
Volume 67 No. 2, June 2004

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ISSN 1174-7943



Editor's Note

In this issue of the *Bulletin* we have a broad range of articles relating to most of the Reserve Bank's core functions, including monetary policy, financial stability and the exchange rate. For the first time in the *Bulletin*, we also feature an interview. On this occasion it is with a visiting academic, Professor George Kaufman, and covers a range of financial stability issues. We also reproduce a public lecture given earlier this year in Wellington by Professor Kaufman. And we feature a copy of the Policy Conclusions paper to emerge from an APEC Policy Dialogue on Financial Disclosure, which was co-chaired by the Reserve Bank earlier in the year.

Our first article covers an issue that is central to the Reserve Bank's function of monetary policy – the Policy Targets Agreement (PTA) - the agreement between the Minister of Finance and the Governor of the Reserve Bank that specifies the monetary policy target. Although much has been written about the PTA as a key element in the New Zealand monetary policy framework, most of that has been on the inflation target itself. On this occasion, we discuss another important aspect of the PTA, though one that receives less prominence and is probably less well understood – the requirement for the Bank, when conducting monetary policy in the pursuit of price stability, to seek to avoid unnecessary instability in economic output, interest rates and the exchange rate.

In this article, we discuss what this requirement means in practice and how we implement it when conducting monetary policy. It discusses the nature of the trade-offs between maintaining a low and broadly stable inflation rate, on the one hand, and seeking to avoid excessive volatility in the real economy and in interest rates and the exchange rate, on the other. It notes that a strict approach to inflation targeting tends to exacerbate volatility in other parts of the economy, whereas a flexible approach to inflation targeting generally results in less volatility in the economy as a whole, but also permits a greater degree of variability in the inflation rate. It therefore notes the need for a sensible balance to be struck in conducting monetary policy, such that inflation is kept low and broadly stable in the medium-term, but where allowance is made for occasional temporary deviations of inflation outside the target range where this is necessary in order to avoid excessive swings in the wider economy.

A variation on this theme appears in our second article. This article discusses the vexed question of what determines exchange rate movements. This has been one of the most problematic elements in the field of economics for many years, with few clear-cut answers as to the key determinants of exchange rate movements in the short or medium-terms. However, in this issue of the *Bulletin*, we discuss one of the frameworks for seeking to explain what drives exchange rate movements – in which the exchange rate is viewed as an asset price. Much like other asset prices (such as financial asset or property prices), the exchange rate can be seen as a function of the present value of future returns able to be earned in one currency versus the present value of future returns earned in another currency. Using this approach, we discuss what kinds of factors can influence exchange rate movements, both in the short-term and medium-term, including changing interest rate levels, economic growth rates, commodity prices and purchasing power parity. The article concludes that the asset price framework does help to explain exchange rate movements, but acknowledges the inherent complexity of the many factors that underlie exchange rate changes, and hence the difficulty in applying any one model to make sense of exchange rate trends.

The third article introduces a complete change of subject matter by providing an analysis of developments in the New Zealand banking sector in 2003. It notes that the banking system continues to perform well, with high levels of profitability (though down on the previous year results), high asset quality and a strong level of capitalisation. The article also provides an update of recent developments in banking supervision policy and related matters.

This will be the final of the regular, annual articles on the banking sector to appear in the *Bulletin* for the foreseeable future. Instead, analysis of the banking sector and wider financial system will be set out in a new publication – a *Financial System Review*. This will be a regular publication, commencing later this year, and will cover a wide range of financial sector issues, including analysis of the structure, performance, soundness and efficiency of the financial system. The *Bulletin* will continue to feature articles on particular aspects of the financial system, such as descriptions of regulatory frameworks and policy developments.

Still on a financial stability theme, the fourth article in this issue of the Bulletin is on the results of the Financial Sector Assessment Programme (FSAP) evaluation of the New Zealand financial system conducted by the International Monetary Fund (IMF) late last year. The FSAP is a programme administered by the IMF and World Bank to assess potential financial sector vulnerability in a country and to evaluate the effectiveness of financial sector regulation. Each country is expected to undergo an FSAP assessment every 7 years or so. The article notes that the FSAP for New Zealand concluded that New Zealand's financial system is sound and well placed to withstand a range of economic and financial shocks. The FSAP also concluded that the financial sector regulatory framework is generally robust and meets most international standards, although there are areas where improvements can be made. The article discusses the nature of these improvements and the policies underway within the Reserve Bank to address these matters.

The Reserve Bank has for many years sponsored a visiting academic programme, whereby a prominent academic from another country spends a couple of months or so in New Zealand, working jointly with the Reserve Bank and Victoria University of Wellington. Earlier this year, Professor George Kaufman, of Loyola University Chicago, spent two months under this programme in Wellington, much of it at the Reserve Bank. In that period, he worked on a range of financial stability issues relevant to the work of the Reserve Bank. This Bulletin contains an interview with Professor Kaufman and a public lecture he gave while in Wellington.

Finally, this Bulletin contains a copy of the Policy Conclusions paper that emerged from the APEC Policy Dialogue on Financial Disclosure, which was held in February this year

and co-chaired by the Reserve Bank of New Zealand and the Ministry of Finance of Chile. The Policy Dialogue was one of a number that have been held under the auspices of the APEC Finance Ministers' process. On this occasion, the topic was financial disclosure in the financial and corporate sectors of countries in the Asia-Pacific region and involved presentations and policy dialogue from participants of 17 of the 21 economies in APEC. It drew attention to the importance of financial disclosure as a means of strengthening the management of financial institutions and other corporate entities, of improving the accountability of directors and management, and of enhancing the ability of investors and creditors to protect their interests when dealing with financial institutions and other corporates

I hope that readers will enjoy this issue of the Bulletin, with its wide variety of content and interesting issues.

Geof Mortlock
Editor
Reserve Bank of New Zealand Bulletin
Reserve Bank of New Zealand
P O Box 2498
Wellington 6001
New Zealand

Telephone 64 4 471 3949
Facsimile 64 4 471 3995