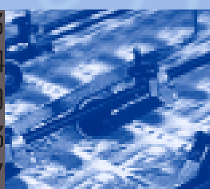
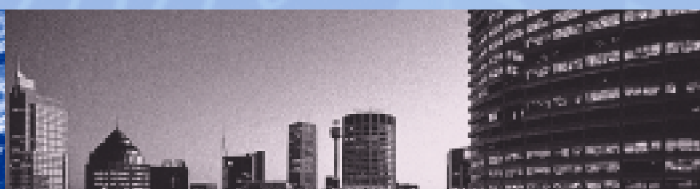
RESERVE BANK OF AUSTRALIA ANNUAL REPORT





2001

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2001

GOVERNOR'S FOREWORD

The Australian economy entered the past financial year growing strongly, as it had done for most of the 1990s. But the year was to prove eventful both for the world economy and our own. The long-expected slowdown in the United States finally became apparent at the beginning of 2001, and signs of weakness emerged in other major countries at about the same time. Australia's economic developments showed a number of similarities with the rest of the world, but with one important difference – the transition effects of the introduction of the GST caused an exceptionally sharp temporary contraction in house-building in the second half of 2000. This, in turn, resulted in a small fall in GDP in the same period, before moderate growth resumed in the first half of 2001.

Notwithstanding this "once-off" timing effect, Australian monetary policy moved broadly in line with monetary policy in most other major countries. The monetary policy tightening in August 2000 was the last in a series of five that began in November 1999. By early February, with the world cycle having turned, inflation remaining low and domestic conditions weaker, the first of three easings occurred which brought the cash rate down from 6.25 per cent to 5.0 per cent.

The development of monetary policy and the economy over the year have been thoroughly explained in the regular *Statements on Monetary Policy*, testimony before the House of Representatives Standing Committee on Economics, Finance and Public Administration, media releases accompanying the changes in monetary policy, and in speeches by senior officers of the RBA. For this reason, the *Annual Report* has for some years now concentrated on giving an account of the other activities of the RBA during the year, as well as presenting the financial statements. The following points summarise the main activities for the year – more detail is to be found in the body of the *Annual Report*.

- Financial market operations, in both domestic and foreign markets, are carried out by the Financial Markets Group. As well as implementing monetary policy through domestic market operations and, from time to time, conducting foreign exchange intervention, the Group has a substantial ongoing role transacting in financial markets to manage the RBA's portfolio and act as agent for the Government. These transactions involve buying and selling Commonwealth Government securities and other highly rated Australian dollar securities outright and under repurchase agreement, buying and selling foreign exchange outright and under swap arrangements, buying and selling foreign government securities, and lending gold. In total, these transactions average about $19 billion per day. Their size and complexity inevitably mean that the RBA cannot avoid exposing itself to an element of financial risk. We have taken the opportunity to devote a major section of the first chapter of this *Report* to outlining the risk management procedures adopted to monitor and control the RBA's exposure.
- The Financial System Group has responsibility for payments system policy (under the purview of the Payments System Board) and for general oversight of financial system stability. In the first area, the major

development during 2000/01 was the designation of the three credit card schemes operating in Australia so that the Payments System Board could determine whether the regulations applied by the schemes – which govern the setting of wholesale (interchange) fees, scheme membership and the rights of merchants to recover costs – are in the public interest. This is a major project involving extensive consultation with interested parties, a public discussion paper and a final report probably by the end of 2001. A fuller account of this project can be found in the forthcoming *Payments System Board Annual Report*. In the second area, a description of the recent developments that have influenced the stability of the Australian financial system is given in this *Annual Report*. It concludes that, overall, the system has shown itself to be prudentially sound by our past standards or standards prevailing overseas, with the one exception being in the area of general insurance (including reinsurance).

- The new National Note Processing Centre located in the premises of Note Printing Australia Limited (NPA) at Craigieburn outside Melbourne opened in June. This replaces the separate note-processing facilities located in each branch, including Sydney, that have operated until recently. At the same time, commercial banks will progressively assume ownership of working stocks of currency currently owned by the RBA, but held externally in Note and Coin Pools operated by armoured car companies. Two results of this change are that the RBA will no longer own notes that are held outside its own premises, and the commercial banks will establish a market for currency that will operate directly between them, and not pass through the RBA as an intermediary.
- The new Regional Offices in Melbourne, Brisbane and Perth are now up and running. They have established good links with businesses, State governments and industry groups in their respective States, and are also fully participating in the work of Economic Group in Sydney, as is an economist added to the RBA's branch in Adelaide.
- The Federation $5 note began circulating on 1 January and was well received by the public. Total note production by NPA was lower in 2000/01 than the previous year when additional stocks of notes were produced to cater for possible increased demand associated with the new millennium. The only new export orders for NPA were from Mexico, Kuwait and the Solomon Islands, but Securency was able to secure export orders for substrate for new notes printed in Mexico, Vietnam, Romania and Austria.

The large reductions in our staff numbers that have occurred virtually every year for nearly 20 years seem to be in the process of levelling out. While further reductions will no doubt occur in some areas in future years, there is also the prospect that increases will occur in other areas, or new functions be taken on. Examples of the latter are the Regional Offices, the new section in Economic Group devoted to regional and industry analysis, and the National Note Processing Centre. The RBA may now be close to the size that is commensurate with discharging its responsibilities using "first best" technology and management practices.

OPERATIONS IN FINANCIAL MARKETS

MONETARY POLICY OPERATIONS

Since the mid 1980s, the RBA has been implementing monetary policy through domestic market operations, rather than using direct controls on banks as was previously the case. The basic nature of these operations has not changed over the intervening period: in essence they involve either sales of securities to reduce the amount of funds in the money market (and so cause interest rates to rise) or purchases of securities to produce the opposite effect. The funds on which market operations focus are a very specialised form of money, known as Exchange Settlement funds. These are the funds that banks hold in their Exchange Settlement accounts at the RBA, and which they use to settle transactions among themselves. Banks' demand for these funds is quite predictable, as it is based on their patterns of payment flows, and so any action by the RBA to change the supply leads to quick and predictable effects on the interest rate at which these funds are borrowed and lent – the so-called cash rate. Changes in this interest rate then feed through to the more general structure of interest rates in the financial system.

During 2000/01, the Reserve Bank Board changed the target cash rate – the way in which monetary policy changes are expressed – on four occasions. In August 2000, the target was raised by 0.25 of a percentage point, to 6.25 per cent, the last in the series of monetary tightenings that had begun the previous November. Then, between February and April 2001, the target was reduced on three occasions, in two cases by 0.5 of a percentage point, and once by 0.25 of a percentage point. This took the cash rate back to 5 per cent, only a little above the lows reached in the early and late 1990s. The background to these changes in policy has been detailed in the various issues of the *Statement on Monetary Policy* that were published during the year.

Movements in the Target Cash Rate

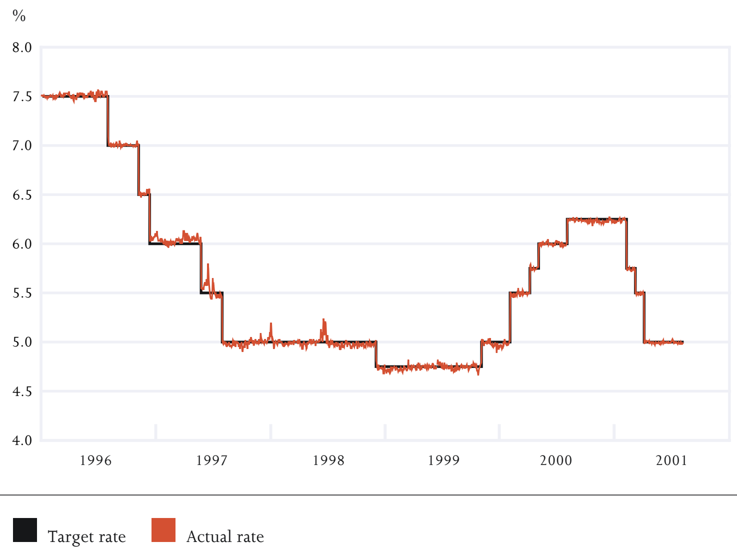
	Change (percentage points)	New Level (per cent)
2 Aug 2000	+0.25	6.25
7 Feb 2001	-0.50	5.75
7 Mar 2001	-0.25	5.50
4 Apr 2001	-0.50	5.00

Even though monetary policy is changed only infrequently, daily market operations are needed to maintain the cash rate around the target during intervening periods. In 2000/01, the difference between the RBA's target cash rate and actual rates in the interbank market averaged less than two basis points, around the same as or even slightly lower than in the past few years.

As can be seen from these outcomes, market operations provide a very effective way of implementing policy. There have, nonetheless, needed to be changes to operating procedures in recent years to take account of market and institutional developments. A major change occurred in 1998 to accommodate the introduction of new payments system arrangements, known as real-time gross settlement (RTGS). These changes were discussed in detail in the 1997/98 *Annual Report*.

More recently, the challenges for market operations have been in adapting to the declining supply of Commonwealth Government securities (CGS) on issue, as the Government used budget surpluses and proceeds of privatisations to repay

CASH RATE



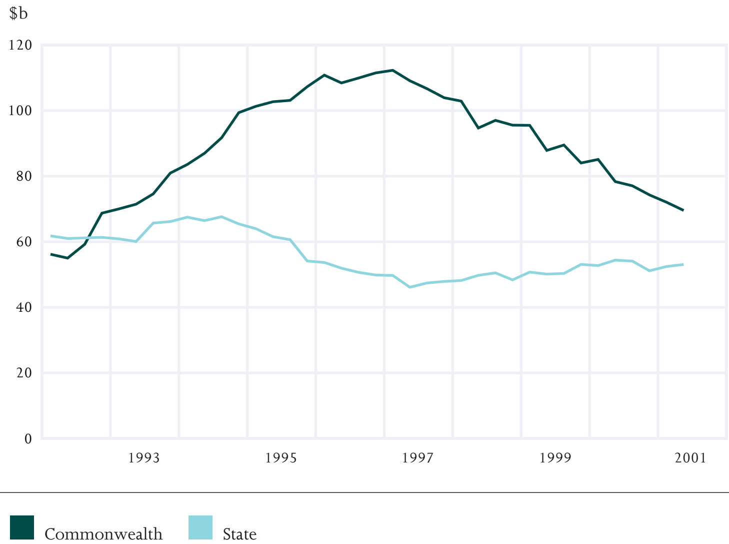
debt. Traditionally, market operations had been limited to transactions in CGS, either outright purchases and sales or repurchase agreements[1] (repos as they are often called). While technically, domestic market operations could be carried out in any asset, the RBA had traditionally confined domestic operations to CGS because they carry no credit risk and the market for them was deep and liquid, facilitating the large transactions often involved in domestic market operations. However, with the supply of CGS in the market declining by more than a third since 1996, it has become necessary to broaden market operations to encompass new instruments.

One such change was to use foreign exchange swaps more actively for domestic liquidity management. Foreign exchange swaps work similarly to repos, with the difference being that Australian dollars are exchanged for foreign currency rather than domestic securities. As with repos, the counterparties can agree the term of the swap to suit their particular needs. Use of these instruments began in a small way in the late 1980s, but has become much heavier in recent years. Turnover in foreign exchange swaps associated with liquidity management grew to $90 billion last year, or about one-quarter as large as repo operations, which themselves increased sharply last year to $393 billion. This rise in repo turnover reflected more pronounced volatility in liquidity flows through the year (see below) and the fall in the average maturity of repos compared with the previous year when the term of many repos had been deliberately extended to span the century-date change.

The usefulness of foreign exchange swaps for

1 Repurchase agreements involve the sale of a security with an agreement to repurchase it on an agreed future date and at an agreed price. This avoids exposing the buyer to the possibility of changes in the price of the security during the term of the repo, and in effect serves the same purpose as a loan of funds collateralised by securities.

SUPPLY OF GOVERNMENT SECURITIES
End quarter



domestic market operations reflects the fact that the foreign exchange market is very deep and liquid. It should also be noted that, while the use of foreign exchange swaps increases the RBA's holdings of foreign exchange, it has no effect on net foreign reserves, as the increased holdings of foreign exchange are matched with a commitment to sell foreign exchange at a pre-determined price and date. For the same reason, use of swaps has no effect on the exchange rate.

The extent to which swaps are helping to ease shortages of securities is illustrated by the fact that, if the RBA eliminated its swap position and replaced these transactions with repos, it would now be holding about 40 per cent of the combined total of securities issued by the Commonwealth and State governments. Clearly, this would not be a viable situation as the market would have great difficulty functioning in such circumstances.

The RBA has also sought to address the problems caused by the declining supply of CGS by widening eligible repo collateral. The first move was in 1997 when securities issued domestically by State borrowing authorities were accepted. This boosted eligible collateral by around $50 billion to around $150 billion, but did not provide a permanent solution as the stock of government securities has continued to fall.

Market Operations for Liquidity Management Purposes

($ billion)

	1996/97	1997/98	1998/99	1999/2000	2000/01
Repurchase agreements[a]					
– Purchases	201	275	300	244	376
– Sales	9	8	13	14	17
Short-term CGS					
– Purchases	23	26	21	9	5
– Sales	1	0	0	0	0
Total domestic operations	234	309	334	267	398
Foreign exchange swaps[a]	35	33	52	67	90

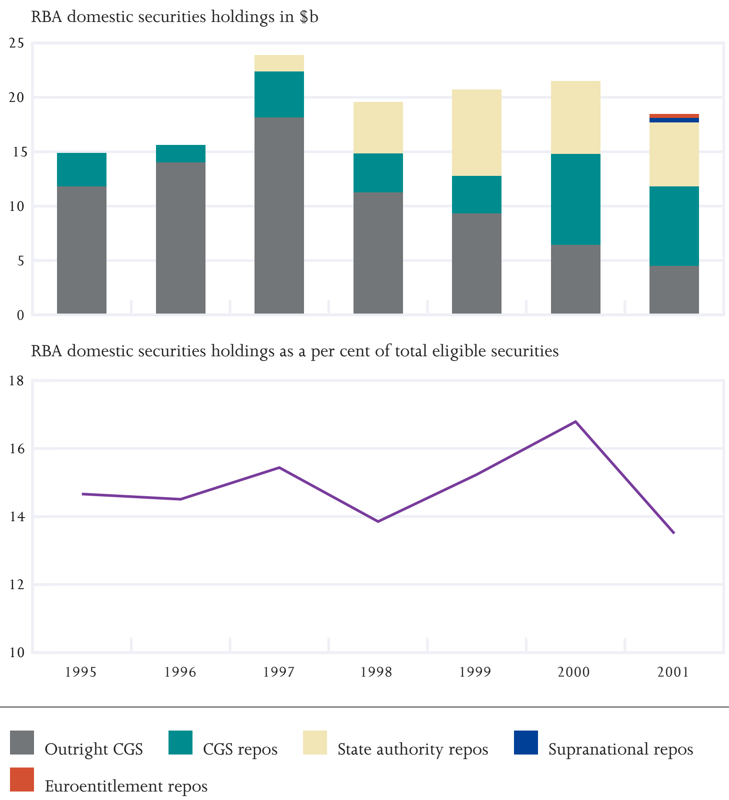
(a) First leg of transaction

In October 2000, eligible repo collateral was further widened to include Australian dollar securities issued by supranational organisations of which Australia is a member, and lodged in Austraclear. The actual outstandings of such securities at the time were quite small, around $3 billion in total, though it is expected that these markets will develop over time. Also in October, the RBA announced that it would lengthen the term to maturity of CGS that it was prepared to buy outright in its market operations from around 12 months to around 18 months.

In June 2001, the RBA announced that it would be prepared to accept Australian dollar securities from a broader range of major supranational organisations. Decisions will be made on a case-by-case basis but subject to a minimum requirement that the organisation has a Aaa-rating. At the same time it was announced that, in addition to State-authority securities issued in Australia, Australian dollar securities issued in euro markets by State authorities, and lodged domestically in Austraclear in a form known as Euroentitlements, would also be accepted. At the time of the announcement, such securities were not held to any significant extent by the RBA's regular counterparties to domestic market operations. Nonetheless, they began being presented to the RBA as collateral shortly after the announcement was made.

These measures, coupled with the increased use of foreign exchange swaps for domestic liquidity-management purposes, helped to ease pressure on the collateral pool during the year. By the end of the financial year, the RBA's holding (outright or on repo) of securities representing eligible collateral for market operations was, as a share of total outstandings, well down from its share a year earlier, at around 14 per cent of the total.

RBA DOMESTIC PORTFOLIO
As at 30 June



Another challenge for market operations over the past year was to respond to the changing pattern of liquidity flows to and from the Commonwealth Government as a result of the introduction of the New Tax System on 1 July 2000.

Under the new system, most companies, superannuation funds and investment income-earning individuals lodge a tax return, known as the Business Activity Statement, and make payments each quarter. These payments encompass liabilities under the Goods and Services Tax and the Pay-As-You-Go tax system, which replaced 11 previous tax collections.

The concentration of tax payments into a few days each quarter, combined with government outlays being relatively even through the quarter, had the potential to result in large swings in government cash balances during each quarter, falling for most of the quarter as payments exceeded tax collections, and then rising sharply as taxes flowed in. This would be reflected in associated swings in market liquidity.

To avoid this, the Australian Office of Financial Management and the RBA jointly announced in June 2000 a modification to the issuance of Treasury notes. Treasury notes are short-term securities traditionally issued by the

Commonwealth to help bridge within-year mismatches in the timing of its receipts and outlays. Rather than being issued for set terms, such as 13 or 26 weeks, as used to be the case, Treasury notes are now issued with standardised maturity dates coinciding with peak tax collection dates. The amount of Treasury notes maturing on those dates is built up in the lead up to the tax collections (helping to bridge the Government's shortfall in cash during that period) and their maturity results in a flow of funds from the Government which helps offset tax receipts.

In the event, these new arrangements have offset less than half the impact of Government transactions around peak tax dates. The rest of the Government's cash fluctuation is being absorbed by its fixed deposits at the RBA. But, while this avoids large swings in Commonwealth current cash balances, it leaves liquidity imbalances in the money market which the RBA needs to smooth through more intensive use of market operations.

Adding to the challenge of smoothing the liquidity implications of the new tax system was the uncertainty relating to the exact timing of tax payments. There was considerable uncertainty as to how much advantage would be taken of deferral provisions introduced by the Government and the extent to which payments would be made through the RTGS system, and so impact on the market immediately, or by cheque, and thereby not impact until the following day.

The RBA was concerned that there would not be enough securities in the market to allow it to rely on repos alone to offset these drains of liquidity that would take place at peak tax collection times. Evidence of this was that transactions involving government securities were commanding a significant premium in the lead up to tax collections. As a result, the RBA supplemented its repo operations at these times with large foreign exchange swaps. The increased use of swaps at these times accounted for much of the rise in swap activity during the year.

Looking ahead, a development which will have implications for liquidity management and the demand for collateral is the likely commencement of "continuous linked settlement" (CLS) for foreign exchange transactions in the coming year. When implemented, CLS will virtually eliminate settlement risk in foreign exchange transactions (see the chapter on "Business Services"). However, it may make liquidity management in domestic markets more difficult as the extension in trading hours required (to 8.00 pm in winter and 10.00 pm in summer) will make it harder for the market to accommodate the Australian dollar payments and receipts involved. Also, while the Australian dollar is relatively heavily traded around the world, the bulk of this trading is ultimately settled on the books of only a very small number of Australian banks. This concentration of business, combined with the somewhat tight schedule of payments to CLS Bank each night, could occasionally result in one or more of those Australian banks having to make large Australian dollar pay-ins to CLS Bank, thereby placing significant demands on domestic liquidity.

Predicting the magnitudes of such drains on liquidity is very difficult but they may, on occasion, be large. Hence, the RBA is discussing with banks the liquidity requirements that could be generated by the commencement of CLS, and seeking to ensure that adequate liquidity is available.

APPEARANCE BEFORE THE HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION IN THE LEGISLATIVE COUNCIL CHAMBER OF THE VICTORIAN STATE PARLIAMENT, MELBOURNE, MAY 2001.

CUSTOMER-BASED OPERATIONS

As in the past four years, the main operation in domestic markets on behalf of the Commonwealth was to assist with debt retirement. The Commonwealth's ability to retire debt early in 2000/01 reflected the fact that it was again in surplus for the year. The RBA sold $2 billion of short-dated CGS and $1 billion of long-dated CGS to the Commonwealth during the year. Most of these securities were acquired by the RBA during 2000/01, with the short-dated CGS largely acquired during the course of normal daily market operations.

STOCK LENDING

The RBA stands ready to lend to the market from its outright holdings of CGS. The purpose of this activity, known as stock lending, is to alleviate temporary market shortages of specific lines of stock. Typically, these shortages arise because dealers short-sell stock to clients as part of their market-making operations, and so need to borrow stock to deliver to the client. The RBA's stock lending activity for the year just ended was sharply down on that for previous years. As noted in previous *Annual Reports,* the RBA changed the pricing of its stock lending so as to be the least attractive lender in the market and avoid the risk that it was displacing activity between market participants. The results of the past year are to a degree a reflection of this pricing policy.

Stock 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
1999/2000	510	8.9	0.6
2000/01	75	1.2	0.1

FOREIGN EXCHANGE OPERATIONS

The most significant transactions the RBA undertakes in the foreign exchange market are those designed to influence the exchange rate, typically referred to as intervention. These involve outright purchases or sales of US dollars against Australian dollars or, occasionally, derivative transactions such as options. These operations are the focus of the discussion below, along with foreign exchange transactions with clients, the main one being the Commonwealth Government.

Foreign exchange swap operations, which are undertaken mainly for domestic liquidity management, have already been discussed under the section on "Monetary Policy Operations", while management of foreign exchange reserves is described in the following section.

The floating exchange rate regime which Australia adopted in 1983 means that the exchange rate fluctuates in response to changes in the demand for and supply of the currency in the market, allowing it to adjust to changes in underlying economic and financial conditions. Under these arrangements, the RBA engages in foreign exchange operations only when it wants to influence the exchange rate.

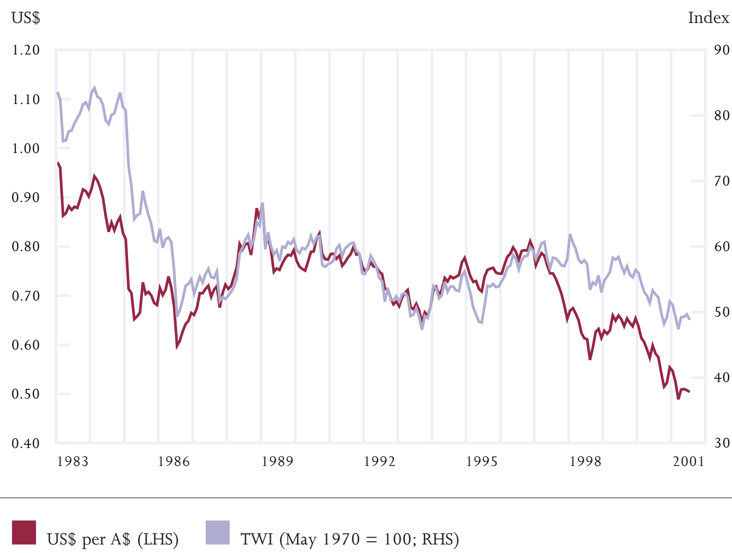
It is a feature of all markets that they can be subject to periods when prices seem to move too far in one direction or another. Foreign exchange markets around the world are particularly prone to such "overshooting". This may be because exchange rates are subject to many and varied influences, and no clear model of exchange rate determination exists. In such circumstances, the market can easily become subject to trend-following behaviour, herding, or various fads. Virtually all central banks therefore maintain a capacity to intervene in the market from time to time. They do this because large and prolonged deviations of the exchange rate from "fair value" can have adverse effects both at the macro level – by affecting confidence and inflationary expectations – and at the micro level – by affecting resource allocation and investment decisions.

The main differences between countries are the extent and frequency of their interventions. Australia's intervention operations are fairly typical of those of developed countries with floating exchange rates. Over the past decade for example, the RBA has intervened on average on about five per cent of all trading days, or a little more than 10 days in every year. In other words, circumstances when intervention occurs tend to arise relatively infrequently.

With the Australian dollar very low by historical standards, the RBA has been inclined to intervene more frequently than average over the past 18 months.

The latest fall in the Australian dollar, which began in January 2000 and lasted through to March 2001, was the fourth time since the floating of the exchange rate that it has moved down by a significant amount. But two aspects of the latest fall made it different from earlier episodes. First, it followed relatively quickly after the previous fall in 1998 – i.e. unlike earlier falls which did not start until the previous one had been largely reversed, this fall and its previous one were punctuated by only a modest rise in 1999.

AUSTRALIAN DOLLAR
Monthly



Second, this was the first time that the exchange rate has fallen without being preceded by a significant negative external shock, such as a large fall in commodity prices or a significant economic contraction among our major regional trading partners. With Australia's international trading environment remaining robust, at least until late in the period, the fall therefore was quite exceptional.

Although the exchange rate started to depreciate in January 2000, it was not until September of that year that the RBA intervened in the market, after the exchange rate had already fallen by over 15 per cent against the US dollar and a little less on a trade-weighted basis. The RBA's practice has always been to allow scope for the exchange rate to adjust, and to intervene only when there is clear evidence of overshooting. Intervention operations continued over the next couple of months. These were on a limited basis, designed to moderate the fall in the exchange rate rather than prevent further movement, recognising that the weakness of the Australian dollar against the US dollar was not unique to it. In fact most floating rate currencies (with the exception of the yen) were falling against the US dollar at this time, indicating that part of the problem was US dollar strength rather than Australian dollar weakness.

The fall in the Australian dollar was eventually partially reversed towards the end of 2000 when there was some reassessment by the market of the exceptional strength of the US dollar. But this rebound proved to be temporary as the US dollar resumed its upward trend during the March quarter this year, despite the substantial easing of monetary policy by the US Federal Reserve over this period. The Australian dollar weakened unilaterally for a time after the publication of the unexpectedly weak figure for December quarter GDP in March. This figure had a major impact on confidence, and led to heavy selling of the currency, sending it to a new low of US47.75 cents by early April. As with the earlier fall, the RBA again intervened in the market to provide a moderating influence. In the event, the level reached in early April proved to be the low point for the currency, as the combination of intervention and a reassessment of the domestic economic situation saw the Australian dollar recover. No further foreign exchange market intervention was undertaken over the rest of the financial year.

Overall, intervention in 2000/01 amounted to around $2.5 billion. This is not large in historic terms, being about the same size as the RBA's intervention in the single episode of June 1998, during the Asian financial crisis. On two occasions during the year, the RBA purchased call options on the Australian dollar to supplement purchases in the spot market.

Foreign exchange sales to the Commonwealth Government for the year were about $4.5 billion, a fairly typical amount. These were offset, however, by interest received on foreign reserves and other transactions. As such, the only impact on net reserves – i.e. reserves the RBA holds outright – came from the intervention noted above. In fact, net reserves fell by only $1.5 billion over the year, to about $9 billion, as valuation changes partially offset the effect of intervention operations.

Gross reserves, which include foreign exchange acquired under swap agreements, rose strongly during the year with the increased use of swaps to help manage domestic liquidity (as discussed in the section on "Monetary Policy Operations"). At the end of the year, total holdings of official reserve assets were $38 billion, up from $28 billion a year earlier. Swaps outstanding rose by $11 billion to $29 billion, the difference between this and the gross reserves figure representing the net reserves position.

During the year there was some discussion among market participants about the adequacy of reserves. Some of this flowed from an incorrect extrapolation of past trends, and did not take adequate account of the extent to which reserves were being supplemented by the unusually high rate of foreign currency interest earnings flowing from the foreign exchange swap position, as well as other transactions. The RBA is comfortable with its current holdings of reserves. Net reserves are about as low as they fell to in the early 1990s and provide adequate scope for intervention.

MANAGEMENT OF FOREIGN CURRENCY ASSETS

In managing its portfolio of financial assets, the RBA draws a sharp distinction between domestic and foreign assets. In the case of the former, the RBA accepts that its special position in the financial system, as well as the large size of its portfolio, rule out active portfolio management as it would be too disruptive to the market. In the case of foreign investments, however, where the RBA is operating in very large foreign markets in which it has no special status, these constraints do not apply, and there is scope to structure holdings of foreign assets to fit in with risk and return objectives.

Financial modelling based on historical patterns of volatility and return in these markets led the RBA to decide some years ago that, for the level of risk it is willing to assume, returns over time would most likely be maximised by holding 40 per cent of the funds in US assets, with 30 per cent each in German and Japanese assets. Identical ratios have also been adopted in regard to the currency exposures across the US dollar, euro and Japanese yen. Duration is targeted at 30 months in each of the asset markets with the maturity on any investment limited to 10.5 years. These "benchmark" allocations are periodically reviewed to ensure that they still represent the optimal risk/return trade-off.

In the past, portfolio managers within the RBA would seek to enhance returns on the portfolio by departing from the benchmark allocations, at times significantly, to take advantage of expected changes in market conditions. This discretionary management was undertaken within limits approved by the Governor. As noted in last year's *Annual Report*, however, a review of these operations after a decade of experience indicated that, even though active management did yield returns in excess of the benchmark, the average size of these returns relative to their variability was not sufficient to justify maintaining such an approach.

During the past year, a more passive approach to management of foreign currency reserves was therefore undertaken. Deviations from benchmark were relatively small, only short-term and, as can be seen from the table below, much smaller than in previous years. The only significant variation from benchmark was in the duration of Japanese securities, as the short position carried over from the previous year was cleared gradually over the first half of the year. In the second half of the year, there were no large or continuous deviations from benchmark.

Deviations from Benchmark
(Absolute size of deviation)

	Average 1993/94-1999/2000	2000/01
Asset allocation (percentage points)		
– US	5.8	0.3
– Germany	6.9	0.3
– Japan	2.8	0.3
Currency allocation (percentage points)		
– US dollars	8.0	0.4
– Deutsche Mark/euro	5.9	0.4
– Japanese yen	2.9	0.2
Duration (months)		
– US	3.9	0
– Germany	3.0	0
– Japan	16.0	6.4

The return for the year, 11.0 per cent measured in SDRs, was the highest since the early 1990s, reflecting mainly large capital gains as yields on bonds fell sharply in the second half of the year. The return achieved for the year was a little above benchmark, mostly due to security lending activities. As the US assets held by the RBA include highly liquid, "on-the-run" US treasury bonds, the RBA is able to take advantage of the market's frequently strong demand to borrow these securities by engaging in stock lending. Interest rates paid by borrowers of stock were particularly high during the past year as debt repayments by the US Treasury have made some stock more scarce. Earnings from these lending operations totalled close to A$44 million during 2000/01, equivalent to 38 basis points on the US portfolio. The remainder of the above-benchmark return reflected short-term trading, within the narrow limits approved by the Governor, to take advantage of market anomalies.

Actual and Benchmark Returns

	Rates of Return in SDRs (per cent)		Value of Difference (A$ million)
	Actual	Benchmark	
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
1999/2000	2.8	3.8	-202
2000/01	11.0	10.8	74

The RBA also holds a portion of its foreign reserves in gold. No outright sales or purchases of gold were made during the past year, leaving gold holdings unchanged at around 80 tonnes.

These are presently valued at $1.4 billion. To enhance the return from this investment, gold holdings are loaned to the market, a program that has been in place for over a decade now. Returns from gold loans were a little lower in 2000/01 than in other recent years, reflecting low levels of gold interest rates in the second half of 2000 when demand from miners for hedging of future gold production was limited. For the main maturity for which the RBA lends (around one year) the interest rate on loans averaged 1.4 per cent during the past year, compared with 2.0 per cent the year before. In absolute terms, returns on gold loans amounted to $17 million for the year, down from $21 million the previous year.

As with the RBA's operations in the domestic money market, the range of eligible securities accepted as collateral for gold loans was widened during the past year to include Australian dollar-denominated securities issued by Aaa-rated supranationals.

RISK MANAGEMENT

Like any institution dealing in financial markets, the RBA is exposed to various financial risks, including credit exposures to counterparties with which it deals or places deposits, movements in market yields and exchange rates which may adversely affect the value of its financial assets, and various operational risks such as fraud and errors. The RBA is somewhat more constrained than commercial institutions when it comes to managing financial risks, particularly those relating to adverse movements in yields and exchange rates, as it must put its policy responsibilities ahead of commercial considerations. Nonetheless, there are some steps the RBA can take to reduce at least some of the risks.

Credit Risks

Credit risk is one exposure that the RBA can keep to a minimum as the nature of its central banking operations leads naturally to low credit exposures. For example, its operations tend to be mainly in government securities markets because these are typically the markets that are deepest and most liquid, important characteristics given the large volumes in which the RBA deals.

Domestic dealings were restricted until 1997 to CGS, which involve no credit risk for the RBA. The falling supply of CGS has since necessitated that repo operations be broadened somewhat, but the RBA has nonetheless sought to maintain the very highest credit standards. Apart from CGS, the only securities it will accept in repo operations are those issued by State borrowing authorities or supranational organisations that have a Aaa-rating.

Counterparty exposures arising from domestic dealing relationships are generally small as all securities transactions are settled on a delivery-versus-payment basis – i.e. in settlement systems that allow the simultaneous transfer of cash and securities. There is some exposure to counterparties in repo transactions in the sense that, should a counterparty fail in its obligation to repurchase the securities it has sold to the RBA, it is possible that the value the RBA could get from liquidating the securities would be less than the cash supplied to the counterparty. However, this risk is reduced by requiring that the counterparty provide 2 per cent over-cover in terms of securities, and marking all security collateral to market daily.

In the case of foreign assets, the RBA again seeks to confine its operations to securities of the highest rating. The bulk of the RBA's foreign assets (over 90 per cent) are held in the form of securities issued by the US, German and Japanese governments. Operational considerations do, however, also require the RBA to hold some deposits with foreign commercial banks, which entail some credit risk. Tight limits are maintained on these exposures. No more than 25 per cent of each country portfolio can be held in the form of commercial bank deposits and the maximum maturity of each deposit may be no more than three months. In addition, there are credit limits on individual counterparties.

The overall framework for managing counterparty exposures on foreign operations revolves around determining a maximum acceptable level of risk for each counterparty. This is based on the counterparty's financial strength, credit rating and size of its capital. Financial strength ratings represent a bank's intrinsic safety and soundness and differ from credit ratings to the extent that the latter are affected also by risks external to the firm (such as actions of governments which could impact on the firm) and by credit support arrangements which might be available (e.g. assistance that may come from owners, the industry group, or official institutions). As such, financial strength ratings seek to measure the likelihood that a bank will require external support whereas credit ratings measure the bank's ability to honour its obligations, which might be affected by a range of factors beyond financial strength.

While financial strength and credit rating are correlated, they do not always go hand in hand. For example, a bank that had a low capital ratio or a risky portfolio, but whose obligations were guaranteed by a highly rated government, could have a low rating on financial strength but a high credit rating. Therefore the RBA uses a matrix of credit ratings and financial strength ratings to determine the maximum risk that it is prepared to accept in relation to a counterparty. These risk limits are expressed as a percentage of the RBA's foreign currency portfolio. In addition, to ensure that the RBA's exposure is not large relative to the counterparty's capital, in situations where the counterparty's capital is smaller than the foreign currency portfolio of the RBA, the percentage limit applies to the size of the counterparty's capital rather than the RBA's portfolio. In essence, the limit applies to the smaller of the RBA's portfolio or the counterparty's capital.

The following table outlines the current matrix. It shows, for example, that the maximum acceptable risk for a counterparty with a credit rating of Aaa and a financial strength rating of A would be 3.75 per cent of the RBA's foreign portfolio. The percentage limit falls away as credit ratings and financial strength ratings decline, particularly once ratings fall below relatively high levels. The percentage limits in the matrix are devised so as to ensure the maximum possible diversification of risks among counterparties, consistent with the need to have sufficient limits available to allow the portfolio to be fully invested.

Maximum Acceptable Level of Risk for Counterparties
(per cent)

Financial Strength Indices	Credit Rating								
	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2
A	3.75	3.74	3.66	3.45	2.75	1.67	0.74	0.38	0.00
B+	3.74	3.73	3.65	3.44	2.75	1.67	0.74	0.38	0.00
B	3.66	3.65	3.58	3.37	2.69	1.63	0.73	0.37	0.00
C+	3.45	3.44	3.37	3.18	2.54	1.54	0.69	0.35	0.00
C	2.75	2.75	2.69	2.54	2.02	1.23	0.55	0.28	0.00
D+	1.67	1.67	1.63	1.54	1.23	0.75	0.33	0.17	0.00
D	0.75	0.75	0.73	0.69	0.55	0.33	0.15	0.08	0.00
E+	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Once a maximum acceptable level of risk has been allocated to a counterparty, the next step is to determine how this will be allocated among the various products that are traded with that counterparty. The RBA is exposed to varying degrees of credit risk on different products due to the different levels of collateralisation, contractual protection, and the volatility of the instruments themselves. For example, an uncollateralised bank deposit is inherently more risky than a cash repo with the same counterparty, because the collateral in the latter provides a significant degree of protection in the event of counterparty default.

As a result, different risk factors and minimum credit ratings are applied to the different classes of product. The accompanying table shows the risk factors and the minimum credit rating of counterparties for various financial instruments. The risk factor for bank deposits is 100 per cent for all three foreign currency portfolios. The risk factor for foreign currency transactions is lower, at 10 per cent, because, apart from the very short period between settlement of the first and second legs of the transaction, the RBA is not exposed to the counterparty for the full amount of the transaction. Rather, its exposure represents the probability that a counterparty will default before settlement date, requiring a replacement transaction at prevailing market rates, which may have moved adversely. Risk factors for repos are lower again because they are fully collateralised with securities marked to market daily. They vary from 1.6 per cent in the US to 9.9 per cent in Japan, reflecting differences in the volatility of security prices in each country and in the average terms of repos.

Risk Factors Applying to Various Financial Instruments

	Risk Factor (per cent)	Minimum Counterparty Credit Rating
Bank Deposits	100.0	Aa3
Foreign Exchange	10.0	A3
Repurchase Agreements:		
– US	1.6	Baa1
– Germany	1.9	Baa1
– Japan	9.9	Baa1
Gold	15.0	Baa1

The application of risk factors to counterparty limits is best illustrated by way of example. As noted, a 100 per cent risk factor applies to bank deposits because there is no protection against default. Therefore, a US$10 million bank deposit would use up US$10 million of the counterparty's available credit limit. On the other hand, the risk factor of 1.6 per cent applying to US repurchase agreements means that a US$10 million repo transaction would use up only US$160 000 of the counterparty's available credit limit.

In addition to the higher risk factor applying to bank deposits, an absolute minimum limit of Aa3 is placed on the credit rating of banks with which deposits are lodged, a much higher rating than that required of firms with which the RBA is prepared to have a dealing relationship in repo or foreign exchange transactions. The minimum credit rating for counterparties in repo transactions is Baa1, while that for foreign exchange counterparties is A3.

The risk limit framework is administered by a "middle office" which is separate from dealing operations. Risk factors are reviewed annually to ensure recent trends in volatility and holding periods are taken into account. Counterparty limits are reviewed monthly to allow for movements in exchange rates, the size of the RBA's foreign currency portfolio and the capital base of each counterparty. This process would also capture any recent upgrades of counterparty credit ratings. Any ratings downgrades result in an immediate cut in limits.

Reflecting the very high standards applying to credit exposures, the RBA has not experienced any losses due to counterparty default.

Interest Rate Risk

The nature of the RBA's financial assets – mainly securities with fixed coupons – means that it is exposed to what is commonly referred to as interest rate risk. This is the risk that the capital value of the securities will fall due to rises in market yields. Unlike commercial financial institutions, which can structure the composition of their liabilities to offset risks in their assets, the RBA can do little to eliminate interest rate risk through this means because of the unique nature of its liabilities. They are mainly notes on issue (which carry no interest rate), current deposits of clients (which pay a floating interest rate) or its own capital.

The RBA therefore needs to find other ways to manage this risk. Again, as with credit risk, a sharp distinction is drawn between domestic and foreign assets. In the case of the former, the RBA accepts that its special position in the financial system means that there is little it can do to actively manage this risk. The structure of its domestic assets is therefore determined purely by policy needs. However, a side effect of the shift over recent years from outright holdings of securities to repo operations (as discussed earlier) has been a reduction in interest rate risk, since the interest rate on repos is more in the nature of a floating rate, and in line with the rate paid on deposit liabilities.

On the foreign side, these constraints do not apply and financial modelling is used to determine the most efficient portfolio structure from a risk/return point of view. As noted in the previous section, this has resulted in a benchmark of 30 months for the duration of foreign assets, with a maximum term to maturity of any single security of 10.5 years.

Exchange Rate Risk

As the holder of Australia's official reserve assets, the RBA of necessity carries a large foreign exchange exposure. It also has little scope to manage this exposure, as the proportion of its assets held in foreign currency is determined by the intervention operations it undertakes to influence the Australian dollar.

On average, about half the RBA's assets have been in foreign currency, but this ratio was as high as 90 per cent in the late 1980s when the RBA was intervening in the market, buying foreign exchange and selling Australian dollars to limit the rise in the exchange rate. At present, holdings of foreign exchange are about 50 per cent of the portfolio, but a large proportion of this is held under swap agreements and is therefore committed to a forward sale at an agreed exchange rate. This means that there is no exposure to exchange rate changes on this part of the portfolio. The RBA's exchange rate risk arises only from its holdings of net reserves which, at present, account for about 15 per cent of the RBA's overall assets. Given the historically low level of the exchange rate, and therefore the probability that it will rise in the future causing losses on foreign currency holdings, a low exposure to foreign currency is appropriate at present.

For any given level of foreign currency holdings, the RBA can seek to minimise its exposure by holding a range of foreign currencies. As noted in the previous section, a relatively even distribution is held among the three major world currencies: 40 per cent in US dollars, 30 per cent in yen and 30 per cent in euros.

OPERATIONAL RISKS

The nature of the RBA's operations means that it undertakes a very large volume of transactions each day. In the past year, for example, settlement flows resulting from transactions in various instruments were as follows:[2]

- domestic securities – A$791 billion;
- foreign securities – A$3 568 billion;
- bank deposits – A$198 billion; and
- foreign exchange and gold – A$383 billion.

These figures mean that, on average on any given day, the RBA has about $19 billion of transactions to settle. It is therefore essential that its systems be efficient and robust, and ensure adequate separation of duties to prevent those staff initiating transactions from also being involved in their settlement.

These systems have several key elements:

- at the managerial level, a clearly defined decision-making hierarchy, with overall guidelines and limits determined by the Governor and authority for decisions clearly delegated below that;
- an organisational structure that maintains clear separation between the front office (dealing), middle office (risk management) and back office (settlement);
- computer systems that automate all the processing, embody the various risk controls (e.g. separation of front and back office functions) and allow dealing staff to monitor compliance with various limits in real time; and
- finally, and perhaps most importantly, ensuring that staff are fully trained and aware of their responsibilities.

2 These figures include both sides of repo transactions as well as the related cash flows.

FINANCIAL SYSTEM STABILITY

Concern with the overall stability of the financial system is a traditional and core responsibility of central banks. The environment most conducive to financial stability is one of low and stable inflation, a reliable payments system and smoothly functioning financial markets. The pursuit of financial stability is therefore integrally linked to the RBA's other policy obligations. The environment is also one in which well-capitalised and prudently managed financial institutions operate within a sound framework of prudential supervision – the responsibility of the Australian Prudential Regulation Authority (APRA) under the Wallis reforms to Australia's financial regulatory structure.

Even within a supportive environment, however, financial institutions are not immune to shocks, of domestic or external origin. The RBA's role is to identify the risks faced by the financial system and assess its ability to manage those risks and absorb any ensuing losses. The RBA does not review the condition of individual financial institutions, which is the preserve of APRA, but focuses instead on a range of "macroprudential indicators" – aggregate financial and economic data which help gauge the soundness of the financial system and potential vulnerabilities.

The selection of macroprudential indicators is conditioned by economic analysis and by the experience of previous episodes of financial instability in Australia and overseas. A recurring theme from these episodes is that rapid and prolonged expansions of credit coupled with excessive asset price inflation are important warning signs of future financial fragility. These indicators need to be weighed against other information, such as measures of the health of major groups of borrowers (the household and business sectors); aggregate prudential data on the strength of financial institutions; market-based information on credit spreads and credit ratings; and readings on the key markets in which financial institutions operate. The RBA's work on macroprudential indicators parallels that of other central banks – particularly those which no longer have responsibility for bank supervision – as well as international financial institutions.

In addition to its focus on macroprudential indicators, the RBA also considers how structural changes have influenced the stability of the Australian financial system. Such changes include the expansion of household balance sheets, the introduction of new financial instruments for managing risks (such as credit derivatives), changes in regulatory policy (including the proposed changes to the 1988 Basel Capital Accord) and shifts in competitive pressures within segments of the financial system.

After buoyant conditions over recent years, the Australian financial system faced a period of greater uncertainty in 2000/01. The international backdrop became less helpful as global growth prospects were scaled back and share prices in many countries fell sharply. Domestically, the loss of momentum in Australia's long-running economic expansion unsettled confidence for a time, credit growth slowed and a large general insurance company, HIH Insurance Limited, collapsed, necessitating a government-sponsored support package for affected policy-holders. In surveying the year, the RBA's broad assessment is that, apart from stresses in the general insurance sector (including reinsurance), the Australian financial system continued to perform strongly in the more difficult conditions and was well-placed at year-end to cope with the uncertainties in the economic outlook.

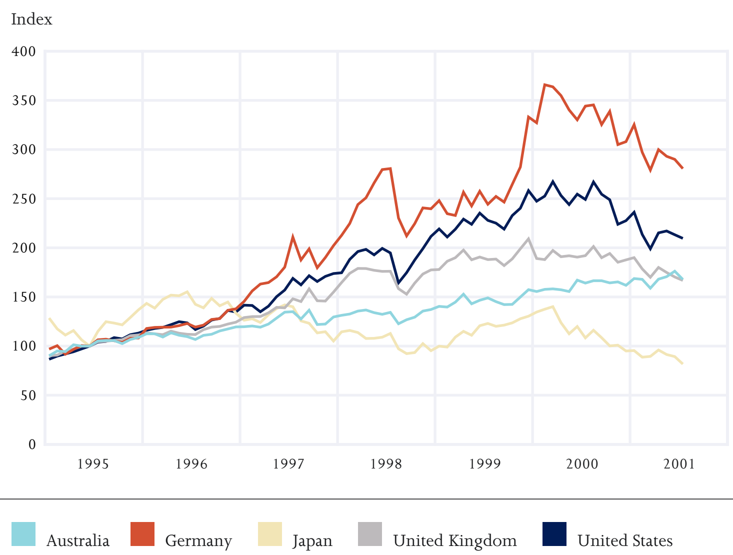
THE STABILITY OF THE AUSTRALIAN FINANCIAL SYSTEM

The International Environment

The reassessment of global growth prospects was triggered by the slowing in US growth in the December quarter of 2000 and was reinforced by the recognition that economic recovery in Japan had stalled. Inevitably, the check to global growth changed perceptions about credit quality, particularly in the United States. US bankruptcies, default rates on junk bonds and corporate loan delinquencies at banks rose and corporate credit downgrades once again exceeded upgrades. As investor sentiment deteriorated, credit spreads widened and corporate debt issuance fell away, particularly for low-rated borrowers. US banks tightened their lending standards, as did banks in many other industrial countries.

The change in sentiment was most marked in the global telecommunications sector, where pessimism about earnings and debt levels increased. Banks' exposures to this sector, mainly through large volumes of syndicated lending, became the focus of attention of supervisory agencies, particularly in Europe. Credit spreads for many international telecommunication companies widened and their share prices fell dramatically in a classic "boom and bust" pattern. With telecommunication and related technology stocks leading the way, major share markets underwent a significant correction.

INTERNATIONAL SHARE PRICE INDICES
June 1995 = 100



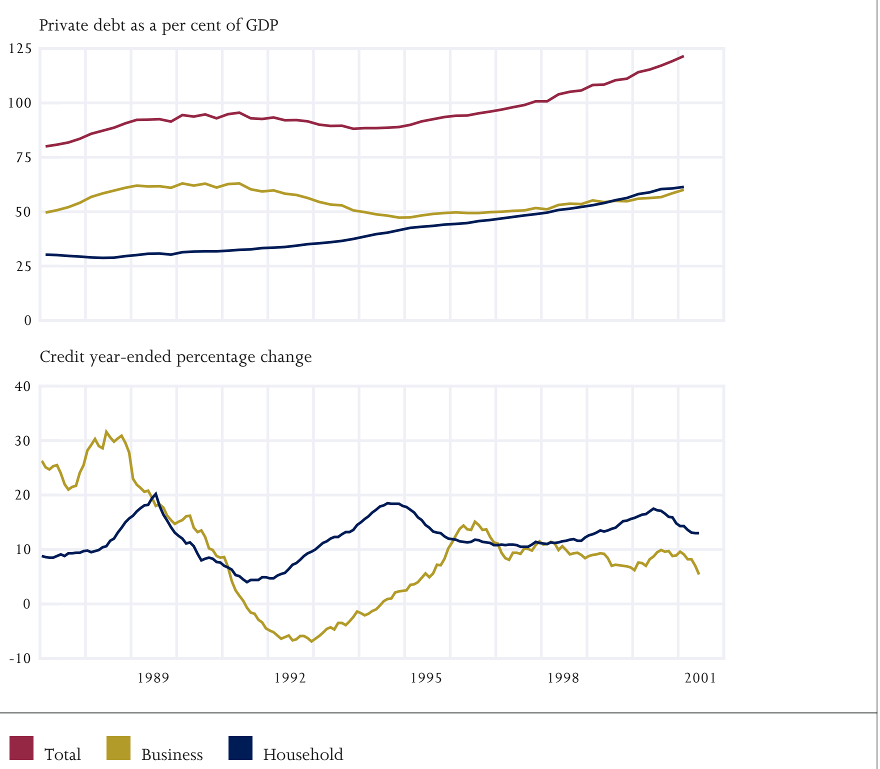
A rebound in global economic growth is expected next year, supported by the aggressive response of US monetary policy and monetary easings in other major economies, but confidence in the global outlook remains fragile. Credit spreads have begun to narrow and major share markets have shown signs, albeit tentative, of stabilising. Despite the fall over the past 15 months, share prices in the United States remain high relative to traditional measures of share valuation. Around year-end, international financial markets came under renewed pressure from emerging market economies, as Argentina and Turkey sought to roll over sizeable amounts of external debt.

Domestic Developments

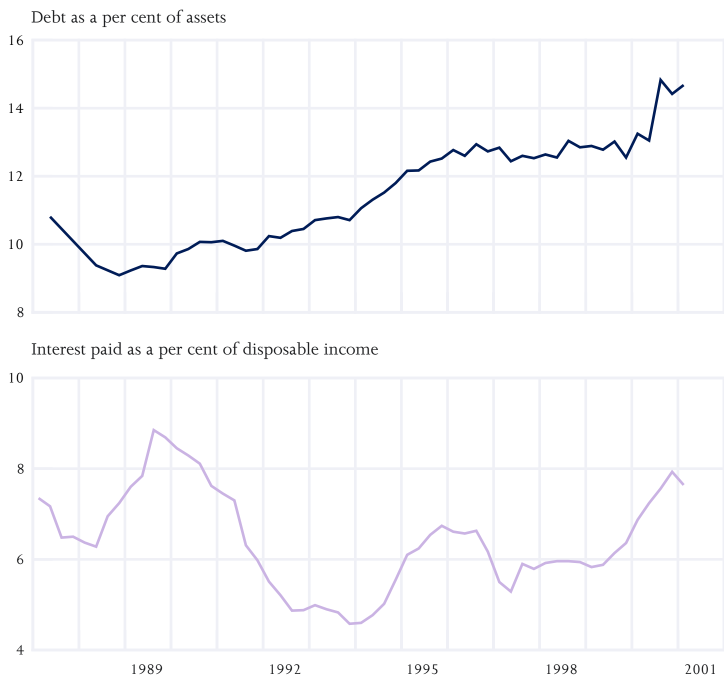
In Australia, too, the credit cycle moderated in 2000/01. After peaking around the beginning of the year, growth in credit extended by Australian financial institutions eased to around 10 per cent, a rate in line with that experienced over most of the 1990s economic expansion. Nonetheless, private sector debt as a ratio to GDP is some 25 percentage points above where it stood when the expansion got under way.

The ***household sector*** has accounted for much of the run-up in private sector debt. Over recent years, credit to households, particularly for housing purposes, has grown at an average rate of

PRIVATE SECTOR INDEBTEDNESS



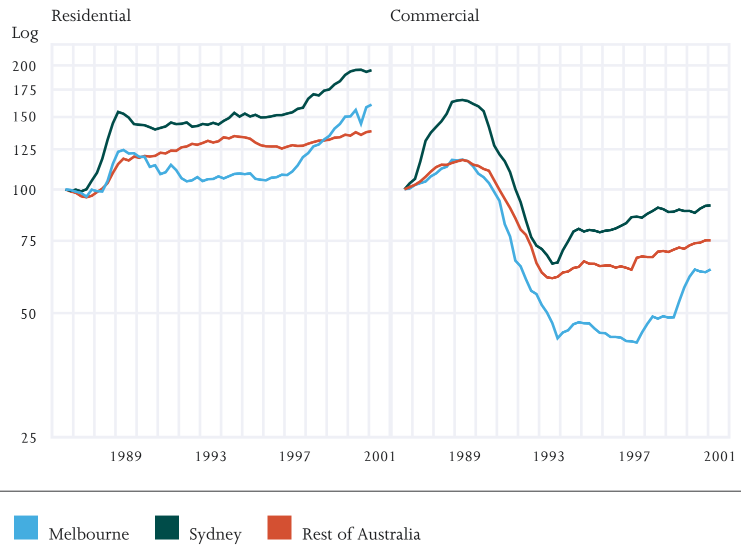
HOUSEHOLD FINANCES



14 per cent a year and household sector debt now matches that of the business sector. The increase in household indebtedness – to levels comparable with other developed countries – has been accompanied by a substantial increase in household wealth, particularly holdings of financial assets.

Even so, households are vulnerable to the risk of future slowdowns in economic activity and falls in asset prices. Their interest burden reached a ten-year high during 2000/01, but remains below its late 1980s peak and has been ameliorated by the recent monetary policy easings. The household sector's main asset is residential property and so it is exposed to property prices. While housing prices rose strongly in the second half of the 1990s, their rate of increase was modest compared with the late 1980s, when prices rose in real terms by 30 per cent in under two years. Although residential property prices in Sydney and Melbourne have been under strong upward pressure, house prices elsewhere in Australia have increased by less than two per cent a year in real terms since 1996.

REAL PROPERTY PRICES*
September 1986 = 100

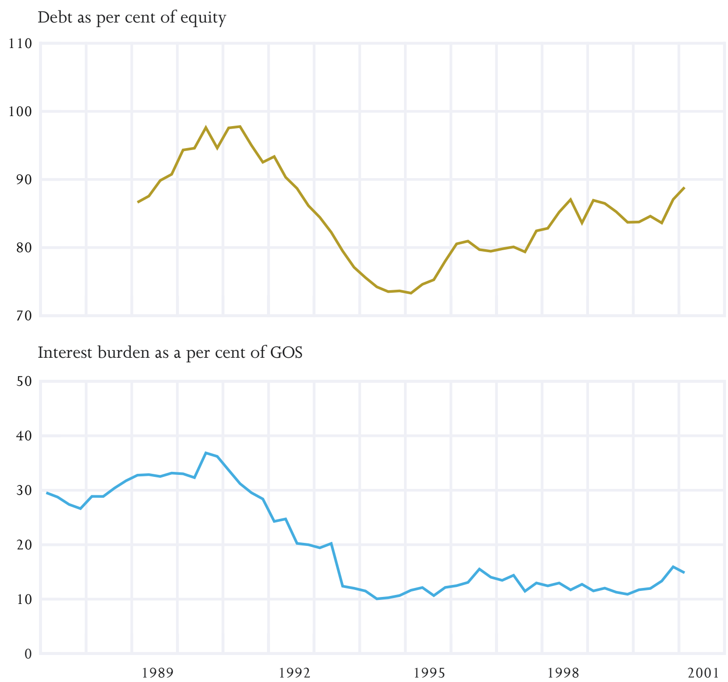


*Property prices relative to the GDP deflator.

One component of credit to households which the RBA has been closely monitoring is margin lending, which allows households to purchase shares and other financial assets using these purchases as collateral. Margin lending is more risky than many other forms of lending and therefore carries a higher risk premium; loans are also typically limited to a maximum loan-to-valuation ratio of 70 per cent for "blue chip" shares. In the more volatile share market conditions during 2000/01, the average loan-to-valuation ratio was around 46 per cent by year-end, well below the maximum, and the number of margin calls increased, though from a low base. While margin lending continues to increase strongly, it remains around only one per cent of total credit outstanding.

In previous episodes of financial instability, the ***business sector*** has been an important source of stress, usually reflecting its excessive take-up of debt in the "good times". A number of current indicators, however, show the business sector to be in relatively sound condition. For one thing, corporate gearing has been more restrained over the 1990s expansion. Strong profitability and a buoyant share market have enabled businesses to draw more on internal sources and equity raisings for their funding; as a consequence, the debt-to-equity ratio of the business sector remains well below its late 1980s peak. Similarly, its interest burden remains low by historical standards. The debt-servicing ability of the business sector has been underpinned by the strong improvement in Australia's productivity performance over recent years and the absence of any obvious over-expansion in productive capacity.

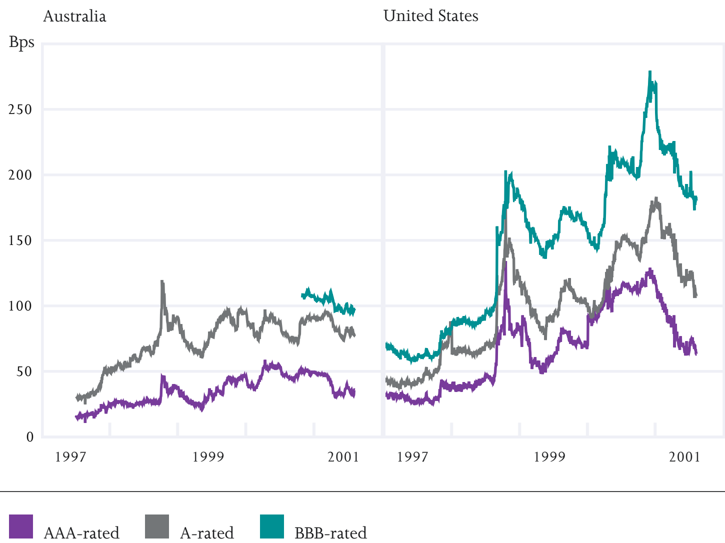
CORPORATE SECTOR FINANCES



Second, there is little evidence of imbalances in individual sectors, particularly construction, which could pose risk for financial institutions. Speculative activity in the construction sector has been far more restrained than in previous expansions; non-dwelling construction as a share of GDP is low compared to late 1980s levels and commercial property prices in real terms remain nearly 40 per cent below their peak. In any event, the share of financial institutions' balance sheets exposed to commercial property has fallen over the decade; for banks, the share is currently around seven per cent. Commercial property developments have been increasingly funded from market sources through listed property trusts. Australian financial institutions have only limited exposures to the telecommunications sector, a matter of prudential concern in other countries.

Third, market indicators show continued confidence in the credit quality of the business sector generally, with credit spreads for low- and high-grade corporate bonds remaining relatively steady or declining during 2000/01. This contrasts with developments in the United States where concerns over credit quality saw spreads widen across all rating grades during the first half of the year, before narrowing more recently. Market confidence has also been reflected in the resilience of the Australian share market compared with share markets in the United States and elsewhere.

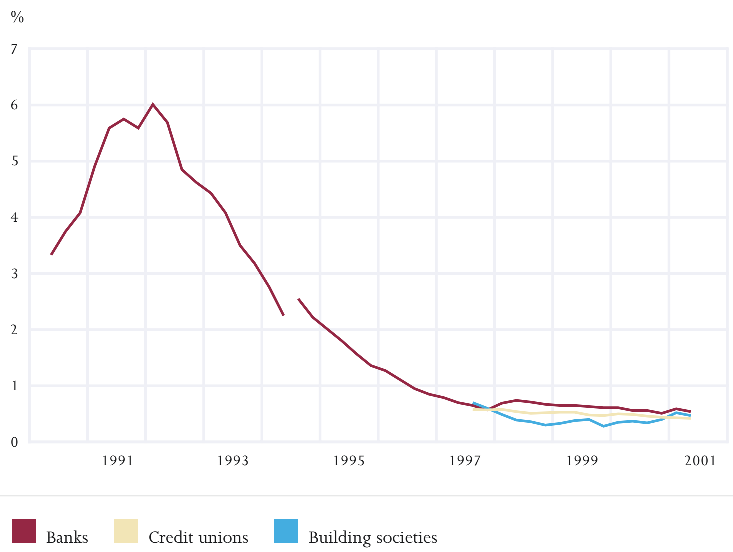
CORPORATE BOND SPREADS



The absence of immediate stresses in the household and business sectors has meant that, notwithstanding the slowing of economic activity, ***authorised deposit-taking institutions*** remain in sound condition, and asset quality is strong. For banks, the ratio of impaired assets to total assets reached a low point of 0.5 per cent at mid-year. However, this measure tends to be backward-looking and can be expected to rise as the consequences of the economic slowdown materialise. More recent readings confirm that the credit quality of some business lending, particularly for small and medium enterprises, has deteriorated. Small businesses have felt the impact of recent falls in sales and business confidence more than other types of business.

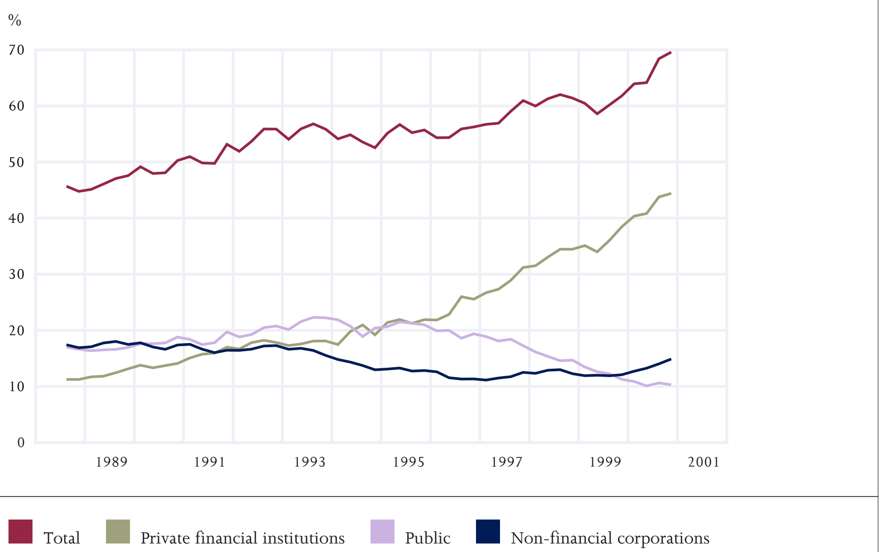
Developments in impaired assets will bear close watching. At the same time, there are good reasons for believing that authorised deposit-taking institutions are less vulnerable to changes in the economic climate than they were a decade ago. Over this period, the concentration of risk in the financial system has changed. Financial institutions have shifted their lending portfolios away from businesses and towards the household sector, which is generally lower risk; the result has been a reduction in the overall risk on domestic lending portfolios. Lending to households now accounts for over half of total credit outstanding compared with one-third at the beginning of the 1990s. The management of credit risk has also been considerably strengthened through improvements in risk monitoring, such as the application of internal credit-grading systems, the shifting of credit risk through securitisation programs and use of credit derivatives, and tight control over the number and size of large exposures. The diversification of income sources into funds management and other fee-generating activities has also reduced the dependence of larger financial institutions on their traditional lending business.

IMPAIRED ASSETS
Per cent of on-balance sheet assets



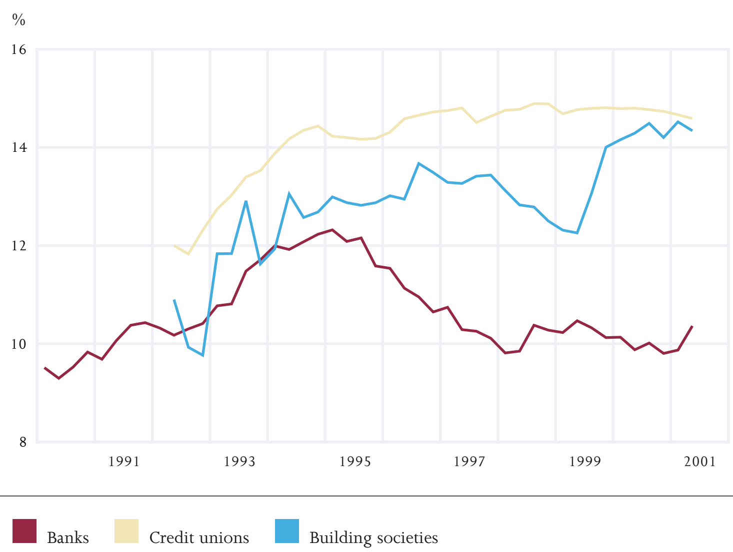
To fund sustained asset growth over recent years, financial institutions – particularly banks – have relied increasingly on borrowings in offshore wholesale markets as a supplement to their domestic deposit base. At the end of 2000, 60 per cent of Australia's gross foreign debt was accounted for by financial institutions. The Australian banking sector carries more foreign borrowings on its balance sheet than is the practice in other countries. However, this does not translate directly into foreign currency exposure. Almost half of the foreign debt issued by Australian financial institutions is denominated in Australian dollars; for the remaining foreign-currency denominated debt, the currency risk is largely hedged through off-balance sheet transactions in the derivatives markets, using currency swaps and forward foreign exchange contracts. Overall, the capital charge on banks' exposure to the risk of losses from market movements is less than one per cent of their capital base.

GROSS FOREIGN DEBT
Per cent of GDP



The profitability of deposit-taking institutions has been strong although, again, this measure is backward-looking. On average, banks have maintained returns on equity in the 14-16 per cent range (after tax) as a result of increased lending volumes, further cost containment and growth in non-interest income; however, banks' average interest margins continue to contract, partly as a result of the increasing use of wholesale funding sources. Returns on equity for building societies and credit unions – which tend to be higher cost institutions than banks and have higher capital ratios – have averaged around 6-7 per cent (after tax) over recent years. Sustained profitability has enabled deposit-taking institutions to maintain capital ratios well above minimum required levels. For banks, an active capital management program, involving share buy-backs and the use of innovative capital instruments, has seen the aggregate risk-weighted capital ratio remain around 10 per cent over 2000/01, just above its lowest level over the 1990s expansion. Provisioning as a share of on-balance sheet assets has been steady over recent years, although more forward-looking approaches might have seen provisions being built up in anticipation of a turn in economic conditions. For building societies and credit unions, capital ratios are close to or at cyclical highs.

RISK-WEIGHTED CAPITAL RATIOS



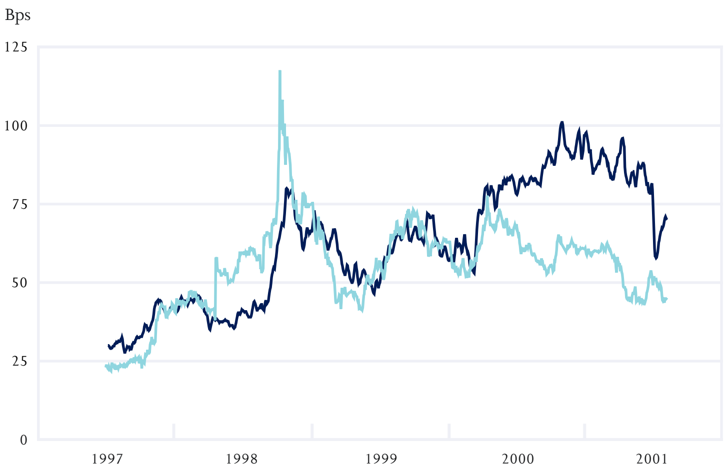
Market indicators continue to signal confidence in the risk profile of Australian banks. The credit spreads on AA-rated bonds issued by Australian banks has declined to around 50 basis points; this is their lowest level in two years and contrasts with the widening of credit spreads on equivalent US bank bonds, which peaked at 100 basis points in mid-year but have since declined. The credit ratings of the major Australian banks have been unchanged over the past three years.

Developments in the General Insurance Sector

The exception to the broadly positive picture of the Australian financial system is general insurance (including reinsurance), which has struggled for profitability and has had some significant failures over the past two years. During 1999/2000, one specialist reinsurance company, New Cap Re, went into liquidation and another, Reinsurance Australia Corporation (ReAc), into run-off mode. In addition, GIO Insurance Limited reported large losses from reinsurance business, for the second year in a row. In March 2001, HIH Insurance Limited, the second biggest general insurance company in Australia, was placed into provisional liquidation. Although the size of HIH's deficiency has yet to be determined, the collapse is likely to be as large as any failure of a financial institution in Australia's history. The reasons behind the demise of HIH, and the adequacy and appropriateness of the regulatory environment for general insurance, are now the subject of a Royal Commission.

The collapse of HIH has had some impact on output and activity, particularly in housing construction where builders previously insured with HIH have taken time to find replacement cover. The collapse did not, however, create the kind of stresses in the financial system that might

SPREAD BETWEEN YIELDS ON BANK AND GOVERNMENT BONDS*



*AA-rated bank bonds.

have been expected with the failure of a deposit-taking institution of comparable size. Unlike deposits, the liabilities of general insurance companies are not repayable on demand. Hence, they do not lend themselves to the kind of "run" that can befall deposit-taking institutions when the failure of one institution has a contagious impact on confidence in the sector as a whole. Australian financial institutions have little direct exposure to HIH and most of that is secured; while secondary exposures are likely to emerge as a result of their customers losing insurance cover, financial institutions are currently in a strong position to absorb any resulting credit losses. The winding-up of HIH has also not involved the distressed selling of financial assets on a scale large enough to destabilise financial markets.

The failure of HIH, following the previous incidences of distress, has reinforced the importance of overhauling the regulatory framework for general insurance, which has seen little change over almost three decades. APRA has developed significant reforms to the prudential requirements for general insurers which will come into effect, under an accelerated timetable, from 1 July 2002.

PAYMENTS SYSTEM DEVELOPMENTS

The Payments System Board of the RBA has responsibility for the safety of the Australian payments system and for promoting efficiency and competition within that system, consistent with overall financial stability. It has the backing of comprehensive powers, to be exercised if other methods of implementation prove to be ineffective.

These powers were invoked for the first time in April 2001, when the RBA brought the credit card systems operated in Australia by Bankcard, MasterCard and Visa under its regulatory oversight. This followed a detailed study of card schemes, conducted jointly with the Australian Competition and Consumer Commission (ACCC) and published in October 2000, which highlighted a number of shortcomings in competition in the provision of card services. The RBA is currently assessing whether the rules of these schemes – covering the collective setting of wholesale fees (known as interchange fees), admission of institutions as members and restrictions on merchants passing on credit card costs to customers – meet a public interest test. A regulatory framework for credit cards will be established during 2001/02 after full public consultation.

On the safety front, the Payments System Board has continued to support the RBA's involvement in the "continuous linked settlement" or CLS Bank which, once operational, will reduce foreign exchange settlement risk for participants (see the chapter on "Business Services"). Major Australian banks are participants in CLS Bank and the Australian dollar is included as an eligible currency.

The Government has recently introduced legislation, under its Corporate Law Economic Reform Program, that will widen the mandate of the Payments System Board by giving it responsibility for the setting of financial stability standards for securities clearing and settlement systems. This responsibility is a recognition of the close interaction between clearing and settlement systems and the payments system, and of the reality that the failure of a clearing and settlement system could have a serious impact on overall financial stability, a matter for which the RBA already has responsibility. Financial stability standards will address the financial soundness of a clearing and settlement facility, and could cover such matters as legal foundations, settlement procedures, risk control techniques, contingency planning and procedures to deal with default by a member. The RBA will undertake regular assessments of compliance with the standards set and if any enforcement action is needed, it would be undertaken on the RBA's behalf by the Australian Securities and Investments Commission (ASIC). Because ASIC also has a range of responsibilities for the operation of clearing and settlement systems, the RBA and ASIC are preparing a Memorandum of Understanding as a basis for co-ordinating their roles.

The Payments System Board's activities will be detailed in its third *Annual Report* to be published shortly.

INTERNATIONAL FINANCIAL CO-OPERATION

While the Asian crisis is now some years behind us, its lessons continue to be reflected in the activities, debates and evolving institutional structures of the international community. Since 1997 and 1998, the nature of the debate has shifted somewhat, from initially trying to resolve crises and seeking to understand their causes, to now implementing programs and policies that might serve to reduce the likelihood or severity of future crises. Progress has not been made in all areas, as in some cases no simple solution has been identified, but the debate itself has broadened the general understanding of the issues.

Much of the implementation has fallen to the International Monetary Fund (IMF), by virtue of its central role in crisis management, its near universal membership, and its mandate for conducting country assessments. However, the establishment of the Financial Stability Forum and the Group of Twenty in 1999 has broadened the fora in which debate and co-operation on the critical issues can be progressed. The RBA has been active in both of these fora.

THE FINANCIAL STABILITY FORUM

Since its inception in 1999, the Financial Stability Forum has undertaken a series of investigations into issues of concern to international financial stability. Australia is represented on the Forum by the Governor, while other staff – from both the RBA and Treasury – have been involved in various working groups.

Highly Leveraged Institutions (HLIs)

One of the Forum's important initial tasks was to examine the implications of the operations of HLIs (predominantly hedge funds) for financial stability and market dynamics. The Forum released the report of its Working Group on HLIs in early 2000 and, in March 2001, reviewed progress on implementation of the report's recommendations.

Perhaps the most significant element of the recent review's findings is that the structure of the hedge fund industry itself has shifted in a way that has reduced many of the previous concerns about their activities. Although the number of hedge funds has increased, their average size has decreased. In particular, many macro hedge funds – the funds considered to have caused the greatest market disruption in Asia during 1997 and 1998 – have either ceased operations entirely, or have been significantly scaled back. According to the review, this reflects "a reassessment of the risk-adjusted expected returns on large directional positions on asset prices" and "the industry perception that increased scrutiny of hedge fund investments would adversely affect potential returns". The review also suggests that market discipline on hedge funds has increased and their overall leverage has fallen, reducing their capacity to disrupt markets. However, lower hedge fund activity has meant that liquidity in some of the markets in which they were previously active has been reduced.

Good progress has been made on some of the Forum's recommendations. Counterparty risk management practices – for example, standards of credit analysis and the level of senior management reporting of HLI exposures – have improved, as has regulatory oversight of HLI credit providers. In February 2001, a set of guidelines for foreign-exchange trading was launched with the support of 16 major commercial and investment banks in response to concerns about the effect of HLI positions on market dynamics.

These guidelines act as a benchmark against which market participants' behaviour can be judged, though they have no legal standing.

Another promising area has been the work of the Multidisciplinary Working Group on Enhanced Disclosure. This group, which worked closely with five major hedge funds and a range of other intermediaries, released its report in April. It recommended that HLIs be encouraged to disclose certain risk information on a routine basis to investors, creditors and counterparties and that consideration be given to regulatory measures if HLIs do not come to do so. Action has been left in the hands of the Multidisciplinary Working Group's sponsor organisations – the Basel Committee on Banking Supervision, the Committee on the Global Financial System, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions.

The Forum also identified several areas where progress has been less encouraging. Efforts to introduce mandatory public disclosure by hedge funds have not made much ground. Legislation in the United States has been seen as critical to this push, but US authorities have been reconsidering the need for such a step. Further work is also needed on exposure measurement by counterparties to HLIs. While progress has been made in measurement of potential future credit exposure, efforts to introduce regular and comprehensive stress testing have progressed slowly.

Financial Standards

The Financial Stability Forum is also promoting adherence to international financial standards and codes in order to help make financial systems less crisis-prone. Work in this area began with the identification of 12 core financial standards by the Forum's Task Force on the Implementation of Standards. More recently, a follow-up group has been raising awareness of financial standards and examining ways to encourage their implementation. The development of detailed methodologies and the encouragement of effective communication between standard-setting bodies have been positive steps. At present, the group is considering the feasibility of further supervisory and regulatory-type incentives, together with the provision of technical assistance to countries moving towards the adoption of new standards. Australia is represented on this group by Treasury.

Offshore Financial Centres

Another area on which the Financial Stability Forum has focused relates to offshore financial centres and their potential to undermine financial stability if inadequately supervised and if information flows between them and supervisors in other countries are insufficient. In May 2000, the Forum publicly identified a number of offshore centres that were considered to perform relatively poorly on the above criteria.

The focus of this work has now largely shifted to the IMF, which has undertaken to conduct or support assessments of offshore centres' adherence to relevant financial standards and codes. The RBA hosted an IMF outreach meeting for offshore centres in the Pacific region to initiate the program in September 2000. Many offshore centres have begun to take steps to enhance their supervisory, regulatory, co-operation and information practices and will now seek IMF assessments or undertake assisted self-assessments.

The Financial Stability Forum will undertake a stock-take of its recommendations in respect of offshore centres in September 2001.

THE GROUP OF TWENTY (G20)

Established in late 1999, the G20 brings together finance ministers and central bank governors from a cross-section of countries at different stages of economic development, along with the European Union, the IMF and the World Bank, for discussions on policies to promote sustainable and equitable economic growth. As well as the annual Ministerial meeting, which the Treasurer and the RBA Governor attend, Deputies' meetings of central bank and finance officials are held twice-yearly.

Since its formation, the G20 has devoted a significant amount of time to examining ways to reduce the frequency and severity of financial crises. At the annual meeting in Montreal in October 2000, Ministers and Governors developed a consensus on appropriate policies which, considered together, would reduce economies' vulnerability to financial crises and also provide an appropriate framework to deal with such an event. The policy agenda seeks to strengthen the international financial system and domestic financial structures in a number of areas: the selection of appropriate exchange rate arrangements, prudent liability management, implementation of international standards and codes, and the development of a workable framework for involving the private sector in the prevention and resolution of financial crises.

In recognition of the trend towards greater international integration of economies and markets, the G20 agenda was extended in Montreal to include discussions on the opportunities and challenges posed by the process of globalisation. Ministers and Governors agreed on the importance of developing policies to ensure that the benefits of globalisation are maximised and shared as widely as possible. Members noted that, while globalisation can produce enormous benefits in raising living standards, there is the real possibility that some societies may experience dislocations during the adjustment phase. The G20 has sought to broaden the globalisation debate – balancing discussions on the benefits of market-based reforms with recognition of the social and human dimensions of economic change.

The current G20 work program aims to develop a deeper insight into the globalisation process. Member countries have agreed to undertake case studies reviewing experiences with globalisation – not only instances where market reforms have brought about clear improvements in economic welfare, but also where the process has been more problematic.

REGIONAL GROUPS

Over the past decade, the RBA has developed strong links with other central banks in the Asian region, both bilaterally and through various regional organisations. The main such organisation for regional central banks is the Executives' Meeting of East Asia-Pacific central banks (EMEAP). This Group brings together central bank officials at various levels, including an annual meeting of Governors. The RBA hosted the annual meeting of Governors in Sydney in July 2001.

After the Asian crisis in the late 1990s, it became clear that central banks from this region were under-represented in international policy discussions. The formation of the Financial Stability Forum and the G20 redressed this to some extent. Four of the 11 central banks on the Financial Stability Forum are from the region, while six regional countries are represented on G20.

Two further steps were taken during the past year to better integrate regional central banks into international discussions. The first was the creation of the Bank for International Settlements (BIS) Asian Consultative Council, which held its first meeting in Basel in June, in conjunction with the Annual Meeting of the BIS. The Council includes central banks from Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Singapore and Thailand. The central banks of New Zealand and the Philippines, which are not members of the BIS, will also be invited to future meetings. The Council will provide advice to the BIS Board on a range of regional issues, including the activities of BIS in Asia, particularly through its Representative Office in Hong Kong. The RBA Governor is the inaugural chairman of the Council.

A second significant event for central banks in the region has been the instigation of regular meetings between EMEAP central banks, the New York Federal Reserve, the European Central Bank and the G10 Committee of Experts on Gold and Foreign Exchange, to discuss developments in global and regional foreign exchange markets. The gathering, now known as the EMEAP Forum on Foreign Exchange Markets, was first held in early 2000, and will convene twice a year. The RBA's Head of International Department is the chairman of the Forum.

OTHER GROUPS

The RBA is active in a number of other groups related to the BIS and G10. Two of these are the G10 Committee on the Global Financial System (CGFS) and the Committee of Experts on Gold and Foreign Exchange, which meet several times a year. These discuss a range of international financial issues and monitor global markets. In addition to taking part in the regular meetings of these groups, the RBA participated in a CGFS working group on *The Implications of Electronic Trading in Financial Markets*, which reported in January 2001. The group found that electronic trading is rapidly gaining ground in fixed-interest markets, having already become the dominant trading medium in the inter-dealer foreign exchange market. The group noted its impact on market structure, particularly the diminishing role of voice-broking and direct dealing between dealers, and found that the relative cost-effectiveness of electronic trading has yet to be fully realised in most markets. The group also raised several issues concerning the potential impact of electronic trading on financial stability, noting that there was still no consensus on the impact of electronic trading on the liquidity and the resilience of a market.

Another G10-related group to which the RBA contributes is the Committee on Payment and Settlement Systems (CPSS). As part of the work of this Committee, the RBA was represented on a group that prepared the report on *Core Principles for Systemically Important Payment Systems* in January 2001. The *Core Principles* codify good practice in the design of high-value payment systems and draw on experience in reform of payment systems over recent years. Because the Australian dollar is one of the seven currencies to be included in initial operations of the "continuous linked settlement" or CLS Bank, the RBA is a member of a CPSS group co-ordinating central bank oversight of the project and liaising with CLS Bank on a range of operational and policy issues. The CPSS has recently begun to focus on retail payments and, reflecting its role in promoting the efficiency of Australia's retail payments system, the RBA was invited to join a

SIXTH EAST ASIA AND PACIFIC (EMEAP) GOVERNORS' MEETING, HOSTED BY THE RBA IN SYDNEY, JULY 2001.

group working on these issues. In the past year, this group has published a report on the clearing and settlement of retail payments.

TECHNICAL ASSISTANCE

Central banks in many developing economies have continued to adapt and broaden their operations in the wake of the late 1990s crises. Many have sought assistance to bring these changes about. The RBA has been willing to play its part in this process and has responded favourably to all direct requests received from central banks during the past year.

Help was provided by allowing staff from other central banks visiting Sydney to see how the RBA undertakes various tasks. During 2000/01, there were 10 such visits by staff of central banks in the region. The main interests of visitors were financial market operations, economic analysis, note issue, accounting and auditing.

Some assistance is more efficiently provided on the ground in the country concerned, and the RBA has stood ready to help where possible. To this end, one staff member has continued to work full-time in providing technical assistance to the Bank of Papua New Guinea, while another undertook a short-term project on liquidity forecasting and market operations. Others have made short-term technical assistance visits to Samoa and Tonga.

Staff were also made available to assist regional and international organisations to help in the training process. One staff member assisted on an IMF mission to Thailand, while another developed and organised technical assistance programs in

Samoa and Tonga on behalf of the Fund. Other staff helped present workshops in India, Samoa and Singapore on behalf of various organisations.

The issue of money laundering has also been high on the agenda of many countries and several international organisations this year. Australia is a member of the Asia/Pacific Group on Money Laundering which is undertaking a series of evaluations of the ability of regional centres to prevent money laundering. The RBA provided staff to assist in two of these evaluations in the past year.

FINANCIAL SUPPORT

From time to time the RBA provides bilateral financial support to countries in the region. In these cases, the RBA acts with the support of, or at the request of, the Commonwealth Government. Such financial arrangements are provided on commercial terms and are therefore at no cost to the RBA.

In 1997, the RBA entered into a foreign exchange swap facility for up to US$1 000 million with the Bank of Thailand, as part of a US$17 billion IMF-led financing package. Improving economic conditions in Thailand through the late 1990s meant that only US$862 million of the facility was drawn down, the last drawing occurring in mid 1999. From March 2001, the Bank of Thailand began repaying the swap as scheduled. By the end of the financial year, US$712 million of the facility remained outstanding.

CO-ORDINATION WITH OTHER GOVERNMENT AGENCIES

The RBA also participates with several Commonwealth Government departments and agencies to formulate Australia's international economic policy. These organisations include the Department of Foreign Affairs and Trade, Treasury and AusAID. This work is co-ordinated through the International Economic Policy Group, which is chaired by the Department of Prime Minister and Cabinet and meets about eight times a year.

BUSINESS SERVICES

The RBA provides banking, registry, settlement and note issue services to a range of customers. Banking and registry services are provided to the Commonwealth and South Australian Governments and some international institutions.[1] Settlement facilities are offered to banks and other financial institutions, while banks and armoured car companies form the customer base for the note issue function. With the exception of a very small amount of registry work, the RBA does not provide business services direct to the public.

In compliance with the Commonwealth Government's competition policy, separate financial data are recorded for the contestable transactional banking, RITS and registry businesses. These businesses fully meet all competitive neutrality and devolved banking requirements, including allowance for all relevant taxes. Pro forma sets of accounts for these contestable businesses, prepared in accordance with competitive neutrality guidelines, are set out elsewhere in this *Report*.

GOVERNMENT BANKING

The RBA provides both core banking and transactional banking facilities to the Commonwealth Government. The core banking facility, which is provided to the Department of Finance and Administration (DoFA), is non-contestable in terms of the Commonwealth Government's competition policy. As part of this facility, the RBA maintains six accounts for the Commonwealth Government, including the Official Public Account (OPA), and provides a limited overdraft facility.[2] The release of funds from the OPA to agencies and the sweeping of the agencies' overnight balances from transactional bankers back to the OPA are also part of the core banking function. Overnight balances are returned to transactional bankers at the start of the next business day. Forecasting data from agencies and transactional bankers are collected electronically to assist the RBA to discharge its monetary policy and liquidity management responsibilities.

The devolution of responsibility for banking activities to agency heads was an integral part of a wider policy aimed at increasing the accountability and efficiency of budget-funded agencies. To encourage them to plan their cash management processes better, DoFA instituted a system of incentives to improve cash management performance. The RBA administers this on behalf of DoFA.

As part of the core banking facility, 5 800 deposits were made in 2000/01 totalling \$53 billion, well up on the 2 500 deposits totalling \$32 billion lodged in the previous year.

The other component of the RBA's government banking business, transactional banking, has undergone significant change over recent years. Under the Commonwealth Government's devolved banking arrangements implemented from 1 July 1999, agencies governed by the *Financial Management and Accountability Act 1997* (*FMA Act*) are required to market-test their transactional banking requirements. This process gathered pace over the past financial year with *FMA Act* agencies issuing nine tenders for their transactional banking requirements. The RBA was

1 For many years, the RBA provided banking and registry services to a number of State and Territory governments. Over recent years, with the exception of South Australia, they have moved to other service providers.

2 The conditions applying to the overdraft facility are set out in "The Separation of Debt Management and Monetary Policy", RBA *Bulletin*, November 1993.

unable to respond to a number of tenders because of special requirements stipulated by some agencies. Of those tenders decided during the year, the RBA retained the business of all agencies for which it bid.

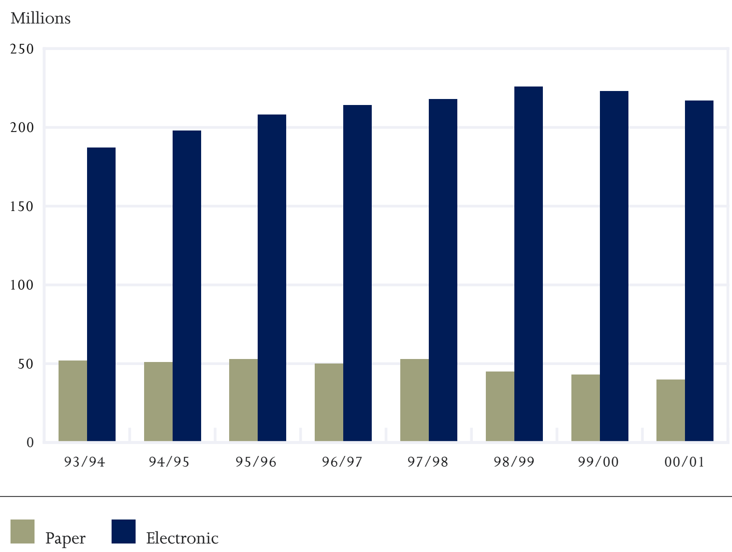
Against the background of a highly competitive transactional banking market, further restructuring of the functional areas within the RBA's Sydney and Canberra offices has been undertaken to enhance efficiency and strengthen the Canberra branch's capacity for the day-to-day contact with and support of customers.

Electronic transactions through the Government Direct Entry System (GDES) fell to 217 million transactions from 223 million during the last year. The major reason for the fall was the streamlining of arrangements for the distribution of payments by Centrelink under its rent deduction scheme. The loss of some Commonwealth Government agency business and the full-year effect of the loss of the direct-entry business of the Western Australian and Australian Capital Territory Governments also contributed to the reduction. These decreases were offset in part by increased volumes from the Australian Taxation Office and the Health Insurance Commission.

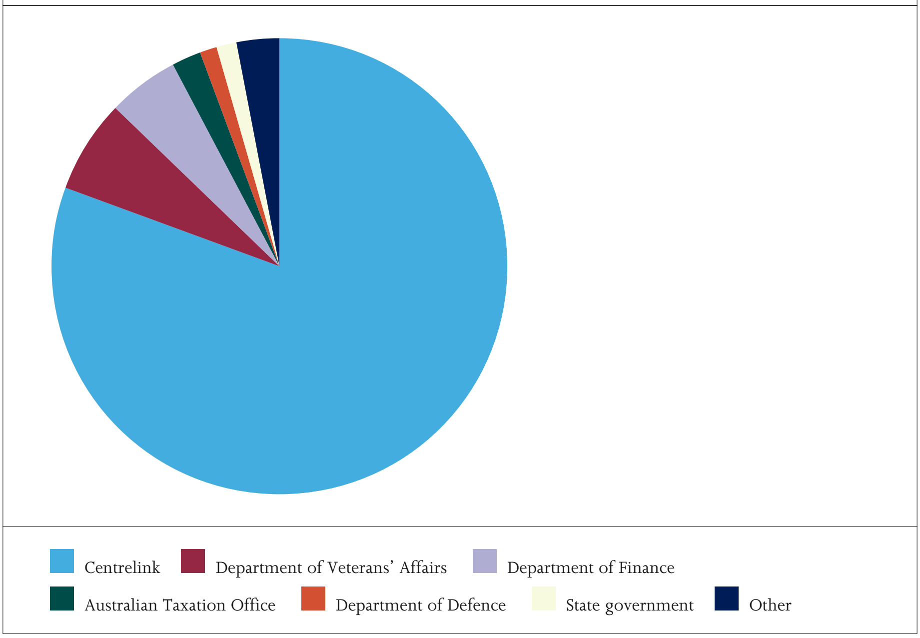
In its capacity as banker to the South Australian Government, the RBA operates as "prime contractor" for the provision of centralised banking services. Where the RBA is unable to provide any of these services in its own right, it contracts out the service and manages the relationship with sub-contractors. As well as continuing to move the mode of delivery of traditional transaction services to a more efficient electronic basis, the extensive use of merchant facilities and purchase-card programs has delivered significant efficiencies to the collection and payment processes of South Australian Government agencies.

Earnings after tax for the transactional banking business in 2000/01 were $5.4 million compared with $2.1 million in the previous year.

BANKING TRANSACTIONS



ELECTRONIC BANKING TRANSACTIONS – 2000/01



BUSINESS DEVELOPMENTS

Over the past year or so the Australian banking industry has experienced a significant increase in fraudulent alteration of cheques. The RBA has responded to this by developing a system specifically designed to protect its customers and itself against financial loss. The new system, known as the Cheque Verification System (CVS), uses cheque issue details provided by customers and image technology to confirm that the information on the cheque presented for collection is valid. Using high-speed image scanners, the captured cheque details are matched to the original cheque information supplied by the customer. Where these data do not match, the cheque is retrieved for visual inspection, and is then accepted or rejected. Rejected cheques are dishonoured through the banking system in the normal manner.

The CVS system has ensured that, where the relevant cheque information has been provided to the RBA by customers, all fraudulently altered cheques have been identified and dishonoured to the presenting bank within the dishonour period. Neither the RBA nor these customers have suffered any losses through fraudulent alteration of cheques since the system was introduced. An additional benefit flowing from the CVS development has been an increased capability for the RBA to respond to customers' enquiries for information on presented cheques. With the stored images of cheques in the cheque database, an interface has been developed to allow online access to these data, which, in most cases, eliminates the need for the time-consuming retrieval of the physical cheque.

The RBA is also represented on the Fraud Committee of the Australian Payments Clearing Association. This Committee deals with fraud activities related to the full range of payment methods (cheques, bills, cards, electronic banking, etc).

In October 2000, the RBA commenced processing overseas pension payments on behalf of Centrelink. Over 50 000 Australian pensioners reside overseas and receive a monthly pension cheque from Centrelink.

A new project is under way to enable direct crediting of overseas bank accounts (in those countries which have an automated clearing house system), as is done with domestic payments. This will enable a more timely and safer delivery at significantly reduced cost to recipients.

One of the Government's primary goals from its Electronic Procurement Implementation Strategy, released in April 2000, was for agencies to issue remittance advices electronically by the end of 2000. To assist agencies meet this goal, the RBA developed an electronic remittance advice service as an extension to its existing RBA Document Printing Service. Other electronic advices/forms were also identified and subsequently introduced. This extended service now provides for delivery of remittance information via email, facsimile or post, the warehousing of remittance information for release on a nominated date and the provision for redirection of returned electronic documents. The South Australian Government has developed an interface to its general ledger system, which will provide its agencies with the capacity to introduce this facility as part of their electronic business solutions.

SETTLEMENT AND REGISTRY SERVICES

The Reserve Bank Information and Transfer System (RITS) provides facilities for the electronic settlement of transactions in Commonwealth Government securities (CGS), electronic tendering for CGS, automatic interest and maturity payments for securities lodged in the system and for settling the interbank payments associated with equity transactions on the Australian Stock Exchange's electronic settlement system, CHESS.

Over 99 per cent of CGS turnover in the market is handled by RITS and securities with a face value of $64 billion are lodged in the system. There are 136 members of the system representing 248 organisations.

RITS also provides facilities through which banks and other approved institutions access their Exchange Settlement accounts with the RBA on a real-time gross settlement (RTGS) basis.

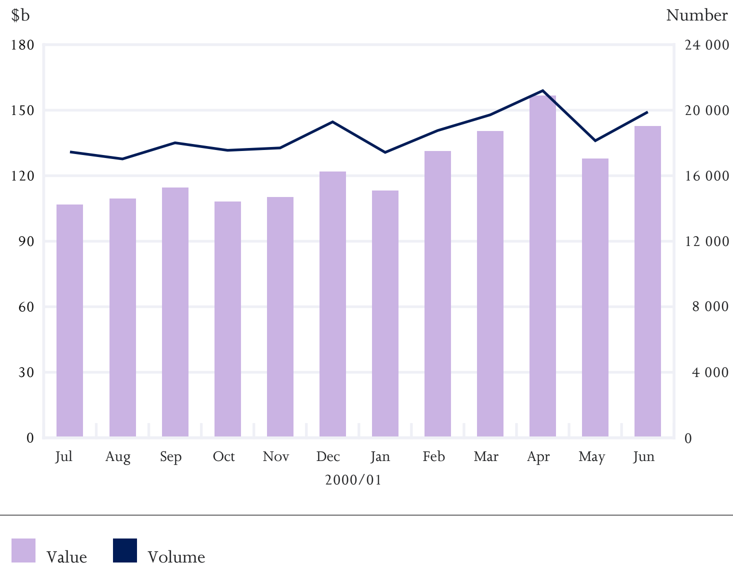
RTGS System

About 90 per cent of total values exchanged between banks are settled across RITS on an RTGS basis and hence are not subject to interbank settlement risk. RTGS payments include securities markets settlements, the Australian dollar leg of foreign exchange transactions and important or time-critical customer payments.

The RTGS system has now been in operation for three years. The daily number and value of transactions settled by RITS increased during 2000/01, with most of the growth occurring between February and April 2001. New peaks for value at $215 billion and volume at 27 400 transactions occurred on 29 June 2001.

Major changes to the settlement of foreign exchange transactions are planned over the coming year with the establishment of the "continuous linked settlement" (CLS) Bank. This is a global initiative which will reduce foreign exchange risk by ensuring that participants settling in one currency do so if, and only if, receipt in the other currency is assured. CLS Bank is being developed by over 60 shareholder banks

RTGS TRANSACTIONS
Average daily value and volume



active in foreign exchange markets, including the four major Australian banks. For Australia, participation in CLS will require alterations to the operating hours of payment and settlement systems so that they overlap with the core hours of the CLS Bank, which are from 3.00pm to 8.00pm in winter and from 5.00pm to 10.00pm in summer. Accordingly, modifications were made to RITS in November 2000 to facilitate this.

Other changes to RITS implemented in November included the introduction of facilities to permit optional real-time gross settlement of high-value equity transactions from CHESS.

Settlement services are also provided for the RBA's own transactions in the domestic securities and foreign exchange markets, as well as for those arising from business conducted by official customers domestically and abroad. The RBA also acts as collator of banks' obligations arising from the low-value clearing streams (paper, and bulk and retail electronic) managed by the Australian Payments Clearing Association.

Registry Services

The RBA provides registry services to the Commonwealth Government, the South Australian Government Financing Authority and a number of other domestic and foreign institutions. These services encompass the issue, transfer and registration of securities, the maintenance of ownership records, the distribution of periodical interest payments and the redemption of securities at maturity.

In line with previous years, the RBA has continued to actively manage this declining area of business, ensuring that the provision of services remains cost-effective for issuers, while maintaining its focus on quality of service.

THE NEW NATIONAL NOTE PROCESSING CENTRE, LOCATED AT NOTE PRINTING AUSTRALIA AT CRAIGIEBURN, VICTORIA.

Forthcoming changes to the *Commonwealth Inscribed Stock Act* will allow for the electronic transfer of ownership. While the impact that this change might have on the RBA's traditional registry operations is not yet clear, the RBA has indicated that it will continue to provide registry services for as long as the Commonwealth requires it to do so.

NOTE ISSUE

The note issue functions of the RBA comprise the issue of notes (new and reissuable); 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 note designs and security features.

Over recent years, significant changes have occurred to the RBA's note issue activities. The volume of notes processed has declined sharply in large part because of changes to note distribution arrangements introduced to eliminate the excessive churn and cross-shipping of notes that was occurring. These changes were facilitated by the move to polymer-based currency notes which, because of their greater security and durability, do not need to be checked for fitness and authenticity as frequently as in the past to keep the circulation clean and free of counterfeits. With the scaling-back of note-processing activities, the decision was taken in late 1999 to close the remaining branch-based cash services operations and to centralise the note-processing function at a new National Note Processing Centre (NNPC) at Note Printing Australia Limited at Craigieburn, outside Melbourne. This facility commenced operation in June 2001 and the Sydney cash services operation was closed.

The reduced note-processing task has, in turn, enabled further changes to be made to note distribution arrangements which will provide a sound framework for the major participants in the cash industry to seek additional efficiencies in cash distribution and inventory management. From August 2001, commercial banks will progressively assume ownership of the working stocks of currency notes and coin currently owned by the RBA, but held externally in Note and Coin Pools. Prior to that, the RBA had provided depository facilities to the main participants in currency distribution arrangements through its ownership of external working stocks of currency. These stocks could be accessed daily. However, arrangements are now being introduced under which those who need the stocks for their ongoing business also own them. Some banks are net receivers of cash and others are net payers. Previously, no direct links had arisen between these parties, as the RBA was interposed between them. Under the new arrangements, participants deal directly with each other to satisfy their demands for currency and reduce their surpluses.

These latest changes will provide further opportunities for the more efficient recirculation of currency between the various participants. Additional features of the new arrangements are that banks will receive payment from the RBA for additional holding costs in the form of interest forgone that will flow from taking ownership of the working stocks, and they will be obliged to ensure that notes are appropriately sorted for fitness for reissue, according to standards set by the RBA.

Notes on Issue

Demand for currency over 2000/01 continued to increase broadly in line with economic activity. The value of notes on issue rose by almost seven per cent to $27.2 billion. Again the increase was driven by strong growth in the $50 and $100 denominations, although their share of total circulation remained steady. There was also unusually strong demand for $5 notes, reflecting the issue of the new Federation $5 note from January 2001.

Value of Notes on Issue

($ million)

At end June	$1[(a)]	$2[(b)]	$5	$10	$20	$50	$100	Total	Increase (per cent)
1995	20	49	332	614	1 848	7 193	8 482	18 538	5.5
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

(a) Last issued May 1984

(b) Last issued June 1988

(c) See Notes To and Forming Part of the Financial Statements, Note 1(j)

Over the course of 2000/01, $125 billion of currency notes were issued into circulation and $123 billion returned. Turnover was up by about 18 per cent on 1999/2000, reflecting the changes made to cash distribution arrangements described in last year's *Annual Report* which have facilitated better access to RBA note stocks held externally in Note and Coin Pools.

Note Processing and Distribution

In the latest year, the number of notes processed through high-speed note counting and sorting machines at the RBA decreased from 450 million ($18 billion) in 1999/2000 to around 153 million ($4 billion). The greater reduction of processing in dollar terms when compared with the reduction in numbers of notes processed reflects higher $5 note-processing levels resulting from the issue of the Federation $5 note into circulation in January. From June 2001, note-processing has been conducted at the NNPC.

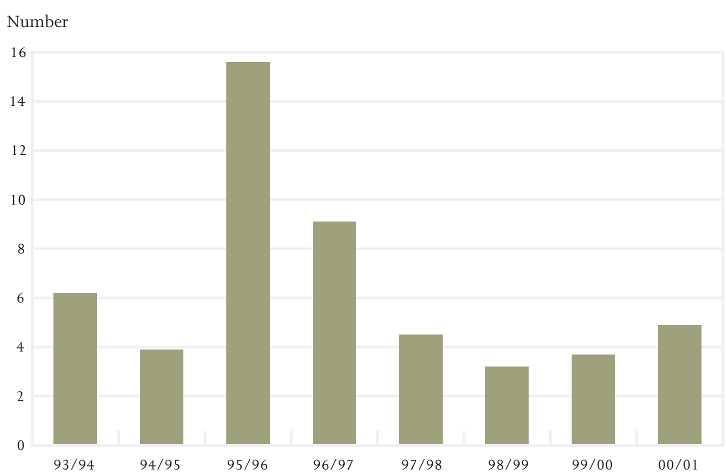
As well as improving the efficiency of circulation of currency within the community, the new cash distribution arrangements also seek to reduce the number of "fit" notes unnecessarily returned for processing. The effects are already becoming evident and in 2000/01 only 77 per cent of notes processed by the RBA were deemed fit for reissue compared to 93 per cent for the previous year.

Counterfeiting Activity

Counterfeiting of Australian currency notes was again low, with only 3 003 counterfeits detected during 2000/01. Although this is an increase compared to the 2 100 counterfeits detected the previous year, the numbers remain modest compared with the experience of other countries and well down on levels seen in some previous years.

The counterfeits detected were for the most part low grade, on a paper substrate and could be easily identified by their different feel compared with a genuine note, as well as by visual inspection. A very small number of counterfeits printed on a plastic material were also detected during the year.

COUNTERFEITS PASSED PER MILLION NOTES IN CIRCULATION



Notwithstanding the low level of counterfeiting activity, the RBA has an active research and development program aimed at continually improving the security of polymer notes by putting obstacles in the way of would-be counterfeiters.

Federation $5 Note

On 1 January 2001 the RBA issued a new $5 note as its contribution to the Centenary of Federation celebrations.

The new note features two prominent Australians who made unique contributions towards the birth and development of our nation. On the front is Sir Henry Parkes and on the reverse is Catherine Helen Spence. The note was designed by Garry Emery, one of Australia's leading graphic designers, who also designed the current $20 note.

It is important that notes are able to be easily authenticated not only by individuals, but also by machines that accept, dispense and count notes. Such machines are becoming much more common. Prior to the issue of a new note, the RBA provides machine manufacturers with sample notes to enable as many note validators as possible to be upgraded in advance of the issue date. The proliferation and sophistication of note-accepting machines has made speedy conversion a more complex and lengthy process leading to the likelihood that not all machines will be converted by issue date. Unfortunately, some conversion problems were encountered with the issue of the Federation $5 note but, within several months, upgrading of equipment was largely complete.

THE RBA IN THE COMMUNITY

The monetary policy framework which has evolved over the past decade requires the RBA to provide specific accountability for its monetary policy actions. Beyond these formal requirements, the credibility and predictability of monetary policy decisions are enhanced by a broad understanding and acceptance of the policy framework. Comprehensive and timely information is also an ingredient in the wider economic debate. The first part of this chapter explains how the RBA has gone about communicating with the markets, the media and public during the past year.

ACCOUNTABILITY

It is now well-established practice for the RBA to appear, at least twice a year, before the House of Representatives Standing Committee on Economics, Finance and Public Administration. During the past year, the Governor and senior officials appeared before hearings of this Committee in December 2000 in Wagga Wagga, and in May 2001 in Melbourne, to answer questions covering a range of issues spanning the conduct of monetary policy, competition and efficiency of payment systems, financial system regulation, and aspects of the RBA's transparency and accountability arrangements. Senior RBA officials also appeared before the Joint Standing Committee on Public Works, and the Parliamentary Joint Statutory Committee on Corporations and Securities' Inquiry into Fees on Electronic and Telephone Banking. At the latter, the RBA officials gave a briefing on the RBA/ACCC's report on *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*.

Each quarter, the RBA publishes a *Statement on Monetary Policy* which gives a detailed assessment of the latest economic and financial conditions, including the outlook for inflation; these are published in February, May, August and November. The *Statements* for May and November are available sufficiently in advance of the hearings of the Standing Committee on Economics, Finance and Public Administration to ensure that Committee members can examine them fully in framing questions for the RBA's officials. Journalists are given advance access to these quarterly *Statements* by way of attendance at "media lock-ups". During the year, lock-up arrangements were made available in Melbourne, as well as the RBA's Head Office in Sydney.

Apart from the publication of the quarterly *Statement on Monetary Policy* and appearances before Parliamentary Committees, the Governors and senior officials addressed various public fora, giving 22 speeches during the year. The Governor spoke mainly about the economy, monetary policy and exchange-rate issues to organisations such as the Committee for Economic Development of Australia and the World Economic Forum Asian/Pacific Economic Summit. The Deputy Governor also spoke about the economy and monetary policy as well as a number of international financial issues, such as crisis management and exchange rate regimes in emerging markets. Assistant Governors and other senior officials gave addresses on related topics such as trends in the global economy, the economic outlook, financial markets and payment systems.

The RBA's Annual Conference in July 2000 was on "The Australian Economy in the 1990s", while the July 2001 Conference, the thirteenth, addressed issues concerning "Future Directions for Monetary Policies in East Asia". As in the past, this Conference brought together prominent economists from




THE GOVERNOR WITH MEMBERS OF THE HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION, OUTSIDE THE WAGGA WAGGA COUNCIL CHAMBERS, BEFORE THE HEARING IN DECEMBER 2000.

overseas as well as Australia. It discussed papers on the economic arguments for a common currency, an intermediate regime involving some co-ordination between countries, and inflation targeting with floating exchange rates.

As in previous years, the RBA made available in both hard copy and electronic format, the results of its research work. In 2000/01, seven *Research Discussion Papers* were published as well as a summary of research undertaken in 2000 in the January issue of the RBA *Bulletin*. Staff gave 28 presentations to specific academic audiences around Australia, including university seminars and conferences and seminars of economics teachers. The RBA also hosted visits by 13 groups of high school economics students to discuss its main policy functions and market operations.

A particular aspect of the RBA's economic and community liaison activities this year was the establishment of Regional Offices in Victoria, Queensland and Western Australia and the boosting of resources of the South Australian branch. The purpose of these offices is to enhance the channels for receiving information about local economic conditions and to improve communication generally between the RBA and local communities. Representatives of the RBA have commenced liaison with businesses across a wide range of industries in each State, including New South Wales. Relations have been also cultivated with the many industry associations residing in each State, State-based economic agencies, such as Treasuries and other departments involved in assessing economic conditions, and the academic community. This work is an important input to the RBA's overall assessment of economic developments.

During the year, the various parts of the RBA concerned with the production and distribution of information and with public relations have been brought together to form a new department – Information Department. This comprises a media and publications group, which manages all the key inter-related functions of production, distribution and media relations concerning online and hard-copy information services, and a document management group, which is responsible for the receipt, storage and internal distribution of the RBA's records and documents, including its archives. The Head of Information Department is a member of the RBA's Publications Committee, which is chaired by the Assistant Governor (Economic) and comprises representatives also from the three policy areas, plus the Secretary and the Head of Systems and Technology Department.

Hard-copy publications continue to be an important means of providing information to the public though demand has been declining over recent years reflecting increased use of the internet for accessing all the information published by the RBA. Apart from the *Annual Reports* to Parliament, the main publications are the monthly RBA *Bulletin*, which reproduces most public presentations by senior officers and provides a comprehensive array of statistics, the quarterly *Statement on Monetary Policy*, the Annual Conference volume and the *Research Discussion Papers*.

A comprehensive review of the Reserve Bank's website was completed during the year, with a revamped site launched at the end of March. The new site provides a greater volume of information about the RBA's activities as well as longer runs of historical data. A key objective in redesigning the site was to improve ease of access, with the technology used on the site designed to: ensure minimal download times, and efficient navigation with tools such as a search engine and frequently asked questions. The site also incorporates user-friendly features that, for example, better enable the printing of material from the site. Management of the website has been centralised under the new Information Department.

Facilitated by an online application process, there was a substantial rise in external use of the RBA's archives during the year. Thirty-one researchers from all States of Australia and overseas requested archival information with many of these conducting their research on-site with the assistance of the RBA's archives staff. The researchers included professional historians, students, post-graduates and writers who were interested in topics including numismatics, banking, domestic and international economic policy and biography.

The present polymer note display on the ground floor of the Head Office building will be developed into a more comprehensive currency note museum. This will draw fully on the Reserve Bank's archives of currency notes and related artefacts to communicate to the public the main features of the history of Australia's currency notes and their links with significant aspects of the nation's economic and social development. When finished, the currency note museum will be fully documented on the website to ensure that members of the public outside Sydney can "visit" the museum.

FINANCIAL AND OTHER CONTRIBUTIONS

As in other recent years, the RBA has continued to provide some financial support for certain projects undertaken by Australian universities. This support in the current year has included the ongoing provision of funding for a monthly survey of inflation expectations, undertaken by the Institute of Applied Economic and Social Research at the University of Melbourne, and for a quarterly survey of union inflation and wage expectations, organised by the Australian Centre for Industrial Relations Research and Training at the University of Sydney.

A financial contribution was also made in the past year towards the cost of holding two academic conferences: the 30th Conference of Economists, to be hosted later in the year in Perth at the University of Western Australia; and the annual PhD Conference in Economics and Business (held jointly by the Australian National University and the University of Western Australia). The RBA also supported the inaugural Elite Executive Honours Scholarship Program, organised by Axiss Australia, the agency established by the Federal Government to promote Australia's position as a global financial services centre; the RBA funded scholarships for two students in the first year of the Program, and undertook to fund a second year of the Program. In addition, the RBA provided the first of two annual contributions to meet the costs of distributing to a core group of policy-makers in Papua New Guinea and the Pacific Islands, the *Pacific Economic Bulletin*, which is produced by the Asia Pacific School of Economics and Management at the Australian National University. During the year, the RBA provided the second of two payments in support of the HC Coombs Memorial Medical Fellowship, sponsored by the Florey Trust in Melbourne, and named in honour of a former Governor of the RBA.

In the international arena, the RBA joined with a number of other central banks, and other institutions, to fund the reconstituted International Accounting Standards Committee, with the aim of establishing robust and internationally consistent accounting standards. The RBA also continued its practice of making an annual contribution to the Group of 30 to support its program of research and publications on issues in international finance.

As part of its broader interaction with the business community the RBA hosts and chairs the Small Business Finance Advisory Panel. The Panel was formed in 1993 and meets once a year to advise the RBA on issues relating to the provision of finance for small businesses. Membership of the Panel is drawn from a wide range of industries and from different parts of the country. The Panel provides an important source of information for the RBA in assessing the conditions being faced by small businesses.

During the year, the RBA contributed a total of $25 000 to 17 charitable organisations. As usual, 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. The Governor is the Chairman of the Foundation, which draws support from staff members of institutions in the financial markets and related fields and which raises money to be applied to research into medical and social problems affecting children.

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; the report for 1999/2000 was tabled in October 2000. The EEO Plan covering the period from July 2000 to June 2001 emphasised greater accountability of line supervisors in achieving EEO goals in relevant work areas. A new plan is currently being developed to set objectives for the coming three years.

Health and Safety, Compensation and Rehabilitation

The RBA is required by Section 74 of the *Occupational Health and Safety (Commonwealth Employment) Act 1991* and Section 107 of the *Safety, Rehabilitation and Compensation Act 1988* to report on health and safety, compensation and rehabilitation matters as they affect the RBA.

Systems for hazard management, which are a major part of compliance with OH&S standards, are well on the way to being implemented in the RBA's Head Office. These systems, which have been successfully implemented in the RBA's remaining branches, aim to reduce the number of reported incidents and injuries on the RBA's premises. The number of such incidents continues to be small, with four notifiable incidents reported under the *Occupational Health and Safety Act*, and seventeen claims for workers' compensation during 2000/01.

The RBA's Health and Safety Agreement places responsibility for hazard management on managers and supervisors. Information sessions for these staff on their respective roles will be completed by end August 2001. The RBA's Health and Safety Policy and OH&S Plan have again been reviewed and are being reissued.

The RBA was granted self-audit status for its Claims Management/Rehabilitation programs from 2000/01. The Claims Management/Rehabilitation Audit and the Management Systems Review and Improvement Program report were completed internally. This is the first year the RBA has submitted its own comprehensive audit report to the Safety Rehabilitation and Compensation Commission. The RBA again complied fully with the requirements of its Class 3 Licence.

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 *Financial Corporations Act 1974*, 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 website (www.rba.gov.au). Other documents held are 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*, including requests for access to documents, should be directed to the Secretary (in Head Office), the Managers of branches

ON 1 JANUARY 2001, A CENTENARY OF FEDERATION PARADE THROUGH THE STREETS OF SYDNEY FEATURED BANNERS DEPICTING AUSTRALIA'S POLYMER NOTES.

(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

Two requests for access to documents under the Act were received in 2000/01, the same number as in the previous year. For one request, access was granted in full; for the other request, access was denied in part, because the RBA held no documents containing the information sought, while the rest of the information sought was available in published form. There were no applications for internal review. One application, which had originally been received in February 1999 and subsequently referred to the Administrative Appeals Tribunal, was withdrawn by the applicant in September 2000; it had been met in part at the time the application was withdrawn. The cost of administering the Act in 2000/01 is estimated to have been approximately $88 990, compared with approximately $116 900 in the previous year; an application fee of $30 was collected by the RBA and no charges were made.

NOTE PRINTING AUSTRALIA

Note Printing Australia Limited (NPA) is a wholly owned subsidiary of the RBA. Based at Craigieburn in Victoria, NPA prints currency notes for Australia and a number of other countries on Guardian® polymer substrate. It was the pioneer of polymer banknote technology and remains the world's leading printer in this field.

NPA's Board comprises chairman Graeme Thompson (formerly a Deputy Governor of the RBA and now Chief Executive Officer of the Australian Prudential Regulation Authority), Dick 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). This Board oversees NPA's operations under broad policy direction from the Reserve Bank Board. NPA's Chief Executive is John Leckenby.

During 2000/01 NPA produced 276 million polymer banknotes. This was fewer than in the previous year because of a lower Australian requirement, due largely to the passing out of the Y2K bulge and to the much longer life of polymer notes. The new Federation $5 note was issued in January 2001 and accounted for about 25 per cent of total production. This note contains a number of new security features developed by NPA and not previously used on Australian banknotes.

With activity levels lower in the second half of the year, NPA took the opportunity to introduce new quality procedures into the print hall and finishing areas. In addition, trials were conducted to prove the viability of new security features developed by the NPA Research and Development Group, in conjunction with CSIRO. A new simultan offset press was commissioned so NPA now has backup on all key production processes as well as extra production capacity. Note processing at the new National Note Processing Centre (NNPC), established within NPA's Craigieburn printing works, commenced in June 2001 (see the chapter on "Business Services").

The development of polymer notes in Australia has now reached a point where our experience shows that their life is approximately five times that of paper. This longevity is generating substantially lower costs for both new note manufacture and processing costs. (Note processing costs have fallen significantly because polymer notes do not have to be returned for checking as often as their paper predecessors.) The consequence for NPA is further reduction in prospective demand for Australian notes. This was recognised last year in a new enterprise bargaining agreement with staff that allowed for greater flexibility in manning and rostering. This has been vital during periods of low demand.

NPA has continued to pursue export business, but new sales have been slow in coming in a very competitive and conservative market. Despite these difficulties, some export sales were achieved and three countries were added to the list of polymer note issuers.

Polymer Notes Export Orders

Year of first issue	Customer	Denomination	Issue
1990	Singapore	50 Dollar	Commemorative
1992	Western Samoa	2 Tala	Circulating
1992	Papua New Guinea	2 Kina	Circulating
1992	Kuwait	1 Dinar	Commemorative
1994	Indonesia	50 000 Rupiah	Commemorative/ circulating
1996	Brunei Darussalam	1, 5, 10 Dollar	Circulating
1996	Thailand	50, 500 Baht	Commemorative
1997	Thailand	50 Baht	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	500 000 Lei	Circulating
2000	Papua New Guinea	2, 10, 20, 50 Kina	Commemorative
2000	Bangladesh	10 Taka	Circulating
2001	Kuwait	1 Dinar	Commemorative
2001	Solomon Islands	2 Dollar	Circulating
2001	Mexico	20 Peso	Circulating

An important part of NPA's business is assisting customers of Securency Pty Ltd (see below) by producing for those customers an initial quantity of polymer notes. These customers have their own printing works but the initial production of notes by NPA is an integral part of the technology transfer process and provides assurance to the customer that NPA's experience will be available in the transition to polymer. Because of the close links between the RBA, NPA and Securency, overseas customers can also receive assistance in introducing the new notes into the community, and training in note processing, note handling and storage.

As well as finished banknotes, NPA can supply high-level security authentication systems to other issuers. This area has grown considerably during the year and some innovations have been achieved that will increase the life of the equipment and lower maintenance costs.

NPA's Research and Development program achieved a significant breakthrough during the year with a patent for the TIDE (Transparent Intaglio Disappearing Effect) security feature moving to the national examination phase. International examination of this patent will be carried out shortly. This print feature has been sold on banknotes already and creates an image that changes as the viewing angle changes. Two provisional patents were also applied for during the year.

NPA's systems are subject to regular audit and it maintains an ISO 9001 certificate. During the year a Risk Management Plan was developed and implementation commenced. All managers were involved in the process and progress towards treating the risks was reviewed by the RBA's auditors, with a satisfactory initial report. Comcare audited NPA's safety program during the year as part of a rolling program and confirmed that NPA was generally performing well.

SECURENCY

Securency Pty Ltd is the company 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 banknotes and Sentinel® for other high security documents such as land titles and share certificates. It produces Guardian® and Sentinel® by applying unique coatings and security features to specialised films manufactured by UCB.

Securency's Board comprises three representatives of the RBA, three appointed by UCB and the Managing Director (a non-voting member). Its offices and plant are located at Craigieburn close to NPA's operations and to a UCB films plant that was commissioned in 1999.

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

Securency Export Customers

Year of Issue	Customer	Product
1998	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	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 (for Romania)	100 000 Lei
2001	National Bank of Romania	50 000 Lei
2001	Central Bank of Mexico	20 Peso
2001	Bangladesh Bank	10 Taka





CHECKING SECURITY AND OTHER FEATURES IN A SHEET OF THE FEDERATION $5 NOTES, AT NOTE PRINTING AUSTRALIA, CRAIGIEBURN, VICTORIA.

Production levels for the past year have been at relatively low levels compared to the previous year, resulting in lower-than-budgeted earnings.

A major achievement was the supply of substrate to the Brazilian central bank and subsequent printing and issue of the 10 Reais banknote to the Brazilian market. This is the first polymer note to be issued in the Americas and has been well accepted by the Brazilian public. A further achievement has been the recently signed agreement for the supply of the 20 Peso circulating banknote in conjunction with NPA for the Mexican central bank. Securency has won an additional contract for the supply of substrate to the Mexican central bank over the next two years.

Other notable projects in the past year were orders supplied for Romania, China and Vietnam. By the end of 2001 all Romanian circulating banknotes will be produced on Guardian® substrate. The Bangladesh Bank announced that, following the successful issue of the 10 Taka note printed by NPA, it will progressively change all notes to polymer, with printing done in Bangladesh.

Several overseas note printers have run trials with Securency's Guardian® and are considering conversion from paper. All of the polymer notes issued in the world to date have been on this material. Securency's marketing efforts of the past year have seen a significant increase in interest around the world, and orders are being pursued with several encouraging prospects in Asia, Europe and South America.

Following the successful issuing of the Land Title in Taiwan and Share Certificates in Belgium, Securency has appointed a dedicated resource to exploit significant global interest generated for these products.

Significant investment continues to be undertaken in research and development that reflects the partners' commitment to remain the market leader in this area. Security features include the Diffractive Optical Element (DOE), which has been incorporated in the 2 000 Lei for Romania and the 100 Yuan for China. This had led to additional capital investment to enable this feature to be applied using a unique inline system designed by Securency. During the year Securency registered one additional patent and several provisional patents lodged in the previous year have moved to the national examination phase. The Self Authenticating patent application continues to progress despite challenge by a competitor.

ADMINISTRATION AND COSTS

With the RBA having absorbed major restructuring and staff reductions over a run of years, the management challenges of the past year were perhaps less demanding, although the business areas of the RBA continued to adjust to the highly competitive environment and some new areas of responsibility were resourced.

As discussed in the chapter on "Business Services", the new National Note Processing Centre (NNPC) commenced operation in June 2001, and the Sydney cash-processing function was closed. All of the RBA's note-processing activities are now centralised at the NNPC, which has a staff complement of 20, with a further 28 staff employed in Head Office to administer note-issue policy and conduct research on related matters. In the mid 1980s, about 650 staff were employed in note-issue activities at the RBA's Head Office and branches around Australia.

The final steps in reorganising banking operations in Sydney and Canberra were implemented, with staff employed in banking operations in the RBA set to fall to about 90, compared with about 850 in the mid 1980s. This further restructuring places the RBA in a good position to bid competitively as Commonwealth Government agencies continue the process of market-testing their transactional banking needs.

The scaling down of cash operations and banking services in recent years had been concentrated in the RBA's branches, most of which as a result had become unviable. The pressure on branches was aggravated by the loss of some State governments as banking customers. Over recent years, the RBA's branches in Melbourne, Brisbane, Perth, Hobart and Darwin have been closed. The branch in Canberra remains open to provide banking services to the Commonwealth, while that in Adelaide still conducts banking for the South Australian Government.

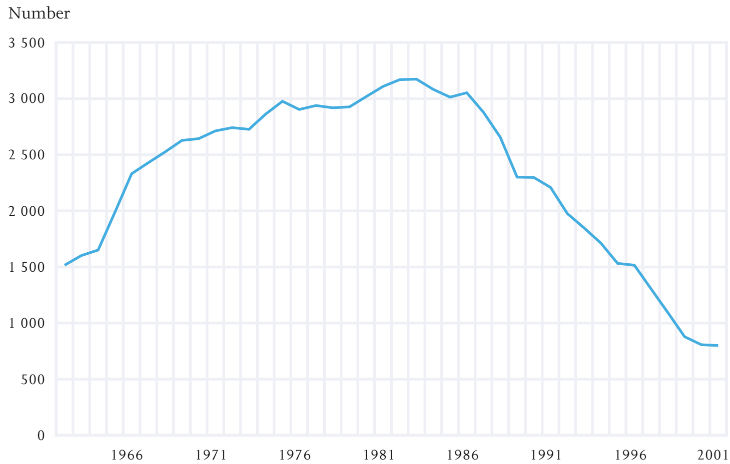
The RBA has now established Regional Offices in Melbourne, Brisbane and Perth, and placed an economist in the branch in Adelaide, to gather at first-hand intelligence about local economic conditions and to improve communication between the RBA and the community more generally. The number of staff engaged directly in analysing regional economies now totals about 15 and their activities are co-ordinated by Economic Analysis Department.

Following a review of the various channels by which the RBA provides information to the community, a new department, Information Department, was created with responsibility for the RBA's print and electronic information services and its relationship with the media. This change, in turn, permitted a streamlining of Secretary's Department, to give it a sharper focus on Board matters, relations with governments and legal affairs.

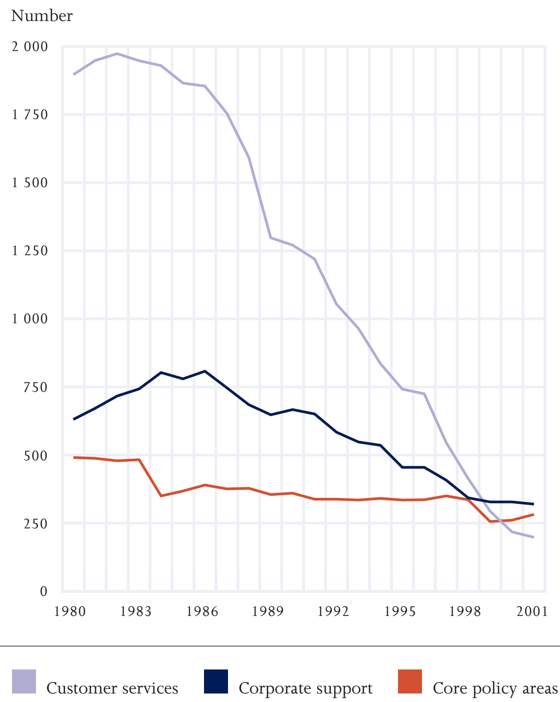
A range of personnel functions, which had previously been dispersed in a number of departments, was consolidated in Personnel Department, which has a brief to continue to develop policies more suitable to staffing a smaller organisation with a more mobile workforce. The Personnel Policy and Support Services Departments were abolished.

Overall in 2000/01, there was little change in the number of staff, at 800, as contraction in some parts of the RBA was offset by growth in new and expanded functions.

NUMBER OF RBA STAFF
As at 30 June, excluding NPA



NUMBER OF RBA STAFF
As at 30 June, excluding NPA



A process of modernising workplace arrangements in the RBA has been in train for some years. As occurred with senior staff in 1999/2000, the assistance of external consultants was sought during the past year to benchmark the responsibilities and remuneration for middle-managerial positions. Following this review, these staff were offered individual employment contracts, in which access to certain benefits, including rostered days and the provision of housing loans through the Officers' Homes Advances scheme, was discontinued. Most staff to whom these contracts were offered accepted them. About 33 per cent of the RBA's staff are now employed under individual employment contracts. Among senior and managerial staff, the proportion is over 80 per cent.

Changes in the conditions of other staff are generally negotiated as part of an enterprise bargaining agreement. A new enterprise agreement was negotiated during the past year, to apply to the calendar years 2001 and 2002. This agreement simplifies a number of the RBA's administrative practices in order to promote opportunities for part-time work, and enhance merit selection processes. Separately, access to the Officers' Homes Advances scheme will no longer be offered to new employees.

The Governors, staff employed under individual employment contracts and other staff received salary increases of 3.5 per cent in July 2000. Staff covered by the RBA's 2001 enterprise agreement received a further 3.8 per cent from July 2001.

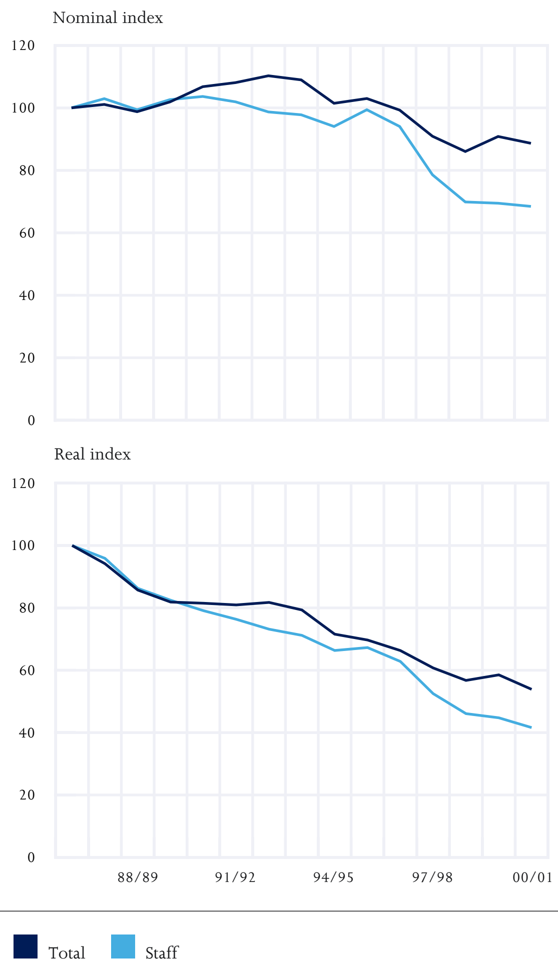
In order to continue to attract staff of high quality, the RBA reformed aspects of its recruitment practices in 2000/01. It also continued its commitment to the development of existing staff, with six staff currently undertaking full-time post-graduate study at universities in Australia and overseas under the Post-Graduate Study Award Scheme. This scheme is currently being reviewed to ensure that it remains appropriate to the RBA's needs. The RBA provided financial support to 64 staff undertaking part-time tertiary studies in Australia. Under the New Apprenticeship Scheme, the RBA employed 15 trainees in the fields of business administration, information technology and print design.

OPERATING COSTS

Notwithstanding the increase in salaries of 3.5 per cent in July 2000, staff costs fell, largely because of the full-year effect of closing branches and other savings in banking and note issue that occurred in 1999/2000. The RBA's total staff costs are now 30 per cent lower, in nominal terms, than they were in 1993/94. In real terms, the fall is much larger.

Total operating costs declined by more than staff costs in 2000/01 because costs in the previous year were boosted by expenses related to distributing currency around Y2K. Operating costs for 2000/01 are higher than in 1998/99, i.e. prior to the Y2K increase, partly because of the cost of establishing the Regional Offices. Nevertheless, as with staff costs, total operating costs are substantially lower, in nominal and real terms, than they were a decade ago.

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
Staff costs	96.7	93.0	98.3	93.0	77.7	69.1	68.7	67.7
Other costs	53.0	46.4	43.2	43.4	47.2	49.1	56.1	54.1
Underlying operating costs	149.7	139.4	141.5	136.4	124.9	118.2	124.8	121.8
Cost of redundancies	9.8	18.0	1.3	7.5	20.7	18.4	9.3	2.6

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

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

(a) Excludes NPA

The share of costs attributable to note distribution decreased in 2000/01, reflecting the reversal of the Y2K-related impact referred to above. Excluding this influence, however, the share of costs associated with note distribution has been on a downward trend for several years. This Y2K-effect also distorted the share of costs due to the RBA's other functions in 1999/2000. Looking beyond this, the share of costs related to monetary policy has tended to rise, partly due in 2000/01 to the effect of establishing the Regional Offices. The share from banking has tended to fall while that for providing settlement services had increased as the RTGS system was developed but has since steadied.

OCCUPATIONAL HEALTH AND SAFETY

The RBA holds a licence to self-insure and manage its workers' compensation claims. The licence has been renewed for a further three years by the Safety Rehabilitation and Compensation (SRC) Commission. While the RBA periodically reviews alternative insurance options, the small number of claims and low costs of in-house administration continue to favour self-insurance.

This year, the RBA presented the SRC Commission with the RBA's first Management Systems Review and Improvement Program (MSRIP) report. The MSRIP report assesses the effectiveness of systems for managing health and safety, compensation and rehabilitation programs. The report provides an overview of the RBA's OH&S performance, its claims experience and its rehabilitation record. On the basis of its performance during the year, the RBA's licence fee for 2001/02 will be 38 per cent lower than for the previous year.

FACILITIES MANAGEMENT

A major effect of the reduction in staff and closing of most branches is that the premises the RBA owns exceed its current needs. During the year, the RBA sold the building in which its branch in Brisbane had been located, for a sum of $13.5 million. The RBA has also begun negotiations to sell its buildings in Hobart and Perth. The building in Melbourne will be retained to support cash processing at the NNPC, house the RBA's Victorian Regional Office and accommodate external tenants.

While the reduction in the RBA's staffing was concentrated in the branches, the number of staff in Head Office has declined by about 40 per cent from its peak. After reviewing the use of the Head Office building, the RBA decided to make better use of the space available by consolidating its operations. This project, involving a major program of works, will convert currently under-used space into useable office space; consolidate the RBA's functions to use less space and do so more efficiently; and lease the resulting surplus space (about 20 per cent of the building) to suitable external tenants.

In accordance with the provisions of the *Public Works Committee Act 1969* the project was referred to the Joint Standing Committee on Public Works for consideration and report. The Committee's report, which followed a Public Inquiry and written submissions from the RBA and other interested parties, recommended that the works proceed at an estimated cost of $21.5 million. This recommendation was endorsed by Parliament in early December 2000.

Since the Parliament's approval, the detailed design of the project has been proceeding. Tenders for the main works were issued in mid May. These works are expected to begin in late August 2001 and continue for around 18 months. As part of a detailed design process, and in recognition of the heritage worth of the building, the RBA commissioned a conservation management plan and heritage impact statement to ensure that the proposed works would not impact adversely on the character of the building.

EARNINGS AND DISTRIBUTION

PROFITS AVAILABLE FOR DISTRIBUTION

The financial assets held by the Reserve Bank to implement monetary policy yield substantial profits each year. The profits available for distribution have two components – underlying earnings on the RBA's portfolio plus gains or losses that are realised when it sells assets in the course of implementing monetary policy or when undertaking operations to manage the composition of its international reserves.

Underlying earnings mainly reflect profits earned from the RBA's role as issuer of currency in Australia. Both currency – the RBA's largest liability – and its capital and reserves are interest-free liabilities. The RBA's underlying earnings come from investing these interest-free funds in interest-earning assets. They are determined mainly by the size of the balance sheet and the interest margin on assets relative to the cost of liabilities. Fees from services the RBA provides, such as from banking and settlement operations, also add to underlying earnings. But its operating costs and interest paid on some liabilities, such as Government deposits and Exchange Settlement accounts, subtract from them.

In 2000/01, underlying earnings were $1 629 million, an increase of about $118 million from the previous year. The increase in 2000/01 was due to growth in the size of the balance sheet as the interest margin was little changed from the previous year. Underlying earnings in the past couple of years have been lower than in the second half of the 1990s, reflecting the abolition of non-callable deposits of banks in July 1999. Since the interest rate paid on these deposits was 5 percentage points below the yield on Treasury notes, while they were invested at market yields, the abolition of non-callable deposits had the effect of reducing the RBA's earnings.

In addition to underlying earnings, the RBA also makes gains or losses due to changes in the value of its assets as prices change in relevant financial markets. Valuation gains on the RBA's portfolio arise when the price of the securities it holds increases as interest rates fall, or when exchange rates of foreign currencies in which the RBA holds assets appreciate against the Australian dollar. Losses are made when interest rates and exchange rates move against the RBA. The RBA realises gains (losses) when it sells securities or foreign exchange at a higher (lower) prices than the cost of these items in its balance sheet.

The RBA's approach to accounting for realised gains (losses) arising from foreign exchange swap transactions has been changed in the past year. In earlier years, sales of foreign exchange under a swap were treated in the same way as an outright sale, with the RBA booking a gain or a loss on the transaction as it occurred. The growth of the swap book, associated with the increased use of swaps for domestic liquidity management, prompted a review of this accounting treatment. The new approach brings the treatment of swaps into line with the long-standing treatment of repurchase agreements, which are structured in the same way as a foreign exchange swap (except that the underlying instrument is a security rather than foreign exchange).

The new treatment recognises that realised gains (losses) on one leg of a swap are exactly offset by unrealised losses (gains) on the other leg. The new approach no longer sees swap transactions immediately realise a gain or loss. While this changed approach has no effect on accounting profits, total realised gains (losses) will be smaller and less volatile than in the past. The RBA's measured realised gains and losses from foreign exchange will now reflect the outcome only of its outright sales of foreign exchange.

In 2000/01, lower interest rates abroad and the lower Australian dollar exchange rate favoured the RBA so that realised gains on its portfolio totalled about $1 200 million, compared with realised losses of $708 million the previous year. Out of the total realised gains, operations associated with managing international reserves saw realised gains on foreign investments of $558 million in 2000/01, with interest rates falling globally. This was offset by sales of domestic securities, related to implementation of monetary policy and assisting the Commonwealth to reduce its debt on issue, which realised a loss of $101 million. Operations in the foreign exchange market saw realised gains of about $743 million. In addition to the gains realised on its portfolio of financial assets, the RBA realised a valuation gain of about $5 million on the sale of its building in Brisbane, a sum which is also available for distribution.

Total earnings available for distribution – the sum of underlying earnings and realised gains – amounted to $2 834 million in 2000/01, compared with $803 million available from profits in 1999/2000. The payment from 1999/2000 profits was supplemented by $676 million deferred from the previous year, with a total payment to the Commonwealth Government of $1 479 million made early in the 2000/01 financial year.

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

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

ACCOUNTING PROFITS

Since 1998, the RBA has followed accepted accounting practice in calculating net accounting profit as the sum of underlying earnings plus valuation changes – both realised and unrealised – in the RBA's portfolio. Valuation changes resulted in gains totalling $1 520 million in 2000/01 which, with underlying earnings of $1 629 million, give a net accounting profit of $3 149 million (this compares with $2 292 million in 1999/2000).

In terms of the *Reserve Bank Act* and in line with international central banking practice, unrealised gains are not available to be paid to the Commonwealth Government. Unrealised gains are set aside in the Unrealised Profits Reserve as a buffer against future unrealised losses, or are realised when the relevant assets are sold.

RESERVES

Section 30 of the *Reserve Bank Act* provides for the Treasurer to determine, after consultation with the Board, the amount, if any, to be credited to the RBA's reserves from earnings available for distribution. The balance of distributable earnings, after any transfer to reserves, is payable to the Commonwealth Government.

Like other banks, the RBA holds capital and reserves to absorb losses that might arise in the course of its operations. While in past years the RBA had maintained two major reserves to deal with such contingencies, the Board decided to consolidate these into the one fund, the Reserve Bank Reserve Fund (RBRF). The balance in the enlarged RBRF stood at $6 152 million on 30 June 2001, the equivalent of 10.6 per cent of the RBA's total assets. The Board regarded this level of reserves as adequate and saw no need to seek from the Treasurer any transfer from profits to the RBRF. Accordingly, all of the funds available for distribution from the RBA's profits in 2000/01 will be paid to the Commonwealth. The practice in recent years has been for the Commonwealth's dividend to be paid 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 Reserve Bank has not made an interim payment from the current year's earnings since 1995/96.

The RBA also maintains unrealised profits and asset revaluation reserves, with the balances in these reserves reflecting the amount by which the market value of the RBA's traded assets, gold and property holdings exceed the price at which they were purchased. They are not available for distribution to the Government until they are realised. The amounts in these reserves vary with market prices but at 30 June 2001 stood at $3 239 million.

The total amount of earnings available for distribution from profits earned in 2000/01 was paid to the Commonwealth Government in August 2001.

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	-	-	-	-	2 834	-	2 834

The RBA's 2000/01 Financial Statements are presented in the following pages.

FINANCIAL STATEMENTS

2001 As at 30 June 2001

STATEMENT OF FINANCIAL POSITION As at 30 June 2001

Reserve Bank of Australia and Controlled Entities

	Note	2001 $M	2000 $M
ASSETS			
Cash and liquid assets	5, 18	680	821
Australian dollar securities	1(d), 17	19 814	22 935
Foreign exchange	1(c), 17	35 786	30 228
Gold	1(b), 17	1 381	1 251
Property, plant and equipment	7	280	292
Loans, advances and other	6	172	167
Total Assets		58 113	55 694
LIABILITIES			
Deposits	8	16 864	15 486
Distribution payable to Commonwealth		2 834	1 479
Other liabilities	9	1 816	4 329
Australian notes on issue	1(j)	27 168	25 434
Total Liabilities		48 682	46 728
Net Assets		9 431	8 966
Capital and Reserves			
Reserves:			
Unrealised Profits Reserve	4	1 809	1 489
Asset revaluation reserves	4	1 430	1 285
Reserve for Contingencies and General Purposes	4	-	3 323
Reserve Bank Reserve Fund	4	6 152	2 829
Capital		40	40
Total Capital and Reserves		9 431	8 966

STATEMENT OF FINANCIAL PERFORMANCE For year ended 30 June 2001

Reserve Bank of Australia and Controlled Entities

	Note	2001 $M	2000 $M
REVENUES			
Interest revenue	2	2 685	2 296
Net gains/(losses) on securities	2	1 520	781
Dividend revenue	2	3	3
Fees and commissions	2	18	17
Other revenue	2	46	79
Total Revenue		4 272	3 176
EXPENSES			
Interest expense	2	955	670
General administrative expenses	2	147	184
Other expense	2	21	30
Total Expenses		1 123	884
Net Profit		3 149	2 292
Net revaluation adjustments in asset revaluation reserves	4	150	240
Net profit plus net revaluation adjustments in asset revaluation reserves	4	3 299	2 532

STATEMENT OF DISTRIBUTION For year ended 30 June 2001

Reserve Bank of Australia and Controlled Entities

	Note	2001 $M	2000 $M
Net Profit		3 149	2 292
Transfer to unrealised profits reserve	4	(320)	(1 489)
Transfer from asset revaluation reserves	4	5	-
Earnings available for distribution		2 834	803
Distributed as follows:			
Payable to the Commonwealth of Australia		2 834	803

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2001

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 have been amended to incorporate the requirements of Order Number 3 of the Commonwealth Authorities and Companies (Financial Statements 2000-2001) Orders. Policy 1.9 of Schedule 1 of this Order provides:-

> "Commonwealth entities that are classified as financial institutions (for example Reserve Bank of Australia), must comply with Australian Accounting Standards (including AAS32, entitled Specific Disclosures by Financial Institutions). In the event of a conflict between the requirements of the standards and this Schedule, the Commonwealth entity classified as a financial institution must comply with the requirements of the standards."

The Reserve Bank of Australia (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 loans gold to financial institutions participating in the gold market. Gold loans are secured to 110% 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, Japan and Germany) 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 and has purchased call options.

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 bi-annual 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 2001 (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 and call options are off-balance sheet items. The RBA did not trade in any other derivative instruments during 2000/01.

(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 bi-annually 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 but 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 held but 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. In the past, the RBA maintained two major reserve funds: the Reserve Bank Reserve Fund (RBRF) provided for potential losses from fraud and other non-insured losses; and the Reserve for Contingencies and General Purposes (RCGP) which provided for events which were contingent and non-foreseeable, mainly those which arise from movements in market values of the RBA's holdings of Australian dollar and foreign securities. During 2000/01 the Board reviewed the structure and adequacy of the Bank's capital and reserves. The decision was made to transfer the funds in the RCGP to the RBRF, and to close the RCGP. On 30 June 2001, balances formerly held in the RCGP were transferred to the RBRF, and the RCGP was closed. The RBRF is now a general reserve providing for all risks previously covered by both the RBRF and RCGP. 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 AAS30. 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 2000/01, or in 1999/2000.

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

(l) Exemptions The RBA has been granted exemptions from the following requirements of Order Number 3 of the Commonwealth Authorities and Companies (Financial Statements 2000-2001). Orders:–

Requirement	Description	Detail of exemption
Policy 10	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 10 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	2001 $M	2000 $M
Note 2 NET PROFITS			
Interest revenue			
Overseas investments	1 (c)	1 480	1 137
Australian dollar securities	1 (d)	1 147	1 107
Overnight settlement systems		39	27
Gold loans		17	21
Other		2	4
		2 685	2 296
Net gains/(losses) on securities			
Overseas investments		485	(232)
Australian dollar securities		(96)	(128)
Foreign currency	1 (c)	1 131	1 141
		1 520	781
Dividend revenue			
Earnings on shares in Bank for International Settlements	6	3	3
Fees and commissions			
Banking services fees received		18	17
Other revenue			
Reimbursement by Commonwealth for loan management and registry expenses		1	2
Rental of Bank premises		9	7
Sales of note products		22	55
Other		14	15
		46	79
Total		4 272	3 176
Less:			
Interest expense			
Deposit liabilities		702	459
Repurchase agreements	1 (e)	253	211
		955	670
General administrative expenses			
Staff costs		83	89
Special redundancy/retirement payments	11	3	10
Depreciation of property	7	7	7
Depreciation of plant and equipment	7	9	8
Premises and equipment		25	26

	Note	2001 $M	2000 $M
Note 2 (CONTINUED)			
Materials used in note production		10	25
Travel		3	3
Consultants' fees	13	2	2
Other		5	14
		147	184
Other expenses			
Agency business reimbursement		1	1
Subsidiary income tax		1	5
Cash distribution expenses		4	8
Other		15	16
		21	30
Total		1 123	884
Net Profit		3 149	2 292

Note 3 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2001

	Average Balance $M	Interest $M	Average Interest Rate %
Interest revenue			
Overseas investments	35 719	1 480	4.1
Australian dollar securities	17 577	1 147	6.5
Loans, advances and other	51	2	3.9
Overnight settlements	695	39	5.6
Gold loans	1 283	17	1.3
	55 325	2 685	4.9
Interest expense			
Exchange settlement accounts	879	50	5.6
Deposits from governments	11 387	643	5.7
Deposits from overseas institutions	514	3	0.5
Overseas repurchase agreements	4 435	213	4.8
Domestic repurchase agreements	690	40	5.8
Other deposits	120	6	5.1
	18 025	955	5.3
Analysis for the year ended 30 June 2000			
Interest revenue total	48 117	2 296	4.8
Interest expense total	13 414	670	5.0

Note 4 RESERVES

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

	2001 $M	2000 $M
Asset revaluation reserves (Note 1(g))		
Gold		
Opening balance	1 125	903
Net revaluation adjustments	135	222
As at 30 June	1 260	1 125
Shares in international financial institutions (Note 6)		
Opening balance	64	63
Net revaluation adjustments	4	1
As at 30 June	68	64
Bank properties (Notes 1(f), 7)		
Opening balance	96	79
Net revaluation adjustments	11	17
Transfers to Statement of Distribution	(5)	-
As at 30 June	102	96
Total asset revaluation reserves		
Opening balance	1 285	1 045
Net revaluation adjustments	150	240
Transfers to Statement of Distribution	(5)	-
As at 30 June	1 430	1 285
Unrealised profits reserve (Note 1(g))		
Opening balance	1 489	-
Net transfers from Statement of Distribution	320	1 489
As at 30 June	1 809	1 489
Reserve for Contingencies and General Purposes (Note 1(g))		
Opening balance	3 323	3 323
Transfer to Reserve Bank Reserve Fund	(3 323)	-
Closing balance	-	3 323
Reserve Bank Reserve Fund (Note 1(g))		
Opening balance	2 829	2 829
Transfer from Reserve for Contingencies and General Purposes	3 323	-
Closing balance	6 152	2 829

	2001 $M	2000 $M
Note 4 (CONTINUED)		
Capital		
Opening and closing balance	40	40
Total capital and reserves		
Opening balance	8 966	7 237
Net profit plus net revaluation adjustments in asset revaluation reserves	3 299	2 532
Distribution to Commonwealth of Australia	(2 834)	(803)
Closing balance	9 431	8 966

Note 5 CASH AND LIQUID ASSETS

This includes net amounts of $565 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 $690 million was owed to the RBA at 30 June 2000.

	2001 $M	2000 $M
Note 6 LOANS, ADVANCES AND OTHER ASSETS		
Shareholding in Bank for International Settlements	70	66
Officers' Home Advances	35	42
Gold coin	18	16
Investment in Securency	9	11
Other	40	32
As at 30 June	172	167

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 2000/01 was $21 530 001; the carrying value of the RBA's investment in Securency was $8 649 000 (2000 - $11 183 000). Securency Pty Ltd has a 31 December balance date.

Note 7 PROPERTY, PLANT AND EQUIPMENT (Note 1(f))

	2001 $M	2000 $M
Properties		
Opening balance	246	235
Additions	-	1
Disposals	(13)	-
	233	236
Depreciation prior to revaluation	(7)	(7)
Book valuation prior to revaluation	226	229
Net revaluation adjustments (Note 4)	11	17
As at 30 June	237	246
The triennial independent revaluation of all Bank properties occurred at 30 June 2001.		
Plant and equipment		
Opening balance	114	93
Additions	6	24
Disposals	(2)	(3)
	118	114
Accumulated depreciation	(75)	(68)
As at 30 June	43	46
Total property, plant and equipment	280	292

Note 8 DEPOSITS

	2001 $M	2000 $M
Banks		
Exchange Settlement accounts	839	1 164
Government & government instrumentalities		
Commonwealth	14 947	13 437
State	455	343
Foreign governments, foreign institutions and international organisations	506	418
Other depositors	117	124
As at 30 June	16 864	15 486

	2001 $M	2000 $M
Note 9 OTHER LIABILITIES		
Provisions (Note 1(i))		
Provision for accrued annual leave	7	7
Provision for long service leave	19	19
Provision for post-employment benefits	53	51
Provision for workers' compensation	1	1
As at 30 June	80	78
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1 (e))	1 654	4 137
Interest accrued on deposits	64	90
Other	18	24
As at 30 June	1 736	4 251
Total other liabilities	1 816	4 329

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

Contingencies

The RBA has a contingent liability, amounting to $74.7 million at 30 June 2001 ($67.4 million at 30 June 2000), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

A contingent liability of $4.6 million exists for remediation work to be carried out on Bank premises.

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 $2.3 million commitments at 30 June 2001 ($1.2 million at 30 June 2000) payable within one year; and no commitments payable beyond one year ($0.6 million at 30 June 2000).

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 2000/01 include $3 million paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 1999/2000 totalled $10 million. Staff leaving the RBA in 2000/01 under these arrangements numbered 46 (99 in 1999/2000).

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 2001	Number 2000
$100 000 – $109 999	1	2
$110 000 – $119 999	6	8
$120 000 – $129 999	7	11
$130 000 – $139 999	15	15
$140 000 – $149 999	11	5
$150 000 – $159 999	4	8
$160 000 – $169 999	4	4
$170 000 – $179 999	4	4
$180 000 – $189 999	7	
$200 000 – $209 999	1	
$210 000 – $219 999		8
$220 000 – $229 999	2	
$230 000 – $239 999	5	1
$240 000 – $249 999	1	
$250 000 – $259 999	1	
$260 000 – $269 999		5
$290 000 – $299 999	4	
$310 000 – $319 999		1
$320 000 – $329 999	1	
$470 000 – $479 999		1
$480 000 – $489 999	1	

Total remuneration received or due and receivable by these 75 executives amounted to $12.913 million (73 executives totalling $11.933 million in 1999/2000). 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).

This table has been expanded to include all members of the Reserve Bank's senior management group. A major reason for this change is that the RBA's senior managers are now employed on similar contractual terms to the executives included in the comparable table in previous Annual Reports. Comparative figures for 1999/2000 have been adjusted accordingly.

Termination payments of $1.113 million were made to executives who left the Bank during 2000/01 ($0.346 million in 1999/2000); 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 $165 000 in 2000/01 ($165 000 in 1999/2000). 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 2000/01, payments to executive and non-executive Board members totalled $1 022 388 ($1 016 312 in 1999/2000). 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 2001	Number 2000
$1 – $9 999	1	
$10 000 – $19 999	1	
$20 000 – $29 999	1	
$30 000 – $39 999	2	5
$40 000 – $49 999	1	
$50 000 – $59 999		1
$60 000 – $69 999	1	
$310 000 – $319 999		1
$320 000 – $329 999	1	
$470 000 – $479 999		1
$480 000 – $489 999	1	

The RBA is not empowered to lend to non-executive members of the Board. Loans to the Governor and Deputy Governor are permitted only in terms of Section 71 of the *Reserve Bank Act*; at 30 June 2001 and 30 June 2000, there were no such loans.

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, $78 500 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 ($68 454 in 1999/2000). The RBA also paid $145 317 for the services of members of the Payments System Board who are not employees of the RBA ($101 534 in 1999/2000).

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 are 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 2000/01.

At 30 June 2001, the OSF had a surplus of assets over accrued benefits of $228 million ($224 million at 30 June 2000). The UK Pension Scheme had a surplus equivalent to $5 million ($5 million at 30 June 2000). During 2000/01, the RBA made superannuation contributions of $2.2 million ($3.1 million in 1999/2000).

Details of the Funds as at 30 June 2001 are as follows:

	2001 $M	2000 $M
Reserve Bank Officers' Superannuation Fund		
Accrued benefits	388	385
Net market value of assets	616	609
Surplus	228	224
Vested benefits	401	398
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	21	20
Net market value of assets	26	25
Surplus	5	5
Vested benefits	20	20
Total Superannuation Funds		
Accrued benefits	409	405
Net market value of assets	642	634
Surplus	233	229
Vested benefits	421	418

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 operates as a central bank, predominantly in one geographical area.

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.

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 %
Assets								
Gold								
Gold loans	1 322	-	307	779	222	-	14	1.6
Gold holdings	59	-	-	-	-	-	59	n/a
Sub-total	**1 381**							
Foreign exchange								
Securities sold under repurchase agreements	-	-	-	-	-	-	-	
Securities purchased under repurchase agreements	5 244	-	5 244	-	-	-	-	4.6
Deposits and other securities	30 222	391	12 206	2 947	6 787	7 750	141	3.1
Accrued interest – foreign exchange	320	-	-	-	-	-	320	n/a
Sub-total	**35 786**							
Australian dollar securities								
Securities sold under repurchase agreements	1 654	-	-	396	485	773	-	4.8
Securities purchased under repurchase agreements	14 879	-	14 879	-	-	-	-	4.9
Other securities	3 174	-	1	910	1 194	1 069	-	5.3
Accrued interest – Australian dollar securities	107	-	-	-	-	-	107	n/a
Sub-total	**19 814**							
Property, plant & equipment	280	-	-	-	-	-	280	n/a
Cash and liquid assets	680	577	-	-	-	-	103	4.8
Other assets	172	35	-	-	-	-	137	3.4
Total assets	**58 113**	1 003	32 637	5 032	8 688	9 592	1 161	3.8
Liabilities								
Australian notes on issue	27 168	-	-	-	-	-	27 168	n/a
Deposits	16 864	3 464	13 400	-	-	-	-	4.8
Profit distribution	2 834	-	-	-	-	-	2 834	n/a
Other	1 816	-	1 654	-	-	-	162	4.8
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								
Interest rate futures	(287)	-	-	-	-	(287)	-	n/a

Note 17 (CONTINUED)

Interest rate risk

As at 30 June 2000

	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	55 694	892	37 065	3 941	6 250	6 288	1 258	5.1
Total liabilities	46 728	6 286	13 107	400	-	-	26 935	2.4
Capital and reserves	8 966							
Total balance sheet	55 694							
Off balance sheet items	(149)	-	(379)	-	147	83	-	n/a

Other liabilities includes amounts outstanding under sale repurchase agreements.
All recognised financial instruments are shown at net fair value.
Off-balance sheet items are shown at nominal market value (difference from net fair value is negligible).

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

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

Credit risk

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

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

As part of an IMF support package during 1997/98, 1998/99, 1999/2000 and 2000/01 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 2001 was the equivalent of $1.4 billion Australian dollars ($1.4 billion at 30 June 2000), on which the RBA is earning a yield of 4.4% (6.15% in 1999/2000). The swaps represent 2.4% of the RBA's total assets as at 30 June 2001 (2.6% at 30 June 2000).

Note 17 (CONTINUED)

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

1. ***Foreign exchange swaps*** – As at 30 June 2001 the RBA was under contract to purchase $16.7 billion of foreign currency and sell $45.6 billion of foreign currency. As of that date there was an unrealised net gain included in net profit of $256 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 2001 about 0.91% of the RBA's foreign currency reserves (excluding gold) were hedged through interest rate futures contracts. The amount of credit risk on these contracts was approximately $3.6 million ($2.5 million at 30 June 2000). As at 30 June 2001 there was an unrealised gain brought to account on those contracts of $0.3 million ($0.2 million unrealised loss at 30 June 2000).

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 table

Security type	Risk rating of security issuer*	Risk rating of counterparties*	% of total asset portfolio as at 30/6/01	% of total asset portfolio as at 30/6/00
Australian dollar securities				
Holdings of Commonwealth Government securities	AAA	n/a	5.7	12.4
Securities sold under repurchase agreements	AAA	AA	2.8	0.0
Securities held under repurchase agreements	AAA	AA	24.0	24.4
	AAA	other	0.4	1.5
	AA	AA	0.9	2.7
	AA	other	0.3	0.2
Foreign investments				
Holdings of securities	AAA	n/a	25.6	11.3
	AA	n/a	16.8	11.9
Securities sold under repurchase agreements	AAA	AA	0.0	5.4
	AAA	other	0.0	1.9
Securities held under repurchase agreements	AAA	AA	5.4	6.8
	AAA	other	3.6	3.9
Deposits	n/a	AAA	0.3	7.3
	n/a	AA	7.4	3.1
	n/a	other	2.4	2.7
Gold loans	n/a	AAA	0.3	0.3
	n/a	AA	1.5	1.4
	n/a	other	0.5	0.5
Other			2.1	2.3
			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 AAS28; 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 2001

	2001 Inflow/(outflow) $M	2000 Inflow/(outflow) $M
Cash flows from operating activities		
Interest received on investments	2 274	2 022
Interest received on loans, advances, and on net overnight settlements systems	41	36
Loan management reimbursement	1	2
Banking service fees received	19	17
Rents received	9	7
Net payments for and proceeds from sale of investments	(3 299)	(5 344)
Interest paid on deposit liabilities	(728)	(388)
Staff costs (including redundancy)	(84)	(99)
Premises, equipment and stores	(25)	(26)
Other	15	21
Net cash provided by operating activities	(1 777)	(3 752)
Cash flows from investment activities		
Net expenditure on property, plant and equipment	9	(22)
Net cash used in investing activities	9	(22)
Cash flows from financing activities		
Profit payment to Commonwealth	(1 479)	(3 000)
Net movement in deposit liabilities	1 379	5 103
Net movement in loans and advances	7	16
Net movement in notes on issue	1 733	1 882
Other	(13)	7
Net cash provided by financing activities	1 627	4 008
Net increase/(decrease) in cash	(141)	234
Cash at beginning of financial year	821	587
Cash at end of financial year	680	821

Note 18 (CONTINUED)

Reconciliation of cash	30 June 2001 $M	30 June 2000 $M
Cash	115	131
Overnight settlements system	565	690
	680	821

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act*	2001 $M	2000 $M
Net profit	3 149	2 292
Increase in interest payable	(26)	72
Increase in interest receivable	-	2
Net loss/(gain) on overseas investments	(743)	232
Net loss/(gain) on Australian dollar securities	(457)	128
Net loss/(gain) on foreign currency	(320)	(1 141)
Increase in income accrued on investments	(100)	(8)
Depreciation of property	7	7
Depreciation of plant and equipment	9	8
Net payments for and proceeds from sale of domestic and foreign investments	(3 299)	(5 344)
Other	3	-
Net cash provided by operating activities	(1 777)	(3 752)

DIRECTORS' STATEMENT

In the opinion of the directors, the financial statements for the year ended 30 June 2001 give a true and fair view of the matters required by Schedule 1 to the Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*.

IJ Macfarlane

Chairman, Reserve Bank Board
9 August 2001

Auditor-General for Australia

Australian National
Audit Office

INDEPENDENT AUDIT REPORT

To the Treasurer

Scope

I have audited the financial statements of the Reserve Bank of Australia for the year ended 30 June 2001. 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 2000-2001) 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 2000-2001) Orders, of the financial position of the Reserve Bank of Australia as at 30 June 2001 and the results of its operations and its cash flows for the year then ended.

P J Barrett

P. J. Barrett
Auditor-General

Sydney
9 August 2001

GPO Box 707 CANBERRA ACT 2601
Centenary House 19 National Circuit
BARTON ACT
Phone (02) 6203 7500 Fax (02) 6273 5355
Email barrep@anao.gov.au

PRO FORMA BUSINESS ACCOUNTS

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

	Transactional Banking Business		RITS		Registry	
	1999/2000 $ million	2000/01 $ million	1999/2000 $ million	2000/01 $ million	1999/2000 $ million	2000/01 $ million
Revenue						
– Service fees	14.9	16.4	3.1	2.7	1.9	1.5
– Other revenue	4.6	6.0	0.2	0.2	0.1	0.1
Total	19.5	22.4	3.3	2.9	2.0	1.6
Expenditure						
– Direct costs	11.4	10.8	2.4	2.6	1.0	0.6
– Indirect costs	4.9	3.6	0.5	0.5	0.6	0.3
Total	16.3	14.4	2.9	3.1	1.6	0.9
Net profit/(loss)	3.3	8.0	0.4	-0.2	0.4	0.7
Net profit/(loss) after taxes [(a)]	2.1	5.4	0.2	-0.2	0.2	0.5
Assets [(b)]						
– Domestic market investments	681.8	772.2	3.4	4.1	2.4	1.6
– Other assets	13.8	12.3	1.6	0.8	0.2	0.1
Total	695.6	784.5	5.0	4.9	2.6	1.7
Liabilities [(b)]						
– Capital & reserves	25.0	25.0	4.0	4.0	2.0	1.0
– Deposits	663.3	751.5				
– Other liabilities	7.3	8.0	1.0	0.9	0.6	0.7
Total	695.6	784.5	5.0	4.9	2.6	1.7

(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

The *Reserve Bank Act 1959* provides the core source of the RBA's governance mandate with Sections 8A and 10 giving the Reserve Bank Board clear responsibility for the RBA's "monetary and banking policy". The relationship of the Board with 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 and Deputy Governor 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 augmented this over time, in order to keep the RBA's policy-making process relevant to the evolving environment, and in parallel with developments overseas. After the current Government came to power 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 higher 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, the RBA's role as prudential supervisor for banks passed to it. The RBA retained responsibility for overall financial system stability – the Treasurer's statement in Parliament of 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 main focus of discussions at the Board's meetings each month is on monetary policy. This discussion occurs against the background of papers prepared by RBA staff about developments in the domestic and foreign economies, and in financial markets. These papers are supplemented by staff presentations at each Board meeting.

The *Reserve Bank Act* 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 Governor-General – a total of nine; at 30 June 2001, there was one vacant position on the Board and, subsequently, Professor WJ McKibbin was appointed as a member of the Board, commencing from 31 July 2001. Five members form a quorum for a meeting of the Board.

In terms of Section 17(1) of the *Reserve Bank Act*, 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 Board meets eleven times each year, on the first Tuesday of each month, except January. Meetings are generally held at the RBA's Head Office in Sydney but occasionally the Board meets in other State capitals. During 2000/01, the Board met twice in Melbourne and once in Perth.

The number of meetings attended by each member in 2000/01 was:

IJ Macfarlane	11	(11)
SA Grenville	11	(11)
EA Evans	9	(9)
KR Henry	2	(2)
JR Broadbent	11	(11)
AR Jackson	5	(6)
FP Lowy	9	(11)
DG McGauchie	3	(3)
HM Morgan	9	(11)
AR Pagan	3	(5)
RFE Warburton	10	(11)

(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:

- assist the Governor and the Board in fulfilling their obligations relating to financial reporting, internal control and compliance with laws, regulations, business ethics and employee conflicts of interest, and fraud;
- enhance contact between management and the Audit Department;
- encourage high-quality auditing of the RBA's activities; and
- strengthen audit independence.

The Committee also acts, at the request of the NPA Board, as NPA's Audit Committee.

The Audit Committee is made up of SA Grenville, Deputy Governor (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 2000/01, the Committee met on four occasions; all members attended each of these meetings.

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 CAC Act* was amended in 1999 to incorporate reforms in the *Corporate Law Economic Reform Program* (CLERP) *Act 1999*, rewriting the conduct provisions in the Corporations Law relating to the duties of directors and other officers.

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 7 August 2001, they resolved that the Chairman sign the Report, and the Financial Statements as at 30 June 2001, 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. On 5 March 2001, the Committee tabled in the Parliament an interim report on the 2000 *RBA Annual Report*, the 2000 *Payments System Board Annual Report*, the Committee's 1 December 2000 public hearing with the RBA in Wagga Wagga and the associated November 2000 *Statement on Monetary Policy*. The Committee held another public hearing with the RBA in Melbourne on 11 May 2001, and on 25 June 2001 it tabled a report based on further discussions at this public hearing on the Annual Reports for 2000 of both the Reserve Bank Board and the Payments System Board, as well as the May 2001 *Statement on Monetary Policy.*

REMUNERATION

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

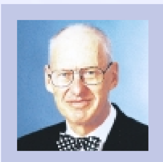
INDEMNITIES

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



SA Grenville

Deputy Governor since 1 December 1996
Present term expires 30 November 2001

KR Henry

Secretary to the Treasury
Member since 27 April 2001

JR Broadbent

Member since 7 May 1998
Present term expires 6 May 2003
Director – Coca Cola Amatil 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 – Woolstock Australia Limited
Deputy Chairman – Australian Wool Testing Authority Limited
Director – Telstra Corporation Limited
Chairman – Telstra Country Wide Advisory Board
Director – Australian Centre for International Agriculture Research
Director – GrainCorp Limited
Director – National Foods Limited
Director – Ridley Corporation Limited

HM Morgan AO
Member since 14 August 1996
Present term expires 28 July 2002
Managing Director and
Chief Executive – WMC Limited
Director – Alcoa Inc
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 – Goldfields Limited
Chairman – HIH Claims Support Limited*
Director – Note Printing Australia Limited
Director – Nufarm Limited
Director – Southcorp Limited
Director – Tabcorp Holdings Limited

* Non-profit company formed to process the Commonwealth Government support package for HIH policy-holders in hardship.

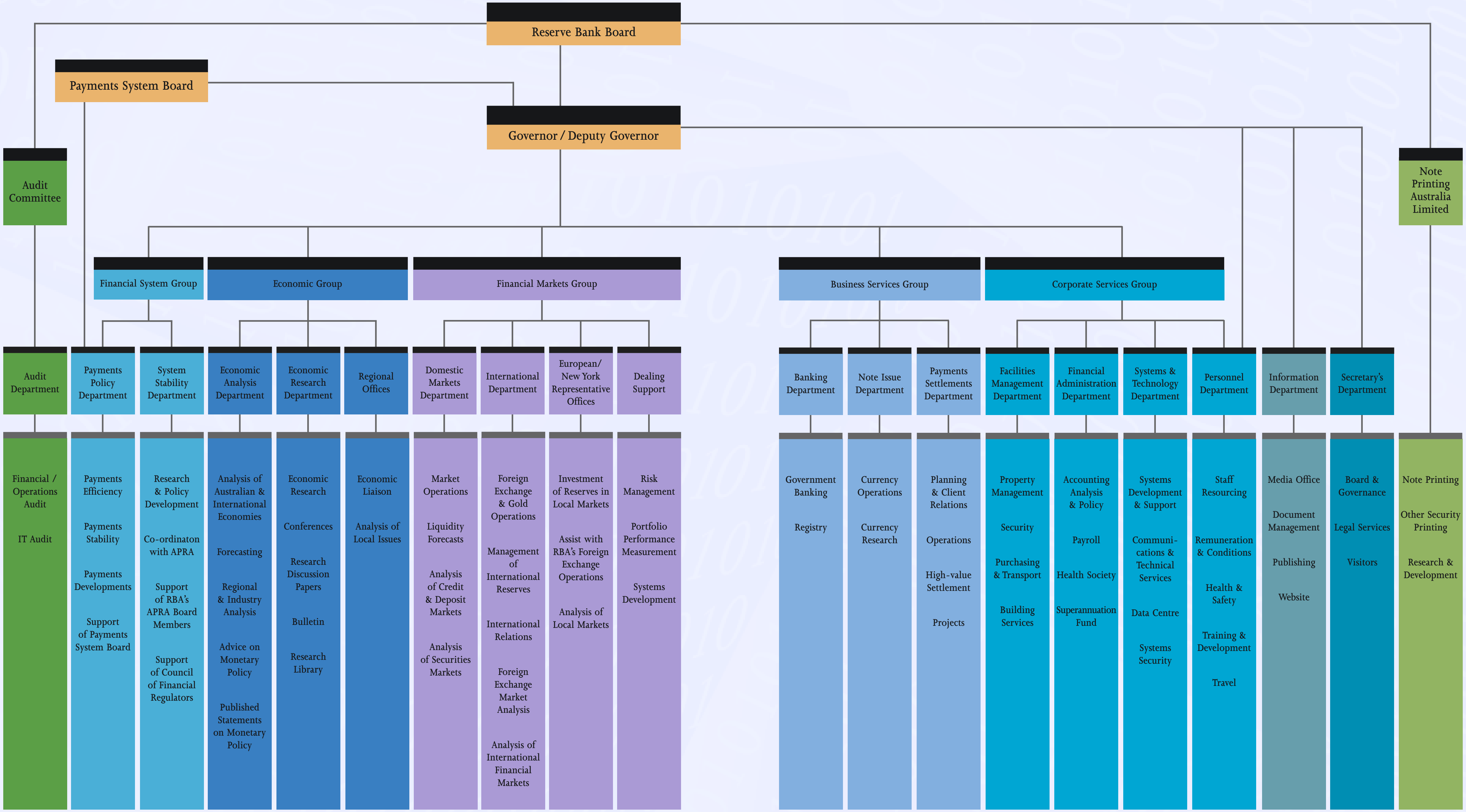
Professor WJ McKibbin was appointed a member of the Reserve Bank Board from 31 July 2001, replacing Professor AR Pagan, whose term ended on 28 November 2000. Professor Pagan had been a member of the Board since 29 November 1995.

The term of Mr AR Jackson AO as a member of the Reserve Bank Board ended on 28 January 2001; he had been a member of the Board since 29 January 1991. He was replaced on 30 March 2001 by Mr DG McGauchie.

Mr EA Evans AC ceased to be a member of the Reserve Bank Board following his retirement as Secretary to the Treasury on 26 April 2001. Mr Evans had been a member of the Board since 10 May 1993. Dr KR Henry was appointed Secretary to the Treasury from 27 April 2001 and became a member of the Reserve Bank Board from that date.

ORGANISATIONAL CHART

JULY 2001



GLOSSARY

ACCC	Australian Competition and Consumer Commission
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
BIS	Bank for International Settlements
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CGS	Commonwealth Government securities
CHESS	Clearing House Electronic Subregister System of the Australian Stock Exchange
CLS	Continuous linked settlement
CSIRO	Commonwealth Scientific and Industrial Research Organisation
CVS	Cheque Verification System
DoFA	Department of Finance and Administration
EEO	Equal employment opportunity
EMEAP	Executives' Meeting of East Asia-Pacific central banks
G10	Group of Ten
G20	Group of Twenty
GDP	Gross domestic product
GOS	Gross operating surplus
GST	Goods and Services Tax
HLI	Highly leveraged institution
IMF	International Monetary Fund
NNPC	National Note Processing Centre
NPA	Note Printing Australia Limited
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

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End June 2001

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