Reserve Bank of Australia

1998

Report and Financial Statements

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30 June 1998

Governor's Foreword

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

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

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

- There was a sharp contrast in the Reserve Bank's activities in the foreign exchange market over the past two financial years. In 1996/97 the Bank was able to take advantage of a strong Australian dollar (the average level was over US78 cents) to replenish its international reserves by buying $5.2 billion of foreign currencies. In 1997/98, on the other hand, with a falling Australian dollar the Bank intervened in the second half of the year by buying Australian dollars when the exchange rate fell. Of the $3.2 billion bought by the Bank in 1997/98, $2.6 billion was bought in mid June when the exchange rate was a little over US60 cents.
- Moving responsibility for bank supervision from the Reserve Bank to the newly created APRA was the biggest single change to the Bank's structure since the abolition of the Exchange Control Department following the float of the Australian dollar in 1983. While the Bank had argued against the proposed change, once the decision had been made with bipartisan political support (and after community consultation), we have given it our fullest support. We are confident that the intellectual capital that has been built up in Bank Supervision Department will not be lost, as its staff was moved almost in its entirety to APRA on 1 July 1998. The Government's decision to appoint Deputy Governor Graeme Thompson as Chief Executive Officer of APRA was a wise one; although he will be a loss to the Bank, he will be an important asset to APRA and will ensure that the difficult transition period is negotiated as smoothly as possible. His departure from the Reserve Bank reduces the number of Deputy Governors to one – the situation that prevailed until 1993. Most importantly from the Bank's point of view, we were able to hand over to APRA a banking system which is in first-rate shape from a prudential viewpoint, with very low bad debts and a comfortable capital ratio.
- At the time of announcing the shift of bank supervision to APRA, the Government made it clear that the Reserve Bank still retained responsibility for the stability of the overall financial system. This follows necessarily from our central role in the payments system, and our unique capacity to act as lender of last resort. Indeed, the original rationale for the establishment of most central banks was this system stability role – the monetary policy role came later. We are now in the process of defining the division of responsibilities under the new system. A small department – System Stability Department – has been established to undertake research on risks to financial stability, keep abreast of new product and market developments, and co-ordinate relations with APRA and the Council of Financial Regulators. In addition, the Bank has gained wider responsibilities for the payments system.
- The full implementation of RTGS on 22 June 1998 marked the completion of a project that had begun in December 1995. During its design and construction phase it occupied 55 Bank staff drawn from five Departments,

as well as a much larger number of people working for Austraclear and the commercial banks. This essential piece of financial infrastructure puts the Australian banking system and our financial markets at world best practice in the payments settlement area. While some other countries reached this point earlier than Australia, our system stands out for its comprehensiveness – from the beginning, over 90 per cent of all transactions by value were settled in real time.

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

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

IJ Macfarlane
Chairman, Reserve Bank Board
11 August 1998

Surveillance of the Financial System

In announcing its response to the Financial System Inquiry, the Government confirmed that the role of the Reserve Bank will be "… *focused on the objectives of monetary policy, overall financial system stability and regulation of the payments system*" (Ministerial Statement by the Treasurer, 2 September 1997). Consistent with this decision, responsibility for supervision of banks in Australia was transferred to the newly established Australian Prudential Regulation Authority (APRA) from 1 July 1998; at the same time, the Reserve Bank gained extensive regulatory powers in the payments system to be exercised by a new Payments System Board within the Bank. These major changes in the structure of financial regulation coincided with the commencement of Australia's real-time gross settlement (RTGS) system for high-value payments, which has made the payments system substantially less vulnerable to risk.

The New Division of Responsibilities

Maintenance of overall financial system stability has always been a core central bank responsibility. This reflects the importance – underscored by the Asian economic crisis – of a smoothly functioning and efficient financial system for community confidence, macroeconomic stability and economic growth. The Reserve Bank's broad mandate in this area is not a new one. Indeed, the evolution of the central banking functions of the Commonwealth Bank owed much to the memory of the economic damage wrought by the banking crisis of the 1890s and the economic and financial distress of the early 1930s. (The establishment of the US Federal Reserve System in 1913 was also based on the need to ensure the stability of the financial system; the monetary policy role came later.)

Over time, the Reserve Bank's approach to its system stability responsibilities has changed. Until the early 1980s, banks, which comprised the core of the financial system, were heavily regulated primarily for monetary policy purposes. These regulations also had the side effect of severely limiting banks' capacity to take risks, and so no specific system of prudential regulation was required. In the subsequent deregulated environment, the Bank introduced a framework of prudential standards for banks and began to monitor their risk-management systems closely to ensure that they managed their affairs prudently. This prudential framework for banks has now been adopted by APRA.

Under the new regulatory structure, the Reserve Bank no longer has an obligation to protect the interests of bank depositors and it will not supervise any individual financial institutions. Rather, it will focus more broadly on potential risks to system stability, on how these risks might be reduced without unduly discouraging financial efficiency and innovation, and on how the Bank should respond to financial disturbances. While the causes of such disturbances can vary, experience abroad suggests a number of recurring factors. These include macroeconomic imbalances and asset price "bubbles" and their subsequent collapse; dislocation in the payments system; inadequate prudential supervision; distortions in the incentives faced by depositors, supervisors, and the managers and owners of financial institutions; and poor-quality information and market signals. Japan's present difficulties, for example, are testament to the interaction between the macroeconomy and the financial system: the bursting of the "bubble economy" of the late 1980s substantially weakened the Japanese banking system and this, in turn, is now acting as a major drag on economic growth.

The Reserve Bank cannot eliminate risk from the financial system, and its system stability responsibilities do not require it to prevent unprofitable financial institutions from going out of business. The taking and managing of risk are an integral part of the process of financial intermediation and essential for the efficient allocation of resources. The task for the Bank is to help ensure that shocks to any part of the financial system do not ultimately threaten the stability of the Australian economy. The Reserve Bank, alone of the regulatory agencies, has the wherewithal to respond to financial shocks by providing emergency liquidity support to the financial system. However, it does not see its balance sheet as available to bolster the solvency of an ailing financial institution. The Bank's most enduring contribution to financial stability, of course, is the preservation of a low-inflation environment.

A new System Stability Department has been established within the Financial System Group to conduct analysis and research on financial stability issues, including developments in financial products, technology and risk management, and to support the Reserve Bank's involvement on the APRA Board and the Council of Financial Regulators (see below). The new Department will not, however, shadow APRA in its supervisory role; the Bank will rely on APRA for its assessments of the health of individual financial institutions. That said, from time to time the Bank may participate in APRA's on-site reviews of, and prudential consultations with, supervised institutions as a way of keeping up-to-date on risk-management techniques and the operations of different types of financial institutions. Such participation was envisaged by the Financial System Inquiry.

The Reserve Bank's mandate for financial system stability and APRA's role in supervising individual institutions are largely complementary. Problems in individual institutions may give rise to broader systemic instability; in turn, systemic risks of domestic or external origin may themselves threaten even well-managed institutions. For these reasons, clear and effective co-ordination between the Bank and APRA will be essential. The Bank's representation on the APRA Board (two members on a Board of nine) is one crucial element of this co-ordination. Another is full and timely exchange of information, on a two-way basis. For its part, through participation in financial markets and its pivotal role in the payments settlement system, the Bank may glean information on individual institutions which would be relevant to APRA; the Bank also envisages sharing with APRA its assessments of domestic and international economic and financial developments.

A formal Memorandum of Understanding now being developed between the Reserve Bank and APRA will be made public in due course, and will cover such matters as information sharing and co-ordination arrangements for the handling of liquidity and solvency problems in financial institutions. A bilateral Reserve Bank/APRA co-ordination committee has also been established to ensure that the co-ordination arrangements work smoothly, particularly in responding to threats to system stability.

The Reserve Bank's Final Year as Prudential Supervisor

The Reserve Bank retained responsibility through 1997/98 for prudential supervision of banks in Australia. Towards the end of the financial year, preparations for the establishment of APRA absorbed increasing resources, culminating in the formal transfer of the Bank's supervision staff to APRA on 1 July. The following gives an account of developments in supervision during the year and the Reserve Bank's assessment of the health of the Australian banking system at the time of the transfer of supervisory responsibilities to APRA.

Developments in supervision

New guidelines for Australian banks covering capital standards for market risk were introduced in January 1998. These guidelines, which follow closely the recommendations of the Basle Committee on Banking Supervision, require banks to hold capital against the risk of losses from movements in interest rates, exchange rates, equity prices and commodity prices. Banks may calculate this requirement using either a standard method or, subject to the agreement of the supervisor, their own risk-measurement models; in the latter case, banks must meet stringent criteria regarding their risk-management practices. By June 1998, the Reserve Bank had granted "internal model status" to ten banks. Visits by supervision staff confirmed that the risk-measurement models of these banks were comparable to the approaches adopted by major international banks. Most banks have sharpened the separation between their trading and risk-management areas by creating an independent risk-control unit with separate reporting lines to senior management; they have also been enhancing the expertise of staff in their settlements and accounting areas (the back office).

The capital charge for market risk was $1.1 billion at end June 1998 and was easily accommodated by banks' total capital of $60.8 billion. The low charge confirmed that most of the market risk assumed by Australian banks is effectively hedged.

The new capital requirement for market risk rendered superfluous the limits which the Reserve Bank had previously imposed on banks' overnight foreign currency positions. Accordingly, these limits were abolished in March 1998. A similar set of limits applying to non-banks authorised to deal in foreign exchange was also abolished.

In April 1998, the Reserve Bank issued new prudential guidelines dealing with liquidity management by banks, which will replace the Prime Assets Requirement (PAR). The PAR arrangements required banks to hold a minimum level of Commonwealth Government securities (CGS), notes and coin and balances with the Reserve Bank. Over recent years, PAR was reduced and its definition broadened in response to concerns about the availability of CGS.

The Reserve Bank came to the view that it was no longer appropriate to mandate a common ratio or minimum holdings of liquid assets for all banks. Instead, the new guidelines place greater emphasis on banks' internal management practices. Under the new framework, the Reserve Bank (then APRA after 1 July) has been meeting with individual banks to reach agreement on a liquidity policy which sets out how each bank plans to manage liquidity under different circumstances. The policy needs to cater for two specific scenarios, namely day-to-day liquidity management and a bank-specific or "name" crisis. Banks can use a range of strategies to manage liquidity, including setting limits on maturity mismatches, holding liquid assets, diversifying liability sources and developing asset sales strategies. Once a liquidity policy is agreed with a bank, that bank will no longer be required to observe PAR. The new arrangements are expected to come fully into effect by the end of 1998.

A pressing operational risk for banks is the Year 2000 problem, which arises because some computer hardware and software will be unable to deal correctly with dates beyond 31 December 1999. Left unchecked, the problem would threaten dislocation within banks and in their dealings with customers and counterparties, with potentially serious disruption to the financial system. For this reason, central banks and other prudential supervisors are taking a close interest in the issue. A generally recommended target date for banks to have their computer systems ready for the century date change is the end of 1998, to allow a full year for testing within each bank and with counterparties.

Australian banks expect to meet this target substantially. Where slippage into 1999 might occur, banks have organised their remedial programs to ensure that critical systems receive the highest priority. The Reserve Bank (and APRA more recently) has been monitoring banks' progress through two comprehensive surveys and in regular prudential consultations. Collectively, banks have allocated the equivalent of over 1 600 of their IT staff and 1 000 non-IT staff to resolving the Year 2000 problem and expect to spend almost $1 billion on corrective actions. Shortages of specialist staff have not been a constraint to this point, but could become so during the complex testing stages or if Australian banks and companies were to lose staff to the global marketplace. Banks are finalising formal contingency plans in the event that their systems are not fully compliant. In July 1998, the Reserve Bank and APRA jointly published a booklet, *Year 2000 Preparations in the Australian Banking and Financial System*, which discusses these issues.

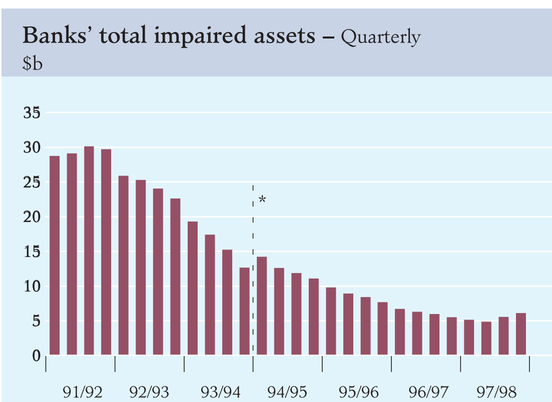
The Reserve Bank has been participating in an interbank working group on the Year 2000 problem and has been liaising on Year 2000 activities with other regulatory agencies in Australia through the Council of Financial Regulators (previously, the Council of Financial Supervisors). Internationally, the Bank is involved in various Year 2000 initiatives, mainly under the aegis of the Bank for International Settlements (BIS). A major focus of international efforts is the development of standardised check-lists and disclosure statements, which will assist financial institutions in monitoring the state of preparedness of their peers. Details on the Reserve Bank's approach to dealing with the Year 2000 problem internally are discussed in "Management of the Bank".

The legal strength of netting arrangements in Australia has been resolved with passage of the *Payment Systems and Netting Act 1998* in June. Typically, banks active in foreign exchange and derivatives markets enter into a large number of contracts with counterparties and generate obligations in both directions; offsetting these obligations in a legally robust way reduces the credit risks facing these banks. The 1988 Basle Capital Accord allows netting arrangements to be reflected in lower capital requirements, at the discretion of a country's bank supervisor; however, the Reserve Bank was unwilling to move in this direction until the legal position had been clarified. The new legislation allows Australian banks to enter into netting contracts with legal certainty; in turn, this will allow the recognition of netting for capital adequacy purposes.

The Australian banking system

APRA has inherited a banking system in very sound financial condition. Notwithstanding some fall-out from the Asian crisis and further pressure on interest margins, returns on equity are high and capital ratios, though below the very high levels reached in the mid 1990s, remain comfortably above minimum requirements.

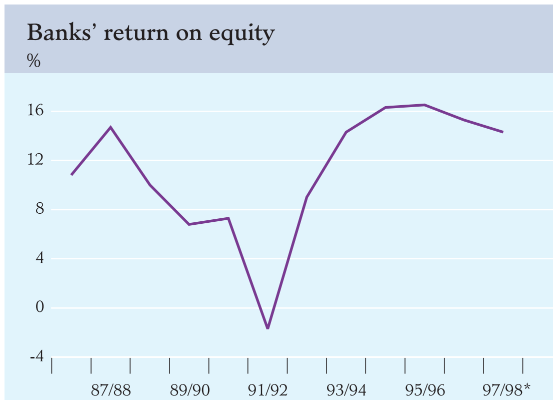
Impaired assets of banks continued to fall through the first half of 1997/98. At their lowest, they represented only 0.6 per cent of banks' total assets, one-tenth of their



* Break in series

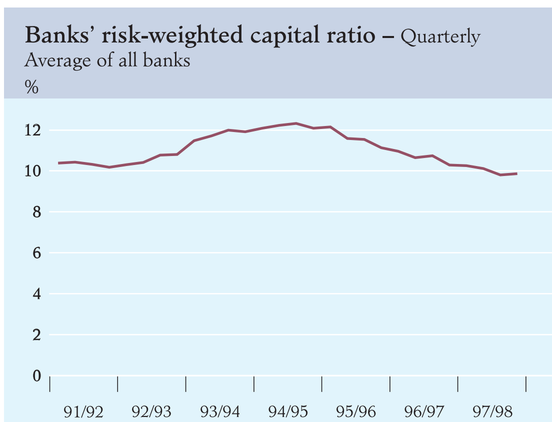
peak early in 1992. The reversal of the trend in the second half of the year reflected some domestic corporate exposures as well as exposures to Asia. Mirroring the trading patterns of Australian business in the Asian region, the major Australian banks have exposures to banks, other financial institutions and corporate customers in most countries in Asia. However, Asian exposures are only a modest proportion of their global business – equivalent to a little over 5 per cent of total assets – and are unlikely to injure significantly the balance sheet strength of any of the Australian banks.

Increased lending volumes, reductions in capital ratios and growth in non-interest income have enabled banks to maintain returns on equity in the 14–15 per cent range, notwithstanding a continued contraction in interest margins and stubbornly high cost-to-income ratios. These returns are broadly in line with those of comparable banks in other Anglo-Saxon countries. Nonetheless, they are high when compared with the benchmark of a risk-free rate of return, measured by the yield on CGS; this benchmark has halved since the late 1980s, when banks' returns on equity were last in the 14–15 per cent range.



* First half annual rate

The aggregate risk-weighted capital ratio for banks has fallen from a peak of just over 12 per cent early in 1995 to a little under 10 per cent as a consequence of strong asset growth, acquisitions and more active conservation of capital resources (including buy-backs of capital instruments).



The number of authorised banks in Australia has changed little over recent years, as foreign bank entrants have made up for exits through domestic mergers.

Authorised banks in Australia

August	1996	1997	1998
Banks	52	50	53
of which:			
– Domestically owned	20	17	16
– Foreign-owned	32	33	37
locally incorporated	13	12	12
branches	19	21	25

Over the past year, banking authorities were granted to AMP Bank and NM Rothschild & Sons (Australia), and branch banking authorities to the Taiwan-based International Commercial Bank of China, ING Bank, Dresdner Bank, ABN Amro and Toronto-Dominion Bank. Banking authorities were relinquished by Advance Bank and Bank of Melbourne after their takeovers by St. George Bank and Westpac, respectively; by NatWest Markets Australia after its businesses were sold to Salomon Smith Barney Australia; and by Bank of New Zealand after its Australian business was absorbed by National Australia Bank.

In September 1997, the Reserve Bank, in consultation with the Australian Securities Commission, formalised the arrangements under which representative offices of foreign banks may operate in Australia. There are at present 34 such representative offices, a number which has declined over the past year or so as many Asian banks have withdrawn their Australian representation to concentrate their energies on their domestic markets.

Payments System

The Reserve Bank's new payments system responsibilities

The new financial regulatory structure gives the Reserve Bank formal responsibility for the safety and efficiency of the payments system in Australia. A Payments System Board has been established in the Bank to determine its payments system policy (see box). The Board's task has been rendered easier by the successful implementation of Australia's RTGS system over the past year.

The payments system began in Australia as an arrangement between private banks. The Reserve Bank has a central role as provider of Exchange Settlement (ES) accounts, which ensure final settlement of payments system obligations, but it has been only one participant in influencing development of the system. This raised two issues as the financial sector developed in sophistication: first, would these institutional arrangements, decided by the interests of the members of the payments system, produce an efficient outcome for the economy as a

The Payments System Board

The Payments System Board has power to determine the Reserve Bank's payments system policy. In terms of the *Reserve Bank Act 1959*, the Board must exercise this power in a way that will best contribute to:

- controlling risk in the financial system;
- promoting the efficiency of the payments system; and
- promoting competition in the market for payment services, consistent with the overall stability of the financial system.

The Payments System Board has a maximum of eight members, comprising the Governor, a representative of the Bank appointed by the Governor, a representative of APRA appointed by its Chief Executive Officer, and up to five other members appointed by the Governor-General for terms of up to five years.

Members of the Payments System Board are not directors of the Reserve Bank in terms of the *Commonwealth Authorities and Companies Act 1997*. However, they are subject to those sections of the Act which deal with the conduct of officers and directors, including disclosure requirements, improper use of inside information and disqualification.

The *Reserve Bank Act 1959* provides a clear delineation of responsibilities between the Payments System Board and the Reserve Bank Board. Instances of conflict over policies should therefore be rare. However, if a conflict were to arise, the view of the Reserve Bank Board would prevail to the extent that there is any inconsistency in policy. If there are disagreements between the Boards on questions of jurisdiction or inconsistency of policy, they are to be resolved by the Governor, who is Chairman of both Boards.

The Payments System Board is required to inform the Government of its policies. In the event of a difference of opinion between the Government and the Board, the provisions of the *Reserve Bank Act 1959* provide a mechanism for dispute resolution.

The members of the Payments System Board appointed in July 1998 are:

IJ Macfarlane	Chairman	Governor
JF Laker	Deputy Chairman	Assistant Governor (Financial System)
GJ Thompson		Chief Executive Officer, APRA
JI Gersh		Partner, Arnold Bloch Leibler
S McCarthy		Director
JG Thom		Visiting Professor, Macquarie Graduate School of Management

The first meeting of the Payments System Board will take place in August.

whole; and second, were the risks to financial stability posed by a disruption to the payments system sufficiently taken into account. Importantly, there was a concern that, *in extremis*, the Reserve Bank could be forced to underwrite the payments system from its own balance sheet. As the issues became better understood by the authorities, pressures for reform of payments system arrangements grew. Against this background, the two recent steps – formalisation of the Bank's role in the payments system and the introduction of RTGS – represent fundamental improvements.

The Reserve Bank's responsibility for safety of the payments system is in line with international trends and reflects the potential of the payments system, if not soundly constructed, to transmit destabilising shocks throughout the financial system more generally. In contrast, the Bank's legislative responsibility for efficiency of the payments system is a world first for a central bank. It acknowledges the conclusion of the Financial System Inquiry that there was considerable scope to increase efficiency; in particular, current arrangements based on industry self-regulation were not necessarily conducive to innovation and the entry of new participants.

The Government saw advantages in a co-regulatory approach and for this reason considerable flexibility has been built into the new regulatory regime. In the first instance, the private sector will continue to operate its payment systems and may enter into co-operative arrangements. If the Australian Competition and Consumer Commission (ACCC) authorises these arrangements as being, on balance, in the public interest, then they can continue.

The Reserve Bank now has an independent responsibility to assess the efficiency of payment systems. If it is satisfied with the performance of a payment system in improving access, efficiency and safety, it may not need to use its powers. Where performance on these scores is not satisfactory, however, the Bank will be able to designate the system concerned as being subject to its regulation. It may then, in the public interest, impose an access regime on that system and/or set standards for safety or efficiency. When it does so, the payment system and its participants would not be subject in that regard to action by the ACCC under the *Trade Practices Act 1974*. The effect is that the ACCC retains responsibility for competition and access in a payment system, unless the Reserve Bank imposes an access regime and/or sets standards for it. If the Bank does so, its requirements are paramount. The Bank and the ACCC are developing a Memorandum of Understanding, to be made public, to promote a consistent approach to policies on access and competition in the payments system.

The Reserve Bank's extensive powers in the payments system are balanced against safeguards for private-sector operators. The likely outcome, in many cases, is that no explicit regulation will be needed. Where the Bank does decide to set access conditions or impose standards, it is required to take into account the interests of all those potentially affected, including existing operators and participants. Full public consultation is required and the Bank's decisions can be subject to judicial review.

As well as its broad responsibilities in the payments system, the Reserve Bank sets the terms for access to its ES accounts. At present, only banks and two Special Service Providers for building societies and credit unions have such accounts. This limitation on access dates from the time when all payments were settled on a deferred net basis; in extreme circumstances, the Reserve Bank could have ended up with credit exposures to payments system participants if an account holder were unable to meet its settlement obligations. The Bank has been reviewing its eligibility criteria to determine what might be appropriate following the introduction of RTGS. Because ES accounts conducted exclusively on an RTGS basis do not expose the Reserve Bank to credit risk, there is scope to offer these accounts to a wider range of institutions which are significant providers of payment services. Such institutions would need to demonstrate that they meet appropriate operational standards, including the ability to manage real-time demands on liquidity.

Retail payment systems will continue to settle on a deferred net basis. Where they are settled across ES accounts, the Reserve Bank could still be exposed to risk, though the value of transactions settled in this way has fallen sharply and a range of risk-management techniques can reduce risks further. In considering requests for ES accounts that will be used to settle retail payments, the Bank will need to balance the competitive advantages of wider access against the credit risks it might assume.

Real-time gross settlement

Australia's RTGS system for high-value payments went "live" on 22 June 1998. This has greatly strengthened the safety of the payments system by replacing a deferred net settlement system, with its attendant settlement risks, with one under which high-value payments are settled individually, as they are made, using funds in members' ES accounts at the Reserve Bank (see box on page 18). It is the culmination of a substantial three-year endeavour by the Bank and other payments system participants.

The elements that make up RTGS were developed separately but co-ordinated by a Cross-Project Steering Committee chaired by the Reserve Bank. The core element – where the exchange of value takes place – was developed from the Reserve Bank Information and Transfer System (RITS), the Bank's existing system for electronic settlement of CGS (which has been operating since 1991). This was modified to make it suitable for settling a wider range of transactions in real time. RTGS business and technical requirements were issued by the Reserve Bank in August 1995 and May 1996, and building and testing took place over the following year. The enhanced RITS system commenced operations in July 1997.

Many of the staff who had been involved in the RTGS project were on hand to witness the new system going "live" on 22 June 1998, launched by Deputy Governor Graeme Thompson, assisted by Bill Hands and Nola McMillan.

Why RTGS?

The reduction of settlement risk in domestic high-value payments systems has been a principal objective of many central banks over the past decade. This risk arises when payment instructions are sent and acted upon by banks and their customers, but settlement of the resulting net obligations occurs some time later. In Australia's deferred net settlement system, final settlement of interbank obligations was not completed until 9.00 am the day following the sending of payment instructions. In the interim, a bank could find itself unable to meet its settlement obligations. Because of the very large values and the multitude of individual transactions involved, the result could have been a serious disruption to payment flows, leaving other banks facing liquidity pressures and even insolvency. The Reserve Bank could provide emergency liquidity to try to stem this type of systemic risk, but in doing so could take on large exposures to payments system participants.

The RTGS system addresses this problem at source by preventing the build-up of unsettled obligations. It is based on the simple premise that if a bank does not have sufficient funds in its ES account, any payment it wants to make will have to be queued until there are funds available. Since payments are not made unless they can be settled, settlement risk is eliminated. If a bank were to fail during the course of the day, there would be no need to unwind a chain of payments or put the Reserve Bank's balance sheet at risk.

Deferred net settlement

During day

1. Payer instructs bank to make payment
2. Banks exchange payment instructions
3. Beneficiary's bank credits account of beneficiary
4. Beneficiary may withdraw funds and make further payments

Overnight

5. Banks calculate net obligations and notify RBA

Next day

6. RBA posts debits and credits to banks' ES accounts.

Previous day's payments would be thrown into doubt if a bank were unable to settle its net obligations.

Real-time gross settlement

During day

1. Payer instructs bank to make payment
2. Payments sent to RBA's RTGS queue
3. Payments for which ES funds not available remain in queue
4. If ES funds available, payer's bank has its ES account debited and beneficiary's bank has its ES account credited
5. Beneficiary's bank notified of payment
6. Beneficiary's bank credits account of beneficiary
7. Beneficiary may withdraw funds and make further payments

Each payment is final as it is made and not at risk if payer's bank subsequently fails.

From that time, ES account holders have been able to monitor the intra-day movements in their settlement obligations arising from transactions in RITS, and in the two other high-value systems which were linked to RITS over the following two months.

Progressively, other payments elements were linked with this. Development by the payments industry of a new high-value payments system using a commercial financial message system (SWIFT) was the second stage. The SWIFT Payment Delivery System (PDS), which is managed by the Australian Payments Clearing Association (APCA), was linked to RITS and commenced operations in August 1997. Migration of payments to the SWIFT PDS was completed in March 1998, mostly from an electronic payments system which has now ceased operation. The third stage, completed in September 1997, linked to RITS the settlement system for semi-government and private-sector debt securities operated by Austraclear. The remaining element was the upgrading of internal procedures and systems by individual members of the payments system to cater for the RTGS environment. This included technical linkages to the SWIFT PDS and changes to the management of within-day liquidity and customer credit limits.

Early in May 1998, as part of the phasing-in of the RTGS system, the Reserve Bank imposed a limit on the extent to which each member's settlement obligations arising in the various high-value systems could exceed its ES account balance. Transactions which would have breached this limit were queued within RITS pending the receipt of sufficient incoming funds; settlement still took place the following day. This limit was gradually reduced to zero over a period of six weeks. From 22 June 1998, high-value payments between members have been processed and settled in real time.

Australia's RTGS system has a number of features which make it equal to world best practice. It has particularly wide coverage, including securities settlements, and accounts for around 90 per cent of the total value of payments exchanged between members. RTGS payments average up to $115 billion a day but have exceeded $150 billion on peak days. Members can perform their within-day customer credit checks and liquidity management on a fully automated basis in their own proprietary systems. They can reserve funds in their ES accounts for priority payments and both bank and non-bank members of RITS can lodge transactions for processing up to five days ahead. Technically, the RTGS system has an extremely high standard of availability and back-up. In the event of a disaster, for example, back-up facilities at a remote site would be able to restore operations within 30 minutes. Contingency arrangements are rigorously re-tested.

The introduction of RTGS has also brought settlement arrangements in Australia's debt securities markets in line with world best practice. Both RITS and Austraclear now provide irrevocable real-time transfer of title to securities at the same time as the corresponding cash payment, including interbank settlement, is completed.

RTGS transactions

(22 June – end July 1998, daily average)

	Value ($ billion)	Number (thousands)
Securities markets settlements:		
– RITS	16	1
– Austraclear feeder system	23	3
Foreign exchange transactions and customer payments:		
– SWIFT PDS feeder system	74	12
Total (excluding intra–day repos with Bank)	113	16

The RTGS system has special features designed to promote efficient use of liquidity during the day, a critical requirement of such systems. The queuing mechanism in RITS has proven helpful in economising on liquidity, while an auto-offset facility within RITS monitors the queue and automatically settles offsetting payments between pairs of banks. As well, an intra-day repo facility provides secured within-day funds, interest-free at banks' discretion. Amendments to the Reserve Bank's operating procedures to improve RITS members' access to liquidity, in preparation for RTGS, are described in "Operations in Financial Markets".

Passage of the *Payment Systems and Netting Act 1998* has underpinned the RTGS system. The Act ensures the finality of RTGS transactions by allowing the Reserve Bank to exempt such transactions from possible application of the "zero hour" rule, which would date the insolvency of an institution from the midnight before it was declared. Such a rule would have threatened the irrevocable nature of RTGS payments and created potentially severe liquidity problems in the payments system. The Act also gives legal certainty to multilateral net settlement arrangements for low-value payments.

To ensure that the RTGS system remains responsive to the needs of users, the Reserve Bank has established two consultative groups with industry participants, which will deal with RITS business and technical operations.

Foreign exchange settlement risk

In December 1997, the Reserve Bank released the results of a survey of foreign exchange settlement practices in Australia. The survey was based on an earlier study undertaken by the BIS in the G10 countries and confirmed that Australian banks face risks similar to those identified by the BIS. The Bank has discussed settlement practices with individual respondents, noting where improvements need to be achieved; a follow-up survey will be undertaken late in 1998 to assess progress.

Banks can reduce their exposure to foreign exchange settlement risk in a number of ways. Some, such as tightening up their own back-office procedures, are within their direct control. Others require legislative change and international co-operation at industry level. As noted above, the recognition in the *Payment Systems and Netting Act 1998* of financial markets' netting allows Australian banks, with legal certainty, to enter into foreign exchange netting contracts to reduce their counterparty credit risk. Enactment of this legislation was a precondition for Australian banks' joining the Exchange Clearing House Limited (ECHO), a private-sector initiative based in the United Kingdom aimed at limiting foreign exchange settlement risk by netting. Three of the major Australian banks have signed letters of intent to join ECHO.

Well-designed netting schemes can substantially reduce foreign exchange settlement risk, but cannot eliminate it. To reduce such risk further, a group of major international banks is planning to establish a limited-purpose vehicle – the Continuous Linked Settlement (CLS) Bank – to facilitate the simultaneous settlement of participants' foreign exchange transactions in eligible currencies across different time zones. The CLS Bank will be supervised by US authorities. All payments to and from the CLS Bank will be through the domestic RTGS systems of those currencies in which the CLS Bank operates. The Reserve Bank has informed CLS Services Limited (the holding company for the CLS Bank) that it would like to see the Australian dollar included as an eligible currency and that the CLS Bank can have access to Australia's RTGS system for this purpose. The four major Australian banks have taken an equity holding in CLS Services Limited. In December 1997, this company merged with ECHO and Multinet, a New York-based foreign exchange netting scheme. These companies had some common owners and the merger enables a pooling of efforts to reduce foreign exchange settlement risk.

Supervisory Co-ordination

The new financial regulatory structure will mean changes in the Reserve Bank's relationship with other agencies involved in the supervision of the financial system. The Bank will maintain a broad range of contacts helpful in carrying out its mandate for financial stability but some specific aspects will be shared with or pass to APRA.

The Reserve Bank and APRA are members, along with the Australian Securities and Investments Commission (ASIC), of a new Council of Financial Regulators. This non-statutory body comprises the head and one other senior representative of the three agencies, with the Governor as chair. Its role, like that of its predecessor

– the Council of Financial Supervisors – is to contribute to the efficiency and effectiveness of regulation by providing a high-level forum for co-operation and collaboration among its members. Focal points of attention for the Council over the past year have been, on the domestic front, preparations for the new regulatory structure and, at the international level, the emerging framework for supervising financial conglomerates being developed by banking, securities and insurance regulators from various countries, including Australia, at the Joint Forum on Financial Conglomerates.

The Reserve Bank works closely with the authorities which have principal responsibility for Australia's anti-money laundering efforts – the Australian Transaction Reports and Analysis Centre (AUSTRAC), the National Crime Authority and Federal and State police. It participates in the Financial Action Task Force and has supported the Asia-Pacific Group on Money Laundering, a group of 13 regional countries, by seconding an officer to its secretariat for the past year.

In the payments area, the Reserve Bank has provided the chair and secretariat for the Australian Payments System Council, a forum for users and providers of payments services. The Council was disbanded in June 1998, following the transfer of payments system responsibilities to the Payments System Board of the Reserve Bank and consumer responsibilities to ASIC. With the changes to the Reserve Bank's role in prudential supervision of banks and the assumption by ASIC of responsibility for all consumer matters in the financial sector, the Bank has stepped down from its position on the Board of the Australian Banking Industry Ombudsman Scheme.

The Reserve Bank has provided the chair of APCA since its inception. In view of the establishment of the Payments System Board, the Bank has relinquished this role but it remains a shareholder of APCA and will continue to appoint a director and participate in the company's activities.

Internationally, the Reserve Bank retains close links with bank supervisors abroad and with various committees based at the BIS. In 1997/98, the Bank accepted an invitation (subsequently passed to APRA) to become a member of the Core Principles Liaison Group of the Basle Committee on Banking Supervision. This Group will be responsible for developing strategies to encourage countries to embrace the Core Principles for Effective Banking Supervision promulgated by the Basle Committee in 1997. The Reserve Bank will host the biannual International Conference of Banking Supervisors, held under the auspices of the Basle Committee, in Sydney in October.

The Reserve Bank also participates in the activities of the Committee on Payment and Settlement Systems (CPSS), also based at the BIS. During the year the Bank accepted invitations to join two CPSS groups. The first of these groups, the Task Force on Principles and Practices for Payment Systems, aims to produce a set of recommendations to guide development of payments systems similar to the Core Principles of the Basle Committee. The second group, the Working Group on Retail Payments, is analysing the factors driving developments in retail payments markets; the opportunity to join this group has been timely given the Reserve Bank's new responsibilities for efficiency of the payments system.

The Reserve Bank takes part in a banking supervision study group formed by the Executive Meeting of East Asia and Pacific central banks (EMEAP) forum; APRA will join the Bank for future meetings. The Bank is also involved in a working group on payments and settlement systems under the auspices of EMEAP, which produced *Financial Markets and Payments Systems in EMEAP Economies* (the full document is available on the EMEAP web site, while the chapter on Australia's system is on the Reserve Bank's site).

The Asian Crisis and the Reserve Bank

The Asian economic and financial crisis was the major single influence on the formulation of Australian macroeconomic policy in 1997/98. The ensuing declines in Asian exchange rates, domestic demand and imports were relatively quickly transmitted to the Australian economy. In the first instance, they affected financial markets, particularly the foreign exchange and equities markets. Shortly after, they showed up as falling exports, a widening current account deficit and a slowing in domestic demand. It is not the intention of this Report to provide a detailed analysis of the Asian crisis as that has already been done in various quarterly reports and speeches by the Governor and Deputy Governor. What follows is, instead, an account of what the crisis has meant for the Reserve Bank's activities over the past year, and the Bank's likely involvement over the coming year.

On the monetary policy front, the crisis has clearly had an influence on the Board's decisions and also on the staff's work in monitoring and forecasting economic developments. The Reserve Bank has taken a number of opportunities to spell out its views on the Asian crisis and on the implications for Australia. While it has been important to avoid alarmism, and to try to preserve community confidence in the economic environment, there were some inescapable consequences that needed to be drawn out. In particular, the community had to recognise that, even if economic policy, including monetary policy, was adjusted with perfect foresight, there was no way of avoiding some widening of the current account deficit, lowering of the exchange rate, and slowdown in economic activity and increase in inflation. In communicating these realities to the public, the Bank's two regular appearances before the House of Representatives Standing Committee on Financial Institutions and Public Administration were particularly useful.

As well as communicating to the Australian public its views about the effects of the Asian crisis, the Reserve Bank has also tried to play a direct role in Australia's efforts to help troubled Asian countries. The Bank was only one of the government entities involved, but through its role as both adviser and banker to government, its wide range of contacts among Asian central banks and its capacity to provide technical assistance directly to Asian countries, it was able to make a significant contribution, particularly when measured against the relatively small size of Australia in the international community. With central issues in the Asian crisis being the volatility of international capital flows, the fragility of financial sectors and the role of exchange rates, this has meant that much of the discussion concerned core central banking issues. The Reserve Bank was in a position to provide to the Australian Government relevant background on the evolving crisis, and to participate actively in the international conferences and discussions leading to the major financing packages that were assembled.

The first of these packages was for Thailand. Following the escalation of the crisis in July 1997, the International Monetary Fund (IMF) convened a meeting in Tokyo early in August to canvass support. While most major countries participated in the meeting, the urgency and critical nature of the situation were most clearly perceived by countries of the region. Regional central banks, in particular, had been discussing these issues within the EMEAP forum. This helped the Tokyo meeting to agree promptly on pledges of support for Thailand amounting to around US$17 billion – with US$10 billion offered by countries of the Asian region. Reflecting the need to commit funds quickly, Australia's contribution of US$1 billion was offered in the form of a central-bank-to-central-bank foreign currency swap. While this funding was provided by the Reserve Bank, it was always recognised that decisions of this nature – which involve a large international relations element – should properly be taken by the Australian Government, rather than by the Reserve Bank. In this case, the Cabinet approved the decision, subject to the Bank's agreement that its balance sheet could be used for this purpose.

As the contagion spread beyond Thailand, the IMF orchestrated subsequent support packages for South Korea and Indonesia. Australia committed up to US$1 billion to each of these (Australia and Japan are the only countries to have participated in all three support packages). For the South Korean and Indonesian pledges, there was sufficient time to arrange provision for funding from the Budget, rather than from the balance sheet of the Reserve Bank.

Over recent years, the Reserve Bank has increased its involvement in international economic relations. For many years, it has participated in IMF and OECD meetings in a subsidiary role as part of the Australian delegation, and has been a member of the Bank for International Settlements (BIS) for three decades. But with Australia's growing involvement in Asia, the Reserve Bank has actively sought to foster ties with central banks of the region, principally through the EMEAP forum; it has also participated in activities relevant to central banking in the Asia-Pacific Economic Cooperation (APEC) forum, and has been ready to take part in regional conferences and training courses. The need for closer links between central banks follows the increasing international integration of financial markets. As noted, this trend was given a major fillip – and great immediacy – by the Asian crisis. Central banks of the region have worked together through EMEAP and, less formally, in bilateral contacts and through the variety of multilateral forums to try to understand the unfolding events, to discuss what collective action might be taken to mitigate the problems, and to devise appropriate responses for domestic policy-making. The Reserve Bank's participation in EMEAP is at its three levels – Governors' meetings (annual), Deputies' meetings (usually biannual, but more frequent over the past year), and in the three Working Groups (for financial markets, payments systems, and banking supervision), which have each met two or three times over the past year.

At the multilateral level, there is a growing acceptance that the current international financial architecture needs to change. In recognition of the gradual shifts in global economic importance, greater representation has been given to Asia, Eastern Europe and Latin America. The Reserve Bank has participated in multilateral forums, most notably at the Meeting of Finance Ministers and Central Bank Governors (the "Willard Group", also known as "the G22") held in Washington in April, and in the Working Parties which have been set up to help define and develop the new international financial architecture. With the special emphasis of this effort focused on capital flows, external debt, information disclosure and prudential supervision, the Bank will have an ongoing role in these efforts to make international economic linkages work better. Also reflecting the need to widen its representation, the BIS (which added four east Asian members during 1996/97) recently opened a regional office in Hong Kong. As the BIS strives to become less eurocentric, the Reserve Bank has had the opportunity to participate in more of its activities.

Outside the central banking fraternity, similar efforts are under way, in concert with our Treasury colleagues. The two groups that had been established in earlier years – the Four Markets Group, comprising Australia, Hong Kong, Japan and Singapore, and the Six Markets Group, comprising China and the United States as well as the previous four – continued. During the year, a new broader group – the "Manila Framework" – was established. This group has a membership focused on Asian countries, with G7 countries also attending; it met three times during 1997/98, once in conjunction with the G7.

Given the extent of the problems in markets and institutions across the Asian region, the past year saw an increase in the frequency of Reserve Bank staff providing technical assistance, either bilaterally with our counterpart central banks, or as part of IMF Technical Assistance Missions. Most of the Bank's technical assistance was focused on the Asia-Pacific region. The Bank seconded officers for short periods of time to the central banks of Indonesia, the Philippines and Thailand, covering issues of foreign exchange, bank supervision, accounting and management.

The Reserve Bank has participated in a variety of regional seminars and conferences – notably, with the South East Asian Central Banks (SEACEN) research and training programs. As usual, the Bank responded positively to requests from other central banks in the region to send some of their officers for technical discussions and training, including two two-month training programs for Chinese financial officers and shorter training programs for officers from the People's Bank of China, Reserve Bank of Fiji, Bank of Papua New Guinea and Central Bank of Samoa. The Reserve Bank also provided assistance to the

National Reserve Bank of Tonga and the Reserve Bank of Vanuatu, to advise on banking supervision issues. During the past year, there were also two Reserve Bank officers on long-term assignment with central banks of the Pacific region, under arrangements with the IMF. Two other Bank officers have been on long-term attachments directly to the IMF.

Operations in Financial Markets

The Reserve Bank's operations in financial markets over the past year encompassed transactions undertaken for policy reasons – that is, domestic monetary policy implementation and intervention in the foreign exchange market – and transactions undertaken for clients and for the management of the Bank's balance sheet. In carrying out its financial markets operations, two main issues faced the Bank:

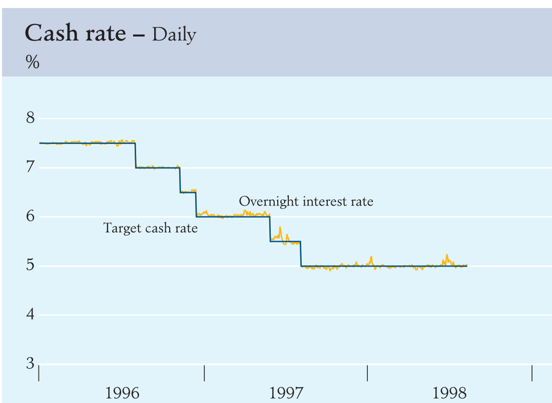
- how to conduct its domestic market operations as the Australian financial system moved towards real-time gross settlement (RTGS), and as the supply of Commonwealth Government securities (CGS), the traditional instrument used in market operations, diminished; and
- how to conduct foreign exchange intervention in a manner which permits necessary adjustment of the exchange rate, but minimises the disruption caused by short-term speculative behaviour.

In addition, the Reserve Bank had to perform the usual task of managing its foreign exchange reserves. This was made difficult because of the extraordinary financial movements that took place in Japan, where a large proportion of the portfolio is normally invested.

Domestic Dealing Arrangements

Preparation for RTGS

The primary objective of domestic market operations is to implement monetary policy, the stance of which is expressed in terms of a target for the cash rate – the interest rate on funds borrowed and lent overnight by financial institutions. The aim of domestic market operations is to supply sufficient liquid funds – Exchange Settlement (ES) funds[1] – to the banking system to maintain the cash rate around the desired level. Monetary policy was last changed on 30 July 1997, when the target for the cash rate was cut by 0.5 of a percentage point, to 5 per cent.



1 ES funds are used by banks to settle obligations among themselves and with the Reserve Bank, and take their name from ES accounts at the Reserve Bank, in which these funds are held.

Demand for ES funds by banks fluctuates from day to day, mainly in response to anticipated settlement obligations. The Reserve Bank manages the amount of ES funds available to banks by buying securities to increase (or selling securities to reduce) the supply of such funds. The bulk of the Reserve Bank's operations to implement policy are in repurchase agreements, or repos[2]. While outright purchases or sales of securities for liquidity management are most efficiently conducted in stock of less than a year to maturity, repos have the advantage of allowing the full spectrum of government securities to be tapped, since stock of any maturity can be used as collateral for a repo.

Changes to dealing arrangements in preparation for the introduction of RTGS began in mid 1996, with the abolition of the group of authorised money market dealers, through which the Reserve Bank had for almost four decades conducted money market operations. Since June 1996, all members of the Reserve Bank Information and Transfer System (RITS), the electronic system for settling transactions in CGS, have been eligible to deal with the Reserve Bank. RITS members include all the banks, as well as investment houses, insurance companies, pension and superannuation funds and nominee companies. In 1997/98, 33 counterparties participated in the Reserve Bank's domestic market operations, covering all of the major institutions in the cash market. Deals were widely spread among the group, with about half of the group undertaking more than $5 billion of transactions with the Bank during the year.

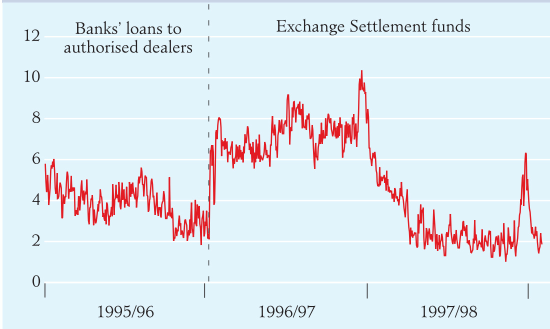
Arrangements under which banks hold their settlement funds changed further in 1997/98. In the period when authorised dealers were the main channel for Reserve Bank operations, banks held settlement balances in the form of interest-earning loans to authorised dealers; interest was not paid on balances in ES accounts. With the abolition of the authorised dealers, however, banks transferred their transaction balances to their ES accounts and it was decided that interest would be paid on these balances to encourage them not to be run down unduly.

Initially, the interest rate was set at 10 basis points below the target cash rate, in line with the typical rate banks received on loans to dealers. However, this had the effect of encouraging banks to increase their holdings of ES funds to a level higher than needed for liquidity management purposes. In June 1997, the Reserve Bank announced that from October that year it would reduce the interest rate paid on ES balances to a rate 25 basis points below the cash rate target. Thereafter, banks progressively reduced ES balances and became more active in borrowing and lending funds among themselves. By December 1997, daily ES balances averaged about $2 billion.

2 A repurchase agreement involves the purchase (or sale) of securities in exchange for cash, with an agreement to reverse the transaction at an agreed price on a future date. As discussed below, they have some similarities with foreign currency swaps, which involve the exchange of foreign exchange (US dollars) for cash and which are also used when necessary to manage domestic liquidity.

They remained around this level until the approach of full implementation of the RTGS system in June 1998, when banks sought the reassurance of a higher level of liquidity, and ES balances rose to about $6 billion. This episode was also one of heightened volatility in financial markets, which typically raises precautionary demand for liquidity, and occurred as the financial year-end approached, when the cash market can be volatile even in generally settled times. As these influences passed and banks grew more accustomed to operating under RTGS, ES balances declined again to around $2½ billion on average by mid July.

Banks' settlement funds – Daily



In general, RTGS systems raise important issues for central banks in managing system-wide liquidity and for individual banks in managing their own liquidity. With the previous system of deferred net settlement, daily liquidity flows – both at the aggregate and bank-specific level – could be predicted quite accurately because they reflected transactions that had already happened. Payments flows under RTGS are, however, made continuously, and at the discretion of banks and their customers; as a result, the actual flow of payments is highly unpredictable. Any unanticipated fluctuation in system liquidity can be potentially disruptive. Also, since payments are made in gross, rather than net, terms, forecasting errors are apt to be larger and liquidity pressures all the greater when errors occur.

To minimise the potential for such disruption under RTGS, steps were taken to ensure the availability of adequate liquidity during the day and overnight (see box on page 32). First, as discussed in "Surveillance of the Financial System", various features have been built into the RTGS system to promote liquidity during the day. Second, on days when cash market conditions turn out to be significantly different from expectations, the Reserve Bank has been prepared to undertake a second round of dealing. In addition, in order to provide banks with confidence that funds would be available in the face of unpredictable swings in liquidity late in the day, an end-of-day borrowing facility with the Reserve Bank was introduced, which is available at banks' discretion. This is a repurchase facility for overnight funds at a rate 25 basis points above the cash rate target, and otherwise granted on the same conditions as repos undertaken in the Reserve Bank's daily liquidity operations. The introduction of each of these measures was designed to reassure markets that, under RTGS, system-wide liquidity would be kept in sufficient supply to maintain the cash rate quite steady around its announced target.

A second round of dealing was needed on 15 occasions in the period since October 1997. This was mostly due to unexpected shifts in the demand for liquidity as banks sought to increase precautionary levels of ES funds at the times when financial markets in Australia and abroad displayed heightened volatility. The frequency of second rounds of dealing rose as the RTGS system was phased in, especially in June 1998, with banks seeking to increase their settlement balances. The market has accepted that the second rounds of dealing are routine, purely for liquidity management purposes, and do not have any implications for monetary policy. It is possible that, under RTGS, a second round of dealing will occur more frequently than in the past.

Banks also used the end-of-day standby facility with increasing frequency during the period of gradual implementation of RTGS in the June quarter. Since early May, nine banks have used the facility, for an average amount of about $65 million. While the end-of-day facility is available to provide a degree of certainty to banks about the supply of end-of-day funds, and it is available at banks' discretion, the Reserve Bank sees the facility essentially as a standby and would not wish to see individual banks make significant use of it too frequently. The above-market cost of overnight funds from the standby facility is designed to discourage excessive recourse to it.

Following the phasing-in of RTGS, some changes in the within-day pattern of trading in the cash market became apparent. Traditionally, trading of cash had largely been completed by late morning each day. The convention was that overnight funds were called or renegotiated by 11.00 am each day; this led to concentration of trading around this time. With RTGS, however, banks have less certainty about their funding needs until later in the day and the period of heaviest trading seems to have moved to mid or late afternoon.

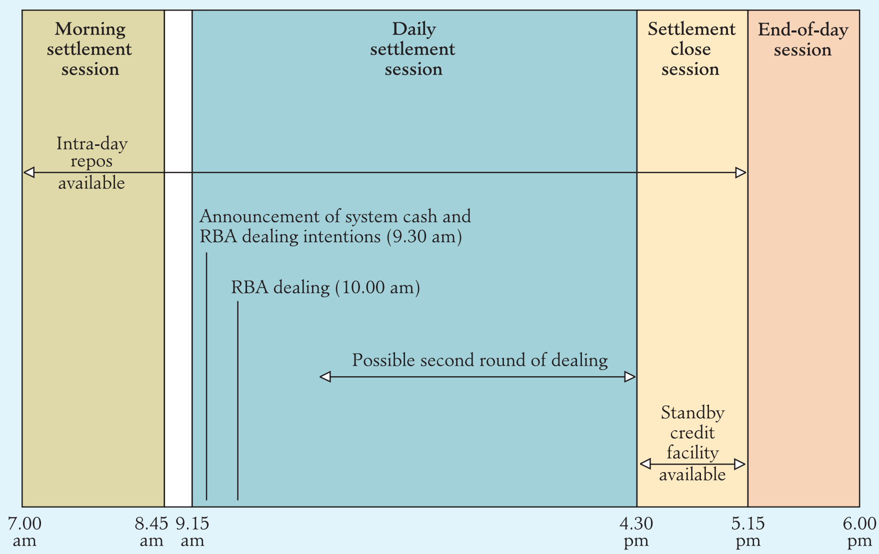
One result of this is that the market's traditional reading for the cash rate, which was based on trading for cash between 10.30 and 11.00 am each day, became less reliable as a guide to market conditions over the day. Among other problems, a reading was not consistently available at 11.00 am each day because the market was insufficiently active on some days to enable the relevant figure to be calculated. For this reason, late in June the Reserve Bank began collecting directly from banks data on the average daily interest rate paid or received on overnight funds in the interbank money market. This series is now published at the end of each day.

Reserve Bank Dealing Operations under RTGS

To promote system liquidity under RTGS, the Reserve Bank has augmented its traditional dealing arrangements. This main features of the new procedures are:

- An intra-day repurchase facility available throughout the day to provide liquidity at banks' discretion at no interest cost. The intra-day facility is available in the morning settlement session, prior to the time at which overnight paper-based transactions are settled, as well as throughout the day. Banks would typically enter an intra-day repo in anticipation of funds arriving from other sources later in the day to unwind the repo. Intra-day repos must be unwound by the end of the settlement close session at 5.15 pm.
- To promote liquidity in the financial system, the Reserve Bank makes the bulk of its payments, and those on behalf of the Commonwealth Government, to banks at the start of the morning settlement session.

The RTGS day

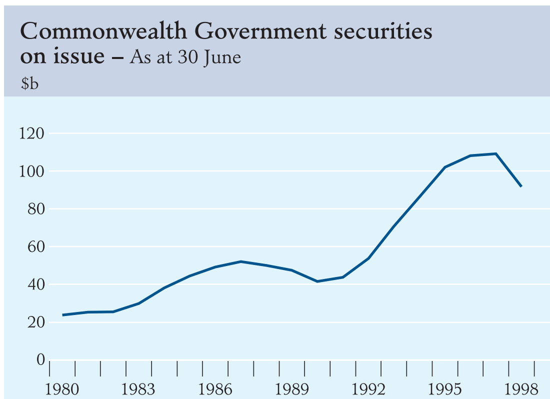


- The Reserve Bank continues to announce the system cash position and its dealing intentions at 9.30 am, early in the daily settlement session, which runs from 9.15 am to 4.30 pm. This dealing round follows the long-established procedures outlined in last year's Annual Report, with the dealing process completed by around 10.15 am.

- Since estimates of system liquidity are likely to be subject to greater forecasting error under RTGS and demand for funds might be more volatile than previously, the Reserve Bank is prepared to undertake a second round of dealing for liquidity management purposes, when cash market conditions are unexpectedly tight or easy. A second round can take place at any time during the day, but is usually conducted before 3.00 pm.
- Apart from the overnight paper-based claims discussed above, banks now finalise their settlement obligations in the settlement close session, between 4.30 pm and 5.15 pm (5.45 pm on Fridays). A bank which is short of ES funds at the end of this session has access to an overnight repo facility, at a penalty rate 25 basis points above the cash rate target. This facility is designed as a safety-valve to ensure end-of-day settlement can be completed by banks at a cost of funds near the cash rate target.

Responses to diminishing supply of CGS

While RTGS was the major force for change in dealing arrangements, the contraction in the supply of CGS, stemming from the Commonwealth's (headline) budget surplus, also had an impact. Over the year, the stock of CGS on issue fell from \$109 billion to about \$92 billion.



In June 1997, in anticipation of this fall, the range of securities which the Reserve Bank was prepared to accept as collateral for repurchase agreements was expanded to include Australian dollar securities issued by the central borrowing authorities of State and Territory governments, as long as they were lodged in the main trading system for these securities, Austraclear. In response to this change, about 30 per cent of the Bank's repurchase transactions were based on securities issued by State and Territory governments in 1997/98, about the proportion that might be expected given the respective amounts of CGS and State government securities on issue.

The Prime Assets Requirement (PAR) for banks was also reduced in June 1997, from 6 per cent of banks' liabilities to 3 per cent and, consistent with their eligibility for repurchase agreements with the Reserve Bank, State government securities also became eligible PAR assets. As the bulk of assets held by banks to meet the PAR ratio had been CGS, the reduction in this ratio, and inclusion of State government securities in its calculation, allowed banks to reduce their holdings of CGS. This freed up the amount of these securities available for trading in the market. As noted in “Surveillance of the Financial System”, in April 1998 the Reserve Bank announced that PAR would be abolished once banks were able to satisfy it (and APRA after 1 July) of the adequacy of their liquidity management policies.

Notwithstanding these changes, there were times during the year when the Reserve Bank’s operations in domestic securities needed to be supplemented by transactions in foreign exchange swaps, in order to maintain desired cash market conditions. As explained in previous Annual Reports, foreign exchange swaps can be used in domestic liquidity management in much the same way as repurchase agreements. The difference is that, rather than exchanging cash for government securities, a foreign exchange swap involves the exchange of cash for foreign exchange. Use of swaps was mostly towards the end of the financial year, as the market increased its demand for liquidity in preparation for the introduction of RTGS, and following the sizeable foreign exchange intervention in June, which led to a substantial withdrawal of liquidity from the market as banks paid to the Reserve Bank the Australian dollars that it had purchased.

The value of foreign exchange swap transactions in 1997/98 was much the same as in earlier years, and remained small relative to the Bank’s transactions in government securities, with turnover of $33 billion compared with turnover in government securities of $309 billion (see table). Swaps outstanding fluctuated during the year. From $2.7 billion at the start of the financial year, they rose to $6.3 billion in January before falling to a low of $2.1 billion in April and then rising again to $7.9 billion by June.

Market operations for liquidity management purposes*

($ billion)

	1995/96	1996/97	1997/98
Repurchase agreements**			
– Purchases	74	201	275
– Sales	14	9	8
Short-term CGS			
– Purchases	25	23	26
– Sales	2	1	–
Total domestic operations	115	234	309
Foreign exchange swaps**			
– Purchases	43	29	31
– Sales	1	6	2

* Market value of transactions

** First leg of transaction

The net amount of securities held by the Reserve Bank under repurchase agreements rose by $3 billion in 1997/98 to $9 billion at end June, though some of this increase was unwound in July. While the repo book was large by historical standards, the daily rolling-over of maturing repos was a smooth process, partly because of the depth of the repo market. Another factor was that the average term of the repo book was lengthened from two days at the end of the previous financial year to about 14 days by mid 1998. This kept the amount of repos maturing each day to a manageable level, thereby containing pressures in the cash market.

Looking ahead, it seems likely that reliance on repurchase agreements backed by domestic securities will inevitably diminish, as the supply of such securities falls, notwithstanding the Government's commitment to sustaining a degree of liquidity in the Commonwealth bond market. It is possible that there will be greater routine reliance on foreign exchange swaps in the Reserve Bank's liquidity management operations, as occurs in a number of European countries.

Debt repurchases for the Commonwealth Government

As well as operations associated with implementation of monetary policy, the Reserve Bank operates in domestic markets as agent for the Commonwealth Government for debt management purposes and to enhance the liquidity of the bond market. This includes the conduct of tenders on behalf of the Commonwealth for the primary issue of securities and the associated settlement and registry systems. In addition, in 1997/98 the Bank purchased from the market a large volume of stock on behalf of the Commonwealth. This purchase was necessary in order to facilitate the process whereby a budget surplus is used to reduce the level of public debt outstanding.

Total purchases by the Commonwealth amounted to $8.0 billion (face value). Apart from $0.9 billion bought directly from the Reserve Bank's portfolio, bonds were purchased from the market by the Bank and on-sold to the Commonwealth. These purchases included $4.4 billion of stock due to mature in 1998/99 and $2.7 billion of longer-term stock.

The Bank also facilitated the early retirement of $7.1 billion of Commonwealth debt due to mature within the financial year. This involved purchasing such stock in the market in the months leading up to maturity dates, and on-selling to the Commonwealth. The advantage of this for the Commonwealth was that it helped to smooth the pressures on its cash balances which would otherwise have occurred if all the stock had been redeemed on maturity date. Each line of stock maturing tends to be large (around $4–5 billion), reflecting the concentration of issues into a few benchmark lines so as to promote market liquidity.

The Domestic Markets dealing room bought $7 billion of Commonwealth bonds from the market in 1997/98, as part of the Government's debt reduction program.

Stock lending

The Reserve Bank is prepared to lend stock from its large domestic bond portfolio to enhance market liquidity. In doing so, the Bank earns an incremental return for accepting limited risk. Stock lending has no implications for the amount of liquid funds in the banking system since, in effect, such stock is exchanged for other stock, not for cash. The scale of stock lending in recent years is shown in the table below.

Stock lending by the RBA

	Number of transactions	Amount lent (face value, $ billion)	Income ($ million)
1994/95	350	12.1	0.6
1995/96	485	16.9	0.7
1996/97	540	11.9	0.7
1997/98	935	16.7	1.1

Over the financial year, around $17 billion of stock was lent to the market, compared with $12 billion the previous year. Around three-quarters of this were lines of stocks included in the 10-year futures basket for the contract traded on the Sydney Futures Exchange. In coming years, as the amount of CGS on issue declines, stock shortages are likely to occur more often. Accordingly, the stock-lending facility might become more important for lubricating the market.

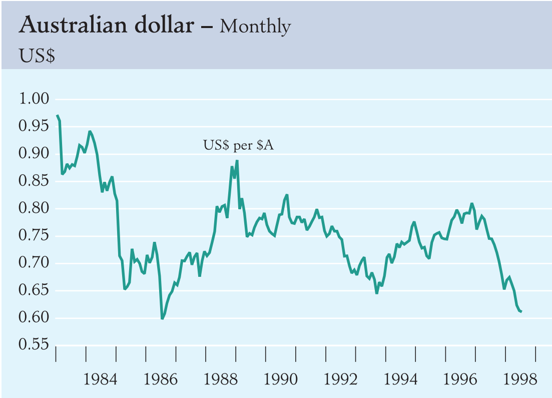
In its stock lending, the Reserve Bank responds to market approaches. To ensure that borrowers of stock exhaust market opportunities before approaching the Bank, policies in relation to this facility were revised in 1997/98 so that its pricing better reflected market conditions, and included a penalty element to discourage early use of the facility. The Bank also aims to ensure that borrowed stock is reasonably dispersed through the market.

Foreign Exchange Intervention

Australia operates a floating exchange rate regime, which means that the exchange rate is determined by the balance of demand and supply in the market for the Australian dollar. The broad factors which influence demand and supply, such as economic and financial conditions in Australia and abroad and the setting of monetary policy relative to that abroad, are well known. But, as is the case in foreign exchange markets in all countries, the way in which the various forces interact at any given point in time is far from being completely understood, so the markets (or the authorities) are rarely ever confident about what is the appropriate level of the exchange rate. On some occasions – fortunately not common – the absence of strongly held beliefs about fair value for the exchange rate means that market participants base their trading on the extrapolation of recent trends or on their assessment of other participants' views, both of which can lead to overshooting.

Foreign exchange intervention can play a useful role at such times in restoring a sense of two-way risk and thereby lessening the momentum which might otherwise result in overshooting. Intervention over the post-float period has generally been of this nature. The Reserve Bank does not intervene to prevent adjustment of the exchange rate; intervention typically takes place only after the exchange rate has already appreciated or depreciated significantly. In that sense, the aim has been a modest one: to limit the size of the movement once a substantial adjustment has already occurred, i.e. to trim the peaks and troughs. The Reserve Bank believes that in the long run it is the effective operation of monetary policy which determines the level of the exchange rate, and that it would be futile in the absence of sound monetary policy to use intervention to pursue a particular level for the exchange rate.

The Reserve Bank remains strongly of the view that the floating exchange rate regime has served Australia very well over the 15 years since its introduction and, given the large fluctuations in our terms of trade, remains much more suited to the Australian economy than any other exchange rate arrangement. Over this

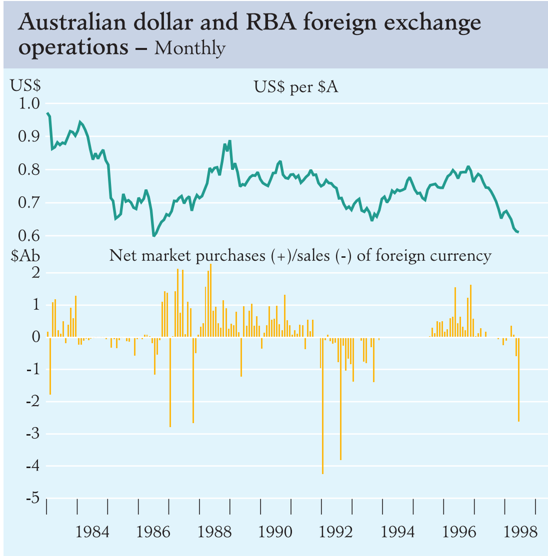


period, the exchange rate against the US dollar generally traded in the range of US60 cents to US80 cents (see graph). Two complete cycles were experienced between the mid 1980s and mid 1990s, and over the past year a third cycle has been in process, as the exchange rate moved down towards US60 cents.

As outlined in the May 1998 *Semi-Annual Statement on Monetary Policy*, the Reserve Bank has accepted that a significant depreciation of the Australian dollar in 1997/98 was appropriate as a response to developments in Asia, and through most of this period it did not seek to exert any influence; until June 1998, intervention in the market was relatively minor and brief. In June, however, larger-scale intervention was undertaken. Speculative selling by large international funds managers was clearly evident and natural buyers of the Australian dollar, such as exporters, whose transactions normally are linked closely to trade flows, began to trade speculatively, turning earlier purchases made at higher rates back into the market. Judging a potential for further instability, and recognising that there had already been a large adjustment in the exchange rate, the Bank felt that there was a case for it to be on the other side of the market. It bought a considerable amount of Australian dollars ($2.6 billion) at levels between US62 cents and US60 cents, though taking care to avoid drawing "lines in the sand".

It is important to recognise that when it intervenes in the foreign exchange market the Reserve Bank simply exchanges one currency asset for another; for example, in June 1998 the Bank sold US dollar assets and purchased Australian dollar assets. Intervention does not change the size of the Bank's balance sheet and does not involve "spending" money, even though it is often described in this way in the popular media. Because intervention by the Reserve Bank throughout the post-float period has followed the pattern of buying foreign currency when it is cheap (i.e. when the Australian dollar is high) and selling it when it is expensive (when the Australian dollar is low), it has yielded significant profits.

The recent intervention continued this pattern, in that the sales of foreign exchange reversed some of the substantial purchases made over late 1996/early 1997 when the exchange rate of the Australian dollar was high. As such, in contrast to some popular claims that, by intervening, the Reserve Bank was handing easy profits to speculators, it was in fact realising substantial profits on earlier purchases of foreign currency. Some of these were reflected in 1997/98 earnings available for distribution and some will be reflected in the coming year when the foreign currency that was sold is delivered. The relationship between intervention and the Bank's profits is explained in more detail in a Research Discussion Paper, entitled *Reserve Bank Operations in the Foreign Exchange Market: Effectiveness and Profitability*, issued in 1994.



In addition to its market sales of foreign exchange, the Reserve Bank undertakes purchases and sales of foreign exchange with the Commonwealth Government to meet its requirements for foreign exchange. These transactions are carried out at market prices. In 1997/98, the Bank bought $1.4 billion in foreign exchange from the Government and sold $4.4 billion to it; net sales were $3.0 billion. These amounts were in line with the Commonwealth's average net purchases and sales in recent years.

RBA foreign exchange transactions

($ billion)

	Transactions							
	With market	With Government	Other (including swaps)	Net transactions	Valuation changes	Net change in Official Reserve Assets	Level of Official Reserve Assets	RBA outstanding foreign exchange swaps
1990/91	4.7	-4.6	1.4	1.4	0.7	2.1	24.0	0.3
1991/92	-4.3	-2.8	3.2	-3.9	2.1	-1.8	22.2	-2.0
1992/93	-10.3	-2.2	8.6	-4.0	2.5	-1.4	20.8	-8.4
1993/94	-2.2	0.5	2.7	1.1	-1.2	-0.1	20.7	-10.8
1994/95	–	-0.7	-1.3	-2.0	1.5	-0.5	20.2	-8.8
1995/96	5.6	-4.9	0.1	0.8	-1.9	-1.1	19.1	-5.4
1996/97	5.2	-1.0	-0.8	3.4	0.3	3.7	22.8	-2.7
1997/98	-3.2	-3.0	6.1	–	2.7	2.6	25.4	-7.9

The net effect of all foreign exchange transactions under-taken by the Reserve Bank in 1997/98 – including market intervention, net sales to the Commonwealth

Government, interest earnings and swaps – was to leave gross holdings of Official Reserve Assets broadly unchanged. Valuation effects added $2.7 billion to reserves during the year. As a result, the overall value of foreign reserves rose by $2.6 billion over the year to $25.4 billion. Net reserves, after deducting swaps outstanding, fell by $2.6 billion to $17.6 billion.

Management of Foreign Reserves

The foreign currency reserves held by the Reserve Bank to provide the wherewithal for intervention in the foreign exchange market need to be carefully managed to ensure that their liquidity, risk and return characteristics are maintained in line with the Bank's objectives. Investments need to be highly liquid, so that they can be made available quickly for intervention purposes when necessary, and need to carry minimal credit risk. Essentially, this means that the bulk of the assets are securities issued by the national governments of the United States, Germany and Japan and deposits with highly rated banks.

In contrast to its role in domestic markets, the Reserve Bank has no special status in markets abroad, and it is therefore able to act like other investors in managing its foreign reserves portfolio, though it is always careful to ensure that its management decisions are consistent with stability in the markets where it is investing.

In view of its objectives, and taking account of past patterns of risk and return in the different markets, the Reserve Bank has judged that its optimal portfolio of foreign assets over the long run is 40 per cent US dollars, 30 per cent yen and 30 per cent Deutsche Marks. Similarly, the optimal duration of assets in each of these portfolios over the long run is determined to be 30 months. These portfolio characteristics are incorporated in a benchmark against which investment decisions are measured.

Composition of benchmark portfolio

	United States	Japan	Germany
Asset allocation (%)	40	30	30
Currency allocation (%)	40	30	30
Duration (months)	30	30	30

The investment climate in 1997/98 was difficult, particularly because of the behaviour of Japanese financial markets. Bond yields in Japan began the year at levels which were already very low by any historical standard. The yield on the benchmark 10-year bond, for instance, was 2.3 per cent at the start of the financial year, at that stage the lowest yield ever reached in Japan and not much above the lows recorded by US bonds in the 1930s depression.

These low running yields, and the risk of large capital losses if bond yields were to rise to more normal levels, had already induced the Reserve Bank to reduce its holdings of long-term bonds, with the result that the duration of its Japanese portfolio was significantly below that of the benchmark. In the event, yields continued to move down, at one stage reaching 1.125 per cent, equalling the lowest recorded by historians (in Genoa in 1619). This meant that the return on Japanese assets underperformed the benchmark, as the short duration limited capital gains when yields fell. Despite this, the Bank remained of the view that the risk/return associated with long-term Japanese bonds did not justify benchmark holdings; duration was kept short of the benchmark and the amount of the portfolio invested in Japanese assets was reduced, with the funds placed in US and German securities, which had higher yields and yet were viewed as having no greater risk of capital losses.

Over the year as a whole, the short duration position meant that the return on the Japanese portfolio, 1.26 per cent, was well below the benchmark return of 3.31 per cent; in dollar terms, this underperformance was equivalent to about $120 million.

Returns in the US and German portfolios exceeded benchmark, by small margins in both cases. In the US portfolio, the return was 7.86 per cent, compared with a benchmark return of 7.70 per cent, while in the German portfolio the return was 5.72 per cent, against a benchmark return of 5.70 per cent. In the US portfolio, this outperformance was equivalent to about $10 million, and in Germany to about $2 million.

Asset and currency allocation decisions contributed about $90 million to portfolio performance relative to benchmark, due mainly to the decision to reduce the allocation to Japan below benchmark, and correspondingly to increase the allocation to the United States and Germany.

Overall, the total return on the foreign exchange component of Official Reserve Assets, measured in a common currency (SDRs), was 4.47 per cent. This was 10 basis points below the return on the benchmark portfolio (see table). The additional returns from asset and currency allocation decisions were not sufficient to offset the below-benchmark returns on Japanese investments.

Actual and benchmark returns in 1997/98

(Per cent)

	Actual	Benchmark
US (in US$)	7.86	7.70
Germany (in DM)	5.72	5.70
Japan (in ¥)	1.26	3.31
Total foreign currency (in SDRs)	4.47	4.57

The Reserve Bank's approach to active reserves management is designed to enhance returns over a long period, and does not guarantee that actual returns will exceed benchmark returns in every year. Since the Bank began measuring performance against a benchmark in 1991/92, returns have exceeded benchmark in five years and have been less than benchmark in the remaining two years; returns have also exceeded benchmark over the seven years taken together (see table).

Actual and benchmark returns: aggregate foreign currency portfolio

	Rates of return in SDRs (per cent)		Value of difference between actual and benchmark returns ($ million)
	Actual	Benchmark	
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

In the case of gold, the Reserve Bank continued its practice of lending part of its holdings to market participants. Over the past year, the bulk of the Bank's holdings of 80 tonnes was on loan. Interest earned through this activity amounted to $21 million in 1997/98, a return of a little under 2 per cent. Nonetheless, the overall return on gold, taking into account changes in its price as well as interest on gold loans, was minus 5.4 per cent, measured in SDRs. This was well below the return on foreign currency assets. As a result, the decision taken last year to reduce gold holdings, and reinvest the proceeds in foreign currency assets, meant that earnings on the Bank's overall portfolio of gold and foreign exchange in 1997/98 were about $280 million higher than if gold holdings had remained at their earlier level. The cumulative gains, taking into account the additional returns made in the previous year, are about $390 million.

In the coming year, the Reserve Bank – like all other international investors – will have to review its European investment policies in the light of progress towards European Monetary Union (EMU). At present the Bank invests only in bonds issued by the German federal government, but with 11 countries now having committed to joining EMU, there will be scope to expand investments to include other highly rated and liquid bonds.

The Impact of Market Operations on the Balance Sheet

The Reserve Bank's balance sheet contracted by $3.6 billion (7 per cent) in 1997/98, reversing the run-up that occurred in the previous year when a number of special factors gave the balance sheet a temporary boost. As noted in last year's Annual Report, in 1996/97 there was a sharp rise in Government deposits and deposits held by banks in ES accounts. The former were bolstered by a special dividend payment by Telstra, ahead of its partial privatisation, while banks' holdings of ES funds temporarily reached high levels in June 1997, for reasons explained earlier in this Report.

On the assets side of the balance sheet, these swings were reflected mainly in holdings of domestic securities. After a rise of $9.3 billion in 1996/97, holdings of these securities fell by $4.4 billion in the latest year. This reflected market operations to neutralise the liquidity impact of swings in Government deposits and ES funds. Within the total, Treasury note holdings were reduced by $0.5 billion through sales and maturities; holdings of Treasury bonds were reduced by $6.9 billion, again through maturities and outright sales. Holdings of securities under repurchase agreements, in contrast, rose by $3.0 billion.

Holdings of gold and foreign exchange rose by $2.1 billion. As noted above, sales for currency intervention purposes were more than offset by swaps undertaken for liquidity management, interest received and valuation effects.

Change in RBA balance sheet 1997/98

($ billion)

Notes on issue	1.6	Domestic securities		
Government deposits	-4.4	– Treasury notes	-0.5	
Deposits of other clients	0.1	– Treasury bonds	-6.9	
ES accounts	-4.2	– Repos	3.0	-4.4
Non-Callable Deposits	0.3	Gold and foreign exchange		2.1
Other liabilities		Other assets		-1.3
(mainly capital and reserves)	3.0			
Total	-3.6	Total		-3.6

Customer Services

The Reserve Bank provides a range of services to customers – banking services for governments, registry services for the Commonwealth and some State government and overseas agencies, electronic settlement facilities for CGS and other transactions using the Reserve Bank Information and Transfer System (RITS), and a bulk currency note-issue facility. All of these activities have recently been reviewed to ensure their operations are efficient and conform to the principles of competitive neutrality. A part of the note-issue function, the specialised currency-distribution service to individual bank branches in metropolitan areas, which had been in operation for more than 30 years, was terminated in mid July 1998. As noted earlier in this Report, the real-time gross settlement (RTGS) system became fully operational on 22 June 1998; the newly formed Payments Settlements Department manages and operates this system.

The expansion of electronic processing of banking and securities transactions, the reorganisation of cash processing and distribution, and the centralisation of functions to improve efficiency have had a substantial impact on the Reserve Bank's branches. Because the amount of remaining business conducted in the Northern Territory had shrunk to a very low level, it was no longer viable to maintain even a very small branch and the Bank closed its Darwin branch on 31 October 1997. Later, as a result of the loss of the Tasmanian Government banking business and the reorganisation of the cash-distribution operations, it was decided to close the Bank's Hobart branch in the second half of 1998 for the same reason.

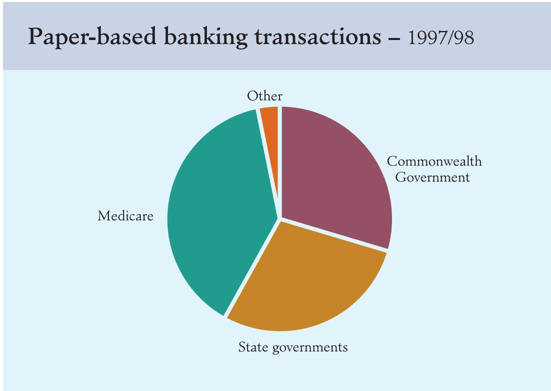
Some of the services provided by the Reserve Bank to customers are contestable, i.e. they can also be provided by private-sector organisations. Other services, such as RTGS and note issue, are core, non-contestable central banking functions. Provision of contestable services by the Reserve Bank is organised on a business-unit basis to facilitate transparency and accountability; each business unit aims for full cost recovery and an appropriate return on capital.

In 1997/98, revenues from contestable activities were $43.1 million, compared with costs of $36.8 million. The latter include direct and indirect costs, commercially based rents and fully allocated overheads in line with competitive neutrality principles.

Banking

During the year, the Reserve Bank continued to seek improvements in its banking operations in order to upgrade the quality of services provided to customers and to improve the profitability of the business.

During 1997/98, outsourcing of cheque-processing operations was commenced, with the Commonwealth Bank of Australia (CBA) being selected as the external service provider. The need to re-equip all branches with new cheque-processing equipment, combined with the likelihood of a further contraction in the volume of its cheque processing, led the Reserve Bank to outsource these operations in order to exploit the economies of scale offered by external providers. The first stage of the project has been implemented and, under agreed arrangements, cheques drawn on the Reserve Bank are now processed by the CBA, which electronically transmits cheque data to the Bank. Outsourcing of the remaining portion of the Reserve Bank's cheque-processing operations (cheques drawn on other financial institutions deposited by Reserve Bank customers) is expected to be completed late in 1998.



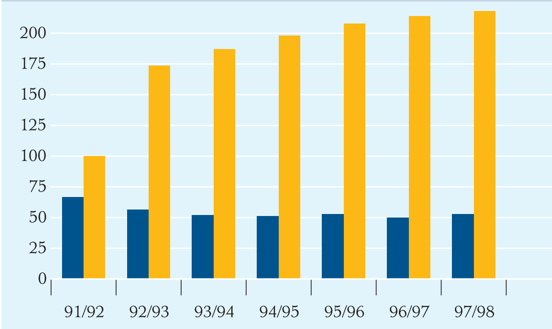
Another innovation was the development of a counter terminal system that provides customers receiving payments from the public with the ability to capture all receipts data needed for updating their systems, as well as all cheque and payment details required for banking purposes to enable same-day crediting to accounts. The system initially operated as a pilot with the Australian Taxation Office (ATO) and it was successfully implemented in the first ATO site in October 1997.

In conformity with competitive neutrality principles, it was agreed in discussions with the Commonwealth Treasury and Department of Finance and Administration (DoFA) that the core account-keeping function, involving the conduct of the Commonwealth Public Account (CPA) and associated major accounts, is a non-contestable area of the banking business. The major cash flows to and from the Government pass through these accounts. It is important for the implementation of monetary policy and for the smooth operation of RTGS that this account-keeping function, which involves handling the Commonwealth's cash balances, remains with the Reserve Bank. To make this clear in operational terms, it is intended in 1998/99 to restructure the banking business to separate the core account-keeping functions associated with the CPA from the transactions-processing part of the banking business, which is one of the contestable services provided.

The Reserve Bank also has been working closely with the Accrual Budgeting Project Group established by DoFA to oversee and co-ordinate the

RBA's banking transaction volumes

Millions

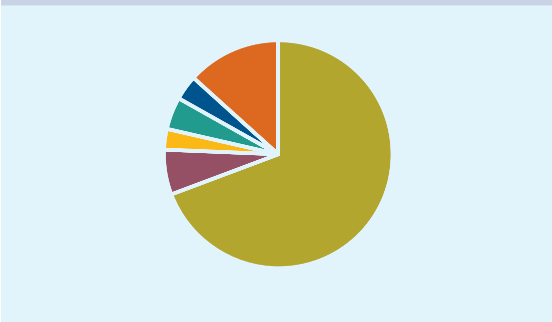


Paper Electronic

implementation of an accrual budgeting framework within the Commonwealth, and to devolve responsibility for banking arrangements to individual budget-sector agencies to replace the present largely centralised administration of banking arrangements. Involvement with the Accrual Budgeting Project Group has centred on providing advice on appropriate bank-account structures and information flows to meet agencies' management-information requirements; developing mechanisms to encourage best cash-management practices; and ensuring that management of cash balances and cash-flow forecasting facilitate the Commonwealth's debt management objectives and the Bank's liquidity management responsibilities.

Banking business volumes increased further in 1997/98. Electronic transactions processed through the Reserve Bank's Government Direct Entry System (GDES) increased by around 2 per cent to 218 million. GDES receives payments data from various customers and subsequently electronically distributes the payments to a wide range of financial institutions. Reflecting the continuing devolution of banking responsibilities to individual State government agencies, the number of customers using ReserveLink, the Bank's PC-based banking package, continued to grow during 1997/98, rising from 278 at end June 1997 to 338 a year later.

Electronic banking transactions – 1997/98



Centrelink*

Department of Veterans' Affairs

Department of Finance

Department of Employment, Education, Training and Youth Affairs

State governments

Other

* Service delivery agency on behalf of the Department of Social Security and part of the Department of Employment, Education, Training and Youth Affairs.

Net earnings from the government banking business rose from $2.8 million in 1996/97 to $3.4 million in 1997/98. This increase reflected cost reductions achieved from restructuring the business as well as higher fee income.

Government banking: net earnings
(1997/98, $ million)

Total revenues	35.5
Total costs	32.1
Net earnings	3.4

Registry and Settlement Services

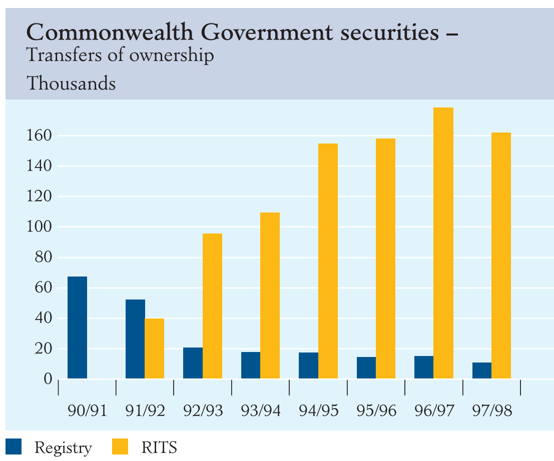
Through its branch network, the Reserve Bank provides registry services on behalf of the Commonwealth Government, the State government borrowing authorities of South Australia and Western Australia, and other domestic and foreign official organisations. These services include the issue, transfer and registration of securities, maintenance of ownership records, periodical payment of interest and the redemption of securities at maturity.

During 1997/98, activity levels continued to decline. The volume of processing undertaken by debt registries generally is in decline as a result of the growth in electronic settlement and contraction in the number of issuers, which increasingly have access to cheaper and more flexible funding in wholesale markets. In response to the contracting business environment and as part of the Reserve Bank's continued efforts to improve operational efficiencies and reduce costs, staffing needs were reviewed and this part of the business was restructured during the year. In achieving these efficiencies, however, the Bank was mindful of the need to retain its focus on quality of service.

Registry services: net earnings
(1997/98, $ million)

Total revenues	3.2
Total costs	2.4
Net earnings	0.8

Settlement services are based on RITS. This system, which allows members to settle their transactions in CGS electronically, handles about 95 per cent of turnover in the market and has $88 billion of securities lodged in it.



As well as the basic trade-settlement function, RITS also provides its 239 members with other facilities, including electronic tendering for CGS;

the automatic payment of interest and maturity proceeds for securities held in the system; provision for members to use securities in RITS to secure loans and settle transactions; a capacity to make high-value payments; and a facility for simultaneous settlement of interbank obligations arising from the settlement of equity transactions on CHESS, the Australian Stock Exchange's electronic settlement facility.

RITS: net earnings
(1997/98, $ million)

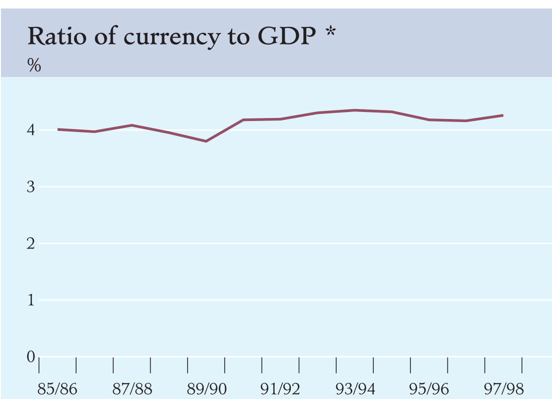
Total revenues	4.4
Total costs	2.3
Net earnings	2.1

As well as the services it provides for other participants in financial markets, the Reserve Bank also has settlement responsibilities arising from its own activities in the domestic securities and foreign exchange markets, and from the activities of its official customers domestically and abroad. These high-value transactions take place across SWIFT, RITS and Austraclear. The Bank also acts as collator of banks' obligations arising from the various settlement streams, advising them each morning of their net settlement positions. The consolidation of all settlement responsibilities in the Payments Settlements Department will lead to improved settlement efficiency and security by ensuring greater separation between the dealing areas of the Bank, where transactions are initiated, and the back-office settlement functions.

Note Issue

The Bank's note-issue activities embrace the storage and issue of new and reissuable notes; the processing of notes returned from circulation for quality-control purposes; and research into and development of note designs and security features.

Extended experience with polymer currency notes continues to confirm the superiority of polymer notes over the paper notes they replaced. It is now over two years since the final note in the new series of polymer notes was issued. For practical purposes, all Australian currency notes in active circulation are now polymer. The benefits of polymer arise from greater security and durability, and reduced machine maintenance and processing requirements.



* GDP for 1997/98 is an estimate; currency includes notes and coin.

Note processing and distribution

Despite the strong growth in electronic payments media, such as EFTPOS and direct entry, the public's demand for currency notes has grown broadly in line with the economy over recent years. During 1997/98, the value of notes issued by the Reserve Bank rose by 7.9 per cent, which was well up from the previous few years. Use of $50 and $100 notes grew strongly; these two denominations now account for about 87 per cent of the value of notes on issue. During the year, the Reserve Bank issued into circulation around $69 billion in currency notes and had $68 billion in notes returned for processing. Of the total notes processed, about 93 per cent were classified as fit for reissue, a percentage which has increased because of the durability and cleanliness of polymer notes. Around 1.4 billion used notes were processed through the Bank's high-speed note-processing machines.

Value of notes on issue

($ million)

At end June	$1	$2	$5	$10	$20	$50	$100	Total	Increase (per cent)
1993	42	70	297	591	1 813	6 284	7 269	16 367	7.8
1994	21	69	313	634	1 795	6 837	7 907	17 577	7.4
1995	20	49	332	614	1 848	7 193	8 482	18 538	5.5
1996	19	48	337	583	1 868	7 928	8 399	19 182	3.5
1997	19	47	351	601	1 837	8 912	8 297	20 064	4.6
1998	19	47	361	617	1 804	9 523	9 280	21 651	7.9

During the year, currency-note distribution and processing operations were reviewed and reorganised, and a number of significant productivity gains were achieved:

- The greater security and durability of polymer notes mean that they do not need to be checked as often for authenticity and wear and tear. In future, the Reserve Bank aims to achieve its objectives by processing notes in circulation on average twice each year, resulting in significant cost savings.
- The operational procedures in the cash services areas were streamlined, not only in relation to machine processing of notes, but also in the manner in which notes are returned to the Reserve Bank from the community and in handling and custodial arrangements within cash services areas.

- In mid July 1998, the Reserve Bank ceased the specialised currency-distribution service provided to some banks. Under this arrangement, currency notes were packed into bags which were distributed by armoured-car companies to individual bank branches in metropolitan areas. Surplus notes were returned to the Reserve Bank in a similar way. However, the Bank did not have a competitive advantage in this area and maintenance of the service had inhibited reform in the industry. The termination of this longstanding arrangement has provided the opportunity for all participants in the cash-handling business to seek to develop more efficient and cost effective currency-distribution methods. Following extensive industry consultations, new arrangements have been implemented, which involve the establishment of note pools whereby limited stocks of currency notes are held by the Reserve Bank at a number of armoured-car depots in capital cities. The changes now see the Bank operating solely as a wholesale supplier and receiver of currency notes.

In large part, these gains reflect the inherent advantages of the polymer substrate now used in the production of Australia's currency notes over the former paper-based technology. They also reflect changing business requirements and the continuing search for greater operational efficiency.

The benefits of polymer notes to the Reserve Bank, as issuer, are well established. Benefits to the wider community are now also being recognised, especially by those organisations involved in the increasingly important area of machine processing of notes using automatic teller machines (ATMs), note validators (which are used in change, ticketing and vending machines) and note-counting equipment. Feedback from these organisations indicates that polymer notes can be processed more efficiently than paper notes. This enables significant productivity gains and lower costs to be achieved. Polymer notes also remain cleaner than paper notes throughout their extended life, after which they can be recycled into other plastic products.

Prior to the first release of the $5 polymer note in 1992, there was considerable liaison with manufacturers of note-processing and accepting equipment; contact continued with extensive pre-release testing programs before the issue of each new polymer note. Throughout the conversion of the total Australian currency-note issue from paper to polymer, it became increasingly clear that polymer notes processed better in machines than their paper predecessors. These initial positive responses have now been confirmed by a recent survey with manufacturers and users of ATMs, note validators and note counters. The vast majority found that machines operated at least as efficiently (and in most cases, more efficiently) when processing polymer compared with paper notes.

Machine processing of notes – polymer versus paper

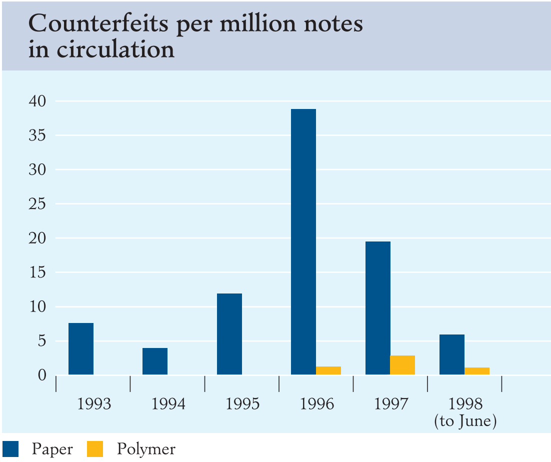
Response of equipment suppliers:	More efficient	As efficient	Less efficient
	Percentage of suppliers		
ATMs	47	53	0
Note validators	82	18	0
Note counters	44	25	31

Reasons suppliers consider polymer better:	Better quality	Deposit less ink/dirt	Create less dust	Feed & count better
	Percentage of suppliers			
	98	79	81	77

Average decline in servicing requirements for various types of equipment (per cent):	Machine jams	Service call-outs	Maintenance staff
	38	32	8

The characteristics of polymer notes mean that a significantly higher proportion of notes in circulation is suitable for efficient machine processing. There was substantial agreement among manufacturers and commercial users that the quality of the circulating polymer notes is currently higher than it was for paper notes, and that polymer notes are cleaner than paper notes, with less ink/dirt being deposited on sensors and less dust being created when processing. Moreover, the stiffer nature of the polymer substrate results in polymer notes feeding, counting and processing more easily throughout their life. Manufacturers and users also reported that these features have translated into significant declines in machine-servicing requirements, resulting in productivity gains and lower costs.

The many benefits of polymer notes are attracting attention from an increasing number of countries. The Reserve Bank, through both its joint venture, Securency Pty Limited, and its subsidiary, Note Printing Australia Limited, has committed significant resources to informing other countries of Australia's successful experience with the change from paper to polymer notes, and the Australian technology behind polymer notes.



Counterfeiting activity

Use of polymer notes in Australia instead of paper notes has seen a significant reduction in counterfeiting activity. In particular, the move to a polymer substrate appears virtually to have stopped the casual or "crime of opportunity" counterfeiter.

The big rise in counterfeiting in 1995 and 1996 was focused on the old paper notes series, mostly $50s and $100s. It reflected, among other things, easy access to colour copiers and scanning devices that required little technical skill to operate. Following the move to polymer for these denominations, counterfeits of the old paper series have fallen sharply.

Despite the Reserve Bank introducing the first polymer note of the new series in July 1992, counterfeits of the polymer note series did not surface until some four and a half years later, and then only in very small numbers. The first of these was a fairly crude version of the $50 polymer note. Initially, all counterfeits were produced on a paper substrate; in many instances, there was no clear window. Such counterfeits were easily detected, including by feel. More recently, a small number of $20 and $100 note counterfeits, which have been produced using a plastic substrate, have appeared. Despite having a reasonably good reproduction of the printed features, the counterfeits were again easily detected, as the thickness and feel were noticeably different from an authentic note; when crumpled, they made a distinctly different sound because of the different substrate being used; there was no embossing, or only a crude embossing, of the denomination in the clear window; and the transparent window lacked clarity.

The risk of counterfeiting is ever present and the Reserve Bank continues to conduct research and develop a new array of advanced features to improve even further the security of polymer notes.

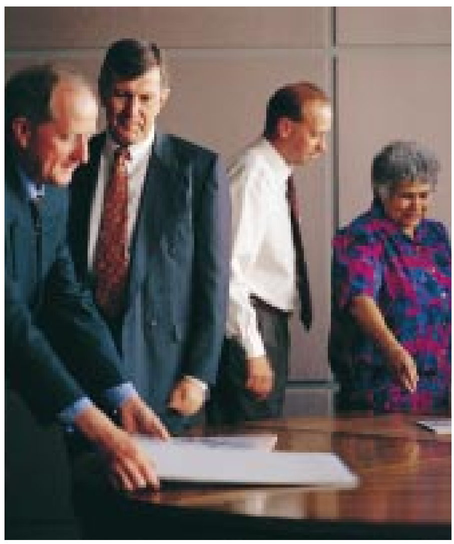
New note design

In conjunction with the celebration of the Centenary of Federation in January 2001, the Reserve Bank plans to issue a new note. To assist in developing the design of the note, the Bank formed an advisory committee of a number of prominent community representatives. The group consisted of Neville Bonner (former Federal Senator), Tim Bowden (journalist), Philip Cox (architect), Brian Fletcher (historian), John Hirst (historian), Janet Holmes à Court (businesswoman),

Janet Holmes à Court and Hugh Mackay discuss Federation note design concepts with Assistant Governor, Geoff Board.

Hugh Mackay (social commentator), Irene Moss (NSW Ombudsman), Lois O'Donoghue (former chairperson of ATSIC) and Tim Potts (arts administrator).

The committee recommended that the Reserve Bank issue a new $5 note featuring Sir Henry Parkes on the front and Catherine Helen Spence on the back. This approach was accepted and design work for a new $5 note, to be issued early in 2001, has commenced. The note is being designed by Garry Emery, one of Australia's leading graphic designers (and designer of Australia's current $20 note). Mr Emery was selected in a competition with several other leading designers.



At a meeting in Melbourne of the consultative committee on the Federation note design: Philip Cox and Lois O'Donoghue, with Geoff Board and David Reynolds.

Management of the Bank

Further adjustment to the Reserve Bank's structure and staffing occurred during the year, in response to changed responsibilities and the continued pursuit of efficiency gains.

Since 1990, the Reserve Bank has been organised into five major groups, each reflecting a key functional activity – economic analysis and research; operations in domestic and international financial markets; supervision of banks and the payments system; the provision of business and cash services; and internal corporate support services. This overall administrative framework continues to operate effectively, but important adjustments within two of the groups took place during the year, in part reflecting changes to the Bank's responsibilities in Australia's new structure of financial regulation.

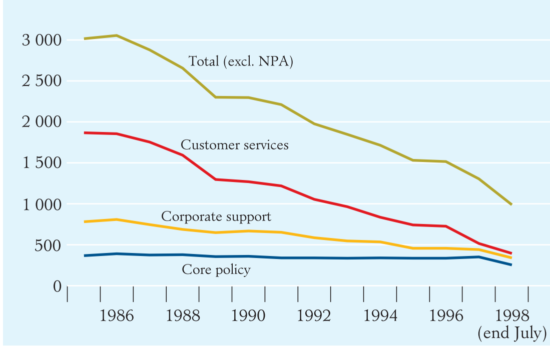
The most substantial change has involved the Financial Institutions Group. On 1 July 1998, Bank Supervision Department within this Group was abolished and most of its 65 staff assigned to APRA. In its place, a new and smaller System Stability Department has been created to support the Reserve Bank's role in protecting the stability of the financial system. At the same time, reflecting the Bank's enhanced powers in the payments system, the former Financial System Department was restructured and renamed Payments Policy Department. The net result of the various adjustments is a reshaped and refocused Financial System Group and a substantial reduction in the total number of staff involved in these respecified core policy functions.

Within the Business Services Group, as the full implementation of the RTGS system in June 1998 grew closer, a new Payments Settlements Department was created. The resulting small increase in staff numbers was, however, more than offset by reductions elsewhere in the Business Services Group: over 90 branch and Head Office staff in the Banking Department and Note Issue Department left the Reserve Bank during the year in terms of agreed redundancy arrangements; a further 130 staff are expected to depart before December 1998. Within these totals, the closure of Darwin branch last year and the closure of Hobart branch later this year will result in the loss of 26 staff.

Adjustment also occurred in some support areas of the Reserve Bank. Personnel Policy Department was reorganised into a smaller strategic unit of 17 (from 31 previously), reflecting contraction of the Bank, the outsourcing of some non-core functions, and devolution of day-to-day staffing decisions to departments. Early in the year, in-house Head Office catering arrangements were outsourced, following an assessment that they could be handled more efficiently by an external provider.

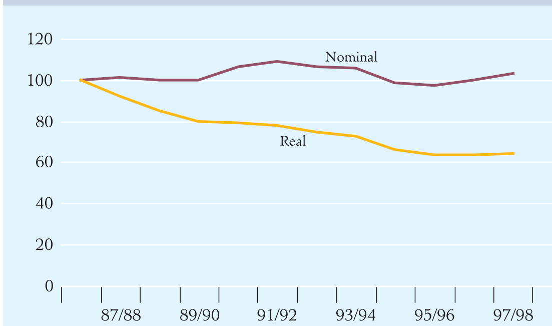
The overall outcome of these various adjustments was a fall of 212 in Reserve Bank staff numbers, excluding Note Printing Australia (NPA), over the year, and a 60 per cent decline in staffing over the past decade. Efforts to reduce costs and increase international competitiveness at NPA resulted in a reduction in staff numbers of 74 over the past year. At end July 1998, there were 987 staff employed by the Bank (excluding the recently corporatised NPA, which employed 183 staff at that date).

RBA staff numbers – As at 30 June



During 1997/98, the Governor, Deputy Governor and senior staff of the Bank received a 4.4 per cent increase in salary, the same rise paid to staff generally in April 1997 under productivity bargaining arrangements. Despite this increase, the reduction in staff numbers meant a significant fall in staff costs. This fall was matched by a rise in other costs, including those arising from the introduction of the Bank's agency-collection services (a significant proportion of which is associated with the management of the ATO's Billpay service); an increase in the volume of note substrate purchased; and payments for guards and cheque processing under outsourcing arrangements. However, these cost rises have been more than matched by increases in revenue or savings in staff costs: the costs of the agency-collection services are recovered from the Bank's customers; the costs for substrate were covered by sales abroad; and payments for guarding services and cheque processing were more than matched by the savings in staff costs made as a result of outsourcing. Overall, the Bank's underlying operating costs (excluding redundancies and certain other one-off items) rose modestly in 1997/98 but remained below their peak in 1991/92. In real terms, of course, costs have fallen significantly since their peak.

'Underlying' operating costs
Index



Operating costs

($ million)

	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Staff costs#	112.3	111.7	108.0	106.6	111.9	93.8
Other costs*	68.7	67.7	59.6	58.8	58.0	81.4
Underlying operating costs	181.0	179.4	167.6	165.4	169.9	175.2
Cost of redundancies	2.7	9.8	18.1	1.3	12.9	29.7

\# Excludes redundancies and, from 1994/95, additional charges to comply with new accounting standard AAS30

* Includes premises and equipment (including depreciation), but excludes IMF Maintenance of Value payment

The share of operating costs absorbed by commercial activities and note production increased in 1997/98, reversing a trend seen in earlier years for core functions (mainly monetary policy, financial system surveillance and note issue) to account for a higher proportion of costs. This was due to increases in non-staff costs mentioned above, i.e. mainly those associated with the agency-collection services and higher payments for substrate. The fall in the share of costs associated with note distribution reflected net savings flowing from the outsourcing of guarding services.

Distribution of operating costs

(Per cent)

	Monetary policy	Financial system surveillance	Note distribution	Note production	Banking, registry and settlement
1996/97	23	11	22	22	22
1997/98	21	10	15	28	26

Measuring the output of a central bank is very difficult. However, the indicators in the accompanying table suggest, despite lower staff numbers, that the Reserve Bank has been able to handle substantially increased volumes in a number of activities.

Indicators of output

(Percentage change, 1990/91 – 1997/98)

Banking and registries	
Banking transactions (including GDES)	280
Bank accounts maintained	75
Registry transactions (including RITS)	330
Transactions in domestic and foreign markets	
Domestic market operations	320
Foreign exchange transactions	150
Transactions in foreign government securities	375
Published economic and policy commentary	135

Improved efficiency has been complemented by a number of corporate human-resource initiatives taken during the past year. A new Equal Employment Opportunity (EEO) Plan was launched to cover the period to June 1999, the fifth in a series of such plans developed since the mid 1980s, details of which are contained in a separate EEO Annual Report tabled in the Australian Parliament each year. Support for the employment of trainees under the Government's Modern Australian Apprenticeship and Traineeship Scheme has continued, and work experience has been provided to a number of students. In June the Reserve Bank's licence to self-insure its workers' compensation claims was renewed by the Safety Rehabilitation and Compensation Commission for a further three years. The number of new claims fell during the year, although the overall costs of active claims were a little higher than last year. Self-insurance costs continued to be lower than those associated with Comcare.

The Reserve Bank continues to encourage staff to invest in further development. Demand for internal training, through formal courses or the Bank's self-paced learning centre, remained at a high level during the year, with over 1 100 person hours of participation by staff. With Reserve Bank financial support, four staff are at present studying full-time at universities abroad under the Bank's Post-Graduate Study Award scheme and a further 146 are involved in part-time tertiary study in Australia.

Year 2000 Problem

The Reserve Bank began working on the Year 2000 problem in 1996. During 1997, a formal project was established and a set of milestones agreed. Since then work on the Year 2000 issue has proceeded in line with the targets. The Year 2000 project is controlled by a Steering Committee which reports to the Governor. The Steering Committee is chaired by the Assistant Governor (Corporate Services), with all business areas reporting directly to the Committee on progress relating to applications in their areas.

The Audit Department is reviewing the project, identifying risks and exposures and providing an independent check on reported progress and resolution of issues. The project is also reviewed by the Australian National Audit Office.

The Reserve Bank operates a range of core applications for banking and business services, policy support and administration. These applications include some 30 mainframe systems employing around 4.5 million lines of code, 10 mid-range systems and more than 50 000 departmental applications (such as spreadsheets) developed in a standard set of PC products.

In the course of the Year 2000 project, more than 1 000 PCs and 300 telecommunications and system software components had to be checked throughout the Reserve Bank's Australian and overseas offices. Property-related systems, such as lifts and air-conditioning, along with security systems and key suppliers, also needed to be assessed and monitored for Year 2000 compliance.

Project milestones

Milestone	Target completion date
Inventory (compiling a list of all software and hardware items, vendors, service providers, suppliers, etc.)	November 1997
Assessment (identifying all dates within these items and determining the scope of potential problems)	March 1998
Remediation (modifying in-house software to be Year 2000 compliant, and purchasing compliant releases of proprietary software and hardware as necessary)	September 1998
Testing (exhaustive compliance testing using special testing environments to avoid interruptions to current operations; proprietary products claimed to be compliant by vendors will also require testing)	December 1998
Implementation (migration of converted and tested in-house software into the Reserve Bank's production environment)	January 1999
Sign-off (each Group or Department providing a statement of compliance for systems, equipment and services under their control)	March 1999
Contingency Planning (developing formal contingency plans to ensure continued operation of critical systems and services during the century roll-over period, particularly where the Reserve Bank's systems interface with external parties)	September 1999

The inventory phase of the project is complete, and the assessment phase is complete for all core processes. Assessment of some low-risk processes will be completed in conjunction with remediation. The remediation phase is now well under way. In fact, it is judged that as at end July 1998 remediation was over 60 per cent complete for core processes.

The Reserve Bank is participating in an interbank working group on Year 2000 issues, which, together with the Australian Payments Clearing Association, is co-ordinating a program of testing of each of the major payment streams. The Bank will participate in these tests, which are expected to begin in October 1998.

Although a good deal of work remains to be done, the Reserve Bank has a high degree of confidence that the objectives of its project will be achieved.

Costs

The total cost for work in the Reserve Bank related to resolution of the Year 2000 problem will be approximately $5 million, the bulk of which is for existing staff redeployed from other activities. During the term of the Year 2000 project, the Bank will have upgraded its mainframe operating environment and extensively overhauled its networks at a cost of around $1.5 million. While these new systems are necessary to ensure the Bank will be Year 2000 compliant, it is probable that they would have been needed even in the absence of the Year 2000 problem, albeit at a later date in some cases.

The Reserve Bank in the Community

An important part of the Reserve Bank's responsibilities is to explain its policies and actions to the public. Good communication is a central element of effective monetary policy, where the credibility and predictability of the policy framework are important elements in achieving goals. More generally, there needs to be broad community acceptance of the Bank's approach to its task.

Journalists are now given advance access to the Reserve Bank's published quarterly economic commentary in a "lock-up".

For monetary policy, the increasing independence of the Reserve Bank in recent years has brought with it a need for much greater accountability, the centre-piece of which is effective communication and dialogue with the public. The formal element of this is the biannual appearances by the Governor before the House of Representatives Standing Committee on Financial Institutions and Public Administration. Coinciding with each of these appearances, the Reserve Bank publishes its *Semi-Annual Statement on Monetary Policy*, reviewing economic and financial developments over the previous six months and giving the Bank's view on the outlook for inflation. These appearances receive widespread media attention, focusing not only on the Governor's prepared statement and detailed report, but also on the extended question-and-answer session. They also provide an opportunity for the Bank to hear the views and priorities of the Members of Parliament who are on the Committee.

This formal framework is supplemented by two regular articles on current economic developments, so that the Reserve Bank reports on its assessment of the economy each quarter. In addition to this regular reporting framework, *ad hoc* speeches by the Governor and senior officers provide the opportunity to keep the public up-to-date with the Bank's thinking.

While monetary policy is inevitably the dominant theme of the Reserve Bank's dialogue with the public, the full range of the Bank's activities has been represented in speeches by senior officials. These are supplemented by articles in the *Bulletin* covering, over the past year, changes to the banking and regulatory framework, the financial markets and various topics in banking and finance.

Links with the academic and educational community are encouraged as they provide both the opportunity to contribute to the academic debate and allow the Reserve Bank to tap into the latest academic thinking. The Bank's tenth annual economic conference was held in June 1998, jointly organised with the Centre for Economic Policy Research at the Australian National University. The theme was "Unemployment and the Australian Labour Market". Participants included leading Australian and overseas academics and practitioners, as well as senior Reserve Bank staff. Regular seminars for teachers of secondary economics and business studies were again conducted during the year (with the text of these sessions available on the Bank's web site, referred to below).

The Research Discussion Paper (RDP) series makes the results of current research within the Reserve Bank available to other economists, by presenting preliminary results of research in order to encourage discussion and comment. During 1997/98, 14 RDPs were published.

Reflecting its interest in education, the Reserve Bank again provided support for academic research and conferences in the economic field. A major financial contribution was made to a conference held at the Australian National University on the Asian crisis. The Bank also contributed to the costs of academic conferences organised by the University of New South Wales, and the

Australian National University with the University of Western Australia. The Bank is contributing – along with other participants in the financial markets – to the establishment of an electronic markets laboratory at the Australian Graduate School of Management at the University of New South Wales. Two ongoing surveys of direct relevance to the Bank's prime areas of responsibility were again financed: a monthly survey of consumers' inflation expectations undertaken by the Melbourne Institute of Applied Economic and Social Research, and a quarterly survey of union inflation and wage expectations, undertaken by the Australian Centre for Industrial Relations, Research and Teaching at the University of Sydney.

Some of the support for these various projects was provided from the Economic and Financial Research Fund (EFRF). The EFRF was set up in 1952 to allocate a part of the Reserve Bank's earnings to encourage academic research. Over recent years, the projects for which funds have been sought from the EFRF have tended to move away from regular academic research. Consequently, the Bank decided during the year to dismantle the formal structure of the EFRF, but to continue to stand ready to make contributions for academically related expenditures.

The Reserve Bank chairs a Small Business Finance Advisory Panel, which it established in 1993. The Panel meets annually, drawing together owners of small and medium-sized enterprises to advise the Bank on issues relating to the provision of finance to this sector. These meetings provide a useful opportunity to assess the conditions faced by small business borrowers.

The Reserve Bank's Internet home page was launched in November 1997 (the address of the web site is www.rba.gov.au). This creates the opportunity for speedy and wide dissemination of the large range of public material produced by the Bank. As well as providing an electronic version of many of its major publications, the site carries a range of information on the functions and operations of the Bank. The web site also contains links to certain other Australian Government agencies, as well as some other central banks. In this context, the Reserve Bank also established an E-mail address (rbainfo@rba.gov.au), to which any enquiries to the Bank from the general public can be directed.

In addition to support in the academic arena, the Reserve Bank makes some modest donations to charitable organisations; total contributions to charity in 1997/98 were $22 600. The Bank is a corporate sponsor of the Financial Markets Foundation for Children's Work-A-Day 4 Kids, a fund-raising activity among staff members of various Australian financial institutions in which participating staff contribute up to a day's pay to the Foundation. The Foundation, of which the Governor is chairman, raises funds for research into medical and social problems affecting children.

The Reserve Bank has mounted a display in its Head Office of historical material relating to note designs. The display contains unissued notes and unused designs from four periods: high-denomination notes from the early 1950s; the “royals” of the early 1960s; designs by four designers prior to the conversion to decimal currency in 1966; and some more recent unused designs for notes. The Reserve Bank’s collection of artworks, the bulk of which was acquired during the 1950s and 1960s, is well regarded in the art community. The Bank generally accedes to requests from public art galleries which seek to include items from its collection in certain specialist exhibitions. During 1997/98, four artworks were on loan under these arrangements.

Statutory Obligations

Equal employment opportunity

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, a report for 1996/97 on the Bank’s equal employment opportunity program was tabled in Parliament in October 1997.

Freedom of information

– Section 8 statement

The Reserve Bank 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 Reserve Bank is Australia’s central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the *Reserve Bank Act 1959*, the *Banking Act 1959*, the *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. The Bank’s 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*; most of this information is also included on the Bank’s web site. Other documents held by the Bank 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 1982*, including requests for access to documents, should be directed to the Secretary, Head Office, or the Managers of branches. Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available in the Bank’s branches.

– Section 93 statement

Six requests for access to documents under the Act were received in 1997/98, compared with two in the previous year. Access to documents was granted in full for three requests and in part for one request, and access was denied for two requests. There were no applications for internal review or for review by the Administrative Appeals Tribunal. The cost of administering the Act in 1997/98 is estimated to have been approximately $8 800, compared with approximately $67 100 in the previous year; application fees of $90 and charges of $380 were collected by the Reserve Bank.

Note Printing Australia

Note Printing Australia (NPA) Limited is a wholly owned subsidiary of the Reserve Bank based at Craigieburn in Victoria. It prints currency notes for Australia and a growing number of other countries, and is the world leader in polymer currency-note printing.

NPA is overseen by a Board, the Chairman of which is Graeme Thompson. The other members are Mark Bethwaite and Dick Warburton, a non-executive member of the Reserve Bank Board. In line with Commonwealth Government competitive neutrality principles, NPA became a corporatised entity on 1 July 1998, having previously operated as an autonomous division of the Reserve Bank.

Following the retirement of Managing Director Bob Larkin on 1 May, Mr Bethwaite became acting Chief Executive of NPA until a permanent successor was appointed. John Leckenby, formerly Group General Manager of the Building Products Group of Email Limited, has now been appointed as Chief Executive, effective 17 August.

In conjunction with the Reserve Bank's Note Issue Department, NPA pioneered the use of polymer notes, as an alternative to traditional paper currency. When Australia's new note series was completed with the issue of the $100 note in 1996, it became the first country in the world to have all its currency notes printed on polymer.

Polymer notes have demonstrated significant advantages over paper in both security and durability. As an example, Australia's paper $10 note had an average life in circulation of eight months; by contrast, its polymer successor, first issued in 1993, is lasting at least $2\frac{1}{2}$ years. One result of this greater durability has been a steady decline in the required annual production of Australian notes. This has, in turn, freed capacity at NPA for other opportunities. As a result, NPA has been developing export markets for polymer notes and has made major progress in recent years. In addition to printing 180 million Australian notes in 1997/98, NPA produced a total of 127 million notes for five other countries – Brunei Darussalam, Malaysia, Papua New Guinea, Sri Lanka and Thailand.

In March 1998, NPA was successful in winning the tender for New Zealand's entire note issue requirements over the next three years. This order is for approximately 120 million notes of five denominations to be issued from 1999.

The table on the following page lists export orders for polymer notes that NPA has filled, or is in the process of filling, since its first export success in 1990.

Polymer notes export orders

Year of first issue	Customer	Denomination	Issue
1990	Singapore	50 Dollar	Commemorative
1992	Western Samoa	2 Tala	Circulating
1992	Papua New Guinea	2 Kina	Circulating
1992	Kuwait	1 Dinar	Commemorative
1994	Indonesia	50 000 Rupiah	Commemorative/ circulating
1996	Brunei Darussalam	1, 5, 10 Dollar	Circulating
1996	Thailand	50, 500 Baht	Commemorative
1997	Thailand	50 Baht	Circulating
1998	Sri Lanka	200 Rupee	Circulating
1998	Malaysia	50 Ringgit	Commemorative
	New Zealand	5, 10, 20, 50, 100 Dollar	Circulating

NPA also markets a number of related technologies which are generating export income. These include a High Level Authentication System for banknotes and a range of Optically Variable Devices for banknotes, ID cards and other security applications.

After winning the Export category in the Prime Minister's Inaugural Awards for Innovation in the Public Sector in 1996/97 in recognition of its overseas success, NPA was awarded a Gold Medal and Star for the print quality of the 50 baht Thai notes at the Australian National Print Awards in March 1998.

Intitiatives to reduce costs and increase the international competitiveness of NPA continued in 1997/98. These included the incorporation of modern technologies such as a Gross Error Detection System on the main-line printing equipment to detect print faults. An order has also been placed for a modern high-speed sorting machine with "machine vision" to replace manual examination of banknotes. This system will reduce dependence on labour-intensive processes, and ensure more consistent product quality.

In 1996/97, NPA achieved ISO 9001 certification, and a number of initiatives were put in place in 1997/98 to maintain that certification. These included external audits of the quality-management system in December 1997 and July 1998. In support of this system, a comprehensive calibration program was implemented for all critical quality-control apparatus. Detailed training and internal audit programs have also continued.

Early in 1996 the Reserve Bank, through NPA, formed a joint-venture company with UCB Films PLC, a Belgian-owned manufacturer of polypropylene films, to market and supply specialised polymer substrate to countries which have their own printing plants. The joint-venture company, Securency Pty Limited, is now well established and has made its first sales of substrate to export markets. Recent negotiations between the Reserve Bank and UCB have identified scope for a significant expansion of Securency's activities. UCB has erected a plant for the manufacture of specialised polymer film on land it purchased from the Reserve Bank adjacent to NPA.

NPA and UCB are also working, together with the Note Issue Department, on an extensive program of research and development with the aim of further improving the security and handling properties of polymer notes. Significant progress has been made on some highly innovative security features, particularly those based on the self-authenticating banknote concept, where the polymer note window is used to carry the means of verifying security features located elsewhere on the note. Over the past year, ten provisional patents have been lodged aimed at protecting new banknote security concepts.

Profit and Earnings Distribution

The Reserve Bank's earnings have two principal components – underlying earnings, broadly defined as net interest income from its portfolio, less costs; and the gains or losses which come from realised valuation changes in its portfolio. The sum of these two items is available to vary reserve holdings and for distribution to the Government.

Interest-earning assets are mainly government securities – both domestic and foreign. Offset against earnings on these assets is the interest which the Reserve Bank pays on its liabilities. The Bank does not have to pay interest on some of the items on the liabilities side of its balance sheet – most notably, the currency issue. Accumulated reserves also provide an interest-free source of funding, and Non-Callable Deposits (which are due to be removed when State-based deposit-taking institutions become subject to prudential supervision by APRA) provide another source of low (or zero) cost funding. With some three-quarters of the liabilities side of its balance sheet not requiring interest payments, the Reserve Bank routinely has net interest earnings of around $1.8 billion, depending on the level of interest rates domestically and abroad.

Financial assets and liabilities are marked to market each week. In calculating how much of these valuation changes should be counted as earnings, the longstanding practice in central banks is that only realised valuation profits are counted as earnings available for distribution. This is consistent with the underlying economics – to pay over unrealised gains would be the equivalent of the central bank financing government deficits. For valuation losses, the convention is that these, whether realised or unrealised, should reduce earnings unless there exists a reserve fund built up from earlier valuation profits (in which case, this can be used to absorb unrealised valuation losses).

With the Reserve Bank's operating costs running at around $200 million and non-interest income at about $100 million, underlying earnings have, over the past five years or so, been around $1.7 billion. Underlying earnings were a little higher in 1997/98. This reflected a number of offsetting factors. The average amount of interest-earning assets held during the year was higher than in the previous year, in part because of the sale of some of the Bank's gold holdings and its replacement in the portfolio by interest-earning foreign assets. But domestic interest rates were lower, reducing the rate of return on domestic assets.

With underlying earnings changing only slowly from year to year, realised valuation effects explain the big year-by-year swings in overall earnings. As in the previous year, earnings in the latest financial year were boosted by the proceeds of gold sales. While all the gold sales were made in 1996/97, some gold was not delivered until September 1997, and the proceeds of these sales are included in the 1997/98 result. These gains represented the difference between the market price of gold sold and the former official price of US$35 per ounce at which it was purchased. Sales of other domestic and foreign securities, which occur in the course of the Reserve Bank's operations, can crystallise gains or losses. The price of securities sold can differ from the purchase price, and the Australian dollar value of the proceeds of sales of foreign government securities varies with exchange rate movements. Apart from gold, realised gains on assets came to $959 million in 1997/98, mostly from foreign exchange gains. In total, realised gains were $1 507 million in 1997/98, down from $1 990 million in the previous year, which were boosted by the delivery of the bulk of the gold sales, but considerably higher than the average for the past ten years.

Sources of earnings available for distribution

($ million)

	Underlying earnings	Realised gains and losses*	Earnings available for distribution
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	1 767	1 507 ***	3 274

* Charges to earnings in 1993/94 and 1995/96 (and to provisions in the two years to 1989/90), when market values of investments and/or foreign exchange holdings fell below cost, are recorded here as capital losses.

** Of which gold sales contributed $1 637 million

*** Of which gold sales contributed $548 million

The Reserve Bank's earnings available for distribution are paid to the Commonwealth Government after any transfers to two reserve funds maintained to deal with contingencies. Earnings available for distribution in 1997/98 were $3 274 million. With the Treasurer's approval, the net gain on realised gold sales has been retained in the Reserve Bank Reserve Fund. With no transfers made to the Reserve for Contingencies and General Purposes, the dividend out of 1997/98 profits was a little more than $2.7 billion, paid in August 1998.

Reserve Bank payments to Government

($ million)

	Earnings available for distribution	Transfers to reserves	Balance available for Commonwealth	Final payment from previous year	Interim payment from current year	Total payment
1988/89	417	277	140	486	–	486
1989/90	1 095	520	575	140	300	440
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				2 726		

Accounting for Profit

Following amendment of the *Reserve Bank Act 1959*, some changes have been made in the way profit is recorded in the accounts. These changes have no effect on underlying earnings or on the amount available for distribution to the Government. The changes relate solely to the treatment of asset revaluations.

General accounting standards require revaluations of current assets to be taken directly to the Profit and Loss Account, even if the gains are unrealised. This concept of profit differs from the long-established and well-accepted view for central banks, noted above, that only *realised* valuation gains should be available for distribution to the Government. In previous years, the Auditor-General acknowledged that there was a conflict between the accounting standard and the profit distribution criteria, and accepted that, as the *Reserve Bank Act 1959* required all profits (excluding additions to reserves) to be distributed to the Government, it was legitimate to calculate profits in accordance with the central bank convention, bringing to account only *realised* valuation effects. The difference between accounting standards and the Reserve Bank's profit-distribution policy was handled by audit qualifications to the accounts. The *Reserve Bank Act 1959* has now been amended, specifically incorporating the longstanding principles regarding valuation effects as a requirement. With this requirement in place, there is no impediment to applying general accounting principles (although there will be a difference between profits – calculated according to general accounting principles – and earnings available for distribution).

Accounting profits now include all changes (both realised and unrealised) in the value of the Reserve Bank's financial assets during the year, apart from changes in the value of gold holdings, as gold is a long-term non-traded asset.

As indicated above, the *Reserve Bank Act 1959*, as amended, specifically requires that unrealised gains should not be available for distribution to the Government. Therefore, in calculating the amount available for distribution, unrealised gains are deducted from accounting profits and transferred to an unrealised profits reserve; the realised gains attributable to changes in value from earlier years are transferred out of the reserve and added to the amount available for distribution. Realised gains on gold sales have been separately transferred from an asset revaluation reserve to make them available for distribution to reserves or the Government (as noted above, these gains were retained in reserves). The outcome for 1997/98 on this basis is shown in the table below. For comparison, 1996/97 profits are shown on the new basis, and as published in last year's Annual Report.

Accounting profits

($ million)

	1996/97 (Annual Report figures)	1996/97 (New basis)	1997/98
Accounting profit	3 705	2 730	4 403
Net transfers to and from unrealised profits reserve	n.a.	-662	-1 687
Realised gain on gold sales	Included in profits above	1 637	548
Realised gain on premises		–	10
Earnings available for distribution	3 705	3 705	3 274

The Reserve Bank's 1997/98 Financial Statements are presented in the following pages.

Balance Sheet as at 30 June 1998

Reserve Bank of Australia

Liabilities	**1997** $'000	**1998** $'000
Capital	40 000	40 000
Reserves:		
Reserve Bank Reserve Fund (Notes 1(f), 3)	2 281 380	2 829 277
Reserve for Contingencies and General Purposes (Notes 1(f), 3)	3 322 946	3 322 946
Unrealised Profits Reserve (Notes 1(f), 3, 16)	662 430	2 349 036
Asset revaluation reserves (Notes 1(f), 3, 16)	1 728 285	1 287 246
Capital and reserves	8 035 041	9 828 505
Australian notes on issue (Note 1(h))	20 063 976	21 650 623
Deposits by:		
Banks:		
Non-callable deposits	4 361 441	4 681 696
Exchange settlement accounts	9 235 175	5 019 291
Government and government instrumentalities:		
Commonwealth	5 164 193	755 632
State	317 676	364 918
Foreign governments, foreign institutions and international organisations	83 213	68 477
Other depositors	120 013	182 668
Other liabilities:		
Profit distribution payable to Commonwealth of Australia	1 700 000	2 725 983
Provisions (Notes 1(g), 4)	77 004	77 944
Other (Note 5)	1 767 359	1 953 837
Total	50 925 091	47 309 574

Balance Sheet as at 30 June 1998

Reserve Bank of Australia

Assets	**1997** $'000	**1998** $'000
Gold and foreign exchange (Note 1(b)):		
Gold	1 757 281	1 236 577
Foreign exchange (Note 15)	21 590 124	24 197 457
Domestic government securities (Notes 1(c), 15)	25 406 665	21 012 026
Loans, advances and bills discounted	107 049	95 441
Bank premises and other durable assets (Notes 1(e), 6)	268 211	273 793
Clearing items (remittances in transit, cheques and bills of other banks) (Note 7)	1 591 013	284 446
Australian notes and coin	79 040	85 041
Other assets (Note 8)	125 708	124 793
Total	50 925 091	47 309 574

IJ Macfarlane
Chairman, Reserve Bank Board
6 August 1998

Profit and Loss Appropriation Statement for year ended 30 June 1998

Reserve Bank of Australia

	1997 $'000	1998 $'000
Net Profit* (Note 2)	2 729 677	4 402 977
Net transfers to Unrealised Profits Reserve (Note 3)	(662 430)	(1 686 606)
Transfer from Asset Revaluation Reserves (Note 3)	1 637 490	557 509
Earnings available for distribution	3 704 737	3 273 880
Reserve Bank Reserve Fund (Note 3)	1 637 490	547 897
Reserve for Contingencies and General Purposes (Note 3)	367 247	–
Commonwealth of Australia	1 700 000	2 725 983
Total	3 704 737	3 273 880

* The published Profit and Loss Appropriation Account for year ended 30 June 1997 showed Net Profit (after deducting amounts provided for contingencies and general purposes) as $3 337.5 million. The 1997 Net Profit has been restated to show the effect of the change in accounting policy on investments; this has resulted in a decrease in the 1997 profit of $607.8 million but has not changed Earnings available for distribution. Refer to Note 16 for full details.

IJ Macfarlane
Chairman, Reserve Bank Board
6 August 1998

Note 1 Summary of accounting policies

The financial statements have been prepared in accordance with the Reserve Bank Act and are based on the form prescribed by the Reserve Bank Regulations. The Bank is now subject to the Commonwealth Authorities and Companies Act 1997 which came into effect on 1 January 1998. The Bank has prepared its 1997/98 financial statements under the Reserve Bank Act and the Reserve Bank Regulations as they were immediately before 1 January 1998; this is in accordance with the transitional arrangements under Regulation 27 of the Audit (Transitional and Miscellaneous) Regulations 1997.

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 Bank'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.

The Bank has changed its accounting policy on the recognition of gains on gold and foreign exchange, domestic investments and premises. From 1 July 1997 all gains on foreign exchange and domestic investments are recognised immediately in the profit and loss account; any unrealised gains are transferred to the Unrealised Profits Reserve and are not available for distribution to the Commonwealth of Australia until they are actually realised. Realised profits on gold and premises are no longer recognised in the profit and loss account, but are now treated as transfers from the relevant asset revaluation reserve. Comparatives have been restated to take account of the effect of this change in accounting policy. Further detail on the change in accounting policy and its effect is contained in Note 16.

The Bank does not fall within the definition of a financial institution under AAS 32 Specific Disclosures by Financial Institutions.

(a) Note Printing Australia The operations of Note Printing Australia (NPA) are conducted as a separate business enterprise. Up to and including 30 June 1998, NPA was not a separate legal entity; its assets, liabilities and profit and loss account are included in the Bank's financial statements, after elimination of transactions internal to NPA and the Bank. On 1 July 1998 Note Printing Australia Limited was formed as a wholly owned subsidiary of the Bank.

Note 1 *(continued)*

(b) Gold and foreign exchange

Gold holdings and gold loans

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 Bank 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.

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 and central banks). The Bank engages in foreign currency swaps and interest rate futures.

Assets and liabilities denominated in foreign currency, other than those subject to swap contracts, 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; this is a change in accounting policy – refer to Note 16.

Foreign government securities

Foreign government securities comprise coupon and discount securities and repurchase agreements. Coupon securities have biannual 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 Bank 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 different maturities. The cash flows are the same as when 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 1998 (including those under swap contracts) have been valued at contract exchange rates.

Note 1 *(continued)*

Interest rate futures

The Bank 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.

Both interest rate futures and foreign currency swaps are off balance sheet items. The Bank did not trade in any other derivative instruments during 1997/98.

(c) Domestic government securities The Bank holds Commonwealth Government Bonds, Treasury Notes, Capital Indexed Bonds, and Treasury Adjustable Bonds. It also holds Australian dollar denominated securities issued 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; this is a change in accounting policy – refer to Note 16.

Commonwealth Government Bonds are coupon securities; the interest is payable biannually 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. 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 Bonds are securities with a coupon rate 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.

(d) Repurchase agreements In the course of its financial market operations, the Bank 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 repurchase price is recognised in the profit and loss account as an offset to interest income over the term of the agreement.

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.

(e) Bank premises and other durable assets A formal valuation of the Bank’s premises is conducted on a triennial basis. The most recent valuation was at 30 June 1998, when Australian premises were valued by officers of the Australian Valuation Office and overseas premises were valued by local independent valuers. The valuations have been incorporated in the accounts.

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

Note 1 *(continued)*

Other durable assets 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 durable assets 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 6.

(f) Reserves Reserves are maintained to cover the broad range of risks to which the Bank is exposed. The Reserve Bank Reserve Fund is a general reserve which provides for potential losses arising from fraud, support of the financial system 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 Bank'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 Bank's assets (gold, premises, and shares in international financial institutions).

Due to the change in accounting policy for foreign exchange and domestic government securities, unrealised gains on these assets are now recognised in the profit and loss account - refer Note 16. 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 new Unrealised Profits Reserve.

(g) Provisions The Bank maintains provisions for accrued annual leave, calculated on salaries prevailing at balance date and including associated payroll tax. The Bank 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 Bank makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(h) Australian notes on issue The Bank 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 1997/98 or 1996/97.

	1997 $'000	1998 $'000
Note 2 Net Profits		
Revenues		
Income from overseas investments (Note 1(b))	796 962	1 043 284
Gains on overseas investments	65 374	104 497
Income from domestic government securities (Note 1(c))	1 615 713	1 059 168
Gains on domestic government securities	394 293	63 811
Gains on foreign currency (Note 1(b))	555 041	2 467 515
Interest on loans, advances, etc.	4 343	19 776
Net interest from overnight settlements systems	3 319	8 841
Reimbursement by Commonwealth for loan management and registry expenses	2 698	2 290
Banking services fees received from Commonwealth	14 871	27 509
Income from rental of Bank premises (incl. cleaning/maintenance fees)	5 721	6 660
Commission on gold loans	35 125	21 277
Sales of numismatic and other note products	17 049	25 030
Earnings on shares in Bank for International Settlements (Note 8)	2 067	2 541
Gain on sale of durable assets	–	1 125
Maintenance of Value payment from International Monetary Fund	19 147	–
Other	17 148	25 226
Total Revenues	3 548 871	4 878 550
Less: Expenses		
Interest on deposit liabilities	628 310	248 025
Staff costs	119 354	101 866
Special redundancy/retirement payments (Note 10)	12 912	29 684
Depreciation of Bank premises (Note 6)	7 091	7 145
Depreciation of durable assets (Note 6)	6 864	6 547
Premises	10 467	11 764
Equipment	11 281	13 150
Stores and stationery	1 280	1 048
Materials used in note production	9 469	16 577
Travel	1 706	2 245
Consultants' fees (Note 12)	1 672	2 129
Telecommunications	1 320	1 808
Reference materials	1 881	2 012
Maintenance of Value payment to International Monetary Fund	–	14 628
Other	5 587	16 945
Total Expenses	819 194	475 573
Net Profit	2 729 677	4 402 977

	1997 $'000	1998 $'000
Note 3 Reserves		
Changes in the Bank's various Reserves are shown below.		
Reserve Bank Reserve Fund (Note 1(f))		
Opening balance	643 890	2 281 380
Appropriation from profits in terms of section 30 of the Reserve Bank Act	1 637 490	547 897
As at 30 June	2 281 380	2 829 277
Reserve for Contingencies and General Purposes (Note 1(f))		
Opening balance	2 955 699	3 322 946
Appropriation from profits in terms of section 30 of the Reserve Bank Act	367 247	–
As at 30 June	3 322 946	3 322 946
Unrealised Profits Reserve (Notes 1(f), 16)		
Opening Balance	–	662 430
Net transfers from Profit and Loss Appropriation	662 430	1 686 606
As at 30 June	662 430	2 349 036
Asset Revaluation Reserves (Notes 1(f), 16)		
Gold		
Opening balance	3 472 670	1 588 663
Net revaluation adjustments	(246 517)	88 766
Transfers to Profit and Loss Appropriation – realised (gains)/losses	(1 637 490)	(547 897)
As at 30 June	1 588 663	1 129 532

	1997 $'000	1998 $'000
Note 3 *(continued)*		
Shares in international financial institutions (Note 8)		
Opening balance	75 510	68 198
Net revaluation adjustments	(7 312)	9 117
As at 30 June	68 198	77 315
Bank premises (Notes 1(e), 6)		
Opening balance	57 953	71 424
Net revaluation adjustments	13 471	18 587
Transfers to Profit and Loss Appropriation – realised (gains)/losses	–	(9 612)
As at 30 June	71 424	80 399
Total Asset Revaluation Reserves		
Opening balance	3 606 133	1 728 285
Net revaluation adjustments	(240 358)	116 470
Transfers to Profit and Loss Appropriation – realised (gains)/losses	(1 637 490)	(557 509)
As at 30 June	1 728 285	1 287 246

	1997 $'000	1998 $'000
Note 4 Other liabilities – provisions (Note 1(g))		
Salaries and wages accrued	2 513	1 667
Provision for accrued annual leave	8 073	7 282
Provision for long service leave	23 908	21 667
Provision for post-employment benefits	42 140	46 628
Provision for workers' compensation	370	700
As at 30 June	77 004	77 944
Note 5 Other liabilities – other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(d))	1 521 497	1 887 117
Remittances in transit	173 113	5 051
Interest accrued on deposits	56 012	27 848
Other	16 737	33 821
As at 30 June	1 767 359	1 953 837
Note 6 Bank premises and other durable assets (Note 1(e))		
Premises		
Opening balance	232 669	238 920
Net expenditure in year	(129)	198
Disposals	–	(6 856)
	232 540	232 262
Depreciation prior to revaluation	(7 091)	(7 145)
Book valuation prior to revaluation	225 449	225 117
Net revaluation adjustments (Note 3)	13 471	18 587
As at 30 June	238 920	243 704

The triennial revaluation of Bank premises occurred at 30 June 1998.

	1997 $'000	1998 $'000
Other durable assets		
Opening balance	95 350	97 838
Additions less disposals	2 488	5 176
	97 838	103 014
Accumulated depreciation	(68 547)	(72 925)
As at 30 June	29 291	30 089

	1997 $'000	1998 $'000

Note 7 Clearing items

This includes net amounts of $284 million owed to the Bank for overnight clearances of financial transactions through the clearing houses, Austraclear and Reserve Bank Information and Transfer System (RITS). (An amount of $1 591 million was owed to the Bank at 30 June 1997.)

Note 8 Other assets

	1997 $'000	1998 $'000
Shareholding in Bank for International Settlements	70 532	79 649
Gold coin	14 976	16 117
Other	40 200	29 027
As at 30 June	125 708	124 793

Note 9 Contingent liabilities and other items not included in the balance sheet

Contingencies

The Bank has a contingent liability, amounting to $67.6 million at 30 June 1998 ($62.8 million at 30 June 1997), 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 Bank 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 Reserve Bank is a respondent on appeal from a judgement given in the Bank's favour by the Federal Court. The Bank is a defendant in two common law matters. The Bank is an appellant in a case regarding a payroll tax assessment and is a respondent and third party before the Administrative Appeals Tribunal in two matters concerning workers' compensation. All cases in which the Bank is defendant or respondent are being defended, and none is judged likely to have a materially adverse effect on the activities, financial condition or operating results of the Bank.

In keeping with Commonwealth Government policy, the Bank carries its own insurance risks except where administrative costs are estimated to be excessive. Experience with self insurance claims is as follows:

	Number of Claims on Bank	
	1997	1998
0 – $10 000	64	32
$10 001 – $20 000	1	–
$20 001 – $30 000	–	3
$40 001 – $50 000	1	–

Note 10 Special redundancy/retirement payments

The Bank's expenses in 1997/98 include $29.7 million paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 1996/97 totalled $12.9 million. Staff leaving the Bank in 1997/98 under these arrangements numbered 249 (195 in 1996/97).

Note 11 Cost of executives

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

Remuneration band	Number 1997	Number 1998
$100 000 – $109 999	1	1
$120 000 – $129 999	6	2
$130 000 – $139 999	5	7
$140 000 – $149 999	4	3
$150 000 – $159 999	2	4
$160 000 – $169 999		1
$170 000 – $179 999	1	2
$180 000 – $189 999	6	2
$190 000 – $199 999	3	4
$200 000 – $209 999	1	
$220 000 – $229 999	2	2
$230 000 – $239 999	1	3
$240 000 – $249 999	1	2
$250 000 – $259 999	1	
$260 000 – $269 999	1	
$280 000 – $289 999		1
$290 000 – $299 999		1
$330 000 – $339 999		1
$340 000 – $349 999	2	
$380 000 – $389 999	1	
$400 000 – $409 999	1*	
$430 000 – $439 999		1

* Less than full year at relevant salary level.

Total remuneration received or due and receivable by these executives amounted to $7.021 million ($7.435 million in 1996/97). Remuneration includes cash salary, the Bank's contribution to superannuation, housing assistance, motor vehicles and health insurance and the fringe benefits tax paid or payable on these benefits.

Note 12 Remuneration of auditor

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services to the Bank totalled $307 000 in 1997/98 ($295 000 in 1996/97). 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 13 Related party and other disclosures

The Remuneration Tribunal determines the remuneration appropriate to the Bank's non-executive Board members. In 1997/98, payments totalled $174 782 ($181 804 in 1996/97). In addition, $40 853 was paid for the services of members of the Board of Note Printing Australia, who are not employees of the Bank ($39 523 in 1996/97).

Payments made by the Bank to a prescribed superannuation fund in connection with the retirement of members of the Board totalled $61 702 in 1997/98 ($367 011 in 1996/97) and are included in staff costs in Note 2. They represent payments made in respect of executive members of the Board on the same bases as for other employees, and for non-executive members in terms of the Superannuation Guarantee Charge.

The Bank is not empowered to lend to non-executive members of the Board. Loans to the Governor and Deputy Governors are permitted only in terms of section 71 of the Reserve Bank Act; at 30 June 1998, there are three such loans (aggregating to $378 260 (three loans aggregating to $433 340 at 30 June 1997)) which have been made for homes in which the officers reside, and are on the same terms and conditions as for other officers of the Bank.

There were no other related-party transactions with Board members; transactions with director-related entities which occurred in the normal course of the Bank's operations were conducted on terms no more favourable than similar transactions with other employees or customers.

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 Bank 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 Bank'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 Bank for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the Bank and the funds during 1997/98.

At 30 June 1998, the OSF had a surplus of assets over accrued benefits of $158 million ($160 million at 30 June 1997). The UK Pension Scheme had a surplus equivalent to $6.7 million ($3.0 million at 30 June 1997). During 1997/98, the Bank made superannuation contributions of $3.3 million ($5.4 million in 1996/97).

Note 13 (continued)

Details of the Funds as at 30 June 1998 are as follows:

	1997 $'000	1998 $'000
Reserve Bank Officers' Superannuation Fund		
Accrued benefits	446 361	410 606
Net market value of assets	606 729	568 889
Surplus	160 368	158 283
Vested benefits	448 079	414 171
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	15 560	18 392
Net market value of assets	18 588	25 153
Surplus	3 028	6 761
Vested benefits	16 615	20 921
Total Superannuation Funds		
Accrued benefits	461 921	428 998
Net market value of assets	625 317	594 042
Surplus	163 396	165 044
Vested benefits	464 694	435 092

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 14 Segment reporting

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

Note 15 – Financial instruments

Australian Accounting Standard AAS 33 Presentation & Disclosure of Financial Instruments applies to reporting periods from 31 December 1997 and is applicable to the Bank for the first time in the 1997/98 Financial Statements. The standard requires disclosure of information relating to both recognised and unrecognised financial instruments; their significance and performance; accounting policy terms and 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 Bank 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 Bank'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. AAS 33 requires disclosure on interest rate risk and credit risk.

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 Bank's balance sheet restated in compliance with AAS 33.

Note 15 (continued)

Interest rate risk

As at 30 June 1998

	Balance Sheet Total $ million	Floating Interest Rate $ million	Repricing Period $ million 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not Bearing Interest $ million	Weighted Average Rate %
Assets								
Gold								
Gold loans	1 145	–	587	372	186	–	–	1.8
Gold holdings	92	–	–	–	–	–	92	n/a
	1 237							
Foreign Exchange								
Securities sold under repurchase agreements	1 405	–	161	–	228	1 016	–	5.2
Securities purchased under repurchase agreements	9 969	–	9 969	–	–	–	–	4.7
Deposits and other securities	12 656	–	4 323	2 225	3 524	2 317	267	4.3
Accrued interest foreign exchange	167	–	–	–	–	–	167	n/a
	24 197							
Domestic Government Securities								
Securities sold under repurchase agreements	445	–	–	–	164	281	–	5.4
Securities purchased under repurchase agreements	9 094	–	9 094	–	–	–	–	5.0
Other securities	11 296	–	4 076	4 047	1 772	1 401	–	5.0
Accrued interest domestic government securities	177	–	–	–	–	–	177	n/a
	21 012							
Loans advances and bills discounted	96	78	–	–	–	–	18	3.4
Bank premises and other durable assets	274	–	–	–	–	–	274	n/a
Clearing items	284	–	–	–	–	–	284	n/a
Australian notes and coin	85	–	–	–	–	–	85	n/a
Other assets	125	–	–	–	–	–	125	n/a
Total Assets	**47 310**	78	28 210	6 644	5 874	5 015	1 489	4.6

Note 15 (continued)

Interest rate risk (continued)

As at 30 June 1998

	Balance Sheet Total $ million	Floating Interest Rate $ million	Repricing Period $ million 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not Bearing Interest $ million	Weighted Average Rate %
Liabilities								
Australian notes on issue	21 651	–	–	–	–	–	21 651	n/a
Deposits	11 073	11 073	–	–	–	–	–	2.7
Profit distribution	2 726	–	–	–	–	–	2 726	n/a
Provisions	78	–	–	–	–	–	78	n/a
Other	1 953	–	1 887	–	–	–	66	4.3
Total Liabilities	**37 481**	11 073	1 887	–	–	–	24 521	1.0
Capital and Reserves	9 829	–	–	–	–	–	–	n/a
Total Balance Sheet	**47 310**							
Off Balance Sheet Items								
Interest Rate Futures*	(1 864)	–	(877)	–	–	(987)	–	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. Repricing period is equivalent to maturity period except for some holdings of domestic government securities (which appear in the 0 to 3 months category):

Approximately $1.7 billion has a maturity period of 1 to 5 years
Approximately $90 million has a maturity period of over 5 years.

* Interest rate futures reflect short 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 third party (customer, bank or other counterparty) will not meet its obligations (or be permitted to meet them) in accordance with agreed terms.

The Bank'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 Bank'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 the Bank undertook a series of foreign currency swaps with the Bank of Thailand. The Bank provided United States dollars, receiving Thai Baht in exchange. The amount outstanding on the swaps at 30 June 1998 was the equivalent of 1.2 billion Australian dollars, on which the Bank is earning a yield of 5.33%. The swaps represent 2.5% of the Bank's total assets as at 30 June 1998.

Note 15 (continued)

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

Foreign exchange swaps As at 30 June 1998 the Bank was under contract to purchase $6.5 billion of foreign currency and sell $14.2 billion of foreign currency. As of that date there was an unrealised net gain of $79.8 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.

Interest rate futures As at 30 June 1998 about 9% of the Bank's foreign currency reserves (excluding gold) were hedged through interest rate futures contracts. The amount of credit risk on these contracts is approximately $9.3 million. As at 30 June 1998 there was an unrealised gain on those contracts of $1.4 million.

Concentration of credit risk

The Bank operates to minimise its credit risk exposure through comprehensive risk management policy guidelines. The following table indicates the concentration of credit risk in the Bank's investment portfolio. See Notes 1(b), 1(c) and 1(d).

Credit Risk Table

Security type	Risk rating of security issuer*	Risk rating of counterparties*	% of total asset portfolio
Domestic government securities			
Holdings of Commonwealth Government Securities	AAA	n/a	24.2
Securities sold under repurchase agreements	AAA	AAA	0.2
	AAA	AA	0.5
	AAA	other	0.3
Securities held under repurchase agreements	AAA	AAA	3.6
	AAA	AA	10.0
	AAA	other	2.7
	AA	AAA	0.1
	AA	AA	2.1
	AA	other	0.7
	other	other	0.2
Foreign investments			
Holdings of securities	AAA	n/a	18.1
Securities sold under repurchase agreements	AAA	AA	2.6
	AAA	other	0.5
Securities held under repurchase agreements	AAA	AA	13.4
	AAA	other	9.5
Deposits	n/a	AAA	0.6
	n/a	AA	4.2
	n/a	other	2.5
Gold loans	n/a	AAA	0.3
	n/a	AA	0.7
	n/a	other	1.4
Other			1.6
			100

* Standard & Poor's ratings

Note 16 Change in accounting policy – investments

During 1997/98 the Bank conducted a detailed accounting review of the makeup, conditions and turnover associated with the domestic government securities portfolio; the results of this review were:

- the portfolio is now more actively managed;
- there are no explicit restrictions on the Bank taking profit when the opportunity exists, provided this is within the overall broader monetary policy framework of the Bank;
- there is regular movement and turnover in the portfolio;
- the securities are marketable securities.

Based on the results of this review the Bank has determined that the domestic government securities portfolio ought to be treated as current assets. From 1 July 1997, the Bank has therefore commenced accounting for all gains, both realised and unrealised, through the Profit and Loss Account. This change also results in domestic government securities being accounted for on a consistent basis with foreign exchange investments, and thus lends clarity and transparency to the financial statements.

Up to and including 1996/97 unrealised gains/losses on investments (gold and foreign exchange and domestic government securities) were passed to/from revaluation reserves provided market price was greater than cost. The accounting policies included treating domestic government securities as non-current assets. That part of the Investments Revaluation Reserve and/or Foreign Currency Revaluation Reserve relating to investments and/or currencies disposed of in the course of the financial year was transferred to the Profit and Loss Account for inclusion in the calculation of net operating earnings. This treatment allowed all realised gains to be distributed in terms of the Reserve Bank Act.

With recent changes to the Reserve Bank Act, the Bank is now required to retain unrealised gains until they are actually realised, and this had made possible the recognition of gains during the year in the profit and loss account. As of 1 July 1997, the Bank made the following changes to its accounting policy for investments:

- Foreign exchange investments are now accounted for in terms of AAS 20 – all gains and losses are recognised in the profit and loss account when they arise;
- Gold investments are now accounted for in terms of AAS 10 – the Bank will continue to use an asset revaluation reserve to recognise unrealised gains, and transfer any realised gains to the Profit and Loss Appropriation Account;
- Domestic investments – all gains and losses are recognised in the profit and loss account when they arise.

The following table shows the effect of the change in accounting policy on the 1997 published figures.

	$'000	$'000
Asset Revaluation Reserves		
As published at 30 June 1997		2 390 715
Transfer to Profit and Loss Account of unrealised gains due to change in accounting policy		
Foreign currency	(428 194)	
Foreign investments	(22 764)	
Domestic investments	(211 472)	(662 430)
Restated as at 30 June 1997		1 728 285
Net Profit		
As published at 30 June 1997 (before transfer to Reserve for Contingencies and General Purposes)		3 704 737
Add transfer of unrealised gains from Asset Revaluation Reserves due to change in accounting policy		
Foreign currency	428 194	
Foreign investments	22 764	
Domestic investments	211 472	662 430
Less transfer to Profit and Loss Appropriation of realised profits on gold sales, due to change in accounting policy		(1 637 490)
Restated as at 30 June 1997		2 729 677
Profit and Loss Appropriation Account		
Restated Net Profit at 30 June 1997		2 729 677
Transfer to Unrealised Profits Reserve due to change in accounting policy		(662 430)
Transfer from Profit and Loss Account of realised profit on gold sales due to change in accounting policy		1 637 490
Available for distribution at 30 June 1997 (unchanged)		3 704 737
Net Profits appropriated as follows:		
Reserve for Contingencies and General Purposes (amount unchanged, but previously disclosed at end of Note 2)		367 247
Reserve Bank Reserve Fund (unchanged)		1 637 490
Commonwealth of Australia (unchanged)		1 700 000
Total		3 704 737

Note 17 Cash flow statement

The following cash flow statement appears as a matter of record to meet the requirements of AAS 28; in the Bank's view, it does not shed any additional light on the Bank'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 1998

	1997 Inflow/(outflow) $'000	1998 Inflow/(outflow) $'000
Cash flow from operating activities		
Interest received on investments	2 164 899	2 449 953
Interest received on loans, advances, etc. and on net overnight settlements systems	7 527	29 262
Loan management reimbursement	2 698	2 290
Banking service fees received from Commonwealth	13 763	16 038
Rents received	5 721	6 660
Net payments for and proceeds from sale of investments	(14 037 063)	4 435 389
Interest paid on deposit liabilities	(592 125)	(276 189)
Staff costs (including redundancy)	(120 103)	(130 609)
IMF Maintenance of Value adjustment	61 998	20 004
Premises, equipment and stores	(22 851)	(26 138)
Other	38 006	35 543
Net cash provided by operating activities	(12 477 530)	6 562 203
Cash flows from investment activities		
Net expenditure on premises and durable assets	(9 996)	(687)
Net cash used in investing activities	(9 996)	(687)
Cash flows from financing activities		
Profit payment to Commonwealth	(2 135 807)	(1 700 000)
Net movement in clearing items	89	–
Net movement in deposit liabilities	11 962 727	(8 209 029)
Net movement in Special Reserve – IMF SDRs	(15 470)	–
Net movement in loans and advances	(8 619)	11 533
Net movement in notes on issue	882 044	1 586 647
Proceeds from gold sales	1 822 749	608 327
Other	198 392	(159 560)
Net cash provided by financing activities	12 706 105	(7 862 082)
Net increase/(decrease) in cash	218 579	(1 300 566)
Cash at beginning of financial year	1 451 474	1 670 053
Cash at end of financial year	1 670 053	369 487

Note 17 (continued)

Reconciliation of Cash	**1997** $'000	**1998** $'000
Cash	79 040	85 041
Overnight settlements system	1 591 013	284 446
	1 670 053	369 487

Reconciliation of net cash provided by operating activities to Net Profit	**1997** $'000	**1998** $'000
Net Profit	2 729 677	4 402 977
Increase in interest payable	36 185	(28 164)
Increase in interest receivable	(135)	645
Gain on sale of foreign currency	(126 847)	(830 263)
Gain on sale of investments	(225 431)	(118 953)
Unrealised gains on investments	(662 430)	(1 686 606)
Increase in income accrued on investments	(247 776)	347 502
Depreciation of Bank premises	7 091	7 145
Depreciation of durable assets	6 864	6 547
IMF Maintenance of Value adjustment (including accrual to end June)	42 851	34 632
Net payments for and proceeds from sale of domestic and foreign investments	(14 037 063)	4 435 389
Other	(516)	(8 648)
Net cash provided by operating activities	(12 477 530)	6 562 203

IJ Macfarlane

IJ Macfarlane
Chairman, Reserve Bank Board
6 August 1998

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 for the year ended 30 June 1998. The financial statements comprise:

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

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 Treasurer.

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 as to whether, in all material respects, the financial statements are presented fairly in accordance with Australian Accounting Standards, other mandatory professional reporting requirements (Urgent Issues Group Consensus Views) and statutory requirements so as to present a view of the entity which is consistent with my understanding of its financial position, the results of its operations and its cash flows.

As indicated in Note 1, the financial statements have been prepared, under transitional provisions contained in legislation associated with the *Commonwealth Authorities and Companies Act 1997*, in accordance with requirements existing immediately before 1 January 1998. Under those transitional provisions, this audit report also reflects the requirements of the then existing subsection 81(2) of the *Reserve Bank Act 1959*.

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

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Centenary House 19 National Circuit
BARTON ACT
Phone (02) 6203 7500 Fax (02) 6273 5355
Email barrep@anao.gov.au

Audit Opinion

I now report that the financial statements are in agreement with the accounts and records of the Bank and, in my opinion:

(i) the financial statements are based on proper accounts and records; and

(ii) the financial statements give a true and fair view, in accordance with applicable Accounting Standards, other mandatory professional reporting requirements and statutory requirements, of the financial position of the Reserve Bank of Australia as at 30 June 1998 and the results of its operations and its cash flows for the year then ended.

P.J. Barrett
Auditor-General

Sydney

6 August, 1998

Glossary

ACCC	Australian Competition and Consumer Commission
APEC	Asia-Pacific Economic Cooperation
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATM	Automatic teller machine
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BIS	Bank for International Settlements
CGS	Commonwealth Government securities
CHESS	Clearing House Electronic Subregister System
CLS	Continuous Linked Settlement (Bank; Services Limited)
CPA	Commonwealth Public Account
CPSS	Committee on Payment and Settlement Systems
DoFA	Department of Finance and Administration
ECHO	Exchange Clearing House Limited
EFTPOS	Electronic funds transfer at point of sale
EMEAP	Executive Meeting of East Asia and Pacific central banks
ES	Exchange Settlement (accounts; funds)
GDES	Government Direct Entry System
IMF	International Monetary Fund
NCDs	Non-Callable Deposits
NPA	Note Printing Australia
PAR	Prime Assets Requirement
PDS	Payment Delivery System
RITS	Reserve Bank Information and Transfer System
RTGS	Real-time gross settlement
SDRs	Special Drawing Rights
SEACEN	South East Asian Central Banks research and training programs
SWIFT	Society for Worldwide Interbank Financial Telecommunication

Reserve Bank Board

End July 1998

IJ Macfarlane
Chairman
Governor since
18 September 1996
Present term expires
17 September 2003

SA Grenville
Deputy Governor since
1 December 1996
Present term expires
30 November 2001

EA Evans
Secretary to the Treasury
Member since
10 May 1993

JR Broadbent
Member since
7 May 1998
Present term expires
6 May 2003
Company Director

AR Jackson, AO
Member since
29 January 1991
Present term expires
28 January 2001
Chairman
Austrim Limited

FP Lowy, AO
Member since
27 June 1995
Present term expires
26 June 2000
Chairman, Westfield
Holdings Limited

HM Morgan, AO
Member since
14 August 1996
Present term expires
28 July 2002
Managing Director,
WMC Limited

AR Pagan
Member since
29 November 1995
Present term expires
28 November 2000
Professor of Economics,
Research School of Social
Sciences, Australian
National University

RFE Warburton
Member since
22 December 1992
Present term expires
21 December 2002
Chairman, Wool
International

Departure of GJ Thompson

Mr Thompson resigned as Deputy Governor of the Reserve Bank on 30 June 1998 and from the Board at the same date. He became Chief Executive Officer of the Australian Prudential Regulation Authority on 1 July 1998.

Death of Dr HC Coombs

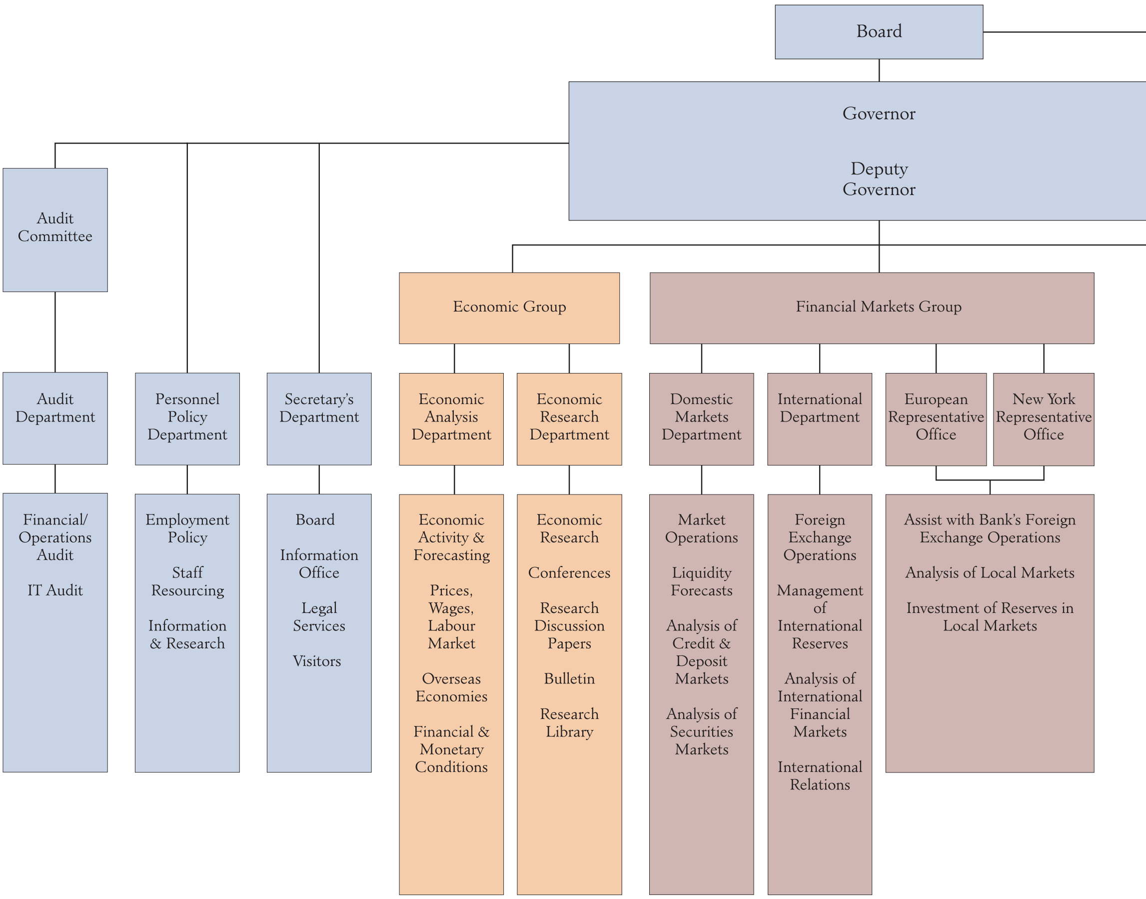
The Bank records, with deep regret, that Dr HC "Nugget" Coombs, who was Governor of the Commonwealth Bank from 1949 to 1960, and of the Reserve Bank from 1960 to 1968, died on 29 October 1997.

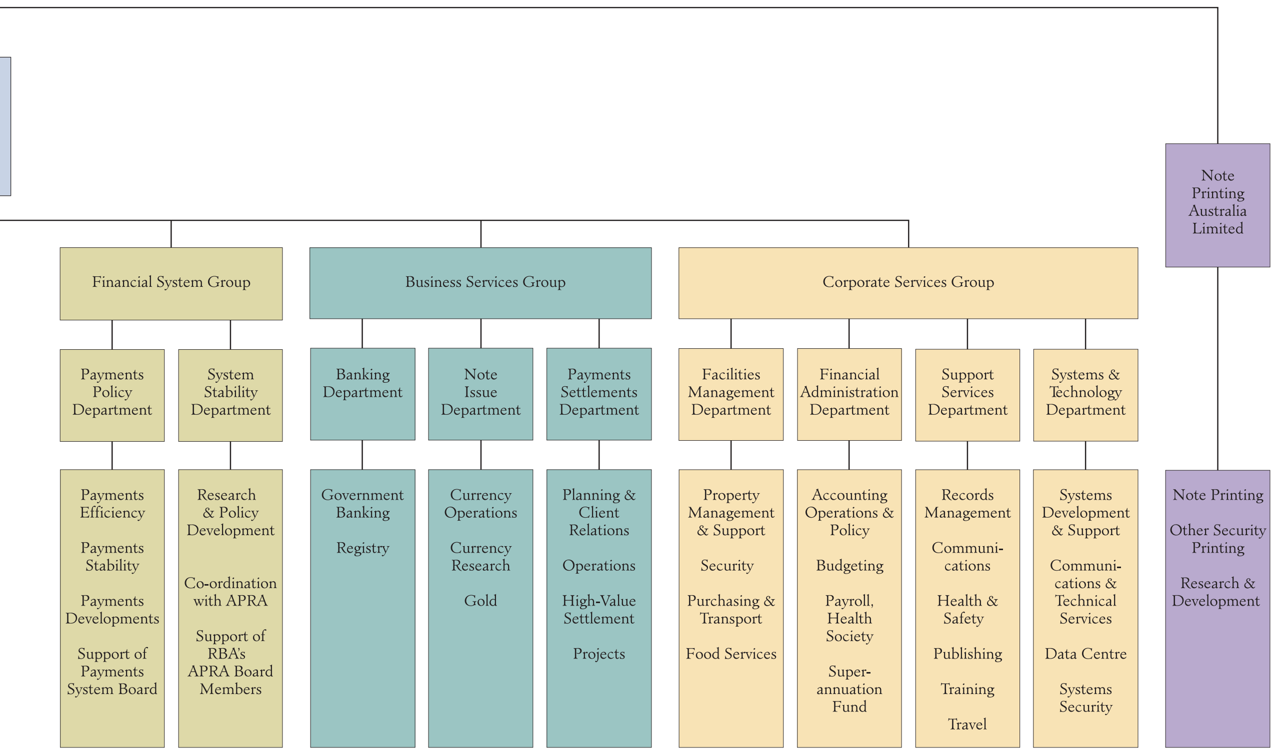
Audit Committee

During the year, the Reserve Bank commissioned a peer review by a leading accounting firm of the Bank's internal audit. Arising from one of the recommendations of this review, the Board has decided to change the composition of the Audit Committee, which was originally established in 1988 following an earlier external review. The Audit Committee is now made up of Dr Grenville, Deputy Governor (Chairman), a non-executive member of the Board, Ms Broadbent, and an external appointed member, Mr GH Bennett, company director and former National Executive Chairman, KPMG Peat Marwick.

Reserve Bank of Australia

End July 1998




Note Printing Australia Limited
Financial System Group
Business Services Group
Corporate Services Group
Payments Policy Department
System Stability Department
Banking Department
Note Issue Department
Payments Settlements Department
Facilities Management Department
Financial Administration Department
Support Services Department
Systems & Technology Department
Payments Efficiency
Payments Stability
Payments Developments
Support of Payments System Board
Research & Policy Development
Co-ordination with APRA
Support of RBA's APRA Board Members
Government Banking
Registry
Currency Operations
Currency Research
Gold
Planning & Client Relations
Operations
High-Value Settlement
Projects
Property Management & Support
Security
Purchasing & Transport
Food Services
Accounting Operations & Policy
Budgeting
Payroll, Health Society
Super-annuation Fund
Records Management
Communi-cations
Health & Safety
Publishing
Training
Travel
Systems Development & Support
Communi-cations & Technical Services
Data Centre
Systems Security
Note Printing
Other Security Printing
Research & Development

Head Office Management

End July 1998

Governor:	Ian Macfarlane
Deputy Governor:	Stephen Grenville

Economic Group

Assistant Governor: Glenn Stevens

Economic Analysis Department

Head:	Malcolm Edey
Deputy Head:	Guy Debelle Jenny Wilkinson

Economic Research Department

Head:	David Gruen

Financial Markets Group

Assistant Governor: Ric Battellino

Domestic Markets Department

Head:	Frank Campbell
Chief Manager:	John Broadbent

International Department

Head:	Bob Rankin
Chief Manager:	Gordon de Brouwer Mike Sinclair

Financial System Group

Assistant Governor: John Laker

Payments Policy Department

Head:	John Veale
Chief Manager:	Michele Bullock

System Stability Department

Head:	Philip Lowe

Business Services Group

Assistant Governor: Geoff Board

Banking Department

Head:	Wes Maley

Note Issue Department

Head:	John Colditz

Payments Settlements Department

Head:	Bill Hands

Corporate Services Group

Assistant Governor: Les Austin

Facilities Management Department

Head:	Richard Mayes

Financial Administration Department

Head:	Robert Gilfoyle

Support Services Department

Head:	Graham Rawstron

Systems & Technology Department

Head:	John Wightman

Personnel Policy Department

Head:	Keith Hall

Secretary's Department

Secretary:	David Emanuel

Audit Department

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Chief Representative:	Neil Mackrell
Deputy Chief Representative:	Lindsay Boulton

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Ritchie Thorburn Design, Sydney.