

Governor's Foreword

The global economy expanded at a pace somewhat below average in 2012/13, but some of the downside risks that had been such a concern a year earlier did not materialise. The actions of the European Central Bank, in particular, were key in stabilising the situation in Europe. China's economy settled to a more moderate but more sustainable pace of expansion, while Japan embarked on a new and aggressive round of expansionary economic policies. The US economy continued to recover gradually, which has seen the Federal Reserve set out the conditions for a change of course on policy.

The Australian economy recorded below-average growth over the year, as the impetus from the extraordinary run-up in investment spending by the resources sector began to abate and as some other sectors remained somewhat subdued. The unemployment rate rose gradually, while inflation remained consistent with the medium-term target. The Board lowered the cash rate three times during 2012/13 and again in August 2013, bringing the total reduction in this cycle to 225 basis points, and the cash rate to 2.50 per cent, the lowest in more than 50 years. These changes were guided, as in past years, by the longstanding framework for monetary policy of flexible inflation targeting.

There was a notable decline in the exchange rate of the Australian dollar late in the year under review. For about two years up to early 2013, the currency had traded mostly at a level above parity with the US dollar and in the high 70s in terms of the trade-weighted index. But as prospects for the US and Australian economies have been reassessed over recent months, it has depreciated somewhat.

These trends also affected the Reserve Bank's balance sheet and earnings. Valuation effects, mostly from the lower exchange rate, raised assets by \$3.6 billion. Underlying earnings, which are essentially driven by the running yield on the portfolio of foreign and domestic assets, were \$0.7 billion, about the same as the previous year and very low by historical standards. This mainly reflects the very low level of interest rates, especially those in the major advanced countries where the Bank holds its foreign assets.

Measured on the basis of accounting standards, which bring to profit and loss both realised and unrealised valuation changes, the Bank recorded a profit of \$4.3 billion, the highest for four years. The *Reserve Bank Act 1959* allows only underlying earnings and net realised valuation gains to be paid to the Commonwealth. Earnings available for distribution amounted to \$588 million, down from \$1 096 million the previous year, mainly because the outcome the previous year included some valuation gains on foreign securities that were realised as yields fell.

The Board's view is that the earnings should be devoted in their entirety to rebuilding the Reserve Bank Reserve Fund (RBRF), the Bank's main permanent capital reserve, which had been depleted by the large accounting losses in 2009/10 and 2010/11. The Treasurer has agreed with this course of action and accordingly no dividend will be paid to the Commonwealth from net profits of the Bank in 2012/13. The RBRF therefore stands at \$2.5 billion and remains well below its target level. Further such transfers will be required in future years.

The Reserve Bank's cost of operations rose by a little over 8 per cent in 2012/13. Some cost increases in the business areas were matched by revenue gains. Stripping those out, operating costs rose by about 6½ per cent. As always, a large share of costs is staff costs. Staff salary increases averaged 4 per cent, the same as the previous year, while staff numbers rose by 64, or 6 per cent, the highest for some years. The transition of some projects into the more intense phase of development accounted for about half of the staffing increase. Costs are again anticipated to rise at an above-average pace in 2013/14, reflecting the further build-up of expenses for major projects; 'business-as-usual' costs should rise at a similar pace as in the year under review.

There are a number of projects underway, including three large and noteworthy ones. The Next Generation Banknote project, announced in September 2012, seeks to keep Australia's banknotes ahead of the efforts of counterfeiters. At about 10 counterfeits detected per million banknotes in circulation, counterfeiting rates remain low at present. But with the current series of banknotes approaching 20 years in circulation, and given the lead times involved in designing, testing and introducing new security features, it is time now to be investing in upgrading the security of the existing designs. The Reserve Bank will be providing more information on the new banknote series in the coming year. The project will also involve the construction of more efficient facilities for the secure storage and distribution of banknotes.

The second project, the New Payments Platform, had its genesis in the *Strategic Review of Innovation in the Payments System* by the Payments System Board in 2012, which saw a need to set some goals for faster and more efficient payments, together with strengthened industry governance arrangements. The private sector has responded to these high-level goals with proposals to build the necessary payments infrastructure. The Reserve Bank will play its own part by building certain key elements of infrastructure that will facilitate the use of the Reserve Bank Information and Transfer System to enable faster payments for the community.

The third major project is an upgrade of the Reserve Bank's banking systems that provide services to its government customers. The current systems have been operating for nearly two decades and, while still reliable, are nearing the end of their useful life. Use of more modern technology will better meet customer needs, improve efficiency and reduce operational risks in the Bank.

Each of these is a complex, multi-year project that will entail considerable expense, but they are in the public interest and are necessary if the Reserve Bank is to fulfil its responsibilities to provide a secure currency, foster a world-class payments infrastructure and provide efficient banking services to the Commonwealth. The Bank is appropriately strengthening its project management and oversight capabilities.

Jillian Broadbent AO finished a 15-year stint on the Board on 6 May 2013, having served with great distinction over three terms. The Board thanks her for her outstanding service and wishes her well. Kathryn Fagg joined the Board on 7 May 2013, bringing the benefit of many years of commercial experience to the Board's deliberations.

Once again the Reserve Bank management and staff performed their roles with their customary quiet dedication and high levels of competence. The Board joins me in thanking them for their efforts.



Glenn Stevens

Chairman, Reserve Bank Board

2 September 2013