



RESERVE
BANK

O F N E W Z E A L A N D

2005-2006 ANNUAL REPORT

Banking

on our future

celebrating our past



Box 1: Understanding our past



On 6 September 2006, Peter Hillary, on behalf of Sir Edmund Hillary, officially opened the Reserve Bank Museum on the ground floor of our building at 2 The Terrace, Wellington. Sir Edmund is the only living New Zealander portrayed on our bank notes. It was both fitting and an honour to have a member of Sir Edmund's family preside at the launch of what we hope will become a resource of national significance.

The Museum is designed to be informative and entertaining across a multitude of subjects encompassing the economy, the financial markets and payments systems, the evolution of our currency, and the role played by the Reserve Bank in all of these.

The development of the New Zealand economy is traced from pre-European times through to the global integration of today. Key events in the history and workings of the Bank are explained. Our valuable collection of rare notes and coins is displayed publicly for the first time. Various artefacts and objects relating to the evolution of the Bank are placed on view. A number of these artefacts are pictured through this *Annual Report*.

The Bank is an organisation that spends much of the time thinking about the future. But it is equally important to understand the events that have led to present-day conventions, and to acknowledge a rich heritage which we can now enjoy with pride.

RESERVE BANK OF NEW ZEALAND

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Our commitment to New Zealanders

As New Zealand's central bank, we will do everything in our power to build national and international confidence in the stability and integrity of New Zealand's money and monetary system. We will do that by:

- operating monetary policy so as to maintain price stability;
- promoting the maintenance of a sound and efficient financial system; and
- meeting the currency needs of the public.

We will critically review our performance regularly and will aim to ensure that we use taxpayers' resources efficiently and effectively.

Our values

Excellence: We pursue excellence in all that we do and we achieve it by actively challenging, reviewing and improving the way we work.

Our people: We value the talents of our people and enhance those talents by providing encouragement, support and opportunities for growth and development.

Our reputation: We strive to inspire public confidence by acting with integrity, exercising sound judgement and using public resources responsibly.

Working together: We respect and encourage both open communication and diverse contributions aimed at achieving the Reserve Bank's goals.



THE YEAR AT A GLANCE

- Consumers Price Index (CPI) inflation was 4.0 percent for the 12 months to 30 June 2006.
- The Reserve Bank continued to tighten monetary policy, raising the Official Cash Rate (OCR) from 6.75 percent to 7.25 percent by December 2005, maintaining it at that level for the rest of the financial year.
- The Reserve Bank and The Treasury looked at potential tools to supplement the OCR in managing inflation, especially in relation to the housing market.
- The Bank participated in government reviews of regulation of non-bank financial institutions, insurance, superannuation schemes, securities offerings, and collective investment schemes.
- The Government decided in principle that a single agency should prudentially regulate and supervise the financial sector, and that that agency should be the Reserve Bank.
- Legislation was initiated in New Zealand and Australia to ensure that the Reserve Bank and the Australian Prudential Regulation Authority (APRA) could support each other in performing their regulatory responsibilities.
- The Bank's policy on outsourcing by major banks was finalised in January 2006.
- The Bank introduced a new liquidity management regime, allowing cash levels to rise to ensure sufficient liquidity to enable participants to settle their payment obligations.
- A 'Bond Lending Facility' was introduced successfully to alleviate pressures in the inter-bank payments and settlement system.
- The Bank finalised preparations for the introduction of smaller, lighter 10, 20, and 50 cent coins on 31 July 2006.
- The Bank commenced a major systems upgrade of the ESAS and Austraclear systems, and a new treasury system was implemented.
- The Bank enhanced its business continuity planning, including civil defence capability, consolidation of Wellington sites, and preparedness for a potential pandemic.
- Construction of the Reserve Bank Museum started.
- The Bank hosted the EMEAP¹ Governors' meeting, and a course on central banking for South Pacific central banks.
- The Reserve Bank spent a net \$35.9 million on activities covered by the Bank's Funding Agreement, which was 8 percent below the \$39 million in the Agreement. The Bank generated a surplus of \$253.9 million. A dividend of \$410.0 million will be paid to the Crown.²

¹ The Executives' Meeting of East Asia-Pacific central banks. See page 44.
² The Payment to Government was confirmed by the Minister of Finance after balance date.

Such experience underlines the need to have an understanding of how uncertainty can be handled within forecasts. Accordingly, we set a strategic priority for this year to improve our forecasting and monetary policy decision-making under uncertainty, which in turn would lay the foundation for redevelopment of our current forecasting model. Both those projects have progressed well, yielding promising results.

In addition we committed resources to other important projects in the economic field, such as research into what drives household behaviours that affect inflation. Other initiatives were not in the year's plan, but had the potential to add to our toolkit. One such initiative was a joint project with The Treasury looking at supplementary stabilisation instruments, which is explained in more detail on page 26.

Each year, we set ourselves a budget and business plan to maintain business-as-usual activities, as well as a programme of initiatives to address especially pressing issues. These are captured within each of our functions and internal services. A handful or so are identified as strategic priorities.

They become the significant goals we aim to achieve in the immediate future and fit within our longer-term plans, expressed in our five-year Funding Agreement with Government and our *Statement of Intent* (SOI).

The wide range of policy initiatives undertaken in banking supervision fitted this pattern of planning and resourcing over multi-year timelines. This year we implemented policies on key regulatory issues: outsourcing, the Basel II capital adequacy regime for banks, local incorporation and bank failure management.

Less predictable has been the potential expansion of our supervisory role into the non-bank financial sector, identified in policy work led by other Government agencies. The initial analysis is almost complete and proposals will be considered by Government in 2006/07.

Foreseeable activity in 2005/06 included preparations for the distribution of new, smaller and lighter plated-steel coins to replace the cupro-nickel 10, 20 and 50 cent coins, and the removal of the 5c coin, introduced in 1967. This project will be completed in 2006/07, and will return substantial benefits to the New Zealand public.

In market operations, our strategic priority to ensure adequate liquidity in the banking system resulted in the implementation of a new liquidity management regime. This received overwhelming support from market participants, removing the volatile and misleading pricing that previously existed.

And there has been the development of a heritage museum, recently opened to the public, explaining our role in the New Zealand economy through an array of static and audio-visual media, as well as displaying unique and valuable banking artefacts. We hope this will add to New Zealanders' understanding of their economy and institutions, as well as providing the opportunity to view historical items previously held in our vaults.

There is much more covered in this *Annual Report*. As our workload adapts and increases, it underlines the reliance we place on the talents and dedication of our people. I am very aware and appreciative of the commitment and energy from staff and the Board needed to make this a successful institution.



Alan Bollard
Governor

THE RESERVE BANK OF NEW ZEALAND – WHAT WE DO

The Reserve Bank of New Zealand is the nation's central bank. The Bank has three main functions, which contribute to New Zealand's monetary policy, financial stability and currency.

Monetary policy

Under the Reserve Bank of New Zealand Act 1989, the Bank is given operational independence to manage monetary policy to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement (PTA). (See pages 24-26 for more detail on monetary policy activity in 2005/06.)

Financial stability

The Act also directs the Bank to promote the "maintenance of a sound and efficient financial system" and to avoid "significant damage to the financial system that could result from the failure of a registered bank".

To achieve these requirements, the Reserve Bank registers banks and operates a banking supervision system designed to encourage banks to manage their risks carefully. The Reserve Bank acts as banker to the banks, providing inter-bank settlement facilities and related payment services. We advise the Government on the operation of the financial system. We manage foreign exchange reserves to enable intervention in the foreign exchange market, if ever required. (See pages 27-33 for related activity in 2005/06.)

Currency

The Reserve Bank issues New Zealand's currency. As required by statute, we control the design and printing of the nation's currency. We then issue currency to banks, which they in turn provide to their customers. We also withdraw from circulation and destroy damaged or unusable currency. (See page 34.)

Other

The Reserve Bank provides cash and debt management services to the Government.

Our internal organisation is illustrated in the chart on page 7. Details of the Board of Directors are provided on pages 8-9. The role of the Board, and the governance and management of the Bank, is described on pages 10-13.



Departmental structure *As at 30 June 2006*

Governors	Department/Heads	Functions	Internal services
Assistant Governor/ Head of Economics Grant Spencer	Economics	Monetary policy formulation	Statistical services
Deputy Governor/ Head of Financial Stability Adrian Orr	Financial Stability	Market operations Foreign reserves management Financial system surveillance and policy	
Governor Alan Bollard	Currency and Building Services Brian Lang	Currency operations	Property management Security
	Financial Services Mike Wolyncewicz	Settlement services Registry and depository services	Accounting services Treasury services
	Knowledge Services Yogesh Anand		Library services Technology services Project management Web publishing
Assistant Governor/ Head of Operations Don Abel	Human Resources Tanya Harris		Human resources strategy and services
	Communications/ Board Secretary Mike Hannah		Communications strategy and services Reputation management Board secretary services
	Risk Assessment and Assurance Steve Anderson		Audit services Risk assessment and assurance Legal counsel