Governor’s Foreword

The year 2013/14 was one of relative stability in terms of monetary policy. The Reserve Bank Board changed the cash rate only once (in August 2013), the lowest number of changes for eight years. With interest rates at a five-decade low, the Board judged monetary policy to be appropriately configured to support demand, consistent with the inflation target, as investment in the mining sector turned down from unprecedentedly high levels.

A stable cash rate did not prevent financing conditions in the economy from easing a little. As intermediaries have faced easier conditions in wholesale funding and securitisation markets, competition to lend has increased and interest rates faced by savers and borrowers have declined slightly relative to the cash rate.

These trends have resulted mainly from the very benign funding conditions in global capital markets. Yields on long-dated sovereign debt in major countries are as low as, or lower than, they were a year ago, even though economic growth in the advanced economies has generally improved somewhat over that period. Credit spreads are approaching the lows seen up to 2007. Most borrowers of standing can access credit cheaply. Countries in ‘peripheral’ Europe that faced exploding borrowing costs two years ago are once again accessing markets at remarkably low yields. Volatility in financial prices has likewise fallen to very low levels. At the time of writing, financial markets seem to attribute a very low probability to any rise in global interest rates that might be prompted by, for example, stronger growth or higher inflation.

Put another way, for asset managers the ‘search for yield’ continues to be challenging. Many investors have moved out along the risk spectrum, driven by the desire to produce an income for their clients – hence the compression in spreads. Those asset holders are receiving virtually no compensation for credit, liquidity or interest rate risks.

The very low yields around the world also mean that the Reserve Bank’s earnings, which are derived from holdings of obligations of the most creditworthy governments, continue to be historically low. ‘Underlying’ earnings, which are essentially net interest earnings less the Bank’s operating costs, declined to $442 million in 2013/14, from around $700 million in the previous two years. But the biggest effects on the Bank’s balance sheet and earnings over the past year stem from some major decisions taken in Australia, and two in particular.

First, the Reserve Bank’s capital has been strengthened. Though it had begun to be replenished after absorbing the large losses from the earlier rise in the exchange rate of the Australian dollar, the Bank’s capital was still at the inappropriately low level of $2.4 billion (3.6 per cent of assets at risk) at the start of the year in review. This has been explained in previous annual reports and the Bank faced the likelihood of a long process of rebuilding capital, given the low interest earnings on its assets. The Australian Government’s decision in October 2013 to make a one-time grant to the Bank of $8.8 billion means that the rebuilding process has been effected in one step. The grant was received in May 2014 and it is treated as revenue and recognised in the Bank’s profit and earnings available for distribution for the 2013/14 financial year. The final step was for the Treasurer to determine that this sum was to be transferred from profit to the Reserve Bank Reserve Fund (RBRF), which means it became available to absorb future losses. As a result, as at 30 June 2014 the RBRF was equivalent to 15.7 per cent of assets at risk, a most satisfactory position.

Second, the achievement of an important milestone in lessening risk in the settlements process has had implications for the Reserve Bank's own operations. As agreed with industry and consistent with objectives set by the Payments System Board, certain payments that had been settled on a 'next-day' basis are now settled on a 'same-day' basis, including some in the evening after the cash market has closed. As a result, there is a greater demand for settlement balances by banks. The Bank has accommodated this demand with the introduction of 'open repos', as described in the chapter on 'Operations in Financial Markets'. This involves a substantial rise in the Reserve Bank's balance sheet and additional dealing on some days, but with no additional cost to industry and no material increase in the Bank's risk profile.

As identified in previous annual reports, the Reserve Bank has a number of projects under way, including introduction of the Next Generation Banknote series, an overhaul of RBA banking systems, introduction of the Committed Liquidity Facility and development of the New Payments Platform. These projects are materially increasing the Reserve Bank's costs of operation and especially its capital spending. They require additional resources in the Bank's Information Technology Department, in project management and in some other specialised skills in order to deliver the necessary outcomes in a timely way, with due management of the associated risks. The Bank also upgraded its compliance function, to keep pace with modern practice.

These imperatives were reflected in a further rise in staff numbers, of about 8 per cent in 2013/14. Most of the additional staffing was in the Information Technology Department, as well as in project management and compliance roles. The staffing complement of the Reserve Bank's 'charter' areas was little changed. Project-related operating costs also contributed substantially to the rise in general operating costs of 10.7 per cent in 2013/14. A smaller, though still significant, rise is expected in 2014/15.

The projects in progress involve substantial expenditure, but are, in the Reserve Bank's view, in the public interest. They have to be completed if the Bank is to meet its 'charter' obligations to issue secure banknotes, offer modern, reliable banking systems for its customers, perform its proper role in liquidity provision and support the private sector's initiatives towards offering faster payments.

At the same time, the Reserve Bank has achieved worthwhile savings in administrative and travel costs, with savings in procurement expenses likely over the next couple of years.

One source of greater efficiency has been the decision to outsource much of the administration of the Officers' Superannuation Fund (OSF) to an external provider. The Bank also took the decision to close the defined benefit component of the OSF to new staff, effective 1 August 2014, in line with community standards for pension benefits. That benefit for existing staff remains fully funded on an actuarial basis. The Bank now provides a defined contribution superannuation benefit to new staff.

The Reserve Bank's international engagement continued to increase, with a particular focus on support for the Australian presidency of the G20 in 2014.

Also worth noting this year is that the Reserve Bank contributed to the Financial System Inquiry, via a detailed and substantive submission and staff secondments. The demand for submissions to various parliamentary inquiries continued to expand. These demands were largely met with existing resources.

The staff and management of the Reserve Bank have met all the demands of their roles with their usual calm professionalism and exemplary standards of quality. Once again, the Board joins me in thanking them sincerely for their contribution to the welfare of the Australian people.

Glenn Stevens
Governor and Chair, Reserve Bank Board
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