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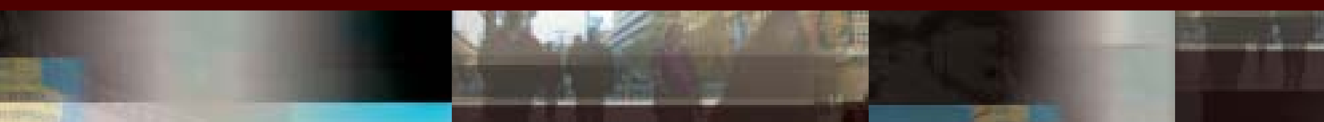

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GOVERNOR'S FOREWORD

The period covered by this Report – the financial year 2001/02 – was an eventful one for the world economy, but a relatively trouble-free one for the Australian economy. The world economy experienced very sluggish growth, with the two biggest economies – the United States and Japan – in recession in the first half of the financial year. Into this environment, the events of September 11 added an additional element of uncertainty, and it seemed for a time that conditions might worsen in 2002. In the event a slow and uncertain recovery is occurring, despite further economic shocks in the form of sovereign debt crises (notably in Argentina), and the revelation of serious deficiencies in corporate governance in the United States.

In Australia, the RBA eased monetary policy three times in the second half of 2001 – once before September 11 and twice after it. On all three occasions, the easing was motivated by a desire to pre-empt the effects on Australia of a probable downturn in the world economy in 2002. When it became clear that another year of downturn for the world economy was unlikely, monetary policy was tightened again in the first half of 2002. These tightenings were fully consistent with the RBA's inflation targeting framework as inflation was near the top of the desired range and forecasts pointed to the likelihood that, if nothing was done, it would in time exceed the range. More details on the conduct of monetary policy can be found in the quarterly *Statement on Monetary Policy*, the testimony to the Parliamentary Economics Committee, media releases at the time of changes and in various speeches by myself and the Deputy Governor.

The financial markets area was the part of the RBA to be most directly affected by the events of September 11. First, as recounted in the body of the Report, it faced an immediate challenge in providing sufficient liquidity to the money market when it opened shortly after the event. This it was able to achieve without a hitch, although other markets, including the foreign exchange market, were inevitably affected. Second, the dealing capacity at our New York Office was immediately taken out of action as it was in a building adjacent to the World Trade Center that was damaged by the collapse. The dealers were switched to London and could not re-occupy the building in New York for three months, but operations were successfully carried out in London during that time.

A change to operating procedures in the financial markets area was announced in July to facilitate the introduction of the Continuous Linked Settlement Bank. This involved the introduction of a new intra-day facility for repurchase agreements in bank bills and certificates of deposit. The facility will be available to banks and some other holders of exchange settlement accounts.

Despite the economic weakness in the world economy and the international shocks referred to earlier, financial systems around the world have shown a great deal of resilience. This is particularly true in Australia, although it has to be admitted that our institutions were barely affected by events in Argentina and the US corporate sector. The payments policy area of the RBA was fully occupied during the year with its review of credit card schemes, overseen by the Payments System Board. This involved extensive consultation with the industry, the release of a consultative document in December 2001, and the preparation of a final set of standards and access regime.

With staff numbers appearing to have finally levelled out, after the long fall of the past two decades, a particular area of activity in the past year in the business and support areas of the RBA has been in consolidating our buildings. The Perth and Hobart buildings were sold and the Sydney Head Office is undergoing extensive renovations to free space on six floors for letting to commercial tenants. One of these floors has already been let.

Interaction with the community has not been diminished by any of the recent changes and we still maintain a presence in Sydney, Melbourne (including Craigieburn), Brisbane, Perth, Adelaide, Canberra, London and New York. Our new Regional Offices have been successful in building a network of contacts among businesses, industry groups and State governments across the country. Their first-hand intelligence about local economic conditions is proving to be a valuable input into the Board's deliberations about the economy.

In Head Office, the project begun last year to bring in-house the operation and development of the computer systems support for Australia's real-time gross settlement (RTGS) arrangements moved forward on schedule. While this required a dozen or so additional staff, the importance of the work fully justifies the commitment. The RTGS system is the cornerstone of interbank payments and is vital to controlling risk in the financial system. When this project is completed later in 2002, it will provide a platform to modernise the RTGS system in coming years so that these arrangements in Australia remain at the forefront of international practice.

The banking business remains important, notwithstanding the fall in staff over nearly 20 years. Although the RBA is a relatively small player in Australia's transactional banking market, we fill an important niche in making payments on behalf of the Commonwealth Government, mainly to social welfare recipients. Costs have been greatly reduced and services have been progressively improved over time, to achieve the desired levels of efficiency and reliability. In the past year, new security systems for cheque-clearing and a web-based banking facility have been developed. Overall, the RBA is now a competitive provider of these relatively specialised services, as demonstrated by our success in holding onto most of our major customers when their business has been put to tender.

The centralised facility for note processing and distribution, the National Note Processing Centre (NNPC), was opened in June 2001 at Note Printing Australia (NPA), and the cash handling facility in Sydney was closed. The transfer to banks of ownership of the working stocks of currency was completed in November. These had previously been owned by the RBA but held in pools external to the RBA and operated by armoured car companies. Now that this has been completed, we no longer have any direct role in cash handling or distribution once currency has left the NNPC, nor do we own any currency held outside our own premises. Taken together, these measures have reduced the cost of note distribution and exposed the market for currency notes to greater commercial discipline.

Both NPA and Securency, our joint venture with the Belgian firm UCB, continue to make progress in promoting export sales based on polymer banknote technology. The supply to Mexico of 176 million printed banknotes from NPA, and a large order of polymer substrate from Securency, added another major name to the growing list of export markets for polymer currency.

Despite the smaller number of staff and buildings, the RBA remains as active as ever in many areas of Australia's financial markets and economy. In fact, we believe that we play a bigger role in the Australian economy than in the days when our physical presence was larger. That is testimony to the dedication of our staff in maintaining high standards across the full range of our responsibilities.

OPERATIONS IN FINANCIAL MARKETS

DOMESTIC MARKET OPERATIONS

Monetary Policy Implementation

As in most developed economies, the stance of monetary policy in Australia is expressed in terms of a short-term market interest rate. In Australia's case it is the cash rate – the interest rate at which banks borrow and lend overnight funds among themselves. The Reserve Bank Board announces its policy decisions in terms of an operational target for the cash rate and the staff then conduct market operations each day to maintain the actual rate around the target.

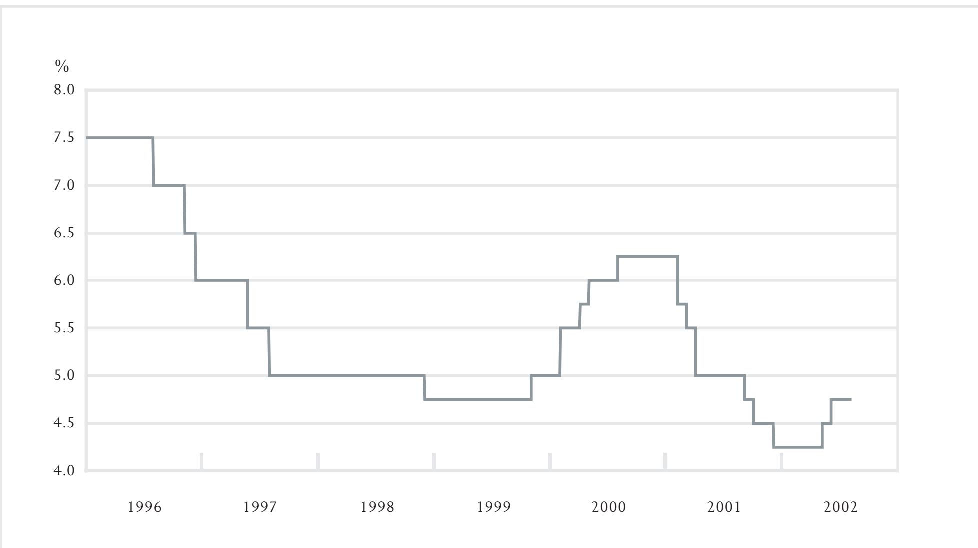
The stance of monetary policy was changed five times in 2001/02. The Board eased policy three times in the second half of 2001, reducing the cash rate target from 5.0 per cent to 4.25 per cent, the lowest level since the early 1970s. In the first half of 2002, policy was tightened twice, taking the target cash rate back to 4.75 per cent. The background to each of these changes was provided at the time through media releases and has been discussed in detail in the quarterly *Statements on Monetary Policy*.

Movements in the Target Cash Rate in 2001/02

	Change (percentage points)	New Level (per cent)
5 Sep 2001	-0.25	4.75
3 Oct 2001	-0.25	4.50
5 Dec 2001	-0.25	4.25
8 May 2002	+0.25	4.50
5 June 2002	+0.25	4.75

The actual cash rate is maintained very close to the target, the average difference in 2001/02 being

GRAPH 1 / TARGET CASH RATE



around 1 basis point. The greatest deviation from the target cash rate occurred in the days immediately following September 11, 2001 when the RBA's market operations increased the supply of funds available to banks – i.e. increased their liquidity – to ensure the continued smooth operation of financial markets (see section on Events of September11, page 9). This meant that the cash rate fell below the target for a few days, though the deviation was only about 6 basis points.

Market operations have traditionally been conducted in domestic securities markets. Until the mid 1980s, these operations were implemented entirely through outright purchases (to inject funds) and sales (to withdraw funds) of Commonwealth Government securities (CGS). The RBA remains willing to undertake such transactions but in recent years has come to rely more heavily on repurchase agreements (repos) (see table). Repos involve the purchase or sale of securities with a simultaneous agreement to reverse the transaction on an agreed date, and at an agreed yield. Because the transaction is generally reversed within a relatively short period, repos involve little market risk. In addition, the fact that the maturity terms can be agreed mutually means that repos provide an ideal liquidity management tool for central banks as they facilitate the reallocation of large amounts of cash to specific dates.

Structural Changes in Financial Markets

As discussed in recent Annual Reports, structural changes in financial markets have meant that the RBA has had to adjust the arrangements under which it conducts its market operations in recent years. The introduction of real-time gross settlement (RTGS) and new arrangements for Commonwealth tax collections have boosted the demand for funds in financial markets. At the same time, the decline in the amount of CGS on issue has reduced the instruments available to the RBA, either to purchase or accept as collateral, in supplying cash to the system. The amount of CGS on issue (excluding the Commonwealth's own holdings) has declined from a peak of $115 billion in early 1997 to $62 billion in mid 2002.

The RBA has adapted to these developments by broadening the range of collateral it is prepared to accept in its domestic repo operations. This started with the decision in 1997 to accept Australian dollar domestic securities issued by State and Territory

Market Operations ($ billion)

	1997/98	1998/99	1999/00	2000/01	2001/02
Repurchase agreements (a)					
– Purchases	275	300	244	376	423
– Sales	8	13	14	17	16
Short-term CGS					
– Purchases	26	21	9	5	1
– Sales	0	0	0	0	0
Total domestic operations	309	334	267	398	440
Foreign exchange swaps (a)	33	52	67	90	90

(a) First leg of transaction

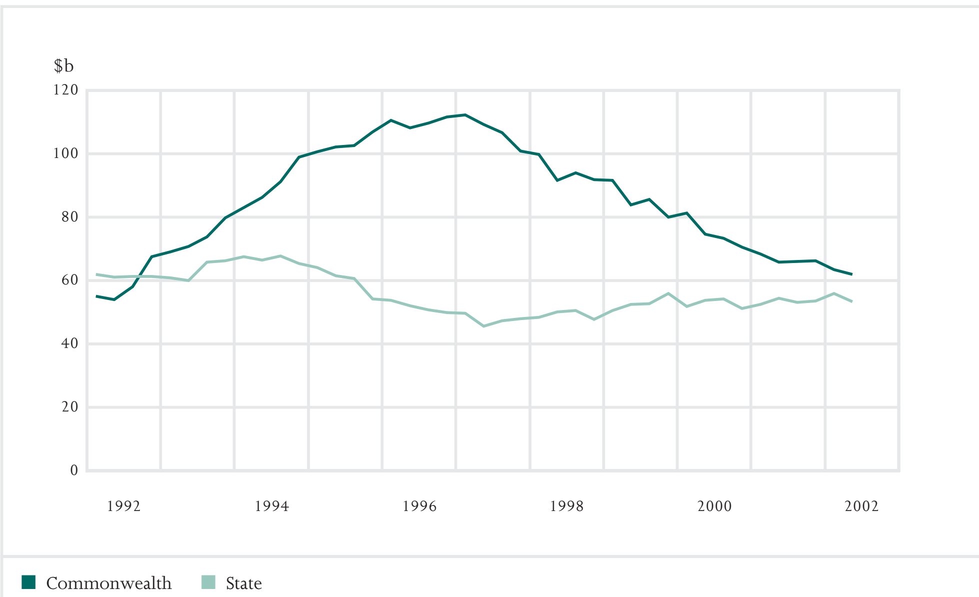
borrowing authorities. This increased the pool of securities available for repo by over 40 per cent at the time. Declines in CGS on issue since then mean that, in June 2002, the repo collateral pool was effectively double what it would have been if the RBA had not made this change. Market participants adjusted quickly to the new arrangements, and between 50 and 60 per cent of the domestic collateral held by the RBA on repo is now typically State government debt.

In October 2000, the RBA announced that it would also accept AAA-rated Australian dollar domestic debt securities issued by select supranational organisations. The range of acceptable supranational issuers was broadened in June 2001, at the same time as the RBA announced that it would also accept Australian dollar securities issued offshore by State and Territory borrowing authorities but lodged in the domestic Austraclear settlement system in a form known as Euroentitlements.

These more recent changes have increased the collateral pool by a relatively slight amount and, to date, less than 5 per cent of domestic collateral on average held by the RBA has been supranational securities or Euroentitlements. However, these securities represent market sectors that have the potential to expand in the years ahead.

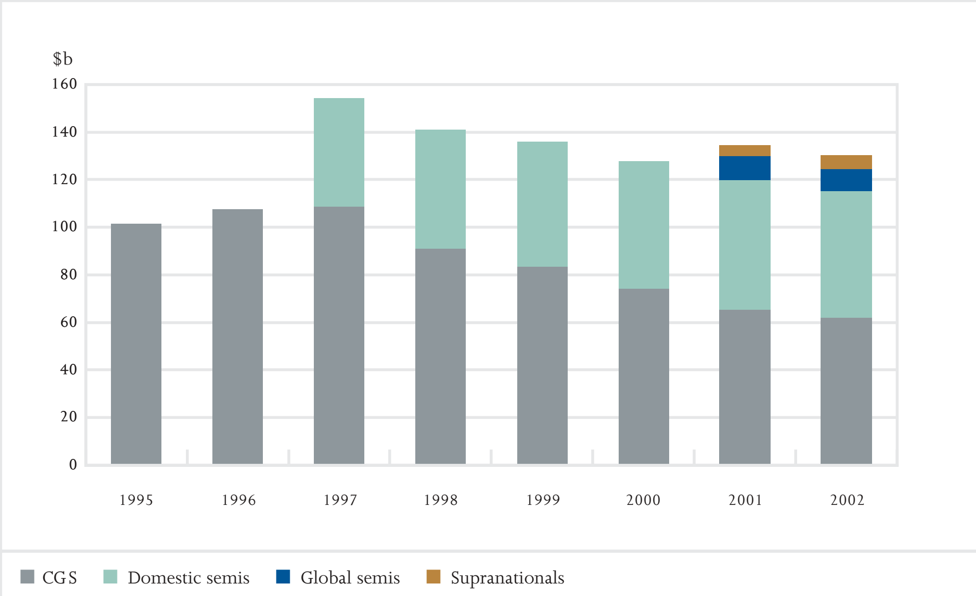
Another key adjustment made in recent years has been the increased use of foreign exchange swaps for domestic liquidity management. To the extent that foreign exchange swaps work in essentially the same way as repos, their use can be seen as an extension of the collateral pool to include foreign currency government securities.[1] The use of swaps was outlined in some detail in last year's Annual Report. RBA turnover in foreign exchange swaps was $90 billion in the year to June 2002, unchanged from the previous year but roughly three times the turnover of four years earlier. Foreign exchange swaps accounted for around

GRAPH 2 / **SUPPLY OF GOVERNMENT SECURITIES** End quarter



[1] In a foreign exchange swap, the foreign currency delivered against the Australian dollars represents collateral in the same way that securities do in a domestic repo. The foreign currency is invested offshore in government debt on either a repo or outright basis.

GRAPH 3 / **TOTAL ELIGIBLE COLLATERAL FOR DOMESTIC MARKET OPERATIONS** End June



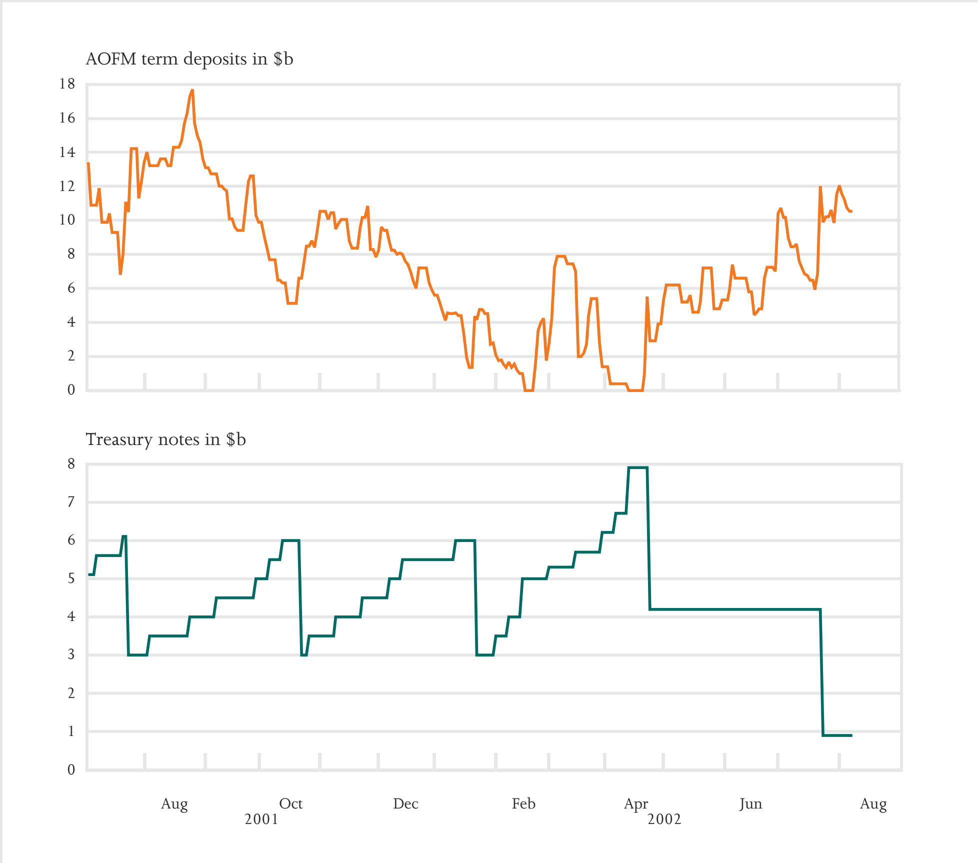
17 per cent of all RBA market operations in 2001/02, essentially unchanged from 2000/01.

These adjustments have proved successful in facilitating the RBA's market operations without creating difficulties in the markets themselves. In addition, the pace at which CGS on issue are falling slowed during the past year. As a result of these developments, the total amount of collateral potentially available for repos with the RBA has increased by 30 per cent since the mid 1990s and the share of the potential collateral pool held by the RBA has remained constant, at around 15 per cent.

As outlined in the 2001 Annual Report, changed taxation collection arrangements, which were aimed at minimising the number of separate tax payments by businesses, have led to a greater concentration of tax payments into a few key dates. Some fine tuning of the new tax arrangements, however, has made these periods easier to handle from a liquidity point of view. In February 2001, the transitional arrangement whereby small and medium companies could stagger their tax payments around two days per quarter, rather than one, was made a permanent feature of the new framework. While peak tax flows have proved somewhat larger than the $15 billion per quarter expected at that time, they have been spread across more days than initially expected. This has meant correspondingly smaller daily peaks in demand for liquidity by banks and less pressure on the collateral pool.

These developments contributed to the decision by the Australian Office of Financial Management (AOFM) to alter the arrangements for the issuance of Treasury notes. Traditionally an instrument used by the Government for within-year cash management, Treasury notes have become less important for this purpose in recent years as the AOFM has been able to use its term deposits at the RBA, on which it receives market rates of interest, to manage within-year fluctuations in its cash position. Balances in these

GRAPH 4 / AOFM TERM DEPOSITS AT THE RBA AND TREASURY NOTES OUTSTANDING



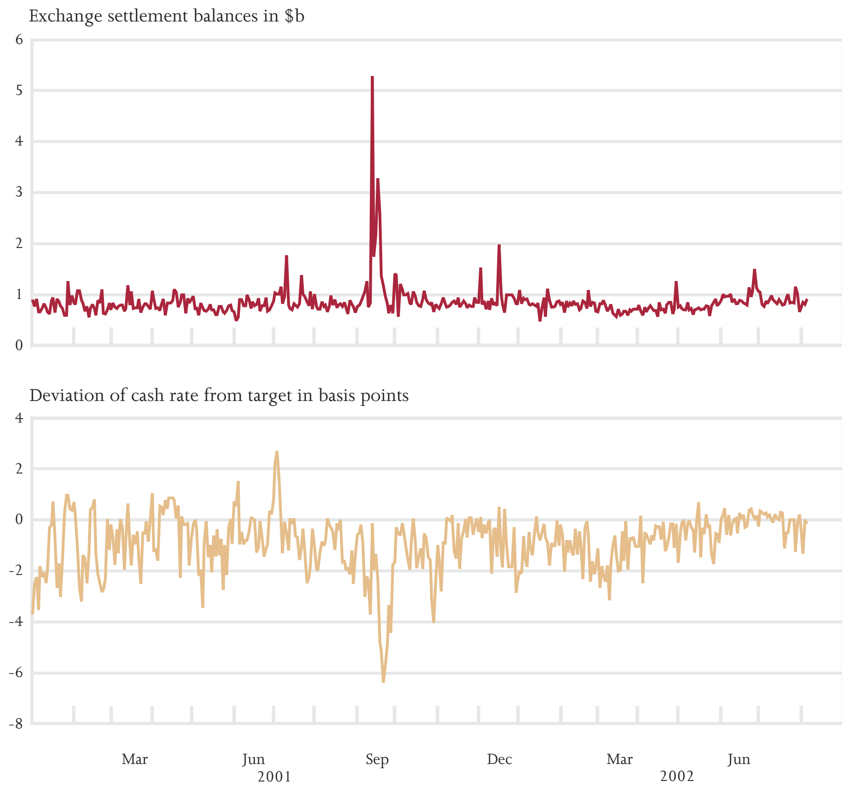
term deposits fluctuate considerably; during the past year, they varied between zero and $18 billion. At end – June 2002, they were $10 billion, compared with $13 billion a year earlier. In May 2002 the AOFM announced that it would in future issue Treasury notes only when needed, rather than maintain a regular issuance schedule.

Events of September 11

Liquidity management arrangements were tested, as they were in most countries, by the events of September 11 in the United States. The September 12 payments day in Australia commenced only hours after the terrorist attacks and some banks were uncertain whether payments due to them as a result of international transactions would be received. There was a risk that this uncertainty would significantly constrain the normal functioning of the interbank money market, as individual banks sought to bolster their own liquidity by delaying payments, thereby contributing to other banks' problems.

The first step taken by the RBA early on the morning of September 12 was to issue a statement confirming that the payments and settlements infrastructure would be operating normally and that the RBA would provide the financial system with as much liquidity as required. In the event, the RBA boosted the amount of Exchange Settlement funds

GRAPH 5 / **EXCHANGE SETTLEMENT BALANCES AND CASH RATE DEVIATION FROM TARGET**



held by banks at the end of the day to over $5 billion, more than six times the amount banks had been demanding in the period leading up to the attacks. Around one-third of these net additional funds was supplied through the normal 10.00 am market operations. The balance was provided through a second round of operations conducted mid-afternoon (one of only four second rounds conducted all year). All funds were secured under repurchase agreement against eligible collateral.

Liquidity in domestic securities markets (i.e. the ability to trade at very fine margins) deteriorated sharply in the immediate aftermath of September 11. Interbank price-making for Treasury and semi-government bonds contracted and, for a few days, client business was undertaken on a "best endeavours" basis. Trading in the corporate bond market virtually ceased.

Activity in the repo market also fell sharply. With borrowers finding it extremely hard to obtain funds in the interbank market, even on a secured basis, the RBA played a critical role in meeting the demand for funds. Overnight Exchange Settlement balances averaged over $2 billion for several days as demand for funds remained high. Conditions returned to more normal levels within a week or so.

In contrast to the lower activity in physical bond and repo markets, turnover in interest rate futures and options traded on the Sydney Futures Exchange held up in the days following September 11. The futures market played an important role in facilitating risk management and price discovery through this period.

Preparation for Continuous Linked Settlement

More recently, the focus has turned to preparing for the introduction of "continuous linked settlement" (CLS). As discussed in last year's Annual Report, CLS is a new system for settling foreign exchange transactions designed to reduce settlement risk. Almost all major banks in the world will participate. One consequence of CLS, however, is that it may increase banks' demand for liquidity. For Australian banks, this may pose particular problems as the period chosen for the global settlement of transactions through CLS Bank is late in the Australian day. Payments to and from CLS Bank will take place between 3.00 pm and 7.00 pm during Eastern Standard Time and between 5.00 pm and 9.00 pm during Eastern Daylight Saving Time in Australia.

Following consultation with market participants, the RBA came to the view that there was a need to provide banks with a new facility designed to meet periodic and potentially large demands for intra-day liquidity at relatively short notice. The existing facility for intra-day liquidity, which is based on government securities, was unlikely to meet banks' needs, particularly as a further decline in the amount of government securities on issue is likely.

Details of the new facility were announced on 15 July 2002. Funds will be provided under repo, as they are under the existing intra-day facility, but the range of acceptable collateral will be widened to include selected bank bills and certificates of deposit. Banks whose securities are eligible must have a short-term credit rating of A1+ or equivalent (the highest possible) and a long-term credit rating of at least AA or equivalent . They must also have maintained a significant amount of eligible securities on issue in the Austraclear settlement system over the previous year. For 2001/02, this has been taken as $1 billion. The RBA will accept only third-party securities – i.e. a bank will not be able to present its own securities to the RBA. This provides an additional layer of protection against credit risk for the RBA. Use of the facility will involve a fee, as opposed to current intra-day repos in government securities, which are provided without charge. This is designed to discourage banks from shifting their holdings of liquid assets from government securities to bank securities. The RBA will review the effectiveness of the new facility on an ongoing basis.

At the same time as the new intra-day facility was announced, the RBA also made some changes to its procedures for normal market operations. It began specifying the preferred maturity date of repos which it is offering to buy or sell, rather than leaving it to the market to nominate maturities. This is designed to give market participants a clearer signal of where the RBA's dealing preferences are. It also announced that, effective 22 July, it would commence offering three and six-month repos at its 10.00 am market operations on a regular basis (usually weekly). Repos undertaken in daily market operations have traditionally been for terms of less than one month, a term structure that suits the RBA's liquidity management requirements. The decision to introduce three and six-month repos followed approaches by market participants and was taken in the interests of the development of the maturity profile of the repo market and indirectly in supporting liquidity in the secondary bond market.

RBA Liquidity Facilities

	Market Operations	Standard Intra-day Repo	New Intra-day Repo	Overnight Repo
Term	Varied	Intra-day but may be extended overnight via Overnight Repo Facility	Intra-day only	Overnight only
Collateral	CGS State Gov debt Supranational debt	CGS State Gov debt Supranational debt	Bank bills CDs	CGS State Gov debt Supranational debt
Rate	Market-determined	Free	5 basis points	Cash rate target + 25 basis points
Overcover	2 per cent	None	None	2 per cent

Other Domestic Operations

In recent years, the RBA has been active in the government bond market in its capacity as fiscal agent for the Commonwealth. These operations, which have been carried out under instruction from the AOFM, have largely involved the retirement of outstanding debt through direct repurchases. In 2001/02, the RBA undertook no transactions of this type and, in future, the AOFM will undertake direct repurchases in its own name. Over the year, the AOFM pursued a consolidation program through the use of conversion tenders rather than direct repurchases.

The other main area of domestic operations is securities lending. The RBA maintains a securities lending facility through which it lends from its outright holdings of CGS on an issue-by-issue basis. The RBA undertakes this activity to assist market participants to cover temporary shortages of particular issues of Treasury bonds. However, the RBA prices its stock lending so as to be a less attractive lender in the market to avoid the risk of displacing private activity. Use of the facility more than doubled in 2001/02 from the very low level recorded the previous year. This increase in activity may reflect an increase in offshore demand for Australian dollar denominated assets as the outlook for the Australian dollar improved. However, at $3.1 billion, turnover remains low compared with some years ago when stock lending was undertaken at near-market rather than penalty rates.

Securities Lending by the RBA

	Number of Transactions	Amount Lent (face value, $ billion)	Net Income ($ million)
1996/97	540	11.9	0.7
1997/98	935	16.7	1.1
1998/99	805	14.6	0.9
1999/00	510	8.9	0.6
2000/01	75	1.2	0.1
2001/02	119	3.1	0.3

FOREIGN EXCHANGE OPERATIONS

The RBA undertakes transactions in foreign exchange markets for several reasons. The least frequent, but most prominent, are those to influence the Australian dollar exchange rate, typically referred to as intervention. More regular, but much lower-key, are transactions associated with the RBA's foreign currency asset management and those on behalf of the RBA's customers, chiefly agencies of the Commonwealth Government.

Australia has a flexible exchange rate regime, and the RBA is prepared to accept substantial fluctuations in the exchange rate, both day-to-day and over the course of the economic cycle. RBA intervention in the market is infrequent, and is undertaken during periods in which the exchange rate appears to be overshooting (either up or down) and is intended to signal to market participants that the RBA believes that the exchange rate is behaving in a way that does not seem warranted by the underlying economic factors in the market. Any potential impact of intervention on the domestic money market is sterilised.

During 2001/02 the only significant intervention occurred just after September 11, and was motivated mainly by the RBA's concerns about the extreme uncertainty in markets generally at that time. That intervention resulted in net purchases of Australian dollars of $1.1 billion. Through the rest of the year, the RBA did not intervene in the market because the exchange rate, even though it has remained low by comparison with its longer-run average level, tended to be either relatively stable or rising.

The RBA also sold $5.3 billion of foreign exchange to the Commonwealth in 2001/02. Early in the year these sales were met partly from reserve assets and partly from interest earnings on foreign investments and other transactions. By the June quarter, however, the RBA began to cover these Government transactions directly in the market, given that the exchange rate had risen significantly from its earlier lows. This is the normal practice.

For the year as a whole, net purchases of foreign exchange from all sources, plus interest earnings on reserves, were slightly larger than sales of foreign exchange to the Government, so overall transactions added to net reserves.

Part of the foreign exchange sold to the Commonwealth during the year was for repayments of some of the foreign currency swaps which the Commonwealth had previously entered into. These repayments were part of a set program agreed between the RBA and the Commonwealth following a review of the Commonwealth swap operations which concluded that all the Commonwealth's outstanding foreign currency swaps should be gradually run off.

That review had been conducted in the previous year after the combination of a falling exchange rate (which boosted the Australian dollar value of swap obligations) and declining Commonwealth (net) debt on issue highlighted the difficulties in managing the swap portfolio. The RBA became involved around the middle of 2000 when the AOFM signalled its intention to accelerate swap repayments in order to prevent the ratio of swaps to total debt on issue from rising above 15 per cent, which had some years earlier been adopted as the top of the benchmark range.

The RBA believed that accelerated repayments at that time (which would have involved sales of Australian dollars and purchases of foreign exchange) would have added substantial further downward pressure on the exchange rate and would have led to realisation of unnecessarily large losses by the Commonwealth, since it would have been selling at what were likely to be historically low levels for the dollar. On RBA advice, the Treasury instructed the AOFM in October 2000 to suspend the benchmark. This decision was formally approved by the Treasurer in December 2000, at which time he also initiated a longer-term review of foreign currency swaps. That review was completed by mid 2001, and a program of gradual reductions in swaps outstanding began to be implemented in October of that year.

RESERVES MANAGEMENT

The RBA holds a portfolio of foreign currency assets which form the major part of Australia's official reserve assets. It has always been the RBA's view that these assets should be invested in very secure instruments and, accordingly, it has traditionally confined its investments mainly to securities issued by AAA-rated foreign governments. This preference was reflected in the benchmark which was adopted in 1991, which weighted the portfolio 40 per cent to US assets, 30 per cent to German assets and 30 per cent to Japanese assets.

That benchmark had remained unchanged until the past year, when two changes were made. First, the weight previously given to German assets was reallocated across both German and French assets. This change followed the high liquidity attained by the French government securities market following the introduction of the euro. Like German government bonds, French government securities are rated AAA.

The second change involved reducing the weight given to Japanese assets, following the substantial reductions in the credit rating of Japanese government securities. With the rating falling to levels five rungs below the AAA standard the RBA normally seeks in its foreign investments, it was felt that a weight of 30 per cent to Japanese assets could no longer be justified. The weight was reduced to 10 per cent. Most of the funds were moved into the European portfolio, though some also went to the US. The result is that the weight of US and Europe are now equal, at 45 per cent.

No changes were made to the duration benchmarks for the various portfolios. Details of the new benchmark portfolio are summarised in the next table.

Composition of the Benchmark Portfolio (previous composition in parentheses)

	US	Europe	Japan
Asset allocation (%)	45 (40)	45 (30)	10 (30)
Currency allocation (%)	45 (40)	45 (30)	10 (30)
Duration (months)	30	30	30

The RBA continued the policy adopted last year of maintaining the portfolio close to benchmark. Deviations from benchmark duration averaged less than one month, while average deviations from benchmark weights for asset and currency composition were very small. These deviations, which reflected transactions by portfolio managers to take advantage of short-term market anomalies, contributed $28 million to returns over the past year. In addition, the RBA sought to enhance returns through securities lending. The return from securities lending has been relatively high in recent years, especially in the US market where debt repayment by the US government has added to the scarcity of the most liquid "on the run" bonds which comprise the bulk of the RBA's investments. The lending of these bonds to other market participants generated $35 million during the past year. This was a little less than in the previous year, in part because of the relative lack of activity during the period of market disruption which followed September 11.

The RBA's New York Office is in a building adjacent to the World Trade Center site and had to be evacuated on September 11. The building remained closed for about three months. The RBA's London office immediately took over responsibility for the US dollar portfolio following September 11 and staff from the US were relocated to London over the following few days to help ensure continuity of operations. The Federal Reserve Bank of New York, which acts as the

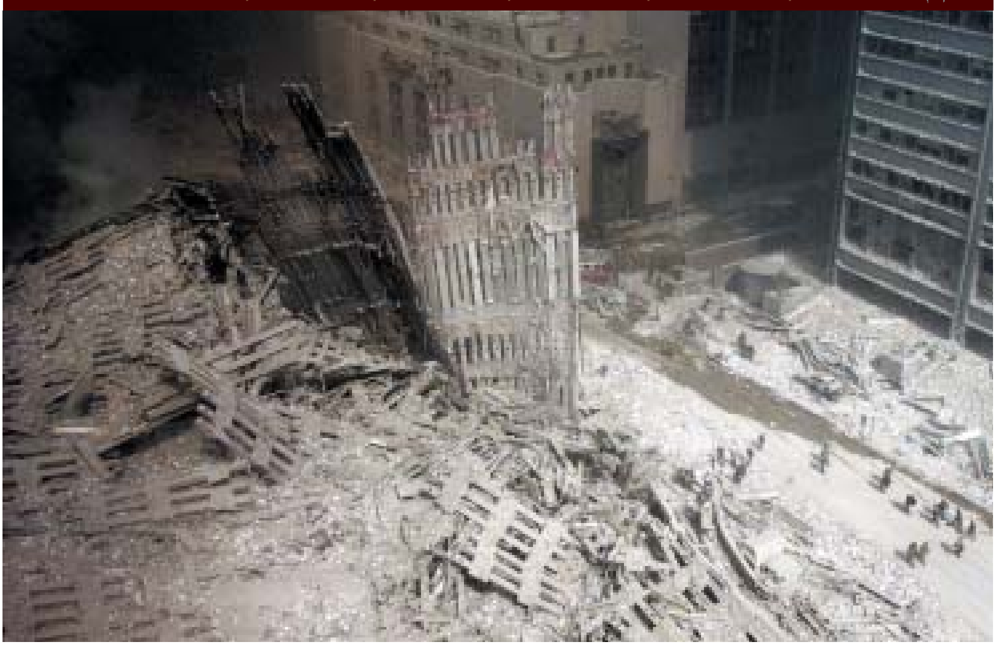
RBA's clearing and settlement agent for US securities transactions, continued to provide an uninterrupted service throughout. The New York Office had resumed normal operations by December 2001.

The total return on foreign reserves for 2001/02 was 3.9 per cent (measured in SDRs), compared with a benchmark return of 3.7 per cent. This difference, measured in Australian dollar terms, was equivalent to $63 million. As noted above, this excess return over benchmark came from securities lending and some limited trading of securities and currencies within delegations approved by the Governor.

Actual and Benchmark Returns

	Actual (%)	Benchmark (%)	Value of difference (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

The RBA's New York Office is at 1 Liberty Plaza, which is the building at the top right-hand corner of the photo. Although this building was adjacent to the World Trade Center, the suite of offices occupied by the RBA faced away from the area of devastation. © Reuters



In addition to its foreign currency assets, the RBA also holds about 80 tonnes of gold, valued at the end of 2001/02 at about $1.5 billion. The return on these holdings consists of the capital gain or loss which result from changes in gold prices, plus the small interest return available through the gold-lending market. Over the past year, interest rates on gold loans declined as gold producers seemed to have less demand for borrowed gold (which they sell to hedge future production). The average rate on one-year loans in 2001/02 was 1.2 per cent, down from 1.4 per cent in the previous year and 2.0 per cent in 1999/2000. Even though there was some decline in the general level of interest rates on gold loans, the RBA's total revenue from gold loans increased over the year from $17 million to $22 million. This is because the maturity of loans was increased to take advantage of the higher interest rates on longer-term loans.

Taking account of the interest on gold loans and the increase in the price of gold, the total return on gold assets in 2001/02 (measured in SDRs) was 13 per cent. This was higher than the return on other official reserve assets for the year, though longer-term comparisons still show the return on gold as falling short of those on interest-earning assets. Since 1997, when the RBA sold 167 tonnes of gold, earnings on the overseas government securities and other foreign currency investments purchased with the proceeds have substantially exceeded those which the RBA would have received if it had held onto the gold. As shown in the table, the Australian dollar equivalent of the proceeds of the gold sales in 1997 was A$2 434 million. The value of the investments purchased with these proceeds had increased to A$3 846 million by June 2002, taking account of interest received and changes in exchange rates. This is a cumulative return of A$1 412 billion, or 58 per cent. If the RBA had retained the gold, its value would have increased by June 2002 to A$3 221 million (taking account of both the increase in the gold price and the interest earned by lending the gold). This is a cumulative return of A$787 million or 32 per cent. The difference between the two amounts (A$625 million) represents the cumulative return achieved by the RBA from switching some of its gold holdings into interest-earning foreign currency assets.

	Value of Gold Sold (A$ million)	Value of Investment of Proceeds (A$ million)
Value at time of sale/investment	2 434	2 434
Value at June 2002	3 221	3 846
Absolute return	787	1 412
Percentage return	32%	58%

RISK MANAGEMENT DERIVATIVES

The nature of the RBA's operations means that it is unavoidably exposed to fluctuations in the value of its assets when exchange rates and interest rates rise and fall. For example, when the Australian dollar falls, the Australian dollar value of the RBA's foreign currency assets rises; conversely, when the exchange rate rises, the value of these assets falls. The RBA's exposure is determined by the size of net reserves, which in turn is determined by its intervention activity undertaken to influence the Australian dollar exchange rate. The RBA has no choice but to accept whatever level of reserves, and hence exposure to the Australian dollar exchange rate, that results from its intervention policy. Any attempt to manage that exposure would undo the original policy intent of the intervention.

Similarly, the value of the RBA's holdings of securities rises when market yields fall and falls when yields rise. The RBA holds government securities in Australia to support its domestic market operations, and in foreign currencies as part of official reserve assets.

At present about 70 per cent of the RBA's assets are in foreign currency and about 30 per cent in Australian dollar securities. However, as described earlier in this chapter, a large proportion of the foreign reserve assets are held under "foreign exchange swap" agreements. In a foreign exchange swap, the RBA buys foreign currency today and simultaneously sells the same parcel of currency forward. For the duration of the swap, the RBA holds foreign currency and invests it in foreign securities or deposits. Under these agreements, as the RBA is already committed to sell the foreign exchange at an agreed future date and at an agreed future price, there is no exposure to movements in the exchange rate on this part of the portfolio. Also, the interest rate earned is essentially an Australian dollar interest rate; any difference in the general levels of interest rates between the two currencies in the swap is offset by the difference in the forward exchange rate.

It will be recalled that the RBA's large holdings of foreign exchange swaps have been built up in recent years because it has been convenient to use them for domestic liquidity management, including the sterilisation of foreign exchange intervention transactions. With the supply of domestic government securities in decline, the RBA has been unable to buy securities (either outright or under repurchase agreements) in the volumes required to supply

The dealing room in the RBA's London Office. From left: Eric Lymer; Anita Godden; Stephanie Weston, Deputy Chief Representative; Sean Maloney.

MONETARY POLICY / MARKETS / STABILITY / PAYMENTS / CURRENCY / BANKING

domestic liquidity consistent with its monetary policy stance. It has therefore increased its use of foreign exchange swaps – which are exactly equivalent to buying foreign currency under repurchase agreements – to meet these needs. The RBA would have acquired the same exposure to Australian interest rates in the process of pursuing its monetary policy goals whether it used purchases of domestic securities or foreign exchange swaps to achieve the outcome. In other words, the foreign exchange swaps have had no material effect on the RBA's exposure to interest rate or exchange rate risk.

The swaps the RBA undertakes are confined to these very simple transactions. They are of very short-term maturity, generally less than three months, and counterparties are confined to highly rated banks so as to keep credit exposures to a minimum.

Apart from these transactions, the RBA undertakes two other types of derivative transactions. The first involves the purchase or sale of interest rates futures contracts on major overseas futures exchanges, to help manage the duration of foreign currency assets. For example, rather than selling securities outright to reduce duration, it is possible to achieve the same effect by selling a futures contract. In that case, even though the RBA has an obligation to deliver securities or cash under the futures contract, it holds the underlying physical security against this. No interest rate futures transactions are undertaken in Australia. The second is the purchase of call options on the Australian dollar as part of exchange rate intervention operations. Such transactions are rare. None was undertaken in 2001/02. They involve an up-front payment by the RBA to purchase a right to buy Australian dollars at a specific exchange rate, but carry no obligation to do so. If, after the RBA bought an option the exchange rate were to continue to fall, the RBA simply would not exercise the option. The risk of loss to the RBA is therefore limited to the amount of the premium paid for the option.

FINANCIAL SYSTEM STABILITY

A resilient and efficient financial system linking the decisions of savers and investors is crucial for community confidence, macroeconomic stability and economic growth. For this reason, central banks have had a longstanding responsibility to safeguard the overall stability of the financial system. The RBA's mandate in this area is closely aligned with its other policy obligations, since low and stable inflation, a reliable payments system and well-functioning financial markets are essential foundations for financial stability.

A low-inflation environment, however, does not guarantee financial stability. Over the past decade, inflation has been successfully reined in by industrial countries yet episodes of financial instability have persisted. Hence, the RBA also attaches high priority to monitoring the health of the Australian financial system and identifying potential vulnerabilities. To assist in this task, it has drawn on earlier episodes of financial instability in Australia and overseas to develop a range of "macroprudential" or financial stability indicators. It has analysed, in each episode, what made the financial system vulnerable to a particular disturbance; what event or factor triggered the bout of instability; how the disturbance was transmitted through the financial system; and the macroeconomic costs involved. Experience confirms the risks to financial stability posed, in particular, by rapid growth in credit fuelling asset price inflation. The RBA's focus on macroprudential indicators, which are constructed from aggregate financial and economic data, complements the role of the Australian Prudential Regulation Authority (APRA) in monitoring the financial condition and risk management processes of individual financial institutions, and the RBA and APRA work closely together through various formal and informal co-ordination mechanisms.

From a financial stability perspective, the past year was a challenging one for policy-makers. A series of unprecedented shocks to the global financial system, beginning with the September 11 terrorist attacks in the United States, hit an already fragile world economy. It is a testimony to the resilience of international financial markets and banking systems, and to the efforts that have been made to strengthen the international financial architecture, that the systemic consequences of these various shocks were relatively muted. Nonetheless, this positive outcome was far from certain as the consequences of each shock unfolded, and there are some important lessons to be learnt. As it had in the earlier Asian crisis, the Australian financial system has weathered the difficult external environment and in the RBA's assessment is in strong overall condition, underpinned by and in turn contributing to the sustained growth of the Australian economy. The general insurance sector, however, remains under some pressure.

THE STABILITY OF THE AUSTRALIAN FINANCIAL SYSTEM

The International Environment

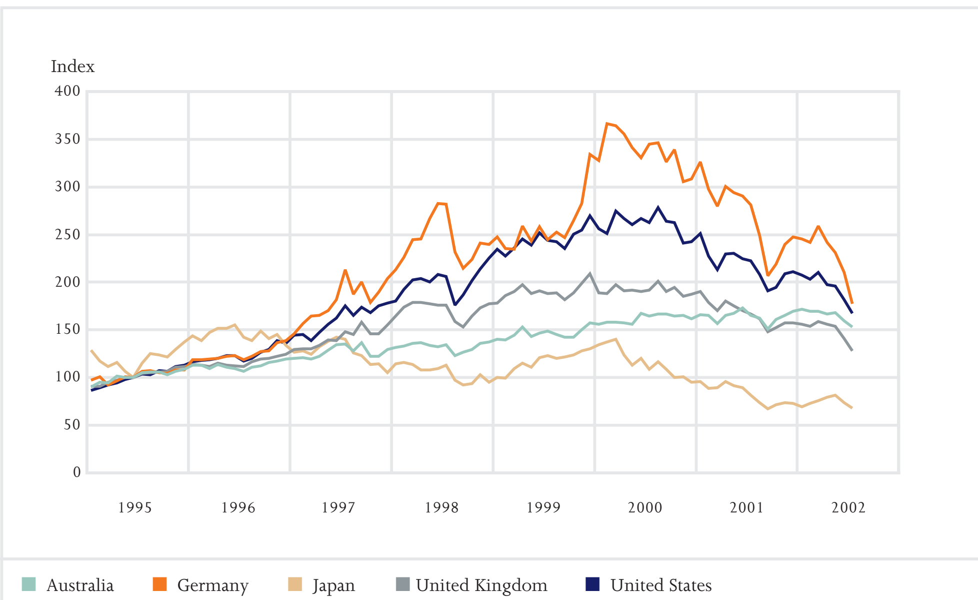
Over the first half of 2001/02, global economic conditions were at their weakest for a decade. The downturn in economic growth, which had begun earlier in the United States in the wake of the collapse of the "high tech" bubble, spread to all major regions. Weaker economic conditions in the United States were quickly reflected in a deterioration in credit quality in that country, particularly for business lending: business loan delinquencies climbed to their highest level since 1993, corporate bond default rates rose to record levels and the number of bankruptcy filings increased sharply.

The global economy was then confronted by three severe financial shocks, in rapid succession: the September 11 terrorist attacks, the collapse of the major US energy company, Enron, and the largest ever sovereign debt default (Argentina). The terrorist attacks had an immediate effect on consumer and business confidence in the United States and elsewhere, with share prices falling sharply and credit spreads widening. Though these financial market impacts proved relatively short-lived, the cumulative effect of the three financial shocks, and other large corporate collapses in the United States, reinforced the widespread pessimism about global economic prospects as 2001 ended.

This pessimism waned during the second half of 2001/02, with the global economy appearing to have turned the corner and a modest recovery getting under way in most major economies. While recovery has been led by the United States, uncertainty remains about its strength and durability because of continuing doubts about the underlying profitability of the business sector. These doubts, and a recognition that share price valuations in the United States are still quite high by historical standards, have weighed on investor confidence over recent months. As a result, share markets in the US and other major economies have come under renewed pressure.

Some very tentative signs of a Japanese recovery have also begun to emerge. In 2001, Japan lapsed back into recession, its third and most severe in a decade. Beset by the legacy of substantial non-performing loans in its banking sector, Japan was seen as increasingly vulnerable to a collapse in investor confidence, particularly with the planned removal of the blanket guarantee on term deposits at banks on 1 April 2002. In the event, this change was achieved with minimal disruption. Australia has important financial linkages to Japan but these have diminished in scale over the past decade and have

GRAPH 6 / **INTERNATIONAL SHARE PRICE INDICES** June 1995 = 100



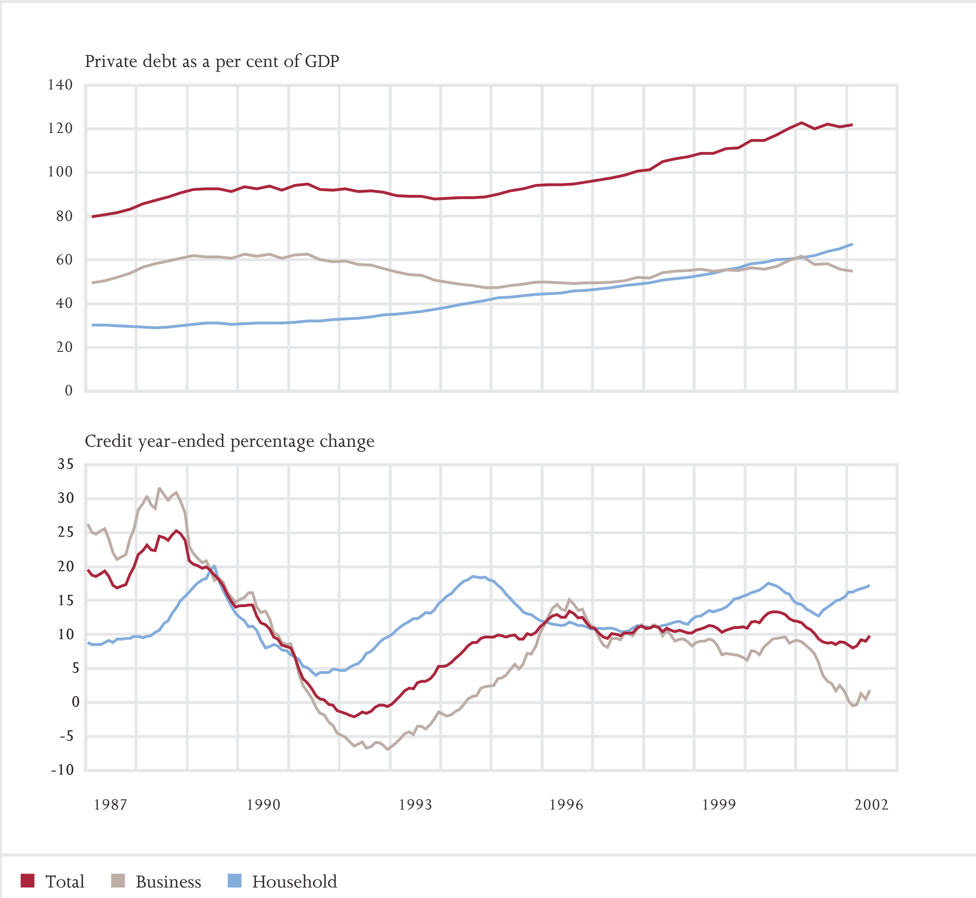
GRAPH 7 / **DIRECT FINANCIAL LINKAGES** Per cent of Australian GDP

been largely decoupled from the trade linkages between the two countries. The claims of Australian banks on Japanese borrowers have fallen from the equivalent of around eight per cent of Australia's GDP in 1991 to one per cent now, pushing Japan from second to sixth position in the ranking of countries to which Australian banks are most exposed. Japan, in turn, is a major creditor nation that has invested heavily in Australia in the past; however, the claims of Japanese banks on Australian borrowers have also fallen substantially, from the equivalent of around 12 per cent of Australian GDP in 1991 to four per cent.

Domestic Developments

Despite the difficult external environment, the Australian financial system continued to perform well in 2001/02, supported by high levels of consumer confidence and the strength of the Australian economy. A feature of domestic developments was the resumption of rapid growth in credit extended by Australian financial institutions to the household sector, after an easing in growth the previous year. Growth in credit to business, however, was at its lowest for some years and growth in total credit, at around 10 per cent, was a little below its recent average. Divergent trends in credit growth over recent years have meant that, for the

GRAPH 8 / PRIVATE SECTOR INDEBTEDNESS

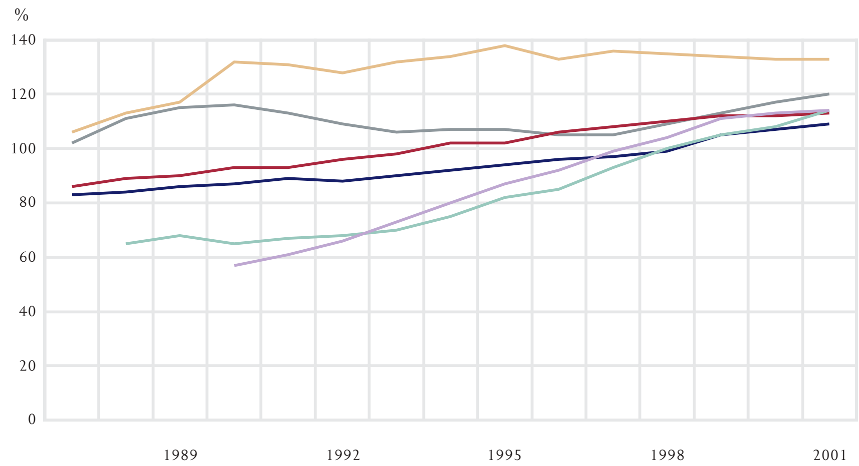


first time in half a century at least, the household sector now has a higher level of debt than the business sector.

The continued willingness of Australian households to incur debt is a natural consequence of the adjustment to a low-inflation (and hence low-interest rate) environment, and improved access to credit arising from financial deregulation. The increase in household indebtedness has been accompanied by a substantial increase in household wealth. After rising strongly over the past decade, the gearing of household balance sheets is now much in line with other developed countries. Despite the increase in debt levels, the interest burden on households is well below previous peaks, as interest rates remain near historically low levels. Nonetheless, any continuation of the recent pace of borrowings, which has been accompanied by a significant increase in the average size of loans, would leave households increasingly vulnerable to adverse economic developments.

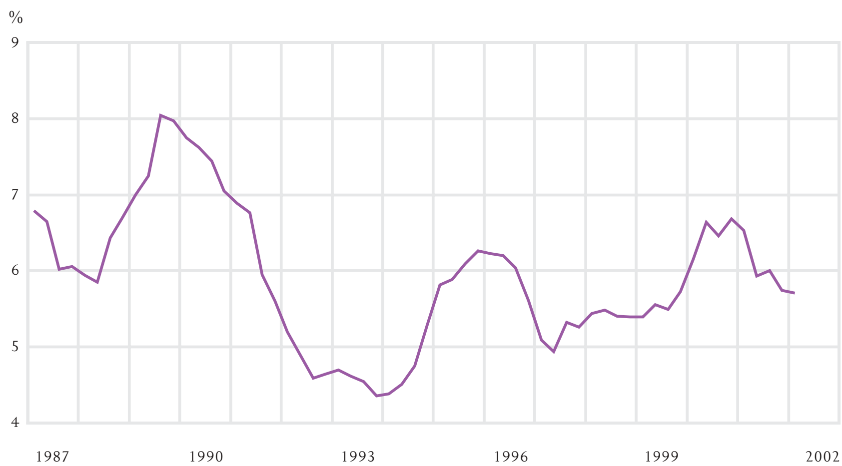
Borrowing for housing has been the main impetus behind the recent increases in household indebtedness; a decade ago, such borrowing accounted for 70 per cent of total household debt but it now accounts for 85 per cent. This surge in borrowing has been associated with a sustained rise in residential property prices. The cumulative rise in real terms over the past few years is comparable to

GRAPH 9 / **HOUSEHOLD FINANCES*** Debt as a per cent of disposable income



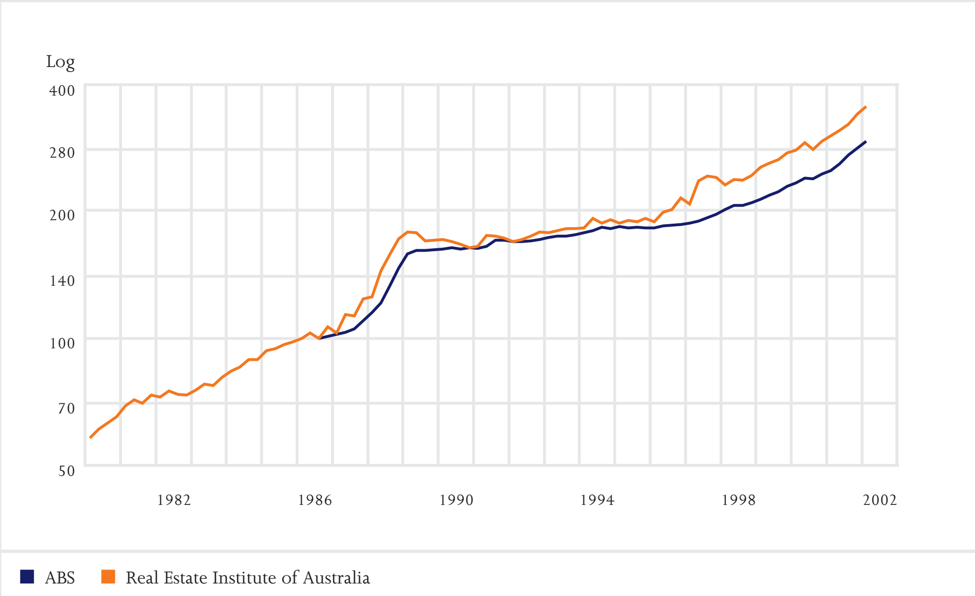
* Includes unincorporated enterprises

GRAPH 10 / **HOUSEHOLD FINANCES** Interest paid as a per cent of disposable income



that of the late 1980s, although the rises recorded then occurred over a shorter period and were more concentrated geographically. Rising residential property prices have been an important contributor to increased household wealth and consumer confidence; however, if property prices overshoot their fundamental levels, any substantial correction could put pressure on household finances, particularly for heavily geared borrowers who entered the property market in the latter part of the upswing. In the case of owner-occupied housing debt, the equity which most borrowers have built up in their

GRAPH 11 / **HOUSE PRICES** September quarter 1986 = 100

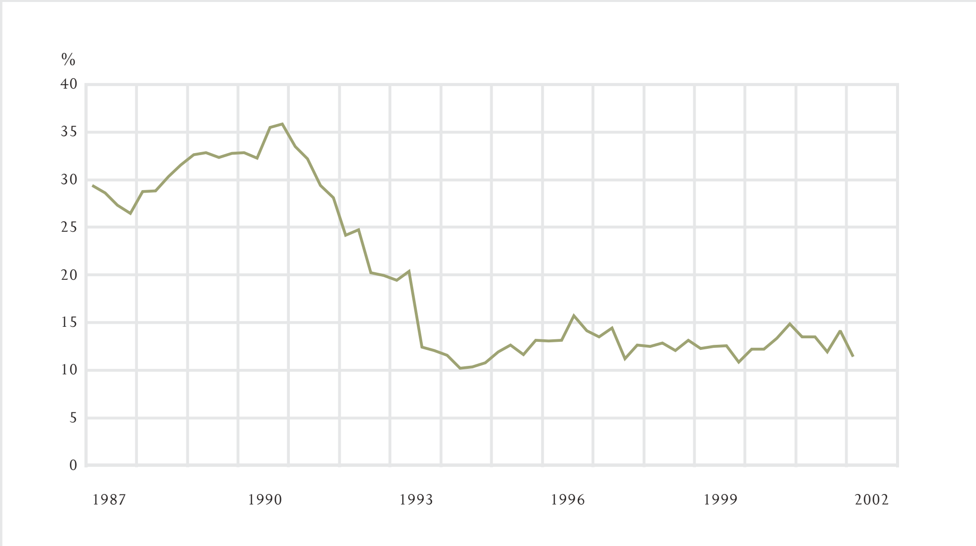


properties acts as a buffer against such pressures. One noteworthy feature of recent trends, however, is the growth in household borrowings for investment properties, which accounted for more than half of the pick-up in new housing approvals over the past 18 months. At this point in time, the investment property market faces low rental yields and rising rental vacancy rates, with additional supply in the offing; such a market may prove a disappointment to borrowers who have entered recently in pursuit of capital gains.

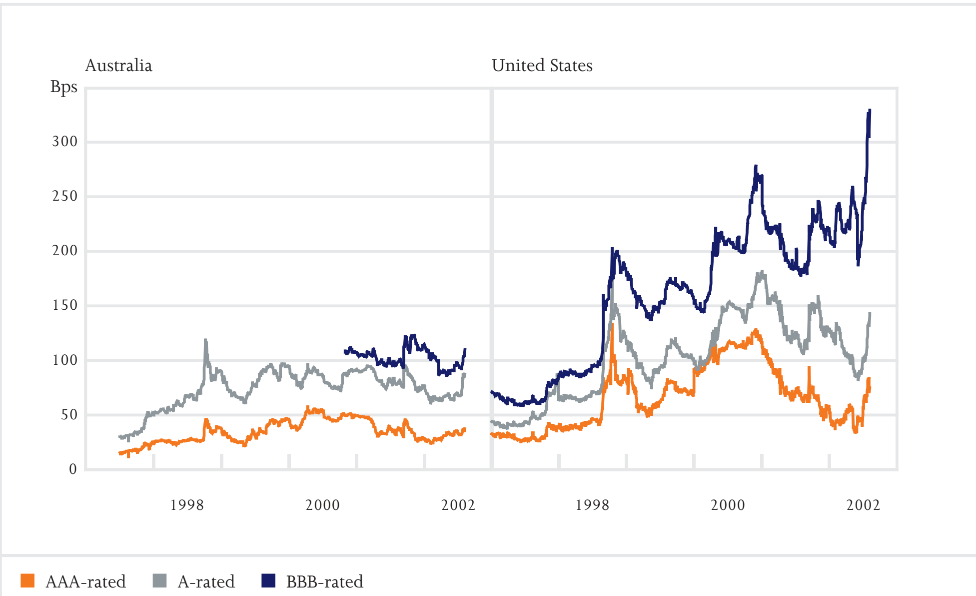
Another component of credit to households which continues to increase strongly, albeit from a low base, is margin lending. Such lending, which allows households to purchase shares and other financial assets using these purchases as collateral, is more risky than other forms of lending and is closely monitored by the RBA. The average loan-to-valuation ratio was around 45 per cent at year-end, its lowest level since the RBA began surveying margin lenders in September 2000 and well below the maximum ratio of 70 per cent that banks are prepared to extend for "blue chip" shares.

Despite a number of high-profile corporate collapses during 2001/02, the financial position of the ***business sector*** remains sound. Improving profitability and generally positive share market sentiment have enabled businesses to rely on accumulated internal funds and equity raisings for their funding. Businesses had only limited additional recourse to the banking system for much of the year, though demand for business credit has picked up recently. As a consequence, the debt-to-equity ratio of the business sector is well below its late 1980s peak and its interest burden is at historically low levels. Market indicators also convey a favourable assessment of the riskiness of the business sector generally. Credit spreads for low- and high-grade corporate debt are on average below their levels of the previous year, and are narrower than comparable spreads in the United States.

GRAPH 12 / **CORPORATE SECTOR FINANCES** Interest paid as a per cent of GOS

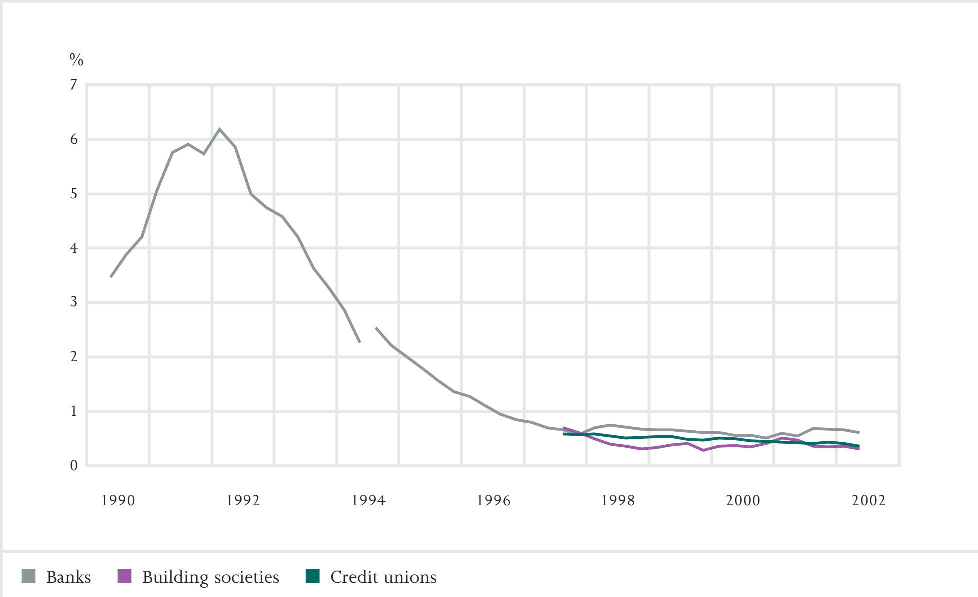


GRAPH 13 / **CORPORATE BOND SPREADS**

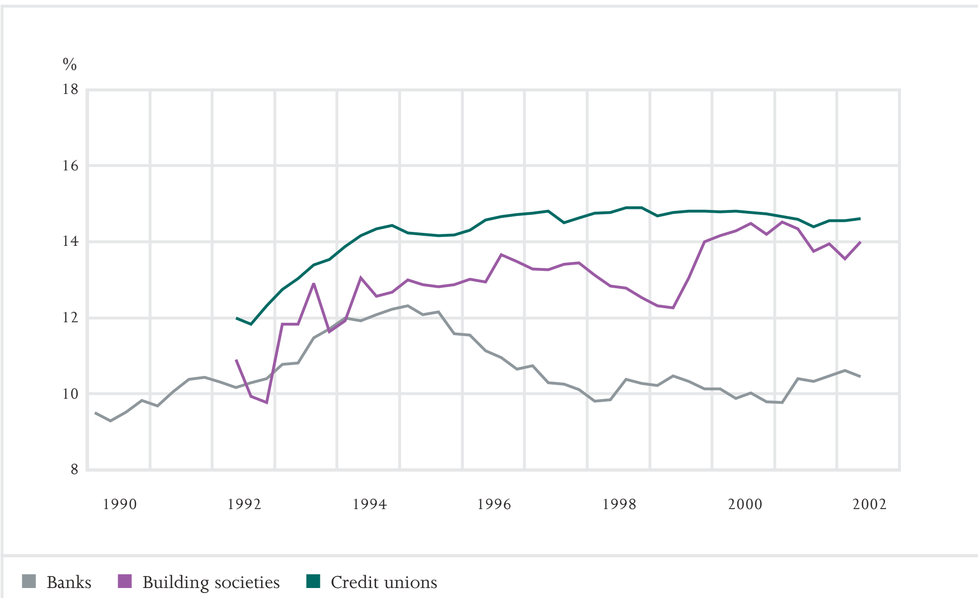


Australia's sustained economic expansion has continued to underpin the strength of ***authorised deposit-taking institutions.*** Notwithstanding recent corporate collapses, asset quality overall has remained robust. For banks, the ratio of impaired assets to total assets was 0.6 per cent at year-end, close to its minimum point over the past decade and only one-tenth its peak in the early 1990s. For building societies and credit unions, impaired asset ratios are at cyclical lows. Problem loans do not appear to be concentrated in particular sectors of the economy.

GRAPH 14 / **IMPAIRED ASSETS** Per cent of on-balance sheet assets



GRAPH 15 / **RISK-WEIGHTED CAPITAL RATIOS**



The growing share of household lending in their balance sheets has, in the main, reduced the risk profile of deposit-taking institutions, although lending portfolios are now more sensitive to the health of household finances and to residential property prices. That said, these institutions appear well-positioned to cope if there were to be any substantial correction in property prices, particularly investment properties. Where housing loans are provided with a loan-to-valuation ratio greater than 80 per cent, these must be fully covered by mortgage insurance provided through an acceptable insurer, with at least an A-rating, if such lending is to attract the concessional risk-weight under APRA's prudential framework. Hence, the risk of loss on such loans is shifted from deposit-taking institutions to insurance companies. Deposit-taking institutions also remain well-capitalised. The aggregate risk-weighted capital ratio for banks rose a little to 10.5 per cent by year-end while capital ratios for building societies and credit unions were around 14 per cent; for each of these groups, capital ratios are well above minimum required levels. The profitability of deposit-taking institutions is high and market indicators continue to signal confidence in the credit quality of Australian banks. Credit spreads on AA-rated bonds issued by Australian banks have declined to around 40 basis points, close to their lowest level in four years and well below credit spreads on equivalent US bank bonds.

Deposit-taking institutions placed greater reliance on domestic deposits, particularly from the household sector, to fund their asset growth over the past year. This represents a marked departure from recent trends, when borrowings in offshore wholesale markets increased significantly at the expense of domestic funding sources. The share of Australia's gross foreign debt accounted for by financial institutions (mostly banks) on a hedged basis has steadied at around 65 per cent over the past year, compared with a share of 32 per cent a decade earlier.

The ***general insurance industry*** remains the exception to the generally positive assessment of the Australian financial system. Following the collapse of HIH Insurance Limited in March 2001 and the earlier failure of some specialist reinsurance companies, the industry faced the catastrophe of the September 11 terrorist attacks and the natural disaster of the Christmas 2001 bushfires in New South Wales. The terrorist attacks led to the largest ever claims on the international insurance chain (with estimates of losses still rising) and cast doubts over the solvency of segments of the global insurance industry. Indications are that the direct exposure of Australian insurers to claims arising out of the terrorist attacks is relatively small, although a more lasting impact is likely to be an increase in global reinsurance premiums and the withdrawal of terrorist cover by reinsurers.

Stresses in the general insurance sector have recently manifested themselves in rising premiums and the reduced provision of specific lines of insurance, such as builders' warranty, public liability and medical indemnity insurance. A number of insurers have exited these lines of business because of financial problems or because these lines were deemed increasingly unprofitable on a reassessment of risk. Higher premiums and reduced access to certain forms of insurance have meant that some businesses and individuals have been unable to obtain adequate insurance cover and have been forced to cease operations or reduce the amount of production. Government assistance has been sought to fill the shortfall in cover and calls for changes to legislation (such as that relating to the allocation of damages in public liability cases) have been made. Against the background of these difficulties, APRA's reform of the regulatory framework for general insurance, which came into force on 1 July 2002, could not have been more timely. New prudential standards, which require general insurers to maintain higher levels of capital and have in place rigorous systems for managing insurance risks, are aimed at improving governance in this industry and reducing the likelihood of failures.

Lessons for Financial Stability

The severe shocks which buffeted the global financial system in 2001/02 have provided some important lessons for policy-makers.

The terrorist attacks of September 11 sharply increased the risks to global financial stability, not only in the United States but around the world. Reflecting the importance of New York to global trading activity, the attacks themselves disrupted the normal operation of financial markets and the trading capacity of global financial institutions. The key priority for central banks was to ensure that financial systems remained functional and that the uncertainty and risk aversion that immediately engulfed markets did not lead to a breakdown in payment and settlement arrangements. The steps taken by the RBA to this end are described in the chapter on "Operations in Financial Markets". The RBA also liaised closely with APRA through this period.

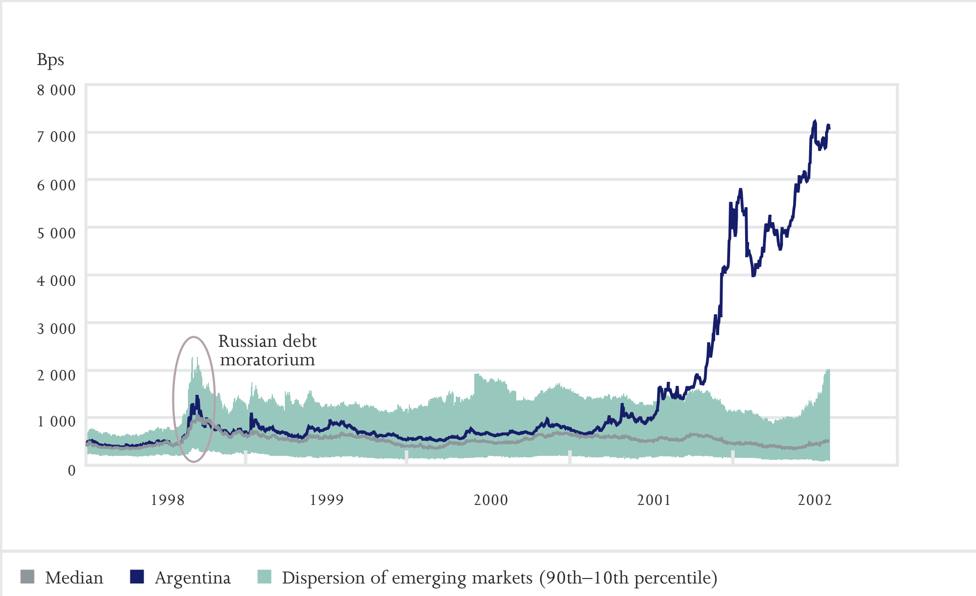
From a financial stability perspective, the terrorist attacks have emphasised the importance of well-developed disaster recovery plans within the financial sector. Fortuitously, preparation for the Y2K problem had already raised awareness of contingency planning among financial institutions. Central banks and financial regulators are now reviewing potential vulnerabilities that may arise from factors such as the concentration of clearing and settlement systems, the loss of key personnel and the location of back-up facilities.

In December, the US energy company Enron filed for Chapter 11 bankruptcy protection, the largest such filing in US history at that point. Enron's collapse threatened to disrupt financial stability through the impact on its creditors or the unwinding of its large positions in financial markets. These fears have not been realised, mainly because exposures to Enron appear to have been widely dispersed. A number of Australian banks announced exposures to Enron but these were small relative to the size of their overall loan portfolios.

The dispersion of exposures to Enron highlights the advances made by financial markets over recent years in developing new financial instruments that allow for the separation and reallocation of risks. The rapid growth of credit derivatives, for example, has facilitated the packaging of credit risk in a form that can be sold by banks providing the credit (the "originating" banks) to a wide investor base, including managed funds and insurance companies. By reducing the concentration of risk associated with the failure of any company, the trading of such financial instruments may be supportive of financial stability. This would not be so, however, if the instruments simply transferred credit risk to a class of investor that is less familiar with such risk and is poorly placed to manage and absorb it. The challenge for policy-makers is to understand the implications for longer run stability of moving towards a financial system in which the traditional "originate and hold" approach to credit risk by banks is replaced by one which emphasises "origination and distribution" of risk. The RBA has been working on this issue with other central banks, under the auspices of the BIS.

One concomitant of the growing trading in risk – whether for traditional financial products such as loans or for non-financial contracts such as energy contracts – is the increasing difficulty faced by investors in understanding the financial position of complex companies, a problem writ large in the case of Enron. More generally, investors have become much more sceptical about accounting and corporate governance practices within the corporate sector, in the United States and elsewhere, and are now punishing companies that resort to opaque or aggressive accounting practices. Some recent corporate failures in Australia have fuelled similar

GRAPH 16 / **EMERGING MARKET SOVEREIGN SPREADS** Stripped-sovereign spreads to US treasuries



concerns though not to the same extent. Internationally, and at home, attention is turning to measures that will enhance accounting standards, the timeliness of financial disclosure by companies and standards of corporate governance.

The collapse of Enron was followed closely, in late December, by the largest ever sovereign debt default when, after continuing economic and political turmoil, the government of Argentina defaulted on its debt and abandoned its decade-long currency board arrangements. Australia has very limited direct financial and trade linkages with Argentina and the Argentine crisis has had minimal impact on the Australian financial system. Initially, there was only limited contagion from Argentina to other emerging-market economies, although investors have recently become more concerned about some neighbouring Latin American countries, particularly Uruguay and Brazil.

PAYMENTS SYSTEM DEVELOPMENTS

The Payments System Board of the RBA has a mandate to promote the safety and efficiency of the payments system in Australia, with the backing of comprehensive powers. That mandate was expanded, in September 2001, when the Board was also given responsibility for the safety of facilities that clear and settle securities transactions in Australia's wholesale financial markets.

The RBA formally exercised its payments system powers for the first time in April 2001, when it brought the credit card schemes operated in Australia by Bankcard, MasterCard and Visa under its regulatory oversight. In December 2001, after detailed discussions with a wide range of interested parties, the RBA released a Consultation Document, *Reform of Credit Card Schemes in Australia*, which proposed a series of measures designed to promote greater efficiency, transparency and competition in the Australian payments system. Underlying these proposed reforms, which are now being finalised, is the RBA's judgment that the restrictions that are imposed by credit card schemes and their members are not in the public interest and result in the community paying a higher cost for its retail payments system than is necessary.

The RBA is also working with industry participants on reform of interchange fee arrangements in debit card and ATM networks. Changes in these areas, particularly if they can be co-ordinated with reform of credit card schemes, will help to ensure that the price signals in card payment networks in Australia promote well-informed consumer choice and efficient resource allocation.

In the safety and stability area, the RBA strongly supports the inclusion of the Australian dollar in the "continuous linked settlement" or CLS Bank, a special-purpose bank which will handle the settlement of foreign exchange transactions in major currencies, including the Australian dollar. This initiative will substantially reduce foreign exchange settlement risks for participants. As described elsewhere in this Report, the RBA has continued to work closely with CLS Bank, the four major banks which are its Australian members, and other participants in the foreign exchange market to ensure its smooth introduction, now expected in the second half of 2002.

The broadening of the Payments System Board's mandate to encompass clearing and settlement facilities for securities and derivatives was confirmed with the passage of the *Financial Services Reform Act 2001* in September 2001. Under a functional allocation of responsibilities, the RBA is charged with ensuring that clearing and settlement facilities conduct their affairs in a way that is consistent with financial system stability. As part of this role, the RBA has the power to set and monitor compliance with financial stability standards for clearing and settlement systems. ASIC has responsibility for all other matters, such as those relating to corporate governance, market integrity and investor protection, as well as undertaking any legal action to enforce compliance with the requirements of either agency, including financial stability standards. The RBA and ASIC have published a Memorandum of Understanding as a basis for co-ordinating their roles. The RBA's financial stability standards will shortly be released in draft form for public comment.

Further information on payment system issues can be found in the Annual Reports of the Payments System Board.

INTERNATIONAL FINANCIAL CO-OPERATION

The soundness of the international financial system and of international financial policies is vital to Australia. To this end, the RBA (together with other agencies, particularly the Commonwealth Treasury) takes part in a range of global and regional groups which foster debate and co-operation in these areas. The global groupings include the Financial Stability Forum (FSF), G20 and the IMF. Regional groupings include the Executives' Meeting of East Asia-Pacific central banks (EMEAP), the Four Markets Group and APEC. The RBA also participates regularly in several major G10 groups.

FINANCIAL STABILITY FORUM

One of the FSF's key roles is to examine the implications of international developments for the stability of the global financial system and, where necessary, co-ordinate initiatives to help deal with any perceived threats. The past year produced a number of challenges, with the combination of a global economic slow-down, the terrorist attacks in the United States, a spate of large corporate failures and the ongoing financial crisis in Argentina. Consequently a large part of the FSF's focus has been on these conjunctural issues.

One important area of work to emerge from discussions has been an assessment of the lessons for financial stability arising from the September 11 terrorist attacks. Work is being undertaken in a number of forums on this issue. The FSF will examine any possible follow-up at its next meeting in September 2002. At the request of the G7, the FSF also assessed global progress on combating terrorist financing. While noting efforts to date, the FSF felt that progress could be further enhanced by improving co-operation between supervisory and law enforcement agencies. To this end it is collecting information on national protocols for inter-agency co-operation with a view to producing a model protocol. The FSF also examined issues raised by recent corporate failures and will hold a more substantive discussion in September.

An issue of particular relevance to Australia discussed by the FSF was a review of the state of the global reinsurance industry. The most immediate concerns followed on from the events of September 11 and the prospect that the associated losses would severely test the underwriting capacity of the sector. So far the industry has proved resilient, helped by rising premiums and a capacity to generate substantial amounts of new capital.

Australia has shared with the FSF some lessons emerging from the failure of HIH, currently the subject of a Royal Commission. At one level, the failure of HIH demonstrates that the demise of a general insurer can have important macroeconomic consequences if a particular line of underwriting business is highly concentrated. HIH held a dominant share of builders' warranty insurance in various States and its failure had an immediate impact on the construction industry as builders sought difficult-to-find and expensive replacement cover. The HIH failure also highlights shortcomings in standards of transparency and disclosure within the insurance industry and the scope for products that may involve very limited or no transfer of risk – commonly known as "financial" or "finite" reinsurance but sometimes (confusingly) marketed as "alternative risk transfer" solutions – to be used as a general source of finance by insurance companies.

The challenge for both insurance regulators and auditors is to differentiate between the various reinsurance products to make sure that there is no confusion about their implications – to ensure, in effect, that general insurers are given credit from a statutory solvency and balance sheet perspective only for those contracts that genuinely improve their risk profile.

The FSF has also made progress on its four main areas of ongoing work. In March it released an assessment of progress on the group's March 2000 recommendations on concerns raised by highly leveraged institutions (HLIs). This issue has been an important one for Asian countries given the disruptive role played by some large hedge funds during 1997 and 1998. The 2002 review found that, on balance, concerns that HLIs could pose a systemic risk to the international financial system are less than before. Funds under management by HLIs continue to grow, but both the number of large macro hedge funds and the degree of leverage used are significantly lower than in the late 1990s. The risk management practices of both HLIs and their counterparties have improved, as has the level and quality of HLI disclosures to counterparties. The report urges supervisory vigilance to ensure that these gains are not transitory. The main area where progress has been disappointing is in efforts to promote public disclosure – both voluntary and mandatory – which appears to have lost momentum given progress in other areas.

In March, the FSF reviewed the progress of offshore financial centres (OFCs) in strengthening their financial supervisory, regulatory, information-sharing and co-operation practices. This follows on from the FSF's move in May 2000 to identify OFCs for which it felt assessment by the IMF was a priority. Many of these countries have now undergone IMF assessments, or have undertaken to do so. Technical assistance to these countries has been stepped up. The FSF will continue to monitor progress.

Two other FSF initiatives have drawn to a close in the past year. The FSF's Follow-up Group on Incentives to Foster Implementation of Standards issued its final report in September. The group found that, while progress has been made in raising awareness of accepted financial standards and the IMF/World Bank processes for assessing them, there continues to be scope for market practitioners to take more account of countries' adherence to standards when making lending decisions. The Australian Treasury was represented on this group. September also saw the publication of a report offering *Guidance for Developing Effective Deposit Insurance Systems*. The FSF sees this as being particularly valuable for countries moving from an implicit or blanket guarantee of deposits to one of more explicit limited coverage.

THE GROUP OF TWENTY (G20)

The G20, established in 1999, comprises the seven largest developed economies together with key medium-sized developed and emerging economies, and provides a forum for discussions on policies promoting sustainable and equitable economic growth. Much of the G20's focus over the past year has been on gaining a better understanding of the benefits and costs of globalisation. The RBA devoted its annual economic conference to hosting, jointly with the Australian Treasury, a workshop in May 2002 which explored the interaction of globalisation, living standards and inequality. G20 member countries are also preparing individual case studies examining their experiences, both positive and negative, with market reform and globalisation; these are expected to be published in the coming year. Other issues under discussion by the G20 include the appropriate policies for sustaining international capital flows and the effectiveness of economic aid.

SOVEREIGN DEBT RESTRUCTURING

An issue which has generated a lot of discussion in recent years is that of private sector involvement in crisis prevention and resolution. Discussion about a mechanism for resolving sovereign debt crises is not new, going back at least to the Rey Report produced by the G10 in May 1996. That report canvassed the possibility of an international bankruptcy court and urged the widespread introduction of collective action clauses (CACs) in bonds. The Asian financial crisis intensified efforts in the late 1990s to reform the international financial architecture, with a heavy focus on ways to ensure private sector involvement in crisis prevention and resolution. This was an issue on which the RBA placed considerable importance, but relatively little was achieved in terms of improving international financial arrangements. The IMF agreed that, to support a restructuring of a country's finances, it would continue to lend to a member that was in arrears to its private creditors, and there was widespread agreement in the official sector (but little action) on the need to include CACs in bond contracts. The idea of an international bankruptcy court foundered on the belief that it would be too difficult to bind parties across a wide range of independent legal systems.

Interest in this topic was heightened in November 2001, when the IMF's First Deputy Managing Director, Anne Krueger, proposed a statutory mechanism for dealing with sovereign debt restructuring, based on domestic bankruptcy law and underpinned by a number of principles:

- protection from litigation by creditors once a temporary standstill on debt repayments is called;
- safeguarding creditors' interests, by requiring debtors to negotiate on restructuring during the standstill period and to implement appropriate economic policies;
- application of majority voting by creditors on restructuring terms, which would be binding across all creditors, rather than separately to individual debt classes and lines; and
- encouragement for new private funding, possibly by granting preferred creditor status on new money.

The proposal envisaged a central role for the IMF, endorsing the initial standstill and subsequent rollovers based on assessments of debt sustainability and the member's economic policies, although later refinement by Krueger has reduced the scope of IMF involvement.

In response to the Krueger proposal, a number of alternatives have been proposed by others (including the US Treasury and private-sector groups) which focus on facilitating contractual agreements between debtors and creditors rather than on the statutory mechanism envisaged by Krueger. The G7 countries have endorsed a proposal to include in bond contracts contingency clauses which would contain several features:

- decisions of a collective super-majority of bond holders would be binding on the minority;
- procedures by which debtors and creditors come together, how creditors would be represented, and what data requirements must be met; and
- details on how the sovereign would initiate the restructure, including the use of a "cooling off" period (i.e. a standstill) between the date when the sovereign notifies creditors it wishes to restructure and the process beginning, during which time debt payments would be adjourned and bond holders prevented from litigating.

The ensuing debate has led to widespread agreement (including in the private sector) about the positive role that CACs could play in facilitating restructurings, although some private-sector scepticism about the use of these clauses to augment powers for sovereigns to initiate standstills remains.

Overall, the debate has demonstrated that there is now acceptance of the need for improved processes to deal with unsustainable sovereign debt as an essential element in the prevention and resolution of financial crises. The RBA sees the active pursuit of contingency clauses embodying the principles above as a practical step forward towards improving the fair involvement of private-sector creditors in the resolution of international financial crises.

COMBATING MONEY LAUNDERING AND THE FINANCING OF TERRORISM

International financial co-operation has also aimed over the past year to improve measures to prevent financing of terrorism. This followed several years in which there were steps towards improving financial co-operation and the prevention of money laundering, including increased pressure on (and technical assistance from the IMF and others to) offshore financial centres to improve their domestic regulatory environments and their interaction with regulators in the major financial markets. The RBA has been involved in these earlier steps through its membership of the FSF, participation in the work of the Financial Action Task Force (FATF), and its support of the Asia-Pacific Group on Money Laundering.

This work was given a new focus on combating the financing of terrorism following September 11. Later that month, the United Nations adopted Resolution 1373, which obliged member states to freeze accounts of those individuals and organisations which had been identified as terrorists (and named as such in the Resolution). Australia's actions in response to this were in two parts. First, to permit an immediate response, action was taken under the *Reserve Bank Act* to implement a freeze on any such accounts and a ban on foreign exchange transactions with the entities named. These sanctions were imposed on 3 October 2001, through the *Banking (Foreign Exchange) Regulations,* and extended to further entities on 17 October and 9 November.

The second action introduced was the *Charter of the United Nations (Anti-Terrorism) Regulations,* which took effect on 21 December 2001. These Regulations specified sanctions on all entities identified by the United States Administration and the United Nations as terrorists, but with wider coverage than the earlier measures taken by the RBA, which they effectively superseded. The list of entities sanctioned was updated further on 20 March and 17 April 2002.

In Australia, operational responsibility for the enforcement of the sanctions (under both sets of Regulations) was and is borne by AUSTRAC and the Australian Federal Police.

Further work on combating the financing of terrorism is expected to be based on the set of Special Recommendations put forward in October 2001 by the FATF, which will in future be used by the IMF as a benchmark in its financial sector assessments. Like other FATF members, Australia has completed a self-assessment of its compliance with the Special Recommendations and is committed to their full implementation.

OTHER GLOBAL GROUPS

In addition to its involvement with the FSF and the G20, the RBA also participates in various groups associated with the BIS and the G10. These include the Committee on the Global Financial System (CGFS), the Markets Committee, and the Committee on Payments and Settlement Systems (CPSS).

Issues considered during the year by the CGFS and Markets Committee included the changing structure of foreign exchange and derivatives markets (based on the publication during the year of the BIS triennial survey of activity in these markets) and policies to strengthen the resilience of financial markets following major disruptions, such as the events of September 11.

In the CPSS, attention was focussed on the forthcoming introduction of CLS to foreign exchange markets. Central bank oversight of the operations of CLS Bank, which is the vehicle through which the settlements are processed, is being co-ordinated through the CPSS. As the Australian dollar is one of the seven currencies that will be settled in CLS Bank, the RBA is represented on the CPSS group reviewing the project and liaising with CLS Bank on operational and policy issues. (The issues raised by CLS for the RBA's domestic operations were discussed in the chapter on "Operations in Financial Markets".)

The CPSS has also continued its interest in retail payments. The RBA is represented on a working group, which has already published two reports, on policy issues for central banks in the regulation of retail payment systems.

REGIONAL GROUPS AND TECHNICAL ASSISTANCE

Central banks in the East Asian region, including the RBA, have established close links over the past decade or so both bilaterally and through multilateral arrangements such as the Executives' Meeting of East Asia-Pacific central banks (EMEAP). The focus of EMEAP has been on fostering operational co-operation and providing for a dialogue on regulatory and supervisory policies; a key issue in the past year has been the potential impact of the Basel II capital rules on regional economies. EMEAP also sponsors meetings with the US Federal Reserve, European Central Bank and the G10 Markets Committee to discuss developments in global and regional foreign exchange markets.

The RBA is also a member of the Asian Consultative Council, established in 2000 by the BIS. The Council provides advice to the BIS Board on central banking issues of importance in the region, and on the services provided in the region by the BIS, including the operations of the BIS Representative Office for Asia and the Pacific located in Hong Kong. The Governor, Ian Macfarlane, has chaired the Council since its inception.

In addition to these formal links, the RBA maintains a large number of bilateral and informal relationships with regional central banks. Some of these take the form of financial assistance provided in conjunction with the Australian Government. When Australia participated in the IMF-led financing package for Thailand in 1997, at the onset of the Asian financial crisis, this was in the form of a foreign exchange swap facility between the RBA and the Bank of Thailand. Drawings of US$862 million were made under this facility up to mid 1999, and repayments began in early 2001. By the end of June 2002, US$520 million had been repaid.

Most of the RBA's bilateral linkages take the form of technical assistance to other regional central banks. One staff member has worked full-time on providing assistance to the Bank of Papua New Guinea, mainly in the areas of financial market operations and the design of a new registry system for PNG Government securities. Others have provided shorter-term assistance to central banks in East Timor, Fiji, Iran, the Solomon Islands and Thailand and participated in providing training courses in the region for SEACEN and other organisations.

BUSINESS SERVICES

The services provided by the RBA encompass:

- banking and registry services for the Commonwealth and South Australian Governments and some international institutions;
- settlement facilities for banks and other financial institutions; and
- note issue services to banks via armoured car companies.

The RBA does not provide business services directly to the general public, with the exception of a very small amount of registry work.

The services provided by the RBA include two contestable businesses: transactional banking and registry. Separate financial data are recorded for these businesses which fully meet all competitive neutrality and devolved banking requirements, including allowance for all relevant taxes. Pro-forma sets of accounts for the contestable businesses, prepared in accordance with competitive neutrality guidelines, are set out elsewhere in this Report.

GOVERNMENT BANKING

The banking services provided to the Commonwealth Government by the RBA comprise two components. A core banking facility is provided to the Department of Finance and Administration (DoFA), which is non-contestable in terms of the Commonwealth Government's competition policy. This facility is made up of a group of bank accounts, including the Official Public Account (OPA), a term deposit facility for the investment of temporarily surplus Commonwealth funds and a strictly limited overdraft facility.

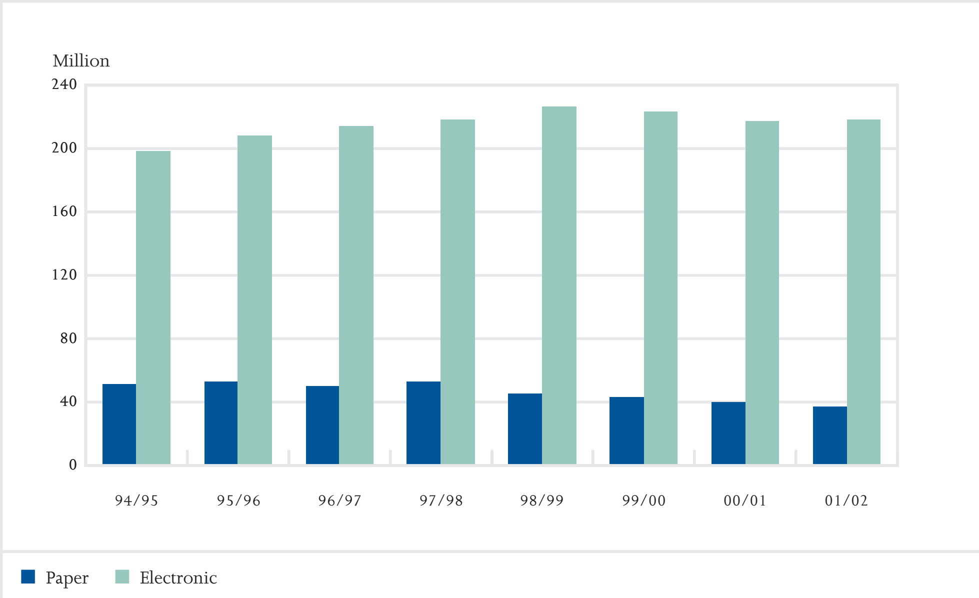
Under the core banking arrangements, payments are made from the OPA to agencies and end-of-day agency balances held with transactional bankers are swept back to the OPA overnight. These balances are returned to transactional bankers at the start of the next business day. The services also embrace electronic collection of forecasting data and reporting on high value transactions from agencies and transactional bankers to assist the RBA in the discharge of its monetary policy and liquidity management responsibilities.

The RBA also administers a term deposit facility, on behalf of DoFA, through which agencies can deposit temporarily surplus departmental funds. During 2001/02, 7 300 deposits totalling $62 billion were made using this facility compared with $53 billion (5 800 deposits) in the previous year.

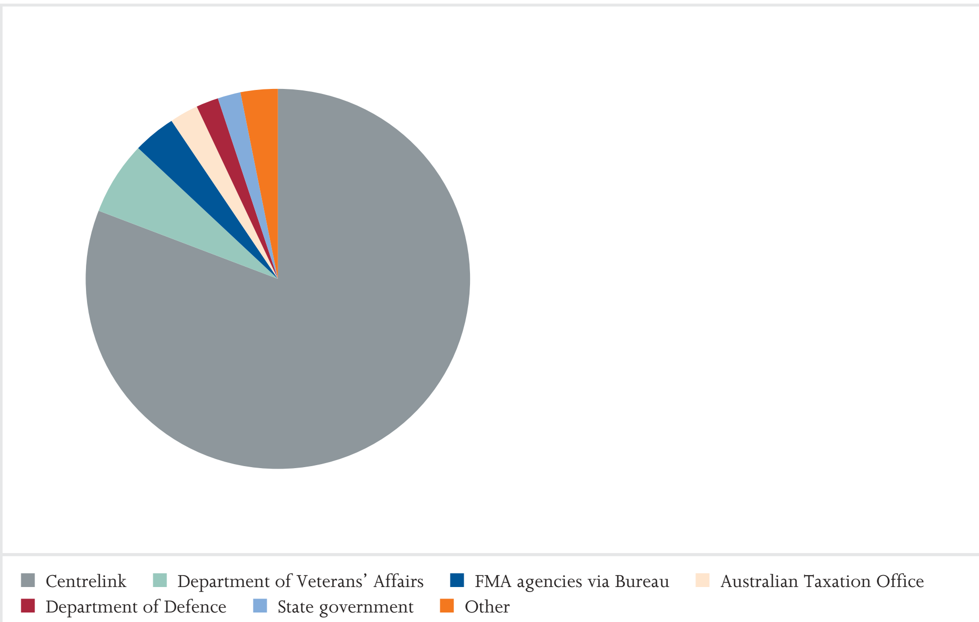
The other component of the RBA's banking business is the provision of contestable transactional banking services to government customers. The separation of the transactions business occurred when the Commonwealth Government implemented its devolved banking arrangements on 1 July 1999. Agencies governed by the *Financial Management and Accountability Act 1997* (*FMA Act*) continued to review their transactional banking requirements and supplier arrangements during 2001/02. Of the reviews completed during the year, the RBA has retained the business of 75 per cent of the agencies involved. The market testing process is continuing, with further agencies expected to review their requirements in the coming year.

Since 1991, the RBA has distributed government payments direct to accounts at financial institutions through its Government Direct Entry System (GDES). This system, which uses an extensive communication network and warehousing capabilities, has incorporated same-day settlement since its inception.

GRAPH 17 / BANKING TRANSACTIONS



GRAPH 18 / ELECTRONIC BANKING TRANSACTIONS – 2001/02



The number of electronic transactions distributed through GDES showed a slight increase in 2001/02 to 218 million, from 217 million the previous year. The increase was due mainly to additional payments being made by the Australian Taxation Office, Centrelink and the Health Insurance Commission, which were partly offset by a decrease in payments by some other customers. In contrast, volumes of paper transactions have continued their steady decline.

The RBA has continued to provide transactional banking and contract management services to the Government of South Australia. This role embraces the provision of banking services across 20 major State Government agencies, covered by the *Public and Finance Audit Act 1987 (SA)*, and processes some seven million electronic and paper transactions through 300 bank accounts.

Earnings after tax for the contestable transactional banking business in 2001/02 were $2.9 million compared with $5.4 million in the previous year.

Business Developments

As mentioned in last year's Annual Report, the RBA has developed a cheque verification system in response to an increase in fraudulent alteration of customer cheques. The system combines cheque issue data provided by customers and image technology to confirm that the information on the cheques, as presented through the banking system, is valid. This system has proved to be most successful. The data-matching process of the system, together with daily reconciliation of presented cheques, has confirmed that, since its introduction, all attempts at fraudulent alteration of cheques have been detected in a timely manner. In addition, to protect further its customers against financial loss, the RBA has also developed a same-day cheque tracking and reconciliation system to complement the cheque verification system. The combined systems are known as the Cheque Reconciliation and Verification System (CRVS). The system has improved the competitiveness of the RBA in the transactional banking market and provides substantial benefits for customers.

During the year, the RBA worked with the Health Insurance Commission (HIC) to improve the efficiency of the arrangements for payment of healthcare service providers. The review resulted in the introduction of a new facility which will streamline the payment process by automatically stopping cheques unpresented within 90 days, and replacing them with direct entry payment via GDES.

As foreshadowed last year, facilities to enable the direct crediting of Australian pension payments to overseas bank accounts in local currency have been developed for Centrelink. The facility has been progressively implemented from November 2001 and so far covers Australian pensioners residing in over 30 countries. Once fully implemented, some 80 per cent of monthly overseas pension payments will be made direct to bank accounts, ensuring more secure and timely delivery of entitlements.

For many years, the majority of government agencies have effected the transfer and receipt of data files with the RBA through *ReserveLink*, the Bank's electronic banking package. *ReserveLink* offers a secure closed network environment for both data and value payment files. Since 2000, agencies have also been able to pass electronic remittance advices and related electronic payments via *ReserveLink* to their e-commerce trading partners. The use of this service has significantly increased to over 300 000 transactions annually. In response to customer demand and in line with government policy, extensive work has been undertaken during the year to establish the infrastructure to allow the RBA to provide, in a secure environment, some banking services via the Internet. Initially, this facility will provide bank account enquiry functions, but it is intended that, subsequently, access to cheque processing output, including image data, will be made available. Customers will be able to receive on-line reports on the status of cheque presentations. The new processes will complement existing initiatives implemented to combat cheque fraud and streamline cheque clearance procedures. Given the often sensitive nature and high value of government payments, the RBA has no plans, at this stage, to provide for value payments to be effected via the Internet. These payments will continue to be made via *ReserveLink* or direct data link.

SETTLEMENT AND REGISTRY SERVICES

The Reserve Bank Information and Transfer System (RITS) is used by banks and other approved institutions to settle interbank payments, mostly on a real-time gross settlement (RTGS) basis. RITS also provides a facility for electronic tendering for Commonwealth Government securities (CGS). From July 1991 until February 2002, the system also provided an electronic depository and settlement service for CGS. In February 2002, in the interests of clearing system efficiency, members transferred all CGS to the Austraclear system operated by SFE Corporation Limited (see below).

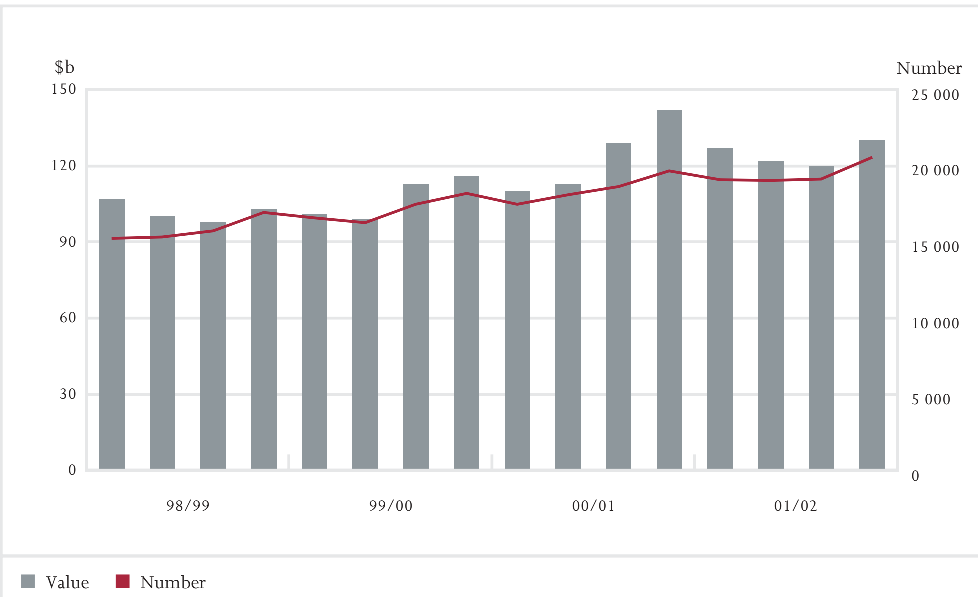
RTGS and Other Settlement Services

About 90 per cent of the value of interbank payments is settled on an RTGS basis; this includes all wholesale debt and money market settlements, Australian dollar foreign exchange settlements and a range of time-critical customer payments.

During 2001/02, the daily number and value of payments settled in RITS was relatively steady, following strong growth in the first half of 2001. Nevertheless, the end of financial year peak on 28 June 2002 of 33 000 transactions totalling over $220 billion was significantly higher than for the final day of the previous financial year.

As noted in earlier chapters, the "continuous linked settlement" (CLS) initiative is expected to commence later in this year. Under CLS, foreign exchange settlement risk in the participating currencies will be reduced due to the simultaneous settlement of both legs of eligible foreign exchange transactions across the books of CLS Bank. The introduction of

GRAPH 19 / **RTGS TRANSACTIONS** Average daily value and number



CLS will mean extended operating hours for RITS to synchronise with CLS settlement hours during the European morning.

In preparation for CLS, co-ordinated testing involving CLS Bank, participating RTGS systems and a small group of member banks has been under way since March 2002. Testing entered a new phase in May, including extended hours for RITS, to enable low-value trial transactions to be processed across the production RTGS systems.

In addition to RTGS payments, RITS settles two batches of netted interbank payments each day. The 9.00 am 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, as well as 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.

Settlement services are also provided for the RBA's own transactions in the domestic securities and foreign exchange markets, as well as those arising from the Commonwealth Government and other official customers.

RITS computer operations, software development and support functions are currently performed for the RBA under contract by Austraclear Limited, part of the SFE Corporation group since its merger with the SFE in 2000. This was a logical arrangement given the close similarity between the securities settlement function in the RITS and Austraclear systems. However, the securities settlement function in RITS is now redundant following the move of CGS from RITS, and, since the Austraclear merger with the SFE, its business focus has necessarily shifted.

As the provision of the infrastructure for interbank settlement is a core central bank activity, the RBA has decided to assume responsibility for the RITS operations, development and support functions currently undertaken by SFE Corporation. This will allow the RITS and Austraclear systems to be developed independently according to their respective business priorities and user requirements. There will be no impact on RITS functionality or services provided to banks and other RITS members.

The RBA is working closely with the SFE Corporation to ensure a smooth transition, which is currently expected to be complete by November 2002.

Transfer of CGS from RITS to the Austraclear System

In July 2001, the RBA wrote to RITS members asking whether they would favour movement of their CGS holdings in RITS to the Austraclear system. If a clear majority of CGS holders within RITS supported such a move, the RBA would cease providing an electronic CGS settlement service and transfer its CGS holdings to Austraclear in order to allow the market to benefit from one central settlement system for debt securities.

As members overwhelmingly supported this proposal, the RBA in October 2001 advised that it would cease providing an electronic settlement system for securities in RITS and that it would assist members to move their portfolios to Austraclear. The transfer of all securities occurred smoothly in the week of 18 to 22 February 2002.

Registry Services

During the year, the RBA provided registry services to the Commonwealth Government, the South Australian Government Financing Authority (SAFA) and a number of other official domestic and foreign institutions. The core functions of this service cover the issue, transfer and registration of securities, the maintenance of ownership records, the distribution of interest payments and the redemption of securities at maturity. After the close of the financial year, SAFA advised that, following a tender process, it had decided to transfer its business to another registry services provider.

The RBA also executed agreements covering the provision of registry services to a number of official foreign entities which have established domestic Australian dollar debt programs.

Changes to the *Commonwealth Inscribed Stock Act*, which enable the electronic transfer of ownership of Commonwealth Government securities, came into effect in early 2002. As yet, these changes have not had any impact on the RBA's traditional registry operation.

In line with the aim of providing quality registry services in the most effective and cost-efficient manner, the registry uses the RBA's CRVS system to protect issuers and stock-holders against losses resulting from the fraudulent alteration of registry cheques. Stock-holders will also be provided with the option of receiving their statements via e-mail during the course of the next financial year. Such a facility would not only provide stock-holders with a more timely delivery of information, but also reduce the cost to issuers of providing information to their stock-holders.

Earnings after tax for the contestable registry business in 2001/02 were $0.2 million compared with $0.5 million in the previous year.

NOTE ISSUE

The RBA's note issue functions include the issue of new and reissuable quality notes; the processing of notes returned from circulation for authentication and quality-control purposes; general oversight of cash distribution arrangements; and research into, and development of new note designs and security features.

Significant changes in the RBA's note issue activities, which began several years ago, were largely completed during 2001. First, in June 2001, the new centralised National Note Processing Centre (NNPC) – located at Note Printing Australia Limited's Craigieburn site – commenced operations. Prior to this, the RBA had run branch-based cash services operations in each capital city. These operations were progressively closed between 1997 and 2001.

Second, in November 2001, the RBA completed the introduction of new cash distribution arrangements. This involved the purchase by commercial banks of working stocks of notes and coin, which previously had been owned by the RBA, but held in note and coin pools operated by armoured car companies. Because commercial banks must purchase stocks of currency for full value, the result of this change in arrangements is that the RBA's balance sheet and profits are higher: when banks purchase currency, the RBA invests the resulting funds in interest-bearing assets. Conversely, the commercial banks have forgone interest, by holding additional currency. As part of the new arrangements, therefore, the RBA agreed to make payments to the commercial banks for interest forgone on currency stocks held in approved cash centres, up to a specified maximum. It is a condition of receiving these payments that banks sort notes for quality, to a standard set and monitored by the RBA.

The intention of these new arrangements is to encourage commercial banks, where possible, to deal directly with each other to manage short-term surpluses and shortfalls in holdings of currency, rather than having each individual bank deal directly with the RBA. The banks have taken some time to adapt to the new system, but as experience grows, improved practices should reduce the level of working stocks of currency held by banks.

Notes on Issue

The changed arrangements for ownership of the working stocks of currency have had a substantial impact on the value of currency recorded as "on issue" as, under the new system, working stocks held by the banks are recorded this way, whereas when they were held by the RBA they were not. Hence, the value of Australian notes on issue increased by $4.8 billion, or 17.5 per cent, over 2001/02 to $32 billion. These factors also had the effect of increasing the share of the value of notes in circulation accounted for by $20 and $50 denominations, and reducing the share attributed to the $100 denomination. However, excluding the effects of the new distribution arrangements, it is estimated that notes on issue grew a little more slowly over 2001/02 (6.2 per cent) than in the previous year (6.8 per cent), while the underlying trend towards a greater proportion of notes on issue being accounted for by the higher denominations continued.

Note Processing and Distribution

Under the new cash distribution arrangements, commercial banks return to the NNPC only notes that are unfit, surplus fit notes following seasonal peaks in demand, and notes requested by the RBA for return for quality sampling purposes.

Over 2001/02, 397 million notes ($13.5 billion) were dispatched from and returned to the NNPC. Around 125 million were processed through high-speed note processing equipment for verification, authentication and quality control. Only 47 per cent of notes processed were deemed fit for reissue, down from 77 per cent last year. The increased proportion earmarked for destruction reflects both the impact of the new cash distribution arrangements which, in addition to improving the efficiency of circulation of currency within the community, also seek to reduce the number of fit notes unnecessarily returned for processing, and a deliberate focus by the RBA on improving the quality of notes in circulation following a temporary decline as the new processing and distribution arrangements were bedded down.

The NNPC also receives notes that have been damaged and cannot easily be assessed for value by the general public or banks. They include notes that have been disfigured, heat affected, defaced or otherwise mutilated. Mutilated notes are returned

Value of Notes on Issue ($ million)

At end June	$1(a)	$2(b)	$5	$10	$20	$50	$100	Total	Increase (per cent)
1996	19	48	337	583	1 868	7 928	8 399	19 182	3.5
1997	19	47	351	601	1 837	8 912	8 297	20 064	4.6
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

(a) Last issued May 1984

(b) Last issued June 1988

(c) See Notes To and Forming Part of the Financial Statements, Note 1(j) to the NNPC for the most part via banks, for closer inspection and assessment. During the year the NNPC assessed 4 987 mutilated note claims with a total value of $2.3 million.

Counterfeiting Activity

Counterfeiting of Australian currency notes increased in 2001/02, with around 14 counterfeits passed per million notes in circulation, compared to around five counterfeits per million in the previous year. This rate remains very low by international standards. Much of the increase was attributable to counterfeiting of the $50 note. Around 92 per cent of counterfeits passed are paper reproductions of polymer notes, and are of poor quality; they are easily detected by simple visual inspection, as well as by feel.

Over recent years, there has been rapid growth in the availability and sophistication of low-cost desktop scanners, printers and image-editing software, and this has led to an increase in digital counterfeiting worldwide. However, for Australia and some other countries, the enhanced security provided by polymer notes remains an important deterrent to counterfeiting. By increasing the range of skills and number of steps required to produce a quality counterfeit note, the use of polymer substrate makes counterfeiting more difficult, time-consuming and costly.

Federation $5 Note

A new $5 note was issued during 2001 as the RBA's contribution to the Centenary of Federation celebrations. Around 70 million pieces were issued over the course of the year. From the beginning of 2002, the RBA began reissuing the standard $5 note. Federation $5 notes will continue to circulate until such time as they become unfit and are withdrawn from circulation.

Change to Note Design

In March 2002, the RBA began issuing a $20 note that incorporated a minor design change: the inclusion of the printed names of Mary Reibey and John Flynn, which appear just beneath their portraits. This change followed numerous enquiries from the public about the people featured on Australia's banknotes. The Federation $5 note, issued in 2001, was the first note to include printed portrait names. Printed names will be included in the design of the $10, $50 and $100 notes when these are next printed.

Information about the portraits on currency notes is available on the Bank's website at www.rba.gov.au.

THE RBA IN THE COMMUNITY

The RBA, as a public institution, is involved with the Australian community on a number of levels. For a start, the RBA is publicly accountable for the conduct of its policy responsibilities. To that end, it publishes a large volume of written material, both for the general reader and for specialists in economic and financial matters. The RBA appears before Parliamentary Committees regularly, and the Governors and senior officers make numerous public speeches. The RBA conducts extensive economic liaison around the country, and supports a range of research work and conferences in fields relevant to its policy responsibilities.

This chapter records those activities during 2001/02, and also includes statements relating to the RBA's legal obligations under various Acts of Parliament.

ACCOUNTABILITY

Since 1996, the RBA has appeared twice yearly before the House of Representatives Standing Committee on Economics, Finance and Public Administration. In 2001/02, there was only one such hearing, on 31 May in Sydney, since the hearing which would normally have taken place in late 2001 was cancelled, due to the Federal Election. The May hearing covered a wide range of issues, including the RBA's views on the outlook for monetary policy, household sector debt, international developments, exchange rates, government debt management, credit card reform, and financial system stability.

The RBA publishes each quarter a detailed assessment of the economy and the outlook for inflation – the *Statement on Monetary Policy*. As is customary, these *Statements* were released in February, May, August and November. The media's reporting of these quarterly *Statements* is facilitated by embargo arrangements in the form of media lock-ups at the RBA's Head Office and the Regional Office in Melbourne where facilities are provided for journalists to report on the *Statement* immediately the embargo is lifted. Senior staff from the Economic Group meet with groups of economists and business representatives in State capitals shortly after the release of the *Statements*, to assist them in absorbing the detailed analysis. The *Statements* are published according to a pre-announced schedule, which twice a year allows for release far enough ahead of hearings of the Standing Committee that Committee members have ample time to frame questions for the Governor and other officials.

COMMUNICATION

The Reserve Bank *Bulletin* has long been the RBA's premier printed vehicle for communication with the general public, with a publication history dating from 1937. The *Bulletin* continues to be an important document of record, reproducing the *Statements on Monetary Policy*, selected speeches, media releases and other articles of interest.

In recent years, however, the demand for hard-copy versions of the *Bulletin* has declined, as the RBA website has been developed. The website contains all the written and statistical material in the *Bulletin*, free of charge. As a result, subscriptions to the hard-copy version of the *Bulletin* have fallen by over 50 per cent since the website was launched in 1997.

The website (at www.rba.gov.au) was further upgraded during 2001/02. In December 2001, a redesigned home page was launched giving easier access to key data, recent news, forthcoming events and "help" facilities. Two major new information services were also provided. The first was a free e-mail notification service which alerts subscribers to all recent news items as soon as they are posted to the website. Some 2900 subscribers have signed up to this service and that number continues to grow. About 15 per cent of subscribers are overseas. There are about 780 subscribers to the e-mail service that is provided for the RBA's Research Discussion Papers.

Second, a Chart Pack was provided on the website, containing over 130 graphs on the Australian economy and financial markets and on broad developments in Australia's trading partners. The Chart Pack is updated monthly and is one of the most frequently accessed parts of the website. It caters for a range of users including those analysing information pertinent to monetary policy formulation as well as those in the academic and teaching professions.

Staff research work is published in a regular series of Research Discussion Papers. Twelve were published during 2001/02, on subjects such as measures of the real exchange rate, the contribution of information technology to productivity growth, inflation targeting, house prices, the use of sentiment surveys, and financial system stability. These papers, which focus on policy issues of interest to the RBA present the views of the authors rather than the RBA or its Board. They are published as such, with a disclaimer, so as to contribute to general discussion by researchers. To ensure wider public access to the results of this research, the RBA produces non-technical versions of some of the Research Discussion Papers from time to time in the *Bulletin*.

The RBA has a media office as part of its

The May 2002 appearance before the House of Representatives Standing Committee on Economics, Finance and Public Administration took place in MacLaurin Hall at the University of Sydney. From left: Ric Battellino, Assistant Governor (Financial Markets); Ian Macfarlane, Governor; Glenn Stevens, Deputy Governor; Malcolm Edey, Assistant Governor (Economic).

Information Department to act as a first contact point for media enquiries and to answer telephone and e-mail enquiries from the public at large. The number of enquiries averaged around 450 per month during the past year.

INTERACTION WITH THE COMMUNITY

Last year's Annual Report detailed the establishment of the RBA's Regional Offices in Victoria (also serving Tasmania), Queensland and Western Australia, whose aim is to gather economic intelligence in their respective regions. During 2001/02, an economist was transferred from Head Office to the Bank's Adelaide branch in order to extend this liaison process to South Australia. Staff from these Offices conduct regular liaison with businesses across a range of industries that are reflective of the State economies. The Offices also maintain contact with industry bodies, economic agencies at the State Government level and the academic community, as well as providing a base from which senior staff from Head Office can interact with the business community in each State. During 2001/02, the staff conducted 850 interviews either in person or by telephone. The information gathered from these activities is collated in Economic Group in Head Office, and forms an important part of the Reserve Bank Board's assessment of economic conditions. During 2001/02, the RBA staff involved in this work hosted a meeting of their counterparts from some other countries, with participation from New Zealand, Canada and the UK.

In addition to the liaison above, the RBA chairs the Small Business Advisory Panel. This Panel, established in 1993, meets once a year to discuss issues relating to the provision of finance for small businesses. Membership of the Panel is drawn from a wide range of industries and from across the country. The Panel represents a valuable source of information on the conditions faced by small businesses.

Since 1989, the RBA has organised an *Annual Conference* on a subject of current economic importance. The 2002 Conference was jointly sponsored by the RBA and the Australian Treasury, and took the form of a workshop for G20 delegates on the topic of *Globalisation, Living Standards and Inequality: Recent Progress and Continuing Challenges*. The conference brought together prominent researchers and officials from G20 countries to discuss papers on measuring trends in inequality and poverty, the costs and benefits of globalisation and the experiences of selected individual countries including India and China. The volume of proceedings is to be released in September. (The chapter on "International Financial Co-operation" gives more detail on the activities of the G20.)

The RBA maintains extensive archives. During the past year, 73 researchers requested archival information with many conducting their enquiries on-site with assistance from RBA archival staff. In 2001/02, there were around 9 000 visitors to the RBA's publications and currency note display area on the ground floor of its Sydney Head Office.

FINANCIAL ASSISTANCE FOR ECONOMIC AND FINANCIAL RESEARCH AND EDUCATION

The RBA routinely provides assistance to various educational and research endeavours and helps fund some regular surveys. A monthly survey of inflation expectations, undertaken by the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne, and a quarterly survey of union inflation and wage expectations by the Australian Centre for Industrial Relations Research and Training at the University of Sydney, are both assisted by RBA funding.

Support was continued for two scholarships under the Elite Executive Honours Scholarship Program organised by Axiss Australia, the Commonwealth agency charged with promoting Australia's position as a global financial services centre; these scholarships were for study at the University of New South Wales in Sydney during 2002. The RBA also made a contribution to a scholarship, inaugurated in late 2001, to be granted for full-time study in the Master of Economics degree at the Australian National University in Canberra.

Each year, part of the RBA's financial assistance to Australian universities takes the form of a contribution to the costs of their organising conferences in economics and closely related disciplines. In 2001/02, these conferences included: the 30th Conference of Economists, held at the University of Western Australia in Perth in September 2001; the annual Conference for PhD students in Economics and Business, hosted by the University of Western Australia in Perth in November 2001; and the 2002 Australasian meeting of the Econometric Society, hosted by the Queensland University of Technology in Brisbane in July 2002.

During the past year, the RBA also assisted with contributions toward the costs of running a number of other conferences which have not directly involved universities but whose subject matter and/or organising bodies are related to the RBA's areas of responsibility and interest, in particular our international relations in the Asian region. In a couple of instances, this assistance has taken the form of provision of accommodation for conference attendees free-of-charge at the HC Coombs Centre for Financial Studies, in Kirribilli. Accommodation was provided in this way for two APEC Future Economic Leaders Think Tanks, which were hosted by Axiss Australia, the first held in August 2001 and the second in April 2002. Assistance was given towards an APEC Regional Training Seminar, conducted at the RBA's training facility in February 2002 by the APEC Bank Supervisors Training Advisory Group, for bank

The Governor with the late Sir Leslie Melville in March 2002, when the Governor gave the Inaugural Sir Leslie Melville Lecture at the Australian National University, to coincide with Sir Leslie's 100th birthday. Sir Leslie had an association with the Bank stretching from 1931 to 1975, first as Economist and later as a Board member.

supervisors from across the Asia/Pacific region. The RBA also provided a financial contribution to the costs of running the 2002 annual meeting of the Asia/Pacific Group on Money Laundering in Brisbane in June 2002.

In the international sphere, the RBA made a second annual contribution, along with those of a number of other central banks and other institutions, to the reconstituted International Accounting Standards Committee. The RBA also continued its longstanding practice of contributing to the Group of Thirty to support its program of research and publications in the area of international finance.

CHARITABLE DONATIONS

During the year, the RBA expanded its contributions to charitable organisations. As in other recent years, the RBA contributed a total of $25 000 to 17 Australian charities, reflecting a broad range of medical problems and disabilities. This included corporate sponsorship of the annual "Work-A-Day 4 Kids" fund-raising event, organised under the auspices of the Financial Markets Foundation for Children, of which the Governor is Chairman. In addition, the RBA this year also provided a similar total amount to four charities assisting people overseas who were adversely affected by certain extraordinary events. The recipients of this support were: the Twin Towers Orphan Fund; the Manhattan Youth Fund; the Afghan Crisis Appeal of Médecins Sans Frontières; and the Afghanistan Emergency Appeal of Oxfam Community Aid Abroad.

STATUTORY OBLIGATIONS

Equal employment opportunity

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the RBA reports to the Australian Parliament each year on its Equal Employment Opportunity (EEO) program. This report also reviews progress of the Bank's Disability Action Plan. The *EEO Annual Report 2001* was tabled on 25 October 2001. A new four-year EEO plan developed during 2001/02 incorporated new advice issued by the Commonwealth to authorities about their obligations under the EEO legislation. These guidelines, in particular, encourage suitable strategies for managing staff from diverse backgrounds.

Health and Safety, Compensation and Rehabilitation

The RBA is required, by Section 74 of the *Occupational Health and Safety (Commonwealth Employment) Act 1991* and the conditions of its licence as a Licensed Authority under the *Safety, Rehabilitation and Compensation (SRC) Act 1988*, to report each year on matters of health and safety, workers' compensation and rehabilitation as they affect the RBA. Over 2001/02, the RBA placed greater emphasis on prevention strategies, particularly in relation to the Occupational Health & Safety (OH&S) aspects of the major building works in Head Office. It also continued to implement a Hazard Management Program and reissued its Health and Safety and Rehabilitation policies. The RBA sought to increase staff awareness of OH&S matters through training programs for supervisors and managers. The RBA's current licence under the *SRC Act* expires at end June 2004.

There were 15 workers' compensation claims in 2001/02, mainly related to minor incidents. One incident required notification to Comcare in terms of Section 68 of the *Occupational Health and Safety (Commonwealth Employment) Act 1991*.

In 2001/02, the RBA fully complied with all conditions of its licence to self-insure and manage its workers' compensation claims, including having adequate provision for its liabilities. The RBA already met the new prudential requirements for self-insurers of workers' compensation that were introduced in July 2002. The RBA's second report under the

Management Systems Review and Improvement Program was accepted by the Safety, Rehabilitation and Compensation Commission. This program aims to improve the effectiveness of OH&S arrangements by promoting sound prevention and rehabilitation strategies and efficient claims management.

Freedom of Information

Section 8 statement

The RBA is an exempt agency under the *Freedom of Information 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*, and the *Payment Systems and Netting Act 1998*, 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*; this information is also included on the RBA's 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 *Freedom of Information Act 1982*, including requests for access to documents, should be directed to the Secretary (in Head Office), the Managers of branches (in Adelaide and Canberra), or the Senior Representatives in the Regional Offices (in Melbourne, Brisbane and Perth). 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

Nine requests (including one transferred from another agency) for access to documents under the *Freedom of Information Act 1982* were received in 2001/02, compared with two requests in 2000/01. Two requests were subsequently withdrawn; for four other requests, access was granted in part, and for one request, access was refused; two requests were being processed at year's end. There were applications for internal review in relation to three of the requests this year: access was granted to some additional documents for one request which had initially been granted in part; access was again declined for another; while one internal review was still in train at year's end.

The total cost to the RBA of administering the *Freedom of Information Act 1982* in 2001/02 is estimated to have been approximately $436 700, compared with approximately $88 990 in 2000/01. Application fees of $330 and charges of $31 233.10 were collected.

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 that produces currency notes and other security documents for Australia and for export. It has been the world pioneer in employing polymer in the manufacture of currency notes and now prints predominantly on Guardian® polymer substrate manufactured by Securency Pty Ltd (see below).

The Board of NPA, operating under a broad charter from the Reserve Bank Board, comprises chairman Graeme Thompson (a former Deputy Governor of the RBA and now Chief Executive Officer of the Australian Prudential Regulation Authority), Richard Warburton (a non-executive member of the Reserve Bank Board), Les Austin (formerly an Assistant Governor of the RBA) and Mark Bethwaite (Chief Executive of Australian Business Ltd). John Leckenby has been NPA's chief executive since 1998.

A major activity for NPA in the past year was fulfiling an important export contract for notes for the Bank of Mexico due for issue in late 2002. This involved both design and production of the 20 peso note. The Bank of Mexico started manufacture of the

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 10 Dollar Millennium Note	Circulating 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

same note in parallel with NPA's production, with NPA and Securency supplying staff to assist in this start-up process.

In all, 176 million export notes were produced in the year. For the year ahead orders are on hand from Nepal, New Zealand, Papua New Guinea and Brunei. Significantly, several of these are repeat orders.

The RBA placed orders for Australian $20 notes and, by year's end, 93 million of these had been supplied. A revised commercial arrangement was entered into with the RBA to provide more predictable demand on the production facility.

During the year NPA won the right to print and assemble the new Australian passport for the Department of Foreign Affairs and Trade, with production to commence in early 2003. As a result NPA will have the exclusive right to produce the Australian passport for ten years. The production equipment to be installed will also provide spare capacity that can be used for export sales. The new passport will have a number of new security features, which will provide increased protection from counterfeiting and reduce the risk of identity fraud.

NPA continues to work closely with Securency on research and development to improve security and handling of currency notes. Ink production has become more sophisticated and NPA has formed a closer working relationship with an ink manufacturer to improve efficiencies and guarantee access to the latest technology. This arrangement is expected to lead to royalty income for NPA in the next few years.

Productivity in the National Note Processing Centre, operated by NPA under contract from the RBA, was improved through the year with increasing throughput levels per operator being achieved.

Although the international note printing market remains very competitive, NPA's commercial outlook has strengthened considerably over the past year. It can expect a steady income from the RBA's annual order coupled with the contribution from the National Note Processing Centre and the start of passport production in 2003.

SECURENCY

Securency Pty Ltd was formed in 1996 as a joint venture between the RBA and UCB Films PLC, a manufacturer of polypropylene films. Securency supplies its press-ready polymer substrate, Guardian®, to NPA and to overseas printers for currency notes and Sentinel® for other high-security documents such as land titles. These products are produced by applying unique coatings and security features to specialised films manufactured by UCB Films.

Securency's Board comprises three directors appointed by the RBA, three appointed by UCB and the company's Managing Director, a non-voting member. Its offices and plant are at Craigieburn, close to NPA's operations and to a UCB films plant that was commissioned in 1999. Myles Curtis has been Securency's chief executive since 1996.

Securency's main customers for security products using polymer substrate – other than those supplied with finished currency notes through NPA – are shown in the table on the next page.

Securency's main project in the past year was the production and supply of polymer substrate to NPA for the Mexican order mentioned above and to the Bank of Mexico for printing in Mexico. In total, substrate for some 425 million notes was delivered.

Securency has also secured an additional order for the supply of substrate to the Bank of Mexico over the next year. This follows the public success of the Brazilian 10 Reais polymer banknote in 2000, the first polymer note to be issued in the Americas.

The printing of three more polymer denominations at the National Bank of Romania's Printing Works in Bucharest completed its entire series on Guardian® polymer substrate. This represents the first full series of circulating polymer notes in Europe.

Securency's marketing efforts of the past year have seen a significant increase in international interest in polymer notes. Orders are being pursued with a number of encouraging prospects in Asia, Africa, Europe and South America. The Bank of Zambia has also announced it will issue two polymer denominations in early 2003.

Securency Export Customers

Year of order	Customer	Product
1998	Bank of Thailand	50 Baht
1999	Bank of Thailand	50 Baht
1999	Central Bank of China, Taiwan	50 NT Dollar
1999	China Engraving & Printing Works, Taiwan	Land title
1999	National Bank of Belgium	UCB Share Certificate
1999	National Bank of Belgium	Financier Share Certificate
1999 & 2000	Central Bank of Brazil	10 Reais
1999	Canadian Bank Note Company	Northern Bank 5 Pound
2000	People's Bank of China	100 Yuan
2001	State Bank of Vietnam	50 Dong
2001	National Bank of Romania	10 000 Lei
2001	Central Bank of Austria Banknote Printing Works	Romania 100 000 Lei
2001 & 2002	National Bank of Romania	50 000 Lei
2001 & 2002	Bank of Mexico	20 Peso
2002	National Bank of Romania	100 000 Lei

Securency recorded a disappointing financial result for 2001 (it reports on a calendar year basis). The future for the joint venture, however, holds considerable promise. Hence, the joint venture partners remain committed to providing Securency with the resources it needs to achieve long-term success.

Due to the increasing global concern for personal security there has also been a considerable interest in innovative polymer-based security documents. This has led to the development of a range of substrates for government-issued documents, which should become commercially available during the latter half of 2002.

Following an intensive company-wide continuous improvement program, Securency achieved the ISO 9001: 2000 Quality Certification to the latest quality systems standard. The systems and processes developed through this program will help to ensure that Securency can meet its customers' increasingly sophisticated requirements.

NPA/Securency restructure

The interdependence of NPA and Securency was recognised in a new agreement on marketing and technical support. The main marketing of currency notes to potential customers is now being carried out by Securency, while NPA continues to service existing customers. This has reduced the duplication of marketing effort overseas and promises to provide NPA with "start-up" orders for those countries converting from paper to polymer notes in their own print works. Such start-up volumes will be produced by NPA as part of a formal technology transfer program.

PolyTeQ Services, a newly created unit of NPA, will supply the extensive technical support required. This unit, jointly funded by Securency and NPA, uses NPA technical staff and other consultants to assist overseas issuers plan and implement the transition to polymer.

Following the restructure, research and development for Securency will be managed by NPA staff and controlled through a Joint Technical Committee reporting to the Boards of both companies. This should ensure the necessary co-ordination of research. With this research base, NPA and Securency are well placed to offer new solutions for document security to a variety of users around the world.

MANAGEMENT OF THE RBA

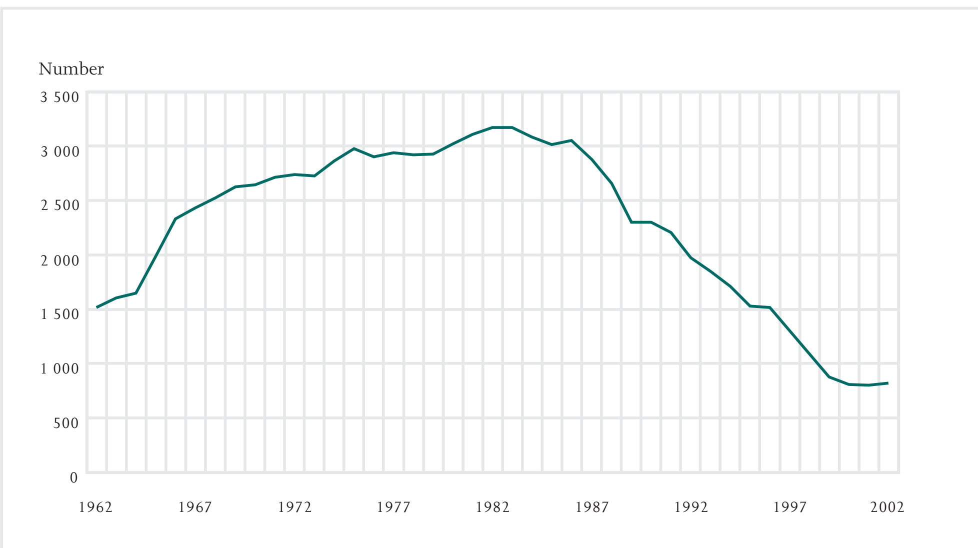
Staffing rose in 2001/02 as the RBA applied additional resources to support some new activities. This contrasts with the experience for most of the preceding two decades, when staff numbers fell progressively from around 3 200 in 1983 to 800 in 2001. This decline came largely from adopting better practices in the banking, registry and currency distribution areas, and partly because the application of information technology produced large efficiency gains. At the same time, the scope of these operations narrowed and costs were lowered elsewhere. Much of the contraction was concentrated in branches, most of which were judged to be in danger of becoming unviable and were therefore closed.

Over the past year or two, change in the RBA has been more incremental than has been typical for some time. The phasing-in of new arrangements for distributing currency was completed in June 2001, as the cash operation in Sydney closed, with a net loss of nine staff. At the same time, the new centralised facility for cash operations, the National Note Processing Centre (NNPC) at Craigieburn in Victoria, opened with about 20 staff, the only staff now involved in cash handling and distribution. These relatively small changes in numbers had been preceded by a period of large staff reductions in note issue: 655 had been employed in this area at its peak in 1983. In addition to the staff at the NNPC, 26 staff in Head Office are responsible for note issue policy and research.

The project to take direct control of the real-time gross settlement (RTGS) system in the Payments Settlements area moved to an advanced phase over the past year, with 11 new staff working directly on developing systems for this project.

In the administrative areas, the RBA has faced greater demands for regulatory and taxation compliance over recent years, with a net of two new staff appointed in 2001/02 to handle these

GRAPH 20 / **NUMBER OF RBA STAFF** As at 30 June, excluding NPA



responsibilities. More generally, there was also an increased intake of new graduates.

Overall, staff numbers increased to 823 in 2001/02, the first rise over a year since 1986.

The RBA continued in 2001/02 the process of modernising its workplace arrangements to attract and retain staff. One aspect of this process has involved designing compensation arrangements that better reflect contemporary market practice. This includes a move toward employing staff on individual employment contracts.

In recent years, external assistance has been sought to benchmark the responsibilities and remuneration of executive and managerial staff. A similar review of more junior staff was completed over the past year. Subsequently, this group was offered individual employment contracts, which involved, among other things, relevant staff forgoing the entitlement to housing assistance. Such assistance had earlier been withdrawn for new employees and for senior staff accepting the terms of contract employment. None of the most senior members of staff has a housing loan from the RBA.

Almost all of the eligible professional staff in policy areas – a group which is typically relatively young and not necessarily always well-placed to take advantage of the staff benefits that the RBA has traditionally made available – took up the latest offer. This suggests the approach has been successful in targeting a group with marketable skills. Individual employment contracts have also been extended to new graduate recruits. This provides a degree of flexibility in the compensation which can be offered to this group and assisted in meeting the increased demand for new graduates in 2002.

With these steps in 2001/02, around 53 per cent of staff – some 435 employees – are now on individual contracts, compared with little more than a dozen executives three years ago. The change to individual contracts has been entirely voluntary. Staff who declined the offer of contract employment have retained their existing conditions.

To date, the enterprise bargaining agreement has remained the basis of changes in conditions of employment for staff generally. Staff covered by this agreement received salary increases of 3.8 per cent in each of July 2001 and July 2002. Increases in salary in 2001/02 for staff on individual contracts were, on average, in line with increases for other staff.

Over the past year, the RBA extended its practices aimed at attracting and developing skilled staff. A more structured development program for graduate recruits was put in place. The cadetship scheme, through which the RBA attracts outstanding students at the start of their honours year at university, was adjusted so that job offers to cadets are now made at an earlier stage than in the past. The Post-graduate Study Award program was revised to make sure that the RBA continues to receive long-term benefits from it. In particular, reimbursement will be required from recipients of awards who leave the RBA prematurely. At end June 2002, seven staff were studying full-time under the Post-graduate Study Award program. A further 52 staff were undertaking part-time tertiary studies in Australia.

The RBA holds a licence to self-insure and manage its workers' compensation claims. The licence was renewed last year for three years by the Safety Rehabilitation and Compensation Commission. A recent review of insurance options indicated that costs still favour self-insurance.

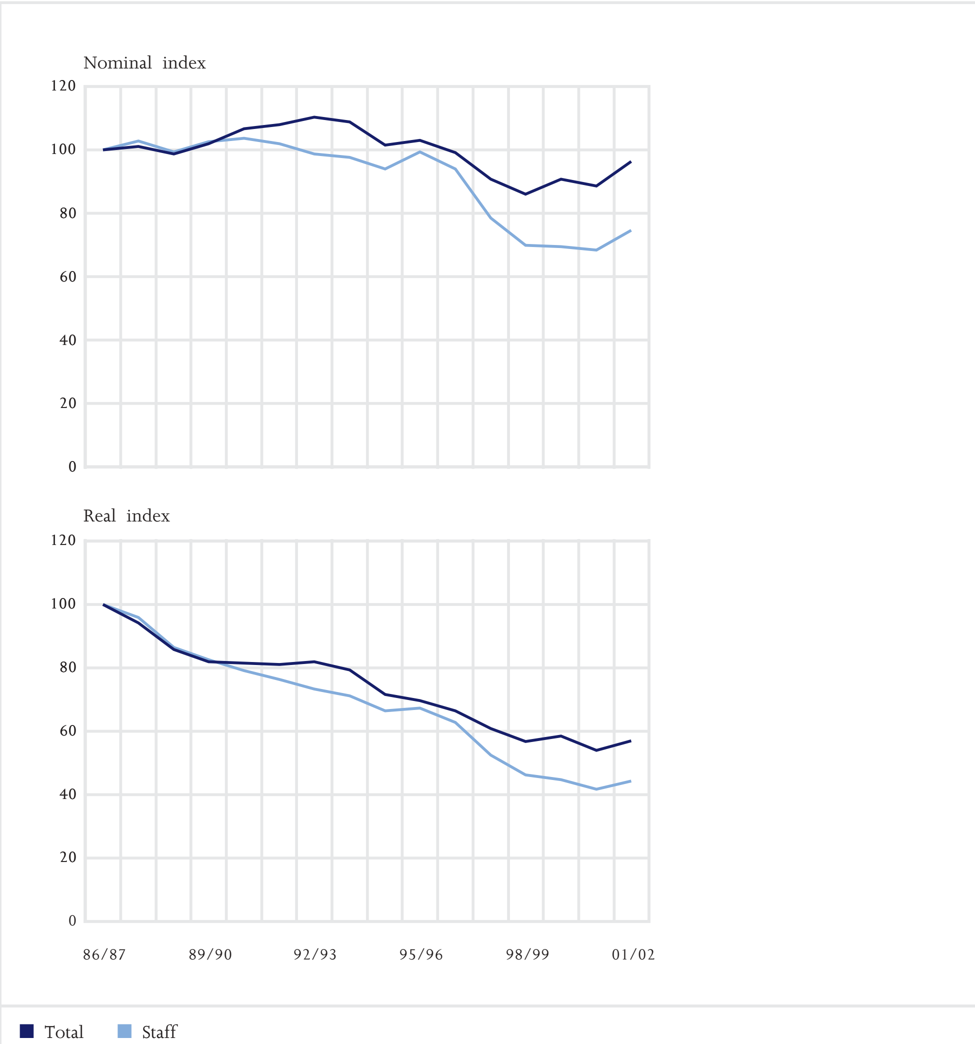
OPERATING COSTS

The increase in total operating costs of about 9 per cent in 2001/02 partly reflected the gearing up of the NNPC and associated currency processing and distribution arrangements. These arrangements have reduced the RBA's risks in the area of note issue by moving ownership of working stocks of currency to the banking system. They have also been associated with an increase in interest earnings and have eliminated over a number of years the costs of cash operations in the RBA as these have been closed. The overall effect on net earnings from these changes to cash arrangements has been favourable. The full-year effect in 2001/02 of establishing the regional economic offices the previous year also increased costs, as did the project to bring the RTGS system in-house. Some significant cost increases – such as those associated with making overseas pension payments on behalf of Centrelink – were offset by increases in revenue.

Despite the rise in total operating costs in 2001/02, these costs remain lower in nominal terms than at their peak in the mid 1990s; in real terms, they are still about 40 per cent below their peak.

More than half of operating costs are now incurred by the core policy functions of monetary policy and financial system surveillance. The remainder is spread

GRAPH 21 / **RBA OPERATING COSTS** 1986/87 = 100



Operating Costs(a) ($ million)

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02
Staff costs	96.7	93.0	98.3	93.0	77.7	69.1	68.7	67.7	73.9
Other costs	53.0	46.4	43.2	43.4	47.2	49.1	56.1	54.1	58.4
Underlying operating costs	149.7	139.4	141.5	136.4	124.9	118.2	124.8	121.8	132.3
Cost of redundancies	9.8	18.0	1.3	7.5	20.7	18.4	9.3	2.6	3.4

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

evenly across note distribution, banking and registry operations, and the provision of settlement services. This pattern differs from a few years ago, when policy functions accounted for around 10 per cent less of operating costs, despite the transfer of responsibility for bank supervision to APRA since then. The new Regional Offices, in particular, have increased the share of spending by policy areas. This rising share of costs associated with policy responsibilities over time is, of course, in the context of the reduction from the peak in overall costs, which has been concentrated elsewhere in the RBA.

The share of resources devoted to the provision of settlement services has increased, with the introduction of RTGS. On the other hand, costs associated with note processing and distribution account for a much smaller proportion of total costs than previously: in 1996/97, note issue accounted for 28 per cent of total operating costs, compared with about 15 per cent in 2001/02. The share of costs incurred by banking and registry

Major refurbishment works at the RBA's Head Office. From left: Richard Mayes, Head of Facilities Management; John Pick, project manager; Frank Campbell, Assistant Governor (Corporate Services) are pictured on the gutted 19th floor.

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

	Monetary policy	Financial system surveillance	Note distribution	Banking and registry	Settlement
1996/97	29	14	28	23	6
1997/98	30	14	23	23	10
1998/99	35	8	20	23	14
1999/2000	35	8	23	20	14
2000/01	41	9	17	18	15
2001/02	43	9	15	18	15

(a) Excludes NPA

has also fallen as these activities have been consolidated, most branch operations closed and the two remaining branches substantially reduced in size.

FACILITIES MANAGEMENT

The closure of the branch operations and lower staffing levels in Head Office have seen the RBA's accommodation needs diminish accordingly. This situation is being addressed by works to make surplus space available for leasing to external tenants in the Head Office in Sydney; by selling branch buildings when they no longer serve a business need; and by letting surplus space to tenants in the remaining branch buildings.

A major project of works for the Head Office building was approved by the Commonwealth Parliament in December 2000 following a recommendation by the Joint Parliamentary Standing Committee on Public Works. This project aims to make more efficient use of the space occupied by the RBA in Head Office, convert previously under-used "back-of-house" space to office accommodation, and lease the resulting surplus space to suitable external tenants. The project is expected to make available for external lease about 5 500 square metres of space out of a total floor space in the building of around 30 000 square metres. The total works are estimated to cost $21.5 million.

The construction phase of the project began in September 2001. Construction is proceeding within budget and on time, with the program expected to be completed in the first quarter of 2003. A marketing campaign has commenced to lease the available space to tenants, with a lease for one floor already signed. The net revenue from leasing all of the available space is estimated at around $2.75 million in a full year.

Over the past year, the RBA sold its premises in Hobart for $4.5 million, and Perth for $18.75 million. It had previously sold its building in Darwin in 1997 and that in Brisbane in June 2001. Currently, discussions are proceeding with a potential buyer for its building in Adelaide. The RBA will continue to own its premises in Melbourne to support the activities of the NNPC, accommodate the Victorian Regional Office, and house external tenants. Its premises in Canberra support the RBA's transactional banking business and accommodate tenants.

EARNINGS AND DISTRIBUTION

As a consequence of its responsibilities as the nation's central bank, the RBA holds a large portfolio of financial assets which generates substantial earnings. These earnings, net of costs, are distributed as a dividend to the Commonwealth, subject to any transfer from earnings to augment reserves.

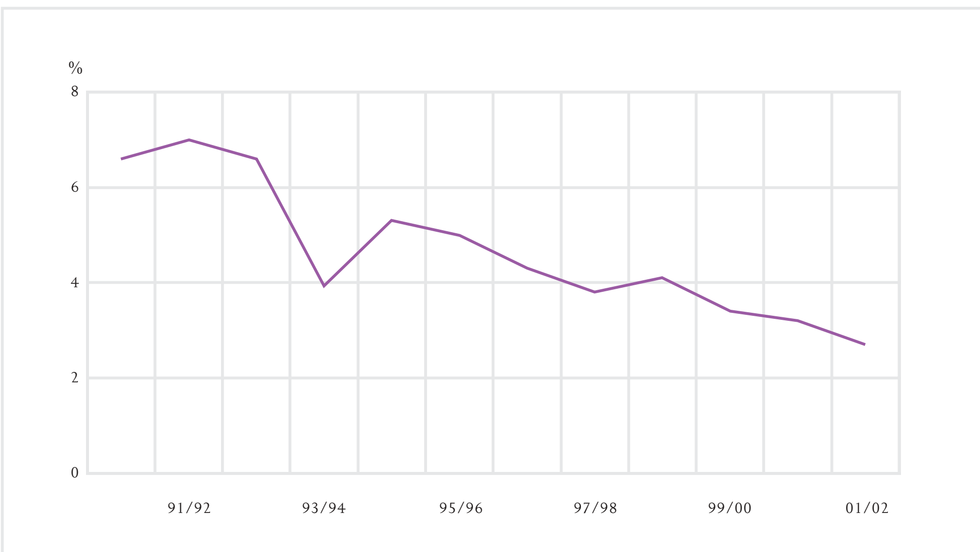
Earnings available for distribution have two sources: underlying earnings, and the valuation gains or losses that are realised when assets are sold in the course of implementing monetary policy or in other portfolio management operations.

Underlying earnings mainly comprise interest earnings on assets minus interest on liabilities. The moderate sums of other revenue received – such as rent and fee income from providing banking services – add to underlying earnings, while operating costs subtract from them.

Fee and rental income aside, underlying earnings arise because about two-thirds of the RBA's liabilities are interest-free, while almost all of its assets earn interest. The RBA is the issuer of currency notes in Australia, a liability of some $31.9 billion on which it pays, for the most part, no interest. Although under new currency distribution arrangements outlined in the chapter on "Business Services", banks are now reimbursed for interest forgone on some of the currency they hold as working balances, this cost is covered since the RBA earns interest from investing the proceeds it receives from banks for these balances. As with the bulk of currency, no interest is paid on capital and reserves of $9.5 billion.

The size of underlying earnings is largely determined by the interest margin on the portfolio and the size of the portfolio itself. Underlying earnings over the past decade or so have been relatively steady, averaging around $1.7 billion a year.

GRAPH 22 / RBA'S AVERAGE INTEREST MARGIN



The main reason why these earnings have not tended to increase as the balance sheet has roughly doubled over this period is that the RBA's interest margin has declined, as market interest rates have fallen. The trend in market interest rates has had a much bigger impact on earnings than on interest costs because, as noted, the RBA does not pay interest on a large component of its liabilities.

This trend in the interest margin has been aggravated by an increase in the proportion of liabilities on which the RBA pays interest. This proportion was less than 10 per cent in 1990, whereas the figure is now over 30 per cent. This shift is explained both by the abolition of some liabilities on which the RBA once paid interest at below-market rates – such as Non-Callable Deposits of banks – and because it has also begun to offer deposit facilities which pay a market rate, such as term deposits for the Commonwealth Government.

In 2001/02, the narrowing in the interest margin, as interest rates fell in response to the easing of monetary policy around the world, saw underlying earnings fall to $1 400 million, from $1 629 million in the previous financial year.

The second component of earnings available for distribution from the RBA is the valuation changes that are realised when assets are sold. Valuation gains arise when the price of a security increases due to a decline in interest rates or because the value of the Australian dollar depreciates against the currencies in which the RBA invests. Valuation losses occur when interest rates rise or the Australian dollar appreciates.

Realised gains on the RBA's assets amounted to $489 million in 2001/02, compared with $1 205 million in 2000/01. Realised foreign exchange gains were $496 million, $247 million lower than in 2000/01 because the Australian dollar exchange rate appreciated for much of the year and the RBA's sales of foreign exchange, including those undertaken on behalf of the Government, were largely covered rather than being met out of portfolio. This reduced the potential for profit from these

Sources of Earnings Available for Distribution ($ million)

	Underlying earnings	Realised gains and losses	Earnings available for distribution
1985/86	1 292	1 371	2 663
1986/87	1 412	2 035	3 447
1987/88	1 508	18	1 526
1988/89	971	-554*	417
1989/90	1 248	-153*	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
1999/2000	1 511	-708	803
2000/01	1 629	1 205	2 834
2001/02	1 400	489	1 889

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

foreign exchange sales. Realised gains on sales of foreign securities were $53 million in 2001/02, down from $558 million last year. Lower realised gains on foreign securities reflected a steadier level of market interest rates in major countries than had been the case in the previous year.

Profits for 2001/02 that are available for distribution amount to $1 889 million.

ACCOUNTING PROFITS

The RBA calculates its accounting profit according to generally accepted accounting principles, under which all valuation gains or losses – whether realised or unrealised – are included in profit and loss. Movements in interest and exchange rates during 2001/02 saw the RBA record an overall valuation gain of $468 million. Combined with underlying earnings of $1 400 million, this yields an accounting profit of $1 868 million (compared with $3 149 million in 2000/01).

RESERVES

As with other financial institutions, the RBA maintains reserves which are available to absorb losses that might arise in the course of its operations. Under the *Reserve Bank Act*, and consistent with best practice for central banks, unrealised gains are not available to be paid to the Commonwealth Government but are transferred to the Unrealised Profits Reserve. Balances in this reserve remain available to absorb future unrealised losses that might arise from unanticipated adverse movements in interest or exchange rates, or they are realised when relevant assets are sold. In 2001/02, the balance in the Unrealised Profits Reserve declined slightly, to a level of $1 798 million on 30 June 2002.

The RBA also maintains asset revaluation reserves, with the value in these reserves reflecting the amount by which the market value of the RBA's holdings of gold and property exceed the price at which they were purchased. The amounts in these reserves stood at $1 520 million at 30 June 2002.

Although balances in the Unrealised Profits Reserve and asset revaluation reserves vary with market prices, the RBA also has a major "permanent" reserve, the Reserve Bank Reserve Fund (RBRF), which has been funded out of past profits and, accordingly, can be viewed as akin to capital. The RBRF 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. At 30 June 2002, the balance of the RBRF stood at $6 152 million, more than 10 per cent of the RBA's total assets.

The *Reserve Bank Act* 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 Commonwealth Government after any such transfers. Since the Board viewed the balance in the RBRF as satisfactory at the end of the financial year, it did not seek a transfer from profits to this reserve. Consequently, all of the earnings available for distribution from 2001/02 will be paid as a dividend to the Commonwealth.

The practice in recent years has been for the RBA to pay the Commonwealth's dividend early in the financial year following that in which it was earned. The exception was in 1998/99, when the Treasurer decided to defer the receipt of some of that year's profits, spreading the dividend over the following two years. The RBA has not made an interim payment from its current year's earnings since 1995/96.

Reserve Bank Payments to Government ($ million)

	Earnings Available for Distribution	Transfers to Reserves	Payments to the Commonwealth: Balance Available from Current Year's Profit	Interim Payment from Current Year's Profit	Payment from Previous Year's Profits	Payment Delayed from Earlier Years	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
1999/2000	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	–	–	–	–	1 889	–	1 889

The RBA's financial statements for 2001/02 are presented in the following pages.

FINANCIAL STATEMENTS

AS AT 30 JUNE 2002

STATEMENT OF FINANCIAL POSITION As at 30 June 2002

Reserve Bank of Australia and Controlled Entities

	Note	2002 $M	2001 $M
ASSETS			
Cash and liquid assets	5, 18	606	680
Australian dollar securities	1(d), 17	21 987	19 814
Foreign exchange	1(c), 17	35 650	35 786
Gold	1(b), 17	1 459	1 381
Property, plant and equipment	1(f), 7	277	280
Loans, advances and other	6	149	172
Total Assets		60 128	58 113
LIABILITIES			
Deposits	8	13 992	16 864
Distribution payable to Commonwealth	1(h)	1 889	2 834
Other	9	2 807	1 816
Australian notes on issue	1(j)	31 930	27 168
Total Liabilities		50 618	48 682
Net Assets		9 510	9 431
Capital and Reserves			
Reserves:			
Unrealised Profits Reserve	1(g), 4	1 798	1 809
Asset revaluation reserves	1(g), 4	1 520	1 430
Reserve Bank Reserve Fund	1(g), 4	6 152	6 152
Capital	4	40	40
Total Capital and Reserves		9 510	9 431

STATEMENT OF FINANCIAL PERFORMANCE For year ended 30 June 2002

Reserve Bank of Australia and Controlled Entities

	Note	2002 $M	2001 $M
REVENUES			
Interest revenue	2	2 196	2 685
Net gains on securities	2	468	1 520
Dividend revenue	2	4	3
Fees and commissions	2	20	18
Other revenue	2	39	46
Total revenue		2 727	4 272
EXPENSES			
Interest expense	2	684	955
General administrative expenses	2	149	147
Other expenses	2	26	21
Total expenses		859	1 123
Net Profit		1 868	3 149
Net revaluation adjustments in asset revaluation reserves	1(g), 4	100	150
Net profit plus net revaluation adjustments in asset revaluation reserves		1 968	3 299

STATEMENT OF DISTRIBUTION For year ended 30 June 2002

Reserve Bank of Australia and Controlled Entities

	Note	2002 $M	2001 $M
Net Profit		1 868	3 149
Transfer from/(to) unrealised profits reserve	4	11	(320)
Transfer from asset revaluation reserves	4	10	5
Earnings available for distribution		1 889	2 834
Distributed as follows:			
Payable to the Commonwealth of Australia		1 889	2 834

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2002

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* and the *Commonwealth Authorities and Companies Act*.

The form and content of the financial statements incorporate the requirements of the Commonwealth Authorities and Companies (Financial Statements 2001-2002) Orders. 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. In particular, as the Reserve Bank of Australia (RBA) is a financial institution, the financial statements have been prepared using AAS32 – *Specific Disclosures by Financial Institutions*.

The RBA has been granted certain exemptions from the requirements of the Orders as detailed in Note 1 (l). These exemptions relate to matters of disclosure and presentation which are of a minor nature and are adequately dealt with in these financial statements.

The statements are a general purpose financial report prepared in accordance with Australian Accounting Standards. Compliance with revised accounting standards has resulted in a small number of comparative amounts being represented and reclassified to ensure comparability with the current reporting period. Unless otherwise stated, the accounting policies and practices followed in these statements are consistent with those followed in the previous year.

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. In other cases, an historical cost basis of accounting is used. Revenue and expenses are brought to account on an accrual basis. All revenues, expenses and profits are from ordinary activities of the RBA.

(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 14, 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 AAS24 – *Consolidated Financial Reports*. 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.

The RBA accounts for its investment in Securency Pty Ltd in accordance with AAS14 – *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 6.

(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 of the date they are received.

Foreign currency swaps

The RBA uses foreign currency swaps to assist daily domestic liquidity management or to smooth the impact of other foreign currency transactions on Official Reserve Assets. 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 set 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 2002 (including those under swap contracts) have been valued at market exchange rates (refer Note 17).

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 and foreign currency swaps are off-balance sheet items. The RBA did not trade in any other derivative instruments during 2001/02.

(d) Australian dollar securities The RBA holds Commonwealth Treasury Fixed Coupon Bonds, Treasury Notes and Treasury Capital Indexed Bonds. It also holds Australian dollar denominated securities, issued by the central borrowing authorities of State and Territory Governments and certain highly-rated supranational organisations, where these are acquired under repurchase agreements. 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 balance sheet 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 A formal valuation of all RBA properties is conducted on a triennial basis. The most recent valuation was at 30 June 2001, when Australian properties were valued by officers of the Australian Valuation Office and overseas properties were valued by local independent valuers. The valuations have been incorporated in the accounts.

Valuations on Australian properties are updated annually for developments in the property markets where the RBA's assets are held. Annual depreciation is based on market values and assessments of useful remaining life.

Plant and equipment are recorded at cost less depreciation, which is calculated at rates appropriate to the estimated useful life of the relevant assets. Depreciation rates are reviewed annually, and adjusted where necessary to reflect the most recent assessments of the useful life of assets.

In the opinion of the Board, values of plant and equipment in the financial statements do not exceed recoverable values.

Details of annual net expenditure, revaluation adjustments and depreciation of these assets are included in Note 7.

(g) 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.

Asset revaluation reserves reflect the impact of changes in the market values of a number of the RBA's assets (gold, premises, and shares in international financial institutions).

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

(h) Profits Profits of the Bank are dealt with in terms of Section 30 of the *Reserve Bank Act* as follows:

(1) Subject to (2) (below), 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 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.

(i) Provisions The RBA maintains provisions for accrued annual leave, calculated on salaries prevailing at balance date 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 AAS 30. 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.

(j) Australian notes on issue The RBA assesses regularly the value of notes still outstanding at least five years after the note issue ceased which are judged to have been destroyed and therefore unavailable for presentation. No amount was written off Australian notes on issue in 2001/02, or in 2000/01.

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.

(k) Rounding Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

(l) Exemptions The RBA has been granted exemptions from the following requirements of the Commonwealth Authorities and Companies (Financial Statements 2001-2002) Orders:-

Requirement	Description	Detail of exemption
Policy 16	Analysis of property, plant and equipment	Information is included in Note 7 of these financial statements. These disclosures are more relevant than the dissections required by Policy 16 of the Orders.
Appendix A	Forms of Financial Statements	Details of revenues and expenses are disclosed in Note 2. The cash flow statement is provided in Note 18.

Note 2 NET PROFITS

	Note	2002 $M	2001 $M
Interest revenue			
Overseas investments	1 (c)	1 186	1 480
Australian dollar securities	1 (d)	957	1 147
Overnight settlements		30	39
Gold loans	1 (b)	22	17
Loans, advances and other		1	2
		2 196	2 685
Net gains/(losses) on securities			
Overseas investments	1 (c)	207	485
Australian dollar securities	1 (d)	(99)	(96)
Foreign currency	1 (c)	360	1 131
		468	1 520
Dividend revenue			
Earnings on shares in Bank for International Settlements		4	3
Fees and commissions			
Banking services fees received		20	18
Other revenue			
Reimbursement by Commonwealth for loan management and registry expenses		1	1
Rental of Bank premises		5	9
Sales of note products		19	22
Other		14	14
		39	46
Total		2 727	4 272
Less:			
Interest expense			
Deposit liabilities		454	702
Currency note holdings of banks	1 (j)	78	
Repurchase agreements	1 (e)	152	253
		684	955
General administrative expenses			
Staff costs		86	83
Special redundancy/retirement payments	11	4	3
Depreciation of property	7	7	7
Depreciation of plant and equipment		8	9
Premises and equipment		25	25
Materials used in note production		8	10

	Note	2002 $M	2001 $M
Note 2 CONTINUED			
Travel		3	3
Consultants' fees	13	2	2
Other		6	5
		149	147
Other expenses			
Agency business reimbursement		3	1
Subsidiary income tax		–	1
Cash distribution expenses		4	4
Other		19	15
		26	21
Total		859	1 123
Net Profit		1 868	3 149

Note 3 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2002

	Average Balance $M	Interest $M	Average Annual Interest Rate %
Interest revenue			
Overseas investments	37 944	1 186	3.1
Australian dollar securities	17 695	957	5.4
Loans, advances and other	45	1	3.1
Overnight settlements	704	30	4.2
Gold loans	1 412	22	1.5
	57 800	2 196	3.8
Interest expense			
Exchange Settlement accounts	870	37	4.3
Deposits from governments	8 945	410	4.6
Deposits from overseas institutions	307	2	0.6
Overseas repurchase agreements	4 944	101	2.0
Domestic repurchase agreements	1 175	51	4.4
Currency note holdings of banks	2 004	78	4.4
Other deposits	112	5	4.0
	18 357	684	3.7
Analysis for the year ended 30 June 2001			
Interest revenue total	55 325	2 685	4.9
Interest expense total	18 025	955	5.3

	2002 $M	2001 $M
Note 4 RESERVES		
Changes in the RBA’s various reserves are shown below.		
Asset revaluation reserves (Note 1(g))		
Gold		
Opening balance	1 260	1 125
Net revaluation adjustments	79	135
As at 30 June	1 339	1 260
Shares in international financial institutions (Note 6)		
Opening balance	68	64
Net revaluation adjustments	6	4
As at 30 June	74	68
Bank properties (Notes 1(f), 7)		
Opening balance	102	96
Net revaluation adjustments	15	11
Transfers (to)/from Statement of Distribution	(10)	(5)
As at 30 June	107	102
Total asset revaluation reserves		
Opening balance	1 430	1 285
Net revaluation adjustments	100	150
Transfers (to)/from Statement of Distribution	(10)	(5)
As at 30 June	1 520	1 430
Unrealised profits reserve (Note 1(g))		
Opening balance	1 809	1 489
Net transfers (to)/from Statement of Distribution	(11)	320
As at 30 June	1 798	1 809
Reserve for Contingencies and General Purposes		
Opening balance	–	3 323
Transfer to Reserve Bank Reserve Fund	–	(3 323)
Closing balance	–	–
Reserve Bank Reserve Fund (Note 1(g))		
Opening balance	6 152	2 829
Transfer from Reserve for Contingencies and General Purposes	–	3 323
Closing balance	6 152	6 152
Capital		
Opening and closing balance	40	40
Total capital and reserves		
Opening balance	9 431	8 966
Net profit plus net revaluation adjustments in asset revaluation reserves	1 968	3 299
Distribution payable to Commonwealth of Australia	(1 889)	(2 834)
Closing balance	9 510	9 431

Prior to 30 June 2001, the Reserve Bank maintained a Reserve for Contingencies and General Purposes (RCGP) which provided for events which were contingent and non-foreseeable, mainly those arising from movements in the market value of the RBA’s holdings of securities. On 30 June 2001, balances in this reserve were transferred to the RBRF and the RCGP was closed.

Note 5 CASH AND LIQUID ASSETS

This includes net amounts of $586 million owed to the RBA for overnight clearances of financial transactions through the clearing houses, Austraclear and Reserve Bank Information and Transfer System (RITS); an amount of $565 million was owed to the RBA at 30 June 2001.

	2002 $M	2001 $M
Note 6 LOANS, ADVANCES AND OTHER ASSETS		
Shareholding in Bank for International Settlements	76	70
Officers' Home Advances	27	35
Gold coin	19	18
Investment in Securency	5	9
Other	22	40
As at 30 June	149	172

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 in 2001/02 was $21 530 001; the carrying value of the RBA's investment in Securency was $5 001 000 ($8 649 000 at 30 June 2001). Securency Pty Ltd has a 31 December balance date.

	2002 $M	2001 $M
Note 7 PROPERTY, PLANT AND EQUIPMENT (Note 1(f))		
Properties		
Opening balance	237	246
Additions	5	–
Disposals	(23)	(13)
	219	233
Depreciation prior to revaluation	(7)	(7)
Book valuation prior to revaluation	212	226
Net revaluation adjustments (Note 4)	15	11
As at 30 June	227	237
The triennial independent revaluation of all Bank properties occurred at 30 June 2001 (Note 1(f)).		
Plant and equipment		
Opening balance	118	114
Additions	17	6
Disposals	(11)	(2)
	124	118
Accumulated depreciation	(74)	(75)
As at 30 June	50	43
Total property, plant and equipment	277	280

	2002 $M	2001 $M
Note 8 DEPOSITS		
Banks		
Exchange Settlement accounts	1 091	839
Government & government instrumentalities		
Commonwealth	12 387	14 947
State	256	455
Foreign governments, foreign institutions and international organisations	146	506
Other depositors	112	117
As at 30 June	13 992	16 864
Note 9 OTHER LIABILITIES		
Provisions (Note 1(i))		
Provision for accrued annual leave	8	7
Provision for long service leave	20	19
Provision for post-employment benefits	47	53
Provision for workers' compensation	1	1
As at 30 June	76	80
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1 (e))	2 671	1 654
Interest accrued on deposits	34	64
Other	26	18
As at 30 June	2 731	1 736
Total other liabilities	2 807	1 816

Note 10 CONTINGENT LIABILITIES AND OTHER ITEMS NOT INCLUDED IN STATEMENT OF FINANCIAL POSITION

Contingencies

The RBA has a contingent liability, amounting to $79.0 million at 30 June 2002 ($74.7 million at 30 June 2001), 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 $11.8 million at 30 June 2002 ($2.3 million at 30 June 2001) payable within one year; and no commitments payable beyond one year.

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

Note 11 SPECIAL REDUNDANCY/RETIREMENT PAYMENTS

The RBA's expenses in 2001/02 include $4 million paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 2000/01 totalled $3 million. Staff leaving the RBA in 2001/02 under these arrangements numbered 31 (46 in 2000/01).

Note 12 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 2002	Number 2001
$100 000 – $109 999	4	1
$110 000 – $119 999		6
$120 000 – $129 999	8	7
$130 000 – $139 999	14	15
$140 000 – $149 999	13	11
$150 000 – $159 999	7	4
$160 000 – $169 999	4	4
$170 000 – $179 999	4	4
$180 000 – $189 999	3	7
$190 000 – $199 999	5	
$200 000 – $209 999	1	1
$210 000 – $219 999	1	
$220 000 – $229 999		2
$230 000 – $239 999		5
$240 000 – $249 999	6	1
$250 000 – $259 999	1	1
$260 000 – $269 999	1	
$290 000 – $299 999		4
$300 000 – $309 999	4	
$320 000 – $329 999		1
$340 000 – $349 999	1	
$480 000 – $489 999		1
$490 000 – $499 999	1	

Total remuneration received or due and receivable by these 78 executives amounted to $13.668 million (75 executives totalling $12.913 million in 2000/01). 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. Remuneration excludes amounts paid to executives posted outside Australia 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 14).

Termination payments of $1.055 million were made to executives who left the Bank during 2001/02 ($1.113 million in 2000/01); these payments are not reflected in the above table.

Note 13 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services totalled $179 000 in 2001/02 ($165 000 in 2000/01). They are included in "Consultants' fees" in Note 2, which also covers legal fees and payments made to specialists for "review and advice" services.

Note 14 RELATED PARTY AND OTHER DISCLOSURES

The Remuneration Tribunal determines the remuneration appropriate to the RBA's non-executive Board members. In 2001/02, payments to executive and non-executive Board members totalled $1 241 410 ($1 022 388 in 2000/01). Remuneration includes amounts paid to members of the Bank Board who are also executives (refer Note 12).

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

Remuneration band	Number 2002	Number 2001
$1 – $9 999		1
$10 000 – $19 999		1
$20 000 – $29 999		1
$30 000 – $39 999	4	2
$40 000 – $49 999	1	1
$60 000 – $69 999	1	1
$160 000 – $169 999	1	
$320 000 – $329 999		1
$340 000 – $349 999	1	
$480 000 – $489 999		1
$490 000 – $499 999	1	

At 30 June 2002 and 30 June 2001 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, $101 787 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 ($78 500 in 2000/01). The RBA also paid $147 252 for the services of members of the Payments System Board who are not employees of the RBA ($145 317 in 2000/01).

Note 15 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act*: 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 2001/02.

At 30 June 2002, the OSF had a surplus of assets over accrued benefits of $183 million ($228 million at 30 June 2001). The UK Pension Scheme had a surplus equivalent to $5 million ($5 million at 30 June 2001). During 2001/02, the RBA made superannuation contributions of $2.3 million ($2.2 million in 2000/01).

Details of the Funds as at 30 June 2002 are as follows:

	2002 $M	2001 $M
Reserve Bank of Australia Officers' Superannuation Fund		
Accrued benefits	426	388
Net market value of assets	609	616
Surplus	183	228
Vested benefits	435	401
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	20	21
Net market value of assets	25	26
Surplus	5	5
Vested benefits	18	20
Total Superannuation Funds		
Accrued benefits	446	409
Net market value of assets	634	642
Surplus	188	233
Vested benefits	453	421

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 16 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 17.

Note 17 FINANCIAL INSTRUMENTS

Australian Accounting Standard AAS33 – *Presentation & Disclosure of Financial Instruments* requires disclosure of information relating to: both recognised and unrecognised financial instruments; their significance and performance; accounting policy terms & 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, 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. AAS33 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 balance sheet.

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 balance sheet restated in compliance with AAS33.

Note 17 CONTINUED

Interest rate risk As at 30 June 2002

	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								
Gold loans	1 421	–	90	539	778	–	14	1.5
Gold holdings	38	–	–	–	–	–	38	n/a
Sub-total	**1 459**							
Foreign exchange								
Securities sold under repurchase agreements	1 607	–	–	–	811	796	–	1.4
Securities purchased under repurchase agreements	7 974	–	7 974	–	–	–	–	2.0
Deposits and other securities	25 791	791	8 446	2 563	7 034	6 712	245	3.3
Accrued interest – foreign exchange	278	–	–	–	–	–	278	n/a
Sub-total	**35 650**							
Australian dollar securities								
Securities sold under repurchase agreements	1 064	–	–	–	251	813	-	4.2
Securities purchased under repurchase agreements	17 654	-	17 654	-	-	-	-	4.7
Other securities	3 185	-	-	1 080	1 220	885	-	5.5
Accrued interest – Australian dollar securities	84	-	-	-	-	-	84	n/a
Sub-total	**21 987**							
Property, plant & equipment	277	-	-	-	-	-	277	n/a
Cash and liquid assets	606	602	-	-	-	-	4	4.7
Loans, advances and other	149	27	-	-	-	-	122	3.3
Total assets	**60 128**	**1 420**	**34 164**	**4 182**	**10 094**	**9 206**	**1 062**	**3.5**
Liabilities								
Australian notes on issue	31 930	2 550	-	-	-	-	29 380	4.8
Deposits	13 992	3 592	10 400	-	-	-	-	4.8
Distribution payable to Commonwealth	1 889	-	-	-	-	-	1 889	n/a
Other	2 807	-	2 671	-	-	-	136	2.5
Total liabilities	**50 618**	**6 142**	**13 071**	**-**	**-**	**-**	**31 405**	**1.4**
Capital and reserves	9 510							
Total balance sheet	**60 128**							
Off balance sheet items								
Interest rate futures	38	-	-	-	-	38	-	n/a

Note 17 CONTINUED

Interest rate risk As at 30 June 2001

	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	58 113	1 003	32 637	5 032	8 688	9 592	1 161	3.8
Total liabilities	48 682	3 464	15 054	-	-	-	30 164	1.9
Capital and reserves	9 431							
Total balance sheet	58 113							
Off balance sheet items	(287)	-	-	-	-	(287)	-	n/a

Other liabilities include 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 on 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.

As part of an IMF support package during 1997/98, 1998/99, 1999/2000, 2000/01 and 2001/02, the RBA undertook a series of foreign currency swaps with the Bank of Thailand. The RBA provided United States dollars, receiving Thai baht in exchange. The amount outstanding on the swaps at 30 June 2002 was the equivalent of $606 million Australian dollars ($1.4 billion at 30 June 2001), on which the RBA is earning a yield of 2.0 per cent (4.4 per cent in 2000/01). The swaps represent 1.0 per cent of the RBA's total assets as at 30 June 2002 (2.4 per cent at 30 June 2001).

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

1. ***Foreign exchange swaps*** – As at 30 June 2002 the RBA was under contract to purchase $15.5 billion of foreign currency and sell $43.7 billion of foreign currency. As of that date there was an unrealised net gain included in net profit of $320 million on these swap positions. 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 2002 the amount of credit risk on interest rate futures contracts was approximately $0.9 million ($3.6 million at 30 June 2001). As at 30 June 2002 there was an unrealised loss brought to account on those contracts of $42 000 ($0.3 million unrealised loss at 30 June 2001).

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. See Note 1(c) Foreign Exchange.

Credit Risk

	Risk rating of security issuer*	Risk rating of counterparties*	% of total asset portfolio as at 30 June 2002	% of total asset portfolio as at 30 June 2001
Australian dollar securities				
Holdings of Commonwealth Government securities	AAA	n/a	5.4	5.7
Securities sold under repurchase agreements	AAA	AA	1.7	2.8
	AAA	other	0.1	0.0
Securities held under repurchase agreements	AAA	AA	25.9	24.0
	AAA	other	1.2	0.4
	AA	AA	1.9	0.9
	AA	other	0.3	0.3
Foreign investments				
Holdings of securities	AAA	n/a	29.8	25.6
	AA	n/a	5.4	16.8
Securities sold under repurchase agreements	AAA	AA	1.2	0.0
	AAA	other	1.5	0.0
Securities held under repurchase agreements	AAA	AA	9.7	5.4
	AAA	other	3.6	3.6
Deposits	n/a	AAA	1.2	0.3
	n/a	AA	6.0	7.4
	n/a	other	1.0	2.4
Gold loans	n/a	AAA	0.2	0.3
	n/a	AA	1.6	1.5
	n/a	other	0.5	0.5
Other			1.8	2.1
			100%	100%

* Standard & Poor's equivalent ratings

Note 18 CASH FLOW STATEMENT

The following cash flow statement appears as a matter of record to meet the requirements of AAS 28; 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 Reserve Bank and overnight settlements system account balances with other banks.

STATEMENT OF CASH FLOWS For the financial year ended 30 June 2002

	2002 Inflow/(outflow) $M	2001 Inflow/(outflow) $M
Cash flows from operating activities		
Interest received on investments	2 056	2 274
Interest received on loans, advances, and on net overnight settlements systems	32	41
Loan management reimbursement	1	1
Banking service fees received	21	19
Rents received	5	9
Net payments for and proceeds from sale of investments	(622)	(3 299)
Interest paid on deposit liabilities	(484)	(728)
Interest paid on currency note holdings of banks	(78)	
Staff costs (including redundancy)	(94)	(84)
Premises and equipment	(25)	(25)
Other	9	15
Net cash provided by operating activities	821	(1 777)
Cash flows from investment activities		
Net expenditure on property, plant and equipment	12	9
Net cash used in investing activities	12	9
Cash flows from financing activities		
Profit payment to Commonwealth	(2 834)	(1 479)
Net movement in deposit liabilities	(2 872)	1 379
Net movement in loans and advances	8	7
Net movement in notes on issue	4 762	1 733
Other	29	(13)
Net cash provided by financing activities	(907)	1 627
Net increase/(decrease) in cash	(74)	(141)
Cash at beginning of financial year	680	821
Cash at end of financial year	606	680

Note 18 CONTINUED

Reconciliation of cash	30 June 2002 $M	30 June 2001 $M
Cash	20	115
Overnight settlements system	586	565
	606	680

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act*	2002 $M	2001 $M
Net Profit	1 868	3 149
Increase/(decrease) in interest payable	(30)	(26)
Net loss/(gain) on overseas investments	(207)	(485)
Net loss/(gain) on Australian dollar securities	99	96
Net loss/(gain) on foreign currency	(360)	(1 131)
Decrease/(increase) in income accrued on investments	65	(100)
Depreciation of property	7	7
Depreciation of plant and equipment	8	9
Net payments for and proceeds from sale of investments	(622)	(3 299)
Other	(7)	3
Net cash provided by operating activities	821	(1 777)

DIRECTORS' STATEMENT

In the opinion of the directors, the financial statements for the year ended 30 June 2002 give a true and fair view of the matters required by the Commonwealth Authorities and Companies (Financial Statements 2001-2002) Orders made under the *Commonwealth Authorities and Companies Act 1997*.

IJ Macfarlane

Chairman, Reserve Bank Board
9 August 2002

INDEPENDENT AUDIT REPORT

Australian National Audit Office

To the Treasurer

Scope

I have audited the financial statements of the Reserve Bank of Australia for the year ended 30 June 2002. The financial statements include the consolidated financial statements of the economic entity comprising the Reserve Bank of Australia and the entities it controlled at the year's end or from time to time during the year. The financial statements comprise:

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

The members of the Board are responsible for the preparation and presentation of the financial statements and the information they contain. I have conducted an independent audit of the financial statements in order to express an opinion on them to you.

The audit has been conducted in accordance with Australian National Audit Office Auditing Standards, which incorporate the Australian Auditing Standards, to provide reasonable assurance as to whether the financial statements are free of material misstatement. Audit procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with Australian Accounting Standards, other mandatory professional reporting requirements and statutory requirements in Australia so as to present a view of the entity which is consistent with my understanding of its financial position, the results of its operations and its cash flows.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In my opinion,

- the financial statements have been prepared in accordance with Schedule 1 of the Commonwealth Authorities and Companies (Financial Statements 2001-2002) Orders; and

- the financial statements give a true and fair view, in accordance with applicable Accounting Standards, other mandatory professional reporting requirements and Schedule 1 of the Commonwealth Authorities and Companies (Financial Statements 2001-2002) Orders, of the financial position of the Reserve Bank of Australia as at 30 June 2002 and the results of its operations and its cash flows for the year then ended.

P.J. Barrett
Auditor-General

Sydney
9 August 2002

GPO Box 707 CANBERRA ACT 2601
Centenary House 19 National Circuit
BARTON ACT
Phone (02) 6203 7300 Fax (02) 6203 7777

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 RBA's audited financial statements.

	Transactional Banking Business		Registry	
	2000/01 $ million	2001/02 $ million	2000/01 $ million	2001/02 $ million
Revenue				
- Service fees	16.4	17.4	1.5	0.8
- Other revenue	6.0	3.8	0.1	0.1
Total	22.4	21.2	1.6	0.9
Expenditure				
- Direct costs	10.8	13.6	0.6	0.5
- Indirect costs	3.6	3.5	0.3	0.2
Total	14.4	17.1	0.9	0.7
Net profit/(loss)	8.0	4.1	0.7	0.2
Net profit/(loss) after taxes (a)	5.4	2.9	0.5	0.2
Assets (b)				
- Domestic market investments	772.2	529.2	1.6	1.4
- Other assets	12.3	8.8	0.1	0.1
Total	784.5	538.0	1.7	1.5
Liabilities (b)				
- Capital & reserves	25.0	25.0	1.0	1.0
- Deposits	751.5	506.1		
- Other liabilities	8.0	6.9	0.7	0.5
Total	784.5	538.0	1.7	1.5

(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 RESERVE BANK BOARD

Sections 8A and 10 of the *Reserve Bank Act 1959* give the Reserve Bank Board clear responsibility for the RBA's "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 been augmented over time, in order to keep the RBA's policy-making process relevant to the evolving 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 Bank's inflation target. The high profile of the RBA's regular appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration, and the quarterly *Statements on Monetary Policy*, have reinforced this process.

When the Australian Prudential Regulation Authority was established in 1998, the RBA's role as prudential supervisor of banks passed to it, but responsibility for overall financial system stability was retained. The Treasurer's statement in Parliament

In August 2001, members of the House of Representatives Standing Committee on Economics, Finance and Public Administration visited the RBA. They are pictured in the international dealing room, from right: Christopher Pyne; Tanya Plibersek; Anna Burke; Ian Macfarlane, Governor; Mike Sinclair, Chief Manager, International Department; Kay Hull; David Hawker, Committee Chairman; Margaret Atkin, Committee Secretariat.

on 2 September 1997 confirmed that the RBA, in addition to monetary policy, was responsible for overall financial system stability and regulation of the payments system.

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

COMPOSITION OF THE RESERVE BANK 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 92-93. Five members form a quorum for a meeting of the Board.

In terms of Section 17(1) of the *Reserve Bank Act 1959*, members of the Board may not be a director, officer or employee of an authorised deposit-taking institution for the purposes of the *Banking Act 1959*.

MEETINGS OF THE RESERVE BANK 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. From time to time, the Board meets in other State capitals.

The number of meetings attended by each member in 2001/02, was:

IJ Macfarlane	11	(11)
SA Grenville	5	(5)
GR Stevens	5	(5)
KR Henry *	10	(11)
JR Broadbent	11	(11)
FP Lowy	9	(11)
DG McGauchie	11	(11)
WJ McKibbin	8	(10)
HM Morgan	10	(11)
RFE Warburton	10	(11)

*GR Potts 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.)

AUDIT COMMITTEE

The primary objectives of the Audit Committee are to:

- ensure a high-quality, independent and effective audit process in the RBA;
- assist the Governor and the Board in fulfilling their obligations relating to financial reporting, compliance with laws and regulations, internal control and 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 2001/02, the Committee met on four occasions; SA Grenville chaired the meetings in July and November 2001 and GR Stevens chaired the meetings in February and May 2002. Ms Broadbent attended all four meetings during the year; Mr Bennett attended three.

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 at the time of the presentation of the annual accounts.

OBLIGATIONS UNDER THE COMMONWEALTH *AUTHORITIES AND COMPANIES (CAC) ACT 1997*

The *CAC Act* is one of three Acts which deal with the financial management, accountability and audit of Commonwealth agencies, authorities and companies. 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.

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 RBA's Annual Report and, at the meeting of the Board on 6 August 2002, they resolved that the Chairman sign the Report, and the Financial Statements as at 30 June 2002, 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 also the Annual Report of the Payments System Board.

REMUNERATION

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

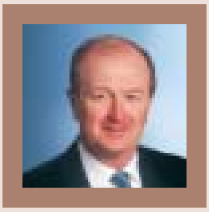
A committee of the RBA non-executive Board members, currently chaired by RFE Warburton, reviews annually the remuneration of the Governor and Deputy Governor in terms of section 24A of the *Reserve Bank Act* 1959.

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, IJ Macfarlane
Governor since 18 September 1996
Present term expires 17 September 2003
Chairman – Payments System Board
Board member – Australian Prudential Regulation Authority



GR Stevens
Deputy Governor since 21 December 2001
Present term expires 20 December 2008

KR Henry
Secretary to the Treasury
Member since 27 April 2001

JR Broadbent
Member since 7 May 1998
Present term expires 6 May 2003
Chairman – Integrated Development Capital Limited
Director – Coca Cola Amatil Limited
Director – Special Broadcasting Service
Director – Westfield America Management Limited
Director – Westfield Management Limited
Director – Woodside Petroleum Limited

FP Lowy AC
Member since 27 June 1995
Present term expires 26 June 2003
Chairman – Westfield Holdings Limited
Director – Daily Mail and General Trust PLC (UK)

DG McGauchie
Member since 30 March 2001
Present term expires 29 March 2006
Chairman – Telstra Country Wide Advisory Board
Chairman – Woolstock Australia Limited
Deputy Chairman – Australian Wool Testing Authority Limited
Director – Australian Centre for International Agriculture Research
Director – GrainCorp Limited
Director – National Foods Limited
Director – Ridley Corporation Limited
Director – Telstra Corporation Limited

WJ McKibbin
Member since 31 July 2001
Present term expires 30 July 2006
Professor of International Economics and Convenor of Division of Economics, Research School of Pacific & Asian Studies – Australian National University
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

HM Morgan AC
Member since 14 August 1996
Present term expires 28 July 2007
Chief Executive Officer – WMC Limited
Director – Alcoa of Australia Limited
Director – Business Council of Australia

RFE Warburton
Member since 22 December 1992
Present term expires 21 December 2002
Chairman – Caltex Australia Limited
Chairman – David Jones Limited
Chairman – AurionGold Limited
Chairman – HIH Claims Support Limited
Director – Note Printing Australia Limited
Director – Nufarm Limited
Director – Southcorp Limited
Director – Tabcorp Holdings Limited

Retirement of SA Grenville

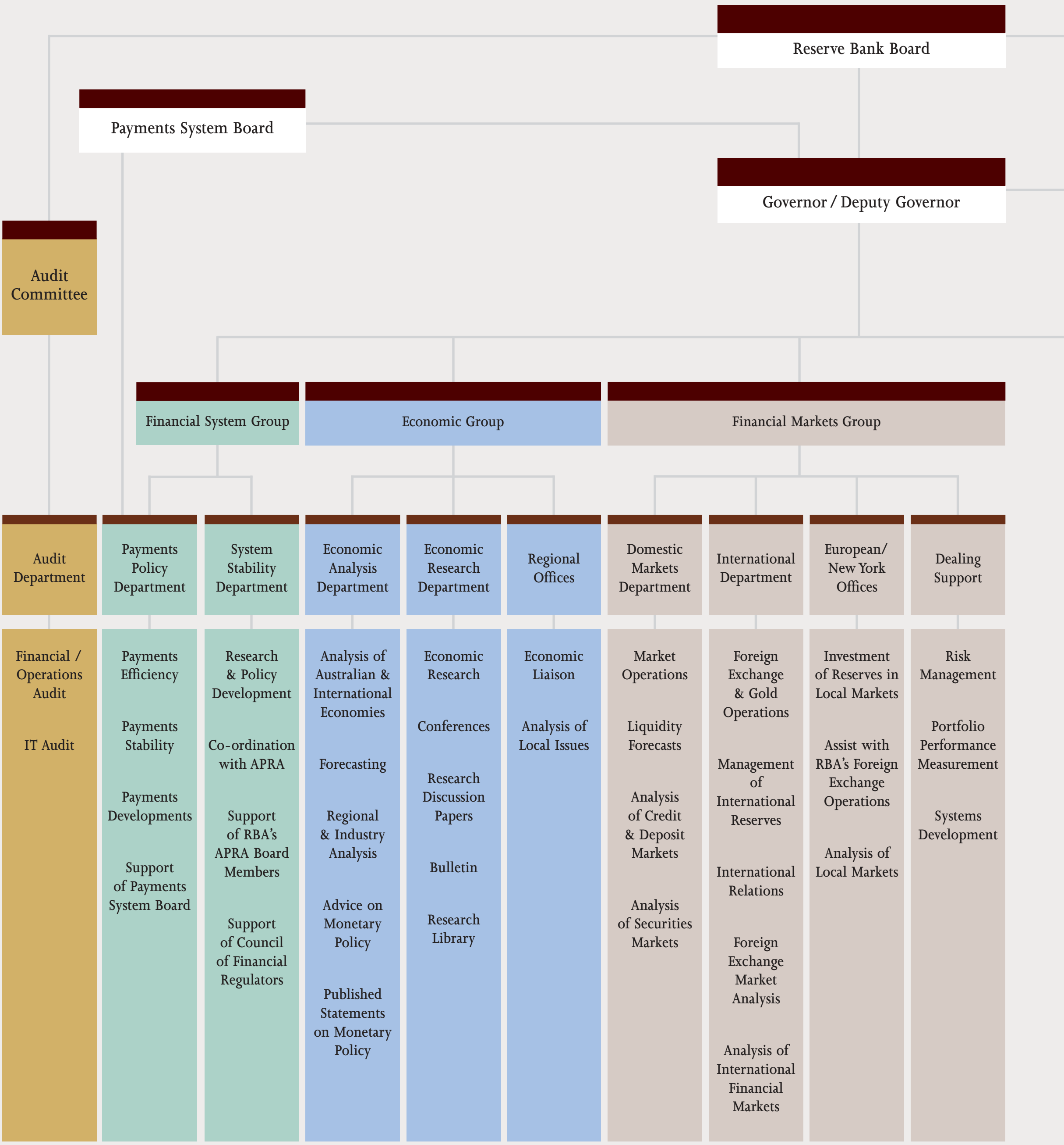
Dr Grenville retired on 30 November 2001 as Deputy Governor of the RBA and Deputy Chairman of the Reserve Bank Board.

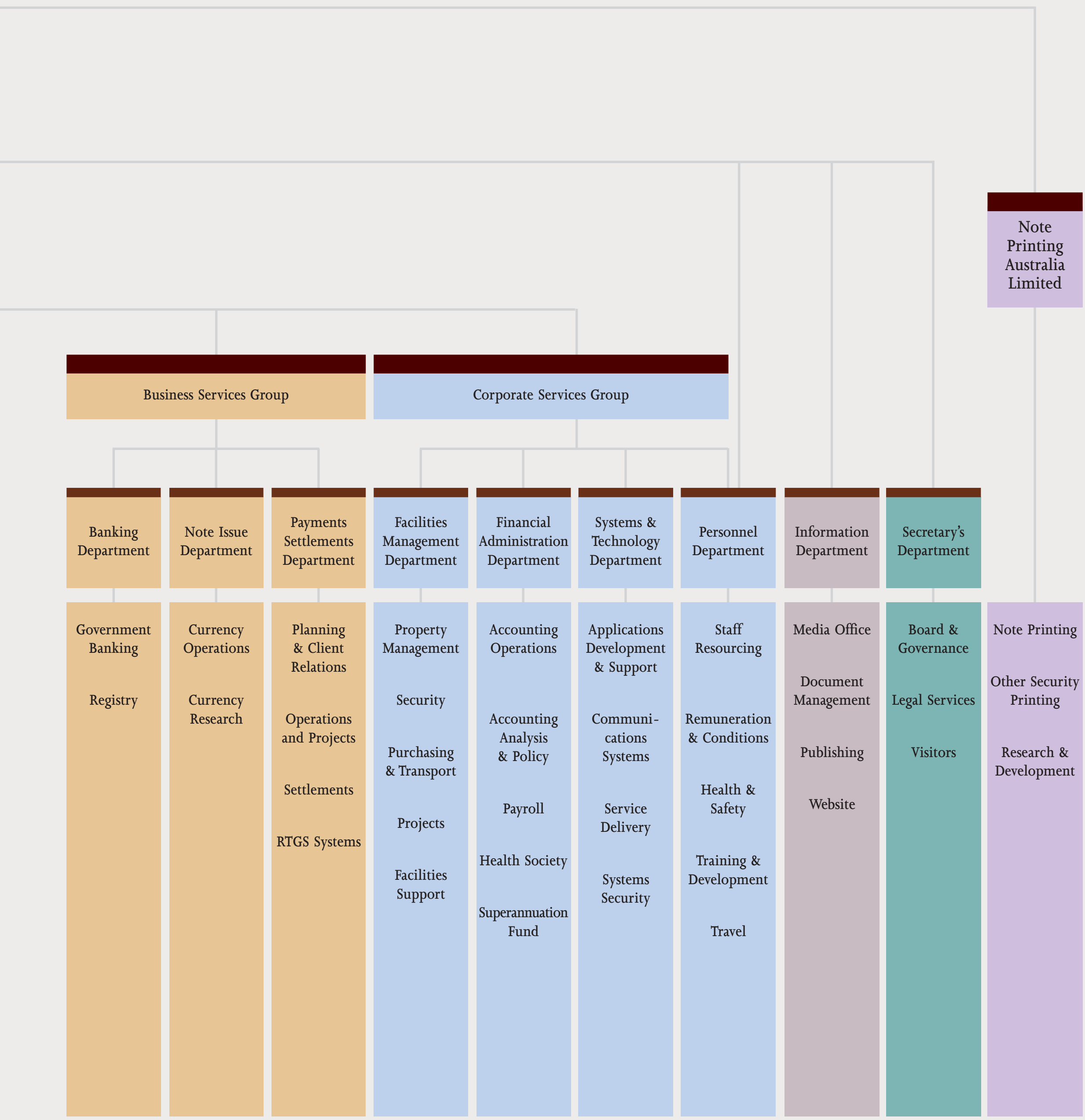
Members of the Board, at a meeting on 6 November 2001, paid tribute to Dr Grenville for his outstanding contribution to the Board's deliberations over five years as Deputy Governor and, before that, for four years as Assistant Governor (Economic). He brought to the Board's discussions economic policy expertise of the highest level.

The Board also acknowledged Dr Grenville's outstanding contribution to developing the RBA's involvements and reputation internationally. It had been a major focus of his period as Deputy Governor and built on a longstanding and influential participation in international matters, particularly in Asia, both during his career in the RBA and in a range of international economic organisations.

ORGANISATIONAL CHART

JULY 2002




Note Printing Australia Limited
Business Services Group
Corporate Services Group
Banking Department
Note Issue Department
Payments Settlements Department
Facilities Management Department
Financial Administration Department
Systems & Technology Department
Personnel Department
Information Department
Secretary's Department
Government Banking
Registry
Currency Operations
Currency Research
Planning & Client Relations
Operations and Projects
Settlements
RTGS Systems
Property Management
Security
Purchasing & Transport
Projects
Facilities Support
Accounting Operations
Accounting Analysis & Policy
Payroll
Health Society
Superannuation Fund
Applications Development & Support
Communi-cations Systems
Service Delivery
Systems Security
Staff Resourcing
Remuneration & Conditions
Health & Safety
Training & Development
Travel
Media Office
Document Management
Publishing
Website
Board & Governance
Legal Services
Visitors
Note Printing
Other Security Printing
Research & Development

GLOSSARY

AOFM	Australian Office of Financial Management
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
BIS	Bank for International Settlements
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CGS	Commonwealth Government securities
CGFS	Committee on the Global Financial System
CHESS	Clearing House Electronic Subregister System of the Australian Stock Exchange
CLS	Continuous linked settlement
DoFA	Department of Finance and Administration
EEO	Equal employment opportunity
EMEAP	Executives' Meeting of East Asia-Pacific central banks
FMA Act	*Financial Management and Accountability Act 1997*
FSF	Financial Stability Forum
G7	Group of Seven
G10	Group of Ten
G20	Group of Twenty
GDP	Gross Domestic Product
GOS	Gross Operating Surplus
HLIs	Highly leveraged institutions
IMF	International Monetary Fund
NNPC	National Note Processing Centre
NPA	Note Printing Australia Limited
OECD	Organisation for Economic Co-operation and Development
OFCs	Offshore financial centres
OH&S	Occupational health & safety
RBA	Reserve Bank of Australia
RITS	Reserve Bank Information and Transfer System
RTGS	Real-time gross settlement
SDRs	Special drawing rights
Y2K	Year 2000

HEAD OFFICE MANAGEMENT

END JULY 2002

Governor: Ian Macfarlane
Deputy Governor: Glenn Stevens

ECONOMIC GROUP

Assistant Governor: Malcolm Edey

Economic Analysis Department
Head: Guy Debelle
Deputy Heads: Chris Aylmer, Jonathan Coppel

Economic Research Department
Head: David Gruen

FINANCIAL MARKETS GROUP

Assistant Governor: Ric Battellino

Domestic Markets Department
Head: Philip Lowe
Chief Manager: Chris Ryan

International Department
Head: Bob Rankin
Chief Managers: Tony Richards, Mike Sinclair

FINANCIAL SYSTEM GROUP

Assistant Governor: John Laker

Payments Policy Department
Head: John Veale
Chief Manager: Michele Bullock

System Stability Department
Head: Keith Hall

BUSINESS SERVICES GROUP

Assistant Governor: Geoff Board

Banking Department
Head: Phil Martin

Note Issue Department
Head: Les Coventry

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

PERSONNEL DEPARTMENT

Head: Graham Rawstron

SECRETARY'S DEPARTMENT

Secretary: David Emanuel

INFORMATION DEPARTMENT

Head: Paul Barry

AUDIT DEPARTMENT

Head: Paul Apps

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