RESERVE
BANK
of
AUSTRALIA

Reserve Bank

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ANNUAL REPORT 2004

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Reserve Bank

Governor's Foreword

After a temporary weak spot in the middle of 2003, the world economic recovery resumed in 2003/04. In Australia it was a year of good growth and low inflation as we completed the thirteenth year of the current economic expansion. In late 2003, when it became clear that the world economic recovery was on track, and the Australian economy was speeding up, the Board took the opportunity to move the cash rate back towards a more neutral level in two quarter point rises. Two additional factors at the time affecting the monetary policy decision-making process were the rapid rise in the exchange rate and the credit-driven overheating in house prices. Both of these abated somewhat in the first half of 2004.

The rises in November and December were the first for around eighteen months. The rate at which interest rates have been increased in Australia has thus been quite gradual by earlier standards. Nevertheless, Australia stands out as the only significant OECD economy in which interest rates were not actually lowered at some stage in 2002 and 2003.

The development of monetary policy during the year has been thoroughly explained in the quarterly *Statement on Monetary Policy*, testimony before the House of Representatives Standing Committee on Economics, Finance and Public Administration, media releases accompanying the changes in monetary policy and speeches by senior officers. For this reason, the Annual Report has for some years now concentrated on giving an account of other activities of the RBA during the year, as well as presenting the financial statements. Among the various activities that occurred during the year, the following are worthy of mention:

In its domestic market operations, the Bank again widened the range of securities in which it will deal in order to cope with the shrinking supply of Commonwealth Government securities. As at March 2004, bank bills and certificates of deposit were made eligible for purchase under repo. Although this involves an increase in credit risk, the magnitude is negligible because banks cannot offer their own paper. In addition they must provide overcover of 2 per cent.

The RBA was very active in its foreign exchange operations in 2003/04, but not in the sense of engaging in foreign exchange intervention aimed at influencing the exchange rate. Instead, the main activity was purchasing foreign exchange to replenish reserves and to provide the Australian Government with its needs, which were particularly heavy during the year as it paid out remaining cross-currency swaps. In the first eight months of the financial year, a period when the Australian dollar rose rapidly, the RBA bought $7 billion of foreign currency for the Government and $10 billion to replenish its own reserves.

International co-operation at both the global and regional level was again a major part of International Department's work. The major regional initiative is the development of Asian Bond Fund 2. This fund will consist of bonds issued in local currency by Asian governments, and is the logical extension of Asian Bond Fund 1, which was made up of bonds issued in US dollars by the same governments. Both initiatives are aimed at improving bond markets in Asia and giving Asian investors, initially central banks, a wider range of Asian investment opportunities.

The Financial System Group contains two departments – Payments Policy Department and System Stability Department. The former advises the Payments System Board which publishes its own Annual Report. During the year, the court case brought by Visa and MasterCard challenging the reform of credit card schemes in Australia was unsuccessful and costs were awarded to the RBA. In February 2004, the Payments System Board designated a second payment system, namely the Visa debit system. The System Stability Department formerly provided an analysis of the stability of the financial system in this Annual Report. In March 2004, it published a *Financial Stability Review* as a stand-alone document. This will now be a semi-annual publication after tabling before the Council of Financial Regulators, which is chaired by the RBA.

The major development affecting Securency was the decision by the State Bank of Vietnam to introduce polymer in its note issue. Also, the Bank of Zambia issued two denominations on polymer, the first polymer banknotes issued on the African continent. This, with the very large Vietnamese order, brings to 22 the number of countries which have used polymer for at least some of their note issue, with Chile also having announced its intention to do so in the near future. Note Printing Australia began the printing and assembly of the new Australian passport for the Department of Foreign Affairs and Trade, incorporating a number of new security features.

Work is nearing completion on the Museum of Australian Currency Notes, which will occupy the eastern end of the ground floor of 65 Martin Place. It replaces the existing "ad hoc" display of notes and historical material previously occupying the site, and is expected to open in October 2004.

Staff numbers remained in the eight hundreds for the fourth year in a row, indicating that the level has stabilised after nearly twenty years of falling numbers. An important challenge at present is to establish a consolidated business resumption site in the Sydney region, but well removed from Head Office. This site will be permanently staffed on a revolving basis by staff from a number of departments. It will involve some interesting management and staffing issues, but should contribute significantly, not only to the security of the RBA's operations, but to the stability of the Australian financial system.

Operations in Financial Markets

The RBA undertakes a large volume of transactions in financial markets in order to carry out its monetary policy responsibilities, service clients (mainly the Australian Government) and manage its balance sheet.

While the move to using market operations to implement monetary policy took place about twenty years ago, the nature of these operations has continued to evolve over the intervening period. New instruments and new dealing arrangements have been adopted to keep pace with developments in markets. This process continued during the past year, with a further widening in the range of securities in which the RBA is prepared to deal in domestic markets.

In the case of foreign exchange operations, the main tasks during the past year were to meet the increased demand for foreign exchange by the Australian Government as it ran off its remaining foreign currency swaps, and to rebuild further the RBA's own foreign reserve holdings following the sales that took place during the currency intervention between 1997 and 2001. A strongly rising exchange rate during the first eight months of the year provided a favourable environment in which to carry out these operations.

Domestic Markets Operations

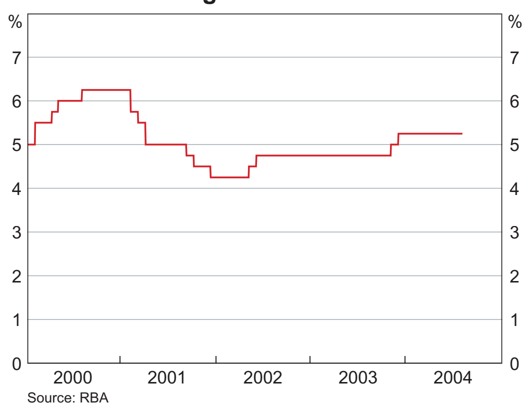
Monetary Policy Implementation

Decisions by the Reserve Bank Board on the appropriate setting of monetary policy are made and communicated in terms of an operational target for the cash rate – the interest rate on overnight, unsecured loans between banks. The cash rate is an important determinant of other wholesale and retail interest rates which, in turn, influence the level of economic activity and inflation.

The target cash rate was increased twice in 2003/04: from 4.75 per cent to 5.00 per cent following the November Board meeting; and then to 5.25 per cent following the December Board meeting. Prior to the November increase, the target had been unchanged for 17 months. The background to both of the policy changes was provided at the time through media releases and subsequently in the RBA's quarterly *Statement on Monetary Policy* as well as in appearances by the Governor

Graph 1

Target Cash Rate



before the House of Representatives Standing Committee on Economics, Finance and Public Administration.

The RBA is responsible for ensuring that the cash rate in the market remains as close as possible to the target set by the Board. A major determinant of the cash rate in the market is the aggregate level of balances held by commercial banks in their accounts at the RBA. These accounts, called Exchange Settlement Accounts (ESAs), constitute the most immediate source of liquidity with which banks meet their daily settlement obligations to each other and to the RBA.

The RBA discharges its responsibility for the implementation of monetary policy by ensuring that the supply of aggregate ESA balances is sufficient for the cash market to clear each day at the target cash rate. It does this by buying securities to increase the supply of ESA balances and selling securities to reduce ESA balances. These transactions may be either outright purchases or sales, or repurchase agreements which involve the sale of a security with an undertaking to repurchase it at a future agreed date and at an agreed price. Arrangements for implementing monetary policy have proved very effective over the years, with volatility in the cash rate exceptionally low by international standards. In 2003/04, it was effectively zero.

The RBA's open market operations are conducted each morning based on banks' expected liquidity demands for the day. A second round of operations may be held later in the day to offset unexpected flows or sudden shifts in demand for ESA balances, but such events are rare. In 2003/04, there were just three second-round operations. Banks also have a standing facility under which they can effectively borrow funds from the RBA at their discretion, but at a 25 basis point penalty. Banks typically use this facility when there are technical or other factors which prevent them from sourcing funds elsewhere. This facility was used on 24 occasions during 2003/04, a little more frequently than in the previous year.

The RBA's turnover in domestic securities in open market operations was $287 billion in 2003/04, down 11 per cent on the previous year as tighter conditions in the government securities market meant that the RBA made greater use of foreign exchange swaps to reshape system liquidity flows (refer table). Repurchase agreements (or repos) in domestic securities

Open Market Operations
($ billion)

	1999/00	2000/01	2001/02	2002/03	2003/04
Repurchase agreements[(a)]					
– Purchases	244	376	423	304	272
– Sales	14	17	16	17	11
Outright purchases[(b)]	9	5	1	3	5
Total operations in domestic securities	267	398	440	324	287
Total FX swaps[(c)]	67	90	90	90	139

(a) First leg of transaction.
(b) Commonwealth Government securities (CGS) only until 2002/03. Thereafter includes State and Territory government securities.
(c) First leg of transaction. Includes swaps arranged outside the daily operations.

continued to account for the bulk of domestic operations. Turnover was significantly lower than in 2002/03 despite a decline in the weighted average term of repos from 20 days to 12 days. Turnover in outright securities transactions remained modest.

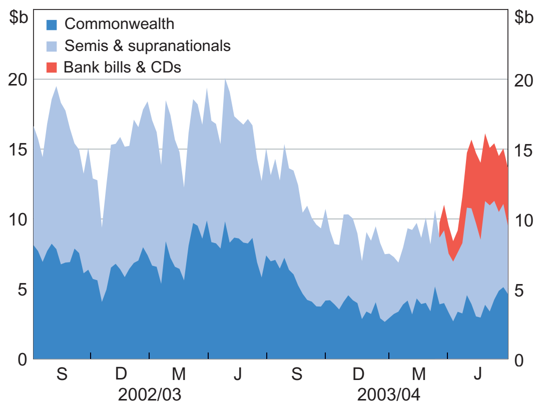
Turnover in foreign exchange swaps involving the Australian dollar increased by 54 per cent in 2003/04, to $139 billion. The RBA adds to ESA balances through a foreign exchange swap by providing Australian dollars to banks in exchange for foreign currency, with an agreement to reverse the transaction on an agreed forward date and at an agreed exchange rate. This has the same effect on ESA balances as using repos in domestic securities where the RBA purchases domestic securities from a bank and simultaneously agrees to sell them back to the same counterparty at an agreed price and date in the future.

Changes to Eligible Securities for Repo Operations

As noted in previous annual reports, shrinkage in the Commonwealth Government securities (CGS) market has been an important driver of change in the RBA's dealing arrangements over recent years. The RBA had traditionally relied on CGS when conducting its operations, and has responded to the decline in the stock of CGS by progressively broadening the range of domestic securities in which it is prepared to transact and also by making greater use of foreign exchange swaps.

Graph 2

RBA Repos Outstanding



In March 2004, the RBA announced that it would start purchasing bank bills and certificates of deposit (CDs) under repo in its open market operations. This decision followed a period of some months in which liquidity in the secondary market for CGS had tightened noticeably. This was marked by generally tighter conditions in the repo market and greater use of the RBA's securities lending facility. In this environment, the amount of CGS that the RBA could buy without having a noticeable effect on pricing in the underlying markets declined markedly. By March, the RBA's holdings of domestic securities under repo had fallen from over $14 billion at the start of the financial year to under $10 billion (refer graph).

In light of these developments, it was decided that the range of eligible domestic securities should be broadened further. The decision to widen access to domestic securities rather than rely even more on foreign exchange swaps reflected a desire on the part of the RBA to maintain flexibility in managing the composition of its balance sheet. The decision to add bank bills and CDs to the list of eligible securities, rather than alternatives such as asset-backed securities or corporate debt securities, reflected the depth and price transparency of the bank bill/CD market combined with the low price risk of the instruments. The RBA had also gained experience in transacting in these instruments through its intra-day repo facility, under which bank bills and CDs have been accepted since 2002.

In order to avoid introducing pricing distortions into the bill market, the RBA elected to apply relatively broad credit criteria in deciding on the eligibility of banks whose bills would be accepted. Issuing banks must have a short-term credit rating of P-1 or equivalent and a long-term credit rating of A3 or above. They must be rated by at least two major agencies. At the time these arrangements were introduced, these criteria captured 35 of the 53 banks licensed to operate in Australia and over 90 per cent of the market by value.

While extending repo operations to bills and CDs has increased the credit exposure of the RBA, the overall impact has been small. A bank dealing in repos with the RBA can offer only third-party bills, not its own, so both the repo counterparty and the issuer of the collateral would need to default before the RBA experienced a loss. Also, the counterparty selling bills to the RBA must provide the RBA with overcover of 2 per cent – i.e. the value of bills supplied must exceed the value of cash provided by the RBA by 2 per cent. Given the short-term nature of these instruments, this level of overcover protects the RBA against quite large adverse yield movements.

The RBA evaluates approaches from counterparties for repos in bank bills and CDs separately from those in government and quasi-government debt securities. The allocation of operations across the two classes of collateral is made primarily on the basis of the relative competitiveness of the approaches but also takes into account balance sheet management considerations. This means that the RBA retains discretion over the amount of bank risk that it is carrying on its balance sheet.

In recent months, the value of bank bills and CDs held under repo by the RBA has averaged around $5 billion. The weighted average rate at which repos involving bank instruments have been accepted has been around 8 basis points above the weighted average rate offered on the "next best" repos using government and quasi-government securities.

At the time of the announcement on bank bills, the eligibility criteria for quasi-government debt securities used in repo transactions were also broadened. Until March of this year, this asset class had been limited to Australian-dollar domestic securities issued by a limited number of AAA-rated supranational institutions. In March, the criteria were extended to include similar issues by AAA-rated foreign sovereigns and government agencies. The latter are required to have an explicit government guarantee (or support deemed by the RBA to be comparable) at either the federal or state government level. This change occurred during and, to some extent, contributed to, a period of increased issuance by non-resident quasi-government entities. While RBA holdings of these securities remain small, they jumped from almost zero in the months leading up to the change in arrangements, to average over $1 billion in May and June of 2004.

Changes to Eligible Securities for Outright Holdings

The RBA also holds domestic securities on an outright basis to facilitate its open market operations.[1] Until March of this year, these outright holdings were limited to CGS. Short-dated

1 *When the RBA needs to reduce aggregate ESA balances, it typically sells securities under repo to the private sector. The RBA is not prepared to "on sell" securities that it already holds under repo and therefore must own some securities on an outright basis which it can use in sell repos.*

CGS are acquired typically in the daily open market operations.[2] Longer-dated Treasury bonds are acquired either at tender when the bonds are issued or in subsequent secondary market trading. As the amount of CGS on issue has declined, there have been fewer such transactions and the RBA's outright holdings of CGS have gradually fallen.

In March, the RBA announced that it would start holding domestic securities issued by Australian State and Territory governments on an outright basis. As with CGS, short-dated instruments issued by State and Territory governments can now be offered through the RBA's open market operations while separate operations will be held to acquire longer-dated securities in the secondary market.

The RBA's Domestic Portfolio

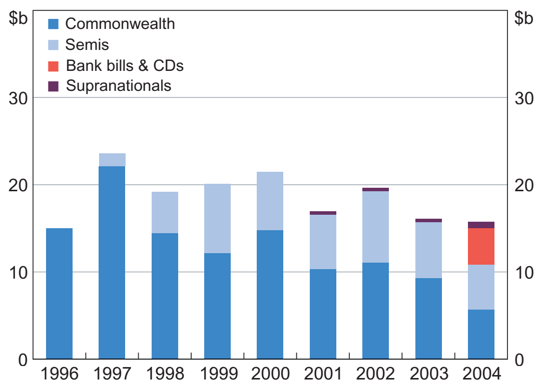
The broadening of the eligibility criteria for domestic securities facilitated a further rundown in the RBA's holdings of CGS. Over the year, holdings of CGS and State securities fell by $5 billion; holdings of bank bills/CDs and other securities increased by $4½ billion.

The addition of bank instruments increased the total pool of eligible domestic securities in which the RBA will deal from around $130 to over $260 billion. This saw the portion of that pool held on the RBA's balance sheet decline from 12 to 6 per cent. By way of comparison, if the RBA had continued to limit its operations to CGS over the years and not used foreign exchange swaps for domestic liquidity management, it would now be holding around 80 per cent of all CGS on issue; clearly, this would not have been feasible.

Graph 3

RBA Domestic Portfolio

As at June



Source: RBA

Securities Lending

The RBA operates a stock lending facility to assist market participants to meet their settlement obligations in specific lines of Treasury bonds. Participants can obtain securities under repo from the RBA on an overnight basis, at a rate that is more expensive than the prevailing market rates. The relative cost of using the facility is designed to avoid undermining the development of the private sector securities lending market. The amount of stock lending the RBA can undertake is limited ultimately by its outright holdings of the securities which, as noted above, have fallen in recent years.

Use of the RBA's facility increased significantly in 2003/04 as liquidity deteriorated in the repo market. Over 180 transactions were undertaken, for a total value of $5 billion. This

2 *The RBA stands ready in its normal daily liquidity operations to purchase securities with remaining maturities of up to around 18 months.*

Securities Lending by the RBA

	Number of transactions	Amount lent Face value ($ billion)	Net income ($ million)
2000/01	75	1.2	0.1
2001/02	119	3.1	0.3
2002/03	32	0.9	0.1
2003/04	185	5.0	0.5

was a considerably higher level of activity than in any of the previous few years. Five different securities accounted for over 90 per cent of the transactions by value.

Foreign Exchange Operations

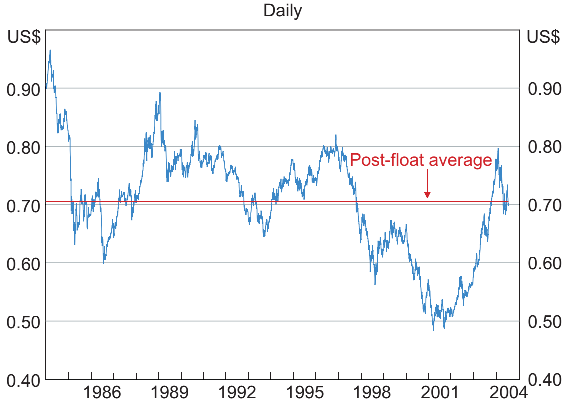
The most prominent of the RBA's operations in the foreign exchange market are those intended to influence the Australian dollar exchange rate, typically referred to as intervention. These transactions, however, are undertaken only infrequently, usually when the exchange rate has moved a long way from its long-term average and this move cannot be explained by economic developments. Most of the RBA's ongoing operations in the foreign exchange market revolve around servicing clients' foreign exchange requirements and adjusting the RBA's holdings of foreign exchange reserves following a period of intervention. In addition to these types of transactions, which all involve either outright purchases or outright sales of foreign exchange, the RBA also undertakes foreign currency swaps to assist in daily management of domestic liquidity (as discussed in the previous section).

Foreign exchange operations during 2003/04 were against the backdrop of a further significant appreciation of the exchange rate through to February 2004, which took the currency to a peak of around US80 cents, much the same level as that prevailing before the start of the Asian crisis in 1997. The exchange rate subsequently fell again and over the rest of the financial year fluctuated around US70 cents, close to its long-term average.

Graph 4

Australian Dollar

Daily



Sources: RBA; Reuters

The RBA did not undertake any foreign exchange transactions during the year directed specifically at influencing the exchange rate. Rather, its objectives were to meet the foreign exchange needs of the Australian Government, which were significantly larger than usual, and to continue to rebuild its holdings of foreign currency reserves.

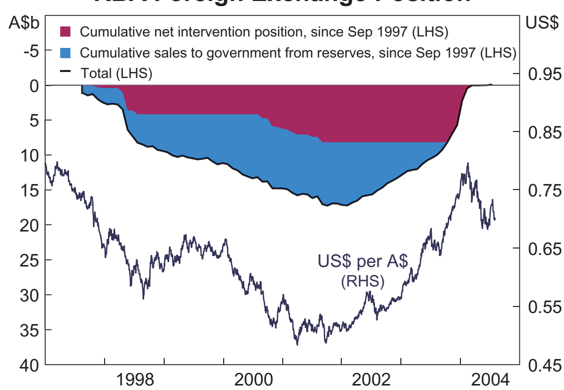
The Australian Government's needs were unusually large in the first half of the financial year because it was continuing to pay out foreign currency liabilities that had built up since the late 1980s through cross-currency swaps. When the Treasurer decided in September 2001 to close out the swap position, the amount of swaps outstanding was around US$6 billion. By the start of 2003/04, this had been reduced to around US$3.5 billion, and the position was completely closed out by late December 2003. Total sales of foreign exchange to the Australian Government during the financial year were $8.6 billion, after $7.4 billion in the previous year; these figures were much higher than the normal level of annual sales of around $3 billion.

With the value of the Australian dollar at higher levels and rising strongly during the year, the RBA also stepped up purchases of foreign exchange for its own account to rebuild reserve holdings. These foreign exchange operations were the completion of an intervention cycle which began in mid 1997 when the Australian dollar fell. As the currency fell between 1997 and 2001, the RBA intervened in the market on various occasions to limit the pace of the fall, selling foreign exchange from its reserve holdings and buying Australian dollars. It also suspended its operations in the market to buy foreign exchange for the Australian Government. Such transactions would have offset the impact of intervention and would also have sent confusing signals to the market. This further reduced the RBA's holdings of foreign exchange reserves, as the Australian Government's needs were met directly from these reserves. As can be seen in the accompanying graph, cumulative net sales of foreign exchange from 1997 peaked at a little over $17 billion by February 2002. About half of that was the result of direct intervention operations and half through sales to the Australian Government from international reserves. At that point, net international reserves had fallen to $7 billion.

Thereafter, the Australian dollar started to rise and, from April 2002, the RBA began buying more foreign exchange in the market than was required to cover the Australian Government's needs. As such, reserve levels started rising again, although only gradually at first. During the past year, the RBA bought a further $10 billion for its own account. The bulk of these purchases took place in late 2003 and early 2004 as the Australian dollar was rising strongly to its peak in February. Since February, the RBA has continued to purchase foreign exchange in the market to offset sales to the Australian Government, but has not made significant purchases for its own account. Net international reserve holdings were not much affected by foreign exchange transactions after February and ended the year around $25 billion.

Graph 5

RBA Foreign Exchange Position

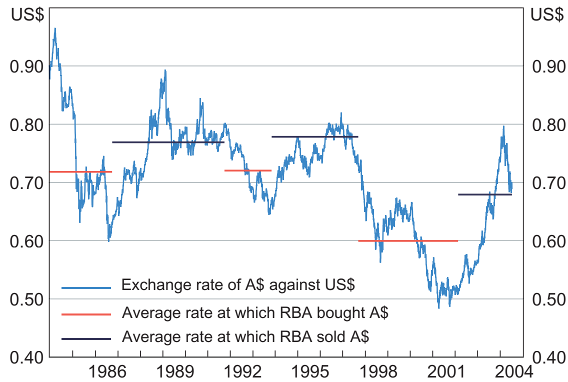


Source: RBA

The RBA's operations in the foreign exchange market are undertaken in pursuit of its various policy objectives, rather than for the purpose of financial gain. Nonetheless, the RBA does monitor the profitability or otherwise of these

Graph 6

Australian Dollar and Average RBA Transaction Rates



Source: RBA

operations after the event, as part of the evaluation of their effectiveness.

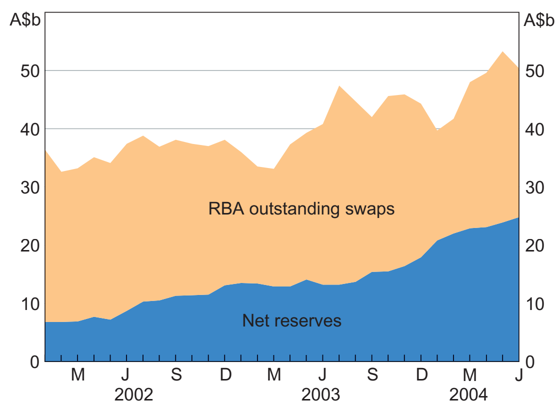
With reserve holdings now restored, the intervention cycle that began in 1997 can be regarded as having been completed, and an evaluation of its profitability is now possible. This can be done by comparing the average exchange rate at which the RBA bought Australian dollars (sold foreign exchange) between 1997 and 2001 with the average rate at which it subsequently sold Australian dollars for foreign currency. The average exchange rate at which Australian dollars were purchased was just under US60 cents while the subsequent sales were at an average exchange rate of around US68 cents. This was a profitable outcome as the average rate at which Australian dollars were sold was about US8 cents higher than the average rate at which they were bought. The profits from the latest cycle of intervention have not yet been realised, as profits are only realised when assets are sold.

As can be seen in the accompanying graph, this was the third cycle of intervention since the float of the Australian dollar in 1983; the previous two cycles were in the second half of the 1980s and the first half of the 1990s. In the 1980s cycle, the margin between the average exchange rate at which the RBA bought Australian dollars and that at which it subsequently sold Australian dollars was US5 cents, while in the early 1990s cycle it was US6 cents.

As noted earlier, the RBA was again active in the foreign currency swap market during the financial year, largely for domestic liquidity management. Turnover in swaps was substantially higher than in the previous year, though swaps outstanding were a little lower at the end of the financial year, at around $26 billion.

Graph 7

Official Reserve Assets



Source: RBA

Total official reserve assets – i.e. amounts held outright as well as foreign exchange held under currency swaps – rose to $50 billion, up from about $40 billion a year earlier. This expansion in foreign asset holdings accounted for the bulk of the rise in the RBA's balance sheet during 2003/04.

Reserves Management

Foreign currency reserve assets are held primarily to support intervention in the foreign exchange market. In investing these assets, priority is therefore given to liquidity and security, in order to ensure that the assets are always available for their intended purpose. Consistent with this, investments are confined largely to instruments issued by highly rated foreign governments, government agencies and financial institutions.

Within these constraints, these assets are managed against a benchmark which specifies asset and currency allocation across the countries in which reserves are held (the United States, Europe and Japan) as well as the duration of the portfolio. The weights given to the three portfolios are 45 per cent, 45 per cent and 10 per cent, respectively, and the duration of each portfolio is set at 30 months. Investments are maintained in a relatively narrow range around the benchmark; portfolio managers have a small amount of discretion to deviate from the benchmark in order to manage the day-to-day flows of funds.

The Benchmark Portfolio

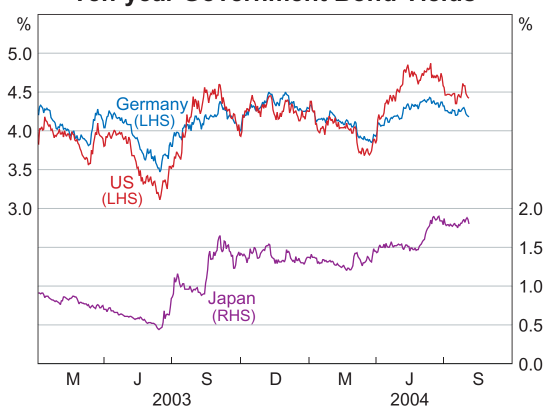
	US	Europe	Japan
Asset allocation (% of total)	45	45	10
Currency allocation (% of total)	45	45	10
Duration (months)	30	30	30

The return on foreign currency assets for the past year was relatively low as a result of the fact that the capital value of bonds fell sharply during the financial year due to rises in market yields. Bond yields had fallen to very low levels towards the end of the previous financial year, as a result of concerns that the world economy might have been facing increased risks of deflation. In July 2003, bond yields in all three portfolios rose sharply as these fears receded. After declining somewhat in the middle of the financial year, yields again rose sharply in the United States and Europe in the June quarter of 2004 as financial markets began to speculate that a monetary policy tightening by the US Federal Reserve was imminent.

On a weighted average basis across the three currency portfolios, the rise in bond yields during the year was the largest since the current approach to reserves management began in 1991 and, as such, so too were the capital losses. The overall rate of return on the US portfolio in 2003/04 was the weakest, at 0.01 per cent. The European portfolio returned 1.89 per cent over the year, while the return on the Japanese portfolio was 0.04 per cent.

Graph 8

Ten-year Government Bond Yields



Source: Bloomberg

Rates of Return in Local Currency by Portfolio (Per cent)			
	US	Europe	Japan
2000/01	8.60	5.65	2.27
2001/02	6.09	4.68	0.40
2002/03	6.65	7.19	1.34
2003/04	0.01	1.89	0.04

Decisions taken by portfolio managers under the trading discretion available to them added $67 million, or 21 basis points, to returns for the year. This incremental return was split between transactions which took advantage of short-term market anomalies ($44 million) and returns from lending securities ($23 million).

Actual and Benchmark Returns			
	Rates of return in SDRs (Per cent)		Value of difference
	Actual	Benchmark	(A$ million)
1991/92	9.8	8.9	165
1992/93	16.3	11.6	420
1993/94	4.0	3.8	31
1994/95	5.2	7.4	-331
1995/96	4.0	3.7	40
1996/97	4.5	4.2	34
1997/98	4.5	4.6	-19
1998/99	4.9	5.1	-26
1999/00	2.8	3.8	-202
2000/01	11.0	10.8	74
2001/02	3.9	3.7	63
2002/03	6.7	6.4	77
2003/04	0.5	0.3	67

The range of eligible securities in the foreign portfolio was widened slightly during the financial year, with the RBA subscribing US$50 million to the Asian Bond Fund (ABF). The Fund is an initiative of the EMEAP (Executives' Meeting of East Asian and Pacific central banks) Group and is designed not only to expand investment opportunities for Asian central banks but also to promote bond markets in the region. The Fund is made up of a basket of US dollar denominated bonds issued by a number of Asian sovereign and quasi-sovereign borrowers, and is managed by the Bank for International Settlements. The RBA's investment in the ABF generated similar returns over 2003/04 to its core US dollar portfolio.

Gold

The RBA also holds 80 tonnes of gold, valued at $1.5 billion. The US dollar price of gold rallied strongly during 2003/04, gaining around 25 per cent through to end April. The price subsequently eased, ending the year up 14 per cent. Part of this rise was due to weakness in the US dollar; in Australian dollar terms, the gold price was around 10 per cent higher over the year.

The RBA seeks to augment its return on gold by making collateralised gold loans to major banks in the gold market. Demand for borrowed gold was softer during the year, reflecting reduced hedging operations by miners, and interest rates on gold loans continued to fall. Interest rates for one-year loans fell to an average of 0.2 per cent from around 0.5 per cent in the previous year. The RBA again lengthened the duration of its portfolio to gain some advantage from higher rates on three to five-year maturities. Nevertheless, returns from gold lending dropped to $16 million in 2003/04 from $19 million the previous year.

International Financial Co-operation

Given the globally integrated nature of economies and financial markets, central banks increasingly require an international perspective in order to carry out their responsibilities. The RBA, in common with most central banks, is therefore involved in a range of co-operative international relationships, both bilateral and multilateral. The nature of these relationships varies across the groups: at the simplest level, they involve discussions to promote understanding of each others' policies and priorities, while in other cases they require a deeper level of co-operation often directed at the development of the regional or global financial infrastructure.

Some international groups are confined to central banks, but most have broader coverage including finance ministries and various financial regulators. In the former category are the bimonthly meetings at the Bank for International Settlements (which involve a broad cross-section of central banks from around the globe) and the Executives' Meeting of East Asian and Pacific central banks, known as EMEAP, which includes eleven central banks from the region. The Financial Stability Forum, a group covering financial authorities from the Group of Seven (G7) and several other significant financial centres, is not strictly confined to central banks, but the RBA acts as Australia's representative. In broader groups, such as the Group of Twenty (G20), the International Monetary Fund and APEC, the RBA participates with other Australian authorities, usually the Australian Department of the Treasury. Co-ordination of Australia's participation in international economic policy issues occurs formally through meetings of the International Economic Policy Group in Canberra, in which the RBA participates. This group is chaired by the Department of the Prime Minister and Cabinet and also includes representatives from the Treasury, Department of Foreign Affairs and Trade, Office of National Assessments and AusAID.

In recent years much of the focus of international co-operation has been directed at improving the quality of international financial infrastructure, given that this has become a key factor in reducing the risk and severity of financial crises. The RBA's contribution to the work of these various fora is outlined below.

Bank for International Settlements (BIS) and Associated Committees

The RBA participates in the meetings of BIS central bank governors that are held on a bimonthly basis, usually at the BIS headquarters in Basel, Switzerland. These meetings provide the opportunity for central bank governors from industrialised and emerging market countries to discuss developments in the global economy as well as major policy issues confronting central banks. Twice each year there is an additional meeting of governors from the Asian region who make up the BIS Asian Consultative Council (ACC). The ACC was established in 2001 to guide the work of the BIS in the Asian region and oversee the work of the BIS representative office for Asia and the Pacific, which is located in Hong Kong. Much of the discussion in the ACC in 2003/04 covered issues relating to the New Basel Capital Accord (Basel II), including the development of a questionnaire on the plans for the implementation of Basel II by central

The RBA hosted the annual BIS Working Party on Monetary Policy in Asia meeting in Sydney on 10/11 June 2004. Malcolm Edey, Assistant Governor (Economic), and Luci Ellis, Economic Analysis Department, represented the RBA.

banks in the Asian region. The Hong Kong office of the BIS organised a number of conferences and workshops during the year in which the RBA participated. These addressed topics such as monetary policy frameworks, Asian bond market development, reserves management, and banking sector issues such as crisis management. In June 2004, the RBA hosted, in Sydney, the annual meeting of the BIS Working Party on Monetary Policy in Asia, which comprises senior central bank officials responsible for monetary policy.

There are a number of committees associated with the BIS and the Group of Ten (G10), including the Committee on the Global Financial System (CGFS) and the Markets Committee, in which the RBA participates along with a small number of other non-G10 countries. The aim of these committees is to promote information-sharing among central banks with the particular focus of identifying any vulnerabilities that might be emerging in the global financial system. The Markets Committee focuses mainly on examining developments in foreign exchange and capital markets. The CGFS has a wider remit, assessing potential sources of stress in the global financial environment. Discussions during the year focused on the likely impact on markets of the global economic recovery and the associated prospect of rising official interest rates. There was also much analysis of the impact of China's economic growth and economic policies on the world economy.

The CGFS undertakes some of its more detailed analysis of issues through working groups. During the past year, there were two such working groups, with the RBA represented on both. One of these working groups examined recent trends in foreign direct investment in the financial sectors of emerging market economies. The report of the working group, which was released in March 2004, found that the surge in financial sector foreign direct investment over the past decade has been instrumental in integrating emerging economies into the global financial system. This integration has brought substantial benefits to host countries' financial systems in terms of efficiency and stability. A second working group is examining the role of ratings agencies in structured finance and is expected to complete its report in the second half of 2004.

While the RBA is not a member of the BIS Committee on Payment and Settlement Systems (CPSS), it does from time to time participate in the Committee's working groups. During 2003/04, the RBA was represented on the CPSS Sub-Group on Foreign Exchange Settlement Risk, which monitors developments in foreign exchange settlement risk as well as providing the basis for co-operative oversight of Continuous Linked Settlement (CLS) Bank.

Executives' Meeting of East Asian and Pacific central banks (EMEAP)

EMEAP continues to be an important element of the RBA's approach to regional central bank co-operation. The group of 11 central banks from the region meet at Governor, Deputy Governor and working group level. The RBA is represented at all levels of EMEAP.

A central focus of EMEAP's work over the past year has been the second phase of the Asian Bond Fund initiative (ABF2). This initiative is aimed at developing bond markets in the Asian region. The first step (ABF1), which became operational in July 2003, pooled US$1 billion of member central banks' foreign exchange reserves in the Fund which in turn invested in US dollar denominated bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies (except Japan, Australia and New Zealand, which already have developed bond markets). ABF2 will be more significant for bond market development as it will invest in local currency denominated bonds. The objective of the initiative is to identify and remove impediments to investment in Asian bond markets and to facilitate private sector investment by improving market infrastructure. The size of the Fund will deliberately be kept small so as not to crowd out private sector investment. While the initial investment is limited to EMEAP central banks, ABF2 is being designed to facilitate investment by private sector and non-EMEAP public sector investors. Work is proceeding on various technical issues involved in setting up the Fund.

Financial Stability Forum

Since its inception in 1999, the Financial Stability Forum has contributed to co-operative efforts and information exchange between authorities responsible for financial supervision, surveillance and stability. Its members are drawn from the central banks, finance ministries and supervisory agencies of the G7 countries and the governors of the central banks of four other economies with globally significant markets (Australia, Hong Kong, the Netherlands and Singapore).

Evaluating the risks facing the international financial system has formed an important part of the Forum's work. The Forum judged the global economy and financial conditions to be improving during the past financial year. Nonetheless it was recognised that the outlook was not without risk, including from the high level of oil prices, the imbalances between major economies, and high levels of household indebtedness.

The Forum has taken an active interest in measures to strengthen the international financial system. Over the past year, it has reviewed progress in work aimed at improving financial reporting, including the move towards international accounting standards and reforms to the process of setting international audit standards. Steps are also being taken to improve transparency and disclosure in the reinsurance industry. It is intended that a range of new information on reinsurance activity worldwide will be available by the end of this year. Efforts will now concentrate on raising the level of public disclosure by individual reinsurers, particularly in relation to their risk exposures and the financial resources they have available to absorb potential losses.

The Forum has also continued its work on improving the quality of information available about credit risk transfer markets. Over the past year, it has worked to identify the principal participants in the market, the main risks incurred and the risk management practices employed. It has also sought information on the effectiveness of credit risk transfer – in particular, whether credit risk transfer has led to undue concentrations of risk that might threaten financial stability and whether buyers of credit risk understand the risks they undertake. The preliminary conclusions are positive – the evidence suggests that credit risk transfer is generally effective in reducing risk concentrations and promoting price discovery.

Group of Twenty (G20)

The G20 was established in 1999 with the aim of providing a forum for discussions on major economic and financial policy issues and promoting sustainable and equitable economic growth through international co-operation. The G20 brings together a cross-section of systemically significant economies along with the European Union, the IMF and the World Bank. The Ministerial meeting, where Australia is represented by the Treasurer and the Governor, is convened annually, while Deputies' meetings of central bank and finance ministry officials are held twice-yearly.

Over time, members' experiences with globalisation have become a focus of the G20's work. The current G20 agenda builds on this work with discussion now focusing on the role of financial sector institution building in maximising the benefits of globalisation and promoting economic growth. During the year, member countries finalised case studies on this topic which are due to be published in a consolidated form in 2004. The Australian case study was prepared jointly by the Treasury and the RBA.

The G20, along with the IMF, has also continued its work promoting crisis prevention and resolution measures. At the G20 Ministerial meeting in October 2003, members welcomed the increasing use of collective action clauses (CACs) in sovereign bond contracts. RBA staff have actively participated in the debate on the use of CACs, with research concluding that CACs do not increase borrowing costs for sovereign bond issuers. Recently, the G20's main focus has been on the development of a voluntary code of conduct aimed at improving the framework for the more orderly workout of sovereign debt crises.

Other issues discussed by the G20 during the year included combating abuse of the financial system, improving the effectiveness of official development assistance, financial integration and growth.

International Monetary Fund (IMF)

While the Treasury bears the primary responsibility for Australia's relationship with the IMF, the RBA has a supporting role, particularly to do with monetary and financial matters. As well as Executive Board decisions to grant assistance to countries experiencing balance of payments difficulties, other issues to which the RBA contributed in the past year included the review of the framework for granting exceptional access to IMF resources, efforts to enhance the quality and effectiveness of IMF surveillance, policies to strengthen the framework for crisis prevention and resolution, and measures to combat money laundering and the financing of terrorism.

APEC Finance Ministers' Process

The APEC Finance Ministers' process during the past year has continued its focus on issues associated with bond market development. An RBA official has acted as Convenor of the Expert Panel for Thailand in the APEC initiative on Securitisation and Credit Guarantee Markets in Asia. In addition, the RBA participated in a number of policy dialogues organised by APEC on financial sector issues. The 2004 APEC Future Economic Leaders Think Tank was again held at the RBA's training centre at Kirribilli. Sponsored by Axiss, the aim of the Think Tank was to bring together promising public sector managers from around the region to discuss policy issues of relevance to member countries. This year's conference, which was held in late June, focused on policy responses affecting capital flows in the region.

Bilateral Relations and Assistance

The RBA continues actively to support developing economies' central banks through training and technical assistance, so as to improve the knowledge of their staff and the effectiveness of their operations. Just as the range and focus of general international co-operation has changed in recent years, so has the manner in which technical assistance and training are provided. One-off, long-term secondments of RBA officers to developing country institutions are now rare, though in certain cases they still have a role to play. More common, on the other hand, are short-term training and technical assistance missions (often involving a number of visits), attachments of developing country staff to the RBA, and formal programs of lectures or seminars.

In 2003/04, most of the RBA's assistance was focused on the areas of monetary policy design and implementation, debt management, foreign exchange markets, reserves management, and the payments system. On a bilateral basis, staff visited the central banks in Egypt, Fiji and Tonga to offer technical assistance in some of these areas. In conjunction with the IMF, a member of staff also provided technical assistance in the payments system area to the National Bank of the Republic of Macedonia.

RBA staff are regularly requested to participate as presenters in training courses in the region. During the year staff visited Indonesia, Malaysia, Singapore and Thailand for this purpose, mainly to assist in courses sponsored by multilateral institutions. The RBA also hosted a number of visits by staff and delegations of other central banks who visited to improve their knowledge and understanding of core policy functions. Visitors in these areas were received from China, Indonesia and Thailand during the year.

Beyond core policy functions, central banks are also working co-operatively on areas such as internal audit, relationships with governments, budgets and planning, human resources, accounting systems and standards, and risk management (encompassing not only financial risk but also the security of both physical premises and electronic communication and data storage systems). The RBA provided assistance in several of these areas to a number of central banks, including those from China, Fiji, Indonesia, Malawi, Pakistan, Papua New Guinea and Thailand.

The RBA has occasionally been requested to assist the Asia/Pacific Group on Money Laundering in its mutual evaluations of member jurisdictions. These evaluations aim to identify where a member's legal, supervisory and law enforcement systems do not meet the international standards for preventing money laundering and combating the financing of terrorism. The objective is to assist members improve their systems rather than draw up a critique. During the year a member of staff participated in the evaluation of the Philippines.

In a similar vein, the RBA has on occasion made its HC Coombs training centre available to multilateral non-profit organisations hosting training programs for developing country participants. This is done in the spirit of assisting the advancement of developing countries and occurred twice in 2003/04, once for a regional workshop run by the Association of Financial Supervisors of Pacific Countries and once for a seminar for Pacific Island and some other neighbouring countries on Financial Soundness Indicators offered by the IMF.

Business Services

The RBA provides a range of services including banking services to the Australian Government and other customers; a registry of Commonwealth Government securities and other securities; payments and settlement services; and note issue services to banks. Where appropriate, services are provided on a commercial basis, with those services run as individual businesses which seek to recover their full costs, and earn a return on notional capital, through fees and charges.

The RBA's principal focus in carrying out these services as a central bank derives directly from the *Reserve Bank Act 1959* which says that:

- the RBA is empowered to carry on business as a central bank, and shall, in so far as the Commonwealth requires it to do so, act as banker and financial agent for the Commonwealth; and
- the RBA is empowered to print currency notes, and to issue, reissue and cancel currency notes.

Accordingly, the principal focus is:

- for banking and registry, to service the Commonwealth's requirements;
- for settlement services, to develop and operate a reliable payment and settlement system that ensures risks are well identified and controlled and that limits the spread of any problems that might arise; and
- for note issue services, to meet the community's requirements for clean, counterfeit-free currency.

These activities are carried out by the Business Services Group which comprises the Banking, Payments Settlements and Note Issue Departments. Services are delivered through Sydney, the branch in Canberra and via the National Note Processing and Distribution Centre (NNPDC) operated by the RBA's subsidiary, Note Printing Australia Limited (NPA), at Craigieburn,Victoria.

Banking

Banking services are provided to the Australian Government and to other customers, including 50 overseas official institutions and central banks.

The RBA provides a central banking facility to the Australian Government consisting of a group of bank accounts, known as the Official Public Account (OPA) Group, whose aggregate balances represent the Government's daily cash position. These banking arrangements include the provision of a term deposit facility for the investment of temporarily surplus funds, the sweeping of balances to and from agencies' accounts held with transactional bankers, and access to a strictly limited overdraft facility. To assist in monetary policy and liquidity management, this service also includes the electronic collection of forecasting data and reporting on high-value transactions from agencies and transactional bankers. The Department of Finance and Administration (Finance) manages this facility on behalf of the Australian Government. A new Central Banking and Related Services Agreement, replacing the previous agreement dating from August 2000, was executed with Finance during the year.

The other component of government banking business is the provision of transactional banking services to government agencies.

Traditional banking services offered by the RBA include bank account facilities and the processing of transactions such as deposits, cheques and bulk direct entry. The major services provided to government agencies are described below. Access to these services is usually via a dedicated leased line connection or via the *ReserveLink* electronic desktop banking package. In recent times, access has also been broadened to include *RBAnet*, an internet-based account and transaction enquiry system.

The Government Direct Entry Service (GDES) receives and processes bulk electronic direct credit and direct debit transactions from government agencies and distributes these to financial institutions. This service makes use of an extensive communication network and warehousing capabilities and is the main transactional banking activity performed by the RBA for its government banking customers. It has incorporated same-day settlement since its inception. GDES transactions processed include government welfare pensions, salaries and vendor payments; 217 million transactions were processed in 2003/04, an increase of 1 million from the previous year.

The RBA Overseas Banking Service provides customers with the ability to send instructions electronically for overseas payments to be made via draft, telegraphic transfer, or direct entry. This service provides government agencies with a secure, timely and cost-effective delivery mechanism for their regular overseas payments. For overseas direct entry payments, the RBA has now established Automated Clearing House arrangements in 22 countries on behalf of Centrelink for the distribution of Australian pension payments to overseas bank accounts in the local currency.

The Document Printing Service enables customers to send payment details electronically to the RBA for the issue of cheques and electronic documents on their behalf. For cheques, the RBA service includes the production, enveloping and mailing of the cheque together with an attached remittance advice. For electronic payments, the service provides for the delivery (by post, email or facsimile) of a remittance advice with the actual payment occurring via direct entry. The volumes of transactions processed via this service increased by 7.5 per cent in 2003/04.

The Cheque Reconciliation and Verification System offers a full cheque reconciliation service for government agencies as well as a verification system to detect whether or not a cheque has been fraudulently altered. This service, developed in-house, uses image technology to confirm that the details of a cheque presented for payment match details of the cheque when it was originally issued. This system enables the RBA to detect changes to cheque information quickly, thereby protecting itself and its customers from losses due to fraudulent cheque alteration. The system has proven to be highly beneficial to government agencies because it minimises their exposure to cheque fraud and has been a significant factor in reducing fraudulent alteration of government cheques.

Government Easypay is a telephone and internet collection service that allows government agencies, which would not normally have the volumes for a stand-alone service, to receive payments from clients using major credit cards. During 2003/04, the volume of collections via this service increased by 35 per cent as additional agencies commenced using this product.

Earnings after tax from transactional banking activities were $3.0 million in 2003/04, compared with $3.2 million in the previous year.

Business Developments

Activities during the past year focused on improving existing banking products and services and on working with major customers – including Centrelink, the Health Insurance Commission, and the Australian Taxation Office – on projects designed to improve processes and better satisfy their banking needs.

Work continued during the year on providing secure banking services via the internet, through *RBAnet*, which is now available to customers. This facility provides enquiry functions to assist customers with all their account, cheque and trace requirements. All information relating to banking transactions and cheque presentations is available on-line. For customers, a major feature of this system is the availability of high-resolution images of deposit transactions (and supporting cheques) and presented cheques (both the front and reverse sides). Given the often sensitive nature and high value of government payments, *RBAnet* does not provide for value payments to be effected via the internet. The RBA will continue to monitor internet security technologies and Australian Government guidelines in this regard. In the meantime *ReserveLink*, which offers a secure closed network environment for both data and value payment files, remains the main method for the transmission of files for the majority of government agencies.

Risk management practices and procedures for banking services are continually under review. This year, particular attention was given to the privacy and protection of customer data and to the standardisation of the methodologies used to identify and manage risks, in conjunction with the RBA's new Risk Management Unit.

During the past year, the RBA worked with a number of government agencies to help them meet their business continuity requirements in relation to payments. As a consequence of this initiative, government agencies are now offered a generic service which will, should an agency suffer a loss of key systems or personnel, allow that agency to continue making payments pending re-establishment of their internal operations and systems.

Arrangements for the provision of banking and safe custody services to overseas official institutions and central banks were also the subject of a detailed review during the year. The review resulted in the RBA adopting a consistent approach to the services offered, as arrangements for individual organisations had evolved separately over many years.

Registry

Registry services are provided to the Australian Government and a number of official foreign institutions which have Australian dollar debt programs. Services provided to all clients include the issue, transfer and registration of securities, the maintenance of ownership records, the distribution of interest payments and the redemption of securities at maturity. Additional services which are specific to the Commonwealth Registry include the management and encashment of physical securities; the maintenance of records relating to unclaimed Commonwealth Government securities (CGS) monies; the undertaking of historical searches; and the provision of a small investor facility which enables retail investors to access CGS.

Traditional paper-based registry activity remains low as in other recent years. This type of activity is now predominantly related to retail-based holdings as large institutional holdings of CGS are held and traded electronically outside the Commonwealth Registry in Austraclear.

Earnings after tax for the CGS registry business in 2003/04 were $0.1 million, the same as in the previous year.

Settlement Services

RTGS and Other Settlement Services

About 90 per cent of the value of interbank payments is settled on a real-time gross settlement (RTGS) basis; this includes all wholesale debt and money market settlements, a range of time-critical customer payments and Australian dollar foreign exchange settlements (including those settled by CLS Bank for which a net settlement is made daily on an RTGS basis).

The Reserve Bank Information and Transfer System (RITS) is the means by which banks and other approved institutions settle these RTGS and other interbank payments across their Exchange Settlement Accounts (ESAs) conducted with the RBA.

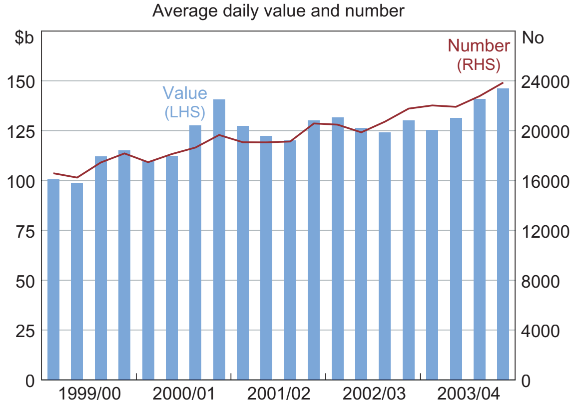
RTGS turnover through RITS grew strongly in 2003/04 in terms of both value and number of payments settled. On average, around 22 600 payments totalling $136 billion were settled across RITS each day. This represented growth of 9.3 per cent and 6.0 per cent, respectively, on the corresponding figures for the previous financial year. The percentage increase in value settled was the largest annual increase since 2000/01; the increase for volume was the highest recorded since the commencement of RTGS in June 1998. The end of financial year on 30 June 2004 saw a daily volume of 35 512 transactions, a record for any single day.

Previous annual reports have discussed the introduction of the Continuous Linked Settlement (CLS) initiative to reduce foreign exchange settlement risk. To the extent that Australian dollar foreign exchange settlements take place across CLS Bank rather than direct gross payments across RITS, CLS was expected to reduce, over time, the number and value of transactions settled by RITS. To date, however, there has been no discernible impact on the continued growth of RITS settlements.

Graph 9

RTGS Transactions

Average daily value and number



Source: RBA

In addition to RTGS payments, RITS settles two batches of netted interbank payments each day. The 9.00am batch consists of positions collated by the RBA on behalf of the Australian Payments Clearing Association arising from the previous day's "low value" clearings (paper, and bulk and retail electronic). The second batch settles net positions for equity transactions in CHESS, the electronic settlement system operated by the Australian Stock Exchange.

RITS also provides a facility for members to participate in electronic tenders for Commonwealth Government securities (CGS). Since February 2002, settlement of successful tender bids has occurred in the Austraclear System, owned by SFE Corporation Limited.

The RBA is working on two major initiatives to improve the functionality provided by RITS to its ESA holders.

The first is the redevelopment of the user interface for on-line access to RITS, used for management of ESAs and RTGS payments, and for participating in CGS tenders (the latter facility is available to all members of RITS).

The objective is to provide a modern windows-based interface that will be simpler for users to learn and operate, provide improved access to account information and provide a better footing for future system development and support. At this stage, the RBA is planning for members to be able to use the new interface by around the middle of 2005.

The other major project under way is the development of improved facilities for the net settlement of batches of related low-value payments at any time during the main RITS business day. These batches could be submitted by any entity approved by the RBA to act as a batch administrator for a particular business stream. One potential use for this new facility, also expected to be available around the middle of 2005, is an initiative in various States to move towards electronic conveyancing and settlement of property transactions, to replace the current use of bank cheques.

Settlement services are also provided for financial market transactions undertaken by the RBA in the domestic securities and foreign exchange markets, and other transactions such as those relating to currency note lodgments and withdrawals. Settlement services are also provided for the Government for their high-value transactions including, for example, the settlement of tenders in CGS. Twenty-eight overseas central banks and official institutions have settlement and safe custody facilities through which the RBA settles their Australian dollar investment transactions.

Note Issue

The note issue functions include the issue and redemption of notes; the machine processing of notes returned from circulation for checking quality and authentication and the destruction of notes no longer fit for further use; organising the production of new notes; general oversight of cash distribution arrangements; and research into counterfeiting activity, new note designs and security features.

Notes on Issue

The value of Australian notes on issue rose by $1.85 billion or 5.7 per cent over 2003/04 to $34.0 billion. The increase occurred relatively evenly across all denominations, except the

Value of Notes on Issue
($ million)

At end June	$1(a)	$2(b)	$5	$10	$20	$50	$100	Total	Increase (Per cent)
1998	19	47	361	617	1 804	9 523	9 280	21 651	7.9
1999	0(c)	46	379	639	1 850	10 356	10 282	23 552	8.8
2000	0(c)	46	397	646	1 917	11 188	11 240	25 434	8.0
2001	0(c)	45	431	662	2 014	12 055	11 961	27 168	6.8
2002	0(c)	45	530	791	2 789	14 718	13 057	31 930	17.5
2003	0(c)	45	515	759	2 510	14 918	13 426	32 173	0.8
2004	0(c)	0(c)	533	791	2 533	15 941	14 224	34 022	5.7

(a) Last issued May 1984
(b) Last issued June 1988
(c) See Notes To and Forming Part of the Financial Statements, Note 1(k)

$20 which experienced a smaller increase than other denominations. Numbers of the higher denomination notes continued to grow somewhat more quickly in 2003/04 than the smaller denominations.

Note Processing

Centralised processing of redeemed notes is performed at the National Note Printing and Distribution Centre (NNPDC) at Craigieburn, Victoria. Armoured car companies transport notes to and from the NNPDC on behalf of the commercial banks. Under agreements between the RBA and the commercial banks, unfit notes, surplus fit notes (following seasonal peaks in demand), and notes requested by the RBA for quality sampling purposes are returned to the NNPDC. As surplus fit notes have already been sorted by banks, they are not resorted by the NNPDC. Commercial banks also draw notes from the NNPDC to meet demand when they cannot meet their requirements from their own holdings or by obtaining them from other banks with note surpluses. Notes that have been previously lodged by banks as surplus fit are used first in meeting banks' orders.

During 2003/04, 280 million notes ($9 billion) were issued (despatched from the NNPDC) and 244 million ($7 billion) were redeemed (returned to the NNPDC). This level of activity is some 32 per cent higher than the previous year.

Of the 280 million notes issued in 2003/04, 123 million were new notes and 157 million were previously circulated notes that were reissued after they had been returned to the NNPDC, processed and judged fit for reissue.

Of the 244 million notes returned to the NNPDC, 196 million notes were processed through high-speed note processing equipment for verification, authentication and quality control compared to 199 million notes processed during 2002/03. Notes deemed fit for reissue represented 47 per cent of notes processed compared to 41 per cent last year. The remaining 48 million notes were surplus fit notes returned to the NNPDC by commercial banks after Christmas or Easter.

Over the past couple of years, the RBA has noticed a decline in the quality of the lower denomination notes received in its sampling program. In order to improve the general quality of notes in circulation, new procedures have been developed with commercial banks and armoured car companies to improve note sorting standards and remove greater volumes of unfit notes from circulation for return to the NNPDC for destruction. As part of this process, commercial banks and armoured car companies have been provided with a revised version of the RBA's Note Sorting Guide.

The RBA has continued the process of evaluating a replacement for its high-speed note processing machines with new machines incorporating improved detectors to identify unfit notes. The new machines should enable a further expansion of the sampling program and better monitoring of compliance with sorting standards by commercial banks and armoured car companies.

The NNPDC also assesses the value of mutilated notes that are difficult for commercial banks to assess accurately and confirms the value of those assessed by commercial banks. During the year the NNPDC assessed 11 200 mutilated note claims with a total value of $2.5 million. The volume of claims assessed was slightly higher than last year but the value was slightly less. During the year, a revised policy for mutilated notes was introduced. Among other changes, it is now necessary to have more than 80 per cent of a note to receive full value. If less than 20 per cent of a note is present (previously less than 50 per cent) no value is given. If between 20 and 80 per cent, value is paid on the percentage of the note present. The new policy is available on the RBA's website.

New Note Orders

The RBA ordered a total of 78 million new Australian notes in 2003/04 from Note Printing Australia. This was made up of 18 million $5 notes, 9 million $20 notes, and 51 million $50 notes.

Distribution

Under arrangements for note and coin distribution introduced in November 2001, the commercial banks own the working stocks of notes and coin required to operate the cash distribution system and are encouraged to deal directly with each other to manage any short-term surplus or deficit in their holdings of currency. Under previous arrangements, the RBA owned the working stocks and commercial banks dealt directly with the RBA for their individual note and coin requirements.

During 2003/04, commercial bank holdings of working stocks were on average some $370 million lower than during the previous year, due to increased efficiencies in cash management procedures.

The RBA pays commercial banks interest forgone on banks' working stocks of notes and coin up to a specified amount, provided the stocks are held in approved cash centres and notes are sorted for quality. The sorting standard is set and monitored by the RBA. As commercial banks gain more experience with these arrangements and further progress is made in developing more efficient distribution and exchange arrangements between them, it is expected that working stock levels will continue to decline.

The RBA bears the cost of producing new notes, costs associated with the return of unfit and sampling notes, and the holding costs of the working stocks up to a specified limit. All other costs associated with the distribution of cash are met by others, including commercial banks, retailers and the public.

Counterfeiting Activity

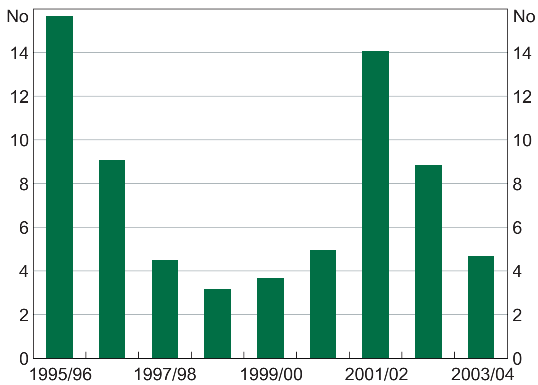
Counterfeiting activity declined in 2003/04, with around five counterfeits passed per million notes in circulation, compared to around nine counterfeits per million in the previous year. Around 3 600 relatively low-quality counterfeits were passed, with a face value of about $187 500. Much of the fall was attributable to a reduced level of counterfeiting of the $50 note. However, the majority of counterfeits was still of the $50 note; the remainder was largely $100 counterfeits. Counterfeiting activity remains low and Australia's experience compares favourably with that of most other countries. Almost all counterfeits (95 per cent) were paper reproductions of polymer series notes, and were easily detected by visual inspection, as well as by feel.

Notwithstanding the low level of counterfeiting activity, the RBA has an active research and development program aimed at continually improving the security of polymer notes by using features that are not easily reproducible by technology available to counterfeiters.

Graph 10

Counterfeits Passed

Per million notes in circulation



Source: RBA

Note Printing Australia and Securency

Note Printing Australia

Note Printing Australia Limited (NPA), based at Craigieburn in Victoria, is a wholly owned subsidiary of the RBA producing banknotes, passports and other security documents for Australia and for export. It is the world pioneer in using polymer substrate and associated security features in manufacturing banknotes and it prints on Guardian® substrate manufactured by Securency Pty Ltd (see over).

NPA's Board operates under a charter from the Reserve Bank Board and comprises chairman Graeme Thompson (a former Deputy Governor of the RBA), Richard Warburton (a former non-executive member of the Reserve Bank Board), Les Austin (a former Assistant Governor of the RBA), Mark Bethwaite (Chief Executive of Australian Business Ltd) and recently appointed Frank Campbell (an Assistant Governor of the RBA).

John Leckenby, NPA's Chief Executive since 1998, retired in mid 2004. Chris Ogilvy is the newly appointed Chief Executive, joining NPA with long experience in the security printing and credit card industries.

During 2003/04, NPA produced 78 million banknotes for the RBA and 87 million export banknotes. An important activity was fulfilling an order for the Monetary Authority of Singapore that issued its first circulating polymer banknote. NPA also worked closely with Vietnamese and Romanian authorities and their printers on the design and production of polymer banknotes issued in those countries.

For 2004/05, in addition to the RBA's requirements, NPA has confirmed orders for the production and delivery of over 300 million export banknotes in Asia, the Pacific and South America. Two-thirds of these are for new customers to polymer banknotes, the remainder being repeat orders.

Full production commenced late in 2003 of the printing and assembly of the new Australian passport for the Department of Foreign Affairs and Trade (DFAT), with new design elements and novel security devices. The next phase in the development and production of Australian passports is the chip insertion program on which NPA has been working closely with DFAT.

NPA operates the National Note Processing and Distribution Centre (NNPDC), under contract with the RBA. The NNPDC, which dispatches and receives notes from commercial banks and processes most notes received, is undergoing a major upgrade of its processing equipment. Acceptance testing of the new equipment commenced in July 2004, with full integration expected by end 2004.

During the year, NPA introduced a new inspection system to improve the quality of notes and reduce reliance on manual examination. Partly because of this, it restructured its activities

NPA Polymer Notes Export Orders

Year of first issue	Customer	Denomination	Issue
1990	Singapore	50 Dollar	Commemorative
1991	Western Samoa	2 Tala	Circulating
1991	Papua New Guinea	2 Kina	Special Issue Circulating
1993	Kuwait	1 Dinar	Commemorative
1994	Indonesia	50 000 Rupiah	Special Issue Circulating
1995	Papua New Guinea	2 Kina	Special Issue Circulating
1996	Papua New Guinea	2 Kina	Circulating
1996	Brunei Darussalam	1, 5, 10 Dollar	Circulating
1996	Thailand	50 Baht	Commemorative
		500 Baht	Special Issue Circulating
1997	Thailand	50 Baht	Circulating
1997	Western Samoa	2 Tala	Circulating
1998	Sri Lanka	200 Rupee	Circulating
1998	Malaysia	50 Ringgit	Commemorative
1999	New Zealand	5, 10, 20, 50 & 100 Dollar	Circulating
		10 Dollar Millennium	Commemorative
1999	Papua New Guinea	50 Kina	Circulating
1999	Romania	2 000 Lei	Commemorative/Circulating
1999	Indonesia	100 000 Rupiah	Circulating
2000	Romania	10 000 Lei	Circulating
2000	Romania	500 000 Lei	Circulating
2000	Papua New Guinea	2, 10, 50 Kina	Special Issue Circulating
2000	Papua New Guinea	10 Kina	Circulating
2000	Bangladesh	10 Taka	Circulating
2001	Kuwait	1 Dinar	Commemorative
2001	Solomon Islands	2 Dollar	Special Issue Circulating
2002	Mexico	20 Peso	Circulating
2002	Nepal	10 Rupee	Circulating
2003	Papua New Guinea	20 Kina	Commemorative
2003	Vietnam	50 000 Dong	Circulating
2004	Singapore	10 Dollar	Commemorative/Circulating

and reduced staffing levels by 31. The current workforce of 200 is employed under an enterprise bargaining agreement that was renegotiated in early 2004.

NPA has continued to work closely with Securency on research and development, marketing and customer support. Securency's marketing strategy includes NPA printing "start-up" orders for those countries with their own printworks which are converting from paper to polymer banknotes. These "start-up" volumes are produced as part of a formal technology, training and knowledge transfer program conducted by PolyTeQ Services, a joint initiative of NPA and Securency. This assists banknote printers and issuers with all facets of the conversion from paper to polymer, drawing on the now extensive experience available from Australia and other countries.

In May 2004, Australia Post issued a series of five stamps commemorating Australian Innovations. One of those stamps acknowledged polymer currency, with an image from the $50 note.

The development and production of polymer banknotes by NPA was acknowledged by Australia Post in its "Australian Innovations" commemorative stamp issue in 2004.

Securency

Securency Pty Ltd was formed in 1996 as a joint venture between the RBA and Belgian-based UCB Group, a manufacturer of unique polypropylene films, resins, coatings and pharmaceuticals. In mid 2004 a consortium led by Candover PLC, a leading UK private equity company, announced that it would acquire UCB's films division, including the interest in Securency.

Securency supplies its press-ready polymer substrate, Guardian®, to NPA and to overseas printers for banknotes, Sentinel® for other high-security documents such as land titles, and Sentrii™ for secure cards. These products are produced by applying unique coatings and security features to specialised films.

Securency's Board comprises three directors appointed by the RBA, three appointed by its joint venture partner and the company's Managing Director, as a non-voting member. Myles Curtis has been Securency's Managing Director since 1996. Securency's offices and plant are located at Craigieburn, on the same site as NPA and adjacent to the films plant that supplies it.

In 2003/04, Securency produced substrate for a range of banknote denominations in Australia, Brunei, Malaysia, New Zealand, Papua New Guinea, Romania, Singapore and

Zambia. These included both repeat orders and new customers. The major order was from the State Bank of Vietnam, which subsequently issued the new VND50 000 and VND500 000 polymer notes in December 2003. The polymer VND50 000 replaced an existing paper note and is a widely circulating note dispensed by automated telling machines, while the VND500 000 is a new denomination. The decision to introduce polymer followed several years of evaluation and printing trials by Vietnam's National Banknote Printing Plant.

In another significant development, the Bank of Zambia issued two denominations on polymer, the 500 and 1000 Kwacha. These were the first polymer notes to be issued on the African continent and were printed by the Canadian Bank Note Company. Securency also won some important new contracts in Asia and South America that will result in new note issues later in 2004. Meanwhile, circulation trials in Brazil and Mexico are progressing well, with the authorities in both cases considering issuing further denominations.

The international market remains very competitive with excess printing capacity and security paper manufacturers determined to retain long-established customers. Even so, Securency is continuing to make headway in building an export market and establishing polymer as a highly credible alternative to traditional paper. In all, 22 countries have now issued polymer banknotes – another two will soon be added – with representatives on all continents. Australia, New Zealand and Romania have converted all their denominations to polymer.

To broaden its market, Securency plans to market polymer substrate for secure documents and payment/identification cards.

An increase in sales, higher average margins due to the inclusion of advanced security features, and tighter cost control each contributed to a stronger bottom line result for Securency in 2003/04. There was more economical use of material due to lower spoilage (assisted by longer production runs) and better management of stocks of raw materials. The stronger Australian dollar helped reduce the cost of imported materials.

During the year, Securency purchased the pre-press equipment of Toyo Ink (Australia) Pty Ltd to ensure guaranteed domestic access to engraved printing cylinders and also bring in-house an important element of the production process. It also invested in a purpose-built sheeter to improve efficiency. Both of these acquisitions became operational in recent months. Securency was awarded ISO14001:1996 Environment Management System Accreditation in April 2004.

In co-operation with its partners, including NPA and the RBA, Securency conducts research into new security features for polymer notes. A new self-authenticating feature is due to be released on a commercial basis later this year.

The RBA in the Community

Activities of the Regional Offices

An important dimension of the RBA's presence in the community is its Regional Office program. There are Regional Offices in Adelaide, Brisbane, Melbourne and Perth. The Melbourne Office also services Tasmania, the Brisbane Office services the Northern Territory and staff in Head Office service New South Wales and the Australian Capital Territory. The Regional Offices have two main roles. One is economic intelligence gathering, with economists in the Regional Offices seeking timely information about business conditions to help inform the economic assessments made as an input to the conduct of monetary policy. A second role is representation, where the presence of RBA staff in regional locations is intended to improve communication between the RBA and the wider community.

The liaison function of the Regional Offices ensures that staff interact with a broad cross-section of the community. RBA staff have cultivated a pool of around 1 400 contacts with which liaison is conducted. The bulk of these are firms, though an important part of the program is liaison with industry associations and government. In particular, there is a relatively high frequency of contact with industry associations. Also, as relationships are becoming well established, there is a growing amount of repeat contact with firms. The amount of liaison has grown steadily over the past few years, and has now levelled out at around 90 contacts per month.

In addition to their contact with businesses and other agencies, Regional Office staff are the first point of contact with the RBA for the public in their States, fielding a large number of enquiries about the role of the RBA, economic statistics and monetary policy decisions. The RBA's presence in the community has also been elevated by the hosting of functions in the Regional Offices. Three of the Offices have hosted Board meetings. Presentations on the *Statement on Monetary Policy* have become a regular occurrence, and are given by senior managers from Head Office who communicate the main themes of the Statement to liaison contacts, as well as engage in discussion with participants. Other RBA staff from Head Office have visited the regions, and given presentations on research work, while Regional Office staff have given presentations to the public in their cities. Many of these have been to teachers' associations, but they have also included presentations to local industry bodies and universities. They have generally been about the framework for monetary policy or current economic conditions.

Accountability

The RBA appears twice-yearly before the House of Representatives Standing Committee on Economics, Finance and Public Administration. In the past year, the Governor and senior officers appeared at hearings in Brisbane and Sydney to respond to the Committee's questions on a range of issues including the domestic and international economic outlook, monetary policy, the exchange rate, housing prices and household debt, payments system reform and governance.

These hearings are open to the media and the public and the proceedings are widely reported. The hearings supplement the long-established legal requirement for the tabling in Parliament of an annual report on operations and financial accounts.

The RBA reports on its analysis of economic and financial conditions, the outlook for inflation and the reasons for recent policy decisions in a detailed quarterly *Statement on Monetary Policy*. Published in February, May, August and November, these Statements keep the wider community informed of the RBA's thinking on monetary policy matters and are a key ingredient in the Parliamentary Committee's discussions with the Governor and officers.

Communication

In addition to these formal requirements, the RBA publishes comprehensive and timely information on all its functions and operations. Speeches are also an important way of communicating the RBA's views and explaining previous interest rate decisions. Over the past year, the Governor and senior officers gave speeches on topics such as the international economy, the economic outlook, financial system stability, regional economic issues, and structural change and risks in the economy.

The *Bulletin*, published monthly, records material such as recent speeches, media releases and statistics and also is a source of articles not published elsewhere on specific topics. In 2003/04, there were articles on household sector developments, financial markets, bank fees, aspects of payments systems and credit risk.

At the RBA's conference on *The Future of Inflation Targeting* (from left to right): Frederic Mishkin, Alfred Lerner Professor of Banking and Financial Institutions, Graduate School of Business, Columbia University; Dr José de Gregorio, Vice-Governor, Central Bank of Chile; and Takatoshi Ito, Professor, Research Center for Advanced Science and Technology, The University of Tokyo.

In March, a new half-yearly report – the *Financial Stability Review* – was introduced; it provides a detailed assessment of the state of the financial system, and identifies potential sources of risk. This new publication replaces the recent practice of including a review of financial system developments in the RBA's annual report.

In November 2003 the RBA made a submission to the Productivity Commission's *Inquiry on First Home Ownership*. This was subsequently published as RBA *Occasional Paper* number 16.

Research work by RBA staff is frequently published in the Research Discussion Paper (RDP) series. In 2003/04, eleven RDPs were published. These covered a wide range of issues, including inflation targeting, asset prices, financial markets, and capital flows, as well as housing and household consumption, wealth and debt. Typically, this work is of interest to professional economists, though non-technical versions of some papers are published in the *Bulletin* to make the research work accessible to a broader audience. In addition to these publications, some staff have also had work published outside the RBA, including in a number of prominent domestic and foreign economic journals. This included, for example, a paper on uncertainty and monetary policy published in the *Economic Record*; a paper on sovereign-debt restructuring published in *International Finance*; and a paper on wage-setting behaviour published in the *Australian Journal of Labour Economics*. While many of the RDPs and externally published papers focus on questions relevant to policy, they represent the views of the authors rather than the RBA and are designed to promote discussion and debate among researchers in these fields.

Each year since 1989, a conference has been held in Sydney to discuss a topic of general interest to policy makers, academics, financial market participants and the general public. This year's conference, titled *The Future of Inflation Targeting*, focused on four main themes: the evolution of inflation targeting regimes, the measurement of inflation, central bank communication, and how inflation targeting might need to adapt to future challenges. In addition to a number of prominent overseas and Australian academics and financial market practitioners, the conference brought together senior staff from a range of central banks around the world. As in previous years, the papers presented at the conference will be published by the RBA in a conference volume towards the end of the year.

The way in which the RBA provides information continues to evolve. The main development has been further strong growth in use of the website. The number of subscribers to the free email services for information posted on the website grew by around 50 per cent to 8 500 over the past year. All information on the website is available free of charge and the RBA continues to seek opportunities to enhance the usefulness and accessibility of the site. Over the past year, a new section on the RBA's domestic market operations was included and the search engine and glossary of terms used on the site were upgraded.

The RBA chairs the Small Business Advisory Panel. This panel was established in 1993 and meets annually to discuss issues relating to the provision of finance for small businesses. Membership of the Panel is drawn from across the country and from a wide range of industries. The Panel represents a valuable source of information on the financial conditions faced by small business.

A project to build a Museum of Australian Currency Notes is close to completion. The museum will tell the story of Australia's currency notes against the background of the country's economic and social development. The museum is located on the ground floor of the Head Office in Sydney and entry will be free of charge. Much of the material in the museum will be reproduced on the RBA website to assist access to the museum from outside Sydney.

RBA Archives' staff, Virginia MacDonald and Cheryl Lindwall, reviewing possible exhibits for the new Museum of Australian Currency Notes.

Paul Barry, Information Department, and Ed Jacka, Facilities Management Department, review progress on the construction work for the Museum, with one of the outside contractors (centre).

Financial Assistance for Economic and Financial Research and Education

The RBA has over many years provided assistance for a variety of research activities which are closely aligned with the Bank's core functions. Ongoing funding has been provided towards the costs of a monthly survey of inflation expectations, undertaken by the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne, and of a quarterly survey of union inflation and wage expectations, by the Australian Centre for Industrial Relations Research and Training at the University of Sydney.

Scholarships under the Elite Executive Honours Scholarship Program, organised by Axiss Australia, the government agency charged with positioning Australia as a global financial services centre, were again supported during 2003/04. This year, the two scholarships funded by the RBA under this Program were for study, respectively, at the Queensland University of Technology in Brisbane and the University of Sydney. The RBA also jointly sponsors, along with the Australian Prudential Regulation Authority (APRA), the Brian Gray Scholarship Program, initiated in 2002 in memory of a former senior officer of the RBA and APRA; four scholarships for 2004 were awarded under this Program, to Honours students for study at the Australian National University (two scholarships), the Queensland University of Technology and the University of Melbourne.

Financial assistance to Australian universities each year includes contributions towards the costs of their organising conferences in economics and closely related fields. In 2003/04, these conferences included: the 2003 Australasian Meeting of the Econometric Society, held at the University of New South Wales in July 2003; the 32nd Conference of Economists, organised by the Economic Society of Australia (Canberra Branch) in Canberra in September/October 2003; and the annual Conference for PhD students in Economics and Business, held at the University of Western Australia in Perth in November 2003. In 2004, a modest financial contribution was provided towards the costs of the Australian and New Zealand Economic and Business Studies Competitions for senior secondary students, which are organised by a committee of students from the Commerce and Economics Society at the University of New South Wales.

Along with a number of other central banks, the RBA made a regular contribution to the reconstituted International Accounting Standards Committee.

Charitable Donations

During the year, the RBA maintained the level of its financial support for charitable organisations, contributing a total of $20 000 to 16 Australian charities which seek to address a broad range of medical problems and disabilities. In addition, the RBA made its second annual contribution of $55 000 to the Financial Markets Foundation for Children, of which the Governor is Chairman; along with a number of other major Australian financial institutions, the RBA has committed to support the Foundation to this extent for a further eight years.

Statutory obligations

Equal Employment Opportunity (EEO)

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the RBA reports to the Australian Parliament each year on its EEO Program. The Equity & Diversity Annual Report 2003 was tabled on 14 October 2003, and included a review of the RBA's Disability Action Plan.

Health and Safety, Compensation and Rehabilitation

The RBA is required, by Section 74 of the *Occupational Health and Safety (Commonwealth Employment) Act 1991 (OH&S Act)* and the conditions of its licence as a Licensed Authority under the *Safety, Rehabilitation and Compensation Act 1988*, to report each year on matters of health and safety, workers' compensation and rehabilitation as they affect the RBA.

The RBA's licence to self insure and manage claims expired at end June 2004; a new licence for a further three-year term was granted by the Safety, Rehabilitation and Compensation (SRC) Commission on 11 June. The number of incidents reported (88) and claims accepted (22) remains steady with the majority relating to travel and lunch-time sporting events. There were no incidents during the period which required notification to Comcare in terms of Section 68 of the *OH&S Act*. Early intervention in rehabilitation has resulted in only one formal return-to-work plan during 2003/04. The RBA's contract with Australia Post to undertake reconsiderations of workers' compensation determinations has been renewed from 1 July 2004; no requests for a reconsideration were received during 2003/04.

During the year, the management systems for prevention, rehabilitation and workers' compensation were reviewed by both independent auditors and auditors from Comcare. All audits confirmed that the RBA continues to comply with the requirements of its licence and relevant legislation. For 2004/05, the RBA has made application to the SRC Commission for self-audit status in OH&S.

As required by its licence conditions, the RBA provided a Management Systems Review and Improvement Program report to Comcare in March 2004. That report confirmed that the RBA continued to perform well against indicators set by the SRC Commission with evidence of continuing improvement shown.

Freedom of Information

Section 8 statement

The RBA is an exempt agency under the *Freedom of Information (FOI) Act 1982* in respect of documents concerning banking operations (including individual open market operations and foreign exchange dealings) and exchange control matters.

Organisation and functions: The RBA is Australia's central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the *Reserve Bank Act 1959*, the *Banking Act 1959*, the *Commonwealth Authorities and Companies Act 1997*, the *Payment Systems (Regulation) Act 1998*, the *Payment Systems and*

Netting Act 1998, the *Corporations Act 2001*, and the *Financial Services Reform Act 2001*, and in Regulations made under those Acts. An organisation chart appears at the end of this Report.

Categories of documents: Lists of publications, including speeches, articles, occasional papers, information booklets, conference volumes, regular media releases and other publications are published from time to time in the RBA *Bulletin*. Most of these publications, as well as other information about the RBA, are also included on the website (www.rba.gov.au). Other documents are held in the form of working notes and files covering policy and operational matters, statistical data, personnel, premises and general administration.

Facilities for access and Freedom of Information procedures: Inquiries under the *FOI Act*, including requests for access to documents, should be directed to the Secretary (in Head Office), the Senior Representatives in the Regional Offices (in Adelaide, Brisbane, Melbourne and Perth) or the Manager of the branch (in Canberra). Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available.

Section 93 statement

Seven requests, all from media organisations, for access to documents under the *FOI Act* were received in 2003/04 and, on a further request received by another Australian Government agency, that agency consulted the RBA for its views on certain documents; by comparison, four requests (including one transferred from another agency) were received in 2002/03. While the number of requests received by the RBA under the *FOI Act* may seem relatively small in comparison with those received by some other Australian Government agencies, the scope of the individual requests coming to the RBA is sometimes very extensive, and requires a large amount of staff resources, including senior management resources, to meet. The estimated number of staff hours spent on dealing with all aspects of the FOI requests in 2003/04 was around 500 hours and in 2002/03 almost 300 hours (i.e. an average of over 70 person-hours per individual FOI request). In 2003/04, access was granted in part on five of the requests (one of which had carried over from the previous year); access was denied on one request; one request was withdrawn by the applicant; and one request was still in progress at the end of the year. One application for internal review was received during 2003/04 (relating to a request which had been denied in part) and was being considered at year's end.

The total cost to the RBA of administering the *FOI Act* in 2003/04 was estimated to have been around $125 830, compared with approximately $60 900 in 2002/03. Application fees of $250 and charges of $1 418 were collected in 2003/04.

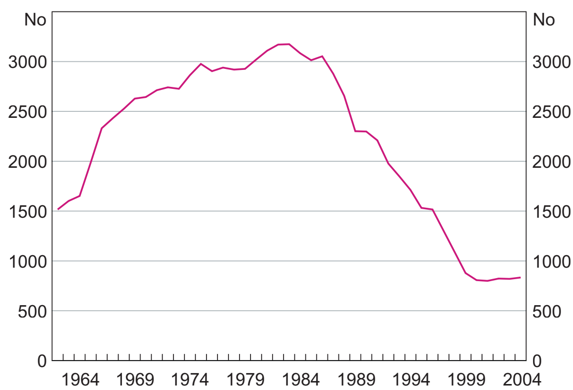
Management of the RBA

Overall staffing levels rose slightly in 2003/04 with total employees numbering 833 at 30 June. This small rise included an increase in staffing in the financial stability area of the Bank, as well as greater demands on IT skills as a program to improve computer systems in the payments and market areas began. More people were also working on the management of risk, both in co-ordinating this activity across the organisation and in improving arrangements for business continuity. By contrast with experience in a number of other recent years, there were no major staffing reductions in branches or elsewhere to offset the small increases in Head Office. More generally, the consolidation of activities evident for most of the past two decades has probably run its course. Further large staff reductions are unlikely as all of the branches, except Canberra, have now been closed, and all of the large efficiency gains have been realised from shedding activities, such as note distribution, limited outsourcing of some non-core services and from applying IT to labour-intensive processing work.

The network of Regional Offices was completed with the opening in 2003 of the office in Adelaide. This office moved to its new permanent premises in September 2003. The Regional Offices have a total complement of 13 staff, in Queensland, South Australia, Victoria and Western Australia. As outlined earlier in this Report, this network plays a key role in gathering information on economic conditions around Australia by liaising directly with businesses, government agencies, industry bodies and universities in the States concerned.

Graph 11

Number of RBA Staff*



* As at 30 June, excluding NPA
Source: RBA

The process of reviewing staffing policies is ongoing. Remuneration policies, although by no means the only relevant factor, are critical to recruiting and retaining staff of suitable quality. The benchmarking of remuneration continued in 2003/04 through participation in industry salary surveys and advice from external remuneration consultants. A further 50 positions from across the organisation were evaluated by the Hay Group with the aim of comparing remuneration with positions of similar responsibility in the private sector. The use of individual employment contracts has, in recent years, provided greater flexibility to match remuneration with responsibility and performance. As well as improving rewards, staff have agreed, within these contracts, to forgo certain entitlements, including housing assistance. None of the most senior staff now has a housing loan from the RBA. Almost 60 per cent of staff are employed on individual contracts, with 80 per cent of staff in managerial and professional positions on contracts. The move to individual contracts is entirely voluntary. Staff who decide against the offer of contract employment retain existing conditions of work.

For staff who remain on an industrial award, an enterprise bargaining agreement (EBA) for 2003 and 2004 provided the basis for changes to remuneration and other employment conditions. This EBA provides more flexibility than in the past to reward staff according to performance within existing budget constraints. Staff covered by this agreement received an annual salary increase of 4.0 per cent in November 2003; they will receive another increase of this size in November 2004. In 2003, staff on individual contracts received, on average, the same annual increase as staff covered by the EBA.

In recruiting, the RBA adopts practices to ensure that it is competitive in the market for high-calibre honours graduates in economics and related disciplines. Twenty-nine graduates, representing 25 per cent of all new employees in 2003/04, began a two-year Graduate Development Program. These graduates were employed mainly in the policy areas, although a small number had qualifications in information technology and accounting. In 2003/04, 28 graduates completed the Graduate Development Program; all were offered and accepted ongoing employment.

These recruitment efforts at the graduate level are supported by the Cadetship Program, which provides two months of work experience before the university honours year begins for students who have completed, to a high standard, three years of undergraduate study. This program also provides financial support during the honours year for cadets who accept a place on the next Graduate Development Program. Sixteen cadetships were offered in 2004. The Cadetship Program has played a leading part in recruiting staff of suitable quality. In 2003/04, for example, almost half of new graduates had been cadets the previous year. In addition to the graduate and cadetship intakes, employment for 11 trainees in business administration, IT and print design was provided through the Australian Government's New Apprenticeship and Traineeship System.

The emphasis on recruiting graduates reflects the sharper focus on the RBA's policy responsibilities as other parts of the organisation have contracted in size over the past two decades. Five years ago, positions in the professional and managerial streams comprised about 40 per cent of staff; this has now risen to almost 60 per cent. More than half of staff now have degree qualifications, while almost a fifth have post-graduate qualifications.

Training and development programs have evolved further in the past year. A new performance management scheme has been introduced, with an increased focus on identifying development needs of staff. Staff seeking to improve their formal qualifications are supported in a number of ways, including through the Post-Graduate Study Award (PGSA) Program. This program provides financial assistance each year to a few of the most capable recent graduates to permit them to undertake full-time post-graduate study in relevant disciplines at universities in Australia and overseas. At 30 June 2004, eight staff were studying overseas under the PGSA Program. Staff who receive these awards are required to agree to reimburse costs if they resign during the term of the award or if they leave the RBA before completing an agreed period of work after they return from their studies. Study assistance is also provided to other staff to obtain relevant qualifications. Fifty-one staff are currently undertaking part-time tertiary studies in Australia, the majority toward post-graduate qualifications. Tuition fees are met on the successful completion of course subjects.

Vocational training continues to be available to staff, much of which is delivered on-line. Face-to-face training courses, which typically make use of external experts to develop and deliver course content, are available in-house.

Further staff development is achieved through transfers and rotations within the organisation, including to overseas and regional offices. Secondments are also available to other relevant institutions. Over the past year, staff have worked at the Bank for International Settlements, the Bank of England, the Australian Treasury, the Australian Taxation Office and the Australian Prudential Regulation Authority (APRA).

Operating Costs

Total operating costs increased by 2.6 per cent in 2003/04 to $144.1 million. Notwithstanding this increase, total operating costs remain about 5 per cent lower in nominal terms than early in the previous decade. Operating costs during the year were boosted by costs associated with currency processing and distribution, as the new arrangements with armoured car companies became fully established and additional note sampling was undertaken. Legal costs in 2003/04 were lower because of the completion of the proceedings related to credit card reform. The RBA's costs were boosted by a total of $6.5 million in 2002/03 and 2003/04 by expenses associated with litigation over credit card reforms. Following a judgment in favour of the RBA, costs totalling $5.4 million were recovered.

The rise in staff costs reflected an annual increase in base salaries of 4 per cent in November 2003, plus some performance payments. Included in staff expenses was an amount of $3.3 million as the RBA recommenced employer contributions to the staff's defined benefit superannuation scheme, after a funding "holiday" since 2000. Total contributions to the staff superannuation fund amount to 9 per cent of salaries, including the contribution of 3 per cent for the productivity award. Average

Graph 12

Operating Costs[a]
($ million)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Staff costs	98.3	93.0	77.7	69.1	68.7	67.7	73.9	77.8	85.5
Other costs	43.2	43.4	47.2	49.1	56.1	54.1	58.4	62.7	58.6
Underlying operating costs	141.5	136.4	124.9	118.2	124.8	121.8	132.3	140.5	144.1
Cost of redundancies	1.3	7.5	20.7	18.4	9.3	2.6	3.4	2.6	0.2

(a) Costs associated with the ongoing operation of the RBA, excluding NPA.

staff levels in 2003/04 were around the level of the previous year. Nominal staff costs remain less than 85 per cent of their level at the peak in 1990/91. In real terms, staff costs are still about half their peak.

In recent years, over half of the RBA's operating costs have been incurred in the core policy areas of monetary policy and financial system surveillance. The apparent shift in resources towards policy areas from earlier years mainly reflects the fact that note issue and banking operations are now much smaller in absolute terms than they were, although there has also been some small increase in resources in the monetary policy and financial stability areas. Policy groups aside, the remaining costs are now spread fairly equally between note distribution, banking and registry operations, and the provision of settlement services. (Details on these activities are provided in the chapter on "Business Services".)

Settlement services account for a slightly increased share of costs following the introduction of RTGS and, subsequently, its in-house operation in recent years. While the share of resources devoted to note processing and distribution has risen in the past year, as the rate of note sampling has been lifted to levels that will provide greater confidence that notes in circulation remain of high quality, these costs are still much less than in the late 1990s. With

Distribution of Underlying Operating Costs[a]
(Per cent)

	Monetary policy	Financial system surveillance	Note distribution	Banking and registry	Settlement
1998/99	35	8	20	23	14
1999/00	35	8	23	20	14
2000/01	41	9	17	18	15
2001/02	43	9	15	18	15
2002/03[b]	45	10	13	17	15
2003/04[b]	46	10	15	14	15

(a) Excludes NPA

(b) Because costs of financial system surveillance have been distorted by costs associated with litigation, these latter costs are excluded from the figures in the table.

the consolidation of banking and registry activities, the share of total costs arising from these operations has declined in the last few years. This trend continued in 2003/04, with changes to cheque processing arrangements.

Facilities Management

The reduction in staffing in recent years, and the shedding of certain activities such as note distribution and branch banking, have greatly reduced the RBA's accommodation needs. The RBA has, as a result, sold the buildings it owned in Darwin, Brisbane, Hobart, Perth and Adelaide, which formerly housed its branches. The only premises it now owns interstate are in Melbourne and Canberra. These buildings are retained because there are business reasons for doing so, although most of the space in them is occupied by tenants. In addition, with the available space in Head Office exceeding requirements, almost four full floors have been leased to tenants.

Also within Head Office, significant progress has been made towards the completion of the Museum of Australian Currency Notes, located on the ground floor in an area previously occupied by a general display area. In conjunction with this project, access for people with disabilities is being upgraded to both the general banking chamber and the museum.

During the year, work commenced on the feasibility phase of a business resumption site. The feasibility phase involved site analysis, facility brief development and risk assessments. The program for the business resumption site is based upon securing a suitable site in 2004/05. The Bank has been assisted by external site and risk assessment specialists and independent cost planners.

The RBA has in recent years adopted a number of environmental policies, many of which have been cost-reducing, including policies to reduce consumption of electricity, gas and water. Energy consumption has been reduced by one third in recent years. Waste paper collection and other recycling practices have been adopted as have purchasing guidelines which encourage the purchase of recycled office products, where appropriate.

Consultancies

Like other large organisations, the RBA employs outside contractors to carry out specific tasks where necessary, and also, from time to time, uses consultants. A consultant is a person or organisation that investigates particular issues and then provides independent advice.

The following consultancies costing $10 000 or more were used during 2003/04:

Name	Project	Cost ($)	Purpose
Bassetts Consulting Engineers	Head Office Building	20 570	Feasibility study on upgrading Head Office electrical infrastructure and improving its resilience
Capital Insight Pty Ltd	Business Recovery (BR)	43 648	Risk assessment of proposed BR site
Gilbert & Tobin	RBA Board	19 679	Legal advice to Reserve Bank Board on its powers and delegations
Hay Group Pty Ltd	Personnel Practices	50 000	Market testing of remuneration of RBA staff
Mallesons Stephen Jacques	Purchased Payment Facilities	26 354	Legal costs associated with proposed regulation of Purchased Payment Facilities
Sinclair Knight Merz Pty Ltd	Business Recovery (BR)	85 800	Due diligence of proposed BR site
TEIMS (Australia) Pty Ltd	NPA IT systems	10 074	Review of information systems used by NPA to control business operations and provide financial information

Risk Management

Objectives and Governance Structure

The RBA is exposed to various risks in carrying out its duties. Financially, the biggest risks are those stemming from its operations in financial markets and the holding of assets needed to support those operations. Like any organisation, the RBA also faces a number of operational risks, ranging from the possibility of loss of key infrastructure as a result of a natural disaster or act of terrorism, to the possibility of fraud or other illegal behaviour on the part of employees. The RBA seeks to manage these risks and to reduce them to the maximum extent possible, consistent with carrying out its public policy responsibilities.

Day-to-day control of most risks is the responsibility of line management, in accordance with well-developed protocols and procedures. This is overseen by a high-level Risk Management Committee comprising the Deputy Governor as Chairman, the Assistant Governors of Financial Markets, Business Services and Corporate Services, the Heads of Audit and Risk Management, the General Counsel and Deputy Secretary. The primary task of the Committee is to ensure that the full spectrum of non-policy risks facing the RBA is assessed and properly managed by staff in accordance with the Bank's policies, and in particular to ensure that risks spanning several areas of the Bank are properly treated. The Committee meets as required but at least quarterly, operates under a formal charter and delegation from the Governor, and reports annually to the Board.

During 2003/04, a small Risk Management Unit was established, headed by a senior and experienced officer, to assist in the consistent treatment of risks across the RBA and co-ordination of those risks that span more than one functional area of the RBA. The Unit is progressively reviewing the risk registers and practices at departmental level and assists the Risk Management Committee in its work.

A further component of risk management is a strong internal audit process. Audit Department co-ordinates closely with – but remains quite separate from – the Risk Management Unit. In addition to monitoring compliance with the Bank's risk management policy as part of detailed audits, Audit Department has a separate, independent brief to look at existing procedures and to provide analysis of the adequacy of these procedures. Audit Department reports directly to the Audit Committee of the Board which meets quarterly (refer chapter on "The Reserve Bank Board and Governance").

The sections below describe various risks, and the associated management practices, in more detail.

Balance Sheet Risks

There are three types of balance sheet risk: credit, interest rate, and exchange rate risk. Most of the responsibility for managing balance sheet risks falls on Financial Markets Group. Detailed procedures manuals, formal delegations, market benchmarks and position and counterparty limits are in force as part of this process. Compliance is independently checked on a daily basis.

Credit Risk

Credit risk is the risk of default by a firm which owes the RBA money or securities – e.g. the issuer of a security that the RBA holds, a bank with which the RBA has deposited funds, or a counterparty with which the RBA has dealt. Over the past year, there have been a number of changes in the RBA's operations which have slightly increased its credit exposure but, compared with the average private financial institution, the RBA's overall exposure to credit risk is still very low.

The ongoing decline in the supply of Commonwealth Government securities has required the RBA to expand the pool of securities eligible for domestic market operations. It has recently widened its outright holdings of domestic securities to include securities issued by State and Territory central borrowing authorities. The RBA currently holds outright about $1.0 billion of these securities, all of which are rated AA or higher.

There has also been an expansion in the range of collateral accepted for the RBA's domestic repurchase agreement transactions. In past years, this process resulted in the inclusion of securities issued by State and Territory borrowing authorities, and supranational organisations which have a AAA rating. More recently, the RBA added bank bills and certificates of deposit issued by highly rated banks licensed in Australia, and Australian dollar denominated securities issued by some foreign governments and government agencies with a AAA rating. The RBA's repo collateral at end June 2004 included $4.1 billion of bank bills and certificates of deposit and $0.6 billion of securities issued by foreign governments and government agencies. Collateral in the form of CGS and State government paper showed a corresponding decline (see table).

In the case of foreign assets, the RBA again confines its holdings to highly rated securities and bank deposits. The bulk of these assets (around 80 per cent) is held in securities issued by the United States, German, French and Japanese governments. Apart from those issued by the

Domestic Portfolio Holdings
($ billion)

	June 2003	June 2004
Outright holdings*		
– Commonwealth Government securities	4.7	3.7
– State and Territory central borrowing authorities	-	1.0
Repurchase Agreements		
– Commonwealth Government securities	7.2	4.6
– State and Territory central borrowing authorities	6.7	4.2
– Supranational organisations	0.4	0.1
– Bank bills and certificates of deposit	-	4.1
– Foreign governments and government agencies	-	0.6

* Includes securities sold under Sell repos

Japanese government, all these securities have credit ratings of AAA. During 2003/04, as noted in the chapter on "International Financial Co-operation", the RBA invested a small portion of its foreign currency reserves in the Asian Bond Fund. The average credit rating of bonds in this Fund is A-, and at least 97 per cent of bonds must be investment grade – i.e. bonds rated equivalent to Standard and Poor's BBB- or higher.

Credit risk on deposits with foreign commercial banks is managed by confining deposits to banks with a high credit rating (AA- or above) and placing limits on exposures to individual banks. Also, no more than 25 per cent of the overall portfolio can be held in commercial bank deposits and the maximum term to maturity of each deposit may be no more than three months.

Counterparty exposures arising from domestic and foreign dealing relationships are generally small, as all securities transactions are settled on a delivery-versus-payment basis – i.e. in settlement systems that accommodate the simultaneous transfer of cash and securities. However, the RBA is exposed to settlement risk on its foreign exchange transactions. This can be significant because the two legs of the foreign exchange transaction are settled in different time zones, so there may be a period when the RBA has paid out funds and not yet received anything in return. It also has some exposure in its repurchase operations as, in the event that a counterparty fails in its obligation to repurchase the securities it has sold to the RBA, the market value of these securities may have fallen to less than the value of the cash lent to the counterparty. To address the latter risk, the RBA requires that all counterparties supply collateral in excess of the value of the cash or assets, including gold, being lent. The market value of collateral is measured on a daily basis and counterparties must supply additional collateral if the market value falls below the agreed amount.

Because the RBA deals with each counterparty across a range of financial products, it has systems in place to aggregate the overall exposure to each counterparty, with individual product exposures weighted by the riskiness of each transaction. The absolute exposure to individual counterparties is limited in accordance with the counterparty's financial strength, credit rating and the size of its capital. Details of the RBA's credit exposures are given in Note 18 to the Financial Statements.

Interest Rate Risk

The bulk of the RBA's financial assets is held in domestic and foreign fixed income securities. These securities carry interest rate risk because their value will fall if market yields rise. The longer the maturity of a security (or, more precisely, its duration) the larger is the risk.

The interest rate risk on the domestic portfolio is relatively small as the bulk of the portfolio consists of short-term repurchase agreements and securities. These types of instruments are best suited to meeting domestic operating objectives. Scope for managing any residual interest rate risk in the domestic portfolio is limited given the size of the Bank's holdings and the policy significance of its transactions.

For foreign investments, the duration of the benchmark has been set at 30 months, with the maximum term to maturity of any single security limited to ten and a half years. This duration has been chosen using financial modelling to judge the most attractive risk/return trade-off.

Overall, across the domestic and foreign portfolios, a one percentage point rise in yields would result in a capital loss equal to 1.8 per cent of the portfolio, or about $850 million.

Exchange Rate Risk

The RBA holds a portfolio of assets denominated in foreign currency pursuant to its role in holding and managing Australia's reserve assets. This enables the RBA to intervene in the foreign exchange market on occasions when it judges such action to be appropriate. This portfolio is exposed to exchange rate risk because the value of these assets measured in Australian dollars varies with fluctuations in the relevant currency exchange rates against the Australian dollar. Note that this risk applies only to that part of the foreign currency portfolio that is held outright as opposed to that part held under foreign exchange swap agreements. Foreign currency held under swap agreements does not expose the RBA to exchange rate risk because the exchange rate for the forward leg of the swap is agreed at the time the transaction is undertaken.

The share of the RBA's portfolio exposed to exchange rate risk fluctuates over time in line with the RBA's intervention operations. When the RBA is selling foreign currency to buy Australian dollars, for example, the proportion of its portfolio exposed to foreign currency risk will fall. At times when the exchange rate is unusually low, and hence more likely to appreciate, intervention is likely to have reduced the RBA's exposure to the effects of a rising exchange rate, and vice versa when the exchange rate is unusually high. To that extent, it can be said that foreign exchange risk is managed. But in general, the RBA's role as custodian of Australia's international reserves means that it has to accept a large foreign exchange risk. This cannot be hedged away without negating the purpose for which the reserves are held. Given current holdings of net international reserves, a 10 per cent rise in the exchange rate of the Australian dollar (on average against all the currencies held in the portfolio) would result in a valuation loss of about $2 billion.

Given the size of the risks on foreign exchange and interest rates, it is imperative that the RBA carry enough capital to absorb valuation losses on occasions when the Australian dollar exchange rate appreciates or local and global interest rates rise. The Board reviews the capital position annually and has during the past year also agreed to an approach which more accurately aligns desired capital with the degree of risk of the various assets on the RBA's books.

Operational Risk

While all parts of the RBA are exposed to operational risks of varying degrees, the most significant are those associated with carrying out the Bank's market operations and supplying banking and settlement services to clients and to the market as a whole.

The RBA's operations in financial markets require it to undertake a large volume of transactions each day. Around 45 000 transactions were undertaken in 2003/04, with average daily settlement flows of around $24 billion. Consequently it is important that the systems and processes that support these operations are efficient and robust. The RBA is currently involved in the installation of a new financial markets trading and settlement platform provided by OpenLink. This system will replace a number of existing systems and put all dealing functionality and risk controls onto an integrated platform.

Like most financial institutions, the RBA is exposed to the risk that staff may take unauthorised actions and expose it to financial loss or reputational damage. It controls this risk through various means: having a clear decision-making hierarchy, with all staff involved in financial dealing having clear limits to their authority to take risks; building controls into the computer systems to prevent unauthorised dealing; separating the initiation of transactions from the settlement of them; having an independent middle office to check compliance; and a strong internal audit function.

A significant part of the RBA's operations is also involved in providing services to clients or the market as a whole. The RBA is the main banker for a number of government agencies, and processes on average about 250 million transactions a year, including all Australian Taxation Office, Health Insurance Commission and Centrelink payments. It also provides real-time interbank payment and settlement services through the RITS system, which typically involve processing about 22 600 payment instructions per day, for an average daily value of $136 billion.

It is important that these functions be carried out not only efficiently but also with complete reliability. The RBA has extensive back-up capacity and plans for business resumption in the event of a loss of access to premises or IT systems. A major program is now under way to develop further these capacities, which will result in substantial investment in more robust facilities over the next few years.

Reputational Risk

Reputational risk arises as an adjunct to all the risks outlined above: the RBA would suffer reputational loss were any of these risks not well managed. Likewise, reputational risk is contained to the extent that the other risks are adequately controlled. Reputational risks are further contained through, among other things, protocols on access to and handling of sensitive information, careful controls governing dealings with the media, and clear guidelines for the conduct of management and staff in carrying out their duties. More fundamentally, making strenuous efforts to maintain a strong organisational culture is key to maintaining a reputation for competence, integrity and impartiality. The RBA invests considerable resources in training for its staff to develop both technical competence and also an awareness of the need for ethical behaviour and the requirement to put aside any personal interests in carrying out official duties. The Code of Conduct for staff is an important vehicle for achieving this goal.

Earnings and Distribution

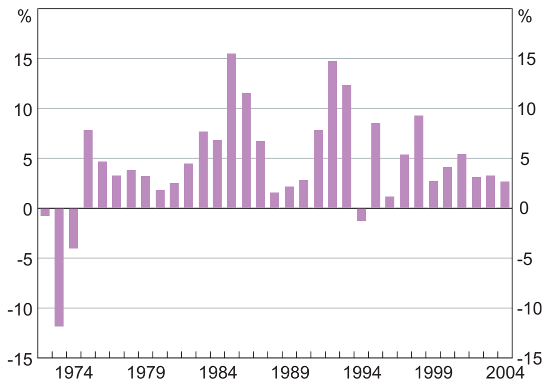
The RBA holds a substantial portfolio of financial assets for the purpose of undertaking operations to implement monetary policy. These assets are denominated both in Australian dollars and in the foreign currencies in which Australia's international reserves are invested. They provide two general sources of income – interest earnings plus valuation gains or losses. Valuation gains arise when market interest rates fall or, for foreign assets, when the Australian exchange rate depreciates; losses occur when interest rates rise or the Australian dollar appreciates. Valuation gains and losses are realised only when assets are sold.

Since 1998, the RBA has observed generally accepted accounting principles when preparing its financial statements so that its accounting profit is measured as earnings from all sources. However, because the RBA's operations are driven by policy considerations, it has virtually no scope to control the market risks that it faces on domestic assets, and only limited scope in the case of foreign assets. Consequently, accounting profits can be volatile as the value of its assets fluctuates with developments in financial markets. The volatility of accounting profits is shown in Graph 13. The influences on this pattern of profits were discussed in detail in the chapter on the "The Variability of Reserve Bank Profits" in the Annual Report for 2003.

Graph 13

Accounting Profits*

Per cent of assets



* Estimated accounting profit before 1998

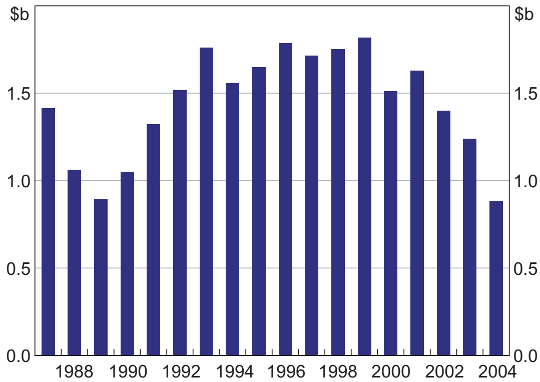
Source: RBA

Although the RBA pays a dividend to the Government each year, only certain components of accounting profits are available for this distribution. Section 30 of the *Reserve Bank Act 1959* determines that the sum available for distribution comprises underlying earnings, i.e. net interest earnings less operating costs, plus any realised valuation gains or losses. Unrealised valuation gains are not available to be distributed but are transferred to the Unrealised Profits Reserve, either to absorb future valuation losses or to be realised when relevant assets are sold.

Underlying earnings arise because the RBA does not pay interest on a large proportion of its liabilities, particularly currency in circulation and capital. By contrast, almost all of its assets earn interest. Underlying earnings in 2003/04 were $882 million, compared with $1 238 million in the previous financial year. This fall in underlying earnings reflected a combination of balance sheet and market developments. A key factor was the policy-driven decision to rebuild international reserves during the year, which led to a switch out of relatively high-yielding domestic assets into lower-yielding foreign assets. Interest earnings on foreign assets were also converted, on average, at an Australian dollar exchange rate higher than in 2002/03, a factor which worked to lower income measured in Australian dollar terms. Although the RBA now has a much larger portfolio of foreign assets, these positive 'volume' effects were not large enough to offset the negative 'price' effects of the switch from domestic assets to foreign assets.

Graph 14

Underlying Earnings



Source: RBA

The decline in underlying earnings in the past year continues the trend evident for a number of years. This reflects two major influences: firstly, the reduction in the level of interest rates around the world over the past decade; and secondly, the fact that the RBA pays interest on a higher proportion of liabilities than was once the case – interest is now paid on almost 40 per cent of total liabilities, compared with about 15 per cent a decade ago. This arises firstly because a higher proportion of its liabilities are term deposits from the Australian Government on which the RBA now pays interest, and secondly because certain liabilities on which it did not pay

Sources of Earnings Available for Distribution
($ million)

	Underlying earnings	Realised gains and losses	Earnings available for distribution
1986/87	1 412	2 035	3 447
1987/88	1 062	464	1 526
1988/89	891	-474*	417
1989/90	1 049	46*	1 095
1990/91	1 322	391	1 713
1991/92	1 516	1 038	2 554
1992/93	1 760	2 803	4 563
1993/94	1 556	-48*	1 508
1994/95	1 649	123	1 772
1995/96	1 784	702*	2 486
1996/97	1 715	1 990	3 705
1997/98	1 750	1 524	3 274
1998/99	1 816	1 860*	3 676
1999/00	1 511	-708	803
2000/01	1 629	1 205	2 834
2001/02	1 400	489	1 889
2002/03	1 238	1 159	2 397
2003/04	882	-188	694

* Includes unrealised losses in excess of previous years' unrealised gains held in reserves

interest in the past – mainly deposits that commercial banks were required to hold at the RBA – have been abolished.

Looking at realised valuation effects, the RBA realised net losses of $188 million in 2003/04, compared with realised gains of $1 159 million in 2002/03. This shift from a position of substantial realised gain to a loss accounts for the bulk of the reduction in earnings available for distribution in 2003/04. The major part of this loss, some $279 million, came from losses on holdings of foreign bonds, as market interest rates overseas rose over the course of the year. The RBA also realised valuation losses of $63 million on domestic investments.

Notwithstanding the rise in the exchange rate, gains of $154 million were realised from foreign exchange sold from the portfolio at favourable exchange rates. The purchase of foreign exchange when the exchange rate was high in the March quarter resulted in large unrealised valuation gains as the exchange rate depreciated later in the year.

Earnings available for distribution – the sum of underlying earnings and realised gains – amounted to $694 million in 2003/04.

Accounting Profits

As noted, in accordance with generally accepted accounting principles, the RBA takes all valuation gains or losses – both realised and unrealised – to accounting profits. The losses realised in 2003/04 were smaller than unrealised gains so that total valuation gains amounted to $1 073 million. Adding these gains to underlying earnings results in total accounting profits in 2003/04 of $1 955 million (compared with $2 173 million in 2002/03).

Reserves and Dividend

Like other financial institutions, the RBA maintains reserves which are available to absorb potential future losses. The Reserve Bank Reserve Fund (RBRF), the major reserve, is available to cover potential losses from a range of risks, including market risk and other events, such as fraud and operational risks, to which most financial institutions are exposed in the course of their operations. The RBRF has been funded over time by transfers from earnings available for distribution and is akin to capital.

The *Reserve Bank Act 1959* provides for the Treasurer to determine, after consultation with the Reserve Bank Board, the amount, if any, to be credited to the RBRF from earnings available for distribution. The balance of distributable earnings is payable to the Australian

Dividend Payment: August 2004
($ million)

Sum deferred from Earnings in 2002/03 (to be paid in 2004/05)	964
Plus	
Total Earnings Available from 2003/04 (payable in 2004/05)	694
Minus	
Earnings from 2003/04 deferred until 2005/06	320
	1 338

Government after any such transfers. At 30 June 2004, the balance of the RBRF stood at $6 285 million. As the Board regarded this balance as satisfactory, it did not approach the Treasurer for a transfer from profits in 2003/04. Accordingly, all of the earnings available for distribution in 2003/04 will be paid as a dividend to the Australian Government.

In recent years, the RBA has usually paid this dividend early in the financial year following that in which it was earned. Exceptions were in 1998/99 and 2002/03, when the Treasurer decided to defer part of dividend payable from profits from those years, spreading the payment over the following two years. In particular, the Treasurer deferred a sum of $964 million from the dividend earned in 2002/03 and decided that this should be paid in 2004/05. The Treasurer has again decided to delay receipt of part of the dividend due from earnings in 2003/04. A sum of $374 million was paid to the Government in August 2004, with a further $320 million to be paid in the 2005/06 year. Accordingly, the total payment made to the Australian Government in August 2004 amounts to $1 338 million; as illustrated in the table opposite, this payment comprises the sum deferred from 2002/03, plus earnings available for distribution in 2003/04 minus the sum deferred from those earnings until 2005/06.

In addition to the RBRF, the RBA maintains a number of other financial reserves. Under the *Reserve Bank Act*, and consistent with international practice for central banks, unrealised gains are not available to be paid but are transferred to the Unrealised Profits Reserve. Balances in this reserve remain available to absorb future unrealised losses that might arise from adverse

Reserve Bank Payments to Government
($ million)

			Payments to the Australian Government				
	Earnings available for distribution	Transfers to reserves	Balance available from current year's profit	Interim payment from current year's profit	Payment from previous year's profit	Payment delayed from previous year	Total payment
1990/91	1 713	210	1 503	400	275	-	675
1991/92	2 554	200	2 354	400	1 103	-	1 503
1992/93	4 563	750	3 813	600	1 954	-	2 554
1993/94	1 508	-	1 508	-	3 213	-	3 213
1994/95	1 772	-	1 772	200	1 508	-	1 708
1995/96	2 486	150	2 336	200	1 572	-	1 772
1996/97	3 705	2 005	1 700	-	2 136	-	2 136
1997/98	3 274	548	2 726	-	1 700	-	1 700
1998/99	3 676	-	3 676	-	2 726	-	2 726
1999/00	803	-	803	-	3 000	-	3 000
2000/01	2 834	-	2 834	-	803	676	1 479
2001/02	1 889	-	1 889	-	2 834	-	2 834
2002/03	2 397	133	2 264	-	1 889	-	1 889
2003/04	694	-	694	-	1 300	-	1 300
2004/05	-	-	-	-	374	964	1 338
2005/06						320	

movements in interest or exchange rates, or they are realised when relevant assets are sold. On 30 June 2004, the balance in the Unrealised Profits Reserve was $2 837 million.

The RBA also maintains asset revaluation reserves, the balances of which reflect the amount by which the market value of its holdings of gold and property exceed the price at which they were purchased. At 30 June 2004, amounts in these reserves were $1 694 million, $181 million more than a year earlier.

The financial statements for 2003/04 are presented in the following pages.

Financial Statements

As at 30 June 2004

Directors' Statement

In the opinion of the directors, the financial statements for the year ended 30 June 2004 give a true and fair view of the matters required by the Finance Minister's Orders 2003-2004 made under the *Commonwealth Authorities and Companies Act 1997*. These statements have been prepared from properly maintained financial records.

IJ Macfarlane

Chairman, Reserve Bank Board
13 August 2004

STATEMENT OF FINANCIAL POSITION As at 30 June 2004
Reserve Bank of Australia and Controlled Entities

	Note	2004 $M	2003 $M
ASSETS			
Cash and liquid assets	6, 19	623	839
Australian dollar securities	1(d), 18	18 317	18 933
Foreign exchange	1(c), 18	52 051	44 929
Gold	1(b), 18	1 492	1 350
Property, plant and equipment	1(f), 8	293	287
Loans, advances and other	7	297	255
Total Assets		73 073	66 593
LIABILITIES			
Deposits	1(g), 9	18 126	14 736
Distribution payable to Australian Government	1(i), 3	1 658	2 264
Other	10	8 411	8 007
Australian notes on issue	1(k)	34 022	32 172
Total Liabilities		62 217	57 179
Net Assets		10 856	9 414
Capital and Reserves			
Reserves:			
Unrealised Profits Reserve	1(h), 5	2 837	1 576
Asset revaluation reserves	1(h), 5	1 694	1 513
Reserve Bank Reserve Fund	1(h), 5	6 285	6 285
Capital	5	40	40
Total Capital and Reserves		10 856	9 414

STATEMENT OF FINANCIAL PERFORMANCE For the year ended 30 June 2004
Reserve Bank of Australia and Controlled Entities

	Note	2004 $M	2003 $M
REVENUES			
Interest revenue	2	1 889	2 175
Net gains on securities and foreign exchange	2	1 073	935
Dividend revenue	2	4	3
Fees and commissions	2	18	20
Other revenue	2	92	37
Total revenue		3 076	3 170
EXPENSES			
Interest expense	2	929	804
General administrative expenses	2	165	170
Other expenses	2	27	23
Total expenses		1 121	997
Net Profit		1 955	2 173
Net revaluation adjustments in asset revaluation reserves	1(h), 5	181	(5)
Net profit plus net revaluation adjustments in asset revaluation reserves		2 136	2 168

STATEMENT OF DISTRIBUTION For the year ended 30 June 2004
Reserve Bank of Australia and Controlled Entities

	Note	2004 $M	2003 $M
Net Profit		1 955	2 173
Transfer (to)/from Unrealised Profits Reserve	5	(1 261)	222
Transfer from asset revaluation reserves	5	–	2
Earnings available for distribution		694	2 397
Distributed as follows:			
Reserve Bank Reserve Fund	5	–	133
Payable to the Australian Government	3	694	2 264
		694	2 397

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2004
Reserve Bank of Australia and Controlled Entities

Note 1 SUMMARY OF ACCOUNTING POLICIES

The financial statements have been prepared in accordance with the *Reserve Bank Act 1959* and the *Commonwealth Authorities and Companies Act 1997*.

The form and content of the financial statements incorporate the requirements of the Finance Minister's Orders (FMOs) 2003-2004. These orders provide that the financial statements of agencies and authorities must comply with accounting standards and accounting interpretations issued by the Australian Accounting Standards Board. As the Reserve Bank of Australia (RBA) is a financial institution, the financial statements have been prepared using AASB1032 – *Specific Disclosures by Financial Institutions*.

The RBA has been granted an exemption from the requirements of the FMOs as detailed in Note 1(m). This exemption relates to a matter of disclosure and presentation which is of a minor nature and is adequately dealt with elsewhere in these financial statements.

The statements are a general purpose financial report prepared in accordance with Australian Accounting Standards. All amounts are expressed in Australian dollars unless another currency is indicated. Current market values are used for the RBA's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises, plant and equipment. Revenue and expenses are brought to account on an accrual basis. All revenues, expenses and profits of the RBA are from ordinary activities. Unless otherwise stated, the accounting policies and practices followed in these statements are consistent with those followed in the previous year.

(a) Consolidation and associated company

The financial statements show information for the economic entity only; this reflects the consolidated results for the parent entity, the Reserve Bank of Australia, and its wholly owned subsidiary, Note Printing Australia Limited. The results of the parent entity do not differ materially from the economic entity and have therefore not been separately disclosed other than in Note 15, Related party and other disclosures. Note Printing Australia Limited was incorporated as a wholly owned subsidiary of the RBA on 1 July 1998, with an initial capital of $20 000 000.

The assets, liabilities and results of Note Printing Australia Limited have been consolidated with the parent entity accounts in accordance with AASB1024 – *Consolidated Accounts*. All internal transactions and balances have been eliminated on consolidation. Note Printing Australia Limited is subject to income tax; its income tax expense is included in the Statement of Financial Performance as part of Other Expenses.

The RBA accounts for its investment in Securency Pty Ltd in accordance with AASB1016 – *Accounting for Investments in Associates*. The carrying amount of the RBA's investment in Securency Pty Ltd is reviewed annually to ensure that it is not in excess of its recoverable amount. The RBA's investment in Securency Pty Ltd is included in Note 7.

(b) Gold

Gold holdings (including gold on loan to other institutions) are valued at the Australian dollar equivalent of the 3pm fix in the London gold market on the last business day of June. The RBA lends gold to financial institutions participating in the gold market. Gold loans are secured to 110 per cent of their market value by Australian dollar denominated collateral security. Interest on gold loans is accounted for on a standard accrual basis.

(c) Foreign exchange

Foreign exchange holdings are invested mainly in securities (issued by the governments of the United States, Germany, France and Japan) and bank deposits (with major OECD foreign commercial banks, central banks and international agencies). The RBA engages in interest rate futures and foreign currency swaps.

Assets and liabilities denominated in foreign currency are converted to Australian dollar equivalents at exchange rates ruling on the last business day of June. Realised and unrealised gains or losses on foreign currency are immediately taken to profit, but only realised gains are available for distribution.

Foreign government securities

Foreign government securities comprise coupon and discount securities and repurchase agreements. Coupon securities have biannual or annual interest payments depending on the currency and type of security. Interest earned on discount securities is the difference between the actual purchase cost and the face value of the security. The face value is received at maturity. Interest earned on securities is accrued over the term of the security.

Marketable securities, other than those contracted for sale under repurchase agreements, are reported at market values on the last business day of June; realised and unrealised gains and losses arising from changes in market valuations during the year are taken to profit. Earnings on foreign currency investments are converted to Australian dollars using the exchange rate on the date they are accrued.

Foreign currency swaps

The RBA uses foreign currency swaps to assist daily domestic liquidity management and to manage its balance sheet holdings. A currency swap is the simultaneous purchase and sale of one currency against another currency for specified maturities. The cash flows are the same as borrowing one currency for a certain period, and lending another currency for the same period. The pricing of the swap must therefore reflect the interest rates applicable to these money market transactions. Interest rates are implicit in the swap contract but interest itself is not paid or received.

Foreign exchange holdings contracted for sale beyond 30 June 2004 (including those under swap contracts) have been valued at market exchange rates (refer Note 18).

Interest rate futures

The RBA uses interest rate futures contracts on overseas exchanges to hedge risks on its portfolio of foreign securities. An interest rate futures contract is a contract to buy or sell a specific amount of securities for a specific price on a specific future date.

Interest rate futures are off-balance sheet items. Interest rate futures positions are marked to market on the last business day of June and valuation gains and losses are taken to profit. The RBA did not trade in any other derivative instruments during 2003/04.

(d) Australian dollar securities

The RBA holds Commonwealth Treasury Fixed Coupon Bonds, Treasury Notes and Treasury Capital Indexed Bonds, and securities issued by the central borrowing authorities of State and Territory Governments. It also holds under repurchase agreements bank bills and certificates of deposit issued by banks licensed in Australia and Australian dollar denominated securities issued by foreign governments, foreign government agencies that have an explicit government guarantee and by certain highly-rated supranational organisations. Realised and unrealised gains or losses on Australian dollar securities are immediately taken to profit, but only realised gains are available for distribution.

Commonwealth Treasury Fixed Coupon Bonds are coupon securities; the interest is payable biannually at the coupon rate. Commonwealth Treasury Notes are discount securities; the interest earned is the difference between the purchase price and the face value on redemption. Treasury Capital Indexed Bonds are coupon securities with the nominal value of the security indexed in line with movements in the Consumer Price Index each quarter until maturity; interest is paid quarterly.

Securities are valued at market prices on the last business day of June except when contracted for sale under repurchase agreements.

(e) Repurchase agreements

In the course of its financial market operations, the RBA engages in repurchase agreements involving foreign and Australian dollar marketable securities.

Securities sold and contracted for purchase under repurchase agreements are reported on the Statement of Financial Position within the relevant investment portfolio and are valued at market prices; the counterpart obligation to repurchase is included in Other Liabilities. The difference between the sale and purchase price is recognised as interest expense over the term of the agreement.

Securities purchased and contracted for sale under repurchase agreements are reported within the relevant investment portfolio at contract amount. The difference between the purchase and sale price is recognised as interest income over the term of the agreement.

(f) Property, plant and equipment

Formal valuations of all the RBA's Australian properties are conducted annually; RBA properties overseas are formally valued on a triennial basis. Australian properties are valued by officers of the Australian Valuation Office and overseas properties are valued by local independent valuers. The most recent valuation of overseas properties was at 30 June 2004. These valuations have been incorporated in the accounts. Annual depreciation is based on market values and assessments of useful remaining life.

From 1 July 2003, plant and equipment has been recognised on a fair value basis in accordance with the FMOs. The fair value of plant and equipment at the beginning and end of the reporting period was determined by an independent valuer. Previously, the Bank valued plant and equipment at cost less depreciation. Adjustments arising from the adoption of fair value are reflected in Net Profits (refer Note 2). Annual depreciation will now be based on fair values and the RBA's assessments of useful remaining life. In accordance with the FMOs, the RBA continues to recognise computer software at cost less depreciation.

Details of annual net expenditure, revaluation adjustments and depreciation of property, plant and equipment and computer software are included in Note 8.

(g) Deposits

Deposits include deposits at call and term deposits. Deposit balances are shown at their face value. Interest is accrued over the term of deposits and is paid periodically or at maturity. Interest accrued but not paid is included in Other Liabilities. Details of deposits are included in Note 9.

(h) Reserves

Reserves are maintained to cover the broad range of risks to which the RBA is exposed. The Reserve Bank Reserve Fund (RBRF) is a general reserve which provides for events which are contingent and non-foreseeable, mainly those which arise from movements in market values of the RBA's holdings of Australian dollar and foreign securities; the RBRF also provides for potential losses from fraud and other non-insured losses. Amounts set aside for this reserve are determined by the Treasurer after consultation with the Board (refer Note 1(i)).

Asset revaluation reserves reflect the impact of changes in the market values of a number of the RBA's assets, mainly non-traded assets (gold; property; and shares in international financial institutions).

Unrealised gains and losses on foreign exchange and Australian dollar securities are recognised in profit from ordinary activities. Until such gains or losses are realised, they are not available for distribution to the Australian Government; in the interim, the amounts are reflected in the Unrealised Profits Reserve.

(i) Profits

Profits of the RBA are dealt with in terms of Section 30 of the *Reserve Bank Act 1959* as follows:

(1) Subject to subsection (2), the net profits of the Bank in each year shall be dealt with as follows:

   (a) such amount as the Treasurer, after consultation with the Reserve Bank Board, determines is to be set aside for contingencies; and

   (b) such amount as the Treasurer, after consultation with the Reserve Bank Board, determines shall be placed to the credit of the Reserve Bank Reserve Fund; and

   (c) the remainder shall be paid to the Commonwealth.

(2) If the net profit of the Bank for a year is calculated on a basis that requires the inclusion of unrealised gains on assets during the year, the amount to which subsection (1) applies is to be worked out as follows:

(a) deduct from the net profit an amount equal to the total of all amounts of unrealised gains included in the net profit; and

(b) if an asset in respect of which unrealised gains were included in the net profit for a previous year or years is realised during the year – add to the amount remaining after applying paragraph (a) the total amount of those unrealised gains.

(j) Provisions

The RBA maintains provisions for accrued annual leave, calculated on salaries expected to prevail when leave is anticipated to be taken and including associated payroll tax. The RBA also maintains provisions for long service leave and post-employment benefits, in the form of health insurance and housing assistance, and associated fringe benefits tax; these provisions are made on a present value basis in accordance with AASB1028 – *Employee Benefits*. In addition, the RBA makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(k) Australian notes on issue

After a note series ceases to be issued, the RBA periodically adjusts its liability for that series, to reflect the likelihood that the remaining notes on issue will not be presented for redemption because they are judged to have been destroyed or are otherwise unavailable for presentation. In 2003/04, the RBA has written down its remaining liability of $45 million for $2 notes, which were last issued in 1988; the gain was included in accounting profits (refer Note 2). No amount was written off Australian notes on issue in 2002/03. If the written down notes are subsequently presented, the RBA will reinstate the liability for these notes and charge an expense against profits.

In 2001/02, the RBA began to pay interest on working balances of currency notes held by banks under revised cash distribution arrangements. Interest is paid on balances up to a certain limit.

(l) Rounding

Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

(m) Exemptions

The RBA has been granted an exemption from the following requirement of the FMOs:-

Requirement	Description	Detail of exemption
Appendix A	Form of Statement of Financial Position and Statement of Financial Performance.	The Statement of Financial Position is presented according to AASB1032 and details of revenues and expenses are disclosed in Note 2.

(n) Australian Equivalents to International Financial Reporting Standards (AEIFRS)

Commonwealth authorities reporting under the *Commonwealth Authorities and Companies Act 1997* will have to adopt AEIFRS for reporting periods beginning on or after 1 January 2005. The adoption of AEIFRS will first reflect in the RBA's published financial statements for the year ending 30 June 2006. The RBA has reviewed the AEIFRS and established procedures to monitor and manage how AEIFRS might affect its financial statements. The RBA has also identified the AEIFRS standards which are likely to affect its accounting policies and measurement of items in its financial statements. The RBA has put in place arrangements which will enable it to comply with AEIFRS when they become mandatory. These arrangements include training of staff on AEIFRS and changing systems and internal controls to gather the financial information required by AEIFRS. The RBA has identified a number of areas in which AEIFRS will affect its financial statements, including in the presentation of information about superannuation. The RBA's evaluation of the AEIFRS is continuing and it is possible that other effects will be identified as a consequence of this ongoing process.

	Note	2004 $M	2003 $M

Note 2 NET PROFITS

	Note	2004 $M	2003 $M
Interest revenue			
Overseas investments	1(c)	1 024	1 056
Australian dollar securities	1(d)	811	1 062
Overnight settlements		37	37
Gold loans	1(b)	16	19
Loans, advances and other		1	1
		1 889	2 175
Net gains/(losses) on securities and foreign exchange			
Overseas investments	1(c)	(587)	1 036
Australian dollar securities	1(d)	(169)	49
Foreign currency	1(c)	1 829	(150)
		1 073	935
Dividend revenue			
Earnings on shares in Bank for International Settlements		4	3
Fees and commissions			
Banking services fees received		18	20
Other revenue			
Reimbursement by Australian Government for loan management and registry expenses		1	1
Rental of Bank premises		5	4
Sales of note products		22	19
Australian notes on issue written down	1(k)	45	–
Other		19	13
		92	37
Total		3 076	3 170
Less:			
Interest expense			
Deposit liabilities	1(g)	670	513
Currency note holdings of banks	1(k)	136	136
Repurchase agreements	1(e)	123	155
		929	804
General administrative expenses			
Staff costs		102	101
Special redundancy/retirement payments	12	3	3
Depreciation of property	1(f), 8	7	7
Depreciation of plant and equipment	1(f), 8	9	9
Premises and equipment	1(f)	24	25

	Note	2004 $M	2003 $M
Note 2 (CONTINUED)			
Materials used in note production		9	8
Travel		3	3
Consultants' fees, legal fees and payments to contractors	14	4	8
Other		4	6
		165	170
Other expenses			
Agency business reimbursement		2	3
Subsidiary income tax		–	–
Cash distribution expenses		6	4
Write down of plant and equipment	1(f), 8	2	–
Other		17	16
		27	23
Total		1 121	997
Net Profit		1 955	2 173

Staff costs in 2003/04 include a gain of $2 million associated with the decline in the balance of the Provision for post-employment benefits (refer Note 10); in 2002/03 Staff Costs included an expense of $8 million due to an increase in the balance of the provision.

Note 3 DISTRIBUTION PAYABLE TO AUSTRALIAN GOVERNMENT

Section 30 of the *Reserve Bank Act 1959* requires that the net profits of the Reserve Bank of Australia, less amounts set aside for contingencies or placed in the RBRF as determined by the Treasurer in consultation with the Board, be paid to the Australian Government (refer Note 1(i)).

	2004 $M	2003 $M
Opening balance	2 264	1 889
Distribution to Australian Government	(1 300)	(1 889)
Transfer from Statement of Distribution	694	2 264
As at 30 June	1 658	2 264

Of the $2 264 million payable to the Australian Government out of profits for 2002/03, $1 300 million was paid in August 2003 and $964 million was paid in August 2004. The Treasurer has again decided, in consultation with the Board, that earnings available for distribution of $694 million from 2003/04 will also be distributed in two tranches – $374 million in August 2004; and $320 million in the 2005/06 financial year. Accordingly, $1 338 million of the balance of the distribution payable account as at 30 June 2004 was distributed to the Australian Government in August 2004, and $320 million will be paid in 2005/06.

Note 4 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2004

	Average balance $M	Interest $M	Average annual interest rate %
Interest revenue			
Overseas investments	49 107	1 024	2.1
Australian dollar securities	14 513	811	5.6
Loans, advances and other	29	1	3.4
Overnight settlements	760	37	4.8
Gold loans	1 398	16	1.2
	65 807	1 889	2.9
Interest expense			
Banks' Exchange Settlement balances	779	38	4.8
Deposits from governments	12 274	625	5.1
Deposits from overseas institutions	549	4	0.7
Overseas repurchase agreements	7 800	81	1.0
Domestic repurchase agreements	885	42	4.8
Currency note holdings of banks	2 676	136	5.1
Other deposits	68	3	3.8
	25 031	929	3.7
Analysis for the year ended 30 June 2003			
Interest revenue total	61 909	2 175	3.5
Interest expense total	21 640	804	3.7

	2004 $M	2003 $M

Note 5 RESERVES

Changes in the RBA's various reserves are shown below.

	2004 $M	2003 $M
Asset revaluation reserves (Note 1(h))		
Gold		
Opening balance	1 222	1 339
Net revaluation adjustments	146	(117)
As at 30 June	1 368	1 222
Shares in international financial institutions (Note 7)		
Opening balance	179	74
Net revaluation adjustments	35	105
As at 30 June	214	179
Bank properties (Notes 1(f), 8)		
Opening balance	112	107
Net revaluation adjustments	–	7
Transfers (to)/from Statement of Distribution	–	(2)
As at 30 June	112	112
Total asset revaluation reserves		
Opening balance	1 513	1 520
Net revaluation adjustments	181	(5)
Transfers (to)/from Statement of Distribution	–	(2)
As at 30 June	1 694	1 513
Unrealised Profits Reserve (Note 1(h))		
Opening balance	1 576	1 798
Net transfers (to)/from Statement of Distribution	1 261	(222)
As at 30 June	2 837	1 576
Reserve Bank Reserve Fund (Note 1(h))		
Opening balance	6 285	6 152
Transfer from Net Profit	–	133
As at 30 June	6 285	6 285
Capital		
Opening and closing balance	40	40
Total capital and reserves		
Opening balance	9 414	9 510
Net profit plus net revaluation adjustments in asset revaluation reserves	2 136	2 168
Transfer to the distribution payable to the Australian Government (Note 3)	(694)	(2 264)
As at 30 June	10 856	9 414

Note 6 CASH AND LIQUID ASSETS

This includes net amounts of $617 million owed to the RBA for overnight clearances of financial transactions through the clearing houses; an amount of $822 million was owed to the RBA at 30 June 2003.

	2004 $M	2003 $M
Note 7 LOANS, ADVANCES AND OTHER ASSETS		
Shareholding in Bank for International Settlements	216	181
Officers' Home Advances	23	25
Gold coin	19	17
Investment in Securency	11	11
Other	28	21
As at 30 June	297	255

The Reserve Bank of Australia has a 50 per cent share in Securency Pty Ltd, which is incorporated in Victoria, Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securency as at 30 June 2004 was $36 530 001. The carrying value of the RBA's investment in Securency as at 30 June 2004 was $11 484 170 ($11 164 670 at 30 June 2003). Securency Pty Ltd has a 31 December balance date.

As at 30 June 2004, other assets included receivables of $15.1 million, of which $11.0 million is current (at 30 June 2003 other assets included receivables of $17.2 million, of which $15.9 million was current).

	Land $M	Buildings $M	Plant and Equipment $M	Computer Software $M	Total $M
Note 8 PROPERTY, PLANT AND EQUIPMENT					
Gross Book Value as at 30 June 2003	89	136	135	5	365
Accumulated depreciation	–	–	(75)	(3)	(78)
Net Book Value	89	136	60	2	287
Additions	–	9	12	3	24
Depreciation/amortisation expense	–	(7)	(9)	–	(16)
Net Revaluation increment/(decrement)	2	(2)	(2)	–	(2)
Disposals	–	–	–	–	–
Gross Book Value as at 30 June 2004	91	136	132	8	367
Accumulated depreciation	–	–	(71)	(3)	(74)
Net Book Value	91	136	61	5	293

	2004 $M	2003 $M

Note 9 DEPOSITS

	2004 $M	2003 $M
Banks' Exchange Settlement balances	1 377	628
Australian Government	16 104	13 784
State Governments	8	13
Foreign governments, foreign institutions and international organisations	573	244
Other depositors	64	67
As at 30 June	18 126	14 736

Note 10 OTHER LIABILITIES

	2004 $M	2003 $M
Provisions (Note 1(j))		
Provision for accrued annual leave	10	8
Provision for long service leave	21	21
Provision for post-employment benefits	53	55
Provision for workers' compensation	1	1
Total employee liabilities as at 30 June	85	85
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(e))	7 315	7 833
Interest accrued on deposits	143	55
Other	868	34
As at 30 June	8 326	7 922
Total other liabilities	8 411	8 007

Note 11 CONTINGENT LIABILITIES AND OTHER ITEMS NOT INCLUDED IN STATEMENT OF FINANCIAL POSITION

Contingencies

The RBA has a contingent liability, amounting to $80.4 million at 30 June 2004 ($72.6 million at 30 June 2003), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

In the course of providing services to its customers, the RBA provides performance guarantees to third parties in relation to customer activities. Such exposure is not material and has not given rise to losses in the past.

Other items

The RBA has commitments of $3.2 million at 30 June 2004 ($8.2 million at 30 June 2003) payable within one year; and commitments of $0.5 million payable beyond one year ($0.5 million at 30 June 2003).

The RBA carries its own insurance risks except where external insurance cover is considered to be more cost-effective or required by legislation.

Note 12 SPECIAL REDUNDANCY/RETIREMENT PAYMENTS

The RBA's expenses in 2003/04 include $3 081 672 paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 2002/03 totalled $2 966 623. Staff leaving the RBA in 2003/04 under these arrangements numbered 31 (34 in 2002/03).

Note 13 REMUNERATION OF EXECUTIVES

The number of executives whose remuneration packages, measured in terms of costs to the RBA, fell within the following bands was:

Remuneration band	Number 2004	Number 2003
$100 000 – $109 999	1	1
$110 000 – $119 999	2	1
$120 000 – $129 999	6	6
$130 000 – $139 999	7	5
$140 000 – $149 999	7	14
$150 000 – $159 999	8	13
$160 000 – $169 999	6	6
$170 000 – $179 999	9	3
$180 000 – $189 999	6	2
$190 000 – $199 999	2	4
$200 000 – $209 999	3	5
$210 000 – $219 999	2	
$220 000 – $229 999	4	1
$230 000 – $239 999	1	2
$240 000 – $249 999	2	1
$260 000 – $269 999	1	4
$270 000 – $279 999		1
$280 000 – $289 999	1	
$290 000 – $299 999	3	
$310 000 – $319 999	2	1
$320 000 – $329 999	1	4
$350 000 – $359 999	1	
$360 000 – $369 999	2	
$380 000 – $389 999		1
$420 000 – $429 999	1	
$500 000 – $509 999		1
$550 000 – $559 999	1	

Total remuneration received or due and receivable by these 79 executives amounted to $15 506 945 (76 executives totalling $14 140 463 in 2002/03). Remuneration includes cash salary, the RBA's contribution to superannuation, housing assistance, motor vehicles, car parking and health insurance and the fringe benefits tax paid or payable on these benefits. After observing a contributions 'holiday' in recent years, the numbers incorporate the effect of the fact that in 2003/04 the RBA resumed contributions to the staff defined benefit scheme at a rate of 6 per cent of salaries. Remuneration excludes amounts paid to executives posted outside Australia, or seconded to other organisations for the whole or part of the financial year.

Remuneration includes amounts paid to executives who are also members of the Bank Board (refer Note 15).

Termination payments of $375 568 were made to executives who left the Bank during 2003/04 ($227 854 in 2002/03); these payments are not reflected in the above table.

Note 14 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services (excluding GST) totalled $186 000 in 2003/04 ($186 000 in 2002/03). They are included in Consultants' fees, legal fees and payments to contractors in Note 2.

Note 15 RELATED PARTY AND OTHER DISCLOSURES

The Remuneration Tribunal determines the remuneration appropriate to the RBA's non-executive Board members. In 2003/04, payments to executive and non-executive Board members totalled $1 221 946 ($1 146 065 in 2002/03). Remuneration includes amounts paid to members of the Bank Board who are also executives (refer Note 13).

The number of directors whose remuneration packages, measured in terms of costs to the RBA, fell within the following bands was:

Remuneration band	Number 2004	Number 2003
$10 000 – $19 999		1
$30 000 – $39 999	5	4
$40 000 – $49 999	1	2
$380 000 – $389 999		1
$420 000 – $429 999	1	
$500 000 – $509 999		1
$550 000 – $559 999	1	

At 30 June 2004 and 30 June 2003 there were no loans by the RBA to the Governor, Deputy Governor or non-executive members of the Board.

There were no other related-party transactions with Board members; transactions with director-related entities which occurred in the normal course of the RBA's operations were conducted on terms no more favourable than similar transactions with other employees or customers.

In addition, $163 222 was paid for the services of non-executive members of the Board of Note Printing Australia Limited who are not employees of the RBA or members of the Bank Board ($106 401 in 2002/03). The RBA also paid $158 923 for the services of members of the Payments System Board who are not employees of the RBA ($154 055 in 2002/03).

Note 16 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act 1959*: the Reserve Bank of Australia Officers' Superannuation Fund (OSF) and the Reserve Bank of Australia UK Pension Scheme. A small part of the assets of the OSF is held by the RBA as nominee for the trustees of the OSF; such assets are not included in these statements. Payment of the funds' current and future benefits is funded by member and Bank contributions and the funds' existing asset bases. The RBA's contributions to the OSF in accordance with the Reserve Bank (Officers' Superannuation) Rules, and to the UK Pension Scheme in accordance with the UK Trust Deed, are included in staff costs in Note 2. Administration and other operational costs (eg salaries, overheads, legal costs and valuation fees) incurred by the RBA for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the RBA and the funds during 2003/04.

At 30 June 2004, the OSF had a surplus of assets over accrued benefits of $60 million ($66 million at 30 June 2003). The UK Pension Scheme had a surplus equivalent to $5 million ($5 million at 30 June 2003). During 2003/04, the RBA made superannuation contributions of $6.2 million ($2.3 million in 2002/03).

Details of the Funds as at 30 June are as follows:

	2004 $M	2003 $M
Reserve Bank of Australia Officers' Superannuation Fund		
Accrued benefits	588	542
Net market value of assets	648	608
Surplus	60	66
Vested benefits	539	508
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	19	19
Net market value of assets	24	24
Surplus	5	5
Vested benefits	21	16
Total Superannuation Funds		
Accrued benefits	607	561
Net market value of assets	672	632
Surplus	65	71
Vested benefits	560	524

Accrued benefits refer to the present value of future benefits payable to current fund members, taking into account assumed future salary increases. Vested benefits are the benefits payable if all current members were to terminate their fund membership at balance date.

Note 17 SEGMENT REPORTING

The RBA's primary function as a Central Bank is the implementation of monetary policy in one geographical area – Australia. Over 95 per cent of the RBA's assets (and a similar proportion of revenues) are managed for that purpose by the Financial Markets Group. Additional information on the make-up of the RBA's financial assets is provided in Note 18.

Note 18 FINANCIAL INSTRUMENTS

Australian Accounting Standard AASB1033 – *Presentation and Disclosure of Financial Instruments* requires disclosure of information relating to: both recognised and unrecognised financial instruments; their significance and performance; accounting policy terms and conditions; net fair values and risk information.

A ***financial instrument*** is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. The identifiable financial instruments for the RBA are its Australian dollar securities, its foreign government securities, bank deposits, interest rate futures, foreign currency swap contracts, gold loans, cash and liquid assets, notes on issue and deposit liabilities.

Net fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction, and is usually determined by the quoted market price net of transaction costs. The RBA's recognised financial instruments are carried at current market value which approximates net fair value.

Financial risk of financial instruments embodies price risk (currency risk and interest rate risk); credit risk; liquidity risk and cash flow risk. AASB1033 requires disclosure on interest rate risk and credit risk.

The interest rate risk and credit risk tables are based on the RBA's settled portfolio as reported in the RBA's Statement of Financial Position.

Interest rate risk

Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates. The following table shows the RBA's Statement of Financial Position restated in compliance with AASB1033.

Note 18 (CONTINUED)

Interest rate risk As at 30 June 2004

	Balance sheet total $M	Floating interest rate $M	Repricing Period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average rate %
Assets								
Gold loans	1 454	–	165	166	1 104	–	19	1.2
Gold holdings	38	–	–	–	–	–	38	n/a
Sub-total	**1 492**							
Foreign exchange								
Securities sold under repurchase agreements	5 635	–	–	–	3 318	2 317	–	3.9
Securities purchased under repurchase agreements	19 283	–	19 283	–	–	–	–	1.3
Deposits and other securities	26 948	655	11 540	4 003	6 169	3 551	1 030	2.1
Accrued interest – foreign exchange	185	–	–	–	–	–	185	n/a
Sub-total	**52 051**							
Australian dollar securities								
Securities sold under repurchase agreements	1 679	–	–	–	822	857	–	5.1
Securities purchased under repurchase agreements	13 645	–	13 320	325	–	–	–	5.3
Other securities	2 919	–	1 681	176	571	491	–	5.3
Accrued interest – Australian dollar securities	74	–	–	–	–	–	74	n/a
Sub-total	**18 317**							
Property, plant & equipment	293	–	–	–	–	–	293	n/a
Cash and liquid assets	623	617	–	–	–	–	6	5.0
Loans and advances	23	23	–	–	–	–	–	3.8
Other	274	–	–	–	–	–	274	n/a
Total assets	**73 073**	**1 295**	**45 989**	**4 670**	**11 984**	**7 216**	**1 919**	**2.9**
Liabilities								
Australian notes on issue	34 022	2 351	–	–	–	–	31 671	0.3
Deposits	18 126	2 860	14 850	–	–	–	416	5.2
Distribution payable to Australian Government	1 658	–	–	–	–	–	1 658	n/a
Other	8 411	–	8 146	11	–	–	254	2.0
Total liabilities	**62 217**	**5 211**	**22 996**	**11**	**–**	**–**	**33 999**	**2.0**
Capital and reserves	10 856							
Total balance sheet	**73 073**							
Off balance sheet items								
Interest rate futures	1 386	–	–	–	–	1 386	–	n/a

Note 18 (CONTINUED)

Interest rate risk As at 30 June 2003

	Balance sheet total $M	Floating interest rate $M	Repricing Period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average rate %
Total assets	66 593	1 797	32 440	8 805	14 234	8 188	1 129	2.7
Total liabilities	57 179	4 946	20 033	–	–	–	32 200	1.4
Capital and reserves	9 414							
Total balance sheet	66 593							
Off balance sheet items	72	–	–	–	–	72	–	n/a

Other liabilities includes amounts outstanding under sale repurchase agreements.

All recognised financial instruments are shown at net fair value.

Off-balance sheet items are shown at nominal market value (difference from net fair value is negligible).

All financial instruments are shown at their repricing period which is equivalent to the remaining term to maturity.

Interest rate futures reflect the positions in interest rate contracts traded in foreign futures exchanges to manage interest rate risk on Official Reserve Assets.

Credit risk

Credit risk in relation to a financial instrument is the risk that a customer, bank or other counterparty will not meet its obligations (or be permitted to meet them) in accordance with agreed terms.

The RBA's maximum exposure to credit risk in relation to each class of recognised financial assets, other than derivatives (off-balance sheet items), is the carrying amount of those assets as indicated in the balance sheet. The RBA's exposures are to highly-rated counterparties and its credit risk is very low.

The RBA's maximum credit risk exposure in relation to off-balance sheet items is:

1. ***Foreign exchange swaps*** – As at 30 June 2004 the RBA was under contract to purchase $9.3 billion of foreign currency and sell $34.8 billion of foreign currency. As of that date there was an unrealised net loss of $797 million on these swap positions included in net profit. The credit risk exposure of these contracts is the cost of re-establishing the contract in the market in the event of the failure of the counterparty to fulfil its obligations.
2. ***Interest rate futures*** – As at 30 June 2004 the amount of credit risk on interest rate futures contracts was approximately $1.4 million ($0.8 million at 30 June 2003). As at 30 June 2004 there was an unrealised gain brought to account on those contracts of $0.3 million ($2.7 million unrealised loss at 30 June 2003).

Note 18 (CONTINUED)

Concentration of credit risk

The RBA operates to minimise its credit risk exposure through comprehensive risk management policy guidelines. The following table indicates the concentration of credit risk in the RBA's investment portfolio (refer Note 1(c)).

Credit risk

	Risk rating of security issuer*	Risk rating of counterparties*	% of total assets as at 2004	% of total assets as at 2003
Domestic Government Securities				
Holdings of Commonwealth Government securities	AAA	n/a	2.8	5.1
Holdings of Semi Government	AAA	n/a	0.9	0.0
securities	AA	n/a	0.4	0.0
Securities sold under	AAA	AAA	1.6	0.0
repurchase agreements	AAA	AA	0.7	1.5
	AAA	other	0.0	0.4
Securities held under	AAA	AA	11.7	18.6
repurchase agreements	AAA	other	0.6	1.0
	AA	AA	4.6	1.9
	AA	other	1.0	0.0
	other	other	0.7	0.0
Foreign investments				
Holdings of securities	AAA	n/a	20.4	25.3
	AA	n/a	3.7	8.1
	A	n/a	0.1	0.0
Securities sold under	AAA	AA	6.2	8.9
repurchase agreements	AAA	other	1.6	0.9
Securities held under	AAA	AA	20.2	14.8
repurchase agreements	AAA	other	6.2	0.9
Deposits	n/a	AAA	0.3	0.6
	n/a	AA	12.6	7.8
	n/a	other	0.0	0.1
Other	n/a	AAA/other	0.1	0.0
Gold loans	n/a	AAA	0.1	0.2
	n/a	AA	1.1	1.0
	n/a	other	0.8	0.8
Other			1.6	2.1
			100	100

* Standard & Poor's equivalent ratings

Note 19 CASH FLOW STATEMENT

The following cash flow statement appears as a matter of record to meet the requirements of AASB1026 – *Statement of Cash Flows*; in the RBA's view, it does not shed any additional light on the RBA's financial results. For the purpose of this statement, cash includes the notes and coin held at the RBA and overnight settlements system account balances with other banks.

STATEMENT OF CASH FLOWS For the year ended 30 June

	2004 Inflow/ (outflow) $M	2003 Inflow/ (outflow) $M
Cash flows from operating activities		
Interest received on investments	1 767	2 011
Interest received on loans, advances, and on net overnight settlements systems	38	38
Loan management reimbursement	1	1
Banking service fees received	17	23
Rents received	5	4
Net payments for and proceeds from sale of investments	(5 135)	(73)
Interest paid on deposit liabilities	(581)	(492)
Interest paid on currency note holdings of banks	(136)	(136)
Staff costs (including redundancy)	(105)	(94)
Premises and equipment	(24)	(25)
Other	25	(105)
Net cash provided by operating activities	(4 128)	1 152
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(16)	(16)
Net cash used in investing activities	(16)	(16)
Cash flows from financing activities		
Profit payment to the Australian Government	(1 300)	(1 889)
Net movement in deposit liabilities	3 390	744
Net movement in loans and advances	2	2
Net movement in notes on issue	1 850	242
Other	(14)	(2)
Net cash provided by financing activities	3 928	(903)
Net increase/(decrease) in cash	(216)	233
Cash at beginning of financial year	839	606
Cash at end of financial year	623	839

Note 19 (CONTINUED)

Reconciliation of cash	2004 $M	2003 $M
Cash	6	17
Overnight settlements systems	617	822
	623	839

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act*	2004 $M	2003 $M
Net Profit	1 955	2 173
Increase/(decrease) in interest payable	88	22
Net loss/(gain) on overseas investments	587	(1 036)
Net loss/(gain) on Australian dollar securities	169	(49)
Net loss/(gain) on foreign currency	(1 829)	150
Decrease/(increase) in income accrued on investments	54	48
Depreciation of property	7	7
Depreciation of plant and equipment	9	9
Net payments for and proceeds from sale of investments	(5 135)	(73)
Other	(33)	(99)
Net cash provided by operating activities	(4 128)	1 152

Auditor-General for Australia

Australian National
Audit Office

INDEPENDENT AUDIT REPORT

To the Treasurer

Scope

The financial statements comprise:

- Directors' Statement;
- Statements of Financial Position, Financial Performance and Distribution; and
- Notes to and forming part of the Financial Statements

for both the Reserve Bank of Australia (the Bank) and its consolidated entity, for the year ended 30 June 2004.

The members of the Bank's Board are responsible for the preparation and true and fair presentation of the financial report in accordance with the Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report.

Audit approach

I have conducted an independent audit of the financial statements in order to express an opinion on them to you. My audit has been conducted in accordance with Australian National Audit Office (ANAO) Auditing Standards, which incorporate Australian Auditing and Assurance Standards, in order to provide reasonable assurance as to whether the financial report is free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgement, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

While the effectiveness of management's internal controls over financial reporting was considered when determining the nature and extent of our procedures, the audit was not designed to provide assurance on internal controls.

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BARTON ACT
Phone (02) 6203 7500 Fax (02) 6273 5355
Email pat.barrett@anao.gov.au

I have performed procedures to assess whether in all material respects the financial statements present fairly, in accordance with the Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*, Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the Bank's performance as represented by the statements of financial performance, financial position and distribution.

The audit opinion is formed on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report; and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the Bank.

Independence

In conducting the audit, I have followed the independence requirements of the ANAO, which incorporate Australian professional ethical pronouncements.

Audit Opinion

In my opinion the financial statements:

(i) have been prepared in accordance with Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997* and applicable Accounting Standards; and

(ii) give a true and fair view, of the matters required by applicable Accounting Standards and other mandatory professional reporting requirements in Australia and the Finance Minister's Orders, of the financial position of the Reserve Bank of Australia and its consolidated entity as at 30 June 2004, and their financial performance for the year then ended.

P.J. Barrett
Auditor-General

Sydney
13 August 2004

Pro Forma Business Accounts

The following sets of accounts for each of the RBA's contestable businesses have been prepared in accordance with competitive neutrality guidelines. These accounts do not form part of the audited financial statements.

	Transactional Banking Business		Registry	
	2002/03 $ million	**2003/04 $ million**	**2002/03 $ million**	**2003/04 $ million**
Revenue				
– Service fees	17.1	15.6	0.7	0.6
– Other revenue	3.6	3.6	0.1	0.1
Total	20.7	19.2	0.8	0.7
Expenditure				
– Direct costs	12.7	11.6	0.5	0.4
– Indirect costs	3.3	3.2	0.2	0.2
Total	16.0	14.8	0.7	0.6
Net profit/(loss)	4.7	4.4	0.1	0.1
Net profit/(loss) after taxes (a)	3.2	3.0	0.1	0.1
Assets (b)				
– Domestic market investments	332.2	459.3	1.3	1.3
– Other assets	2.9	8.2	0.1	0.1
Total	335.1	467.5	1.4	1.4
Liabilities (b)				
– Capital & reserves	25.0	25.0	1.0	1.0
– Deposits	306.1	437.9		
– Other liabilities	4.0	4.6	0.4	0.4
Total	335.1	467.5	1.4	1.4

(a) In accordance with competitive neutrality guidelines, income tax expense has been calculated and transferred to the Commonwealth as a notional part of the RBA's annual profit distribution.

(b) As at 30 June

The Reserve Bank Board and Governance

The Role of the Board

Sections 8A and 10 of the *Reserve Bank Act 1959* give the Reserve Bank Board responsibility for "monetary and banking policy". The relationship of the Board and the government-of-the-day is set out in Section 11. Routinely, the "Government is to be informed, from time to time, of the Bank's monetary and banking policy". In practice this is done in the regular monthly meetings which the Governor, Deputy Governor and senior officers have with the Treasurer shortly after each Board meeting.

The Act itself has not been changed with respect to the mandate for monetary policy, but procedures and practices have evolved over time, in order to keep the RBA's policy-making process relevant to the changing environment, and in parallel with developments overseas. In 1996, the responsible Minister, the Treasurer, and the Governor jointly signed the *Statement on the Conduct of Monetary Policy*, which confirmed the RBA's independence in making monetary policy, and endorsed the RBA's inflation target. The Governor's twice-yearly appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration, and the quarterly *Statement on Monetary Policy,* have reinforced this process. An updated, though basically unchanged, second *Statement on the Conduct of Monetary Policy* was released at the time of the announcement by the Treasurer in July 2003 of the appointment of the Governor for a term of a further three years.

When the Australian Prudential Regulation Authority was established in 1998, it took on the prudential supervision of banks, but the RBA retained responsibility for overall financial system stability. In March 2004 the RBA began publishing a separate *Financial Stability Review* containing its assessment of the state of the financial system. This stand-alone publication will be published half-yearly.

The *Reserve Bank Act 1959* was amended in 1998 to establish the Payments System Board, which is responsible for payments system policy, and reports separately in its own Annual Report.

Composition of the Board

The Board comprises the Governor, who is Chairman, the Deputy Governor, the Secretary to the Treasury and six external members, appointed by the Treasurer – a total of nine. Details of the current members are set out on pages 90 and 91. Five members form a quorum for a meeting of the Board.

Meetings of the Board

The *Reserve Bank Act 1959* does not stipulate the frequency of Board meetings. For many years the Board's practice has been to meet eleven times each year, on the first Tuesday of each month, except January. Most meetings are held at the Head Office in Sydney. By custom, one meeting each year is held in Melbourne and, from time to time, the Board also meets in other State capitals; the Board held its June 2004 meeting in Brisbane.

Number of meetings attended by each member in 2003/04:		
IJ Macfarlane	11	(11)
GR Stevens	11	(11)
KR Henry *	10	(11)
JR Broadbent	11	(11)
RG Gerard	9	(11)
FP Lowy	9	(11)
DG McGauchie	10	(11)
WJ McKibbin	11	(11)
HM Morgan	10	(11)

* ML Parkinson attended one meeting in place of KR Henry, in terms of the provisions of Section 22 of the *Reserve Bank Act 1959*.
(The figure in brackets is the number of meetings the member was eligible to attend.)

Conduct of Board Members

On appointment to the Board, each member is required under the *Reserve Bank Act 1959* to sign a declaration to maintain secrecy in relation to the affairs of the Board and the RBA. Further, members must by law meet the general obligations of directors of statutory authorities, as set out in the *Commonwealth Authorities and Companies (CAC) Act 1997*. The *CAC Act* sets standards of conduct for directors and officers of Commonwealth authorities, with many of these requirements being modelled on comparable areas of the Corporations Law. As such, directors must:

- discharge their duties with care and diligence;
- act in good faith, and in the best interests of the RBA;
- not use their position to benefit themselves or any other person, or to cause detriment to the RBA or any person;
- not use any information obtained by virtue of their position to benefit themselves or any other person, or to cause detriment to the RBA or any person; and
- declare any material personal interest where a conflict arises with the interests of the RBA.

Over and above these legislated requirements, members recognise their responsibility for maintaining a reputation for integrity and propriety on the part of the Board and the RBA in all respects. Hence, during the past year, they have agreed to adopt a Code of Conduct which provides a number of general principles as a guide for the conduct of individual members in fulfilling their duties and responsibilities as members of the Board.

Audit Committee

The primary objectives of the Audit Committee are to:

- ensure a high-quality, independent and effective audit process;
- assist the Governor and the Board in fulfilling their obligations relating to financial reporting, compliance with laws and regulations, internal control, employee conflicts of interest, business ethics and prevention of fraud; and

- enhance contact between management and the Audit Department.

The Committee also acts, at the request of the Note Printing Australia Limited (NPA) Board, as NPA's Audit Committee.

The Audit Committee is made up of the Deputy Governor as Chairman, a non-executive member of the Reserve Bank Board, JR Broadbent, and an external appointed member, GH Bennett, company director and former National Executive Chairman, KPMG Peat Marwick. During 2003/04, the Committee met on four occasions; all members attended each of these meetings. The two external members of the Committee also meet with the external auditor in the absence of management from time to time.

Minutes of Audit Committee meetings are circulated to the Reserve Bank Board for information, and discussion as appropriate, and a report on the Committee's activities for the year is prepared for the Board at the time of the presentation of the annual accounts.

Reporting Obligations under the *Commonwealth Authorities and Companies (CAC) Act 1997*

The RBA is a Commonwealth authority for the purposes of the *CAC Act* and, for these purposes, the members of the Reserve Bank Board are the directors of the RBA. As such, they are responsible for the preparation of the Annual Report and, at the meeting of the Board on 3 August 2004, they resolved that the Chairman sign the Report, and the Financial Statements as at 30 June 2004, transmit them in accordance with the requirements of the *CAC Act,* and arrange publication.

The House of Representatives Standing Committee on Economics, Finance and Public Administration has, in its Standing Orders, an obligation to review the Annual Report of the RBA, and the Annual Report of the Payments System Board.

Remuneration

Fees of the non-executive members of the Board are determined by the Remuneration Tribunal.

A committee of the non-executive Board members, currently chaired by DG McGauchie, reviews annually the remuneration of the Governor and Deputy Governor in terms of Section 24A of the *Reserve Bank Act 1959*.

Indemnities

Under the provisions of Section 27 of the *CAC Act,* and pursuant to a Board resolution on 3 November 1998, members of the Reserve Bank Board have been indemnified against liabilities incurred arising out of the proper discharge of their responsibilities, provided that any such liability does not arise from conduct involving a lack of good faith. This indemnity does not extend to claims by the RBA itself or any subsidiary of the RBA. A similar indemnity was extended to the members of the Payments System Board, pursuant to a resolution by the Reserve Bank Board on 3 November 1998.

Reserve Bank Board

Chairman: Ian Macfarlane AC

Governor since
18 September 1996
Present term ends
17 September 2006

Chairman – Payments System Board

Chairman – Council of Financial Regulators

Glenn Stevens

Deputy Governor since
21 December 2001
Present term ends
20 December 2008

Ken Henry

Secretary to the Treasury
Member since
27 April 2001

Jillian Broadbent AO

Member since 7 May 1998
Present term ends
6 May 2008

Director – Coca-Cola Amatil Limited

Director – Special Broadcasting Service

Director – Woodside Petroleum Limited

Robert Gerard AO

Member since 20 March 2003
Present term ends
19 March 2008

Chairman & Managing Director – Gerard Corporation Pty Ltd

Frank Lowy AC

Member since 27 June 1995
Present term ends
9 December 2005

Chairman – Westfield Holdings Limited

Chairman – Lowy Institute for International Policy

Chairman – Australian Soccer Association

Director – Daily Mail and General Trust PLC (UK)

Donald McGauchie AO

Member since 30 March 2001
Present term ends
29 March 2006

Chairman – Telstra Corporation Limited

Chairman – Rural Finance Corporation of Victoria

Deputy Chairman – Ridley Corporation Limited

Director – National Foods Limited

Director – Nufarm Limited

Director– James Hardie Industries NV

Warwick McKibbin

Member since 31 July 2001
Present term ends
30 July 2006

Executive Director, Centre for Applied Macroeconomic Analysis & Professor of International Economics, Research School of Pacific & Asian Studies – Australian National University

Professorial Fellow – Lowy Institute for International Policy

Non-Resident Senior Fellow – The Brookings Institution, USA

President – McKibbin Software Group Inc (USA)

Director – McKibbin Software Group Pty Ltd

Director – EconomicScenarios.com Pty Ltd

Hugh Morgan AC

Member since 14 August 1996
Present term ends
28 July 2007

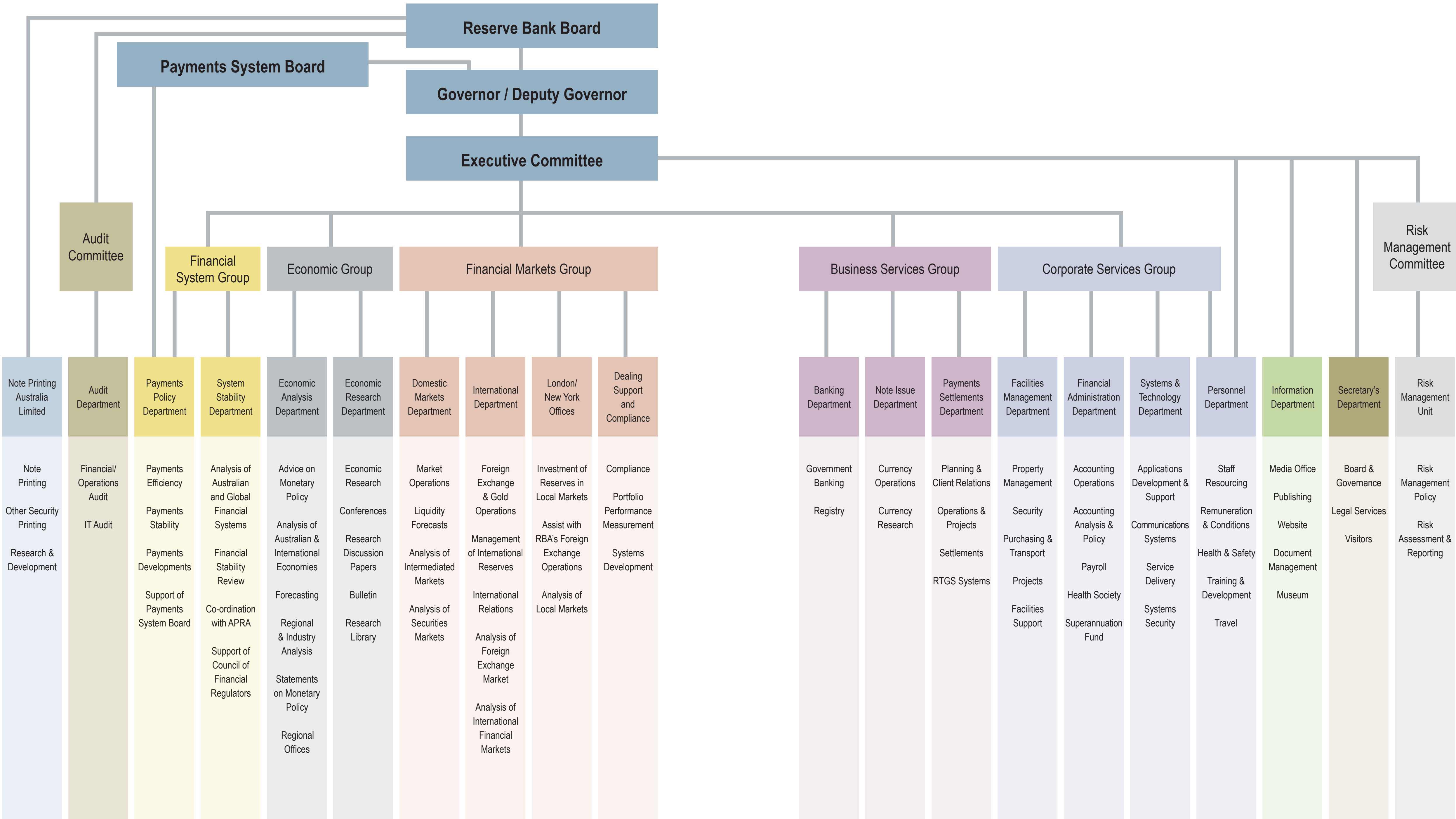
Principal – First Charnock Pty Ltd

President – Business Council of Australia

Joint Chairman – Commonwealth Business Council

Member – Lafarge International Advisory Board

Organisational Chart | July 2004



Glossary

ABF	Asian Bond Fund
ACC	Asian Consultative Council (of the BIS)
APEC	Asia-Pacific Economic Co-operation
APRA	Australian Prudential Regulation Authority
BIS	Bank for International Settlements
CAC	Collective action clause
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CD	Certificate of deposit
CGS	Commonwealth Government securities
CGFS	Committee on the Global Financial System (of the BIS)
CHESS	Clearing House Electronic Subregister System of the Australian Stock Exchange
CLS	Continuous linked settlement
CPSS	Committee on Payment and Settlement Systems (of the BIS)
EEO	Equal employment opportunity
EMEAP	Executives' Meeting of East Asian and Pacific central banks
ESA	Exchange Settlement Account
Finance	Department of Finance and Administration
FX	Foreign exchange
GDES	Government Direct Entry Service
G7	Group of Seven
G10	Group of Ten
G20	Group of Twenty
IMF	International Monetary Fund
NNPDC	National Note Processing and Distribution Centre
NPA	Note Printing Australia Limited
OECD	Organisation for Economic Co-operation and Development
OH&S	Occupational health & safety
OPA	Official Public Account
RBA	Reserve Bank of Australia
RBRF	Reserve Bank Reserve Fund
RITS	Reserve Bank Information and Transfer System
RTGS	Real-time gross settlement

Head Office Management | End July 2004

Governor	Ian Macfarlane
Deputy Governor	Glenn Stevens

Economic Group

Assistant Governor — Malcolm Edey

Economic Analysis Department

Head	Tony Richards
Deputy Heads	Luci Ellis
	Christopher Kent

Economic Research Department

Head — Vacant

Financial Markets Group

Assistant Governor — Ric Battellino

Domestic Markets Department

Head	Chris Ryan
Chief Manager	James Whitelaw

International Department

Head	Guy Debelle
Chief Managers	Ric Deverell
	Mike Sinclair

Financial System Group

Assistant Governor — Philip Lowe

Payments Policy Department

Head	John Veale
Chief Manager	Michele Bullock

System Stability Department

Head	Keith Hall
Chief Manager	Marianne Gizycki

Business Services Group

Assistant Governor — Bob Rankin

Banking Department

Head — Phil Martin

Note Issue Department

Head — John Taylor

Payments Settlements Department

Head — Bill Hands

Corporate Services Group

Assistant Governor — Frank Campbell

Facilities Management Department

Head — Richard Mayes

Financial Administration Department

Head — Darryl Ross

Systems & Technology Department

Head — John Wightman

Secretary's Department

Secretary — David Emanuel

Audit Department

Head — Paul Apps

Information Department

Head — Paul Barry

Personnel Department

Head — Graham Rawstron

Risk Management Unit

Head — Peter Stebbing

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