RESERVE
BANK
of
AUSTRALIA

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Reserve Bank

ANNUAL REPORT 2007

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CONTENTS

Governor's Foreword

The structure of this year's *Annual Report* differs from that in recent years. The Report first sets out the Reserve Bank's functions and objectives, and then outlines its governance, accountability and communication arrangements, before describing activities during the year. The costs of those activities are then explained, followed by a detailed treatment of earnings and distribution. Statutory material and the formal financial statements appear at the end of the document.

There were some significant changes in personnel during 2006/07. At Board level, after 10 years as Governor, Ian Macfarlane retired from the Reserve Bank in September 2006. As a result of my own appointment, a new Deputy Governor was required and I am delighted that the Treasurer selected Ric Battellino for that role. Graham Kraehe joined the Board from February 2007 and at its July 2007 meeting the Board farewelled Hugh Morgan, who has been a forceful advocate of sound money for many years. Several key senior management changes flowed from Ric Battellino's appointment. The Bank's senior ranks continue to be filled with exceptionally capable and experienced people.

The Reserve Bank's staff has increased somewhat over the past two years, after a long period in which it had declined or been fairly stable. This growth reflects additional activities that the Bank needs to undertake but also a rise in the resilience required from our systems. A case in point is the new dedicated business resumption site in north-western Sydney. It carried construction and IT costs of $39 million and will have an ongoing operational cost, including additional staff, of about $4 million per year from now on. But not to have such capacity is no longer acceptable. The project was delivered on time and on budget. The new facility has been operational from mid July.

A major upgrade to the RITS system, which is Australia's main high-value payments system, was rolled out to customers during the year, at substantial cost to the Reserve Bank. Handling about $170 billion in transactions on the average day, this critical piece of infrastructure is provided to the Australian financial community at a high level of reliability, at a total annual cost of just $11 million.

Efforts to improve the quality of notes in the hands of the public continued, with the introduction of a new program of incentives for note sorting by banks and armoured car companies. This carries some financial cost to the Reserve Bank, but the payoff will be better quality, cleaner notes in the community as unfit notes are more effectively removed from circulation.

The Reserve Bank's economic policy work continued as normal. Monetary policy was tightened somewhat in the first half of the financial year and again in August 2007, as the Board acted to keep inflation close to the target. The Board's reasoning for its decisions, as well as the Bank's assessment of the economic situation and prospects, are given in statements announcing policy changes and in the detailed material in the *Statement on Monetary Policy* published each quarter, so they are not repeated here. Financial stability continues to be a key focus, with the

Bank publishing its regular *Financial Stability Review* twice yearly and working with APRA, ASIC and the Treasury as the Council of Financial Regulators, which met four times during the year. The activities of the Payments System Board are reported in its own annual report.

A highlight in the area of international relations was the co-hosting of the G-20 meeting of finance ministers and central bank governors in Melbourne in November 2006, followed by the Bank for International Settlements bi-monthly meetings held in Sydney, attended by governors from 45 central banks. These were the largest meetings of their kind ever held in Australia and were very successful.

The Reserve Bank's balance sheet expanded further, to around $132 billion at the end of June, a rise of 25 per cent from the previous year and an increase of 120 per cent over five years. This was in large part a result of the accumulation of Government deposits resulting from budget surpluses and the accompanying need for the Bank to hold counterpart assets with an appropriate risk profile. It had no impact on monetary policy or financial conditions. Now that the Future Fund is in operation, the balance sheet is likely to diminish in size over the next year or two.

The Bank's financial results for 2006/07 were affected by the rise in the exchange rate of the Australian dollar. As previous annual reports of the Bank have explained in some detail, and as this report again outlines, central banks which hold their nations' foreign currency reserves on their balance sheet are exposed to considerable currency risk. When the Australian dollar exchange rate appreciates, the accounts record a fall in the value of foreign assets. In 2006/07, the rising Australian dollar meant that the Bank experienced a substantial unrealised valuation loss on its financial assets, which exceeded the flow of income from its assets during the year. Therefore, the Bank recorded a loss in 2006/07, as measured by Australian equivalents to International Financial Reporting Standards.

This is not the first such loss – the Reserve Bank last experienced one on an AIFRS basis in 1993/94 – and it is unlikely to be the last. The reason is that there is very little scope for a central bank to manage foreign currency risk without compromising its policy obligations. Foreign assets cannot be hedged back to Australian dollars because that would defeat the purpose of holding them. This risk has to be accepted as part and parcel of being a central bank. In some years very large valuation gains will be observed. But on some other occasions, the Bank can expect to record a valuation loss.

A strong capital position is needed in order to absorb sustained valuation losses should they occur. The Reserve Bank's capital position, at a little over 10 per cent of assets at risk, is strong and has not been impaired by the outcome in 2006/07 because the unrealised valuation losses were mostly offset against unrealised gains from earlier years, which were held in reserve. The remainder has been charged against other sources of income, leaving capital unaffected.

Earnings available for distribution are determined by the provisions of the *Reserve Bank Act 1959*, which have proven over the years to be a very sound basis for determining an appropriate flow of dividends while maintaining the soundness of the Bank's balance sheet. The Act provides for the flow of net interest earnings plus any realised valuation gains to be available as a dividend. *Un*realised gains are not distributed but are retained either until they are offset by future unrealised losses or until they become realised. If unrealised losses exceed previous unrealised gains, the difference reduces earnings available for distribution *pari passu*, which is the situation this year. As a result, the dividend available to the Government from the 2006/07 result will be slightly smaller than last year's. Details are spelled out in the chapter on Earnings and Distribution.

The Reserve Bank's activities in its various areas of responsibility are set out in the chapters that follow. The staff's contribution to the Bank's work was, as usual, of the highest professional calibre and the Board joins me in thanking them for their efforts.

Glenn Stevens

Chairman, Reserve Bank Board
16 August 2007

Functions and Objectives of the Reserve Bank

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

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

(a) the stability of the currency of Australia;

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

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

For more than a decade now, this general mandate has found concrete expression in the form of a medium-term inflation target. Monetary policy aims to keep the rate of consumer price inflation at 2–3 per cent, on average. The *Third Statement on the Conduct of Monetary Policy*, released by the Treasurer and the Governor in September 2006, records the common understanding of the Government and the Bank on key aspects of the monetary policy framework.

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

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

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

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

Governance

The Reserve Bank Board

The Reserve Bank Board comprises the Governor (Chairman), Deputy Governor (Deputy Chairman), Secretary to the Treasury and six external members, appointed by the Treasurer – a total of nine. Current members are shown on pages 10 and 11; at the time of printing, there was one vacancy on the Board.

Board Meetings in 2006/07 – Attendance by Members[(a)]

Ian Macfarlane[(b)]	3	(3)
Glenn Stevens[(c)]	11	(11)
Ric Battellino[(d)]	4	(4)
Ken Henry	11	(11)
Jillian Broadbent	10	(11)
Roger Corbett	10	(11)
Graham Kraehe[(e)]	3	(4)
Donald McGauchie	10	(11)
Warwick McKibbin	10	(11)
Hugh Morgan	11	(11)

(a) Figures in brackets show the number of meetings each member was eligible to attend.
(b) Ian Macfarlane's term as Governor ended on 17 September 2006.
(c) Glenn Stevens was Deputy Governor until 17 September 2006 and Governor from 18 September 2006.
(d) Ric Battellino was appointed Deputy Governor on 14 February 2007.
(e) Graham Kraehe was appointed to the Board on 14 February 2007.

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

Most meetings are held at the Head Office in Sydney. By custom, one meeting each year is held in Melbourne, usually in the first half of the year, and from time to time the Board also meets in other Australian capitals.

Conduct of Reserve Bank Board Members

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

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

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

Remuneration and Indemnities

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

A committee of the non-executive Reserve Bank Board members reviews annually the remuneration of the Governor and Deputy Governor in terms of section 24A of the *Reserve Bank Act 1959*.

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

Audit Committee

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

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

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

Members of the Audit Committee are the Deputy Governor (Chairman), a non-executive member of the Reserve Bank Board, Jillian Broadbent, and an external member, George Bennett, company director and former National Executive Chairman of KPMG Peat Marwick. During 2006/07, the Committee met on five occasions; all members attended each of these meetings. The two external members of the Audit Committee also meet with the external auditors, in the absence of management, annually. At its July 2007 meeting, the Committee considered the draft financial statements for the year ended 30 June 2007 and agreed that the statements be presented to the Reserve Bank Board with its endorsement.

Reserve Bank Board | August 2007

Members of the Reserve Bank Board attending the August 2007 Board meeting at the Bank's Head Office in Sydney. From left to right, Graham Kraehe, Warwick McKibbin, Jillian Broadbent, Glenn Stevens (Governor and Chairman), Ric Battellino (Deputy Governor), Ken Henry (Secretary to the Treasury), Donald McGauchie and Roger Corbett.

Glenn Stevens (Chairman)

Governor since 18 September 2006
Present term ends 17 September 2013

Chairman – Payments System Board
Chairman – Council of Financial Regulators

Ric Battellino

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

Ken Henry AC

Secretary to the Treasury
Member since 27 April 2001

Jillian Broadbent AO

Member since 7 May 1998
Present term ends 6 May 2008

Director – Coca Cola Amatil Limited
Director – Special Broadcasting Service
Director – Woodside Petroleum Limited

Roger Corbett AM

Member since 2 December 2005
Present term ends 1 December 2010

Director – Fairfax Holdings Limited
Director – Wal-Mart Stores Inc
Chairman – CIES Food Business Forum

Graham Kraehe AO

Member since 14 February 2007
Present term ends 13 February 2012

Chairman – BlueScope Steel Limited
Director – Brambles Industries Limited
Director – Djerriwarrh Investments Limited

Donald McGauchie AO

Member since 30 March 2001
Present term ends 29 March 2011

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

Warwick McKibbin

Member since 31 July 2001
Present term ends 30 July 2011

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

Hugh Morgan AC

Hugh Morgan's term on the Board ended on 28 July 2007

Accountability and Communication

Relationship with Government

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

Reporting Obligations

The Reserve Bank is a Commonwealth authority for the purposes of the *Commonwealth Authorities and Companies Act 1997* (CAC Act) and, for these purposes, the members of the Reserve Bank Board are the directors of the Reserve Bank. As such, they are responsible for the preparation of the annual report and, at the meeting of the Board on 7 August 2007, they resolved that the Chairman sign the annual report and financial statements as at 30 June 2007, transmit them in accordance with the requirements of the CAC Act and arrange publication.

The House of Representatives Standing Committee on Economics, Finance and Public Administration has, in its Standing Orders, an obligation to review the annual report of the Reserve Bank and the annual report of the Payments System Board. The Committee holds twice-yearly hearings, at which the Bank presents its views on the economy and responds publicly to questions from Committee members. In 2006/07, the Governor, Deputy Governor and senior officers attended hearings in Sydney in August 2006 and in Perth in February 2007. These appearances, and the quarterly *Statement on Monetary Policy* (see below), are important elements of the arrangements embodied in the understandings between the Governor and the Treasurer outlined in the *Third Statement on the Conduct of Monetary Policy*.

Communication

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

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

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

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

Communication also takes the form of speeches. During 2006/07, the Governor, Deputy Governor and senior officers gave 18 speeches on various topics, such as the economic conjuncture and outlook, reform of the payments system, underlying inflation, risk and the financial system, capital flows, developments in retail finance, and the foreign exchange market.

The Reserve Bank disseminates research conducted by the staff in the form of *Research Discussion Papers* (RDPs). While the views expressed in these papers are those of the authors and do not necessarily represent those of the Bank, their publication encourages discussion and comment on economic issues among a broad range of researchers. During 2006/07, 13 RDPs were released on a wide range of topics, including the measurement of inflation and the modelling of a number of aspects of the Australian economy, such as the behaviour of the household sector. Staff have also had their work accepted in various publications, such as the *International Journal of Central Banking, Asian Economic Papers* and *The Economic Record*.

The Bank holds regular conferences, bringing together academics, central bankers and other economics practitioners. The 2007 conference was on 'The Structure and Resilience of the Financial System'. A volume of the conference papers and discussions will be published later in 2007, the 19th in the series. The Bank also issued a call for papers for a research workshop to be held later this year focusing on issues relating to monetary policy in open economies, with the aim of attracting papers from academics and practitioners, both domestically and overseas.

The Bank publishes information in both electronic and hardcopy formats. Demand for hardcopy publications has been declining as use of the website continues to grow strongly. In 2006/07, the number of page views/downloads of information on the website averaged 40 200 per day. The number of subscribers to the email service for alerts about information published on the site totalled nearly 12 000 at the end of June 2007.

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

Operations in Financial Markets

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

In recent years, there has been a substantial increase in the size of the Reserve Bank's balance sheet, reflecting the increase in deposits placed with the Bank by the Australian Government and its agencies, in particular the Future Fund. Over the past five years, the balance sheet has risen by 120 per cent to $132 billion. This growth, combined with the decline in Commonwealth Government securities (CGS) on issue, has had a significant impact on the Bank's operations. To offset the effect of these and other flows on domestic liquidity, the Bank has accepted a broader range of domestic securities and made greater use of its foreign portfolio, initially through foreign exchange swaps.

Reserve Bank Balance Sheet
($ billion)

	June 2002	June 2006	June 2007
Assets	***60***	***105***	***132***
Foreign	37	74	96
– Net reserves[a]	7	30	32
– FX swaps	29	34	48
– Other	1	10	16
Domestic	23	31	36
Liabilities	***60***	***105***	***132***
Deposits	14	43	66
Currency	32	38	40
Other (including capital)	14	24	26

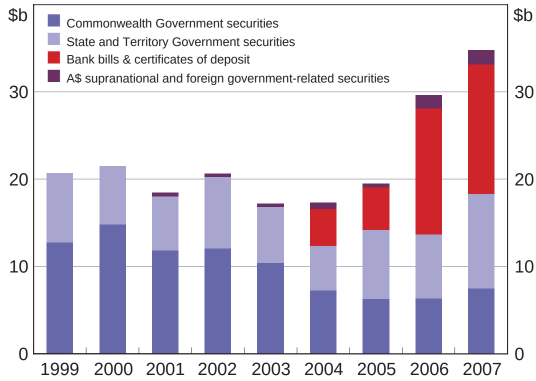
(a) Excludes Special Drawing Rights and Australia's reserve position at the International Monetary Fund

In 2006/07, the Reserve Bank's net purchases of assets from the market were around $27 billion. This comprised an increase of $22 billion in holdings of foreign assets, mostly purchased under foreign currency swap arrangements, and around $5 billion of domestic assets. Most of the increase in domestic assets was securities issued by State and Territory government borrowing authorities (semis) bought under repurchase agreements (repos). At the end of June 2007, semis accounted for around 31 per cent of the Bank's portfolio of domestic securities, up from 25 per cent a year earlier. The share of the domestic portfolio in commercial bank paper bought under repo was around 43 per cent, a little lower than a year earlier.

This rate of expansion of the balance sheet, however, is unlikely to continue in the period ahead. The Future Fund has begun to run down its deposits at the Reserve Bank and invest the proceeds in a broader range of assets. These withdrawals have been fairly small to date but the process is expected to continue throughout 2007/08, leading to some contraction of the Bank's balance sheet over the year.

The effectiveness of the Reserve Bank's operations in financial markets has not been affected by the growth of the balance sheet. Furthermore, the increased size of the Bank's asset holdings has not been reflected proportionately in the Bank's risk exposure, namely its exposure to changes in interest rates and exchange rates. This is because the Bank has structured its operations to minimise the increase in risk, largely by investing in short-term assets with little foreign exchange exposure. Overall, the Bank's risk exposure remains adequately covered by its capital.

RBA Domestic Portfolio
As at end June



Source: RBA

Domestic Market Operations

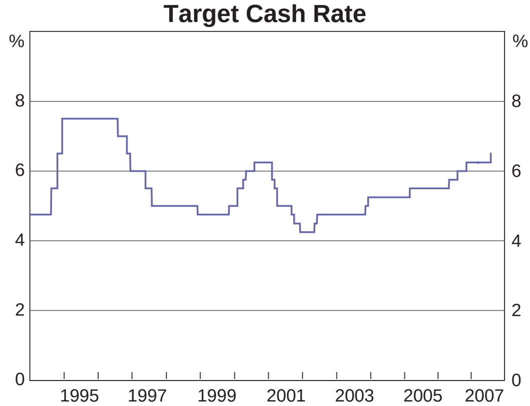
Monetary Policy Implementation

Monetary policy is determined by the Reserve Bank Board and is effected in terms of an operational target for the cash rate – the interest rate on unsecured overnight loans between banks in the money market. This rate is a key determinant of interest rates in other wholesale and retail markets, which in turn affect economic activity and inflation.

The Board increased the target for the cash rate on two occasions in 2006/07 – from 5.75 per cent to 6.0 per cent at its August 2006 meeting and then to 6.25 per cent at the November meeting. The target was increased further in August 2007, to 6.5 per cent. These actions were part of a gradual tightening of monetary policy in Australia that began in 2002. The rationale for the changes was provided at the time through media releases and subsequently in the Reserve Bank's quarterly *Statement on Monetary Policy* and appearances by the Governor and senior officers before the House of Representatives Standing Committee on Economics, Finance and Public Administration.

Once the Board's decision on the target for the cash rate is announced, the operational responsibility of Domestic Markets Department is to ensure that the cash rate in the market remains close to the target. The announcement of a change is normally sufficient in itself to move the cash rate to the new target, though, over time, the Bank needs to undertake transactions to ensure that it stays around this level. These transactions – which are also

Target Cash Rate



Source: RBA

referred to as open market operations – are aimed at affecting the aggregate level of balances held by banks in accounts with the Reserve Bank. These balances, known as exchange settlement (ES) balances or ES funds, are the most immediate source of liquidity available to the banks to meet their daily settlement obligations to each other and to the Reserve Bank.

The Reserve Bank manages changes in the aggregate supply of and demand for ES funds – which would otherwise produce significant variations in the cash rate from the target – by buying and selling securities, usually under repos. The Bank liaises closely with its banking customers – the most significant being the Australian Government – and with commercial banks to identify potential changes in the supply of and demand for ES funds. On the basis of this information, it adjusts the size of its daily market operations to keep the cash rate close to the target. While the demand for ES balances by individual banks can vary from day to day, banks in total have sought to hold around $750 million in daily balances over recent years.

The arrangements for managing the supply of ES funds have proved to be effective and are well understood by participants in the wholesale money market. As in recent years, there were few occasions in 2006/07 on which the actual cash rate deviated from the target; the vast majority of transactions in the market for overnight funds took place at the target rate. Notwithstanding the stability of the cash rate, activity in the overnight cash market has continued to rise. Average daily turnover in 2006/07 was around $7 billion, some 60 per cent higher than in the previous year.

The Reserve Bank's operations in the domestic market are conducted each morning, though on rare occasions a second round of operations may be undertaken later in the day to offset large unexpected flows or shifts in demand for ES funds. No second-round operations were conducted in 2006/07.

Standing Facility for Overnight Repurchase Agreements

	Number of times used	Value ($ million)
2001/02	11	673
2002/03	14	1 673
2003/04	24	2 159
2004/05	11	1 394
2005/06	10	436
2006/07	24	3 589

The Reserve Bank also offers a standing facility under which banks can borrow funds overnight on a secured basis, but at a 25 basis point margin above the cash rate. Banks will typically use this facility late in the day if they face operational or other factors that limit their ability to source funds in the market. The facility was used on 24 occasions in 2006/07 for a total value of $3.6 billion. While this was more than in recent years, it did not reflect any particular development in the market.

Turnover of domestic securities in market operations by the Reserve Bank was $464 billion in 2006/07, $45 billion more than in 2005/06. As in previous years, the vast majority of these operations were repos, which offer greater flexibility in managing liquidity than outright transactions because their maturities can be tailored to accommodate anticipated changes in liquidity. The average maturity of repos, at 17 days, was around the same as in the previous financial year. An increase in the size of ES flows from day to day largely accounted for the increase in turnover in market operations.

Open Market Operations ($ billion)	2002/03	2003/04	2004/05	2005/06	2006/07
Repurchase agreements[(a)]					
– Purchases	304	272	391	409	459
– Sales	17	11	10	6	2
Outright purchases[(b)]	3	5	5	4	3
Total operations in domestic securities	324	287	405	419	464
Foreign exchange swaps[(a)]	90	139	106	157	211
Total	414	426	511	576	675

(a) First leg of transaction.
(b) CGS only until 2002/03. Thereafter includes State and Territory Government securities.

As has been the case for a number of years, foreign exchange swaps played a significant role in the Reserve Bank's market operations during 2006/07. For example, if the domestic banking system is short of funds, the Bank will undertake a swap in which it lends Australian dollars to the market in exchange for foreign currency for a specific period and at an agreed exchange rate for the reversal of the transaction.[1] This transaction has the same effect on domestic liquidity as using open market operations to buy government securities under repo. The difference between the two is that Australian dollars are exchanged for foreign currency in a swap, whereas they are exchanged for a domestic security in a repo. The bulk of the swaps has generally been for relatively short maturities, around two to three months, which aligns with the maturity of the Bank's deposit liabilities. Reflecting the greater usage of foreign exchange swaps for liquidity purposes, turnover in those instruments rose from $157 billion in 2005/06 to $211 billion in 2006/07.

Long-dated Liquidity Operations

In addition to the market operations noted above, the Reserve Bank also buys longer-dated securities on an outright basis in the secondary market. The purpose of these operations is to provide some maturity diversification in the Bank's portfolio of domestic assets.

When long-dated operations were introduced in late 2004, the Bank indicated that it would generally look to make purchases of around $50 to $100 million at fairly regular intervals. The Bank also indicated in its consultations with market participants that, while there was no firm target, acquiring around $2 billion of State and Territory Government securities over time would be likely to satisfy the Bank's portfolio objectives as well as provide sufficient securities to undertake market operations if needed. In 2005 and the first part of 2006, the Bank conducted long-dated operations roughly once a month. During 2006/07, it undertook six long-dated operations, purchasing a total of around $600 million of securities, which brought the value of longer-dated semis in the domestic portfolio to $2.0 billion.

1 *The exchange rate for the reversal of the swap is determined by adjusting the current exchange rate for the interest rate differential between the two relevant countries for the time to maturity of the swap. Because the exchange rate for the reversal is fixed, foreign exchange held under swaps does not expose the Reserve Bank to risk of valuation losses from adverse exchange rate movements.*

Securities Lending

The Reserve Bank lends securities that it holds on an outright basis on its balance sheet. These transactions assist the flow of securities through the market and allow market participants to meet settlement obligations. Most of the Bank's transactions involve lending CGS, though a small share of lending from the Bank's portfolio also involves semis. The Bank's income from securities lending rose by $0.25 million to $1.14 million in 2006/07, largely due to a rise in the average maturity of lending transactions from around six to nine days.

Securities Lending by the Reserve Bank

	Number of transactions	Amount lent (face value, $ billion)	Net income ($ million)
2001/02	119	3.1	0.27
2002/03	32	0.9	0.13
2003/04	185	5.0	0.50
2004/05	264	11.9	0.56
2005/06	460	20.3	0.89
2006/07	438	22.4	1.14

In addition to lending securities from its own portfolio, the Reserve Bank operates a securities lending facility on behalf of the Australian Office of Financial Management (AOFM). This facility allows market participants to access any line of Treasury bonds but at a penalty relative to market prices for securities lending. Securities lending transactions through the AOFM facility are typically small in number and volume, reflecting the penalty in the price. Total lending through the facility was $1.3 billion in 2006/07, slightly more than the previous year.

Foreign Exchange Operations

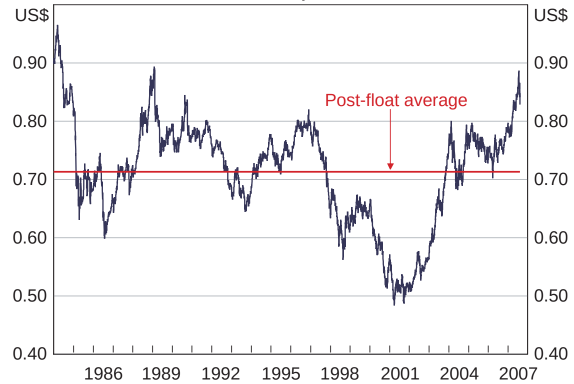
The Reserve Bank's operations in foreign exchange markets in 2006/07 comprised two main activities. The first was transactions in the foreign exchange market on behalf of its clients. The largest client is the Australian Government, which has an ongoing need for foreign currency to cover items such as defence expenditure, embassy running costs and foreign aid. Over the course of the year, these foreign currency needs totalled $5.1 billion, about $400 million higher than the previous year. The Bank covered these sales by buying foreign currency in the market. Consequently, these sales had no impact on the Bank's overall holdings of foreign currency. This is the normal course of business unless the Australian dollar is judged to be at exceptionally low levels, in which case the Bank may choose to meet the Government's foreign currency requirements out of its net reserves.

Secondly, as described above, the Reserve Bank has made increasing use of foreign exchange swaps to manage domestic liquidity, as the size of the balance sheet has grown with the increased level of deposits lodged at the Bank and as the amount of CGS outstanding has declined.

During 2006/07, the Bank did not undertake any transactions to influence the overall level of the exchange rate. Transactions of this nature, known as intervention, are usually undertaken when the exchange rate has moved a long way from its long-term average and in a way that is inconsistent with economic conditions. While the Australian dollar appreciated to an 18-year high against the US dollar and a 22-year high on the trade-weighted index, the Bank viewed these movements as being broadly consistent with developments in the Australian economy, particularly the continued increase in Australia's terms of trade to its highest level in over five decades.

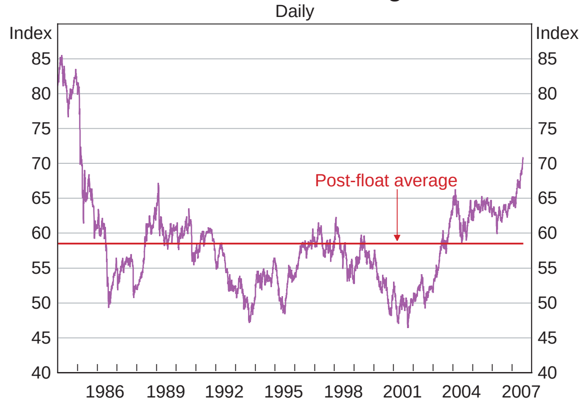
More generally, the Bank has not sought to influence the exchange rate following the period between 1997 and 2001 when it sold foreign currency to support the Australian dollar. Since then, a process of rebuilding reserves has been undertaken, in which the Bank has utilised periods of exchange rate strength to add to reserves in a measured way. With the exchange rate appreciating to multi-year highs during 2006/07, the Bank took the opportunity to step up the pace of its reserves building operations from that undertaken in 2004/05 and 2005/06. Most of these purchases took place between March and June 2007, when the exchange rate reached its highs. Additions to reserves, including earnings, over 2006/07 were $4.9 billion, around twice that accumulated in 2005/06. However, the effect of these purchases on the Australian dollar measure of foreign exchange reserves was partially offset by valuation losses generated by the appreciation of the Australian dollar against those currencies in which reserves are held. Consequently, net foreign reserves (i.e. official reserve assets excluding those held under foreign currency swaps) increased to $32.2 billion at the end of June 2007 from $30.2 billion a year earlier. Gross reserve assets, which also include foreign exchange held under swaps, increased from $64 billion in 2005/06 to $80 billion, primarily reflecting the increase in swaps over the year noted previously.

Australian Dollar
Daily



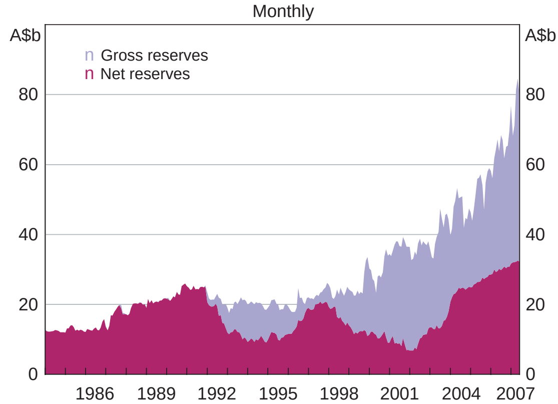
Source: Reuters

Australian Dollar Trade-Weighted Index
Daily



Source: RBA

RBA Official Reserve Assets
Monthly



Source: RBA

Reserves Management

The Reserve Bank holds a portfolio of foreign currency denominated assets and gold, which form the major part of Australia's official reserve assets.[2] The Bank's primary concern in managing these assets is their security and liquidity. By focusing on these factors, the Bank aims to ensure that these assets are both secure and available for use at short notice to fund intervention. Subject to these considerations, the Bank also seeks to maximise the return on these assets where possible.

The importance placed on security means that the Bank invests primarily in bonds with a high credit standing, backed by governments with sufficient financial resources to ensure full and timely repayment. In practice, this has meant that the Bank has predominantly invested in liquid government bonds issued by the United States, Europe (Germany and France) and Japan. These securities are viewed as among the most secure investments available across the broad spectrum of financial market instruments. The markets for these bonds are also among the world's most advanced in terms of their size, scope and depth, providing confidence that the funds can be readily made available at short notice if needed.

In determining its investments across these instruments, the Bank gives careful consideration to their risk and return characteristics. These considerations are reflected in the allocation of the benchmark portfolio of 45 per cent to the United States and Europe respectively, and 10 per cent to Japan. The Bank's benchmark portfolio also takes account of the duration (or weighted-average maturity) of the investments. Generally, government bonds of longer maturities experience greater fluctuation in value. To limit this exposure, the Bank invests, on average, at a sufficiently short maturity to provide some protection against large movements in bond yields. Accordingly, the Bank invests at an average duration of 30 months in each portfolio, with a maximum term to maturity of 10.5 years.

The Benchmark Portfolio

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

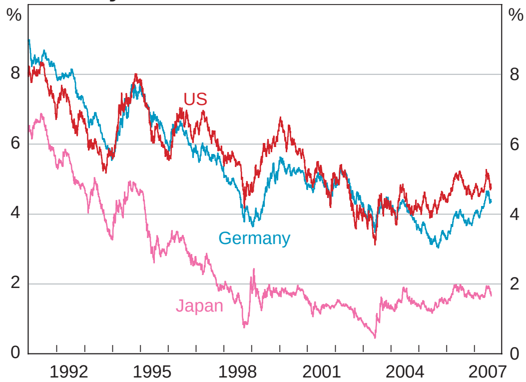
Over 2006/07, the investment of reserves under this framework generated earnings of $2.9 billion, compared with $1.3 billion in 2005/06. This reflects the impact of various factors. Firstly, the size of the Bank's portfolio has increased. Secondly, investments in the United States and Europe, which account for the majority of the Bank's reserves portfolio, benefited from a higher average level of yields than in recent years. This contributed to higher interest earnings, though part of this was offset by losses in the value of existing holdings of bonds as yields rose. In addition, the translation of foreign currency income to Australian dollars at a higher average exchange rate than in previous years lowered the Australian dollar value of foreign earnings.

2 *Official reserve assets also include Special Drawing Rights and Australia's reserve position at the International Monetary Fund.*

The Bank continues to hold a small proportion of its assets in other Asian government bonds, as part of the Asian Bond Fund initiative established by EMEAP central banks to boost the development of bond markets in the region (see the 2005 *Annual Report*). These assets are invested in two separate funds, one of which invests in US dollar denominated bonds and the other in local currency denominated bonds. The investment of funds is co-ordinated by the Bank for International Settlements, under a mandate determined by EMEAP. The amount invested by the Reserve Bank in these funds is currently $371 million. The return over 2006/07 was 9.8 per cent across both funds. This is above the returns earned on the Bank's broader reserves portfolio, consistent with the higher average yield available on Asian government bonds, their longer duration and the increase in the market value of bond holdings associated with declining yields.

The Reserve Bank also holds around 80 tonnes of gold, valued at around $2 billion, as part of its official reserve assets. Gold prices rose by around 6 per cent in US dollar terms over 2006/07. However, the rise in the value of the Australian dollar against the US dollar over the year saw the gold price, in Australian dollar terms, fall by 7 per cent.

10-year Government Bond Yields



Source: Bloomberg

Rates of Return in Local Currency by Portfolio
(per cent)

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

Actual and Benchmark Returns on Total Foreign Currency Portfolio
Rates of return in SDR (per cent)

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

The Bank is prepared to lend its gold holdings, on a collateralised basis, to major participants in the gold market. Demand for gold loans over the course of the year has continued to be minimal, with interest rates on loans with a maturity up to one year around 4 basis points and around 35 basis points for maturities of up to five years. Given these very low returns, the Bank decided not to renew the bulk of gold loans that matured during 2006/07. As such, the amount of gold on loan fell from 53 tonnes at end 2005/06 to 42 tonnes, and income generated from gold lending activities fell from $13.4 million in 2005/06 to $11.1 million.

The Bank continually reviews the framework under which its investments are made. In the past, major changes to the framework have included an increase in the duration of the US portfolio, from 12 months to 30 months, in 1996 and a reduction in the share allocated to the Japanese portfolio, from 30 per cent to 10 per cent, in 2001. Minor adjustments to the framework are also made from time to time to reflect changes in financial markets, the development of new instruments and changes to the Bank's panel of counterparties. Over the past year, the Bank has added bonds issued by some international financial institutions to its list of eligible outright investments.

As well as these operational changes, the Reserve Bank has a broader responsibility to ensure that its reserves management framework continues to represent the most effective approach to investing reserves. The principles on which the current management framework rest – including eligible markets, instruments and the portfolio's duration – were developed during the first half of the 1990s. At that time, financial markets were smaller and the range of financial instruments narrower than is the case today. With the rapid growth, increased sophistication and increased liquidity of financial markets since that time, a wider range of options is now potentially available for the Bank to meet its investment objectives. Consequently, the Bank is undertaking a broad review of the policies, objectives and guidelines for the investment of foreign reserves. In undertaking this review, the Bank does not envisage any changes to the core policy and operational objectives that underpin the investment of reserves. However, it is possible that the combination of investments which best satisfies these objectives will change.

Risk Management

A range of financial risks arise from the Reserve Bank's balance sheet, including exchange rate, interest rate and credit risk. As these risks derive from the Bank's operations in financial markets, Financial Markets Group has the main responsibility for managing them, within parameters and controls set by the Governor and the Reserve Bank Board. Position and counterparty limits, formal delegations, procedures manuals and market benchmarks are part of the day-to-day control and mitigation of these risks.

Compliance with the control framework for the Reserve Bank's financial market activities is monitored and reported daily by the middle office to both the Assistant Governor (Financial Markets) and Head of the Risk Management Unit. Performance and risk on the Bank's financial assets are also reported daily to senior management. Included in this are exceptions to normal operations, such as system problems, deficiencies in procedures or failures to follow procedures.

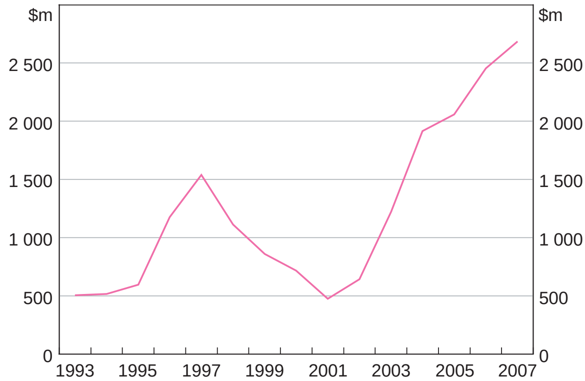
Exchange Rate Risk

Exchange rate risk arises from the Reserve Bank's holdings of foreign currency assets, which are used to support intervention operations. The value of these assets (when measured in Australian dollars) varies with movements in the exchange rate between the currencies in which the assets are denominated and the Australian dollar. The size of this risk varies with the size of foreign exchange holdings.

Exchange rate risk is controlled to an extent by diversification of foreign currency assets across three currencies. The exchange rate risk on a portfolio invested across a basket of currencies is lower than the risk on the same size portfolio invested in only one currency. The benefit of diversification, in terms of risk reduction, is illustrated by the fact that over the past five years the Australian dollar has appreciated by 50 per cent against the US dollar, while it has appreciated by only 33 per cent in terms of the basket of currencies held in the Reserve Bank's foreign portfolio, which includes 45 per cent US dollars, 45 per cent euros and 10 per cent yen.

Exchange Rate Risk on RBA Foreign Currency Portfolio

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



Source: RBA

With the Reserve Bank's foreign currency reserves having been returned to normal levels after the interventions around the turn of the decade, foreign currency risk on the balance sheet has increased. As intervention and reserves replenishment operations are determined by policy considerations, the level of exchange rate risk resulting from these operations cannot be offset. Intervention operations themselves do, however, help to reduce exchange rate risk, as they reduce the level of the Bank's holdings of foreign currency when the Australian dollar is low, which reduces the level of risk when the Australian dollar is most likely to appreciate. Conversely, the Bank will tend to hold more foreign currency when the Australian dollar is high and more likely to depreciate. Foreign currency assets acquired through swap operations do not entail foreign exchange risk as the forward rate embedded in the swap hedges the risk.

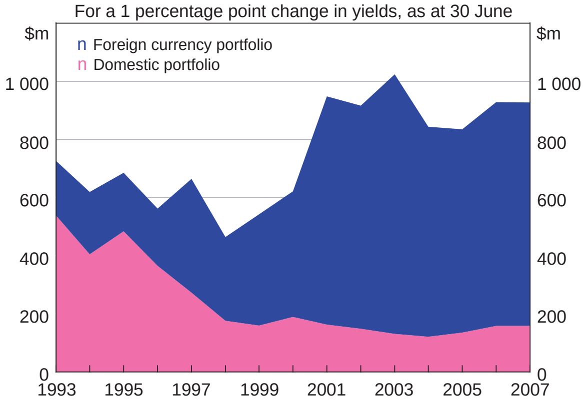
At current levels of reserves holdings, foreign currency risk is around $2.7 billion for each 10 percentage point movement in the exchange rate. This was the main factor that contributed to the accounting loss reported by the Bank this year (see the chapter on Earnings and Distribution).

Interest Rate Risk

As a significant part of the Reserve Bank's balance sheet is held in securities that earn a fixed rate of interest, the value of the Bank's assets will tend to fluctuate with changes in market interest rates. Increases in market interest rates will reduce the value of these assets, which have a fixed income stream. Conversely, when market interest rates fall investors are willing to pay a premium for the higher fixed income stream offered on existing securities. Securities with a longer maturity (or duration) will have an income stream fixed for a longer period and so will be exposed to a greater degree of interest rate risk.

Interest Rate Risk on RBA Portfolio

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



Source: RBA

Over the past year, an increase in interest rate risk owing to the growth of the balance sheet has been offset by a reduction in the average maturity of assets. This is because money received for Future Fund deposits was invested in relatively short maturities broadly to match the maturity of the deposits – i.e. the Bank effectively hedged the risk on these deposits. Across the domestic and foreign portfolios, the Bank would suffer a valuation loss of about $950 million if interest rates in Australia and abroad were to rise by 1 percentage point across the yield curve. This has not changed much over the past five years. Such a loss would be partially offset by increases in interest income, over time, as shorter-term investments were reinvested at higher interest rates.

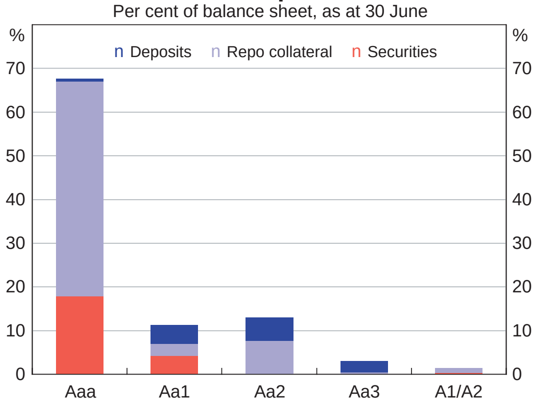
Credit Risk

Credit risk is the potential for financial loss arising from issuer or counterparty default. For the Reserve Bank's operations, this can arise through default by the issuer of securities held outright, default by the banks with which funds have been deposited or default by the counterparties with which transactions have been undertaken. In contrast to exchange rate and interest rate risk, there is no policy imperative for holding a given level of credit risk, so this risk can be reduced to relatively low levels.[3]

To minimise its exposure to credit risk the Reserve Bank mainly holds highly rated securities. In the domestic portfolio, these include securities issued by the Australian Government and State and Territory government borrowing authorities. There are, however, also some repos in bank bills. Securities issued by the US, German, French and Japanese governments, as well as deposits held with the Bank for International Settlements, are the main investments in the foreign portfolio, although some of the portfolio is also held in commercial bank deposits. Over the past year the Bank began to invest a small amount in securities issued by certain highly rated supranational institutions. A small amount of the foreign portfolio is invested in the Asian Bond Funds, which have an average credit rating well within the range of investment-grade paper.

Credit Exposures

Per cent of balance sheet, as at 30 June



Source: RBA

3 Details of the Reserve Bank's credit exposures are given in Note 16 to the Financial Statements.

The risk of default by institutions with which the Reserve Bank has deposited funds and by counterparts to transactions with the Bank is controlled in a number of ways. Foreign currency deposits are placed only with commercial banks that have a high credit rating (a short-term rating of P-1 and a long-term rating of Aa3 or above). Foreign counterparties to transactions with the Bank must also have high credit ratings, with foreign exchange transactions limited to counterparties rated P-1 (short term) and at least A3 (long term), while foreign repos and gold lending transactions, which are secured with high-quality assets, are limited to counterparties rated P-2 and Baa1 or better. Other measures to control risks include requiring repos and gold loans to be over-collateralised, and requiring securities provided as collateral to be revalued daily and that counterparties supply additional securities if the value of the securities falls below a required amount.

To control the size of the loss were a default to occur, exposures to foreign counterparties are limited according to their financial strength, credit rating and the size of their capital base. Credit exposure to each counterparty is aggregated across all the products in which the Reserve Bank has dealt with that counterparty, with individual product exposures standardised through product risk factors.

No minimum credit rating or exposure limits are explicitly assigned in the domestic portfolio as operations are conducted for policy purposes. However, as dealings are restricted to RITS members, which are primarily banks operating in Australia, the credit ratings of domestic counterparties tend to be high.

Settlement risk, which can arise when a counterparty cannot supply the cash or securities to complete a deal, is eliminated for securities transactions through the use of delivery-versus-payment systems, which involve the simultaneous exchange of securities for cash. In contrast, settlement risk can be quite significant for foreign exchange transactions as the two currencies of the foreign exchange transaction are settled in different time zones, which may require the Reserve Bank to pay out funds before it receives any funds in return. While this risk is controlled to an extent by dealing only with highly rated counterparties, the size of any potential loss is further controlled by limiting the total value of foreign currency transactions settling with a given counterparty on a given day.

Business Services

The Reserve Bank provides a range of business services to other institutions in the Australian financial system, to the Australian Government and some of its agencies, and to other central banks and international bodies. Services include: facilities for Australian dollar real-time settlement for high-value transactions; Australian dollar exchange settlement facilities; and facilities for transactional banking, custody, registry and associated services. In addition, the Bank manages the supply of Australian dollar banknotes to participants in the cash distribution network.

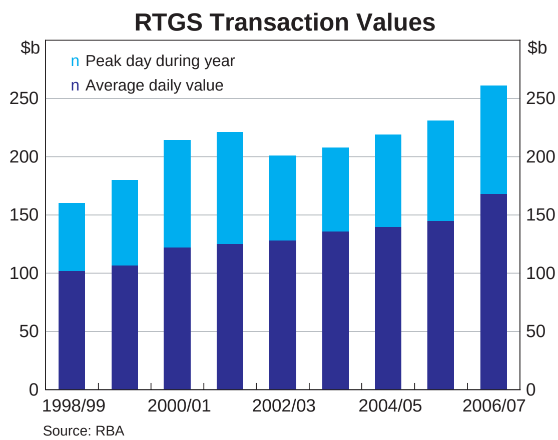
Most of these services fall within the core activities of central banks. Some services fall outside this core however, namely the transactional banking and registry services provided to Australian government agencies. These services are provided on a commercial basis in line with the Australian Government's competitive neutrality guidelines. This ensures that these services are provided on a comparable basis to similar services offered by commercial banks and other private-sector organisations.

Settlement Services

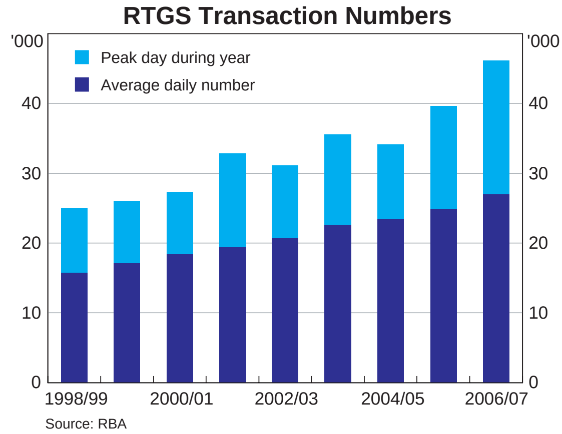
The Reserve Bank owns and operates the Reserve Bank Information and Transfer System (RITS), a real-time interbank payment and settlement service central to the operation of Australia's financial system infrastructure. It is accessed by around 60 Australian licensed banks and other institutions approved by the Reserve Bank to operate an Exchange Settlement Account (ESA).

Payments between these institutions are settled in RITS across respective ESAs; about 90 per cent, by value, is settled on a real-time gross settlement (RTGS) basis. All wholesale debt and money market transactions, Australian dollar legs of foreign exchange transactions and a range of time-critical customer payments are settled in this manner.

The number and value of RTGS transactions has risen in each financial year since the implementation of RTGS in Australia in June 1998. In 2006/07, the average number of RTGS settlements rose by 8.3 per cent to around 27 000 each day. Total average values settled rose more rapidly, by 15.8 per cent to $168 billion. On a peak day (such as the end of financial year or following a public holiday), the number and value of transactions settled is normally 50–60 per cent higher than on a typical day. In 2006/07, the highest daily value of transactions was $260 billion, on 29 June 2007.



In addition to RTGS payments, RITS settles two batches of netted interbank payments each day. One relates to low-value payments (cheque clearings, direct entry credits and debits, and retail electronic payments originating in systems such as EFTPOS), which are cleared overnight and settled at 9:00 am. The other batch settles net positions for equity transactions on the Australian Stock Exchange, which are first cleared through the Exchange's electronic settlement system, CHESS, before the net payments are settled over RITS. In November 2006, settlement of the CHESS batch migrated to a new batch settlement facility. This facility allows approved batch administrators for nominated (non-RTGS) payment streams to submit batches of netted interbank payments to RITS, by SWIFT message or manual entry, at any time during the business day.



The batch settlement facility is part of a broader Reserve Bank program to upgrade the RITS technical architecture and to enhance its core business functionality. A key element of the RITS evolution program is the migration to a modern browser-based user interface, which was completed by all external users during 2006/07. The new interface has provided these users with improved access to information, increased efficiency of RTGS payment management and extremely high security standards through the use of digital certificates on hardware tokens. The Reserve Bank has introduced RITS user forums to obtain feedback on use of the new interface and suggestions for improvement. Over the next two years, major milestones in the RITS evolution program will include the upgrade of hardware and software platforms and the use of additional liquidity optimisation features.

Settlement services are also provided for banknote lodgements and withdrawals by commercial banks and for high-value transactions undertaken by the Reserve Bank and its customers, including the Australian Government and overseas central banks and official institutions. At the end of June 2007, 37 central banks and official institutions overseas were using the settlement and safe custody services provided by the Reserve Bank to settle their Australian dollar transactions.

The criticality of these operations dictates the need for an extremely high level of contingency planning to ensure the continued availability of RITS and other settlement services provided by the Reserve Bank. The technical infrastructure supporting these services was strengthened during 2006/07 by the commissioning of new data centres at Head Office and at its new business resumption site. In the event of an operational incident affecting the Reserve Bank or ESA holders using RITS, good communication arrangements are also very important. In 2006/07, the Reserve Bank trialled a new facility to allow automated e-mail and telephone communications with RITS members. It is expected that this facility will be available for external communications in the second half of 2007.

Banking

The Reserve Bank provides banking and related services to the Australian Government, the Future Fund Board of Guardians, the Communications Fund and a number of overseas central banks and other official institutions. It also provides transactional banking services to around 90 government agencies. The services provided to these government agencies are focused on payments and bill collection services, and are provided on a commercial basis in line with the Australian Government's competitive neutrality guidelines. A number of commercial banks also provide transactional banking services to government agencies.

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

The Reserve Bank has also established term deposit investment facilities for other government entities, including the Future Fund Board of Guardians and the Communications Fund, based on the term deposit service it provides to the Australian Government. The Bank has also agreed to provide a debt securities custodian service to the Communications Fund, which is managed by the AOFM under a delegated authority from the Minister for Communications, Information Technology and the Arts and the Minister for Finance and Administration. Securities held by the Reserve Bank on behalf of the Communications Fund are held in Austraclear, a debt securities settlement system owned by Austraclear Limited (a wholly owned subsidiary of the ASX Ltd). Transactional banking services offered by the Reserve Bank include the provision of direct entry payments, high-value payments settled through RITS and cheque payments. The Bank's larger customers access these services through direct link arrangements, while smaller customers use ReserveLink, the Bank's desktop banking facility. During 2006/07, the Bank processed 256 million direct entry payments, 18 million cheques and around 5 100 high-value transactions on behalf of its customers.

The Reserve Bank provides its government agency customers with access to a number of bill collection services, including BPAY©, over-the-counter collections at Australia Post offices and card-based collection services via telephone and the internet. It also offers an overseas banking service, which enables its customers electronically to request overseas payments to be made via cheque, electronic funds transfer (wires) and direct entry payments. Overseas cheque and wire payments can be made in over 100 currencies, while overseas direct entry payments can be initiated in the local payments systems of 24 countries. These overseas direct entry payments are initiated by Centrelink to recipients of Australian government pensions who live abroad.

An internet-based service delivery system, known as RBANet, allows agencies to initiate account and transaction enquiries, perform statistical analysis of transaction activity at aggregate and account levels and manage the status of unpresented cheques. All of the Reserve Bank's proprietary banking systems are supported and developed by a dedicated in-house team of IT specialists. This, along with the specialised nature of the Reserve Bank's transactional banking services, allows the Bank to respond quickly to the needs of its government agency clients.

During the year, three of the Bank's client agencies market tested their transactional banking services. In all cases, the Bank was successful in retaining their business. A fourth agency has market tested telephone and internet bill payment services, with the result yet to be announced.

Earnings after tax in 2006/07 for the Reserve Bank's transactional banking services were $2.7 million, compared with $2.9 million the previous year.

Registry

The Reserve Bank provides registry services to the Australian Government and a number of official foreign institutions which have Australian dollar debt programs. In common with other registry operators, the services provided to clients include registration of new issuance, ongoing maintenance of ownership records, distribution of interest payments and redemption of securities at maturity. Additional services that are specific to the Commonwealth Registry include management and encashment of bearer securities; maintenance of records relating to Commonwealth Government securities (CGS) unclaimed monies; provision of reports to the AOFM summarising transactions arising from its CGS lending facility; and undertaking historical searches.

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

Because wholesale financial market participants settle their CGS trades electronically in Austraclear, the level of transaction activity in the Reserve Bank's registry is quite low and consists mainly of small-investor activity. Earnings after tax for the CGS registry business in 2006/07 were $0.1 million, the same as the previous year.

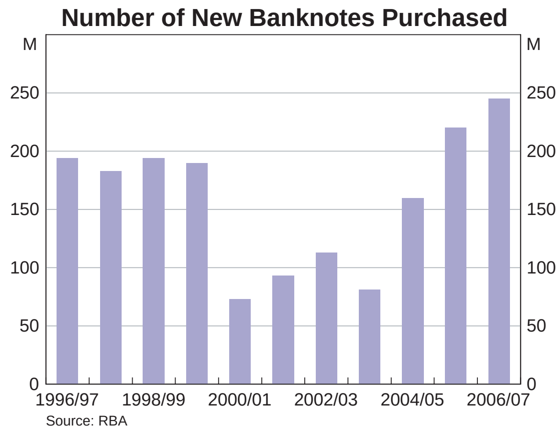
Note Issue

The Reserve Bank's note issue role is to ensure that the Australian public maintains its confidence in the nation's currency. This role involves three main responsibilities, namely:

- meeting the public's demand for currency through the issue and redemption of banknotes;
- maintaining a high quality of banknotes in circulation, including controlling the quality of new banknotes, evaluating banknotes returned from circulation and destroying banknotes no longer fit for circulation; and
- conducting research into and development of banknote designs and security features.

New Banknote Purchases

The Reserve Bank took delivery of 245 million new banknotes from Note Printing Australia in 2006/07, up from 220 million the previous year. This consisted of 51 million $5 banknotes, 42 million $10 banknotes, 80 million $20 banknotes and 72 million $50 banknotes. As has been



the case for a number of years, the Reserve Bank did not purchase any new $100 banknotes and continues to run down the stock acquired in 1999 as part of its contingency preparations for Y2K.

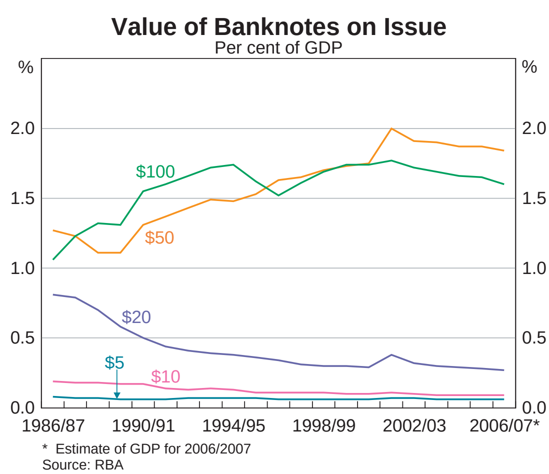
Banknotes on Issue

At end June 2007 there were 902 million banknotes on issue, with a value of $40.3 billion. This is equivalent to 43 banknotes worth about $1 900 for every Australian. By both value and number, the high denomination banknotes comprised the majority of banknotes on issue. Specifically, the $50 banknote accounted for nearly half of the value of banknotes on issue and 43 per cent of the number of banknotes on issue, while the $100 banknote accounted for 42 per cent of the value and 19 per cent of the number of banknotes on issue.

Value of Banknotes on Issue
($ million)

At End June	$5	$10	$20	$50	$100	Total[a]	Total (per cent of GDP)
2001	431	662	2 014	12 055	11 961	27 168	3.9
2002	530	791	2 789	14 718	13 057	31 930	4.3
2003	515	759	2 510	14 918	13 426	32 173	4.1
2004	533	791	2 533	15 941	14 224	34 022	4.0
2005	539	837	2 584	16 740	14 924	35 624	4.0
2006	572	857	2 690	18 044	15 903	38 066	3.9
2007	591	894	2 846	19 228	16 730	40 289	3.9 *

(a) Includes $1 and $2 banknotes remaining on issue.
* Estimate of GDP for 2006/07.



Over the past two decades, the growth in the value of banknotes in circulation has largely matched the nominal growth of the economy. This stability is consistent with that experienced in many other developed countries. Despite this, the total value of the higher-denomination banknotes, namely the $50 and $100, has increased as a share of GDP at the expense of some lower denominations. This partly reflects changes in the denominations withdrawn from ATMs, with the $50 increasingly replacing the $20 in many machines. In the case of the $100, which is only beginning to be issued from ATMs, its relative growth since its inception in 1984 is attributable to its role as a store of wealth.

Distribution

Working stocks of surplus banknotes that are owned by commercial banks are held in approved cash centres (ACCs) located throughout Australia. Commercial banks draw on these stocks when they need additional banknotes, and deal directly with each other in order to manage short-term variations in their individual stocks. When overall demand is unable to be met from stocks held at ACCs, the Reserve Bank distributes Australian banknotes in wholesale quantities to the commercial banks through the National Note Processing and Distribution Centre (NNPDC), located within Note Printing Australia at Craigieburn.

Throughout the year, banknotes deemed to be unfit by the commercial banks are returned to the NNPDC and processed through high-speed sorting equipment to confirm their quality and authenticity. Returned banknotes that are deemed to be fit by the NNPDC are reissued. Of the 219 million banknotes returned to the NNPDC during 2006/07, 123 million were identified as being unfit and were destroyed.

During 2006/07, the Reserve Bank issued 267 million banknotes from the NNPDC, with a face value of $9 billion. Of these banknotes, 114 million were previously circulated banknotes, reissued after processing, while 153 million were new banknotes. The remainder of the delivered new banknotes were added to the Reserve Bank's inventories.

Banknote Quality

The Reserve Bank aims to achieve a high quality of banknotes on issue. This ensures that the public can more easily detect counterfeit banknotes and that banknotes remain appropriately fit for use, particularly through the banknote accepting and dispensing machines used throughout the community. Achievement of this goal requires that the Reserve Bank issues high quality new banknotes and that unfit banknotes are returned to the NNPDC for destruction. As such, in the process of identifying unfit banknotes, the commercial banks and armoured car companies play an important role in achieving this quality objective.

With this objective in mind, the Reserve Bank reimburses commercial banks the cost associated with the return of unfit banknotes and banknotes required as part of quality assessment and cleansing programs. The arrangements with the commercial banks and armoured car companies were further enhanced in September 2006 with the introduction of the Note Quality Reward Scheme (NQRS). The NQRS offers significant incentives for commercial banks and armoured car companies to achieve a high standard of quality for banknotes stored at ACCs, while at the same time giving participants the freedom to choose the type of sorting equipment and infrastructure that best suit their particular requirements.

As part of the NQRS, banknote quality is assessed regularly from samples of banknotes selected by Reserve Bank staff from the working stocks of banknotes held at ACCs. These samples are sent to the NNPDC where they are processed through high-speed banknote processing machines and assigned a quality score. Based on the quality score achieved, a reward

Staff in Note Issue Department, Martin Bowerman and Jodie Worby, are shown preparing work in advance of a visit to approved cash centres to select note samples under the Note Quality Reward Scheme (NQRS). The Reserve Bank established the NQRS with commercial banks in September 2006 as a means of improving the quality of notes in circulation.

or penalty is then applied. In order to encourage changes in fitness sorting behaviour and/or the infrastructure in all ACCs throughout the country irrespective of their size and location, a framework of minimum reward/penalty thresholds has been established.

Although sampling commenced during the trialling of the NQRS arrangements prior to September 2006, the first payment was made only in January 2007, based on banknote quality scores received in December 2006. Encouragingly, data collected to date show an improvement in banknote quality.

Damaged Banknotes

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

During 2006/07, the NNPDC assessed around 28 500 banknote claims, and paid value of around $3 million. The number of claims was only slightly higher than last year, while the value of claims paid was lower.

Counterfeiting in Australia

The rate of counterfeiting in Australia remains very low by world standards. In 2006/07, there were about six counterfeit banknotes passed per million banknotes in circulation. By a considerable margin, the most commonly counterfeited denomination was the $50 banknote, with around 10 counterfeits detected for every million genuine $50 banknotes in circulation. In contrast, counterfeits of the other Australian banknote denominations represented less than a third of the total counterfeits by value and number.

Counterfeit Banknotes in Australia
2006/07

	$5	$10	$20	$50	$100	Total
Number	50	274	722	3 920	580	5 546
Value ($)	250	2 740	14 440	196 000	58 000	271 430
Parts per million	0.4	3.1	5.1	10.2	3.5	6.2

Over the past few years, counterfeiting rates have remained considerably lower than a decade ago and below the levels of counterfeiting experienced in other developed nations. Importantly, there is little evidence of 'professional' counterfeiting activity in Australia and most counterfeits are relatively crude, printed on paper using widely available reprographic technologies. This, combined with the relatively low counterfeiting rates, suggests that printing banknotes on polymer substrate continues to be a significant inhibiting factor. Nonetheless, the Reserve Bank takes all counterfeiting incidents seriously even though the level of counterfeiting is currently quite low. In particular, the Bank conducts extensive research and development into improving the security of Australia's banknotes and works with law enforcement agencies in Australia and overseas to monitor and combat emerging counterfeiting trends.

Numismatics

Prior to February 2007, the Reserve Bank sold Australian banknotes that were of numismatic interest through the Royal Australian Mint. Largely reflecting the prospect of increases in administrative charges to the public, these arrangements were terminated on 28 February 2007. In its place, the Bank will provide collectors and dealers with access to similar numismatic products through an annual public auction. Following a tender process, the Bank has appointed a company to conduct a public and internet auction of first and last prefix banknotes and to sell uncirculated banknotes in October/November 2007. The Reserve Bank continues to offer uncirculated banknotes for sale through its Sydney and Canberra branches.

Note Printing Australia

Note Printing Australia Limited (NPA), based at Craigieburn in Victoria, is a wholly owned subsidiary of the Reserve Bank, which produces banknotes for Australia and export and was the first banknote printer in the world to print on polymer substrate. With Securency Pty Ltd, which supplies print-ready polymer substrate, it has led the way in establishing polymer technology as a viable alternative to paper for banknotes.

During 2006/07, NPA produced 245 million notes for the Reserve Bank and 213 million export notes, continuing the high level of production established the previous year. Among its export deliveries were orders for Banco Central de Chile, Bank Negara Malaysia, the Bank of Papua New Guinea, the Brunei Currency and Monetary Board, the Monetary Authority of Singapore and the Reserve Bank of New Zealand. A number of other banknote printers have now taken up the polymer technology, in many cases assisted by technology transfer from NPA.

Investment this year, including upgrades to two Intaglio printing presses and the leasing of a new numbering machine, has tightened process controls, improved print quality and increased productivity. The outlook is for another strong production year in 2007/08, with an order for 280 million notes from the Reserve Bank and confirmed export orders of 177 million notes for countries in the Asia-Pacific region.

NPA was awarded two medals at the 24th National Print Awards in the category of security printing. A gold medal was awarded for the Brunei $10 000 and a silver medal for the Brunei $500.

As the Reserve Bank has undertaken a program to improve the quality of banknotes in circulation, the National Note Processing and Distribution Centre (NNPDC), operated by NPA under contract from the Reserve Bank to reissue or withdraw circulating Australian notes, processed a significantly higher volume of notes than in recent years, achieving higher rates of productivity in the process.

NPA continued to work with Securency in research and development, marketing and customer support for international business. NPA has now printed 56 denominations for 18 countries, including Australia, since 1990. Securency has supplied polymer to overseas printers for a further 27 denominations in 12 countries. In all, 25 countries, covering all continents, have issued polymer notes. As well as Australia, New Zealand, Romania and Vietnam have converted all their denominations to polymer, while Brunei and Papua New Guinea are approaching full conversion.

In addition to banknotes, NPA prints other security documents, including Australia's passports. During 2006/07, 800 000 Australian passports were printed and assembled for the Department of Foreign Affairs and Trade, of which 780 000 books were of the 'M' series electronic chip passports. The new design 'N' series passports are expected to be launched during 2008. In recent years NPA has widened the range of security products it offers using polymer note-printing technology, including by producing academic transcripts for a number of universities.

NPA's Board operates under a charter from the Reserve Bank Board and comprises Graeme Thompson (Chairman), Richard Warburton AO, Les Austin, Mark Bethwaite and Frank Campbell. Mark Bethwaite will leave the Board at the end of September 2007 after 17 years of valuable service, including a brief period as acting Managing Director.

Securency

Securency Pty Ltd is a joint venture between the Reserve Bank and Innovia Films, a global supplier of polypropylene films. Securency sells locally to NPA, and to overseas-based banknote printers, high-security polymer substrates produced by applying unique coatings and security features to the specialised films supplied by Innovia. It currently supplies three types of substrate: Guardian® to high-security printers for banknotes; Sentinel® for other high-security documents such as land titles and academic transcripts; and Sentrii® for secure cards.

With growing demand from traditional and new customers, Securency again achieved record output during 2006/07. Repeat orders for high-volume circulating denominations from several countries point to the success of polymer note technology, which combines the benefits of reduced long-term cost with significantly lower rates of counterfeiting.

Securency produced substrate for 14 countries during the year. These comprised Australia, Brunei, Chile, Guatemala, Hong Kong, Malaysia, Mexico, New Zealand, Nigeria, Papua New Guinea, Romania, Singapore, Taiwan and Vietnam. In excess of 90 per cent of Securency's revenue comes from exports.

Twelve new denominations were launched on polymer during the year, and two countries were added to the list of polymer issuers. Nigeria issued a 20 naira polymer note and Hong Kong issued a $10 polymer note in mid 2007. The other new denominations comprised the Brunei $20, $500, $1 000 and $10 000; Mexico's 50 peso; Romania's 200 lei; Singapore's $5 and $20; and Vietnam's 10 000 and 200 000 dong. A redesigned 2 kina was produced for Papua New Guinea as part of its new note series. Significantly, in 2006 Vietnam completed the changeover of all note denominations to polymer. Romania also added the 200 lei denomination to its series of polymer notes. An innovative optically variable security feature called G Switch®, which was launched on the PNG 100 kina, has now been successfully incorporated in banknotes for Brunei, Hong Kong, Mexico, Nigeria and Papua New Guinea.

Securency has now doubled its manufacturing capacity at Craigieburn, with a second line commissioned in early 2007. This major capital investment in new plant and facilities is already enabling Securency to improve its customer service and response times and will be the blueprint for further expansion internationally in the coming few years.

Securency is continuing to invest in technology to stay ahead of counterfeiters, and plans to install a dedicated pilot line press to accelerate its research and development program. Specifications are being finalised and the plant will be commissioned in late 2007 or early 2008. As part of its risk management strategy, Securency will also build a new coating facility at the Craigieburn site in the latter part of 2007, enabling it to be self-sufficient in sourcing this critical raw material.

Polymer notes have been very successful in Mexico and other Latin American countries. Against this background, early in 2007 Securency and Banco de Mexico entered a joint-venture

Securency's new polymer substrate line, commissioned early in 2007, has doubled its production capacity.

First Stone ceremony at the construction site of Securency's joint-venture substrate plant in Queretaro, Mexico. Graeme Thompson, Securency Chairman (fourth from left), Myles Curtis, Securency Managing Director (fifth from left) and Hon Neil Mules, Australian Ambassador to Mexico (third from left), with senior representatives of Banco de Mexico and government.

agreement to establish a polymer security substrate manufacturing plant in Mexico. This plant, located in Queretaro, north of Mexico City, will be operational in 2009.

Given the interest in polymer technology in Latin America, Banco de Mexico hosted the Regional Polymer Banknote Symposium in Mexico City in June 2007. The symposium provided a forum for delegates and internationally recognised experts from the banknote industry to exchange experiences in currency issuance. Participants included senior officials of Banco de Mexico and regional central banks and printing agencies from 18 countries.

Securency's Board comprises three directors appointed by the Reserve Bank, three appointed by Innovia and the company's Managing Director, Myles Curtis, as a non-voting member. Securency's offices and plant are located at Craigieburn, on the same site as NPA and adjacent to the Innovia plant that supplies it.

International Financial Co-operation

The Reserve Bank interacts with its counterparts in other countries across the spectrum of its activities, both on a bilateral basis and through its involvement in international groupings and international institutions. The Bank continued to participate in the International Economic Policy Group, which is the Australian government body responsible for exchanging information on and co-ordinating Australia's approach to international economic policy matters.

Two key initiatives in the international co-operative efforts of the Reserve Bank during 2006 were its involvement in the chairing of the G-20 forum and the bilateral exchange program with Bank Indonesia, which is conducted under the auspices of the Australian Government's Government Partnership Fund. These and other aspects of the Reserve Bank's international co-operation activities are described below.

Group of Twenty (G-20)

The G-20 has been meeting since 1999 to discuss matters of international economic and financial significance for systemically important advanced and emerging market countries. Representatives of finance ministries and central banks from the 19 member countries and the European Union participate in the meetings, as do representatives from the IMF and World Bank.

Australia was chair of the G-20 during 2006, with the role shared between the Australian Treasury and the Reserve Bank. The year culminated with a meeting of finance ministers and central bank governors in Melbourne in November. The Governor joined the Treasurer in chairing the meeting and the Assistant Governor (Economic) – the Reserve Bank's G-20 Deputy – was also a participant. In addition, the Reserve Bank provided substantial logistical and technical support with over 20 staff from across the Bank acting as liaison officers for the attending central bank governors and also for the Managing Director of the IMF. The cost to the Reserve Bank of its involvement in the G-20 in 2006/07 is estimated to have been around $700 000.

The agenda of the November meeting covered the global economic outlook, the functioning of global energy and minerals markets, the financial implications of demographic change, and reform of the IMF and World Bank. In each of these areas the discussion benefited from the broad experience and range of perspectives among the membership and the relatively informal dialogue that is a characteristic of the G-20. One of the topics that received particular attention was the financial implications of demographic change. This was the subject of a G-20 workshop hosted by the Reserve Bank in Sydney in July 2006. On the topic of IMF and World Bank reforms, the G-20 meetings helped to develop the broad consensus that led to the IMF Governors agreeing, in September 2006, to increase the voting share of four of the most under-represented IMF members (China, Korea, Mexico and Turkey).

In 2007, Australia has remained closely involved in setting the G-20's agenda through its membership of the G-20 management troika, an oversight committee of G-20 deputies that also includes the 2007 chair (South Africa) and the 2008 chair (Brazil). The G-20's agenda for 2007

Treasurer Peter Costello and Governor Glenn Stevens represented Australia at the G-20 meeting of finance ministers and central bank governors in Melbourne in November 2006.

G-20 Meetings

Date	Event	Location
2006		
July	G-20 Workshop on Demography and Financial Markets	Sydney
October	Second Meeting of G-20 Finance and Central Bank Deputies	Sydney
November	Meeting of G-20 Finance Ministers and Central Bank Governors	Melbourne
2007		
March	G-20 Workshop on Reform of Bretton Woods Institutions	Rio de Janeiro
March	First Meeting of G-20 Finance and Central Bank Deputies	Pretoria
May	G-20 Workshop on Commodities and Financial Stability	Washington
July	G-20 Workshop on Fiscal Policy	Istanbul
September	Second Meeting of G-20 Finance and Central Bank Deputies	Durban
November	Meeting of G-20 Finance Ministers and Central Bank Governors	Cape Town

is focused on the financial stability aspects of commodity markets, the relationship between fiscal policies and economic development and poverty reduction, as well as its ongoing emphasis on IMF reforms.

Bank for International Settlements (BIS) and Associated Committees

The Reserve Bank continued to participate in the bi-monthly meetings of governors and the associated committees of the BIS. These focus on a wide range of monetary, financial and central banking issues, as well as on global macroeconomic developments. In November 2006, these BIS meetings were held in Sydney to coincide with the hosting of the G-20 forum by Australia and involved 45 governors of central banks. Reserve Bank staff provided significant logistical support for this event.

During the year, the Governor participated in the two meetings of the BIS Asian Consultative Council (ACC). The ACC is responsible for overseeing the work program of the BIS Asian office in Hong Kong, including the office's research agenda. Over the past year,

Governors of BIS member central banks held their bi-monthly meetings in Sydney in November 2006.

the Reserve Bank contributed directly to this research by co-authoring two articles that were published in the BIS *Quarterly Review*. Some of this research was undertaken by a Reserve Bank officer during a four-month secondment to the BIS Asian office in the second half of 2006.

The Assistant Governor (Financial Markets) represented the Reserve Bank on two BIS committees, namely the Committee on the Global Financial System (CGFS) and the Markets Committee. The CGFS examines issues relevant to the stability of financial markets and the global financial system, while the focus of the Markets Committee is on the short-run implications of particular current events for the functioning of financial markets. The CGFS commissioned three working groups in 2006/07 in which Bank staff participated. One of these working groups studied the relationship between institutional investors, global savings and asset allocation; it released its report in February 2007. The report highlighted the impact of recent and prospective regulatory and accounting changes on the investment decisions of institutional investors. Of the two other working groups, one is considering the implications for financial stability of the development of local-currency bond markets, while the other is examining issues surrounding the private equity and leveraged finance markets. Both working groups are expected to release their reports during 2007/08.

The Reserve Bank also continued to second senior staff to the BIS. In February 2007, a member of staff from Economic Group commenced a two-year secondment and a member of staff from Audit Department was seconded to the Internal Audit Department of the BIS for nine months.

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

EMEAP is the primary forum for co-operation among central banks in the Asia-Pacific region. EMEAP governors met in the Philippines in June 2007, where they discussed issues surrounding the implications of reserves accumulation for EMEAP economies as well as the possible impact on EMEAP economies of any rise in global risk aversion. EMEAP governors also met with representatives from the Eurosystem central banks while they were in Sydney attending the BIS bi-monthly meetings in November 2006. Governors discussed key issues confronting policy-makers in both regions, including: the link between the integration of emerging economies into the world economy and global inflation; global imbalances and their implications for financial stability; and regional financial integration, with a focus on the ongoing processes of financial integration in the Asia-Pacific region and Europe.

A key development in EMEAP during the year was the creation of a new committee of EMEAP deputies, to examine issues relating to monetary and financial stability in the region in greater detail. This new EMEAP Monetary and Financial Stability Committee held its first meeting in April 2007. Discussions focused on global imbalances, asset price cycles and monetary policy, the implications of demographic change for financial markets, and the short-lived effect of the turbulence in stock markets in the early part of 2007.

The EMEAP process also entails three working groups, which cover financial markets, banking supervision, and payments and settlements issues. The Head of Payments Policy Department at the Reserve Bank was the chair of the Working Group on Payments and Settlement Systems for part of 2006/07, including for a meeting of the Group held in Sydney in October. One of the issues on which the Group made progress during the year related to oversight of SWIFT, the messaging infrastructure utilised globally for most foreign exchange and correspondent banking. EMEAP has been seeking to obtain improved access to oversight information on SWIFT and is working with SWIFT's lead overseer, the National Bank of Belgium, towards achieving this aim.

The Working Group on Financial Markets continued to monitor and analyse developments in individual country markets during the four meetings it held during 2006/07, one of which was hosted by the Reserve Bank. There was also ongoing work undertaken by this Group relating to the Asian Bond Funds, which were established to assist the development of regional bond markets. Both the Korean and Indonesian country funds were opened to private-sector investment during the year (see the 2005 *Annual Report* for more detail on the Asian Bond Funds). The Group also continued its regular bi-annual meetings on foreign exchange with representatives from the Federal Reserve Bank of New York, European Central Bank, Bank of England and Bank of Canada.

The Working Group on Banking Supervision continued to devote much of its time to issues relating to the implementation of the new Basel Capital Framework in the Asia-Pacific region. To facilitate this, the Group maintained its interaction with the Basel Committee on Banking Supervision, including holding one high-level meeting with Committee members in Hong Kong in November 2006. Consistent with efforts to enhance regional surveillance, the Working Group devoted more time to reviewing and comparing macro-prudential surveillance techniques in member countries and reporting on the condition of member countries' banking systems. The Working Group also established a number of Interest Groups to explore technical issues in more detail, including one co-ordinated by the Reserve Bank on macro stress-testing techniques.

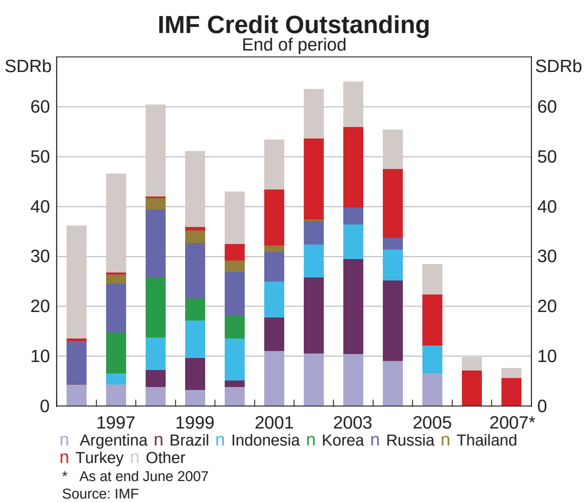
Financial Stability Forum (FSF)

Since being formed eight years ago, the FSF has worked to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to spread from country to country. The FSF's mandate is to assess vulnerabilities affecting the international financial system and to identify and oversee action needed to address these vulnerabilities. FSF members meet twice a year to co-ordinate their efforts and share information. Membership of the FSF comprises senior representatives from central banks, finance ministries and supervisory agencies of the G7 countries, and central bank governors from Australia, the ECB, Hong Kong, the Netherlands, Singapore and, more recently, Switzerland, which was invited to become a member of the FSF in January 2007. Other participants in the FSF include representatives from the BIS, IMF, World Bank and other international forums.

In response to a request by the G7 finance ministers and central bank governors, the FSF updated its 2000 *Report on Highly Leveraged Institutions*. The updated report recommends action by financial authorities, counterparties, investors and hedge fund managers to strengthen protection against potential systemic risks relating to hedge funds and other highly leveraged institutions. The report recognised the contribution hedge funds have made to financial innovation and market liquidity, but noted that there are heightened risk measurement, valuation and operational challenges for market participants.

International Monetary Fund (IMF)

In 2006 Australia concluded its first Financial Sector Assessment Program (FSAP) with the IMF. As noted in the 2006 *Annual Report*, a core element in this process was an evaluation of Australia's compliance with a number of internationally accepted standards and codes relating to banking, insurance, securities regulation and systemically important payment systems. A second element was stress-testing of the financial system – a task that was jointly undertaken by IMF staff, the Australian authorities and the five largest Australian banks, with the Reserve Bank playing the key co-ordinating role. The main findings of the Australian assessment were released by the IMF in October 2006, with the detailed assessments of standards and codes released in November. The assessment concluded that Australia's financial sector is mature and strong, and that both the banking system and



the regulatory and supervisory structure are sound. RITS was found to be a sound and efficient payments system that fully complies with the international standards.

The IMF's FSAP initiative is part of a broader shift in the focus of its activities, away from lending activities towards other areas of its mandate, particularly surveillance. This partly reflects a decline in the IMF's lending in recent years, as most of those countries affected by the financial crises of the past decade have repaid their IMF loans and as buoyant global conditions have resulted in little demand emerging for new large-scale borrowing.

As the IMF strengthens its surveillance activities, capital market developments, global financial stability and financial market supervision are becoming an increasingly significant part of its work. The Reserve Bank has been a strong supporter of efforts to improve the effectiveness of the IMF's advice in these areas. The Bank has participated in a number of initiatives designed to tap in to the expertise of practitioners in the financial and capital markets arena, particularly in the Asian region. The Assistant Governor (Financial Markets) and Head of Domestic Markets Department participated in two such seminars hosted by the IMF in 2006/07, one on the IMF's exchange rate analysis and the other on the role of hedge funds in Asian financial markets.

On a parallel track, the Reserve Bank has supported Australia's efforts to modernise the IMF's governance structure, especially in the areas of voting and representation, so that it better reflects both the changing dynamics of the global economy and the evolving role of the IMF. As a result of the decision at the 2006 IMF Annual Meetings to increase the voting share of four of the most under-represented emerging market economies, Korea (which is one of the countries in Australia's constituency group) saw its voting share of total IMF votes rise from 0.76 per cent to 1.34 per cent.

Government Partnership Fund (GPF)

As described in the 2006 *Annual Report*, the Reserve Bank has an extensive capacity-building program in place with Bank Indonesia under the Australian Government's GPF. Following the successful completion of the program's first year in 2006, the 2007 program has seen an increase in the exchange of officers.

While the program remains focused on capacity building in the areas of monetary policy and financial stability, the scope has broadened to include most other areas of central banking, including payments systems and risk management. Reflecting the broader coverage, visits by Bank Indonesia officers have moved from a fixed three-month period to more flexible shorter periods, depending on the nature of the work. As a result, the number of Bank Indonesia visitors to the Reserve Bank is expected to more than double in 2007, to around 35.

There will also be a substantial number of short-term visits by Reserve Bank staff to Indonesia. In the first half of 2007 Reserve Bank officers who visited Indonesia undertook workshops and training sessions in the areas of payments system oversight, risk management and the implementation of a business liaison program in Indonesia, along the lines of the Reserve Bank's program. The Head of Financial Stability Department also visited Indonesia to give a series of presentations on Australia's experience of participating in the IMF's FSAP; stress-testing methodologies; and, in connection with the establishment of an Indonesian Financial System Stability Forum, the functioning of the Australian Council of Financial Regulators. A common theme of these visits has been the exchange of information on both the technical aspects and organisational structure supporting core central banking responsibilities, in line with the overall aim of the GPF program to strengthen Indonesia's economic governance and public-sector management capabilities.

Asia-Pacific Economic Cooperation (APEC)

The Reserve Bank's involvement in APEC has centred on the financial sector and capital market initiatives undertaken by the grouping during the year. The Deputy Governor, Assistant Governor (Financial System) and other senior management presented to and attended workshops on financial sector reform, bond market development and the APEC Future Leaders' Meeting. As in previous years, the Bank provided the HC Coombs Centre as the venue for the Future Leaders' Meeting.

South Pacific Central Bank Governors

The Reserve Bank places considerable importance on promoting relations with the central banks of the South Pacific region. In addition to the exchange of staff and technical visits by Reserve Bank officers, the central bank governors of the six Pacific Island nations that have their own currencies (Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu) meet annually to discuss matters of mutual interest with their counterparts from Australia and New Zealand. This year's meeting in December 2006 was held in Wellington, with representatives from the Pacific Financial Technical Assistance Centre and the IMF also participating. The implications for the Pacific Island economies of global economic developments and the new Basel Capital Framework were the main issues discussed, as well as the management of foreign exchange reserves and the role of remittances in the Pacific region.

Bilateral Relations and Co-operation

In addition to the GPF program with Bank Indonesia, throughout 2006/07 the Reserve Bank maintained an active program of technical co-operation with other central banks, particularly in the Asia-Pacific region. A member of staff returned from a two-year secondment to the National Reserve Bank of Tonga, while another member of staff made a short-term visit there to advise on liquidity management and forecasting. An officer also visited the Bank of Papua New Guinea (BPNG) to provide support on the development of BPNG's risk management policies. These visits were in addition to the frequent electronic communications with central banks throughout the region.

As in previous years, the Reserve Bank received many visitors during 2006/07 from overseas central banks interested in observing how the Bank carries out its responsibilities. This year there were visits from the central banks of the People's Republic of China, Fiji, Nigeria and Thailand.

The Reserve Bank in the Community

Activities of the Regional Offices

In addition to its head office located in New South Wales, the Reserve Bank has offices in Victoria, Queensland, South Australia and Western Australia.[1] This network of Regional Offices is an important component of the Reserve Bank's presence in the community, fostering greater communication with members of the public, business, government and academia in their respective States and facilitating events involving the Reserve Bank in their local area.

As part of the Reserve Bank's efforts to keep the public informed of its evolving views on the economy, Regional Office staff regularly give presentations on economic developments to business groups, community organisations and educational institutions, in both State capitals and regional centres. In addition, senior staff from Economic Group visit the Regional Offices each quarter, following the release of the *Statement on Monetary Policy*, to brief groups of liaison contacts on the main themes. There were 56 such presentations and briefings in 2006/07.

In addition to their representational role, the Regional Offices are a key component of the Reserve Bank's business liaison program. Since 2001, the Bank has systematically built relationships across a broad cross-section of the business community, with a view to gaining first-hand insights into conditions in different industries and regions within the national economy.

Staff from the Reserve Bank's WA Office, Mark Gugiatti (Economist), second from left, and Virginia Christie (Senior Representative), at the Geraldton Port Authority with Peter Klein (CEO, Geraldton Port Authority), left, and Phil McAuliffe (Project Manager Infrastructure & Business Development, Mid West Development Commission), right.

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

The staff involved in the regional liaison program have built up a pool of over 1 500 regular contacts around the country, visiting about 100 of them each month. The information obtained is reported in detail to Head Office and incorporated into the material prepared for monthly Board meetings and in the quarterly *Statement on Monetary Policy*. In this way, information obtained from liaison is used as a complement to standard sources, such as data from the Australian Bureau of Statistics and business surveys, in forming the Reserve Bank's assessment of the economy.

Museum of Australian Currency Notes

The Museum, which opened in March 2005, exhibits the story of Australia's currency notes against the background of the nation's broader history. After an introductory stage on developments before Federation, which includes Australia's first gold coins, visitors can review the various series of notes produced since the first Australian notes in 1913–1915. The final stage in the Museum focuses on Australia's polymer banknotes, including information on their design, security, recycling and other features. As well as viewing the original notes, visitors can learn about the men and women represented on the notes over the years, the artwork used in their design and some of the key historical episodes in Australian history through the Museum's displays of archival film, photographs and documents.

About 8 650 people visited the Museum in 2006/07. The museum has been particularly popular with school groups, many of which receive a short presentation on the Reserve Bank or, in the case of senior students, a talk on the Australian economy. Most of the information in the Museum is on the Reserve Bank's website, where visitors can also take a virtual tour of the Museum. Around 160 000 people visited the Museum online in the past year, over half from other countries.

Virginia MacDonald of Information Department welcomes members of the public visiting the Museum of Australian Currency Notes on Australia Day.

Financial Assistance for Research and Education

The Reserve Bank sponsors a range of research and related activities, such as conferences and workshops, that are associated with its primary responsibilities. Several universities and think-tanks were sponsored by the Reserve Bank in 2006/07, with their activities focusing on areas including macroeconomics, econometrics and financial markets. Sponsorships such as these can be on a one-off basis or ongoing.

For many years the Bank has contributed towards the cost of a monthly survey of inflation expectations, undertaken by the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne, and a quarterly survey of union inflation and wage expectations, undertaken by the Workplace Research Centre at the University of Sydney.

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

Financial assistance to Australian universities each year includes contributions towards the costs of their organising conferences in economics and closely related fields. In 2006/07, these conferences included the annual Conference for PhD Students in Economics and Business, held at the Australian National University; the Economic Society of Australia's 35th Conference of Economists, held at Curtin University; the 12th Melbourne Money and Finance Conference, held at the University of Melbourne; the 12th Australasian Macroeconomic Workshop, held at La Trobe University; the Australasian Meeting of the Econometric Society, held at the University of Queensland; the University of New South Wales' 19th Australasian Finance and Banking Conference; and the Financial Integrity Research Network Doctoral Tutorial, held at the University of Technology Sydney. The Bank was also a sponsor of the Melbourne Centre for Financial Studies' inaugural International Distinguished Lecture, delivered by Mervyn King, Governor of the Bank of England.

In order better to engage and support students of economics, the Reserve Bank is sponsoring an essay competition for undergraduate students across Australia, to be organised jointly with the University of New South Wales Economics Society. Entrants are required to submit a 2 000-word essay analysing the consequences of an ageing population for Australia's future economic growth and commenting on its implications for economic policy. The winners of the competition will receive a prize and be recognised by a presentation at the Reserve Bank.

In conjunction with APRA, the Bank has continued sponsorship of the Brian Gray Scholarship Program, initiated in 2002 in memory of a former senior officer of the Reserve Bank and APRA; three scholarships were awarded under this program in 2007, two for honours year studies and the other for a Bachelor of Science degree majoring in Statistics, Finance and Mathematics, all at the Australian National University.

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

Charitable Activities

During the year, the Reserve Bank made its fifth annual contribution of $50 000 to the Financial Markets Foundation for Children, of which the Governor is Chairman; along with several other Australian financial institutions, the Bank is committed to support the Foundation to this extent for a further five years. In July 2007, in its second public event to raise funds, the Governor addressed the Anika Foundation, which was established in 2005 to raise funds to support research into adolescent depression and suicide.

Reserve Bank staff interact with the community in a number of volunteering capacities, including, in the past year, the Cancer Council's Daffodil Day fundraiser, the Jeans for Genes Day annual fundraiser for the Children's Medical Research Institute and the Christmas food collection for the Salvation Army's Streetlevel Mission. Staff also run a Benevolent Fund, funded by regular salary deductions and special fund raisings, which makes donations to the charities it supports.

Management of the Reserve Bank

Operating Costs

The Reserve Bank requires staff and other resources to conduct its operations and meet its policy objectives. Operating costs incurred in carrying out its activities in 2006/07 amounted to about $185 million, a rise of 6.2 per cent from the previous year. Cost increases related to existing activities amounted to 5½ per cent, and new or temporary activities accounted for the remainder of the rise. These included the construction, fitting out and staffing of the new self-contained business resumption site (BRS); preparations for and co-hosting of the G-20 meeting of finance ministers and central bank governors held in Melbourne in November 2006; establishing a new data centre to strengthen the Bank's information technology (IT) systems infrastructure and contain associated risks; and development of new systems in support of economic analysis and the delivery of business services.

Operating Costs[(a)]
($ million)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Staff costs	73.9	77.8	85.5	91.4	101.0	110.2
Other costs	58.4	62.7	58.6	68.8	73.1	74.7
Underlying operating costs	132.3	140.5	144.1	160.2	174.1	184.9
Cost of redundancies	3.4	2.6	0.2	0.2	0.2	0.2

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

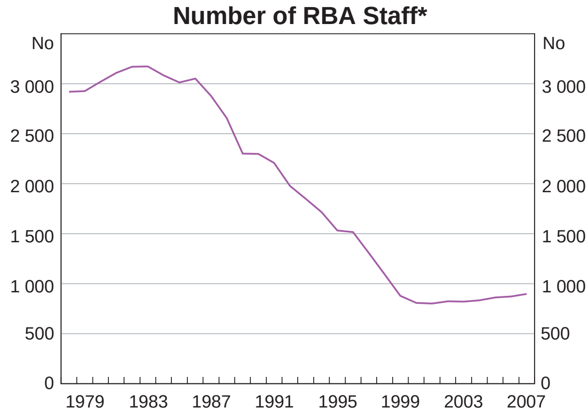
Like most other financial institutions, staff costs represent the largest single expense, accounting for around 60 per cent of total operating costs in recent years. The increase in staff costs in 2006/07 reflected a rise in base salaries of 4 per cent in November 2006, as well as some increase in staffing and the use of short-term contractors to assist with the projects mentioned above. On actuarial advice, the Bank increased its contributions to the staff superannuation fund, restoring funding to a more normal long-term rate, after contributions had been made at significantly below the long-term norm, also on actuarial advice, for much of the previous decade.

Total employees numbered 896 at 30 June, a rise of 2.8 per cent over the year. More than half of the increase came from staffing the BRS, which became operational in mid 2007. When fully operational, this facility will employ 60 permanent staff in settlements, banking and IT. Some of these positions will be transferred from Head Office, but the new and fully operational BRS results in some increase in both staffing and costs. By providing greater certainty about the continuity of the Reserve Bank's critical systems, the BRS also strengthens Australia's financial

The completed business resumption site building, Bella Vista, Sydney (above).

Richard Mayes, Head of Facilities Management Department, third from left, inspects the auxiliary generator installation at the business resumption site with, from left to right, Martin Patience of Grindley Construction (builder), Rudi Valla of Dem (architect) and Matilde El Azzi from the RBA project team.

system infrastructure. The groups responsible for monetary policy, financial market operations and financial system stability account for around half of the Reserve Bank's total operating costs. Banking, note issue and settlements each account in roughly equal measure for the remainder.



* As at 30 June, excluding NPA
Source: RBA

Staff numbers have tended to rise since 2001 after a period of large staff reductions. These staff reductions were associated with the loss of State government banking business in a number of the Bank's branches around Australia and the application of computer technology to the Bank's banking and registry activities. This permitted these activities to be consolidated in one location, Sydney, whereas they had previously been conducted in each of the States, and with many fewer staff. Large reductions in staff numbers also occurred with the outsourcing of tasks associated with the distribution of banknotes. The major reductions in staffing occurred in the branches.

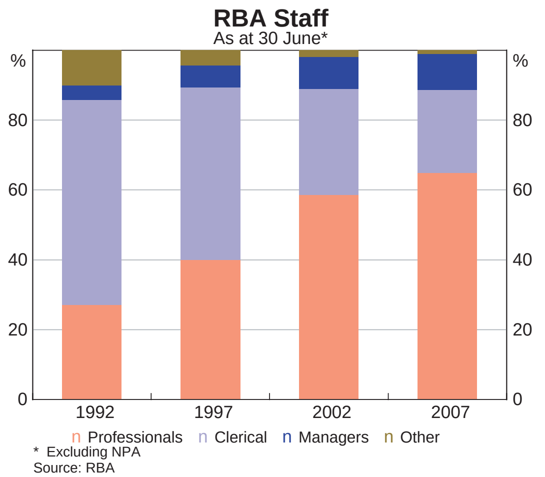
Over time, the Bank has faced the need to put more resources into systems, leading to staff increases in the computing area, as well as higher spending on equipment. With greater reliance on IT for the delivery of services, the Bank's policy and operational areas have also required commensurately higher standards of security, availability and efficiency in these IT and communications systems. This has led to a significant addition of new staff with relevant, specialised skills.

The benefits of these developments in the Bank's IT systems are reflected in a number of its activities. The resumption of responsibility for computer operations, software development and support functions for RITS has reduced operating risks associated with the interbank settlements system and improved access to, and the efficiency of, the system itself. The Bank's systems for market operations are now fully integrated from front-office to back-office, including reporting functions, both increasing efficiency and reducing risk. Development of internet-based systems has improved the public's access to policy-related material as well as to the systems used by the Reserve Bank's banking customers. A number of systems have also been developed to assist analysis in the Bank's policy areas.

In light of their increasing call on resources, the Reserve Bank has considered from time to time the case for outsourcing some of its IT functions. It has generally decided against this approach, however, either because costs would not be significantly reduced by doing so or because outsourcing of critical systems, with the attendant diminution of control over them, would court risks that the Bank would not regard as acceptable.

Staffing

The current climate of strong expansion in the financial sector has presented more challenges for the Bank than has been the case for some time, as other financial institutions seek well-trained, professional staff, including from the Reserve Bank. The highly competitive jobs market in financial services means that, like other financial institutions, the Bank must keep its staffing policies under continual review.



That said, the Reserve Bank has continued to recruit an adequate number of high-calibre staff from across Australia in recent years. Forty-one graduates, predominantly with honours degrees, joined the 2007 two-year Graduate Development Program, more than half from interstate. Graduates are employed in areas related to economic and financial policy, IT, accounting and law.

The professional staff now account for almost two-thirds of the Reserve Bank's employees, compared with just over a quarter a decade and a half ago. Over half of the staff hold a bachelor's degree and a fifth have post-graduate qualifications.

Financial support is provided to employees who undertake part-time study in disciplines related to their work and, in a limited number of cases, for full-time post-graduate study at universities in Australia and overseas. Almost a quarter of current staff have received financial support for study over the course of their career. There is ongoing career development and training, including management training, and secondments to other organisations. During 2006/07, staff were seconded to the BIS, Bank of England, Bank of France, Reserve Bank of New Zealand, APRA and ASIC.

The majority of staff are employed on individual contracts, which provide flexibility in awarding remuneration based on performance and market relativities. Independent consultants are engaged to ensure that remuneration policies are consistent with market practice. During the past year, the policy on providing concessional housing loans to some staff was reviewed, resulting in the cessation of further drawings on such loans by the minority of staff who still had access to them. Staff employed on individual contracts had already been ineligible for housing loan assistance for some time, as had new staff employed under the Bank's enterprise agreement since 2001. Subsidised lending to employees is no longer consistent with employing staff on remuneration comparable to market arrangements, nor is it appropriate for a central bank.

The terms of employment for the minority of staff not employed on individual contracts continue to be determined by the Reserve Bank's enterprise agreement. The agreement covering

2005 and 2006 provided for a salary increase of 4 per cent in November 2006; there was also scope for modest additional payments in recognition of good performance. Staff on individual contracts received, on average, the same salary increase in 2006/07 as those on the enterprise agreement.

Risk Management

In common with other organisations, the Reserve Bank encounters a variety of risks in carrying out its functions. The largest of these, in monetary terms, is associated with the holding of financial assets on its balance sheet and comprises exchange rate, interest rate and credit risk, but the Bank also faces significant operational and other risks.

A degree of risk is inherent in any enterprise. Risk cannot be eliminated but it can be managed. This is achieved through a process of assessment, control and monitoring. Individual managers in the various parts of the Reserve Bank are responsible for managing their own areas of risk. The Risk Management Committee ultimately oversees the management of all non-policy risks in the Reserve Bank. A centralised risk management group, the Risk Management Unit, helps areas manage their risks effectively and in a manner that is broadly consistent across the Bank, particularly where risks span more than one department, but does not itself assume those risks.

The control framework is reviewed through regular audits of the Reserve Bank's operations. The Bank has an independent internal audit function and the Audit Committee reports directly to the Reserve Bank Board.

Operational Risk

Balance sheet risks are managed by Financial Markets Group, as set out in the section on Risk Management in the chapter on Operations in Financial Markets. Operational risks of various kinds arise throughout the Reserve Bank, but the largest results from the Bank's operations in financial markets and its provision of banking and settlement services to clients and the market. In 2006/07, the Reserve Bank undertook around 95 000 transactions in global financial markets, with average daily settlement flows of around $37 billion. As the main banker for a number of government agencies, the Reserve Bank processes about 280 million transactions a year, including all Australian Taxation Office, Medicare Australia and Centrelink payments. It also provides real-time interbank payment and settlement services through RITS, which typically involves processing around 27 000 payment instructions per day, for an average daily value of $170 billion.

The types of risk that can arise in these operations include the risk of unauthorised or fraudulent transactions by staff, mishandling sensitive information, process errors, system errors or business interruptions due to disasters. While these risks can give rise to financial loss, equally important for a central bank is the potential damage to the organisation's reputation.

Controls in place to manage operational risk include a clear decision-making hierarchy, detailed procedures manuals, embedded controls in computer systems to prevent unauthorised transactions and enforce limits, back-up systems, and separation of duties in particular areas.

Programs have been initiated to heighten staff awareness about their legal and statutory responsibilities as employees of the Reserve Bank. During the past year, most staff completed a formal training program to enhance awareness of the potential for fraudulent behaviour in all parts of the Bank, as well as the relevant controls and procedures that are in place to deal with it. The Code of Conduct, with which staff are expected to comply, is reviewed from time to time to ensure it remains contemporary and relevant.

Disaster recovery and business continuity arrangements were strengthened by the completion of the Reserve Bank's BRS, which enhances the Bank's ability to maintain its critical functions – including RITS, banking operations and operations in financial markets – if access to Head Office systems or accommodation is lost. This project strengthens the financial system infrastructure in Australia, and is in line with steps being taken by banks and central banks around the world to cope with disruptions to their activities.

Finally, the Bank continued to develop its response to the key issues that might arise if an avian flu pandemic were to occur in Australia or overseas. While initiated in response to the threat posed by avian flu, much of the work that has been undertaken to date has been beneficial for business continuity planning in the event of a major disruption to the Bank's operations from any source. Some of the changes brought about by this work have also introduced efficiency gains for the Bank's regular operations, such as an enhanced capacity for Reserve Bank staff to work on a remote basis.

Facilities Management

The Reserve Bank owns and manages its premises where there is a business need. Current property assets in Australia are: in Sydney, the Head Office building, the HC Coombs Centre for Financial Studies and the BRS; the Melbourne and Canberra offices; and the Craigieburn site north of Melbourne, where Note Printing Australia, the National Note Processing and Distribution Centre and Securency are located. Any surplus space in these buildings is leased to external tenants on commercial terms; the gross annual income from these leases amounted to $6.5 million in 2006/07. In other locations, the Bank leases office space as required, such as for the Regional Offices in Adelaide, Brisbane and Perth.

Major steps were taken in 2006/07 to strengthen both the resilience and security of facilities used for critical operations. In February 2007, the BRS reached practical completion, following a 13-month construction period. The project was completed ahead of schedule and well within the approved budget. During the year, the data centre at Head Office was also modernised. This strengthened the delivery of power and communications infrastructure and generally improved its resilience.

Following an extensive risk-assessment process, a major upgrade of the Head Office electrical infrastructure commenced during the year. The upgrade involves replacing the main switchboard, which has been in place since the mid 1960s, and associated electrical infrastructure, and improving system redundancy; the construction phase began in April 2007 and is due to be completed in early 2008.

Since 1992/93, the Reserve Bank has achieved overall reductions in energy intensity (consumption per unit of occupied area) averaging 2.5 per cent per annum. During the year, an energy audit of the Head Office building was completed, which identified a range of further improvements, some of which have been implemented while others are currently subject to investigation. Additionally, 'green power' was purchased for about 10 per cent of the Bank's needs in NSW and the ACT as part of new electricity supply arrangements. During the year, the Reserve Bank's environmental initiatives also included several pilot programs focusing on office waste recycling. These pilot programs have achieved reductions in paper consumption and fuel consumption for pool motor vehicles of 6 per cent and 17.5 per cent, respectively.

The BRS has been designed to achieve a 4.5 star Australian Building Greenhouse Rating, including such features as rainwater harvesting and high energy-efficiency in the lighting, air-conditioning, facade and roof systems.

Consultancies

The Reserve Bank employs outside contractors or professional service providers to carry out specific tasks where necessary, and also, from time to time, uses consultants. A consultant investigates particular issues and then provides independent advice. In 2006/07, the following four consultancies were undertaken in Australia.

Consultancies(a)
2006/07

Name	Project	Cost ($, excl. GST)	Purpose
Edgar Dunn & Co.	Study of costs of different payment methods	30 345	Advice on the design of the study on payment costs
Australian Government Solicitor	Management of crises in the financial system	16 110	RBA share of legal advice provided to CFR
Mallesons Stephen Jaques	Mainframe computer	27 997	Legal advice on proposed licensing arrangements for mainframe software
Hay Group Pty Ltd	RBA personnel	54 545	Market testing of remuneration of RBA staff

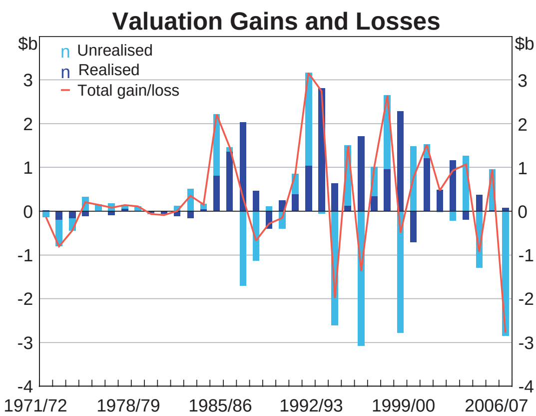
(a) Costing $10 000 or more.

Earnings and Distribution

The Reserve Bank's balance sheet in important respects is like that of other financial institutions. The Bank holds financial assets, on which it earns interest, funded by capital, deposits and other liabilities. The composition of this balance sheet differs from that of a commercial bank, however, because while banks typically hold a high proportion of loans to the private sector, the assets of central banks are more usually in the form of highly rated, government-issued domestic and foreign securities. This means that the composition of the risks faced by central banks differs from that faced by other financial institutions. Central banks primarily have exposure to market risks, rather than the credit risks typically faced by commercial banks. Although the securities held by central banks generate a stream of interest payments, measured income is also affected, often significantly, by valuation gains (or losses) that reflect movements in the prices of the assets held: as security yields rise the price of these securities falls, while a fall in yields leads to higher prices. Valuation losses also occur on foreign assets when the exchange rate appreciates, as these assets are then worth less when measured in Australian dollars; foreign exchange valuation gains occur when the exchange rate depreciates.

Reflecting these characteristics, earnings of the Reserve Bank are typically viewed as having two components. The first of these is underlying earnings – the net interest earned on financial assets less the Bank's operating and other non-interest costs. Underlying earnings are relatively stable and usually substantial, since a large proportion of the Bank's assets is funded by banknotes and its capital and reserves, on which no interest is payable, while almost all of its assets earn interest. The second component of profit is valuation gains and losses that arise from movements in the value of assets. Valuation gains or losses are realised only when assets are sold; they otherwise remain unrealised.

The Reserve Bank differs from other financial institutions in another important respect, since it holds financial assets and liabilities for policy purposes, not primarily for gain. This means that the Bank's discretion to manage market risk on these assets is limited. As movements in interest and exchange rates can be volatile, valuation gains and losses are also highly variable and unpredictable. (The underlying issues and longer-term trends in Reserve Bank profits were discussed in the chapter on The Variability of Reserve Bank Profits in the 2003 *Annual Report*.) More to the point, because it must hold large open positions in foreign exchange and a liquid portfolio of securities, the Bank will inevitably make valuation losses in years in which the exchange rate appreciates or bond yields rise,



Source: RBA

or, as in 2006/07, both occur. Valuation losses have been a particularly important influence on the Reserve Bank's earnings in the past year as the exchange rate appreciated by 12 per cent in weighted-average terms against the currencies in which Australia's international reserves are invested. Bond yields also rose around the world.

For reporting purposes, the recognition and measurement of the Reserve Bank's profit and loss follow in all respects normal commercial standards under Australian equivalents to International Financial Reporting Standards (AIFRS). Distribution of these earnings is, however, determined by section 30 of the *Reserve Bank Act 1959*. This legislation determines that only underlying earnings and realised gains are to be made available for distribution. The sum of these components is usually referred to as earnings available for distribution, or distributable earnings. On the other hand, unrealised gains are transferred to the Unrealised Profits Reserve until realised at a future time, or to remain available to absorb future unrealised losses. This approach to distribution of the Reserve Bank's profits, as embedded in the Act, reflects prudent central banking practice. It recognises the principle that unrealised gains should not be distributed, as this would erode the capacity to absorb subsequent unrealised losses, which, for the reasons discussed, are inevitable in some years.

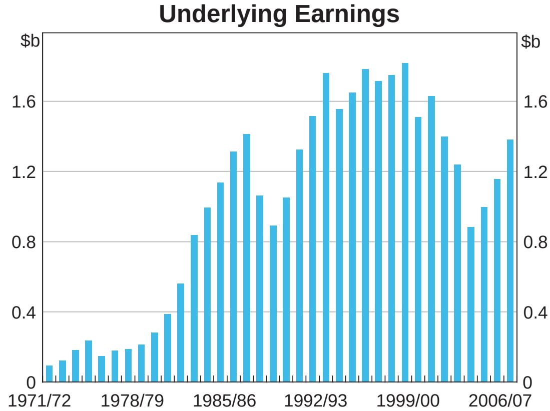
Experience is that transfers of gains to the Unrealised Profits Reserve occur about as frequently as transfers of unrealised losses. Moreover, as valuation gains and losses are of moderate size in most years, the balance in the Unrealised Profits Reserve is usually large enough to absorb valuation losses, thereby cushioning the impact on the dividend payment of the adverse effects of a rise in the exchange rate or bond yields. If, however, unrealised losses exceed the balance in this reserve, sound practice is for the difference to be charged against income from other sources, namely from underlying earnings and realised gains. In 2006/07, unrealised valuation losses amounted to $2 846 million, which exceeded by $371 million the balance in the Unrealised Profits Reserve at the start of the year. This has the effect of reducing earnings available for distribution by this amount.

Distributable Earnings

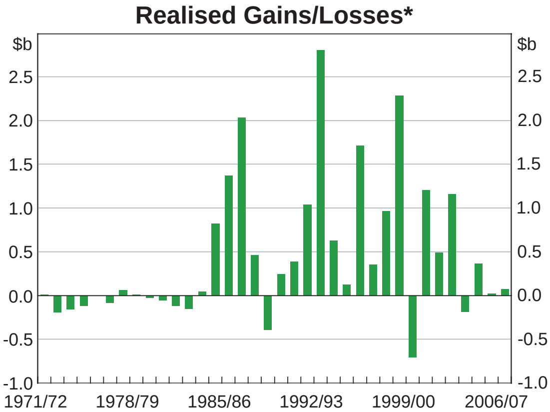
The Reserve Bank's underlying earnings in 2006/07 were $1 381 million, compared with $1 156 million the previous year. This increase reflects the global rise in interest rates, which continued the trend of recent years, following a period in which rates had declined to unusually low levels.

Gains of $75 million were realised on the portfolio in 2006/07, compared with $21 million the previous year. Foreign exchange gains of $205 million were realised as foreign exchange was sold in daily operations for customers and to manage foreign currency reserves at exchange rates below those at which

Underlying Earnings



Source: RBA



* Does not include unrealised losses in excess of previous years' gains held in reserves or gains realised on the sale of gold.
Source: RBA

the foreign exchange was purchased. These gains were offset by losses of $122 million and $11 million realised on foreign and domestic securities respectively, as interest rates rose during 2006/07 and lines of stock were turned over in the normal course of managing these portfolios.

In addition, as noted, an amount of $371 million was charged against these other sources of income in 2006/07, the sum by which unrealised losses on foreign exchange and securities exceeded the balance of unrealised gains held in the Unrealised Profits Reserve. This approach is consistent with accounting principles and section 30 of the *Reserve Bank Act 1959*, i.e. unrealised valuation losses reduce the amount available for distribution unless there are reserves built up from earlier unrealised gains that are sufficient to absorb the unrealised losses. Such a charge against other sources of income has previously occurred in five of the past 20 years, the most recent being in 1998/99.

Sources of Earnings Available for Distribution

($ million)

	Underlying earnings	Realised gains and losses	Unrealised losses charged to other sources of income	Earnings available for distribution
1986/87	1 412	2 035	–	3 447
1987/88	1 062	464	–	1 526
1988/89	891	-394	-80	417
1989/90	1 049	245	-199	1 095
1990/91	1 322	391	–	1 713
1991/92	1 516	1 038	–	2 554
1992/93	1 760	2 803	–	4 563
1993/94	1 556	628	-676	1 508
1994/95	1 649	123	–	1 772
1995/96	1 784	1 712	-1 010	2 486
1996/97	1 715	1 990	–	3 705
1997/98	1 750	1 524	–	3 274
1998/99	1 816	2 284	-424	3 676
1999/00	1 511	-708	–	803
2000/01	1 629	1 205	–	2 834
2001/02	1 400	489	–	1 889
2002/03	1 238	1 159	–	2 397
2003/04	882	-188	–	694
2004/05	997	366	–	1 363
2005/06	1 156	21	–	1 177
2006/07	1 381	75	-371	1 085

Earnings available for distribution – the sum of underlying earnings and realised gains less the charge for 'excess' unrealised losses – amounted to $1 085 million in 2006/07, compared with $1 177 million distributed from profits the previous year.

Reserves and Dividend

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

In accordance with the *Reserve Bank Act 1959*, after consultation with the Reserve Bank Board, the Treasurer determines the amount, if any, to be credited to the RBRF from earnings available for distribution. The balance of distributable earnings after any such transfers is payable as a dividend to the Australian Government. As the Board regards the balance of $6 286 million in the RBRF at 30 June 2007 as satisfactory, it did not approach the Treasurer for a transfer from profits in 2006/07. Consequently, all of the earnings available for distribution in 2006/07, a sum of $1 085 million, was paid as a dividend to the Australian Government in August 2007.

The Reserve Bank also maintains a number of other financial reserves. As outlined earlier, under the *Reserve Bank Act 1959* unrealised gains are not available to be distributed but are transferred to the Unrealised Profits Reserve. That reserve started the year with an accumulated balance of $2 476 million, but this was more than absorbed by the unrealised valuation losses of $2 846 million made during the year. At 30 June 2007, the balance in the Unrealised Profits Reserve was nil, after transferring the charge against profit.

The Reserve Bank also holds asset revaluation reserves for its gold holdings, shares in the BIS, and property, plant and equipment. The balances in these reserves represent the difference between the market value of these assets and the prices at which they were purchased. Balances in these reserves at 30 June 2007 stood at $2 239 million, a decrease of $115 million from a year ago, mainly reflecting a decrease in the Australian dollar value of the Bank's holding of gold. Balances in these reserves are distributed only in the event that the underlying assets are sold. On that score, gains of $3 million were realised from the sale of overseas properties in 2006/07; this amount has been included as a realised gain and will be distributed as earnings.

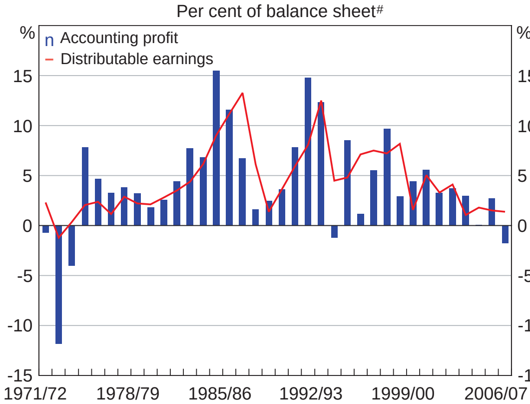
Accounting Profits

As the Reserve Bank reports under AIFRS, in accordance with the *Commonwealth Authorities and Companies Act 1997*, total accounting profits include revenue from all sources, including valuation gains and losses, both realised and unrealised. After allowing for net unrealised valuation losses of $2 475 million, the Bank recorded a total accounting loss of $1 393 million. The Bank has reported on the basis of generally accepted accounting principles or AIFRS since 1998. If the Bank had reported on the same basis as it currently does in earlier periods, it would

Reserve Bank Payments to Government
($ million)

	Earnings available for distribution	Transfers to reserves	Payments to the Australian Government: Balance available from current year's profit	Interim payment from current year's profit	Payment from previous year's profit	Payment delayed from previous years	Total payment
1990/91	1 713	210	1 503	400	275	–	675
1991/92	2 554	200	2 354	400	1 103	–	1 503
1992/93	4 563	750	3 813	600	1 954	–	2 554
1993/94	1 508	–	1 508	–	3 213	–	3 213
1994/95	1 772	–	1 772	200	1 508	–	1 708
1995/96	2 486	150	2 336	200	1 572	–	1 772
1996/97	3 705	2 005	1 700	–	2 136	–	2 136
1997/98	3 274	548	2 726	–	1 700	–	1 700
1998/99	3 676	–	3 676	–	2 726	–	2 726
1999/00	803	–	803	–	3 000	–	3 000
2000/01	2 834	–	2 834	–	803	676	1 479
2001/02	1 889	–	1 889	–	2 834	–	2 834
2002/03	2 397	133	2 264	–	1 889	–	1 889
2003/04	694	–	694	–	1 300	–	1 300
2004/05	1 363	–	1 363	–	374	964	1 338
2005/06	1 177	–	1 177	–	1 063	320	1 383
2006/07	1 085	–	1 085	–	1 177	300	1 477
2007/08	–	–	–	–	1 085	–	1 085

RBA Profits*
Per cent of balance sheet#



* Accounting profit is estimated prior to 1998
\# Excludes sell repos and Future Fund deposits
Source: RBA

have disclosed accounting losses on four previous occasions since 1970, the latest being in 1993/94.

The Reserve Bank's Financial Statements for 2006/07, and accompanying Notes to the Accounts, appear in the following pages.

Statutory Obligations

Equal Employment Opportunity (EEO)

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the Reserve Bank reports to the Australian Parliament each year on its EEO Program. The *Equity & Diversity Report 2006* was tabled on 10 October 2006 and incorporated initiatives for staff with disabilities consistent with the *Commonwealth Disability Strategy*.

A prime focus of the EEO Program in 2006 was an Assistive Technology Survey, the purpose of which was to investigate whether staff with disabilities would benefit from using any assistive software, electro-mechanical, electronic, computer or other device to help them carry out their work. The Reserve Bank's System Accessibility Technical Group established a facility to test a range of technologies that might assist staff who have a permanent or temporary disability. The responses from the survey were used to help select the technologies to be installed in the test facility.

Health and Safety, Compensation and Rehabilitation

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

The Reserve Bank's licence to self-insure and manage claims for workers' compensation, which was due to expire on 30 June 2007, was extended by the Safety Rehabilitation and Compensation Commission on 25 June for a four-year term until 30 June 2011. The Bank also renewed, for a similar term, its Agreement with Australia Post to undertake reconsiderations of determinations issued by Reserve Bank delegates.

The Reserve Bank is committed to the health and safety of its staff, contractors and visitors. It has a comprehensive OH&S Management System developed in consultation with staff and unions, which aims to ensure that its workplaces are free from work-related death, injury and disease. During 2006/07, prevention remained a key focus and included initiatives to improve the capacity of all staff to effectively manage OH&S, expand the Bank's suite of well-being programs and develop critical-incident training for higher-risk groups. Preparations were also underway to implement recent changes to the OH&S Act for more direct staff consultation/representation arrangements on OH&S matters. Seventy-two incidents were reported during the period, which resulted in 24 claims for workers' compensation: 67 per cent of these occurred away from the workplace. There were no dangerous occurrences requiring notification to Comcare.

The Reserve Bank has a strong performance record, confirmed by external audits during the year in each of the three functions of OH&S, Claims Management and Rehabilitation. The audits found the Bank to be materially compliant with relevant legislation and its Conditions of Licence, with high achievement in each function. The Bank has set further targets for 2007/08 progressively to reduce the potential for work-related injuries and disease.

Freedom of Information

Section 8 statement

Organisation and functions: The Reserve Bank is Australia's central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the *Reserve Bank Act 1959*, the *Banking Act 1959*, the *Commonwealth Authorities and Companies Act 1997*, the *Payment Systems (Regulation) Act 1998*, the *Payment Systems and Netting Act 1998*, the *Corporations Act 2001* and the *Financial Services Reform Act 2001*, and in Regulations made under those Acts. An overview of the structure of the Reserve Bank is provided in the organisational chart, which appears on pages 104 and 105.

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*. These publications, as well as other information about the Bank, are also available on the Reserve Bank's website (www.rba.gov.au). Other documents are held in the form of working notes and files covering policy and operational matters, statistical data, personnel, premises and general administration.

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

Facilities for access and Freedom of Information procedures: Enquiries under the FOI Act, including requests for access to documents, should be directed to the Secretary of the Reserve Bank. Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available.

Section 93 statement

Four requests for access to documents under the FOI Act were received in 2006/07. Access was granted on three requests, while access was denied on one request.

The estimated number of staff hours spent dealing with all aspects of FOI requests in 2006/07 was around 26 hours. The total cost to the Reserve Bank of administering the FOI Act in 2006/07 is estimated to have been about $6 400. Application fees of $90 were collected; there were no other charges.

Financial Statements

As at 30 June 2007

Directors' Statement

In the opinion of the directors, the financial statements for the year ended 30 June 2007 give a true and fair view of the matters required by the Finance Minister's Orders 2006-2007 made under the *Commonwealth Authorities and Companies Act 1997*. These statements have been prepared from properly maintained financial records and are signed in accordance with a resolution of the directors. The Reserve Bank has applied one reporting exemption granted under the Finance Minister's Orders in preparing its 2006/07 financial statements as outlined in Note 1(j).

Glenn Stevens

Chairman, Reserve Bank Board
9 August 2007

BALANCE SHEET As at 30 June 2007

Reserve Bank of Australia and Controlled Entities

	Note	2007 $M	2006 $M
ASSETS			
Cash and cash equivalents	6	586	575
Australian dollar securities	1(b), 16	34 955	30 306
Foreign exchange	1(b), 16	93 538	71 689
Gold	1(c), 16	2 001	2 151
Property, plant and equipment	1(d), 8	421	329
Loans, advances and other	7	393	397
Total Assets		131 894	105 447
LIABILITIES			
Deposits	1(b), 9	65 830	43 204
Distribution payable to Australian Government	1(f), 3	1 085	1 477
Other	10	16 072	11 493
Australian notes on issue	1(b), 16	40 289	38 065
Total Liabilities		123 276	94 239
Net Assets		8 618	11 208
Capital and Reserves			
Reserves:			
Unrealised profits reserves	1(e), 5	53	2 528
Asset revaluation reserves	1(e), 5	2 239	2 354
Reserve Bank Reserve Fund	1(e), 5	6 286	6 286
Capital		40	40
Total Capital and Reserves		8 618	11 208

INCOME STATEMENT For the year ended 30 June 2007
Reserve Bank of Australia and Controlled Entities

	Note	2007 $M	2006 $M
INCOME			
Interest revenue	2	5 400	3 477
Net gains/(losses) on securities and foreign exchange	2	(2 774)	935
Dividend revenue	2	4	5
Fees and commissions	2	17	18
Other revenue	2	63	63
Total Income		2 710	4 498
EXPENSES			
Interest expense	2	3 857	2 174
General administrative expenses	2	217	207
Other expenses	2	29	24
Total Expenses		4 103	2 405
Net Profit/(Loss)		(1 393)	2 093

STATEMENT OF DISTRIBUTION For the year ended 30 June 2007
Reserve Bank of Australia and Controlled Entities

	Note	2007 $M	2006 $M
NET PROFIT/(LOSS)		(1 393)	2 093
Transfer (to)/from unrealised profits reserves	5	2 475	(933)
Transfer (to)/from Reserve Bank Reserve Fund	5	–	–
Transfer from asset revaluation reserves	5	3	17
Earnings available for distribution		1 085	1 177
Distributed as follows:			
Reserve Bank Reserve Fund	5	–	–
Payable to the Australian Government	3	1 085	1 177
		1 085	1 177

STATEMENT OF CHANGES IN CAPITAL AND RESERVES

For the year ended 30 June 2007

Reserve Bank of Australia and Controlled Entities

	Note	2007 $M	2006 $M
Opening balance of Capital and Reserves	5	11 208	9 603
Plus:			
Net Profit/(Loss)	2	(1 393)	2 093
Gain/(loss) on revaluation of gold	5	(149)	647
Gain/(loss) on revaluation of shares in international institutions	5	(14)	25
Gain on revaluation of properties	5	51	17
Total revaluation gains/(losses)		(112)	689
Total income and expenses		(1 505)	2 782
Less:			
Transfer to the distribution payable to Australian Government	3	(1 085)	(1 177)
Closing balance of Capital and Reserves	5	8 618	11 208

CASH FLOW STATEMENT For the year ended 30 June 2007
Reserve Bank of Australia and Controlled Entities

This statement meets the requirements of AASB 107 – *Cash Flow Statements* and the Finance Minister's Orders 2006-2007. In the RBA's view, due to the nature of central banking activities, this statement does not shed additional light on the RBA's financial results. For the purpose of this statement, cash includes the notes and coin held at the Reserve Bank and overnight settlements system account balances with other banks.

	2007 Inflow/ (outflow) $M	2006 Inflow/ (outflow) $M
Cash flows from operating activities		
Interest received on investments	4 274	2 933
Interest received on loans, advances, and on net overnight settlements systems	58	50
Loan management reimbursement	1	1
Banking service fees received	17	19
Dividends received	4	5
Rents received	7	6
Net payments for and proceeds from sale of investments	(24 177)	(16 363)
Interest paid on deposit liabilities	(3 226)	(1 735)
Interest paid on currency note holdings of banks	(179)	(166)
Staff costs (including redundancy)	(135)	(128)
Premises and equipment	(31)	(28)
Other	20	(18)
Net cash provided by operating activities	(23 367)	(15 424)
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(59)	(31)
Net cash used in investing activities	(59)	(31)
Cash flows from financing activities		
Profit payment to Australian Government	(1 477)	(1 383)
Net movement in deposit liabilities	22 626	13 976
Net movement in loans and advances	2	2
Net movement in notes on issue	2 223	2 441
Other	63	(14)
Net cash provided by financing activities	23 437	15 022
Net increase/(decrease) in cash	11	(433)
Cash at beginning of financial year	575	1 008
Cash at end of financial year	586	575

CASH FLOW STATEMENT (CONTINUED) For the year ended 30 June 2007
Reserve Bank of Australia and Controlled Entities

Reconciliation of cash	Note	2007 $M	2006 $M
Cash		15	15
Overnight settlements systems	6	571	560
		586	575

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act 1959*	Note	2007 $M	2006 $M
Net Profit/(Loss)		(1 393)	2 093
Increase/(decrease) in interest payable		(75)	(59)
Net loss/(gain) on overseas investments	2	80	826
Net loss/(gain) on Australian dollar securities	2	117	137
Net loss/(gain) on foreign currency	2	2 577	(1 898)
Decrease/(increase) in income accrued on investments		(529)	(148)
Depreciation of property	8	6	7
Depreciation of plant and equipment	8	10	15
Net payments for and proceeds from sale of investments		(24 177)	(16 363)
Other		17	(34)
Net cash provided by operating activities		(23 367)	(15 424)

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2007
Reserve Bank of Australia and Controlled Entities

Note 1 SUMMARY OF ACCOUNTING POLICIES

The Reserve Bank of Australia reports its financial statements in accordance with the *Reserve Bank Act 1959* and the *Commonwealth Authorities and Companies (CAC) Act 1997*. In accordance with the Finance Minister's Orders (FMOs) 2006-2007, which are issued pursuant to the *CAC Act 1997,* the RBA has prepared its financial statements for the year ended 30 June 2007 under Australian equivalents to International Financial Reporting Standards (AIFRS), other accounting standards and accounting interpretations issued by the Australian Accounting Standards Board. These financial statements comply fully with International Financial Reporting Standards. As the RBA is a financial institution, these financial statements have been prepared using AASB 130 – *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. The RBA has been granted an exemption from a requirement of the FMOs as detailed in Note 1(j).

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

The Australian Accounting Standards Board has issued AASB 7 – *Financial Instruments: Disclosures* and amendments to AASB 101 – *Presentation of Financial Statements* which will apply to the RBA's financial statements in 2007/08. In accordance with the FMOs, the RBA has not 'early adopted' the new provisions of these standards. Application of the standards will not affect the amounts recognised in the financial statements, but may result in the disclosure of additional information in relation to the Bank's financial instruments.

(a) Consolidation and joint venture

The financial statements show information for the economic entity only; this reflects the consolidated results for the parent entity, the Reserve Bank of Australia, and its wholly-owned subsidiary, Note Printing Australia Limited. The results of the parent entity do not differ materially from the economic entity and have therefore not been separately disclosed. Note Printing Australia Limited was incorporated as a wholly-owned subsidiary of the RBA on 1 July 1998, with an initial capital of $20 000 000. Note Printing Australia Limited's total assets, liabilities and capital as at 30 June 2007 were $75.6 million, $24.6 million and $51.0 million respectively ($63.2 million, $16.8 million and $46.4 million as at 30 June 2006).

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

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

(b) Financial instruments

A *financial instrument* is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. The RBA's financial instruments are its Australian dollar securities, foreign government securities, bank deposits, interest rate futures, foreign currency swap contracts, gold loans, cash and cash equivalents, notes on issue, deposit liabilities and its shareholding in the Bank for International Settlements. The RBA accounts for its financial instruments in accordance with AASB 139 – *Financial Instruments: Recognition and Measurement* and reports these instruments under AASB 132 – *Financial Instruments: Disclosure and Presentation*.

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

Australian dollar securities

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

Commonwealth Treasury Fixed Coupon Bonds are coupon securities; the interest is received biannually at the coupon rate and the principal is received at maturity. Treasury Capital Indexed Bonds are coupon securities with the nominal value of the security indexed in line with movements in the Consumer Price Index each quarter until maturity; interest is paid quarterly.

Foreign exchange

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

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

Foreign government securities

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

Foreign bank deposits

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

Foreign currency swaps

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

Foreign exchange holdings contracted for sale beyond 30 June 2007 (including those under swap contracts) have been valued at market exchange rates (Note 16).

Interest rate futures

The RBA uses interest rate futures contracts on overseas exchanges to hedge risks on its portfolio of foreign securities. An interest rate futures contract is a contract to buy or sell a specific amount of securities for a specific price on a specific future date.

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

Bank for International Settlements

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

Repurchase agreements

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

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

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

Cash invested in securities purchased and contracted for sale under repurchase agreements is secured to 102 per cent of the market value of the securities. The proceeds of securities sold and contracted for purchase under repurchase agreements equates to the market value of these securities.

Deposit liabilities

Deposits include deposits at call and term deposits. Deposits are classified as financial liabilities under AASB 139. Deposit balances are shown at their amortised cost, which is equivalent to their face value. Interest is accrued over the term of deposits and is paid periodically or at maturity. Interest accrued but not paid is included in Other Liabilities (Notes 10 and 16). Details of deposits are included in Note 9.

Australian notes on issue

Notes on issue are recorded at face value, which is equivalent to their amortised cost under AASB 139.

Prior to 2005/06, the RBA periodically adjusted its liability for note series that ceased to be issued, to reflect the likelihood that the remaining notes on issue from these series would not be presented for redemption because they were judged to have been destroyed or were otherwise unavailable for presentation. Under this policy, notes totaling $133 million were written down and the gains included in accounting profits. As these notes were written down prior to 1 January 2005, the RBA has not had to re-recognise the liability for the notes under AIFRS. Where written-down notes are subsequently presented, the RBA will reinstate the liability for these notes and charge an expense against profits. In 2006/07 notes with a face value of $402,000 which had been written down previously were presented to the RBA and re-recognised as a liabilitity ($502,000 in 2005/06); a corresponding expense was charged against profits.

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

(c) Gold

Gold holdings (including gold on loan to other institutions) are valued at the Australian dollar equivalent of the 3pm fix in the London gold market on balance date. Revaluation gains and losses on gold are transferred to the gold revaluation reserve (Note 5). The RBA lends gold to financial institutions participating in the gold market. As outlined in Note 1(b), gold loans are a financial instrument and the RBA accounts for these loans in accordance with AASB 139 and reports the loans under AASB 132. Gold loans are secured to 110 per cent of their market value by Australian dollar denominated collateral. Interest on gold loans is accounted for on an accrual basis.

(d) Property, plant and equipment

Formal valuations of all the RBA's Australian properties are conducted annually; RBA properties overseas are formally valued on a triennial basis. Australian properties are valued by officers of the Australian Valuation Office and overseas properties are valued by local independent valuers. The most recent valuation of overseas properties was at 30 June 2007. In accordance with AASB 116 – *Property, Plant and Equipment*, properties are valued at fair value. For almost all of the RBA's properties this is based on observable market prices and the assumption that assets would be exchanged between knowledgeable, willing parties at arm's length. Due to their specialised nature, the value of the Craigieburn property has been determined on the basis of vacant possession, while the RBA's business resumption site in outer metropolitan Sydney is valued at depreciated replacement cost. Valuation gains and losses are transferred to the Property Revaluation Reserve (Note 5). These valuations have been incorporated in the accounts. Annual depreciation is based on market values and assessments of useful remaining life.

Plant and equipment is recognised on a fair value basis; valuation gains and losses are treated in accordance with AASB 116. Plant and equipment is valued by independent valuers on a triennial basis. The most recent independent valuation was on 30 June 2005. Annual depreciation is based on fair values and the RBA's assessments of useful remaining life. Computer software is accounted for in accordance with AASB 138 – *Intangible Assets*. Software is recognised at cost less accumulated amortisation, which is calculated at rates based on the estimated useful life of the relevant assets. Amortisation expense for computer software is included in Other Expenses in Note 2.

The useful lives used for each class of asset are:

	Years
Buildings	17-50
Fitout and furniture	5-10
Computer equipment	
– hardware	4-5
– software	4-7
Office equipment	4-5
Motor vehicles	4-5
Plant	4-15

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

(e) Reserves

The Reserve Bank Reserve Fund (RBRF) is a general reserve which provides for events which are contingent and non-foreseeable, including to cover exceptional losses on RBA's holdings of domestic and foreign securities that cannot be absorbed by its other resources; the RBRF also provides for potential losses from fraud and other non-insured losses. Amounts set aside for this reserve are determined by the Treasurer after consultation with the Board (refer Note 1(f)).

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

Unrealised gains and losses on foreign exchange and Australian dollar securities are recognised in profit from ordinary activities. Until such gains or losses are realised, they are not available for distribution to the Australian Government; in the interim, the amounts are reflected in the Reserve for Unrealised Profits on Investments. If unrealised losses exceed the balance in the Unrealised Profits Reserve they are, to the extent of the excess, charged against other sources of income consistent with the *Reserve Bank Act 1959* and accounting practice.

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

(f) Profits

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

(1) Subject to subsection (2), the net profits of the Bank in each year shall be dealt with as follows:

(a) such amount as the Treasurer, after consultation with the Reserve Bank Board, determines is to be set aside for contingencies; and

(b) such amount as the Treasurer, after consultation with the Reserve Bank Board, determines shall be placed to the credit of the Reserve Bank Reserve Fund; and

(c) the remainder shall be paid to the Commonwealth.

(2) If the net profit of the Bank for a year is calculated on a basis that requires the inclusion of unrealised gains on assets during the year, the amount to which subsection (1) applies is to be worked out as follows:

(a) deduct from the net profit an amount equal to the total of all amounts of unrealised gains included in the net profit; and

(b) if an asset in respect of which unrealised gains were included in the net profit for a previous year or years is realised during the year – add to the amount remaining after applying paragraph (a) the total amount of those unrealised gains.

(g) Provisions

The RBA maintains provisions for accrued annual leave in accordance with AASB 119 – *Employee Benefits*, calculated on salaries expected to prevail when leave is anticipated to be taken and including associated payroll tax. The RBA also maintains provisions for long service leave and post-employment benefits, in the form of health insurance and housing assistance, and associated fringe benefits tax; these provisions are made on a present value basis consistent with AASB 119. In addition, the RBA makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(h) Superannuation funds

The RBA includes in its balance sheet an asset representing the surpluses in its defined benefit superannuation funds in accordance with AASB 119 – *Employee Benefits*; the counterpart to this asset is the Reserve for Unrealised Profits on Superannuation. Actuarial gains and losses are recognised under the 'corridor' approach; that is, these gains and losses in excess of 10 per cent of the funds' assets or defined benefit obligations are charged (or credited) to accounting profits over the expected average remaining working lives of the employees concerned. The asset recorded on the balance sheet is the funds' assets less defined benefit obligations, plus actuarial gains and losses not included in the balance sheet under the 'corridor' approach. Details of the superannuation funds and superannuation expenses are included in Note 14.

(i) Rounding

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

(j) Exemptions

The RBA has been granted an exemption from the following requirement of the FMOs:

Requirement	Description	Detail of exemption
44.3	Superannuation schemes	The surpluses in the RBA's defined benefit superannuation schemes are accounted for in accordance with the 'corridor' approach under AASB 119 – *Employee Benefits*.

	Note	2007 $M	2006 $M
Note 2 NET PROFITS			
Interest revenue			
Overseas investments	1(b), 4	3 276	2 092
Australian dollar securities	1(b), 4	2 056	1 322
Overnight settlements	4	56	49
Gold loans	1(c), 4	11	13
Loans, advances and other	4	1	1
		5 400	3 477
Net gains/(losses) on securities and foreign exchange			
Overseas investments	1(b)	(80)	(826)
Australian dollar securities	1(b)	(117)	(137)
Foreign currency	1(b)	(2 577)	1 898
		(2 774)	935
Dividend revenue			
Earnings on shares in Bank for International Settlements	1(b)	4	5
Fees and commissions			
Banking services fees received		17	18
Other revenue			
Reimbursement by Australian Government for loan management and registry expenses		1	1
Rental of Bank premises		7	6
Sales of note products		31	30
Other		24	26
		63	63
Total		2 710	4 498
Less:			
Interest expense			
Deposit liabilities	1(b), 4	3 150	1 676
Currency note holdings of banks	1(b), 4	179	165
Repurchase agreements	1(b), 4	528	333
		3 857	2 174
General administrative expenses			
Staff costs		118	111
Superannuation costs	1(h), 14	15	13
Special redundancy/retirement payments		1	–
Depreciation of property	1(d), 8	6	7
Depreciation of plant and equipment	1(d), 8	10	15
Premises and equipment	1(d)	31	28

	Note	2007 $M	2006 $M
Note 2 (CONTINUED)			
Materials used in note production		22	22
Travel		3	3
Consultants' fees, legal fees and payments to contractors		2	2
Other		9	6
		217	207
Other expenses			
Agency business reimbursement		3	3
Subsidiary income tax		2	–
Cash distribution expenses		6	8
Other		18	13
		29	24
Total		4 103	2 405
Net Profit/(Loss)		(1 393)	2 093

Staff costs in 2006/07 includes a credit of $1.3 million associated with the decrease in the balance of the Provision for post-employment benefits (the credit in 2005/06 was $4.9 million) (refer Note 10). Post-employment health care costs of $1.4 million are included in Staff Costs ($4.7 million in 2005/06).

The RBA's aggregate research and development expenditure recognised as an expense in 2006/07 was $0.7 million ($0.6 million in 2005/06); this is included in Other Expenses.

Note 3 DISTRIBUTION PAYABLE TO AUSTRALIAN GOVERNMENT

Section 30 of the *Reserve Bank Act 1959* requires that the net profits of the Reserve Bank of Australia, less amounts set aside for contingencies or placed in the RBRF as determined by the Treasurer after consultation with the Board, shall be paid to the Australian Government (see Note 1(f)). Also under Section 30, unrealised profits are not available for distribution and are transferred to the unrealised profits reserves where they are available to absorb future unrealised valuation losses or are realised when relevant assets are sold.

	2007 $M	2006 $M
Opening balance	1 477	1 683
Distribution to Australian Government	(1 477)	(1 383)
Transfer from Statement of Distribution	1 085	1 177
As at 30 June	1 085	1 477

An amount of $1 177 million from earnings in 2005/06 was paid to the Australian Government in August 2006, along with the $300 million payment which had been deferred from earnings in 2004/05. Accordingly, the total payment to the Government in 2006/07 was $1 477 million. Earnings available for distribution of $1 085 million from earnings in 2006/07 will be paid in August 2007.

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

Note 4 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2007

	Average balance $M	Interest $M	Average annual interest rate %
Interest revenue			
Overseas investments	79 042	3 276	4.1
Australian dollar securities	33 227	2 056	6.2
Overnight settlements	949	56	5.9
Gold loans	2 119	11	0.5
Loans, advances and other	19	1	5.0
	115 356	5 400	4.7
Interest expense			
Banks' Exchange Settlement balances	805	47	5.9
Deposits from governments	50 350	3 093	6.1
Deposits from overseas institutions	2 183	9	0.4
Currency note holdings of banks	2 937	179	6.1
Overseas repurchase agreements	10 175	470	4.6
Domestic repurchase agreements	962	58	6.0
Other deposits	16	1	2.8
	67 428	3 857	5.7
Analysis for the year ended 30 June 2006			
Interest revenue total	88 569	3 477	3.9
Interest expense total	43 373	2 174	5.0

Interest revenue for 2006/07 includes $4 372 million calculated using the effective interest method for financial assets not at fair value through profit and loss ($2 588 million in 2005/06). Interest expense for 2006/07 includes $3 857 million calculated using the effective interest method for financial liabilities not at fair value through profit and loss ($2 174 million in 2005/06).

	2007 $M	2006 $M

Note 5 CAPITAL AND RESERVES

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

	2007 $M	2006 $M
Asset revaluation reserves		
Gold (Note 1(c))		
Opening balance	1 991	1 361
Net revaluation adjustments	(149)	647
Transfers (to)/from Statement of Distribution	–	(17)
As at 30 June	1 842	1 991
Shares in international financial institutions (Notes 1(b), 7)		
Opening balance	223	198
Net revaluation adjustments	(14)	25
As at 30 June	209	223
Bank properties, plant and equipment (Notes 1(d), 8)		
Opening balance	140	123
Net revaluation adjustments	51	17
Transfers (to)/from Statement of Distribution	(3)	–
As at 30 June	188	140
Total asset revaluation reserves (Note 1(e))		
Opening balance	2 354	1 682
Net revaluation adjustments	(112)	689
Transfers (to)/from Statement of Distribution	(3)	(17)
As at 30 June	2 239	2 354
Unrealised profits reserves		
Reserve for unrealised profits on investments (Note 1(e))		
Opening balance	2 476	1 540
Net transfers (to)/from Statement of Distribution	(2 476)	936
As at 30 June	–	2 476
Reserve for unrealised profits on superannuation (Note 1(h))		
Opening balance	52	55
Net transfers (to)/from Statement of Distribution	1	(3)
As at 30 June	53	52
Total unrealised profits reserves		
Opening balance	2 528	1 595
Net transfers (to)/from Statement of Distribution	(2 475)	933
As at 30 June	53	2 528
Reserve Bank Reserve Fund (Note 1(e))		
Opening balance	6 286	6 286
Transfers (to)/from Statement of Distribution	–	–
As at 30 June	6 286	6 286
Capital		
Opening and closing balance	40	40

Note 6 CASH AND CASH EQUIVALENTS

This includes net amounts of $571 million owed to the RBA for overnight clearances of financial transactions through the clearing houses; an amount of $560 million was owed to the RBA at 30 June 2006.

	Note	2007 $M	2006 $M
Note 7 LOANS, ADVANCES AND OTHER ASSETS			
Shareholding in Bank for International Settlements	1(b)	253	267
Superannuation asset	1(h)	53	52
Officers' Home Advances		18	20
Investment in Securency	1(a)	29	21
Computer software	1(d)	5	6
Other		35	31
As at 30 June		393	397

The Reserve Bank of Australia has a 50 per cent share in Securency Pty Ltd, which is incorporated in Victoria, Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securency as at 30 June 2007 was $36.5 million. The carrying value of the RBA's investment in Securency as at 30 June 2007 was $29.1 million ($21.2 million at 30 June 2006). Securency has a 31 December balance date. The RBA's share of Securency's profit before income tax in 2006/07 was $11.4 million ($8.3 million in 2005/06); its share of Securency's income tax expense in 2006/07 was $3.5 million ($0.7 million in 2005/06). Securency's current and non-current assets as at 30 June 2007 were $43.8 million and $52.9 million respectively ($27.0 million and $29.7 million as at 30 June 2006). Current and non-current liabilities on 30 June 2007 were $21.0 million and $17.6 million ($13.6 and $0.7 million on 30 June 2006). Securency's revenue and expenses for 2006/07 were $109.8 million and $87.0 million ($77.3 and $60.7 million in 2005/06). The RBA provides facilities to Securency under operating leases. In 2005/06, the RBA also provided a finance lease facility to Securency for $5.6 million in relation to the construction of a new building on the Bank's land at Craigieburn. The finance lease was fully drawn down during 2006/07 and the balance of the lease receivable as at 30 June 2007 was $4.7 million. The lease was provided on commercial terms and at arm's length; it has a term of 10 years.

During 2006/07, the RBA acquired $0.2 million of computer software ($1.4 million in 2005/06) and amortised $1.6 million ($1.4 million in 2005/06). At 30 June 2007 the gross book value of the RBA's computer software amounted to $10.0 million and accumulated amortisation on this software was $5.2 million ($9.9 million and $4.1 million respectively at 30 June 2006). The RBA had contractual commitments of $1.9 million as at 30 June 2007 for the acquisition of computer software ($0.4 million at 30 June 2006).

As at 30 June 2007, other assets included receivables of $21.6 million, all of which was current (at 30 June 2006 other assets included receivables of $21.9 million, of which $18.0 million was current).

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

Note 8 PROPERTY, PLANT AND EQUIPMENT

	Land	Buildings	Plant and Equipment	Total
Gross Book Value as at 30 June 2006	109	155	83	347
Accumulated depreciation	–	–	(18)	(18)
Net Book Value	109	155	65	329
Additions	–	40	25	65
Depreciation expense	–	(6)	(10)	(16)
Net revaluation increment/(decrement)	14	44	–	58
Disposals	(3)	(11)	(1)	(15)
Net additions to net book value	11	67	14	92
Gross Book Value as at 30 June 2007	120	222	107	449
Accumulated depreciation	–	–	(28)	(28)
Net Book Value	120	222	79	421

The net book value of buildings as at 30 June 2007 includes expenditure of $5.9 million on work in progress which has been capitalised in the carrying amount of these assets ($13.4 million as at 30 June 2006). Additions include expenditure of $6.1 million on work in progress that was capitalised during 2006/07 ($18.0 million in 2005/06). As at 30 June 2007, the RBA had contractual commitments of $6.2 million to acquire buildings, plant and equipment ($27.0 million at 30 June 2006).

Note 9 DEPOSITS

	2007 $M	2006 $M
Banks' Exchange Settlement balances	1 714	1 285
Australian Government	62 262	40 055
State Governments	3	3
Foreign governments, foreign institutions and international organisations	1 838	1 847
Other depositors	13	14
As at 30 June	65 830	43 204

	2007 $M	2006 $M
Note 10 OTHER LIABILITIES		
Provisions (Note 1(g))		
Provision for accrued annual leave	11	11
Provision for long service leave	24	24
Provision for post-employment benefits	56	58
Provision for workers' compensation	1	1
	92	94
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(b))	14 494	9 923
Interest accrued on deposits	55	130
Other	1 431	1 346
	15 980	11 399
Total Other Liabilities as at 30 June	16 072	11 493

During 2006/07, annual leave of $7.0 million was accrued by staff, while $6.7 million of accrued leave was used. Staff accrued and used long service leave of $3.2 million and $2.5 million respectively in 2006/07; the provision for long service leave also decreased by $0.5 million due to the increase in the interest rate used to discount future cash flows. The RBA provided an additional $2.9 million for post-retirement benefits in 2006/07, while benefits of $1.6 million were paid out of the provision; an increase in the discount rate further reduced the provision by $2.8 million. The balance of the provision for post-employment benefits will change if assumptions regarding the length of staff service, the longevity of retired staff, increases in medical costs and the discount rate vary.

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

The RBA has a contingent liability, amounting to $64.2 million at 30 June 2007 ($71.1 million at 30 June 2006), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

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

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

Note 12 KEY MANAGEMENT PERSONNEL

AASB 124 – *Related Party Disclosures* requires disclosure of information relating to aggregate compensation of key management personnel. The key management personnel of the RBA are members of the Reserve Bank Board, members of the Payments System Board and senior staff who have responsibility for planning, directing and controlling the activities of the RBA during the reporting period; this group comprised 21 in total (20 in 2005/06) and includes the Governor, Deputy Governor, Assistant Governors, non-executive Reserve Bank Board members and non-executive Payments System Board members. Fees of the non-executive members of the Reserve Bank Board and the Payments System Board are determined by the Remuneration Tribunal. A committee of non-executive Board members reviews annually the remuneration of the Governor and Deputy Governor in terms of Section 24A of the *Reserve Bank Act 1959*. The Governors determine the remuneration of other key executives.

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

	2007 $	2006 $
Short-term employee benefits	3 172 165	3 275 238
Post-employment benefits	580 651	589 359
Other long-term benefits	318 635	120 999
Share based payments	–	–
Termination benefits	–	–
Total Compensation	4 071 451	3 985 596

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

As at 30 June 2007 and 30 June 2006 there were no loans by the RBA to key management personnel.

There were no other related party transactions with Board members; transactions with director-related entities which occurred in the normal course of the RBA's operations were conducted on terms no more favourable than similar transactions with other employees or customers. In addition, $169 604 ($170 180 in 2005/06) was paid for non-executive members of the Board of Note Printing Australia Limited who are not employees of the RBA.

Note 13 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services (excluding GST) totalled $275 000 in 2006/07 ($227 000 in 2005/06); this includes audit services in relation to the RBA's subsidiary Note Printing Australia. These fees are included in Consultants' Fees, Legal Fees and Payments to Contractors in Note 2.

Note 14 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act 1959*: the Reserve Bank of Australia Officers' Superannuation Fund (OSF) and the Reserve Bank of Australia UK Pension Scheme. A small part of the assets of the OSF is held by the RBA as nominee for the trustees of the OSF; such assets are not included in the RBA's financial statements. Payment of the funds' current and future benefits is funded by member and RBA contributions and the funds' existing asset bases. The RBA's superannuation expense in relation to the OSF and the UK Pension Scheme is included in accounting profits and shown in Note 2. Administration and other operational costs (eg salaries, overheads, legal costs and valuation fees) incurred by the RBA for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the RBA and the funds during 2006/07.

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

Funding valuation

Full independent actuarial valuations of the OSF and UK Pension Scheme are conducted every three years to determine funding for these schemes. The most recent funding valuation of the OSF was at 30 June 2005 and for the UK Pension Scheme at 1 July 2004. At the most recent valuations, the actuaries indicated that, on the basis of accrued benefits, both funds were in surplus and that the funds were in a satisfactory financial position.

The OSF triennial funding valuation as at 30 June 2005 was based on the Aggregate Funding method, consistent with the accounting standard for superannuation funds, AAS 25 – *Financial Reporting by Superannuation Plans*. Under this standard, the accrued benefits of the OSF were determined as the present value of the future benefits payable to members (allowing for future salary increases), discounted using the expected rate of return on the assets held to fund these benefits. At the time of the triennial review, the surplus of the OSF on this measure was $64 million, as the assets of the OSF of $614 million exceeded the accrued benefits of $550 million. Subsequent to the triennial review, the OSF surplus measured on the basis of AAS 25 as at 30 June 2007 amounted to $189 million (assets of $796 million less accrued benefits of $607 million).

Consistent with the actuary's funding recommendation, the Bank increased its contributions to the OSF from January 2007 to a rate of 18.3 per cent of salaries (from 15 per cent). This represents a return to a more normal long-term funding rate after a period of a decade or more in which funding had occurred at significantly less than the long-term rate, also on actuarial advice. The main financial assumptions in the triennial valuation were that the annual post-tax rate of return on assets for benefits of active members was 6.25 per cent and 6.75 per cent (pre-tax) for assets for current pensions, annual salary increases of 4.0 per cent and annual pension increases of 3.5 per cent.

The triennial funding valuation for the UK Pension Scheme was based on the Attained Age method. The surplus of the UK Pension Scheme as at 30 June 2007, measured in accordance with AAS 25, was $3 million (assets of $23 million compared with accrued benefits of $20 million).

Accounting valuation

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

The principal actuarial assumptions for the AASB 119 valuation used in the case of the OSF were a discount rate of 6.35 per cent (6.0 per cent in 2005/06), future salary increases of 4.0 per cent (4.0 per cent in 2005/06), future pension increases of 3.5 per cent (3.5 per cent in 2005/06) and an assumed return on plan assets of 8.3 per cent (7.0 per cent in 2005/06). The actual return on plan assets of the OSF for 2006/07 was 19.0 per cent (12.1 per cent in 2005/06). The assumptions used for the UK Pension Scheme were a discount rate of 5.80 per cent (5.25 per cent in 2005/06), future salary increases of 5.2 per cent (5.0 per cent in 2005/06), future pension increases of 3.2 per cent (3.0 per cent in 2005/06) and an assumed return on plan assets of 5.0 per cent (4.75 per cent in 2005/06). The actual return on plan assets of the UK Pension Scheme for 2006/07 was 3.7 per cent (4.2 per cent in 2005/06). The expected overall rates of returns are based on the actuaries' models of returns for major asset classes and reflect the historic rates of return and volatility for each class and correlations across asset classes.

Details of the Funds are as shown on the following pages. In the case of the OSF, these details relate only to the defined benefit component of the fund; defined contribution accumulation balances, on which the Bank has no actuarial risk, are excluded. This has no effect on the measurement of the surpluses in the OSF. At 30 June 2007 accumulation balances in the OSF totalled $144.4 million ($113.3 million as at 30 June 2006).

Asset Distribution as at 30 June	**OSF**		**UK Pension Scheme**	
(% of fund assets)	**2007**	**2006**	**2007**	**2006**
Cash and short-term securities	5.0	9.2	–	–
Fixed interest securities	7.1	16.1	–	–
Indexed securities	3.2	3.5	93.0	94.0
Domestic shares	41.7	28.6	7.0	6.0
Foreign shares	6.0	7.0	–	–
Property				
Direct	4.5	8.9	–	–
Indirect	19.5	18.9	–	–
Private equity and alternative investments	13.0	7.8	–	–
Total	100	100	100	100

Note 14 (CONTINUED)	OSF		UK Scheme		Total	
	2007 $M	2006 $M	2007 $M	2006 $M	2007 $M	2006 $M
Opening balances:						
Net market value of assets	672	614	24	23	696	637
Accrued benefits	(650)	(607)	(20)	(19)	(670)	(626)
Surplus	22	7	4	4	26	11
Actuarial losses not included in balance sheet under Corridor	26	43	–	–	26	43
Opening superannuation asset	48	50	4	4	52	55
Change in net market value of assets	124	58	(1)	1	122	59
Change in accrued benefits	20	(44)	2	(1)	22	(44)
Change in actuarial losses not included in balance sheet under Corridor	(143)	(17)	(2)	–	(144)	(17)
Total change in superannuation asset	1	(2)	–	–	1	(2)
Closing balances:						
Net market value of assets	796	672	23	24	819	696
Accrued benefits	(631)	(650)	(17)	(20)	(648)	(670)
Surplus	165	22	5	4	171	26
Actuarial losses not included in balance sheet under Corridor	(117)	26	(2)	–	(118)	26
Closing superannuation asset	49	48	4	4	53	52
Actuarially assumed return on plan assets	44	37	1	1	45	38
Benefit payments	(27)	(26)	(1)	(1)	(28)	(27)
Actuarial gains on assets	95	40	–	–	95	40
Contributions from RBA to defined benefit schemes	13	8	–	–	13	8
Contributions tax	(2)	(1)	–	–	(2)	(1)
Exchange rate gains/(losses)	–	–	(1)	1	(1)	1
Change in net market value of assets	124	58	(1)	1	122	59
Current service cost	(23)	(21)	–	–	(23)	(21)
Interest cost	(34)	(27)	(1)	(1)	(35)	(28)
Benefit payments	27	26	1	1	28	27
Contributions tax	2	1	–	–	2	1
Experience adjustments on benefits	7	(11)	–	–	7	(11)
Effects of changes in benefit actuarial assumptions	41	(12)	2	–	43	(12)
Exchange rate gains/(losses)	–	–	1	(1)	1	(1)
Change in accrued benefits	20	(44)	2	(1)	22	(44)

Note 14 (CONTINUED)	OSF		UK Scheme		Total	
	2007 $M	2006 $M	2007 $M	2006 $M	2007 $M	2006 $M
Actuarial (gains)/losses on assets	(95)	(40)	–	–	(95)	(40)
Experience adjustments on benefits	(7)	11	–	–	(7)	11
Effects of changes in benefit actuarial assumptions	(41)	12	(2)	–	(43)	12
Amortisation of actuarial gains/losses	–	–	–	–	–	–
Change in actuarial losses not included in balance sheet under Corridor	(143)	(17)	(2)	–	(144)	(17)
Superannuation expense included in Income Statement						
Current service cost	22	20	–	–	22	20
Interest cost	32	26	1	1	33	27
Assumed return on plan assets	(42)	(36)	(1)	(1)	(43)	(37)
Amortisation of actuarial gains/losses under Corridor	–	–	–	–	–	–
Productivity and superannuation guarantee contributions	3	3	–	–	3	3
Total superannuation expense	15	13	–	–	15	13

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

As at 30 June 2005, the surplus in the OSF was $7 million (net market value of assets of $614 million less accrued benefits of $607 million). Experience adjustments arising on these assets and liabilities during 2004/05 were $38 million and $11 million respectively. The surplus in the UK Pension Scheme at 30 June 2005 was $4 million (net market value of assets of $23 million less accrued benefits of $19 million). The experience adjustments on these assets and liabilities during 2004/05 were $1 million and nil respectively.

Note 15 SEGMENT REPORTING

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

Note 16 FINANCIAL INSTRUMENTS

Australian Accounting Standard AASB 132 – *Financial Instruments: Disclosure and Presentation* requires disclosure of information relating to financial instruments; their significance and performance; accounting policies; terms and conditions; fair values and risk information. The RBA is exposed to a range of financial risks due to its policy and operational responsibilities. The RBA holds financial assets for purposes of market operations to implement monetary policy, provides banking services to its customers, operates Australia's high value payments and inter-bank settlement systems and issues Australia's currency notes. Reflecting its policy responsibilities, the RBA has no discretion to manage the foreign exchange risk on its foreign currency reserves. In addition, the RBA has limited scope to manage the interest rate exposure on its holdings of foreign and domestic securities. The Operations in Financial Markets chapter in this *Annual Report* provides additional information on the RBA's management of financial risks.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction, and is usually determined by the quoted market price. The RBA's Australian dollar securities, foreign government securities, interest rate futures, foreign currency swap contracts and its shareholding in the Bank for International Settlements are carried in the balance sheet (and shown in this note) at fair value. The RBA's bank deposits, cash and cash equivalents, notes on issue and deposit liabilities are carried in the balance sheet (and shown in this note) at face value, which is equivalent to their amortised cost using the effective interest method; this approximates fair value.

Financial risk of financial instruments embodies market risk (currency risk and interest rate risk); credit risk; liquidity risk and cash flow risk.

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

Foreign exchange risk

Foreign exchange risk is the risk that the value of a financial instrument will fluctuate due to changes in exchange rates. The RBA's net foreign currency exposure as at 30 June 2007 was $29.9 billion ($28.1 billion as at 30 June 2006).

Interest rate risk

Interest rate risk is the risk that the fair value of a financial instrument will fluctuate due to changes in market interest rates. The following table shows the RBA's balance sheet restated in compliance with AASB 132.

Note 16 (CONTINUED)

Interest rate risk As at 30 June 2007

	Balance sheet total $M	Floating interest rate $M	Repricing period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average coupon rate %	Weighted average effective rate %
Assets									
Gold loans	1 064	–	–	390	640	–	34	1.35	1.35
Gold holdings	937	–	–	–	–	–	937	n/a	n/a
Sub-total	**2 001**								
Foreign exchange									
Balances with central banks	357	352	–	–	–	–	5	4.27	4.27
Securities sold under repurchase agreements	13 652	–	1 282	2 223	4 145	6 002	–	4.26	4.71
Securities purchased under repurchase agreements	49 778	–	49 778	–	–	–	–	4.93	4.93
Other securities	12 268	–	3 991	2 090	2 365	1 800	2 022	2.53	2.63
Deposits	16 928	27	16 899	–	–	–	2	5.02	5.02
Accrued interest – foreign exchange	555	–	–	–	–	–	555	n/a	n/a
Sub-total	**93 538**								
Australian dollar securities									
Securities sold under repurchase agreements	663	–	–	168	300	195	–	7.11	6.35
Securities purchased under repurchase agreements	30 351	–	29 551	800	–	–	–	6.29	6.29
Other securities	3 772	–	125	305	1 945	1 397	–	6.45	6.50
Accrued interest – Australian dollar securities	169	–	–	–	–	–	169	n/a	n/a
Sub-total	**34 955**								
Property, plant & equipment	421	–	–	–	–	–	421	n/a	n/a
Cash and cash equivalents	586	571	–	–	–	–	15	6.25	6.25
Loans and advances	18	18	–	–	–	–	–	4.04	4.04
Other	375	–	–	–	–	–	375	n/a	n/a
Total assets	**131 894**	**968**	**101 626**	**5 976**	**9 395**	**9 394**	**4 535**	**4.90**	**4.95**
Liabilities									
Australian notes on issue	40 289	2 588	–	–	–	–	37 701	0.40	0.40
Deposits	65 830	2 996	61 106	50	–	–	1 678	6.25	6.25
Distribution payable to Australian Government	1 085	–	–	–	–	–	1 085	n/a	n/a
Other	16 072	–	14 470	–	–	–	1 602	4.20	4.20
Total liabilities	**123 276**	**5 584**	**75 576**	**50**	**–**	**–**	**42 066**	**4.01**	**4.01**
Capital and reserves	8 618								
Total balance sheet	**131 894**								
Off balance sheet items									
Interest rate futures	526	–	–	–	–	–	526	n/a	n/a

Note 16 (CONTINUED)

Interest rate risk As at 30 June 2006

	Balance sheet total $M	Floating interest rate $ M	Repricing period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average coupon rate %	Weighted average effective rate %
Total assets	**105 477**	**1 548**	**78 348**	**3 587**	**10 852**	**8 781**	**2 331**	**3.87**	**3.95**
Total liabilities	94 239	5 720	46 402	2 400	–	–	39 717	3.33	3.33
Capital and reserves	11 208								
Total balance sheet	**105 447**								
Off balance sheet items	2 594	–	–	–	–	–	2 594	n/a	n/a

Other liabilities include amounts outstanding under sale repurchase agreements.

All financial instruments are shown at their repricing period which is equivalent to the remaining term to maturity.

Interest rate futures reflect the positions in interest rate contracts traded in foreign futures exchanges to manage interest rate risk on Official Reserve Assets.

Sensitivity to risks

The sensitivity of the fair value of the RBA's financial assets to fluctuations in the exchange rate and interest rates is shown below.

	Change in fair value $M
Impact on:	
Net foreign exchange holdings of:	
A rise of 10 per cent in the value of the A$	2 684
An increase of 1 percentage point in yield curves overseas	768
Australian dollar securities of:	
An increase of 1 percentage point in the yield curve in Australia	159

Concentration of foreign exchange

The RBA's net holdings of foreign exchange were distributed as follows as at 30 June:

	% of foreign exchange as at 2007	% of foreign exchange as at 2006
US dollar	45	45
Euro	45	45
Japanese yen	10	10
Total foreign exchange	100	100

Note 16 (CONTINUED)

Fair value of financial instruments

AASB 130 requires that the fair value of financial assets and liabilities be disclosed according to their accounting classification under AASB 139.

	2007 $M	2006 $M
Assets		
At fair value through Profit or Loss	30 631	33 493
Loans and receivables	98 944	69 956
Available-for-sale	839	842
Total financial assets as at 30 June	130 414	104 291
Non-financial assets	1 480	1 156
Total assets as at 30 June	131 894	105 447
Liabilities		
At fair value through Profit or Loss	1 321	1 310
Not at fair value through Profit or Loss	120 668	91 323
Non-financial liabilities	1 287	1 606
Total liabilities as at 30 June	123 276	94 239

Credit risk

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

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

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

1. ***Foreign exchange swaps*** – As at 30 June 2007 the RBA was under contract to purchase $11.3 billion of foreign currency and sell $59.9 billion of foreign currency. As of that date there was an unrealised net gain of $1 091 million on these swap positions included in net profit. 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 its obligations.
2. ***Interest rate futures*** – As at 30 June 2007 the amount of credit risk on interest rate futures contracts was approximately $1.6 million ($3.4 million at 30 June 2006). As at 30 June 2007 there was an unrealised gain brought to account on those contracts of $1.1 million ($1.6 million unrealised loss at 30 June 2006).

Note 16 (CONTINUED)

Concentration of credit risk

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

Credit risk

	Risk rating of security issuer*	Risk rating of counterparties*	% of total assets as at 2007	% of total assets as at 2006
Domestic Government Securities				
Holdings – Commonwealth Government securities	AAA	n/a	1.1	2.1
Holdings – Semi Government securities	AAA	n/a	1.6	1.5
	AA	n/a	0.2	0.0
Securities sold under repurchase agreements	AAA	AA	0.5	0.1
	AAA	A	0.1	0.1
Securities held under repurchase agreements	AAA	AA	9.4	9.0
	AAA	A	1.1	0.7
	AAA	other	1.4	1.9
	AA	AA	10.0	11.5
	AA	A	0.0	0.2
	AA	other	0.0	0.0
	A	AA	1.1	1.4
	A	A	0.0	0.1
Foreign investments				
Holdings of securities	AAA	n/a	4.3	10.2
	AA	n/a	3.9	0.0
	A	n/a	0.3	8.8
Securities sold under repurchase agreements	AAA	AA	9.0	7.2
	AAA	A	1.2	1.7
	AA	AA	0.1	0.0
	AA	A	0.1	0.0
	A	AA	0.0	0.2
	A	A	0.0	0.1
Securities held under repurchase agreements	AAA	AAA	0.3	0.2
	AAA	AA	34.9	25.1
	AAA	A	2.1	2.1
	AA	AAA	0.0	0.0
	AA	AA	0.7	0.0
	AA	A	0.2	0.0
	A	AAA	0.0	0.0
	A	AA	0.0	0.1
	A	A	0.0	0.1
Deposits	n/a	AAA	0.6	0.6
	n/a	AA	12.3	11.1
	n/a	A	0.0	0.0

Other	n/a	AAA	0.0	0.0
	n/a	AA	0.7	0.0
	n/a	A	0.1	0.0
	n/a	other	0.0	0.3
Gold loans	n/a	AAA	0.1	0.1
	n/a	AA	0.6	0.7
	n/a	A	0.1	0.6
	n/a	BBB	0.1	0.0
Other			1.8	2.2
			100	100

* Standard & Poor's equivalent ratings

Auditor-General for Australia

Australian National
Audit Office

INDEPENDENT AUDITOR'S REPORT

To the Treasurer

Scope

I have audited the accompanying financial statements of the Reserve Bank of Australia and controlled entities, which comprise: a directors' statement; balance sheet; income statement; statement of distribution; statement of changes in capital and reserves; cash flow statement; summary of significant accounting policies, and other explanatory notes.

The Responsibility of the Board of Directors for the Financial Statements

The members of Board are responsible for the preparation and fair presentation of the financial statements in accordance with Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997* and the Australian Accounting Standards (including the Australian Accounting Interpretations). This responsibility includes establishing and maintaining internal controls relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances. In Note 1, the directors also state that the financial statements comply fully with International Financial Reporting Standards.

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of

GPO Box 707 CANBERRA ACT 2601
19 National Circuit BARTON ACT
Phone (02) 6203 7500 Fax (02) 6273 5355
Email ian.mcphee@anao.gov.au

accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Independence

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

Auditor's Opinion

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

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

(b) give a true and fair view of the matters required by the Finance Minister's Orders including the Reserve Bank of Australia and controlled entities' financial position as at 30 June 2007 and of their financial performance and their cash flows for the year then ended; and

(c) comply with International Financial Reporting Standards, as disclosed in Note 1.

Ian McPhee
Auditor-General

Sydney
9 August 2007

Pro Forma Business Accounts

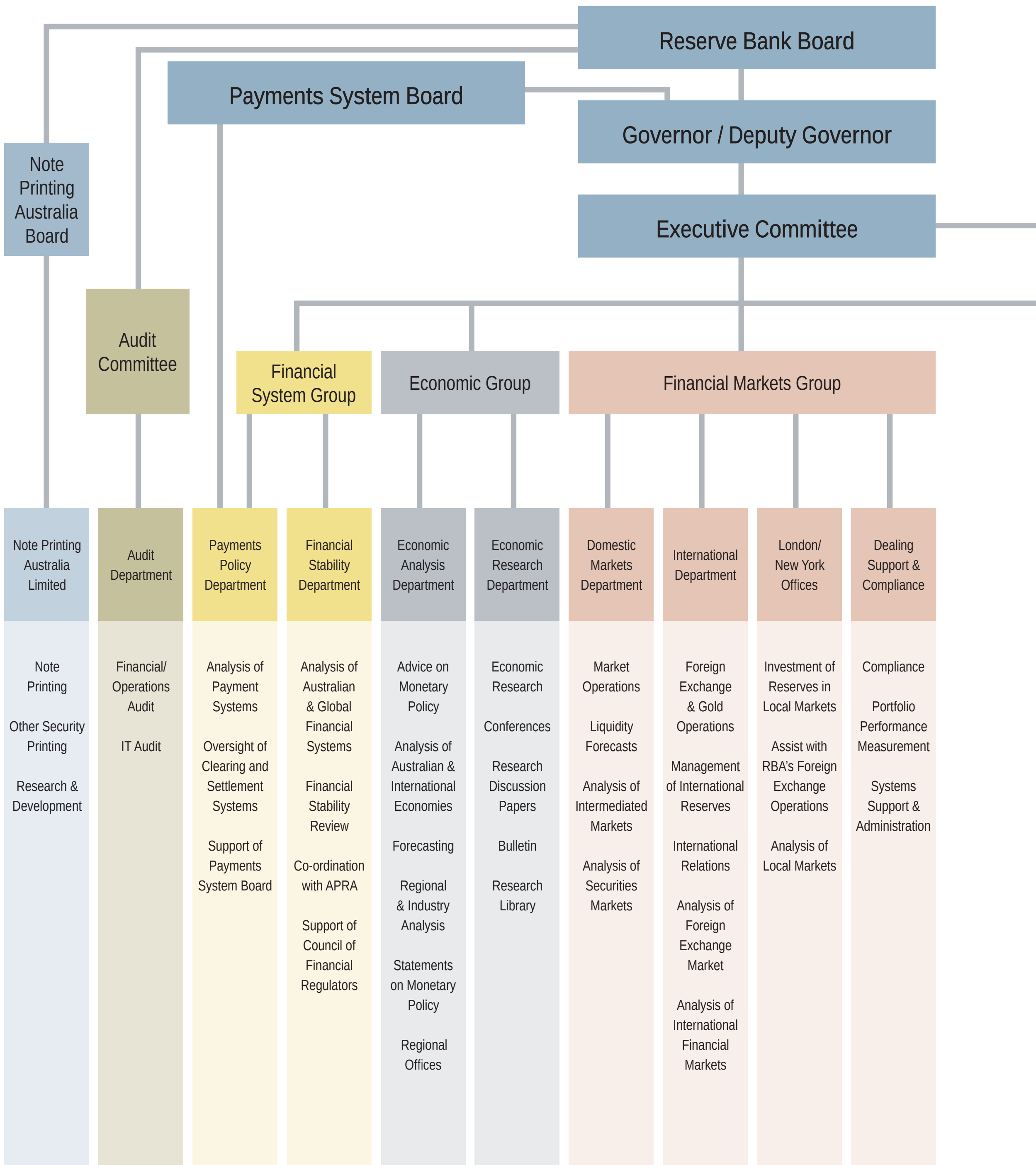
The following sets of accounts for each of the Reserve Bank's contestable businesses have been prepared in accordance with competitive neutrality guidelines. These accounts do not form part of the audited financial statements.

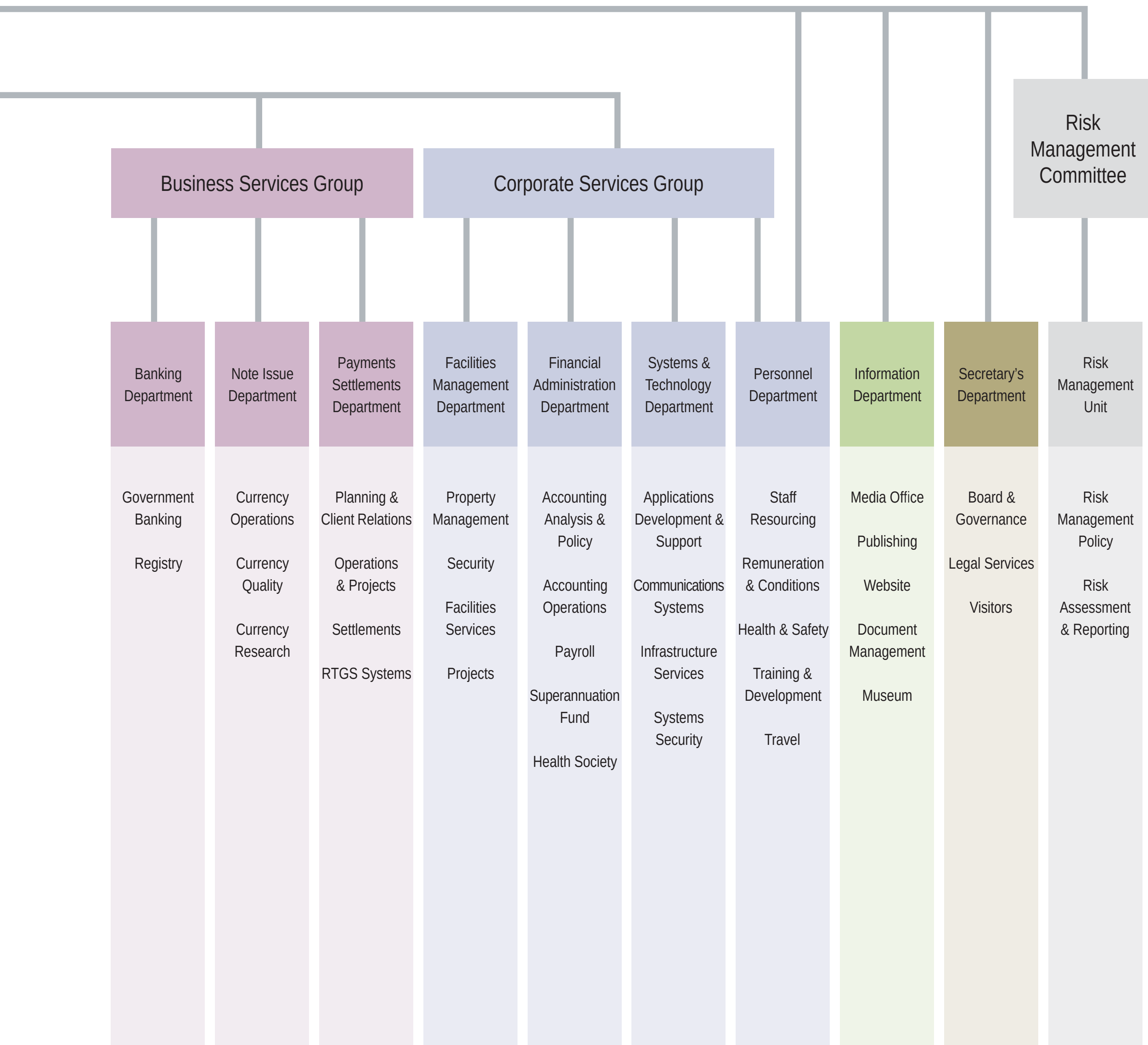
	Transactional Banking		Registry	
	2005/06 $ million	2006/07 $ million	2005/06 $ million	2006/07 $ million
Revenue				
– Service fees	15.5	15.4	0.6	0.6
– Other revenue	4.5	5.4	0.1	0.1
Total	20.0	20.8	0.7	0.7
Expenditure				
– Direct costs	12.5	13.1	0.4	0.3
– Indirect costs	3.4	3.8	0.1	0.2
Total	15.9	16.9	0.5	0.5
Net profit/(loss)	4.1	3.9	0.2	0.2
Net profit/(loss) after taxes[(a)]	2.9	2.7	0.1	0.1
Assets[(b)]				
– Domestic markets investments	337.0	365.8	1.3	1.1
– Other assets	7.7	8.3	0.0	0.1
Total	344.7	374.1	1.3	1.2
Liabilities[(b)]				
– Capital & reserves	25.0	25.0	1.0	1.0
– Deposits	312.5	344.6		
– Other liabilities	7.2	4.5	0.3	0.2
Total	344.7	374.1	1.3	1.2

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

(b) As at 30 June.

Organisational Chart | July 2007




Risk Management Committee
Business Services Group
Corporate Services Group
Banking Department
Government Banking
Registry
Note Issue Department
Currency Operations
Currency Quality
Currency Research
Payments Settlements Department
Planning & Client Relations
Operations & Projects
Settlements
RTGS Systems
Facilities Management Department
Property Management
Security
Facilities Services
Projects
Financial Administration Department
Accounting Analysis & Policy
Accounting Operations
Payroll
Superannuation Fund
Health Society
Systems & Technology Department
Applications Development & Support
Communications Systems
Infrastructure Services
Systems Security
Personnel Department
Staff Resourcing
Remuneration & Conditions
Health & Safety
Training & Development
Travel
Information Department
Media Office
Publishing
Website
Document Management
Museum
Secretary's Department
Board & Governance
Legal Services
Visitors
Risk Management Unit
Risk Management Policy
Risk Assessment & Reporting

Head Office Management | End July 2007

Governor:	Glenn Stevens
Deputy Governor:	Ric Battellino

Economic Group

Assistant Governor:	Malcolm Edey

Economic Analysis Department

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

Economic Research Department

Head:	Christopher Kent

Financial Markets Group

Assistant Governor:	Guy Debelle

Domestic Markets Department

Head:	John Broadbent
Chief Manager:	Jonathan Kearns

International Department

Head:	Keith Hall
Chief Managers:	Mike Sinclair
	Vacant

Financial System Group

Assistant Governor:	Philip Lowe

Financial Stability Department

Head:	Chris Ryan
Chief Manager:	Chris Aylmer

Payments Policy Department

Head:	Michele Bullock
Chief Managers:	Carl Schwartz
	John Simon

Business Services Group

Assistant Governor:	Bob Rankin

Banking Department

Head:	Greg Johnston

Note Issue Department

Head:	Michael Andersen

Payments Settlements Department

Head:	Nola McMillan

Corporate Services Group

Assistant Governor:	Frank Campbell

Facilities Management Department

Head:	Richard Mayes

Financial Administration Department

Head:	Darryl Ross

Systems & Technology Department

Head:	Michael Hogan

Secretary's Department

Secretary:	David Emanuel
Deputy Secretary:	Anthony Dickman

Audit Department

Head:	Paul Apps

Information Department

Head:	Paul Barry

Personnel Department

Head:	Graham Rawstron

Risk Management Unit

Head:	Peter Stebbing

Contact Details

Head Office

65 Martin Place
Sydney NSW 2000
Telephone: (02) 9551 8111
Fax: (02) 9551 8000
Internet: www.rba.gov.au
E-mail: rbainfo@rba.gov.au

Regional Offices

Queensland

Senior Representative Officer:
Karen Hooper
12 Creek Street
Brisbane QLD 4000
Telephone: (07) 3002 6100
Fax: (07) 3002 6110

South Australia

Senior Representative Officer:
Miriam Martin
25 Grenfell Street
Adelaide SA 5000
Telephone: (08) 8113 3500
Fax: (08) 8113 3510

Victoria

Senior Representative Officer:
Ben McLean
60 Collins Street
Melbourne VIC 3000
Telephone: (03) 9270 8600
Fax: (03) 9270 8610

Western Australia

Senior Representative Officer:
Virginia Christie
45 St Georges Terrace
Perth WA 6000
Telephone: (08) 9323 3200
Fax: (08) 9323 3210

Canberra Branch

Manager: Scott Kennedy
20-22 London Circuit
Canberra ACT 2600
Telephone: (02) 6201 4800
Fax: (02) 6201 4875

Overseas Offices

Europe

Chief Representative: John Veale
Deputy Chief Representative: Vicki Newman
7 Moorgate
London EC2R 6AQ
Telephone: 44 20 7600 2244
Fax: 44 20 7710 3500

New York

Chief Representative: James Whitelaw
Deputy Chief Representative: Daniel Pavlik
505 Fifth Avenue
New York, NY 10017
Telephone: 1 212 566 8466
Fax: 1 212 566 8501

Note Printing Australia Limited

Chief Executive: Chris Ogilvy
Hume Highway
Craigieburn VIC 3064
Telephone: (03) 9303 0444
Fax: (03) 9303 0491

Glossary

AIFRS	Australian equivalents to International Financial Reporting Standards
AOFM	Australian Office of Financial Management
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
BIS	Bank for International Settlements
BRS	Business resumption site (of the RBA)
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CFR	Council of Financial Regulators
CGFS	Committee on the Global Financial System (of the BIS)
CGS	Commonwealth Government securities
CHESS	Clearing House Electronic Subregister System (of the Australian Stock Exchange)
CLS	Continuous linked settlement
EEO	Equal employment opportunity
EFTPOS	Electronic funds transfer at point of sale
EMEAP	Executives' Meeting of East Asia-Pacific Central Banks
ES	Exchange settlement
ESA	Exchange Settlement Account
FOI	Freedom of Information
FSAP	Financial Sector Assessment Program
G7	Group of Seven
G-20	Group of Twenty
GDES	Government Direct Entry Service
GPF	Government Partnership Fund (with Indonesia)
IMF	International Monetary Fund
IT	Information technology
NNPDC	National Note Processing and Distribution Centre
NPA	Note Printing Australia Limited
OECD	Organisation for Economic Co-operation and Development
OH&S	Occupational health & safety
OPA	Official Public Account
RBA	Reserve Bank of Australia
RBRF	Reserve Bank Reserve Fund
RITS	Reserve Bank Information and Transfer System
RTGS	Real-time gross settlement
SWIFT	Society for Worldwide Interbank Financial Telecommunication