Governor's Foreword

The global economy experienced rather more difficult conditions in 2011/12 than in the preceding year. Although fears a year ago of a 'double dip' in the United States were not borne out, the long-running crisis in Europe worsened. Financial market sentiment swung repeatedly, from extreme risk aversion as some critical moment approached, to relief as the hurdle was cleared, soon followed by fretting about the next one. Through it all, though, the mood darkened as the sheer magnitude of the problems facing a number of European countries, and the euro area as a whole, became ever more apparent. The process of strengthening public and private finances in Europe, and building genuinely European structures for fiscal and banking policies to accompany the common monetary policy, will take some time. Hence, periodic bouts of anxiety are likely to be a recurring feature of the period ahead.

Risk aversion saw changes to financial pricing that affected Australia in important ways. The very large rise in the exchange rate that had been a feature of the preceding years – and which saw the Reserve Bank recording large valuation losses – abated. Whether that is a precursor to a significant fall, a pause before a further rise, or whether in fact the currency has reached a new, higher, mean value, cannot be known. In any event, the large valuation losses sustained on the Reserve Bank's own balance sheet in the preceding year were not repeated, and the Bank returned to profit, amounting to about $1.1 billion, as measured by the accounting standards. Underlying earnings remained low, however – in fact, they were lower in nominal terms than at any time in the past three decades, due to the very low level of yields on the Bank's assets.

This exceptionally low level of yields on highly rated debt is a major global phenomenon. The Commonwealth of Australia has been borrowing at the lowest cost it has faced since Federation. Yields on long-term securities issued by the United States – a nation not without serious fiscal challenges – are well below 2 per cent, while German government bond yields are negative out to about two years, such is the 'flight to safety' that has been occurring. Central bank policy rates of course remain extremely low in major countries.

These sorts of yields have, as noted, reduced the Reserve Bank's earnings considerably. But the implications extend far more widely: around the world, pension funds, insurance companies, small savers and official investors with very large portfolios have sought to avoid private credit risk, sovereign credit risk of 'peripheral' European countries and, increasingly, re-denomination risk in Europe. The purchases of government debt by major central banks, as part of their 'unconventional' response to very weak economic conditions, have also played a role. In the process, however, investors in these securities are having to accept very low earnings. Many retirees around the world may find their income streams disappointing over the years ahead.

On the Reserve Bank's own balance sheet, the effects of the large valuation losses incurred in earlier years will be in evidence for some time yet. Although the Bank's net worth remains strongly positive, it is the Board's view that the capital buffers run down to absorb the losses of the preceding two years need to be replenished. To that end, the Deputy Prime Minister and Treasurer determined that a substantial proportion of the earnings in 2011/12 should be transferred to the Reserve Bank Reserve Fund. The process of rebuilding capital will need to continue for several more years.

Monetary policy in Australia has responded to the changing dynamics of the international and domestic economy. Although in early 2011 it was widely expected that monetary policy would probably need to be tightened, as the expansionary effects of the resource investment boom worked through the economy, the cash rate was in fact lowered four times during the past year as the global economy softened, the non-mining sector grew more slowly than anticipated and evidence emerged that inflation was easing. The cash rate ended the financial year at 3.5 per cent, which by historical standards is unusually low, and which helped to produce lending rates in the economy a little below their medium-term averages. These changes were made according to the medium-term, flexible inflation target that has guided monetary policy for nearly 20 years now. As of this writing, the available data show an economy recording growth close to trend, unemployment at just over 5 per cent (little changed from a year earlier) and inflation at about 2 per cent in underlying terms.

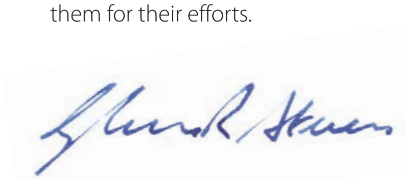
The work of maintaining and upgrading key aspects of the Reserve Bank's capability to deliver financial services to the private sector and government continued. Over the next several years the need to replace or upgrade key elements of critical financial infrastructure in the banking and settlements areas is likely to see substantial investment, and an associated increase in staffing. On the other hand, some other services that had long been provided by the Reserve Bank, such as registry services for government securities, will migrate to private providers, on efficiency grounds.

International engagement continues to grow in importance, with the Reserve Bank active in numerous international bodies and committees. Two highlights were the establishment of representation in China for the first time and the conclusion of a foreign currency swap agreement with the People's Bank of China, aimed at facilitating the growing flows of goods, services and capital between the two countries.

Graeme Kraehe completed his term on the Board during the past year, having made a very strong contribution to its work over five years. Heather Ridout joined the Board, bringing many years of experience to the role.

Ric Battellino retired as Deputy Governor in February, after 39 years in the Reserve Bank. He made an enduring contribution to the institution, with great integrity, and I thank him for his counsel and support particularly over the past five years. In his successor, Philip Lowe, the Deputy Prime Minister and Treasurer has made an outstanding choice.

The management and staff of the Reserve Bank have once again gone about their work with calm professionalism and high standards in the face of not inconsiderable challenges. The Board joins me in thanking them for their efforts.



Glenn Stevens
Chairman, Reserve Bank Board
5 September 2012