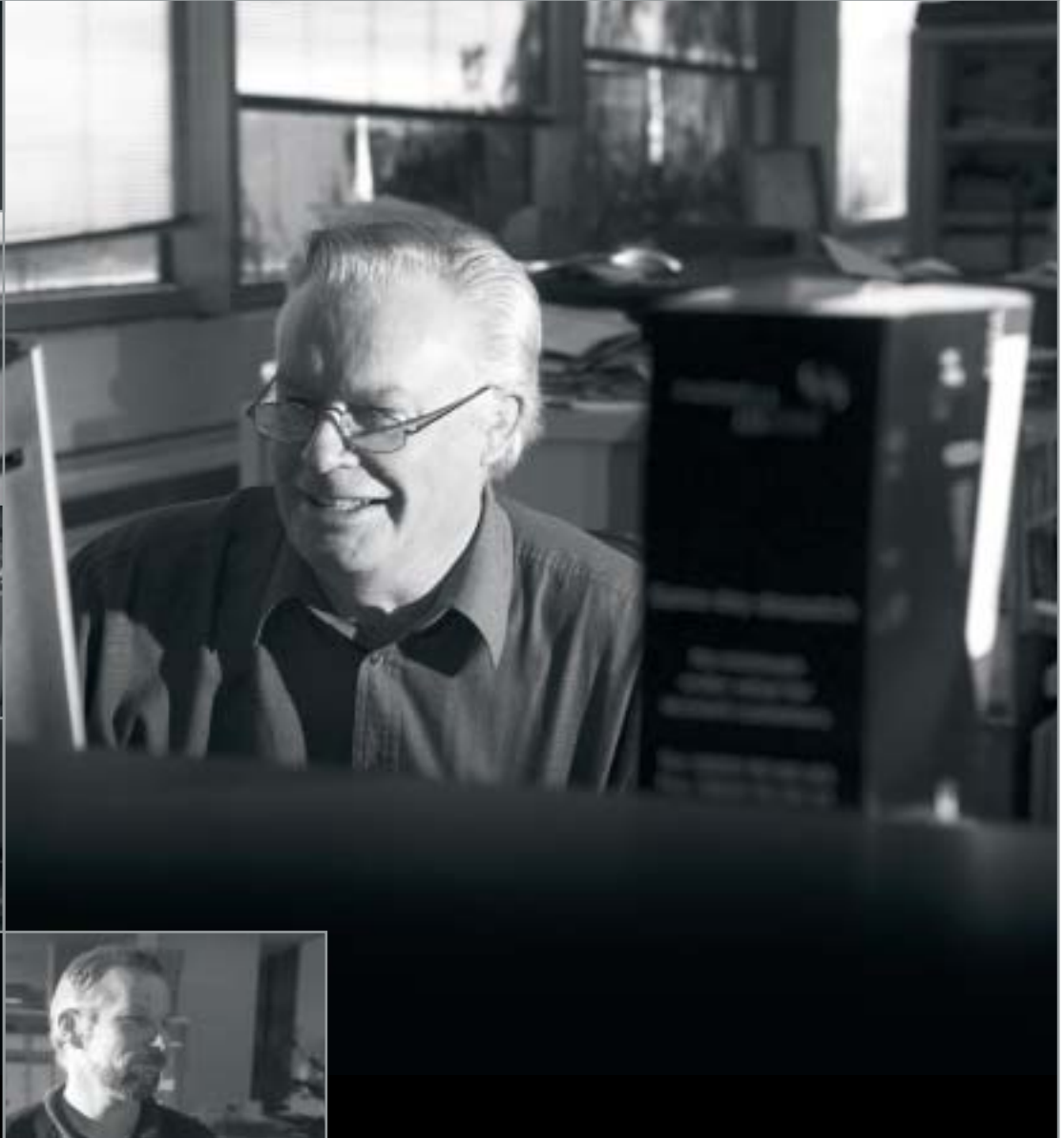
Assets		Liabilities
Foreign reserves funded mainly by loans from The Treasury.	\$5.6 billion	Loans from the Debt Management Office to fund the purchase of foreign reserves.
Assets arising from managing the cash operations of the Crown.	\$1.6 billion	Obligations to repay deposits with the Reserve Bank from the Crown and various others.
New Zealand Government Securities purchased with monies received from issuing currency.	\$2.9 billion	Obligation to replace bank notes and coins already in circulation.
		Equity
Other assets funded by the Equity of the Reserve Bank, including the Reserve Bank building and New Zealand Government Securities.	\$0.4 billion	The net investment by the Government in the Reserve Bank.
	Total \$10.5 billion	

¹³ In this section, an output, function, cost, asset or liability etc. that begins in capitals (eg, Net Expenditure) signifies an item in the financial tables and in the Bank's Financial Statements.

¹⁴ The Funding Agreement was varied in March 2004, as a result of the Bank obtaining an enhanced capacity to intervene in the foreign exchange markets. While the variation did not change the levels of net expenditure agreed previously, it provided that any expenditure incurred by the Bank in carrying out foreign exchange intervention under section 16 of the Reserve Bank Act would be excluded from the Funding Agreement and would be funded from the Equity of the Bank.

¹⁵ Income from other specified activities includes earnings from Exchange Settlement Account Services (ESAS), Registry Services, the Overseas Investment Commission Secretariat, and sales of collectors' currency and scrapped obsolete coins.





Financial Position 2003/04

At the end of the financial year (30 June 2004), the Reserve Bank's Total Assets, and Total Liabilities and Equity, were \$10.5 billion, compared with \$11.7 billion in the previous year. Key details were as follows:

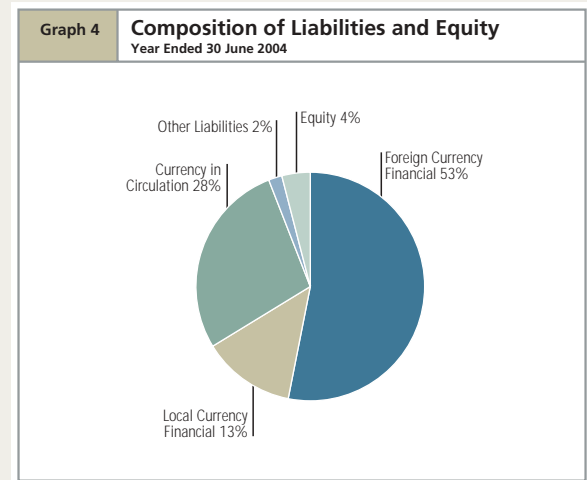
- Foreign currency assets and liabilities were similar to the previous year. These included our investment in the shares issued by the Bank for International Settlements, which was valued at \$95.7 million.
- Reductions in the Bank's New Zealand dollar assets were largely due to our reduced need to hold assets to offset liquidity shortfalls.
- Reductions in the Bank's New Zealand dollar liabilities were largely due to a bond maturity that lowered the balance in the Government Settlement Account.

- Immediately after balance date, on 1 July 2004, the Bank received from the Crown additional capital of \$1 billion. This was invested in New Zealand Government Securities. The additional capital provides the Bank with the financial capacity required to undertake intervention in the foreign exchange market. The additional \$1 billion capital and its investment in New Zealand Government Securities are not included in the Financial Statements in this *Annual Report*.

For a more complete picture of the financial position of the Reserve Bank as at 30 June 2004, see table 7 and graph 4.

Table 7: Financial Position 2003/04

	2004 June (\$m)	2003 June (\$m)
Assets:		
Foreign Currency Financial ¹⁶	5,681	6,216
Local Currency Financial ¹⁶	4,777	5,430
Other Assets	39	38
Total Assets	10,497	11,684
Liabilities and Equity:		
Foreign Currency Financial ¹⁶	5,574	5,102
Local Currency Financial ¹⁶	1,382	3,165
Currency in Circulation	2,920	2,806
Other Liabilities	200	195
Equity	421	416
Total Liabilities and Equity	10,497	11,684



¹⁶ 'Foreign Currency Financial' and 'Local Currency Financial' mean assets and liabilities denominated in either foreign currency (eg, United States dollar bonds) or local currency (eg, New Zealand Government Securities) respectively.

Financial Performance 2003/04

The operating expenditure of the Reserve Bank was \$37.0 million, which was \$0.7 million or 1.9 per cent below budget, and \$0.6 million or 1.6 per cent above actual expenditure for the previous year. In particular:

- Personnel Expenses were \$1.0 million more than budgeted, mainly due to restructuring and recruiting new staff;
- costs of issuing new coins and bank notes were \$1.0 million lower than budgeted, mainly due to fewer new bank notes than expected being issued during the Christmas seasonal peak;
- Asset Management Expenses were slightly lower than budget; and
- Other Operating Expenses were \$0.5 million less than budgeted, mainly due to lower-than-expected communication expenses and computer expenses.

Net expenditure on activities covered by the Funding Agreement was 11 per cent below the \$31 million permitted in the Funding Agreement. Underspending of the Funding Agreement by \$3.4 million was transferred to the Bank's Equity, which at 30 June 2004 was \$420.7 million.

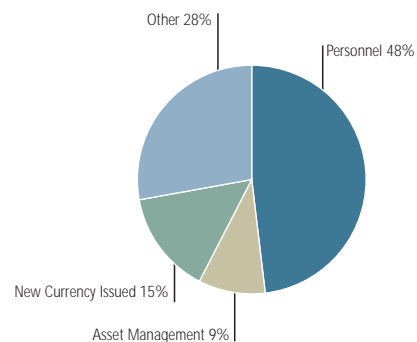
The Operating Surplus of the Reserve Bank was \$195.1 million against \$197.5 million budgeted.¹⁷ For the year under review, \$191.7 million will be paid to the Crown.

For a more complete picture of the Bank's financial performance during 2003/04, see table 8 and graphs 5 and 6.

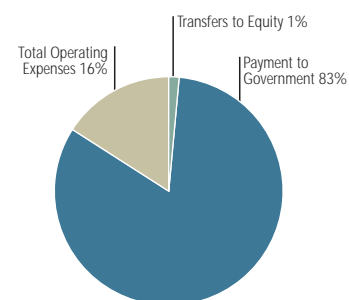
Table 8: Financial Performance 2003/04¹⁸

	2004 June		2003 June
	Actual (\$m)	Budget (\$m)	Actual (\$m)
Operating Income:			
Net Investment Income	222.7	226.2	216.1
Other Income	9.4	9.0	9.3
Total Operating Income	232.1	235.2	225.4
Operating Expenses:			
Personnel Expenses	17.8	16.8	15.6
New Currency Issued Expenses	5.4	6.4	6.1
Asset Management Expenses	3.5	3.7	4.0
Other Operating Expenses ¹⁹	10.3	10.8	10.6
Total Operating Expenses	37.0	37.7	36.3
Income Retained under the Funding Agreement	9.4	9.2	9.5
Net Expenditure under the Funding Agreement	27.6	28.5	26.8
Operating Surplus	195.1	197.5	189.1
Surplus for Appropriation to Government	195.1	197.5	189.1
Transfers to Equity	3.4	2.5	4.7
Payment to Government	191.7	195.0	184.4

Graph 5 Composition of Operating Expenses
Year Ended 30 June 2004



Graph 6 Appropriation of Operating Income
Year Ended 30 June 2004



¹⁷ Actual versus budgeted operating expenditure is a better guide to management performance than the Operating Surplus of the Reserve Bank, which moves up and down as interest rates change. Most of the income of the Bank comes from interest earned on the financial assets backing currency in circulation.

¹⁸ Figures in this section have been rounded. Totals have not been adjusted for rounding. Where amounts have been reclassified, comparative figures have been restated.

¹⁹ For the components of 'Other Operating Expenses', refer to note 34 on page 93.

Five Year Financial Position and Performance

To get a sense of how the Reserve Bank has evolved financially, it is useful to examine its financial performance over the last five years.

Key points to note are that from 2000 to 2004:

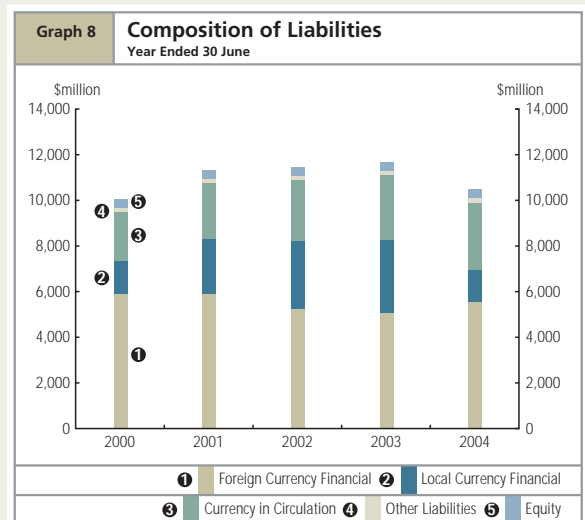
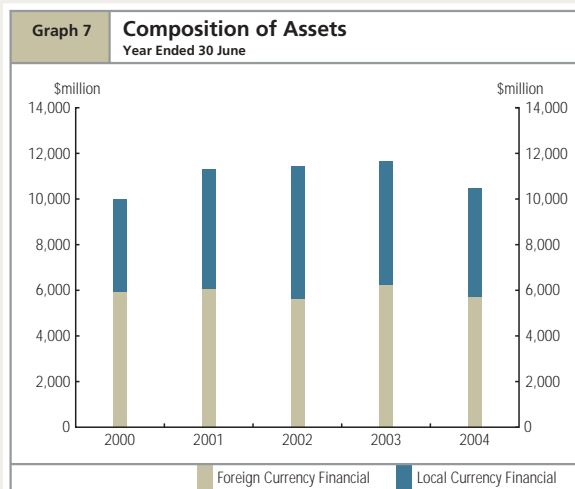
- the functions of the Reserve Bank did not change;
- staff numbers reduced from 237 to 210 (FTE), mostly due to fewer staff being required for currency processing;

- the income of the Bank increased in line with the increase in the amount of Currency in Circulation;
- currency processing in Auckland and Christchurch ceased, and our building in Auckland was sold; and
- changes in exchange rates resulted in changes in levels of foreign currency assets and liabilities.

A more complete picture is presented in tables 9 and 10, and graphs 7, 8, 9 and 10.

Table 9: Five Year Financial Position²⁰

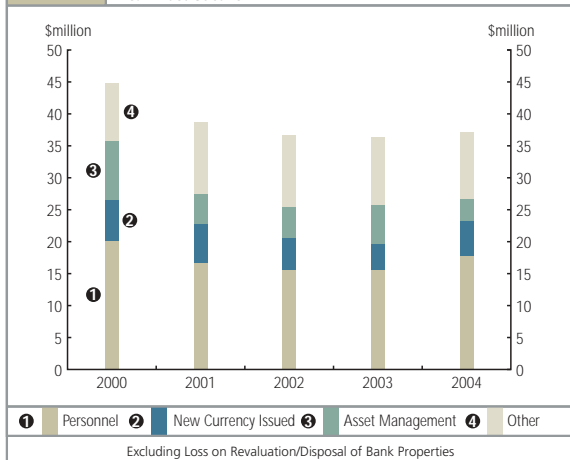
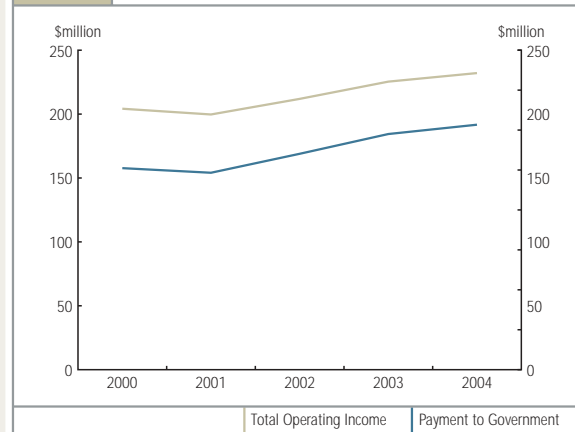
	2004 June (\$m)	2003 June (\$m)	2002 June (\$m)	2001 June (\$m)	2000 June (\$m)
Assets:					
Foreign Currency Financial	5,681	6,216	5,606	6,054	5,898
Local Currency Financial	4,777	5,430	5,821	5,225	4,092
Other Assets	39	38	38	46	51
Total Assets	10,497	11,684	11,465	11,325	10,041
Liabilities and Equity:					
Foreign Currency Financial	5,574	5,102	5,253	5,908	5,899
Local Currency Financial	1,382	3,165	2,962	2,379	1,405
Currency in Circulation	2,920	2,806	2,659	2,463	2,160
Other Liabilities	200	195	180	170	177
Equity	421	416	411	405	400
Total Liabilities and Equity	10,497	11,684	11,465	11,325	10,041



²⁰ Figures in this section have been rounded. Totals have not been adjusted for rounding error. Where amounts have been reclassified, comparative figures have been restated.

Table 10: Five Year Financial Performance

	2004 June (\$m)	2003 June (\$m)	2002 June (\$m)	2001 June (\$m)	2000 June (\$m)
Operating Income:					
Net Investment Income	222.7	216.1	201.6	190.5	192.8
Other Income	9.4	9.3	10.3	9.2	11.4
Total Operating Income	232.1	225.4	211.9	199.7	204.2
Operating Expenses:					
Personnel Expenses	17.8	15.6	15.6	16.8	20.2
New Currency Issued Expenses	5.4	6.1	4.7	4.7	9.3
Asset Management Expenses	3.5	4.0	5.0	6.1	6.3
Other Operating Expenses	10.3	10.6	11.3	11.1	9.0
Loss on Disposal of Property	0.0	0.0	0.3	0.8	0.0
Total Operating Expenses	37.0	36.3	36.9	39.5	44.8
Income Retained under the Funding Agreement	9.4	9.5	11.1	10.8	11.8
Net Expenditure under the Funding Agreement	27.6	26.8	25.8	29.4	33.1
Operating Surplus	195.1	189.1	175.0	160.2	159.4
Taxation ²¹	0.0	0.0	0.0	0.7	0.1
Surplus for Appropriation to Government	195.1	189.1	175.0	159.5	159.3
Transfers to Equity	3.4	4.7	6.1	5.4	1.6
Payment to Government	191.7	184.4	168.9	154.1	157.7

Graph 9 Operating Expenses
Year Ended 30 June**Graph 10 Operating Income**
Year Ended 30 June

21 There was no taxation expense in 2002 to 2004, as RBNZ Registry Limited, a subsidiary company of the Reserve Bank, ceased trading on 30 June 2001.

Five Year Costs of Services

This section describes how the expenditure of the Bank has changed over time.

The Reserve Bank classifies its outputs according to nine main functions, as described on page 49. Over the last five years:

- Net Expenditure under the Funding Agreement has remained relatively stable;
- the cost of providing Financial System Surveillance services has increased steadily, reflecting higher levels of staffing, legal and other professional service costs;
- Currency Operations expenses were higher during the 2000 financial year, largely due to the costs of introducing polymer bank notes, but their longer life has

resulted in lower note issue costs in subsequent years;

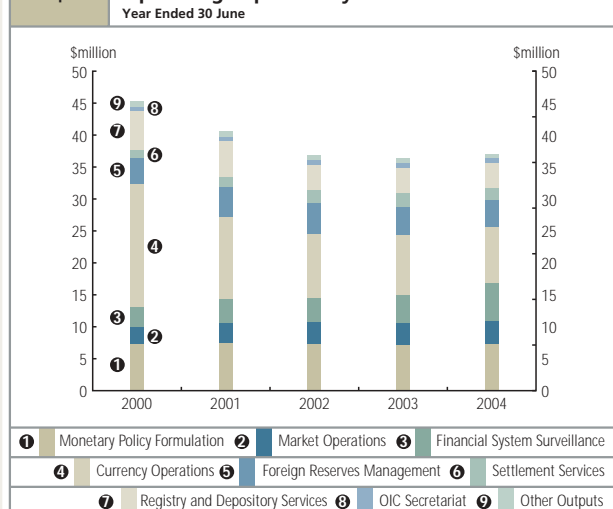
- lower Registry and Depository Services expenditure after 2001 was due to the outsourcing of the Bank's registry services; and
- increased Settlement Services costs reflect new services provided to settlement account holders, these costs being recovered through fees charged.

For more information about the total expenditure incurred to provide each function for the last five years, including internal transfers between functions, see table 11 and graphs 11 and 12.

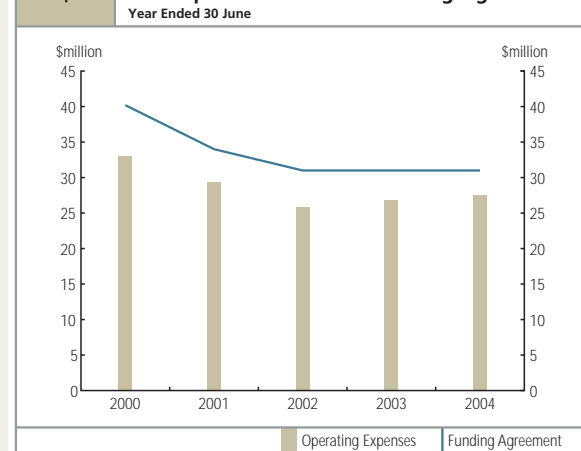
Table 11: Five Year Costs of Services²²

Functions:	2004 June (\$m)	2003 June (\$m)	2002 June (\$m)	2001 June (\$m)	2000 June (\$m)
Monetary Policy Formulation	7.3	7.1	7.3	7.4	7.2
Market Operations	3.6	3.4	3.3	3.2	2.8
Financial System Surveillance	5.8	4.4	3.9	3.6	3.1
Currency Operations	8.8	9.4	10.0	12.9	19.2
Foreign Reserves Management	4.3	4.4	4.8	4.7	4.1
Settlement Services	2.0	2.3	2.1	1.7	1.3
Registry and Depository Services ²³	3.8	3.9	3.9	5.5	6.1
Overseas Investment Commission Secretariat	0.9	0.7	0.9	0.7	0.7
Other Outputs	0.5	0.7	0.7	0.9	0.8
Total	37.0	36.3	36.9	40.6	45.3
Less Intercompany Transactions	0.0	0.0	0.0	0.4	0.4
Total for Bank	37.0	36.3	36.9	40.2	44.9
Income Retained under the Funding Agreement	9.4	9.5	11.1	10.8	11.8
Net Expenditure under the Funding Agreement	27.6	26.8	25.8	29.4	33.1

Graph 11 Operating Expenses by Function



Graph 12 Net Expenses under the Funding Agreement



22 These numbers have been restated to show Net Expenditure under the Funding Agreement methodology applicable from 1 July 2000.

23 These figures include taxation expenses.



As described earlier, each year the Reserve Bank prepares a list of priorities and projects in addition to its 'business as usual' activities. The priorities and projects set for the 2004/05 financial year are reported below, followed by details of the Bank's budget for the period.

Bank Priorities for 2004/05

1. Rethink outsourcing policies

- Develop, consult on, and begin implementing an 'outsourcing' policy for systemically important banks. This policy is to ensure that the board of a bank, or a statutory manager, has unambiguous legal and operational reach over the bank's core functions and resources if a service provider, including a parent bank, fails to deliver.

2. Resolve whether alternatives are possible to mandatory local incorporation for systemically important banks

- Decide whether a 'buttressed-branch' organisational form is an acceptable alternative to requiring local incorporation of systemically important banks, and initiate any necessary legislative or regulatory initiatives following from that decision.

3. Test the Reserve Bank's capacity to manage a bank failure

- Develop and test techniques and processes for managing financial system stress, including a major bank failure, and undertake a bank failure exercise.

4. Refine foreign exchange intervention strategy and processes

- Develop and maintain a capability to manage the Reserve Bank's new levels of reserves and capital.
- Design a decision-making framework and protocols for intervening in the foreign exchange market to reduce, at the margin, the extremes of the exchange rate cycle.
- Continue to develop foreign exchange intervention protocols for combating dysfunction in the foreign exchange market.

5. Identify policy options to reduce exchange rate variance

- Identify structural explanations for New Zealand's exchange rate variability, and its costs and benefits to the economy, and ensure that the Reserve Bank's monetary policy arrangements are appropriate for an economy in which the exchange rate fluctuates.
- Research additional policy tools that might assist in reducing interest rate and/or exchange rate variability.

6. Identify monetary policy approaches that deal better with uncertainty

- Identify different types of uncertainties and best practice responses when setting monetary policy.
- Investigate additional forecasting approaches that represent low-cost, credible alternatives to current model-based projections, and integrate them into the monetary policy process as alternative perspectives.

7. Treasury system implementation

- Complete implementation and testing of software, so the Reserve Bank's new treasury system is operational by 30 June 2005.

8. Silver coinage review

- Finalise a strategy to provide 'silver' coin that is more cost-effective to produce and more user-friendly for the public and cash handlers.

9. Develop and implement management and key person strategy

- Enhance the Reserve Bank's management capacity by developing a range of resources, programmes, and processes based on the Bank's management profile.

Major Projects

In addition, the Bank has identified the following as key projects for 2004/2005:

1. Electronic document management system implementation

- Implement a replacement records and document management system, including revised file classification and email migration, by 31 March 2005.

2. CLS implementation

- Ensure that the Reserve Bank is ready to commence live processing of New Zealand dollars in CLS Bank before November 2004, as scheduled by CLS Bank.

3. Business Continuity Planning (BCP)

- Review, confirm and implement agreed BCP strategies and any incremental infrastructure upgrades by 30 June 2005.

Budget Information for 2004/05

The following outlines the budget plans for the Reserve Bank for 2004/05.²⁴

Key expectations and assumptions are that:

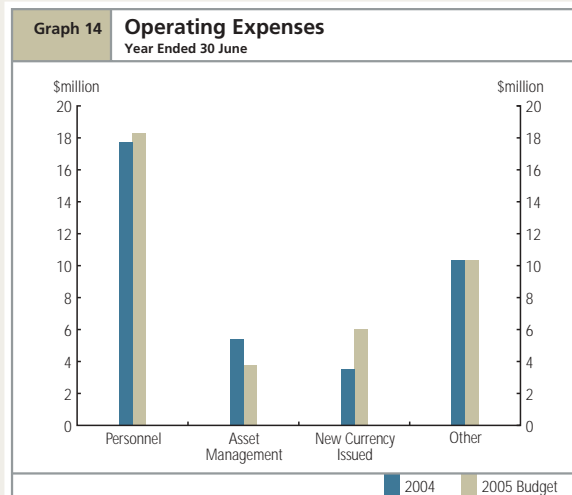
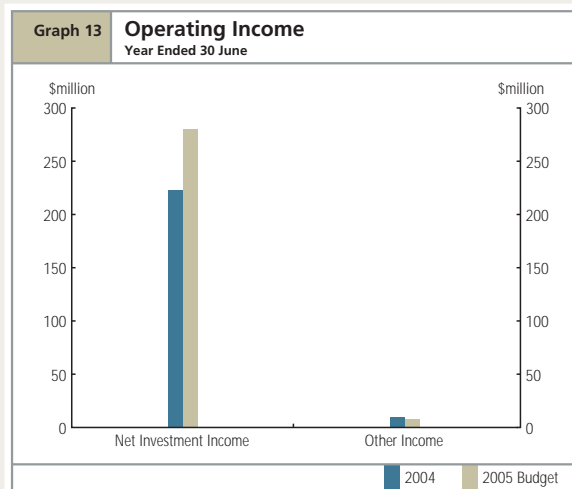
- the current functions of the Bank will continue;
- activity in the Foreign Reserves Management and Market Operations functions will be similar to the previous year;
- interest and exchange rates will be those prevailing as at 31 March 2004;
- the Bank will have no material open foreign currency positions during the year;
- the capital injection of \$1 billion received from the Crown on 1 July 2004 will remain invested in a portfolio of New Zealand Government Securities;
- Operating Income and the surplus transferred to the Crown will increase due to higher income from Government Securities;

- Personnel Expenses will increase as a result of more staff working on the Monetary Policy Formulation, Market Operations, and Financial System Surveillance functions, and the Overseas Investment Commission Secretariat;
- Other Operating Expenses, such as professional fees relating to contracted security services and advice relating to Financial System Surveillance, will increase;
- Registry and Depository Services expenses will decrease, due to the closure of the retail registry business in December 2004; and
- currency expenses will increase as a result of more currency in circulation and the faster replacement of damaged or unfit \$5 notes.

Tables 12 and 13 and graphs 13 to 16 provide more detail.

Table 12:
Budgeted Financial Performance 2004/05²⁵

	Budget 2005 (\$m)	Actual 2004 (\$m)
For the year ended 30 June		
Operating Income:		
Net Investment Income	280.7	222.7
Other Income	8.3	9.4
Total Operating Income	289.0	232.1
Operating Expenses:		
Personnel Expenses	18.3	17.8
Asset Management Expenses	3.8	5.4
New Currency Issued Expenses	6.0	3.5
Other Operating Expenses	10.4	10.3
Total Operating Expenses	38.5	37.0
Surplus Available for		
Appropriation to Government	250.5	195.1
Funding Agreement		
Under-Expenditure	2.9	3.4
Provision for Transfer of		
Surplus to Government	247.6	191.7

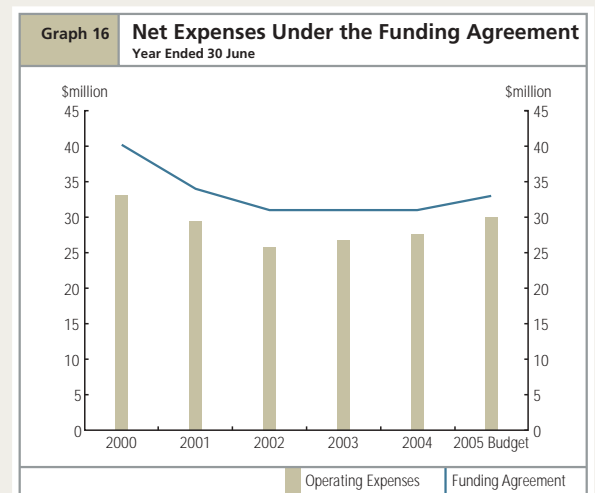
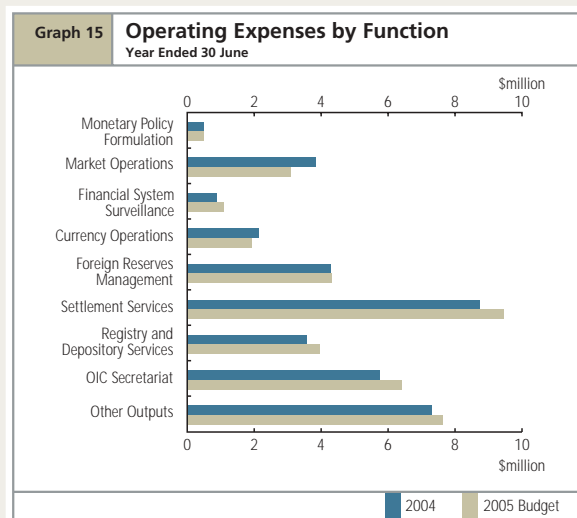


²⁴ The budget figures are provided in accordance with section 163 (1) (d) of the Reserve Bank of New Zealand Act 1989.

²⁵ Figures have been rounded. Totals have not been adjusted for rounding.

Table 13: Budgeted Costs of Services 2004/05

	Operating Income Budget 2005 \$000	Operating Income Actual 2004 \$000	Operating Expenses Budget 2005 \$000	Operating Expenses Actual 2004 \$000	Operating Surplus (Deficit) Budget 2005 \$000	Operating Surplus (Deficit) Actual 2004 \$000
For the year ended 30 June						
Functions:						
Monetary Policy Formulation	0	0	7,632	7,326	(7,632)	(7,326)
Market Operations	796	(781)	3,965	3,565	(3,169)	(4,346)
Financial System Surveillance	36	3	6,402	5,768	(6,366)	(5,765)
Currency Operations	198,930	195,880	9,476	8,767	189,454	187,113
Foreign Reserves Management	2,500	(1,459)	4,322	4,277	(1,822)	(5,736)
Settlement Services	1,846	2,067	1,930	2,137	(84)	(70)
Registry and Depository Services	3,924	4,791	3,108	3,842	816	949
Overseas Investment Commission Secretariat	1,081	829	1,084	864	(3)	(35)
Other Outputs	0	0	501	488	(501)	(488)
Total for Bank before Earnings on Investments Funded by Equity	209,113	201,330	38,420	37,034	170,693	164,296
Earnings on Investments Funded by Equity	79,960	30,841	0	0	79,960	30,841
Total for Bank	289,073	232,171	38,420	37,034	250,653	195,137
Income Retained under the Funding Agreement			8,441	9,423		
Net Expenditure under the Funding Agreement			29,979	27,611		



Reserve Bank of New Zealand

Board of Directors

Annual Report for the Year ended 30 June 2004

This report is made pursuant to section 53A of the Reserve Bank of New Zealand Act 1989.

The Reserve Bank undertakes a number of roles that are of fundamental importance for a sound and efficient financial system and a well functioning economy. These roles include its primary function to formulate and implement monetary policy with the purpose of maintaining stability in the general level of prices. They also include the registration and prudential supervision of banks. Another important function is the supply of New Zealand's currency. If any of these functions were not conducted well, there could be major ramifications for the New Zealand economy and for individual New Zealanders.

Our role as directors of the Bank is to keep the Bank's performance in carrying out these, and its other functions, under constant review. In doing so, we have placed as much attention on the Bank's financial stability functions (including banking registration and prudential supervision) as on the monetary policy role. Without a sound and efficient financial system the country cannot have a sound and efficient economy.

During the period, there have been major matters to deal with in the financial stability field. In a July 2003 speech (published in the September 2003 *Reserve Bank Bulletin*) the Governor, Dr Alan Bollard, committed to keeping the Bank's prudential regulatory system invigorated and focused. The Board has been supportive of this policy direction.

We found the IMF Financial Stability Assessment Programme (FSAP) report, and the exercise leading to the preparation of that report, particularly useful in our review role. We were pleased that the report recognised the strength of the New Zealand banking system, together with the overall soundness and transparency of the financial policies that underlie this strength. We were also pleased that the IMF supported the Bank's planned reinvigoration of financial stability policy, while wishing to maintain the strong market disciplines that characterise New Zealand's financial stability regime. The IMF highlighted some key issues as candidates for policy attention. Included amongst these were potential crisis management problems arising from the existence of a systemically important foreign bank branch operating within New Zealand, and from subsidiaries of foreign banks not being economically viable on their own at all times due to their outsourcing of key activities offshore. The Bank's work agenda was already addressing each of these issues. Over the next year, we will be keeping under close review the Bank's responses to all the issues raised in the IMF's report.

Major events have occurred over the past year, which have given the Reserve Bank the chance to revisit aspects of its bank registration and supervision approach. One such event was the acquisition of The National Bank of New Zealand Limited by ANZ Banking Group (New Zealand) Limited. The Reserve Bank processed this transaction with thoroughness and in a timely manner, and we have

followed closely the policy decisions being taken regarding its implementation. A major issue facing the Bank through the period has been that of local incorporation of systemically important banks in New Zealand. We are keeping the Bank's policies and proposals in this field under review. We note the wider policy desire of the Government to harmonise trans-Tasman arrangements to the mutual benefit of New Zealand and Australia. This desire is being incorporated into the Bank's analysis of relevant matters.

It is the Board's duty to ensure that the Reserve Bank uses its powers for the purposes stated in the Act. In terms of the bank registration and prudential supervision functions, these purposes are "Promoting the maintenance of a sound and efficient financial system" and "Avoiding significant damage to the financial system that could arise from the failure of a registered bank". We continue to keep these purposes uppermost in our minds when reviewing the Bank's work in the financial stability field.

The Board has also been active in keeping the ongoing formulation and implementation of monetary policy under review. In this regard, we regularly review performance relative to the Policy Targets Agreement (PTA) signed between the Minister of Finance and the Governor in September 2002. We note that throughout the year to June 2004, the annual rate of CPI inflation stayed within a range of 1.5 per cent to 2.4 per cent. The Official Cash Rate (OCR) has been changed on occasions but has stayed within a range bounded by 5.0 per cent and 5.75 per cent. Consequently, interest rates (especially at the short end) have followed a relatively smooth path over the year.

Perhaps more important for our review function is the outlook for inflation based on current and expected monetary policy settings. In its June 2004 *Monetary Policy Statement*, the Bank forecast annual CPI inflation to rise to 3.25 per cent throughout 2005 before falling to 2.25 per cent in the latter half of 2006. The Bank forecasts GDP growth to average between 2.5 per cent and 3.0 per cent per annum over the next three years. These forecasts incorporate a projected rise in 90 day interest rates to 6.5 per cent. Current market forecasts of CPI inflation over the next two years (given by NZIER's June 2004 Consensus Forecasts) show an average forecast of 2.7 per cent in the year to March 2005 and 2.4 per cent in the year to March 2006. Consensus Forecasts of GDP growth over each of the next two years are 3.0 per cent and 2.2 per cent respectively. We see each of these expectations and recent outcomes as being consistent with requirements set out in the PTA. In particular, despite the projected short-term rise in inflation, CPI inflation is projected to be maintained within a range of 1 to 3 per cent per annum *on average over the medium term*, and there is little volatility in interest rates and output growth.

As noted in last year's Reserve Bank Non-Executive Directors' 2003 Annual Report, there has, however, been greater volatility in New Zealand's exchange rates. The TWI started the year (July 2003) at 62.3, rising to a peak of 69.0 in February, and troughing at 61.5 in May. We are aware of concerns in some quarters at the degree of this volatility. At the same time, we are aware that the world currency markets have shown considerable volatility which has impacted on New Zealand rates. For instance, the US-Australian exchange rate has ranged between 0.64 and 0.80 over the year.

For some time, the Bank has been examining measures and policies which may be used to dampen exchange rate volatility. The Board is supportive of the Bank conducting detailed analysis in this area. We kept under close review the work within the Bank on whether it should seek an increase in its capital and in its foreign reserves so as to give it greater capability to stand against extreme exchange rate movements. We are cognisant of the potential dangers and costs that can arise from injudicious exchange rate intervention. We are also cognisant of regimes that have successfully 'taken the edge' off major exchange rate cycles. The Bank's internal analysis of the options in this regard was rigorously researched. We were privy to the depth of this research and consider that the Bank's recommendations are well grounded and supported by its analysis. We are comfortable with the resulting moves to increase the Bank's capital and foreign reserves portfolio.

Notwithstanding these moves, the exchange rate is likely to remain an avenue through which the New Zealand economy is subject to volatility. This will continue to pose some difficulties for monetary policy implementation at times. Volatility in the housing market and related areas is also likely to cause continuing complexities for the Bank's monetary policy tasks. Over the past year, the Bank has had to make judgements in its monetary policy decisions that involve trading off the risk of an overheated domestic economy against the risk of low profitability for the traded goods sector, while maintaining inflation within the required range. Additional analytical work that investigates potential methods of dampening these types of volatility will need to remain a vital part of the Bank's research programme.

Other areas of the Bank's activities continue to be conducted effectively. The vital role of the Bank in providing a high quality currency for everyday transactions continues to be conducted efficiently, especially in light of the major cost savings over recent years. The Bank's role in providing and supervising high value payments systems is important for the soundness and efficiency of the financial system and appears to have been conducted effectively throughout the year.

The Bank has taken two major investment decisions (other than capital and foreign reserves decisions) over 2003/04. It became a shareholder in the Bank for International Settlements, and invested in the Asian Bond Fund along with other East Asian central banks. The Board considered the Bank's internal analysis prior to taking these decisions and supported the decisions.

Some of the Bank's policy programmes, especially in the financial stability field, are placing greater resource requirements on the Bank. We have been supportive of the Governor increasing staffing in key financial stability areas to ensure that policy development is rigorously undertaken and completed in a timely manner. In this field, having appropriate precautionary policies in place is very important in that they may prevent a very sizeable recession if a potential crisis is thereby averted.

Overall, the Bank operates with a much reduced call on state resources than hitherto, and this is pleasing. We do not expect, however, to see a continuation of the expenditure reduction trend witnessed over the past 10 years. We anticipate that the Bank will have to expand its staff complement slightly in order to address the complex policy tasks that it has before it. These tasks are reflected in the Bank's priorities and key projects that it has adopted for the coming year. We therefore expect to see some small upward movement in the Bank's expenditure being required over coming years.

The Bank's governance arrangements changed during the year with the passage of the Reserve Bank of New Zealand Amendment Act 2003. The Amendment Act provided for the roles of Chief Executive and Chair of the Board of Directors to be split, with a non-executive director being elected annually as Chair by the non-executive directors. Arthur Grimes was elected Chair in September 2003, and Alison Paterson was appointed by directors as Deputy Chair.

During the year, Ruth Richardson's term as Director came to an end and the directors wish to record their thanks for her extremely valuable contributions. Professor Marilyn Waring joined the Board as a director, bringing valuable experience and public policy insights to the role. The Governor, Alan Bollard, remains a director of the Bank following the legislative change. He continues to provide highly competent and effective leadership of a complex organisation. Dr Bollard has a strong and open working relationship with the Board which greatly assists the Board, and the Bank generally, in performing its roles.

As noted in the 2003 Annual Report, Dr Rod Carr did not seek reappointment as the Bank's Deputy Governor when his existing term expired. In his place, the Board appointed Adrian Orr as Deputy Governor, on the recommendation of the Governor. The Bank is fortunate to be able to appoint someone of Mr Orr's calibre and experience and he is making a highly effective contribution to the Bank. The Board also welcomes Dr Don Abel to the Bank as Assistant Governor, replacing Murray Bain who departed after a very positive contribution to the Bank to become Chief Executive of another government agency. David Archer, Assistant Governor, is to take leave of absence from the Bank to take up a position at the Bank for International Settlements. David has contributed hugely to the Bank since he joined the staff in 1978. The Board thanks him for his efforts to date and wishes him every success during his period of leave.



Arthur Grimes
Chair
Board of Directors
Reserve Bank of New Zealand
19 July 2004



Alison Paterson
Deputy Chair
Board of Directors
Reserve Bank of New Zealand
19 July 2004

