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Editor's Note

This edition of the *Bulletin* contains five articles and one speech. The predominant themes of this edition relate to the foreign exchange market and financial stability, with all of the articles dealing with different aspects of these themes.

The first article, *International capital flows, external debt, and New Zealand financial stability*, continues the series of articles in the *Bulletin* on external vulnerability issues. It discusses New Zealand's continuing reliance on foreign capital to fund significant proportions of New Zealanders' investment and consumption expenditure, and the potential vulnerability to which this gives rise. The article explains the sources of much of New Zealand's external debt and discusses the factors that influence investors' decisions to hold New Zealand dollar assets. In assessing the potential vulnerability associated with an adverse change in market sentiment, the article draws out a range of factors that assist in reducing the economy's vulnerability, including the importance of sound economic policy and transparency arrangements, and high quality risk management in the financial and corporate sectors.

The external theme is continued in the second article, *Trends in foreign exchange trading*. This article discusses recent trends in foreign exchange markets, both globally and locally, drawing on data contained in a recent survey conducted by the Bank for International Settlements. As noted in the article, there have been some significant changes in the size and structure of the New Zealand foreign exchange market in recent years, including a migration of a significant proportion of New Zealand dollar trading to Australian markets. The article also comments on developments in liquidity and volatility in the New Zealand foreign exchange market, drawing comparisons with markets in other countries.

The foreign exchange market is also the theme of the third article, *Foreign exchange settlement risk survey*. This article discusses an important aspect of the foreign exchange market - one that is receiving increasing attention, both internationally and in New Zealand - the settlement risk on foreign exchange transactions (commonly known as "Herstatt risk"). Herstatt risk arises when there is a difference between the time at which an entity makes an irrevocable payment in one currency and the time at which that entity receives the other leg of the transaction (ie the other currency being traded) in final, settled terms. In some cases, this timing difference can be relatively long - more than one day - and tends to involve very large

amounts of money. It can therefore pose a risk to a bank (or non-bank corporate) in circumstances where the bank or corporate has paid away in one currency, but has not received the amount owed to it on the other side of the transaction. This risk can become an actual loss where the party owing the currency has become insolvent. The article discusses the various factors that influence the size and duration of Herstatt risk and the means by which this risk can be reduced.

Still on a foreign exchange theme, the fourth article in the *Bulletin*, *The current state of New Zealand monetary union research*, deals with the issue of currency union - an issue the Reserve Bank has addressed in a number of *Bulletin* articles and speeches in recent times. The article notes that the choice of currency, including a decision to enter into a currency union, is ultimately a matter that lies with a country's government and is generally considered as part of a broader range of economic integration issues. However, given the interest in currency union issues, both globally and in New Zealand, the Reserve Bank continues to conduct research on this subject in order to promote a well-informed public debate. This article summarises some of the literature on currency union matters, including work undertaken within New Zealand. It provides an indication of some of the issues on which the Bank is likely to conduct further research in the future.

The final article in this *Bulletin*, *Policy lessons on promoting financial stability*, deals with a wide range of financial stability issues. The article is a slightly amended version of a paper released recently under the auspices of the APEC Finance Ministers' process. The paper, authored by the Reserve Bank with assistance from other APEC economies, summarises the policy issues discussed at a Policy Dialogue on Banking Supervision - a workshop of policy practitioners from APEC economies held earlier this year in Mexico. The Policy Dialogue was chaired by the Reserve Bank and the National Banking and Securities Commission of Mexico. The article sets out a wide range of policy issues relevant to the promotion of financial stability, including banking supervision, corporate governance, financial disclosure, financial market structure and aspects of economic policy.

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