GOVERNOR'S FOREWORD

The financial year just completed was a disappointing one for the world economy. It started promisingly, but the good growth that had occurred in the first half of 2002 faded. Although the world economy did not relapse into recession, its growth was sluggish throughout most of the year and underlying inflation continued to edge down from its already low starting point. In the first half of 2003, the world economy received further disruption from the short-lived Iraq War and the fear that the outbreak of Severe Acute Respiratory Syndrome would turn into a major epidemic.

Throughout the year, the Australian economy performed well, although there was a clear difference in tone between the beginning and the end of the year. With the outlook for the world economy still seeming strong in the early part of the financial year, and with Australian inflation heading up, it looked for a time that further monetary policy tightening might be needed (it having been tightened in May and June 2002). But as the year progressed, bad news on the world economy and a more benign outlook for Australian inflation changed the picture. Indeed, by the end of the year, with further falls in world interest rates and talk of possible deflation abroad, both of which were leading to a strongly rising Australian dollar, the choice the Reserve Bank Board faced was whether to leave interest rates where they were or lower them. In the event, the former alternative was chosen, which meant that there were no changes in official interest rates in 2002/03. More details on the rationale behind the conduct of monetary policy can be found in the quarterly *Statements on Monetary Policy*, the testimonies to the House of Representatives Standing Committee on Economics, Finance and Public Administration, and in various speeches made during the year.

Although there were no changes in monetary policy, the RBA's operations in financial markets were at least as active as in other years. On the domestic side, in addition to the normal daily liquidity management transactions, we had to adjust to the introduction of the continuous linked settlement system for settling foreign exchange transactions between banks. This involved not only the provision of a new intra-day liquidity facility, but also the extension of the settlement session time to as late as 9.00 pm during Australian eastern daylight saving time. On the foreign side, a major activity during the year was the steady replenishment of the international reserves that had been used in earlier years to limit the fall in the Australian dollar. The fact that the Australian dollar appreciated by 20 per cent against the US dollar over the course of the year made this exercise relatively easy.

International economic relations with the major groupings such as the Bank for International Settlements, the Financial Stability Forum and the Group of 20 again involved active participation by senior management. At the regional level, our major involvement is through EMEAP (the Executives' Meeting of East Asian and Pacific central banks). A significant concrete achievement of this body during the year was the establishment of the Asian Bond Fund, through which central banks in the region can invest some of their international reserves in US-dollar denominated debt issued by Asian governments. Although the initial offering of

US$1 billion is quite small (as is Australia's share of US$50 million), it is a promising start which will lead on to bigger volumes and in time, it is hoped, to the inclusion of debt issued in local currencies.

The Australian financial system experienced a relatively uneventful year despite quite divergent movements in asset prices, with share prices falling moderately and residential property prices continuing to rise strongly. Credit growth was again rapid, with the vast majority of loans being directed to the already overheated residential property market.

In response to a recommendation of the HIH Royal Commission, the Government announced a major change to the Australian Prudential Regulation Authority (APRA), whereby its Board would be replaced by an executive group of three members. Dr John Laker, formerly Assistant Governor (Financial System), was appointed to head APRA on 1 July 2003.

Reforms to credit card schemes in Australia, designed to enhance competition and the efficiency of Australia's payment systems, were announced by the RBA in August 2002. Some changes came into effect on 1 January 2003, while others will be implemented in October 2003. The two international credit card schemes – Visa and MasterCard – have challenged the reforms in the Federal Court. After a six-week hearing, a decision is expected in the coming month. Reform to the pricing of EFTPOS and ATM networks is proceeding, with the industry playing a major role and the RBA a supporting one.

The project to bring in-house the computer system supporting Australia's real-time gross settlement system (RTGS) was completed on schedule on 21 October 2002. This had formerly been outsourced, but bringing it in-house means we have greater control, not only over its day-to-day operation, but over its future evolution.

The Head Office consolidation project, whereby four floors previously occupied by the RBA were renovated and made available for rent, was completed ahead of schedule and within budget in December 2002. So far, long-term leases have been signed for more than a third of the available space and tenanted by legal groups. The Adelaide building was sold in February 2003, and the Adelaide Regional Office opened shortly thereafter. We now have a complete suite of Regional Offices located in Adelaide, Brisbane (also serving the Northern Territory), Melbourne (also serving Tasmania) and Perth.

As mentioned in the most recent Annual Reports, the size of the RBA, as measured by staff numbers, is levelling out at around 820 people. It took nearly two decades to reduce numbers from a peak of 3 200 in 1983 and, at times, it seemed the shrinkage would continue inexorably. However, there is reason now to believe that a new equilibrium has been found, both in terms of numbers and Australia-wide structure. I am confident that this major transformation has not in any way reduced the functional interaction between the RBA and the Australian community; indeed, there are a number of ways in which it has been improved.