

Operations in Financial Markets

Financial markets functioned considerably better over 2009/10 than in the previous year. As a result, the Reserve Bank was able to undertake its operations in financial markets without needing to employ the policy measures used to address the distressed financial conditions in 2008/09.

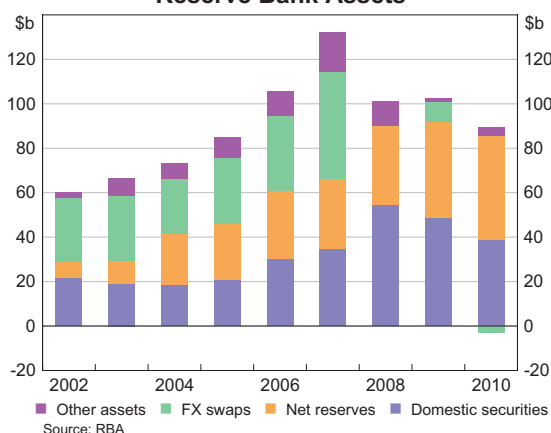
The Balance Sheet

Over the past year, there has been some contraction in the size of the Reserve Bank's balance sheet, though its broad composition has remained relatively steady. This is in contrast to the previous year when measures undertaken to support financial market conditions, in particular the term deposit facility with authorised deposit-taking institutions (ADIs) and the US dollar swap facility with the Federal Reserve, led to a large expansion and subsequent contraction in the balance sheet.

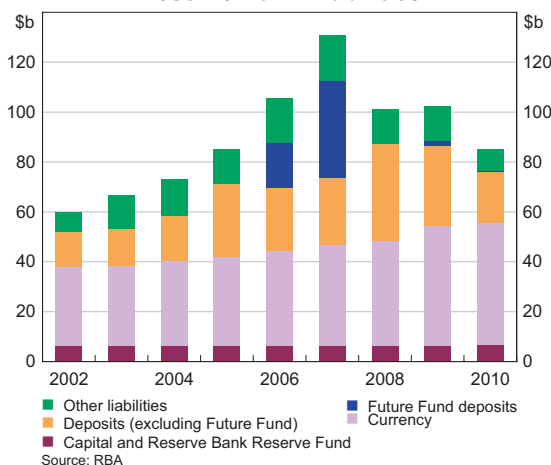
With financial conditions in Australia recovering faster than in most other developed economies, the Reserve Bank was able to unwind some of the extraordinary liquidity measures it had undertaken. As a result, over 2009/10 the size of the Bank's balance sheet declined by around \$17 billion, to \$86 billion. Currency on issue was broadly unchanged, following a large rise in the previous year when the turbulence in financial markets resulted in higher demand for banknotes. Australian Government deposits fell by around \$13 billion. Other liabilities also declined, as revaluation losses from the appreciation of the Australian dollar exchange rate reduced the Bank's Unrealised Profits Reserve (see the chapter on 'Earnings and Distribution').

There was a corresponding rundown of the Reserve Bank's asset holdings, with the level of repurchase agreements (repos) using domestic assets and foreign assets (in the form of foreign exchange swaps) both declining. Net foreign exchange reserves rose slightly.

Reserve Bank Assets



Reserve Bank Liabilities



Reserve Bank Balance Sheet

\$ billion

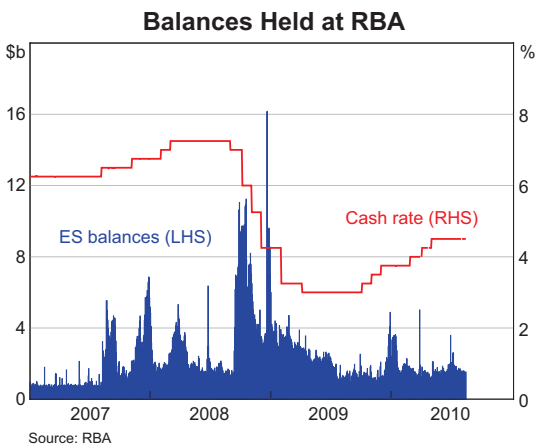
	June 2008	June 2009	June 2010
<i>Assets</i>	101	103	86
Foreign	45	54	47
– Net reserves	36	43	47
– FX swaps	0	9	-3
– Other	9	1	3
Domestic	56	48	39
<i>Liabilities</i>	101	103	86
Deposits	39	34	21
Currency	42	48	49
Other (including capital)	20	20	16

Source: RBA

Domestic Market Operations

To implement monetary policy, the Reserve Bank Board sets a target for the cash rate – the rate at which banks borrow and lend to each other on an overnight unsecured basis. This rate affects interest rates in other wholesale and retail markets, which in turn affect economic activity and inflation. Over the past year, the Board increased the cash rate target on six occasions, in increments of 25 basis points, lifting the rate from 3 per cent to 4.5 per cent. This followed the very large reduction in the cash rate in the preceding year.

To ensure that the Board's target is met, the Reserve Bank operates in the cash market to maintain a level of exchange settlement (ES) balances consistent with the cash rate trading at target. ES balances are liabilities of the Reserve Bank held by financial institutions to settle their payment obligations with each other and the Bank. The Reserve Bank pays interest on ES balances at a rate 25 basis points below the cash rate target. This creates an incentive for institutions to recycle ES balances within the market. Over the past year, the cash rate has traded at the target on all but two business days (when it traded one basis point lower).



Over the past year, ES balances have averaged around \$1.7 billion. This is well below the previous couple of years, during which the Reserve Bank increased the supply of ES balances to meet increased demand as market participants became more cautious in their cash management. Given the improvement in market conditions over 2009/10, it has usually only been around balancing dates at the end of a calendar quarter that banks have sought to hold higher ES balances. In these instances, the Bank has accommodated the additional demand by allowing the level of ES balances to rise temporarily.

Payment flows between ES account holders and the Reserve Bank or its customers (principally, the Australian Government) alter the aggregate supply

of ES funds. The Bank will generally offset the liquidity impact of these flows by purchasing (or more rarely, selling) securities in its open market operations. Most of the Bank's transactions within the domestic market are contracted as repos. Under a repo, one party agrees to sell a security to another with an agreement to repurchase the security at a future date at a pre-agreed price. In its market operations, the Reserve Bank is willing to purchase both government debt securities ('general collateral') and private debt securities under repo. To guard against a possible loss if the counterparty to the transaction is not able to repurchase its security at the agreed time, leaving the Bank holding the security, the Bank imposes a margin (or 'haircut') on the security's initial price. These margins range from 2 to 10 per cent, depending on the price and credit risk characteristics of the security, and protect the Bank against adverse moves in the security's price (see the chapter on 'Risk Management').

During 2009/10, as the Reserve Bank's balance sheet contracted, there was a fall in the level of the domestic repo book as well as a significant shift in its composition. During the height of the market turmoil the Bank shifted towards holding private securities in the repo portfolio, in a way that was designed to be helpful to the markets for private debt securities. ADIs were also able to put together securities backed by mortgages on their books – 'internal securitisations' – and use them as collateral in the Bank's market operations. At various stages throughout the financial crisis, as much as 90 per cent of the Bank's repo portfolio was in private securities (including internal securitisations).

With market conditions improving throughout the year, the Reserve Bank has increased the share of general collateral in its repo operations relative to private-sector securities back towards pre-crisis levels. The Bank has also stated that generally it would not expect to see internal securitisations offered as collateral in market operations on a regular basis, though they remain eligible collateral.

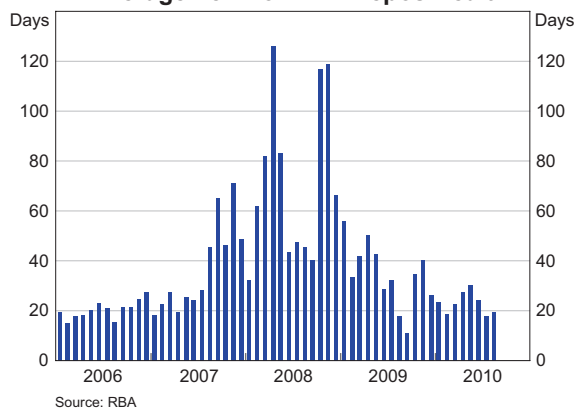
These developments have seen the share of general collateral rise to around 60 per cent in June 2010, compared with 10 per cent a year earlier. Internal securitisations now comprise less than 10 per cent of the Reserve Bank's repo portfolio, compared with around half in June 2009.

Australian Dollar Securities Held under Repurchase Agreements

	June 2008		June 2009		June 2010	
	\$ billion	Per cent of total	\$ billion	Per cent of total	\$ billion	Per cent of total ^(a)
General collateral						
– CGS	0.9	2	2.5	6	3.3	9
– Semis	4.0	7	1.2	3	10.8	31
– Supras	1.5	3	0.4	1	2.2	6
– Government guaranteed	0.3	1	5.6	16
Private Securities						
– ADIs	45.3	82	11.8	28	8.8	25
– RMBS (internal securitisations)	21.2	50	3.1	9
– RMBS (other)	2.9	5	4.9	11	0.5	1
– ABCP	0.3	1	0	0	0.4	1
– Other	0	0	0.2	0	0.1	0
Total	55.1		42.5		34.8	

(a) Does not sum to 100 owing to rounding
Source: RBA

Average Term of RBA Repos Dealt



For much of the past year, the average term of the repos contracted by the Reserve Bank has generally been less than a month. Again, this represents a normalisation of the Bank's operations, as shorter terms provide the most flexibility for conducting market operations. Nevertheless, the Bank remains willing to deal for longer terms if the demand is there and if it suits the Bank's liquidity management needs. In this regard, over the past year the Bank has occasionally contracted repos with terms as long as 12 months.

In addition to its regular morning operations, the Reserve Bank is willing to conduct a second round of dealing with the market on the same day should liquidity conditions require it. In 2009/10, only two second-round operations were conducted.

ES account holders may also occasionally face unexpected funding shortfalls late in the settlement session. Although these shortfalls are generally met by participants borrowing funds from another bank, ES account holders are able to access a standing overnight facility with the Reserve Bank. Under this facility, banks can borrow funds on a secured basis at a rate 25 basis points above the cash rate. During 2009/10, the facility was used on five occasions for aggregate borrowings totalling \$1.0 billion. The lower usage of the facility over the past year in part reflects an increase in the willingness of ES counterparties to lend late in the settlement session.

Usage of Overnight Standing Facility

	Number of times used	Value (\$m)
2005/06	10	436
2006/07	24	3 589
2007/08	18	4 220
2008/09	15	3 257
2009/10	5	1 035

Source: RBA

In addition to repurchase transactions, the Reserve Bank is willing to purchase CGS and State government securities (semis) on an outright basis in its daily operations, provided these securities have a term to maturity not exceeding 18 months. Outright purchases of longer-dated government securities are transacted through separate, less regular, operations. During 2009/10, the Bank conducted seven 'long-dated' operations, purchasing securities totalling \$750 million. At present, the Bank holds around \$3 billion of longer-dated securities on an outright basis, almost all of these being State government securities not guaranteed by the Australian Government. These holdings of government securities assist with the Bank's liquidity management; in circumstances where the Bank needs to drain ES balances from the market, the Bank is able to sell its securities under repo.

On occasion, the Reserve Bank may also sell its securities under repo to satisfy market demand for the specific securities that the Bank owns. The effect of these transactions on ES balances is generally offset by a purchase of other securities under repo from the same counterparty. During 2009/10, the Bank's income from securities lending was negligible, amounting to less than \$0.1 million.

In addition to lending securities from its own portfolio, the Reserve Bank operates a lending facility for CGS on behalf of the Australian Office of Financial Management (AOFM). This facility allows market participants to borrow specific lines of CGS via a repo with the Reserve Bank. An offsetting repo in other CGS or government-related securities is transacted at the same time. During 2009/10, \$2.9 billion of CGS was lent under this facility, significantly less than in the previous year. The increase in CGS on issue has meant that there have been fewer occasions when dealers have had difficulty finding these securities in the market in order to settle their transactions.

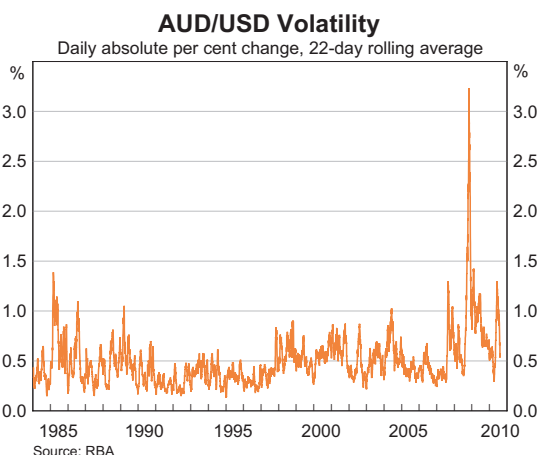
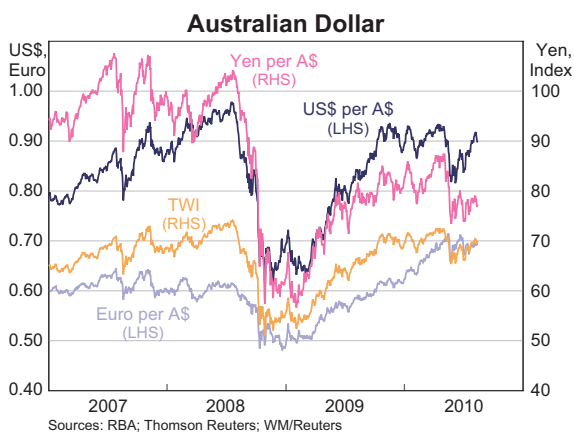
Foreign Exchange Operations

The Reserve Bank carries out transactions in the foreign exchange market on a daily basis. The Bank operates in both the spot market and the market for foreign exchange swaps. Most of these transactions are undertaken on behalf of the Bank's clients and are typically small by value. Some result from the day-to-day management of the Bank's portfolio of foreign currency assets. Other larger but less frequent transactions arise from policy operations. These are mostly transactions undertaken to assist with the Bank's management of domestic liquidity, and complement the Bank's open market operations. On rare occasions, the Bank intervenes in the foreign exchange market. Intervention is only carried out to address disorderly market conditions or when the exchange rate is judged to be significantly mispriced.

The Australian dollar appreciated from its trough in March 2009, supported by the improving outlook for global growth, related increases in commodity prices and the broad improvement in global risk appetite. The relatively positive outlook for the domestic economy and associated widening in interest rate differentials also supported the appreciation. The Australian dollar reached a high of around US\$0.94 in November 2009, 5 per cent below its 2008 peak, but around 40 per cent higher than its 2008 lows on a trade-weighted basis.

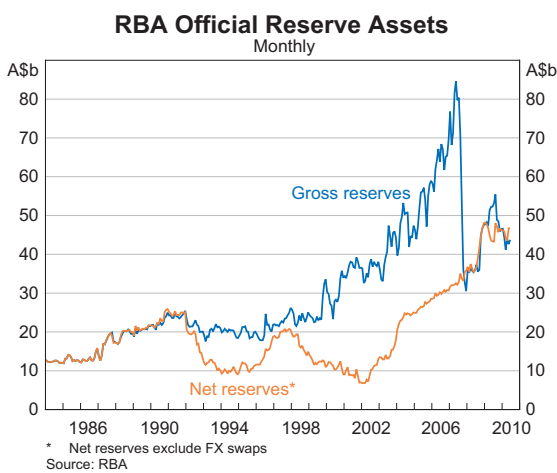
Through the early months of 2010, the Australian dollar traded within a reasonably wide band. Over this period, sentiment toward the currency remained positive even as concerns about developments in Europe were building. Volatility in the exchange rate trended lower. This combination of a relatively favourable fundamental outlook and declining volatility encouraged a build-up of positions in the Australian dollar against a range of currencies, particularly the yen and the euro.

In May, an escalation of concerns about sovereign risk in Europe led to a sharp depreciation in the Australian dollar as some of these positions were unwound. The exchange rate depreciated particularly sharply against the yen and the US dollar, which enjoyed safe haven status as in late 2008. The Australian dollar depreciated by around 10 per cent on a trade-weighted basis over the first three weeks



of May. Volatility increased noticeably. While the speed and size of the adjustment in the currency placed some strains on the foreign exchange market, these were modest and short-lived compared with developments after the collapse of Lehman Brothers in 2008. Accordingly, the Reserve Bank did not judge it necessary to intervene.

Over the financial year, transactions in foreign currency and earnings on foreign currency assets added \$6.8 billion to net foreign currency reserves. Net transactions in 2009/10 included the purchase from the Australian Government of \$4.8 billion of Special Drawing Rights (SDRs) at the IMF. The Australian Government had received additional SDRs as part of the General SDR Allocation in August and the Special SDR Allocation in September (see the chapter on 'International Financial Co-operation'). Valuation losses arising from the net appreciation of the Australian dollar reduced the value of net reserves (in Australian dollar terms) by \$3.4 billion. As a result, the Australian dollar value of net foreign currency reserves rose by \$3.4 billion over the financial year to \$46.7 billion.



As it has done for some years, the Reserve Bank continued to utilise foreign exchange swaps as part of its domestic liquidity operations. At the end of June 2010, the Bank had a net obligation to receive foreign currency of \$3.0 billion. Gross reserves, namely foreign exchange held outright (net reserves) adjusted for foreign exchange held or lent under foreign exchange swaps, ended the financial year at \$43.7 billion.

As noted above, the Reserve Bank provides foreign exchange services to its clients. While these include a number of foreign official institutions, the Bank's largest client is the Australian Government. The Government purchases foreign currency from the Bank to meet a range of obligations, including defence expenditure, foreign aid and the costs of

maintaining its diplomatic presence around the world. The Bank typically covers sales of foreign exchange to its clients directly from the market but can fund them temporarily from reserves if market conditions warrant this. In 2009/10, the Bank sold \$7.3 billion of foreign currency to the Australian Government, which was covered in the market.

Reserves Management

The Reserve Bank also regularly undertakes transactions in foreign money and bond markets as part of the management of the portfolio of foreign currency assets that it holds on its balance sheet. These assets along with gold, which is also held on the Bank's balance sheet, comprise the major part of Australia's official reserve assets. The Reserve Bank draws on the foreign currency portfolio to implement policy operations in the foreign exchange market and assist with the management of domestic liquidity.

The investment mandate under which these assets are managed places a high priority on investing only in assets of the highest credit quality and ensuring that the portfolio has sufficient liquidity to meet its policy objectives in all market conditions. These requirements have implications for the selection of investment currencies and individual asset classes, as well as the risk management framework. They are embodied in an internal benchmark that is used to guide the investment process.

The benchmark is a hypothetical portfolio that represents the Reserve Bank's best estimate of the long-run optimal investment allocation given the policy objectives of the portfolio and the various constraints under which it is managed. The Bank has managed its portfolio to an internal benchmark for almost 20 years, over which time there have been few adjustments to the benchmark. Since inception, this has restricted currency exposure to the US dollar, the euro (the Deutschemerk prior to 1999) and the Japanese yen. Since 2001, the allocation across these three currencies has been 45 per cent each to the US dollar and euro and 10 per cent to the yen. Benchmark investments are limited to sovereign debt issued by the governments of the United States, Germany, France and Japan; investments secured by sovereign or quasi-sovereign debt under repos; and commercial bank deposits. Exposure to interest rate risk is limited by the prescription of a benchmark duration target within each currency. This target was reduced to 18 months for all three portfolios in 2008/09 and no changes were made in 2009/10.

The Benchmark Portfolio

	US	Europe	Japan
Asset allocation (% of total)	45	45	10
Currency allocation (% of total)	45	45	10
Duration (months)	18	18	18

Source: RBA

Over 2009/10, the return on foreign currency assets, measured in SDRs, was 2 per cent, considerably below returns recorded in recent years. The Australian dollar value of the return on reserves was \$0.3 billion, also considerably lower than in the previous financial year. This outcome largely reflected the very low level of global bond yields over the year, which limited interest earnings across all three portfolios, and the higher average Australian dollar exchange rate, which reduced the Australian dollar value of foreign earnings by 17 per cent. Modest mark-to-market capital gains on holdings of bonds contributed to returns.

Rates of Return in Local Currency by Portfolio

Per cent

	US	Europe	Japan
2003/04	0	1.9	0
2004/05	4.1	5.8	1.1
2005/06	1.2	0.1	-0.9
2006/07	5.6	2.2	1.1
2007/08	8.1	4.0	1.7
2008/09	5.2	8.1	1.8
2009/10	2.3	2.7	0.8

Source: RBA

For some years, the Reserve Bank has maintained investments in two regional bond funds established by EMEAP central banks to support the development of local bond markets. These funds comprise the Asian Bond Fund initiative. The Bank has investments in both the US dollar denominated fund, ABF1, and the local currency denominated fund, ABF2. At the end of June 2010, the total allocation of reserves to these funds was \$443 million. The return on these investments over 2009/10 was 9.5 per cent, measured in US dollar terms. These investments are managed externally and outside the benchmark framework.

As noted, the Reserve Bank holds the gold tranche of Australia's official reserve assets on its balance sheet. Gold holdings are around 80 tonnes, unchanged from the previous year. Over 2009/10, the price of gold rose by 34 per cent in US dollar terms and by 28 per cent in Australian dollar terms. As a result, the value of the Bank's holdings of gold increased by around \$0.8 billion to \$3.7 billion.

The Reserve Bank is prepared to lend gold from its holdings to participants in the gold market provided such loans are secured by high-quality collateral. In recent years, gold leasing rates have been low and there has been little demand from the market for gold loans. As a result, the amount of gold on loan has progressively declined as maturing loans have not been renewed. In 2009/10, income from gold loans declined further to \$0.4 million. In June 2010, there were 3 tonnes of gold on loan.