

Contents

Editor's Note	3
Articles	
Recent developments in New Zealand's financial stability <i>Michael Gordon, Leslie Hull and Clive Thorp, Financial Stability Department</i>	5
Neutral real interest rates revisited <i>Nils Björkstén and Özer Karagedikli, Economics Department</i>	18
Risk management in the Reserve Bank: a 2003 perspective <i>Steve Anderson, Risk Assessment and Assurance</i>	28
International efforts to combat the financing of terrorism <i>Ken Matthews, Financial Stability Department</i>	34
Monetary policy and the volatility of real exchange rates in New Zealand: Summary of a lecture by Professor Ken West <i>David Hargreaves, Economics Department</i>	42
Has the rate of economic growth changed? Evidence and lessons for monetary policy: Summary of a lecture by Matthew D. Shapiro <i>Christopher Plantier, Economics Department</i>	44
Summary of a new Reserve Bank of New Zealand paper: Overview of New Zealand financial sector regulation <i>Geof Mortlock, Financial Stability Department</i>	46
Speeches	
Financial system regulation in New Zealand <i>Alan Bollard, Governor, and Tim Ng, Manager, Financial System Policy, Reserve Bank of New Zealand</i>	47
Extract from an address to the Property Council of New Zealand <i>Alan Bollard, Governor, Reserve Bank of New Zealand</i>	54
For the record	
Discussion Papers	56
Recent news releases	57
Reserve Bank policy statements	61
Publications	63
Articles and speeches in recent issues of the Reserve Bank Bulletin	64

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

This issue of the *Bulletin* contains a wide variety of subject matter, ranging across quite a number of the Reserve Bank's functions, including aspects of our internal management.

We lead this issue with our annual review of developments affecting New Zealand's financial stability. In this review, we conclude that New Zealand's financial sector has remained resilient despite continued global economic weakness and that there do not appear to be any immediate concerns for domestic financial stability. Banks are well capitalised, with sound asset quality, good risk management systems and strong parent banks, and corporate credit quality remains satisfactory.

However, we are keeping a careful watch on potential threats to financial stability, particularly developments in the household sector, where household borrowing remains very high and where many households have a high exposure to real estate. We are also keeping a watchful eye on corporate and rural sector developments, including their capacity to ride through any further appreciation in the New Zealand dollar. And, in view of the fact that New Zealand's financial system is dominated by Australian banks, the state of the Australian economy and financial system is always on our radar screen. On that front, it is pleasing to see that Australia continues to enjoy a robust economy and that its banking system remains in good health.

Monetary policy in New Zealand is implemented by the Reserve Bank setting the Official Cash Rate. This influences the level of most other interest rates in the New Zealand economy, and thereby affects the level of economic activity and inflationary pressures. In setting interest rates, it is therefore important to know what level of interest rates will stimulate or constrain economic activity. Our second article - *Neutral real interest rates revisited* - discusses this issue by looking at the "neutral real interest rate" in New Zealand. This is the interest rate, after taking off the inflation rate, that is neither stimulatory nor contractionary in its effect on the economy - ie it is neutral in its impact on economic activity.

In the article, we discuss the various ways of estimating the neutral real interest rate, and we make the point that there is no perfectly reliable means of doing this. Therefore, any estimate of the neutral real rate is approximate only and

subject to many uncertainties. Notwithstanding this, we arrive at broad estimates of the neutral real rate for New Zealand and we compare that rate with estimates for earlier years. Those estimates reveal a marked decline in the level of the neutral real rate. We offer a number of explanations for why this trend has occurred. However, we also note that, although New Zealand's neutral real rate has declined, it remains higher than in some other developed economies, such as the United States and, to a lesser extent, Australia. The article discusses why this is so and what factors might influence the future direction of the neutral real rate in New Zealand.

We change tack in our third article and look inwards to how the Reserve Bank manages its risks. We published an article on this topic in the December 1999 issue of the *Bulletin*, in which we described the then newly formed Risk Assessment and Assurance Department in the Reserve Bank and explained how the Bank controlled its risks. Quite a lot has happened since then, both within the Bank and in the way the business community views risk management. In our third article - *Risk management in the Bank: a 2003 perspective* - we provide an update of our approach to risk management in the Bank, including by reference to the devices we use to identify, monitor and control the risks associated with our two main functions - monetary policy and banking supervision.

Following the terrorist attacks in September 2001, there have been a number of developments in measures to combat the financing of terrorism. Our fourth article - *International efforts to combat the financing of terrorism* - discusses the characteristics of terrorist financing and summarises the international initiatives to counter the financing of terrorist activities, including measures taken by the United Nations, the Financial Action Task Force, regional bodies and national authorities. It then discusses in greater detail the actions that have been taken by the New Zealand government in this area.

One of the issues that frequently confronts the Bank is the tendency for the New Zealand dollar to fluctuate quite sharply against other currencies, periodically putting pressure on the exporting sector and generally creating uncertainty in the economy. Although much of this fluctuation in the exchange rate is attributable to factors outside of our control, we

nonetheless seek to minimise any unnecessary effects on the exchange rate arising from our monetary policy actions. In that context, we are currently thinking about whether the Bank can reduce real exchange rate volatility, while continuing to pursue our price stability objective.

To help us in this work, we recently had the benefit of research by a visiting academic with strong credentials in monetary economics, Professor Ken West. The culmination of his work with us was a lecture given earlier this year at Victoria University on the subject of *Monetary policy and the volatility of real exchange rates in New Zealand*. We summarise the main findings of his research in this issue of the *Bulletin*. On the basis of his model, Professor West concluded that there appear to be trade-offs in seeking to reduce variability in the real exchange rate. Reduced variability in the real exchange rate is likely to be associated with increased volatility in other key economic variables, such as interest rates, inflation and real economic growth.

We have also benefited from the research of another visiting academic, Professor Matthew Shapiro. Professor Shapiro's research led to a lecture given earlier this year at Victoria University on the subject of *Has the rate of economic growth changed? Evidence and lessons for monetary policy*. In this *Bulletin*, we summarise the main findings from Professor Shapiro's research, including the fundamental point that

monetary policy can do little to affect the level of productivity in the economy in the long run, but that central banks should still be cognisant of potential changes in productivity of the economy over time, so as to be better informed of the inflation consequences of a given growth rate in total output.

Finally, this issue of the *Bulletin* contains a brief summary of a paper that the Bank has placed on its website. The paper provides a comprehensive description of the main components of the financial system in New Zealand and the regulatory framework governing it, including banking supervision and securities market regulation. It is intended to be a useful reference document for interested parties, including the International Monetary Fund when they conduct an assessment of New Zealand's financial system later this year.

I hope that readers find this issue of the *Bulletin* informative and stimulating.

Geof Mortlock, Financial Stability Department
Reserve Bank of New Zealand
P O Box 2498, Wellington, New Zealand
Email mortlockg@rbnz.govt.nz
Telephone 64-4-471-3949
Facsimile 64-4-471-3800