
Reserve Bank of New Zealand Bulletin

Volume 65 No. 1, March 2002

Contents

Editor's Note	3
Articles	
The Taylor Rule and its relevance to New Zealand monetary policy <i>Chris Plantier and Dean Scrimgeour, Economics Department</i>	5
Exchange rate strategies for small open developed economies such as New Zealand <i>Nils Bjorksten and Anne-Marie Brook, Economics Department</i>	14
The Reserve Bank's external communications <i>Paul Jackman, Corporate Affairs Manager</i>	28
Managing human resources — a central bank perspective <i>Donna Hickey, Human Resources, Geof Mortlock, Economics Department</i>	34
Extracting market expectations from option prices <i>Aron Gereben, Financial Markets Department</i>	43
Polymer bank notes — the New Zealand experience <i>Brian Lang, Head of Currency and Building Services</i>	53
Speeches	
Inflation targeting 14 years on <i>A speech delivered by Donald T Brash, Governor of the Reserve Bank of New Zealand at the American economics Association conference in Atlanta on 5 January 2002.</i>	58
An indebted people <i>A speech delivered by Donald T. Brash, Governor of the Reserve Bank of New Zealand to the Canterbury Employer Chamber of Commerce on 25 January 2002.</i>	71
For the record	
Recent news releases	81
Publications	83
Articles and speeches in recent issues of the Reserve Bank Bulletin	85

This document is also available on the Reserve Bank's website (<http://www.rbnz.govt.nz>)

© Reserve Bank of New Zealand

ISSN 1174-7943

Editor's Note

When one thinks about a central bank, one tends to think mainly about monetary policy, given that this is the most visible function of most central banks. But central banks have more strings to their bow than monetary policy. This is certainly true for the Reserve Bank of New Zealand. In addition to having responsibility for monetary policy, we also have major responsibilities in a range of other areas, including oversight of the financial system, registration and supervision of banks, advising on exchange rate policy issues, managing foreign exchange reserves and managing bank notes and coins. In addition, the Bank maintains an involvement in a range of other policy issues, such as currency union issues, the factors that influence the potential growth of the economy and the implications of a low saving rate for the economy. And there is much to the Bank behind the scenes. As an organisation with a major balance sheet and with responsibility for important policy issues, there is a need for the Bank to maintain sound practices in corporate governance, risk management and the management of human resources.

The *Bulletin* provides a vehicle for giving exposure to a number of these issues and to reveal aspects of the Bank's functions and organisation that tend to fall in the shadows of its higher profile functions. In recent issues of the *Bulletin*, we have attempted to broaden the range of subject matter to provide a greater understanding of the Bank's lesser known functions and to promote a better informed public debate on various policy issues. This issue of the *Bulletin* is no exception. It contains six articles and two speeches, covering a wide range of topics. Indeed, there is "something for everyone" in this issue.

The first article, *The Taylor rule and its relevance to New Zealand monetary policy*, relates to the Bank's monetary policy function and discusses the use that the Bank makes of what has become known as the "Taylor rule". The Taylor rule is a formula devised to assist central banks to assess the appropriate level of short-term interest rates in order to produce a desired inflation outcome. It is based on relationships between the output gap, neutral real interest rates and the extent to which actual inflation has departed from the desired inflation target. The article notes that the Taylor rule provides a useful input into the monetary policy decision-making process at the Bank, but is merely one of

many pieces of information to which the Bank has regard when deciding where to set the Official Cash Rate.

The second article, *Exchange rate strategies for small open developed economies such as New Zealand*, continues the series of articles we have published in recent editions of the *Bulletin* on exchange rate-related issues. It is an edited version of a paper presented by the Bank to an economic workshop on Exchange Rate Strategies for Developed Open Economies in the New Millennium, held in Wellington in February 2002. The article notes that the large swings in the New Zealand exchange rate over the past decade have promoted debate on alternative exchange rate strategies that might allow for reductions in exchange rate variability, and potentially better economic growth performance. In discussing these issues, the article compares exchange rate volatility and cyclical variability for the New Zealand dollar with other currencies and assesses the merit of different options available to reduce exchange rate movements.

An important aspect of the business of most organisations is communication. This is no less true for a central bank, where communication plays an important role in promoting clear understanding of policy decisions and better informed debate on policy issues. The third article, *The Reserve Bank's External Communications*, deals with these issues. It reviews the way the Bank communicates its decisions and policies to external audiences and assesses why the Bank needs a communications programme, the methods used, and the way evolving circumstances are changing the Bank's approach to its external communications.

A change of theme is introduced in the fourth article - *Managing Human Resources – A central bank perspective*. This article looks behind the public image of the Bank and summarises developments in its human resources policies and practices over recent years. The management of human resources is a vital area of most organisations, but it is especially important for a central bank, given that credibility is a central bank's most important attribute, and that the quality of its staff are integral to a central bank's performance and credibility. Therefore, managing human resources effectively is a critical element in maintaining an effective and credible central bank. This article summarises the evolution of the Bank's approach to human resources management, placing this in the context of the changes that

have occurred within the Bank's structure and governance arrangements over the last decade or so.

Indicators of market expectations based on option prices are gaining in popularity among central banks. The Bank recently began to use these indicators in financial stability and monetary policy analysis. An article in this edition of the *Bulletin* – *Extracting market expectations from option prices* – provides a non-technical overview of these techniques and highlights how they might be used, through examples. The article discusses techniques that use information in the prices of financial options to reveal the nature of the uncertainty that surrounds the market expectations about financial market indicators, such as stock indices and the exchange rate.

In May 1999, the Bank issued its first polymer bank note into circulation. By March 2000 all denominations had been converted from paper to polymer. By the end of 2001 approximately 110 million polymer notes had been issued into circulation. The polymer notes were introduced for a number of reasons, including their enhanced security features (and therefore a lower risk of counterfeit), longer life and

lower processing costs. Now that the first of the polymer notes have been in circulation for nearly three years, it is timely to assess their performance against the expectations that the Bank had of them when they were introduced. That is the purpose of the article – *Polymer bank notes – the New Zealand experience* – in this edition of the *Bulletin*.

Also included in this edition of the *Bulletin* are two speeches given recently by the Governor of the Bank, Don Brash. One of these speeches – *Inflation targeting 14 years on* – reviews the New Zealand approach to inflation targeting and assesses its achievements. The second speech – *An indebted people* – discusses the extent of New Zealand's external indebtedness and the implications of this for the economy.

Geof Mortlock, Economics Department
Reserve Bank of New Zealand
P O Box 2498, Wellington, New Zealand
Email mortlockg@rbnz.govt.nz
Telephone 64-4-471-3690
Facsimile 64-4-473-1209