Reserve Bank of New Zealand
Board of Directors
Report for the Year ended 30 June 2005

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

The Reserve Bank has the statutory responsibilities to operate monetary policy to maintain price stability, to promote maintenance of a sound and efficient financial system and to provide currency to meet the needs of the public. The Bank's Board of Directors has the duty to keep under constant review the Bank's actions with respect to each of these and related functions. Our review role is designed to ensure that the Bank meets the objectives set for it, uses its resources soundly and stewards its resources so that it can meet its objectives sustainably in the future.

The 2004/05 year has been a challenging one for the Bank in many respects. We believe that the Bank – led by the Governor, Dr Alan Bollard – has acquitted itself well in meeting its objectives in the face of these challenges. It has used resources soundly, and has been investing in new systems and staff to make sure that the institution is in a strong ongoing position to exercise its functions in future.

Monetary Policy

The Bank is obliged to meet the monetary policy objectives set out in the Policy Targets Agreement (PTA) signed between the Governor and the Minister of Finance in September 2002. The PTA requires the Bank to implement monetary policy so as to keep CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term. While there is no formal definition of 'the medium term', the Bank and the Board use a three-year time horizon as a useful working definition. Over the three years to June 2005, CPI inflation has averaged 2.2 per cent per annum, well within the 1-3 per cent target range.

Looking forward, the environment for monetary policy is not so comfortable. The Bank's June 2005 *Monetary Policy Statement* (*MPS*) projected that inflation will average just below 3 per cent per annum for the next three years, staying between $2^3/_4$ per cent and 3 per cent through to the end of 2007. This inflationary pressure comes at a time when the growth rate of the New Zealand economy has been outperforming almost all other developed countries for the past five years. The resulting pressure on productive capacity has caused inflation to rise to near 3 per cent, standing at 2.8 per cent for the year to June 2005.

The Board is required to keep the Bank's monetary policy decisions under close review. We assess the Bank's internal forecasting and monetary policy processes leading up to its Official Cash Rate (OCR) decisions, and consider the regular advice tendered to the Governor. We have noted international agencies' assessments of the Bank's monetary policy processes. Our view is that the Bank follows a rigorous and internationally respected approach to implementing monetary policy. This process has led the Bank to continue raising the OCR a further four steps from 5.75 per cent to 6.75 per cent in the year to June 2005, continuing a tightening cycle that began in early 2004.

While New Zealand's short-term interest rates continue to be higher than in other developed countries, we consider that the Bank's tightening has been necessary given the ongoing strength of inflationary pressures.

The Board is mindful of the Bank's duty under the PTA to implement monetary policy in a manner that seeks to avoid unnecessary instability in output, interest rates and the exchange rate. Output has continued to grow strongly for a prolonged period, while the interest rate cycle has been muted compared with past interest rate cycles in New Zealand. The trade-weighted exchange rate (TWI) has stayed within a band of 64.2-71.7 over the year to June 2005. While historically very high (in part reflecting high export commodity prices), the TWI has been quite stable through the year. (Individual cross rates, largely beyond the control of the Reserve Bank, have exhibited greater variability.) The high exchange rate has helped to mute overall inflationary pressure by reducing inflation in traded goods prices at a time that non-traded goods prices have risen considerably faster than 3 per cent.

While helpful in the control of inflation, the high and appreciating exchange rate has the potential to cause longer-term difficulties for parts of the traded goods sector, especially for those sectors that have not enjoyed strongly rising world commodity prices. Mindful of these effects, the Bank has investigated through the year whether there are methods of implementing monetary policy to control inflation that have less of an impact on the exchange rate. The Bank's staff have conducted research on the issue and presented this to the Board. We welcome continued work in this field. Nevertheless, it is apparent from this work that no developed country with a flexible exchange rate has found a sure way of lessening exchange rate movements of the type seen in New Zealand and elsewhere.

Over the year, Government increased the Bank's capital, which the Bank used to increase its foreign reserves holdings. This increase means that the Bank is in a stronger position to intervene in the foreign exchange market should such intervention be desirable. The Bank has formulated explicit procedures to make judgements as to whether intervention is consistent with its monetary policy responsibilities and whether it is warranted and feasible. It has discussed its criteria for intervention with the Board. It has also presented to the Board aspects of its risk management processes pertaining to management of the reserves and any interventions.

Financial System Stability and Efficiency

The Bank has continued in its efforts to rejuvenate aspects of banking supervision with the aim of ensuring that the financial system is sound and efficient, and capable of withstanding the impact of any potential failure of a systemically important bank. The Reserve Bank of New Zealand Act requires the Bank to implement policy in pursuit of these objectives.

Key aspects of this policy process have involved development of the Bank's outsourcing policy related to the location and jurisdictional control of banking functions, and its policy requiring systemically important banks to have key functions incorporated within a New Zealand entity. The Board has kept the development and implementation of these policies under close review. We are satisfied that the Bank has formulated and implemented the policies in a manner that is consistent with the purposes and requirements of the Reserve Bank Act.

The Bank has had to address an additional dimension of financial stability policy with the development of closer trans-Tasman coordination of banking and financial system supervision. This programme forms part of a broader governmental initiative to work towards a single economic market with Australia. In addressing the trans-Tasman issues, the Bank – with the full support of the Board – has been mindful that it has legal responsibilities under its Act to implement bank registration and supervision policies to maintain a sound and efficient financial system and to avoid significant damage to the financial system that could arise following the failure of a registered bank. The Board formally resolved its expectation that the Bank would continue to implement its existing banking regulation policy programme designed to meet its legislated responsibilities under the Act. This programme includes the Bank's work in designing an appropriate local incorporation policy for systemically important banks and in achieving suitable bank outsourcing arrangements.

The Board has welcomed the Bank working with other agencies in New Zealand and Australia to enhance coordination of banking and other financial system policies in the two countries. The Board is concerned, however, that this be done in a way that the Bank's ability to carry out its legal responsibilities is not undermined. The long-term soundness of the New Zealand financial system and the strength of the broader economy require well-considered regulatory policies. These policies must be developed to reduce the chance of financial crisis and to meet the stability requirements that any crisis that did occur would pose. We continue to keep this field of policy development under very close review.

Currency

The Bank undertook a major initiative through the year in reviewing the provision of coinage to the New Zealand public. The result of extensive in-house consideration, followed by major external consultation, was a decision to introduce new 'silver' coins in the 2005/06 year. The Board took an active part in reviewing the case for changing the coinage. Part of this review involved examining the financial case for doing so and the financial risk-management arrangements (including hedging) that were involved. We consider that there is a strong case for the changes that the Bank proposed.

Consistent with the Bank's intention, the Board sought widespread consultation surrounding the coinage proposals with both the general public and with key affected groups. We are satisfied that the views of a range of groups were ascertained and given due weight in the Bank's decision-making process. The announcement of the decision to demonetise the 5 cent coin and to reduce the size of remaining 'silver' coins is one, we believe, that has considerable merit.

Other Functions

Most of the Bank's other functions, such as market operations and provision of settlement services, are related to its three core functions of monetary policy, financial system stability and currency provision. We are satisfied that these supporting functions have been conducted efficiently over the past year.

One function that the Bank has long supported, but that did not fit well with the Bank's core functions, is the provision of the secretariat for the Overseas Investment Commission (OIC). During the year, the Government took the decision to disband the OIC and place its functions in Land Information New Zealand. We note that the OIC relocation will entail the loss of some long-standing staff of the Bank, including the head of the OIC, Steven Dawe. We thank Mr Dawe and his staff for their excellent service to the Bank and to the OIC.

Resources and Management

In our report last year, the Board foreshadowed a possible need to increase the resources of the Bank over time in order to meet growing requirements imposed especially by the financial system stability function. We have also been aware of the need to upgrade certain of the Bank's systems that had reached the end of their useful life. The Board has been supportive of the resulting system developments, and we are also supportive of the modest increase in staff numbers that has occurred within the Bank. We are particularly pleased to see that the Bank has increased its complement of staff with senior commercial banking experience.

The Board was involved in the Bank's long-term planning processes, culminating in its Statement of Intent, which provided background to the renegotiation of the Bank's Funding Agreement with the Government. The Funding Agreement sets the Bank's allowable expenditure, for most of its functions, for a five-year period. A new Funding Agreement was signed in April 2005 and ratified by Parliament in June 2005. We reviewed the proposed Agreement and supported the increase in resources that it makes available for the Bank to implement its expanded policy work. The Board is satisfied that the new Agreement provides adequate resources for the Bank to carry out all its statutory functions in a comprehensive, but suitably constrained, manner.

The composition of the Board has remained unchanged through the year. Paul Baines was reappointed as a Director at the start of the year, and Alison Paterson and John Goulter were reappointed during the year.

The Board records its appreciation of the excellent leadership within the Bank of the Governor, Dr Alan Bollard. He has been most ably supported by the Deputy Governor, Adrian Orr, and by the other senior staff of the Bank. We have also been impressed by the calibre of the Bank's broader staff complement. We wish them well in what we anticipate will be another challenging year over 2005/06.

Arthur Grimes
Chair
Board of Directors
Reserve Bank of New Zealand
6 August 2005

Alison Paterson
Deputy Chair
Board of Directors
Reserve Bank of New Zealand
6 August 2005

on behalf of the Directors.