Governor's Foreword

The 2015/16 financial year saw moderate growth in the global economy, lower than normal inflation and, once again, periods of anxiety in financial markets. It also saw the continuation of extremely low interest rates. This has included negative policy rates in a handful of jurisdictions, including two of the most important – the euro area and Japan – and only the smallest of increases in the policy rate in the United States. It seems as though very low interest rates are likely to persist for some time yet. At the time of writing, a significant share of the sovereign bonds on issue in the world are trading with negative yields. The full implications of this are yet to be seen.

To be sure, these conditions reflect the long shadow of the global financial crisis of 2007–08 and its aftermath, although it is not clear whether this fully explains the situation. Even countries that did not suffer a banking crisis eight years ago are finding strong growth more elusive than they had hoped. If, as some argue, other, longer-term, factors are also at work – such as less favourable demographics, slower productivity growth and reduced entrepreneurial dynamism – these are influences that monetary policy cannot overcome.

In Australia, growth over the past year at around 3¼ per cent was higher than expected at the time of the 2015 annual report. Yet inflation declined and was lower than expected. This was an unusual combination and not unrelated to what is happening around the world.

Stepping back, it can be seen that, overall, the economy's adjustment to the lower terms of trade and the unwinding of the mining investment boom has been proceeding reasonably well in the circumstances. As those regions and sectors that had been leading growth fell back, other regions and sectors saw faster growth.

A year from now, the fall in mining capital spending will probably largely be completed. As that headwind diminishes, present indications are that there are reasonable prospects for ongoing growth in the economy, still with quite low inflation. While the growth outlook is reasonable, the economy could sustain faster growth than forecast at present. But the challenge of securing faster growth on a durable basis, without a further step-up in private sector leverage, is one that will not be met by monetary policy alone.

During 2015/16, the Reserve Bank Board adjusted the cash rate only once, in May 2016, in response to the shift in the inflation outlook. This change was made consistent with the flexible inflation targeting framework that has been in place since the early 1990s, which seeks an average inflation rate of between 2 and 3 per cent over time. The objective has been delivered: over the past 20 years, the average CPI increase has been 2.5 per cent per annum and variability in the real economy has been quite contained, particularly in the face of very substantial shocks since the mid 2000s. For the future, inflation targeting remains, in the view of this writer, the best monetary policy framework available. However, it may need to be operated with considerable flexibility so as to allow what may be a reasonably protracted return to 2–3 per cent inflation.

The Bank's earnings for the year were $2.9 billion. Underlying earnings were $1.2 billion, an increase from the preceding year reflecting a rise in net interest income and the full annual effect of the fees from the Committed Liquidity Facility. Earnings available for distribution to the Commonwealth, which include underlying earnings and valuation gains that have been realised, amounted to $4.6 billion, about $1.2 billion more than the previous year. With the Treasurer's agreement, some of the earnings are being retained so as to augment the Bank's capital in line with growth in the size of the balance sheet. With this, the balance sheet remains very strong.

As measured, the cost of running the Reserve Bank's routine operations in 2015/16 rose by 7.4 per cent. But the previous year's costs had been held down by the delay in finalising the new Workplace Agreement, which meant that pay rises for 2014 were not paid until August 2015. Abstracting from this and the rise in depreciation, costs of 'business as usual' activities rose by 3.6 per cent.

As foreshadowed in previous annual reports, the large portfolio of projects continued to ramp up in 2015/16. This has seen staff numbers increase further, with a number of specialist roles, particularly IT professionals, on short-term contracts required to meet project requirements. At the time of writing, the build-up in staff numbers is largely complete and, if projects run according to their schedules, project costs will peak in 2016/17. Thereafter, capital expenditure for these projects and associated staffing will start to decline, but depreciation charges against the larger asset base will be a greater share of ongoing operating costs for the foreseeable future.

Among the major projects is the Next Generation Banknote program to upgrade Australia's banknotes. As described in the chapter on 'Banknotes', this is a large and very complex project, the aim of which is to maintain a supply of banknotes with innovative security features that are more secure against counterfeiting. While counterfeiting rates remain low by international standards, they are rising and so an upgrade of the banknotes' security features is a timely investment. The design of the new

$5 banknote was released in April 2016 and the new banknote is scheduled to enter circulation on 1 September. It is planned that the new $10 banknote will be launched in late 2017.

Among other projects, the Reserve Bank's investment as part of the New Payments Platform has continued and it is expected that it will be completed in time for the industry's scheduled go-live date in late 2017. Overhauling the technology that supports government banking continues. The system that provides comprehensive information on the assets that the Bank would accept when providing liquidity support to banks moved close to completion during 2015/16. The project to outsource the administration of the Officers' Superannuation Fund is scheduled for completion by mid 2017. When fully implemented, this will permanently reduce operating costs by about 1 per cent.

For the first time, this annual report contains a chapter devoted to reporting on the Reserve Bank's performance in 2015/16 against the performance objectives set out in the corporate plan for 2015/16. That chapter, which is a new reporting requirement for Commonwealth entities, summarises outcomes during the year across the Bank's areas of responsibility, namely monetary policy, financial stability, financial market operations, payments, banking, currency and financial position and capital.

The management and staff of the Bank reached their customary high standards in carrying out their duties, and the Reserve Bank Board joins me in thanking them. The Board itself has seen some change, with Roger Corbett AO and John Edwards retiring from the Board at the end of their respective terms, having served with distinction. The Board warmly welcomed Allan Moss AO and Ian Harper as new members, who bring valuable acumen and experience to the Board's deliberations. It was particularly pleasing that Philip Lowe was appointed to be the Bank's eighth Governor.

As I approach the end of my term, I express my personal thanks to the staff, my senior colleagues and members of the Reserve Bank Board, past and present, for their support and for their great contribution to the economic prosperity and welfare of the people of Australia.

Glenn Stevens AC
Governor and Chair, Reserve Bank Board
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