Reserve Bank Non-Executive Directors' 2002 Annual Report[1]

The Non-Executive Directors' Committee of the Board of Directors (NEDC) considers that during 2001/2002 the Reserve Bank performed its duties well and thus made a significant contribution to the performance of the New Zealand economy. The Reserve Bank's responsibilities were discharged effectively, risks were well managed, and costs were held.

Governor's resignation

The most significant event facing the Reserve Bank and its Board of Directors during the year under review was Dr Brash's sudden resignation on 26 April 2002. The Bank's institutional strength was illustrated by the way it dealt with this event and continued with 'business as usual'. At the time of writing, the Board is preparing its recommendation to the Treasurer on the appointment of a new Governor.

The NEDC can also report that the events that followed Dr Brash's resignation brought credit to the Reserve Bank. On the day of Dr Brash's resignation there was no financial market turmoil. As was made clear very quickly, for the Reserve Bank it was business as usual. Deputy Governor Rod Carr assumed the mantle of Acting Governor and a *Monetary Policy Statement* was presented a few weeks later.

It is important to record the non-executive directors' appreciation of the contribution that Dr Brash made while serving as Governor. New Zealand's inflation record in the 1970s and early 1980s made grim reading. In addition, the economy was enduring major structural changes. Dr Brash became Governor in 1988 and in that very difficult environment his stewardship was decisive. Price stability was achieved in 1991 and Dr Brash's exceptional communications skills were pivotal in building community support for the Bank keeping to its appointed task.

Dr Brash's achievement went well beyond monetary policy. New Zealand now has a banking supervision regime that is unique by international standards. A complex regulatory regime was replaced by a method of bank scrutiny and public accountability that uses market mechanisms and openness.

In addition, under Dr Brash's imprimatur, the Reserve Bank itself was reformed. Staff numbers were reduced from about 700 to under 200, reflecting substantial productivity and efficiency gains. Inside the Bank, Dr Brash fostered a distinctive culture of openness and honest intellectual debate. Professor Lars Svensson, in his review of monetary policy, said "I was struck by the Reserve Bank being the least hierarchical central bank that I have come across … it shows in the free and informal exchange of views and information between the junior and senior staff, including the Governor."[2]

The NEDC would therefore like to take this opportunity to formally thank Dr Brash for his remarkable contribution.

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[1] This report was drafted prior to Mr Hugh Fletcher joining the Board.
[2] Lars Svensson, *Independent Review of the Operation of Monetary Policy in New Zealand*, February 2001, p 40

Amendments to the Act

The Reserve Bank of New Zealand Amendment Bill is currently before Parliament. The Bill follows on from Professor Svensson's report, and, if enacted, the key changes in relation to governance will be that:

- the Governor will no longer act as chairperson of the Reserve Bank's board of directors, and instead a non-executive director, elected by the directors, will be chair of the board;
- Deputy Governors will be removed from the board, though the Governor will remain a Board member; and
- the Board will be required to issue an annual report on the Bank's and the Governor's performance, a practice that was adopted in 2001.

In the NEDC's view these changes remain within the intent of the Reserve Bank of New Zealand Act 1989 and the Bank's governance will be enhanced by the change to a non-executive chair of the Board.

The Bill also makes a number of technical amendments to the banking supervision sections of the Act.

Monetary policy

Throughout the year under review, the NEDC monitored the Reserve Bank's monetary policy performance and reviewed *Monetary Policy Statements* (PTA) when they were issued. We scrutinised the thinking underlying OCR decisions and the processes used to make these decisions. We are satisfied that the Bank professionally discharged its obligations under the Reserve Bank of New Zealand Act and the PTA and that the Bank maintains decision-making processes that compare well to relevant international best practice.

Inflation, as measured by the year-on-year increase in the CPI, was held within the 0 to 3 per cent target range during the year under review.

The 11 September 2001 terror attacks presented a shock sufficient to warrant an unscheduled interest-rate decision. On 19 September the OCR was cut by 50 basis points to 5.25 per cent. The NEDC believes that this decision was consistent with the requirements of the PTA. The monetary policy framework has built into it the expectation that sometimes the Reserve Bank has to act quickly and, indeed, this was such a case.

The subsequent tightening of monetary policy that began in March 2002 attracted much hostile comment. But as events have unfolded, the balance of evidence so far suggests that it too fitted the requirements of the PTA. For central banks the risk is that they make their monetary policy decisions too late and too cautiously. If a central bank is able to make a decision early in a business cycle then the amplitude of that tightening or easing is likely to be less than if the same decision is made a few months later. This is in the spirit of the December 1999 amendment to the PTA, which states that "In pursuing its price stability objective, the Bank … shall seek to avoid unnecessary instability in output, interest rates and the exchange rate."

However, we note that the Bank's May 2002 *Monetary Policy Statement* said that, in terms of the next one or two quarters, "There is a material risk that annual CPI inflation could move above 3 per cent."[3] This is a matter of concern. In retrospect, the March 2002 tightening may

[3] Reserve Bank of New Zealand, May 2002 *Monetary Policy Statement*, page 17

prove to have been too late and/or too timid, despite public perceptions. Certainly, the NEDC has seen no compelling evidence to suggest that the Bank was premature or over-reacted in this instance.

The NEDC has come to these judgements via a process of assessment that has been substantially enhanced over the last two years. The Bank typically releases its quarterly *Monetary Policy Statements* on a Wednesday. As soon as the *MPS* is issued, detailed information about how the decisions were made are provided to all non-executive directors. This includes the written advice received by the Governor on the impending interest-rate adjustment. Then on the Friday the Board meets, initially to hear a detailed presentation from the Bank's staff as to how the *MPS* was prepared and how the OCR decision was made. The NEDC then meets separately to further consider what it has heard. If the NEDC is satisfied that the *MPS* "meets the requirements of section 15(2) of the Act and is consistent with the Bank's primary function and the policy targets agreed with the Minister", then a resolution is passed to that effect. This is then taken for adoption to a full meeting of the Board that same afternoon.

It is also worth noting, in regard to monetary policy, that the NEDC reaches its view of the Bank's performance in part from direct contact with participants in the New Zealand economy. Each year the Board holds a number of meetings out of Wellington and included in these programmes are consultations with local business people.

Financial system stability

Monetary policy in itself is part of a larger picture, stable money being but one of the building blocks of a robust financial system. During the year, the Board was regularly briefed on the Bank's activities in regard to the registration and supervision of banks and the inter-bank payment system. Noteworthy events included the provision of advice to the Minister on the proposal to establish a state-owned bank, the subsequent registration of KiwiBank and the development of a policy on local incorporation of banks. The Reserve Bank also had discussions with the major banks about how it would manage a failure of a systemically important bank. The Board was briefed on improvements to the settlement services that the Reserve Bank provides to twelve banks in New Zealand. We are satisfied that these activities were consistent with the development and maintenance of a sound and efficient financial system.

Other functions

During the year, the Board also kept under review the Bank's other responsibilities. These included supplying New Zealand's currency and managing foreign reserves. The NEDC is satisfied that these functions were performed efficiently and effectively.

The use of resources and risk management

During 2001/2002, our monitoring of the Bank's use of resources included particular scrutiny of the Bank's risk management, human resource management, and operating efficiency and effectiveness. We received monthly financial reports on revenues and expenditures against budget, and in-depth briefings on the foreign reserves management function and on human resource management. Financial risk management monitoring is performed by the Audit Committee of the Board. The Audit Committee received regular reports from the Bank's Risk Assessment and Assurance Department on the internal audit function.

The Bank's operating expenditure in 2001/2002 was within budget and within the amount provided for in the Bank's Funding Agreement.[4] The NEDC judges that the Bank has been prudent in regard to the resources used to carry out its work and its management of risks.

Directors

During the year under review, the terms of two directors, Professor Viv Hall and Sir Gil Simpson, came to an end. The NEDC would like to thank them both for their contributions throughout their time on the Board. In December 2001 Mr Murray Sherwin, who as Deputy Governor and deputy chief executive was an executive Board member, resigned. Mr Sherwin served with the Bank for many years in many roles, and his contribution was substantial. Our thanks to him for that contribution to the Bank and to the Board's discussions.

Bill Wilson
Chair of the Non-Executive Directors' Committee of the Board of Directors
Reserve Bank of New Zealand

1 July 2002

[4] The Funding Agreement can be found on the Bank's website at:
www.rbnz.govt.nz/about/whatwedo/0090769.html