RESERVE BANK OF NEW ZEALAND 1991 ANNUAL REPORT : GOVERNOR'S STATEMENT

The Annual Report was prefaced by a statement by the Bank's Governor, Dr Donald Brash. The text of his statement is reproduced here.

Just over a year has passed since the Reserve Bank of New Zealand Act 1989 came into force. The Act clearly establishes the respective monetary policy roles of the Government and the Bank, and confirms the Bank's entry into a new era of greater autonomy in implementing monetary policy. We are now fully accountable for our decisions and actions in this and our other functions. In this new environment, our attention is focused more closely on achieving specified objectives and accounting for our performance.

Accountability is the focus of this years Annual Report. The Statement of Service Performance of the Report describes the conduct of our functions during 1990/91, while objectives for 1991/92 are set out in another section. Internal management developments and budget performance are covered under 'Organisational Issues and Financial Performance'. The financial statements describe our financial performance in 1990/91, and the accounts of our subsidiary, RBNZ Registry Limited.

Monetary Policy and Price Stability

Monetary policy has been consistently directed towards price stability in recent years. The 1989 Act formalised price stability as the objective for monetary policy. In turn, Policy Targets Agreements with successive Ministers of Finance have given the price stability goal a more concrete form. The first of these Agreements, signed in March 1990, required the Bank to lower inflation, measured by the Consumers Price Index (CPI), to 0 to 2 per cent by the end of 1992. Following the change of Government, the Agreement was modified in December 1990, extending the target date by one year.

In keeping with the 1992 objective, we had set out a series of indicative inflation ranges that we would be seeking to meet between 1990 and the end of 1992. The first of these was 3 to 5 per cent inflation in the year ended December 1990. This range helped guide monetary policy over most of 1990. In the event, inflation at 4.9 per cent fell just within the indicative range. Excluding the impact of oil price rises and other one-off events, underlying inflation over this period was significantly lower, at 4.3 per cent.

Success in 1990 in part reflected our readiness to maintain appropriately firm monetary conditions. Firm policy continued in the face of sharp rises in oil prices following the Iraqi invasion of Kuwait in August. Experience has demonstrated the danger of allowing higher oil prices to lead to ongoing inflation. Monetary policy therefore aimed to limit significant spill-over of oil costs into higher wages and second-round price increases.

Underlying inflation in 1990 was little changed from 1989. However, 1989 and 1990 represent the first time in 25 years that underlying inflation has fallen below 5 percent in two successive years. Holding the line in the face of the oil price increase, together with weak economic activity and, in particular, the emergence of greater wage restraint in late 1990, has set the scene for lower inflation over coming years.

Better inflation prospects, the Government's fiscal package of 19 December 1990, and the extension of the target date provided room for a moderate easing of monetary policy from the end of 1990. These factors, together with falling world interest rates, contributed to the reductions in New Zealand's nominal interest rates which have occurred since November.

Inflationary pressures moderated further in early 1991. Most world commodity prices relevant to New Zealand fell, including oil prices after the quick resolution of the Gulf conflict. In the March quarter, the CPI rose by only 0.6 per cent, the lowest quarterly rise since 1969. As at March 1991, inflation is down to 4.5 percent (measured on a year-on-year basis).

As noted, prospects for a significant further fall in inflation are favourable. There is a strong likelihood that the Bank's new indicative inflation range for 1991 of 2.5 to 4.5 per cent will be met without the need for additional monetary policy pressure. Indeed, a slight easing in pressure has recently occurred. Achieving and maintaining price stability will assist the continuing economic adjustment New Zealand faces, and will help build the foundation for longer-term recovery.

Banking Supervision

The banking system faced another difficult year in 1990/91, as banks continued to adjust to the decline in asset prices. The profitability of most banks remained low, reflecting continued loan provisioning and competitive pressures. However, most banks increased their levels of capital in relation to their risk-adjusted assets, and reduced their large loans and other exposures relative to capital. The banking system is therefore now stronger in some major respects than in recent years.

We have monitored progress in resolving the affairs of DFC New Zealand Limited, and have assisted the statutory manager in his work towards this objective. Our involvement arose from the possible adverse impact of DFC's failure on confidence in New Zealand's financial system. A proposal for restructuring DFC's debt was put to creditors in October 1990 - this received widespread support, bringing a difficult phase to completion. Financial contributions from the Crown and shareholders helped complete the arrangements.

We have reviewed our handling of the DFC failure. The review confirmed the need for the developments in supervision policy we had already planned, particularly new guidelines for internal controls, strengthened external audit arrangements and a sharpened focus on the role of bank directors. Our failure-management procedures will also be improved as a result.

Currency

One and two dollar coins were released for circulation in February 1991. One and two dollar notes remain legal tender but their use will be phased out as they are returned through the banking system. The change was made to improve efficiency - the new coins are expected to last upwards of 20 years while, to maintain the quality of circulating currency, the one and two dollar notes needed to be replaced, on average, after six months.

Administrative and Staffing Issues

Improved management has significantly reduced the Bank's costs. Staff numbers are now 366, a fall of 35 per cent over three years. Annual operating expenditure, measured on a consistent basis, has fallen by $11.7 million (19 per cent) in nominal terms during that period, or by an even larger 32 per cent after adjusting for inflation.

We are also well placed to contain our future costs. In line with the requirements of the new Act, an agreement has been reached with the Minister of Finance, covering the amount of our non-commercial operating expenditure during the five years starting 1990/91. Under this agreement, we are committed to holding costs at constant dollar levels (on average) over the full period. This reflects our determination to ensure effective resource management, and our confidence that price stability will be achieved and maintained. Expenditure in 1990/91, the first year of the agreement, was $55.5 million (including extraordinary items), $1.2 million beneath the agreed amount. Budgeted expenditure in 1991/92 is $55.1 million, $1.5 million below agreement levels.

Turning to other matters, the Deputy Governor, Mr R.L. Knight, retired in December 1990. Mr Knight had a long and distinguished career at the Bank, making major contributions particularly to monetary policy and the deregulation of the financial system. He also had periods as an Executive Director of the International Bank for Reconstruction and Development and as Deputy Governor of the Bank of Papua New Guinea. The value of Mr Knight's service was recognised, on his retirement, by current and past Ministers of Finance from both major political parties.

Finally, my sincere thanks go to the staff of the Bank. This has been a very challenging period, both personally and professionally. I am most grateful for their efforts in meeting financial and output objectives during the year.

D.T. Brash
Governor