Governor's Foreword

Following the practice started last year, this Report aims to be primarily an account of the Reserve Bank's activities in 1997/98, rather than a commentary on economic developments. Even with that aim in mind, however, it is impossible to avoid starting with the observation that the biggest single influence on many of our activities over the past year was the Asian economic and financial crisis. Since this crisis is usually dated from the floating of the Thai baht on 2 July 1997, its arrival coincided almost exactly with the financial year covered by this Report, but its influence became more pronounced as the year progressed, and seems likely to dominate economic developments in the coming year as well.

Despite the difficulties posed by our external economic environment, domestic developments have not stood still, and the past year has witnessed some major structural changes to the Reserve Bank's responsibilities. The two major ones were the creation of the Australian Prudential Regulation Authority (APRA) and the full implementation of the real-time gross settlement (RTGS) system. While a lot of resources had to be devoted to these major changes, most of the staff were occupied with the normal business of the Bank – monitoring economic and financial developments; dealing in the money, bond and foreign exchange markets; supervising banks; providing banking and registry services; and printing and issuing currency notes. The following points summarise the main events of 1997/98 and the activities of the Reserve Bank:

- The economy performed well in 1997, with economic growth of about 4 per cent, inflation of $1\frac{1}{2}$ per cent and the unemployment rate falling by about half a percentage point. By 1998, however, the economy began to slow as the effects of the economic contraction in Asia were felt. The widening of the current account deficit, in conjunction with financial markets' concern about the effects of the Asian crisis on our general economic prospects, led to a substantial decline in the value of the Australian dollar. Apart from an easing of monetary policy in July 1997, there were no further changes over the remainder of the financial year.
- In its money market operations, the Reserve Bank's main task for most of the year was to maintain stability in the cash rate at its desired level, and to accommodate the temporary strains associated with the introduction of RTGS in the latter part of the year. In bond markets, the Bank, as agent for the Commonwealth Treasury, purchased from investors around $7 billion of Commonwealth Government securities during the year. This retirement of debt was made possible by the large (headline) surplus in the Government's accounts.

- There was a sharp contrast in the Reserve Bank's activities in the foreign exchange market over the past two financial years. In 1996/97 the Bank was able to take advantage of a strong Australian dollar (the average level was over US78 cents) to replenish its international reserves by buying $5.2 billion of foreign currencies. In 1997/98, on the other hand, with a falling Australian dollar the Bank intervened in the second half of the year by buying Australian dollars when the exchange rate fell. Of the $3.2 billion bought by the Bank in 1997/98, $2.6 billion was bought in mid June when the exchange rate was a little over US60 cents.

- Moving responsibility for bank supervision from the Reserve Bank to the newly created APRA was the biggest single change to the Bank's structure since the abolition of the Exchange Control Department following the float of the Australian dollar in 1983. While the Bank had argued against the proposed change, once the decision had been made with bipartisan political support (and after community consultation), we have given it our fullest support. We are confident that the intellectual capital that has been built up in Bank Supervision Department will not be lost, as its staff was moved almost in its entirety to APRA on 1 July 1998. The Government's decision to appoint Deputy Governor Graeme Thompson as Chief Executive Officer of APRA was a wise one; although he will be a loss to the Bank, he will be an important asset to APRA and will ensure that the difficult transition period is negotiated as smoothly as possible. His departure from the Reserve Bank reduces the number of Deputy Governors to one – the situation that prevailed until 1993. Most importantly from the Bank's point of view, we were able to hand over to APRA a banking system which is in first-rate shape from a prudential viewpoint, with very low bad debts and a comfortable capital ratio.

- At the time of announcing the shift of bank supervision to APRA, the Government made it clear that the Reserve Bank still retained responsibility for the stability of the overall financial system. This follows necessarily from our central role in the payments system, and our unique capacity to act as lender of last resort. Indeed, the original rationale for the establishment of most central banks was this system stability role – the monetary policy role came later. We are now in the process of defining the division of responsibilities under the new system. A small department – System Stability Department – has been established to undertake research on risks to financial stability, keep abreast of new product and market developments, and co-ordinate relations with APRA and the Council of Financial Regulators. In addition, the Bank has gained wider responsibilities for the payments system.

- The full implementation of RTGS on 22 June 1998 marked the completion of a project that had begun in December 1995. During its design and construction phase it occupied 55 Bank staff drawn from five Departments, as well as a much larger number of people working for Austraclear and the commercial banks. This essential piece of financial infrastructure puts the Australian banking system and our financial markets at world best practice in the payments settlement area. While some other countries reached this point earlier than Australia, our system stands out for its comprehensiveness – from the beginning, over 90 per cent of all transactions by value were settled in real time.

- Although there were no new Australian currency notes introduced in 1997/98, it was nevertheless quite an eventful period for Note Printing Australia (NPA). On 1 July 1998 NPA was formally corporatised as a wholly owned subsidiary of the Reserve Bank, which further emphasised its commercial autonomy. During the year NPA won an important new export order to print the entire note issue of New Zealand on polymer.

In keeping with a trend over the past 15 years, there was a further reduction in staff numbers in 1997/98. The main influences were the outsourcing of cheque clearing and the withdrawal from some specialised note-issuing activities, such as bag make-up for individual bank branches. In addition, two of the Reserve Bank's branch operations – in Darwin and Hobart – fell below minimum viable size; Darwin was closed in October 1997, the first closure since Launceston in 1973, and Hobart will close later this year. There seems to be no end to the process of technological innovation and the changes it implies for the Reserve Bank's work. In the process the Bank is becoming a smaller, younger and better-educated institution. While this has put us in a better position to handle the challenges of the future, many of the changes have been unsettling. Staff have again shown a remarkable ability to accept these changes, and to adjust where necessary.

IJ Macfarlane
Chairman, Reserve Bank Board
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