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## Editor's Note

### Central banking in New Zealand — looking back and looking forward

This is my final issue of the *Bulletin* as its Editor. After four and a half years, I hand over the reins to a new Editor with effect from the December 2004 issue of the *Bulletin*. The new Editor is Bernard Hodgetts, a colleague from the Economics Department of the Reserve Bank.

In my time as Editor, I have used the Editor's Note to summarise the content of each *Bulletin* and to draw connections between articles. On this occasion, I will let the articles speak for themselves and instead dedicate the Editor's Note to a broader theme – the changes that have occurred in central banking in recent times. In particular, I would like to focus on the emergence of a more holistic and integrated approach to central banking, which is something that has become more apparent in my time as Editor. Indeed, many issues of the *Bulletin* have contained articles and speeches that reflect this development.

In New Zealand, as in many countries around the world, central banking has seen major changes in the last 20 years or so. These changes have centred mainly on the two core functions of central banks – monetary policy and the pursuit of financial stability.

The 1980s was a decade of major financial sector reform in New Zealand and around the world. In New Zealand, it saw the deregulation of banks and other financial institutions, the abolition of foreign exchange controls, removal of interest rate controls, abandonment of a pegged exchange rate in favour of a floating rate, the opening up of the banking sector, the privatisation of state-owned financial institutions and the rapid developments in the quality and range of financial services. This liberalisation saw the emergence of a markedly different financial sector in New Zealand — one characterised by foreign ownership and control of the banking system, and the evolution of a more dynamic, sophisticated, and efficient financial system.

However, as with any period of rapid change, not all went well. By the late 1980s and early 1990s, some parts of the corporate sector in New Zealand, and in some other countries, including Australia, were experiencing severe difficulties. These culminated in the collapse of a number of financial institutions, and problems for a number of banks in

New Zealand. In part, these difficulties reflected the severe economic turbulence and sweeping economic reforms of the time. It also reflected the higher risks associated with a liberalised financial system – risks that were insufficiently identified, understood, and managed by the bankers of the day.

The difficulties of the late 1980s and early 1990s spurred the development of improved risk management capacity in the financial system, with the senior management of banks and other financial institutions investing substantial resources in this area. The late 1980s and 1990s also saw an increasing recognition of the importance of financial stability and the damage that occurs, not only within the financial system, but also in the wider economy, when financial systems become unstable. Reflecting this, banking supervision and payment system reform became important central banking themes in the 1990s, both in New Zealand and around the world. Although New Zealand tended to adopt a relatively unintrusive approach to the supervision of banks, the 1990s nonetheless saw the development of a regulatory framework for banking that stressed the importance of risk management, relying on a combination of official supervision, sound corporate governance, and disclosure. The 1990s was also a period in which central banks, including our own, developed greater awareness of payment system risk as a key ingredient in financial system stability, and pursued major reforms to ensure that payment system risk was well managed. The introduction of real-time gross settlement and robust netting arrangements in New Zealand were the result.

Of course, the 1980s and 1990s were also important decades for the development of that other mainstay of central banking: monetary policy. In New Zealand and in many countries, a renewed emphasis came to be placed on fighting inflation, spurred on by the bitter experience of the high inflation that characterised much of the world in the latter half of the 1970s and into the 1980s. At home, this saw the emergence of a monetary policy focused on reducing inflation and then maintaining a low and broadly stable inflation rate. By the late 1980s, this was formalised

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through the use of inflation targeting and increasing central bank independence. This was encapsulated in the coming into force of the Reserve Bank of New Zealand Act 1989, which enshrined in statute the single monetary policy objective of price stability, and conferred full operational independence on the Reserve Bank in the pursuit of monetary policy. New Zealand was the first country in the world to adopt formalised inflation targeting.

Over this period, to a large extent the development of banking supervision and payment system policies, and the pursuit of inflation targeting, were treated as separate and distinct functions within the Reserve Bank. Although there was a recognition of the connections between them, relatively little emphasis was placed on those connections. This was also a period when price stability was the clear focus of the Reserve Bank, and the inflation target acquired great prominence in the Bank's public communication and internal thinking. Reflecting this, the early Policy Targets Agreements between the Minister of Finance and the Governor of the Bank placed emphasis on keeping inflation within the target band.

More recently, central banking in New Zealand has evolved towards a more holistic approach, with a greater recognition of the connections between price stability, the economy in general and financial stability, and a greater emphasis on the Bank's role in the promotion of a sound and efficient financial system. Although price stability remains the primary function of the Bank, it is now pursued within a somewhat broader context, where price stability is seen as part of a mix of macroeconomic goals. This is reflected in the Policy Targets Agreement, which now gives greater emphasis than in the past to avoiding unnecessary instability in economic output, interest rates, and the exchange in the pursuit of price stability. The inflation target has also become less rigid, with the Bank now being required to keep inflation within the target band on average over the medium term, rather than in every 12 month period.

Recent years have also seen strengthened emphasis on the promotion of financial stability, and a broadening of approach in its pursuit. Banking supervision has received particular attention of late, with a stronger focus on the Bank's role as a host supervisory authority in a foreign-owned

banking system, and with a strengthening of various aspects of supervision policies and practices. The Bank has also broadened its financial stability role, increasing the resources it devotes to the analysis of macro-financial indicators and taking a greater interest in the linkages between the wider economy and the financial sector. We have also increased our attention to the non-bank financial sector, particularly the non-bank deposit-taking financial institutions. The linkages between New Zealand's financial stability and developments in other countries' economies and financial systems have also received increasing attention from the Bank, with especial emphasis on Australia and Asia. We have strengthened and formalised our relationships with other financial sector regulators in New Zealand, and with other central banks and regulators around the world. In some respects, we are now a broader central bank than was once the case.

The broadening of the focus of central banking is by no means unique to New Zealand. Around the world, central banking is increasingly looking at the bigger picture, at the linkages between the real economy and the financial system, and at the connections between the different components within the financial system. It is also focusing more on the international connections between economies and financial systems, with a greater recognition that, in a world of greater global and regional integration, instability in one country can be transmitted to another via a number of channels, and not always obviously.

Although these are phenomena facing all countries, they are of striking relevance to New Zealand, given that ours is a particularly open economy, and we have a financial system that is greatly dominated by foreign ownership and control. These developments make it all the more essential that central banking in New Zealand, as elsewhere, takes a more holistic approach to the pursuit of stability, where monetary policy, banking supervision, payment system policy, exchange rate policy, and macro-financial analysis, are increasingly seen as an integrated package of policy instruments in the pursuit of monetary and financial stability, rather than as distinct elements of central banking.

In recent years, the *Bulletin* has reflected this more holistic approach to central banking. We have featured many

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articles that highlighted the connections between the different elements of central banking, between financial stability and wider economic stability, and between the health of the New Zealand financial system and economy and that of other countries in the region. I have little doubt that the next few years will see even more attention being given to these issues, and an increasing recognition that, when it comes to central banking, like many things in life, the whole is indeed greater than the sum of the parts.

It has been a privilege to have served as Editor of the *Bulletin* these past four and a half years. I am pleased with what

we have managed to achieve in the *Bulletin*, particularly given that we are a relatively small central bank with limited resources. I am confident that the *Bulletin* will be in safe hands under the stewardship of the next Editor, Bernard Hodgetts. I wish him well in the role. And I wish our readers all the very best for the future. I am sure the *Bulletin* will continue to be a source of constant learning, for its authors, its Editors, and its readers.

Geof Mortlock  
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*Reserve Bank of New Zealand Bulletin*