Reserve Bank of New Zealand
Board of Directors
Annual Report for the Year ended 30 June 2004

This report is made pursuant to section 53A of the Reserve Bank of New Zealand Act 1989.

The Reserve Bank undertakes a number of roles that are of fundamental importance for a sound and efficient financial system and a well functioning economy. These roles include its primary function to formulate and implement monetary policy with the purpose of maintaining stability in the general level of prices. They also include the registration and prudential supervision of banks. Another important function is the supply of New Zealand's currency. If any of these functions were not conducted well, there could be major ramifications for the New Zealand economy and for individual New Zealanders.

Our role as directors of the Bank is to keep the Bank's performance in carrying out these, and its other functions, under constant review. In doing so, we have placed as much attention on the Bank's financial stability functions (including banking registration and prudential supervision) as on the monetary policy role. Without a sound and efficient financial system the country cannot have a sound and efficient economy.

During the period, there have been major matters to deal with in the financial stability field. In a July 2003 speech (published in the September 2003 *Reserve Bank Bulletin*) the Governor, Dr Alan Bollard, committed to keeping the Bank's prudential regulatory system invigorated and focused. The Board has been supportive of this policy direction.

We found the IMF Financial Stability Assessment Programme (FSAP) report, and the exercise leading to the preparation of that report, particularly useful in our review role. We were pleased that the report recognised the strength of the New Zealand banking system, together with the overall soundness and transparency of the financial policies that underlie this strength. We were also pleased that the IMF supported the Bank's planned reinvigoration of financial stability policy, while wishing to maintain the strong market disciplines that characterise New Zealand's financial stability regime. The IMF highlighted some key issues as candidates for policy attention. Included amongst these were potential crisis management problems arising from the existence of a systemically important foreign bank branch operating within New Zealand, and from subsidiaries of foreign banks not being economically viable on their own at all times due to their outsourcing of key activities offshore. The Bank's work agenda was already addressing each of these issues. Over the next year, we will be keeping under close review the Bank's responses to all the issues raised in the IMF's report.

Major events have occurred over the past year, which have given the Reserve Bank the chance to revisit aspects of its bank registration and supervision approach. One such event was the acquisition of The National Bank of New Zealand Limited by ANZ Banking Group (New Zealand) Limited. The Reserve Bank processed this transaction with thoroughness and in a timely manner, and we have followed closely the policy decisions being taken regarding its implementation. A major issue facing the Bank through the period has been that of local incorporation of systemically important banks in New Zealand. We are keeping the Bank's policies and proposals in this field under review. We note the wider policy desire of the Government to harmonise trans-Tasman arrangements to the mutual benefit of New Zealand and Australia. This desire is being incorporated into the Bank's analysis of relevant matters.

It is the Board's duty to ensure that the Reserve Bank uses its powers for the purposes stated in the Act. In terms of the bank registration and prudential supervision functions, these purposes are "Promoting the maintenance of a sound and efficient financial system" and "Avoiding significant damage to the financial system that could arise from the failure of a registered bank". We continue to keep these purposes uppermost in our minds when reviewing the Bank's work in the financial stability field.

The Board has also been active in keeping the ongoing formulation and implementation of monetary policy under review. In this regard, we regularly review performance relative to the Policy Targets Agreement (PTA) signed between the Minister of Finance and the Governor in September 2002. We note that throughout the year to June 2004, the annual rate of CPI inflation stayed within a range of 1.5 per cent to 2.4 per cent. The Official Cash Rate (OCR) has been changed on occasions but has stayed within a range bounded by 5.0 per cent and 5.75 per cent. Consequently, interest rates (especially at the short end) have followed a relatively smooth path over the year.

Perhaps more important for our review function is the outlook for inflation based on current and expected monetary policy settings. In its June 2004 *Monetary Policy Statemen*t, the Bank forecast annual CPI inflation to rise to 3.25 per cent throughout 2005 before falling to 2.25 per cent in the latter half of 2006. The Bank forecasts GDP growth to average between 2.5 per cent and 3.0 per cent per annum over the next three years. These forecasts incorporate a projected rise in 90 day interest rates to 6.5 per cent. Current market forecasts of CPI inflation over the next two years (given by NZIER's June 2004 Consensus Forecasts) show an average forecast of 2.7 per cent in the year to March 2005 and 2.4 per cent in the year to March 2006. Consensus Forecasts of GDP growth over each of the next two years are 3.0 per cent and 2.2 per cent respectively. We see each of these expectations and recent outcomes as being consistent with requirements set out in the PTA. In particular, despite the projected short-term rise in inflation, CPI inflation is projected to be maintained within a range of 1 to 3 per cent per annum *on average over the medium term*, and there is little volatility in interest rates and output growth.

As noted in last year's Reserve Bank Non-Executive Directors' 2003 Annual Report, there has, however, been greater volatility in New Zealand's exchange rates. The TWI started the year (July 2003) at 62.3, rising to a peak of 69.0 in February, and troughing at 61.5 in May. We are aware of concerns in some quarters at the degree of this volatility. At the same time, we are aware that the world currency markets have shown considerable volatility which has impacted on New Zealand rates. For instance, the US–Australian exchange rate has ranged between 0.64 and 0.80 over the year.

For some time, the Bank has been examining measures and policies which may be used to dampen exchange rate volatility. The Board is supportive of the Bank conducting detailed analysis in this area. We kept under close review the work within the Bank on whether it should seek an increase in its capital and in its foreign reserves so as to give it greater capability to stand against extreme exchange rate movements. We are cognisant of the potential dangers and costs that can arise from injudicious exchange rate intervention. We are also cognisant of regimes that have successfully 'taken the edge' off major exchange rate cycles. The Bank's internal analysis of the options in this regard was rigorously researched. We were privy to the depth of this research and consider that the Bank's recommendations are well grounded and supported by its analysis. We are comfortable with the resulting moves to increase the Bank's capital and foreign reserves portfolio.

Notwithstanding these moves, the exchange rate is likely to remain an avenue through which the New Zealand economy is subject to volatility. This will continue to pose some difficulties for monetary policy implementation at times. Volatility in the housing market and related areas is also likely to cause continuing complexities for the Bank's monetary policy tasks. Over the past year, the Bank has had to make judgements in its monetary policy decisions that involve trading off the risk of an overheated domestic economy against the risk of low profitability for the traded goods sector, while maintaining inflation within the required range. Additional analytical work that investigates potential methods of dampening these types of volatility will need to remain a vital part of the Bank's research programme.

Other areas of the Bank's activities continue to be conducted effectively. The vital role of the Bank in providing a high quality currency for everyday transactions continues to be conducted efficiently, especially in light of the major cost savings over recent years. The Bank's role in providing and supervising high value payments systems is important for the soundness and efficiency of the financial system and appears to have been conducted effectively throughout the year.

The Bank has taken two major investment decisions (other than capital and foreign reserves decisions) over 2003/04. It became a shareholder in the Bank for International Settlements, and invested in the Asian Bond Fund along with other East Asian central banks. The Board considered the Bank's internal analysis prior to taking these decisions and supported the decisions.

Some of the Bank's policy programmes, especially in the financial stability field, are placing greater resource requirements on the Bank. We have been supportive of the Governor increasing staffing in key financial stability areas to ensure that policy development is rigorously undertaken and completed in a timely manner. In this field, having appropriate precautionary policies in place is very important in that they may prevent a very sizeable recession if a potential crisis is thereby averted.

Overall, the Bank operates with a much reduced call on state resources than hitherto, and this is pleasing. We do not expect, however, to see a continuation of the expenditure reduction trend witnessed over the past 10 years. We anticipate that the Bank will have to expand its staff complement slightly in order to address the complex policy tasks that it has before it. These tasks are reflected in the Bank's priorities and key projects that it has adopted for the coming year. We therefore expect to see some small upward movement in the Bank's expenditure being required over coming years.

The Bank's governance arrangements changed during the year with the passage of the Reserve Bank of New Zealand Amendment Act 2003. The Amendment Act provided for the roles of Chief Executive and Chair of the Board of Directors to be split, with a non-executive director being elected annually as Chair by the non-executive directors. Arthur Grimes was elected Chair in September 2003, and Alison Paterson was appointed by directors as Deputy Chair.

During the year, Ruth Richardson's term as Director came to an end and the directors wish to record their thanks for her extremely valuable contributions. Professor Marilyn Waring joined the Board as a director, bringing valuable experience and public policy insights to the role. The Governor, Alan Bollard, remains a director of the Bank following the legislative change. He continues to provide highly competent and effective leadership of a complex organisation. Dr Bollard has a strong and open working relationship with the Board which greatly assists the Board, and the Bank generally, in performing its roles.

As noted in the 2003 Annual Report, Dr Rod Carr did not seek reappointment as the Bank's Deputy Governor when his existing term expired. In his place, the Board appointed Adrian Orr as Deputy Governor, on the recommendation of the Governor. The Bank is fortunate to be able to appoint someone of Mr Orr's calibre and experience and he is making a highly effective contribution to the Bank. The Board also welcomes Dr Don Abel to the Bank as Assistant Governor, replacing Murray Bain who departed after a very positive contribution to the Bank to become Chief Executive of another government agency. David Archer, Assistant Governor, is to take leave of absence from the Bank to take up a position at the Bank for International Settlements. David has contributed hugely to the Bank since he joined the staff in 1978. The Board thanks him for his efforts to date and wishes him every success during his period of leave.

Arthur Grimes
Chair
Board of Directors
Reserve Bank of New Zealand
19 July 2004

Alison Paterson
Deputy Chair
Board of Directors
Reserve Bank of New Zealand
19 July 2004