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Contents

Editor's Note	3
Articles	
The role of the Reserve Bank's macro model in the formation of interest rate projections <i>Tim Hampton, Economics Department</i>	5
Corporate governance in the financial sector <i>Geof Mortlock, Economics Department</i>	12
Developments in the New Zealand banking industry <i>Denys Bruce, Banking System Department</i>	26
Developments in credit markets over two decades <i>Clive Thorp, Economics Department</i>	38
For the record	
Discussion Papers	51
Recent news releases	53
Publications	57
Articles and speeches in recent issues of the Reserve Bank Bulletin	59

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Editor's Note

In recent issues of the *Bulletin*, we have broadened the range of subjects discussed, traversing a number of the Reserve Bank's functions, including aspects of the Bank's inner workings that rarely see the light of day. This is a pattern we plan to continue, in recognition that central banks have responsibilities that relate not only to the promotion of price stability, but also to a wider sphere of objectives, including the promotion of a sound and efficient financial system. And we see ourselves having some responsibility to promote greater public understanding on economic and financial issues, particularly in areas that relate to our functions as a central bank.

In the March 2002 issue of the *Bulletin*, we published an article on what is known as the "Taylor rule" – a relatively simple formula devised to explain monetary policy interest rate settings on the basis of the output gap and the extent to which actual inflation differs from the target inflation rate. We noted that the Taylor rule is merely one of a number of possible "monetary policy reaction functions" used by central banks as part of the process of forming a view on where interest rates should be set in order to curb inflationary pressures.

The first article in the June 2002 issue of the *Bulletin* continues this theme, by looking at the way the Reserve Bank's economic model determines an interest rate path for the purpose of economic projections. The article notes that one of the key components of all macroeconomic projections is the projected path for monetary policy – as reflected in the short-term interest rate. Until recently, virtually all projections published by central banks were based on the assumption of a constant nominal interest rate over the projection period, where the interest rate chosen was the interest rate prevailing at the time the projections were prepared. However, there is growing international interest in formulating different ways for describing the actions of monetary policy – so-called monetary policy reaction functions. There is also growing interest in macroeconomic projections that incorporate interest rate responses based on reaction functions. Projections that include interest rate paths drawn from such monetary policy reaction functions are referred to as *endogenous* interest rate projections, which means the projected interest rate is responding to projected movements in other variables within the model.

The Reserve Bank is unique in that we are currently the only central bank that prepares *and* publishes economic projections based on endogenous interest rates – an approach we adopted in 1997. The article outlines the reasons why we believe endogenous interest rate projections are preferable to a constant interest rate assumption and presents the policy reaction function in our model projections, along with the reasons for choosing this specification. The article also discusses how we use the projections in practice.

Although monetary policy is the Bank's main function, our other major area of responsibility is the promotion of financial stability. We do this in a number of ways, including through supervising banks, encouraging strong market disciplines in the financial system and fostering a robust payment system. Another important element in promoting financial stability is encouraging sound corporate governance and risk management in banks. No amount of supervision or regulation by a central bank or supervisory authority will succeed in promoting financial stability unless the people who run the banks and other financial institutions have a commitment to identifying, monitoring and managing their institution's risks. And that is why corporate governance, and the factors that influence it, is so important.

Our second article deals with this issue. It is an amended version of a paper prepared by the Reserve Bank for the Commonwealth Secretariat as a contribution to a technical assistance programme to strengthen corporate governance in the financial sectors of Commonwealth countries. The article deals with the subject of corporate governance in the financial sector and the relationship between corporate governance and the management of banking risks. It also summarises the Bank's approach to strengthening corporate governance in the New Zealand banking system, including the measures adopted in the Bank itself to maintain its own sound governance arrangements.

Continuing with the theme of financial stability, this issue of the *Bulletin* also contains the Bank's annual review of the state of the banking system, drawing on information disclosed by banks in their quarterly disclosure statements. The article notes that the relatively robust economic environment in New Zealand over the last 18 months or so, coupled with sound risk management practises by banks,

appear to have sheltered the banking industry from most of the ill effects of the international economic downturn. Reflecting this, the New Zealand banking industry performed well in 2001. The article notes that banks' after-tax profits increased and the industry remained in a strong financial position, not only in terms of credit ratings, but also in terms of asset quality, capital adequacy, and the management of exposures to key banking risks.

Our final article in this issue discusses the changing sources of and demand for credit since 1980. It updates the long-run series of household financial assets and liabilities introduced two years ago in the *Bulletin* and provides a more detailed breakdown of the long-term financial asset series. The article also presents a 20 year agriculture credit series and summarises other business sector borrowing. The data series reported in this article place current data in historical context and are intended to contribute to analytical work in a number of areas. We intend to prepare another article in the future to discuss policy and other implications arising from changes to the credit environment.

Finally, I would like to thank those readers of the *Bulletin* who responded to the survey we sent out in April this year.

We received a significant number of responses to the survey and obtained very helpful feedback from readers. We are currently processing the results of the survey and will then assess what, if any, changes we may make to the *Bulletin* to better meet the needs of our readers. We aim to report the survey results and our reaction to them in the September issue of the *Bulletin*.

One change we have already decided to make to the *Bulletin*, commencing with this issue, is to include a summary of recent *Discussion Papers* issued by the Bank. This was something that a number of our readers had suggested, and we view it as a useful way of alerting readers to the issues covered by our *Discussion Papers*. The summary of recent *Discussion Papers* is set out towards the end of this issue of the *Bulletin*.

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