RESERVE BANK of AUSTRALIA

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ANNUAL REPORT 2008

Reserve Bank

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Governor's Foreword

2007/08 was a turbulent year for the world economy. Large increases in oil and other commodity prices disrupted growth and inflation rates, while serious problems in international financial markets further complicated the tasks facing central banks.

For some years, long-time observers had expressed concerns about underpricing of risk, the build-up of leverage and the growing complexity of financial instruments. But, despite these general misgivings, it was not possible to predict with any accuracy how or when the process of unwinding would occur, or what its economic consequences would be. It was apparent by the middle of 2007 that loss experiences in US sub-prime mortgages were severe and that financial institutions with exposures were going to be badly affected. But no-one foresaw the sudden loss of confidence displayed in the world's largest financial houses, manifested in a severe disruption in interbank markets, beginning in August last year. As the financial year unfolded, very large write-offs had to be made and new capital raised. By the middle of 2008, it was clear that the US economy and banking system had been seriously weakened, and there were concerns about conditions in some other major countries as well.

As a result, the past year has presented some of the most demanding circumstances for the domestic market operations of central banks, including the Reserve Bank of Australia, seen for many years. Practices that had been largely settled since the mid 1980s had to be adapted quickly in the face of very unusual and fast-moving developments.

The Reserve Bank moved early to expand the scope of its daily operations, accepting a wider variety of collateral in repurchase operations, dealing at considerably longer terms than usual and, for brief periods, significantly pushing up the quantity of settlement funds in the system. The intention of this was to maintain liquidity in the domestic financial system, as local and international markets underwent the difficult and potentially disruptive process of re-pricing risk. There was never any doubt about the solvency of any Australian bank. Indeed, the very sound position of the local banks was a major source of strength for the Australian financial system during this period. Overall, the rise in term funding spreads to the official yield curve has generally been smaller in Australia than in continental Europe, the United Kingdom or the United States. The Reserve Bank's balance sheet changed considerably as a result of these factors and also because the Future Fund drew down its deposits with the Bank as it invested its funds in line with its mandate. The details of these developments and the Bank's response are set out in the chapter on The Balance Sheet and Operations in Financial Markets.

When measured according to Australian equivalents to International Financial Reporting Standards, the Reserve Bank earned a profit of $1.4 billion in 2007/08, following a loss in the preceding year. Underlying earnings, at over $2 billion, were the highest yet recorded. However, a rise in the exchange rate of the Australian dollar against other currencies once again resulted in unrealised valuation losses on the Bank's portfolio of foreign assets. As was explained in last year's annual report, a central bank has to accept these exposures as part of maintaining its country's official reserve assets. As well as reducing total profits, the unrealised valuation losses, consistent with the *Reserve Bank Act 1959* and sound accounting practice, reduced the quantity of distributable profits since, this year, there were no offsetting previously unrealised gains. Hence, the dividend payable to the Australian Government was less than underlying earnings on this occasion, though higher than in the preceding four years.

Monetary policy was adjusted through the year as required, consistent with the long-established framework of flexible inflation targeting. The basis of those decisions was, as usual, set out in the statements announcing the decisions and the quarterly *Statement on Monetary Policy*. The Board also decided late in 2007 to change its disclosure practices. It now releases a statement each month regardless of whether or not the cash rate is to be changed, and releases minutes of the monetary policy meeting of the Board with a two-week lag, which is now common practice among many central banks. In a related change, the timing of the announcement of the policy decision was brought forward to be shortly after the conclusion of the meeting. From a governance perspective, this is far preferable to waiting nearly 24 hours to make the announcement.

During the year, the Board welcomed John Akehurst as a new member and Jillian Broadbent was re-appointed to a third five-year term.

The regular work on assessing financial stability continued – and the *Financial Stability Review*, published every six months, ranks alongside the *Statement on Monetary Policy* as one of the Reserve Bank's premier publications. In addition, the payments policy area worked on a major review of payments reforms, which will be the subject of separate reporting by the Payments System Board in due course.

The Reserve Bank reviewed and restructured its currency activities during the year. An Assistant Governor (Currency) now has responsibility solely for currency matters, which involves overseeing note issue, research on note design and chairing the Boards of Note Printing Australia and Securency.

The Reserve Bank's staff, led by a very talented team of assistant governors and department heads, responded to demanding circumstances with their customary skill, professionalism and dedication. On behalf of the Board, I thank them most sincerely for their efforts.

Glenn Stevens

Chairman, Reserve Bank Board
14 August 2008

Functions and Objectives of the Reserve Bank

The Reserve Bank of Australia is Australia's central bank. It is established under the *Reserve Bank Act 1959*, which empowers it to conduct its operations and sets out the objectives of the Bank's monetary policy. Section 10(2) of the *Reserve Bank Act 1959* states:

'It is the duty of the Reserve Bank Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank ... are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:

(a) the stability of the currency of Australia;

(b) the maintenance of full employment in Australia; and

(c) the economic prosperity and welfare of the people of Australia.'

For more than a decade now, this general mandate has found concrete expression in the form of a medium-term inflation target. Monetary policy aims to keep the rate of consumer price inflation at 2–3 per cent, on average, over the cycle. The fourth *Statement on the Conduct of Monetary Policy*, issued by the Treasurer and the Governor in December 2007 following the election of the new Government, records the common understanding of the Government and the Reserve Bank on key aspects of the monetary policy framework.

In addition to conducting monetary policy, the Reserve Bank also:

- holds Australia's foreign currency reserves;
- operates Australia's main high-value payments system;
- provides banking services to the Australian Government; and
- designs, produces and issues Australia's banknotes.

The Reserve Bank has not, since 1998, been responsible for prudential supervision of banks. It has, however, a general responsibility, within the limits of its powers, to foster stability of the overall financial system.

The responsibilities of the Reserve Bank for ensuring the stability, efficiency and competitiveness of the payments system arose in 1998 from amendments to the *Reserve Bank Act 1959*. These amendments also established the Payments System Board, which is separate from the Reserve Bank Board and issues its own annual report. The Reserve Bank's main powers in relation to the payments system are set out in the *Payment Systems Regulation Act 1998*.

Governance

The Reserve Bank Board

The Reserve Bank Board comprises nine members: the Governor (Chairman), Deputy Governor (Deputy Chairman), Secretary to the Treasury and six external members appointed by the Treasurer.

In December 2007, the Australian Government introduced new arrangements under which the Secretary to the Treasury and the Governor will maintain a register of eminent candidates of the highest integrity from which the Treasurer will make new appointments to the Board. This initiative was contained in the fourth *Statement on the Conduct of Monetary Policy* agreed between the Governor and the Treasurer. In May 2008, Jillian Broadbent was re-appointed to the Board for a third term of five years. Current members are shown here and on page 9.

Board Meetings in 2007/08 – Attendance by Members[a]

Glenn Stevens	11	(11)
Ric Battellino	11	(11)
Ken Henry[b]	10	(11)
John Akehurst[c]	7	(8)
Jillian Broadbent	11	(11)
Roger Corbett	10	(11)
Graham Kraehe	10	(11)
Donald McGauchie	11	(11)
Warwick McKibbin	10	(11)

(a) Figures in brackets show the number of meetings each member was eligible to attend.
(b) David Gruen (Executive Director, Macroeconomic Group, Australian Treasury) attended one meeting in place of Ken Henry, as provided in section 22 of the *Reserve Bank Act 1959*.
(c) John Akehurst was appointed to the Board on 31 August 2007 and sworn in as a member on 23 September 2007.

The Board meets 11 times a year, on the first Tuesday of each month except in January. Five members form a quorum.

Most meetings are held at the Reserve Bank's Head Office in Sydney. By custom, one meeting each year is held in Melbourne – this year in April. From time to time the Board also meets in other Australian capitals, with the September 2007 meeting held in Perth.

Conduct of Reserve Bank Board Members

On appointment to the Reserve Bank Board, each member is required under the *Reserve Bank Act 1959* to sign a declaration to maintain secrecy in relation to the affairs of the Board and the Reserve Bank. Further, by law, members must meet the general obligations of directors of statutory authorities, as set out in the *Commonwealth Authorities and Companies Act 1997* (CAC Act). The CAC Act sets standards of conduct for directors and officers of Commonwealth authorities. Directors must:

- discharge their duties with care and diligence;
- act in good faith, and in the best interests of the Reserve Bank;

- not use their position to benefit themselves or any other person, or to cause detriment to the Reserve Bank or any person;
- not use any information obtained by virtue of their position to benefit themselves or any other person, or to cause detriment to the Reserve Bank or any person; and
- declare any material personal interest where a conflict arises with the interests of the Reserve Bank.

Over and above these legislated requirements, members recognise their responsibility for maintaining a reputation for integrity and propriety on the part of the Board and the Reserve Bank in all respects. Members have adopted a Code of Conduct that provides a number of general principles as a guide for their conduct in fulfilling their duties and responsibilities as members of the Board; a copy of the Code is on the Bank's website.

Remuneration and Indemnities

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

A committee of the non-executive Reserve Bank Board members reviews annually the remuneration of the Governor and Deputy Governor as required by section 24A of the Reserve Bank Act.

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 Reserve Bank itself or any subsidiary of the Bank. 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.

Audit Committee

The objectives of the Audit Committee of the Reserve Bank Board are to:

- ensure a high-quality, independent and effective audit process; and
- assist the Governor and the Board in fulfilling their obligations relating to financial reporting, compliance with laws and regulations, internal control and risk assessment, employee conflicts of interest, business ethics and prevention of fraud.

The Committee also acts, at the request of the Board of Note Printing Australia Limited (NPA), as NPA's Audit Committee.

Members of the Audit Committee during 2007/08 were the Deputy Governor (Chairman), a non-executive member of the Reserve Bank Board, Jillian Broadbent, and an external member, George Bennett, company director and former National Executive Chairman of KPMG Peat Marwick. At its August 2008 meeting, the Board appointed Ms Broadbent as Chairman of the Audit Committee, to comply with amendments to regulations issued under the CAC Act that apply to audit committees of Commonwealth authorities, which provide that the chair must not be an executive director of the authority. The Deputy Governor will remain a member of the Audit Committee for the time being.

During 2007/08, the Committee met on four occasions; all members attended each of these meetings. The two external members of the Audit Committee also meet with the external auditors, in the absence of management, annually. At its July 2008 meeting, the Committee considered the draft financial statements for the year ended 30 June 2008 and agreed that the statements be presented to the Reserve Bank Board with its endorsement.

Members of the Reserve Bank Board attending the June 2008 Board meeting at the Bank's Head Office in Sydney. From left to right, Donald McGauchie, Ken Henry (Secretary to the Treasury), Warwick McKibbin, Graham Kraehe, Ric Battellino (Deputy Governor), Glenn Stevens (Governor and Chairman), Jillian Broadbent, Roger Corbett and John Akehurst.

Reserve Bank Board | August 2008

Glenn Stevens (Chairman)

Governor since 18 September 2006
Present term ends 17 September 2013

Chairman – Payments System Board
Chairman – Council of Financial Regulators

Ric Battellino

Deputy Governor since 14 February 2007
Present term ends 13 February 2012

Ken Henry AC

Secretary to the Treasury
Member since 27 April 2001

John Akehurst

Member since 31 August 2007
Present term ends 30 August 2012

Deputy Chairman – Coogee Resources Limited
Director – CSL Limited
Director – Securency International Pty Ltd
Director – University of Western Australia Business School

Jillian Broadbent AO

Member since 7 May 1998
Present term ends 6 May 2013

Director – Coca-Cola Amatil Limited
Director – Special Broadcasting Service

Roger Corbett AO

Member since 2 December 2005
Present term ends 1 December 2010

Chairman – ALH Group Limited
Deputy Chairman – PrimeAg Australia Limited
Director – Fairfax Holdings Limited
Director – Wal-Mart Stores Inc

Graham Kraehe AO

Member since 14 February 2007
Present term ends 13 February 2012

Chairman – BlueScope Steel Limited
Chairman – Brambles Limited
Director – Djerriwarrh Investments Limited
Member – Australasian Council of INSEAD

Donald McGauchie AO

Member since 30 March 2001
Present term ends 29 March 2011

Chairman – Telstra Corporation Limited
Deputy Chairman – James Hardie Industries NV
Director – Nufarm Limited

Warwick McKibbin

Member since 31 July 2001
Present term ends 30 July 2011

Executive Director, Centre for Applied Macroeconomic Analysis & Professor of International Economics, College of Business and Economics – Australian National University
Professorial Fellow – Lowy Institute for International Policy
Non-Resident Senior Fellow – The Brookings Institution, USA
President – McKibbin Software Group Inc (USA)
Director – McKibbin Software Group Pty Ltd
Director – EconomicScenarios.com Pty Ltd

Accountability and Communication

Relationship with Government

Section 11 of the *Reserve Bank Act 1959* sets out the relationship between the Australian Government and the Reserve Bank Board. It confers substantial independence on the Board, but balances this with an obligation to inform the Government of its policies 'from time to time' and a requirement for Parliamentary accountability. The regular meetings of the Governor, Deputy Governor and senior officers with the Treasurer shortly after Board meetings serve to keep the Government informed.

Reporting Obligations

The Reserve Bank is a Commonwealth authority for the purposes of the *Commonwealth Authorities and Companies Act 1997* (CAC Act) and, for these purposes, the members of the Reserve Bank Board are the directors of the Reserve Bank. As such, they are responsible for the preparation of the annual report and, at the meeting of the Board on 5 August 2008, they resolved that the Chairman sign the annual report and financial statements as at 30 June 2008, transmit them in accordance with the requirements of the CAC Act and arrange publication.

The House of Representatives Standing Committee on Economics (formerly 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 Reserve Bank and the annual report of the Payments System Board. The Committee holds twice-yearly hearings, at which the Bank presents its views on the economy and responds publicly to questions from Committee members. In 2007/08, the Governor, Deputy Governor and senior officers attended hearings on the Gold Coast in August 2007 and in Sydney in April 2008. These appearances, and the quarterly *Statement on Monetary Policy*, are important elements of the arrangements embodied in the understandings between the Governor and the Treasurer outlined in the fourth *Statement on the Conduct of Monetary Policy*, which was issued in December 2007 following the election of the new Government.

During the past year, senior staff of the Reserve Bank also provided evidence before Federal Parliamentary committees conducting various inquiries. These included the Senate Standing Committee on Economics Inquiry into Private Equity Investment, in July 2007; the House of Representatives Standing Committee on Economics, Finance and Public Administration Inquiry into Home Lending Practices and Processes, in August 2007; the Senate Select Committee on Housing Affordability, in April 2008; the Senate Select Committee on State Government Financial Management, in July 2008; and the House of Representatives Standing Committee on Economics Inquiry into Competition in the Banking and Non-banking Sectors, in August 2008.

Communication

The Reserve Bank views it as very important to ensure a high degree of transparency about its goals, decision-making processes and the analysis and reasons behind policy decisions. Transparency not only facilitates the accountability of an independent central bank in a democracy, it also increases the effectiveness of monetary and other policies by promoting informed decision-making by the community.

In 2007, the Reserve Bank Board reviewed the Bank's communications arrangements. It decided that a statement would be issued after each Board meeting, outlining the reasons for the Board's monetary policy decision, whether or not the cash rate target was to be changed. Previously, a statement of reasons was given only if the decision was to change the cash rate. The Board also decided that, consistent with best central banking practice, its decision would be announced at 2.30 pm on the day of the Board meeting, rather than, as previously, at 9.30 am the following morning. Finally, the minutes of the monetary policy meeting of the Board are now published two weeks after each meeting. These changes further enhance the Reserve Bank's transparency and accountability.

Apart from these Board-related communications, the Reserve Bank has a longstanding and extensive program of communication.

The quarterly *Statement on Monetary Policy* informs the financial markets, media and wider community about the Reserve Bank's thinking on monetary policy and provides a basis for the Parliamentary Committee's questioning of the Bank. These statements provide an analysis of the state of the economy, the outlook for inflation and economic growth and further explanation of recent decisions on interest rates.

The Reserve Bank *Bulletin* is a monthly record of media releases, speeches, monetary policy minutes and a wide range of comprehensive statistics, plus articles on various topics, which in the past year included commodity prices, hedge funds, banks' global bond funding, the kangaroo bond market and banking fees.

The *Financial Stability Review*, published in March and September each year, gives a detailed assessment of the overall condition of Australia's financial system. As well, there is analysis and views on issues of specific interest; in the past year such issues included interest-only loans, owner-occupier housing debt and assets, international financial reporting standards and private equity in Australia.

Communication also takes the form of speeches. During 2007/08, the Governor, Deputy Governor and senior officers gave over 20 speeches on various topics, including the economic conjuncture and outlook; reform of the payments system; inflation; risk and the financial system; market operations; central bank communications; housing costs and liquidity; and the lender of last resort.

The Reserve Bank disseminates research conducted by the staff in the form of *Research Discussion Papers* (RDPs). While the views expressed in these papers are those of the authors and do not necessarily represent those of the Bank, their publication encourages discussion and comment on economic issues among a broad range of researchers. During 2007/08, nine RDPs were released on a range of topics, which included business and household behaviour, economic

Reserve Bank Governor Glenn Stevens (centre), Deputy Governor Ric Battellino (second from left) and, from left to right, Assistant Governors Philip Lowe, Malcolm Edey and Guy Debelle appearing before the House of Representatives Standing Committee on Economics in Sydney in April 2008.

forecasting, the effects of monetary policy, and international trade and finance. Staff have also had their work accepted in various publications, such as the *Journal of Monetary Economics*, *The Journal of Real Estate Research*, *The Australasian Journal of Regional Studies* and *Australian Economic Papers*.

The Reserve Bank holds regular conferences, bringing together academics, central bankers and other economics practitioners from Australia and overseas. The 2008 conference was on ‘Lessons from the Financial Turmoil of 2007 and 2008’. A volume of the conference papers and discussions, the 20th in the series, will be published later in 2008. The Bank also issued a call for papers for a Research Workshop to be held later in the year, focusing on issues relating to monetary policy in open economies. This follows a similar Research Workshop held in December 2007, which featured 14 papers by academics and central bankers from Australia and overseas.

In November 2007, the Reserve Bank, in conjunction with the Melbourne Business School, held a conference as part of its review of reforms to Australia’s payments system. A volume of the papers and discussions was published in April 2008.

The Reserve Bank publishes information in both electronic and hardcopy formats. Demand for hardcopy publications has been declining as use of the website continues to grow strongly. In 2007/08, the number of page views/downloads of information on the website averaged about 60 000 per day, almost 50 per cent higher than in the previous year. The number of subscribers to the e-mail service for alerts about information published on the site totalled around 13 300 at the end of June 2008.

To assist the media’s reporting on key Reserve Bank publications, lock-ups are provided to give media representatives early access, under embargo, to the monetary policy minutes and the *Financial Stability Review*, as well as the *Statement on Monetary Policy*.

The Balance Sheet and Operations in Financial Markets

The primary reason the Reserve Bank operates in financial markets is to implement the Board's monetary policy decisions. However, the Bank also undertakes a large volume of transactions on behalf of its clients, particularly in the foreign exchange market, as well as on its own account to manage its balance sheet.

Over the past year, the size and composition of the Reserve Bank's balance sheet changed significantly. The balance sheet declined in size by $31 billion as a result of a reduction in deposits placed with the Bank by the Australian Government and its agencies, in particular the Future Fund. This, combined with policy decisions taken by the Bank in response to the global credit turmoil, had a material effect on the size and composition of its holdings of assets.

Reserve Bank Balance Sheet

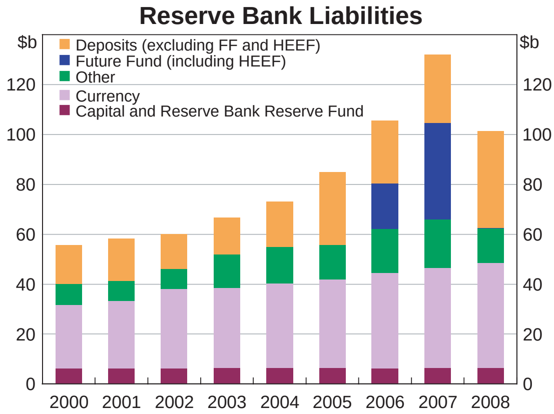
$ billion

	June 2002	June 2007	June 2008
Assets	*60*	*132*	*101*
Foreign	37	96	45
– Net reserves[a]	7	32	35
– FX swaps	29	48	0
– Other	1	16	10
Domestic	23	36	56
Liabilities	*60*	*132*	*101*
Deposits	14	66	39
Currency	32	40	42
Other (including capital)	14	26	20

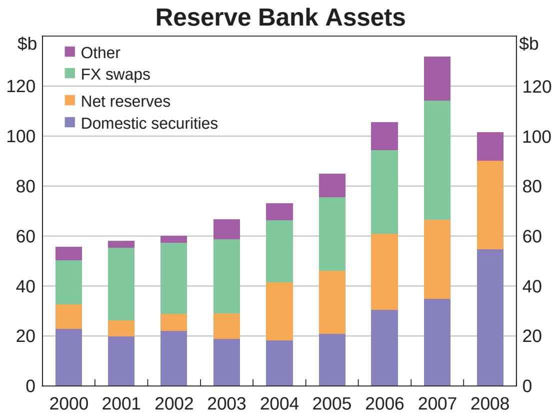
(a) Excludes Special Drawing Rights and Australia's reserve position at the International Monetary Fund

For a number of years there had been a substantial increase in the size of the balance sheet, reflecting the increase in government deposits as a result of ongoing budget surpluses. In 2006, some of these deposits were transferred in name to the Future Fund upon its establishment, while remaining on deposit at the Reserve Bank. Since June 2007, deposits held by the Future Fund have fallen by around $40 billion as the Fund withdrew most of its deposits and invested the funds in a broader range of assets. This movement in deposits was partially offset by an increase in government deposits held by the Australian Office of Financial Management (AOFM), reflecting the budget surplus in 2007/08, such that there was a net decline in deposits of $27 billion.

As these deposits, which are a liability of the Reserve Bank, were reduced, the Bank correspondingly ran down its asset holdings, primarily by reducing its holdings of foreign exchange held under swap. As noted in previous annual reports, the Bank had made extensive use of foreign exchange swaps in recent years to manage domestic liquidity as the balance sheet had grown.



Source: RBA



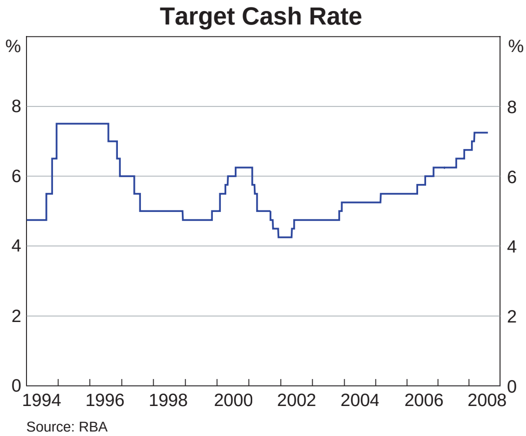
Source: RBA

At the same time, as is described in more detail below, the composition of the Reserve Bank's asset holdings also changed as a result of the Bank's response to the global credit turmoil. To ease tensions in the domestic money market, the Bank made increased use of repurchase agreements (repos) using domestic assets rather than foreign assets (in the form of foreign exchange swaps). The major increase was in the Bank's holdings of securities issued by authorised deposit-taking institutions (ADIs) acquired under repo, which rose from around 40 per cent of the Bank's portfolio of domestic securities to around three-quarters. In September and October 2007, the Bank also expanded the range of collateral eligible for open market operations, to include residential mortgage-backed securities (RMBS) and asset-backed commercial paper (ABCP). At end June 2008, RMBS and ABCP purchased under repo amounted to $3.3 billion, about 6 per cent of the domestic portfolio.

Over recent years, the Reserve Bank has reduced its reliance on Commonwealth Government securities (CGS) for domestic market operations, reflecting the shortage of such securities in the market. Over the past year, the Bank has sold virtually all of its remaining outright holdings of CGS as part of its market operations, to reduce its demands on the market, accommodating the sale through an expansion of the domestic repurchase book. The recent announcement by the Government that net issuance of CGS in 2008/09 and beyond is being increased is expected to promote some improvement in liquidity in this market.

Domestic Market Operations

The Reserve Bank Board implements monetary policy by setting a target for the cash rate – the interest rate on overnight unsecured loans in the interbank market. This rate affects interest rates in other wholesale and retail markets, which in turn affect economic activity and inflation.



The Board increased the target for the cash rate on four occasions in 2007/08, by increments of 25 basis points on each occasion. Since February 2008, the Board's decision on the cash rate target has been announced at 2.30 pm on the day of each Board meeting, with the target being effective from the next day. Previously, the outcomes of the Board's deliberations were announced on the day they became effective, usually the business day after the Board meeting.

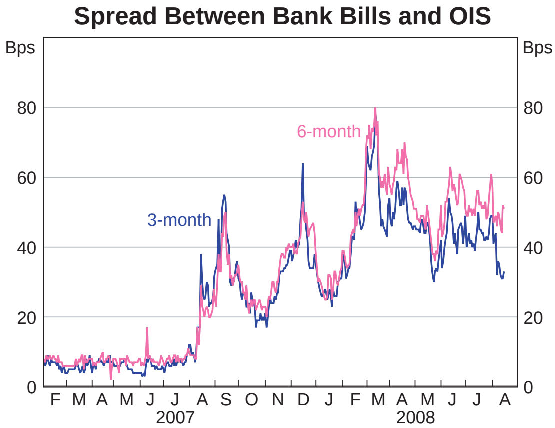
Once the Board's decision on the target is announced, it is the responsibility of the Domestic Markets Department to ensure that the cash rate remains close to the target. The announcement of a change in monetary policy is normally sufficient in itself for the market to move the cash rate to the new target. Over time, however, the Reserve Bank needs to carry out transactions with the market, generally referred to as open market operations, to ensure the cash rate stays at this level. These transactions adjust the volume of exchange settlement (ES) balances held at the Bank. ES balances are the most immediate source of liquidity to banks and are used to meet their settlement obligations with each other and the Bank.

Payment flows between the Reserve Bank's customers and the private sector alter the aggregate amount of ES balances. The major customer of the Bank is the Australian Government. Most days, the Bank will act to offset the liquidity impact of these flows by purchasing (or, more rarely, selling) securities in its open market operations. The vast majority of these transactions are structured as repos, meaning that the counterparty transfers the title of the securities to the Reserve Bank in exchange for funds for the duration of the agreement. In 2007/08, the Bank conducted market operations on all but four business days, for a total of $304 billion.

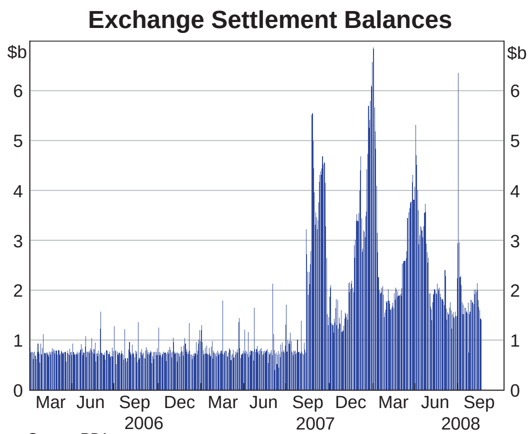
The Reserve Bank remunerates ES balances at a rate 25 basis points below the cash rate target. This creates an incentive for account holders to recycle excess balances within the interbank market. As a result, the aggregate volume of ES balances is typically reasonably low – in recent years, it has usually been around $750 million.

Throughout much of 2007/08, however, market participants sought to maintain much higher ES balances as the functioning of global money markets became impaired, largely stemming from developments in the US sub-prime mortgage market. As banks all over the world became less certain of their own funding requirements and less confident of the credit profile of their counterparties, the interbank borrowing markets in most countries, including Australia, became quite tight as banks were more inclined to hold onto liquid balances. Although this was most evident in term markets, where borrowing rates increased sharply, the tightening of credit limits and the generally precautionary attitude meant there was a concern that ES funds would be more difficult to source. This resulted in increased demand for ES balances.

The Reserve Bank's initial response in August 2007 to this increased demand was to increase the supply of ES balances, from the level of around $750 million that had prevailed for a number of years, to more than $5 billion. If the Bank had not increased the supply, the cash rate would have risen above the target set by the Board as financial institutions bid more aggressively for funds in an attempt to increase their cash balances. Because of the framework for monetary operations, in particular the fact that the Bank deals in the market every day, the Bank was able very quickly to gauge the extent of the increased demand for cash and react accordingly.



Sources: Bloomberg; RBA; Tullet Preborn (Australia) Pty Ltd



Source: RBA

As the demand for cash in the market ebbed and flowed throughout the past year, the Reserve Bank continued to vary the supply of ES balances. Since August 2007, ES balances have averaged almost $3 billion, peaking at $6.9 billion at the end of December 2007. ES balances have generally increased towards the end of calendar quarters, as institutions have sought to hold more liquid assets on their balance sheets through the quarter-end. This phenomenon had been evident prior to the credit turmoil, but has been accentuated over the past year. Reflecting the improved sentiment in financial markets from around mid March, ES balances tended to decline through the June quarter to around $1.5 billion.

As with many other central banks, the Reserve Bank responded to credit market developments by significantly altering the structure of its balance sheet and the nature of its transactions with the market. To a large degree, however, these changes were made within the Bank's existing operational framework.

As the strained market conditions continued into September 2007, the Reserve Bank, in addition to increasing ES balances, announced changes to the range of collateral that would be accepted at its open market operations. Other central banks also introduced changes to their operating frameworks around this time.

The range of eligible collateral for repurchase agreements with the Reserve Bank had been gradually expanded over the previous decade, prompted by the evolving nature of the debt markets in Australia. As the stock of CGS declined and the Reserve Bank's balance sheet grew, the Bank needed to accept other highly rated collateral from its counterparties. Securities issued by the borrowing authorities of State and Territory governments became eligible collateral in 1997, followed by AAA-rated Australian dollar debt of certain supranationals in 2000. The range of eligible securities was widened in 2004 to include bank bills and certificates of deposit issued by ADIs as well as Australian dollar debt of foreign government agencies, and from mid September 2007 the Bank began accepting highly rated ADI securities with a remaining term to maturity longer than 12 months as collateral on its repos. These securities are subject to minimum credit-rating requirements and margins as high as 9 per cent, compared with a margin of 2 per cent on repos secured by government securities or short-dated ADI paper.

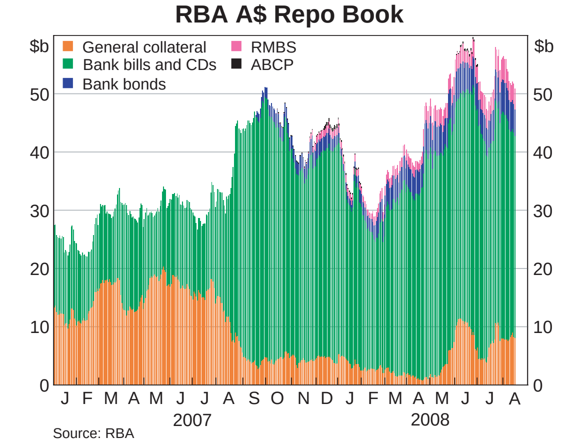
With the market for securitised debt being particularly dislocated, the Reserve Bank announced that, from early October, RMBS and ABCP would also be eligible collateral. In addition to being of the highest credit quality (AAA-rated and P-1 rated, respectively), the Bank provides funds against these securities to the extent that at least 90 per cent of the assets backing them comprise prime 'full-doc' residential mortgages. Furthermore, a margin of at least 10 per cent is imposed. The RMBS and ABCP can be sponsored by both ADIs, namely banks, building societies and credit unions, as well as non-ADIs. The securities are vetted by the Reserve Bank's Risk Management Unit before being deemed to be eligible collateral.

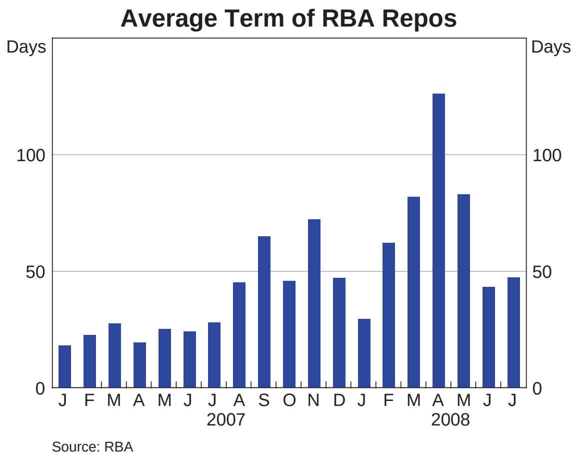
Separate from this day-to-day dealing, the Reserve Bank has been working with APRA and market participants to strengthen arrangements for dealing with extreme market disruptions. Reflecting that, both the Bank and APRA have encouraged ADIs to package residential mortgages they are retaining on their balance sheets into a securitised form as a means of accessing contingent financing from the Reserve Bank, if they were to experience serious funding difficulties. By end June, eight institutions had created these 'self-securitised' RMBS and several more were in the process of doing so.

When counterparties bid at the Reserve Bank's market operations, they are required to bid separately for repos backed by 'general collateral' (Commonwealth Government, semi-government and supranational securities), ADI paper, RMBS and ABCP. In this way, the Reserve Bank can more easily identify where pressures may be more intense in specific markets. It also means that the Bank retains control over the composition of its asset holdings.

Counterparties have always been prepared to pay a higher interest rate for repos secured by private paper than those secured against general collateral. During the period of market turmoil, when yields on private securities in the market rose sharply, institutions were able to purchase bank bills in the market and use them for collateral in repos with the Reserve Bank at a rate which, though higher than the rate on general collateral, was still cost effective. The Bank adjusted the structure of its repo portfolio in response to this shift in demand in a way that was designed to be helpful to the market for private debt securities. At various stages throughout 2007/08, as much as 90 per cent of the Bank's collateral holdings were in ADI paper, compared with an average of around 50 per cent over 2006/07. The increased holdings of these assets on the Bank's balance sheet helped to underpin the market in these securities while risk was being repriced. Investors could be confident that, while holding these assets, they would have access to a certain degree of liquidity should it be required.

In addition to changing the composition of its collateral as market conditions warranted, the Reserve Bank has also varied the maturity of its repo transactions quite significantly. Particularly at times when term markets for bank funding became highly stressed, the Bank signalled that it was willing to deal for longer terms so as to provide greater certainty of funding for counterparties and encourage liquidity in the underlying market for bank paper. In mid April 2008, the Bank nominated a preferred term of up to one year and accepted some approaches at that maturity, including in RMBS.





As noted above, the overriding purpose of the Reserve Bank's operations in financial markets is the implementation of monetary policy, namely maintaining conditions that keep the cash rate as close as possible to the Board's target. Throughout 2007/08, notwithstanding the large swings in the demand for cash, the cash rate target was met on all but 3 per cent of trading days, with the largest deviation being only 2 basis points. By international standards, this is a very small variation.

Deviations from Cash Rate Target

Number of days

	Basis point deviations					
	-2	-1	0	1	2	3
2002/03	0	27	223	3	0	0
2003/04	0	0	250	5	0	0
2004/05	0	0	253	0	0	0
2005/06	0	0	253	0	0	0
2006/07	0	2	249	0	0	1
2007/08	1	8	244	0	0	0

Standing Facility for Overnight Repurchase Agreements

	Number of times used	Value ($ million)
2002/03	14	1 673
2003/04	24	2 159
2004/05	11	1 394
2005/06	10	436
2006/07	24	3 589
2007/08	18	4 220

In addition to its regular morning operations, the Reserve Bank is willing to conduct a second round of dealing with the market should liquidity conditions require it. In 2007/08, no second-round operations were conducted.

Individual ES account holders which face funding shortfalls are able to access a standing overnight facility with the Reserve Bank. Under this facility, banks can borrow funds on a secured basis at a rate 25 basis points above the cash rate. Generally, this facility is accessed only if banks encounter unexpected funding shortfalls late in the settlement session arising from operational constraints or forecasting errors. During 2007/08, the facility was used on 18 occasions for aggregate borrowings of $4.2 billion.

Long-dated Liquidity Operations

As noted above, in its regular market operations the Reserve Bank generally undertakes transactions using repos. Although the Bank is willing to purchase CGS and semi-government securities on an outright basis in its daily operations, these transactions are restricted to debt securities having a maturity of 18 months or less. The Bank's outright purchases of longer-dated securities are contracted via separate operations that are carried out on a regular basis.

During 2007/08, the Reserve Bank conducted five long-dated operations, purchasing $550 million of securities, compared with six operations in the previous financial year. The value of long-dated semi-government securities held outright in the Bank's portfolio is currently around $2 billion. Sales of these securities in market operations provide another avenue by which the Bank may withdraw funds from the system to maintain the supply of ES balances in line with overall demand.

Securities Lending

The Reserve Bank lends CGS and semi-government securities that it holds on an outright basis on its balance sheet. These securities are lent to market participants via repos, with an offsetting reverse repo contracted with the same counterparty against 'general collateral'. Income from securities lending amounted to $0.8 million in 2007/08.

In addition to lending securities from its own portfolio, the Reserve Bank operates a securities lending facility in CGS on behalf of the AOFM. This facility allows market participants to borrow any CGS on issue via repo with the Reserve Bank. An offsetting reverse repo in other CGS must also be undertaken, but at a margin of 300 basis points. In 2007/08, total lending through the facility was $2.5 billion, more than twice that in the previous financial year. In May 2008, the AOFM announced that the collateral eligible to be pledged in the offsetting repo would be broadened to include any general collateral (i.e. semi-government and supranational securities as well as CGS).

Securities Lending by the Reserve Bank

	Number of transactions	Amount lent (face value, $ billion)	Net income ($ million)
2002/03	32	0.9	0.13
2003/04	185	5.0	0.50
2004/05	264	11.9	0.56
2005/06	460	20.3	0.89
2006/07	438	22.4	1.14
2007/08	243	13.8	0.82

Foreign Exchange Operations

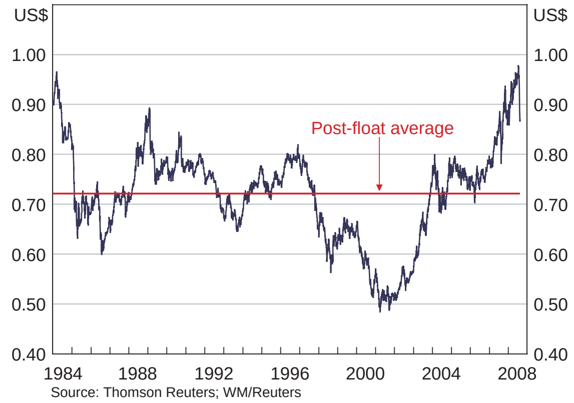
The Reserve Bank operates in foreign exchange markets on behalf of its clients and on its own account. The Bank's client transactions in foreign exchange are dominated by transactions with the Australian Government. The Reserve Bank sells foreign currency to the Government to enable the latter to meet its foreign currency obligations, such as defence expenditure, foreign aid and embassy running costs. In 2007/08, the Bank sold $5 billion of foreign currency to the Government. As is typically the case, the Bank covered these sales by purchasing foreign currency in the market on its own account.

The Reserve Bank may operate in the foreign exchange market on its own account to influence the Australian dollar exchange rate, to assist domestic liquidity management and to manage its own holdings of foreign currency reserves. Transactions to influence the exchange rate or market conditions more generally, usually known as intervention, are relatively infrequent. They are undertaken only when the value of the Australian dollar is judged to have moved to levels that are inconsistent with underlying economic developments or when conditions in the foreign exchange market are thin and disorderly.

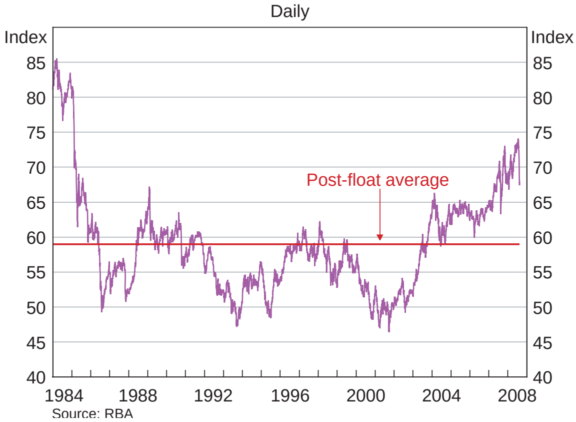
The Australian dollar continued to appreciate over the past year, reaching 25-year highs against the US dollar and 23-year highs on a trade-weighted basis in July 2008. The Reserve Bank viewed the appreciation as broadly consistent with developments in the Australian economy and the terms of trade. However, volatility in the Australian dollar increased sharply in the second half of 2007 in response to the developments in global credit markets and associated swings in investor risk appetite. In August 2007, a particularly sharp depreciation in the Australian dollar took place amid thin and disorderly conditions. To improve liquidity in the market at that time, the Reserve Bank sold a modest amount of foreign exchange and bought the Australian dollar. These transactions were not intended to influence the level of the exchange rate. This was the first intervention undertaken by the Bank since 2001.

As noted above, the Reserve Bank's holdings of foreign exchange swaps were run off over the second half of 2007. While small foreign exchange swap transactions were undertaken in the first half of 2008, the Bank ended the financial year with no net outstanding swap commitments. This rundown in holdings of foreign exchange under swaps meant that there was a sharp decline in gross foreign currency reserves over the second half of 2007. Gross reserves comprise both those held outright and those held under swap. Those held under swap entail an obligation to exchange the foreign currency back into Australian dollars (at a predetermined exchange rate)

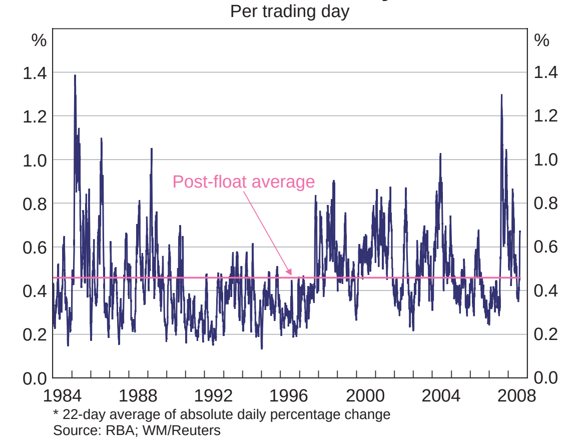
Australian Dollar



Australian Trade-Weighted Index



AUD/USD Volatility*



when the swap agreement matures. Net reserves, which are gross reserve assets excluding those held under foreign currency swaps, rose over the year as the Bank continued to add to reserves in a measured way with the Australian dollar around multi-year highs. Net purchases of reserves in the market and earnings on reserves totalled $4.5 billion in 2007/08, around the same as in 2006/07. The valuation effect of the appreciation of the Australian dollar against those currencies in which reserves are held had a small offsetting influence, such that the Australian dollar measure of net reserves rose by $3.7 billion over the year to $35.9 billion.

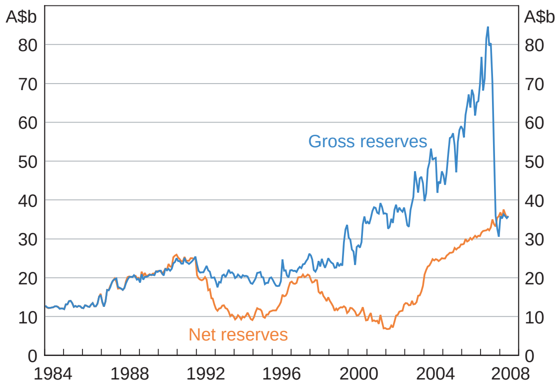
Reserves Management

The Reserve Bank holds gold and foreign currency reserve assets primarily to facilitate its intervention in the foreign exchange market. Given the role of the foreign currency reserves portfolio, the Bank places a high priority on holding assets that are liquid and of high credit quality. In practice, this means that a large portion of the portfolio is invested in government bonds issued by the United States, Germany, France and Japan. These securities are among the most liquid and most secure of all the financial market instruments available to the Bank.

Since the early 1990s, the Reserve Bank has invested its portfolio of reserves in line with its long-run benchmark. The benchmark represents the Bank's optimal long-run portfolio given its investment constraints. It has a currency and asset allocation of 45 per cent to the United States, 45 per cent to Europe and 10 per cent to Japan. Consideration is also given to the weighted average maturity, or duration, of the benchmark portfolio. Securities with longer duration are more sensitive to interest rate fluctuations. In order to manage this exposure, the Bank invests at an average duration of 30 months in each currency portfolio and limits the maturity of individual securities to 10.5 years. Since 2000, the portfolio management framework has allowed for only a very modest amount of discretion on the part of portfolio managers around the benchmark. In 2007/08, the actions resulting from this discretion generated an additional $83 million in returns.

RBA Official Reserve Assets

Monthly



Source: RBA

Over 2007/08, the return on foreign currency assets, measured in SDRs, was 6.5 per cent, compared with a return of 3.1 per cent the previous year. However, the Australian dollar value of the return on reserves declined from $2.9 billion in 2006/07 to $2.3 billion in 2007/08. This largely reflected the fact that gross reserves were substantially lower because of the rundown in foreign exchange swaps noted above, as well as the valuation effect of the higher Australian dollar. Local currency returns were greater in the US and Japanese portfolios than in the previous year as the net decline in bond yields over the year led to capital gains on the Reserve Bank's holdings of bonds. The higher local currency return on the European portfolio reflected a smaller rise in bond yields than in the previous year.

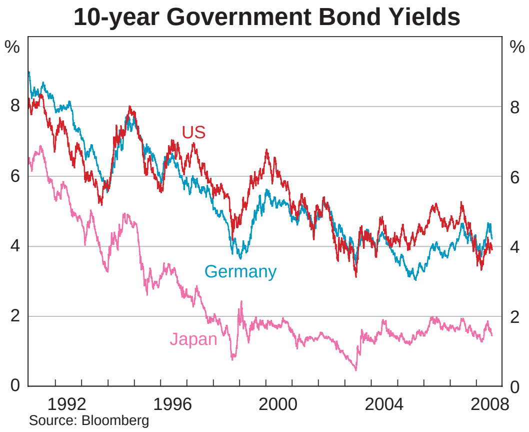
The Benchmark Portfolio

	United States	Europe	Japan
Asset allocation (% of total)	45	45	10
Currency allocation (% of total)	45	45	10
Duration (months)	30	30	30

Actual and Benchmark Returns on Total Foreign Currency Portfolio

Rates of return in SDR (per cent)

	Actual	Benchmark	Value of difference (A$ million)
2001/02	3.9	3.7	63
2002/03	6.7	6.4	77
2003/04	0.5	0.3	67
2004/05	4.7	4.5	38
2005/06	1.2	1.0	55
2006/07	3.1	3.0	40
2007/08	6.5	6.2	83



As noted in last year's annual report, the Reserve Bank has continued to hold a small amount of its reserves in the Asian Bond Funds. The US dollar and local currency denominated Asian Bond Funds are an initiative of the EMEAP group, designed to expand investment opportunities and promote bond markets in the region. The amount invested in both the US dollar denominated bond and local currency denominated bond funds is currently $343 million, down from $371 million in 2006/07. The fall reflects the rise in the value of the Australian dollar. The return over 2007/08 in US dollar terms was 4.6 per cent.

As part of its official reserves assets, the Reserve Bank also holds about 80 tonnes of gold. Over 2007/08, gold prices rose by around 43 per cent in US dollar terms and by around 26 per cent in Australian dollar terms. As a result, the Bank's gold holdings rose in value by about $0.5 billion to around $2.5 billion.

The Reserve Bank offers to lend its gold holdings against quality collateral to major participants in the gold market. However, interest from the market to borrow gold was minimal over the course of 2007/08, with gold leasing rates at very low levels. Reflecting this, the Bank continued to take delivery of maturing gold loans and the total amount of gold on loan declined to 27 tonnes, from 42 tonnes at end June 2007. The income generated from gold lending also declined, to $8.3 million from $11.0 million in the previous year.

Rates of Return in Local Currency by Portfolio
Per cent

	United States	Europe	Japan
2001/02	6.1	4.7	0.4
2002/03	6.6	7.2	1.3
2003/04	0	1.9	0
2004/05	4.1	5.8	1.1
2005/06	1.2	0.1	-0.9
2006/07	5.6	2.2	1.1
2007/08	8.1	4.0	1.7

Banking and Payments

The Reserve Bank provides a range of banking, registry and payment settlement services to other institutions in the Australian financial system, to the Australian Government and some of its agencies, and to other central banks and international bodies. These include the provision of banking services to the Australian Government for the core public accounts operated by the Department of Finance and Deregulation, facilities for transactional banking, custody, registry and associated services, and the operation of a real-time gross settlement system for Australian dollar high-value payments.

The Reserve Bank charges fees for these services, being particularly careful where these services extend beyond the core activities of central banks – e.g. the transactional banking and registry services provided to Australian government agencies – to ensure that they are provided on a comparable basis to similar facilities offered by commercial banks and other private-sector organisations.

Banking

The Reserve Bank provides banking and related services to the Australian Government, the Future Fund, the Australian Office of Financial Management (AOFM) and a number of overseas central banks and other official institutions. It also provides transactional banking services to various government agencies. These services are focused on payment and bill collection services, and are provided on a commercial basis in line with the Australian Government's competitive neutrality guidelines. A number of commercial banks also provide transactional banking services to government agencies.

As the core banker to the Australian Government, the Reserve Bank maintains a group of accounts, called the Official Public Accounts (OPA) Group, in which the Commonwealth's at-call cash balances are held. It also provides the Government with a term deposit facility for investment of its cash reserves and a strictly limited short-term overdraft facility to cater for occasions where there is an unexpected demand on Commonwealth cash balances. These broad arrangements have been established under an agreement with the Department of Finance and Deregulation. The AOFM has day-to-day responsibility for ensuring there are sufficient cash balances in the OPA Group and for investing excess Commonwealth funds in term deposits at the Reserve Bank. The Bank also offers term deposit investment facilities to other government entities, including the Future Fund Board of Guardians and the Communications Fund, based on the term deposit service it provides to the Australian Government.

The Reserve Bank also provides a debt securities custodian service to the Communications Fund, which is currently managed by the AOFM under a delegated authority from the Minister for Communications, Information Technology and the Arts and the Minister for Finance and Deregulation. Securities held by the Bank on behalf of the Communications Fund are held in

Austraclear, a debt securities settlement system owned by Austraclear Limited (a wholly owned subsidiary of the ASX Ltd).

The Reserve Bank's transactional banking services are used by around 90 government agencies. These agencies can require service features that are common to government but not routinely requested by other users of payment and collection services. Because of its particular focus on the government sector, the Reserve Bank is able to provide facilities tailored to their specific requirements. These include features such as extremely high standards of system reliability and availability, purpose-built overnight reporting and the flexibility to react quickly when changes in government policy require consequent changes to systems and processes.

The Reserve Bank's transactional banking services include the provision of direct entry payments, high-value payments settled through the Reserve Bank Information and Transfer System and cheque payments. The Bank's larger customers access these services through direct link arrangements, while smaller customers use ReserveLink, the Bank's desktop banking facility. An internet-based service delivery system, known as RBANet, allows agencies to initiate account and transaction enquiries, perform statistical analysis of transaction activity at aggregate and account levels and manage the status of unpresented cheques. All of the Reserve Bank's proprietary banking systems are supported and developed by a dedicated in-house team of IT specialists. During 2007/08, direct entry transactions processed by the Reserve Bank on behalf of its customers accounted for around 12½ per cent of the total number of direct entry payments in the Australian payments system. The number of cheque and high-value electronic payments processed on behalf of government clients is much smaller and accounted for only a minor share of the total number of these payments.

The Reserve Bank also provides its government agency customers with access to a number of bill collection services, including BPAY©, over-the-counter, phone and internet-based collections via Australia Post, and card-based collection services via telephone and the internet using a third-party service provider. During the past year, a number of government agencies began using these bill collection services for the first time. The Bank also offers an overseas banking service, which enables customers electronically to request overseas payments to be made via cheque, electronic funds transfer (wires) and direct entry. Overseas cheques can be drawn in 30 currencies, while wire payments can be made in more than 130 currencies. The Bank's customers can also initiate overseas direct entry payments in the local payments systems of 23 countries.

In July 2007, the Reserve Bank's business resumption site (BRS) became operational. For Banking Department, this saw the transfer of 16 permanent positions to the BRS. The Department's senior management team also works from the BRS on a rotational basis, with one member of the team working from the BRS on most business days. The BRS also houses back-up systems supporting the Reserve Bank's banking and registry services. These arrangements have enhanced the Bank's ability to continue to provide banking services in the event that its Head Office, or primary systems, are unavailable.

Earnings after tax in 2007/08 for the Reserve Bank's transactional banking services were $2.3 million, compared with $2.7 million the previous year.

Registry

The Reserve Bank provides registry services to the Australian Government, under an agreement with the AOFM, and a number of official foreign institutions that have Australian dollar debt programs. In common with other registry operators, the services provided to clients include registration of new issuance, ongoing maintenance of ownership records, distribution of interest payments and redemption of securities at maturity.

The Reserve Bank also offers a small-investor facility using its own CGS holdings, which enables retail investors to buy CGS. Information relating to the small-investor facility, including indicative buying/selling prices, is available on the Reserve Bank's website.

Because wholesale financial market participants settle their CGS trades electronically in Austraclear, the level of transaction activity in the Reserve Bank's registry is quite low and consists mainly of small-investor activity. Earnings after tax for the CGS registry business in 2007/08 were $0.1 million, the same as the previous year.

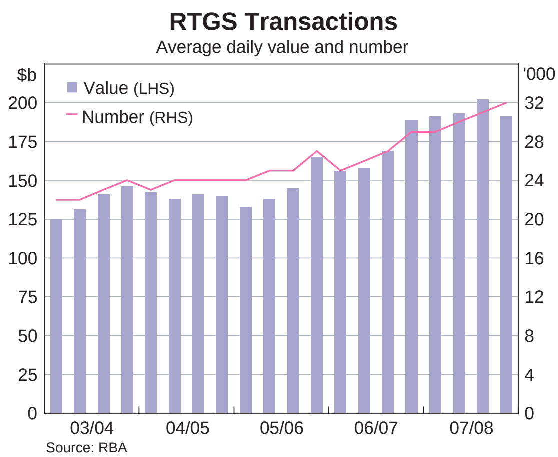
Settlement Services

The Reserve Bank Information and Transfer System (RITS) is owned and operated by the Reserve Bank, and provides the Australian financial system with a real-time interbank payment and settlement service. It is accessed by around 60 institutions approved by the Bank to operate an Exchange Settlement Account (ESA).

Payments between these institutions are settled in RITS across respective ESAs. About 90 per cent of these payments, by value, are settled on a real-time gross settlement (RTGS) basis, including time-critical customer payments, all wholesale debt and money market transactions and Australian dollar legs of foreign exchange transactions. The latter includes Australian dollar trades involved in Continuous Linked Settlement (CLS), for which net amounts are paid to and received from CLS Bank each day.

During 2007/08, the value and number of RTGS transactions grew strongly, continuing the trend evident over the previous financial year. On average, RITS settled 31 000 transactions totalling $194 billion each day in 2007/08, representing growth of 13.5 per cent and 15.8 per cent, respectively, over comparable figures for 2006/07. The highest daily value of transactions during the year was $312 billion, on 28 September 2007.

RITS has operated as an RTGS system since June 1998. Over the 10 years since then, the transaction load handled by the system has almost doubled on most measures.



RITS: Settled RTGS Transactions
Excluding within-day repurchase agreements with the RBA

	1998/99	2007/08
Average daily number	15 783	30 656
Peak daily number	25 024	46 670
Average daily value ($b)	101.8	194.3
Peak daily value ($b)	160.1	311.8

RITS also settles batches of netted interbank payments. One batch is a dedicated multilateral settlement at around 9.00 am, mainly for payments arising from cheque, direct entry and retail card transactions, which are cleared overnight prior to interbank settlement across RITS. In addition, RITS provides a flexible batch settlement facility for approved parties to submit batches of netted interbank payments to RITS at any time during the business day. This facility is used once each day by the Australian Stock Exchange for settlement of payments arising from equity transactions cleared through its electronic settlement system, CHESS. The facility was also used on 12 May for the first settlement arising from the Electronic Conveyancing system established by the Victorian Government to facilitate electronic settlement, transfer, mortgage and lodgement of property title.

The Reserve Bank invests significant resources to ensure that RITS technical infrastructure and operational resilience are commensurate with its critical importance to the financial system. As part of an ongoing RITS evolution program, the original character-based RITS user interface has been replaced with a modern browser-based interface utilising high security standards. This project was completed during 2007/08 with the cut-over to the new interface of all Reserve Bank administration and management functionality; it follows migration of functionality for external users during the previous year. Completion of this project has allowed the Bank to commence an upgrade of the core RITS hardware, operating system and database. This is expected to be completed during 2009 and will further strengthen RITS resilience. It will also provide a better base for system support and maintenance, and deliver improvements in capacity and performance.

Future improvements to RITS business functionality planned for the coming two years include the introduction of additional liquidity optimisation features, including targeted bilateral offsetting of queued payments.

Commencement of operations at the BRS has provided a significant enhancement to the Reserve Bank's capacity to maintain RITS and Reserve Bank settlement operations in the event of a major contingency affecting its Head Office premises. Staff located at the BRS enable the operation of split shifts, with staff present at both Head Office and the BRS during RITS settlement hours, to maintain continuity of operations in the event that an incident compromises the occupation of either site.

To enhance communications in response to an operational disturbance, the Reserve Bank has established arrangements to communicate with RITS Members via distribution of e-mail, SMS and voice messages. This facility replaces the use of time-consuming call trees and provides rapid distribution of information to a large number of contacts simultaneously. The service also provides communications facilities for the Australian Payments Clearing Association in the event of a crisis.

Settlement services are also provided for banknote lodgements and withdrawals by commercial banks and for high-value transactions undertaken by the Reserve Bank and its customers, including the Australian Government and overseas central banks and official institutions. At the end of June 2008, 37 central banks and official institutions overseas were using the settlement and safe custody services provided by the Bank to settle their Australian dollar transactions.

Currency

In early 2008 the Reserve Bank decided to bring together the oversight of all its activities related to banknotes under a single Assistant Governor (Currency), who is responsible for the Note Issue Department of the Reserve Bank and also chairs the Boards of Note Printing Australia Limited (NPA), the wholly owned subsidiary that prints Australia's banknotes, and Securency International Pty Ltd, the joint-venture company that produces the polymer substrate used for Australia's banknotes (and those for many other countries as well). As part of this reorganisation, Graeme Thompson stepped down from the chairs of both NPA and Securency, positions he had held since the two organisations were first incorporated in the 1990s. The Bank thanks Mr Thompson for his contribution to the development of the two companies over many years. John Akehurst, a member of the Reserve Bank Board, joined the Securency Board in July 2008.

Note Issue

The Reserve Bank is responsible for the production and issuance of new banknotes and the destruction of old, unfit banknotes. It also must ensure that the public retains confidence in the currency, such that banknotes remain an effective payment mechanism and store of wealth. The Bank maintains this confidence by:

- making sure that there are always enough banknotes available to meet the public's demand;
- maintaining a high quality of banknotes in circulation; and
- conducting research to ensure that the currency remains secure against counterfeiting.

New Banknote Purchases

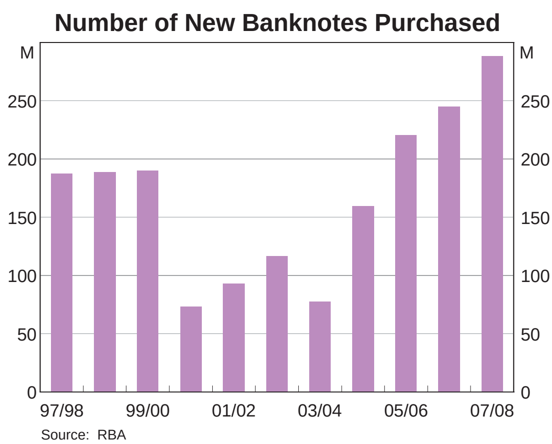
The Reserve Bank purchased 288 million new banknotes from NPA in 2007/08, an increase of 43 million banknotes from that purchased in the previous year. The order consisted of 52 million $5 banknotes, 61 million $10 banknotes, 103 million $20 banknotes, and 72 million $50 banknotes. Although no $100 banknotes were purchased in 2007/08, the Reserve Bank's stock of $100 banknotes, acquired in 1999 as part of Y2K contingency preparations, has been run down to a level where a quantity of new $100 banknotes is expected to be purchased in 2008/09.

Banknotes on Issue

Most of the new banknotes purchased by the Reserve Bank were used to replace unfit banknotes or added to the Bank's inventories. Over the year, therefore, the number of banknotes in circulation increased only modestly, to 930 million at the end of June 2008. These had a value of $42.1 billion. This is equivalent to 44 banknotes, worth $1 970, for every Australian. The $50 banknote accounted for nearly half of the value of banknotes on issue and 43 per cent of the number of banknotes on issue, while the $100 banknote accounted for 42 per cent of the value and 19 per cent of the number of banknotes on issue.

Comparing a printed sheet to an intaglio plate in preparation for a forthcoming $100 note production run.

Over the past 15 years, in line with the broad experience in many other developed countries, the growth in the value of banknotes in circulation has largely matched the nominal growth of the economy, and the value of banknotes on issue has remained generally between 3¾ and 4 per cent of nominal GDP.



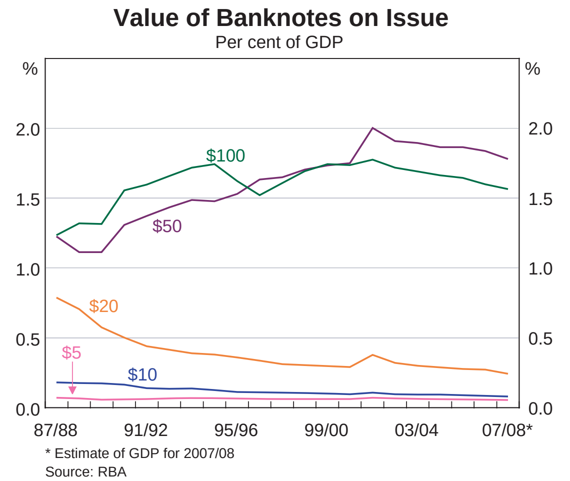
Notwithstanding this stability, the denominational split has changed considerably over this period. A decline in the share of $20 banknotes has been mirrored by an increase in the share of $50 banknotes. This is largely a reflection of $50 banknotes replacing $20 banknotes as the primary banknote dispensed from ATMs. Currently, 75 per cent of banknotes dispensed from ATMs are $50 banknotes, whereas in the 1990s this share was closer to 50 per cent.

Value of Banknotes on Issue

$ million

At End June	$5	$10	$20	$50	$100	Total[a]	Total (per cent of GDP)
2004	533	791	2 533	15 941	14 224	34 022	4.0
2005	539	837	2 584	16 740	14 924	35 624	4.0
2006	572	857	2 690	18 044	15 903	38 066	3.9
2007	591	894	2 846	19 228	16 730	40 289	3.8
2008	614	917	2 732	20 111	17 690	42 064	3.7 *

(a) Includes $1 and $2 banknotes remaining on issue. * Estimate of GDP for 2007/08.



Distribution

A core objective of the Reserve Bank is to ensure that there are sufficient banknotes to meet the public's demand. In addition to the surplus stocks of banknotes maintained by the Bank, the commercial banks also maintain a surplus stock of banknotes in approved cash centres located throughout Australia. These stocks are designed to ensure that there are sufficient banknotes to meet their customers' day-to-day currency requirements. In addition to dealing directly with each other, commercial banks are also able to replenish these stocks from the Reserve Bank's National Note Processing and Distribution Centre (NNPDC), located within NPA at Craigieburn, Victoria.

Banknotes deemed to be unfit by the commercial banks and armoured car companies are returned to the NNPDC and processed through high-speed sorting equipment to confirm their quality and authenticity. Returned banknotes that are subsequently deemed to be fit by the NNPDC are re-issued. Unfit banknotes are destroyed. Of the 199 million banknotes returned to the NNPDC during 2007/08, 107 million were identified as being unfit for re-issue and were destroyed.

During 2007/08, the Reserve Bank issued 228 million banknotes from the NNPDC, with a face value of $8 billion. Of these banknotes, 80 million were banknotes that had previously been in circulation, while 148 million were new banknotes. The remainder of the purchased new banknotes were added to the Reserve Bank's inventories, to be issued as required.

Banknote Quality

Another objective of the Reserve Bank is to achieve a high quality of banknotes in circulation. This maintains the functionality of banknotes for handling by the public and for processing through the various banknote accepting and dispensing machines that are increasingly present in the community. High-quality banknotes also assist the public's detection of counterfeits. This objective requires that the Reserve Bank issues high-quality banknotes and that unfit banknotes are efficiently withdrawn from circulation.

The commercial banks and armoured car companies play an important role in achieving this quality objective. Specifically, under the Note Quality Reward Scheme, the Reserve Bank reimburses banks and armoured car companies for outsorting unfit banknotes from circulation.

Since this scheme was introduced in September 2006, there has been a significant improvement in banknote quality, though the improvement in quality has been greatest for the higher denomination banknotes. A contributing factor is that lower denomination banknotes tend to remain in circulation relatively longer than higher denomination banknotes, before being returned to financial institutions for fitness sorting and ultimately to the NNPDC for assessment and destruction.

Some banknotes become damaged in circulation beyond the normal levels of wear and tear and become unsuitable for sorting through high-speed sorting equipment. The Reserve Bank has a policy of paying value for severely damaged banknotes that can be authenticated as genuine Australian banknotes, subject to the amount of the banknote that remains recognisable. Although commercial banks can assess damaged banknotes and pay the assessed value for them, all damaged banknotes are returned to the NNPDC for final assessment and destruction. Under this policy, most damaged banknotes receive full value. However, where a large piece of a banknote is missing, only the appropriate partial value is paid.

During 2007/08, the NNPDC assessed around 24 000 banknote claims, and paid value of around $6.5 million. While the number of claims was 15 per cent less than in the previous year, the value of claims paid was significantly higher. A major contributing factor for this was the large amount of claims related to contaminated banknotes received following the widespread flooding of parts of northern New South Wales and Queensland.

Counterfeiting in Australia

As part of its objective of maintaining public confidence in Australian banknotes, the Reserve Bank monitors the incidence of counterfeits detected in Australia. Almost all counterfeits of Australian banknotes are of poor quality, printed on a paper substrate and easily identified by feel as well as by visual inspection.

Counterfeit Banknotes in Australia
2007/08

	$5	$10	$20	$50	$100	Total
Number	60	173	415	5 281	1 059	6 988
Nominal value ($)	300	1 730	8 300	264 050	105 900	380 280
Parts per million	0.5	1.9	2.9	13.0	6.1	7.4

Compared with the volume of genuine banknotes in circulation, the number of counterfeits passed remains very low. In 2007/08, about 7 000 counterfeits were detected with a nominal face value of around $380 000. Over the past year, about seven counterfeits were detected per million genuine banknotes in circulation, up from around six counterfeits detected per million banknotes in 2006/07. As in previous years, the $50 banknote is the most heavily counterfeited denomination, accounting for around 75 per cent of all counterfeits passed.

The Reserve Bank maintains a close relationship with Australian Federal and State law enforcement agencies in monitoring developments in counterfeiting activity. In an effort to improve the timeliness of counterfeiting data in Australia, and to reduce administrative costs, the Bank and the Australian Federal Police are working together to develop new administrative and processing procedures for the handling and assessment of counterfeits. These procedures are likely to involve the transfer of some administrative responsibilities to the Reserve Bank.

Banknote Research and Development

To ensure a continuing low level of counterfeiting activity in Australia, the Reserve Bank works closely with NPA and Securency to facilitate the development of new security features for polymer banknotes. For many years, the Bank has funded a range of research initiatives undertaken by NPA's Technical Development Group. In the past, this work has resulted in significant new developments, such as the polymer substrate now used in all Australian banknotes and in many other countries.

In order to co-ordinate these research and development activities more effectively, and facilitate co-operation with other central banks, the Reserve Bank decided to take direct responsibility for them. Accordingly, on 1 July 2008 the Technical Development Group at NPA was transferred to the Bank's Note Issue Department. It will remain located in Craigieburn and continue to work closely with staff at NPA and Securency, as well as develop new links to other banknote research groups around the world.

The Reserve Bank's research group will also continue to participate with NPA and Securency on a Joint Technical Committee, which facilitates mutual discussion and review of research proposals and programs in all three organisations, with the aim of maximising enhancements to the polymer banknote technology.

Numismatics

In late 2007, the Reserve Bank conducted its first annual auction of Australian numismatic banknotes. Some 60 000 first and last prefix banknotes produced in 2006 were offered through two channels: a public auction in Melbourne on 2 November 2007 and an online auction held between 22 October and 9 November 2007. In conjunction with the online auction, standard uncirculated banknotes were also offered for sale. Most of the banknotes sold attracted prices at or close to the reserve, while some banknotes with serial numbers of special interest to collectors sold well above their reserve prices.

The second of these annual numismatic auctions was held during June and July 2008, comprising banknotes produced in 2007. The process and results were similar to those in 2007.

The Reserve Bank intends to review the results of the 2007 and 2008 auctions before deciding whether to continue to offer numismatic products in this way in future.

Note Printing Australia

Note Printing Australia Limited is a wholly owned subsidiary of the Reserve Bank located at Craigieburn, Victoria. It produces Australian banknotes for the Reserve Bank and Australian passports for the Department of Foreign Affairs and Trade, and operates the NNPDC under a contract from the Reserve Bank. It also supplies banknotes to a number of other countries in the Asia-Pacific region and banknote security products to a number of overseas banknote printers.

NPA is overseen by a Board, which has a charter from the Reserve Bank Board emphasising the efficient production of Australian banknotes to the Reserve Bank's specifications and the continuing support of the polymer currency note technology pioneered by NPA and now supplied and supported primarily by Securency. The NPA Board comprises Bob Rankin, Assistant Governor (Currency) and Chairman; Richard Warburton AO; Les Austin, a former senior Reserve Bank officer; and Darryl Ross, the Reserve Bank's Chief Financial Officer. NPA's Chief Executive is Bernhard Imbach.

In 2007/08, NPA produced 470 million banknotes, of which 288 million were Australian banknotes for the Reserve Bank and 182 million were banknotes for export. This volume is in line with the level of production in recent years. Export customers during the year included the Brunei Currency and Monetary Board, Banco Central de Chile, Bank Negara Malaysia, the Reserve Bank of New Zealand and the Bank of Papua New Guinea.

During the year, NPA printed and assembled 2.0 million Australian passports, up from 0.8 million the previous year. Work also continued on a new design for Australian passports, which is expected to be introduced later in 2008.

Investment at NPA in recent years has focused on improving process controls, print quality and productivity. A major investment has been made in the pre-press area, which manufactures the plates used on the printing presses. This area is now entirely digital. NPA has now decided to undertake a significant further investment to bring its key production equipment up to the most advanced technology standards available. This investment program, which will be implemented over the next two years, will be supported by a new subscription of capital from the Reserve Bank of $40 million, bringing the total capital of the company to about $100 million.

NPA earned a profit after tax of $6.4 million in 2007/08, up from $5.1 million in 2006/07. NPA's financial accounts are consolidated with the accounts of the Reserve Bank.

Securency

Securency International Pty Ltd is a joint venture between the Reserve Bank and Innovia Films, a global supplier of polypropylene films based in the United Kingdom. Securency manufactures high-security substrates for banknotes and other security documents by applying proprietary coatings and security features to the specialised films supplied by Innovia. The range of substrates made at present by Securency comprises Guardian® for banknotes, Sentinel® for security documents such as land titles, and Sentrii® for security cards.

Securency's Board comprises three directors appointed by the Reserve Bank, three appointed by Innovia, and the company's Managing Director, Myles Curtis, as a non-voting director. The directors appointed by the Reserve Bank are Bob Rankin (Chairman), Les Austin and John Akehurst (a member of the Reserve Bank Board). Securency's headquarters are in Craigieburn, Victoria, adjacent to both NPA and Innovia's Australian film manufacturing plant.

The increasing success of polymer banknote technology, and the resulting increases in production of Guardian® substrate, has necessitated a rapid expansion of Securency's production capacity in recent years. After a second production line was commissioned in Craigieburn in early 2007, work has commenced on another new production facility in Queretaro, Mexico, which is scheduled to be commissioned late in 2008. The Mexican plant is owned by Securency Mexico SACV, a joint venture with Banco de Mexico, the Mexican central bank. It is expected that the Mexican plant will supply the growing demand for polymer banknotes in Latin America, as well as provide contingent support for the Craigieburn plant.

Securency International was awarded the Victorian Exporter of the Year in 2007. Myles Curtis, Managing Director, Securency International (left), receives the award from the Hon. Theo Theophanous, Victorian Minister for Industry and Trade (right), with Joseph Mamo, CFO & Director of Strategic Planning, Securency International (centre).

In order to facilitate the joint venture in Mexico, Securency underwent a corporate re-organisation in 2007, in which a new holding company, Securency International Pty Ltd, was established to undertake marketing and corporate services and to own all intellectual property associated with the polymer banknote technology. Securency International is also the partner with Banco de Mexico in the Securency Mexico joint venture, which will be responsible for manufacturing operations in Mexico. The existing Australian manufacturing operations are now undertaken by the newly established Securency Australia Pty Ltd, a wholly owned subsidiary of Securency International.

Securency has always had a strong commitment to research and development. In 2008, work commenced on the construction of a new research centre in Craigieburn, which will house the company's research team and provide improved facilities for both research on new security features and their development to production stage. The centre is scheduled to be in operation by 2009.

Securency supplied Guardian® substrate in the past year for 13 countries, comprising Australia, Brunei Darrussalam, Chile, Guatemala, Hong Kong, Malaysia, Mexico, New Zealand, Nigeria, Papua New Guinea, Romania, Singapore and Vietnam. Twenty-six countries have now issued banknotes using Securency's polymer substrate since the first such banknote – the Australian $10 banknote issued in 1988 to commemorate the bicentenary of European settlement in Australia – was issued 20 years ago.

Securency earned a profit after tax of $13.5 million in 2007, about the same as in 2006. The Reserve Bank equity accounts for its investment in Securency.

International Financial Co-operation

The Reserve Bank continued its regular participation in the major international financial groupings and institutions during 2007/08. Many of the discussions undertaken in these fora over the past year centred on the credit market disruptions that emerged in August 2007, the potential for these disruptions to spill over from the United States and Europe to other economies (many of whose markets were less exposed to structured finance products) and the role of central banks in responding to the conditions faced. Further detail on the Bank's involvement in international co-operation activities is outlined in this chapter.

Financial Stability Forum (FSF)

The FSF was first convened in 1999 in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to spread. The FSF aims to improve co-ordination and information exchange among countries and international agencies responsible for financial regulation and stability. It brings together senior representatives from the central banks, finance ministries and supervisory agencies of the G7 countries, as well as the heads of the European Central Bank and central banks of Australia, Hong Kong, the Netherlands, Singapore and Switzerland. Its membership also includes representatives from a number of international bodies, including the Basel Committee on Banking Supervision, the Bank for International Settlements and the International Monetary Fund.

As a result of the recent turbulence in credit markets, the G7 finance ministers and central bank governors asked the FSF in late 2007 to analyse the weaknesses that contributed to the financial market turmoil and to set out recommendations for increasing the resilience of markets and institutions. The FSF presented its *Report on Enhancing Market and Institutional Resilience* to the G7 in April 2008 and recommended actions in five areas:

- strengthening prudential oversight of capital, liquidity and risk management;
- enhancing transparency and valuation;
- changing the role and uses of credit ratings;
- strengthening the authorities' responsiveness to risks; and
- developing more robust arrangements for dealing with stress in the financial system.

In considering the areas for policy responses, the FSF gave priority to identifying corrective actions that were most likely to achieve tangible gains, whether these were actions by individual firms, private-sector groups or public authorities. Initiatives are already under way at both the international and domestic levels in the above five areas. The FSF will facilitate the co-ordination of these initiatives and report on progress in due course. In conjunction with other Australian financial authorities, the Reserve Bank is addressing the FSF's recommendations in an Australian context, with a particular focus on ongoing work to strengthen crisis management arrangements.

Bank for International Settlements (BIS) and Associated Committees

Given its broad membership (55 central banks and monetary authorities), the bimonthly BIS meetings are an effective vehicle for central bank governors to exchange views on a wide range of monetary, financial and central banking issues. This was especially the case during 2007/08 when developments in financial markets were rapidly evolving. At their meetings, governors were updated on the latest developments in credit markets and discussed the underlying causes and potential economic consequences of the turmoil. They also considered the output from a number of BIS-related committees that had undertaken detailed analyses of policy responses to the turmoil.

The Assistant Governor (Financial Markets) represented the Reserve Bank on two such BIS committees – the Committee on the Global Financial System (CGFS) and the Markets Committee. The CGFS examines issues relevant to the stability of financial markets and the global financial system, while the focus of the Markets Committee is on the short-run implications of current events for the functioning of financial markets. In order to gain a deeper understanding of issues that arose during the financial turmoil, the CGFS established two working groups of relevant experts. One of these groups examined the effectiveness of central banks' liquidity operations during the turmoil; the Assistant Governor (Financial Markets) represented the Reserve Bank on this group. The recommendations of the group were included in the FSF *Report on Enhancing Market and Institutional Resilience* as part of the proposals for developing more robust arrangements for dealing with stress in the financial system. Following a request from the FSF, the CGFS also asked a working group to re-examine issues raised in its report in 2005 on *The Role of Ratings in Structured Finance*. The reports from both of these groups were released by the CGFS in July 2008, as was a report by another CGFS working group that examined issues surrounding private equity and leveraged finance markets. Finally, the Reserve Bank's Chief Representative in Europe is participating in a CGFS working group examining issues surrounding capital flows to emerging market economies.

Given the importance of central banks' open market operations during the turmoil, the Markets Committee collated and published information on the monetary policy frameworks and market operations of its members. In addition, a senior manager from the Financial Markets Group participated in a taskforce that reported to the Markets Committee on the increased importance of commodity markets for financial markets.

On two occasions during the year, central bank governors from the Asian region met with the General Manager of the BIS in the BIS Asian Consultative Council. Members of the Asian Consultative Council also participated in an annual discussion with governors represented on the BIS Board, during which they discussed progress over the past decade in developing Asian money markets and the relative resilience of those markets to the recent turmoil in US and European markets.

Two senior officials from the Reserve Bank worked on secondment at the BIS during the year, while a number of senior officials participated in various conferences organised by the BIS at its Basel headquarters and at its Asian representative office in Hong Kong.

Group of Twenty (G-20)

The G-20 brings together 19 systemically important economies from all regions of the globe, as well as the European Union, IMF and World Bank. Its balanced representation of both advanced and emerging market economies gives it a unique perspective in addressing issues related to global economic and financial stability.

Over the past year, under the leadership of South Africa (2007 chair) and now Brazil (2008 chair), the G-20 continued its work on developing the broad consensus that led to IMF Governors agreeing on the second stage of IMF voting reform, with members engaging in full and frank discussions at a series of meetings. The gradual convergence of the G-20 membership towards consensus was echoed in the broader IMF membership, with IMF Governors agreeing in April 2008 on a package of quota and vote reform to increase the voice of developing and emerging market economies (see below).

In keeping with its genesis in the financial crises of the 1990s, the G-20 is also actively discussing the recent crisis in credit markets, with the Reserve Bank chairing a G-20 Study Group on Global Credit Market Disruptions. The Study Group is exploring two issues: the causes of the recent credit market disruptions in developed financial systems, and the international transmission mechanisms from developed to emerging economies. The composition of the G-20 makes it well suited to such a discussion, with the Study Group's mission being to facilitate the sharing of information among G-20 members on their experiences. Deputies will consider the findings and discuss possible policy implications at their August 2008 meeting.

Governor Glenn Stevens at the G-20 meeting of finance ministers and central bank governors in Kleinmond, South Africa, in November 2007. Also pictured is IMF Managing Director Dominique Strauss-Kahn.

In 2008, the G-20 continued its regular round of discussions on selected policy themes. Members discussed, with private-sector and academic experts, the subjects of 'Competition Policy in the Financial Sector', 'Clean Energy and Global Markets' and 'Fiscal Space for Growth and Social Policy'.

International Monetary Fund (IMF)

The past year has seen significant progress on the IMF's reform agenda. In April 2008, following two years of intensive discussions, IMF Governors voted in favour of changes to the quota and voting share structure to enhance the participation and voice of emerging market and developing countries, and realign members' shares with their relative weight and role in the global economy. A second major reform during 2007/08 was the agreement on a new and sustainable income and expenditure framework, which will transform the IMF's income model from one that primarily relies on lending to one that generates revenue from various sources, including by broadening its investment authority.

The IMF is continuing to reform its day-to-day activities, with the recent financial market crisis providing added impetus to existing efforts to enhance and deepen its surveillance work in the financial sector and financial markets areas. The Reserve Bank strongly supports the Fund's efforts in these areas. As part of its own efforts to strengthen capacity, particularly at the IMF Executive Board, the Reserve Bank decided in 2008 to sponsor an adviser to the Office of the Executive Director for Australia at the IMF. The adviser's key focus is on providing advice on capital market and financial sector supervision issues, as well as the role of the IMF in global crisis prevention and crisis management. In addition, the Head of International Department visited China, along with IMF staff, to provide expert advice on the requirements associated with the IMF's Financial Sector Assessment Program and financial stability analysis issues, while a senior manager from the Bank's Financial Markets Group was a member of an IMF technical assistance mission to the Bank of Thailand.

Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)

EMEAP is the primary forum for co-operation among central banks in the Asia-Pacific region. As noted in last year's annual report, the framework for EMEAP's oversight of monetary and financial issues was strengthened with the creation of a separate committee, the Monetary and Financial Stability Committee (MFSC). During 2007/08, the meetings of the MFSC were a key vehicle for EMEAP deputy governors to discuss the events unfolding in global credit markets and share experiences of the effects on their own economies.

EMEAP deputy governors also have responsibility for overseeing the work undertaken by EMEAP's three working groups: the Working Group on Banking Supervision, the Working Group on Financial Markets and the Working Group on Payments and Settlement Systems. With the formation of the MFSC, the surveillance role of the working groups has also been enhanced. Hence, many of the discussions of the working groups during the year focused on the disruptions in credit markets in the United States and Europe and the potential channels for their transmission to the economies of east Asia. Following a presentation by the Head of the

FSF Secretariat to its meeting in May 2008, the MFSC asked the working groups to consider the relevance of the FSF recommendations for Asia.

Continuing a practice adopted in recent years, EMEAP governors met with their counterparts from the Eurosystem at a joint seminar in June 2008. Discussions ranged across short-term challenges facing central banks, including the pick-up in global inflationary pressures and ongoing financial turmoil, to more long-term issues such as the implications of climate change and associated policies for price stability.

Government Partnership Fund (GPF)

Since 2005, the Reserve Bank has had an extensive capacity-building program in place with Bank Indonesia (BI) under the Australian Government's Government Partnership Fund. This program is aimed at supporting Indonesia's economic governance and public sector through an exchange of skills and knowledge between Australian public-sector institutions and their Indonesian counterparts.

Over time, the range of activities involving the exchange of staff between the Reserve Bank and BI has expanded from the core areas of monetary policy, financial markets and financial stability to encompass nearly all aspects of central banking. In 2007/08, agreement was reached to include a further two areas, human resources and auditing, in the program. Staff exchanges between the two central banks numbered nearly 40 in 2007/08, bringing the total number of exchanges to around 75 since the first year of the program in 2005/06.

Note Issue Department's Terence Turton (standing) represented the Reserve Bank at a discussion forum in Jakarta hosted by Bank Indonesia on the topic of cash centre implementation and outsourcing cash management.

Lindsay Boulton, Head of Risk Management, with a former Deputy Governor of the Reserve Bank, Stephen Grenville, at a workshop on market operations in Bandung, Indonesia in March 2008.

Among the visits by Reserve Bank staff to BI, in March 2008 staff from the Economic and Financial Markets Groups participated in a workshop on Indonesian inflation and exchange rate issues, representing the culmination of joint research work over the previous year. Also in March, a senior manager from the Bank conducted a workshop on money market operations, with a second workshop held in July 2008. Several officers from the Note Issue Department participated in a forum on cash processing and distribution in late 2007, while an officer from one of the Bank's State Offices participated in a seminar on business liaison at the Bandung Branch of BI in February 2008.

South Pacific Central Bank Co-operation

The Reserve Bank places considerable importance on promoting relations with the central banks of the South Pacific region. The annual meeting of South Pacific Central Bank Governors provides a forum for governors from those countries with their own currencies – Australia, Fiji, New Zealand, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu – to discuss a range of financial and monetary issues, including some that are unique to small island economies. The December 2007 meeting was hosted by the National Reserve Bank of Tonga in Nuku'alofa, Tonga. Representatives from the BIS, IMF and the Pacific Financial Technical Assistance Centre (PFTAC) also participated. The main issues discussed were regional central bank legislation, the development of financial systems of member countries, the management of foreign exchange reserves and the channels through which overseas economic developments affected Pacific island economies.

The Reserve Bank continued to foster close relations through a series of bilateral visits. A manager from the Financial Markets Group visited the Reserve Bank of Vanuatu and the Central Bank of Solomon Islands to discuss areas for potential technical co-operation, as well as participating in a joint Bank of England-PFTAC-IMF workshop in Vanuatu on central bank operations, settlement and monetary policy issues. Another staff member from the Financial Markets Group presented to the Board of the Bank of Papua New Guinea on issues relating to foreign exchange reserves management.

Bilateral Relations and Co-operation

In recent years the focus of the Reserve Bank's international co-operation has shifted away from long-term secondments of our staff overseas, or the long-term hosting of visitors in Australia, towards providing information and assistance via short-term visits to the Reserve Bank and through electronic means. This shift has been facilitated by improvements in IT. The Reserve Bank received short-term visitors from a range of countries during the year, including Bangladesh, Chile, the People's Republic of China, Malaysia, Pakistan, South Africa, South Korea, Thailand, Timor-Leste, Tonga and Vanuatu. The focus of the visits varied greatly and (where appropriate) the Reserve Bank was willing to share information across the full range of its operations.

A manager from the International Department provided advice on reserves management to the Bank of Papua New Guinea, and the Reserve Bank hosted a senior officer from the Reserve Bank of India (RBI) for three months, focusing on a wide range of human resource topics. That visit was part of a new exchange initiative between the two central banks, which will involve the reciprocal placement of a Reserve Bank officer in RBI's head office in Mumbai in late 2008.

The Reserve Bank Risk Management Unit's Celine Chiu (left) and Peter Stebbing, then Head of Risk Management (third from right), with members of a visiting delegation from the Banking and Payments Authority and Petroleum Fund of Timor-Leste in September 2007.

The Reserve Bank in the Community

Activities of the State Offices

While the majority of Reserve Bank staff and senior management are located in Head Office in New South Wales, the Bank also has offices in Victoria, Queensland, South Australia and Western Australia.[1] These State Offices play an important role in the Bank's business liaison program and in ensuring the Bank is accessible to the wider community.

Since 2001, the Reserve Bank has systematically established relationships across a broad cross-section of the business community. Economists in Head Office, as well as in each of the State Offices, have built up a pool of around 1 500 regular contacts around the country, visiting nearly 100 of them each month. The information obtained is reported to Head Office and incorporated into the material prepared for monthly Reserve Bank Board meetings and the quarterly *Statement on Monetary Policy*. In this way, information obtained from liaison complements standard sources – such as data from the Australian Bureau of Statistics and business surveys – in forming the Reserve Bank's assessment of the economy.

The State Offices also play a significant role in the Reserve Bank's efforts to keep the public informed of its evolving views on the economy. State Office staff regularly give presentations on economic developments to business groups, community organisations and educational institutions, in both State capitals and regional centres. In addition, senior staff from Economic Group visit the State Offices each quarter, following the release of the *Statement on Monetary Policy*, to brief groups of liaison contacts on the main themes of the *Statement*. There were over 50 such presentations and briefings in 2007/08.

Liaison with Small Businesses

The Reserve Bank continues to convene its Small Business Advisory Panel, which meets annually to discuss issues relating to the provision of finance and the broader economic environment for small businesses. Membership of the Panel is drawn from a wide range of industries across the country. The Panel represents a valuable source of information on the financial and economic conditions faced by small businesses.

Museum of Australian Currency Notes

The Museum, which opened in March 2005, exhibits the story of Australia's currency notes against the background of the nation's broader history. After an introductory stage on developments before Federation, which includes Australia's first gold coins, visitors can review the various series of notes produced since the first Australian notes in 1913–1915. The final stage in the Museum focuses on Australia's polymer banknotes, including information on their

1 The Victorian Office covers Tasmania, the South Australian Office covers the Northern Territory and staff in Head Office cover the Australian Capital Territory.

design, security, recycling and other features. As well as viewing the original notes, visitors can learn about the men and women represented on the notes over the years, the artwork used in their design and some of the key episodes in Australian history through the Museum's displays of archival film, photographs and documents.

About 11 000 people visited the Museum in 2007/08. The museum has been particularly popular with school groups, many of which receive a short presentation on the Reserve Bank or, in the case of senior students, a talk on the Australian economy. Most of the information in the Museum is on the Reserve Bank's website, where visitors can also take a virtual tour of the Museum. Overall usage of the Museum online in the past year was around 560 000 page views/downloads.

Financial Assistance for Research and Education

The Reserve Bank supports a range of research and related activities, such as conferences and workshops, that are closely aligned with its primary responsibilities. The Bank provided sponsorship to several universities and think-tanks in 2007/08, with activities focusing on areas including macroeconomics, econometrics and financial markets. Sponsorships such as these can be on a one-off basis or ongoing.

For many years the Reserve Bank has contributed towards the cost of a monthly survey of inflation expectations, undertaken by the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne, and a quarterly survey of union inflation and wage expectations, undertaken by the Workplace Research Centre at the University of Sydney. The Bank also provides funding for the Melbourne Institute's *Wages Report*.

The Reserve Bank continued to provide financial support for the *International Journal of Central Banking*, the primary objectives of which are to disseminate first-class policy-relevant and applied research on central banking and to promote communication among researchers both inside and outside central banks. The Bank continued its support of the International Accounting Standards Committee Foundation following completion in 2005 of the initial five-year support plan, and also its long-standing practice of contributing to the Group of Thirty's program of research and publications in the area of international finance.

Financial assistance to Australian universities each year includes contributions towards the costs of their organising conferences in economics and closely related fields. In 2007/08, these conferences included the 20th Conference for PhD Students in Economics and Business, held at the University of Western Australia; the Economic Society of Australia's 36th Conference of Economists, held in Hobart; the 13th Melbourne Money and Finance Conference; the 13th Australasian Macroeconomic Workshop, held at Sydney University; the Australasian Meeting of the Econometric Society, held at the University of Queensland; the University of New South Wales' 20th Australasian Finance and Banking Conference; the Financial Integrity Research Network PhD Tutorial, held at the University of Technology, Sydney; and the 3rd Annual Workshop in Macroeconomic Dynamics, held at the University of Melbourne.

The Reserve Bank sponsors an annual essay competition for undergraduate students across Australia, jointly organised with the University of New South Wales Economics Society, in order to engage and support students of economics. This year, entrants are required to submit

Economic Group's Adam Cagliarini (left), with winners of the inaugural Economics Competition sponsored by the Reserve Bank. From left, Callum Jones, Virginia Gogan and Ashley Cheng, with the other competition judges, Hazel Bateman and Glenn Otto of the University of New South Wales.

a 2 000-word essay explaining the changes in housing costs and affordability over the past two decades, and analysing possible government responses. The Bank will host a presentation ceremony for the prize winners later in the year.

In conjunction with APRA, the Reserve Bank has continued sponsorship of the Brian Gray Scholarship Program, initiated in 2002 in memory of a former senior officer of the Reserve Bank and APRA. Two scholarships were awarded under this program in 2008, for honours year studies at the Queensland University of Technology, examining default options for superannuation funds, and at the University of Western Australia, on measurement of house prices using a characteristics-based approach.

The Reserve Bank also provides annual sponsorship for one officer from the Bank of Papua New Guinea to study at post-graduate level at an Australian university. The most recent scholarship holder completed a Master of Business (Applied Finance) degree at the Queensland University of Technology in March 2008.

Charitable Activities

During the year, the Reserve Bank made its sixth annual contribution of $50 000 to the Financial Markets Foundation for Children, of which the Governor is Chairman. Along with several other Australian financial institutions, the Bank is committed to support the Foundation to this extent for a further four years. In July 2008, in its third public event to raise funds, the

Governor addressed the Anika Foundation, which was established in 2005 to support research into adolescent depression and suicide.

During the year, the Reserve Bank revised its corporate philanthropy program to include an initiative of dollar matching staff payroll deductions to the Reserve Bank Benevolent Fund, a Workplace Giving Program and a Volunteer Day Program, where staff give their time and labour to a charitable organisation and the Bank donates the equivalent of a day's pay to that charity. Previously, the Reserve Bank made an annual contribution to a range of charities (some of which overlapped with those supported by the staff Benevolent Fund). Concurrently, the Benevolent Fund took the opportunity to revise the charities it supports to a core set of 12 recognised charities working in the areas of welfare, illness, alcohol and drug dependency, disability and community issues. Under these new initiatives, the Bank donated $33 000 to charitable organisations in 2007/08, equivalent to the amount donated by the Benevolent Fund.

Reserve Bank staff engaged with the community in a number of volunteering capacities in the past year, including the Cancer Council's Daffodil Day and Australia's Biggest Morning Tea fundraisers, the National Breast Cancer Foundation's Pink Ribbon Day, the Jeans for Genes Day annual fundraiser for the Children's Medical Research Institute, and the Christmas food collection for the Salvation Army's Streetlevel Mission.

Management of the Reserve Bank

Operating Costs

The Reserve Bank's operating costs in 2007/08 were $196.3 million, an increase of 6.2 per cent from the previous year. More than half of these costs arise from the conduct of the Bank's responsibilities for monetary and payments system policies, including its operations in financial markets. About a quarter are associated with providing banking and settlement services, including the real-time interbank settlement system and provision of transactional banking services on behalf of the Australian Government. About 15 per cent of costs arise from issuing banknotes.

Operating costs in 2007/08 were boosted by a number of factors. These include the start of operations at the Reserve Bank's business resumption site (BRS) in Sydney's north-west, which added $6.9 million to the Bank's running costs; an appreciation in the value of the Bank's buildings, leading to higher depreciation charges; and strengthened risk management and assurance activities, partly associated with containing financial risks related to managing a balance sheet of around $100 billion and operating key parts of Australia's financial infrastructure. These controls must be reliable and resilient, as the Reserve Bank operates in financial markets in Australia and overseas, more or less continuously, as well as providing key financial services to the Australian financial system and the Australian Government. Contemporary risk controls are highly 'IT intensive', with related costs rising accordingly. At the same time, during 2007/08 the Bank took steps to contain costs in banknote-handling activities and in providing overseas banking services to the Government.

Expenditure on staff continues to represent the Reserve Bank's largest cost, accounting for around 60 per cent of total operating costs in 2007/08, including remuneration, on-costs and other related costs for training, recruitment and the like.

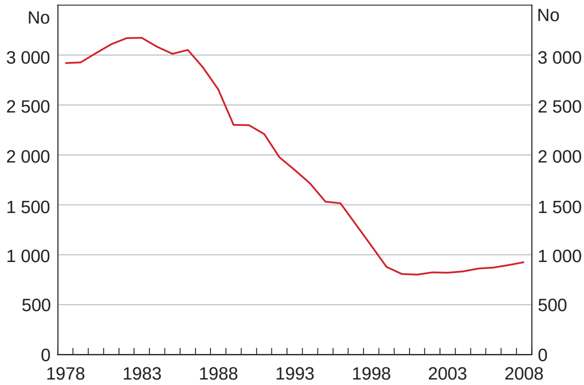
Operating Costs[(a)]
$ million

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Staff costs	68.7	67.7	73.9	77.8	85.5	91.4	101.0	110.2	119.1
Other costs	56.1	54.1	58.4	62.7	58.6	68.8	73.1	74.7	77.2
Underlying operating costs	124.8	121.8	132.3	140.5	144.1	160.2	174.1	184.9	196.3
Cost of redundancies	9.3	2.6	3.4	2.6	0.2	0.2	0.2	0.2	0.2

(a) Costs associated with the ongoing operation of the Reserve Bank, excluding NPA.

Our People

Number of RBA Staff*



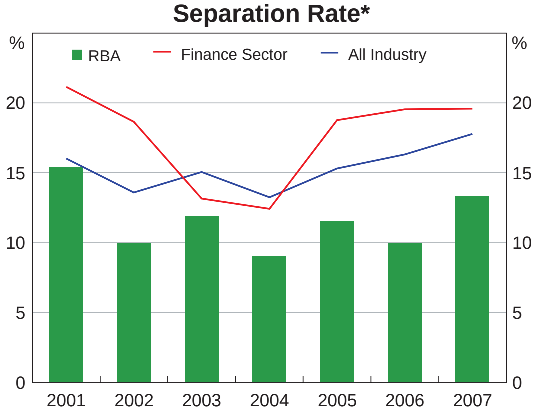
* As at 30 June, excluding NPA
Source: RBA

Over the year to June 2008, the total number of employees at the Reserve Bank increased by 30 to 926, a rise of 3.3 per cent; the rise was similar in full-time equivalent terms. This continues a trend of small increases over the past few years.

The Reserve Bank strives to create a stimulating work environment and offer remuneration packages that attract and engage the best employees to meet its goal of promoting Australia's economic wellbeing. Integral to this is the development of staff and the creation of opportunities for them to achieve their potential. As a research and knowledge-based organisation, this takes a number of forms, including:

- on-the-job and structured training designed to promote functional expertise, innovation, leadership and improved productivity;
- financial support for employees undertaking part-time study in disciplines related to their work and, in a limited number of cases, for full-time post-graduate study at universities in Australia and overseas; and
- secondments to other organisations that extend our employees' breadth of knowledge and experience. Over the past year, for example, the Reserve Bank has had staff on secondment with APRA, ASIC, the IMF, the Bank of England and the BIS. At the same time, the Reserve Bank has hosted secondees from the Bank of England and the Reserve Bank of India. The Bank has also participated in a long-term staff exchange program with the Bank of France.

Separation Rate*



* Employee separations as a share of the average number of staff
Sources: InfoHRM Benchmarking Report; RBA

The Reserve Bank seeks to provide its employees with competitive remuneration. The majority of staff are employed on individual contracts, which provide flexibility in remuneration based on performance and market relativities. Independent consultants are engaged to ensure that remuneration is broadly consistent with market practice. Some staff are covered by the Reserve Bank's enterprise agreement. Staff, on average, received a salary increase of 4 per cent in 2007/08, with scope for a modest additional payment in recognition of good performance. The Bank keeps under review its arrangements for consulting staff on matters affecting their interests and maintains a dialogue – both formal and informal – with staff and their nominated representatives.

Staff turnover in 2007/08, at just under 13 per cent, was slightly higher than in previous years, though it remains low by industry standards. The Reserve Bank recruited 147 people over the past financial year. Over 50 new graduates and post-graduates joined the Graduate Development Program, with these recruits drawn mainly from the economics and finance fields. Increasingly, however, the Bank is sourcing graduates from areas such as law, accounting and IT. A range of methods were used to recruit other staff, including internships, traineeships and targeting experienced professionals in the fields of IT, facilities management and business services. Over the same period, 117 people left the organisation, mainly owing to voluntary resignation.

The BRS became fully operational in July 2007. In staffing this facility, the Reserve Bank sought to accommodate staff needs – primarily by asking for volunteers to be based permanently at the site – while simultaneously seeking to ensure that the required mix of skills and qualifications would be represented. There are currently 56 employees based permanently at the BRS, mainly from the banking, payments settlements and IT areas. Staff at Head Office that are deemed to be critical to the Reserve Bank's operations also regularly spend time at the BRS to ensure that work can be undertaken seamlessly from this location.

Around 6 per cent of the Reserve Bank's staff are located outside Sydney. Within Australia, the Bank employs people in Melbourne, Brisbane, Perth and Adelaide to gather economic intelligence and, in the case of Canberra, to undertake transactional banking services. Overseas, the Reserve Bank has representative offices in London and New York, whose role is to manage Australia's foreign exchange reserves and monitor developments in global financial markets across all time zones.

The Reserve Bank is committed to, and benefits from, diversity in its workplace. The Bank's diversity program aims to ensure that all staff are treated with respect in the workplace and are afforded equal opportunity throughout their careers at the Bank.

Facilities

The Reserve Bank owns or leases premises in locations in which there is a business need to do so. It owns office premises in Sydney, Melbourne, Canberra, the note printing facility at Craigieburn (north of Melbourne) and the BRS, in north-west Sydney. The building in Melbourne's CBD houses the State Office for Victoria and Tasmania and is also a holding point for banknotes, while staff in the Canberra Branch provide banking services to the Reserve Bank's government customers. Surplus accommodation in the buildings that the Bank owns is leased to external tenants; gross income from these leases amounted to $6.9 million in 2007/08. The Reserve Bank's buildings are revalued annually by external valuers; they increased in value by $38 million over the past year, to $378 million as at 30 June 2008. The Bank leases office space in Adelaide, Brisbane and Perth for the Bank's other State Offices.

During the year, the Reserve Bank continued to strengthen the resilience of its facilities. With the BRS becoming fully operational, maintenance and testing arrangements have been established to ensure that critical building services at the BRS continue in the event of power or other services being lost, either temporarily or for an extended period. In addition, a project was completed at Head Office to upgrade the electrical infrastructure, which included increasing the redundancy and reliability of the main electrical switchboard.

Environmental Management

The Reserve Bank continues to develop environmental policies and initiatives to promote sustainable practices in its business operations. As a 'greenfields' project, the design of the BRS incorporated a number of 'best practice' standards, such as storm-water harvesting and grey-water recycling; the building is designed to achieve a four-and-a-half star Australian Building Greenhouse Rating. In addition, water management plans and co-mingled waste recycling programs were established at several sites and gas-fired boilers in two locations were upgraded to improve energy efficiency.

Consultancies

The Reserve Bank employs external contractors or professional service providers to carry out specific tasks where necessary, and also, from time to time, uses consultants. In 2007/08, the following five consultancies were undertaken in Australia.

Consultancies[(a)]
2007/08

Consultant	Project	Cost ($, excl. GST)	Purpose
Deloitte Touche Tohmatsu	Note printing process reviews	52 405	Assessment of production and security arrangements
Hay Group Pty Ltd	Job evaluation	73 491	Market testing of staff remuneration
KPMG	Review of risk management function	33 600	External assessment of the effectiveness of arrangements for risk management in the RBA
KPMG	Review of trading operations	65 000	External assessment of the effectiveness of controls over the RBA's trading system
PricewaterhouseCoopers	RBA personnel	35 000	Remuneration benchmarking review

(a) Costing $10 000 or more.

Risk Management

Objectives and Governance Structure

In carrying out its responsibilities, the Reserve Bank faces a range of risks, the most significant of which, in terms of potential financial impact, flow directly from its operations in financial markets and the assets it must hold to support these operations. The Bank also faces significant operational risks, as it provides high-volume banking and settlement services to its customers and the financial system. In addition, security risks, both IT and physical, arise because of the sensitive nature of information with which the Bank deals, the fact that communications with the financial system, businesses and the community is of strategic importance to the Bank, and because of the valuable physical assets it holds. Operating risks vary from the potential loss of key infrastructure, either temporarily or for an extended period, to the possibility of fraud or other unethical behaviour on the part of employees.

The Reserve Bank works to contain the risks it faces to levels that are consistent with meeting its policy and operational objectives, while maintaining the confidence of its customers, counterparties, the Government and the community more generally that it is equipped to carry out its responsibilities to the high standard expected. The framework the Bank has established for managing risk at the strategic level involves assessing risks and monitoring and reviewing controls to ensure that threats are contained to acceptable levels. Underpinning this approach is the principle that risk management remains an integral part of the job of line managers themselves. As such, the prime responsibility for controlling and mitigating risks on a day-to-day basis rests with managers of the various business areas within the organisation. More generally, management also promotes a culture that emphasises the careful analysis and control of risk throughout the Bank.

Arrangements for risk management in the Reserve Bank are overseen by the Risk Management Committee (RMC), which is chaired by the Deputy Governor and comprises the Assistant Governors for Banking & Payments, Corporate Services, Currency and Financial Markets; the Chief Financial Officer; the Heads of Audit and Risk Management; and the General Counsel and Deputy Secretary. Reflecting changes to the organisational structure, membership of the RMC was expanded during 2007/08 to include the Assistant Governor of the Banking & Payments Group and the Chief Financial Officer. The RMC is responsible for ensuring that the full spectrum of non-policy risks is properly assessed and managed across the Bank. It meets as needed, but at least once every three months, and keeps the Audit Committee of the Reserve Bank Board advised of its activities.

The RMC is assisted in carrying out its responsibilities by the Risk Management Unit (RMU), whose main role is to help different areas of the Reserve Bank manage their risk environment within a broadly consistent framework across the Bank. The Audit Department complements and co-ordinates closely with – but remains separate from – the RMU. In addition to providing assurance that the Bank's risk management policies are effective, the

Audit Department also has a separate, independent brief to test the adequacy of procedures and controls at all levels of the Bank.

Since it was established in 2003, the RMU has operated as a stand-alone unit with a direct reporting line to the RMC. The role and structure of the RMU was reviewed over the course of 2007/08 to determine the extent to which it was meeting the expectations and needs of business areas of the Reserve Bank. Several changes were made as a result. Principal among them was an expansion of the responsibilities of the RMU to include the middle office function associated with the Bank's operations in financial markets. This function had previously been located in the Financial Markets Group. The purpose of the relocation was to lift the point at which the front and middle office reporting lines come together to the level of the RMC. At the same time, the RMU was aligned with the Reserve Bank's broader financial control function to ensure that the risks affecting the Bank's financial position are fully monitored.

The sections below describe the various risks and associated management practices in more detail.

Operational Risk

All parts of the Reserve Bank are exposed to operational risks of varying degrees. The most significant are those associated with carrying out market operations and supplying banking and settlement services to the Bank's clients and the market as a whole. There would also be potential for significant financial loss or damage to the Bank's reputation if sensitive information was mishandled.

A significant risk common to almost all financial institutions is the threat of loss or damage to reputation from unauthorised transactions by staff. The Reserve Bank controls this risk in a number of ways, including by having a clear decision-making hierarchy; controls over access to computer systems; and separation of staff who initiate transactions from those who settle them. Independence of the middle office, to monitor compliance with trading and investment guidelines and provide reports on risk exposures, is a further key control. This was strengthened during the year by the relocation of the middle office to the RMU.

Operational risk in the Financial Markets Group arises from the large volume of transactions undertaken in markets each day. Around 80 000 transactions were undertaken in 2007/08, with daily settlement flows averaging around $43 billion. These risks are managed by ensuring that systems and processes are efficient and robust. Consistent with this, in 2007/08 the Reserve Bank commissioned an external review of the processes and controls underpinning its financial markets trading system. The purpose of the review was to identify any shortcomings that could give rise to fraud-related trading losses similar to those that emerged in several high-profile financial institutions in recent years. The review, which was undertaken in October 2007, found no major weakness in the system, indicating that the controls were consistent with broad industry practice.

A significant part of the Reserve Bank's operations is also involved in providing services to clients or the market as a whole. The Reserve Bank is the main banker for a number of government agencies, and processes around 280 million transactions a year on their behalf. It also provides real-time interbank payment and settlement services through RITS, which typically involves processing about 31 000 payment instructions per day, for an average daily value of $194 billion.

It is important that these functions be carried out efficiently and reliably. The Reserve Bank has extensive plans and back-up capacity for business continuity in the event that access to Head Office facilities or IT systems is lost. These were enhanced in July 2007 when the Bank commissioned its self-contained business resumption site. Several of the Reserve Bank's operational areas have staff based permanently at the site to ensure that critical functions can be maintained if access to Head Office is lost. Other business areas in the Reserve Bank regularly test their back-up arrangements at the site.

Portfolio Risks

The Reserve Bank's balance sheet is subject to a number of risks, including exchange rate risk, interest rate risk and credit risk. The Portfolio Risk and Compliance Section, as part of the RMU, has primary responsibility for monitoring these risks within the parameters defined by the Governor. The framework used in the day-to-day control and mitigation of these risks includes position and counterparty limits, formal delegations and market benchmarks. Compliance with the control framework is reported daily to both the Assistant Governor (Financial Markets) and Head of Risk Management. Performance and risk on the Reserve Bank's financial assets are also reported daily to senior management.

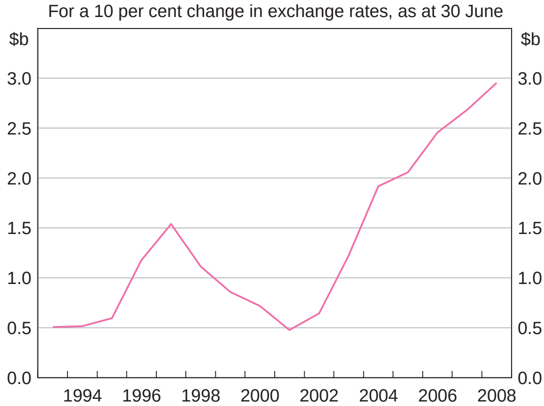
Exchange Rate Risk

Foreign currency assets are held by the Reserve Bank to support intervention operations in the Australian dollar market. As a result, the level of foreign currency exposure is determined on policy grounds and the resulting exchange rate risk cannot be separately hedged. The value of foreign currency assets (when measured in Australian dollars) varies with changes in the Australian dollar exchange rate against the currencies in which the assets are denominated. An appreciation of the Australian dollar relative to these currencies will result in a decline in the Australian dollar value of the foreign currency assets. The larger the size of foreign exchange assets, the greater the potential loss from an exchange rate appreciation.

Diversification of foreign currency assets across three currencies mitigates exchange rate risk somewhat. The exchange rate risk on a portfolio invested across a basket of currencies is lower than the risk on a portfolio of the same size invested in only one currency. For example, over the past five years the Australian dollar has appreciated by 45 per cent against the US dollar, but by only 5 per cent against the euro and 30 per cent against the yen. Against a basket of currencies in the

Exchange Rate Risk on RBA Foreign Currency Portfolio

For a 10 per cent change in exchange rates, as at 30 June



Source: RBA

Reserve Bank's foreign portfolio, which includes 45 per cent in the US dollar, 45 per cent in euro and 10 per cent in yen, the Australian dollar has risen by 25 per cent.

The timing of intervention and reserves replenishment also has some mitigating effect on exchange rate risk. Intervention tends to reduce the level of foreign currency holdings when the Australian dollar is low, which reduces the level of risk when the Australian dollar is most likely to appreciate. In turn, the Reserve Bank will tend to hold more foreign currency and be more exposed to exchange rate risk when the Australian dollar is high and so not likely to appreciate much further. Foreign currency assets acquired through swap operations do not entail foreign exchange risk, as the forward rate embedded in the swap hedges the risk.

Exchange rate risk on the balance sheet has increased in recent years. This has occurred as the Reserve Bank has rebuilt foreign currency reserves following a period of intervention at the turn of the decade. At current levels of reserves holdings, the potential valuation loss from a 10 per cent depreciation of the Australian dollar would be around $3 billion.

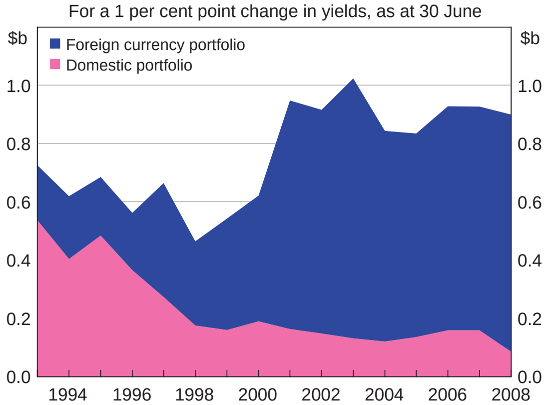
Interest Rate Risk

The value of the Reserve Bank's balance sheet tends to fluctuate with changes in market interest rates. Increases in market interest rates reduce the value of securities that earn a fixed rate of interest, which make up most of the securities held by the Bank. In contrast, when market interest rates fall, the value of these securities rises, as investors are willing to pay a premium for the higher fixed-income stream. Securities with a longer maturity (or duration) will have an income stream fixed for a longer period and so will be exposed to a greater degree of interest rate risk.

Over the past year, the interest rate risk faced by the Reserve Bank has declined marginally. A reduction in the holdings and average maturity of Australian government securities has been partly offset by a rise in foreign security holdings. In addition, an overall reduction in the size of the balance sheet has had little impact on interest rate risk; this has reflected the withdrawal of government deposits that were invested in relatively short maturities to broadly match the maturity of these deposits (i.e. effectively hedging the risk on the deposits).

Interest Rate Risk on RBA Portfolio

For a 1 per cent point change in yields, as at 30 June

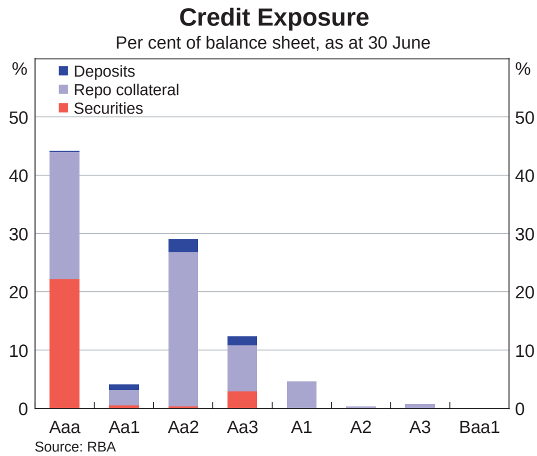


Source: RBA

Across the domestic and foreign portfolios, the Reserve Bank would suffer a valuation loss of about $900 million if interest rates in Australia and abroad rose by 1 percentage point across the yield curve. This is consistent with the level of valuation risk observed over much of the past five years. As shorter-term investments are reinvested at higher interest rates, such a loss would be partially offset over time.

Credit Risk

Credit risk is the possibility of financial loss owing to default by an issuer or counterparty. This risk can arise for the Reserve Bank through default by the issuers of securities held outright, default by banks with which funds have been deposited or default by counterparties with which transactions have been carried out. Unlike the financial risks discussed above, there is no policy imperative for having a given level of credit risk. As a result, this risk can be set at low levels.



The Reserve Bank mostly holds highly rated securities to minimise exposure to credit risk. For the domestic portfolio, the securities held outright include those issued by the Australian Government or State and Territory government borrowing authorities. A large proportion of the domestic portfolio also consists of repos, the largest component being repos in bank bills. Repos carry limited credit risk because they are a collateralised loan – i.e. both the counterpart to the repo and the issuer of the collateral would have to default simultaneously for the Reserve Bank to experience a loss. To reduce credit risk on repos further, the Bank requires excess collateral (referred to as over-cover) and imposes margin calls when this falls below a set level.

Over the past year, the Reserve Bank has expanded the range of collateral it is willing to accept under repo for open market operations to include bank bonds, a greater range of bank bills, residential mortgage-backed securities (RMBS) and asset-backed commercial paper (ABCP). In order to maintain a low level of credit exposure, the Bank sets strict eligibility criteria upon all collateral, ensuring that only high-quality securities are received. These criteria include high credit ratings and, in the case of RMBS and ABCP, mortgage insurance and a limit on funds provided against low-doc loans. The Reserve Bank also requires a higher level of over-cover for bank bonds, RMBS and ABCP.

For the foreign portfolio, the main investments are securities issued by the US, German, French and Japanese governments as well as certain highly rated supranational institutions. In addition, deposits are held with the BIS and some commercial banks. A small amount of the foreign portfolio is invested in the Asian Bond Funds, which have an average credit rating well within the range of investment grade paper.

Defaults by institutions with which the Reserve Bank has deposited funds and by counterparts to transactions represent the major source of credit risk faced. Foreign currency deposits are placed only with commercial banks that have a short-term rating of P-1 and long-term rating of Aa3 or above. Foreign exchange transactions are limited to counterparties rated P-1 and at least A3, while foreign repos and gold lending transactions, which are secured with high-quality assets, are limited to counterparties rated P-2 and Baa1 or better. In addition, limits are placed on exposures to those institutions that are eligible as counterparties. Other measures to control risk include requiring repos and gold loans to be over-collateralised, and requiring securities provided as collateral to be revalued daily and for counterparties to supply additional securities if the value of the securities falls below a specified amount.

The Reserve Bank has closely monitored developments in counterparty credit risk throughout the recent period of turmoil in global financial markets. In particular, the appropriateness of counterparty limits has been closely scrutinised on an ongoing basis.

No minimum credit rating or exposure limits are explicitly assigned to counterparties for domestic operations, as these are conducted for policy purposes. However, dealings are restricted to members of RITS.

Settlement risk can arise when a counterparty may not be able to complete a deal. This risk has been eliminated for securities transactions through the use of delivery-versus-payment systems, which involve the simultaneous exchange of securities for cash. However, settlement risk can be significant for foreign exchange transactions, as the two currencies of the foreign exchange transaction are settled in different time zones. This may require the Reserve Bank to pay out funds before any are received in return. This risk is controlled by dealing only with highly rated counterparties and limiting the total value of foreign currency transactions settling with an individual counterparty.

Legal Risk

In common with other organisations, the Reserve Bank acquires a broad range of goods and services in carrying out its work. In most instances, these are provided under detailed written contracts, the content of which has been agreed in advance between the Reserve Bank and the vendor. In circumstances where services are required over a long period, the contracts are regularly reviewed and, where applicable, re-negotiated to ensure that the services provided to the Bank are at a high level in terms of quality, reliability and value for money.

Many of the Reserve Bank's financial market activities are also executed under written contract. For example, repo transactions entered into by the Bank in domestic and foreign currency denominated securities are carried out under internationally recognised legal agreements, which specify the nature of the transactions and the rights of the parties involved, including the actions to be taken if either party fails to meet its obligations under the agreement. At the time of preparing this annual report, the Bank was finalising work on signing similar internationally recognised agreements with counterparties underpinning all of its foreign exchange transactions.

Reputational Risk

Reputational risk arises as an adjunct to all the risks outlined above: the Reserve Bank would suffer reputational loss were any of these risks not well managed. Likewise, reputational risk is contained to the extent that the other risks are adequately controlled. Reputational risks are further contained through, among other things, protocols on access to and handling sensitive information, careful controls governing dealings with the media, and clear guidelines for the conduct of management and staff in carrying out their duties. Making strenuous efforts to maintain a strong and cohesive organisational culture is key to maintaining a reputation for competence, integrity and impartiality. The Bank invests considerable resources in training its staff to develop both technical competence and also an awareness of the need for ethical behaviour and the requirement to put aside personal interests in carrying out official duties. The Code of Conduct for staff is an important vehicle for achieving this goal.

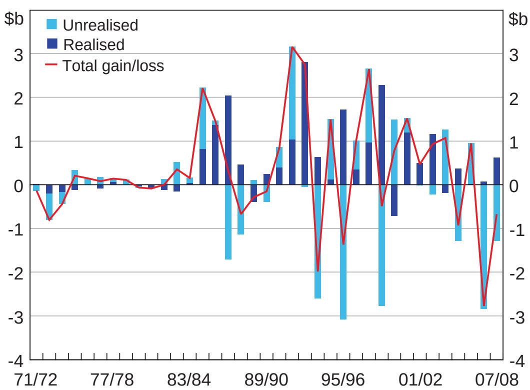
Earnings and Distribution

The Reserve Bank holds assets, amounting to about $100 billion at 30 June 2008, primarily to conduct operations in financial markets in pursuit of its monetary policy objectives. These financial assets include Australia's foreign exchange reserves and a portfolio of domestic securities to carry out liquidity management operations in Australia. The counterpart liabilities are composed of banknotes on issue, deposits of the Australian Government and other customers, and capital and reserves. No interest is payable on about half of these liabilities, namely banknotes and capital and reserves, whereas almost all of the Reserve Bank's assets earn interest. Consequently, its net interest income is sizeable. Net interest income, plus banking fees and rents less non-interest costs, are regarded as the Bank's underlying earnings. This is a relatively predictable and stable component of the Reserve Bank's profits, typically moving in line with the cycle in interest rates and the size of the balance sheet.

Since the Reserve Bank's assets are predominantly held in the form of highly rated domestic and foreign securities, valuation gains and losses that occur as the market prices of these assets fluctuate also affect profits. Valuation gains occur when bond yields fall (prices rise) or the exchange rate depreciates; losses occur when bond yields rise or the exchange rate appreciates. Gains or losses are realised when the underlying assets are sold in the course of operations to implement monetary policy or in managing foreign exchange reserves; they otherwise remain unrealised.

Since the Reserve Bank holds its assets for policy purposes, it has limited scope to manage the market risks it faces and, consequently, valuation gains and losses are both unpredictable and volatile. Valuation losses cannot be avoided in years in which there is either an appreciation of the exchange rate or rise in bond yields. The rise in the exchange rate of about 4 per cent in 2007/08 (based on a measure weighted by the currencies in which Australia's foreign exchange reserves are invested) led to valuation losses during the year. The unrealised valuation loss was smaller than in the previous year, when the reserves-weighted exchange rate rose by 12 per cent, but, for reasons discussed below, the impact on the dividend payable to the Australian Government is larger in the latest year.

Valuation Gains and Losses*



* On investments
Source: RBA

The Reserve Bank's accounting profit is measured in accordance with Australian equivalents to International Financial Reporting Standards (AIFRS) and includes earnings from all sources (i.e. underlying earnings plus realised and unrealised valuation gains and losses). The distribution of profits is governed by section 30 of the *Reserve Bank Act 1959*, which determines, in effect, that underlying earnings and realised gains or losses are to be made available for distribution. By contrast, unrealised gains are not distributed but are transferred to the Unrealised Profits Reserve, where they remain available either to absorb future valuation losses or to be realised if the underlying assets are eventually sold. This legislative framework is designed to ensure that the Reserve Bank's capacity to absorb valuation losses, when they occur, is not eroded by the distribution of earlier unrealised gains.

While unrealised gains are transferred to the Unrealised Profits Reserve, the treatment of unrealised losses depends on the size of the loss and the balance held in this reserve. When unrealised losses are smaller than the balance of the reserve, they are absorbed by it (in other words, they are effectively offset against previously accumulated net unrealised gains). However, in years in which the unrealised loss exceeds the balance of this reserve, the amount by which the loss exceeds this balance is charged against other sources of income to restore the balance of the reserve to nil, consistent with accounting principles and sound central banking practice. Such a charge has the effect of reducing earnings available for distribution *pari passu*.

As the Unrealised Profits Reserve had been fully depleted in the previous year, all of the unrealised losses recorded in 2007/08 were charged against the other sources of the Reserve Bank's earnings, thereby reducing the dividend payable commensurately.

Earnings Available for Distribution

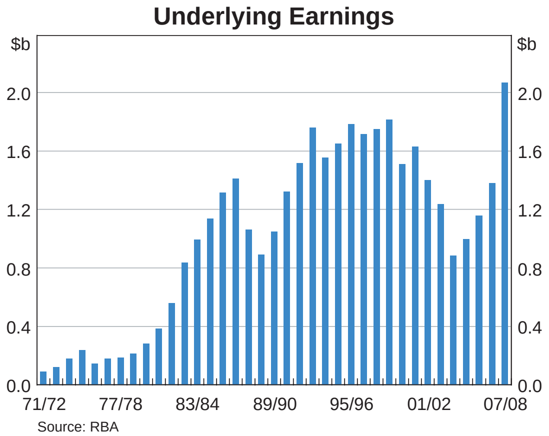
Earnings available for distribution were $1 403 million in 2007/08, compared with $1 085 million in 2006/07. The various components of earnings available for distribution in 2007/08 were as follows:

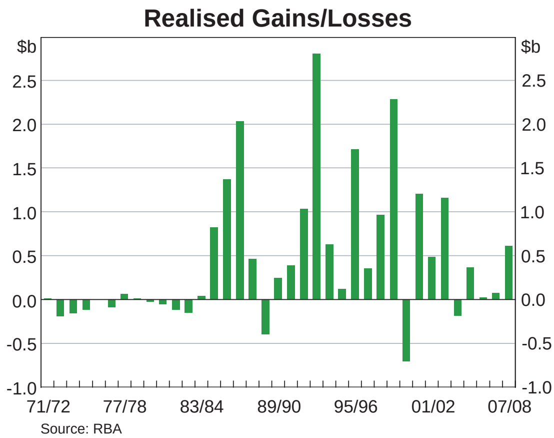
(i) Underlying earnings were $2 068 million, about $690 million more than last year, and higher than in any previous year. This increase reflects higher domestic interest rates, combined with the Reserve Bank holding more higher-yielding domestic assets (compared with foreign assets) as its market operations were more heavily concentrated in A$ securities in the latest year than in the recent past. The rise in underlying earnings was tempered by declining interest rates in the United States and the appreciation of the Australian dollar exchange rate, which tended to reduce the A$ value of interest earnings on foreign securities.

(ii) Realised gains of $614 million, comprising:

- gains of $485 million on foreign securities. These gains were realised in the normal course of managing foreign reserves over the first three quarters of the year as bond yields fell and securities were sold at higher prices than they had been purchased. Some losses were realised in the June quarter as bond yields rose;
- gains of $138 million from sales of foreign exchange; and
- losses of $9 million on domestic securities.

(iii) A charge against other sources of income for the unrealised valuation loss of $1 279 million, virtually all of which is due to the net appreciation of the exchange rate. The effect of this charge is to restore the unrealised profits reserve to nil on balance date. Charges of this kind have been made about one year in four, on average, over the past couple of decades.





While the unrealised valuation loss on the Reserve Bank's investments was smaller in 2007/08 than in 2006/07, the latest loss had a larger impact on earnings available for distribution because in the previous year the starting balance of about $2.5 billion in the Unrealised Profits Reserve absorbed most of the earlier unrealised loss. With a 'nil' balance in this reserve at the start of the latest year, all of the unrealised loss had the effect of reducing distributable earnings.

Earnings over a longer period are shown in the table below.

Reserves and Dividend

The Reserve Bank maintains a general reserve, the Reserve Bank Reserve Fund (RBRF), to provide for events that are contingent and non-foreseeable, including to cover losses from exceptionally large falls in the market value of its holdings of domestic and foreign securities that cannot be absorbed by its other reserves. This reserve also provides for losses that might arise from other business and operational risks, including fraud, to which the Reserve Bank is exposed. The RBRF has been funded over the years by transfers from earnings available for distribution and is essentially capital.

Under section 30 of the *Reserve Bank Act 1959*, transfers to the RBRF (from distributable earnings) are determined by the Treasurer after consultation with the Reserve Bank Board. The Act requires that the balance of distributable earnings after any such transfer be paid as a dividend to the Australian Government, the Reserve Bank's owner. The Board regarded the balance of $6 286 million in the RBRF at 30 June 2008 as satisfactory and did not seek a transfer to this Fund. Consequently, all of the earnings available for distribution in 2007/08, a sum of $1 403 million, was paid as a dividend to the Australian Government in August 2008.

The Reserve Bank also maintains a number of other financial reserves. As outlined above, in accordance with the Reserve Bank Act, unrealised gains are not available to be distributed but are transferred to the Unrealised Profits Reserve. As discussed, the charge made against other sources of income for unrealised losses in 2007/08 restored the balance of this reserve to nil as at 30 June 2008, the same as in the previous year.

Sources of Earnings Available for Distribution
$ million

	Underlying earnings	Realised gains and losses	Unrealised losses charged to other sources of income	Earnings available for distribution
1986/87	1 412	2 035	–	3 447
1987/88	1 062	464	–	1 526
1988/89	891	-394	-80	417
1989/90	1 049	245	-199	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	628	-676	1 508
1994/95	1 649	123	–	1 772
1995/96	1 784	1 712	-1 010	2 486
1996/97	1 715	1 990	–	3 705
1997/98	1 750	1 524	–	3 274
1998/99	1 816	2 284	-424	3 676
1999/00	1 511	-708	–	803
2000/01	1 629	1 205	–	2 834
2001/02	1 400	489	–	1 889
2002/03	1 238	1 159	–	2 397
2003/04	882	-188	–	694
2004/05	997	366	–	1 363
2005/06	1 156	21	–	1 177
2006/07	1 381	75	-371	1 085
2007/08	2 068	614	-1 279	1 403

Asset revaluation reserves are maintained for non-traded assets such as gold holdings, shares in the BIS and property, plant and equipment. The balances in these reserves represent the difference between the market value of these assets and the cost at which they were acquired. Balances in these reserves at 30 June 2008 stood at $2 807 million, an increase of $568 million from a year earlier, mainly reflecting an increase in the Australian dollar value of the Reserve Bank's holdings of gold.

Accounting Profit

The Reserve Bank's financial statements (and accompanying Notes to the Accounts) are prepared in accordance with AIFRS, consistent with the Finance Minister's Orders issued under the *Commonwealth Authorities and Companies Act 1997*. As noted, accounting profit is measured as profit from all sources.

Accounting profit in 2007/08 was $1 430 million, compared with an accounting loss of $1 393 million the previous year. The move from loss to profit reflects a smaller unrealised loss in 2007/08 and larger underlying earnings and realised gains.

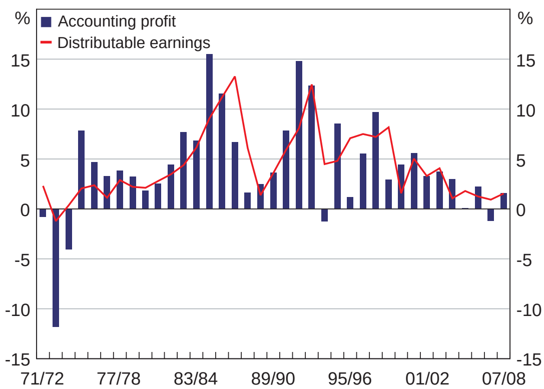
Reserve Bank Payments to Government

$ million

	Earnings available for distribution	Transfers to reserves	Payments to the Australian Government				
			Balance available from current year's profit	Interim payment from current year's profit	Payment from previous year's profit	Payment delayed from previous year	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
1999/00	803	–	803	–	3 000	–	3 000
2000/01	2 834	–	2 834	–	803	676	1 479
2001/02	1 889	–	1 889	–	2 834	–	2 834
2002/03	2 397	133	2 264	–	1 889	–	1 889
2003/04	694	–	694	–	1 300	–	1 300
2004/05	1 363	–	1 363	–	374	964	1 338
2005/06	1 177	–	1 177	–	1 063	320	1 383
2006/07	1 085	–	1 085	–	1 177	300	1 477
2007/08	1 403	–	1 403	–	1 085	–	1 085
2008/09	–	–	–	–	1 403	–	1 403

RBA Profits*

Per cent of balance sheet#



* Accounting profit is estimated prior to 1998
# Excludes sell repos
Source: RBA

Statutory Obligations

Equal Employment Opportunity (EEO)

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the Reserve Bank reports to the Australian Parliament each year on its equity and diversity program. The *Equity and Diversity Annual Report 2007* was tabled on 19 September 2007.

The Reserve Bank's program aims to ensure that all staff are treated with dignity and respect in the workplace and experience equal opportunity throughout their careers with the Bank. Much of the focus in 2007/08 was on information accessibility, with new initiatives including the purchase of an online accessibility training package, demonstrations of the various accessibility tools that are available and a workshop for non-managerial staff. The Bank introduced more flexible leave arrangements for staff on individual contracts in order to assist them in balancing responsibilities at work and at home. The Bank's Equity & Diversity Policy Committee also focused on streamlining the committee framework and improving the statistics on equity and diversity in the workplace, with a view to identifying issues and priorities more effectively.

Health and Safety, Compensation and Rehabilitation

The Reserve Bank is required, in terms of section 74 of the *Occupational Health and Safety Act 1991* (OH&S Act) and the conditions of its licence as a Licensed Authority under the *Safety, Rehabilitation and Compensation Act 1988*, to report each year on matters of health and safety, workers' compensation and rehabilitation as they affect the Bank.

The Reserve Bank is committed to the health and safety of its staff, contractors and visitors. It has a comprehensive OH&S Management System, developed in consultation with staff, which aims to ensure that its workplaces are free from work-related death, injury and disease. During 2007/08, the Bank focused on introducing suitable health and safety arrangements at its business resumption site and on the prevention of ergonomic, manual handling and lunch-time sport injuries. During the year, there were 11 claims for workers' compensation, compared with 24 in the previous financial year; two incidents required notification to Comcare. The Bank also expanded its suite of wellbeing programs to include Bank-wide health initiatives (such as the 10 000 Steps Program) and seminars on health topics.

In accordance with changes to the OH&S Act, the Reserve Bank reconstituted its OH&S Committee to include employee representatives. Changes to the Reserve Bank's Health and Safety Management Arrangements (HSMAs) were also required, including increased consultation with staff. The changes to the HSMAs, along with a revised Health & Safety Business Plan (2008–2012), will be implemented by September 2008.

The Reserve Bank has a strong track record in all aspects of occupational health and safety, as confirmed by external audits during the year. The audits in each of the three functions of OH&S, claims management and rehabilitation found the Bank to be materially compliant with the relevant legislation and the Bank's Conditions of Licence, with high achievement in each function. In recognition of this strong performance, the Bank has now been granted Tier Three status in each of these functions, the highest status achievable.

Freedom of Information

Section 8 statement

Organisation and functions: The Reserve Bank is Australia's central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the *Reserve Bank Act 1959*, the *Banking Act 1959*, the *Commonwealth Authorities and Companies Act 1997*, the *Payment Systems (Regulation) Act 1998*, the *Payment Systems and Netting Act 1998*, the *Corporations Act 2001* and the *Financial Services Reform Act 2001*, and in Regulations made under those Acts. An overview of the structure of the Reserve Bank is provided in the organisational chart, which appears on pages 108 and 109.

Categories of documents: The Reserve Bank publishes speeches, reports, articles, occasional papers, conference volumes, information booklets, minutes of the monetary policy meetings of the Reserve Bank Board, media releases, statistical data and various other documents. These are available on the Reserve Bank's website (www.rba.gov.au), which also provides other information about the Bank. The Reserve Bank publishes a monthly *Bulletin*, which includes speeches, reports, media releases, statistical data and other items. Other documents are held in the form of working notes and files covering policy and operational matters, statistical data, staff, premises and general administration.

The right of access to documents in the possession of Australian Government agencies in terms of the *Freedom of Information Act 1982* (FOI Act) applies to the Reserve Bank. However, the Bank is an exempt agency under the FOI Act in respect of documents concerning banking operations (including individual open market operations and foreign exchange dealings) and exchange control matters.

Facilities for access and Freedom of Information procedures: Enquiries under the FOI Act, including requests for access to documents, should be directed to the Secretary of the Reserve Bank. 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

Ten requests for access to documents under the FOI Act were received in 2007/08. Access was granted in full on three requests and in part on one request, while access was denied on two requests. No relevant documents were found in response to two requests. Two requests, which were received late in the financial year, were still in progress at the end of June 2008.

The estimated number of staff hours spent dealing with all aspects of FOI requests in 2007/08 was around 100 hours. The total cost to the Reserve Bank of administering the FOI Act in 2007/08 is estimated to have been about $28 660. Application fees of $270 were collected; charges of around $100 were levied.

Financial Statements

As at 30 June 2008

Directors' Statement

In the opinion of the directors, the financial statements for the year ended 30 June 2008 give a true and fair view of the matters required by the Finance Minister's Orders 2007-2008 made under the *Commonwealth Authorities and Companies Act 1997*. These statements have been prepared from properly maintained financial records and are signed in accordance with a resolution of the directors.

Glenn Stevens

Chairman, Reserve Bank Board
14 August 2008

BALANCE SHEET As at 30 June 2008
Reserve Bank of Australia and Controlled Entities

	Note	2008 $M	2007 $M
ASSETS			
Cash and cash equivalents	6	862	586
Australian dollar securities	1(b), 16	54 702	34 955
Foreign exchange	1(b), 16	42 505	93 538
Gold	1(c), 16	2 509	2 001
Property, plant and equipment	1(d), 8	456	421
Loans, advances and other	7	438	393
Total Assets		101 472	131 894
LIABILITIES			
Deposits	1(b), 9	39 006	65 830
Distribution payable to Australian Government	1(f), 3	1 403	1 085
Other	10	9 786	16 072
Australian notes on issue	1(b), 16	42 064	40 289
Total Liabilities		92 259	123 276
Net Assets		9 213	8 618
Capital and Reserves			
Reserves:			
Unrealised profits reserves	1(e), 5	80	53
Asset revaluation reserves	1(e), 5	2 807	2 239
Reserve Bank Reserve Fund	1(e), 5	6 286	6 286
Capital	5	40	40
Total Capital and Reserves		9 213	8 618

INCOME STATEMENT For the year ended 30 June 2008
Reserve Bank of Australia and Controlled Entities

	Note	2008 $M	2007 $M
INCOME			
Interest revenue	2	5 204	5 400
Net gains/(losses) on securities and foreign exchange	2	(665)	(2 774)
Dividend revenue	2	4	4
Fees and commissions	2	18	17
Other revenue	2	82	63
Total Income		4 643	2 710
EXPENSES			
Interest expense	2	2 940	3 857
General administrative expenses	2	231	217
Other expenses	2	42	29
Total Expenses		3 213	4 103
Net Profit		1 430	(1 393)

STATEMENT OF DISTRIBUTION For the year ended 30 June 2008
Reserve Bank of Australia and Controlled Entities

	Note	2008 $M	2007 $M
NET PROFIT		1 430	(1 393)
Transfer (to)/from unrealised profits reserves	5	(27)	2 475
Transfer (to)/from Reserve Bank Reserve Fund	5	–	–
Transfer from asset revaluation reserves	5	–	3
Earnings available for distribution		1 403	1 085
Distributed as follows:			
Reserve Bank Reserve Fund	5	–	–
Payable to the Australian Government	3	1 403	1 085
		1 403	1 085

STATEMENT OF CHANGES IN CAPITAL AND RESERVES

For the year ended 30 June 2008

Reserve Bank of Australia and Controlled Entities

	Note	2008 $M	2007 $M
Opening balance of Capital and Reserves	5	8 618	11 208
Plus:			
Net Profit	2	1 430	(1 393)
Gain/(loss) on revaluation of gold	5	513	(149)
Gain/(loss) on revaluation of shares in international institutions	5	17	(14)
Gain/(loss) on revaluation of properties	5	38	51
Total revaluation gains/(losses)		568	(112)
Total income and expenses		1 998	(1 505)
Less:			
Transfer to the distribution payable to Australian Government	3	(1 403)	(1 085)
Closing balance of Capital and Reserves	5	9 213	8 618

CASH FLOW STATEMENT For the year ended 30 June 2008
Reserve Bank of Australia and Controlled Entities

This statement meets the requirements of AASB 107 – *Cash Flow Statements* and the Finance Minister's Orders 2007-2008. In the RBA's view, due to the nature of central banking activities, this statement does not shed 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.

	2008 Inflow/ (outflow) $M	2007 Inflow/ (outflow) $M
Cash flows from operating activities		
Interest received on investments	4 972	4 274
Interest received on loans, advances, and on net overnight settlements systems	62	58
Loan management reimbursement	–	1
Banking service fees received	17	17
Dividends received	4	4
Rents received	8	7
Net payments for and proceeds from sale of investments	24 082	(24 177)
Interest paid on deposit liabilities	(2 329)	(3 226)
Interest paid on currency note holdings of banks	(199)	(179)
Staff costs (including redundancy)	(120)	(135)
Premises and equipment	(34)	(31)
Other	(5)	20
Net cash provided by operating activities	26 458	(23 367)
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(23)	(59)
Net cash used in investing activities	(23)	(59)
Cash flows from financing activities		
Profit payment to Australian Government	(1 085)	(1 477)
Net movement in deposit liabilities	(26 824)	22 626
Net movement in loans and advances	8	2
Net movement in notes on issue	1 775	2 223
Other	(33)	63
Net cash provided by financing activities	(26 159)	23 437
Net increase/(decrease) in cash	276	11
Cash at beginning of financial year	586	575
Cash at end of financial year	862	586

CASH FLOW STATEMENT (CONTINUED) For the year ended 30 June 2008

Reserve Bank of Australia and Controlled Entities

Reconciliation of cash	**Note**	**2008 $M**	**2007 $M**
Cash		9	15
Overnight settlements systems	6	853	571
		862	586

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act 1959*	**Note**	**2008 $M**	**2007 $M**
Net Profit		1 430	(1 393)
Increase/(decrease) in interest payable		14	(75)
Net loss/(gain) on overseas investments	2	(506)	80
Net loss/(gain) on Australian dollar securities	2	34	117
Net loss/(gain) on foreign currency	2	1 137	2 577
Decrease/(increase) in income accrued on investments		238	(529)
Depreciation of property	8	9	6
Depreciation of plant and equipment	8	13	10
Net payments for and proceeds from sale of investments		24 082	(24 177)
Other		7	17
Net cash provided by operating activities		26 458	(23 367)

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2008
Reserve Bank of Australia and Controlled Entities

Note 1 SUMMARY OF ACCOUNTING POLICIES

The Reserve Bank of Australia (RBA) reports its financial statements in accordance with the *Reserve Bank Act 1959* and the *Commonwealth Authorities and Companies (CAC) Act 1997*. These financial statements for the year ended 30 June 2008 have been prepared under Australian equivalents to International Financial Reporting Standards (AIFRS), other accounting standards and accounting interpretations issued by the Australian Accounting Standards Board, in accordance with the Finance Minister's Orders (FMOs) 2007-2008, which are issued pursuant to the *CAC Act 1997*. These financial statements comply fully with International Financial Reporting Standards. The RBA has not sought any exemptions from the requirements of the FMOs in 2007/08.

These financial statements and attached notes are a general purpose financial report prepared in accordance with relevant AIFRS. Elections as to the accounting treatment under AIFRS made by the Bank are noted appropriately. All amounts are expressed in Australian dollars unless another currency is indicated. The RBA is classified as a for-profit public-sector entity for purposes of financial disclosure. Fair values are used for the RBA's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for properties, plant and equipment. Revenue and expenses are brought to account on an accrual basis. All revenues, expenses and profits of the RBA are from ordinary activities.

(a) Consolidation and joint venture

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. 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. Note Printing Australia Limited's total assets, liabilities and capital as at 30 June 2008 were $82.6 million, $22.6 million and $60.0 million respectively ($75.6 million, $24.6 million and $51.0 million as at 30 June 2007). Subsequently, the RBA provided NPA with additional capital of $15.0 million in July 2008 and will provide a further $25.0 million of capital around July 2009.

The assets, liabilities and results of Note Printing Australia Limited have been consolidated with the parent entity accounts in accordance with AASB 127 – *Consolidated and Separate Financial Statements*. All internal transactions and balances have been eliminated on consolidation.

The RBA equity accounts for its investment in Securency International Pty Ltd in accordance with AASB 131 – *Interests in Joint Ventures*. The RBA's investment in Securency International Pty Ltd is included in Note 7.

(b) Financial instruments

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 RBA's financial instruments are its Australian dollar securities, foreign government securities, bank deposits, interest rate futures, foreign currency swap contracts, gold loans, cash and cash equivalents, notes on issue, deposit liabilities and its shareholding in the Bank for International Settlements. The RBA accounts for its financial instruments in accordance with AASB 139 – *Financial Instruments: Recognition and Measurement* and reports these instruments under AASB 7 – *Financial Instruments: Disclosures*.

The RBA brings its foreign and domestic securities transactions and foreign exchange transactions to account on a trade date basis; that is, it recognises the effects of purchases and sales of these securities in the Income Statement and the Balance Sheet on the date these transactions are arranged (not when the transactions are settled). Bank deposits and repurchase agreements are brought to account on settlement date.

Australian dollar securities

The RBA holds Commonwealth Treasury Fixed Coupon Bonds and Treasury Capital Indexed Bonds, and securities issued by the central borrowing authorities of State and Territory Governments. It also holds under repurchase agreements: bank bills, certificates of deposit and debt securities of authorised deposit taking institutions licensed in Australia; Australian dollar denominated securities issued by foreign governments, foreign government agencies that have an explicit government guarantee (or equivalent support) and by certain highly-rated supranational organisations; and selected Australian dollar domestic residential mortgage backed securities and asset-backed commercial paper. Domestic securities, except those contracted for sale under repurchase agreements, are classified under AASB 139 as 'at fair value through profit or loss', as they are held for purposes of conducting monetary policy and may be sold or lent, typically for short terms, under repurchase agreements. In accordance with this standard, the securities are valued at market bid prices on balance date; realised and unrealised gains or losses are taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1 (f)). Interest earned on the securities is accrued over the term of the security and included as revenue in the Income Statement.

Commonwealth Treasury Fixed Coupon Bonds and fixed income securities issued by the central borrowing authorities of State and Territory Governments are coupon securities; the interest is received biannually at the coupon rate and the principal is received at maturity. 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.

Foreign exchange

Foreign exchange holdings are invested mainly in securities (issued by the governments of the United States, Germany, France and Japan) and bank deposits (with highly-rated international banks, central banks and international agencies). The RBA engages in interest rate futures and foreign currency swaps.

Assets and liabilities denominated in foreign currency are converted to Australian dollar equivalents at the relevant market bid or offer exchange rate ruling on balance date in accordance with AASB 121 – *The Effects of Changes in Foreign Exchange Rates*. Realised and unrealised gains or losses on foreign currency are taken to profit, but only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1 (f)). Interest revenue and revaluation gains and losses on foreign currency assets and interest expense on foreign currency liabilities are converted to Australian dollars using the relevant market bid or offer exchange rate on the date they are accrued or recognised, in accordance with AASB 121.

Foreign government securities

Foreign government securities comprise coupon and discount securities and securities held under repurchase agreements. Coupon securities have biannual or annual interest payments depending on the currency and type of security; the principal of these securities is received at maturity. Interest earned on discount securities is the difference between the actual purchase cost and the face value of the security; this is amortised over the term of the securities. The face value is received at maturity. Foreign securities, except those contracted for sale under repurchase agreements, are classified under AASB 139 as 'at fair value through profit or loss', as they are held for trading. In accordance with this standard, the securities are valued at market bid prices on balance date; realised and unrealised gains or losses are taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1 (f)). Interest earned on securities is accrued over the term of the security as revenue in the Income Statement.

Foreign bank deposits

The RBA invests part of its foreign currency reserves in deposits with highly-rated international banks; it also maintains working accounts in foreign currencies. Deposits are classified as 'loans and receivables' under AASB 139 and recorded at their face value, which is equivalent to their amortised cost using the effective interest method. Interest is accrued over the term of deposits and is received periodically or at maturity. Interest accrued but not paid is included in Accrued Interest (Note 16).

Foreign currency swaps

The RBA uses foreign currency swaps to assist daily domestic liquidity management and to manage its balance sheet holdings. A foreign 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 certain 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 2008 (including those under swap contracts) have been valued at market exchange rates (Note 16).

Interest rate futures

The RBA uses interest rate futures contracts on overseas exchanges to manage interest rate risk 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 positions are classified under AASB 139 as 'at fair value through profit or loss'. In accordance with this standard, futures positions are marked to market on balance date at the relevant bid or offer price and valuation gains and losses taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1 (f)).

Bank for International Settlements

Under AASB 139 the RBA's shareholding in the Bank for International Settlements (BIS) is classified as 'available for sale' for accounting purposes. The shareholding is valued at fair value and revaluation gains and losses are transferred directly to the revaluation reserve for shares in international financial institutions (Note 5). The fair value is estimated on the basis of BIS' net asset value, less a discount of 30 per cent. Dividends are recognised as revenue in the Income Statement when declared.

Repurchase agreements

In the course of its financial market operations, the RBA engages in repurchase agreements involving foreign and Australian dollar marketable securities.

Securities sold and contracted for purchase under repurchase agreements are classified under AASB 139 as 'at fair value through profit or loss', as they are held for trading, and reported on the Balance Sheet within the relevant investment portfolio. In accordance with this standard, the securities are valued at market bid prices on balance date and realised and unrealised gains or losses on securities are taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1 (f)). The counterpart obligation to repurchase the securities is reported in Other Liabilities (Note 10) at amortised cost; the difference between the sale and purchase price is accrued over the term of the agreement and recognised as interest expense.

Securities purchased and contracted for sale under repurchase agreements are classified under AASB 139 as 'loans and receivables' and valued at amortised cost. The difference between the purchase and sale price is accrued over the term of the agreement and recognised as interest revenue.

Deposit liabilities

Deposits include deposits at call and term deposits. Deposits are classified as financial liabilities under AASB 139. Deposit balances are shown at their amortised cost, which is equivalent to their face value. Interest is accrued over the term of deposits and is paid periodically or at maturity. Interest accrued but not paid is included in Other Liabilities (Note 10). Details of deposits are included in Note 9.

Australian notes on issue

Notes on issue are recorded at face value. Prior to 2005/06, the RBA periodically adjusted its liability for note series that had ceased to be issued, to reflect the likelihood that the remaining notes on issue from these series would not be presented for redemption because they were judged to have been destroyed or were otherwise unavailable for presentation. Under this policy, notes totaling $133 million were written down and the gains included in accounting profits. As these notes were written down prior to 1 January 2005, the RBA has not had to re-recognise under AIFRS the liability for these notes. If the written-down notes are subsequently presented, the RBA will reinstate the liability for them and charge an expense against profits. In 2007/08, notes with a face value of $214 000 which had previously been written down were presented to the RBA and re-recognised as a liability ($402 000 in 2006/07); a corresponding expense was charged against profits.

In 2001/02, the RBA began to pay interest on working balances of currency notes held by banks under revised cash distribution arrangements. Interest is paid on balances up to a certain limit.

(c) 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 balance date. Revaluation gains and losses on gold are transferred to the gold revaluation reserve. The RBA lends gold to financial institutions participating in the gold market. As outlined in Note 1(b), gold loans are a financial instrument and the RBA accounts for these loans in accordance with AASB 139 and reports these loans under AASB 7.

(d) Property, plant and equipment

Formal valuations of all the RBA's Australian properties are conducted annually; overseas properties are formally valued on a triennial basis. Australian properties are valued by an independent valuer; overseas properties are valued by local independent valuers. The most recent independent valuation of overseas properties was at 30 June 2007. In accordance with AASB 116 – *Property, Plant and Equipment*, properties are valued at market value, which reflects observable prices and are based on the assumption that assets would be exchanged between knowledgeable, willing parties at arm's length. Reflecting the specialised nature of the respective assets, the value of the Craigieburn property has been determined on the basis of vacant possession, while the RBA's business resumption site in outer metropolitan Sydney is valued at depreciated replacement cost. Valuation gains and losses are transferred to the Property Revaluation Reserve. These valuations have been incorporated in the accounts. Annual depreciation is based on fair values and assessments of the useful remaining life of the relevant asset.

Plant and equipment is recognised on a fair value basis; valuation gains and losses are treated in accordance with AASB 116. Plant and equipment is valued by independent valuers on a triennial basis. The most recent independent valuation was on 30 June 2008. Annual depreciation is based on fair values and the RBA's assessments of the useful remaining life of individual assets. Computer software is accounted for in accordance with AASB 138 – *Intangible Assets*. Software is recognised at cost less accumulated amortisation, which is calculated on the basis of the estimated useful life of the relevant assets. Amortisation expense for computer software is included in Other Expenses in Note 2.

The range of useful lives used for each class of newly-purchased assets is:

	Years
Buildings	20-49
Fitout and furniture	5-10
Computer equipment	
– hardware	3-5
– software	4-7
Office equipment	4-5
Motor vehicles	5
Plant	4-15

Details of annual net expenditure, revaluation adjustments and depreciation of buildings, and plant and equipment are included in Note 8; details of computer software are included in Note 7.

(e) Capital and Reserves

The capital of the Reserve Bank was established by the *Reserve Bank Act 1959*.

The Reserve Bank maintains the Reserve Bank Reserve Fund (RBRF), a general reserve, to provide for events which are contingent and non-foreseeable, including covering losses from exceptionally large falls in the market value of its holdings of domestic and foreign securities that cannot be absorbed by its other resources. This reserve also provides for other risks to which the RBA is exposed, including fraud and operational risk. The RBRF has been funded over the years by transfers from earnings available for distribution and is, in all respects, essentially capital. The Reserve Bank Board assesses the adequacy of the balance of the RBRF each year. In line with Section 30 of the *Reserve Bank Act 1959*, the Treasurer, after consultation with the Reserve Bank Board, determines any amounts to be credited to the RBRF from earnings available for distribution (refer Note 1(f)).

The Bank also holds a number of other reserves which form part of its equity. Unrealised gains and losses on foreign exchange, foreign securities and Australian dollar securities are recognised in profit from ordinary activities. Until such gains or losses are realised, however, they are not available for distribution to the Australian Government; such amounts are reflected in the Reserve for Unrealised Profits on Investments. If unrealised losses exceed the balance held in the Unrealised Profits Reserve they are, to the extent that unrealised losses exceed this balance, charged against other sources of income consistent with the *Reserve Bank Act 1959* and accounting practice.

Unrealised gains and losses on the surplus of the staff superannuation funds are also recognised in the Income Statement in accordance with the 'corridor' approach under AASB 119 – *Employee Benefits*. These amounts are reflected in the Reserve for Unrealised Profits on Superannuation.

Balances of asset revaluation reserves in the balance sheet reflect differences between the fair value of a number of the RBA's assets, mainly non-traded assets (gold; property, plant and equipment; and shares in international financial institutions), and their cost. These unrealised gains are transferred directly to the relevant reserve and are not included in accounting profits. The unrealised gains on these assets are not distributable until the gains are realised through the sale of the relevant asset.

The Earnings and Distribution chapter in this Annual Report provides additional information on the RBA's capital and reserves.

(f) Profits

Profits of the RBA are dealt with in terms of Section 30 of the *Reserve Bank Act 1959* as follows:

(1) Subject to subsection (2), 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 is 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.

(g) Provisions

The RBA maintains provisions for accrued annual leave in accordance with AASB 119 – *Employee Benefits*, calculated on salaries expected to prevail when leave is anticipated to be taken 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 consistent with AASB 119. In addition, the RBA makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date.

(h) Superannuation funds

The RBA includes in its balance sheet an asset representing the surpluses in its defined benefit superannuation funds in accordance with the 'corridor' approach under AASB 119 – *Employee Benefits*; the counterpart to this asset is the Reserve for Unrealised Profits on Superannuation. Details of the superannuation funds and superannuation expenses are included in Note 14.

(i) Rounding

Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

	Note	2008 $M	2007 $M
Note 2 NET PROFITS			
Interest revenue			
Overseas investments	1(b), 4	2 042	3 276
Australian dollar securities	1(b), 4	3 092	2 056
Overnight settlements	4	61	56
Gold loans	1(c), 4	8	11
Loans, advances and other	4	1	1
		5 204	5 400
Net gains/(losses) on securities and foreign exchange			
Overseas investments	1(b)	506	(80)
Australian dollar securities	1(b)	(34)	(117)
Foreign currency	1(b)	(1 137)	(2 577)
		(665)	(2 774)
Dividend revenue			
Earnings on shares in Bank for International Settlements	1(b)	4	4
Fees and commissions			
Banking services fees received		18	17
Other revenue			
Reimbursement by Australian Government for loan management and registry expenses		–	1
Rental of Bank premises		8	7
Sales of note and security products		41	31
Superannuation revenue	1(h), 14	8	–
Other		25	24
		82	63
Total		4 643	2 710
Less:			
Interest expense			
Deposit liabilities	1(b), 4	2 342	3 150
Currency note holdings of banks	1(b), 4	199	179
Repurchase agreements	1(b), 4	399	528
		2 940	3 857
General administrative expenses			
Staff costs		141	118
Superannuation costs	1(h), 14	–	15
Special redundancy/retirement payments		–	1
Depreciation of property	1(d), 8	9	6
Depreciation of plant and equipment	1(d), 8	13	10
Premises and equipment	1(d)	34	31

	Note	2008 $M	2007 $M
Note 2 (CONTINUED)			
Materials used in note and security products		21	22
Travel		3	3
Consultants' fees, legal fees and payments to contractors		2	2
Other		8	9
		231	217
Other expenses			
Agency business reimbursement		2	3
Subsidiary income tax		3	2
Cash distribution expenses		5	6
Other		32	18
		42	29
Total		3 213	4 103
Net Profit		1 430	(1 393)

Staff costs in 2007/08 includes an expense of $12.8 million associated with the increase in the balance of the Provision for post-employment benefits (in 2006/07 there was a credit of $1.3 million) (refer Note 10). Post-employment health care costs of $13.5 million are included in Staff Costs ($1.4 million in 2006/07).

The RBA's aggregate research and development expenditure recognised as an expense in 2007/08 was $0.6 million ($0.7 million in 2006/07); this is included in Other Expenses.

Note 3 DISTRIBUTION PAYABLE TO AUSTRALIAN GOVERNMENT

Section 30 of the *Reserve Bank Act 1959* requires that the net profits of the Reserve Bank of Australia, less amounts set aside for contingencies or placed in the RBRF as determined by the Treasurer after consultation with the Board, shall be paid to the Australian Government (see Note 1(f)). Also under Section 30, unrealised profits are not available for distribution and are transferred to the Unrealised Profits Reserve where they remain available to absorb future valuation losses or are realised when relevant assets are sold. Unrealised losses are, in the first instance, absorbed within the Unrealised Profits Reserve; if such losses exceed the balances in this reserve, the amount by which the losses exceed the balances is charged against other sources of income.

	2008 $M	2007 $M
Opening balance	1 085	1 477
Distribution to Australian Government	(1 085)	(1 477)
Transfer from Statement of Distribution	1 403	1 085
As at 30 June	1 403	1 085

An amount of $1 085 million from earnings in 2006/07 was paid to the Australian Government in August 2007. Earnings available for distribution of $1 403 million from 2007/08 will be distributed in August 2008.

	Average balance	Interest	Average annual interest rate
	$M	$M	%

Note 4 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2008

	Average balance $M	Interest $M	Average annual interest rate %
Interest revenue			
Overseas investments	52 787	2 042	3.9
Australian dollar securities	44 459	3 092	7.0
Overnight settlements	916	61	6.6
Gold loans	1 037	8	0.8
Loans, advances and other	14	1	5.7
	99 213	5 204	5.2
Interest expense			
Banks' Exchange Settlement balances	2 587	171	6.6
Deposits from governments	32 322	2 151	6.7
Deposits from overseas institutions	2 041	20	1.0
Currency note holdings of banks	2 911	199	6.8
Overseas repurchase agreements	10 355	356	3.4
Domestic repurchase agreements	673	43	6.5
Other deposits	15	–	1.7
	50 904	2 940	5.8
Analysis for the year ended 30 June 2007			
Interest revenue total	113 181	5 400	4.8
Interest expense total	67 249	3 857	5.7

Interest revenue for 2007/08 includes $4 190 million calculated using the effective interest method for financial assets not at fair value through profit and loss ($4 372 million in 2006/07). Interest expense for 2007/08 includes $2 940 million calculated using the effective interest method for financial liabilities not at fair value through profit and loss ($3 857 million in 2006/07).

Note 5 CAPITAL AND RESERVES

Changes in the RBA's Capital and Reserves are shown below.

	2008 $M	2007 $M
Asset revaluation reserves		
Gold (Note 1(c))		
Opening balance	1 842	1 991
Net revaluation adjustments	513	(149)
As at 30 June	2 355	1 842
Shares in international financial institutions (Notes 1(b), 7)		
Opening balance	209	223
Net revaluation adjustments	17	(14)
As at 30 June	226	209
Bank properties, plant and equipment (Notes 1(d), 8)		
Opening balance	188	140
Net revaluation adjustments	38	51
Transfers (to)/from Statement of Distribution	–	(3)
As at 30 June	226	188
Total asset revaluation reserves (Note 1(e))		
Opening balance	2 239	2 354
Net revaluation adjustments	568	(112)
Transfers (to)/from Statement of Distribution	–	(3)
As at 30 June	2 807	2 239
Unrealised profits reserves		
Reserve for unrealised profits on investments (Note 1(e))		
Opening balance	–	2 476
Net transfers (to)/from Statement of Distribution	–	(2 476)
As at 30 June	–	–
Reserve for unrealised profits on superannuation (Note 1(h))		
Opening balance	53	52
Net transfers (to)/from Statement of Distribution	27	1
As at 30 June	80	53
Total unrealised profits reserves		
Opening balance	53	2 528
Net transfers (to)/from Statement of Distribution	27	(2 475)
As at 30 June	80	53
Reserve Bank Reserve Fund (Note 1(e))		
Opening balance	6 286	6 286
Transfers (to)/from Statement of Distribution	–	–
As at 30 June	6 286	6 286
Capital		
Opening and closing balance	40	40

Note 6 CASH AND CASH EQUIVALENTS

This includes net amounts of $853 million owed to the RBA for overnight clearances of financial transactions through the clearing houses; an amount of $571 million was owed to the RBA at 30 June 2007.

	Note	2008 $M	2007 $M
Note 7 LOANS, ADVANCES AND OTHER ASSETS			
Shareholding in Bank for International Settlements	1(b)	269	253
Superannuation asset	1(h)	80	53
Officers' Home Advances		10	18
Investment in Securency	1(a)	35	29
Computer software	1(d)	5	5
Other		39	35
As at 30 June		438	393

The Reserve Bank of Australia has a 50 per cent share in Securency International Pty Ltd (Securency), which is incorporated in Victoria, Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securency as at 30 June 2008 was $50 million. The carrying value of the RBA's investment in Securency as at 30 June 2008 was $35.1 million ($29.1 million at 30 June 2007). Securency has a 31 December balance date. The RBA's share of Securency's profit before income tax in 2007/08 was $8.8 million ($11.4 million in 2006/07); its share of Securency's income tax expense in 2007/08 was $2.8 million ($3.5 million in 2006/07). Securency's current and non-current assets as at 30 June 2008 were $61.5 million and $80.9 million respectively ($43.8 million and $52.9 million as at 30 June 2007). Current and non-current liabilities on 30 June 2008 were $22.5 million and $38.2 million ($21.0 and $17.6 million on 30 June 2007). Securency's revenue and expenses for 2007/08 were $103.2 million and $85.6 million ($109.8 and $87.0 million in 2006/07). The RBA provides facilities to Securency under operating leases. In 2005/06, the RBA also provided a finance lease to Securency for $5.6 million in relation to the construction of a new building on the Bank's land at Craigieburn. The finance lease was fully drawn down during 2006/07. The lease was provided on commercial terms and at arm's length; it has a term of 10 years. The balance of the lease receivable as at 30 June 2008 was $4.3 million ($4.7 million as at 30 June 2007).

During 2007/08, the RBA acquired $0.3 million of computer software ($0.2 million in 2006/07) and amortised $1.8 million ($1.6 million in 2006/07). At 30 June 2008 the gross book value of the RBA's computer software amounted to $11.1 million and accumulated amortisation on this software was $5.7 million ($10.0 million and $5.2 million respectively at 30 June 2007). The RBA had contractual commitments of $0.7 million as at 30 June 2008 for the acquisition of computer software ($1.9 million at 30 June 2007).

As at 30 June 2008, other assets included receivables of $24.4 million, all of which are current (at 30 June 2007 other assets included receivables of $21.6 million, all of which were current).

	Land	Buildings	Plant and Equipment	Total
	$M	$M	$M	$M

Note 8 PROPERTY, PLANT AND EQUIPMENT

	Land $M	Buildings $M	Plant and Equipment $M	Total $M
Gross Book Value as at 30 June 2007	120	222	107	449
Accumulated depreciation	–	–	(28)	(28)
Net Book Value	120	222	79	421
Additions	–	7	13	20
Depreciation expense	–	(9)	(13)	(22)
Net revaluation increment/(decrement)	12	26	–	38
Disposals	–	–	(1)	(1)
Net additions to net book value	12	24	(1)	35
Gross Book Value as at 30 June 2008	132	246	85	463
Accumulated depreciation	–	–	(7)	(7)
Net Book Value	132	246	78	456

The net book value of buildings as at 30 June 2008 includes expenditure of $1.2 million on work in progress which has been capitalised in the carrying amount of these assets ($5.9 million as at 30 June 2007). Additions include expenditure of $8.2 million on work in progress that was capitalised during 2007/08 ($6.1 million in 2006/07). As at 30 June 2008, the RBA had contractual commitments of $4.0 million to acquire buildings, plant and equipment ($6.2 million at 30 June 2007).

Note 9 DEPOSITS

	2008 $M	2007 $M
Banks' Exchange Settlement balances	6 359	1 714
Australian Government	30 979	62 262
State Governments	3	3
Foreign governments, foreign institutions and international organisations	1 651	1 838
Other depositors	14	13
As at 30 June	39 006	65 830

	2008 $M	2007 $M
Note 10 OTHER LIABILITIES		
Provisions (Note 1(g))		
Provision for accrued annual leave	12	11
Provision for long service leave	24	24
Provision for post-employment benefits	69	56
Provision for workers' compensation	–	1
	105	92
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(b))	9 125	14 494
Interest accrued on deposits	69	55
Other	487	1 431
	9 681	15 980
Total Other Liabilities as at 30 June	9 786	16 072

The provision for workers' compensation at 30 June 2008 was $329 000 ($408 000 at 30 June 2007). During 2007/08, annual leave of $7.3 million was accrued by staff, while $6.8 million of accrued leave was used. Staff accrued and used long service leave of $3.1 million and $2.5 million respectively in 2007/08; the provision for long service leave also decreased by $0.2 million due to the increase in the interest rate used to discount future cash flows. The RBA provided an additional $14.5 million for post-retirement benefits in 2007/08, while benefits of $1.2 million were paid out of the provision; an increase in the discount rate further reduced the provision by $0.8 million. The balance of the provision for post-employment benefits will change if assumptions regarding the length of staff service, the longevity of retired staff, increases in medical costs or the discount rate vary.

Note 11 CONTINGENT LIABILITIES AND OTHER ITEMS NOT INCLUDED IN THE BALANCE SHEET

The RBA has a contingent liability, amounting to $60.9 million at 30 June 2008 ($64.2 million at 30 June 2007), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

In the course of providing services to its customers, the RBA provides performance guarantees to third parties in relation to customer activities. Such exposure is not material and has not given rise to losses in the past.

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

Note 12 KEY MANAGEMENT PERSONNEL

AASB 124 – *Related Party Disclosures* requires disclosure of information relating to aggregate compensation of key management personnel. The key management personnel of the RBA are members of the RBA Board, members of the Payments System Board and senior staff who have responsibility for planning, directing and controlling the activities of the RBA. In 2007/08, this group comprises 22 in total (21 in 2006/07), including the Governor and Deputy Governor, 8 non-executive RBA Board members, 6 non-executive Payments System Board members and 6 senior staff. Fees of the non-executive members of the Reserve Bank Board and the Payments Systems Board are determined by the Remuneration Tribunal. A committee of non-executive Board members reviews annually the remuneration of the Governor and Deputy Governor in terms of Section 24A of the *Reserve Bank Act 1959*. The Governors determine the remuneration of other key executives.

The remuneration of the RBA's key management personnel was as follows:

	2008 $	2007 $
Short-term employee benefits	3 618 564	3 172 165
Post-employment benefits	668 114	580 651
Other long-term benefits	144 990	318 635
Share based payments	–	–
Termination benefits	–	–
Total Compensation	4 431 668	4 071 451

Short-term benefits include cash salary, and in the case of staff, annual leave, motor vehicle benefits, car parking, health benefits and the fringe benefits tax paid or payable on these benefits. Post-employment benefits include superannuation benefits and, in the case of staff, health benefits. Other long-term benefits include long service leave. The components of remuneration are reported on an accruals basis.

As at 30 June 2008 and 30 June 2007 there were no loans by the RBA to key management personnel.

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, $97 354 ($169 604 in 2006/07) was paid for non-executive members of the Board of NPA Limited who are not employees of the RBA or members of the Bank Board.

Note 13 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services (excluding GST) totalled $315 000 in 2007/08 ($275 000 in 2006/07); this includes audit services in relation to the RBA's subsidiary Note Printing Australia. These fees are included in Consultants' Fees, Legal Fees and Payments to Contractors in Note 2.

Note 14 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act 1959*: the Reserve Bank of Australia Officers' Superannuation Fund (OSF) and the Reserve Bank of Australia UK Pension Scheme. A small part of the assets of the OSF is held by the RBA as nominee for the trustees of the OSF; such assets are not included in the RBA's financial statements. Payment of these superannuation funds' current and future benefits is funded by member and RBA contributions and the funds' existing asset bases. The RBA's superannuation income for 2007/08 (expense for 2006/07) in relation to the OSF and the UK Pension Scheme is included in accounting profits and shown 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 2007/08.

The OSF is a hybrid fund. Most members receive a Bank-funded defined benefit in accordance with the rules of the fund; other member benefits include unitised defined contribution accumulation balances, which comprise the RBA's productivity and superannuation guarantee contributions and members' personal contributions, plus earnings on these contributions. The OSF is classified as a single-employer plan for the purposes of AASB 119 – *Employee Benefits*. The UK Pension Scheme is a defined benefit scheme.

Funding valuation

Full independent actuarial valuations of the OSF and UK Pension Scheme are conducted every three years to determine funding for these schemes. The most recent funding valuation of the OSF was at 30 June 2005 and for the UK Pension Scheme at 30 June 2007. At the most recent valuations, the actuaries indicated that, on the basis of accrued benefits, both funds were in surplus and that the funds were in a satisfactory financial position. The next triennial funding valuation for the OSF for 30 June 2008 will be undertaken in 2008/09.

The OSF triennial funding valuation as at 30 June 2005 was based on the Aggregate Funding method, consistent with the accounting standard for superannuation funds, AAS 25 – *Financial Reporting by Superannuation Plans*. Under this standard, the accrued benefits of the OSF were determined as the value of the future benefits payable to members (allowing for future salary increases), discounted using the expected rate of return on the assets held to fund these benefits. At the time of the triennial review, the surplus of the OSF on this measure was $64 million, as the assets of the OSF of $614 million exceeded the accrued benefits of $550 million. Subsequent to the triennial review, the OSF surplus measured on the basis of AAS 25 as at 30 June 2008 amounted to $115 million (assets of $755 million less accrued benefits of $640 million).

Consistent with the actuary's funding recommendation, the Bank maintained its contribution rate to the OSF at 18.3 per cent of salaries in 2007/08. The main financial assumptions in the triennial valuation were that the annual post-tax rate of return on assets for benefits of active members was 6.25 per cent, that for assets for current pensions was 6.75 per cent (pre-tax), with annual salary increases of 4.0 per cent and annual pension increases of 3.5 per cent.

The triennial funding valuation for the UK Pension Scheme was based on the Attained Age method. The surplus of the UK Pension Scheme as at 30 June 2008, measured in accordance with AAS 25, was $2 million (assets of $23 million compared with accrued benefits of $21 million).

Accounting valuation

For financial statement purposes, the financial positions of the superannuation schemes are valued in accordance with AASB 119. Under AASB 119, accrued benefits are determined by discounting future benefits payable to current fund members at the yield on government bonds of similar maturity on the reporting date. The approach under AASB 119, in contrast with the results of the actuary's triennial valuations noted above, does not take into account that the assets held by the superannuation schemes to fund future benefits have generally earned a higher rate of return on average than government bonds.

The principal actuarial assumptions for the AASB 119 valuation used in the case of the OSF were a discount rate of 6.54 per cent (6.35 per cent in 2006/07), future salary increases of 4.0 per cent (4.0 per cent in 2006/07), future pension increases of 3.75 per cent (3.5 per cent in 2006/07) and an assumed return on plan assets of 8.7 per cent (8.3 per cent in 2006/07). The actual return on plan assets of the OSF for 2007/08 was -3.3 per cent (19.0 per cent in 2006/07). The assumptions used for the UK Pension Scheme were a discount rate of 6.3 per cent (5.8 per cent in 2006/07), future salary increases of 5.9 per cent (5.2 per cent in 2006/07), future pension increases of 3.9 per cent (3.2 per cent in 2006/07) and an assumed return on plan assets of 4.9 per cent (5.0 per cent in 2006/07). The actual return on plan assets of the UK Pension Scheme for 2007/08 was 14.0 per cent (3.7 per cent in 2006/07). The expected overall rates of returns are based on the actuaries' models of returns for major asset classes and reflect the historic rates of return and volatility for each class and correlations across asset classes.

Details of the funds are as shown on the following pages. In the case of the OSF, these details relate only to the defined benefit component of the fund; defined contribution accumulation balances, on which the Bank has no actuarial risk, are excluded. This has no effect on the measurement of the surpluses in the OSF. At 30 June 2008 accumulation balances in the OSF totalled $144.4 million ($144.4 million as at 30 June 2007).

Asset Distribution as at 30 June	**OSF**		**UK Pension Scheme**	
(% of fund assets)	**2008**	**2007**	**2008**	**2007**
Cash and short-term securities	6.3	5.0	–	–
Fixed interest securities	4.4	7.1	–	–
Indexed securities	3.1	3.2	94.3	93.0
Domestic shares	36.9	41.7	5.7	7.0
Foreign shares	4.7	6.0	–	–
Property				
Direct	5.2	4.5	–	–
Indirect	21.3	19.5	–	–
Private equity and alternative investments	18.1	13.0	–	–
Total	100	100	100	100

Note 14 (CONTINUED)	OSF		UK Scheme		Total	
	2008 $M	2007 $M	2008 $M	2007 $M	2008 $M	2007 $M
Opening balances:						
Net market value of assets	796	672	23	24	819	696
Accrued benefits	(631)	(650)	(17)	(20)	(648)	(670)
Surplus	165	22	5	4	171	26
Actuarial (gains)/losses not included in balance sheet under Corridor	(117)	26	(2)	–	(118)	26
Exchange rate (gains)/losses	–	–	–	–	–	–
Opening superannuation asset	49	48	4	4	53	52
Change in net market value of assets	(41)	124	(1)	(1)	(42)	122
Change in accrued benefits	(49)	20	2	2	(47)	22
Change in actuarial (gains)/losses not included in balance sheet under Corridor	117	(143)	(2)	(2)	115	(144)
Exchange rate (gains)/losses	–	–	1	–	1	–
Total change in superannuation asset	27	1	–	–	27	1
Closing balances:						
Net market value of assets	755	796	22	23	777	819
Accrued benefits	(679)	(631)	(16)	(17)	(695)	(648)
Surplus	76	165	6	5	82	171
Actuarial (gains)/losses not included in balance sheet under Corridor	–	(117)	(3)	(2)	(3)	(118)
Exchange rate (gains)/losses	–	–	1	–	1	–
Closing superannuation asset	76	49	4	4	80	53
Actuarially assumed return on plan assets	63	44	1	1	64	45
Benefit payments	(27)	(27)	(1)	(1)	(29)	(28)
Actuarial gains/(losses) on assets	(90)	95	2	–	(88)	95
Contributions from RBA to defined benefit schemes	16	13	–	–	16	13
Contributions tax	(2)	(2)	–	–	(2)	(2)
Exchange rate gains/(losses)	–	–	(3)	(1)	(3)	(1)
Change in net market value of assets	(41)	124	(1)	(1)	(42)	122
Current service cost	(19)	(23)	–	–	(20)	(23)
Interest cost	(36)	(34)	(1)	(1)	(37)	(35)
Benefit payments	27	27	1	1	29	28
Contributions tax	2	2	–	–	2	2
Experience adjustments on benefits	(20)	7	–	–	(20)	7
Effects of changes in benefit actuarial assumptions	(3)	41	–	2	(4)	43
Exchange rate gains/(losses)	–	–	2	1	2	1
Change in accrued benefits	(49)	20	2	2	(47)	22

Note 14 (CONTINUED)	OSF		UK Scheme		Total	
	2008 $M	2007 $M	2008 $M	2007 $M	2008 $M	2007 $M
Actuarial (gains)/losses on assets	90	(95)	(2)	–	88	(95)
Experience adjustments on benefits	20	(7)	–	–	20	(7)
Effects of changes in benefit actuarial assumptions	3	(41)	–	(2)	4	(43)
Amortisation of actuarial gains/(losses)	3	–	–	–	3	–
Change in actuarial losses not included in balance sheet under Corridor	117	(143)	(2)	(2)	115	(144)
Superannuation expense/(income) included in Income Statement						
Current service cost	19	22	–	–	20	22
Interest cost	36	32	1	1	37	33
Assumed return on plan assets	(63)	(42)	(1)	(1)	(64)	(43)
Amortisation of actuarial (gains)/losses under Corridor	(3)	–	–	–	(3)	–
Productivity and superannuation guarantee contributions	3	3	–	–	3	3
Total superannuation expense/ (income)	(8)	15	–	–	(8)	15

The components of this table may not add due to rounding.

The surplus of the funds and experience adjustments on plan assets and accrued benefits as at 30 June for the current reporting period and previous three reporting periods are:

	2008 $M	2007 $M	2006 $M	2005 $M
OSF				
Closing balances:				
Net market value of assets	755	796	672	614
Accrued benefits	(679)	(631)	(650)	(607)
Surplus	76	165	22	7
Experience adjustments on assets	(90)	95	40	38
Experience adjustments on benefits	(20)	7	(11)	(11)
UK Scheme				
Closing balances:				
Net market value of assets	22	23	24	23
Accrued benefits	(16)	(17)	(20)	(19)
Surplus	6	5	4	4
Experience adjustments on assets	2	–	–	1
Experience adjustments on benefits	–	–	–	–

The components of this table may not add due to rounding.

Note 15 SEGMENT REPORTING

The RBA's primary function as a central bank is the implementation of monetary policy in one geographical area – Australia. Over 95 per cent of the RBA's assets (and a similar proportion of revenues) are managed for that purpose by the Financial Markets Group. Additional information on the make-up of the RBA's financial assets is provided in Note 16.

Note 16 FINANCIAL INSTRUMENTS AND RISK

As the central bank of Australia, the RBA is responsible for implementing monetary policy and managing Australia's foreign reserve assets. As a consequence, the RBA holds a range of financial assets, including Australian dollar securities, foreign government securities, bank deposits, interest rate futures contracts, foreign currency swaps, gold loans, cash and cash equivalents. The RBA also holds a shareholding in the Bank for International Settlements. As to financial liabilities, the RBA issues Australia's banknotes and offers deposit facilities to its customers, mainly the Australian Government, and eligible financial institutions. Accordingly, the main financial claims on the RBA are currency notes on issue as well as deposit liabilities. The RBA also provides banking services to its customers, and operates Australia's high-value payments and inter-bank settlement systems. These payment and settlements occur through accounts held on the RBA's balance sheet.

AASB 7 – *Financial Instruments: Disclosures* requires disclosure of information relating to financial instruments; their significance and performance; terms and conditions; fair values; risk exposures and risk management.

Financial Risk

The risks incurred by virtue of holding financial instruments include market risk, credit risk and liquidity risk. The RBA is exposed to a range of financial risks reflecting its policy and operational responsibilities. The chapters on the Reserve Bank's Balance Sheet and Operations in Financial Markets and Risk Management provide additional information on the RBA's management of these financial risks.

Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises: foreign exchange risk, interest rate risk, and other price risk.

Foreign exchange risk

Foreign exchange risk is the risk that the fair value or cash flows of foreign currency assets and liabilities will fluctuate because of movements in exchange rates. Foreign exchange risk arises from the RBA's foreign currency assets, which are held to support the RBA's operations in the foreign exchange market. The value of these assets, measured in Australian dollars, varies with movements in the value of the Australian dollar exchange rate against the currencies in which the assets are invested. An appreciation in the exchange rate results in valuation losses, while a depreciation leads to valuation gains. The overall level of foreign currency exposure is determined by policy considerations and cannot otherwise be managed to reduce foreign exchange risk. The RBA's net foreign currency exposure as at 30 June 2008 was $33.0 billion ($29.8 billion as at 30 June 2007). Within the overall exposure and to a limited extent, foreign currency risk can be reduced by holding assets across a diversified portfolio of currencies. The RBA holds foreign reserves in three currencies – the US dollar, the Euro and the Yen – because the markets for these currencies are highly liquid and suitable for investing foreign exchange reserves. (See *Concentration of foreign exchange* below.)

The RBA also undertakes foreign currency swaps to assist its daily domestic market operations. These instruments carry no foreign exchange risk since the exchange rates at which both legs of the transaction are settled are agreed at the time the swap is undertaken.

Concentration of foreign exchange

The RBA's net holdings of foreign exchange (excluding its holding of SDRs) were distributed as follows as at 30 June:

	% of foreign exchange	
	2008	2007
US dollar	45	45
Euro	45	45
Japanese yen	10	10
Total foreign exchange	100	100

Sensitivity to foreign exchange risk

The sensitivity of the RBA's profit and equity to a movement of +/-10 per cent in the value of the Australian dollar exchange rate as at 30 June is shown below. These figures are generally reflective of the RBA's exposure over the financial year.

	2008 $M	2007 $M
Loss/decrease in equity due to a 10 per cent appreciation in the reserves-weighted value of the A$	–2 997	–2 705
Profit/increase in equity due to a 10 per cent depreciation in the reserves-weighted value of the A$	3 664	3 306

Interest rate risk

Interest rate risk is the risk that the fair value or cash flows of financial instruments will fluctuate because of movements in market interest rates. The RBA's balance sheet is exposed to considerable interest rate risk because most of its assets are financial assets, such as domestic and foreign securities, which have a fixed income stream. The price of such securities increases when market interest rates decline, while the price of a security will fall if market rates rise. Interest rate risk increases with the maturity of a security because the associated income stream is fixed for a longer period.

The interest rate risk table (overpage) is based on the RBA's contracted portfolio as reported in the RBA's balance sheet. All financial instruments are shown at their repricing period which is equivalent to the remaining term to maturity. Other liabilities include amounts outstanding under sale repurchase agreements. Interest rate futures reflect the positions in interest rate contracts traded on foreign futures exchanges.

Note 16 (CONTINUED)

Interest rate risk As at 30 June 2008

	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 coupon rate %	Weighted average effective rate %
Assets									
Gold loans	866	–	155	620	62	–	29	1.36	1.36
Gold holdings	1 643	–	–	–	–	–	1 643	n/a	n/a
Sub-total	**2 509**								
Foreign exchange									
Balances with central banks	314	311	–	–	–	–	3	1.70	1.70
Securities sold under repurchase agreements	9 086	–	–	1 700	3 748	3 638	–	3.37	3.10
Securities purchased under repurchase agreements	13 537	–	13 537	–	–	–	–	2.42	2.42
Other securities	14 337	198	1 787	2 473	5 004	4 049	826	3.38	3.72
Deposits	5 008	27	4 980	–	–	–	1	3.41	3.41
Accrued interest – foreign exchange	223	–	–	–	–	–	223	n/a	n/a
Sub-total	**42 505**								
Australian dollar securities									
Securities sold under repurchase agreements	–	–	–	–	–	–	–	–	–
Securities purchased under repurchase agreements	51 451	–	41 392	10 059	–	–	–	7.52	7.52
Other securities	2 777	–	384	–	1 438	955	–	6.33	7.26
Accrued interest – Australian dollar securities	474	–	–	–	–	–	474	n/a	n/a
Sub-total	**54 702**								
Property, plant & equipment	456	–	–	–	–	–	456	n/a	n/a
Cash and cash equivalents	862	853	–	–	–	–	9	7.25	7.25
Loans and advances	10	10	–	–	–	–	–	4.72	4.72
Other	428	–	–	–	–	–	428	n/a	n/a
Total assets	**101 472**	**1 399**	**62 235**	**14 852**	**10 252**	**8 642**	**4 092**	**5.34**	**5.39**
Liabilities									
Australian notes on issue	42 064	2 483	–	–	–	–	39 581	0.43	0.43
Deposits	39 006	8 221	29 406	–	–	–	1 379	7.21	7.21
Distribution payable to Australian Government	1 403	–	–	–	–	–	1 403	n/a	n/a
Other	9 786	–	9 123	–	–	–	663	1.91	1.91
Total liabilities	**92 259**	**10 704**	**38 529**	**–**	**–**	**–**	**43 026**	**3.45**	**3.45**
Capital and reserves	9 213								
Total balance sheet	**101 472**								
Off balance sheet items									
Interest rate futures	99	–	–	–	–	–	99	n/a	n/a

Note 16 (CONTINUED)

Interest rate risk As at 30 June 2007

	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 coupon rate %	Weighted average effective rate %
Assets									
Gold loans	1 064	–	–	390	640	–	34	1.35	1.35
Gold holdings	937	–	–	–	–	–	937	n/a	n/a
Sub-total	**2 001**								
Foreign exchange									
Balances with central banks	357	352	–	–	–	–	5	4.27	4.27
Securities sold under repurchase agreements	13 652	–	1 282	2 223	4 145	6 002	–	4.26	4.71
Securities purchased under repurchase agreements	49 778	–	49 778	–	–	–	–	4.93	4.93
Other securities	12 268	228	3 991	2 090	2 365	1 800	1 794	2.57	2.67
Deposits	16 928	27	16 899	–	–	–	2	5.02	5.02
Accrued interest – foreign exchange	555	–	–	–	–	–	555	n/a	n/a
Sub-total	**93 538**								
Australian dollar securities									
Securities sold under repurchase agreements	663	–	–	168	300	195	–	7.11	6.35
Securities purchased under repurchase agreements	30 351	–	29 551	800	–	–	–	6.29	6.29
Other securities	3 772	–	125	305	1 945	1 397	–	6.45	6.50
Accrued interest – Australian dollar securities	169	–	–	–	–	–	169	n/a	n/a
Sub-total	**34 955**								
Property, plant & equipment	421	–	–	–	–	–	421	n/a	n/a
Cash and cash equivalents	586	571	–	–	–	–	15	6.25	6.25
Loans and advances	18	18	–	–	–	–	–	4.04	4.04
Other	375	–	–	–	–	–	375	n/a	n/a
Total assets	**131 894**	**1 196**	**101 626**	**5 976**	**9 395**	**9 394**	**4 307**	**4.90**	**4.95**
Liabilities									
Australian notes on issue	40 289	2 588	–	–	–	–	37 701	0.40	0.40
Deposits	65 830	2 996	61 106	50	–	–	1 678	6.25	6.25
Distribution payable to Australian Government	1 085	–	–	–	–	–	1 085	n/a	n/a
Other	16 072	–	14 470	–	–	–	1 602	4.20	4.20
Total liabilities	**123 276**	**5 584**	**75 576**	**50**	**–**	**–**	**42 066**	**4.01**	**4.01**
Capital and reserves	8 618								
Total balance sheet	**131 894**								
Off balance sheet items									
Interest rate futures	537	–	–	–	–	–	537	n/a	n/a

Sensitivity to interest rate risk

The figures below show the effect on the RBA's profit and equity of a movement of +/-1 percentage point in interest rates, given the level, composition and modified duration of the RBA's foreign currency and Australian dollar securities as at 30 June. The valuation effects shown are generally reflective of the RBA's exposure over the financial year.

	2008 $M	2007 $M
Change in profit/equity due to movements of +/-1 percentage point across yield curves:		
Foreign currency securities	–/+828	–/+784
Australian dollar securities	–/+86	–/+159

A rise in interest rates would be associated with a valuation loss; a fall in interest rates would be associated with a valuation gain.

Other price risk

The RBA holds Australia's shares in the Bank for International Settlements as a member of the BIS. This is mainly to maintain and develop strong relationships with other central banks which are to Australia's advantage. Shares in the BIS are owned exclusively by its member central banks and monetary authorities. For accounting purposes, the RBA treats BIS shares as 'available for sale' and the fair value of these shares is estimated on the basis of the BIS' net asset value, less a discount of 30 per cent. Accordingly, these shares are revalued to reflect movements in the net asset value of the BIS and in the Australian dollar. The price risk faced on BIS shares is incidental to the general reasons for holding them and is immaterial compared with other market risks faced by the RBA. For this reason, this exposure is not included as part of the RBA's net foreign currency exposure outlined above.

Credit Risk

Credit risk is the potential for financial loss arising from an issuer or counterparty defaulting on its obligations to repay the principal or interest payments due on an asset, or to settle a transaction. For the RBA, credit risk arises from exposure to the issuers of securities that it holds; banks with which it deposits funds; and counterparties which are yet to settle transactions. The RBA's credit exposure is low compared with that of most commercial financial institutions, as it manages such risks within a highly risk-averse framework. In particular, credit risk is managed by: holding securities of a limited number of highly-rated governments; holding deposits with highly-rated banks in amounts consistent with their credit ratings and capital positions; and holding collateral only of low credit risk against buy repurchase agreements and gold loans.

Cash invested under repurchase agreements in overseas markets is secured by collateral in the form of government securities or securities issued by US agencies; the RBA takes and maintains collateral to the value of 102 per cent of the cash invested. Cash invested under domestic buy repurchase agreements is secured by securities issued by Australian governments, Australian banks and various asset backed securities (see Note 1(b)). The RBA holds collateral to a value between 102 and 110 per cent of the amount invested according to the risk profile of the collateral held. Gold loans are secured by Australian dollar securities to 110 per cent of the market value of the gold loaned.

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 maximum credit risk exposure in relation to off-balance sheet items is:

1. ***Foreign exchange swaps*** – As at 30 June 2008 the RBA was under contract to purchase $5.2 billion of foreign currency ($10.8 billion at 30 June 2007) and sell $5.2 billion of foreign currency ($59.5 billion at 30 June 2007). As of that date there was an unrealised net gain of $3 million on these swap positions included in net profit ($1 091 million unrealised gain at 30 June 2007). The exposure of these contracts to credit risk is the cost of re-establishing the contract in the market if a counterparty fails to fulfil its obligations.
2. ***Interest rate futures*** – As at 30 June 2008 the amount of credit risk on interest rate futures contracts was approximately $1.4 million ($1.6 million at 30 June 2007). As at 30 June 2008 there was an unrealised gain brought to account on those contracts of $0.9 million ($1.1 million unrealised loss at 30 June 2007).

Concentration of credit risk

As noted, 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.

As at 30 June 2008 (or 30 June 2007) the RBA held no past due or impaired assets.

	Risk rating of security/issuer[1]	Risk rating of counterparties[1]	% of total assets	
			2008	2007
Domestic Government Securities				
Holdings – Commonwealth Government securities	AAA	n/a	0.0	1.1
Holdings – Semi Government securities	AAA	n/a	2.3	1.6
	AA	n/a	0.5	0.2
Securities sold under repurchase agreements	AAA	AA	0.0	0.5
	AAA	A	0.0	0.1
Securities held under repurchase agreements	AAA	AA	7.7	9.4
	AAA	A	0.6	1.1
	AAA	other	0.1	1.4
	AA	AA	36.5	10.0
	AA	A	0.1	0.0
	AA	other	0.1	0.0
	A	AA	5.3	1.1
	A	A	0.4	0.0
	BBB	AA	0.0	0.0
	other[2]	AA	0.3	0.0

Foreign investments				
Holdings of securities	AAA	n/a	11.0	4.3
	AA	n/a	2.9	3.9
	A	n/a	0.3	0.3
Securities sold under repurchase agreements	AAA	AA	4.2	9.0
	AAA	A	4.7	1.2
	AA	AA	0.0	0.1
	AA	A	0.1	0.1
Securities held under repurchase agreements	AAA	AAA	0.3	0.3
	AAA	AA	7.8	34.9
	AAA	A	5.2	2.1
	AA	AAA	0.0	0.0
	AA	AA	0.0	0.7
	AA	A	0.3	0.2
Deposits	n/a	AAA	0.3	0.6
	n/a	AA	4.7	12.3
Other	n/a	AA	0.0	0.7
	n/a	A	0.0	0.1
Gold loans	n/a	AAA	0.1	0.1
	n/a	AA	0.5	0.6
	n/a	A	0.2	0.1
	n/a	BBB	0.1	0.1
Other			3.4	1.8
			100	100

1 Standard & Poor's equivalent ratings
2 This category includes Asset Backed Commercial Paper (ABCP), which does not have a long-term credit rating.

Liquidity Risk

Liquidity risk is the risk that the RBA will encounter difficulty in meeting obligations associated with its financial liabilities. As the ultimate source of liquidity in Australian dollars, the RBA has the powers and operational wherewithal to create liquidity in unlimited amounts in Australian dollars at any time. A small component of the RBA's liabilities is in foreign currencies, namely foreign sale repurchase agreements. All risks associated with these instruments, including liquidity risk, are managed by ensuring the liability is fully hedged.

Liquidity risk is also associated with financial assets to the extent that the RBA may have to sell a financial asset at less than its fair value. The RBA manages this risk by holding a diversified portfolio of highly liquid domestic and foreign assets.

Fair Value of Financial Instruments

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. The RBA's Australian dollar securities, foreign government securities, interest rate futures, foreign currency swap contracts and its shareholding in the Bank for

International Settlements are carried in the balance sheet (and shown in this note) at fair value. The RBA's bank deposits, cash and cash equivalents, notes on issue and deposit liabilities are carried in the balance sheet (and shown in this note) at face value, which is equivalent to their amortised cost using the effective interest method; this approximates fair value.

AASB 7 requires that the fair value of financial assets and liabilities be disclosed according to their accounting classification under AASB 139.

	2008 $M	2007 $M
Assets		
At fair value through Profit or Loss	26 446	30 631
Loans and receivables	71 637	98 944
Available-for-sale	1 131	839
Total financial assets as at 30 June	99 214	130 414
Non-financial assets	2 258	1 480
Total assets as at 30 June	101 472	131 894
Liabilities		
At fair value through Profit or Loss	399	1 321
Not at fair value through Profit or Loss	90 264	120 668
Non-financial liabilities	1 596	1 287
Total liabilities as at 30 June	92 259	123 276

Auditor-General for Australia

Australian National Audit Office

INDEPENDENT AUDITOR'S REPORT

To the Treasurer

Scope

I have audited the accompanying financial statements of the Reserve Bank of Australia and controlled entities for the year ended 30 June 2008, which comprise: a directors' statement; balance sheet; income statement; statement of distribution; statement of changes in capital and reserves; cash flow statement; and notes to and forming part of the financial statements including the summary of accounting policies.

The Responsibility of the Board of Directors for the Financial Statements

The members of the Board are responsible for the preparation and fair presentation of the financial statements in accordance with the Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997* and Australian Accounting Standards (including the Australian Accounting Interpretations). This responsibility includes establishing and maintaining internal controls relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

My responsibility is to express an opinion on the financial statements based on my audit. My audit has been conducted in accordance with the Australian National Audit Office Auditing Standards, which incorporate Australian Auditing Standards. These auditing standards require that I comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the financial

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statements by the Reserve Bank of Australia in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Independence

In conducting the audit, I have followed the independence requirements of the Australian National Audit Office, which incorporate the requirements of the Australian accounting profession.

Auditor's Opinion

In my opinion, the financial statements of the Reserve Bank of Australia and controlled entities:

(a) have been prepared in accordance with the Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997,* and the Australian Accounting Standards (including the Australian Accounting Interpretations); and

(b) give a true and fair view of the matters required by the Finance Minister's Orders including the Reserve Bank of Australia and the controlled entities' financial position as at 30 June 2008 and their financial performance and their cash flows for the year then ended.

Ian McPhee
Auditor-General

Pro Forma Business Accounts

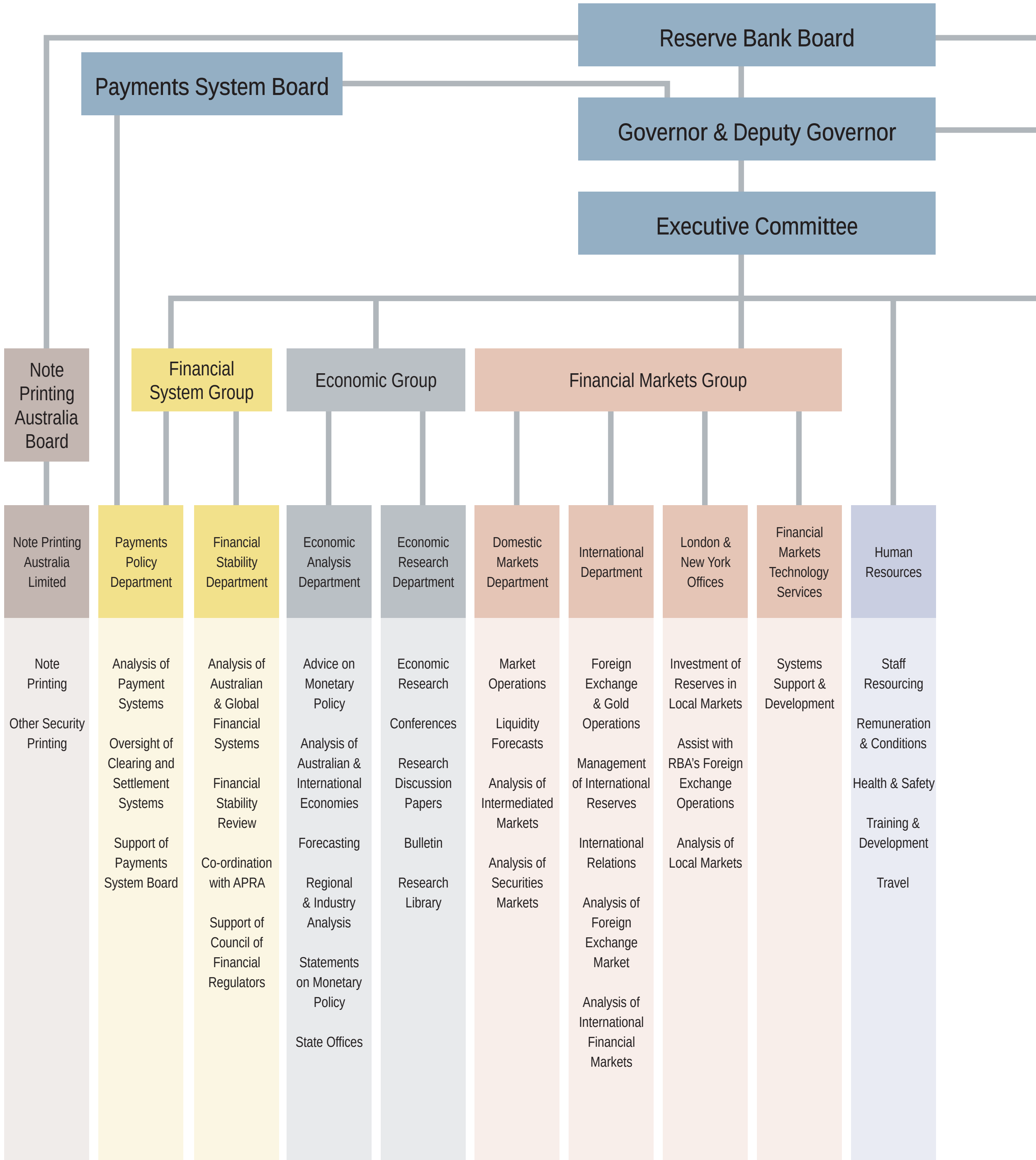
The following sets of accounts for each of the Reserve Bank's contestable businesses have been prepared in accordance with competitive neutrality guidelines. These accounts do not form part of the audited financial statements.

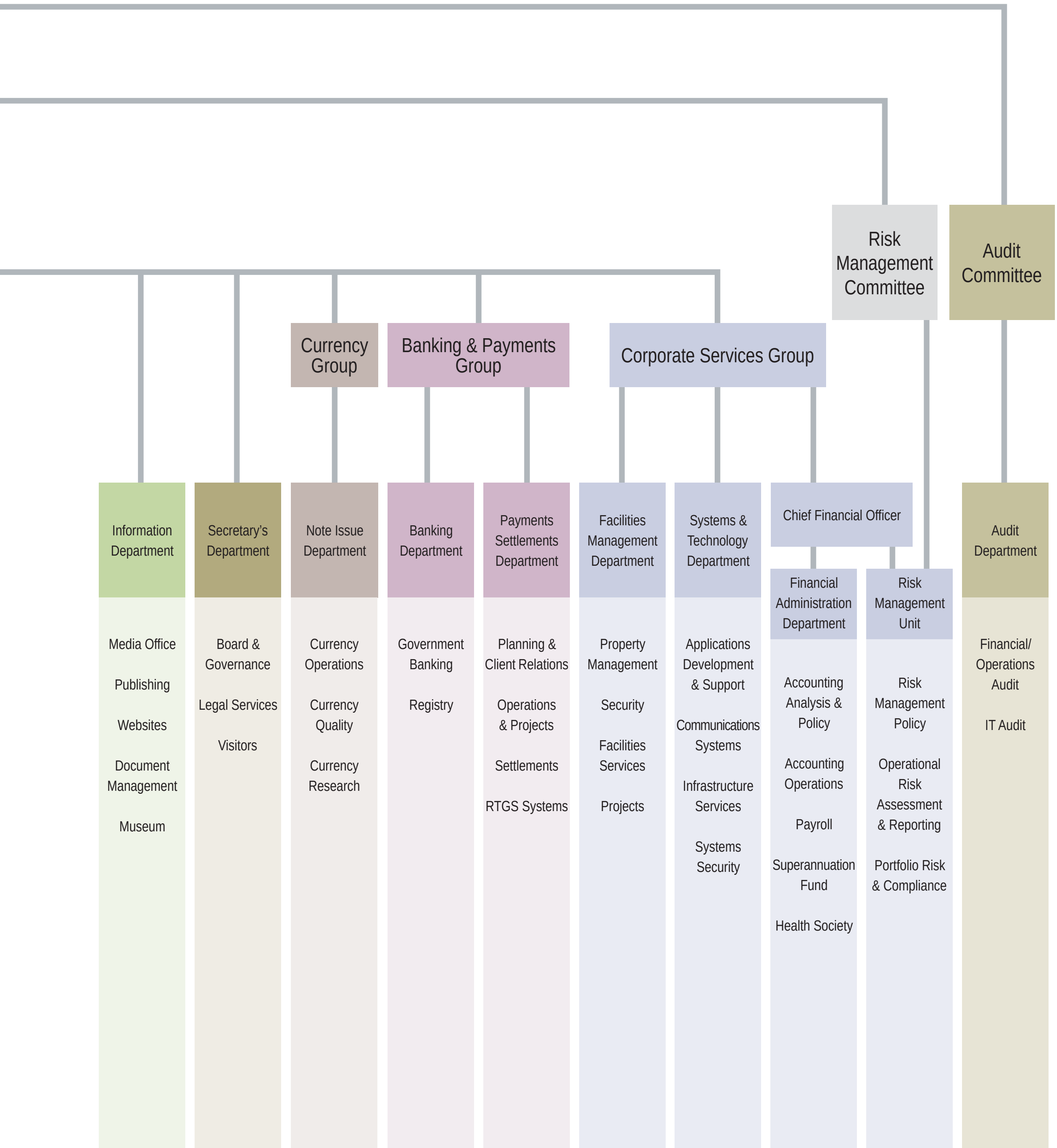
	Transactional Banking		Registry	
	2006/07 $ million	2007/08 $ million	2006/07 $ million	2007/08 $ million
Revenue				
– Service fees	15.4	15.5	0.6	0.5
– Other revenue	5.4	6.0	0.1	0.1
Total	20.8	21.5	0.7	0.6
Expenditure				
– Direct costs	13.1	12.8	0.3	0.3
– Indirect costs	3.8	5.3	0.2	0.1
Total	16.9	18.1	0.5	0.4
Net profit/(loss)	3.9	3.4	0.2	0.2
Net profit/(loss) after taxes(a)	2.7	2.3	0.1	0.1
Assets(b)				
– Domestic markets investments	365.8	409.4	1.1	1.3
– Other assets	8.3	10.1	0.1	0.1
Total	374.1	419.5	1.2	1.4
Liabilities(b)				
– Capital and reserves	25.0	25.0	1.0	1.0
– Deposits	344.6	387.9		
– Other liabilities	4.5	6.6	0.2	0.4
Total	374.1	419.5	1.2	1.4

(a) In accordance with competitive neutrality guidelines, income tax expense has been calculated and transferred to the Commonwealth as a notional part of the Reserve Bank's annual profit distribution.

(b) As at 30 June.

Organisational Chart | August 2008




Risk Management Committee
Audit Committee
Currency Group
Banking & Payments Group
Corporate Services Group
Information Department
Media Office
Publishing
Websites
Document Management
Museum
Secretary's Department
Board & Governance
Legal Services
Visitors
Note Issue Department
Currency Operations
Currency Quality
Currency Research
Banking Department
Government Banking
Registry
Payments Settlements Department
Planning & Client Relations
Operations & Projects
Settlements
RTGS Systems
Facilities Management Department
Property Management
Security
Facilities Services
Projects
Systems & Technology Department
Applications Development & Support
Communications Systems
Infrastructure Services
Systems Security
Chief Financial Officer
Financial Administration Department
Accounting Analysis & Policy
Accounting Operations
Payroll
Superannuation Fund
Health Society
Risk Management Unit
Risk Management Policy
Operational Risk Assessment & Reporting
Portfolio Risk & Compliance
Audit Department
Financial/ Operations Audit
IT Audit

Head Office Management | August 2008

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Deputy Governor: Ric Battellino

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Assistant Governor: Malcolm Edey

Economic Analysis Department

Head: Tony Richards
Deputy Heads: James Holloway
David Orsmond
Head of Regional and Industry Analysis: Ric Deverell

Economic Research Department

Head: Christopher Kent

Financial Markets Group

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Domestic Markets Department

Head: John Broadbent
Deputy Head: Jonathan Kearns

International Department

Head: Vacant
Deputy Heads: Alexandra Heath
James Whitelaw

Financial System Group

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Financial Stability Department

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Deputy Head: John Simon

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Banking Department

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Payments Settlements Department

Head: Nola McMillan

Currency Group

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Head: Lindsay Boulton

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Glossary

ABCP	Asset-backed commercial paper
ADI	Authorised deposit-taking institution
AIFRS	Australian equivalents to International Financial Reporting Standards
AOFM	Australian Office of Financial Management
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATM	Automatic teller machine
BIS	Bank for International Settlements
BRS	Business resumption site (of the RBA)
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CFR	Council of Financial Regulators
CGFS	Committee on the Global Financial System (of the BIS)
CGS	Commonwealth Government securities
CHESS	Clearing House Electronic Subregister System (of the Australian Stock Exchange)
CLS	Continuous linked settlement
EEO	Equal employment opportunity
EMEAP	Executives' Meeting of East Asia-Pacific Central Banks
ES	Exchange settlement
ESA	Exchange Settlement Account
FOI	Freedom of Information (Act)
FSF	Financial Stability Forum
G7	Group of Seven
G-20	Group of Twenty
GPF	Government Partnership Fund (with Indonesia)
IMF	International Monetary Fund
IT	Information technology
MFSC	Monetary and Financial Stability Committee (of EMEAP)
NNPDC	National Note Processing and Distribution Centre
NPA	Note Printing Australia Limited
OECD	Organisation for Economic Co-operation and Development
OH&S	Occupational health & safety
OIS	Overnight indexed swap (rate or market)
OPA	Official Public Accounts
RBA	Reserve Bank of Australia
RBRF	Reserve Bank Reserve Fund
RITS	Reserve Bank Information and Transfer System
RMBS	Residential mortgage-backed securities
RMU	Risk Management Unit
RTGS	Real-time gross settlement
SDR	Special Drawing Right