



ANNUAL REPORT
2007-2008

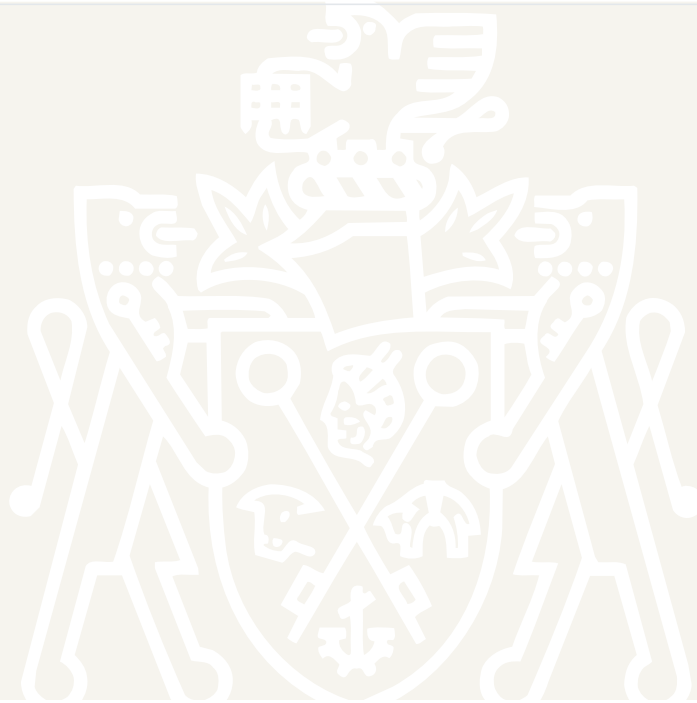
RESERVE BANK OF NEW ZEALAND
ANNUAL REPORT
2007-2008

*Reserve Bank of New Zealand Annual Report and Financial Statements for the financial year ended
30 June 2008, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989,
published September 2008.*

ISSN 0110 7070

CONTENTS

Our Vision and Values	3
The Reserve Bank of New Zealand – what we do.....	4
The year at a glance	5
Governor’s Statement.....	6
Board of Directors’ Report for the year ended 30 June 2008	8
Planning and reporting framework.....	12
Strategic Priorities and outcomes 2007/08	13
Reserve Bank departmental structure	14
Board of Directors	15
Governance.....	16
Chronology	20
The year in review	22
- Monetary policy formulation	22
- Domestic markets and foreign reserves management.....	23
Box 1: Developments in foreign reserves management.....	25
- Financial system surveillance and policy.....	27
Box 2: Expansion of the Reserve Bank’s prudential role ...	29
- Currency operations	30
- Depository and settlement services.....	30
- Human resources.....	32
- Knowledge services	34
Box 3: Intranet	34
- Internal financial services	35
- Communications	36
- Property management and security	36
Box 4: Sustainability	37
Box 5: Reserve Bank Museum	38
- International activities.....	38
Our financial statements – an overview.....	39
Box 6: Volatility and capital injection	47
- Projected financial performance 2008/09	48
- Strategic priorities for 2008/09	50
Contents of the Financial Statements	51
Management Statement.....	52
Audit Report.....	53
Reserve Bank of New Zealand 2007/08 Financial Statements.....	56
Five-year historical financial information	106



OUR VISION

We promote a sound and dynamic monetary and financial system.

WE WORK TOWARDS OUR VISION BY:

- operating monetary policy to achieve and maintain price stability;
- assisting the functioning of a sound and efficient financial system;
- meeting the currency needs of the public;
- overseeing and operating efficient payment systems; and
- providing effective support services to the Bank.

OUR VALUES

INTEGRITY

- Being professional and exercising sound judgement.

INNOVATION

- Actively improving what we do.

INCLUSION

- Working together for a more effective Bank.

THE RESERVE BANK OF NEW ZEALAND – WHAT WE DO

The Reserve Bank of New Zealand is the nation's central bank. The Bank has three main functions, which contribute to New Zealand's prosperity and advancement.

Monetary policy

Under the Reserve Bank of New Zealand Act 1989, the Bank is given operational independence to manage monetary policy to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement. (See page 22 for more detail on monetary policy activity in 2007/08.)

Financial stability

The Act also directs the 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". (See pages 27-29 for activity in 2007/08.)

To achieve these requirements, the Reserve Bank registers banks and operates a banking supervision system designed to encourage banks to manage their risks carefully. 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 required.

Currency

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. (See page 30.)

The Reserve Bank also provides settlement services to the Government and financial institutions.

Our internal organisation is illustrated in the chart on page 14. Details of the Reserve Bank Board of Directors are provided on page 15. The role of the Board, and the governance and management of the Bank, are described on pages 16-19.

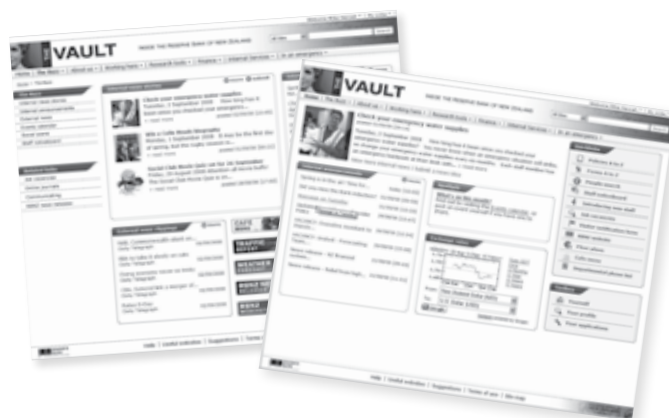
THE YEAR AT A GLANCE

- Consumers Price Index (CPI) inflation rose from 2.0 percent for the 12 months to June 2007 to 4.0 percent for the 12 months to 30 June 2008.
- The Bank raised the Official Cash Rate (OCR) in July 2007 from 8.0 percent to 8.25 percent, where it remained for the rest of the year. (The Bank cut the OCR to 8.0 percent on 24 July 2008.)
- The Bank made a submission to the Finance and Expenditure Committee's Inquiry into the Future Monetary Policy Framework.

- The Bank built a holding of unhedged foreign reserves to enable a more effective foreign exchange intervention capacity.
- The Bank took measures to reduce volatility in interest rates, which stemmed largely from the US sub-prime mortgage crisis.
- The Bank widened the pool of high-grade debt securities available for banks to borrow against at the Reserve Bank, in the event that cash became hard to access in the markets.

- Legislation was introduced to Parliament to give effect to Cabinet's decision that the Bank will be the new prudential regulator of non-bank deposit takers.
- The Reserve Bank accredited four New Zealand banks under the Basel II accord.
- The Bank issued a consultation paper on prudential regulation of the insurance industry.

- Parliament approved a \$600 million capital injection for the Bank as a buffer against potential future financial volatility on its balance sheet.
- The Reserve Bank became the first central bank to become a member of CLS Bank, allowing the Bank to simultaneously settle both elements of foreign exchange transactions, thereby reducing settlement risk.
- The Reserve Bank spent a net \$38.1 million on activities covered by its Funding Agreement, which was 7.1 percent below the \$41 million in the Agreement. The Bank generated a surplus of \$535 million. It is proposed that a dividend of \$168 million be paid to the Crown.¹



► During the year we refreshed our Intranet to enhance communication across our diverse teams, reflecting our values of Inclusion and Innovation.

¹ The dividend to the Crown is subject to confirmation by the Minister of Finance after balance date. Additional volatility in the Bank's net income, equity and distribution will result from having an open foreign exchange position and from an accounting policy change. See page 46.



GOVERNOR'S STATEMENT

Central banks are expected to steer a steady course, negotiating hazards like inflation, recession and financial stresses, so others can go about their business achieving economic prosperity. When these three hazards all threaten at the same time, both in New Zealand and internationally, we have a big challenge on our hands.

For some years we have been highlighting in our *Financial Stability Reports* the growing risks from cheap international credit, over-stretched economies, growing international imbalances, and the international housing boom. Many people have recognised this would be unsustainable, but few picked the trigger event for the correction. A year ago we started to hear about problems arising from the holders of financial instruments originating from US sub-prime mortgages. This quickly turned into a short-term credit crunch around the Western world, then into pressure on investment banks as they revalued their credit-based assets, and broadly into an increased cost of funding for all financial institutions.

Australasian banks have had little exposure to the sub-prime related credit instruments, but they are not insulated from the ultimate effects. There is a particular vulnerability in countries like Australia and New Zealand with low savings rates and a high reliance on foreign funding. The domestic situation has been exacerbated by the failure of many finance companies, especially some property development finance companies, which in turn has sped up withdrawals from some property

and mortgage trusts, forcing freezes. Withdrawn money has flowed back into the banks as deposits. We believe the banking system remains robust, but some of the more peripheral parts of the financial system have suffered a lot. This has affected just over \$5 billion of funds, much of which is frozen, but not necessarily lost. Serious as this is, it needs to be remembered that institutions not affected by these current events account for almost 90 percent of funds in the financial system. The vast bulk of the system – banks and others – are well capitalised businesses.

Tighter monetary policy through 2006/07 and 2007/08 and tougher international credit conditions have contributed to a rapid cooling of the housing and construction sectors. For years we have been warning of the risks in the way that some New Zealanders have invested in property and little else. Housing is looking extremely weak in the US and some other countries. It is not as bad in New Zealand, but the drop in housing activity and house prices together with more expensive mortgage funding is now hitting households. At the same time, shoppers are facing significant price rises, and these two pressures are depressing household consumption. Together with a drought earlier in the year, that has been enough to end the decade of uninterrupted growth.

Oil prices have been rising inexorably for the last four years, consistently topping expert forecasts, and continuing until recent falls. We have seen a parallel rise in mineral and industrial commodity prices, spreading over the last few years into food prices. This has been driven by a combination of supply, demand and regulatory forces, and we believe it contains both temporary and ongoing elements. This is bad news for New Zealand (the price of oil and industrials)

and good news too (the price of dairy and other primary products). It is hard to invest and regulate wisely with such huge price movements happening, especially when they are confused by major (and related) swings in the value of the pricing currency – the US dollar. New Zealand businesses have coped reasonably well with this so far.

The upshot of all these price shocks is worldwide inflation pressure. Central banks around the world are increasing their CPI estimates month by month, which is a rather unpleasant phenomenon. We have had a similar such experience in New Zealand. The CPI has now been outside the target zone for three quarters, and will likely not return in zone till later next year. Compared with some other central banks we have one advantage: we have been running conspicuously tight monetary policy through the recent strong growth period, helping to anchor inflationary expectations and actions. We have room to continue to loosen monetary policy if we judge that is necessary.

This has been a testing time for the 23 or so countries around the world that now use inflation targeting, an approach first formally applied in New Zealand. We now have two decades' experience using it. What we have learned is that inflation targeting is not a perfect technique, that it may be offset by distortions in domestic or foreign markets, that its power should not be over-rated, and that it cannot achieve more than price stability. It is easy to make public criticisms of monetary policy. But we believe there is no better practical alternative available. The Reserve Bank and the New Zealand Treasury have been looking at improved ways to apply flexible inflation targeting in the New Zealand context. There are some possibilities, but they are not easy ones.

On a more positive front, we have been experiencing excellent dairy prices and there are signs of better prices for some other important commodities. These are big enough to make a major difference for us. When primary prices are high the country benefits. Beyond primary production, many businesses are facing a tough time, but the lower New Zealand dollar is beginning to help exporters, and the economy as a whole is much more flexible than it used to be, ready to take advantage of an international recovery when it comes. The various policy frameworks in New Zealand are still rated top class by international agencies.

We are a full-service central bank. That means we do monetary policy, bank supervision, payment and settlement services, currency, liquidity and foreign reserves management all in one building. In addition we maintain close relations with the New Zealand Treasury and other parts of Government. In principle, that means we are better placed than some of our offshore colleagues (where these functions are split) to identify economic-financial problems and do something about them.

I am pleased to be able to report that the Reserve Bank is in good shape to deal with current macroeconomic and financial stresses. We have been doing a lot of development over the past few years preparing for situations like this. These developments are described in this Annual Report. They include work to improve the robustness of the financial system: improved bank surveillance, better bank governance requirements, new Reserve Bank liquidity measures, minimum bank liquidity requirements, refreshed and extended payment and settlements technologies, stress testing, and new regulation planned for non-bank financial institutions and the insurance industry.

We are also using our Reserve Bank balance sheet in different ways. We have a new foreign exchange policy to help smooth peaks and troughs in the New Zealand dollar. In addition, we have built up a planned open foreign exchange position to give us more leverage in the event of severe volatility in the markets. We have a new capital injection from the Government, and have invested in a more sophisticated treasury management system.

We continue to develop our macroeconomic stabilisation tools. These now include a suite of data-driven forecasting models, and a new central forecasting and policy model, and we have done considerable work on the preconditions, effects and management of a slowing economy.

Because of the current difficult economic conditions, my introduction this year has focused on the preparedness of the Bank's front-line operations. But none of this would work without the dedication and skill of our knowledge and IT teams, our finance and treasury units, our payment and settlement operators, our liquidity team, our currency operators and building and security support people, as well as others who do work in communications, human resources, risk and other support functions. The pressure is on and it is not an easy time for them, but I know they will deliver.

Thanks also to the managers and governors of the Bank for their energy, support and advice. Finally, to the Chairman and Board of the Bank whose task it is to monitor and advise us, our gratitude.



Alan Bollard

Governor

3 September 2008

BOARD OF DIRECTORS'

REPORT FOR THE YEAR ENDED 30 JUNE 2008

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

The Reserve Bank's Board of Directors is responsible for keeping the performance of the Bank and of the Governor under constant review across all Bank functions.

Monetary policy

The Bank has a mandate, through the Policy Targets Agreement (PTA) signed by the Minister of Finance and the Governor, to keep inflation in the Consumers Price Index (CPI) to within 1 to 3 percent on average over the medium term. New Zealand is one of a large number of countries in which the principal aim of monetary policy is to maintain price stability.

At the time of our last Annual Report, CPI inflation stood at 2.0 percent. For the year to June 2008, CPI inflation registered 4.0 percent and is forecast by the Bank to rise still further. The inflation situation is similar, or worse, in many comparable countries, with the world facing its most pronounced inflationary episode since the 1970s.

In the normal course of events, a 4.0 percent (and rising) inflation rate, following inflation that had averaged 2.9 percent in the three years to June 2007, could be considered undesirable. However, current international developments have proceeded well beyond the normal course of events.

Several factors, most notably international commodity price rises, have affected inflation in New Zealand and elsewhere. The Dubai crude oil price rose by 94 percent between June 2007 and June 2008. Food prices have also risen sharply around the world. In some countries, it is common to report

CPI inflation excluding the influence of volatile food and energy prices. For instance, the United States annual rate of CPI inflation ex-food-and-energy (CPIX) stood at 2.4 percent in June 2008; in New Zealand the comparable measure was 1.5 percent. Since 2003, the rate of New Zealand's CPIX inflation has averaged 2.3 percent. Notwithstanding these outcomes, inflation trends remain of concern. Part of the concern relates to the flow-on effects of high measured inflation rates to inflation expectations. As expectations climb, it becomes more difficult – and more costly – to bring inflation back down. Another concern is that high inflation is affecting household living standards. Many families are finding that food and petrol costs are placing major strains on their budgets and their standard of living.

At the same time as world energy and food prices have risen substantially, world asset markets have declined dramatically, raising recessionary risks. Share prices and property prices, in particular, have fallen sharply, reducing spending power both in New Zealand and elsewhere. The ongoing global credit crisis has further exacerbated the economic downturn through a tightening in the price and availability of credit. The liquidity of asset markets has reduced substantially and, internationally, both interest rates and exchange rates have become more volatile.

Faced with these pressures, the Bank has had to walk a tightrope in implementing monetary policy. The Bank raised the OCR to 8.25 percent in July 2007, following a sequence of rises over the previous year. This rate is high by developed country standards; nevertheless, household savings remained weak and domestic expenditure remained strong for much of the year.

Strong house price inflation continued through calendar 2007; non-tradable inflation (that is, inflation in products not generally traded internationally), fell only gradually from 4.1 percent p.a. in June 2007 to 3.4 percent in June 2008. Taken in isolation, these outcomes might suggest that monetary policy should have been tighter over the past one to three years than was the case. However, the delicate state of the international economy, the high trade-weighted exchange rate index (TWI), and weakening domestic expenditures could be taken as contrary indicators that policy should have been looser, notwithstanding the high measured CPI inflation. The Bank's choice, following July 2007, to keep the OCR stable through the remainder of the financial year, represented a balancing of these factors. It was consistent with the requirement in the PTA to implement policy in a manner that avoids unnecessary instability in interest rates, the exchange rate and output.

The TWI averaged 70.9 over 2007/08, varying between 65.6 and 76.9 through the year. While not particularly volatile, the TWI was undoubtedly high, being 18 percent above its 20-year average. In part, this was due to extreme weakness in the United States dollar against most currencies, including the New Zealand dollar. By contrast, the New Zealand dollar averaged within 3 percent of its 20-year average against the Australian dollar. These variations in relative value across currencies demonstrate that in the face of extreme international movements, the New Zealand dollar will inevitably be volatile against at least some currencies. This would be the case even with different OCR settings and/or with use of any of the supplementary stabilisation tools that have been analysed by the Reserve Bank and The Treasury.

It is important to stress that if the New Zealand dollar had not strengthened against the US dollar (in the face of US dollar weakness) there would have been a sizeable impact on tradable goods prices. As it was, inflation in internationally tradable goods within the CPI stood at 4.8 percent for the year (compared with a fall of 0.5 percent over the previous year). Food price inflation was 6.9 percent for the year to June 2008, while petrol price inflation registered 25.9 percent. A weaker New Zealand dollar would have resulted in food and petrol prices being even higher still, thereby exacerbating not only CPI inflation but also the already severe effects of these price rises on New Zealand households and businesses.

Despite the rise in domestic CPI inflation, the Board considers that the implementation of monetary policy over 2007/08 has been consistent with the requirements of the PTA. Inflation remains anchored, is currently below rates experienced in many countries faced with similar shocks, and is expected to fall back below 3.0 percent as commodity prices level off or fall.

Financial volatility has been much less marked in New Zealand than in some developed countries, although the economy is inevitably being affected by the international downturn.

Financial system stability and efficiency

The international economy has faced major disruptions as a result of financial instability in the United States and elsewhere. Internationally, some commercial banks and other large financial institutions have failed; share markets, property markets and some debt securities have lost substantial

value, causing considerable losses for many asset holders. In New Zealand, a number of non-bank financial institutions have failed, imposed a moratorium or had to restructure.

The Reserve Bank plays important roles designed to reduce the negative impacts of adverse financial events on the New Zealand economy. Currently, the Reserve Bank registers and supervises banks that operate in New Zealand. As outlined in recent years' *Annual Reports*, the Reserve Bank has sought to improve its supervision of registered banks through a number of means, including requiring systemically important banks to be incorporated in New Zealand and ensuring that outsourcing arrangements are robust. The Basel II regime has been implemented to refine capital requirements placed on banks. One aspect of this regime is the ability for the Bank to impose extra (pillar two) capital requirements to deal with New Zealand-specific risks. These risks potentially include macroeconomic shocks that may, for instance, impair loans to the property market.

In the current international environment, this precautionary preparatory work is shown to have been well justified. Available evidence indicates that the New Zealand banking sector has withstood the international financial turmoil which has led to increased bank funding costs, and remains in a sound position. Nevertheless there is still work to be done. The Reserve Bank is investigating the potential role of a prudential liquidity policy for banks; this is especially relevant given that a material portion of New Zealand banks' liabilities is sourced from offshore wholesale markets. The Board is supportive of the Reserve Bank's endeavours in this area.

As well as a regulatory role with regard to liquidity, the Bank plays a system-wide role in providing access to liquidity for the financial sector. Recent changes to its liquidity management structures have included the shift to a 'fully-cashed-up' system and changes to the types of security that the Bank accepts in its liquidity management operations. These changes have meant that liquidity conditions in New Zealand have continued to operate relatively smoothly even in the face of liquidity problems in other jurisdictions that have resulted in international sources of liquidity proving more difficult to access for New Zealand financial institutions.

Cabinet has decided that the Bank will become the regulator of non-bank deposit takers (NBDTs) and of insurance companies. Legislation was passed by Parliament on 3 September 2008 to give effect to the Bank's NBDT role. The Bank has been gearing up its staffing and systems to take on these responsibilities; it is particularly important that the Bank is ready to undertake this role as soon as its legal responsibilities begin given the current disruption in the finance company sector. Already, the Bank has been involved

in advising the Government on issues with NBDTs. The Board is confident that the Bank is equipping itself to carry out its new roles in relation to NBDTs in a rigorous and professional manner.

The gearing up required to supervise the insurance sector will entail greater preparation by the Bank given that there is less similarity between insurance companies and banks than between banks and NBDTs. The Bank is unlikely to take on responsibilities for insurance until at least 2010, and the Board is satisfied that the Bank is acquiring the necessary expertise for its future work in this field.

Times of financial crisis emphasise the vital role played by sound payments systems, especially those with real-time settlement features. The Reserve Bank has been a pioneer of real-time settlement systems in New Zealand through its provision of ESAS and Austraclear. ESAS enables large-value transactions to be settled between financial institutions on a real-time basis while Austraclear enables the simultaneous exchange of securities and cash by its members. In addition to these facilities, the Reserve Bank became the first central bank to join the international CLS Bank, enabling real-time settlement of both legs of foreign exchange transactions. These moves to real-time settlement are helping to reduce a major systemic risk in the financial system that could arise from contagion stemming from the failure of an individual party trading securities. The Board has been fully supportive of the Bank taking these steps, and considers that the financial cost involved will be well repaid through the reduction in system risk.

The Bank has significantly changed aspects of its balance sheet management, especially in relation to its foreign exchange asset and liability management. The Bank now holds a portion of its foreign assets on an unhedged basis, and can shift the unhedged proportion upwards or downwards, within limits, in support of its monetary policy objectives. This is a move towards central bank orthodoxy, away from the previous position where the Bank had an almost completely hedged foreign currency position at all times.

The Board has been heavily involved in scrutinising the proposals leading to the adoption of this position. We have supported the move, noting that the new approach will enable the Bank to 'lean against the wind' in relation to perceived unjustifiable exchange rate pressures. Taking such a position becomes a supplementary instrument that the Bank can use to signal its expectations with respect to currency cycles. It also places the Bank in a stronger position to implement action to counter disorderly foreign exchange rate markets if these were to arise.

There are some risks involved as a result of the Bank adopting an open foreign exchange position, with the Bank's operating surplus expected to become more volatile. In addition to increased volatility, the Bank could have a reduction in income as a result of holding some foreign rather than New Zealand securities. The Board considers that the Bank's move to diversify its foreign currency exposures represents a prudent response designed to mitigate these risks. Over the first year of operation, the diversified open position has resulted in a positive financial return for the Bank. Nevertheless, there will be times when the Bank's short-term financial outcomes will be adversely affected as a result of the open position, and it will be important to consider financial outcomes on a multi-year basis.

Currency and premises

New Zealand's currency needs are well met by the Bank. Counterfeiting rates are extremely low by international standards which is important in order for users to have confidence in the integrity of the currency. The move to smaller coins in 2006 has had the effect of strongly increasing the demand for 10, 20 and 50 cent coins. This has resulted in greater coinage expenditure than budgeted. Nevertheless the Board is satisfied that the move to smaller coins has resulted in considerable expenditure savings for the Bank as well as improving the standard of coinage available to the public.

The Bank has, for some years, looked to re-establish a presence in Auckland, principally for disaster recovery purposes. The ESAS and Austraclear payment systems are replicated between Wellington and Auckland which ensures their continuity of service in the event of either site experiencing a stoppage. However, the business support for these systems is provided only at our main building on The Terrace. Although the Bank has an alternative site within Wellington to cope with outages at The Terrace, a disaster that affected all of Wellington would not be as easily resolved. The Board has consistently indicated that it favours the establishment of an out-of-town disaster recovery site that may, in principle, be shared with other government agencies.

We therefore welcome the Bank's intention to complete plans for a new site in Auckland over 2008/09 which will provide staffed business support for essential Bank services in the event of a major Wellington emergency.

Administration and resources

The Board closely monitors the Bank's resource use and risk management procedures. During the year, the Bank signed a revised funding agreement with the Minister of Finance in order to provide the resources required to fulfil its new duties with regard to NBDT and insurance sector supervision. It also received an extra \$600 million of capital in recognition of the effects of the new International Financial Reporting Standards (IFRS) accounting rules, which will result in greater volatility in the Bank's reported financial outcomes, even where there are no changes in actual cash flows. The Board considers these moves to be appropriate. With regard to risk management, we note that the Bank's information technology systems have been steadily upgraded over recent years. The Board's Audit Committee maintains a close liaison with both external and internal auditors to ensure that systems are appropriate and that risks faced by the Bank are well managed. We are confident that this area of the Bank's operations is very well managed, as befits both a large financial institution and the nation's central bank.

The most important resource of the Bank is its personnel. Given the difficulties in world financial markets, we are fortunate not only to have a highly experienced Governor, Dr Alan Bollard, but also three deputy/assistant governors reporting to him who have each held senior roles in commercial banks. Other staff within the Reserve Bank have also worked in commercial banks and/or in international financial organisations. The two external monetary policy advisers bring further external perspectives to bear on the policy-setting process. This means that policy is implemented with practical knowledge of the issues faced by outside financial and commercial organisations. It has helped, for instance, in designing liquidity management policies suited to the current internationally volatile situation.

In addition, the Board brings considerable commercial and public policy experience to bear in our scrutiny of the Bank's activities and in our advice to the Governor. We appreciate the frankness of the Governor and his staff in their dealings with the Board and welcome the open nature of analysis and discussion within the Bank. We thank the Rt Hon Ted Thomas for his significant contribution to the Board in his five years as a director until February 2008, and welcome Dr Chris Eichbaum as a new director beginning in August 2008.



Arthur Grimes
Chair
3 September 2008



Alison Paterson
Deputy Chair
3 September 2008

PLANNING AND REPORTING FRAMEWORK

WHERE THE 2007-2008 ANNUAL REPORT FITS

TABLE 1

	2005/06	2006/07	2007/08	2008/09	2009/10
PLANNING	FUNDING AGREEMENT (FIXED TERM)				
	STATEMENT OF INTENT (ROLLED FORWARD)				
	DETAILED BUDGET				
REPORTING	ANNUAL REPORT				
	MONETARY POLICY STATEMENTS (QUARTERLY)				
	FINANCIAL STABILITY REPORTS (SIX MONTHLY)				

The Bank adopts a number of Strategic Priorities in addition to its business-as-usual activities. A number of our Strategic Priorities for 2007/08 were multi-year priorities, set in the context of our longer-term planning funded through the five-year Funding Agreement.

The Funding Agreement signed in April 2005, and subsequently ratified by Parliament, covers the five years to 30 June 2010. Funding rises from \$39 million in the first year (2005/06) to \$46.9 million in 2009/10². This funding reflects various factors, including the need to:

- invest in the replacement and upgrading of our treasury and document management systems, our economic forecasting and data systems, and our core financial reporting system;
- strengthen our supervisory capability, including the extension of our prudential responsibilities to cover non-bank deposit takers and insurance companies; and
- ensure that robust business continuity process arrangements remain in place.

2 The Bank and the Minister have signed a variation to the Funding Agreement for the 2008/09 and 2009/10 financial years to cover the costs of additional advice and establishment of new prudential responsibilities. The variation increases funding for 2008/09 from \$41.0 million in the original Funding Agreement to \$43.3 million, and for 2009/10 from \$43.0 million to \$46.9 million. The variation to the Funding Agreement was ratified by Parliament on 17 June 2008.

STRATEGIC PRIORITIES AND OUTCOMES 2007/08

Last year we adopted a number of priorities, which we report on here. Priorities for the 2008/09 year are on page 50.

PRIORITY 1	OUTCOME
<p>Management Enable managers to continually develop leadership and management competencies.</p>	<p>We continued to invest in developing managers' leadership competencies through focused workshops, training and discussion forums, and individual managers continued with their personal development plans. The staff are significantly more positive about leadership at the Bank than two years ago, indicating this priority is starting to deliver the desired result. Because of its importance, this priority remains central to the Bank.</p>
PRIORITY 2	OUTCOME
<p>Model redevelopment Upgrade the current policy and forecasting model.</p>	<p>We have further developed a new forecasting model, KITT (Kiwi Inflation Targeting Technology), intended to replace the current Forecasting and Policy System (FPS). KITT uses state-of-the-art estimation techniques. The model is being progressively integrated into the forecast process in a way that maintains the integrity of the existing forecasting and monetary policy process.</p>
PRIORITY 3	OUTCOME
<p>Macroeconomic policy framework Assess how to maintain price stability while avoiding unnecessary damage to the external sector.</p>	<p>We made a submission to the Finance and Expenditure Committee's Inquiry into the Future Monetary Policy Framework, that the monetary policy framework is appropriate but limited in its ability to cushion the economy when abnormal pressures arise. The framework works relatively well, but works best when monetary policy is supported by other aspects of economic policy and by the design and operation of the regulatory and tax systems.</p>
PRIORITY 4	OUTCOME
<p>Financial sector regulatory arrangements Help develop and implement new non-bank regulatory arrangements.</p>	<p>The Reserve Bank of New Zealand Amendment Bill No. 3 required all non-bank deposit takers to be registered by the Reserve Bank and to comply with minimum prudential requirements. The Bill was passed by Parliament on 3 September 2008.</p> <p>The Bank has also released a consultation paper on insurance. Policy development for the prudential regulation and supervision of the insurance sector is well advanced.</p>
PRIORITY 5	OUTCOME
<p>Basel II implementation Develop and implement policy on bank capital requirements under Basel II.</p>	<p>The Reserve Bank's capital adequacy and disclosure requirements have been updated to reflect the Basel II framework, and came into effect in the March and June quarters 2008. We accredited four banks to use their own models as the basis of determining their minimum capital requirements in relation to credit and operational risk.</p>

RESERVE BANK DEPARTMENTAL STRUCTURE

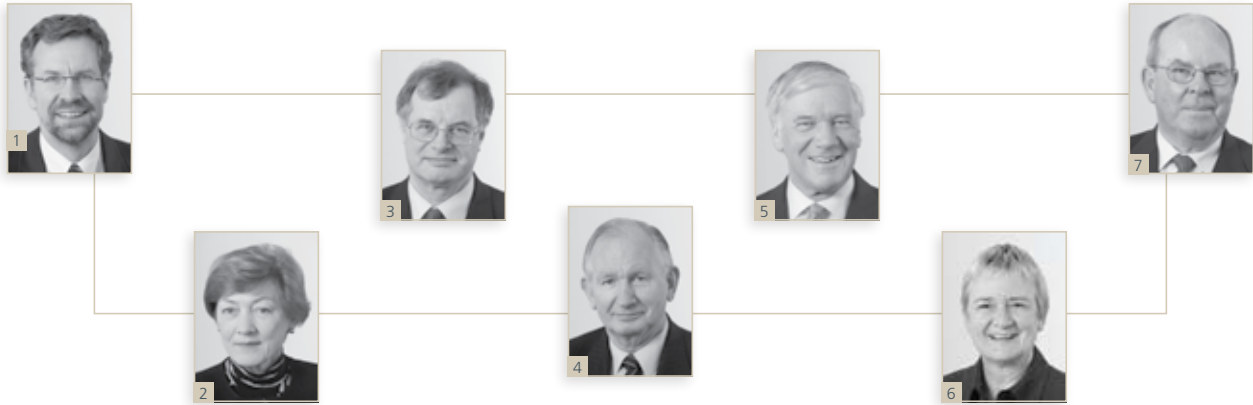
AS AT 30 JUNE 2008



* Simon Tyler and Toby Fiennes were appointed 1 November 2007, following a restructuring of the Financial Stability Department.

** Appointed 24 September 2007, following Tanya Harris' appointment as Chief Information Officer.

BOARD OF DIRECTORS



NON-EXECUTIVE

1 **Dr Arthur Grimes**

Chair Reserve Bank of New Zealand Board of Directors
Economic Consultant
Senior Fellow – Motu Economic & Public Policy Research Trust
Adjunct Professor of Economics – University of Waikato
Director – Phillips Symposium Limited
Trustee – Reserve Bank Superannuation Fund; Wellington International Jazz Festival Trust
Chair – Hugo Strategy Panel
Principal – GT Research & Consulting
First appointed 13 March 2002 – current term expires 12 March 2012

2 **Alison Paterson** *qso*

Deputy Chair Reserve Bank of New Zealand Board of Directors and Chair Reserve Bank of New Zealand Board of Directors' Audit Committee
Company Director
Chair – Abano Healthcare Group Limited; Oversight Committee, Ambulance New Zealand; BPAC NZ Limited; Governing Board, Centre of Research Excellence Growth and Development, University of Auckland
Director – Metrowater Limited; Nga Pae o te Maramatanga (Maori CORE, University of Auckland); Vector Limited
Member – Massey University Council
Board Member – Barnardos New Zealand
First appointed 1 February 1995 – current term expires 31 January 2010

3 **Paul Baines**

Company Director
Chair – Barnardos New Zealand
Director – EDS (New Zealand) Pension Fund Limited; Fletcher Building Limited; Gough, Gough & Hamer Limited; New Zealand School of Music Limited; Todd Corporation Limited
Board Member – New Zealand Institute of Economic Research
Trustee – Chamber Music New Zealand
First appointed 1 July 1999 – current term expires 30 June 2009

4 **The Rt Hon Edmund Thomas** *DCNZM PC QC**

Distinguished Visiting Fellow, Law School, Auckland University
Retired Judge of the Court of Appeal of New Zealand
Member of the Privy Council
First appointed 1 March 2003 – term expired 29 February 2008

5 **Hugh Fletcher**

Company Director
Chair – Advisory Board, No 8 Ventures**; IAG New Zealand Limited; IAG New Zealand Holdings Limited
Director – Insurance Australia Group Limited; Fletcher Building Limited; Rubicon Limited; Vector Limited
Chancellor – University of Auckland
Member – The University of Auckland Council; The University of Auckland Foundation; New Zealand Advisory Board of L.E.K. Consulting
First appointed 10 June 2002 – current term expires 9 June 2012

6 **Dr Marilyn Waring**

University Professor
Professor of Public Policy, Auckland University of Technology
Board Member: Canadian Index of Well Being; AUT Economic Development Centre Board; Institute of Judicial Studies
Treasurer – Association of Women's Rights In Development
First appointed 4 February 2004 – current term expires 3 February 2009

7 **John Goulter** *DCNZM JP*

Company Director
Chairman – New Zealand Lotteries Commission; NZ Business and Parliament Trust; Ngapuhi Asset Holding Company Limited
Director – Television New Zealand Limited
Former Managing Director Auckland International Airport Limited
First appointed 9 February 2000 – current term expires 8 February 2010

EXECUTIVE

Dr Alan Bollard

Governor

SECRETARIAT

Mike Hannah

Board Secretary

* Dr Chris Eichbaum has been appointed a director, effective from August 2008, following Mr Thomas's retirement.

** Ceased 5 July 2008



GOVERNANCE

Authority and accountability

The Reserve Bank of New Zealand is wholly owned by the New Zealand Government. The Bank's authority and accountability are based on:

- **the Reserve Bank of New Zealand Act 1989**, which specifies the Reserve Bank's functions and duties;
- **the Policy Targets Agreement**, 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;
- **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; and
- **the Statement of Intent**, which is an annual three-year statement provided to the Minister of Finance covering the Bank's operating environment, functions, objectives and strategies for the three years, and projected income and expenditure for the first financial year.

The Reserve Bank also subscribes to a statement of its Vision and Values. These can be found on page 3.

The Governor

The Reserve Bank Act makes the 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.

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 and was reappointed in May 2007 to a further five-year term expiring in September 2012.

Management structure

The Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Financial Stability, a Head of Operations, a Head of Economics, and the heads of the Bank's various departments, as outlined on page 14. The posts of Governor and Deputy Governor are required by statute, the current Deputy Governor also being the Head of Financial Stability. In addition, the Head of Operations and the Head of Economics are currently designated Assistant Governors.

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

- the Senior Management Group, 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 market developments;
- the Official Cash Rate Advisory Group, which advises the Governor on monetary policy decisions, typically eight times a year;³

³ This group also includes the Bank's two part-time external monetary policy advisers, who provide outsiders' perspectives to mitigate the risk of narrow information sources. At year's end, the two external advisers were Ms Liz Coutts and Ms Bronwyn Monopoli.

- the Financial Systems Oversight Committee, which meets fortnightly to consider policy issues relating to the financial system;
- the Asset and Liability 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 credibility and reputational interests.

Board of Directors

The Reserve Bank has a Board of Directors, the membership of which is shown on page 15. 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. The Chair must be a non-executive member, and is appointed by the non-executive directors for a renewable term of 12 months. The current Chair is Dr Arthur Grimes.

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 provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on pages 8–11. It has the responsibility to confirm that Monetary Policy Statements (MPSs) are consistent with the Policy Targets Agreement. 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. The Board does not direct Bank policy, monetary or otherwise.

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 Policy Targets Agreement or in carrying out his or her other duties, has been 'inadequate', then the Board can 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 of Directors' Audit Committee monitors the external and internal audit functions. 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 nine times and the Audit Committee met four times during the year under review.

Parliamentary scrutiny

The 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*.

Public accountability

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

The Bank publishes an annual *Statement of Intent* and an *Annual Report*, which report on governance, corporate objectives, strategies, and performance. It releases a quarterly *Monetary Policy Statement*, which explains current monetary policy and provides detailed economic projections. It also publishes a six-monthly *Financial Stability Report*, assessing the robustness of the New Zealand financial system. On our website (www.rbnz.govt.nz), 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 Bulletins*, published research papers and discussion papers, and an extensive website.

Financial management

The Reserve Bank is both a statutory agency and a financial institution. It receives no funding from the Consolidated Account. Instead, income is generated, mainly by investing the proceeds from issuing currency and the Government's equity contribution to the Reserve Bank. 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 and foreign currency assets, from which it receives income. The income directly associated with issuing currency is referred to as 'seigniorage'.

The Reserve Bank Act requires that the Minister of Finance and the Governor of the Reserve Bank enter into funding agreements to specify the amount of the Bank's income that may be used to meet the Bank's expenses in each financial year. The funding agreement must be tabled in Parliament and does not become effective until ratified by a resolution of Parliament. The Act makes provision for each funding agreement to apply for a period of five consecutive financial years.

The Governor and the Minister may subsequently agree to vary the provisions of a funding agreement (or terminate a funding agreement and enter into a new agreement).

The funding agreement specifies the agreed amount of its income that the Bank may use to finance its operating expenses for the years concerned. In the event that actual expenditure is less than that provided in the funding agreement, the amount of that under-expenditure is added to the Bank's equity and is not required to be distributed to the Crown. Conversely, if in any year the Bank's operating expenses exceed the amount provided in the funding agreement for that year, the expenditure in excess of that agreed amount must be financed from the Bank's equity. Capital expenditure is funded by the Bank from its own resources, with depreciation included in annual operating expenditure.

The policy intent of this arrangement is to support the operational and financial independence of the Bank, while also providing incentives for expenditure control, appropriate stewardship for resources and a basis for public accountability.

On 23 June 2005, Parliament ratified a Funding Agreement covering the period 1 July 2005 to 30 June 2010. The Funding Agreement for 2005–2010 provides for the following agreed levels of net expenditure:⁴

2005/06	\$39.0 MILLION
2006/07	\$34.0 MILLION
2007/08	\$41.0 MILLION
2008/09	\$43.3 MILLION
2009/10	\$46.9 MILLION

These figures include a variation to the current Funding Agreement, ratified by Parliament on 17 June 2008, to account for the new prudential responsibilities to be assumed by the Bank.

Cabinet agreed in June 2007 that legislation should be enacted for the Bank to undertake prudential regulation of non-bank deposit takers and insurance companies. The Bank and the Minister signed a variation to the Funding Agreement for the 2008/09 and 2009/10 financial years to cover the costs of additional advice and establishment of new prudential responsibilities. The variation increased funding for 2008/09 from \$41.0 million to \$43.3 million, and for 2009/10 from \$43.0 million to \$46.9 million.

The Reserve Bank Act determines the amount of income earned during the year that is available for distribution. The income that is available for distribution is known as 'notional surplus income', which is calculated under section 158 of the Act.

The Minister of Finance determines the extent to which the Bank's notional surplus income is to be distributed to the New Zealand Government or added to the reserves of the Bank. In determining the distribution amount, the Minister must have regard to the capital requirements of the Bank, the views of the Bank's Board, and any other relevant matters.

The formula for calculating the amount available for distribution was changed in 2004 to exclude unrealised valuation gains and losses. The calculation of notional surplus income excludes all foreign exchange gains and losses.

During 2007/08, we explored different dividend policy options in order to achieve a more consistent level of distribution, and sufficient flexibility, while retaining accountability. As a result, we proposed changing the Bank's dividend policy from a formula-based approach (that is, notional surplus income) to a principles-based approach by removing from the Act the sections that provide for and refer to notional surplus income, and instead requiring the Bank to include in its *Statement of Intent* a 'statement of dividend principles' that the Bank will apply in determining the amount it recommends to the Minister it pays as a dividend. Amendments to relevant sections of the Act were passed in September 2008.

Risk management

The 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 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;
- risks associated with the operations of payments systems which can arise from technical faults; and
- risks associated with being a small organisation, such as the loss of key staff.

⁴ Net expenditure is gross expenditure less income from certain activities, including charges for ESAS and Austraclear, rentals, scrapping coins, and hedging. The material reduction in net expenditure specified in the Funding Agreement for 2006/07 was a function of expected proceeds received from salvaging demonetised coins.

The Bank sees risk management as an integral part of the general management task and the responsibility of day-to-day management.

The 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 providing advice on and monitoring the Bank's risk management frameworks. The internal audit role also rests with this department.
- A Risk Unit within the Bank's Financial Markets Department that provides specialised advice on financial market risk management. This includes recommendations on interest rate, credit and liquidity risk limits, and the reporting of specialised measures of financial risk.

In addition, succession planning is a management priority. A Business Continuity Process strategy has been adopted, with a number of initiatives completed, including a decision to establish an Auckland office to mitigate business support risk in the event of a regional disaster in Wellington.

The Board and its Audit Committee also contribute to the review of the Bank's risk management processes.

Conflicts of interest

The Bank maintains policies and practices to avoid or manage conflicts of interest among all Bank staff, including Governors. The policy requires that all staff act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy states that staff must avoid situations where their integrity might be questioned, and that their best protection is full disclosure of any potential conflicts.

Governors and departmental managers are required to provide the Bank with regular updates as to their personal interests, so that any potential conflict of interest is recorded. This is done quarterly. If any other staff have a particular concern, they can also record their interests in the same way.

Staff must not be personally involved, directly or indirectly, in regular trading in wholesale financial markets in which the Bank has, or might have, a significant influence. This includes domestic wholesale money, bond and foreign exchange markets, and interest and exchange rate futures, options and swaps markets, and shares in entities supervised by the Bank. At no time can Bank staff own or control shares in banks or their parent companies that the Bank supervises. The policy states that staff must not use inside information to benefit when depositing or withdrawing funds from financial

institutions, or purchasing or selling bonds or shares, or when changing between fixed and floating rates for a loan. It is unacceptable to use inside information, whether to avoid losses or to make gains.

Under sections 56 and 61 of the Reserve Bank Act, the Minister must have regard to the likelihood of conflict of interest in appointing a director to the Board, and directors must disclose their interests in any contract with the Bank. On appointment to the Board, directors sign a declaration that they will observe confidentiality in relation to the affairs of the Bank and will not make use of any confidential information they may acquire regarding Bank operations. They also provide lists of their other directorships and major interests in relation to which they would not wish to receive relevant Board papers or participate in Board discussions.

Governors' interests

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

Dr Bollard: The interests of his wife, Jenny Morel, in No 8 Ventures Management Limited.

Mr Spencer: None.

Dr Abel: None.

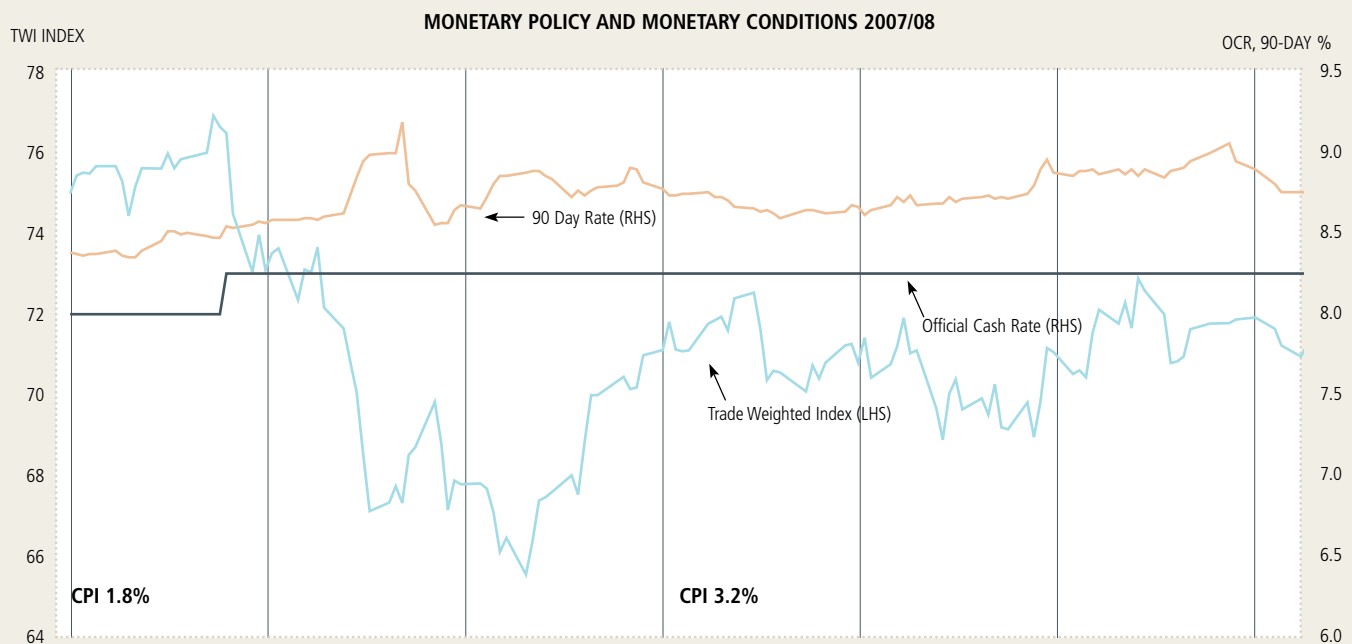
Dr McDermott: Director of Phillips Symposium Limited and Margai Consultants Limited

Management and monitoring processes

Within the 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 on outputs and projects, and to explain any significant variances. The expenses of the Governor are reviewed by the Chair of the Board of Directors' Audit Committee. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are watched closely.

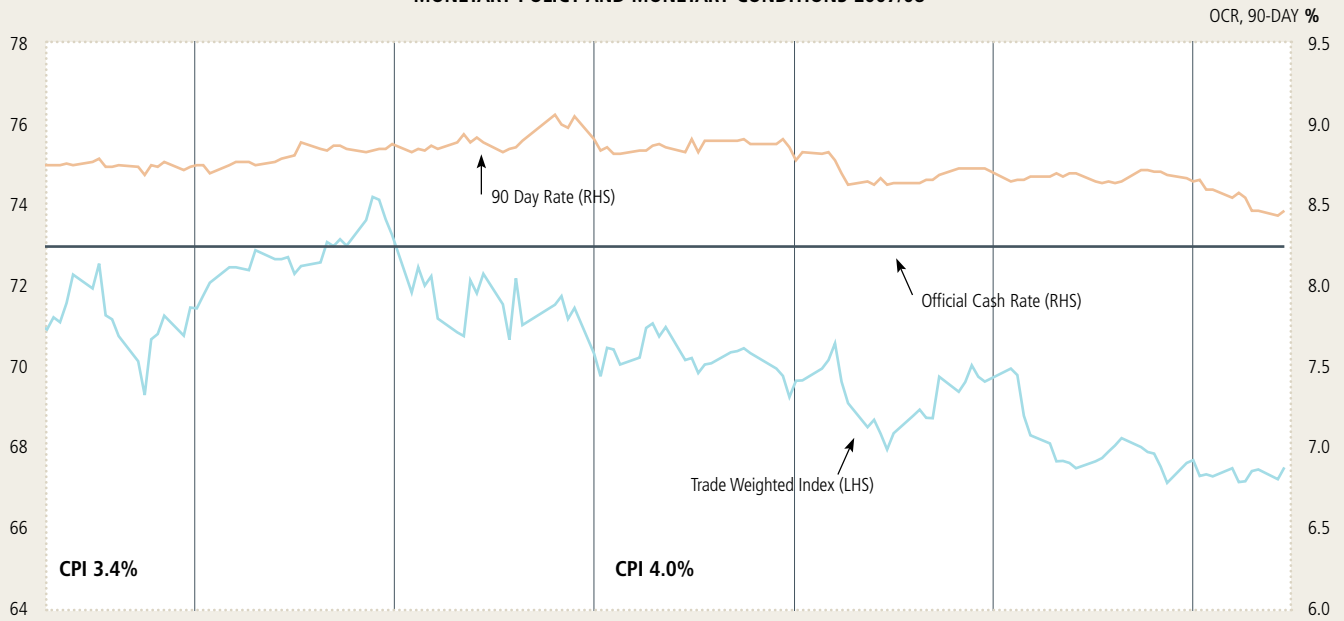
The internal audit function within the Bank is performed by the Bank's Risk Assessment and Assurance Department. The Bank is audited externally by the Auditor-General, who has contracted PricewaterhouseCoopers as his agent. In addition, the Minister of Finance can order a performance audit.

CHRONOLOGY



JULY	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER	DECEMBER
<p>10 JULY</p> <p>40th anniversary of decimalisation</p> <p>12 JULY</p> <p>The Reserve Bank announces it will hold unhedged foreign reserves.</p> <p>26 JULY</p> <p>The Reserve Bank raises OCR to 8.25 percent.</p>	<p>16 AUGUST</p> <p>The Reserve Bank says it is monitoring financial markets following US sub-prime crisis.</p> <p>23 AUGUST</p> <p>The Reserve Bank says it will accept New Zealand bank paper in the repo facility.</p>	<p>12 SEPTEMBER</p> <p>Cabinet announces a new regulatory framework for non-bank deposit takers.</p> <p>13 SEPTEMBER</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p>	<p>1 OCTOBER</p> <p>JPMorgan Chase Bank NA is registered as a bank in New Zealand.</p> <p>25 OCTOBER</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p>	<p>1 NOVEMBER</p> <p>The Reserve Bank restructures its Financial Stability Department.</p>	<p>6 DECEMBER</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p> <p>10 DECEMBER</p> <p>Four New Zealand banks are accredited under the Basel II Accord.</p> <p>17 DECEMBER</p> <p>Cabinet decides the Reserve Bank will be the new insurance prudential regulator.</p>

MONETARY POLICY AND MONETARY CONDITIONS 2007/08



Graph 1

JANUARY	MARCH	APRIL	MAY	JUNE
<p>24 JANUARY</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p>	<p>6 MARCH</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p>	<p>24 APRIL</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p>	<p>7 MAY</p> <p>The Reserve Bank announces new liquidity measures.</p> <p>15 MAY</p> <p>The first disclosures are made under Basel II for New Zealand banks.</p> <p>27 MAY</p> <p>The Reserve Bank issues a consultation paper on prudential regulation of the insurance industry.</p>	<p>5 JUNE</p> <p>The Reserve Bank leaves the OCR unchanged at 8.25 percent.</p> <p>JULY (AFTER BALANCE DATE)</p> <p>24 JULY</p> <p>The Reserve Bank cuts the OCR to 8.0 percent.</p>



Photo ▶ Providing up-to-date analysis of the economy and inflationary pressures is a key function of the Forecasting team.

THE YEAR IN REVIEW

Monetary policy formulation

OBJECTIVE⁵

To achieve and maintain stability in the general level of prices. A published Policy Targets Agreement (PTA) requires the Bank to maintain inflation, as measured by the Consumers Price Index, between 1 and 3 percent per annum on average over the medium term. It also requires that: "In pursuing its price stability objective, the Bank shall ... seek to avoid unnecessary instability in output, interest rates and the exchange rate."

Economic overview

Economic activity weakened over the second half of 2007/08, driven mainly by domestic demand. In particular, demand from the household sector deteriorated over this period following a dramatic slowing in the housing market. The weakening has occurred in an environment of rising international prices for oil, food, and other imported goods. At the same time, persistent underlying inflation and a decline in the New Zealand dollar saw headline inflation increase from 2.0 percent to 4.0 percent by the end of the financial year.

Labour costs have also risen significantly, reflecting the difficulty in finding staff, and adding to the challenges for monetary policy.

Monetary policy has remained focused on ensuring that medium-term inflation settles comfortably within the 1-3 percent target band. Over much of the 2007/08 financial year, we left the OCR unchanged at 8.25 percent to allow previous OCR increases to have their full effect. These increases have contributed to the slowing in economic activity, which is expected to reduce domestic inflation pressures over the next two years.

INITIATIVES AND STRATEGIES

- Redevelop the current forecasting and policy model.
- Review macroeconomic policy options for reducing cyclical pressures on the external economy while maintaining price stability.
- Develop and maintain a range of best-practice structural and statistical models for use in forecasting and policy analysis.
- Analyse trends in the composition of household balance sheets, identify key drivers and model the impact on household spending and savings.
- Improve the quality, accessibility, relevance and reliability of Reserve Bank statistics.

During the year, the Economics Department made progress on several of the three-year initiatives outlined in the *Statement of Intent*.

5 'Objectives' and 'Initiatives and strategies' refer throughout this document to those contained in the 2007-2010 *Statement of Intent*.

We have further developed a new forecasting model, KITT (Kiwi Inflation Targeting Technology). This multi-sector Dynamic Stochastic General Equilibrium (DSGE) model is intended to replace the current Forecasting and Policy System (FPS) model. KITT presents a rich sectoral interpretation of both the demand and supply sides of the economy, using state-of-the-art estimation techniques. We are continuing to ensure that the model is sensibly integrated into the forecast process, maintaining the integrity of the monetary policy forecast process.

We also continued to develop the statistical models that provide competing forecasts to those produced by our main forecasting model. These models help ensure that the economic projections underpinning the Bank's monetary policy decisions are subject to robust scrutiny.

We started a project to design and build an integrated computer application to improve the collection and analysis of financial sector statistics. One of the main objectives of the project is to improve the quality of financial statistics produced by the Bank.

We undertook a review of the work that the Economics Department had done on household balance sheets over recent years. Lessons from this work were set out in a *Bulletin* article in December.

The Economics Department also prepared and presented a submission on housing affordability to Parliament's Commerce Select Committee and provided some analytical input to the group in the Department of Prime Minister and Cabinet working on housing affordability issues.

In the financial year, we made a submission to the Finance and Expenditure Committee's Inquiry into the Future Monetary Policy Framework. The main points of the submission were that we believe that the monetary policy framework is appropriate but is limited in its ability to cushion the economy when abnormal pressures arise. Furthermore, the framework works relatively well but works best when monetary policy is supported by other aspects of economic policy and by the design and operation of the regulatory and tax systems with appropriate international conditions.

We recommended that the Committee:

- a. encourage further work by the relevant agencies to ensure that housing land supply and the development of new subdivisions is not unduly restricted by regulatory or administrative constraints;
- b. review the taxation of investment income and the tax treatment of the financing of the purchase of investment assets;

- c. encourage the development of a framework under which higher thresholds are in place before substantial increases in government spending (or tax reductions) occur at times when demand pressures are intense;
- d. consider whether variations in new migrant approvals could be used as a supplementary tool; and
- e. allocate additional resources to improve the overall range, quality, and timeliness of New Zealand's macroeconomic statistics.

At the time of writing, the Finance and Expenditure Committee had not yet reported back.

Domestic markets and foreign reserves management

OBJECTIVES

To implement monetary policy; to assist in the efficient functioning of the New Zealand financial system; to manage official foreign reserves; and to manage the Crown's financial liquidity.

The Reserve Bank operates in the financial markets daily to implement monetary policy and to ensure adequate and stable liquidity in the inter-bank system.

INITIATIVES AND STRATEGIES

- Complete the review of the structure of the Bank's balance sheet to ensure that it best meets the statutory requirements of the Bank (including monetary policy, currency, bank liquidity, and foreign reserves).⁶ Implement any changes resulting from the review.
- Manage the new liquidity management regime. Complete the transition to steady state so that the banking system has adequate liquidity, and risks (both the Bank's and the market's) are being balanced appropriately.
- Undertake a review of the strategic risk management objectives for credit, market and liquidity risks.
- Continue to work closely with the Debt Management Office to ensure that the comparative advantages offered by the two agencies are fully utilised in managing the Crown's foreign exchange and debt management business.

6 A joint project with Financial Services Group.



Photo ▶ The Foreign Reserves team implemented major changes in the way the Bank manages its foreign reserves.

Financial markets have seen increased volatility over the last year as a result of the global credit crunch, which stemmed from losses on investments in securities backed by US sub-prime mortgages. As a result, global markets avoided more risky investments, leading to higher and more volatile short-term interest rates. Our Domestic Markets team successfully implemented a number of initiatives over the year in order to reduce the volatility of New Zealand interest rates and return them to more 'normal' levels. New Zealand short-term interest rates, including the overnight cash rate, have since stabilised.

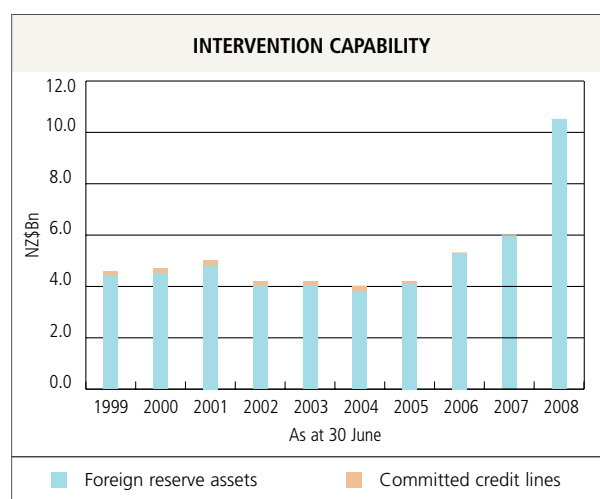
The recently introduced liquidity management regime (where the Reserve Bank moved to a 'cashed-up' system⁷) was ideally suited to deal with the recent global credit issues. Other central banks responded in a similar fashion by increasing the level of settlement cash in their systems. We needed only to add a small amount of cash to improve liquidity conditions. We also moved to widen the pool of high-grade debt securities available for banks to borrow against in the event that cash was hard to access from the markets.

While the New Zealand interest rate market has stabilised in recent times, local banks continue to encounter issues with funding access and costs, most notably in global markets. We continue to closely monitor developments in the domestic and financial markets.

We maintain the capacity to intervene in the foreign exchange market in a crisis, or as a tool to influence the level of the exchange rate. This intervention capacity, which increased substantially during the year, consists of a diversified portfolio of foreign currency assets that can be realised

quickly. These assets are financed by a mix of foreign currency loans from the Treasury and from the Bank's own liabilities. The Minister of Finance, in consultation with the Bank, determines the amount of reserves required, specified as a range denominated in Special Drawing Rights (SDRs⁸). Total reserves held for intervention at 30 June 2008 were 4.9 billion SDRs (NZD10.5 billion).

The Bank is participating in an inter-agency working party whose brief is to promote the development of New Zealand's capital markets. A sub-group of officials investigating financial literacy has found a need for better co-ordination in the government sector to improve and accelerate financial competency across New Zealanders.



Graph 2

7 See RBNZ Annual Report 2006-2007, page 25.

8 The SDR is the unit of account of the International Monetary Fund and some other international organisations. Its value is based on a basket of key international currencies.

BOX 1: DEVELOPMENTS IN FOREIGN RESERVES MANAGEMENT

The Reserve Bank holds foreign reserves for two purposes – to intervene in event of extreme market disorder or to help trim the peaks and troughs of the exchange rate cycle in support of monetary policy.

This year, we made some significant changes in the way we manage the Bank's portfolio of foreign reserves as part of the review of the Bank's balance sheet (one of our strategic priorities for 2006/07).

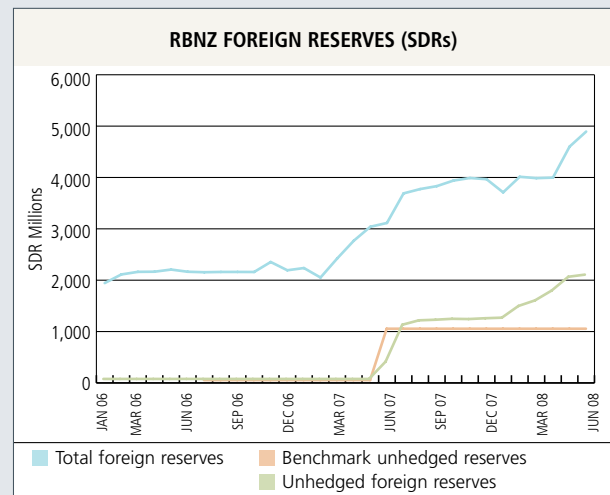
One change is in the way the Bank finances foreign reserves. Historically, the Bank has financed its holdings of liquid foreign currency assets by borrowing offshore in foreign currencies with long-term foreign currency-denominated loans. Thus, the Bank held what are usually termed 'hedged reserves' – the currency denomination of foreign reserves matched that of the liabilities funding those reserves, meaning the Bank was largely hedged against exchange rate movements.

Holding only hedged reserves carries potential risks in the event of an exchange rate crisis. If the Bank needed to intervene, say, to halt a large, rapid fall in the New Zealand dollar, it would need to sell foreign assets to buy New Zealand dollars. If the exchange rate fell and stayed low after the Bank had intervened, the Bank would be left with large losses on its foreign borrowings. Moreover, it could be expensive or difficult to refinance these foreign borrowings during a crisis.

This type of foreign reserves financing is different to the approach usually taken by central banks which typically hold at least some unhedged reserves, where a portion of foreign asset holdings are funded in local currency; for example by using the proceeds of domestic currency issuance to acquire foreign currency assets.

With a substantial portion of reserves unhedged, a run-down in foreign assets during a crisis would not expose the Bank to significant exchange rate losses and risk. This safer position would likely mean that the Bank's crisis intervention actions would be more credible.

However, holding reserves in this form also means that the net equity of the Reserve Bank will fluctuate with the exchange rate cycle – unrealised losses may be incurred when the New Zealand dollar is strong, and gains may be recorded when the exchange rate is weak.



Graph 3

The outcome of the review of the balance sheet was that we should move more towards the international norm, away from holding all hedged reserves to a mixture of hedged and unhedged reserves. We also decided to retain the flexibility to change the relative mix of hedged versus unhedged reserves over time, looking to hold more unhedged reserves when the New Zealand dollar is relatively high, and more hedged reserves when it is relatively low.

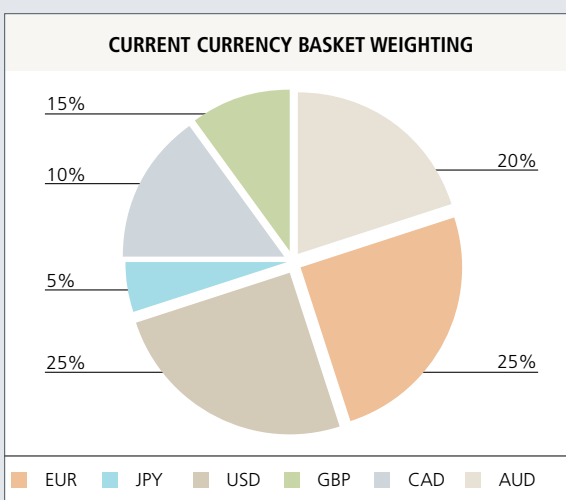
As a benchmark, we will hold SDR 1,000 million of unhedged reserves (and thus a net short New Zealand dollar, long foreign currency 'open foreign exchange' position) on average, with the ability to move above and below that benchmark over the exchange rate cycle. At 30 June, we held a net open foreign currency position of NZD 4,444 million.

As a result, the Bank's net open foreign exchange position has increased over the year and at 30 June was above the benchmark level. The level of unhedged reserves at 30 June 2008 reflects two factors: first, the relatively high and at times unjustified level of the exchange rate through 2007/08; and second, the increased risk that the country faces with external funding of the balance of payments deficit. This latter risk has been underlined by an uncertain and difficult global financial environment.

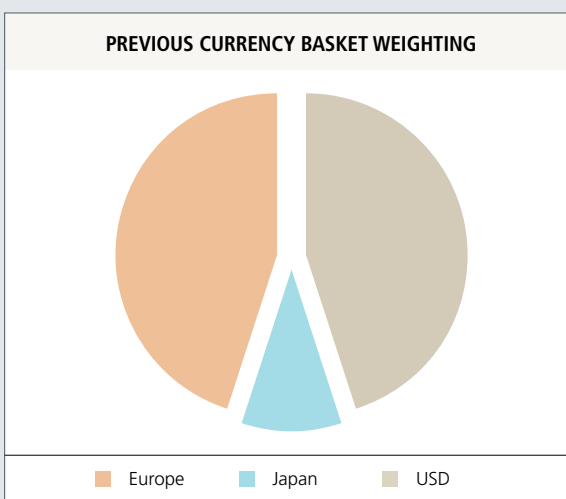
Another development has been in the currency composition of the Bank's open foreign exchange position.

In 2004, the Bank successfully sought the capacity to use foreign exchange intervention to influence the exchange rate where intervention would be useful from a monetary policy perspective. At that time, the Bank decided to hold a basket of currencies, including the US dollar, the euro and the Japanese yen. These currencies are among the most liquid currencies in the world and are also the markets in which the Bank physically holds its foreign reserves.

With the move to maintaining a more permanent net open foreign exchange position, we concluded that a more diversified currency basket is now appropriate, including British pounds, the Canadian dollar and the Australian dollar, as well as the three core currencies. The new basket has the advantage of offering a higher average yield at lower risk than the narrower basket. The charts shown to the right compare the old and new currency baskets.



Graph 4



Graph 5



Photo ▶ Monitoring of banks' compliance with banking regulations is undertaken by the Banking Oversight team.

Financial system surveillance and policy

OBJECTIVES

To register and supervise banks so as to maintain a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.

Surveillance and outlook

Over the last financial year, the New Zealand financial system withstood a severe test of disruption in global financial markets, initially triggered by losses in the US sub-prime mortgage market.

New Zealand's banks have not been directly affected by difficulties in the US sub-prime mortgage market, nor have they invested in the complex investment vehicles associated with current difficulties in that market. However, they have been affected by the greater cost and difficulty of funding in global debt markets.

Driven more by the domestic property market downturn, New Zealand's non-bank financial sector continued to face considerable upheaval, with many finance companies placed in receivership or reporting difficulties. However, failures in the sector are unlikely to have widespread negative effects on the financial system.

New Zealand's financial markets remained sound during this period, in the face of signs that the New Zealand economy was slowing after a sustained period of strong growth.

High-value payment systems run by the Bank continue to provide an important contribution to financial stability, particularly so in periods of market volatility.

The New Zealand branch of JP Morgan Chase Bank was registered as a bank during the year, taking the number of registered banks in New Zealand to 17.

There continue to be some risks to financial stability in the year ahead, with several challenges on the horizon. Following years of economic expansion, growing levels of household debt, and continued savings and investment imbalances, a slowdown in economic activity is under way. Indications of this include an unwinding in the overheated housing market and the failure of several non-bank deposit takers.

Moreover, the international environment is uncertain as the ripples from the sub-prime crisis continue to spread, large losses are realised by some of the world's largest banks, and global inflation pressures continue. While this has led to increased funding pressure on New Zealand banks, the financial system remains well placed to withstand these pressures.

INITIATIVES AND STRATEGIES

- Continue to work with other agencies to strengthen prudential regulation of the financial sector.
- Complete the implementation of the Bank's policies on outsourcing and Basel II.
- Complete the formulation and implementation of the Bank's crisis management capabilities, assessing their robustness through failure management scenarios.
- Potentially become the prudential regulator for parts of the non-bank financial sector.
- Review the efficiency of the banking system.

Liquidity

We are reviewing our prudential rules for banks' liquidity risk management, which promote sound management of liquidity risk. We expect to consult industry and other interested parties on a revised set of prudential requirements for liquidity risk management, and to implement the new policy later in 2008.

Non-Bank Deposit Takers

Following the Cabinet announcement of the new regulatory framework requiring all deposit takers to be registered by the Reserve Bank, and to comply with minimum prudential requirements, the Reserve Bank of New Zealand Amendment Bill No. 3 was passed by Parliament on 3 September 2008. For more details see box 2.

Policy development for the prudential regulation and supervision of the insurance sector is also well advanced, and it is expected a bill could be introduced early in 2009, with the implementation of the regime in 2010.

Basel II

During the year, we worked with locally incorporated New Zealand banks to implement the Basel II capital adequacy framework. This framework will better align a bank's minimum capital requirements with key bank risks, and came into force for most banks in the first quarter of 2008.

We updated our rules for the capital that banks have to hold and what they must disclose, reflecting the new Basel II requirements. These are under either a 'standardised' or 'advanced' (internal risk-based) approach. Those applying for the advanced model need to be accredited by the Reserve Bank to use their own models.

Four banks were accredited to use advanced models. The other three locally incorporated banks in New Zealand did not apply for accreditation and will operate under the standardised approach.

Crisis management

Over the year, we continued to extend our crisis management capabilities. This work has three main strands: refining our crisis management toolkit, which provides guidance on managing a bank crisis; implementing policies to reduce the impact of crises on the financial system; and undertaking crisis simulation exercises that test our crisis management capabilities.

In November 2007, we held a third crisis simulation exercise. The New Zealand Treasury, Australian Prudential Regulatory Authority and Reserve Bank of Australia participated in the exercise. This provided valuable insight into our readiness for a crisis situation and potential cross-border issues.

We are also developing an information-sharing Memorandum of Understanding with the Reserve Bank of Australia.

Our outsourcing policy for large banks ensures that they have the capacity to maintain core banking functions under normal circumstances and particularly under stress. This supports our crisis management objectives. To date, the implementation of the outsourcing policy awaits completion with one bank.

Financial Action Task Force

We have been working with the Ministry of Justice (the lead agency) and other government departments and agencies to prepare for the mutual evaluation by the Financial Action Task Force and the Asia Pacific Group on Money Laundering. New Zealand will undergo this mutual evaluation in 2009, to assess its compliance with the Financial Action Task Force's recommendations to combat money laundering and terrorist financing. The Bank has also been working closely with the inter-agency working group developing proposals for legislation and supervisory arrangements that will strengthen New Zealand's compliance with those recommendations.

BOX 2: EXPANSION OF THE RESERVE BANK'S PRUDENTIAL ROLE

The Government announced in June 2007 that the Reserve Bank would be the single prudential regulatory authority in New Zealand. In September 2007, the Minister announced a new regulatory framework for non-bank deposit takers and insurance, in addition to our current responsibilities as the prudential regulator and supervisor of registered banks. Legislation is expected in 2008 and 2009 to establish the regulatory regime for the non-bank deposit taker sector.

Non-Bank Deposit Takers

Under the new regime, the Reserve Bank will license and set minimum prudential requirements for non-bank deposit takers. We will have crisis response powers and a responsibility for assessing the overall prudential soundness of the sector.

Our regulation-making powers will cover:

- credit rating regulations, including the type of rating, what it relates to and the threshold;
- capital regulations, including minimum capital requirements and capital ratio requirements;
- related-party lending regulations, including the definition of a related-party, framework for calculation, and maximum lending limits;
- liquidity requirement regulations, which may include minimum amounts of liquid assets relative to short-term liabilities, maturity matching of assets and liabilities, or other measures such as prudent cash flows management;
- powers for the Bank to dis-approve prospective directors and senior managers and remove incumbents if already appointed; and
- the ability for the Reserve Bank to declare an entity a deposit taker, or to exempt it from all or parts of the non-bank deposit taker regime.

Work has begun on developing regulations, and while prudential requirements will be introduced over time, the above requirements are all expected to be in place by 2010.

Trustees will continue to be the front-line supervisors of non-bank deposit takers' compliance with the prudential rules. Their functions include establishing a trust deed for particular offers of securities, prescribing the financial, reporting and other covenants in the trust deed, enforcing trust deed covenants, and supervising and monitoring non-bank deposit takers in line with the definitions and prudential requirements that we set. Trustees will be subject to greater oversight by the Securities Commission under the new regulatory arrangements, and there will be a minimum set of requirements for the content of trust deeds.

Insurance

In December 2007, the Government announced the Reserve Bank would become the regulator and supervisor of the insurance sector. The intention is to bring regulation of insurers into line with international practices, through the introduction of light-handed but effective regulation that will keep compliance costs low, preserve competitive neutrality and promote confidence in the sector.

The Reserve Bank's role is expected to include:

- licensing and delicensing insurers;
- prescribing and supervising compliance with the regulatory prudential requirements;
- applying fit and proper requirements to directors and senior managers; and
- exercising crisis management powers in the event of a situation of distress or the potential failure of a licensed insurer.

Policy development for the prudential regulation and supervision of the insurance sector is well advanced, and it is expected a bill could be introduced early in 2009, with the implementation of the regime in 2010.

Currency operations

OBJECTIVES

To meet the currency needs of the public by ensuring the supply and integrity of bank notes and coins.

The Bank meets the currency needs of the public by arranging the procurement, secure storage and issue of New Zealand bank notes and coins, as well as maintaining the quality and verifying the authenticity of currency in circulation.

The value of currency in circulation continues to grow steadily. In the year to 30 June 2008, it rose by 2.6 percent to \$3.4 billion. The number of \$50 bank notes in circulation rose by 11.1 percent in 2007/08, while the total number of notes in circulation fell slightly by 0.2 percent. This is due to the increasing use of \$50 notes in ATM machines and their consequent use by the general public. However, \$20 notes continue to make up almost half of the notes in circulation.

The demand for the 10, 20 and 50 cent coins continues to be much higher than prior to the introduction of the new, smaller coins in 2006. The number of these coins issued in 2007/08 was between four and six times that in years prior to the 'silver coin' changeover.

There were 115 million notes and 413 million coins in circulation at the end of June this year.

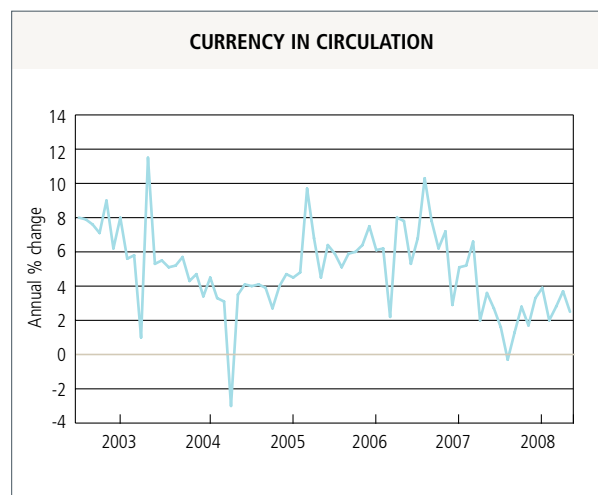
INITIATIVES AND STRATEGIES

- Finalise cash distribution arrangements in the event of a pandemic or similar disaster.
- Investigate possible enhanced security features for bank notes.

A key objective of the Bank's cash operations is to maintain the quality and ensure the integrity of bank notes in circulation. This involves the Bank processing notes on advanced machinery to check for counterfeits and poor-quality notes. During the past 12 months, the Bank has machine-processed over 30 million bank notes. The number of counterfeits detected was less than one per million notes in circulation, which is very low by international standards.

The Bank has agreed a framework with banks and cash-in-transit companies for the distribution of cash in the event of a pandemic or similar emergency. Reserves of currency are also held in Australia to be sent to New Zealand if, for example, cash in the Bank's Wellington building cannot be accessed.

Early planning has started for a possible upgrade of security features on New Zealand's bank notes during the term of the Bank's 2010–2015 five-year Funding Agreement.



Graph 6

Depository and settlement services

OBJECTIVE

To ensure that payments system infrastructure services are provided efficiently and meet international standards.

Stable, secure and efficient payment and settlement systems are critical elements of the country's infrastructure. Payment and settlement systems that meet high standards contribute to economic performance by increasing certainty, reducing risk and allowing the community to use systems efficiently.

The Reserve Bank is the operator of New Zealand's Real Time Gross Settlement environment, comprising the Exchange Settlement Account System (ESAS) and the Austraclear New Zealand system.

The ESAS system processes high-value payments between financial institutions on a real-time basis. ESAS is an important component to the service operated by CLS Bank⁹, which facilitates simultaneous exchange of both legs of foreign exchange transactions. On average, each day, payments with a value of \$38.9 billion are made through ESAS.

9 CLS Bank is a US-based bank that facilitates the reduction of settlement risk of foreign exchange transactions by simultaneously settling both legs of foreign currency transactions.

The Austraclear New Zealand system is a securities clearing and settlement system that simultaneously exchanges cash and securities (such as shares and bonds) between buyers and sellers. The main users of the Austraclear system are financial institutions, large investors, fund managers, brokers and their agents. The average value of payments settled in Austraclear each day is \$6.3 billion.

The value of transactions processed by the Austraclear system each day declined markedly in 2006/07 when the Bank changed the domestic liquidity management regime. In particular, intraday reverse-repurchase agreements ceased to be used as larger cash balances were now able to liquefy intraday payments. After the change, the primary domestic market liquidity instrument became foreign currency swaps which, in the main, are transacted for terms of several weeks or months.

Transactions processed through ESAS cannot be revoked once they have been processed. This feature adds to certainty and so reduces risk in the financial system.

We have an ongoing programme to ensure these systems are continually developed to meet users' changing needs, and to respond both to changes in technology and increasingly higher international standards for performance, security and resilience.

INITIATIVES AND STRATEGIES

- Complete the upgrade for ESAS and Austraclear systems before 31 December 2007.¹⁰
- Implement new accountability arrangements for ESAS and Austraclear through reporting and formal consultation on plans.
- Engage with the settlements industry and respond to long-term needs.
- Improve business continuity planning and disaster recovery capability by arranging for out-of-Wellington business support for payment systems, and ensure greater flexibility in backup computing and service provision arrangements.

A major upgrade of the Austraclear and ESAS systems, which ensures up-to-date technology is being used, was implemented in September 2007. We are now concentrating on delivering a stream of enhancements that allow users to operate more efficiently, including the electronic movement of securities between the Austraclear system and registries, eliminating significant paperwork and reducing operational risk.

TABLE 2: KEY ESAS STATISTICS

	2004	2005	2006	2007	2008
Average daily transaction volumes	3,693	4,507	5,472	6,081	7,023
Average daily transaction values	\$35.3bn	\$32.3bn	\$36.6bn	\$36.3bn	\$38.9bn

TABLE 3: KEY AUSTRACLEAR STATISTICS

	2004	2005	2006	2007	2008
Average daily transaction volumes	1,124	1,131	1,123	1,077	1,119
Average daily transaction values	\$10.1bn	\$9.3bn	\$9.6bn	\$6.6bn	\$6.3bn

The statistics show that in broad terms volumes and values for ESAS show modest growth and those for Austraclear have remained relatively static since the Bank changed its liquidity management regime in 2006/07.

TABLE 4: KEY ESAS-AUSTRACLEAR STATISTICS

	2004	2005	2006	2007	2008
ESAS-Austraclear system availability during core hours	99.92%	99.95%	99.94%	99.92%	99.23%

10 See also 'Knowledge services', page 34.

The 2007/08 financial year was the first year in which new governance arrangements operated for the Austraclear system. We published an inaugural annual plan and annual report for that system, and established the Austraclear Users' Advisory Committee. The new governance framework formalises members' input to systems changes and pricing and gives users the opportunity to review the performance of the Bank as operator of the system. We retain decision-making power in respect of the system, but are required to consider and formally respond to members' views.

We have made a decision to establish an office in Auckland to provide business support in the event that a regional disaster affects the primary operating site in Wellington. During 2008/09, we will complete plans for the new site which will augment existing backup computer facilities that are located in Auckland.

With respect to Austraclear, the performance metric for system availability was impacted by a number of telecommunications faults and also outages for a total of five-and-a-half hours during the first week that the upgraded system was migrated to production. The issues over this transitional period were resolved quickly, and only minor extensions to the end-of-day cut-off time for Austraclear were required.

A limited number of incidents have occurred since September 2007, where the upgraded ESAS-Austraclear system was not available either to all users or to a sub-set of users. In all cases, the period of unavailability and impact on users was relatively limited. The Bank follows up all incidents to ensure that the chances of reoccurrence are minimised and to ensure that key metrics of system availability are improved.

Human resources

OBJECTIVE

To provide strategic human resource advice and support services.

We recognise that the nature of the Bank's work is dependent on employing and developing the best people.

To do this, we strive to create a motivating working environment where all Bank staff can do their best work, further develop their skills and knowledge, and feel a sense of satisfaction that they are working for the Bank.

INITIATIVES AND STRATEGIES

- Enable managers to continually develop leadership and management competencies across the Bank.
- Continue a formal review of key-person risk within the Bank and how it can be mitigated.
- Review the Bank's staff appraisal and personal development programme.

The Bank's priority to continue to invest in the development of our managers was reflected in our staff satisfaction survey results this year with the rating for leadership being significantly more positive than in other benchmarked organisations.

Staff feel motivated by the quality management and leadership at the Bank and the opportunity to develop knowledge and skills. Overall staff satisfaction continues to be in the top quartile of the total organisations surveyed and particular strengths for the Bank are keeping staff well informed, and trust in senior management.

Our expanding prudential supervision responsibilities mean that staff numbers will increase slightly over the next three years. A management plan has been initiated to ensure this expansion is a success.

As part of the Bank's retention and development planning, our focus remains on providing training and development opportunities for all staff and ensuring staff have regular performance feedback to ensure they know how they are doing.

With increasing labour market pressures, we have seen an increase in staff turnover over the last year. Nevertheless, the Bank's focus on staff development and training, work-life balance and challenging and interesting work continues to provide an attractive working environment, and many staff who leave the Bank choose to return a few years later.

TABLE 5: HUMAN RESOURCE STATISTICS

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total staff at 30 June (FTE)	283	237	199	182	193	210	218	223	221	223
Average years of service at 30 June	8.8	9.4	9.4	9.2	9.2	8.8	8.0	7.4	7.4	7.6
Annual staff turnover	10.0%	10.4%	14.9%	13.5%	11.3%	13.5%	9.0%	9.3%	12.3%	17.4%

Remuneration

Staff

The Reserve Bank spent \$22 million on personnel in 2007/08. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 6 shows the number of staff who received over \$100,000 in total remuneration¹¹, in bands of \$10,000.

TABLE 6: STAFF REMUNERATION IN 2007/08

TOTAL REMUNERATION	STAFF NUMBERS 2008
\$100,000 to \$109,999	9
\$110,000 to \$119,999	10
\$120,000 to \$129,999	9
\$130,000 to \$139,999	7
\$140,000 to \$149,999	11
\$150,000 to \$159,999	3
\$170,000 to \$179,999	4
\$180,000 to \$189,999	4
\$190,000 to \$199,999	3
\$200,000 to \$209,999	1
\$210,000 to \$219,999	1
\$220,000 to \$229,999	1
\$230,000 to \$239,999	1
\$250,000 to \$259,999	1
\$260,000 to \$269,999	1
\$290,000 to \$299,999	1
\$330,000 to \$339,999	1
\$380,000 to \$389,999	1
\$540,000 to \$549,999	1
Total staff receiving \$100,000 or more	70

Non-executive directors' remuneration

Non-executive directors' remuneration consists of directors' fees. Directors' fees represent consideration for services provided to the Bank for acting as directors of the Bank. Certain non-executive directors receive additional remuneration due to their involvement in Board committees. All remuneration paid to non-executive directors is included in the following table. There are no fees paid to the Governor, who is an executive director of the Bank.

TABLE 7: NON-EXECUTIVE DIRECTORS

TOTAL REMUNERATION	2008 \$000	2007 \$000
A Grimes (Chairman)	57	48
A Paterson (Deputy Chair)	38	32
P Baines	28	24
H Fletcher	28	24
J Goulter	28	24
Rt Hon E Thomas	17	22
M Waring	26	22
Total non-executive directors' remuneration	222	196

Insurance and indemnity arrangement

Section 179 of the Reserve Bank Act provides that every officer, employee or director of the Bank is not personally liable for acts done or omitted to be done in the exercise or performance in good faith of that person's functions, duties, or powers under the Act. Under section 179A of the Act, the Crown provides an indemnity to every officer, employee or director of the Bank and certain other persons for any liability arising as a result of exercising or failing to exercise any power conferred under the Act, unless the exercise or failure to exercise the power was in bad faith.

The Bank also provides income protection insurance to specified senior executives, and for other staff, it provides insurance that extends the cover available from the Accident Compensation Corporation for work-related accidents.

11 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 6 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.

Knowledge services

OBJECTIVES

To provide strategic information management and information technology services.

Over the past year, we have continued to align the Bank's technology investment to support its business requirements.

INITIATIVES AND STRATEGIES

Enhance the Bank's web functional capability to provide a more secure information-sharing medium.

Upgrade the Bank's data management capability to provide a more flexible and user-friendly solution.

Extend the Bank's knowledge management strategy by automating frequently used processes and implementing tools that allow easy sharing of information and documents across teams; and evaluating digital capture of archive records and physical documents.

Upgrade internally developed computer applications over the next three years in order to ensure the versions of software used are fully supported and, where possible, use standardised language.

Continue enhancing the Bank's business continuity infrastructure, through reviewing arrangements for an out-of-Wellington business support for critical functions and ensuring greater flexibility in backup computing arrangements.

Complete the upgrade for the ESAS and Austraclear systems and supporting network infrastructure before 31 December 2007.¹²

A project to replace our statistical data capture and reporting systems has commenced. During 2008/09, the project will focus on the design and build of the new base system. Subsequently, we will integrate and migrate data from existing surveys, retire legacy systems, and ensure we have data to support the Bank's wider prudential supervisory role.

The upgrade of the Austraclear and ESAS systems went live in September 2007 and we are working on further improvements to meet business needs.

A significant upgrade was made to our treasury system, Findur, and functions were enhanced.

The Bank continues to upgrade its infrastructure to consolidate, modernise and automate systems. This includes moving to a storage area network environment, upgrading our telecommunications services, internal network and system upgrades, and a refresh of the Bank's desktops and laptops.

As a knowledge-worker organisation, we maintain a number of information management platforms to ensure that Bank staff have relevant, accurate and timely information available to them.

Business continuity planning remains an important activity that is co-ordinated on behalf of the Bank by the Programme Management Office. In addition to regular review and monitoring of business continuity plans and exercises, we will assist in the Bank's decision to establish an office in Auckland to provide critical support services in the event of a regional disaster and enhance our disaster recovery computer facilities located in Auckland.

BOX 3: INTRANET

In May 2008, the Bank's refreshed Intranet went live. The earlier Intranet had been in use since 1999. Little had changed in eight years, with the exception of regular updating of content.

A project team was established across the Bank to audit the current site content, gather detailed business requirements and analyse users' needs. The team came up with a number of recommendations to provide an Intranet that enhanced communications, collaboration, and teamwork, and delivered timely and accurate information on a modern technology platform.

The new Intranet now provides more useful information and tools to Bank staff in an easily accessible way.

¹² See also 'Depository and settlement services', page 30.



Photo ▶ Enhancements to the Bank's core treasury system were implemented by a joint team from Financial Services and Knowledge Services Groups.

Internal financial services

OBJECTIVES

To provide support services for the Bank's key financial operations, including financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

The Bank's Financial Services Group is responsible for providing transaction processing capability for the Bank's foreign reserves and liquidity management operations. The group also provides management and financial reporting, and internal accounting operations services.

INITIATIVES AND STRATEGIES

- Finalise the review of the Bank's balance sheet and implement changes arising from that review.
- Finalise the business case for utilising services of CLS Bank to settle the Bank's foreign exchange transactions and, if approved, implement the service.
- Adopt International Financial Reporting Standards from 1 July 2007.
- Continue to enhance workflows, reports, and processes for financial operations and securities transaction activities.
- Review options for replacement of the Bank's general ledger system.

During the 2007/08 financial year, a number of enhancements were made to the Bank's core treasury system. A significant upgrade to that system was completed and the Bank now uses the latest available version. The Bank's Balance Sheet Review Project was concluded and one significant outcome was the decision in July 2007 that a portion of the Bank's foreign reserves would be held on an unhedged basis. This entailed changes to the risk measurement and monitoring regime administered by Financial Services Group.

On 30 June 2008, we became the first central bank to become a member of CLS Bank. The CLS Bank system allows the Bank to simultaneously settle both elements of foreign exchange transactions, thereby reducing settlement risk. Currently, the Bank uses the CLS Bank system for settlement of transactions involving the exchange of US dollars and New Zealand dollars. In due course other currencies will be added.

The 2007/08 financial year is the first year that the Bank has reported its financial results under New Zealand International Financial Reporting Standards.

In 2008/09, the Bank will evaluate options for replacing its 15-year-old financial management system, with implementation of a new system planned for 2009/10.

Communications

OBJECTIVES

To provide strategic advice and management for the Bank's external and internal communications, to assist in maintaining its reputation and credibility.

Our reputation for integrity is critical to our ability to perform as an inflation-targeter, prudential supervisor and reliable provider of currency and of payments systems. The Bank's Communications Committee oversees developments and initiatives to ensure our reputation is maintained. To support the Bank's policy actions and operations, we use news releases, speeches, press conferences, the website and internal communications.

INITIATIVES AND STRATEGIES

- Deliver the Bank's communications to target audiences through the most appropriate channels; in particular, key messages on monetary policy and the outcome of the review of institutional arrangements for prudential regulation.
- Provide the Bank with timely advice on reputational risks and opportunities, and with strategies for their mitigation or utilisation.
- Develop further initiatives for internal communications, including contributing to the Intranet redevelopment.
- Publish an updated suite of public information books, brochures and factsheets, and review and update the Bank's corporate communications standards.
- Maintain crisis capability.

We began webcasting key announcements and press conferences during the year to reach wider domestic and international audiences. Forty-nine off-the-record speeches and two on-the-record speeches were delivered. Many more speeches are delivered off-the-record so that we can explain our activities to general audiences while ensuring markets are not confused by repeated messages. We also published two brochures and eight factsheets to provide wider understanding of the Bank's purposes.

The Intranet development during the year opened opportunities for enhancing communication within the Bank.

Education initiatives included the Bank's annual Monetary Policy Challenge for senior secondary school students. Teams compete to assess economic conditions and deliver their 'Official Cash Rate decision'. The competition was won by New Plymouth Girls' High School, ahead of Timaru Boys' High School and Lindisfarne College, Hawke's Bay.

We added Economic Worksheets to the resources available to economics teachers and students on our website, and continued to provide financial support to the Enterprise New Zealand Trust's work to establish financial literacy unit standards.

With other teams in the Bank, our Communications staff participated as planned in a bank crisis simulation exercise in Wellington, and a volcanic explosion simulation based in Auckland, to assess our ability to operate successfully in financial and operational crises.

Property management and security

OBJECTIVES

To provide appropriate accommodation for the Bank to ensure that all functions, including cash operations, can be conducted unimpeded in a secure environment.

The Bank maintains its own premises in Wellington and manages security arrangements to ensure it has secure, appropriate accommodation.

INITIATIVES AND STRATEGIES

- Plan and refurbish the building to meet current and future Bank needs for accommodation.
- Maintain the building at the required standard, with fully let tenanted areas.
- Assist in the establishment and maintenance of off-site accommodation for business continuity planning purposes.
- Upgrade the civil defence capability of the Bank and provide support to tenants.

Refurbishing was undertaken on one floor to modernise it after 15 years. Planning began to reoccupy additional floor space at the end of a tenancy lease. This will provide accommodation required by staff for the additional regulatory work to be undertaken by the new Prudential Supervision Department. The Bank building has been fully tenanted throughout the year.

The Bank has taken a number of steps to measure and reduce its 'carbon footprint'. A building energy audit was conducted, providing the Bank with several avenues to investigate and actions to generate energy savings. (See box 4 for additional information.)

The Bank has been fully committed in 2007/08 to the ongoing improvement of its safety and security systems, and of course, staff training. Several key Bank staff and tenants took part in a training course on the Co-ordinated Incident Management System, a recognised structure used and understood by emergency services.

Security implemented an upgraded card access system that allows more effective control of access to all parts of the Bank building by Bank staff and visitors. Enhancements have also been made to the Bank's closed-circuit television monitoring system.

There was a loss of power to the Reserve Bank building in December when a fused switch failed and the emergency generator did not start. The Bank put business continuity plans into action and these worked well. Some staff moved to the Bank's Wellington business continuity site and all payment services were switched to the Bank's Auckland processing facilities. There was a degree of disruption to some work for a few hours but all essential activities were maintained.

BOX 4: SUSTAINABILITY

During 2007/08, the Bank has undertaken a number of sustainability initiatives.

Information was collected on the Bank's travel, energy use, and waste. This was used to estimate the Bank's 'carbon footprint' using the standard template provided by the Ministry for the Environment. It was found that electricity, gas and air travel were the three largest contributors.

The Bank initiated a review of its energy use. A comprehensive energy audit analysing all aspects of energy use in the building found that the Bank has historically taken a very proactive approach to energy management and that monitoring of energy use has been of a high standard.

Nevertheless, several new cost-effective opportunities were identified to further reduce energy use, the result of new technologies and increasing energy costs. Improvements to the operation of the heating, ventilation, and air conditioning system are likely to generate the largest savings. Other technical adjustments such as peak load shifting can lead to energy and/or financial savings. These and other steps will be taken during 2008/09.

The Bank is one of the first organisations to be chosen to participate in the Building Energy End-Use Study. Over the project's six-year life, energy use in a number of office buildings of different ages throughout the country will be monitored in a major study being carried out by BRANZ Limited. This will complement a similar 10-year national study into the use of energy in households by the same organisation.

Bank staff and tenants have participated in these studies and initiatives. A survey of Bank staff generated a number of insights and suggestions for future actions.

The Bank continues to run a successful programme for the recycling of waste products including paper, cardboard, glass, plastic, aluminium and fluorescent lights.

BOX 5: RESERVE BANK MUSEUM

The Museum opened on 6 September 2006 and over 11,900 people have visited it. In the 2007/08 financial year, there were 5,220 visitors.

The main purpose of the Museum is to educate and inform, and to highlight and celebrate New Zealand's wider economic and banking history, as well as the origins and role of the Reserve Bank.

The Museum provides a resource for schools and tertiary education organisations. While there, students are given presentations on the functions of the Bank with specific emphasis on 'Targeting Inflation'.

The MONIAC (Monetary National Income Analogue Computer), invented by New Zealander Bill Phillips and using water flows as a calculating medium for forecasting an economy, has quickly become a favourite with visitors, especially when it is demonstrated and different economic scenarios are played out.

In 2007, we commemorated the 40th anniversary of the issue of decimal currency. A popular exhibition described the life of James Berry, who designed our first decimal coins. Also displayed were images of other designs of his that did not make the final selection.

The Museum welcomes groups and individuals and is open 9:30am to 4:00pm, Monday to Friday except public holidays.

For further information

Email: Museum@rbnz.govt.nz

or

Telephone: 04 4713-682.

International activities

The Reserve Bank maintains a number of international relationships, including those with other central banks and multilateral organisations. We also participate in a range of international conferences and workshops.

The Bank continued its active engagement with the Executives Meeting of East Asia and Pacific central banks and monetary authorities (EMEAP). It hosted the Working Group on Financial Markets in Christchurch in November, and participated in regular meetings of Governors, Deputy Governors, the Monetary and Financial Stability Committee, the Working Group on Banking Supervision, the Working Group on Payment and Settlement Systems, and the Information Technology Directors' Meeting.

Currently, we are involved in The New Zealand-Pacific Remittance Project, aimed at reducing the transactional cost of remittances between New Zealand and Pacific Island countries. A project co-ordinator was contracted last year and is being jointly funded by the Bank, The Ministry of Pacific Island Affairs, the World Bank and New Zealand Aid.

Sending money 'home' to support relatives is very much a part of everyday life for the Pacific peoples living in New Zealand. The cost of remitting funds can be as high as 25 percent, and the objective of the project is to facilitate the development of transactional products that can reduce costs to 5-7 percent by 2009. Most recent figures show that remittances to the Pacific region have tripled over the past decade to now stand at \$560 million annually.

In February/March, the Bank contributed to the International Monetary Fund's (IMF) annual Article IV consultation visit to New Zealand. The Bank is actively engaged on New Zealand's interests in the IMF through advice on a wide range of policy issues and the secondment of staff to New Zealand's Constituency Office at the IMF.

The Bank's international linkages continue to deepen through ongoing engagement with world-renowned academics and a steady flow of visitors from other central banks and international organisations.

OUR FINANCIAL STATEMENTS – AN OVERVIEW

FINANCIAL STATISTICS AT A GLANCE

	2008 \$M	2007 ¹³ \$M
FINANCIAL PERFORMANCE (YEAR TO 30 JUNE):		
Operating surplus	535	351
Net operating expenses	38.1	30.4
FINANCIAL POSITION (AS AT 30 JUNE):		
Total assets	25,162	20,961
Equity	1,926	1,436
Foreign reserves intervention capacity	10,534	6,029
Net open foreign exchange position	4,444	701
DISTRIBUTION (YEAR TO 30 JUNE):		
Distribution to Government	168	193

Financial highlights

- Operating surplus – The Bank's operating surplus (operating income less operating expenses) was \$535 million in 2008 (\$351 million in 2007). Operating income for 2008 included a net gain¹⁴ of \$225 million from building a net open (unhedged) foreign exchange position during the year, the value of which rose as the New Zealand dollar fell.
- Operating expenses – Net operating expenses (operating expenses less income retained under the funding agreement) were \$38.1 million in 2008 (\$30.4 million in 2007). Net operating expenses were abnormally low in 2007 because the proceeds from selling the recovered old 'silver' coins exceeded the cost of issuing new coins made of plated steel.
- Distribution to Government - The Bank will distribute \$168 million to the Government in 2008 (\$193 million in 2007). Gross foreign exchange gains, which are not included in the statutory formula for calculating the annual distribution to the Government, were \$344 million and these returns increased the Bank's equity¹⁵.

13 Comparative numbers have been restated using New Zealand equivalents to International Financial Reporting Standards.

14 This comprises gains on foreign exchange of \$344 million less funding costs of \$119 million.

15 As reported on page 46, the distribution has been calculated using the existing statutory formula. Changes to the regime used for determining the annual distribution were enacted on 3 September 2008.

FINANCIAL DEVELOPMENTS

1 Foreign reserves intervention capacity and net open foreign exchange position

There were three material changes to the Bank's foreign reserves intervention capacity during 2007/08.

First, the Bank built up its absolute level of foreign currency available for foreign reserves intervention from \$6.0 billion to \$10.5 billion.

Secondly, in July 2007 the Bank announced it would hold part of its foreign exchange reserves on an unhedged basis, that is, with a net open position, which gives rise to foreign exchange rate risk. As unhedged reserves can be cashed up more readily than hedged reserves, this provides additional insurance against prolonged exchange rate weakness if reserves are required to be used in a crisis. The level of unhedged foreign reserves is likely to vary relative to hedged foreign reserves over the exchange rate cycle.

The Bank's net open foreign exchange position has grown from \$0.7 billion at 30 June 2007 to \$4.4 billion at 30 June 2008.

Finally, the Bank diversified the currencies in which it holds its foreign reserves. The Bank added British pounds, Canadian dollars and Australian dollars to the Bank's reserves currencies, and scaled back the proportion of reserves held in US dollars, euros and Japanese yen.

The Bank's net income can be expected to vary more in future due to volatility in exchange rates and interest rates. However, the Bank's net open foreign exchange position is expected to be profitable, on average, over the long term.

2 International financial reporting standards

From 1 July 2007, when the Bank adopted New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), its holdings of New Zealand government securities have been accounted for at market value, with unrealised gains and losses booked directly to equity. Previously, these assets had been valued on a yield-to-maturity basis. In future, reported equity will be more variable as a result of this change in accounting methodology.

At 30 June 2008, the Bank's holdings of New Zealand government securities recorded an unrealised loss of \$32 million (2007 \$136 million unrealised loss). The reduction in the unrealised loss resulted from a reduction in market interest rates over the year.

3 Equity injection

In March 2008, the Bank completed a review of its capital requirements in light of changes in the Bank's mode of operation and the new accounting rules and, subsequently, Parliament approved a \$600 million capital injection for the Bank. Most of the additional capital was to cover potential losses on the Bank's government securities portfolio under the new accounting policy whereby changes in market values are now explicitly recognised in the Bank's financial statements.

The \$600 million capital injection was received on 2 July 2008. This has been invested in treasury bills issued by the New Zealand government. The capital injection was not recorded in equity as at 30 June 2008.

4 Global market disorder

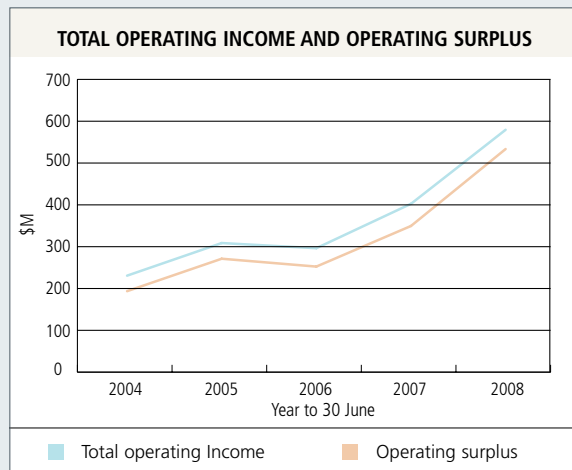
In August 2007, the Bank took steps to ease short-term liquidity pressures in the banking system by extending the range of securities it would accept in its domestic market liquidity operations. In May 2008, the Bank announced temporary new measures to ensure there was sufficient liquidity in the New Zealand banking system in the event of further international financial market turbulence. Most of the new measures took effect in June 2008.

Disorder in global financial markets during the year has had a limited impact on the Bank's own financial position and performance. The most discernable impact has been increased volatility due to changes in foreign exchange rates and reduced interest income on foreign currency assets as interest rates fell overseas. Interest income from holding foreign reserves also declined later in the 2007/08 financial year, following a decision by the Bank to hold an increased proportion of reserves in higher-quality, lower-yielding liquid securities.

REVIEW OF FINANCIAL PERFORMANCE AND FINANCIAL POSITION

OPERATING SURPLUS

	2008 \$M	2007 \$M
Operating income:		
Net investment income	573	365
Other Income	8	39
Total operating income	581	404
Total operating expenses	46	53
Operating surplus:	535	351



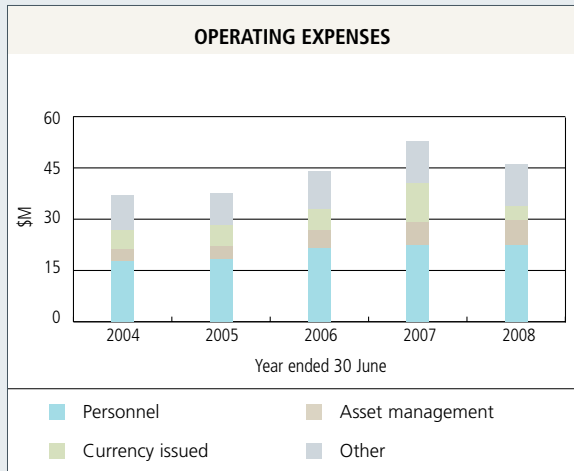
Operating income

Most of the Bank's interest income comes from earnings on the financial assets backing currency in circulation and the investment of the Bank's equity. Income varies with changes in market interest rates and exchange rates.

The principal driver of the Bank's net investment income in 2008 was the favourable foreign exchange performance of its net open foreign exchange position.

Net investment income included foreign exchange gains of \$344 million. These were partially offset by a net interest cost of \$119 million to fund the net open foreign currency position.

Interest rates on foreign currency investments are lower than the interest rates on New Zealand dollar investments. A net open foreign exchange position therefore results in lower interest earnings than would be the case if funds were invested in New Zealand dollar-denominated financial instruments. The Bank made a decision to hold higher-quality, lower-yielding instruments in its foreign reserves portfolios, which reduced interest income.

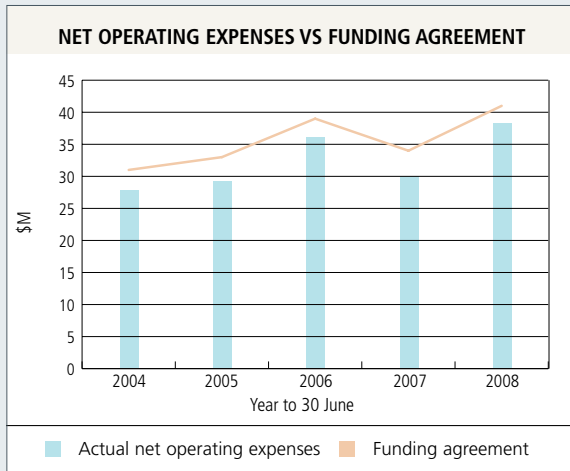


Operating expenses

In 2008, operating expenses were \$46.2 million which was 4.9 percent under budget. The main factor causing this under-spending was the higher-than-planned level of staff vacancies arising from increased staff turnover and longer lags in recruitment of replacement staff.

NET OPERATING EXPENSES

	2008 ACTUAL \$M	2008 BUDGET \$M	2007 ACTUAL \$M
Personnel	22.4	24.0	22.4
Currency issued	4.2	4.6	11.7
Asset management	7.2	6.9	6.7
Other expenses	12.4	13.1	12.8
Total operating expenses	46.2	48.6	53.6
Income retained under the funding agreement	8.1	7.3	23.2
Net operating expenses	38.1	41.3	30.4
Net operating expenses specified in the funding agreement	41.0	41.0	34.0
Funding agreement under-expenditure (over-expenditure)	2.9	(0.3)	3.6



Outcome against the funding agreement

Actual net operating expenses were \$38.1 million in 2008.

This was \$2.9 million under the \$41 million level provided for in the funding agreement for the 2008 year.

Total operating expenses were abnormally high in 2007 due to the cost of issuing new 'silver' coins. These costs were offset by the revenue from selling the old coins for scrap.

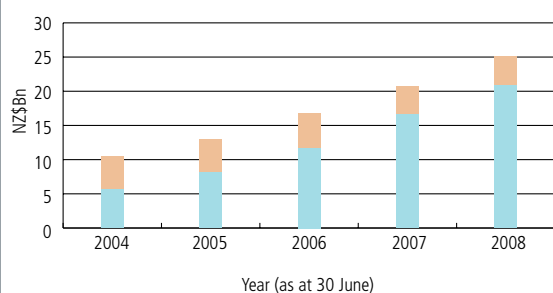
The level of net operating expenses has increased over the term of this funding agreement, reflecting an expansion of the Bank's responsibilities, and the renewal and replacement of systems and improvements to the Bank's business continuity capabilities.

The funding agreement was amended in April 2008 by increasing the approved level of net operating expense for 2008/09 from \$41.0 million to \$43.3 million and that for 2009/10 from \$43.0 million to \$46.9 million. These changes were required to fund increased policy advice responsibilities and activities associated with greater oversight of non-bank financial institutions.

FINANCIAL POSITION AS AT 30 JUNE

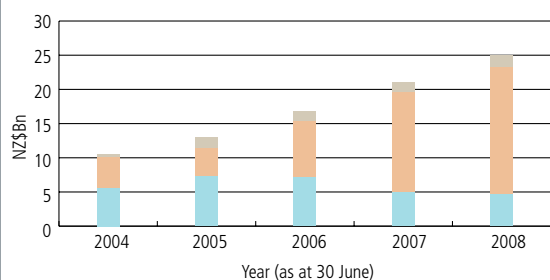
	2008 \$M	2007 \$M
Assets:		
Foreign currency financial	20,754	16,647
Local currency financial	4,307	4,222
Other assets	101	92
Total assets	25,162	20,961
Liabilities and equity:		
Foreign currency financial	4,605	4,870
Local currency financial	14,925	11,009
Currency in circulation	3,448	3,361
Other liabilities	258	285
Equity	1,926	1,436
Total liabilities and equity	25,162	20,961

LOCAL AND FOREIGN CURRENCY ASSETS



Local currency and other assets Foreign currency assets

LOCAL AND FOREIGN CURRENCY LIABILITIES AND EQUITY



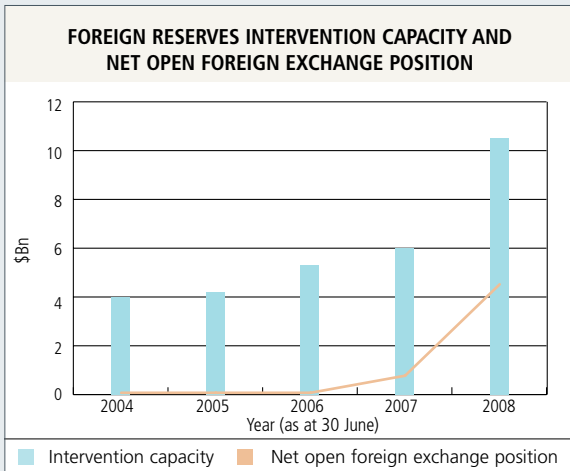
Equity Local currency and other liabilities Foreign currency liabilities

Changes to the statement of financial position

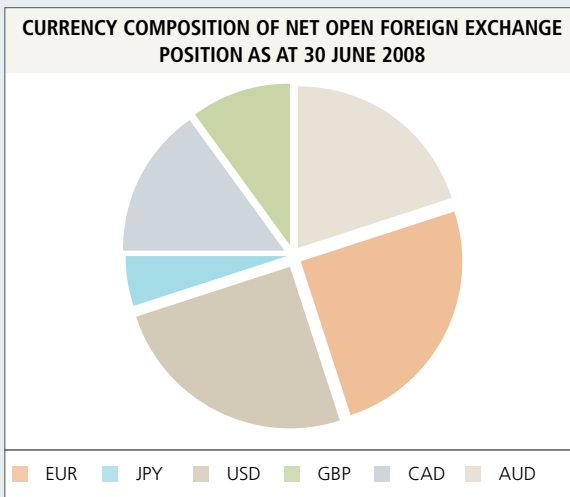
Assets grew by \$4.2 billion in 2008. This reflected a decision to increase foreign reserves intervention capability. On the liability side, the main feature was an increase in the Crown's balance at the Bank of \$3.7 billion.

At 30 June 2008, the Bank's holdings of New Zealand government securities recorded an unrealised loss of \$32 million (2007 \$136 million unrealised loss).

Gross foreign exchange gains, which are not included in the statutory formula for calculation of the annual distribution to the government, were \$344 million and these returns increased the Bank's equity.



	2008 \$M	2007 \$M
Net open foreign exchange position	4,444	701



Foreign reserves intervention capacity and net open foreign exchange position

Foreign reserves intervention capacity grew from \$6.0 billion to \$10.5 billion.

In June 2007, the Bank intervened in the foreign exchange market for the first time since the New Zealand dollar was floated in 1985.

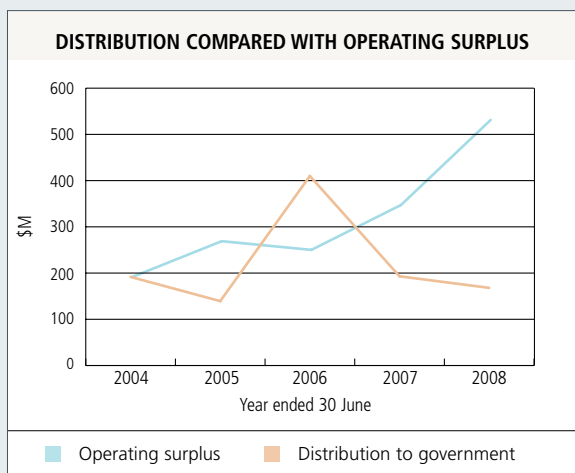
In July 2007, the Bank announced it would in future hold a portion of its foreign reserves on an unhedged basis, so managing a position that is subject to foreign exchange risk.

The Bank progressively increased its open foreign exchange position during the year from \$0.7 billion at 30 June 2007 to \$4.4 billion at 30 June 2008.

The pie chart shows the composition of foreign currencies included in the net open foreign exchange position. During the year, the Bank diversified its holdings of foreign currencies in order to mitigate risk and reduce holding costs, while maintaining the ability to quickly liquidate foreign assets.

DISTRIBUTION TO GOVERNMENT

	2008 \$M	2007 \$M
Distribution to government	168	193



Distribution to the Government

The Bank will distribute \$168 million to the Government in 2008 (\$193 million in 2007).

Notional surplus income (NSI) is the amount available for distribution to the Crown, calculated in accordance with a statutory formula. For 2008 the full amount of notional surplus income will be distributed.

In recent years, the NSI has been volatile and a poor reflection of the amount that, in an economic sense, should be available for distribution to the Government. Distributions based on the 2006 and 2007 NSI calculations were adjusted with the agreement of the Minister of Finance because of unusual outcomes in each case.

During 2007/08, we explored different distribution policy options. As a result, we have proposed changing the Bank's distribution policy from a formula-based approach (i.e., NSI) to a principles-based one. This would be achieved by removing from the Act the sections that refer to NSI and instead requiring the Bank to include in its *Statement of Intent* the principles to be applied in determining the amount of dividend to be recommended to the Minister. Amendments to the relevant sections of the Act were passed in September 2008.

BOX 6: VOLATILITY AND CAPITAL INJECTION

The Bank's reported net income and equity will be more variable than in the past. Additional volatility will result from the Bank having an open foreign exchange position, and from an accounting policy change.

Most of the Bank's earnings come from interest earned on financial assets. Variability in the Bank's income mainly reflects changes in New Zealand and global interest and exchange rates, which are influenced by conditions in local and international financial markets. For example, instability in financial markets emanating from the sub-prime US mortgage market was a major source of global interest rate volatility in 2008.

The financial performance of the Bank's net open foreign exchange position is directly affected by changes in the New Zealand dollar exchange rate. The Bank initially held the net open foreign exchange position in three currencies – US dollars, euro and Japanese yen, but has extended the range of currencies in which reserves are held to also include British pounds, Australian dollars and Canadian dollars.

Broadening the currency basket has resulted in a more diversified portfolio mix which is expected to deliver both smoother and stronger financial returns compared with the previous less diversified basket.

The reported equity of the Bank will also be more variable in future. When the Bank adopted NZ IFRS, its holdings of New Zealand government securities were reported in the financial statements at market value, with unrealised gains and losses booked directly to equity. Prior to the Bank's adoption of NZ IFRS, the portfolio of New Zealand government securities was valued on a yield-to-maturity basis, which did not take account of changes to market interest rates.

In order to give the Bank the financial capacity to intervene in foreign currency markets, the Bank received an equity injection of \$1 billion on 1 July 2004. An additional \$600 million capital was received on 2 July 2008. The capital provided by the latter injection was provided primarily as a buffer to protect reported equity from potential changes in the valuation of New Zealand government securities under the new accounting policy described above.

Financial projections

The following table outlines the Reserve Bank's budgeted income and expenditure for 2008/09. The budgeted income and expenditure have been prepared using the accounting policies used in the preparation of the Bank's financial statements for the year ended 30 June 2008 as described on pages 61 to 69 of this Annual Report.

The key assumptions underlying the budget for the year ended 30 June 2009 are that:

- the Bank's current functions will continue, with the Bank undertaking preparatory work for the prudential supervision of non-bank financial institutions;

- interest rates, exchange rates and the open foreign exchange position used in compiling the budget were those prevailing at 30 April 2008, which was when the budget was prepared. Further, these are assumed to remain unchanged from that date through until 30 June 2009;
- there will be no material changes to the Bank's liquidity management operations; and
- additional capital of \$600 million was received on 2 July 2008.

The following table sets out projected income and expenditure for the Bank for the year ended 30 June 2009.

PROJECTED FINANCIAL PERFORMANCE 2008/09

	2009 BUDGET	2008 ACTUAL
Operating income:	\$ M	\$ M
Net investment income	303	573
Other income	8	8
Total operating income	311	581
Operating expenses:		
Personnel	25	22
Currency issued	6	4
Asset management	8	7
Other expenses	13	13
Total operating expenses	52	46
Operating surplus	259	535
Net operating expenses specified in the funding agreement	43.9	41.0
Funding agreement under-expenditure (over-expenditure)	(0.6)	2.9

Importantly, the budget assumes no foreign exchange gains or losses will arise in 2009 and that net interest income is reduced as a result of holding an open foreign exchange position. Actual financial results could differ materially from those budgeted.

The increase in personnel costs includes the cost of additional staff for the financial system surveillance/policy function.

One feature of the projected income and expenditure is that, as anticipated, the Bank forecasts that the net operating expenses will be \$43.9 million against a level of \$43.3 million provided for in the funding agreement.¹⁶ The difference of \$0.6 million will be funded from the Bank's equity.

The additional \$0.6 million of expenditure in 2008/09 will be drawn from underspending in the previous three years of the funding agreement. At 30 June 2008, the cumulative underspending of the current funding agreement was \$9.6 million.

¹⁶ The variation to the funding agreement, which increased the funding level for 2008/09 from \$41 million to \$43.3 million, was ratified by Parliament on 17 June 2008.

NET EXPENDITURE BY FUNCTION

FOR THE YEAR ENDED 30 JUNE	NET EXPENDITURE ¹⁷	
	2009 BUDGET \$000	2008 ACTUAL \$000
Functions		
Monetary policy formulation	9,450	9,104
Domestic market operations	5,448	5,829
Financial system surveillance/policy ¹⁸	11,628	8,248
Currency operations	9,188	7,206
Foreign reserves management	7,571	7,650
Settlement services	405	362
Registry and depository services	(313)	(1,005)
Other outputs	478	668
Net expenditure	43,855	38,062

17 Net expenditure comprises operating expenses less income earned from certain Bank operations as specified in the funding agreement.

18 Net expenditure for the financial system surveillance/policy function will increase significantly in 2009. This reflects the additional advice that the Bank will provide and additional responsibilities that the Bank will assume in respect of the regulation of non-bank financial institutions.

STRATEGIC PRIORITIES FOR 2008/09

Each year we adopt a number of priorities, which we report on in the Annual Report. Below are the priorities for the 2008/09 year. We report on the priorities for 2007/08 on page 13.

DEPARTMENT	PRIORITY
1 PRUDENTIAL SUPERVISION	<p>PRUDENTIAL LIQUIDITY POLICY</p> <p>Develop and implement a prudential liquidity policy for registered banks.</p>
2 PRUDENTIAL SUPERVISION	<p>EXTENDED PRUDENTIAL REGULATORY REGIME</p> <p>Implement new regulatory arrangements for non-bank deposit-takers and develop a prudential regime for the insurance sector.</p>
3 BANK-WIDE	<p>MANAGEMENT DEVELOPMENT</p> <p>Support management in further developing their values-based leadership competencies.</p>
4 ECONOMICS	<p>ECONOMIC MODEL CONSTRUCTION AND IMPLEMENTATION</p> <p>Introduce a state-of-the-art model into the policy and forecasting process.</p>
5 KNOWLEDGE SERVICES/ ECONOMICS	<p>FINANCIAL SECTOR INFORMATION SYSTEM (FSIS) DEVELOPMENT</p> <p>Design and build an integrated computer application to improve the collection and analysis of financial sector statistics.</p>