Governor's Foreword

This is my first annual report as the Reserve Bank of Australia's eighth Governor. I am very honoured to have been appointed to this important position of public service. My appointment follows the retirement of Glenn Stevens AC after 10 years as Governor. During that time Glenn made an outstanding contribution to public policy in Australia, serving the public interest with great distinction. He also provided leadership within the Bank as we managed a period of significant change, undertaking major projects of national interest. I am fortunate to have these strong achievements to build on as I commence my term as Governor.

Over the course of 2016/17, there was a progressive improvement in the global economy. Nearly a decade after the onset of the financial crisis, a reasonably broad-based pick-up in global growth now looks to be under way. Unemployment rates are trending lower and are at, or below, multi-decade lows in some of the largest economies. Policy interest rates in the United States have been increased several times and a number of other central banks are considering when to remove some of the monetary stimulus that has been put in place over recent years. This is a marked change from the years since the financial crisis, when the issue had been how much additional monetary stimulus would be required. Financial markets, including in emerging market economies, have to date coped well with this change.

As has been the case for some years now, inflation is below target in most economies. Although there was some increase in inflation over the past year, this was largely on the back of higher oil prices. Wage growth remains low, even in countries with low unemployment rates. In some countries this largely reflects weak productivity growth, but this is not the whole story. A reduced sense of job security and an increased sense of competition look to be weighing on wage outcomes in many advanced economies, including here in Australia. How long this lasts will have a bearing on the future course of global monetary policy.

Over the year in review, Australia's national income benefited from a rise in commodity prices, in contrast to the decline in prices over recent years. Growth in output in Australia over 2016/17 was a little lower than earlier expected, but the drag from the large decline in mining investment is now coming to an end. The unemployment rate ended the year a little below where it started the year. Wage growth remains low, partly reflecting the same factors that are at work internationally. Inflation, too, remains low, but it increased over the year. The coming year is likely to see better growth in the Australian economy.

The Reserve Bank Board adjusted the cash rate target once in the year in review, lowering it to 1.5 per cent in August 2016. This followed inflation outcomes earlier that year that were noticeably lower than expected. Since then the Board has held the cash rate steady, with the stimulatory setting of monetary policy helping the economy adjust to the winding down of the mining investment boom.

Over the year, the Board has paid close attention to developments in household balance sheets and housing markets. It has sought to strike a reasonable balance in delivering an average rate of inflation over time of between 2 and 3 per cent in a way that promotes the public interest and does not add to medium-term financial stability risks. The importance of financial stability considerations in interest rate decisions was formally recognised in the revised *Statement on the Conduct of Monetary Policy* that was agreed between the Treasurer and me on my appointment as Governor in September 2016.

During the year the Reserve Bank worked closely with other financial regulators, including through the Council of Financial Regulators, to address the medium-term financial stability risks arising from household borrowing. The various measures have helped strengthen lending standards. There is a strong culture of cooperation between the various regulatory agencies in Australia and this was on display again during the year in review. This is a valuable aspect of Australia's regulatory arrangements and one that does not exist in all countries.

In 2016/17, the Reserve Bank recorded an accounting loss of $0.9 billion, reflecting valuation losses on holdings of foreign assets due to the exchange rate appreciation over the year. The underlying rate of return on the Bank's assets remained low, a result of the low level of interest rates in Australia and elsewhere. Over the year, underlying earnings were $1.0 billion and an additional $0.3 billion was earned in realised capital gains.

The Reserve Bank Board is committed to the Bank having a strong balance sheet so that it can effectively perform its operations under a wide range of scenarios. As the balance sheet has grown over recent times, there has been an increase in the share of the Bank's assets that have relatively low market risk. Given this change, the Board undertook a review of the capital framework during the year to ensure the amount of capital held against the various assets is determined by the risk of those assets. The new framework at present delivers a similar dollar target for capital as the previous arrangements, but is more sensitive to risk. With the current balance in the Reserve Bank Reserve Fund consistent with the Board's target capital level, the Bank did not seek a transfer to this fund in 2016/17. Accordingly, with the unrealised valuation loss being absorbed by previously accumulated unrealised gains, a dividend of $1.3 billion will be paid to the Australian Government.

Over recent years the Reserve Bank has been undertaking significant investments in important public interest projects, many of which have a high information technology component. The Bank has been building a core part of Australia's New Payments Platform, with this major effort completed on time. This payments infrastructure will allow Australians to make real-time, information-rich payments without having to exchange BSB and account numbers. We are also making a large investment in our banking systems, so that we can continue to provide high-quality and cost-effective banking services to the Australian Government and its agencies. One result of this work is that the Australian Government will be able to make and receive payments over Australia's New Payments Platform.

A major achievement of the Reserve Bank early in the year in review was the issuing of a new $5 banknote. The new banknote was developed over many years and has world-leading security features. I am pleased to be able to report that it has been well accepted by the public. The year also saw the completion of construction of a new vault and banknote distribution centre in Craigieburn, Victoria. This investment was made necessary by the continuing growth in the value of banknotes in circulation. While cash is being used less in day-to-day transactions, the value of banknotes on issue relative to GDP is at its highest in more than five decades, reflecting its ongoing use as a store of value.

There was a further increase in the Reserve Bank's staff numbers over 2016/17, reflecting the extra effort on the large payments and banking projects. Operating costs for ongoing activities, excluding depreciation and project work, rose by 4.6 per cent. As projects are completed, some reduction in staff numbers is expected in 2017/18. The Bank recently commissioned an external review of its operational efficiency. The review provided assurance that the support services were functioning well in helping pursue the Bank's objectives and also recommended some areas for improvement. We are now in the process of implementing those recommendations.

Australia is well served by having a central bank with highly competent staff who share a strong commitment to serving the public interest. The Reserve Bank's staff have high standards and go about their work with quiet professionalism. The Reserve Bank Board joins me in thanking the staff for their service.

Philip Lowe
Governor and Chair, Reserve Bank Board
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