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## Editor's Note

Central banks have a wide range of functions, generally including monetary policy, exchange rate policy, financial system surveillance, provision of settlement accounts to commercial banks and the issuance of notes and coins. At first sight, it might seem that some of these functions are quite disparate, with little in common. However, on closer examination, it can be seen that most of the functions of a central bank are interlinked and contribute to a common theme – that of macro-financial stability. Indeed, the promotion of macro-financial stability is the very *raison d'être* of central banks, and this is no less true in the case of the Reserve Bank of New Zealand as for other central banks around the world.

We are tasked with the job of promoting stability in a number of ways – through monetary policy (to maintain stability in the general level of prices), through our supervision of the banking system (to maintain a sound and efficient financial system) and through the oversight of the payment system (again, to promote a robust and efficient financial system). As the issuer of notes and coins, the Bank seeks to provide the public with a secure and convenient means of payment, and one that broadly holds its value through time.

This issue of the *Bulletin* contains five articles. Although they cover a wide range of subject matter – including aspects of monetary policy, the payment system, financial markets and the history of money in New Zealand – they are linked by the common thread of stability. Each in their own way focuses on different elements of the Reserve Bank's task of helping to make the New Zealand financial system and wider economy a more certain and stable place to do business, to produce goods and services, to consume, to save and to invest.

The first article deals with an important element of the New Zealand monetary policy framework – the output gap. The output gap (the measure of the difference between the actual output of the economy over a particular period and the 'trend' output of the economy), as one of the core links between the real economy and inflation, is essential to monetary policy formulation and provides a useful way of thinking about inflationary pressure in the economy. It has long been a commonly used device at central banks to represent how "hot" or "cold" the economy is at any

particular time and to forecast likely inflationary pressures. The output gap can also be a useful indicator of the volatility of activity in the economy – whether resources are alternating quickly or gradually between periods of substantial resource strain to periods of substantial resource abundance. The article discusses the output gap, its strengths and weaknesses, the various ways it can be measured, and how it fits into the monetary policy process at the Reserve Bank.

As noted above, a core aspect of the way the Reserve Bank promotes macro-financial stability is through the supervision of banks and oversight of the payment system. These roles recognise the importance of the financial system in the wider economy and the need for it to remain robust in the face of economic shocks. The robustness of New Zealand's financial system will be subject to additional scrutiny this year, given that New Zealand is scheduled to undergo an assessment by the International Monetary Fund under the Financial Sector Assessment Programme (FSAP). The FSAP is a relatively new surveillance and assessment programme developed and jointly managed by the International Monetary Fund (IMF) and World Bank. It is designed to assess the potential vulnerabilities in a country's financial system and to evaluate the adequacy of financial sector regulation and supervision, using international standards and codes as benchmarks, as well as a number of other analytical tools.

The second article in this issue of the *Bulletin* explains the FSAP and discusses the key elements within it. Later this year and in 2004, the *Bulletin* will include articles that draw from the FSAP and the work being undertaken by the Reserve Bank and other government agencies in preparation for it.

One of the key elements of the financial system is the payment system. In modern market-based economies, day-to-day activity involves many millions of transactions for goods, services and financial assets, the payment for which results in the transfer of money. For participants to have confidence in their ability to effect transactions and access their funds, it is important that the systems are efficient, reliable and secure. Payment mechanisms, however, may both be an origin and channel through which financial shocks can be transmitted across markets and national boundaries. Accordingly, robust payment systems are a core element in maintaining financial stability and it is in the private and public

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interest to ensure that, in the event of a shock or disruption, any systemic impact is minimised.

The third article in the *Bulletin* considers current developments in the payment system arena. It reviews two major international payment system initiatives and the potential implications for New Zealand, and reports on the structure and operational changes occurring at the domestic level. The article explains the role of the Reserve Bank in the domestic payment system and comments on some of the issues and challenges looking ahead.

The financial system is more than just the banking and payment systems. It encompasses many other elements, including the financial markets, such as the money markets, foreign exchange market and swaps market. The Bank takes a close interest in financial markets, both because they are important to broader systemic stability and efficiency and also because of their relevance to monetary policy. The fourth of our articles deals with a new development in New Zealand's financial markets – the introduction last year of a new type of financial instrument – the Overnight Indexed Swap (OIS). This article is intended as a primer, explaining what the OIS is and how it is used by market participants to manage interest rate risks and to take a view on the direction of the Official Cash Rate (OCR). From the Bank's perspective, we are most interested in using OIS yields to derive estimates of market expectations of the OCR. This article also highlights developments in the New Zealand OIS market to date.

The final article in this issue of the *Bulletin* deals with a fundamental element of what central banks are all about – money. A central bank's stock in trade is money. This is no less true in New Zealand than in any other country. It is perhaps not surprising, therefore, that the Reserve Bank takes more than a passing interest in the historical development of notes and coins in New Zealand. The article summarises the legal history of notes and coins in New Zealand, beginning in the early days of colonisation and tracing the key developments through to the modern era. Although the focus of the article is on the development of the legal framework governing notes and coin, rather than other aspects of money, it also discusses some of the economic and social issues that shaped these legal developments.

I hope our readers enjoy this issue of the *Bulletin*, with all its variety of subject matter.

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