

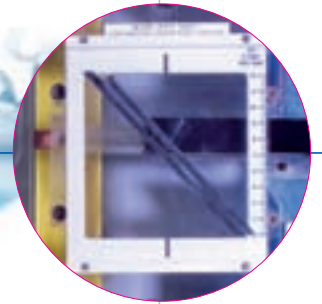


RESERVE
BANK

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

Operating
in a fluid
environment

2006-2007 ANNUAL REPORT

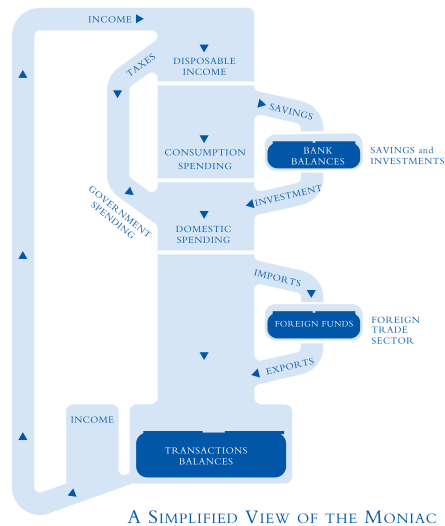


THE MONIAC



- 1** We set interest rates
- 2** We supervise banks
- 3** We manage foreign reserves
- 4** We issue cash
- 5** We provide settlement services for banks

THE MONIAC



The Monetary National Income Analogue Computer (MONIAC) machine was designed by New Zealand economist Bill Phillips and first unveiled at the London School of Economics in 1949. It is now on display in the Reserve Bank Museum.

The MONIAC demonstrates how the macro-economy works, using a flow of water to represent money being pumped around the system. It is based on a Keynesian/Classical design, with various tanks representing households, business, government, exporting and importing sectors of the economy.

When water is pumped around the system it can be measured as income, spending and GDP. Experiments with fiscal policy, monetary policy and exchange rates can be carried out, and the overall effects printed out on the graphs.

The MONIAC has some claim to being the world's first economic computer. It could carry out calculations unable to be performed by any other computer at the time. It is calibrated for the UK economy. The model pictured is the first full-scale MONIAC. Approximately 14 machines were built and sent around the world.

This MONIAC was donated by the London School of Economics, restored, and brought to NZ in 1987 by the New Zealand Institute of Economic Research. They have kindly loaned it for display at the Reserve Bank.

Sections of the MONIAC relating to the Bank's functions are illustrated through the Annual Report.

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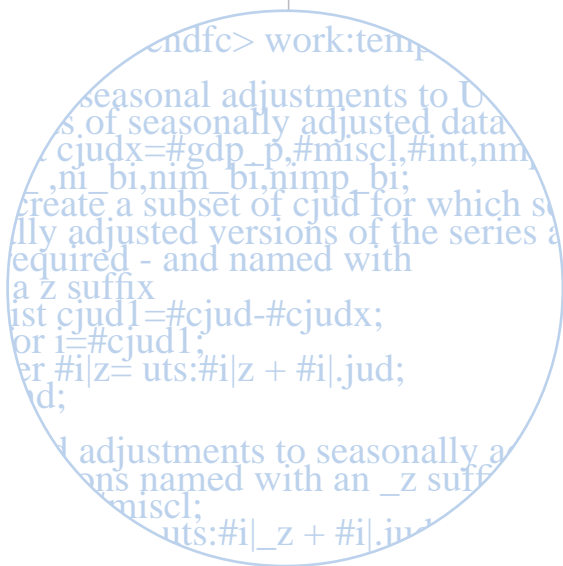
RESERVE BANK OF NEW ZEALAND

2006-2007 ANNUAL REPORT

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Reserve Bank of New Zealand Annual Report and financial statements for the financial year ended 30 June 2007, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989, published September 2007.

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HOW WE WORK

Theory and computing power has moved on from the MONIAC. Since the 1970s, the Reserve Bank has used sophisticated computer-based models to interpret information and build a picture of how the economy might evolve over the next few years.

Above is an example of the computer code used in one of these models.

These models are used to:

- provide policy advice on the Bank's interest rate decision;
- produce and publish projections (with some judgemental adjustment); and
- conduct economic research on the New Zealand economy.

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Our Vision

We promote a sound and dynamic monetary and financial system.

We work towards our Vision by:

- operating monetary policy to achieve and maintain price stability;
- assisting the functioning of a sound and efficient financial system;
- meeting the currency needs of the public;
- overseeing and operating efficient payment systems; and
- providing effective support services to the Bank.

Our Values

Integrity

Being professional and exercising sound judgement.

Innovation

Actively improving what we do.

Inclusion

Working together for a more effective Bank.



THE YEAR AT A GLANCE

- Consumers Price Index (CPI) inflation fell from 4.0 percent for the 12 months to June 2006 to 2.0 percent for the 12 months to 30 June 2007.
- The Official Cash Rate (OCR) remained at 7.25 percent for much of the year, but the Bank raised it 75 basis points between March 2007 and June 2007 to 8.0 percent.
- The Bank introduced smaller, lighter 10, 20, and 50 cent coins on 31 July 2006 and withdrew the 5 cent coin from circulation.
- A new Policy Targets Agreement (PTA) was signed by the Governor of the Reserve Bank and the Minister of Finance.
- In June 2007, the Bank announced that it had intervened in the New Zealand dollar foreign exchange market for the first time since the New Zealand dollar had been floated in March 1985.
- The Bank began preparing for Parliament's Finance and Expenditure Committee's Inquiry into the Future Monetary Policy Framework, which is due to report later in 2007.
- The New Zealand retail operation of Westpac Banking Corporation was locally incorporated as Westpac New Zealand Limited. St George Bank New Zealand Limited (also known as Superbank) ceased operations.
- In late 2006, New Zealand and Australia each introduced legislative changes recommended by the Trans-Tasman Council on Banking Supervision to ensure that the Reserve Bank and the Australian Prudential Regulation Authority (APRA) could support each other in performing their existing regulatory responsibilities.
- Cabinet confirmed that the scope of the Reserve Bank's prudential functions would widen to include the prudential regulation of non-bank deposit-takers (NBDTs) and insurers.
- The Reserve Bank Museum opened in September 2006, with over 6000 visitors recorded by 30 June 2007.
- The Bank hosted the 15th Meeting of South Pacific Central Bank Governors in Wellington.
- The Reserve Bank spent a net \$29.1 million on activities covered by the Bank's Funding Agreement, which was 14 percent below the \$34 million in the Agreement. The Bank generated a surplus of \$332.9 million. A dividend of \$193.0 million will be paid to the Crown.¹
- The Bank progressed a review of the financing and structure of its balance sheet, the results of which were announced in July 2007.

¹ The dividend to the Crown is subject to confirmation by the Minister of Finance after balance date.

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GOVERNOR'S STATEMENT

It has been a challenging and very public year for the Reserve Bank of New Zealand. Most of the focus has been on the state of the economy and the role of monetary policy. But this should not detract from other important developments that have been happening in foreign exchange, banking, financial systems, payment systems and currency.

The economy slowed a little during 2006 in response to monetary policy tightenings, but by the start of 2007 it was clear that the housing market was strengthening again and international dairy prices were rising rapidly. Because of this, the Bank resumed its monetary policy tightening, with four increases in the OCR by August 2007.

Until recently, this has been an unusual period of strong international liquidity, low risk premia, falling yen and US dollar, and strong demand for commodity currencies. Like the Australian dollar, the Canadian dollar, and other currencies, the New Zealand dollar has traded at two-decade highs. This has put pressure on some parts of our export sector, focussed media attention on the NZ/US exchange rate, and made our monetary policy decisions harder.

Since balance date, there have been changes. Developments in the US subprime mortgage market have seen global investors become more risk-averse, seeking 'safer havens', with resulting pressures on global liquidity.

Along with other markets, the New Zealand dollar has come off its highs. Moreover, the difficulties faced by some finance companies in New Zealand have added to the sense of uncertainty among local investors. We have taken some action to ensure the smooth functioning of our financial markets, and we will continue to monitor developments.

Meanwhile, we have had many discussions about ways to lessen the impact of the OCR on the exchange rate, and have developed some ideas about supplementary instruments. The Finance and Expenditure Committee of Parliament has commenced an inquiry into monetary policy. We welcome this inquiry and the open debate it will bring on the objectives and instruments of stabilisation policy.

Our monetary policy framework is now very conventional by international standards. Since its inception in 1989 it has successfully delivered average inflation of around 2.5 percent. But monetary policy cannot do everything and it cannot easily dampen the exchange rate, especially when abnormal international or domestic pressures arise. The best it can do is to maintain stable prices so businesses can invest for growth in a secure environment. To help this, it is worth the appropriate agencies looking more closely at the tax environment for housing, measures to enhance housing supply, and ways to limit fiscal pressures when the economy is tight.

This year the Reserve Bank intervened to sell the New Zealand dollar as it continued to be at unjustified and exceptionally high levels. The Bank has also developed its foreign reserves policy further. The Bank has now sold New Zealand dollars in order to hold some of its foreign



reserves on an unhedged basis. This 'passive intervention' is to give us better insurance in the event of a New Zealand dollar crisis. In addition, under certain defined conditions, we may carry out limited 'active intervention' to help stabilise currency peaks and troughs. This is similar to the Reserve Bank of Australia's approach.

We continue to hone our oversight of the financial system. Overall we think it is sound and well-placed to deal with less favourable economic conditions, although there is never room for complacency. We note that household debt has doubled in the last five years in a benign lending environment, and this could lead to greater asset quality problems for lending institutions in the future.

It has been an important year for our main commercial banks. We are working through new capital requirements with them to meet enhanced 'Basel II' accreditation standards. In addition they are putting new outsourcing policies in place to meet our requirements. The trans-Tasman legislation to ensure that the Reserve Bank and the Australian Prudential Regulation Authority (APRA) can support each other in performing their existing regulatory responsibilities has been working well.

Cabinet has decided the Reserve Bank will take over the lead regulation for finance and insurance companies, and for anti-money laundering regulation in this sector. That means a lot of work designing legislation and, in due course, helping institutions meet the new standards.

Behind the scenes away from the public eye, we run New Zealand's wholesale payment and settlement systems. With approximately \$40 billion of transactions

a day, this is a crucial part of New Zealand's financial infrastructure. This year we have put in place a technological upgrade and new governance rules to stay at the forefront of international practice.

One of the biggest physical projects the Bank has undertaken this year has been to upgrade New Zealand's small denomination coins. We have collected the old cupro-nickel coins, sold them for recycling at very advantageous prices, and introduced new coins that incorporate leading-edge developments in metallurgy. This all happened very smoothly for the banks, retailers, vending machine operators and the public. The Bank won a number of awards for this exercise.

All these developments are detailed in this Annual Report. They only happened with the hard work, professionalism and energy of our staff, and with the advice and monitoring of our Board. I thank them all.

Alan Bollard

Governor

27 August 2007

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BOARD OF DIRECTORS' REPORT FOR THE YEAR ENDED 30 JUNE 2007

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

The Reserve Bank's Board of Directors is responsible for keeping the performance of the Bank and of the Governor under constant review across all Bank functions. One particular focus is on the achievement of the monetary policy targets agreed to between the Governor and the Minister of Finance in the Policy Targets Agreement (PTA). In keeping with s.53 of the Reserve Bank of New Zealand Act, the Board assesses the consistency of the Bank's Monetary Policy Statements with its primary function and with the targets set under the PTA. We also closely monitor the Bank's activities across its other functions, and ensure that the Bank's use of resources is in keeping with its output requirements and with its five-year funding agreement.

With respect to monetary policy, the Board made a submission in July 2007 to Parliament's Finance and Expenditure Committee (FEC) Inquiry into the Future Monetary Policy Framework. Our key conclusions with regard to monetary policy in that submission were that:

- The current legislative framework for the conduct of monetary policy is sound.
- The current Policy Targets Agreement is appropriate in allowing the Bank to implement monetary policy flexibly in its pursuit of price stability.
- The Bank has set monetary policy in accordance with its obligations under the Reserve Bank of New Zealand Act and has met the medium term targets agreed with the Minister of Finance in the Policy Targets Agreements.

In light of significant imbalances in the New Zealand economy, we support the investigation of alternative instruments or structural policy changes that may (a) assist the Bank in achieving its monetary policy objectives; and (b) assist the transition to a more balanced economy.

In the field of financial system stability, the Board has taken an active role in reviewing the Bank's implementation of its banking supervision responsibilities and, in particular, its requirements with respect to trans-Tasman banks. We have had an ongoing involvement in scrutinising and commenting on proposed changes to the regulation of non-bank deposit-takers. We are satisfied that the proposed system for supervising these institutions, which will place greater responsibilities on the Reserve Bank, is sound and is consistent with the Bank's broader financial system responsibilities.

Monetary Policy, Exchange Rates and Foreign Reserves

The Board uses a wide variety of information to undertake its evaluation and monitoring role, including having access to the same papers and advice that inform the Bank's decisions and operations. At meetings that follow monetary policy decisions, these papers include summaries of recent developments in the macro-economy and in domestic and international financial markets, results from business and consumer surveys, guidance on the near-term outlook for various sectors of the New Zealand economy, longer-term economic projections, as well as a précis of information from the Bank's business contacts and material on the views of markets and other commentators. A small subset of senior Bank staff provides the Governor with non-binding formal advice on changes to the OCR, and these are made available to the Board on a non-attributed basis. In addition, the OCR advice tendered by the Bank's two external monetary policy advisors who take part in the OCR advisory process is made available to directors.

The PTA requires the Bank “to keep future CPI inflation outcomes between 1 percent and 3 percent on average over the medium term.” In pursuing this objective, the PTA requires that “the Bank shall implement monetary policy in a sustainable, transparent and consistent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.” Sometimes, there is tension between these objectives in the short term, but the Act and the PTAs make clear that price stability is the primary goal for monetary policy. Over the current cycle, future inflation has on occasions risked rising above 3 percent p.a. The Bank has reconciled the tension in the policy objectives by interpreting the price stability obligation as a requirement for inflation to be comfortably within 1 and 3 percent over the second half of a three year forecasting horizon. The Board is satisfied that this interpretation is in keeping with the specification of the PTA.

Inflation in the Consumers Price Index (CPI) for the year to June 2007 was 2.0 percent. This shows a welcome reduction compared with the inflation rate to June 2006 which stood at 4.0 percent. For the prior three years, the annual inflation rate to June was 2.8 percent (2005), 2.4 percent (2004) and 1.5 percent (2003). Thus inflation over the past three years has averaged 2.9 percent p.a. while over the past five years, the average has been 2.5 percent p.a. These averages have been towards the top, but within, the target band set by the PTA.

The raw inflation data conceal some underlying pressures affecting inflation and the broader economy. Some of these pressures can be anticipated but others represent surprises that cannot be forecast. Monetary policy decisions are

therefore based on imprecise information, and inflation (as well as other) outcomes can be influenced by external factors over which a central bank has little direct control.

The Board’s monitoring of the Bank’s monetary policy decisions requires it to separate the effects of decisions on outcomes from the impact that good or bad fortune may have had on these outcomes. Good policy based on all relevant information can still deliver undesirable outcomes if unforeseen, adverse economic ‘shocks’ buffet the economy. Conversely, inappropriate policy that is countered by offsetting surprises as the economy evolves can yield outcomes that are consistent with the PTA. In monitoring the Bank, the Board therefore does not assess inflation outcomes in isolation; rather, the Board assesses whether the Bank has set policy appropriately in *pursuit* of its targets, given the prevailing economic environment and judgements of likely future economic developments.

In recent years, several noteworthy developments in the domestic economy and in international financial markets have made policy determination – and its evaluation – somewhat more complicated than is usual. On the domestic front, sustained strength in household consumption has been accompanied by high house price inflation and by sizeable negative rates of household saving (i.e., setting aside capital gains, household consumption has significantly exceeded household income). Some commercial activities have benefited from high prices for commodity exports while, for others, the exchange rate appreciation has been a major factor in rendering them uncompetitive.

Other important economic developments have included those related to oil prices, fiscal policy and migration. Imbalances have been manifest in many sectors of the economy: annual CPI inflation exceeded 3 percent for five quarters from September 2005 to September 2006, non-tradeables inflation has exceeded 3 percent consistently since June 2002, the deficit on the current account increased to levels widely considered unsustainable, and household debt levels rose to historical highs. Land prices have risen sharply, while significant regulatory and other pressures are apparent in the construction sector. Productivity growth has been low, with trend labour productivity growth averaging just 1.0 percent p.a. over the past five years in spite of historically strong plant and machinery and other business investment. The Board has been concerned with the development of these wider imbalances.

We are satisfied that the Bank has recognised the general nature of strengthening resource pressures, though, like other forecasters, it has been surprised by the magnitude and persistence of some of these pressures. Productivity growth has been lower than the Bank previously forecast. Oil prices rose much further than the Bank and others initially expected; and more recently, the strength in dairy prices has been much greater than anyone (including those in the dairy industry) anticipated.

We consider it reasonable and appropriate that the Bank has chosen to 'look-through' the transitory components of some of these inflationary pressures such as those from oil prices. The Bank has endeavoured to set policy to ensure that the obligations of price stability and the avoidance of unnecessary volatility in ancillary variables have been met, as well as to ensure that expectations of future inflation rates have remained anchored within the target range.

Most recent measures of public and 'expert' inflation expectations for between one and four years ahead are in the 2.5 percent - 2.7 percent range.² While indicating a broadly-held expectation that inflation will continue within the upper third of the target range, these expectations are consistent with the PTA. They have been formed over a period of sustained economic growth with very low unemployment; in these circumstances it is comforting that expectations have been held to this level. The inflation expectations are consistent with a number of measures of 'core' inflation; for instance, the Bank's factor model estimate of core CPI inflation for the year to June 2007 stands at 2.5 percent.

We note that the Bank's forecasts have generally been more accurate than the private sector consensus both over the latest cycle and over prior periods.³ Importantly, this indicates that the Bank has used all available information to inform policy decisions. In other words, 'surprises' to such variables as commodity prices and foreign exchange rates could not reasonably have been anticipated with the information then available.

At an aggregate level, national output (and employment) has followed a remarkably stable trajectory. While GDP growth for the latest year (to March 2007) is lower than trend, at 1.7 percent, this needs to be interpreted in light of the inflationary pressures that continue in the economy and in light of history: expansion of GDP is now into its tenth year of unbroken growth while unemployment, at 3.8 percent, is at extremely low levels indicating few available labour resources for expansion. Long-term interest rates have also been broadly stable: the New Zealand 10-year government bond rate has varied within a range of just 5.5 percent to 6.9 percent over the past four years.

The exchange rate has experienced greater instability, especially relative to the US dollar, and there has been some instability in other asset prices, notably property prices. New Zealand is not alone in facing such pressures. Housing market 'exuberance' has been well documented across a number of countries. Other commodity-producing countries such as Canada and Australia have experienced similar exchange rate pressures. The Canadian dollar recently reached a 30-year high against the United States dollar (USD). The Australian dollar (AUD) has also approached long-term highs against the USD. By contrast, the USD is at historically low levels. Movements in the New Zealand dollar (NZD) relative to the AUD have been relatively constrained. Over the year to 30 June 2007, the NZD/AUD averaged 0.8726, just 1.6 percent higher than its decade average of 0.8592. In the same year, the NZD/AUD moved within a range of 0.8072 to 0.9095, representing a range of 6 percent either side of its decade average. By contrast, over the year to 30 June 2007, the NZD/USD averaged 0.6863, 20.7 percent higher than its decade average of 0.5684. Over the year, the NZD/USD moved within a wide range of 0.6046 to 0.7696, with the peak rate being 35 percent above the decade average. (In July 2007, the peak rate rose even further for a short period to 0.8064.) The difference in behaviour of the NZD/USD compared with the NZD/AUD reflects the weak state of the United States dollar against most currencies, including the New Zealand dollar.

2 Reserve Bank of New Zealand *Monetary Policy Statement*, June 2007, p. 18.

3 See Jane Turner, Aidan Yao and Tim Hampton, *An Assessment of Recent Reserve Bank Forecasts*, paper presented to New Zealand Association of Economists conference, June 2007.

The sustained strength in housing and household consumption has proven to be a major influence on inflationary pressures in the current cycle. On several occasions over the past three years, the Bank has increased the OCR to dampen this strength. Throughout this period, New Zealand has maintained amongst the highest short-term interest rates in the OECD. This too has influenced the exchange rate.

Despite higher levels of household debt, a variety of factors have combined to ensure that New Zealand households have been less affected by tighter monetary policy than in previous cycles. Some external commentators and analysts held views different to those of the Bank on the need for policy tightening in the early part of the cycle, and this dampened the effect of OCR increases on longer-term interest rates. This effect, coupled with a sustained period of very low global interest rates and bouts of increased competition between commercial banks, appears to have reduced the response of domestic interest rates to a given increase in the OCR. Households have tended to shift their mortgage borrowing to longer term fixed rates (2-5 years) and away from floating rates that more closely mirror the OCR. Overseas investors, through the so-called 'carry trade', have invested significantly in New Zealand short-term financial instruments which have considerably higher yields than in most other countries, especially Japan. Tighter policy has therefore had a larger impact on the exchange rate and on the traded sector of the economy, than on effective mortgage rates, longer-term interest rates and the non-traded sector.

As discussed in our FEC submission, the Board is cognisant of the fact that the Bank's policy tightening has prompted a relatively slow response in effective mortgage interest rates in the current cycle. The Bank has devoted significant resources to examining this phenomenon and to understanding the related problem of the excessive share of highly-leveraged housing in New Zealanders' asset portfolios. These examinations included the 'Supplementary Stabilisation Instruments' (SSI) project

launched in November 2005, and the 'Macro Policy Forum' of June 2006. International experts who were invited to the latter concluded broadly that New Zealand's macro policy framework can be improved only at the margin, that monetary and fiscal policies have generally been set prudently, and that the imbalances of recent years can be attributed to the differential impact of various external developments on different sectors of the economy.

The SSI project sought to identify instruments that could be used to supplement the short-term interest rate as additional mechanisms for monetary policy implementation. While the OCR remains the primary monetary policy instrument, the Board supports the Bank's examination of such ancillary instruments. The Bank has the discretion to intervene in foreign exchange markets to influence the value of the dollar should it be exceptionally and unjustifiably priced. The option of foreign exchange intervention is an additional tool but, at most, it is anticipated to reduce the cyclical amplitude of the exchange rate only at the margin. The Board has reviewed the Bank's criteria for intervention and considers that these criteria are consistent with its mandate and that the Bank has a robust system for intervention decisions.

In June 2007, the Bank announced that it had intervened in the foreign exchange market. While this represented a departure from its practice over the preceding 22 years, the intervention itself was consistent with the stated intervention criteria. These criteria had been well signalled to the market and broader community in advance of the intervention. The currency intervention provided a clear signal, in addition to the Bank's own comments, that the New Zealand dollar, on a trade-weighted basis, was over-valued and that investors could have expected it to fall from its historically high levels.

The Board has reviewed the Bank's recently announced changes to its financing and management of New Zealand's foreign currency reserves. We consider that the changes will result in the Bank having a more effective means of responding to foreign exchange crisis situations and that the new approach is consistent with international best practice.

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Financial System Stability and Efficiency

The Bank has been active in refreshing its approaches to promoting financial sector stability over recent years. The year to June 2007 has seen welcome progress in issues of trans-Tasman banking. Westpac has incorporated its local retail operations as Westpac New Zealand Limited, bringing to fruition the Reserve Bank's long-standing policy of requiring systemically important banks to be locally incorporated. Strong relationships with Australian supervisory agencies have been further cemented through the introduction of legislative changes that will help ensure mutual support by agencies on each side of the Tasman in performing their regulatory responsibilities. Implementation of the Basel II capital adequacy framework is being progressed with acknowledgement of the need to be cognisant of elements relevant to trans-Tasman banks.

Given the strong linkages between the Australian and New Zealand banking systems, these developments are welcome. They reflect the importance of regulatory authorities in both countries acting to support the soundness of the broader Australasian financial system. Each of the outcomes is consistent with the Board's insistence that the integrity of New Zealand's supervisory and regulatory regime be maintained while at the same time supporting trans-Tasman cooperation and harmonisation.

The Board has taken a major role in scrutinizing new proposals for regulating non-bank deposit-takers. Until now, the Reserve Bank has been responsible for regulating and supervising banks, but has had no such role for non-bank institutions. Government has recently resolved,

subject to the successful passage of legislation, that the Reserve Bank will become the regulator, but not the direct supervisor, of most non-bank deposit-takers. This move is in response to deficiencies in the current regime in which non-bank deposit-takers operate. In particular, there is a lack of consistency and transparency in current supervisory arrangements for these classes of institution.

The proposed arrangements will place on the Reserve Bank the role of prudential regulator for most (bank and non-bank) deposit-takers. The Reserve Bank will remain the frontline supervisor of banks, while trustee companies will be the frontline supervisor of non-bank deposit-takers. They will have to operate within the regulatory framework set by the Reserve Bank. Arrangements with regard to the Bank's role relating to insurance companies have yet to be finally determined.

These new responsibilities will require an expansion of the Bank's resources devoted to financial stability, and will require intense work early in the new regime to ensure that an appropriate regulatory framework is set in place. The proposals include some modifications to the relationship between Government and the Bank in certain aspects of the Bank's roles. These are outlined in more detail in the Bank's *Annual Report*. The Board has paid particular scrutiny to these aspects of the proposal to ensure that the Bank's independence across its other functions is not compromised. We are satisfied that the current proposals do not undermine the Bank's autonomy in relation to its primary monetary policy function.

Currency

The Bank introduced a new set of 10, 20 and 50 cent coins in July 2006 to replace the former set of coins. It also demonetised the old 5 cent coin. The project involved the recovery of 350 million old coins with the issuance during 2006/07 of 207 million new coins.

A project of this magnitude requires diligent management to ensure that it is delivered on time, within budget and without any major hitches. It is a credit to the Bank's staff that each of these aspects was achieved. The project has delivered to New Zealanders a more convenient set of coinage while also saving the taxpayer around \$4 million per annum relative to the costs of maintaining the former coins.

Administration

The move to the new coinage is indicative of the Bank's ongoing commitment to prudent use of resources while at the same time ensuring that it meets its statutory responsibilities. The Bank adopts sound processes for deciding its priorities, and for budgeting accordingly. The Board has an active role in advising on, and monitoring, the adoption and delivery of these prioritised projects.

The Bank has a five-yearly funding agreement with Government that forms the basis for its annual budget. The Bank pays an annual dividend to Government out of its earnings. The move to IFRS accounting standards will see some greater volatility in the Bank's reported earnings even with no changes to operations. Changes to balance sheet management – in particular the recently announced shift to holding an unhedged foreign exchange position

within the balance sheet – will also result in greater earnings volatility. Dividend policy has been adjusted accordingly to ensure that distributions to Government reflect underlying financial performance and do not result in any unwarranted diminution of the Bank's financial soundness.

New responsibilities are being placed on the Bank, especially with the move to regulate non-bank deposit-takers. These extra responsibilities will require the Bank to increase its staff resources modestly over coming years.

The Reserve Bank of New Zealand has an international reputation of being one of the most efficiently run of all central banks. It also maintains a strong reputation for high quality research, policy development and policy implementation. The Board recognises that these reputations are the result of high quality staff and management, led by the Governor, Dr Alan Bollard. We are delighted that Dr Bollard has been reappointed to the role of Governor for a further five years. The reappointment is recognition of his excellent contributions in the role over the past five years. The job of central bank governor is never straight-forward and the Bank faces a number of ongoing challenges, especially in monetary policy, arising from international and domestic developments. The Board is confident that the Bank has the staff and the leadership to meet these challenges successfully.

RESERVE BANK DEPARTMENTAL STRUCTURE As at 30 June 2007

Governors	Department/Heads	Functions	Internal Services
	Economics John McDermott**	Monetary policy formulation	
	Deputy Governor/ Head of Financial Stability Grant Spencer**	Financial Stability	Domestic market operations Foreign reserves management Financial system surveillance and policy
	Currency and Building Services Alan Boaden***	Currency operations	Property management Security
Governor Alan Bollard*	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		Risk assessment and assurance Audit services Legal services

* Alan Bollard was reappointed in May 2007 to a new five-year term expiring in September 2012.

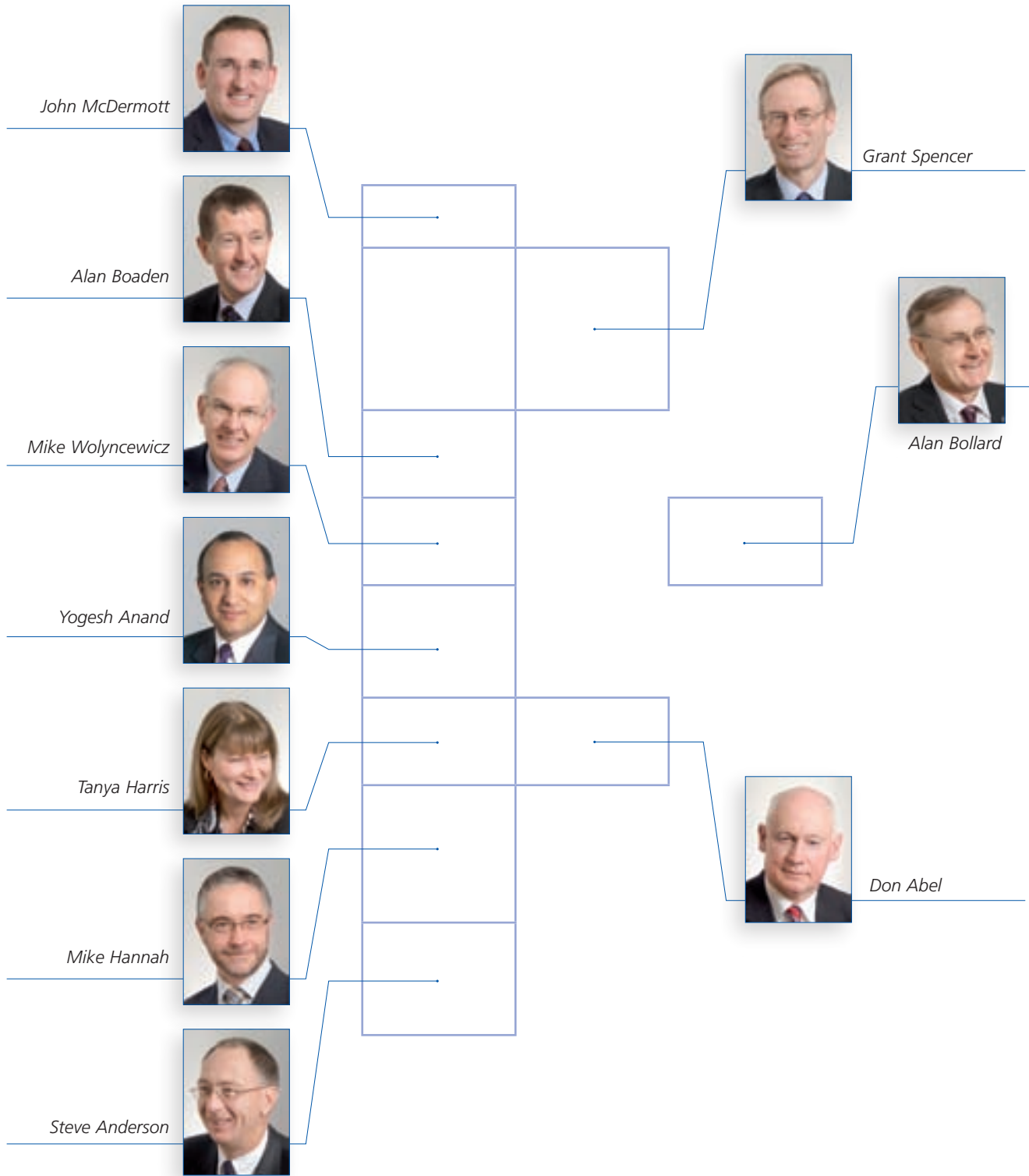
** Grant Spencer replaced Adrian Orr as Deputy Governor and Head of Financial Stability in February 2007, following Mr Orr's appointment as Chief Executive of the New Zealand Superannuation Fund.
Bernard Hodgetts was acting Head of Economics from 6 February to 10 June 2007.

John McDermott took up the role of Head of Economics on 11 June 2007.

*** Alan Boaden was appointed Head of Currency and Building Services on 16 December 2006, following the retirement of Brian Lang.

**** In April 2007, it was announced that Yogesh Anand had been appointed as Head of Information Technology Services for the Bank of International Settlements in Basel, Switzerland from August 2007. Tanya Harris was appointed Chief Information Officer on 30 May, to take up her appointment in July.

Lindsay Jenkin took up the appointment of Head of Human Resources on 24 September 2007.



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BOARD OF DIRECTORS

Non-Executive



Dr Arthur Grimes

Chair Reserve Bank of New Zealand Board of Directors
Economic Consultant
Principal – GT Research & Consulting
Senior Fellow – Motu Economic & Public Policy Research Trust
Adjunct Professor of Economics – University of Waikato
Director – Phillips Symposium Limited
Trustee – Reserve Bank Superannuation Fund; Wellington Jazz Trust
First appointed 13 March 2002 – current term expires 12 March 2012



Alison Paterson QSO

Deputy Chair Reserve Bank of New Zealand Board of Directors and Chair Reserve Bank of New Zealand Board of Directors' Audit Committee
Company Director
Chair – Abano Limited; Oversight Committee, Ambulance New Zealand; BPAC NZ Limited; Electricity and Gas Complaints Commission; Governing Board, Centre of Research Excellence Growth and Development, University of Auckland
Director – Metrowater Limited; Nga Pae o te Maramatanga (Maori CORE, University of Auckland); Vector Limited⁴
Member – Massey University Council
Board Member – Barnardos New Zealand
First appointed 1 February 1995 – current term expires 31 January 2010



Paul Baines

Company Director
Chair – Barnardos New Zealand
Director – EDS (New Zealand) Pension Fund Limited; Fletcher Building Limited; Gough, Gough & Hamer Limited; Greenstone Fund Limited⁵; New Zealand School of Music Limited; Todd Corporation Ltd⁶
Board Member – New Zealand Institute of Economic Research
First appointed 1 July 1999 – current term expires 30 June 2009



Hugh Fletcher

Company Director
Chair – Advisory Board, No 8 Ventures; IAG New Zealand Limited; IAG New Zealand Holdings Limited
Director – Fletcher Building Limited; Rubicon Limited; Vector Limited⁷
Chancellor – University of Auckland
Member – United Nations Office of Project Services Advisory Board⁸; The University of Auckland Council; The University of Auckland Foundation; New Zealand Advisory Board of L.E.K. Consulting
First appointed 10 June 2002 – current term expires 9 June 2012



John Goulter DCNZM JP

Company Director
Chairman – New Zealand Lotteries Commission; United Carriers Group Limited; NZ Business and Parliament Trust
Director – Television New Zealand Limited; Vector Limited⁹
External Adviser – ABN-AMRO New Zealand Limited
Former Managing Director Auckland International Airport Limited
First appointed 9 February 2000 – current term expires 8 February 2010



The Rt Hon Edmund Thomas DCNZM PC QC

Distinguished Visiting Fellow, Law School, Auckland University
Retired Judge of the Court of Appeal of New Zealand
Member of the Privy Council
First appointed 1 March 2003 – current term expires 29 February 2008



Dr Marilyn Waring

University Professor
Professor of Public Policy, Auckland University of Technology¹⁰
First appointed 4 February 2004 – current term expires 3 February 2009

Executive

Dr Alan Bollard
Governor

Secretariat

Mike Hannah
Board Secretary

4 Commenced 7 March 2007.
5 Retired June 2007.
6 Commenced May 2007.
7 Commenced 24 May 2007.

8 Defunct from 1 January 2007.
9 Resigned December 2006.
10 Commenced 29 May 2006.



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 24–25 for more detail on monetary policy activity in 2006/07.)

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". (See pages 27–30 for activity in 2006/07.)

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 required.

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 31.)

Other

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

Our internal organisation is illustrated in the chart on page 12. Details of the Reserve Bank Board of Directors are provided on pages 14–15. The role of the Board, and the governance and management of the Bank, are described on pages 17–21.

GOVERNANCE

Authority and accountability

The Reserve Bank of New Zealand is wholly owned by the New Zealand Government. The Bank's authority and accountability are based on:

- **the Reserve Bank of New Zealand Act 1989**, which specifies the Reserve Bank's functions and duties;
- **the PTA**, which is a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve;
- **the Bank's Funding Agreement**, which is a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Bank's income can be retained by the Bank to meet its operating costs; and
- **the Statement of Intent (SOI)**, which is an annual three-year statement provided to the Minister of Finance covering the Bank's operating environment, functions, objectives and strategies for the three years, and projected income and expenditure for the first financial year.

The Reserve Bank also subscribes to a statement of its Vision and Values. These can be found on page 2.

The Governor

The Reserve Bank Act makes the Bank's Chief Executive – the Governor – accountable for the Bank's actions.

In monetary policy, and in most other matters, decision-making authority resides with the Governor.

The Governor is appointed for a five-year term. The Act sets specific criteria for the appointment, reappointment, and dismissal of a Governor. The current Governor, Dr Alan Bollard, took up his appointment in September 2002 and was reappointed in May 2007 to a further five-year term expiring in September 2012.

Management structure

The Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Financial Stability, a Head of Operations, a Head of Economics, and the heads of the Bank's various departments, as outlined on page 12. The posts of Governor and Deputy Governor are required by statute, the current Deputy Governor also being the Head of Financial Stability. In addition, the Head of Operations is designated an Assistant Governor.

The Governor receives advice from a number of internal committees within the Bank. These are:

- the Senior Management Group, which meets weekly to consider the management and day-to-day operation of the Bank;
- the Monetary Policy Committee, which meets weekly to advise the Governor on economic and financial market developments;
- the Official Cash Rate Advisory Group, which advises the Governor on monetary policy decisions, typically eight times a year;¹¹
- the Financial Systems Oversight Committee, which meets fortnightly to consider policy issues relating to the financial system;
- the Asset and Liability Committee, which meets monthly to consider balance sheet management and related risks; and
- the Communications Committee, which meets weekly to consider communications issues and the Bank's credibility and reputational interests.

Board of Directors

The Reserve Bank has a Board of Directors, the membership of which is shown on pages 14–15. Under the Act, the Board of Directors must comprise not less than five and not more than seven non-executive members, who are appointed for five-year terms by the Minister of Finance. In addition, the Governor is a Board member. The Chair must be a non-executive member, and is appointed by the non-executive directors for a renewable term of 12 months. The current Chair is Dr Arthur Grimes.

The Board's primary function is to monitor the performance of the Governor and the Bank, on behalf of the Minister of Finance. It has the responsibility to confirm that *Monetary Policy Statements (MPSS)* are consistent with the PTA. The Board does this by holding regular meetings at which it receives extensive briefings on the Bank's activities, decisions, and policies. At these meetings, the Board also provides advice to the Governor. The Board does not direct Bank policy, monetary or otherwise.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. If the Board believes that the Governor's performance, in meeting the requirements

of the PTA or in carrying out his or her other duties, has been 'inadequate', then the Board can recommend to the Minister of Finance that the Governor be dismissed. The Board also appoints the Deputy Governor on the recommendation of the Governor. The Board provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on pages 6–11.

The Board of Directors' Audit Committee monitors the internal audit function. The Committee also receives reports from the Bank's external auditor and reviews the Bank's annual financial statements. Directors on that committee are Mrs Alison Paterson (Chair), Mr Paul Baines, Mr Hugh Fletcher, and Mr John Goulter.

The Board of Directors met nine times and the Audit Committee met four times during the year under review.

Parliamentary scrutiny

The Bank's activities are scrutinised by Parliament's Finance and Expenditure Select Committee. Typically, four hearings are held annually, covering the quarterly *MPSS*.

Transparency

An important aspect of the governance of the Bank is its transparency.

The Bank publishes an annual *SOI* and an *Annual Report*, which report on governance, corporate objectives, strategies, and performance. It releases a quarterly *MPS*, which explains current monetary policy and provides detailed economic projections. It also publishes a six-monthly *Financial Stability Report (FSR)*, assessing the robustness of the New Zealand financial system. On our website (www.rbnz.govt.nz), a *Statement of Principles* summarises our bank registration and supervision policies.

We also make information on our policies and activities widely available via speeches, brochures, media interviews, quarterly *Reserve Bank Bulletins*, published research papers and discussion papers, and an extensive website.

¹¹ This group also includes the Bank's two part-time external monetary policy advisers, who provide outsiders' perspectives to mitigate the risk of narrow information sources. At year's end, the two external advisers were Ms Liz Couetts and Ms Bronwyn Monopoli.

Financial management

The Reserve Bank is both a statutory agency and a financial institution. It receives no funding from the Consolidated Account. Instead, income is generated, mainly by investing the proceeds from issuing currency and the government's equity contribution to the Reserve Bank. Banks pay the Reserve Bank the face value of currency being issued to them. The Reserve Bank invests the funds in New Zealand Government Securities and foreign currency assets, from which it receives income¹². The income directly associated with issuing currency is referred to as 'seigniorage'.

The Reserve Bank Act requires that the Minister of Finance and the Governor of the Reserve Bank enter into funding agreements to specify the amount of the Bank's income that may be used to meet the Bank's expenses in each financial year. The funding agreement must be tabled in Parliament and does not become effective until ratified by a resolution of Parliament. The Act makes provision for each funding agreement to apply for a period of five consecutive financial years. The Governor and the Minister may subsequently agree to vary the provisions of a funding agreement (or terminate a funding agreement and enter into a new agreement)¹³.

The funding agreement specifies the agreed amount of its income that the Bank may use to finance its operating expenses for the years concerned. In the event that actual expenditure is less than that provided in the funding agreement, the amount of that underexpenditure is added to the Bank's equity and is not required to be distributed to the Crown. Conversely, if in any year the Bank's operating expenses exceed the amount provided in the funding agreement for that year, the expenditure in excess of that agreed amount must be financed from the Bank's equity. Capital expenditure is funded by the Bank from its own resources, with depreciation included in annual operating expenditure.

The policy intent of this arrangement is to support the operational and financial independence of the Bank, while also providing incentives for expenditure control, appropriate stewardship for resources and a basis for public accountability.

On 23 June 2005, Parliament ratified a Funding Agreement covering the period 1 July 2005 to 30 June 2010. The Funding Agreement for 2005–2010 provides for the following agreed levels of net expenditure:¹⁴

2005/06	\$39 million
2006/07	\$34 million
2007/08	\$41 million
2008/09	\$41 million
2009/10	\$43 million.

The Reserve Bank Act determines the amount of income earned during the year that is available for distribution. The income that is available for distribution is known as 'notional surplus income', which is calculated under section 158 of the Act.

The Minister of Finance determines the extent to which the Bank's notional surplus income is to be distributed to the New Zealand Government or added to the reserves of the Bank. In determining the distribution amount, the Minister must have regard to the capital requirements of the Bank, the views of the Bank's Board, and any other relevant matters.

The formula for calculating the amount available for distribution was changed in 2004 to exclude unrealised valuation gains and losses. This change has resulted in the amount of surplus available to be paid as dividend (or credited to the Bank's reserves) becoming more volatile. This is because realised and unrealised foreign exchange gains and losses, which broadly offset each other in the calculation of the Bank's net operating surplus, are treated differently in the calculation of the amount available for distribution.

From 2006/07, the calculation of notional surplus income excludes all foreign exchange gains and losses. This change delivers a more stable flow of annual dividends than was formerly the case and will better reflect the amount of the Bank's income that is available for distribution.

¹² The Bank's financial structure has changed significantly over the last two years. These changes are explained in box 1 on page 26.

¹³ In June 2007, as part of the Review of Financial Products and Providers, the Government made the decision for the Reserve Bank to be the single prudential regulator for New Zealand. This will widen the scope of the Bank's prudential functions and is likely to lead to an increase in the level of resources the Bank requires to perform this function. In these circumstances, the Governor and the Minister could agree on a variation to the current Funding Agreement for the required additional resources.

¹⁴ Net expenditure is gross expenditure less income from certain activities, including charges for Exchange Settlement Account System and Austraclear, rentals, scrapping coins, and hedging. The material reduction in net expenditure in 2006/07 is a function of expected proceeds to be received from salvaging demonetised coins.

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Risk management

The Bank faces a wide range of risks, some general and others unique to central banks. Of these, the most fundamental risk is making policy errors in relation to monetary policy, or the financial or banking systems, thereby causing damage to the economy and to the Bank's reputation and credibility. Other more specific risks include:

- credit and interest rate risks associated with our day-to-day liquidity management in domestic financial markets;
- risks associated with holding foreign currency reserves, including credit, interest, and exchange rate risks;
- risks associated with processing and storing currency, including risks of theft and robbery; and
- risks associated with being a small organisation, such as the loss of key staff.

The Bank sees risk management as an integral part of the general management task and the responsibility of day-to-day management.

The Bank has two units with specific responsibilities in relation to monitoring and managing risk. These are:

- The Bank's Risk Assessment and Assurance Department, which is responsible for providing advice on and monitoring the Bank's risk management frameworks. The internal audit role also rests with this department.
- A 'Risk Unit' within the Bank's Financial Stability Department that provides specialised advice on financial market risk management. This includes recommendations on interest rate, credit and liquidity risk limits, and the development of specialised measures within this area, such as 'value-at-risk (VaR)'.

In addition, succession planning is a management priority. The Bank is continuing to make progress with the execution of knowledge management strategies agreed earlier. A Business Continuity (BCP) strategy has been adopted, with a number of initiatives well advanced, including planning for a possible avian influenza pandemic.

The Board and its Audit Committee also contribute to the review of the Bank's risk management processes.

Conflicts of interest

The Bank maintains policies and practices to avoid or manage conflicts of interest among all Bank staff, including Governors. The policy requires that all staff act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy states that staff must avoid situations where their integrity might be questioned, and that their best protection is full disclosure of any potential conflicts.

Governors and departmental managers are required to provide the Bank with regular updates as to their personal interests, so that any potential conflict of interest is recorded. This is done quarterly. If any other staff have a particular concern, they can also record their interests in the same way.

Staff must not be personally involved, directly or indirectly, in regular trading in wholesale financial markets in which the Bank has, or might have, a significant influence. This includes domestic wholesale money, bond and foreign exchange markets, and interest and exchange rate futures, options and swaps markets, and shares in registered banks. At no time can Bank staff own or control shares in banks or their parent companies that the Bank supervises. The policy states that staff must not use inside information to benefit when depositing or withdrawing funds from financial institutions, or purchasing or selling bonds or shares, or when changing between fixed and floating rates for a loan. It is unacceptable to use inside information, whether to avoid losses or to make gains.

Under sections 56 and 61 of the Reserve Bank Act, the Minister must have regard to the likelihood of conflict of interest in appointing a director to the Board, and directors must disclose their interests in any contract with the Bank. On appointment to the Board, directors sign a declaration that they will observe confidentiality in relation to the affairs of the Bank, and will not make use of any confidential information they may acquire regarding Bank operations. They also provide lists of their other directorships and major interests in relation to which they would not wish to receive relevant Board papers or participate in Board discussions.

Management and monitoring processes

Within the Bank, all activities and expenditure must be authorised and in accordance with a comprehensive set of Bank policies and procedures. The Board receives monthly reports comparing actual outcomes against budget, prepared by the Bank's Financial Services Group. Departments are required to provide regular reports that describe progress to date on outputs and projects, and to explain any significant variances. The expenses of the Governor are reviewed by the Chair of the Board of Directors' Audit Committee. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are watched closely.

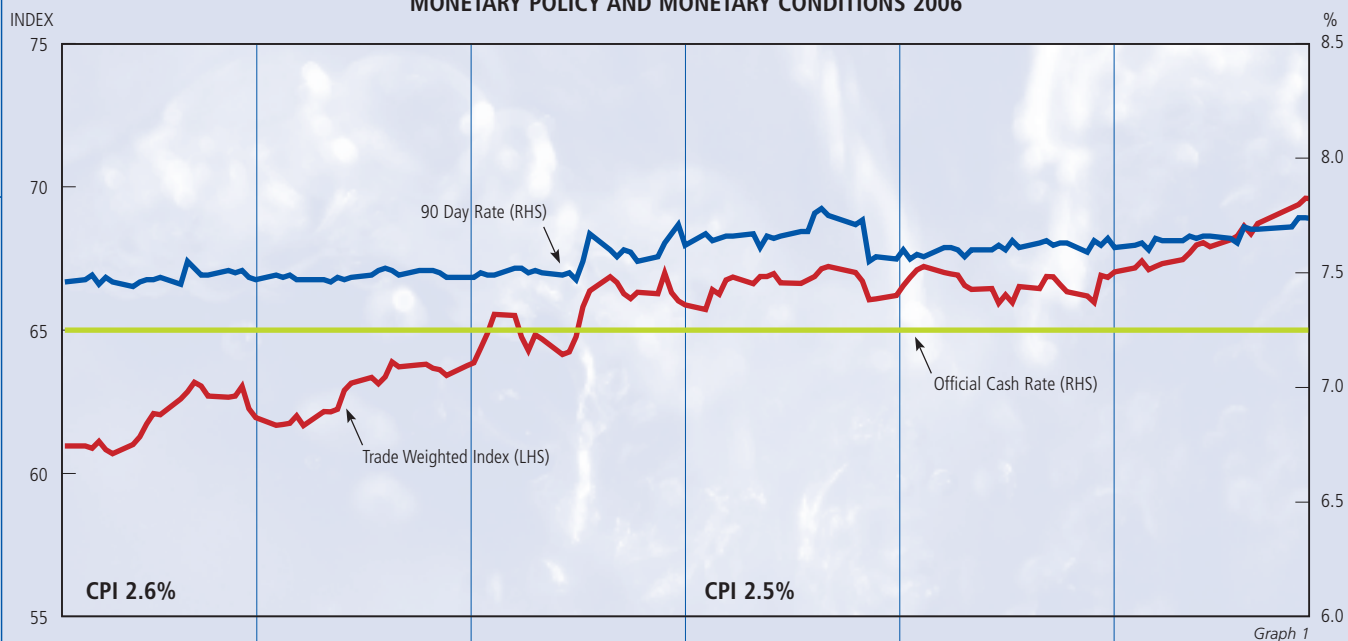
The internal audit function within the Bank is performed by the Bank's Risk Assessment and Assurance Department. The Bank is audited externally by the Auditor-General, who has contracted PricewaterhouseCoopers as his agent. In addition, the Minister of Finance can order a performance audit.



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CHRONOLOGY

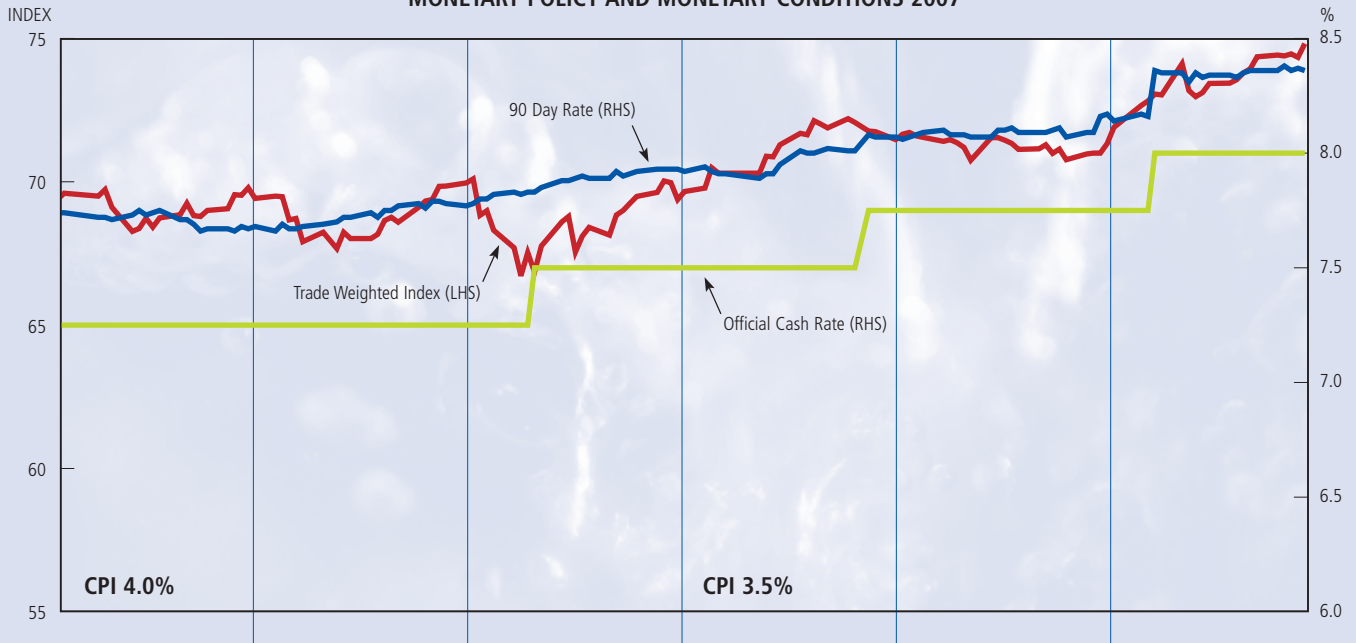
MONETARY POLICY AND MONETARY CONDITIONS 2006



JULY	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER	DECEMBER
<p>17 July CPI inflation for the year to June 2006 is announced at 4.0 percent.</p> <p>27 July The Reserve Bank leaves the OCR unchanged at 7.25 percent.</p> <p>31 July The Bank introduces smaller, lighter 10, 20, and 50 cent coins and withdraws the 5 cent coin from circulation.</p>		<p>6 September The Reserve Bank Museum is opened.</p> <p>14 September The Reserve Bank leaves the OCR unchanged at 7.25 percent.</p>	<p>25 October CPI inflation for the year to September 2006 is announced at 3.5 percent.</p> <p>26 October The Reserve Bank leaves the OCR unchanged at 7.25 percent.</p> <p>31 October The New Zealand retail operation of Westpac Banking Corporation is locally incorporated as Westpac New Zealand Limited.</p>		<p>7 December The Reserve Bank leaves the OCR unchanged at 7.25 percent.</p> <p>12 December St George Bank New Zealand Limited (known as Superbank) ceases operations.</p> <p>December Legislation comes into force to ensure the Reserve Bank and APRA can support each other in performing their existing regulatory responsibilities.</p>

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MONETARY POLICY AND MONETARY CONDITIONS 2007



JANUARY	FEBRUARY	MARCH	APRIL	MAY	JUNE
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17 January
CPI inflation for the year to December 2006 is announced at 2.6 percent.

25 January
The Reserve Bank leaves the OCR unchanged at 7.25 percent.

8 March
The Reserve Bank raises the OCR to 7.50 percent.

18 April
CPI inflation for the year to March 2007 is announced at 2.5 percent.

26 April
The Reserve Bank raises the OCR to 7.75 percent.

24 May
The Minister of Finance reappoints Dr Alan Bollard to a second term as Governor, and they sign a new PTA.

24 May
Parliament's Finance and Expenditure Committee announces an Inquiry into the Future Monetary Policy Framework.

7 June
The Reserve Bank raises the OCR to 8.0 percent.

11 June
The Reserve Bank confirms it has intervened in the foreign exchange market to sell New Zealand dollars.

19 June
Cabinet announces the Reserve Bank is to be the single prudential regulator for New Zealand.

12 July
The Reserve Bank announces changes to its foreign exchange management.

16 July
CPI inflation for the year to June 2007 is announced at 2.0 percent.

THE YEAR IN REVIEW

Monetary policy formulation

Statement of Intent 2006–2009 – Objectives

To achieve and maintain stability in the general level of prices. A published Policy Targets Agreement (PTA) requires the Bank to keep future inflation outcomes, as measured by the Consumers Price Index, between 1 and 3 per cent per annum on average over the medium term. It also requires that: "In pursuing its price stability objective, the Bank shall ... seek to avoid unnecessary instability in output, interest rates and the exchange rate."

Economic overview

The economy grew only modestly over the first half of 2006/07 but further growth in domestic demand resulted in a stronger expansion over the second half of the year. A buoyant housing and labour market and higher government spending underpinned domestic demand over this period, especially in the household sector, offsetting subdued export activity. With productive resources already stretched, domestic inflation pressures remained strong, but declining oil prices over the second half of 2006 and a further appreciation of the New Zealand dollar saw headline inflation decline from 4.0 percent to 2.0 percent by the end of the financial year.

Over this period, monetary policy remained focused on ensuring that medium-term inflation settled comfortably within the 1 to 3 percent target band. Over much of 2006, the Bank left the OCR unchanged at 7.25 percent to allow previous increases to have their full effect. However, new signs that domestic demand had not cooled to the extent expected saw the Bank lift the OCR by 75 basis points between March and June 2007 to 8.0 percent.

From late 2006 onwards, there was a sharp rise in world prices for New Zealand's dairy exports. Although positive for New Zealand's trade deficit, it also added further stimulus to the economy, creating an additional challenge for monetary policy, given the limited inflation headroom.

Statement of Intent 2006–2009 – Initiatives and strategies

- *Replace or redevelop the current forecasting and policy model.*
- *Review macroeconomic policy options for reducing cyclical pressures on the external economy while maintaining price stability.*
- *Develop and maintain a range of best-practice structural and statistical models for use in forecasting and policy analysis.*
- *Analyse trends in the composition of household balance sheets; identify key drivers; and model the impact on household spending and savings.*
- *Improve the quality, accessibility, relevance, and reliability of Reserve Bank statistics.*

During the year, the Economics Department made progress on several of the three-year initiatives outlined in the *SOI*.

Substantial progress was made in developing a new Dynamic Stochastic General Equilibrium (DSGE) model of the economy, intended to replace the current Forecasting and Policy System (FPS). By the end of the financial year, a prototype DSGE model had been constructed and was in the evaluation and testing stage. The aim is to integrate the DSGE model into the Bank's forecasting process over the coming year.

We also continued to develop additional statistical models that provide competing forecasts to those produced by our main forecasting model. These models help ensure that the economic projections underpinning the Bank's monetary policy decisions are subject to robust scrutiny.

We undertook further work examining the factors leading to the marked decline in household savings over the past decade. In November, the Bank held a workshop to discuss research in this area, which was attended by a number of academics and government agencies with an interest in this important topic. We offered assistance to Statistics New Zealand in its efforts to upgrade the statistics in this area.

During the year, we developed a range of measures of core inflation to help assist the analysis of the inflation process in New Zealand. We also completed a review of the Trade Weighted Exchange Rate Index (TWI) to assess whether it remains an appropriate measure of New Zealand's effective exchange rate. As a result of that review, some new measures have been introduced.

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We continued to subject our monetary policy decision-making process to external scrutiny during the year, with several additional peer reviews. As a result of these reviews, we have continued to make incremental improvements to our processes. Later in the year, we also began preparing for the Finance and Expenditure Committee's Inquiry into the Future Monetary Policy Framework, which is due to report later in the 2007/08 financial year.

Domestic market operations & foreign reserves management

Statement of Intent 2006–2009 – Objectives

To assist in the efficient functioning of the New Zealand financial system, to manage official foreign reserves, to manage the Crown's financial liquidity, and to implement monetary policy.

The Reserve Bank operates in the financial markets daily to implement monetary policy and to ensure adequate and stable liquidity in the inter-bank system.

Statement of Intent 2006–2009 – Initiatives and strategies

- *Review the structure of the Bank's balance sheet to ensure that it best meets the statutory requirements of the Bank (including monetary policy, currency, bank liquidity, and foreign reserves).*
- *Complete and potentially implement the liquidity management review, which aims to ensure that the banking system has adequate liquidity, with collateral requirements and risks being balanced appropriately.*
- *Continue to work closely with the Debt Management Office to ensure that the comparative advantages offered by the two agencies in managing the Crown's foreign exchange and debt management business are being utilised fully.*

July 2006 saw the beginning of the Bank's new liquidity management regime, following a review last year. The Bank now operates a 'cash-up system' for the commercial banks that have Exchange Settlement

Account System (ESAS) accounts. This differs from the previous regime, in which banks were required to hold large stocks of New Zealand government securities and to lodge these securities with the Bank during the day to enable payments. In the new cashed-up system, ESAS account holders receive interest at the OCR on their end-of-day balances. The Bank has continued to provide 'collateralised'¹⁵ overnight borrowing facilities for banks, at an interest rate set at a margin over the OCR.

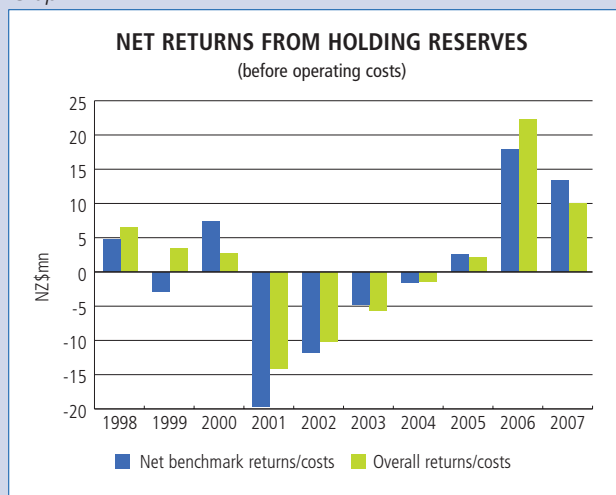
The new regime has been working effectively and has gained widespread interest from other central banks. The new operating system has made the Bank more active in the markets – mainly foreign exchange swap and New Zealand government repo markets – and has helped improve the Bank's monitoring and understanding of market pressures. The Bank has continued to operate an emergency bond repo facility each day, where New Zealand government bonds held by the Bank are made available to the repo market. The rationale for this facility is to increase the availability of New Zealand government bonds to avoid settlement failures of bond transactions.

The Reserve Bank maintains the capacity to intervene in the foreign exchange market in a crisis, or as a tool to influence the level of the exchange rate. This intervention capacity consists of a diversified portfolio of foreign currency assets that can be realised quickly. These assets are financed by a mix of foreign currency loans from the Treasury and from the Bank's own liabilities. The Minister of Finance, in consultation with the Bank, determines the amount of reserves required, specified as a range denominated in Special Drawing Rights (SDRs)¹⁶. Total reserves held for intervention at 30 June 2007 were 3.07 billion SDRs (\$NZ6.03 billion).

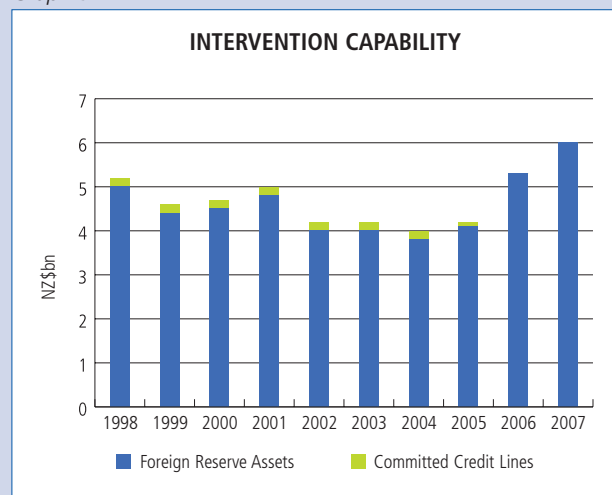
In June 2007, the Bank announced that it had intervened in the New Zealand dollar market for the first time since the New Zealand dollar had been floated in March 1985. This intervention followed a number of comments by the Governor that the New Zealand dollar was at exceptional and unjustified levels.

¹⁵ In practice, the Reserve Bank normally provides funding to the banks by buying government bonds in 'reverse-repurchase agreements' (in which the seller is obliged to repurchase the bond at a specific future date) or by entering foreign exchange swap transactions. These forms of transactions enable the Reserve Bank to lend the registered banks the New Zealand dollar liquidity they need, in effect collateralised by government bonds or foreign cash, for the term of the loan.

¹⁶ The SDR is the unit of account of the International Monetary Fund and some other international organisations. Its value is based on a basket of key international currencies.

Graph 2¹⁷

Graph 3



Box 1: Balance sheet review

The Bank's balance sheet review aimed to ensure that the balance sheet is appropriately structured to support the Bank's policy objectives.

There were two main outcomes of this review:

- The Bank will use its own funds to finance its holdings of foreign reserve assets.
- The Bank will finance a portion of its foreign reserves with New Zealand dollar-denominated liabilities as opposed to long-term foreign exchange-denominated loans.

The Bank's use of internal funds for reserves

Historically, the Bank has borrowed foreign currency funds from the Treasury to finance foreign reserves. However, the Bank has access to significant funding sources in the form of currency in circulation and commercial bank settlement account balances (a New Zealand dollar-denominated loan that pays interest at the OCR). The review concluded that the Bank could use these funding sources to finance reserves more flexibly than borrowing from the Treasury without adversely impacting the overall cost of holding reserves. For a portion of the foreign currency reserves, the Bank uses long-term currency and interest rate swaps to hedge the foreign currency risk that would otherwise result from solely using New Zealand dollar-denominated liabilities to fund foreign currency reserves.

Management of foreign exchange risk

The balance sheet review also examined the Bank's management of foreign exchange risk. Historically, the Bank has maintained a very small exposure to foreign exchange risk by borrowing reserves in the currencies in which

reserves are held. The balance sheet review concluded that it would be appropriate to hold a portion of the Bank's foreign currency reserves on an unhedged basis. This would be additional insurance against prolonged exchange rate weakness, if reserves are required to be liquidated in a crisis. This change in hedging approach is consistent with the approach of most other central banks, which tend to hold most, if not all, of their foreign reserves unhedged.

Another aspect of the review has been to allow scope for the Bank to change the level of unhedged foreign reserves relative to hedged foreign reserves over the exchange rate cycle. Generally, it is more profitable to hold more reserves unhedged when the exchange rate is high and increase the amount of foreign exchange hedges when the exchange rate is lower. The Bank will consider its existing foreign exchange intervention criteria when deciding whether to change the level of foreign exchange hedges relative to a long-term benchmark level. This means that the Bank will need to judge that the exchange rate is at least exceptional and unjustified before changing the level of currency hedges relative to a benchmark level. In these situations, the Bank might signal its view on the exchange rate by moving its level of foreign exchange hedges (a high exchange rate will see hedges reduced and a low exchange rate will see hedges increased). Overt intervention aimed at influencing the exchange rate directly via transacting in the market will still require all of the Bank's intervention criteria to be met; that is, intervention will need to be PTA-consistent and opportune, when the exchange rate is exceptional and unjustified.

¹⁷ Graph 2 shows the underlying economic returns from holding reserves. It excludes the impact of changes in assumptions used to value term loans from the Treasury introduced in 2005/06. The impact of the changes in valuation assumptions was to decrease reported returns by \$73.4 million in 2005/06 and increased reported returns by \$14.6 million in 2006/07.

Financial system surveillance and policy

Statement of Intent 2006–2009 – Objectives

To register and supervise banks so as to maintain a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.

Surveillance and outlook

The financial system remained sound over the past year:

- New Zealand banks were well capitalised and profitable, with low reported levels of impaired assets, and strong credit ratings.
- Asset growth in the finance company sector moderated and a further finance company failure occurred at the end of the year. While risks remain, within the sector, consolidation should be beneficial to the stability of the sector going forward.
- New Zealand's financial markets remained sound during a period that saw the New Zealand dollar continue to strengthen.
- The payments and settlements system operated smoothly during the year, with only minor outages experienced.

There was one addition and one deletion to the list of registered banks during the year, with the number registered remaining at 16 at the end of the year. The addition was the New Zealand retail operation of Westpac Banking Corporation, which was locally incorporated as Westpac New Zealand Limited. Non-retail operations continue to be operated through a branch of Westpac Banking Corporation. The deletion was St George Bank New Zealand Limited (also known as Superbank), which ceased operations.

No payments systems were approved for designation during the year. Changes to the rules of the two designated payments systems were reviewed and these systems remained designated.

Looking forward, some risks to financial stability persist. New Zealand's current account deficit continues to grow, fanned by domestic savings-investment imbalances and high levels of household debt. Much of the debt has been funnelled into the housing market, putting upward pressure on house prices. Part of the growth in mortgage debt has involved some banks offering new mortgages that require little or no borrower deposit (high loan-to-value loans). Some households' ability to service this debt has continued to deteriorate.

Statement of Intent 2006–2009 – Initiatives and strategies

- Continue to work with other agencies to assess the scope for wider prudential regulation of the non-bank financial sector and the role of the Bank in this area.
- Complete the implementation of the Bank's policies on outsourcing, Basel II, and local incorporation.
- Complete the formulation and implementation of the Bank's crisis management capabilities, assessing their robustness through failure management scenarios.
- Review the efficiency of the banking system.

New Zealand's reliance on foreign savings increases the vulnerability of its financial system to an adverse external shock. Notwithstanding this kind of risk, the financial system remains well placed to withstand a period of less favourable economic conditions.

Policy initiatives

The Reserve Bank has progressed a number of financial sector policy initiatives during the year. One priority was to contribute to the Government's Review of Financial Products and Providers (RFPP). This work is described in box 2.

Work has continued on implementing the Basel II framework for New Zealand banks. It is designed to better align a bank's minimum capital requirements with key bank risks, and provides the option for banks to use their own models to determine regulatory capital requirements. Over the past year, the Bank worked to update its capital adequacy standards to reflect Basel II and commenced reviewing the internal models of those banks seeking to calculate their own minimum capital requirements. Basel II implementation in New Zealand is scheduled for January 2008.

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During the year, the Bank made minor changes to its definition of bank capital and to its disclosure rules for banks. These changes were designed to address the introduction of the New Zealand equivalents to international financial reporting standards.

In late 2006, New Zealand and Australia each introduced legislative changes recommended by the Trans-Tasman Council on Banking Supervision to ensure that the Reserve Bank and the APRA could support each other in performing their existing regulatory responsibilities.¹⁸ The changes reflect the strong links between the banking and financial systems of the two countries and the close working relationship between the countries' financial regulators. These new trans-Tasman legislative provisions are an important advance in home-host supervisory cooperation between Australia and New Zealand.

Related to this, the Reserve Bank continues to work closely with APRA to coordinate supervision where possible, maximising effectiveness while avoiding undue costs on banks.

In addition, the Reserve Bank continues to work with APRA and the Reserve Bank of Australia in planning responses to distress in trans-Tasman banks and the financial system.

To promote soundness and efficiency in the retail payment system, the Bank has continued to engage with the New Zealand Bankers' Association (NZBA) on two NZBA-led projects. The Failure to Settle project is primarily concerned with reducing risk in the retail payment system. The Access and Governance project seeks to promote open access for financial institutions to the retail payment system.

During the year, the Reserve Bank published its views on payment system governance in the *Reserve Bank Bulletin*¹⁹. This document discusses the importance of good governance promoting sound and efficient payment systems.

¹⁸ See "The Reserve Bank of New Zealand Amendment Act 2006", http://www.rbnz.govt.nz/research/bulletin/2002_2006/2006dec69_4desourdy.pdf for more details.

¹⁹ See "Statement on Payment System Governance", <http://www.rbnz.govt.nz/finstab/payment/2641543.html> for more details.

Box 2: Review of Financial Products and Providers (RFPP)

In line with our objectives outlined in the *SOI*, the Reserve Bank has participated actively in the Government's RFPP. The review is led by the Ministry of Economic Development (MED), with input from the Reserve Bank, the Treasury, the Ministry of Consumer Affairs, and the Securities Commission.

The products and providers covered by the wide-ranging review include insurance, superannuation, collective investment schemes, platforms and portfolio management services, NBDTs, securities offerings and issuers of equity and debt securities. These products and providers are currently regulated by numerous laws, which has led to gaps in coverage, inconsistencies and unnecessary compliance costs.

In June 2007, the Government confirmed that the Bank should be the single agency responsible for the prudential regulation of the financial sector. The Bank will also become the lead agency responsible for providing policy advice on prudential regulation to the Minister of Finance.

This will widen the scope of the Reserve Bank's prudential functions to include the prudential regulation of NBDTs and insurers.

NBDTs

For NBDTs, trustee corporations will continue to be the front-line supervisors. The Bank's role will be limited to licensing NBDTs, developing and enforcing minimum prudential and governance requirements and applying credit rating requirements. The Bank will also assist in the revision and simplification of public disclosure requirements for NBDTs.

The overall objective for prudential regulation of the NBDT sector is to promote a sound and efficient financial system.

The new framework is expected to provide a more consistent approach to the supervision of NBDTs and provide a stronger basis for confidence in the NBDT sector. Improved disclosure and credit ratings will assist depositors to make better-informed investment decisions.

Insurers

The Reserve Bank will report back to Cabinet with proposals for the insurance prudential regulatory regime during the fourth quarter of 2007. This follows on from the public consultation document released in September 2006, which noted that current regulatory arrangements were

outdated, lacked teeth and fell well short of international standards. However, insurance is not an industry in crisis and a non-intrusive regulatory environment would continue.

Changes to the Reserve Bank's accountability and governance arrangements

Given the expansion of the Bank's regulatory role, some changes are proposed to the Bank's governance and accountability arrangements. The changes preserve the independence of the Bank's monetary policy functions and support the extension of its prudential regulatory functions. Changes include:

- A Ministerial authority to comment on the Bank's draft *SOI* and require the Bank to demonstrate how it has taken these comments into account in the formulation of its objectives for the financial sector;
- A Ministerial authority to direct the Bank to have regard to a statement of Government policy objectives for the financial sector;
- An amendment to the Reserve Bank Act to reflect the increase in focus on prudential regulation, while recognising that monetary policy remains the Bank's primary function;
- The Reserve Bank's *SOI* is to provide more information about the Bank's intended actions and measures for judging performance;
- The Bank's *Annual Report* is to report against the enhanced *SOI*;
- The Bank's biannual *FSR* is to provide information on the performance of the prudential regulation regime and its implications for the financial sector, and is to be provided to Parliament; and
- The Bank's Board and the Treasury are to increase their monitoring of financial sector regulation.

Over the coming period, the Bank will work with the Government in the drafting and passage of legislation necessary to enact these changes to the supervision regime for non-banks and insurers.

Box 3: Financial Stability Report

The *Financial Stability Report (FSR)* provides a regular overview of the Reserve Bank's assessment of financial system stability in New Zealand. The financial system comprises financial institutions, financial markets, and payment and settlement systems. Financial stability is likely to be achieved when all relevant financial risks are adequately identified, priced, and allocated to those best able to manage them. Under these conditions, the financial system is likely to be resilient to a wide range of economic and financial shocks, and able to absorb financial crises with least disruption.

The *FSR* aims to contribute to informed discussion of New Zealand's financial system and the risks to financial system stability. It also provides a summary of the Bank's activities aimed at promoting financial system soundness and efficiency.

In the May 2007 *FSR* the Reserve Bank noted that international conditions had been generally been favourable for financial stability. Overall, global economic growth had remained robust, and financial markets performed strongly. Against this backdrop, New Zealand's financial system continued to be stable.

New Zealand financial markets were relatively liquid, with volatility slightly below historical levels. The May *FSR* noted that banks' balance sheets were strong and reported capital holdings exceeded regulatory requirements. Bank asset quality remained good and banks were highly profitable. The stability of New Zealand's large banks was further supported by the healthy state of their Australian parents.

More recently, United States sub-prime mortgage defaults have added to uncertainty and volatility in financial markets. This will be one of the developments to be discussed in the next *FSR*, which will be released in November 2007.

Key systemic risks that have been discussed in recent *FSRs* are summarised below.

- Record levels of household debt, combined with stretched house prices, leaves the New Zealand economy and its banking system relatively more exposed to negative economic shocks. Slower economic growth would put more strain on household debt servicing obligations.
- Alongside household debt, non-financial corporate sector debt has also grown rapidly. The agriculture sector is vulnerable to fluctuations in commodity prices, higher interest rates, and the continued strength of the New Zealand dollar. The health of farm balance sheets is heavily dependent on land prices, which have been buoyed by strong global dairy prices.
- Higher debt levels increase New Zealand's reliance on foreign savings. If foreign investors thought New Zealand dollar assets were becoming riskier, they could demand a higher premium for buying those assets and New Zealand borrowers could be confronted with sharply higher interest rates.
- Global imbalances remain a feature of the international environment. The US and some other economies (including New Zealand) have large current account deficits, while oil exporters and Asian economies such as Japan and China continue to run substantial current account surpluses. Large and persistent saving and investment imbalances raise the possibility of a disorderly correction in foreign exchange and capital markets.

Currency operations

Statement of Intent 2006–2009 – Objectives

To meet the currency needs of the public by ensuring the supply and integrity of bank notes and coins.

The Bank meets the currency needs of the public by arranging the procurement, secure storage and issue of New Zealand bank notes and coins, as well as maintaining the quality and verifying the authenticity of currency in circulation.

Statement of Intent 2006–2009 – Initiatives and strategies

- *Implement the modernisation of the 'silver' coins.*
- *Improve the forecasting of currency demand.*
- *Report on currency trends and electronic-money developments.*

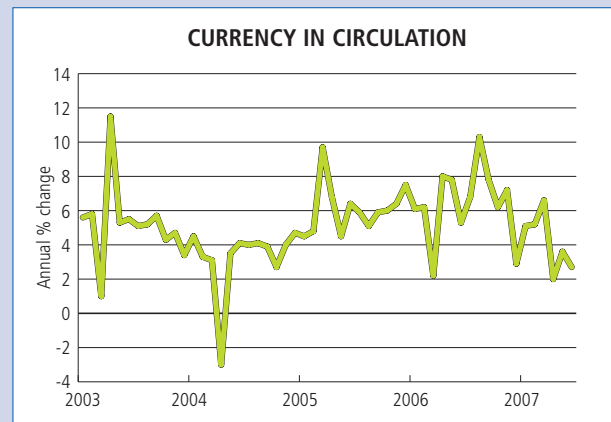
The Reserve Bank issued new, smaller, lighter 10, 20 and 50 cent coins on 31 July 2006 and progressively withdrew the old cupronickel coins over the following months (see box 4, page 39).

The value of currency in circulation continues to grow steadily. In the year to 30 June 2007, it rose by 2.7 percent. There were 115 million notes and 334 million coins in circulation at the end of June this year.

The number of higher-value notes in circulation has increased significantly over the last year. The number of \$50 and \$100 notes rose by 9.8 percent and 3.0 percent respectively, while numbers of \$20 notes declined slightly. The face value of \$100 notes in circulation is now higher than that of any other denomination but there are still far more \$20 notes. They make up almost 50 percent of notes on issue.

A key objective of the Bank's cash operations is to ensure the integrity of bank notes in circulation. This involves the Bank running notes through sophisticated machinery to check for counterfeits and poor quality notes. In September 2006, the Bank's new note processing machinery was upgraded to check the quality and authenticity of bank notes more efficiently and more effectively. During the past 12 months, 60 million bank notes have been processed by the Bank.

Graph 4



Box 4: 'Silver' coin project

On 31 July 2006, the Bank issued new, smaller, lighter 10, 20 and 50 cent coins, and started withdrawing the corresponding old cupronickel coins. The old 5 cent coin was withdrawn and not replaced. The Bank pre-positioned about 80 million new coins at bank branches throughout the country prior to 31 July to assist a speedy changeover. The Bank also conducted a highly effective communications programme to inform the public about the new coins and to encourage the return of the old coins.

The old coins were declared no longer legal tender with effect from 1 November 2006. The Bank has recovered 350 million, or 2,280 tonnes, of the old coins. This is about one-third of the coins issued since decimal currency was introduced in 1967. These coins were sold to an overseas company, which melted them down to make new blank coins for other countries.

The income from the sale of the old coins not only covered all the costs of introducing the new coins, but also resulted in a surplus for the project overall. The substantial rises in copper and nickel prices in recent years mean that the new, smaller, plated-steel coins are expected to generate annual savings for the Bank of about \$4 million compared with what the cupronickel coins would have cost.

The Bank won two valued awards for the 'silver' coin project. The Association of Blind Citizens of New Zealand presented the Extra Touch Award to the Bank in recognition of its commitment to ensure the new coins would be easily identifiable by blind and vision-impaired people. The Public Relations Institute of New Zealand judged the silver coin communications programme the national winner in the Government Public Relations Programme category of their annual awards.

Depository and settlement services

Statement of Intent 2006–2009 – Objectives

To ensure that payments system infrastructure services are provided efficiently and meet international standards.

The Reserve Bank is the operator of New Zealand's Real Time Gross Settlement (RTGS) environment, comprising the ESAS and the Austraclear New Zealand system. An efficient and secure payments system is an integral part of ensuring the smooth operation of the financial markets in particular and the smooth functioning of the economy in general.

The ESAS system processes high-value payments between financial institutions on a real-time basis. ESAS is an integral part of the service operated by CLS Bank²⁰, which facilitates simultaneous exchange of both legs of foreign exchange transactions. On average, each day, payments with a value of \$36.3 billion are made through ESAS.

The Austraclear New Zealand system is a securities clearing and settlement system to allow the simultaneous exchange of cash and securities (such as equities and fixed interest securities) between buyers and sellers. The main users of the Austraclear system are financial institutions, large investors, fund managers, brokers and their agents. The average value of payments settled in Austraclear each day is \$6.6 billion.

Given the community's dependence on payment systems, it is important that sound decisions are made to ensure the ongoing resilience and development of these systems.

Statement of Intent 2006–2009 – Initiatives and strategies

- *Improve business continuity planning and disaster recovery capability by arranging for out-of-Wellington business support for payment systems, and ensure greater flexibility in backup computing and service provision arrangements.*
- *Engage with the settlements industry to define long-term needs and to evaluate options for delivering the services required.*
- *Complete the upgrade for ESAS and Austraclear systems before 31 December 2007.*

The Bank is scheduled to implement a major upgrade of the ESAS and Austraclear systems in October 2007. This will conclude a project that has spanned the last 18 months. The project will result in ESAS and Austraclear being fully supported until at least 2011 and the systems' architecture will allow changes that accommodate new products and services to be made more easily than has been the case in the past. The capital cost of the upgrade will be recovered from users of the system over four years.

A new interface to Austraclear using the SWIFT secure messaging system was implemented in November 2006. This enables Austraclear users to process transactions directly from their core treasury systems to the principal securities settlement system, reducing operational risk and making users' operations more efficient.

Table 1: Key ESAS statistics

	2003	2004	2005	2006	2007
Average daily transaction volumes	3,271	3,693	4,507	5,472	6,081
Average daily transaction values	\$32.6bn	\$35.3bn	\$32.3bn	\$36.6bn	\$36.3bn
ESAS system availability during core hours	99.94%	99.92%	99.95%	99.94%	99.92%

Table 2: Key Austraclear statistics

	2003	2004	2005	2006	2007
Average daily transaction volumes	1,183	1,124	1,131	1,123	1,077
Average daily transaction values	\$9.9bn	\$10.1bn	\$9.3bn	\$9.6bn	\$6.6bn

²⁰ CLS Bank is a United States-based bank that facilitates the reduction of settlement risk of foreign exchange transactions by simultaneously settling both legs of foreign currency transactions.

Late in the year, the Bank announced important changes to the governance arrangements for the Austraclear system. A user Advisory Committee has been established, which formalises members' input to systems changes and pricing and gives users the opportunity to review the performance of the Bank as operator of the system. The Bank retains decision-making power in respect of the system, but is required to consider and formally respond to members' views. The Bank now prepares an annual plan and annual report for the system and these will be reviewed by the Advisory Committee. The Rules of the Austraclear system, which set out the rights and obligations of users and the Bank as system operator, will be amended to include provisions for the formation and operation of the Advisory Committee.

The reduction in the average daily transaction value in 2007 is attributable to reduced trading of fixed interest securities following implementation of the new liquidity management regime for the New Zealand banking system described on page 25.



Human resources

Statement of Intent 2006–2009 – Objectives

To provide strategic human resource advice and support services.

The Bank recognises that the nature of its work is dependent on employing and developing the best people. To do this, it strives to create the right working environment so people are motivated to do their best work and where all staff can further develop their skills and knowledge.

Statement of Intent 2006–2009 – Initiatives and strategies

- *Provide leadership training to support managers to be high-performing individuals and leaders within the Bank.*
- *Continue a formal review of key-person risk within the Bank and how it can be mitigated.*
- *Continue the Bank's staff appraisal system that incorporates a career development plan for each staff member.*

The Bank's priority to invest in the development of our managers continued this year through its Managers' Forum and the managers' Leadership Development Programme. As with many other organisations, the Bank's working culture is expressed in its statement of Vision and Values (see page 2). The task of refreshing these during the year reflected a cohesive culture across the organisation. The next staff survey at the end of the calendar year 2007 will provide us with further opportunity to develop the Bank's working environment.

The Bank remains focused on having healthy and safe working spaces and ensuring that staff are equipped to handle a range of emergency situations. A significant cross-section of the Bank's staff has now been trained in first aid, CPR, and fire and rescue training. Staff have also been involved in pandemic and general awareness training to cope with a range of emergency and BCP situations.

Table 3: Human resource statistics

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total staff at 30 June (FTE)	281	283	237	199	182	193	210	218	223	221
Average years of service at 30 June	8.3	8.8	9.4	9.4	9.2	9.2	8.8	8.0	7.4	7.4
Annual staff turnover	8.8%	10.0%	10.4%	14.9%	13.5%	11.3%	13.5%	9.0%	9.3%	12.3%

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Remuneration

The Reserve Bank spent \$21.8 million on personnel in 2006/07. This included all forms of remuneration, direct expenditure on training, and redundancy payments.

Table 4 shows the number of staff who received over \$100,000 in total remuneration²¹ in 2006/07.

Table 4: Staff receiving \$100,000 or more in 2006/07

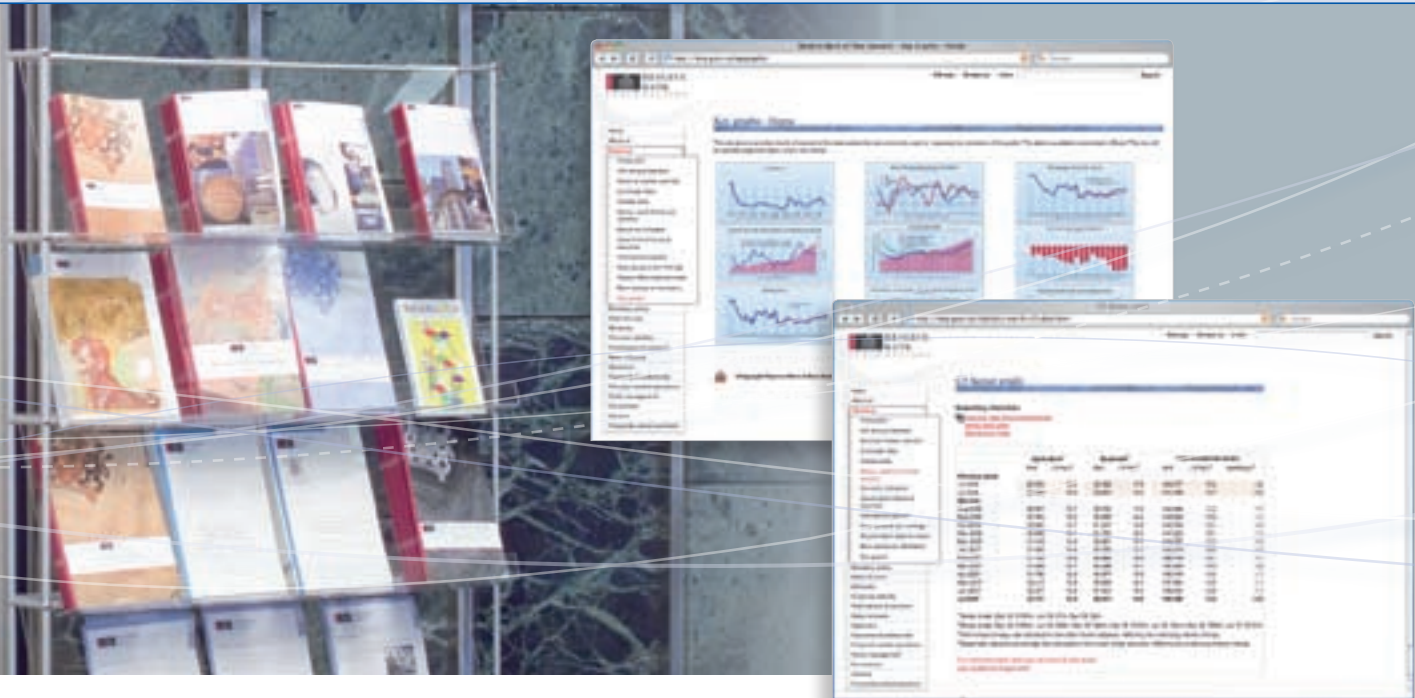
Total remuneration	Staff numbers 2007
\$100,000 to \$109,999	12
\$110,000 to \$119,999	8
\$120,000 to \$129,999	14
\$130,000 to \$139,999	8
\$140,000 to \$149,999	4
\$150,000 to \$159,999	4
\$160,000 to \$169,999	2
\$170,000 to \$179,999	8
\$180,000 to \$189,999	1
\$190,000 to \$199,999	1
\$210,000 to \$219,999	1
\$230,000 to \$239,999	1
\$240,000 to \$249,999	4
\$310,000 to \$319,999	1
\$330,000 to \$339,999	1
\$520,000 to \$529,999	1
Total	71

Insurance and indemnity arrangement

Section 179 of the Reserve Bank Act provides that every officer, employee or director of the Bank is not personally liable for acts done or omitted to be done in the exercise or performance in good faith of that person's functions, duties, or powers under the Act. Under Section 179A of the Act, the Crown provides an indemnity to every officer, employee or director of the Bank and certain other persons for any liability arising as a result of exercising or failing to exercise any power conferred under the Act, unless the exercise or failure to exercise the power was in bad faith.

The Bank also provides income protection insurance to specified senior executives, and for other staff it provides insurance that extends the cover available from the Accident Compensation Corporation for work-related accidents.

²¹ Total remuneration includes the annual cost to the Reserve Bank of all elements of contracted remuneration (salaries, any benefits provided, fringe benefit tax, superannuation), plus any bonuses or redundancy payments. The information in Table 4 sets out the amount unconditionally earned during the financial year. The remuneration of the Governor is set by the Minister of Finance on the recommendation of the Board's non-executive directors, who also determine the remuneration of the Deputy Governor. The Bank's remuneration policy is to pay all staff on the basis of performance on the job, while having regard to prevailing market conditions based on salary surveys and assessments made by an independent remuneration consultant.



Knowledge services

Statement of Intent 2006–2009 – Objectives

To provide information management and information technology services.

The Bank has continued to invest in strengthening its information management and technology systems to support its business.

Statement of Intent 2006–2009 – Initiatives and strategies

- Enhance the Bank's web functional capability to provide a more secure information-sharing medium.
- Extend the Bank's knowledge management strategy by implementing the collaboration and workflow tools provided with the Bank's new document management system; and evaluating digital capture of archive records and physical documents.
- Upgrade all internally developed computer applications over the next three years in order to ensure the versions of software used are fully supported and, where possible, use standardised language.
- Continue enhancing the Bank's business continuity infrastructure, through reviewing arrangements for an out-of-Wellington business support for critical functions and ensuring greater flexibility in backup computing arrangements.
- Complete the upgrade for the ESAS and Austraclear systems and supporting network infrastructure before 31 December 2007.

The project to upgrade the Austraclear and ESAS systems has been referred to elsewhere (see page 32). The supporting infrastructure and telecommunications network, which is used by customers in both New Zealand and Australia, was also upgraded. A secure Internet-based connection has also been made available to our customers and this will go live with the upgraded application in October 2007.

The Bank has begun reviewing options for the replacement of its statistical collection management systems. The objective is to remove any technology risk, as well as ensure support for the Bank's wider prudential supervisory responsibilities.

Significant improvements to our document and records management system were implemented in the current year.

Work has continued on enhancing our BCP capability. This has included consolidation of the Wellington-based BCP sites, review of options for a potential regional disaster, and ongoing review of our plans.

A project to redevelop the Bank's internal intranet site is under consideration. This would provide improved functionality, access to information and internal communication.

The Bank has continued to improve its information collection and information management and information technology platforms.

Financial services

Statement of Intent 2006–2009 – Objectives

To provide support services for the Bank's key financial operations, including financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

The Bank's Financial Services Group is responsible for providing transaction processing capability for the Bank's foreign reserves and liquidity management operations.

The group also provides management and financial reporting, and internal accounting operations services.

Statement of Intent 2006–2009 – Initiatives and strategies

- Evaluate options for the Bank to access alternative means for utilising the services of CLS Bank, and implement the preferred option.
- Adopt IFRS from 1 July 2007.
- Progressively review and redesign workflows, reports, and processes for securities trading activities.
- Evaluate the merits of servicing other government entities' processing requirements using the Bank's treasury system.
- Review the Bank's balance sheet structure to ensure it is appropriate for meeting the Bank's statutory obligations.

The Bank will be ready to adopt New Zealand equivalents to International Financial Reporting Standards (IFRS) from 1 July 2007. Some modest system changes will be implemented over the next year to further automate financial reporting. The Bank will also evaluate options for replacing its 14-year-old general ledger system, with implementation of a new system planned for 2009.

A number of reporting enhancements have been made to the Bank's treasury systems to accommodate changes to the Bank's business and reporting requirements under the new accounting standards, and to improve processing efficiency.

Early in the 2007/08 financial year, the Bank will finalise the business case for becoming a member of CLS Bank.

Communications

Statement of Intent 2006–2009 – Objectives

To provide strategic advice and management for the Bank's external and internal communications, and the maintenance of its reputation and credibility.

The Bank's Communications Committee provides strategic advice to ensure the Bank's key messages are delivered and its credibility and reputation are maintained. The Bank uses a range of communications tools to support its policy actions and operations, including news statements, speeches, press conferences, media relations, in-house publication to desktop stage, the website and internal communications.

Statement of Intent 2006–2009 – Initiatives and strategies

- Deliver the Bank's communications to target audiences through the most appropriate channels, including web and hard-copy publication, news releases, press conferences, briefings, and day-to-day liaison with stakeholders.
- Provide the Bank with timely advice on reputational risks and opportunities, and with strategies for their mitigation or utilisation.
- Deliver a public awareness campaign for the new 'silver' coins.
- Provide communications support for the Bank's new public heritage museum.
- Update the Bank's suite of brochures and release a history of New Zealand coins.
- Further enhance internal communications.
- Further enhance crisis preparation.

The Bank maintained its public communication programme through the publication of four quarterly MPSS, which carried the OCR decision, four mid-quarter OCR statements, and the six-monthly FSR, as well as press conferences, media interviews, and speeches.

The Bank focused its speeches during the year on households' savings patterns and access to global credit, the impact of strong commodity prices on the New Zealand economy, and the review of financial institution supervision. The range of topics reflected the policy challenges the Bank saw in the economy.



A range of fact sheets was produced, supporting the new Reserve Bank Museum.

A comprehensive public awareness campaign was delivered to support the modernisation and launch of the new lighter coins and the collection of the old 'silver' coins.

The Bank once again provided sponsorship to a financial literacy programme offered by the Enterprise New Zealand Trust, and hosted the annual Monetary Policy Challenge for secondary school economics students. The Challenge is designed to expand students' understanding of monetary policy. The 2006 Challenge was won by St Kentigern College of Auckland, with Burnside High School of Christchurch coming second, followed by Hutt Valley High School of Wellington.

Property management and security

Statement of Intent 2006–2009 – Objectives

To provide appropriate accommodation for the Bank to ensure that functions, including cash operations, can be conducted unimpeded at all times in a secure environment.

The Bank maintains its own premises in Wellington to ensure secure accommodation.

Statement of Intent 2006–2009 – Initiatives and strategies

- *Plan and refurbish the building to meet current and future Bank needs for accommodation.*
- *Provide appropriate space and fit-out for a public heritage museum and function area on the ground floor.*
- *Upgrade the security of the building and vaults to provide a continued safe and secure working environment.*
- *Assist in the establishment and maintenance of off-site accommodation for business continuity planning purposes.*
- *Maintain the building at the required standard, with fully-let tenanted areas.*

Some office areas occupied by the Bank have been upgraded, extending the use of open-plan layouts. The ground floor area was fitted out, and the Museum opened in September 2006. There were over 6,000 visitors to the Museum by 30 June. The vehicle turning circle and car park were refurbished.

The Bank has leased and fitted out two floors in a Wellington city building to consolidate the three existing local BCP sites into a single location.

The Bank has made a number of improvements to its security equipment and operations, including the Bank's electronic access control and digital CCTV systems. Also, special attention has been given to Civil Defence training for security officers and other staff.

The building has been fully tenanted throughout the year.



Other outputs (international)

The Reserve Bank maintains a number of international relationships, including those with other central banks and multilateral organisations. We also participate in a range of international conferences and workshops.

Last year was a particularly active one for the Bank's involvement in the Executives Meeting of East-Asia and Pacific central banks and monetary authorities (EMEAP).²²

The Bank chaired informal meetings of Governors in Singapore and Sydney, together with the 31st meeting of Deputy Governors in Auckland. As Chair of both the Governors and Deputy Governors meetings, the Bank played an important role in shaping initiatives to strengthen regional cooperation among member countries.

The Bank also jointly chaired with the European Central Bank the third high-level seminar of Central Banks in the East-Asia Pacific Region and the Euro Area in November 2006. The purpose of these seminars is to exchange views on issues relevant to both the Euro Area and the East Asia-Pacific regions, and to deepen relations between EMEAP and the Eurosystem. Topics included:

- the link between the integration of emerging economies in the world economy and global inflation;
- global imbalances and their implications for financial stability; and
- regional financial integration, with focus on the ongoing processes of financial integration in the Asia-Pacific region and Europe.

In addition, the Bank regularly participated in other EMEAP meetings, including the Monetary and Financial Stability Committee; the Working Group on Financial Markets; the Working Group on Banking Supervision; the Working Group on Payment and Settlement Systems; and the IT Directors' Meeting.

In December, the Bank hosted in Wellington the annual meeting of South Pacific Central Bank Governors. Issues covered included the management of foreign reserves in the South Pacific and the importance of remittances to the Pacific Island countries.

In December, the Bank hosted a mission from the OECD as part of its biannual Economic Survey of New Zealand, while in February, the Bank contributed to the International Monetary Fund's (IMF's) annual Article IV consultation visit to New Zealand. The Bank is actively engaged on New Zealand's interests in the IMF through advice on a wide range of policy issues and the secondment of staff to New Zealand's Constituency Office at the IMF.

The Bank's international linkages continue to deepen through the ongoing engagement with world-renowned academics, and a steady flow of visitors from other central banks and international organisations.

²² EMEAP comprises the central banks and monetary authorities of: Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand.



Planning and reporting framework

The Bank adopts a number of Strategic Priorities in addition to its business-as-usual activities. A number of our Strategic Priorities for 2006/07 were multi-year priorities, set in the context of our longer-term planning funded through the five-year Funding Agreement.

The Funding Agreement signed in April 2005, and subsequently ratified by Parliament, covers the five years to 30 June 2010. Funding rises from \$39 million in the first year (2005/06) to \$43 million in 2009/10.

This is a material increase in spending over the previous five-year period, reflecting various factors, including the need to:

- invest in the replacement and upgrading of our treasury and document management systems, our economic forecasting and data systems, and our core financial reporting system;
- strengthen our supervisory capability; and
- ensure that robust BCP arrangements remain in place.

Where the 2006-2007 Annual Report fits

	2005/06	2006/07	2007/08	2008/09	2009/10
(i) Planning		Funding Agreement (fixed term)			
		Statement of Intent (rolled forward)			
		Detailed budget			
(ii) Reporting		Annual Report			

Strategic priorities and outcomes 2006/07

Priority 1	Outcome
Improve leadership and management competencies through training and development.	The Bank's investment in the development of its managers continued this year through our Managers' Forum and the managers' Leadership Development Programmes. Managers attended a leadership development programme designed to create an individual development plan to improve leadership and management competencies. They also attended a two-day leadership workshop, presented by an international educator on leadership and management.
Priority 2	Outcome
Replace or redevelop the current forecasting model.	During the year, a prototype DSGE model of the New Zealand economy was developed, and is now being tested, evaluated, and refined. The aim is to integrate the model into the Bank's economic forecasting process during 2008.
Priority 3	Outcome
Assess how to maintain price stability without unnecessary damage to the external sector.	Work continued on analysing additional instruments and policy approaches that could assist monetary policy in maintaining price stability.
Priority 4	Outcome
<p>Develop and implement institutional arrangements for the prudential regulation of the New Zealand financial system, including:</p> <ul style="list-style-type: none"> • assess the scope for wider prudential regulation of the non-bank financial sector and identify the role of the Bank in this area; and • implement home-host cooperation practices and frameworks for bank regulators that have interests in New Zealand. 	The Reserve Bank participated in the Government's Review of Financial Products and Providers and in the parallel review of institutional arrangements for the Bank's regulatory functions. In June 2007, the Minister of Commerce announced that the Reserve Bank would become the single prudential regulator for New Zealand, with responsibility for banks, insurers and NBDTs. At the same time, the Bank was given responsibility for policy development in respect of both insurers and NBDTs and is now developing coherent, detailed, regulatory frameworks for both sectors.

Priority 5	Outcome
Develop and implement policy on bank capital requirements under Basel II international standards.	A draft capital adequacy framework was released for standardised banks. The Bank proceeded to review applications from banks wishing to use their own internal models for calculating regulatory capital. Basel II will be implemented at the start of 2008.
Priority 6	Outcome
Review the balance sheet structure to best meet monetary policy, currency, bank liquidity, and foreign reserves requirements.	Key elements of the review were completed, including a reassessment of the Bank's ability to finance foreign reserves using internal financial resources as opposed to raising funds from the New Zealand Debt Management Office (NZDMO). The outcome, announced on 12 July 2007, is that the Bank will move towards funding reserves using its own resources and use NZDMO only when there are insufficient internal resources or when it is in the broader Crown interest to do so. Also, the Bank's exposure to foreign exchange risk was reviewed, culminating in the Bank moving to hold a portion of its foreign reserves on an unhedged basis as opposed to the Bank's previous policy of hedging all foreign reserves.
Priority 7	Outcome
Implement the modernisation of New Zealand's 'silver' coins.	New, smaller, lighter 10, 20 and 50 cent coins were issued on 31 July 2006. Eighty million new coins were pre-positioned at bank branches prior to their official release and the new coins replaced the old cupronickel coins within a few weeks in most parts of the country. The old 5, 10, 20 and 50 cent coins were progressively withdrawn and were declared no longer legal tender with effect from 1 November 2006.

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FINANCIAL PERFORMANCE

Financial statistics at a glance

	2007 \$m	2006 \$m
Financial Performance (year to 30 June):		
Operating Surplus	332.9	253.9
Net Operating Expenses	29.1	35.9
Financial Position (as at 30 June):		
Total Assets	21,100.3	16,859.9
Equity ²³	1,578.7	1,421.4
Net Open Foreign Exchange Position	701.0	(49.9)
Distribution (year to 30 June):		
Dividend to Government	193.0	410.0

Review of Financial Performance and Financial Position

Operating Surplus

	2007 Actual \$m	2007 Budget \$m	2006 Actual \$m
Operating Income:			
Net Investment Income	362.0	346.4	289.8
Other Income	23.3	20.0	8.1
Total Operating Income	385.3	366.4	297.9
Operating Expenses:			
Personnel	21.8	22.0	21.6
New Currency Issued	11.1	10.1	6.1
Asset Management	6.6	6.5	5.2
Other Expenses	12.9	14.6	11.1
Total Operating Expenses	52.4	53.2	44.0
Operating Surplus	332.9	313.2	253.9

Operating Income

Most of the Bank's income comes from interest earned on the financial assets backing currency in circulation and the investment of the Bank's Equity. Income varies with changes in market interest rates.

Net Investment Income for 2007 includes a foreign exchange gain of \$5.6 million. This gain is after accounting for currency losses of \$10.8 million recorded on the Net Open Foreign Exchange Position established for currency intervention purposes. In addition, funding costs of \$0.8 million were incurred in respect of the foreign exchange intervention. Therefore, the total financial impact was a reduction of Net Investment Income of \$11.6 million.

Accounting policies require that foreign exchange gains and losses be determined based on market exchange rates current at balance date, and in the case of intervention these losses are unrealised. Intervention positions are taken on with the explicit expectation that they will be held for a significant length of time. While the intervention has resulted in a reported loss in the Bank's accounts over the short period to balance date, the position is expected to be profitable over time as the exchange rate retraces to justified levels. Reduced net interest income and greater income volatility due to foreign exchange gains and losses can be expected in future years as the Bank will henceforth hold a portion of its foreign reserves unhedged.

In 2007, Other Income included non-recurring receipts of \$16.6 million from the disposal of demonetised old 'silver' coins.

Operating Expenses

Operating Expenses were abnormally high in 2007 due to the cost of issuing new 'silver' coins.

Higher Asset Management expenses reflect additional depreciation on investment in critical systems and capital expenditure on improvements to the Bank's building.

Lower than budgeted Other Expenses is mainly due to the deferral of planned expenditure relating to the Bank joining CLS Bank.

23 On 1 July 2007, after NZ IFRS adjustments, the Bank's equity was \$1,436 million.

Net Operating Expenses

	2007 \$m	2006 \$m
Total Operating Expenses	52.4	44.0
Income Retained under the Funding Agreement	23.3	8.1
Actual Net Operating Expenses	29.1	35.9
Net Operating Expenses Specified in the Funding Agreement	34.0	39.0
Underexpenditure of the Funding Agreement	4.9	3.1

Outcome against the Funding Agreement

Actual Net Operating Expenses were \$29.1 million in 2007. This was \$4.9 million under the \$34 million level provided for in the Funding Agreement for the 2007 year.

The underspending was mainly due to:

- higher-than-expected proceeds from the sale of demonetised old 'silver' coins; and
- the deferral of planned expenditure relating to the Bank joining CLS Bank.

The \$4.9 million underspending was added to the Bank's Equity.

Financial Position as at 30 June

	2007 \$m	2006 \$m
Assets:		
Foreign Currency Financial	16,653	11,745
Local Currency Financial	4,358	5,035
Other Assets	89	80
Total Assets	21,100	16,860
Liabilities and Equity:		
Foreign Currency Financial	4,869	7,130
Local Currency Financial	11,009	4,529
Currency in Circulation	3,360	3,348
Other Liabilities	283	432
Equity	1,579	1,421
Total Liabilities and Equity	21,100	16,860

Changes to the Bank's Balance Sheet

The Bank's balance sheet grew by \$4.2 billion over the year, reflecting the change in the way the Bank provides liquidity to the banking system. This change has meant increased Foreign Currency Financial assets and increased Local Currency Financial liabilities, together with the use of foreign currency swaps.

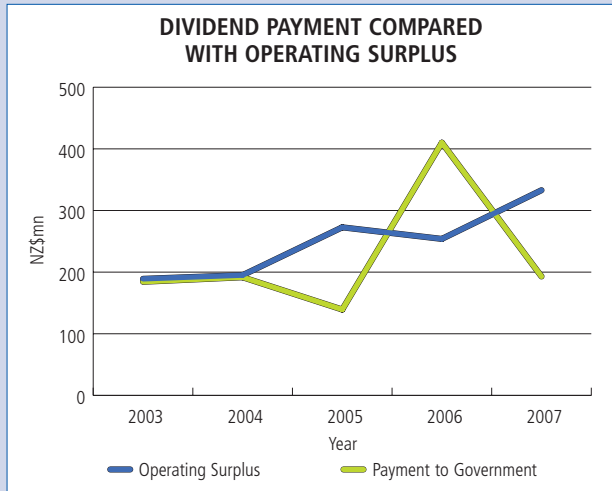
Net Open Foreign Exchange Position

	2007 \$m	2006 \$m
Net Open Foreign Exchange Position	701.0	(49.9)

Net Open Foreign Exchange Position

In June 2007, the Bank intervened in foreign currency markets, buying foreign exchange with New Zealand dollars. The Bank's net exposure to foreign currency at 30 June 2007 was a net asset position of \$701.0 million (2006 \$49.9 million net liability position).

After balance date, the Bank announced it will normally fund at least part of its foreign reserve assets on an unhedged basis. This will not necessarily increase the level of foreign currency assets. Net Investment Income will decrease because interest rates on foreign currency assets are lower than those in New Zealand. Reported income will also be more volatile than previously as foreign currency exchange rates change together with changes in the Bank's net asset position in each currency.



Dividend paid to the Government

The Bank will pay a dividend of \$193 million to the Government in 2007. The dividend in 2006 of \$410 million was abnormally large and essentially compensated for the smaller dividend of \$130 million in 2005.

Notional surplus income (NSI) is the amount available for distribution to the Crown.

NSI is based on the Bank's realised income. From 2007, the NSI excludes all foreign currency gains and losses. Previously, NSI included realised foreign exchange gains and was highly volatile and a poor indicator of the Bank's income that could be distributed.

NSI also excludes any underspending of the Funding Agreement.

The Minister of Finance has agreed that \$193 million be paid to the Government in 2007. This is based on the NSI of \$328 million less \$136 million, being the unrealised loss on the Bank's holdings of New Zealand government securities, booked directly to Equity for the first time on 1 July 2007 when the Bank adopted International Financial Reporting Standards (IFRS). Up to this point, these assets had been valued on a yield-to-maturity basis. The distribution of \$193 million in 2007 will ensure that the Bank's Equity is consistent with the range in previous years.

On 1 July 2007, after IFRS adjustments, the Bank's Equity was \$1,436 million, down from \$1,579 million prior to the adoption of IFRS.

Going forward, income and Equity will become more volatile due to unrealised gains and losses on the Bank's holdings of New Zealand government securities and gains and losses on foreign currency.

Transformation of the Bank's financial structure

Over the last four years the Bank's financial structure has been transformed by a series of important initiatives designed to improve the Bank's policy effectiveness.

2004	2005	2006	2007	2008
Acquired financial capability to intervene in foreign exchange markets. Equity injection of \$1 billion. Commenced increasing the level of foreign exchange reserves held for crisis purposes.	Dividend rules changed to distribute realised gains only. New five year Funding Agreement entered into and ratified by Parliament.	Liquidity management review was completed in the 2006 financial year and implemented over 2007. This will result in higher levels of aggregate New Zealand dollar liquidity provided to the banking system. It will also increase the Bank's foreign currency assets, New Zealand dollar liabilities and foreign currency swaps. The Bank implemented a new treasury system and revised models and assumptions used to value foreign currency loans from the Treasury.	Balance sheet review undertaken in 2007 and with staged implementation. In late 2006, the Bank used core New Zealand dollar funding and swaps to finance foreign reserves. Previously all core foreign assets were financed by foreign currency loans from the Treasury. In July 2007, the Bank announced a decision to partially fund core reserves on an unhedged basis, so managing an open foreign exchange position. The Bank also announced that the portion of unhedged foreign reserves would fluctuate with the exchange rate cycle. In June 2007, the Bank intervened in foreign currency markets.	The Bank will adopt International Financial Reporting Standards from 1 July 2007. ²⁴

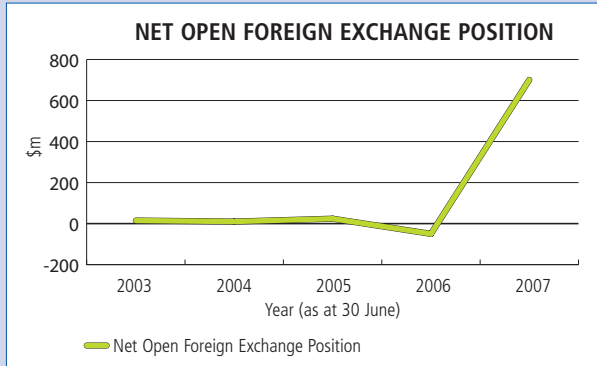
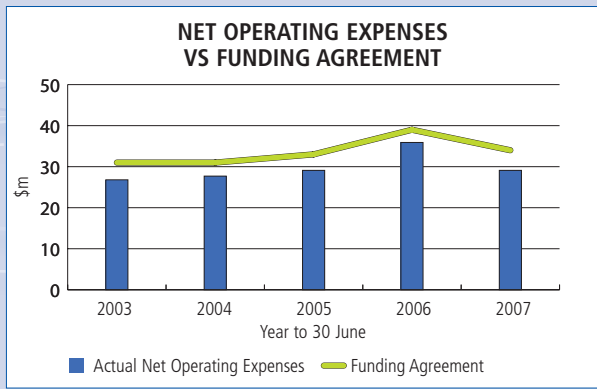
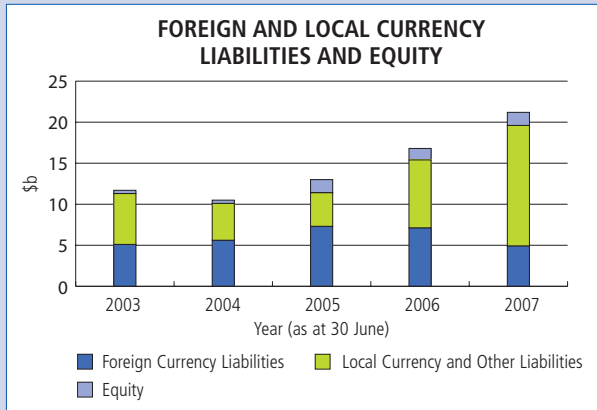
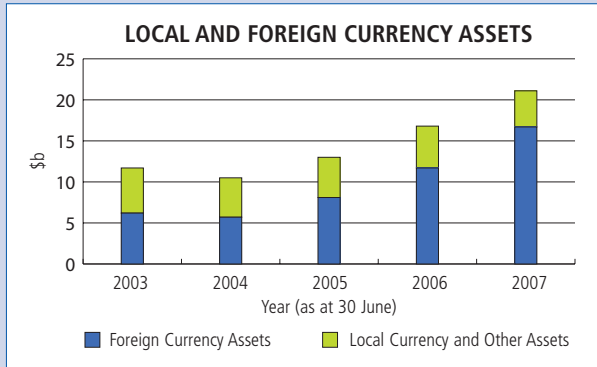
As a result of these changes, the Bank's policy effectiveness has been enhanced:

- The Bank has an additional equity buffer to absorb the risks from open foreign exchange positions.
- While the Bank's earnings and equity will be more variable than in the past, the open foreign exchange positions can be expected to be profitable over time.
- The Bank has greater flexibility in how it funds foreign reserve assets.
- The Bank is better able to meet the requirements of the Policy Targets Agreement by being able to intervene in the foreign currency markets when circumstances are appropriate.
- The Bank's crisis management capability is increased by holding higher levels of core foreign reserves and partially funding these by using New Zealand dollars.
- The liquidity needs of the New Zealand payment system are no longer constrained by shortages of suitable collateral.
- The Bank is better placed to deliver policy and operational outcomes by funding investment in systems and bolstering policy capabilities.

Previously, the Bank's foreign currency assets were almost fully matched by foreign currency liabilities. That was an unusual approach internationally and the structure of the Bank's foreign reserves will now more closely resemble the approach used by most other central banks.

²⁴ Note 44 of the Bank's Annual Financial Statements for 2007, on page 100, sets out the implications for the Bank of adopting International Financial Reporting Standards.

The programmes have materially changed the Bank's financial structure:



- Foreign Currency Assets have materially increased in 2007 as a result of improvements to the way the Bank provides liquidity to the New Zealand banking system. Foreign currency swaps have been used to hedge foreign currency risk. This initiative has had relatively little impact on the Bank's earnings.
- The Bank no longer exclusively funds its core foreign reserves by borrowing foreign currency from the Treasury.
- Intervention in foreign currency markets and maintenance of a core open foreign exchange position will increase volatility of earnings and equity.
- Equity will also be more volatile due to the adoption of International Financial Reporting Standards (IFRS) which require changes in the unrealised market-value of the Bank's holdings of New Zealand government securities to be recorded as a change to equity. At 30 June 2007, the unrealised loss as a result of market-valuing the Bank's holdings of New Zealand government securities was \$136 million. The revaluation amount reflects changes in market interest rates since the securities were purchased. If, as expected, the securities are held to maturity, the returns and cash flow profile of the securities will remain unchanged from those anticipated when the securities were purchased.
- As the Bank did not adopt IFRS until 1 July 2007, the revaluation adjustment of \$136 million was not reflected in the reported valuation of those securities and Equity in the Bank's accounts at 30 June 2007.

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THE YEAR AHEAD

Strategic priorities for 2007/08

	Department	Priority
1	Bank-wide	Management Enable managers to continually develop leadership and management competencies.
2	Economics	Model redevelopment Upgrade the current policy and forecasting model.
3	Economics	Macroeconomic policy framework Assess how to maintain price stability while avoiding unnecessary damage to the external sector.
4	Financial Stability	Financial sector regulatory arrangements Help develop and implement new non-bank regulatory arrangements.
5	Financial Stability	Basel II implementation Develop and implement policy on bank capital requirements under Basel II.

Budget information

The following outlines the budget for the Bank for 2008.

The key assumptions underlying the budget for the year ended 30 June 2008 are that:

- the Bank's current functions will continue;
- foreign reserves will be increasingly funded from the Bank's resources rather than loans from the Treasury;
- there will be no material changes to the Bank's liquidity management operations;
- there will be no changes to interest and exchange rates during the year;
- the Bank holds an open foreign currency position during the year equal to that at 31 July 2007²⁵. As foreign currency rates are assumed to remain constant through the year, the budget assumes no foreign exchange gains and losses will arise on that open foreign exchange position²⁶. It is necessary to make these assumptions, as to do otherwise could be seen as restricting the Bank's range of decision-making options with respect to the implementation of monetary policy and foreign reserves management operations; and
- there is no change in the value of the Bank's land and buildings.

The Budget for 2008 has been prepared on a basis consistent with the adoption of International Financial Reporting Standards (IFRS) from 1 July 2007. Note 44 of the Bank's Annual Financial Statements for 2007 on page 100 explains the impact of adopting IFRS.

The budget for 2008 is based on the assumptions stated above. Actual outcomes could differ materially from budgeted outcomes. In particular, the extent and timing of any open foreign exchange positions, together with changes in interest and foreign exchange rates, could have a significant impact on actual financial results.

Key changes from the results for 2007 are:

- reduced interest income compared with 2007, reflecting the fact that with an open foreign currency position (with foreign currency assets exceeding foreign currency liabilities), foreign currency assets yield less interest income than corresponding investments in New Zealand dollar-denominated financial instruments;
- decreased currency costs due to the large issue of new 'silver' coins in 2007; and
- reduced other income compared with 2007, when the Bank received funds from the sale for scrap of demonetised old 'silver' coins.

The increase in budgeted staff costs is attributable to the impact of the new accounting policy for defined benefit superannuation scheme expenses, an employer subsidy for KiwiSaver, a slight increase in overall staff numbers and an increase in staff remuneration.

Tables 5 and 6 provide more detail.

²⁵ The position at 31 July 2007 has been used as a reference point for this budget because of the significant change in the Bank's open foreign currency position since the 2008 budget was originally prepared in April 2007.

²⁶ The budget for 2008 included in this *Annual Report* differs from that included in the Bank's *2007-2010 Statement of Intent*. The budget included in the *2007-2010 Statement of Intent* was prepared before the Bank decided to hold a significant net open foreign currency position.

Table 5: Budgeted Financial Performance 2007/08

For the year ended 30 June	2008 Budget \$m	2007 Actual \$m
Operating Income:		
Net Investment Income	275.5	362.0
Other Income	7.3	23.3
Total Operating Income	282.8	385.3
Operating Expenses:		
Personnel	24.0	21.8
New Currency Issued	4.6	11.1
Asset Management	6.9	6.6
Other Expenses	13.1	12.9
Total Operating Expenses	48.6	52.4
Operating Surplus	234.2	332.9
<i>Outcome under the Funding Agreement</i>		
Net Operating Expenses	41.3	29.1
Net Operating Expenditure Specified in the Funding Agreement	41.0	34.0
Funding Agreement Underexpenditure (Overexpenditure)	(0.3)	4.9

This budget should be read in conjunction with the assumptions detailed on page 48. In particular, we note that the budget assumes no changes to interest rates or foreign exchange rates occur during the financial year and the Bank retains for the full year its open foreign exchange position that it held at 31 July 2007. Actual financial results could differ materially from those budgeted.

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Table 6: Budgeted Costs of Services 2007/08

For the year ended 30 June	Operating Income Budget 2008 \$000	Operating Income Actual 2007 \$000	Operating Expenses Budget 2008 \$000	Operating Expenses Actual 2007 \$000	Operating Surplus (Deficit) Budget 2008 \$000	Operating Surplus (Deficit) Actual 2007 \$000
Functions:						
Monetary Policy Formulation	0	0	9,799	8,865	(9,799)	(8,865)
Domestic Operations	7,242	12,419	6,271	4,227	971	8,192
Financial System Surveillance	36	37	8,824	8,312	(8,788)	(8,275)
Currency Operations	223,641	242,157	9,511	17,854	214,130	224,303
Foreign Reserves Management	(59,128)	24,525	8,242	7,645	(67,370)	16,880
Settlement Services	5,940	8,645	1,987	1,992	3,953	6,653
Registry and Depository Services	4,021	3,572	3,179	2,738	842	834
Other Outputs	0	0	735	763	(735)	(763)
Total for Bank before Earnings on Investment funded by Equity	181,752	291,355	48,548	52,396	133,204	238,959
<i>Earnings not allocated to functions:</i>						
Earnings on Investments funded by Equity	100,995	93,982	0	0	100,995	93,982
Total for Bank	282,747	385,337	48,548	52,396	234,199	332,941
Income Retained under the Funding Agreement			7,295	23,267		
Net Operating Expenses			41,253	29,129		

This budget should be read in conjunction with the assumptions detailed on page 48. In particular, we note that the budget assumes no changes to interest rates or foreign exchange rates occur during the financial year and the Bank retains for the full year its open foreign exchange position that it held at 31 July 2007. Actual financial results could differ materially from those budgeted.

Operating income for each function includes allocations of notional interest income and expenditure on New Zealand dollar funding provided by (or provided to) the function through internal lending and borrowing. Notional interest rates take into account the estimated term of the funding and the associated external interest earned or incurred. Earnings on Equity are not allocated to individual functions.

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