Reserve Bank

RESERVE BANK OF AUSTRALIA
ANNUAL REPORT

2000

CONTENTS

GOVERNOR'S FOREWORD

For the world economy, the twelve months covered by this Report have been a period of relative calm and prosperity, after the turbulence of the previous two years. Domestically, it was a good year for the economy, with strong growth and falling unemployment, although inflation was somewhat higher than it had been for several years. Because of the combination of ongoing strength in economic activity, and rising inflation, it has been a more eventful year than its immediate predecessors for monetary policy, with a series of tightenings occurring, the first since 1994.

It is always difficult to start the tightening phase of monetary policy, particularly if it is done pre-emptively as it should be - that is, before clear signs of overheating have emerged. An important part of the task was to communicate the idea that the stance of monetary policy that had been reached in 1998/99 was expansionary, and hence no longer appropriate for the stronger economic environment we faced in late 1999 and 2000. The task was made somewhat easier on this occasion because most other developed countries reached a similar conclusion at approximately the same time. In all, there were four tightenings of monetary policy in Australia during 1999/2000 and another in August 2000, which amounted to a cumulative increase in the overnight cash rate of 150 basis points.

Detailed accounts of monetary policy have been provided on an ongoing basis through the year, such as in the two *Semi-Annual Statements on Monetary Policy*, the two quarterly reports on the economy and financial markets, testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration, speeches and the media releases accompanying the monetary policy changes. As such, this Report focuses on other important events which had an impact on the activities of the Reserve Bank during 1999/2000. In summary, the main points were as follows:

- In its market operations, the main task on the domestic side was to bring about the tightenings of monetary policy and to maintain the cash rate steady at the new levels. The biggest challenge in this area was to cope with the declining volume of government paper. The solution has been to make greater use of repurchase agreements, both on government securities and, more particularly, foreign exchange (the latter usually known as foreign exchange swaps). On the foreign side, the RBA did not undertake any direct intervention during the year, although a large part of its sales to the Government was not passed through to the market, in line with the usual practice when the exchange rate is low.
- International responsibilities are now absorbing more time and resources than even a few years ago. In conjunction with other areas of government, the RBA has made a strong effort to ensure that Australia is well-represented in the various new international groupings that will effectively be "writing the future rules" of international financial markets. Australia is now one of

the eleven countries in the Financial Stability Forum, and one of the Group of Twenty. Along with the other international and regional groups of which the RBA was already a member, this has led to a significant increase in work and travel. The RBA has also continued to participate in technical assistance programs, both on a bilateral basis and through IMF-sponsored missions.

- The experience in the business services area has been mixed, with some key areas still very busy, but others having to contract further as technological change and a loss of customers reduce demand. As mentioned in the previous Report, the Western Australian and Australian Capital Territory Governments have taken their banking business elsewhere, as has the Commonwealth Department of Finance and Administration for its own departmental transactions business. This follows earlier moves by the Queensland, Northern Territory and Tasmanian Governments. As well, existing key Commonwealth Government customers have tended to centralise their banking in one or two locations, rather than maintain operations in each State.
- The situation was finally reached where the volume of work needed to be performed in most of our branches fell to the point where we could no longer justify maintaining staff at a level that would constitute a viable branch. Following the closure of Darwin and Hobart branches in earlier years, the decision was reluctantly taken to close Melbourne, Brisbane and Perth branches during 2000. Adelaide branch remains in operation as it is supported by the banking business of the South Australian Government. In the case of Melbourne, although the CBD branch has closed, the note-processing function will be centralised at Note Printing Australia. The branches, at their peak, performed an important operational role in banking, registry and cash distribution, and, to a limited extent, they acted as a conduit for information about local economic conditions, though they were not designed specifically for that purpose. We are extremely conscious, however, that if no offsetting measures are taken, the closure of branches would run the risk of putting us out of touch with regional issues at a time when they are becoming more important. As a result, we are in the process of strengthening our capacity for monitoring local conditions, and seeking to improve our channels of communication with States and regions. This will involve, among other things, a small, but targeted, representation in State capitals.
- The year just completed was the second year in which supervision of banks has been carried out by the Australian Prudential Regulation Authority. With the departure of bank supervision, the RBA retained responsibility for the overall stability of the financial system and for regulation of the payments system. Apart from overseeing the smooth transition into the new century (the so-called Y2K problem), carrying out the former of these responsibilities

was relatively uneventful - as would be expected, the financial system is in very good shape from a prudential perspective at this stage of a long economic expansion. The RBA's work in overseeing the payments system is moving away from the wholesale side, now that real-time gross settlement (RTGS) is well-established, towards more focus on retail payments systems.

- Note Printing Australia had an extremely busy year, producing 656 million notes, more than double the previous year's figure. Demand for notes was augmented by the Australian contingency order for Y2K purposes, and by a large export order from Indonesia as well as others from New Zealand and Papua New Guinea. Brazil and Taiwan have also been added to the list of countries to use polymer notes, both printing their own on substrate produced in Australia.

As in the past few years, I would like to conclude this foreword by thanking the staff for the job they have done during the year, and recording my appreciation of the way they have coped with the almost continuous downsizing of the RBA, which has been going on for many years. Instead of simply outlining in a paragraph or two the main changes that have occurred in the past year, we have decided to devote a whole chapter of this Report to an account of the evolution of the RBA over the past decade and a half. It is an interesting story in itself, and also a microcosm of the changes that have been happening in the economy as a whole.

I J Macfarlane
Chairman, Reserve Bank Board

3 August 2000

OPERATIONS IN FINANCIAL MARKETS

Monetary Policy Operations

Most of the operations the RBA undertakes in financial markets are for the purpose of implementing monetary policy. Monetary policy changes are announced in terms of a target for the cash rate - the interest rate on overnight interbank loans in the money market - and domestic money market operations are undertaken each day to maintain the cash rate around the target level. The cash rate target was increased four times in 1999/2000, from 4.75 per cent to 6.0 per cent, and again to 6.25 per cent in August 2000.

Movements in the Target Cash Rate

	Change (percentage points)	New level (per cent)
3 Nov 1999	+0.25	5.00
2 Feb 2000	+0.50	5.50
5 Apr 2000	+0.25	5.75
3 May 2000	+0.25	6.00
2 Aug 2000	+0.25	6.25

The cash rate is determined in the market each day by the interaction of the demand for and supply of Exchange Settlement (ES) funds - the funds banks use to settle transactions with each other and with the RBA. The RBA's ability to influence this rate rests on the fact that it is the sole supplier of these funds. It can increase or decrease the supply of ES funds by undertaking domestic market operations.

Banks' demand for ES funds is transactions based - i.e. their demand is determined by their settlement obligations with each other and with the RBA. As was discussed in last year's Annual Report, the RTGS system for interbank settlement introduced in June 1998 has enabled banks to manage their liquidity more efficiently than in the past. Accordingly, the average level of ES funds remained low last year at about $1.2 billion, about half pre-RTGS holdings. Holdings of ES funds were, however, quite volatile in the first half of the year as banks prepared to make large payments associated with settlement of the sale of the second tranche of Telstra and as they prepared for Y2K (discussed more fully below).

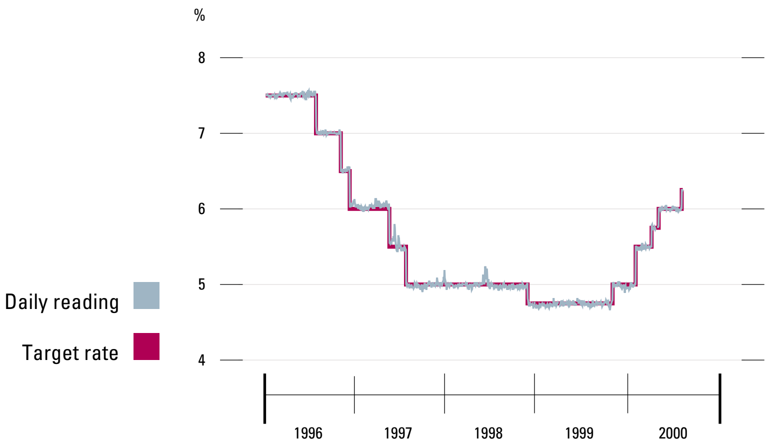
The operating procedures that have been put in place over recent years have proved effective in terms of achieving the cash rate objective, as the actual cash rate is routinely maintained close to the target. Daily variation between the two averaged about two basis points in the past year.

In pursuing the cash rate objective, the RBA faced two main challenges during the year. The first was the constraint imposed by the falling supply of Commonwealth Government securities (CGS), the main instrument used in market operations. The second, and less significant of the two, was the liquidity preparation for Y2K.

Y2K began to become an issue in financial markets around the middle of 1999, as market participants started to prepare for the potential withdrawal of liquidity around year end. As well as needing to fund withdrawals of deposits by customers as the latter increased their holdings of currency, banks had to allow for the possibility that market conditions might be disrupted, making it difficult to raise funds. These concerns were common to banks around the world.

The RBA felt that it had a responsibility to ensure that market confidence was maintained.

Cash Rate



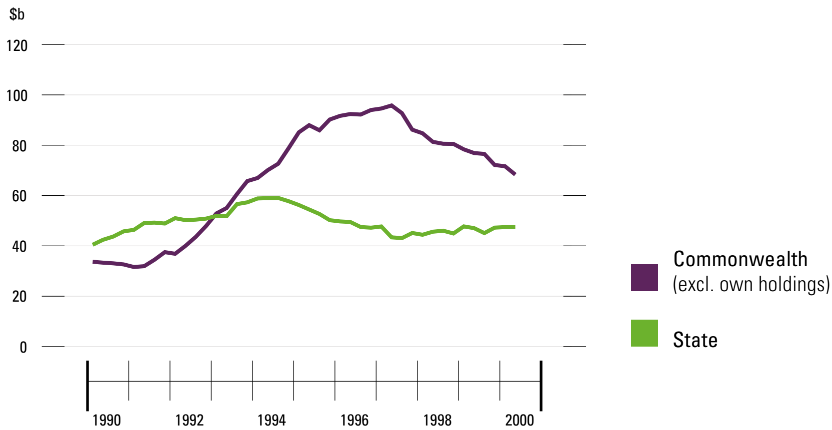
As well as liaising with banks about their overall Y2K preparations (see chapter on "Financial System Stability"), a number of measures were announced in mid 1999 to assist banks in their liquidity management. These included an offer to extend the term of repurchase agreements[I] (repos) undertaken with market participants to span the date change and to provide a fixed deposit facility for holders of Exchange Settlement accounts. The RBA also announced that it would supplement its dealings in government securities with foreign exchange swaps and repurchase agreements in bank bills and CDs, if necessary.

In the event, Y2K was handled without market disruption. The RBA's counterparties availed themselves of the longer-term repos and the fixed deposit facility to a moderate extent, and use of foreign exchange swaps was expanded (see below). The RBA did not, however, need to extend its operations to include bank paper.

The declining supply of CGS was a more difficult problem, and one that will be longer-lasting. These securities have been the basis of domestic market operations for many years. In theory, operations could be carried out in any type of instrument, but CGS have been favoured because they carry no credit risk and the market for them has tended to be very deep and liquid, thereby facilitating the large transactions volumes the RBA needs to undertake.

I Repurchase agreements (or repos) involve a purchase or sale of securities with a simultaneous agreement between the parties to reverse the transaction at an agreed price and date in the future. A foreign exchange swap is essentially a repurchase agreement, with Australian dollars exchanged for foreign exchange rather than securities.

Supply of Government Bonds
End quarter



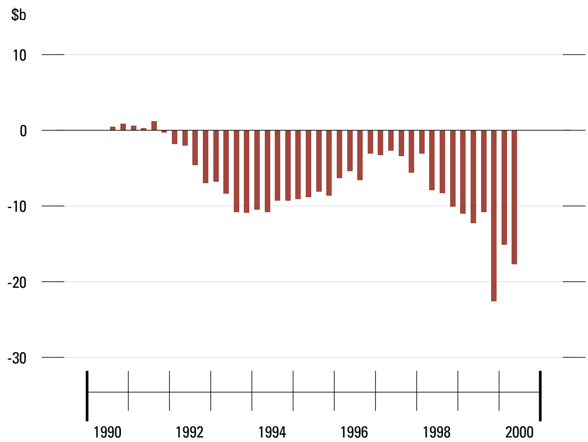
Three years ago, in response to emerging supply shortages in CGS, repo operations were expanded to include securities issued in Australia by State authorities. This provided a one-off boost to the pool of securities available for repos, but did not add to supply on an ongoing basis as the States, like the Commonwealth, are running balanced or surplus budgets and thereby reducing, rather than increasing, their overall debt on issue.

In the past year, the declining supply of government securities caused the RBA again to look at alternatives. It decided that, for the immediate future, the most attractive alternative was to expand its use of foreign exchange swaps.

The RBA, like other central banks, has been using foreign exchange swaps for some years now. In Australia's case, their use has tended to be directed at managing financial flows at times when large-scale intervention has been undertaken in the foreign exchange market. Swaps are particularly efficient at such times because they avoid the need to undertake what would otherwise be a series of transactions in both foreign and domestic holdings of bonds to achieve the same purpose. The main change in the past year was that much more significant use was made of swaps purely for domestic liquidity management - i.e. in situations where no outright foreign exchange transactions had been undertaken.

The first step-up in use of foreign exchange swaps for liquidity management was in October 1999, when investors paid for the first instalment of their subscriptions to the privatisation of the second tranche of Telstra. The resulting flows saw almost $10 billion transferred from banks' ES balances to the Commonwealth's account at the RBA. This drain in banking sector liquidity was accommodated to a large degree by buying foreign exchange from banks (in exchange for

RBA's Swaps Outstanding*



* Negative sign denotes a commitment to deliver foreign exchange in the second leg.

Australian dollars) under swap agreements. Further heavy use of swaps was undertaken towards the end of 1999 to boost banking sector liquidity in preparation for Y2K.

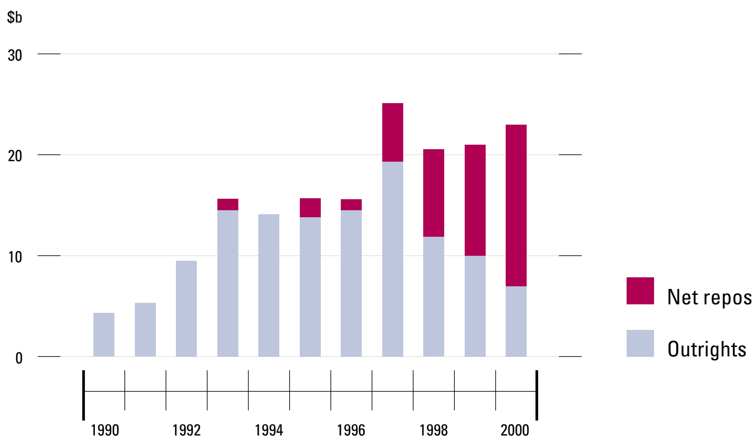
In total over the year, $67 billion of foreign exchange swaps (including roll-overs) were undertaken, accounting for about 20 per cent of all liquidity management operations. At their peak in late 1999, the amount outstanding in foreign exchange swaps reached $23 billion, though, by the end of the year, this had fallen back to about $18 billion.

To the extent that the RBA buys foreign currencies under these swaps, its holdings of foreign exchange rise, as do its forward commitments to deliver foreign exchange. There is, therefore, no effect on its *net* foreign reserve position, and no change in its exposure to foreign exchange risk. Also, because the swap agreement consists of a spot transaction and an offsetting forward transaction, there are no net changes in demand for either currency and thus no effect on the exchange rate.

The increased use of swaps took some of the pressure off operations in domestic securities, though the domestic repo book nonetheless rose to a new high. The amount of repos outstanding was $16 billion at the end of the year, up from about $11 billion the year before. Securities held under repo now account for a large share (70 per cent) of the RBA's total holdings of domestic securities. Early in the 1990s, this share was around 5 per cent.

Despite the rise in repos outstanding, within-year turnover in repos fell for the first time in several years as the average maturity of repos was lengthened. The lengthening in maturity was partly a reflection of steps taken in preparation for Y2K, but was also aimed at trying to reduce the roll-over task involved in a large repo book.

RBA's Holdings of Domestic Securities
As at 30 June



Market Operations for Liquidity Management Purposes
($ billion)

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

* First leg of transaction

The RBA's demand for securities was boosted during the year by the decision of the Commonwealth Government to invest some of its funds arising from the budget surplus in fixed deposits with the Bank. These deposits stood at $9.2 billion at the end of the financial year, up from $2 billion a year earlier.

One moderating influence on the RBA's demand for government securities was the abolition, effective 1 July 1999, of the requirement that banks hold one per cent of assets as non-callable deposits with it. The return of these funds provided banks with additional liquidity of around $5 billion, which was offset on the day by sales of government securities. By and large, this operation went smoothly and has had no ongoing implications other than permanently to lower the RBA's holdings of securities (and its ongoing earnings) relative to levels that otherwise would have prevailed. The counterpart to this contraction in bond holdings was the reduction in the RBA's deposit liabilities to the banks.

Events over the past year have demonstrated that foreign exchange swaps can be an effective instrument of domestic operations. Use of swaps will most likely continue to grow. It is intended to use them to provide large medium-term injections of cash rather than as a normal part of day-to-day domestic operations. They are less suited to this latter role as settlement arrangements are more complicated than for domestic securities, due to the fact that they involve transactions in different time zones. For this reason, the RBA has not ruled out other innovations to its domestic market operations and is keeping abreast of thinking of central banks in other countries which are starting to face similar shortages of government securities.

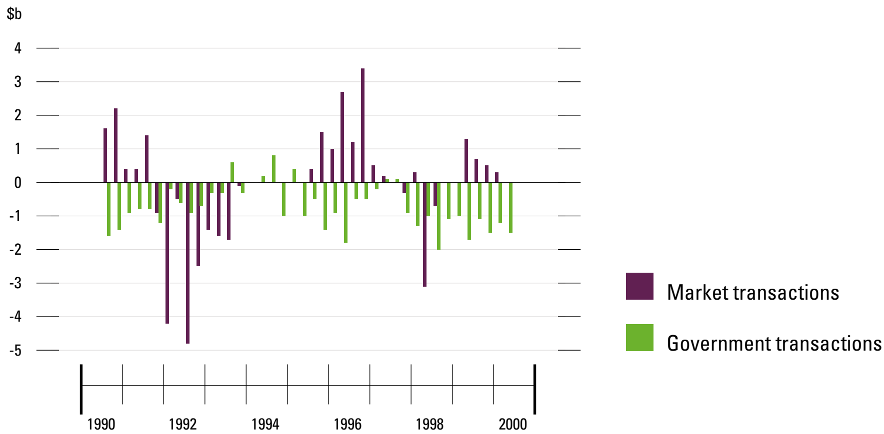
Foreign Exchange Intervention

Australia has had a floating exchange rate regime since 1983, with the Australian dollar rising and falling with changes in the demand for, and supply of, currency in the market. This regime has proved beneficial for Australia as the fluctuations in the exchange rate, which can at times be quite wide, act to cushion the effect on the domestic economy of external economic disturbances such as changes in the terms of trade.

As has been explained in previous Annual Reports, this does not mean, however, that the RBA can be totally indifferent to movements in the exchange rate. The exchange rate is a component of the inflation-targeting regime, and so can have implications for monetary policy. In addition, exchange markets are capable in some circumstances of "over-shooting", or moving temporarily by more than can be explained by changes in underlying economic and financial conditions. When these events occur, they can have adverse effects on the economy both at the macro level - by affecting confidence and inflation expectations - and at the micro level - by affecting resource allocation and investment decisions. The RBA is prepared to use foreign exchange intervention if it believes it is facing a serious overshoot in the exchange rate in either direction.

Circumstances which give rise to overshooting occur only infrequently, and so intervention is similarly infrequent. The RBA intervened to support the Australian dollar in a substantial way on several occasions in 1998; prior to that, the most recent substantial support was in 1993. In these episodes, there were some sales of foreign currency assets to buy Australian dollars. Between such episodes, the RBA takes opportunities provided by strength in the exchange rate to rebuild its holdings of foreign currency assets.

RBA's Purchases and Sales of Foreign Exchange
Quarterly total, sales are shown as a negative



During the past year, the RBA did not seek to influence the exchange rate through market intervention. On some occasions, such as in April/May 2000, it did have sufficient concerns about the possibility of overshooting that it undertook some preparations for intervening, but in the event no outright purchases of the currency were undertaken. Through this period, however, the RBA did provide some support for the Australian dollar through its handling of Government foreign exchange transactions (see below).

Customer-Based Operations

The RBA undertakes substantial operations in both domestic and foreign exchange markets on behalf of its customers, mainly the Commonwealth Government.

During the past year, the main operation in government securities on behalf of the Commonwealth was, as in the previous year, to assist with government debt retirement. The Commonwealth's ability to retire debt early reflected ongoing underlying budget surpluses, and some major privatisations. The RBA sold almost $8 billion of CGS to the Commonwealth Government during the year, with around $5 billion of these securities coming directly from the RBA's books and the rest purchased from the market at opportune times in the course of liquidity management operations.

Operations on behalf of customers are conceptually quite separate from those associated with the implementation of monetary policy and liquidity management. However, the RBA is able to take advantage of customer flows to help in its policy operations. For example, the Commonwealth's willingness to retire debt early was used to help smooth the potentially large injections of liquidity into the market that would have been concentrated on the days on which CGS would otherwise have matured. This in turn assists the Commonwealth to manage its own cash flows.

The Commonwealth Government has a substantial need for foreign exchange each year, mostly to cover payments for defence equipment, embassies and aid. These needs are met through the RBA to ensure that government foreign exchange activities, which can be very large, do not conflict with the RBA's own foreign exchange operations. All transactions are at market prices.

In normal times, sales of foreign exchange to the Government are passed more or less simultaneously into the market by buying foreign exchange from market counterparties, so that they do not use up foreign exchange reserves. At other times, when the RBA may be considering or undertaking intervention in the market, such as where the exchange rate is falling and significantly below its long-run average level, any passing through of Government transactions may exacerbate exchange rate pressures or even undo some of the stabilising effect of intervention. At such times, the Government's needs are met initially from the RBA's portfolio, and passed through to the market (thus replenishing reserves) when market conditions are more favourable. In the past year, the RBA has sold $4.9 billion in foreign currencies to the Government and passed $1.6 billion of this through to the market. In the second half of the year, when the exchange rate had fallen to low levels, none was passed through.

Stock Lending

One activity in domestic financial markets that falls halfway between a policy and a client transaction is stock lending. This activity involves lending of domestic government securities to market participants in order to alleviate temporary market shortages of specific lines of stock. Typically, these shortages arise as a result of settlement failures or difficulties in accessing stock held by offshore investors. There is a strong demand from market participants for this service. From the RBA's perspective the service is a useful one because it helps in the efficient working of the market; it also earns a small amount of income.

An active stock-lending market exists between market participants themselves, so the RBA is careful not to discourage such activity. It prices its stock lending so that it would be the least attractive counterparty for anyone seeking particular stock.

Stock Lending by the RBA

	Number of transactions	Amount lent (face value, $ billion)	Income ($ million)
1995/96	485	16.9	0.7
1996/97	540	11.9	0.7
1997/98	935	16.7	1.1
1998/99	805	14.6	0.9
1999/2000	510	8.9	0.6

Balance Sheet Management

Risk Analysis

In order to be able to undertake transactions in financial markets, the RBA needs to maintain a portfolio of financial assets in which it deals. The main assets are domestic and foreign government securities and foreign currency deposits with overseas banks and central banks. These assets are balanced by liabilities, consisting mainly of notes on issue, deposits by governments and commercial banks, and capital.

As with any entity holding substantial financial assets and liabilities, the RBA is thereby exposed to financial risks, either from adverse changes in interest rates or exchange rates, or default by those with whom it has deposited funds or transacted.

The credit risk faced is limited because the RBA holds only securities of government issuers with a high credit standing and deals only with highly rated counterparties. All securities held are issued by Australian governments or central governments (and their agencies) of the three major industrial countries. Part of foreign currency investments is also held as deposits with commercial banks. Exposure is limited to banks rated AA- or above.

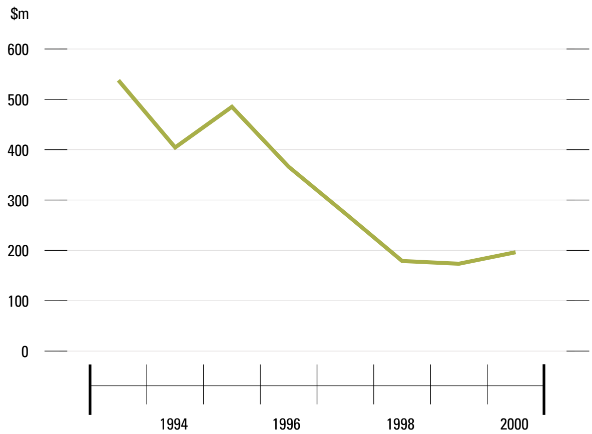
Interest rate risk and exchange rate risk cannot be avoided or minimised in the same way that credit risk has been. The RBA is exposed to risk of significant loss from a rise in the general level of interest rates because it holds substantial amounts of fixed-interest assets, which suffer a fall in capital value when interest rates rise. There is no offsetting gain on the liability side of the balance sheet as liabilities are predominantly interest-free or floating-rate, which do not change in capital value when interest rates change.

Exposure to interest rate risk could be eliminated by holding only floating-rate assets and liabilities, but to do so would be impractical as it would be difficult to carry out monetary policy functions effectively using only these instruments. Moreover, to do so would reduce the long-run average interest income because interest rates tend to be lower on floating-rate instruments than on longer-term fixed-rate securities. Over a long period of time, the RBA is rewarded in the form of higher average interest earnings for accepting its exposure to the risk of short-term capital losses.

It should also be recognised that the RBA cannot be an active manager of its domestic interest rate risk. Given its monetary policy responsibilities, any actions by the RBA to increase or decrease its level of risk would be interpreted by other market participants as a change in its view about the future direction of interest rates. Also the large size of the RBA's domestic asset portfolio would mean that any attempt at risk management would be quite disruptive to the market.

For these reasons, the RBA accepts interest rate risk on its domestic portfolio as being an unavoidable consequence of its policy operations. Based on the average size of the domestic portfolio over the past year, the effect of a rise in the general level of Australian interest rates of one percentage point (other things equal) would be to cause a loss of about $200 million. This is less than was the case some years ago, as the relatively higher proportion of securities held under repo has had the side-effect of reducing risks.

Interest Rate Risk of RBA's Domestic Securities Portfolio
For a one percentage point change in yields, as at 30 June



The RBA has, however, taken a more active approach to management of interest rate risk on its foreign securities portfolio. Here, it is just another player; its actions have no policy significance, nor are they big enough relative to the markets in question to be disruptive. The framework for this management is described in the section on reserves management below.

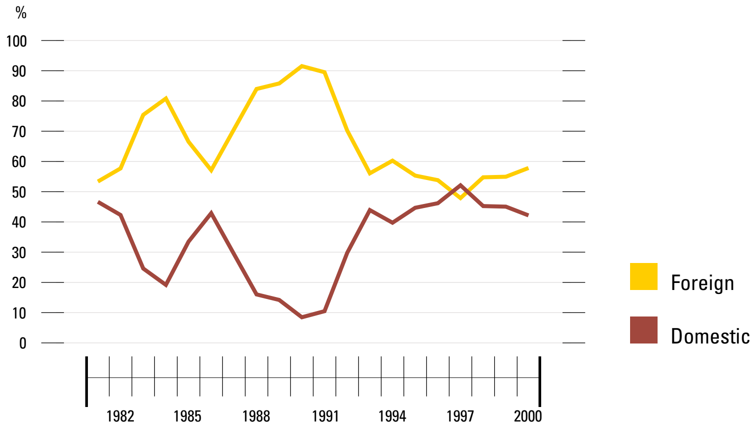
Exchange rate risk for the RBA arises because it holds a substantial proportion of its assets in foreign currencies, while its liabilities are in Australian dollars. It needs to hold a portfolio of foreign currency assets to fund its intervention operations. A rise in the exchange rate causes a capital loss, measured in Australian dollars, on the foreign currency assets (i.e. a given amount of foreign currency is worth less in Australian dollars); a fall in the exchange rate causes a capital gain. The size of the loss or gain would depend on the level and composition of reserves at the time and the sizes of the moves in the exchange rate against each of the currencies represented in reserves. Based on the average level of reserves during the past year, a uniform one per cent appreciation of the Australian dollar would result in a loss of about $120 million. This is lower than in recent years because holdings of foreign currencies have been reduced following earlier intervention. On average over the exchange rate cycle, the risk factor would typically be about twice that noted above.

The RBA must hold a long open position in foreign exchange if reserves are to be available for intervention. There is no scope for direct management of exchange rate risk (including hedging) as foreign exchange holdings are determined by intervention operations. They tend to rise and fall over the exchange rate cycle as currencies are bought and sold.

In sum, while the RBA faces a number of risks similar to other financial entities, it differs

RBA Assets

Proportion of domestic and foreign assets, including gold, as at 30 June



from these in that it must give prominence in its operations to its policy objectives; management of risks and returns are, of necessity, secondary considerations. Only *within* the foreign currency portfolio does it have discretion to manage the composition of assets in keeping with its risk/return objectives. These activities are usually referred to as "reserves management". Details of reserves management operations during the past year are discussed in the remaining part of this chapter.

Reserves Management Operations

Assets in foreign currencies are managed to achieve the highest return within defined risk parameters, taking into account the need to ensure funds are available at short notice when required for intervention.

The task of managing the foreign exchange reserves is assigned to an internal team of portfolio managers. They work to a benchmark portfolio which has been determined by taking into account the need for liquidity and security and the past patterns of risk and return in the major world markets.

The benchmark portfolio, which was put in place in the early 1990s, has three main parts. The first is the allocation of assets across the different world markets in which the RBA invests. This allocation has 40 per cent of assets in the United States and 30 per cent in each of Japan and Europe. The second is currency allocation, for which the benchmark is the same as for assets: 40 per cent to the US dollar, and 30 per cent each to the yen and the euro. The third is the duration of assets in each market; this specifies that duration in each market should be 30 months, with a maximum maturity for any one security of 10.5 years.

Composition of the Benchmark Portfolio

		US	JAPAN	EUROPE
Asset allocation	(%)	40	30	30
Currency allocation	(%)	40	30	30
Duration	(months)	30	30	30

The portfolio managers are guided by the benchmark portfolio in making their investments, though they can make changes to asset and currency allocations, and the duration of investments, within limits approved by the Governor, to take account of market circumstances. A middle office, independent of the portfolio managers, monitors their compliance with these limits and measures their investment performance in comparison with the benchmark.

The market background against which foreign currency reserves were invested in 1999/2000 was dominated by the continued strong performance of the US economy and US financial markets and the maintenance of Japan's exceptional "zero interest rate" monetary policy. The low level of official interest rates in Japan meant that long bond yields fell to 0.7 per cent in mid 1997, a level unprecedented in the recorded history of any country. Yields have since risen to between 1.5 per cent and 2 per cent, still an unusually low level.

The low level of yields in Japan has complicated the task of investment management. As well as providing very low ongoing interest income, such low levels of yields expose the investor to the risk of significant capital losses in the event that yields were to rise to more normal levels. Against this background, the RBA has felt it prudent to maintain the duration of its Japanese bond portfolio below benchmark in recent years. This has led to some underperformance relative to the benchmark as, with an upward-sloping yield curve, there was some sacrifice of interest income. In the past year the Japanese portfolio returned 0.4 per cent, whereas the return on the benchmark was 1.0 per cent.

In the US and European bond portfolios, duration was kept close to benchmark during the year. The uncertainty surrounding bond yields due to the conjuncture of rising official interest rates and volatility in share markets meant that only small, and short-term, trading positions were undertaken in these markets. Returns on both the US and European portfolios were slightly in excess of their benchmarks for the year. In the case of the US portfolio, the respective returns were 5.0 per cent and 4.6 per cent, and in the European portfolio, 1.9 per cent and 1.7 per cent.

Currency allocation to the euro was progressively increased in the second half of 1999, building on a position initially established towards the end of the previous financial year. This reflected a view by the portfolio managers that the euro was at an unusually low level and that it was likely to appreciate over the medium term. In the event, the overwhelming strength of the US economy meant that markets remained biased in favour of the US dollar. The euro depreciated by 8 per cent against the US dollar during the year and the portfolio therefore underperformed relative to the benchmark.

The overall return on the foreign currency portfolio was 2.8 per cent (measured against the Special Drawing Right as a numeraire) against the benchmark return of 3.8 per cent. Most of this underperformance was attributable to the over-weight position in the euro.

A longer run of returns is shown in the table below. Over the nine years during which an active approach to reserves management has been followed, the compound return was 6.1 per cent, a little above the return on the benchmark portfolio, of 5.9 per cent. Returns relative to benchmark have fluctuated from year to year, but in recent years have tended to be below benchmark.

Actual and Benchmark Returns

	Rates of return (per cent) Actual	Benchmark	Value of difference (A$ million)
1991/92	9.8	8.9	165
1992/93	16.3	11.6	420
1993/94	4.0	3.8	31
1994/95	5.2	7.4	-331
1995/96	4.0	3.7	40
1996/97	4.5	4.2	34
1997/98	4.5	4.6	-19
1998/99	4.9	5.1	-26
1999/2000	2.8	3.8	-202
	6.1	5.9	112

Analysis of the factors contributing to returns shows that the recent underperformance relative to benchmark has resulted from investment positions which had been taken in anticipation of medium-term macroeconomic developments - e.g. the short duration position in Japanese bonds which has been held for a number of years and the recent long position in the euro. In contrast, short-term investment positions designed to take advantage of anomalies in the market have more consistently made a positive contribution to returns, albeit relatively small.

After reviewing the experience over the past nine years, it has been decided that the low average return to active management and the relatively high variability of returns do not warrant continuing to take investment positions of either the size or frequency of the past. The investment approach is therefore moving to one which seeks to maintain the portfolio close to benchmark.

This revised approach also sits better with the RBA's increasing role in international financial policy discussions (see the chapter on "International Financial Co-operation" for details). It will help to avoid any perceptions of possible conflict of interest which might have arisen between participation in these discussions and the RBA's role as an active investor in the main global markets.

In addition to investments in foreign currencies, the RBA also holds about 80 tonnes of gold, currently valued at $1.2 billion. No outright transactions in gold were undertaken during the year, but an active gold loan program, involving virtually all gold holdings, was maintained. The average maturity of loans outstanding is six months, with the longest maturity at a little over one year. Total returns for gold-lending operations for the year were $21 million, a little higher than in the previous year.

At the end of the year, responsibility for gold lending was transferred from the Business Services area of the Bank to Financial Markets, in order to take advantage of synergies with other financial market operations.

INTERNATIONAL FINANCIAL CO-OPERATION

The three years since the Asian crisis began have seen a substantial push within the international community for reform of the international financial system. The problems in Asia (and in Eastern Europe and Latin America as well) not only damaged the growth performance of the countries directly affected, but had repercussions on major financial markets, and brought a recognition on the part of the international financial community that changes should occur in the so-called international financial architecture. The RBA believed that it should contribute as strongly as possible to this work, given the potential for major changes to the shape of international financial markets to emerge from the process. As a result, the RBA increased significantly the resources devoted to participating in the main global and regional initiatives aimed at improving the functioning of the international financial system. In this work, the RBA co-operates closely with other arms of government, such as the Treasury and the Department of Foreign Affairs and Trade.

The unfolding crisis not only highlighted specific deficiencies in policies, but also exposed shortcomings in the way international financial issues were handled by the world community - in the international forums where these issues are discussed, and where rules and procedures are developed. In essence, two main groupings carried these responsibilities: the G7, which consists of the world's seven largest developed countries (United States, Japan, Germany, France, United Kingdom, Italy and Canada); and the IMF/World Bank, with around 180 members. The former was too narrow to carry out the necessary consultation and co-ordination among countries, while the latter was too large to allow decisive actions to deal with emerging problems.

The initial response of the international community was to set up the G22, an ad hoc group of 22 countries including those affected by the crisis. This group was able to make quick progress on a number of issues, but the feeling was that its membership was not balanced, with some claiming that Asian countries (which made up 10 of the 22) were over-represented.

In the event, that group has been replaced by two new international groupings, which seem to have a greater degree of permanance than the G22. The two groupings are the Financial Stability Forum and the G20.

Financial Stability Forum

The Financial Stability Forum was established in early 1999 by the G7. The Forum includes the G7 countries themselves, the major international financial institutions and four other countries representing significant financial centres. Australia was chosen as a member of this latter group along with Hong Kong, the Netherlands and Singapore. Australia is represented in the Forum by the Governor. By covering all the world's major financial centres, the Financial Stability Forum is in a good position to promote international financial stability and co-operation through the formulation of consistent rules and procedures relating to financial institutions. It is expected that this will be its main focus.

Since its establishment, the Financial Stability Forum has produced a series of working group studies and reports on international capital flows, offshore financial centres, highly leveraged institutions (HLIs), deposit insurance and the implementation of international financial standards. The RBA participated in the working group on HLIs, and Australia (through the Treasury) participated in the task force on standards.

Report on Highly Leveraged Institutions

The potentially damaging impact of HLI activities on the stability and dynamics of international financial markets has been an issue of particular concern over the past two years or so, and one which the RBA has consistently pressed in various international groups. The RBA therefore welcomed the Forum's report on HLIs and fully supports the recommendations.

The Report considered both the systemic issues raised by the near-collapse in 1998 of Long Term Capital Management, a large hedge fund, and the potential impact of HLIs on market dynamics in small and medium-sized open economies. In relation to issues of systemic stability, the Report focused on the "breakdown in counterparty credit and trading discipline" which allowed both a high degree of leverage and large, risky positions to be built. On the impact of HLIs on small and medium-sized economies, it concluded that HLIs may from time to time establish large and concentrated positions in medium-sized markets and "have the potential materially to influence market dynamics". It went on to say that "the size and duration of effects can be amplified through herding or other market participants moving to the sidelines". The Report was also concerned about aggressive practices alleged in some countries, but there was no agreement on the scale of these practices, nor on the implications for market integrity.

Overall, the Report concluded that the issues raised merited "a concerted international policy response" and made a number of recommendations. These recommendations incorporated work undertaken by the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions (IOSCO) and in many respects were similar to conclusions reached by the US President's Working Group on Financial Markets. Much of the focus was on the risk management practices of HLI counterparties and regulatory oversight of credit providers.

The report also recommended measures to improve disclosure by large unregulated hedge funds, development of market practices guidelines for participants in foreign exchange markets, improved financial market infrastructure (including collateral practices), and enhanced financial market surveillance, both national and international.

The RBA believes that these recommendations, when fully implemented, will adequately address the systemic stability issues posed by HLIs. They may also be sufficient to contain the potential problems which HLIs can pose for market dynamics, although this is less certain. In this regard, the RBA was pleased that the Report leaves open the possibility of taking further steps should they appear necessary in future.

The United States, which is the country out of which most HLIs operate, is pushing ahead with legislation which will give effect to many of these recommendations. The *Hedge Funds Disclosure Act (Baker Bill)* would require quarterly disclosure of risk taking and leverage by large hedge funds (those with capital in excess of US$1 billion, or in a group of funds with assets greater than US$3 billion). A second piece of legislation, the *Derivatives Reform Act of 1999 (Markey-Dorgan Bill)*, would enable the US Securities and Exchange Commission to obtain quarterly disclosure statements from non-bank over-the-counter derivatives dealers, and to issue Large Trader Reporting Rules, allowing the agency to monitor and report on the activities of hedge funds.

Report on Financial Standards

The Financial Stability Forum recognised at its inception the importance of economic and financial standards in promoting sound financial systems, and at an early stage set up a Compendium of Standards on its web site. More recently, the *Issues Paper of the Task Force on Implementation of Standards* was released, proposing a strategy for fostering the implementation of international standards.

As a step in this direction, the Forum identified a set of key standards, considered likely to make the greatest contribution to reducing vulnerabilities and strengthening the resilience of financial systems. This was intended to allow a more focused approach to the implementation of standards, although priorities will vary considerably between countries.

Report on Offshore Financial Centres

The Forum's report on offshore financial centres was followed by publication of a classification of offshore centres according to the Forum's perceived ranking of the quality of their regulation and their degree of co-operation with other regulators. The purpose of this publication was to encourage efforts to improve regulatory systems in these centres. Several countries in the Pacific region were identified as having scope for improvement.

Group of Twenty

The other new international group, the G20, was set up in late 1999 and consists of countries of systemic significance in terms of the world economy. As well as the G7, it includes Argentina, Australia, Brazil, People's Republic of China, India, Indonesia, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. The European Union, the IMF and the World Bank are also included in the Group. Australia is represented in this group by the Treasurer and the Governor. It is expected to have a somewhat broader agenda than the Financial Stability Forum, covering general issues relevant to the world economy.

Since its inception, the G20 has focused on three main issues: choices between exchange rate regimes; liability management by national authorities; and private sector involvement in crisis prevention and resolution. The RBA was asked to lead the discussion on the issues facing national authorities in choosing an exchange rate regime at a G20 meeting for deputies in March 2000. G20 Ministers and Governors will consider these issues further at a meeting later in 2000.

Assistant Governor Glenn Stevens chairing a session at an international conference in Hong Kong. Other participants (left to right): Bijan Aghevli, formerly of the IMF; former Japanese Vice Minister of Finance for International Affairs, Eisuke Sakakibara; and Professor Ronald McKinnon of Stanford University.

The role of the private sector in crisis prevention and resolution is also an issue on which the RBA has placed considerable importance in the past two years. Over this period there has been substantial progress in identifying the principles and possible tools which could be used to obtain appropriate private sector involvement. There remains much to be done, however, in spelling out how these tools can be applied in practice. While much of the practical application is likely to fall to the IMF, which is considering the issues at present, the RBA sees an important role for the G20 in providing a venue for continuing discussion of the issues as well as for review of the IMF's performance in achieving private sector involvement.

Other International Groups

In addition to these global groups, the RBA participates in a range of work with the Bank for International Settlements (BIS) and associated G10-based committees.

Here the RBA is currently involved in three main initiatives. The first is a Study Group set up by the Committee on the Global Financial System to investigate the possible effects of the growth in electronic trading on market dynamics. The second is a G10 Working Party studying the causes of financial sector consolidation and its consequences for competition and efficiency, monetary policy and financial system stability. The third involves work on payments and clearing systems through the Committee on Payment and Settlement Systems.

One project undertaken by the latter Committee during the year was development of a set of Core Principles for Systemically Important Payment Systems, to provide a set of reference points for countries reforming and modernising their payment systems; this work was released for comment during the year and is expected to be finalised by end 2000. Another project involved oversight of work by private sector banks to establish a "continuous linked settlement" or CLS Bank, an initiative to reduce the risks associated with the settlement of foreign exchange transactions. A third project involved analysis of retail payment systems in the G10 countries and Australia; this is particularly relevant to the RBA given its statutory responsibility for the efficiency as well as the safety of Australia's payments system. Further details of these projects and other work on payments system policy issues can be found in the Annual Report of the Payments System Board, due to be released in October.

In addition, the Bank has remained an active participant in regional groups including:

- the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), consisting of eleven countries in the region. EMEAP has three permanent working groups: on financial markets (which the RBA chairs); on payment and settlement systems; and on banking supervision (on which both the RBA and APRA are represented);
- the Manila Framework Group, which consists of representatives of central banks and Ministries of Finance or Treasuries of twelve Asian countries plus the United States, Canada, and the international institutions;
- the Asia-Pacific Economic Cooperation Group (APEC); and
- the Four Markets and Six Markets Groups of major financial centres in the Asia-Pacific area.

With the exception of EMEAP, the Treasury is also a participant in the above regional groups.

A common theme that emerged in regional discussions over the past year or so was the need to stimulate development of bond markets in the Asian region. While countries such as Australia and Japan have highly developed markets, many other countries do not. This is seen as an obstacle to corporations raising finance, and as tending to skew the provision of finance towards the banking system. As the events of recent years showed, heavy concentration of financing through banks can make it difficult for corporations to raise funds when economic conditions deteriorate and banks subsequently adopt more cautious lending policies and cut back their provision of credit.

While these issues were discussed at most of the forums, the work was mainly taken forward by the Four Markets Group (Japan, Australia, Hong Kong and Singapore). The Group commissioned a paper to look at various aspects of bond market development, including trading arrangements, settlement and clearing and the role of credit rating agencies. Aspects of the paper are to be discussed further with private sector market participants at a meeting arranged for later this year by the Japanese Ministry of Finance.

International Co-operation

In addition to participating in international discussions and programs, the RBA also regularly provides bilateral technical assistance to countries, mainly in the Asia-Pacific region. On occasion, it also provides financial support,

The Governor addressing a gathering of investors in London.

usually by means of a foreign exchange swap between the RBA and the central bank of the country concerned. Any such financial arrangement is provided on commercial terms and therefore at no cost to the RBA. Such activities are distinct from the Commonwealth Government's aid programs, but because they nonetheless have a significant foreign policy element, and are therefore broader than pure central banking, the RBA acts only with the support of, or at the request of, the Commonwealth Government.

Financial Support

During the year, the RBA, at the request of the Commonwealth Government, provided a temporary facility to the Bank of Papua New Guinea through a foreign exchange swap. The facility provided bridging finance to Papua New Guinea pending the establishment of an IMF/World Bank program and an accompanying longer-term loan from the Commonwealth Government. The facility, which was for the Australian dollar equivalent of US$80 million, was provided in December 1999 and repaid in June 2000 when the Commonwealth facility commenced.

The swap agreement entered into with the Bank of Thailand in 1997, as part of a US$17 billion IMF-led financing package, remained in place during the past year. However, with economic conditions in Thailand improving, no drawdowns have been made since July 1999. The amount drawn remains at US$862 million, against a limit of US$1 000 million. Repayments under the swap are due to commence early in 2001.

Technical Assistance

For many central banks in the region, the past year saw an intensification of their efforts to upgrade their operations across a wide range of central bank functions. In many cases, this was in response to lessons learnt during the financial crisis a couple of years ago. A

number of these sought assistance from the RBA in this work or asked to visit the Bank to study the approach it adopts in carrying out its various functions. During the year, the RBA received 18 study visits from regional central banks; the main areas of interest were financial market operations, note issue, accounting and auditing.

The RBA also responded positively to a number of requests from overseas central banks for staff to provide technical assistance. One staff member was allocated to work full-time in providing technical assistance to the Bank of Papua New Guinea, and another was provided for a short-term project on debt management issues. Another member of staff has worked as adviser to the Central Bank of Samoa since 1998 (with the cost met by the IMF). Other staff visited the South African Reserve Bank, to assist with policy and technical aspects of an inflation-targeting regime, and the Bank of Thailand, to assist with the development of an RTGS system. RBA staff have also participated on missions, led by the IMF or other agencies, to Thailand and India and participated in regional workshops in Indonesia, Malaysia, and Singapore.

The Deputy Governor, Stephen Grenville, served on the Independent Review Committee of the Indonesian Bank Restructuring Agency (IBRA), which is charged with the task of handling the bad debt problems incurred by the Indonesian banking system.

Co-ordination with Other Government Agencies

The RBA is one of several Commonwealth Government departments and agencies which are involved in international economic policy and relations. Others include the Department of Foreign Affairs and Trade, the Treasury and AusAID. Co-ordination among these and other relevant agencies is through the International Economic Policy Group, which is chaired by the Department of Prime Minister and Cabinet and meets about once a month.

Promoting Australia as a Financial Centre

While the RBA's main focus in its international work has been on the improvement of the international financial system itself, it has also sought at all times to promote Australia as an example of an economy with sound and efficient financial markets. This has included support for AXISS, the Government's initiative to promote Australia as a centre for global and regional finance, including through the secondment of a senior staff member of the RBA.

FINANCIAL SYSTEM STABILITY

The RBA has a mandate to safeguard the stability of the Australian financial system. This responsibility is a longstanding one and was reconfirmed - and given sharper focus - in Australia's new financial regulatory structure, which came into effect from 1 July 1998. The division of responsibilities resulting from the Financial System Inquiry saw the establishment of the Payments System Board within the RBA to promote the safety and efficiency of the Australian payments system, and the transfer of responsibility for the supervision of banks in Australia to a new integrated regulator, the Australian Prudential Regulation Authority (APRA).

The smooth transition to these new regulatory arrangements has occurred against a backdrop of proven resilience in the Australian financial system and, over the past twelve months, more settled conditions in international financial markets. Australian financial institutions have continued to benefit from the long economic expansion and credit quality is high by historical standards.

Taking a longer sweep, the risks facing the Australian financial system have changed in nature over the past decade. In particular, financial markets have come to play a much more significant role in linking the decisions of savers and investors. Individuals, largely for retirement purposes, have built up substantial holdings of assets which earn market-related returns, and financial institutions now rely more heavily on wholesale financial markets to fund their balance sheet growth and manage their risks. While market vagaries can complicate the task of maintaining financial stability, other developments over this period - including improved risk management practices in financial institutions, a more sophisticated framework of prudential supervision and stronger underpinnings for the payments system - have enhanced the capacity of the Australian financial system to withstand financial shocks, whatever their source.

The RBA's Responsibility for System Stability

In pursuing its mandate for financial stability, the RBA's objective is to ensure that disturbances in any part of the financial system do not threaten the health of the economy more broadly. This task is closely linked to the Bank's monetary policy obligations and it draws on all its policy areas. The most important down-payment the RBA can make on financial stability is the maintenance of low and stable inflation. It can also contribute by ensuring a robust payments system, by monitoring changes in the patterns of financial intermediation and developments in financial markets, and by participating in various initiatives to strengthen the international financial architecture. In addition, it can, *in extremis*, make use of its balance sheet to support a fundamentally sound financial institution facing liquidity difficulties, if system stability is at risk.

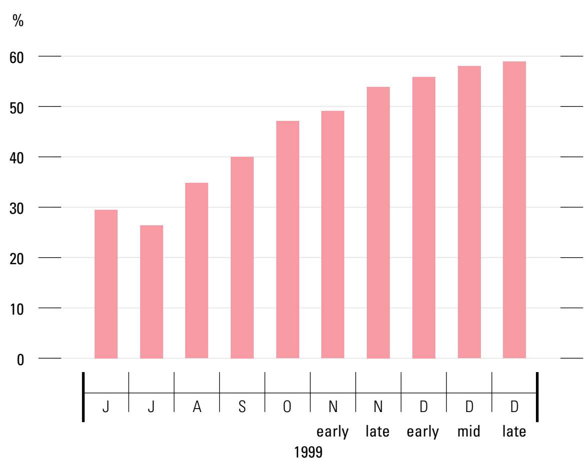
Y2K

A first and unique test of Australia's new financial regulatory structure was the Y2K problem. Although technical in its origins, this problem had the potential to spark a loss of public confidence in individual financial institutions and, at worst, in the financial system as a whole. In developing a broad-based response, the RBA worked closely with APRA and the Australian Securities and Investments Commission (ASIC), under the auspices of the Council of Financial Regulators of which all three institutions are members.

The RBA's Y2K contingency planning included building up its buffer stocks of currency notes and announcing changes to its normal dealing operations to ensure that market liquidity did not come under pressure ahead of the date change; it also oversaw the testing of domestic payments systems. Over the final months of 1999, the priority was to reassure the Australian community that its deposits were safe from the Y2K problem and that it could have full confidence in the preparations of financial institutions. The RBA spoke to banks, building societies and credit unions about the need for clear communications with their customers about Y2K. It also took opportunities to reinforce the message that it would be "business as usual" over the date change period. As that period approached, public opinion polling commissioned by the Bank suggested that the information campaign was working, with a clear majority of respondents not concerned about the impact of the Y2K problem on the financial system and satisfied

Y2K Opinion Polling

Respondents feeling well informed by their main financial institution



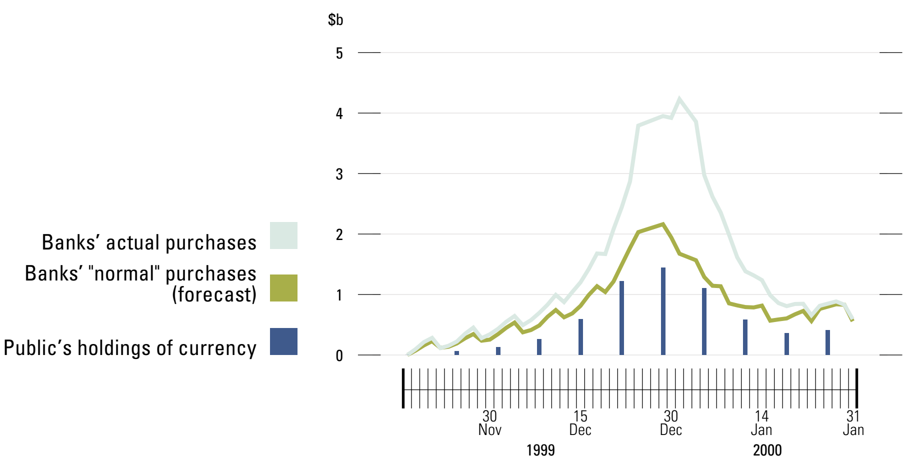
with the reassurances received from their financial institutions. During December and early January, the RBA and APRA operated a joint communications centre in the Bank's Head Office to monitor Y2K developments in the financial system and co-ordinate briefings for Government, the media and overseas regulatory agencies.

As it turned out, the arrival of Y2K was virtually incident-free, a testament to the preparations by financial institutions and the regulatory agencies, and the good sense of the Australian community. As part of their preparations, banks purchased considerable additional currency notes from the RBA but, in the event, the public's demand for cash rose only moderately above the usual end-of-year peak, and financial institutions did not require additional liquidity assistance.

Co-operation with APRA

In other areas as well, co-operation between the RBA and APRA has proven effective, both at Board and operational levels. The RBA/APRA Co-ordination Committee, chaired by the RBA, has met on a regular basis to deal with a range of ongoing matters, such as the sharing of information and procedures for crisis management, and issues of particular interest; during 1999/2000, the latter included arrangements for the collection of financial data, and the level of public disclosure by authorised

Cumulative Currency Purchases
From 16 November 1999



deposit-taking institutions (ADIs). The RBA is taking part in a major APRA project to improve the comprehensiveness and consistency of data obtained from financial institutions and to centralise their collection (except for payments data) by APRA; the Australian Bureau of Statistics is also closely involved in this project. The Co-ordination Committee has completed a preliminary assessment of public disclosure by ADIs in areas such as the structure of capital, risk exposures and capital adequacy. For listed Australian banks, the level of disclosure - though not the frequency - compares favourably with international standards, but disclosure by other institutions tends to fall short. The Co-ordination Committee will return to this issue in the context of proposals for improved disclosure of banks' capital adequacy and risk management strategies put forward by the Basel Committee on Banking Supervision, which is currently reviewing the 1988 Capital Accord. As part of the co-operation arrangements, RBA staff continued their occasional participation in APRA's on-site reviews of supervised institutions, to enable the Bank to stay attuned to changes in supervisory processes and risk management practices in financial institutions.

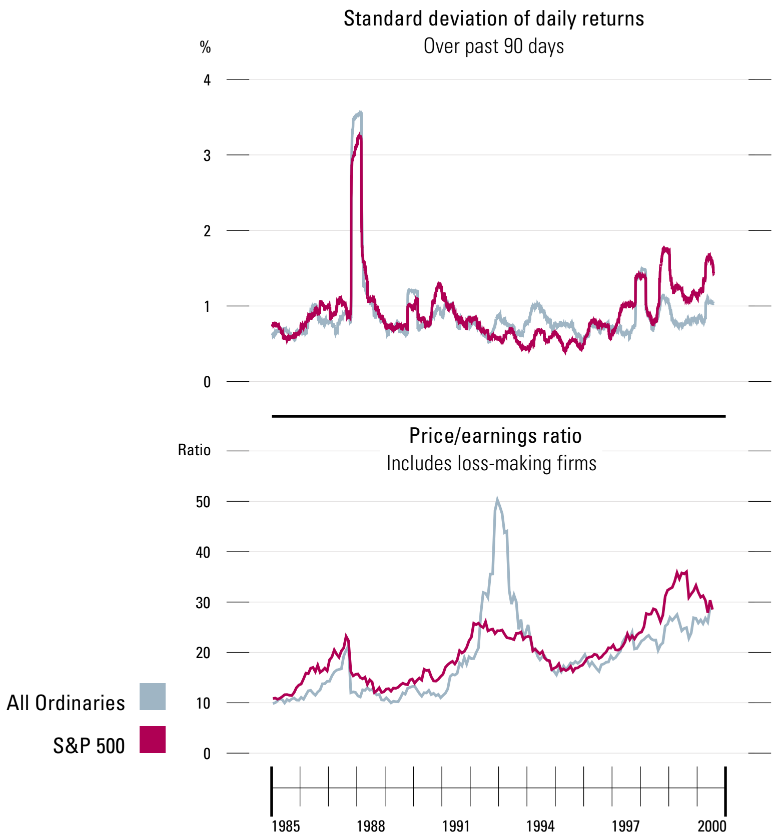
The Stability of the Australian Financial System

Recent Developments

During 1999/2000, the Australian financial system remained in healthy condition, a beneficiary of the long period of expansion in the Australian economy and a more supportive international environment. The global financial market turmoil and reduced appetite for risk of the previous year gave way to a recovery of confidence and a narrowing of credit spreads in global markets. However, a process of gradual monetary tightening in major economies has, over recent months, been associated with increasing volatility in share markets.

Although globally share prices have fallen from their recent peaks, and substantially so for technology stocks, share price valuations (relative to earnings) in the United States in mid 2000 remain high by historical standards. Any future US share market instability would probably flow quickly through to share markets in other countries and, if accompanied by large changes in global portfolio allocations, might lead to rapid realignments in currency markets. Sustained share market falls would also have a direct impact on financial institutions with share market exposures and, more generally, on wealth and confidence in the countries concerned. For these reasons, share market developments have the potential to threaten the stability of global financial markets over the period ahead.

Share Market Volatility

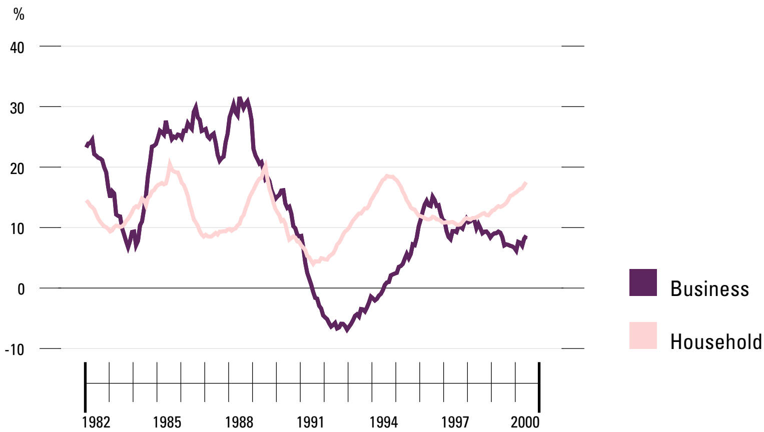


Continued rapid growth of credit was the major domestic development in the Australian financial system over 1999/2000, as it was the previous year. Credit extended by Australian financial institutions rose by 13.1 per cent. Within that total, credit to households grew by 17.5 per cent, well above its average over the past seven years and again outstripping growth in credit to business. The fundamental process at work over recent years has been the gearing-up of household balance sheets in response to the shift to a low-inflation environment and improved access to credit. While it is difficult to judge whether this process has further to run, recent rises in debt-servicing burdens might be expected to curb, to some extent, the willingness of households to assume additional debt.

One component of credit which has been growing especially rapidly, albeit from a small base, is margin lending for share purchases. Over the past year, margin lending by Australian financial institutions rose by 39 per cent. Because of the volatility of share prices,

Credit*

Year-ended percentage change

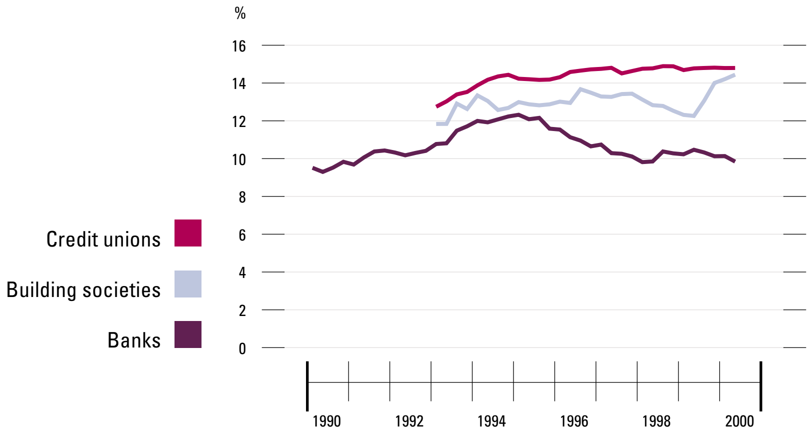


* Adjusted for breaks in series

such lending is more risky than lending for housing and therefore carries a higher risk premium; margin loans are also typically limited to a maximum of 70 per cent of a portfolio of "blue chip" stocks, and even less for other securities. Some lenders have responded to recent share market volatility by tightening their margin lending criteria. The RBA will continue to monitor developments in this area but, at around only one per cent of total credit outstanding, the level of margin lending is not considered a potential source of systemic risk.

Notwithstanding further compression of interest margins over the year, banks have been able to maintain high levels of profitability as a result of significant asset growth, cost containment and further increases in non-interest income. For the major banks, non-interest income now accounts for around 40 per cent of total income, and this share is likely to increase further following recent acquisitions of fund management businesses by banks. Asset quality across the banking system remains strong, although the current ratio of impaired assets to total assets of around

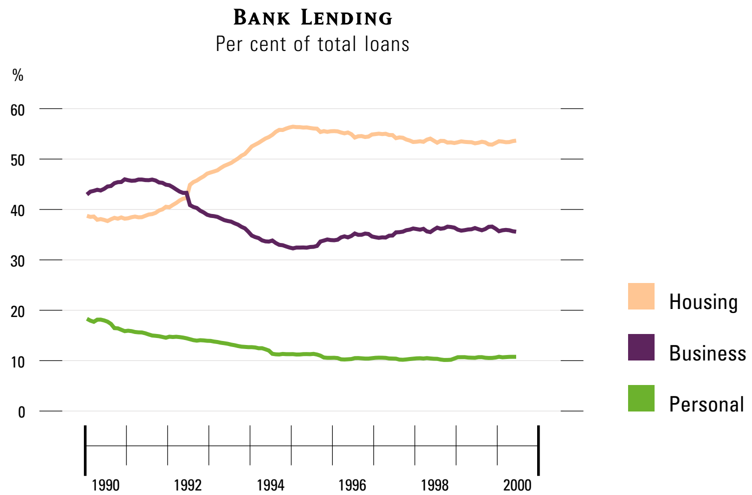
Risk-weighted Capital Ratio



0.6 per cent may prove to be a low point. After falling for a period, the profitability of building societies and credit unions has steadied over the past two years, with growth in non-interest income and favourable loan loss experience important contributors; however, cost reductions have proved more elusive for these groups.

The capital ratios of banks, building societies and credit unions remain well above minimum required levels. The aggregate risk-weighted capital ratio for banks fell to 9.8 per cent by year-end, returning to early 1998 levels; earlier signs of an upward trend in general provisions for bad and doubtful debts have been reversed. Capital management by banks has become a much more active process with a number of banks conducting capital buy-backs in 1999/2000; over the period ahead, such management would call for care if indications of a deterioration in asset quality were to emerge.

The one area of the Australian financial system that has been under some stress is the reinsurance industry. A small number of Australian reinsurers with active international operations announced substantial losses as a result of a series of natural disasters in a number of countries, including Australia. The losses were borne by shareholders of these companies and, in some cases, by overseas creditors. However, they did not shake public confidence in the general insurance industry nor threaten overall financial stability. The prudential framework for general insurance is under review by APRA.

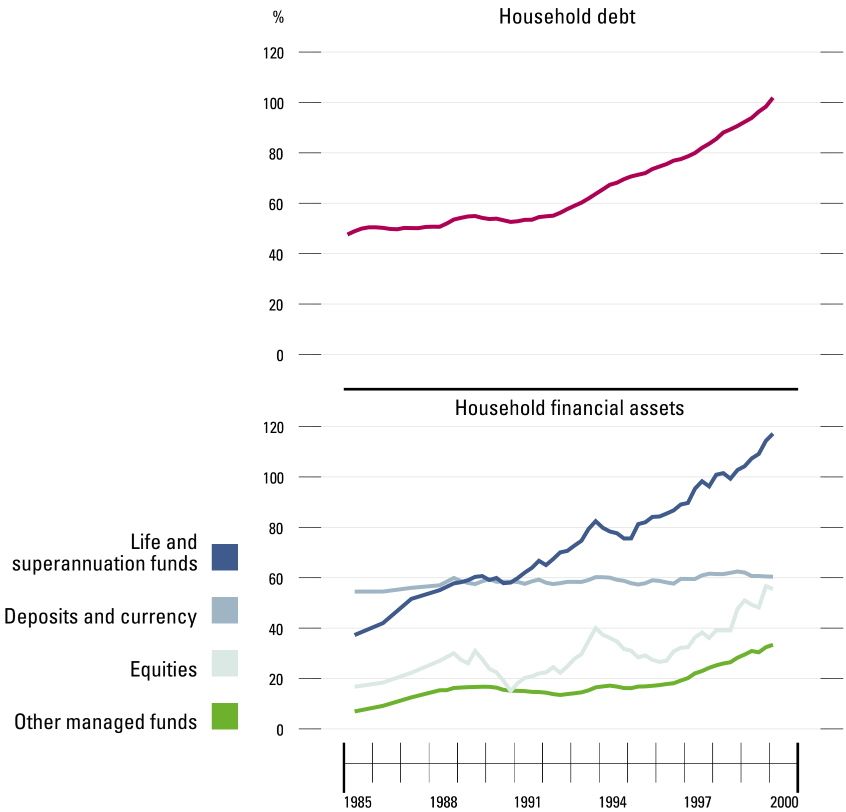


Longer-Term Changes

Stepping back from contemporary influences, the current vigour of the Australian financial system is also the product of various structural changes that have played out over the past decade. Perhaps the most notable has been a general strengthening in the balance sheets of authorised deposit-taking institutions. The past decade has witnessed strong growth in credit to households, particularly for housing, but moderate growth in lending to business; high levels of corporate profits (after interest) and a buoyant share market have enabled businesses to make greater use of internal funding and equity raisings for expansion. For financial institutions, the consequence of these divergent credit trends has been a shift in the structure of assets towards lower-risk loans and, as a consequence, an improvement in average credit quality. This has been reinforced by the tendency of households to substitute home-equity loans for personal unsecured loans. Although some housing lending has been removed from banks' balance sheets through securitisation, the share of housing loans in total lending remains close to historical highs.

Another important structural change has been the growth in the wealth of the household sector and, within that, in its holdings of financial assets. These assets have increasingly taken the form of market-linked investments, such as superannuation and shares, while the relative importance of direct claims on financial institutions, such as deposits, has fallen. From the household sector's viewpoint, this deepening of balance sheets has decreased its relative exposure to the risk that financial institutions might fail but increased its exposure to changes in market prices.

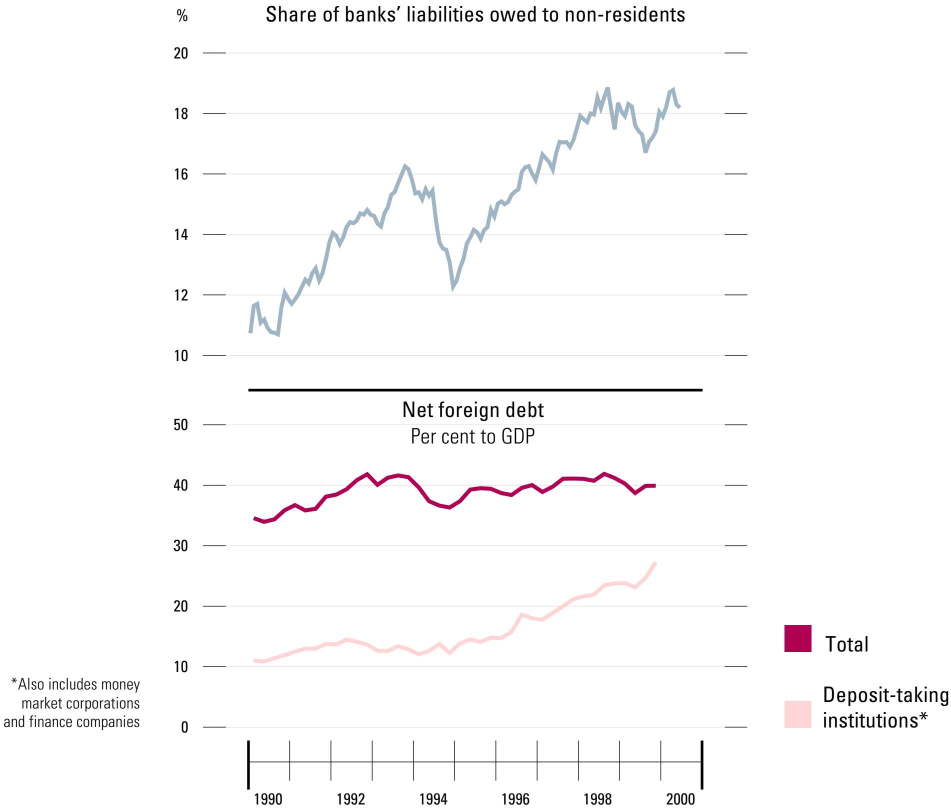
Financial Liabilities and Assets of the Household Sector
Per cent to household disposable income



In the face of the household sector's reduced appetite for deposits, financial institutions, particularly banks, have turned increasingly to offshore wholesale markets to fund their balance sheet growth, mainly through issuing debt securities. Recourse to wholesale markets is part of a broader international trend for banks. Much of the offshore borrowing by Australian banks is denominated in foreign currencies and the associated currency risk is hedged, usually through the swaps market. Hence, Australian banks carry only small net foreign exchange exposures and, because they tap offshore markets on a reasonably continuous basis, are subject to close and ongoing market scrutiny.

To confront changes in the nature and complexity of their risks, authorised deposit-taking institutions have made a substantial effort to strengthen their risk management practices over the past decade. The improvements include an institution-wide focus on risk, the development of credit-grading systems and more sophisticated measurement

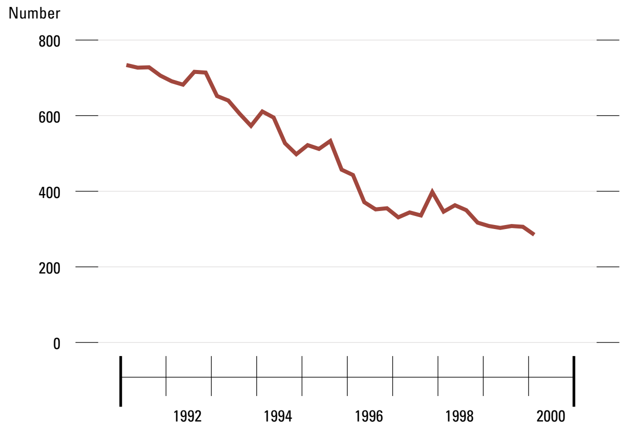
Overseas Borrowings by Financial Institutions



and control of market-related risks. For these institutions, the obvious pay-off has been greater financial strength and a general firming in external credit ratings over the second half of the decade. The improvements are evident, for example, in the substantial fall in the value and number of credit exposures which are large relative to banks' capital. Another example is the better management of exposures to commercial property, where risk now tends to be measured on a portfolio basis rather than loan-by-loan. A third is the diversification of risks and income sources across financial sectors - as banks expand beyond traditional deposit-taking and lending businesses into funds management, life insurance and other fee-generating activities - as well as geographically; for the major banks, the share of profits generated overseas has risen over the decade from around 20 per cent to around 35 per cent.

Complementing these improvements in risk management at the firm level has been a major strengthening of the Australian payments

Banks' Large Exposures
Number greater than 10 per cent of capital



system, which has greatly reduced the risk that difficulties in one or more financial institutions might cascade through the financial system. The key reform was the introduction, in June 1998, of a real-time gross settlement (RTGS) system for high-value payments. This replaced a deferred net settlement system under which settlement obligations between banks accumulated over the course of the day and were not settled until 9.00 am the next morning. The deferred nature of settlement left open the possibility that a bank might be unable to meet its obligations, putting other institutions under severe liquidity and even insolvency pressures. The RTGS system eliminates this risk by ensuring that settlement obligations arising from high-value transactions are extinguished at the same time as the transactions are completed. The RTGS system settles over 90 per cent of payments (by value) exchanged between financial institutions in Australia and it has taken Australia to world's "best practice" in this area.

Important though the focus on financial institutions is, any assessment of financial stability must also acknowledge that financial markets now account for a rising share of financing activity. One expanding market supplementing traditional intermediation is the market for asset-backed securities, particularly mortgage-backed securities, which has grown over the past decade to the equivalent of almost 10 per cent of total credit outstanding. Assets of the listed property trust sector have also been rising rapidly. Increasingly, commercial property developments are being funded through such trusts, ensuring that there is a timely, market-based assessment of conditions in the commercial property sector. More generally, business has turned to new equity issues on the Australian Stock Exchange as an important source of finance. While the long-term corporate bond market has also expanded, institutions outside the financial sector have made only limited use of this market to date.

Whether the more pervasive role which financial markets now play has changed the overall level of risk in the Australian financial system is moot. Recent overseas experience suggests that financial disturbances are increasingly likely to originate in, and be transmitted through, financial markets. However, experience also shows that, provided the financial system itself is robust, market-related disturbances can be handled through prompt policy responses and can have a less severe impact on the macroeconomy than the failure of financial institutions. The growth of financial markets also provides a more diverse range of financing options, making the economy less susceptible to difficulties in any one part of the financial system. In addition, financial markets give businesses and households greater scope to manage their risks. Whatever the balance of these various impacts, it is clear that avoiding excessive speculation in asset markets, financed either through traditional intermediation or market-related debt, is critical to ensuring financial stability.

Payments System Developments

The Payments System Board of the RBA has responsibility for the safety of the Australian payments system and for promoting efficiency and competition within that system, consistent with overall financial stability. The Board oversees the RBA's new and comprehensive powers in this area which allow it, amongst other things, to determine rules for participation or set standards for safety and efficiency in a particular payment system. To date, the RBA has made only limited use of these powers, preferring to work co-operatively with payments system participants, as the new regulatory regime envisaged.

While the safety and robustness of the domestic payments system scores highly against emerging international norms, particularly with the introduction of the RTGS system, further progress is needed in reducing foreign exchange settlement risk. The Payments System Board has strongly supported a global initiative - the "continuous linked settlement" or CLS Bank - to reduce such risk through the simultaneous settlement of participants' foreign exchange transactions in eligible currencies, which will include the Australian dollar.

On the efficiency front, the Board has focused its attention on the pricing and other incentives for using different types of payment instruments. The current incentives are encouraging the use of credit cards over more efficient and less costly alternatives, such as direct debits for regular bill payments. The RBA has been conducting a joint study with the Australian Competition and Consumer Commission into interchange fees and access criteria in the debit and credit card markets, to determine whether current arrangements are conducive to the efficient provision of card services. The findings of the joint study will be released shortly. In addition, the Board has been working closely with major billing institutions to develop consumer safeguards which might encourage greater acceptance of direct debits in Australia. The Board has continued to encourage banks and other financial institutions to speed the availability of cheque funds to what is now clearly "best practice" of three days. The Board's activities will be described in its second Annual Report to be published in October.

BUSINESS SERVICES

The RBA provides a range of banking, registry, note issuing and settlement services for its customers. Banking services are provided to the Commonwealth Government and one State Government (South Australia). Currency notes are processed and issued into the community via banks and armoured car companies, while registry and settlement facilities are provided almost exclusively to banks and other financial institutions. By and large, the RBA does not provide business services to the public - the exception is a small number of registry transactions (accounting for less than one per cent of total turnover in bonds).

A major focus of the Banking Department over the past year has been to position the business to manage the effects of the Government's competition policy on the market for transactional banking services. Responsibility for their own banking arrangements has been devolved to Government agencies themselves, and a number have market -tested their transactional banking requirements. This process will gather momentum during the coming year.

The combined effects of declining business volumes, technology and centralisation of functions by major customers have significantly reduced the role of the RBA's branches in providing banking services. In addition, the impact of the new polymer currency note technology has been of greater significance than originally envisaged. The volume of note processing undertaken by branches has diminished considerably as a result of the improved durability and security of polymer notes and the effect of changes to note distribution arrangements. The combined impact of these reductions in activity in the banking and note issue functions led to a situation where staff numbers in branches were falling below what was considered to be the minimum viable size in terms of security and staff management. This situation had been developing over a number of years and finally the decision to close a number of branches became unavoidable. Darwin and Hobart branches were the first to be affected, closing in 1997 and 1998, respectively. An announcement was made to staff on 8 November 1999 of the pending closure of Melbourne, Brisbane and Perth branches, the cessation of cash-processing operations at Adelaide and Sydney branches and the establishment of a centralised note-processing facility at the RBA's subsidiary, Note Printing Australia Limited (NPA) at Craigieburn, Melbourne. The closure of branches and the transfer of the remaining branch activities to Head Office and Craigieburn has been a major task and has occupied a lot of the time of the Banking and Note Issue Departments.

A longer-term perspective of changes in the RBA's structure is provided in the next chapter.

Government Banking

Commencing 1 July 1999, the RBA's banking business was separated into two components in order to comply with the Commonwealth Government's competitive neutrality and devolved banking arrangements. The non-contestable core account-keeping function undertaken on behalf of the Department of Finance and Administration (DoFA) was split from the contestable transactional processing business conducted for Commonwealth agencies. From 1 July 1999, Commonwealth agencies were given responsibility for conducting their own banking arrangements.

In its core account-keeping role, the RBA maintains six accounts, including the Official Public Account (OPA), whose aggregate balances represent the Commonwealth's daily cash balance. In addition, it provides a limited overdraft facility for the Commonwealth. The core banking function also embraces the release of funds from the OPA to agencies, the sweeping of overnight balances from transactional bankers to the OPA and provision and maintenance of an agency term deposit scheme on behalf of DoFA.

The core account-keeping function also provides for the electronic collection of forecasting data from agencies and reporting on high value transactions on agencies' accounts by transactional banks to assist the RBA in discharging its monetary policy and liquidity management responsibilities.

As noted above, under the devolved banking arrangements, agencies which come within the scope of the *Financial Management and Accountability Act 1997 (FMA Act)* have been delegated the powers to open and operate bank accounts. These *FMA Act* agencies may operate official bank accounts, including trust accounts, with the RBA in its capacity as transactional banker or with a private sector bank provided the arrangements comply with the core protocols on devolved banking established by DoFA. Agencies must undertake all significant foreign exchange transactions with the RBA in order to ensure that these transactions are put through the market in a manner consistent with exchange rate policy.

Business Trends

During the year, the RBA has been heavily involved with Commonwealth agencies in reviewing, refining and improving the banking arrangements put in place for them late in 1998/99. These arrangements had been established in time to allow agencies to take full responsibility for their own banking arrangements as from 1 July 1999, when DoFA withdrew its provision and support of centralised banking arrangements.

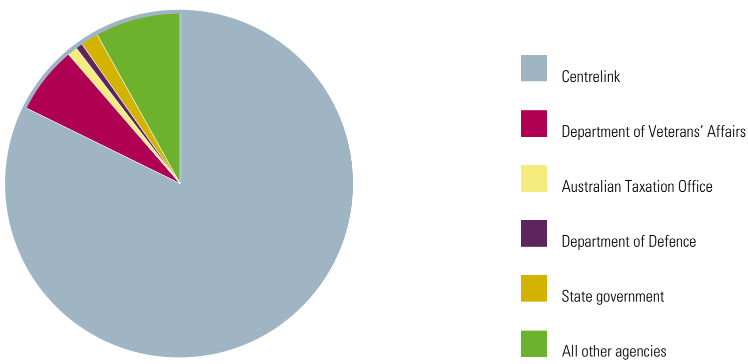
In line with DoFA's banking devolution guidelines, agencies are beginning to undertake the task of market-testing the banking services currently provided to them by the RBA. As at 30 June 2000, five lead agencies had completed market-testing; three chose to move their banking requirements to private sector banks and two elected to remain with the RBA. The Bank was requested by DoFA to assist in the development of a market-testing kit to simplify the process for agencies yet to undertake market-testing. The coming year is expected to see the majority of agencies complete the exercise. The outcome of this process, the take-up of the Commonwealth's e-commerce initiatives and the working-through of major customers' centralisation projects, are likely to lead to the need for further adjustments to the RBA's banking operations in the period ahead.

The effect of the loss of the Australian Capital Territory and Western Australian State Government banking businesses and increased acceptance of the Health Insurance Commission's efforts to encourage electronic crediting of Medicare rebates were the major reasons for the reduction in the RBA's paper transactions volumes during the year. Paper transactions declined by 4.5 per cent to 43 million items in 1999/2000.

Electronic transactions through the Government Direct Entry System (GDES) fell by less, mainly because of the Medicare initiatives and continuing efforts of the RBA's remaining customers to move from paper-based to electronic transactions. Electronic transactions declined from 226 million to 223 million transactions during the year.

The RBA fully supports customer initiatives to move away from the more expensive and less efficient paper-based payment mechanisms. It is directly involved in a range of finance-industry and government-sponsored developments aimed at fostering the growth of e-commerce. The RBA is represented on the Commonwealth Government's Electronic Payments Focus Group and the Commonwealth Procurement Online 2000 Steering Committee. One aim of these latter initiatives is to encourage Commonwealth agencies to introduce electronic arrangements (including Internet-based) which would enable up to 90 per cent of agencies' procurement needs to be conducted and settled electronically with suppliers by 31 December 2000.

Electronic Banking Transactions — 1999/2000



System Linkages

Under the previous "whole of government" banking arrangements, most Commonwealth agencies were linked electronically to the RBA via DoFA. Most of the larger agencies running their own mainframe systems had direct data links to the RBA. Prior to the devolution of responsibility for banking to agencies themselves, DoFA outsourced the Commonwealth's centralised accounting and payroll system to an external supplier, CITEC. In order to facilitate the transition to the new devolved banking arrangements, the RBA agreed to provide CITEC with the same distribution services previously provided to DoFA until 31 December 2000, for those agencies which remained on the centralised system as at 1 July 1999.

As part of the devolution process, agencies were no longer required to use the Commonwealth's centralised accounting and payroll system. A panel of providers had been established by the Commonwealth for the provision of these systems and many agencies moved down this path. In moving to new accounting and payroll systems, agencies were required to establish their own data links to their transactional banker. For those agencies remaining with the RBA on 1 July 1999, who did not have direct mainframe links with it, this was achieved by installing the RBA's customer desk-top banking package, ReserveLink.

In order to satisfy agencies' devolved banking requirements, an upgraded version of ReserveLink was developed. This included new security measures, using smart card technology and enhanced reporting capabilities.

Sets of accounts for the RBA's various contestable businesses are given in the chapter "Pro Forma Business Accounts".

Registry and Security Settlement Services

The Reserve Bank Information and Transfer System (RITS) provides its 143 members (representing 267 organisations) with facilities for the electronic settlement of transactions in Commonwealth Government securities (CGS). The system handles over 99 per cent of CGS turnover in the market and has securities with a face value of $73 billion lodged in it.

The system also provides facilities for electronic tendering for CGS, automatic interest and maturity payments for securities lodged in the system and for settling the interbank component of equity transactions on CHESS, the Australian Stock Exchange's electronic settlement system. RITS is also Australia's real-time gross settlement system and is the means through which banks and other approved institutions access their Exchange Settlement accounts with the RBA.

RTGS System

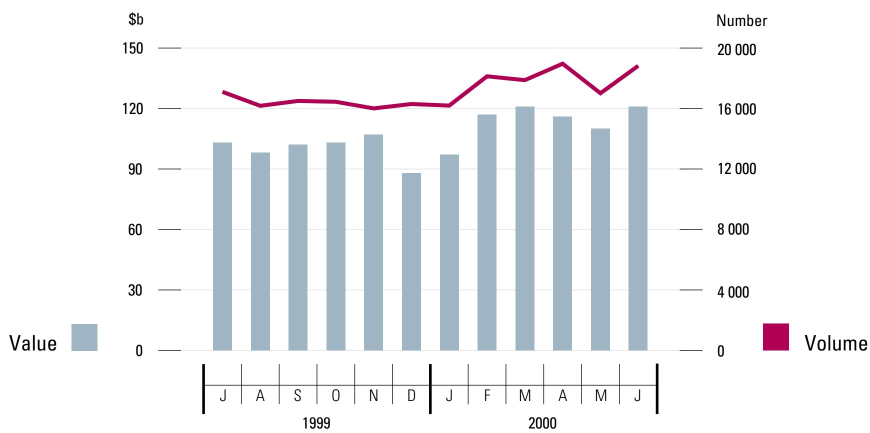
RITS provides the platform for the RTGS system. About 90 per cent of total values exchanged between banks is settled across RITS on an RTGS basis and hence is not subject to interbank settlement risk. RTGS payments include securities markets settlements, the Australian dollar leg of foreign exchange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

This financial year was one of consolidation as the RTGS system progressed through its second year of operation. On average, the daily number and value of transactions settled by RITS increased over the year. However, there was a noticeable decline around the century date-change followed by strong growth over the following months.

Work proceeded on a number of initiatives during the year. The RITS Regulations, which underpin the operation of the system, were amended to cater for widening of access to Exchange Settlement accounts. The first institution approved under the new arrangements, the Sydney Futures Exchange Clearing House, commenced operating its own Exchange Settlement account on 28 February 2000. Testing is well advanced for changes to RITS to cater for the introduction of "continuous linked settlement" of foreign exchange transactions through the new CLS Bank in the second half of 2001. This will involve extended operating hours for RITS and participating banks, in order to line up with the CLS operating window during the European morning.

Work is also underway to permit optional real-time gross settlement of high-value equity transactions from CHESS. This feeder system is scheduled to commence operations towards the end of 2000. To improve the efficiency of securities settlement further, RITS is also being enhanced to enable details of securities transactions to be passed using standard SWIFT messages. This is a major step towards straight-through processing and implementation is planned for the second half of 2001.

RTGS TRANSACTIONS
Average daily value and volume



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

Registry Services

The RBA provides registry services on behalf of the Commonwealth Government, the State government borrowing authority of South Australia, and some other domestic and foreign official organisations. Services include the issuance of securities, maintenance of ownership records, payment of interest and redemption of securities at maturity.

In 1999/2000, registry activity continued to decline. At end June 2000, stock accounts totalled 21 400, down by seven per cent from the level 12 months earlier. As in previous years, the RBA maintained a program of review, to ensure that its registry service remained as cost-effective as possible, given the small scale of the operation. As a consequence, staffing levels in registry further declined in 1999/2000. The cost to the Government, through its agency the Australian Office of Financial Management (AOFM), for the operation of the registry declined by 19 per cent during the year and a further decline of around 20 per cent is forecast in 2000/2001.

Note Issue

The note issue functions of the RBA comprise the issue of notes (new and reissuable); the processing of notes returned from circulation for authentication and quality-control purposes; general oversight of cash distribution arrangements; and research into and development of note designs and security features.

The move to polymer currency notes has continued to have a significant impact on the RBA's note issue activities. The greater security and durability of polymer notes mean that they do not need to be checked for authenticity and fitness as frequently as in the past to keep the circulation clean and free of counterfeits. In combination with changes to cash distribution arrangements, this has resulted in a significantly reduced note-processing task.

Volumes of notes processed at the RBA's five note-processing centres declined during the year and were expected to decline further. Against that background, the decision was taken to centralise the Bank's note-processing activities at one site. After careful consideration, it was decided that a single note-processing operation should be established at the RBA's subsidiary, Note Printing Australia Limited (NPA), at Craigieburn. This site has geographical advantages and note processing complements a number of NPA's existing operations. Current plans are for the new facility to be established in the first half of 2001.

Note Processing and Distribution

Notwithstanding continued strong growth in the volume and value of electronic financial transactions, demand for currency has continued to increase, with notes in circulation

VALUE OF NOTES ON ISSUE
($ million)

AT END JUNE	$1 (a)	$2 (b)	$5	$10	$20	$50	$100	TOTAL	INCREASE (PER CENT)
1994	21	69	313	634	1795	6837	7907	17577	7.4
1995	20	49	332	614	1848	7193	8482	18538	5.5
1996	19	48	337	583	1868	7928	8399	19182	3.5
1997	19	47	351	601	1837	8912	8297	20064	4.6
1998	19	47	361	617	1804	9523	9280	21651	7.9
1999	0(c)	46	379	639	1850	10356	10282	23552	8.8
2000	0(c)	46	397	646	1917	11188	11240	25434	8.0

(a) Last issued May 1984
(b) Last issued June 1988
(c) See Notes To and Forming Part of the Financial Statements, Note 1(i)

again increasing at a faster rate than economic activity. The value of notes on issue in 1999/2000 rose by eight per cent to $25.4 billion. $50 and $100 notes continue to show the strongest increase, with the two denominations increasing their share of the total value of notes in circulation from 82 per cent in the early 1990s to 88 per cent in June 2000. During 1999/2000, around $107 billion in currency notes were issued into circulation and $105 billion returned. These values are up significantly (by around 35 per cent) on last year, reflecting strong demand for notes by banks in the run-up to Y2K.

In early 1999/2000, changes to cash distribution arrangements enabled armoured car companies to service all their customers - banks and other commercial customers (authorised deposit-taking institutions, retailers, casinos and other large cash-handling organisations) - from the one combined note holding. Previously, the two groups were serviced from separate note holdings and this had inhibited the efficient recirculation of currency. The changed arrangements provide greater opportunities for the redistribution of notes in the community and reduce the volume of notes moving in and out of the RBA.

Over the year, around 450 million notes, with a value of around $18 billion, were returned to the RBA for processing through its high-speed note counting and sorting machines. This compares with one billion notes processed during 1998/99 (with a value of around $40 billion). Close to 93 per cent of notes returned were classified as fit for reissue.

As explained in the chapter on "Financial System Stability", the RBA ordered additional notes in preparation for Y2K. Although most of the stocks of notes were held within the RBA, the distribution of notes to RBA branches, banks and armoured car companies was a major task during the year. In the event, although demand in the lead-up to 2000 was higher than in a normal year, the quantity of notes was more than adequate and the additional notes that had been distributed flowed back to the RBA in early 2000.

Counterfeiting Activity

Counterfeiting activity has continued at low levels with around 2 100 counterfeits being detected over the year. This is higher than the 1 700 detected during the previous year, but significantly lower than the outcomes of other recent years.

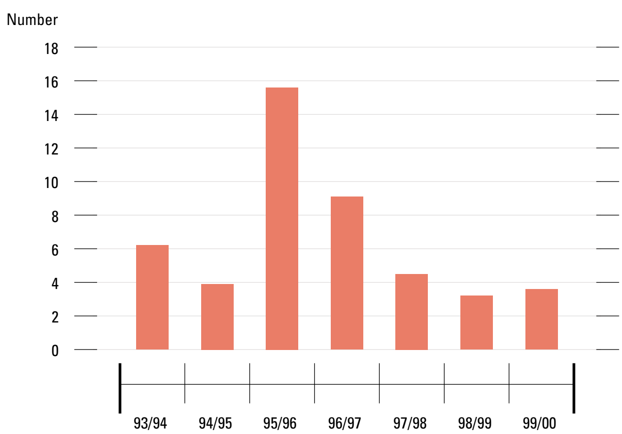
Most counterfeits detected during the year were relatively crude reproductions of polymer notes on paper. Despite the low level of activity, the risk of counterfeiting remains and the RBA continues to conduct research and further develop the security of polymer notes.

Centenary of Federation - New $5 Note Design

The RBA announced plans in its 1998 Annual Report to issue a newly designed $5 note in early January 2001 as a contribution to the Centenary of Federation celebrations.

It also announced at that time that one side of the note will feature Sir Henry Parkes, commonly known as the "Father of Federation". The other side of the note will depict Catherine Helen Spence, the author, political reformer and first woman to stand for election to public office in Australia. The designer of the note is Garry Emery, one of Australia's leading graphic designers, who also designed the current $20 note. Production of the new note is underway and the project is on track for the first of the notes to be issued in January 2001.

Counterfeits Passed per Million Notes in Circulation



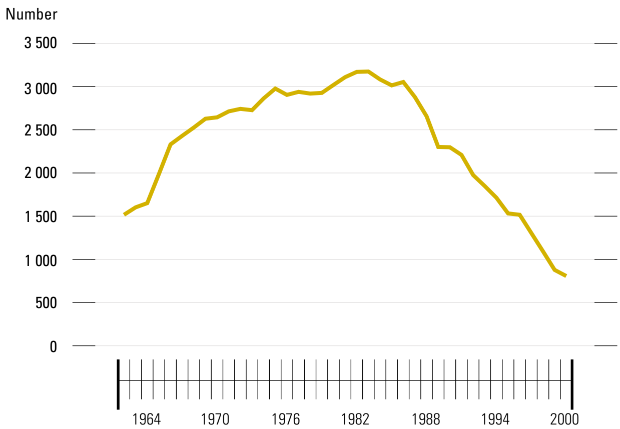
THE EVOLVING STRUCTURE OF THE RBA

This chapter gives an overview of how the RBA as an organisation has evolved over the past 40 years, with a particular emphasis on the past 15 or so years. It is during this latter period that - even though the Bank has continued to expand in terms of the size of its balance sheet - it has contracted markedly in terms of numbers of staff.

Staff numbers in the RBA reached a peak in 1983, when 3 186 people were employed, excluding the note-printing function. By June 2000, the comparable figure was 807, a fall of three-quarters. Staff employed by the RBA are now only a little over half that when it was established as a separate entity in 1959.

The key to understanding why staff numbers have fallen so markedly is to recognise that, until recently, most of the RBA's staff were engaged in Business Services, which consisted of three main activities - transactional banking, registry operations and the issue and processing of currency notes. Although the RBA is known to the public primarily for its monetary policy role, the number of staff employed in the policy areas has always been quite small - until recently, it has typically been less than 20 per cent of total staff. Aside from the loss of bank supervision, there has been no contraction of staff in these areas in recent years. Accordingly, all of the contraction has been in Business Services and among support staff. Business Services now employs about 220 people, compared with nearly 2 000 in 1983. Since its activities were mainly carried out in the branches, most of the contraction in staff numbers has taken place there, although Head Office numbers have also declined by about 40 per cent.

Number of RBA Staff
As at 30 June, excluding NPA



Staff in Business Services

	BANKING	REGISTRY	PAYMENTS SETTLEMENTS*	NOTE DISTRIBUTION	TOTAL
1983	855	440	-	655	1950
1990	655	165	-	450	1270
2000	115	5	45	55	220
Change	-740	-435	45	-600	-1730

* Payments Settlements Department was established in 1998 to operate the real-time gross settlement system and the Reserve Bank Information and Transfer System (RITS)

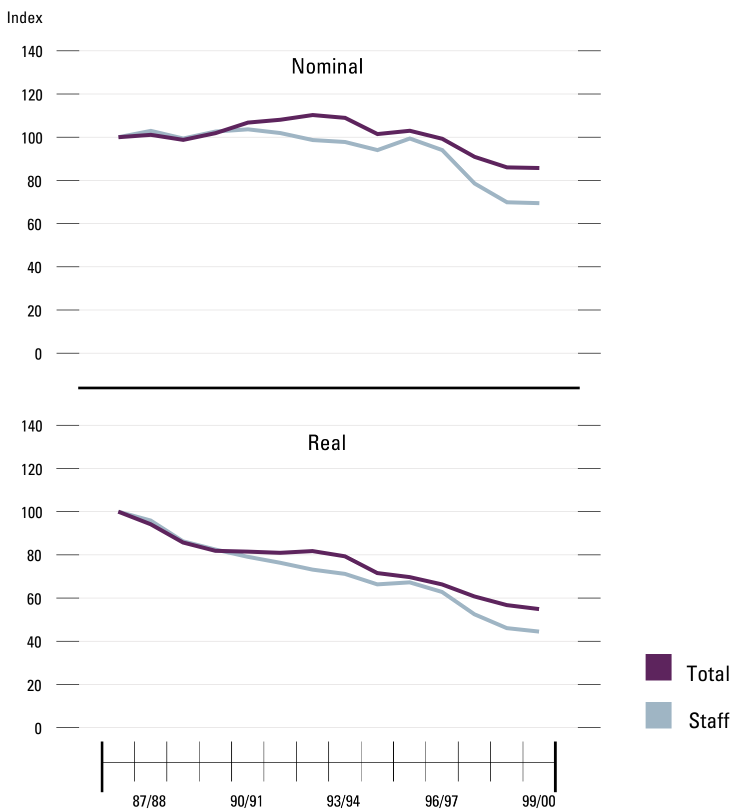
An important factor behind the changes was the decline in banking activities for State governments. When it was separated from the Commonwealth Bank, the RBA retained the banking business of both the Commonwealth Government and a number of State governments. Although banking for State governments was not a core central banking function, State governments were big customers and they formed a significant part of the economic foundation on which the RBA branches were based. Except for Sydney and Melbourne, branches depended heavily on their State governments as customers. As State governments took their business elsewhere, it had a profound impact on the volume of work at the branches.

Of even more importance were changes in technology. Transactional banking and registry services were essentially large-scale, clerically based processing activities, and hence were very labour-intensive. They were also quite decentralised with, for example, separate registries maintained in each State. As technology improved, more and more clerical processes were automated, direct entry replaced cheques and better communications allowed one centralised account or registry to replace six separate ones. As a result, staff numbers were sharply reduced. The combination of losing State government business and being able to conduct the Commonwealth business (banking and registry) with far fewer people explains most of the reduction in total staff numbers, and is the reason why this reduction was concentrated in the branches.

Another more recent factor has been the Commonwealth Government's competitive neutrality principles, which require that the prices which the RBA charges customers fully reflect commercial criteria. At the same time, Government agencies have had to put their banking business out to tender, so the RBA has had to compete with other providers.

In addition to the reductions in the RBA's business service functions, there were also staff cut-backs involved in regulation and in internal support functions. The loss of Exchange Control Department in 1983 and Bank Supervision Department in 1998 were obviously important, but there were others as well, including Rural Credits Department and a significant number of staff whose job was to monitor developments among non-bank financial intermediaries. These reductions have been only partly offset by adding new functions, so that the net reduction in jobs due to loss of functions was about 270 staff. Obviously, with far fewer staff in the "front line", the need for internal support such as personnel, accounting, auditing and facilities

RBA Operating Costs*
1986/87 = 100



* Figures for 1999/2000 exclude direct costs associated with currency distribution specifically for Y2K reasons.

management was correspondingly reduced. In addition, a number of service functions which were formerly performed by the Bank's own staff were outsourced. In most cases, the outsourcing was in response to lower volumes, but in some it was also because the in-house operation was not meeting industry "best practice".

These changes have been reflected in a significant reduction in the Bank's staff costs, which are now about 30 per cent lower than in 1986/87. Staff costs have not fallen as much as staff numbers because average salaries have risen in line with the rest of the economy, and because the reductions in staffing have occurred disproportionately at the lower clerical levels.

Since 1986/87, total costs have fallen by 14 per cent, which is less than the fall in staff costs. The difference is partly due to the greater use of technology and partly to outsourcing. After adjusting for inflation, these falls in costs are a good deal larger, with staff costs down by 55 per cent and total costs by 45 per cent.

The following sections give more details on developments in individual areas of the RBA.

(i) Banking Services

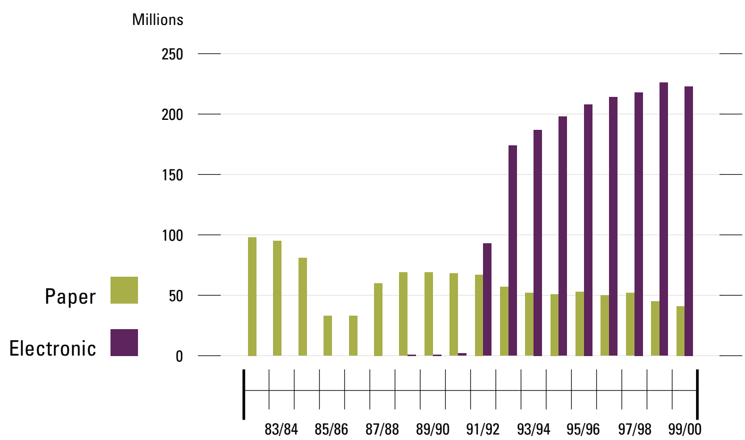
Transactional banking has seen the most pronounced decline in staffing. This has been the result of the continued application of technology, aimed at improving efficiency and reducing costs for customers, as well as the reduction in demand for banking services.

The progressive replacement of paper-based banking transactions with cheaper and more efficient electronic systems began with electronically delivered welfare payments and the computerised processing of cheques early in the 1980s. This was followed by the automation of banking accounting systems and the electronic transfer of banking information with other financial institutions. The RBA's development in 1991 of the Government Direct Entry System (GDES) made electronic payments on behalf of Government agencies easier, cheaper and quicker. This was achieved by establishing a network of communication links with major Government agencies and larger financial institutions, with a desk-top banking facility for smaller institutions. Over time, the RBA also developed new systems to facilitate retail payments to, and international transactions by, Government agencies. Now, more than 80 per cent of the RBA's transactions are handled electronically, compared with virtually none less than a decade ago.

In some cases, such as the automation of banking systems, innovation had an immediate impact on staffing but the full impact of other changes, such as the introduction of GDES, was spread out over time. GDES itself has been refined to deliver more efficient transactional services while the administrative efficiencies, which GDES and other new systems made possible, took time to become apparent.

In addition to technological change, to which all financial institutions have been subject, the loss of a number of customers, including State governments, has also taken its toll on RBA staff levels. The intensification of competition

Banking Transactions



has occurred in the context of the Commonwealth Government's competitive neutrality principles. These require the RBA, in areas in which it competes with private sector suppliers, to achieve a commercial rate of return, pay taxes, observe the same regulatory framework as applies to private competitors and operate with commercial transparency. These principles provided a strong incentive for the Bank to ensure that it was not incurring any unnecessary expenses. Although the principles were formally introduced in 1997, the Bank had anticipated them and moved to run its separate businesses on fully commercial lines from the mid 1990s.

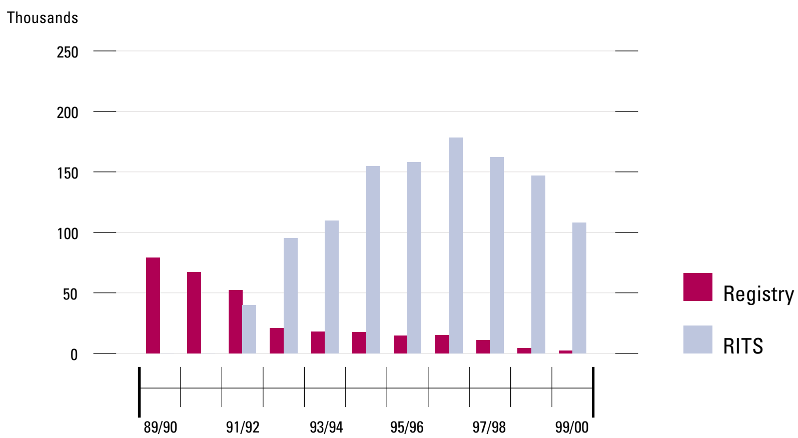
As discussed in the previous chapter, the Commonwealth Government moved a step further in 1999, devolving responsibility for transactional banking to individual Government agencies, and requiring that these agencies market-test their banking arrangements.

(ii) Registry and RITS

The RBA's registry business has also been transformed from a labour-intensive, paper-based operation to one heavily dependent on technology; at the same time, it has faced a dramatic decline in demand for its services. The registry currently holds 21 400 stockholder accounts, compared with 315 000 in 1990, while the annual volume of trades through the registry has declined over the same period from about 80 000 to about 2 500.

The turning point for the registry business came in the mid 1980s, when the Commonwealth Government changed its pattern of debt issuance by ceasing to issue bearer securities in 1985 and Australian Savings Bonds (ASBs) in 1988. Registry systems were also automated around this period. The demise of the ASB, in particular, led to the almost complete cessation of demand for registry services by households. After the introduction of the Reserve Bank

Transfers of Commonwealth Government Securities
Thousands of transactions



Information and Transfer System (RITS) - which involved electronic transfer of securities and the consolidation of the holdings of professional traders of CGS in a single registry account - demand from the wholesale markets for registry services also virtually disappeared because RITS performed the same task so much more efficiently. In the late 1990s, central borrowing authorities of two States, previously customers of the RBA, began to use the services of a private provider.

In contrast with the registry, the RITS business has enjoyed strong growth in market activity, with transfers through RITS increasing, in net terms, from about 40 000 in 1991/92 to about 117 000 in the past year. The decline in RITS turnover from its peak in 1996/97 mainly reflects the reduction in CGS on issue due to the run of budget surpluses.

More fundamentally, the reduction in staff numbers in the registry business was the consequence of an improved approach to debt management - through the elimination of bearer bonds and ASBs and Australia's commitment to establishing high standards in securities settlement through RITS. Although there is now only a small fraction of the staff formerly employed in the combined registry and RITS areas, the service provided is much better and fully in line with international "best practice".

(iii) Note Issue

Note issue is a core central banking function and it is not contestable by the private sector. Note distribution, however, is subject to competitive neutrality dictates. Staff reductions in this area initially followed the same pattern as in banking, with some early mechanisation of note-processing and steps taken to identify, and cut, unreasonable costs. The absence of any charge to banks for note-processing and distribution services, and the RBA's involvement in retail supply of notes and in coin processing, had encouraged overuse of such services, adding to its costs.

The introduction of high-speed note-processing machines in the first half of the 1980s led to a higher quality of notes in circulation, along with some reduction in note handlers. Computerisation of clerical functions led to some efficiencies but the need to move cash physically under secure conditions limited the application of technology compared with banking and registry. In the late 1980s, the RBA introduced a charge for its note-bag distribution service to banks' branches as a way of recouping some of the costs, and to influence banks' demand for note-processing, although a full charge was levied only in 1996.

The transfer of coin-handling to armoured car companies in 1987 resulted in a large fall in RBA staff numbers. In 1998, the RBA also withdrew from retail note-distribution activities, which had a further significant impact on staffing. Under the new arrangements, the RBA stores a stock of notes at depots of armoured car companies, which distribute these notes to meet customers' orders. These arrangements are more efficient and cost-effective than in the past, and are in line with the objectives of competitive neutrality policy.

The introduction of polymer notes in 1992 also increased productivity in note issue and distribution. These notes have a longer life, are cleaner and less susceptible to counterfeiting than paper notes and, accordingly, do not need to be checked as often for authenticity and wear and tear.

Of the remaining 55 staff employed in the note issue function, about half are involved in administering the remaining wholesale cash distribution process, along with developing policy and conducting research on note issue matters, which are core functions of the RBA. The remainder are employed in note-processing operations. This activity will, in future, be conducted at the National Note Processing Centre at Craigieburn in Victoria

(iv) Impact on Branches

As explained earlier, the reduction in staff in the RBA's business services has been concentrated in the branches, because this is where the majority of banking, registry and note processing and distribution activities were carried out. The number of staff in branches has fallen from about 1 950, at the peak in 1982, to about 50 now working in the two remaining branches in Adelaide and Canberra.

Until the past decade or so, the RBA's branches were quite autonomous and contained their own administrative structures. These arrangements were appropriate when business services could be provided on a decentralised basis, but came under pressure as a consequence of computer technology and the pursuit of efficiencies and cost savings. For example, the introduction of the automated banking system and GDES, both of which operate on the Bank's mainframe computer, directly reduced branch staff employed in manual banking processes as well as in computing support. As employment in branches fell and the RBA moved its business services to a more commercial footing, branch administrative functions became more difficult to sustain since their costs undermined its ability to compete.

Provision of Financial Services to State Governments

(Year in which service ceased)

STATE	BANKING	REGISTRY	BRANCH CLOSED IN:
Northern Territory	1986	(a)	1997
Tasmania	1998	(a)	1998
Queensland	1995	(a)	2000
Western Australia	1999	1998	2000
Victoria	(a)	(a)	2000
Australian Capital Territory	1999	(a)	-
South Australia	(b)	(b)	-
New South Wales(c)	(a)	1997	1997

(a) Function never supplied by the RBA

(b) Function still supplied by the RBA

(c) The RBA's banking and registry operations have been centralised as business lines in its Head Office but the branch for New South Wales closed in 1997.

For many years, servicing State and Territory governments provided branches with a critical mass to supply banking services on a cost-effective basis. However, once these customers moved their banking business elsewhere, the remaining business activities in these branches were too small to be viable. The decision to centralise Commonwealth Government banking operations in the RBA's Head Office and Canberra branch will enable the Bank to exploit whatever economies of scale are available so that it can continue to deliver competitive services to its remaining customers.

(v) Changes in Policy Functions

Outside the business services area, some of the important changes in the RBA's structure over the past two decades can be attributed to regulatory and institutional reform in Australia. Certain reforms had a direct impact on staff numbers, including:

- the floating of the exchange rate and the abolition of exchange controls in December 1983;
- the ending of the RBA's subsidised lending to primary producers and the closure of its Rural Credits Department in 1988; and
- the transfer of responsibility for bank supervision to APRA from July 1998. After financial deregulation in the early 1980s, the RBA had built up its capacity to supervise banks.

Other changes in the RBA's policy functions have been more evolutionary, generally in response to ongoing developments in financial markets and in the financial infrastructure. One such change has been the RBA's greatly increased involvement in the payments system. The Bank has always been an important participant in the payments system; banks have always settled their obligations among themselves across accounts at the RBA and the efficient operation of the payments system was a necessary precondition for the effective implementation of monetary policy.

Given this confluence of interests, the RBA in the late 1980s began to develop RITS, with the aim of bringing settlement arrangements for CGS up to world's "best practice". RITS was subsequently adopted as the most suitable platform for the real-time gross settlement (RTGS) system for high-value interbank payments which was completed in June 1998. The RBA has built up its staff numbers involved in operating the RITS and RTGS systems together. At the same time, the RTGS system brought the demise of authorised money market dealers - the group through which the Bank had traditionally carried out operations to implement monetary policy - and a small reduction in the Bank's staff who had supervised their activities. In July 1998, the RBA was given a formal role in the governance of the Australian payments system, with the establishment of the Payments System Board with strong regulatory powers. A new department was established to service this Board. At the same time, the RBA's responsibility for the stability of the financial system was confirmed by the Government. This involved a small addition to staff.

Another change that has been evolutionary in nature is that the RBA has taken a more sophisticated approach to the management of its portfolio of financial assets, especially the foreign assets it holds as official reserves. This

Changes in Policy Functions

		Staff reductions	Staff increases
Function Abolished			
Exchange Control		180	
Rural Credits		13	
Official Forward Exchange		6	
Authorised Money Market Dealers		4	
Non-bank Surveillance and Consumer Issues		21	
Function Added			
Payments Policy			24
RITS/RTGS			22
System Stability			10
International Relations			6
"Regulatory" Functions			
Banking Regulation		69	
Bank Supervision	**-1985**		65
	-1998	65	
Risk Manangement			
Internal Audit		55	
Middle Office			17
Total		413	144

has for the most part been accommodated within existing resources or with only minor increases. An important exception, however, is that the RBA has committed additional staff to a "middle office" in Financial Markets Group to ensure that trading staff comply with risk parameters and that senior managers are informed in a timely way about risk positions and portfolio performance. This emphasis on risk management in general saw internal audit shift to a risk-based audit framework which focuses on the integrity of systems designed to control risks faced by the Bank, rather than checking the accuracy of individual transactions. The reduced number of staff in audit also reflects reductions in paper-based transactions and the closure of the branches.

In general, resources have been reallocated to issues that are likely to be significant for medium-term policy, and away from matters of declining relevance. As an example, the RBA ceased its detailed monitoring of the activities of non-bank financial intermediaries as their importance in the intermediation process declined over the 1990s. On the other hand, it has become more heavily involved in international deliberations on global financial policy in the wake of the Asian crisis. Staffing has been augmented accordingly.

(vi) Support Costs

In the face of strong competitive pressures to ensure a low-cost service to its business customers, the RBA has for some time closely scrutinised costs which looked high or procedures which involved unnecessary duplication. In many non-core areas where the RBA had no comparative advantage, a benchmarking process showed that its cost structure and work practices were out of line with industry standards, offering scope for substantial cost savings through outsourcing. By 1997, the RBA had fully outsourced its building maintenance, cleaning, catering and security guard services. It has, however, taken a selective approach to outsourcing, weighing the costs and benefits on a case-by-case basis. After evaluating the costs of external providers, for example, the RBA "insourced" the management of its workers' compensation arrangements and decided to retain mainframe computing services in-house.

In general administrative areas, as well, staffing has been pruned in response to falling staff numbers overall, the impact of technology and, where possible, a sharper commercial focus. Staff numbers in Personnel Policy, Facilities Management, Financial Administration and Systems and Technology Departments have been reduced over the past decade, easing the burden of overheads on business areas. Overall, staffing in the corporate support area has fallen by about 60 per cent from its peak in the mid 1980s, to a level of about 330 at present.

Selected Reductions in Support Staff

Support Activities	
Ancillary Staff (a)	175
Corporate Support	15
Facilities Management	35
Financial Administration	24
Legal Services	4
Personnel Policy	10
Systems and Technology	10
	273
Outsourcing (b)	
Building Maintenance	30
Catering	26
Cleaners	79
Security Guards	116
	251

(a) Cleaners, messengers, security guards, chauffeurs, storemen
(b) Staff reductions in addition to those identified above

The RBA in 2000

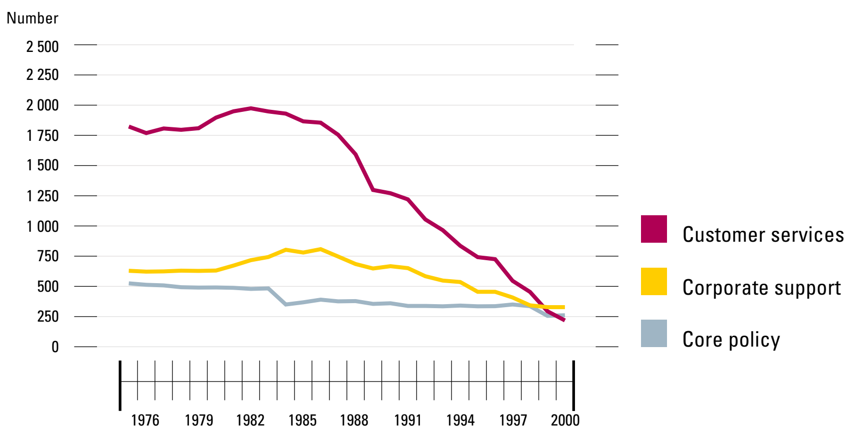
The progressive restructuring of the RBA has seen its focus sharpen toward its core functions. This is reflected in staff numbers: for the first time in the RBA's history, there are now about as many staff employed in the core policy areas - of monetary policy, financial system stability and payments systems - as provide business services or corporate support.

Over recent years, apart from the transfer of bank supervision staff to APRA, staff numbers in the core policy areas have been quite stable.

This is against a background of growing demands in the policy sphere. The market-oriented implementation of monetary policy, the introduction of an inflation-targeting framework and the RBA's responsibility for financial system stability, have put a premium on the Bank's policy analysis and have led to greater pressure on the Bank to be transparent and accountable. Like other policy agencies, the RBA has devoted considerable resources to conducting analysis and preparing advice. The volume of regular written material emanating from the RBA on the economy, financial markets and monetary policy has increased greatly over the past ten years or so. The greater workload of the policy areas has been accommodated within a largely stable number of staff by making greater use of technology. The proportion of clerical staff in these areas has fallen considerably over the past 15 years.

In contrast to other agencies, the capacity to conduct operations in financial markets is unique to a central bank. The operational and policy roles are closely linked since a central bank's main task is the formulation and implementation of monetary policy. Notwithstanding the reduction in overall staffing, the scale of the RBA's policy-driven transactions has increased strongly over the past decade, meaning that its role as a participant in the money and foreign exchange markets has increased. Given that its balance sheet has continued to grow (currently to a level of around $55 billion in assets), the RBA is well-placed to carry on significant operations with the private financial system and to meet its policy objectives.

NUMBER OF RBA STAFF
As at 30 June, excluding NPA



ADMINISTRATION AND COSTS

As mentioned elsewhere in the Report, the major challenge for management in 1999/2000 was the closure of several branches and the further restructuring of the Business Services Group. Faced with these major changes, the task was to ensure a smooth transition to the new arrangements. This placed considerable pressure on the Business Services Group, particularly staff working towards the closure of their own branch operations. It is a great credit to their professionalism that the restructuring proceeded swiftly and smoothly. By end April, the Brisbane and Perth branches, together with the note-processing functions in Adelaide, had closed. Business at Melbourne branch took a little longer to wind up, reflecting its size, but it too had been effectively closed by end June. However, staff from Facilities Management Department are still working in each location pending final decisions about the future of the branch buildings.

During the year, provision of legal services was reorganised. In place of a small in-house legal section undertaking most of the RBA's routine legal work, an experienced General Counsel was appointed to provide high-level advice and co-ordinate the outsourcing of work to legal firms.

In total, a net 71 staff left the RBA's employment last year, largely as a result of the branch closures. There will be associated staff losses in Head Office once the new centralised cash-processing facility is complete and the Sydney cash-processing function comes to an end.

In 1999/2000 staff numbers fell to 807 by end June, down from 878 a year earlier. This fall of around eight per cent followed a reduction of around 20 per cent in 1998/99.

Declining staff numbers have important implications for staff planning since there are now fewer career opportunities for many long-serving officers. Reflecting this, the RBA, with the assistance of external consultants, reviewed the employment conditions of its senior staff during 1999/2000 to ensure that they were commensurate with the needs of a smaller institution. As a result, virtually all senior staff are now employed on individual employment contracts - a major shift away from the concept of tenure traditionally associated with RBA service. As part of this adjustment, a number of benefits were discontinued for senior staff, including rostered days and the provision of home loans through the Officers' Homes Advances scheme.

Changes in the conditions of service for staff generally are negotiated as part of the productivity bargaining agreement. The current two-year agreement expires on 31 December 2000. As part of this agreement, a number of more flexible working conditions for staff were introduced during the year, including the provision of half-day leave, job sharing and leave-in-lieu-of-overtime arrangements. The RBA worked with staff to ensure that there is some additional flexibility available over the Olympic period in Sydney. On the remuneration front, flowing from the certified agreement, all salaried staff (plus Governor and Deputy Governor) received an increase in salary of 3.5 per cent in July 1999 followed by a second tranche of the same percentage in July 2000.

The fall in staff numbers resulted in a further decline in staff costs in 1999/2000. However, the 3.5 per cent pay rise from July 1999, and the fact that most redundancies did not occur until the final quarter of the year, meant that the fall in staff costs was not as sharp as the drop in numbers. Other costs were boosted in 1999/2000 by spending required to ensure adequate cash was readily available to the community in case of Y2K-related demand. The RBA paid over $6 million in transport and insurance to place currency notes at various locations around the country where they could be quickly accessed if needed. Overall, underlying operating costs rose in 1999/2000, but the rise was accounted for by the Y2K-related expenses. Even in nominal terms, costs are around 18 per cent below their peak in 1992/93.

OPERATING COSTS(a)
($ million)

	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
Staff costs	97.6	96.7	93.0	98.3	93.0	77.7	69.1	68.7
Other costs	53.9	53.0	46.4	43.2	43.4	47.2	49.1	56.1
Underlying operating costs(b)	151.5	149.7	139.4	141.5	136.4	124.9	118.2	124.8
Cost of redundancies	2.7	9.8	18.0	1.3	7.5	20.7	18.4	9.3

(a) Excludes NPA
(b) Excludes note purchases from NPA and, from 1994/95, additional charges to comply with accounting standard AAS30

The share of costs attributable to note distribution rose in 1999/2000, reflecting the Y2K-related expenses referred to above. The share of costs absorbed by banking fell due to branch closures and the full-year effects of earlier declines in staff numbers.

DISTRIBUTION OF UNDERLYING OPERATING COSTS(a)
(Per cent)

	MONETARY POLICY	FINANCIAL SYSTEM SURVEILLANCE	NOTE DISTRIBUTION	BANKING AND REGISTRY	SETTLEMENT
1996/97	29	14	28	23	6
1997/98	30	14	23	23	10
1998/99	35	8	20	23	14
1999/2000	35	8	23	20	14

(a) Excludes NPA

The RBA holds a licence to self-insure its workers' compensation claims. These have been falling, reflecting declining staff numbers, the exit from some currency-processing work with a higher risk profile, as well as progress in implementing a new hazard management program. The tendency, noted in last year's Report, for the average cost of claims to rise despite their numbers declining was less evident this year. Given the small number of claims, the cost of continuing to self-insure was reviewed during the year. However, these costs continue to be lower than insurance premiums charged by Comcare.

As in past years, the RBA assisted staff undertaking further career development. At end June 2000, seven staff were studying full-time under the Post Graduate Study Award Scheme, including six at overseas universities. Over the year, financial support was also provided to 83 staff undertaking part-time tertiary studies in Australia.

The RBA provided employment for trainees through the Reserve Bank New Apprenticeship and Traineeship System Agreements 1999 and 2000, and work experience was provided to a number of students.

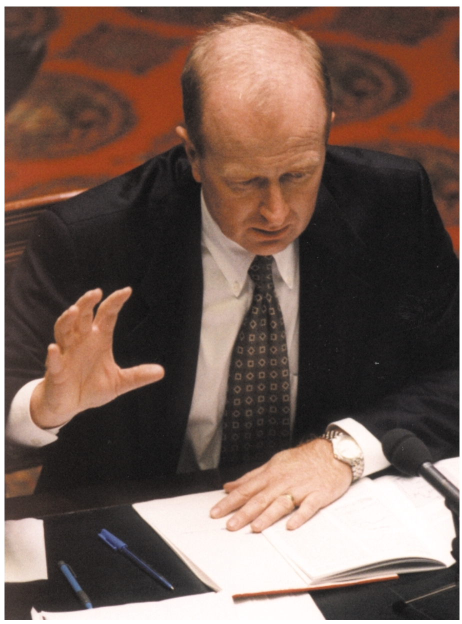
THE RBA IN THE COMMUNITY

An important element of the RBA's task is to explain its role and actions to the community at large and to contribute to community activity in areas which are complementary to its activities. Successful monetary policy requires financial markets to have a thorough understanding of the policy framework, but there also needs to be, in the community as a whole, a broad understanding and acceptance of the logic of policy. The RBA accepts that accountability is part-and-parcel of independence.

Accountability

A central channel for accountability is through appearances before Parliamentary Committees. The Governor and senior officials appeared before the House of Representatives Standing Committee on Economics, Finance and Public Administration on three occasions to answer questions about the conduct of monetary policy and other issues relating to its broader responsibilities, including payments systems. Shortly before the two regular appearances (in Sydney in November 1999 and in Melbourne in May 2000), the Bank published its *Semi-Annual Statement on Monetary Policy*, giving its detailed assessment of the latest economic and financial conditions. The third appearance before the Committee in Sydney in February 2000, was part of the Committee's Inquiry into international financial market effects on Government policy.

The RBA has also appeared before other Parliamentary Committees on matters where it is seen to have a particular expertise. In May, the Assistant Governor (Financial Markets) appeared at a hearing of the Joint Committee of Public Accounts and Audit, as part of that Committee's examination of an audit report by



Assistant Governors Laker, Stevens and Battellino appearing before Parliamentary Committees.

the Auditor-General into Commonwealth debt management. In June, he appeared at a hearing of the Senate Select Committee on Superannuation and Financial Services.

In conjunction with the various hearings of these Parliamentary Committees, the RBA has provided additional detailed information on subjects of particular interest to the Committees. It provided to the House of Representatives Standing Committee on Economics, Finance and Public Administration papers on bank fees on small businesses (in November), and on bank fees (in May), and to the Joint Committee of Public Accounts and Audit a paper on management of the Reserve Bank's portfolios of financial assets (in May). These papers are now part of the public record.

Senior officers have also presented the RBA's perspective on current issues in various public forums. For example, the Governor gave a talk on "Managing the Expansion" to the Economic Society in Melbourne and another to the Australian Business Economists in Sydney. He delivered the Chris Higgins Memorial Lecture, on "Monetary Policy in Economic Expansions" in Canberra and the R.C. Mills Memorial Lecture on the "Stability of the Financial System" in Sydney. The Deputy Governor spoke on "Financial Crises and Globalisation" at a conference in Canberra organised by The Reinventing Bretton Woods Committee. Three of the Assistant Governors also gave major presentations during the year to interstate audiences.

Interest in Australia among international audiences has been heightened by the Australian economy's good performance over the 1990s, particularly during the Asian crisis. The Governor's talk to Australian Business in Europe, in London in May, was directed primarily at the international investment community. The Deputy Governor spoke on "The International Reform Agenda: Unfinished Business" at the World Economic Forum's 1999 East Asian Economic Summit in Singapore in October. The Assistant Governor (Financial System) gave a presentation on "Monitoring Financial System Stability" to participants from Australia and overseas at the International Banking Summer School in Melbourne in September.

Given the close attention which is now paid to all comments which are made by the Governor, a decision was taken during the year to discontinue a longstanding practice of giving informal, semi-private addresses to small audiences. Often these semi-private audiences were composed of groups of institutional

At the RBA's 1999 Conference on "Capital Flows and the International Financial System", the Governor with former Chairman of the US Federal Reserve Board, Paul A Volcker.

investors from offshore (sometimes in Australia and sometimes overseas), and some Australian market participants and commentators expressed the view that they were being disadvantaged by not having access to remarks which were being made in these gatherings. All the Governor's speeches are now before public audiences and open to the press.

Most of the public presentations by senior officers during the past year were reproduced in the Bank's *Bulletin* and published on the web site (www.rba.gov.au) at the time the presentations were being given. As has been practice in recent years, the RBA published in January - both in the *Bulletin* and on the web site - a summary of the economic and financial research undertaken during the previous calendar year. During 1999/2000, nine Research Discussion Papers (RDPs) were published, in hard copy and on the RBA's web site. The RDPs are intended to make the results of current economic research within the RBA available to other economists, by presenting preliminary results of research in order to encourage discussion and comment. To this end, authors of the papers may express their own views, which are not necessarily those of the Bank.

The progressive evolution of the RBA's web site continued during the year. In March, at the time of the release of that month's issue of the *Bulletin*, the *Bulletin* statistical tables were for the first time made available on the web site. The tables on the web site are in the same format as published in the *Bulletin*, but they include historical as well as the most recent data, and they are updated monthly, at the same time as the *Bulletin* is released. As a result of this expansion in the scope of the web site, there has been a significant increase in the number of visits to the site.

With the increasing trend towards using electronic media as the primary vehicle for publishing information, the Bulletin Editorial Committee was reconstituted into a Publications

Participants at the RBA's 1999 Conference (left to right): Tharman Shanmugaratnam of the Monetary Authority of Singapore, RBA Board Member, Jillian Broadbent and APRA Chairman, Jeff Carmichael.

Committee in April. The chairmanship of the new Committee remains with the Assistant Governor (Economic) and the composition of the Publications Committee, while remaining essentially the same as its predecessor (with representatives from the three policy areas of the Bank, plus the Bank's Secretary), was widened to include the Head of Systems and Technology Department to take account of the expanded focus on electronic methods of publication.

Following the accidental premature release of the 2 February Monetary Policy announcement, the Bank has reviewed publication procedures for market-sensitive information to ensure that it is released in a timely and equitable manner.

The RBA's annual Economic Conference has continued to attract participation by highly regarded economists from around the world. The 1999 conference was held in August on the theme of "Capital Flows and the International Financial System", with presentations from *inter alia* Paul Volcker, Eisuke Sakakibara, Max Corden and Barry Eichengreen. The theme of the 2000 conference, held in July, was "The Australian Economy in the 1990s", with presentations by a number of Australian economists plus Professor Bradford DeLong from the University of California, Berkeley, and Professor Charles Bean from the London School of Economics. All the presentations at the Conferences are made available on the RBA's web site, and then compiled into a hard-copy conference volume.

Other contributions to academic discussion have involved RBA staff making formal presentations to university audiences. Senior staff from Economic and Financial System Groups have made presentations to students at universities in both Sydney and Melbourne and at the March conference of the New South Wales Economics Teachers.

Financial and Other Contributions

The practice in recent years of making financial contributions to various projects undertaken by Australian universities has continued. This has included the provision of funding for: a monthly survey of inflation expectations undertaken by the Institute of Applied Economic and Social Research at the University of Melbourne (support which has been provided for a number of years); a third, and final, annual contribution, along with a number of other financial institutions, to the Securities Trading and Research Laboratory ("Starlab") of the University of New South Wales; and an ongoing quarterly survey of union inflation and wage expectations, organised by the Australian Centre for Industrial Relations Research and Training at the University of Sydney.

Funds were also contributed in the past year towards the running of a number of academic conferences: the 28th Conference of Economists, held at La Trobe University in Melbourne; the annual PhD Conference in Economics and Business (held jointly by the Australian National University and the University of Western Australia); the 12th annual Australasian Finance and Banking Conference, at the University of New South Wales; a conference on International Migration into the 21st Century, at the University of Western Australia; and a conference on banking and finance organised by the University of Melbourne's Centre of Financial Studies. In addition, the RBA undertook to fund, for two years, the costs of distributing to a core group of policy-makers in Papua New Guinea and the Pacific Islands, the *Pacific Economic Bulletin*, produced by the Asia Pacific School of Economics and Management at the Australian National University. Financial assistance was also provided to the Sir Roland Wilson Foundation, which encourages study and research, through graduate programs at the Australian National University, in areas associated with the career of Sir Roland who was Secretary to the Treasury from 1951-66 (and member of the Reserve Bank Board). The RBA also continued its support for three places at the University of Technology, Sydney in information technology. Outside the academic field, the RBA provided a financial contribution to the costs of running of the conference, held in Sydney in May, of the Asia/Pacific Group on Money Laundering (which is part of the Financial Action Task Force, formed under the auspices of the G7 Economic Ministers). It also continued its practice of making an annual contribution to the Group of 30 to support its program of research and publications on issues in international finance. A sum of $200 000 was paid to the Sydney City Council to assist in upgrading the section of Martin Place outside the RBA's Head Office building; the same amount was paid in 1998/99.

As part of its broader community relations, the RBA chairs the Small Business Finance Advisory Panel. This Panel, established in 1993, draws on a number of small and medium-sized businesses across Australia from a wide spectrum of industries to provide advice to the Bank on issues relating to the provision of finance to the sector. These annual meetings provide a useful opportunity to assess the conditions faced by small businesses.

During the year, the RBA contributed a total of $24 800 to 27 charitable organisations. It is a corporate sponsor of the annual "Work-A-Day 4 Kids" fund-raising event, which is organised under the auspices of the Financial Markets Foundation for Children. The Governor is Chairman of the Foundation, which draws support from staff members of institutions in the financial markets and related fields and which raises money to be applied to research into medical and social problems affecting children.

Statutory Obligations

Equal Employment Opportunity

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the RBA reports to the Australian Parliament each year on its Equal Employment Opportunity (EEO) program; the report for 1998/99 was tabled in October 1999. The Report includes details of the Bank's EEO Plan which concluded at end June 2000. A new Plan was developed to operate for the following year; the new Plan carries forward the broad objectives of the previous Plan, but incorporates new strategies to achieve those objectives.

Health and Safety, Compensation and Rehabilitation

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

A major focus of the Occupational Health and Safety Plan during the year was to implement progressively a new system for identifying, assessing and controlling hazards in the RBA's workplaces. The system was successfully implemented in the remaining branch offices and a start was made on Head Office areas during the year. In support of this program, the Health and Safety Policy has been reviewed and reissued.

In 1999/2000, one Occupational Health and Safety Audit was undertaken by representatives from the Safety Rehabilitation and Compensation Commission compared to two audits in the previous year. The positive result from this audit continued the trend of the earlier audits and is welcomed for acknowledging the contribution being made by staff in promoting sound health and safety practices.

Only a small number of new claims for workers' compensation were received during the year. Most were for injuries of a minor nature, and claims management and rehabilitation arrangements were effective in determining claims quickly and returning staff affected to work with little lost time. The closure of branches has reduced the RBA's risk profile somewhat and, with an active hazard management program being implemented, the scope for work-related injuries should continue to diminish.

Sue Williams and David Angliss (far right) in discussions at the RBA's Small Business Finance Advisory Panel. Other participants (left to right): John Broadbent and Frank Campbell from the RBA's Financial Markets Group.

The RBA's performance in managing claims in terms of its licence to self-insure was also the subject of an audit by the Safety Rehabilitation and Compensation Commission. Partly as a result of a number of initiatives implemented last year, the audit reported a high level of compliance with obligations under the Act and conditions of the RBA's licence to self-insure. One of these initiatives involves contracting out reviews of primary determinations made by the RBA to another licensed authority. This decision will reduce overheads involved in managing the small number of determinations which are disputed.

Freedom of Information — section 8 statement

The RBA is an exempt agency under the *Freedom of Information Act 1982* in respect of documents concerning banking operations (including individual open market operations and foreign exchange dealings) and exchange control matters.

Organisation and functions: The RBA is Australia's central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the *Reserve Bank Act 1959*, the *Banking Act 1959*, the *Financial Corporations Act 1974*, the *Commonwealth Authorities and Companies Act 1997*, the *Payment Systems (Regulation) Act 1998*, and the *Payment Systems and Netting Act 1998* and in Regulations made under those Acts. An organisation chart appears at the end of this Report.

Categories of documents: Lists of publications, including speeches, articles, occasional papers, information booklets, conference volumes, regular media releases and other publications, are published from time to time in the Reserve Bank *Bulletin*; this information is also included on the web site (www.rba.gov.au). Other documents held are in the form of working notes and files covering policy and operational matters, statistical data, personnel, premises and general administration.

Facilities for access and Freedom of Information procedures: Inquiries under the *Freedom of Information Act*, including requests for access to documents, should be directed to the Secretary, Head Office, or the Managers of branches (in Adelaide and Canberra). Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available.

— SECTION 93 STATEMENT

Two requests for access to documents under the Act were received in 1999/2000, compared with three in the previous year. One request was withdrawn before it was processed and access to the documents sought was denied for the other request. There were no applications for internal review and there was one application for review by the Administrative Appeals Tribunal, relating to a request received in 1998/99. The cost of administering the Act in 1999/2000 is estimated to have been approximately $116 900, compared with approximately $67 100 in the previous year; application fees of $30 and charges of around $3 780 were collected by the Bank.

NOTE PRINTING AUSTRALIA

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

NPA is headed by a Board comprising chairman Graeme Thompson (formerly a Deputy Governor of the RBA and now Chief Executive Officer of the Australian Prudential Regulation Authority), Dick Warburton (a non-executive member of the Reserve Bank Board), Les Austin (an Assistant Governor of the RBA) and Mark Bethwaite. The NPA Board oversees its operations under broad policy direction from the Reserve Bank Board. NPA's Chief Executive is John Leckenby.

During 1999/2000 NPA produced 656 million polymer notes, which was more than double the previous year's figure. As a result, profit was above the level of recent years and produced an unusually high rate of return. Because of a build-up of notes for Y2K, which were subsequently not required, plus continuing proof of much longer life for polymer notes, there will be a significantly reduced need for the production of Australian notes over the next three years, after which production should settle to a more consistent pattern. Of the total production last year, 30 per cent was for Australia - including the additional contingency order for Y2K purposes - with the remaining 70 per cent to meet export orders. In addition, NPA subcontracted some production to two other overseas printers to ensure customer needs were met at a time when its own capacity was stretched. For a time in the second half of 1999 the plant was running 24 hours a day, seven days a week. The exceptional efforts of staff throughout the year, and this period in particular, were greatly appreciated by the NPA Board and senior management.

Over the period 1992 to 1996, Australia progressively converted its entire note issue from paper to polymer. New Zealand has subsequently followed suit and a growing number of other countries have commissioned NPA to print commemorative or circulating notes. This export business is expanding as the superiority of polymer over paper becomes more widely recognised. This superiority is based on polymer's longer life, greater protection against counterfeiting, improved cleanliness, ease of machine-processing and recycling capability.

The table below summarises NPA's export record. Early successes were mainly in the Asia Pacific region, but in the past year this has extended to Europe. NPA has three overseas marketing offices - covering the Americas, Europe/Middle East/Africa, and Asia - with the Pacific region serviced from Craigieburn. These offices have a sizeable list of potential new customers.

Reserve Bank Board members inspecting the printing works at Note Printing Australia, Craigieburn, Victoria.

Polymer Notes Export Orders

YEAR OF FIRST ISSUE	CUSTOMER	DENOMINATION
1990	Singapore	50 Dollar
1992	Western Samoa	2 Tala
1992	Papua New Guinea	2 Kina
1992	Kuwait	1 Dinar
1994	Indonesia	50 000 Rupiah
1996	Brunei Darussalam	1, 5, 10 Dollar
1996	Thailand	50, 500 Baht
1997	Thailand	50 Baht
1998	Sri Lanka	200 Rupee
1998	Malaysia	50 Ringgit
1999	New Zealand	5, 10, 20, 50 & 100 Dollar 10 Dollar Millennium Note
1999	Papua New Guinea	50 Kina
1999	Romania	2 000 Lei
1999	Indonesia	100 000 Rupiah
2000	Papua New Guinea	2, 10, 50 Kina

NPA's close involvement in Australia's move to polymer notes means it can provide comprehensive support to overseas central banks moving to polymer technology. This assistance includes advice on introducing new notes to the community and training in note-processing, note-handling and storage. NPA can also supply high-level authentication systems to other issuers.

An important element of NPA's strategy, both domestically and internationally, is to maintain its leadership in security and other technology associated with polymer. It has an active research and development program in partnership with the CSIRO and others. Five patent applications were lodged during the year and a number of provisional patents lodged in the previous year have moved to the national examination stage.

The pressures on production facilities during 1999/2000 revealed NPA's vulnerability to ageing machinery. Consequently the NPA Board approved a substantial capital investment program including a new overcoating press, a new simultan press and further upgrades to numbering equipment. When this program is complete all key processes will have back-up.

NPA has been improving its efficiency over recent years. These efforts have borne fruit in increasing export sales and the ability to handle short-term pressures on capacity, as was well demonstrated during the past year. However, the trend decline in NPA's base load annual production for Australia due to the substantially increased life of polymer notes means that even greater flexibility will be desirable in future. Near the end of the year a new program was commenced to reduce costs and further improve efficiency, and discussions were held with staff about more flexibility in employment arrangements.

NPA's systems are subject to regular external audit and NPA maintains its ISO 9001 certification. A comprehensive risk management process was instituted during the year.

SECURENCY

Securency Pty Ltd is the company formed in 1996 as a joint venture between the RBA and UCB Films PLC, a manufacturer of polypropylene films. Securency markets and supplies its press-ready polymer substrate, *Guardian*®, to NPA, and to countries with their own note printing plants but wishing to introduce polymer notes. It produces *Guardian*® by applying unique coatings and security features to clear films manufactured by UCB. It also markets and supplies an alternate polymer substrate, Sentinel, to overseas printers for other high-security documents, such as land titles.

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

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

Securency Export Customers

YEAR OF ISSUE	CUSTOMER	PRODUCT
1998	Bank of Thailand	50 Baht
1999	Central Bank of China, Taiwan	50 NT Dollar
1999	China Engraving & Printing Works, Taiwan	Land Title
1999	National Bank of Belgium	UCB Share Certificate
1999	Central Bank of Brazil	10 Reais
1999	Canadian Bank Note Company	Northern Bank 5 Pound

A major achievement in the past year was to secure an order for substrate to be used for a circulating note in Brazil, the first polymer note to be issued in the Americas. In conjunction with a Canadian printer, Securency also secured an order from Northern Bank in the United Kingdom for a commemorative/circulating polymer note. Several other overseas note printers have run trials with Securency's *Guardian*® and are considering conversion from paper. All of the polymer notes issued in the world to date have been on this material.

Included in Securency's investment program that commenced in July 1998, the upgrade of its production facility was completed during the year with the latest equipment installed and commissioned. This equipment is now in full production and allows for the manufacture of a greater range of security features.

As part of the expansion of the business, a flexible enterprise bargaining agreement was negotiated with the AMWU Printing Division and certified by the Australian Industrial Relations Commission during the year. The establishment of the agreement has been key to expansion plans and has enabled the employment of more than 30 additional staff during the year.

EARNINGS AND DISTRIBUTION TO GOVERNMENT

Earnings available for distribution come from two sources - underlying earnings and gains or losses realised when sales of assets are made from the RBA's portfolio. Underlying earnings are relatively stable, whereas realised gains or losses can vary widely, depending on the volume of financial assets sold and the prices received for them. In 1999/2000, underlying earnings were $1 511 million, while there were realised valuation losses of $708 million.

Underlying earnings are derived to a significant extent from note issue. Currency notes are the largest liability item on the RBA's balance sheet, and no interest is paid on them. Nor is interest paid on capital and reserves, but other liabilities, like government deposits and exchange settlement accounts, do attract interest. Interest paid on the latter is, however, quite small compared with the income received by the Bank on holdings of government securities, both domestic and foreign. The RBA also earns some non-interest income (e.g. from its banking and settlement service fees, exports of notes by NPA and from rental income) and, on the expenses side, must cover its operating costs. Underlying earnings, the net outcome of these influences, represent the RBA's core income.

In 1999/2000, underlying earnings were down on those of earlier years. The main reason for this was the abolition of non-callable deposits from 1 July 1999. The interest rate on non-callable deposits had been set at 5 percentage points below the Treasury note yield; clearly, this had meant that the investment of these funds had been profitable to the RBA in the past, but this income was forgone after non-callable deposits were repaid to the banks.

The second major influence on earnings is the gains and losses arising when domestic or foreign securities are sold for more or less than their original purchase price. The risks which the RBA experiences from valuation changes of the components of its balance sheet are discussed in the chapter on "Operations in Financial Markets". The RBA's policy role constrains its capacity to avoid or limit these valuation risks, as a commercial bank would do. Over a run of years, this produces considerable volatility (both gains and losses) in asset valuations and, when these are realised, in earnings. This volatility might be expected to even out over the longer run. Given the shifts in interest rates and exchange rates during the decade of the nineties, the RBA has had far more realised gains than losses. In 1998/99, for example, the gains were so large that the Treasurer exercised his discretion to spread the distribution of the dividend (boosted by almost $1.9 billion of realised valuation gains), taking $3 billion in 1999/2000 and the balance of $676 million in 2000/01.

In 1999/2000, however, realised valuation effects have gone against the RBA, with losses recorded both from interest rate changes and exchange rate movements. In 1999/2000, in an environment of generally rising interest rates, sales of securities resulted in realised losses of $385 million; these sales occurred in the course of normal domestic market operations, and in adjusting the composition of international reserves.

The RBA also recorded net realised losses of $323 million due to foreign exchange swaps. The RBA treats swaps in the same way as foreign exchange purchases or sales. Receipts of foreign currency under a swap are regarded as a purchase and added to foreign exchange holdings; they are marked to market along with other holdings resulting in unrealised gains or losses. Deliveries under swaps are regarded as sales of foreign currency and produce realised gains or losses. The roll-over of swaps can result in realised gains or losses matched by corresponding unrealised losses or gains. The result is that, although swaps have no impact on accounting profit (because realised and unrealised outcomes are offset), they do impact on measured realised gains or losses.

The result of netting underlying earnings of $1 511 million with the total realised valuation loss of $708 million gives earnings available for distribution to the Government or for varying reserves of $803 million in 1999/2000, well below the $3 676 million which was available in the previous year. The distribution is, of course, supplemented by the $676 million of dividend carried over from the previous year.

Sources of Earnings Available for Distribution
($ million)

	UNDERLYING EARNINGS	REALISED GAINS AND LOSSES	EARNINGS AVAILABLE FOR DISTRIBUTION
1985/86	1 292	1 371	2 663
1986/87	1 412	2 035	3 447
1987/88	1 508	18	1 526
1988/89	971	-554 *	417
1989/90	1 248	-153 *	1 095
1990/91	1 322	391	1 713
1991/92	1 516	1 038	2 554
1992/93	1 760	2 803	4 563
1993/94	1 556	-48 *	1 508
1994/95	1 649	123	1 772
1995/96	1 784	702 *	2 486
1996/97	1 715	1 990	3 705
1997/98	1 750	1 524	3 274
1998/99	1 816	1 860 *	3 676
1999/2000	1 511	-708	803

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

The RBA's earnings available for distribution are paid to the Commonwealth Government, after any transfers to the two reserve funds maintained to deal with contingencies. Reserves have been increased in recent years by the transfer of the proceeds of gold sales. Given the resulting adequate level of reserves, no additions were made to them from 1999/2000 earnings. The full amount available for distribution of $803 million will be paid to the Government in August 2000. The balance of earnings from 1998/99 of $676 million was paid on 6 July 2000.

Following changes introduced in 1998, the RBA's accounting profit is calculated according to general accounting principles, in which all valuation changes resulting from marking the portfolio to market are brought into the profit and loss account. However, both widely accepted central banking practice and the *Reserve Bank Act* require that unrealised profits are not paid to the Government. These are transferred from accounting profit and held in an Unrealised Profits Reserve as a buffer against future unrealised losses, or until they are realised, at which time they become available to the Government. During 1999/2000, unrealised profits were recorded on foreign currency holdings as the fall in the exchange rate over the year made foreign currency holdings worth more in Australian dollar terms. After taking account of net realised foreign exchange losses and losses on securities, gains on investments came to $781 million. These gains combined with underlying earnings of $1 511 million, so that accounting profits reached $2 292 million, compared to $1 326 million in the previous year.

The RBA's 1999/2000 Financial Statements are presented in the following pages.

RBA Payments to Government
($ million)

	Earnings available for distribution	Transfers to reserves	Balance available for Commonwealth	Payment from previous year	Interim payment from current year	Final payment from 1998/99	Total payment
1990/91	1 713	210	1 503	275	400	-	675
1991/92	2 554	200	2 354	1 103	400	-	1 503
1992/93	4 563	750	3 813	1 954	600	-	2 554
1993/94	1 508	-	1 508	3 213	-	-	3 213
1994/95	1 772	-	1 772	1 508	200	-	1 708
1995/96	2 486	150	2 336	1 572	200	-	1 772
1996/97	3 705	2 005	1 700	2 136	-	-	2 136
1997/98	3 274	548	2 726	1 700	-	-	1 700
1998/99	3 676	-	3 676	2 726	-	-	2 726
1999/2000	803	-	803	3 000	-	-	3 000
2000/01	-	-	-	803	-	676	1 479

FINANCIAL STATEMENTS

As at 30 June 2000 : Reserve Bank of Australia

BALANCE SHEET As at 30 June 2000

Reserve Bank of Australia and Controlled Entities

	Note	2000 $M	1999 $M
ASSETS			
Cash and liquid assets	5, 18	821	587
Domestic government securities	1(d), 17	22 935	21 633
Foreign exchange	1(c), 17	30 228	25 370
Gold	1(b), 17	1 233	1 013
Loans, advances and bills discounted		60	76
Other assets	6	125	129
Property, plant and equipment	7	292	265
Total		55 694	49 073
LIABILITIES			
Deposits	8	15 486	10 383
Profit distribution payable to Commonwealth		1 479	3 676
Other liabilities	9	4 329	4 225
Australian notes on issue	1(i)	25 434	23 552
Capital and Reserves			
Reserves:			
Unrealised Profits Reserve	4	1 489	–
Asset revaluation reserves	4	1 285	1 045
Reserve for Contingencies and General Purposes	4	3 323	3 323
Reserve Bank Reserve Fund	4	2 829	2 829
Capital		40	40
Capital and reserves		8 966	7 237
Total		55 694	49 073

PROFIT AND LOSS APPROPRIATION STATEMENT For year ended 30 June 2000

Reserve Bank of Australia and Controlled Entities

	Note	2000 $M	1999 $M
Net Profit	2	2 292	1 326
Net transfers from/(to)			
Unrealised Profits Reserve	4	(1 489)	2 349
Transfer from asset revaluation reserves	4	–	1
Earnings available for distribution		803	3 676
Earnings applied:			
Reserve Bank Reserve Fund	4	–	–
Reserve for Contingencies and General Purposes	4	–	–
Commonwealth of Australia		803	3 676
Total		803	3 676

Note 1 SUMMARY OF ACCOUNTING POLICIES

The financial statements have been prepared in accordance with the *Reserve Bank Act* and the *Commonwealth Authorities and Companies Act*.

The form and content of the financial statements have been amended to incorporate the requirements of Order Number 5 of the Commonwealth Authorities and Companies Orders (Amendment No. 1) 1999. Policy 1.5 of Schedule 2 of this Order provides:-

> "The Reserve Bank of Australia must comply with Australian Accounting Standards (including AAS32, entitled Specific Disclosures by Financial Institutions). In the event of a conflict between the requirements of the standards and this Schedule, the Reserve Bank of Australia must comply with the requirements of the standards."

The Reserve Bank of Australia (RBA) has been granted certain exemptions from the requirements of the Orders as detailed in Note 1 (k). These exemptions relate to matters of disclosure and presentation which are of a minor nature and are adequately dealt with in these financial statements.

The statements are a general purpose financial report prepared in accordance with Australian Accounting Standards. Unless otherwise stated, the accounting policies and practices followed in these statements are consistent with those followed in the previous year.

All amounts are expressed in Australian dollars unless another currency is indicated. Current market values are used for the RBA's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises and shares in international financial institutions. In other cases, an historical cost basis of accounting is used. Revenue and expenses are brought to account on an accrual basis.

(a) Consolidation and associated company The financial statements show information for the economic entity only; this reflects the consolidated results for the parent entity, the Reserve Bank of Australia and its wholly owned subsidiary, Note Printing Australia Limited. The results of the parent entity do not differ materially from the economic entity and have therefore not been separately disclosed other than in Note 14, Related party and other disclosures. Note Printing Australia Limited was incorporated as a wholly owned subsidiary of the RBA on 1 July 1998, with an initial capital of $20 000 000.

The assets, liabilities, profit and loss account of Note Printing Australia Limited have been consolidated with the parent entity accounts in accordance with AAS24 "Consolidated Financial Reports". All internal transactions and balances have been eliminated on consolidation. Note Printing Australia Limited is subject to income tax; its income tax expense is included in Other Expenses in Note 2.

The RBA accounts for Securency Pty Ltd in accordance with AAS14 "Accounting for Investments in Associates". The carrying amount of the RBA's investment in Securency Pty Ltd is reviewed annually to ensure it is not in excess of its recoverable amount. The RBA's investment in Securency Pty Ltd is included in Note 6.

(b) Gold Gold holdings (including gold on loan to other institutions) are valued at the Australian dollar equivalent of the 3pm fix in the London gold market on the last business day of June. The RBA loans gold to financial institutions participating in the gold market. All gold loans are secured to 110% of their market value by Australian dollar denominated collateral security. Loans are usually for periods between 3 and 12 months, with very few extending beyond 12 months. Interest on gold loans is accounted for on a standard accrual basis.

(c) Foreign exchange Foreign exchange holdings are invested mainly in securities (issued by the governments of the United States, Japan and Germany) and bank deposits (with major OECD foreign commercial banks, central banks and international agencies). The RBA engages in interest rate futures and foreign currency swaps and has purchased call options.

Assets and liabilities denominated in foreign currency are converted to Australian dollar equivalents at exchange rates ruling on the last business day of June. Realised and unrealised gains or losses on foreign currency are immediately taken to profit and loss.

Foreign government securities

Foreign government securities comprise coupon and discount securities and repurchase agreements. Coupon securities have bi-annual or annual interest payments depending on the currency and type of security. Interest earned on discount securities is the difference between the actual purchase cost and the face value of the security. The face value is received at maturity. Interest earned on securities is accrued over the term of the security.

Marketable securities, other than those contracted for sale under repurchase agreements, are reported at market values on the last business day of June; realised and unrealised gains and losses arising from changes in market valuations during the year are taken to the profit and loss account. Earnings on foreign currency investments are converted to Australian dollars using the exchange rate of the date they are received.

Foreign currency swaps

The RBA uses foreign currency swaps to assist daily domestic liquidity management or to smooth the impact of other foreign currency transactions on Official Reserve Assets. A currency swap is the simultaneous purchase and sale of one currency against another currency for specified maturities. The cash flows are the same as borrowing one currency for a set period, and lending another currency for the same period. The pricing of the swap must therefore reflect the interest rates applicable to these money market transactions. Interest rates are implicit in the swap contract but interest itself is not paid or received.

Foreign exchange holdings contracted for sale beyond 30 June 2000 (including those under swap contracts) have been valued at market exchange rates (refer Note 17).

Interest rate futures

The RBA uses interest rate futures contracts on overseas exchanges to hedge 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, foreign currency swaps and call options are off-balance sheet items. The RBA did not trade in any other derivative instruments during 1999/2000.

(d) Domestic government securities The RBA holds Commonwealth Treasury Fixed Coupon Bonds, Treasury Notes, Treasury Capital Indexed Bonds, and Treasury Adjustable Rate Bonds. It also holds Australian dollar-denominated securities issued in Australia by the central borrowing authorities of State and Territory Governments where these are acquired under repurchase agreements. Realised and unrealised gains or losses on domestic government securities are immediately taken to profit and loss.

Commonwealth Treasury Fixed Coupon Bonds are coupon securities; the interest is payable bi-annually at the coupon rate. Commonwealth Treasury Notes are discount securities; the interest earned is the difference between the purchase price and the face value on redemption. Treasury Capital Indexed Bonds are coupon securities with the nominal value of the security indexed in line with movements in the consumer price index each quarter until maturity; interest is paid quarterly. Treasury Adjustable Rate Bonds are securities whose coupon rate is periodically reset by reference to movements in the Australian Bank Bill Swap Reference Rate; interest is payable each quarter.

Securities are valued at market prices on the last business day of June except when contracted for sale under repurchase agreements.

(e) Repurchase agreements In the course of its financial market operations, the RBA engages in repurchase agreements involving foreign and domestic marketable securities.

Securities sold but contracted for purchase under repurchase agreements are reported on the balance sheet within the relevant investment portfolio and are valued at market prices; the counterpart obligation to repurchase is included in "Other liabilities". The difference between the sale and purchase price is recognised as interest expense in the profit and loss account.

Securities held but contracted for sale under repurchase agreements are reported within the relevant investment portfolio at contract amount. The difference between the purchase and sale price is recognised as interest income over the term of the agreement.

(f) Property, plant and equipment A formal valuation of all RBA properties is conducted on a triennial basis. The most recent valuation was at 30 June 1998, when Australian properties were valued by officers of the Australian Valuation Office and overseas properties were valued by local independent valuers. The valuations have been incorporated in the accounts.

Valuations on Australian properties are updated annually for developments in the property markets where the RBA's assets are held. Annual depreciation is based on market values and assessments of useful remaining life.

Plant and equipment are recorded at cost less depreciation, which is calculated at rates appropriate to the estimated useful life of the relevant assets. Depreciation rates are reviewed annually, and adjusted where necessary to reflect the most recent assessments of the useful life of assets.

In the opinion of the Board, values of plant and equipment in the financial statements do not exceed recoverable values.

Details of annual net expenditure, revaluation adjustments and depreciation of these assets are included in Note 7.

(g) Reserves Reserves are maintained to cover the broad range of risks to which the RBA is exposed. The Reserve Bank Reserve Fund is a general reserve which provides for potential losses arising from fraud and other non-insured losses. The Treasurer determines each year, after consultation with the Board, the amount to be credited to the Reserve Fund.

The Reserve for Contingencies and General Purposes provides cover against risks relating to events which are contingent and non-foreseeable. The major risks in the category arise from movements in market values of the RBA's holding of domestic and foreign securities. Amounts set aside for this Reserve are determined by the Treasurer after consultation with the Board.

Asset revaluation reserves reflect the impact of changes in the market values of a number of the RBA's assets (gold, premises, and shares in international financial institutions).

Unrealised gains on foreign exchange and domestic government securities are recognised in the profit and loss account. Until such gains are realised, they are not available for distribution to the Commonwealth of Australia; in the interim the amounts are retained in the Unrealised Profits Reserve.

(h) Provisions The RBA maintains provisions for accrued annual leave, calculated on salaries prevailing at balance date and including associated payroll tax. The RBA also maintains provisions for long service leave and post-employment benefits, in the form of health insurance and housing assistance, and associated fringe benefits tax; these provisions are made on a present value basis in accordance with AAS 30. In addition, the RBA makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(i) Australian notes on issue The RBA assesses regularly the value of notes still outstanding at least five years after the note issue ceased which are judged to have been destroyed and therefore unavailable for presentation. No amount was written off Australian notes on issue in 1999/2000; $19 million was written off in 1998/99.

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

(k) Exemptions The RBA has been granted exemptions from the following requirements of Order Number 5 of the Commonwealth Authorities and Companies Orders:-

Requirement	Description	Detail of exemption
Policy 15	Analysis of property, plant and equipment	Information is included in Note 7 of these financial statements. These disclosures are more relevant than the dissections required by Policy 15 of the Orders.
Appendix A	Forms of Financial Statements	Details of revenues and expenses are disclosed in Note 2. The cash flow statement is provided in Note 18.

	Note	2000 $M	1999 $M

Note 2 NET PROFITS

	Note	2000 $M	1999 $M
Interest revenue			
Overseas investments	1 (c)	1 133	963
Domestic government securities	1 (d)	1 107	1 199
Loans and advances		8	5
Overnight settlement systems		27	19
Gold loans		21	18
		2 296	2 204
Net gains/(losses) on securities			
Overseas investments		(232)	(106)
Domestic government securities		(128)	(276)
Foreign currency	1 (c)	1 141	(108)
		781	(490)
Dividend revenue			
Earnings on shares in Bank for International Settlements	6	3	3
Fees and commissions			
Banking services fees received		17	21
Other revenue			
Reimbursement by Commonwealth for loan management and registry expenses		2	2
Rental of Bank premises		7	7
Sales of note products		55	14
Gain on sale of plant and equipment		–	1
Australian notes on issue write-off	1 (i)	–	19
Other		15	13
		79	56
Total		3 176	1 794
Less:			
Interest expense			
Deposit liabilities		459	181
Repurchase agreements	1 (e)	211	116
		670	297
General administrative expenses			
Staff costs		89	87
Special redundancy/retirement payments	11	10	18
Depreciation of property	7	7	7
Depreciation of plant and equipment	7	8	7
Premises and equipment		26	24
Materials used in note production		25	10
Travel		3	2
Consultants' fees	13	2	1
Other		14	5
		184	161

	Note	2000 $M	1999 $M
Note 2 (CONTINUED)			
Other expenses			
Agency business reimbursement		1	1
Subsidiary income tax		5	(2)
Cash distribution expenses		8	1
Other		16	10
		30	10
Total		884	468
Net Profit		2 292	1 326

Note 3 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2000

	Average Balance $M	Interest $M	Average Interest Rate %
Interest revenue			
Overseas investments	28 500	1 133	4.0
Domestic government securities	17 738	1 107	6.2
Loans and advances	201	8	3.8
Overnight settlements	523	27	5.1
Gold loans	1 155	21	1.8
	48 117	2 296	4.8
Interest expense			
Exchange settlement accounts	1 121	55	4.9
Deposits from governments	7 353	394	5.4
Deposits from overseas institutions	236	5	2.0
Overseas repurchase agreements	3 451	158	4.6
Domestic repurchase agreements	1 107	53	4.8
Other deposits	146	5	3.6
	13 414	670	5.0
Analysis for the year ended 30 June 1999			
Interest revenue total	45 975	2 204	4.8
Interest expense total	11 617	297	2.6

	2000 $M	1999 $M

Note 4 RESERVES

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

	2000 $M	1999 $M
Unrealised Profits Reserve (Note 1(g))		
Opening balance	–	2 349
Net transfers from (to) Profit and Loss Appropriation	1 489	(2 349)
As at 30 June	1 489	–
Asset revaluation reserves (Note 1(g))		
Gold		
Opening balance	903	1 130
Net revaluation adjustments	222	(227)
As at 30 June	1 125	903
Shares in international financial institutions (Note 6)		
Opening balance	63	77
Net revaluation adjustments	1	(14)
As at 30 June	64	63
Bank properties (Notes 1(f), 7)		
Opening balance	79	80
Net revaluation adjustments	17	–
Transfers to Profit and Loss Appropriation – realised (gains)/losses	–	(1)
As at 30 June	96	79
Total asset revaluation reserves		
Opening balance	1 045	1 287
Net revaluation adjustments	240	(241)
Transfers to Profit and Loss Appropriation – realised (gains)/losses	–	(1)
As at 30 June	1 285	1 045
Reserve for Contingencies and General Purposes (Note 1(g))		
Opening and closing balance	3 323	3 323
Reserve Bank Reserve Fund (Note 1(g))		
Opening and closing balance	2 829	2 829

Note 5 CASH AND LIQUID ASSETS

This includes net amounts of $690 million owed to the RBA for overnight clearances of financial transactions through the clearing houses, Austraclear and Reserve Bank Information and Transfer System (RITS); an amount of $478 million was owed to the RBA at 30 June 1999.

	2000 $M	1999 $M
Note 6 OTHER ASSETS		
Shareholding in Bank for International Settlements	66	65
Gold coin	16	13
Investment in Securency	11	11
Other	32	40
As at 30 June	125	129

The Reserve Bank of Australia has a 50 per cent share in Securency Pty Ltd, which is incorporated in Victoria Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securency in 1999/2000 was $21 530 001; the RBA's investment in Securency was $11 183 000 (1999 - $10 765 000). Securency Pty Ltd has a 31 December balance date.

	2000 $M	1999 $M
Note 7 PROPERTY, PLANT AND EQUIPMENT (Note 1(f))		
Properties		
Opening balance	235	244
Additions less disposals	1	(2)
	236	242
Depreciation prior to revaluation	(7)	(7)
Book valuation prior to revaluation	229	235
Net revaluation adjustments (Note 4)	17	–
As at 30 June	246	235
The triennial revaluation of all Bank properties occurred at 30 June 1998.		
Plant and equipment		
Opening balance	93	103
Additions less disposals	21	(10)
	114	93
Accumulated depreciation	(68)	(63)
As at 30 June	46	30
Total property, plant and equipment	292	265

	2000 $M	1999 $M

Note 8 DEPOSITS

	2000 $M	1999 $M
Banks		
Exchange Settlement accounts	1 164	1 909
Non callable deposits	–	5 255
Government & government instrumentalities		
Commonwealth	13 437	2 511
State	343	388
Foreign governments, foreign institutions and international organisations	418	61
Other depositors	124	259
As at 30 June	15 486	10 383

Note 9 OTHER LIABILITIES

	2000 $M	1999 $M
Provisions (Note 1(h))		
Salaries and wages accrued	–	2
Provision for accrued annual leave	7	7
Provision for long service leave	19	18
Provision for post-employment benefits	51	50
Provision for workers' compensation	1	1
As at 30 June	78	78
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(e))	4 137	4 104
Interest accrued on deposits	90	18
Other	24	25
As at 30 June	4 251	4 147
Total other liabilities	4 329	4 225

Note 10 CONTINGENT LIABILITIES AND OTHER ITEMS NOT INCLUDED IN THE BALANCE SHEET

Contingencies

The RBA has a contingent liability, amounting to $67.4 million at 30 June 2000 ($55.4 million at 30 June 1999), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

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

Other items

The RBA has commitments of $1.2 million at 30 June 2000 ($2.9 million at 30 June 1999) payable within one year; and commitments of $0.6 million payable beyond one year ($1.7 million at 30 June 1999).

The RBA carries its own insurance risks except where administrative costs are estimated to be excessive.

Note 11 SPECIAL REDUNDANCY/RETIREMENT PAYMENTS

The RBA's expenses in 1999/2000 include $10 million paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 1998/99 totalled $18.4 million. Staff leaving the RBA in 1999/2000 under these arrangements numbered 99 (155 in 1998/99).

Note 12 REMUNERATION OF EXECUTIVES

The number of executives whose remuneration packages, measured in terms of costs to the RBA, fell within the following bands was:

Remuneration band	Number 2000	Number 1999
$110 000 – $119 999	1	2
$120 000 – $129 999		2
$130 000 – $139 999	1	6
$140 000 – $149 999	1	4
$150 000 – $159 999	8	5
$160 000 – $169 999	4	
$170 000 – $179 999	4	
$180 000 – $189 999		1
$190 000 – $199 999		2
$200 000 – $209 999		5
$210 000 – $219 999	8	
$230 000 – $239 999	1	1
$240 000 – $249 999		3
$250 000 – $259 999		1
$260 000 – $269 999	5	
$300 000 – $309 999		1
$310 000 – $319 999	1	
$450 000 – $459 999		1
$470 000 – $479 999	1	

Total remuneration received or due and receivable by these 35 executives amounted to $7.073 million (34 executives totalling $6.316 million in 1998/99). Remuneration includes cash salary, the RBA's contribution to superannuation, housing assistance, motor vehicles, car parking and health insurance and the fringe benefits tax paid or payable on these benefits. Remuneration excludes amounts paid to executives posted outside Australia for the whole or part of the financial year. Remuneration includes amounts paid to executives who are also members of the Bank Board (refer Note 14).

Termination payments of $0.048 million were made to executives who resigned or retired during 1999/2000 ($0.941 million in 1998/99); these payments are not reflected in the above table.

Note 13 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services totalled $165 000 in 1999/2000 ($160 000 in 1998/99). They are included in "Consultants' fees" in Note 2, which also covers legal fees and payments made to specialists for "review and advice" services.

Note 14 RELATED PARTY AND OTHER DISCLOSURES

The Remuneration Tribunal determines the remuneration appropriate to the RBA's non-executive Board members. In 1999/2000, payments to executive and non-executive board members totalled $1 016 312 ($979 786 in 1998/99). Remuneration includes amounts paid to members of the Bank Board who are also executives (refer Note 12).

The number of directors whose remuneration packages, measured in terms of costs to the RBA, fell within the following bands was:

Remuneration band	Number 2000	Number 1999
$30 000 – $39 999	5	5
$50 000 – $59 999	1	1
$300 000 – $309 999		1
$310 000 – $319 999	1	
$450 000 – $459 999		1
$470 000 – $479 999	1	

The RBA is not empowered to lend to non-executive members of the Board. Loans to the Governor and Deputy Governor are permitted only in terms of section 71 of the *Reserve Bank Act*; at 30 June 2000, there were no such loans ($77 007 at 30 June 1999).

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, $68 454 was paid for the services of non-executive members of the Board of Note Printing Australia Limited who are not employees of the RBA or members of the Bank Board ($41 408 in 1999). The RBA also paid $101 534 for the services of members of the Payments System Board who are not employees of the RBA ($94 504 in 1999).

Note 15 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act:* the Reserve Bank of Australia Officers' Superannuation Fund (OSF) and the Reserve Bank of Australia UK Pension Scheme. A small part of the assets of the OSF are held by the RBA as nominee for the trustees of the OSF; such assets are not included in these statements. Payment of the funds' current and future benefits is funded by member and Bank contributions and the funds' existing asset bases. The RBA's contributions to the OSF in accordance with the Reserve Bank (Officers' Superannuation) Rules, and to the UK Pension Scheme in accordance with the UK Trust Deed, are included in staff costs in Note 2. Administration and other operational costs (eg salaries, overheads, legal costs and valuation fees) incurred by the RBA for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the RBA and the funds during 1999/2000.

At 30 June 2000, the OSF had a surplus of assets over accrued benefits of $224 million ($185 million at 30 June 1999). The UK Pension Scheme had a surplus equivalent to $5 million ($5 million at 30 June 1999). During 1999/2000, the RBA made superannuation contributions of $3.1 million ($3.0 million in 1998/99).

Details of the Funds as at 30 June 2000 are as follows:

	2000 $M	1999 $M
Reserve Bank Officers' Superannuation Fund		
Accrued benefits	385	398
Net market value of assets	609	583
Surplus	224	185
Vested benefits	398	396
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	20	19
Net market value of assets	25	24
Surplus	5	5
Vested benefits	20	19
Total Superannuation Funds		
Accrued benefits	405	417
Net market value of assets	634	607
Surplus	229	190
Vested benefits	418	415

Accrued benefits refer to the present value of future benefits payable to current fund members, taking into account assumed future salary increases. Vested benefits are the benefits payable if all current members were to terminate their fund membership at balance date.

Note 16 **SEGMENT REPORTING**

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

Note 17 **FINANCIAL INSTRUMENTS**

Australian Accounting Standard AAS33 – Presentation & Disclosure of Financial Instruments – requires disclosure of information relating to: both recognised and unrecognised financial instruments; their significance and performance; accounting policy terms & conditions; net fair values; and risk information.

A ***financial instrument*** is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. The identifiable financial instruments for the RBA are its domestic government securities, its foreign government securities, bank deposits, interest rate futures, foreign currency swap contracts, gold loans, notes on issue and deposit liabilities.

Net fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction, and is usually determined by the quoted market price net of transaction costs. All of the RBA's recognised financial instruments are carried at current market value which approximates net fair value.

Financial risk of financial instruments embodies price risk (currency risk and interest rate risk); credit risk; liquidity risk; and cash flow risk. AAS33 requires disclosure on interest rate risk and credit risk.

The interest rate risk and credit risk tables are based on the RBA's settled portfolio as reported in the RBA's balance sheet.

Interest rate risk

Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates. The following table shows the RBA's balance sheet restated in compliance with AAS33.

Interest rate risk
As at 30 June 2000

	Balance sheet total $M	Floating interest rate $M	Repricing period $M 0 to 3 months	3 to 12 months	1 to 5 years	over 5 years	Not bearing interest $M	Weighted average rate %
Assets								
Gold								
Gold loans	1 227	–	425	756	46	–	–	1.5
Gold holdings	6	–	–	–	–	–	6	n/a
Sub-total	**1 233**							
Foreign exchange								
Securities sold under repurchase agreements	4 066	–	83	64	2 279	1 640	–	5.6
Securities purchased under repurchase agreements	5 964	–	5 964	–	–	–	–	6.5
Deposits and other securities	20 020	149	13 473	1 247	2 506	2 275	370	4.1
Accrued interest foreign exchange	178	–	–	–	–	–	178	n/a
Sub-total	**30 228**							
Domestic government securities								
Securities sold under repurchase agreements	21	–	21	–	–	–	–	4.5
Securities purchased under repurchase agreements	15 997	–	15 997	–	–	–	–	5.9
Other securities	6 768	–	1 102	1 874	1 419	2 373	–	6.0
Accrued interest domestic government securities	149	–	–	–	–	–	149	n/a
Sub-total	**22 935**							
Loans, advances and bills discounted	60	42	–	–	–	–	18	3.7
Property, plant & equipment	292	–	–	–	–	–	292	n/a
Cash and liquid assets	821	701	–	–	–	–	120	5.7
Other assets	125	–	–	–	–	–	125	n/a
Total assets	**55 694**	892	37 065	3 941	6 250	6 288	1 258	5.1
Liabilities								
Australian notes on issue	25 434	–	–	–	–	–	25 434	n/a
Deposits	15 486	15 486	–	–	–	–	–	5.9
Profit distribution	1 479	–	–	–	–	–	1 479	n/a
Other	4 329	–	4 307	–	–	–	22	5.3
Total liabilities	**46 728**	15 486	4 307	–	–	–	26 935	2.4
Capital and reserves	8 966							
Total balance sheet	**55 694**							
Off balance sheet items								
Interest rate futures	(149)	–	(379)	–	147	83	–	n/a

Interest rate risk
As at 30 June 1999

	Balance sheet total $M	Floating interest rate $M	Repricing period $M 0 to 3 months	3 to 12 months	1 to 5 years	over 5 years	Not bearing interest $M	Weighted average rate %
Total assets	49 073	194	29 159	5 910	6 631	5 276	1 903	3.8
Total liabilities	41 836	10 193	4 104	–	–	–	27 539	0.9
Capital and reserves	7 237	–	–	–	–	–	–	n/a
Total balance sheet	49 073							
Off balance sheet items	(26)	–	(7)	–	(1)	(18)	–	n/a

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

All Financial Instruments are shown at their repricing period which is equivalent to the remaining term to maturity. (In 1999 approximately $1.8 billion holdings of domestic government securities which appear in the 0 to 3 months category, had a maturity period of 1-5 years.)
Interest rate futures reflect the positions in interest rate contracts traded in foreign futures exchanges to manage interest rate risk on Official Reserve Assets.

Credit risk

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

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

As part of an IMF support package during 1997/98, 1998/99 and 1999/2000 the RBA undertook a series of foreign currency swaps with the Bank of Thailand. The RBA provided United States dollars, receiving Thai baht in exchange. The amount outstanding on the swaps at 30 June 2000 was the equivalent of $1.4 billion Australian dollars ($1.3 billion at 30 June 1999), on which the RBA is earning a yield of 6.15% (4.82% in 1999). The swaps represent 2.6% of the RBA's total assets as at 30 June 2000 (2.6% at 30 June 1999).

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

1. ***Foreign exchange swaps*** – As at 30 June 2000 the RBA was under contract to purchase $10.1 billion of foreign currency and sell $27.5 billion of foreign currency. As of that date there was an unrealised net gain of $279.0 million on these swap positions. The credit risk exposure of these contracts is the cost of re-establishing the contract in the market in the event of the failure of the counterparty to fulfil their obligations.

2. ***Interest rate futures*** – As at 30 June 2000 about 0.49% of the RBA's foreign currency reserves (excluding gold) were hedged through interest rate futures contracts. The amount of credit risk on these contracts is approximately $2.5 million ($0.1 million at 30 June 1999). As at 30 June 2000 there was an unrealised loss on those contracts of $0.2 million ($0.2 million at 30 June 1999).

Concentration of credit risk

The RBA operates to minimise its credit risk exposure through comprehensive risk management policy guidelines. The following table indicates the concentration of credit risk in the RBA's investment portfolio. See Note 1(c) Foreign exchange.

Credit risk table

Security type	Risk rating of security issuer*	Risk rating of counterparties*	% of total asset portfolio as at 30/6/00	% of total asset portfolio as at 30/6/99
Domestic government securities				
Holdings of Commonwealth Government securities	AAA	n/a	12.4	18.9
Securities sold under repurchase agreements	AAA	AA	0.0	1.4
Securities held under repurchase agreements	AAA	AA	24.4	19.0
	AAA	other	1.5	1.5
	AA	AA	2.7	3.3
	AA	other	0.2	0.1
Foreign investments				
Holdings of securities	AAA	n/a	11.3	21.4
	AA	n/a	11.9	0.0
Securities sold under repurchase agreements	AAA	AA	5.4	4.6
	AAA	other	1.9	2.3
Securities held under repurchase agreements	AAA	AA	6.8	11.2
	AAA	other	3.9	3.8
Deposits	n/a	AAA	7.3	1.4
	n/a	AA	3.1	4.0
	n/a	other	2.7	2.9
Gold loans	n/a	AAA	0.3	0.2
	n/a	AA	1.4	1.3
	n/a	other	0.5	0.6
Other			2.3	2.1
			100%	100%

*Standard & Poor's equivalent ratings

Note 18 CASH FLOW STATEMENT

The following cash flow statement appears as a matter of record to meet the requirements of AAS 28; in the RBA's view, it does not shed any additional light on the RBA's financial results. For the purpose of this statement, cash includes the notes and coin held at the Reserve Bank and overnight settlements system account balances with other banks.

Statement of Cash Flows for the financial year ended 30 June 2000

	2000 Inflow/(outflow) $M	1999 Inflow/(outflow) $M
Cash flow from operating activities		
Interest received on investments	2 022	2 040
Interest received on loans, advances, and on net overnight settlements systems	36	24
Loan management reimbursement	2	2
Banking service fees received	17	28
Rents received	7	7
Net payments for and proceeds from sale of investments	(5 344)	(91)
Interest paid on deposit liabilities	(388)	(190)
Staff costs (including redundancy)	(99)	(106)
IMF Maintenance of Value adjustment	–	(15)
Premises, equipment and stores	(26)	(24)
Other	21	20
Net cash provided by operating activities	(3 752)	1 695
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(22)	11
Net cash used in investing activities	(22)	11
Cash flows from financing activities		
Profit payment to Commonwealth	(3 000)	(2 726)
Net movement in deposit liabilities	5 103	(689)
Net movement in loans and advances	16	38
Net movement in notes on issue	1 882	1 920
Other	7	(31)
Net cash provided by financing activities	4 008	(1 488)
Net increase/(decrease) in cash	234	218
Cash at beginning of financial year	587	369
Cash at end of financial year	821	587

Note 18 (CONTINUED)

Reconciliation of cash	30 June 2000 $M	30 June 1999 $M
Cash	131	109
Overnight settlements system	690	478
	821	587

Reconciliation of net cash provided by operating activities to Net Profits in terms of the Reserve Bank Act	2000 $M	1999 $M
Net profit	2 292	1 326
Increase in interest payable	72	(10)
Increase in interest receivable	2	–
Net loss/(gain) on overseas investments	232	106
Net loss/(gain) on domestic government securities	128	276
Net loss/(gain) on foreign currency	(1 141)	108
Increase in income accrued on investments	(8)	(6)
Depreciation of property	7	7
Depreciation of plant and equipment	8	7
IMF Maintenance of Value adjustment (including accrual to end June)	–	(15)
Net payments for and proceeds from sale of domestic and foreign investments	(5 344)	(91)
Write-off of Australian notes	–	(19)
Other	–	6
Net cash provided by operating activities	(3 752)	1 695

DIRECTORS' STATEMENT

In the opinion of the directors, the financial statements for the year ended 30 June 2000 give a true and fair view of the matters required by Schedule 2 to the Finance Minister's Orders made under the Commonwealth Authorities and Companies Act 1997.

I J Macfarlane
Chairman, Reserve Bank Board

3 August 2000

Auditor-General for Australia

Australian National
Audit Office

INDEPENDENT AUDIT REPORT

To the Treasurer

Scope

I have audited the financial statements of the Reserve Bank of Australia (the Bank) for the year ended 30 June 2000. The financial statements include the consolidated financial statements of the economic entity comprising the Reserve Bank of Australia and the entities it controlled at the year's end or from time to time during the year.

The statements comprise:

- Balance Sheet
- Profit and Loss Appropriation Statement
- Notes to and forming part of the financial statements, and
- Directors Statement.

The members of the Bank's Board are responsible for the preparation and presentation of the financial statements and the information they contain. I have conducted an independent audit of the financial statements in order to express an opinion on them to you.

The audit has been conducted in accordance with Australian National Audit Office Auditing Standards, which incorporate the Australian Auditing Standards, to provide reasonable assurance as to whether the financial statements are free of material misstatement. Audit procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion whether, in all material respects, the financial statements are presented fairly in accordance with Australian Accounting Standards, other mandatory professional reporting requirements and statutory requirements in Australia so as to present a view which is consistent with my understanding of the Bank's and the economic entity's financial position, the results of their operations and their cash flows.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In my opinion,

(i) the financial statements have been prepared in accordance with Schedule 2 of the Finance Minister's Orders;

(ii) the financial statements give a true and fair view, in accordance with applicable Accounting Standards, other mandatory professional reporting requirements and Schedule 2 of the Finance Minister's Orders, of the financial position of the Bank and the economic entity as at 30 June 2000 and the results of their operations and their cash flows for the year then ended.

P J Barrett

P. J. Barrett
Auditor-General

Sydney
3 August 2000

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Centenary House 19 National Circuit
BARTON ACT
Phone (02) 6203 7500 Fax (02) 6273 5355
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PRO FORMA BUSINESS ACCOUNTS

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

	TRANSACTIONAL BANKING BUSINESS		RITS		REGISTRY	
	1998/1999 $MILLION	1999/2000 $MILLION	1998/1999 $MILLION	1999/2000 $MILLION	1998/1999 $MILLION	1999/2000 $MILLION
Revenue						
- Service fees	20.4	14.9	3.8	3.1	2.6	1.9
- Other revenue	3.0	4.6	0.2	0.2	0.1	0.1
Total	23.5	19.5	4.0	3.3	2.7	2.0
Expenditure						
- Direct costs	12.7	11.4	2.4	2.4	1.4	1.0
- Indirect costs	6.2	4.9	0.4	0.5	0.5	0.6
Total	18.9	16.3	2.8	2.9	1.9	1.6
Net profit/(loss)	4.6	3.3	1.2	0.4	0.8	0.4
Net profit/(loss) after taxes (a)	2.8	2.1	0.7	0.2	0.5	0.2
Assets (b)						
- Domestic market investments	587.9	681.8	4.1	3.4	2.6	2.4
- Other assets	23.0	13.8	0.8	1.6	0.3	0.2
Total	610.9	695.6	4.9	5.0	2.9	2.6
Liabilities (b)						
- Capital & reserves	25.0	25.0	4.0	4.0	2.0	2.0
- Deposits	576.2	663.3				
- Other liabilities	9.7	7.3	0.9	1.0	0.9	0.6
Total	610.9	695.6	4.9	5.0	2..9	2.6

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

(b) As at 30 June

THE RESERVE BANK BOARD AND GOVERNANCE

The Role of the Reserve Bank Board

The *Reserve Bank Act* provides the core source of the RBA's governance mandate with Sections 8A and 10 giving the Reserve Bank Board clear responsibility for the Bank's "monetary and banking policy". The relationship of the Board with the government-of-the-day is set out in Section 11. Routinely, the "Government is to be informed, from time to time, of the Bank's monetary and banking policy". In practice this is done in the regular monthly meetings which the Governor and Deputy Governor have with the Treasurer shortly after each Board meeting.

While the Act itself has not been changed with respect to the mandate for monetary policy, procedures and practices have augmented this over time, in order to keep the RBA's policy-making process relevant to the evolving environment, and in parallel with developments overseas. When the current Government came to power in 1996, the responsible Minister, the Treasurer, and the Governor jointly signed the "Statement on the Conduct of Monetary Policy", which confirmed the RBA's independence in making monetary policy, and endorsed the Bank's inflation target. The higher profile of the RBA's regular appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration, and the *Semi-Annual Statements on Monetary Policy*, have reinforced this process.

When the Australian Prudential Regulation Authority was established, the RBA's role as prudential supervisor passed to it. The RBA retained responsibility for overall financial system stability - the Treasurer's statement in Parliament of 2 September 1997 confirmed that the RBA, in addition to monetary policy, was responsible for overall financial system stability and regulation of the payments system.

The main focus of discussions at the Board's meetings each month is on monetary policy. This discussion occurs against the background of papers prepared by RBA staff about developments in the domestic and foreign economies, and in financial markets. These papers are supplemented by staff presentations at each Board meeting. During the past year the Board did not have a need to consider major policy issues relating to overall financial system stability, though it was briefed on the RBA's planning for Y2K; see reference in "Governor's Foreword".

The *Reserve Bank Act* was amended in 1998 to establish the Payments System Board which is responsible for the RBA's payments system policy and reports separately in its own Annual Report.

Composition of the Reserve Bank Board

The Board comprises the Governor, who is Chairman, the Deputy Governor, the Secretary to the Treasury and six external members, appointed by the Governor-General - a total of nine. Five members form a quorum for a meeting of the Board.

In terms of section 17(1) of the *Reserve Bank Act*, members of the Board may not be a director, officer or employee of an authorised deposit-taking institution for the purposes of the *Banking Act 1959*.

Meetings of the Reserve Bank Board

The Board meets eleven times each year, on the first Tuesday of each month, except January. The number of meetings attended by each member in 1999/2000 was:

IJ Macfarlane	11
SA Grenville	10
EA Evans	11
JR Broadbent	10
AR Jackson	11
FP Lowy	9
HM Morgan	9
AR Pagan	11
RFE Warburton	10

Audit Committee

The primary objectives of the Audit Committee are to:

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

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

The Audit Committee is made up of Stephen Grenville, Deputy Governor (Chairman), a non-executive member of the Board, Jillian Broadbent, and an external appointed member, George Bennett, company director and former National Executive Chairman, KPMG Peat Marwick. During 1999/2000, the Committee met on four occasions; all members attended each of these meetings. In addition, the Committee visited NPA where it was briefed on NPA's Risk Management Plan.

Minutes of Audit Committee meetings are circulated to the Board for information, and discussion as appropriate, and a report on the Committee's activities for the year is prepared at the time of the presentation of the annual accounts.

Obligations under the Commonwealth Authorities and Companies (CAC) Act 1997

The *CAC Act* is one of three Acts which deal with the financial management, accountability and audit of Commonwealth agencies, authorities and companies. The *CAC Act* sets standards of conduct for directors and other officers of Commonwealth authorities with many of these requirements being modelled on comparable areas of the Corporations Law. The *CAC Act* was amended in 1999 to incorporate reforms in the *Corporate Law Economic Reform Program (CLERP) Act 1999* rewriting the conduct provisions in the Corporations Law relating to the duties of directors and other officers.

The RBA is a Commonwealth authority for the purposes of the *CAC Act* and, for these purposes, the members of the Reserve Bank Board are the directors of the RBA. As such, they are responsible for the preparation of the RBA's Annual Report and, at the meeting of the Board on 1 August 2000, they resolved that the Chairman sign the Report, and the Financial Statements as at 30 June 2000, transmit them in accordance with the requirements of the *CAC Act* and arrange publication.

The House of Representatives Standing Committee on Economics, Finance and Public Administration has, in its Standing Orders, an obligation to review the Annual Report of the RBA. On 13 March 2000, the Committee tabled in the Parliament its interim report on the Annual Report for 1998/99, and on the 29 November 1999 public hearing with the RBA and the associated November 1999 *Semi-Annual Statement on Monetary Policy*. On 26 June 2000, the Committee tabled its final report on the RBA's Annual Report for 1998/99, the first Annual Report of the Payments System Board, the May 2000 *Semi-Annual Statement on Monetary Policy*, and on the Committee's discussion of these reports at the public hearing with the RBA on 22 May 2000.

Indemnities

Under the provisions of section 27 of the *CAC Act*, and pursuant to a Board resolution on 3 November 1998, members of the Reserve Bank Board have been indemnified against liabilities incurred arising out of the proper discharge of their responsibilities, provided that any such liability does not arise from conduct involving a lack of good faith. This indemnity does not extend to claims by the RBA itself or any subsidiary of the RBA. A similar indemnity was extended to the members of the Payments System Board, pursuant to a resolution by the Reserve Bank Board on 3 November 1998.

RESERVE BANK BOARD

CHAIRMAN : I J MACFARLANE

Governor since 18 September 1996
PRESENT TERM EXPIRES 17 SEPTEMBER 2003

Chairman – Payments System Board
Board member – Australian Prudential Regulation Authority

S A GRENVILLE

Deputy Governor since 1 December 1996
PRESENT TERM EXPIRES 30 NOVEMBER 2001

E A EVANS, AC

Secretary to the Treasury
Member since 10 May 1993

J R BROADBENT

Member since 7 May 1998
PRESENT TERM EXPIRES 6 MAY 2003

Director – Coca Cola Amatil Limited
Director – Woodside Petroleum Limited

H M MORGAN, AO

Member since 14 August 1996
PRESENT TERM EXPIRES 28 JULY 2002

Managing Director and Chief Executive – WMC Limited
Director – Alcoa Inc

A R JACKSON, AO

Member since 29 January 1991
PRESENT TERM EXPIRES 28 JANUARY 2001

Chairman and Chief Executive – Austrim Nylex Limited
Chairman – Australian Trade Commission (Austrade)
Director – St Frances Xavier Cabrini Hospital
Director – Seven Network Limited
Director – Titan Petrochemicals and Polymers Berhad - Malaysia

A R PAGAN

Member since 29 November 1995
PRESENT TERM EXPIRES 28 NOVEMBER 2000

Professor of Economics – Research School of Social Sciences, Australian National University

F P LOWY, AC

Member since 27 June 1995
PRESENT TERM EXPIRES 26 JUNE 2003

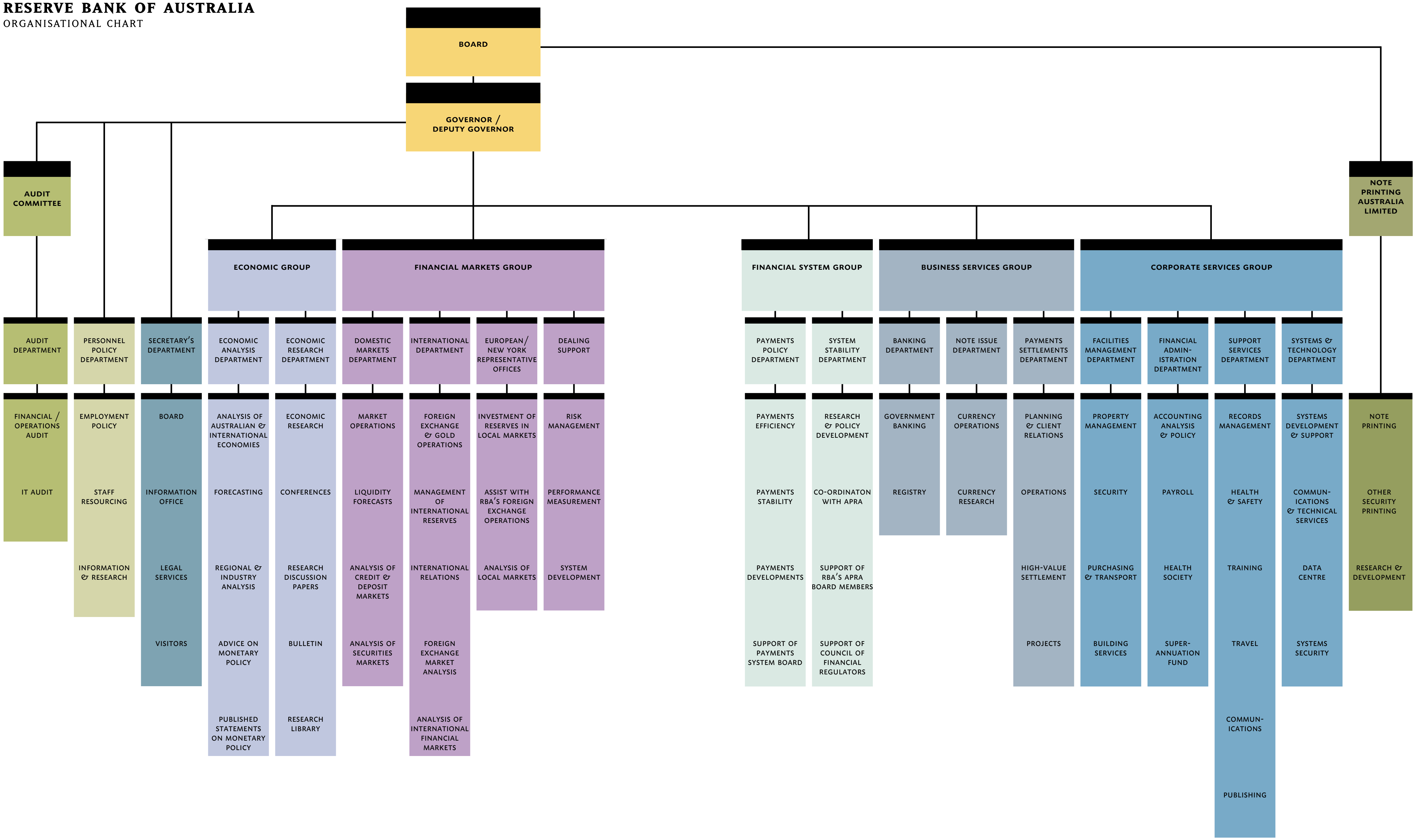
Chairman – Westfield Holdings Limited
Director – Daily Mail and General Trust PLC (UK)

R F E WARBURTON

Member since 22 December 1992
PRESENT TERM EXPIRES 21 DECEMBER 2002

Chairman – David Jones Limited
Chairman – Goldfields Limited
Director – Caltex Australia Limited
Director – IAMA Limited
Director – Note Printing Australia Limited
Director – Nufarm Limited
Director – Southcorp Limited
Director – Tabcorp Holdings Limited

RESERVE BANK OF AUSTRALIA
ORGANISATIONAL CHART



GLOSSARY

ADI	AUTHORISED DEPOSIT-TAKING INSTITUTION
AOFM	AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT
APEC	ASIA-PACIFIC ECONOMIC COOPERATION
APRA	AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
ASB	AUSTRALIAN SAVINGS BOND
ASIC	AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION
BIS	BANK FOR INTERNATIONAL SETTLEMENTS
CAC ACT	COMMONWEALTH AUTHORITIES AND COMPANIES ACT
CGS	COMMONWEALTH GOVERNMENT SECURITIES
CHESS	CLEARING HOUSE ELECTRONIC SUBREGISTER SYSTEM
	OF THE AUSTRALIAN STOCK EXCHANGE
CLS	CONTINUOUS LINKED SETTLEMENT
CSIRO	COMMONWEALTH SCIENTIFIC AND INDUSTRIAL RESEARCH ORGANISATION
DOFA	DEPARTMENT OF FINANCE AND ADMINISTRATION
EEO	EQUAL EMPLOYMENT OPPORTUNITY
EMEAP	EXECUTIVES' MEETING OF EAST ASIA-PACIFIC CENTRAL BANKS
ES	EXCHANGE SETTLEMENT (ACCOUNTS; FUNDS)
FMA ACT	FINANCIAL MANAGEMENT AND ACCOUNTABILITY ACT
G7	GROUP OF SEVEN
G10	GROUP OF TEN
G20	GROUP OF TWENTY
G22	GROUP OF TWENTY-TWO
GDES	GOVERNMENT DIRECT ENTRY SYSTEM
GDP	GROSS DOMESTIC PRODUCT
HLI	HIGHLY LEVERAGED INSTITUTION
IBRA	INDONESIAN BANK RESTRUCTURING AGENCY
IMF	INTERNATIONAL MONETARY FUND
IOSCO	INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS
MOU	MEMORANDUM OF UNDERSTANDING
NPA	NOTE PRINTING AUSTRALIA
OPA	OFFICIAL PUBLIC ACCOUNT
RBA	RESERVE BANK OF AUSTRALIA
RDP	RESEARCH DISCUSSION PAPER
RITS	RESERVE BANK INFORMATION AND TRANSFER SYSTEM
RTGS	REAL-TIME GROSS SETTLEMENT
SWIFT	SOCIETY FOR WORLDWIDE INTERBANK FINANCIAL TELECOMMUNICATION
Y2K	YEAR 2000

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End June 2000

Governor	Ian Macfarlane
Deputy Governor	Stephen Grenville

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