Reserve Bank of Australia

Report and Financial Statements

1997

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Governor's Foreword

This *Annual Report* marks a departure from tradition in that it is primarily a report on the operations of the Reserve Bank, rather than an economic commentary. The reason for this change is that we now have so many opportunities during the year to report on the economy and monetary policy that we do not need to use the *Annual Report* for this purpose. The four quarterly reports on the economy (one of which was issued only a fortnight ago), the two appearances before a Parliamentary Committee, the published explanations at the time of monetary policy changes, and the various speeches and articles in the Bank's monthly *Bulletin* fulfil the Bank's communications role more than adequately.

But there are other operations that we undertake besides monetary policy where there are fewer opportunities to communicate; this Report allows us to give a fuller account of these as well. The main ones are our operations in the money, bond and foreign exchange markets, our supervision of the banking system, our participation in the payments system, our provision of banking and other commercial services, and the printing and issuing of currency notes.

More details of these activities are contained in this *Annual Report* than in previous Reports. We have also provided, where possible, some objective indicators of performance or cost of the various activities, with the aim of improving public accountability. This information is not always available, but we remain committed to the view that increasing transparency and accountability are crucial for the public support of any national institution such as the central bank.

Notwithstanding these considerations, any recording of the year's events must start with our most public activity – monetary policy – and then proceed to the others. The following list is intended to cover the main operations of the Bank over the past year.

- Monetary policy was eased five times, bringing the cash rate down from 7.5 per cent in July 1996 to 5.0 per cent in August 1997. This was in response to forecast developments in the economy, which showed inflationary pressures easing and slower economic growth. Over the course of the year, GDP appears to have risen by a little less than 3 per cent and underlying inflation was 1.7 per cent. In many circumstances, this would be seen as a good result for an economy in the sixth year of an expansion, but developments in the labour market were disappointing. Employment grew by less than 1 per cent, which left the unemployment rate in the mid to high 8 per cent range through the year.

- In August 1996, at the time of my appointment, the Treasurer and I jointly signed the *Statement on the Conduct of Monetary Policy*. This was an important further step in clarifying the relationship between the Bank and the Government within the framework of the Reserve Bank Act.
- Operations in domestic financial markets over the past year were directed principally to implementing the five reductions in interest rates at the time of monetary policy easings, and maintaining stability in the cash rate between policy changes. Some significant changes were made to our dealing arrangements in the money market to handle the ending of the "authorised money market dealer" arrangements and to prepare for real-time gross settlement (RTGS). In the foreign exchange market, the main action was a reasonably substantial purchase of foreign currency in the first half of 1996/97 to rebuild international reserves.
- On the bank supervision side, the main new activity has been preparation for implementing capital adequacy requirements for market risk. Some changes in banking and finance policy have been put on hold pending the release of the Financial System Inquiry's report and the Government's response. The Bank made two published submissions to the Inquiry.
- In the payments system area, on the other hand, there was a large team effort involved in building the RTGS system (due for completion by April 1998). This is an essential piece of financial infrastructure if Australia is to compete seriously in world financial markets. Four of the five functional areas of the Bank are involved in this project, with about 50 people working on it at any one time. Close co-operation with banks and other financial services providers is also essential to get this project completed on time.
- Banking, registry and settlement services to customers, principally the Commonwealth Government, continued to be provided in the most cost-efficient manner possible. Further efforts were made to keep down costs and ensure that these services were provided on a commercial basis. This has been an ongoing preoccupation of the Bank, but was given further impetus by the Government's Competitive Neutrality Taskforce which has been examining public sector commercial activities to ensure they compete on even terms with private sector providers.
- Two-thirds of the Bank's gold holdings were sold in the second half of 1996/97 and the proceeds invested in foreign government securities. This change in the composition of international reserves was only the fourth major change in the post-war period. The first was the move out of sterling into US dollars in the late sixties, the second was diversification into other currencies, and the third was the benchmark in 1991, which involved a relatively even distribution of reserves between US dollars, Japanese yen and German marks.

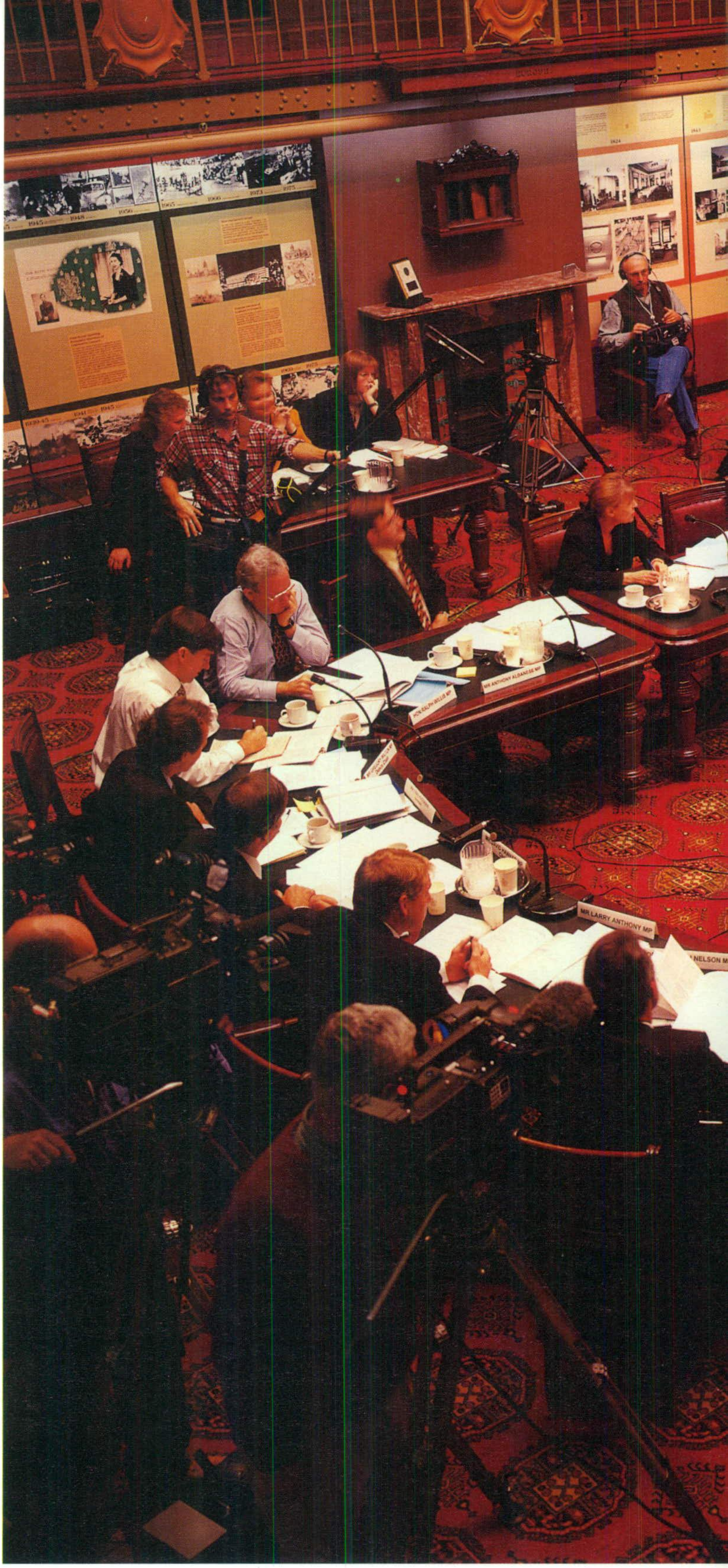
- No new designs for domestic currency notes were introduced over the past year as the transition of the Australian note issue from paper to polymer has been completed. Production for export continued to rise and in 1996/97 was equivalent to two-thirds of domestic production; notes were produced for Thailand, Brunei, Papua New Guinea and Western Samoa.

Turning to the management of the Bank, the most striking aspect has been the almost continuous fall in staff numbers for over a decade. From a peak of 3 841 in 1983, staff numbers (including Note Printing Australia) have now fallen to 1 571 in June 1997, including a decline of around 210 in 1996/97. A fall of this magnitude gives the impression of some draconian pruning initiated by Governors, but that certainly was not the intention. The decline in numbers over recent years resulted from a rolling series of re-examinations of procedures and staffing levels, largely initiated within departments or by Assistant Governors. The replacement of manual paper-based processes by automatic data processing was, of course, a major part of the story, but there were other efficiencies as well. One benefit of these economies is that operating costs of the Bank are now lower in nominal terms than at the beginning of the decade.

Of course, changes of this magnitude have been unsettling for staff. The biggest changes have been in the business services area, where staff have recognised that to keep their business they have to provide service of the highest quality as cost-effectively as possible. In other areas too, staff have shown a remarkable capacity to cope with reorganisation, which nearly always results in downsizing. I am grateful for the professional way in which these changes have been achieved and for the loyalty and tolerance of the staff over recent years.

This Report, and financial statements, have been prepared in accordance with the provisions of Section 81 of the Reserve Bank Act 1959. I have pleasure in submitting it to the Treasurer and arranging for its tabling in the Senate and House of Representatives.

IJ Macfarlane
Chairman
Reserve Bank Board



Appearance before the House of Representatives Standing Committee on Financial Institutions and Public Administration, in the Jubilee Room of the NSW Parliament House, Sydney, May 1997. The Governor was accompanied by Deputy Governor Graeme Thompson, and Assistant Governor (Economic) Glenn Stevens.

Statement on the Conduct of Monetary Policy

The *Statement on the Conduct of Monetary Policy,* which was issued on 14 August 1996, cleared up any remaining ambiguity about the relationship between the Government and the Bank. In it, the Government stated its understanding of the high degree of independence given to the Bank under its Act and endorsed the objective of keeping underlying inflation between 2 and 3 per cent, on average. Importantly, it also provided for increased accountability through half-yearly reports on monetary policy and appearances by the Governor before a Parliamentary Committee. The first appearance under this arrangement took place on 8 May 1997.

In one sense, the Statement was a continuation of what was becoming apparent under the previous Government and hence showed the degree of bipartisan support for the Bank's approach. In addition, however, it was a very important clarification that has dispelled suspicions about the Australian monetary framework, particularly on the part of some overseas institutions and investors. The text of the Statement is reproduced below.

Statement on the Conduct of Monetary Policy

This statement records the common understanding of the Governor (designate) of the Reserve Bank and the Government on key aspects of Australia's monetary policy framework. It is designed to clarify respective roles and responsibilities.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the appointment of a new Governor of the Reserve Bank, it is appropriate and timely for the Governor (designate) and the Government to set out clearly their mutual understanding of the operation of monetary policy in Australia.

It is expected that this statement will contribute to a better understanding both in Australia and overseas of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

Relationship between the Reserve Bank and the Government

The Reserve Bank Act gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute.

Section 11 of the Reserve Bank Act prescribes procedures for the resolution of policy differences between the Bank and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's independence. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Bank's responsibility for monetary policy the Act provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other industrial countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time. However, the Government will no longer make parallel announcements of monetary policy adjustments, when the Reserve Bank changes the overnight cash rate. This will enhance both the perception, as well as the reality, of the independence of Reserve Bank decision making.

Objectives of monetary policy

The framework for the operation of monetary policy is set out in the Reserve Bank Act 1959 which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to the objectives of:

- the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium term price stability the Reserve Bank has adopted the objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in underlying inflation over the cycle while preserving a clearly identifiable benchmark performance over time.

The Governor (designate) takes this opportunity to express his commitment to the Reserve Bank's inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the Bank's objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

Transparency and accountability

Monetary policy needs to be conducted in an open and forward looking way because policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

In recent years the Reserve Bank has taken steps to make the conduct of policy more transparent. Changes in policy and related reasons are now clearly announced and explained. In addition, the Bank has upgraded its public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its regular quarterly report on the economy. In furthering the arrangements already in place the Governor (designate) will support the release by the Bank of specific statements on monetary policy and the role it is playing in achieving the Bank's objectives. It is intended that these statements will include information on the outlook for inflation and will be released at roughly six monthly intervals.

The Governor (designate) has also indicated that he plans to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Financial Institutions and Public Administration.

The Treasurer expressed support for these arrangements, seeing them as a valuable step forward in enhancing transparency and accountability in the Reserve Bank's conduct of monetary policy – and therefore the credibility of policy itself.

The Government and Bank recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

14 August 1996

Operations in Financial Markets

The Bank operates in financial markets to implement monetary policy, to manage its own portfolio of assets and to carry out transactions on behalf of its customers. By far the largest and most important operations are those related to monetary policy. These have been used to give effect to five easings since June 1996.

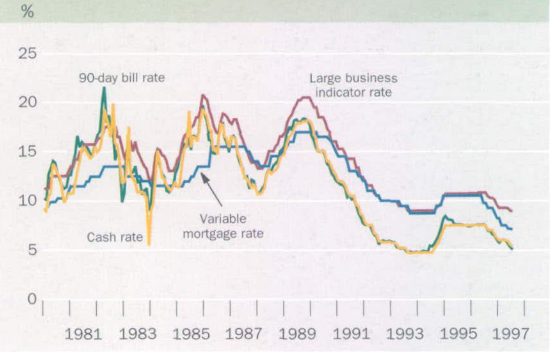
Operations for Monetary Policy Purposes

Domestic market operations

Domestic market operations became the main mechanism for implementing monetary policy in Australia in the mid 1980s, replacing the previous reliance on various administrative controls on banks.

These operations are used to influence the "cash" rate – the overnight interest rate in the money market. The Bank's high degree of control over the cash rate (see following box) gives it the ability to influence the short end of the yield curve and interest rates charged by intermediaries. This model of monetary policy implementation, which uses the cash rate as the main instrument, is common to most central banks, the best known being the US Federal Reserve.

Selected interest rates – Monthly



Since 1990, the practice has been to announce all changes in the cash rate by media release on the morning the changes take effect. Such announcements sometimes occur in the days following the Bank's Board meeting early in the month, or they may be later if, for example, the Board's decision is contingent on the release of further data or if there is a need to wait for more settled market conditions. The announcement states the new target level for the cash rate together with the reasons why the Board has decided to make the change.

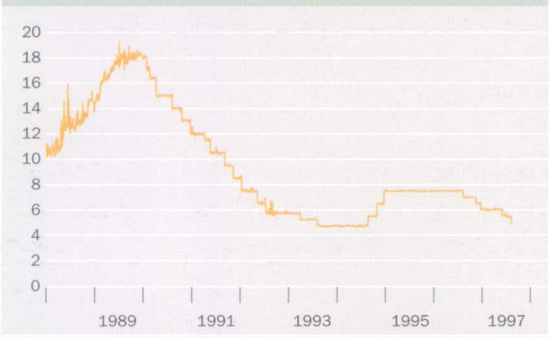
Monetary policy has been eased in five steps since July 1996, the cash rate target being cut by 0.5 of a percentage point in each step. The easings took the cash rate from its opening level of 7.5 per cent to 5.0 per cent by late July 1997.

How Market Operations Affect the Cash Rate

The cash rate is the interest rate paid on overnight funds in the money market. Commercial banks are the main players in this market, borrowing and lending overnight to manage their settlement balances, known as *exchange settlement funds* after the accounts at the Reserve Bank in which they are held. Commercial banks need to hold exchange settlement funds because they are the means used to settle among themselves and with the Bank. There is no regulatory requirement governing the amount of funds held; rather, each bank seeks to hold enough to meet its daily settlement obligations. Exchange Settlement Accounts must be maintained in credit at all times.

The Bank's ability to achieve a particular cash rate stems from its control over the supply of exchange settlement funds. Purchases of securities by the Bank add to the supply of funds while sales reduce supply. If the Bank supplies more funds than banks wish to hold, banks will try to shed funds by lending more in the cash market, resulting in a tendency for the cash rate to fall. Conversely, if the amount of funds supplied is less than banks wish to hold, they will respond by borrowing more in the cash market to try to build up their holdings of exchange settlement funds; in the process, they will bid up the cash rate.

Cash rate – Daily



While the cash rate is determined each day by the interaction of demand and supply, the Bank's practice (since 1990) of announcing its target for the cash rate has a strong influence in keeping the daily cash rate close to the target. Market participants now work on the assumption that the Bank will use its market operations to inject funds if the cash rate rises above the target, and to withdraw funds if the cash rate falls below it. Participants tend to react only mildly to any excess or shortage of cash in the market because they expect the imbalance to be short-lived. As can be seen, this tends to keep the cash rate more stable than was the case before 1990.

Monetary policy changes: 1996/97
(Per cent)

	Change	New cash rate target
31 July 1996	-0.5	7.0
6 November 1996	-0.5	6.5
11 December 1996	-0.5	6.0
23 May 1997	-0.5	5.5
30 July 1997	-0.5	5.0

These days, the market tends to move to the new cash rate as soon as the Bank makes its announcement – that is, before it undertakes its market operations. As discussed in the accompanying box, market participants now work on the assumption that the Bank will enforce the new cash rate and therefore move there in anticipation. Nonetheless, the adjustment in rates is underpinned through market operations: on each of the five days when policy was eased during the past year, the Bank used its market operations to leave surplus funds in the market. The size of operations undertaken to achieve a given cash rate target takes into account not only the money market opening cash position (the amount of funds that would otherwise be available to the market on the day), but also other factors which affect market behaviour, such as the outlook for the availability of funds in the days ahead.

Market operations on days of policy changes
($ million)

	Money market opening cash position (Deficit-/surplus+)	RBA operations (Purchases+/sales-)	Funds left in market after RBA operations
31 July 1996	-800	2 600	1 800
6 November 1996	-100	2 800	2 700
11 December 1996	450	600	1 050
23 May 1997	450	1 200	1 650
30 July 1997	-50	1 300	1 250

Market operations are undertaken almost every day, not just on days on which policy is changed. In intervening periods, they are used to maintain the cash rate close to the target. This "liquidity management", as it is termed, involves the use of market operations to adjust the supply of funds in the face of the various factors which affect funds availability (e.g. Commonwealth Government transactions, the Bank's foreign exchange operations and currency flows).

The Bank's operations include both outright purchases and sales of short-dated Commonwealth Government securities (CGS) and repurchase agreements (also known as repos). The latter involve a purchase or a sale of securities with a simultaneous undertaking to reverse the transaction at an agreed date and price in the future. Repos have become the main instrument used in market operations, accounting for about 90 per cent of transactions. This is due to the flexibility they offer in managing liquidity flows because their maturity can be tailored to market needs and because they give access to a wide range of securities (securities used in repos can be of any maturity). The repo market in Australia is large, with daily turnover of about $6 billion, permitting sizeable volumes of sales or purchases when necessary.

The total value of the Bank's domestic market operations in 1996/97 was much larger than in previous years, with repo turnover more than doubling to almost $200 billion. This growth reflected the fact that, with interest rates generally falling over the year, financial institutions held on to longer-dated paper to maximise their chances of making capital gains and hence shortened the maturity of assets they were prepared to sell to the Bank. This was most evident in the shortening of the term of repos, the majority being of overnight maturity. As a consequence, the Bank was required to roll over its repo position at a higher frequency than in the past.

Domestic market operations for monetary policy purposes

($ billion)

	1994/95	1995/96	1996/97
Repurchase agreements			
– Purchases	45.1	69.2	187.2
– Sales	56.0	14.2	7.9
Short CGS			
– Purchases	8.3	24.6	23.8
– Sales	1.2	1.9	1.4

The size of daily market operations varies a good deal but on average was about $800 million a day in 1996/97. Generally, transactions on any one day are undertaken with around four or five counterparties.

Outright transactions in short-term CGS were around the same volume as last year, at about $25 billion. Most of these involved purchases of Treasury notes though about $8 billion in near-maturing bonds were purchased during the year.

The total value of bids or offers received by the Bank each day almost always exceeds the volume needed for its operations, on average by about three to one. There were several episodes during 1996/97, however, when the total value of deals presented by the market was insufficient to satisfy liquidity management objectives through transactions in CGS. They occurred at times when the Bank was looking to inject a substantial amount of liquidity into the market – such as in the peak company tax periods of early December 1996 and March and June 1997. During these episodes, transactions in CGS were supplemented by foreign currency swaps. Foreign currency swaps work in much the same way as repurchase agreements in securities, the difference being that the underlying asset exchanged

Daily Dealing Procedures

At 9.30 each morning, the Bank announces through electronic news services its estimate of the *money market cash position*. This is the change in the availability of exchange settlement funds to banks if no domestic market operations were undertaken. It reflects flows between the Bank and the other banks resulting from the transactions undertaken by the Bank's clients (principally the Commonwealth Government) or the Bank itself (e.g. foreign exchange operations and currency issues).

As well as publishing the money market cash position, the Bank also states whether it intends to buy (to inject funds), or sell (to withdraw funds), or to refrain from dealing on the day. Any change in monetary policy is also announced at this time.

Market participants can then submit bids (if the Bank is selling) or offers (if the Bank is buying) up to 10.00 am. For repos, these bids and offers specify the interest rate and term at which the participant is willing to deal; for outright sales or purchases, they specify the stock and yield. Market operations are conducted in the form of a tender – i.e. bids or offers are accepted in order of attractiveness based on term and yield, up to the volume necessary to maintain the cash rate around the desired level. Dealing is usually completed by 10.30 am. The Bank monitors market conditions throughout the day and, should conditions turn out differently from those expected, it may re-enter the market for a second round of dealing; such instances, however, tend to be rare.

These arrangements will remain in place when the new RTGS system becomes operational next year, though additional rounds of dealing may be required more frequently than at present. Under RTGS, the availability of funds may turn out to be different from the estimated money market cash position announced each morning. At present, that figure is firm because it is based on overnight clearings, but under RTGS it will be based on expected flows during the day and the final figure will not be known until the end of the day. Accordingly, the estimate on which the morning operations are based will be subject to a degree of forecasting error.

for cash is foreign exchange rather than securities. (Foreign exchange swaps do not change the foreign exchange exposures of the parties and therefore have no effect on the exchange rate.) Over the year, the Bank undertook around $10 billion in swaps to manage cash market conditions. These were unwound by the end of the year.

Until the past year, the Bank's operating procedures had been broadly unchanged for over a decade. Apart from the occasional use of foreign exchange swaps, operations were confined to CGS and were carried out with a group of counterparties known as the authorised money market dealers. In the past year, however, a number of changes were made in preparation for the introduction of a real-time gross settlement (RTGS) system in Australia (described in "Surveillance of the Financial System"). In mid 1996, the Bank:

- broadened the range of counterparties with which it was prepared to undertake market operations to include all members of the Reserve Bank Information and Transfer System (RITS), which is the settlement system for Commonwealth Government securities;
- withdrew the facilities it had provided to the authorised money market dealers; and
- began to pay interest on balances in banks' Exchange Settlement Accounts at the Bank. This provided banks with an alternative to their previous practice of holding transactions balances with the authorised money market dealers. Accordingly, the interest rate on these balances was set at 10 basis points below the cash rate target, similar to the margin which had applied on average to funds placed with the authorised dealers.

One consequence of these changes in arrangements was that the balances in banks' Exchange Settlement Accounts grew quickly. Whereas banks had typically placed funds of about $3½ billion with the authorised dealers, over the course of the past year balances in Exchange Settlement Accounts built up to an average of around $7 billion, and often higher. By the end of 1996/97, for example, these balances had reached a level of almost $10 billion. Instead of using the Accounts simply as a transactions facility, some banks viewed them as an attractive investment avenue in their own right, offering a rate competitive with short-term government paper from an institution of absolute creditworthiness, and with considerably less market risk.

This build-up of balances caused some difficulty on occasions, in that funds injected through purchases of securities were simply held by banks in their Accounts rather than lent into the market more generally. As a result, there were times when the cash rate remained above the target even though the Bank had supplied adequate liquidity to the market overall. Essentially, banks' behaviour suggested that a margin of 10 basis points between the rate paid on their Accounts and the rate available in the market was not sufficient to induce banks to undertake market loans.

This issue was addressed in June this year when, as part of a further package of measures to prepare for the introduction of the RTGS system, the Bank announced it would reduce the interest rate on Exchange Settlement Account balances to a margin of 25 basis points below the cash rate target. This change will take effect from October 1997. Other changes announced at the same time included:

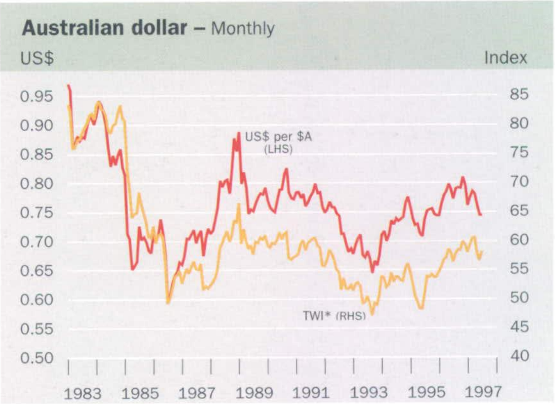
- the introduction of an end-of-day credit facility to holders of Exchange Settlement Accounts, again effective October 1997. This facility, which will take the form of overnight repos, will permit these institutions to generate liquidity to cope with any end-of-day pressures under RTGS. Use of the facility will be at the discretion of the account-holder, though the interest rate applying will be at a margin of 25 basis points above the cash rate target;
- the broadening of repo operations to include Australian dollar-denominated securities issued by the central borrowing authorities of State and Territory Governments. This

change became effective in late June 1997, when such securities were also made eligible for inclusion in banks' Prime Assets Requirement (PAR) holdings; and

- the reduction in the minimum PAR ratio from 6 per cent of banks' liabilities (excluding capital) to 3 per cent (see "Surveillance of the Financial System").

Foreign exchange operations

In Australia's exchange rate system, the exchange rate for the Australian dollar is determined among buyers and sellers of Australian dollars in the market. Nonetheless, the Bank takes a close interest in movements in the exchange rate, as do all central banks. Exchange rates play too important a role in the transmission of monetary policy for central banks to be completely indifferent to their movements.



* May 1970 = 100

The Bank has been prepared to accept fairly wide variations in the exchange rate over the economic cycle, recognising that these movements can play a benevolent role in helping to insulate the domestic economy from various shocks. After the sharp fall in the exchange rate in the latter part of 1984 and early 1985, the trade-weighted index of the Australian dollar has varied around a fairly flat trend, ranging between a high of 68 and a low of 47, with an average of about 57. The variability of the Australian dollar, in trade-weighted terms, is similar to that of other major countries with floating exchange rates. Variability was above average in the 1980s but has declined in the 1990s.

Variability of trade-weighted exchange rates

(Average percentage deviation from 13-month moving average trend)

Currency	1984-97*	1984-89	1990-97*
Australian dollar	2.7	3.2	2.4
Japanese yen	2.3	2.1	2.6
US dollar	2.0	1.9	2.1
New Zealand dollar	1.9	2.8	1.3
Pound sterling	1.8	2.0	1.7
Canadian dollar	1.0	0.8	1.1
German mark	0.9	0.7	1.1
French franc	0.7	0.6	0.7

* To May 1997

There have been episodes since the float in which the Bank has taken action to influence the exchange rate, either because market overshooting had pushed the exchange rate to levels which could have compounded problems of economic management, or because market conditions had become unsettled in reaction to economic news or other events. The most powerful, and only certain, way for a central bank to influence the exchange rate is through monetary policy. But there can be circumstances in which the use of monetary policy for this purpose may have other, undesirable, consequences for the economy more generally. For this reason, almost all central banks with floating exchange rates engage from time to time in intervention – i.e. buying or selling currency in the open market – with the aim of influencing market expectations about the exchange rate.

The Bank's foreign exchange market intervention typically involves purchases or sales of Australian dollars in exchange for US dollars, as the US dollar is the main currency against which the Australian dollar trades. Intervention does not involve "spending" the Bank's assets; it is simply the exchange of one type of asset for another. The Bank maintains a capacity to intervene on a 24-hour basis, through its main foreign exchange dealing room in Sydney, which operates from 6.00 am to 6.30 pm local time, or through its offices in London and New York.

RBA foreign exchange transactions and holdings of official reserve assets
($ billion)

	Transactions[1]				Change in reserves due to valuations	Total change in reserves	Level of official reserve assets	Swaps outstanding[4]
	Spot transactions[2]	Swaps	Interest received	Change in reserves due to transactions				
1990/91	–	–0.1	1.6	1.5	0.7	2.2	24.0	0.3
1991/92	–7.8	2.2	1.6	–3.9	2.1	–1.8	22.2	–2.0
1992/93	–12.5	7.1	1.5	–3.9	2.5	–1.4	20.8	–8.4
1993/94	–1.7	1.9	0.8	1.0	–1.2	–0.2	20.7	–10.8
1994/95	–0.6	–2.2	0.9	–2.0	1.5	–0.5	20.2	–8.8
1995/96	3.8	–3.5	0.6	0.8	–1.9	–1.1	19.1	–5.4
1996/97	5.6	–3.1	0.9	3.4	0.3	3.7[3]	22.8[3]	–2.7

1 Sales shown as (–), purchases as (+)

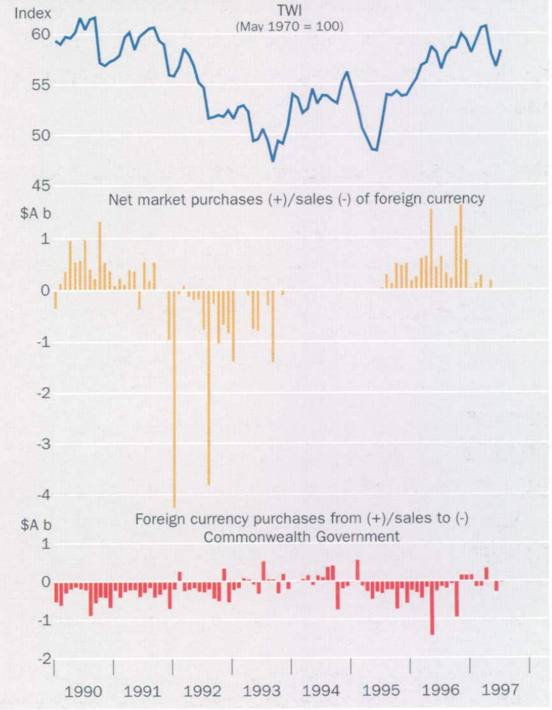
2 Includes transactions with dealers, Commonwealth Government and other clients

3 This figure excludes securities sold under repurchase agreements, for consistency with previous years and with the definition of reserves in the *Official Reserve Assets* media release. The figures differ from holdings of foreign assets shown in the Bank's balance sheet which, from 1 July 1996, include securities sold under repurchase agreements.

4 Change in level of swaps outstanding reflects transactions in swaps shown in table plus changes in the valuation of swaps outstanding.

Foreign exchange market intervention is not intended to target any particular level of the exchange rate. For one thing, it is difficult to judge when the exchange rate has overshot, until it has done so by a large margin, since understanding about how economic forces affect exchange rates is far from precise. The Bank's intervention objectives are fairly modest: to slow movements in the exchange rate when the market is moving quickly to a position which appears to be out of line with fundamental economic conditions, or to calm market conditions when there is a short-term overreaction to news. Though history provides examples of both, episodes which require intervention are not very common. The most recent bout of intervention aimed at influencing the exchange rate was between late 1991 and September 1993, when the Bank supported the exchange rate with market purchases of $18 billion of Australian dollars in exchange for US dollars. Some of these transactions were funded by sales of foreign exchange assets (i.e. by a rundown in official reserves) and some through the swap market; at the end of that period, swaps outstanding were around $11 billion. The Bank also met the Commonwealth Government's net foreign exchange needs of over $3 billion during this period directly from official reserve assets.

Australian dollar and RBA foreign exchange operations



From late 1993 until the first half of 1995, as the Australian dollar gradually appreciated, the Bank did not undertake transactions in the market and continued to meet the Commonwealth's foreign exchange needs out of reserves. Since mid 1995, however, it has begun to buy back foreign exchange to cover net sales to the Commonwealth and to rebuild official reserves. Its net spot purchases were $3.8 billion in 1995/96 and $5.6 billion in 1996/97. Purchases were used, in part, to reduce the outstanding swaps position. In addition to these market transactions, interest received on foreign currency investments has also added to official reserves.

Market purchases of foreign exchange during the past year were concentrated at times when the exchange rate was rising, particularly the December quarter. The Bank was not targeting any particular exchange rate level, but its purchases would have acted to slow the appreciation of the exchange rate.

The average exchange rate at which the Bank's purchases of US dollars have been made since mid 1995 is about US78.3 cents. This compares with an average rate of US71.4 cents for sales during the intervention of the early 1990s, a difference which resulted in considerable profit for the Bank.

Profits from intervention can be measured meaningfully only over a long period of time, taking into account a complete cycle in the exchange rate. The Bank, of course, is not motivated by profits in deciding on intervention strategy, but it does monitor profitability over time. This is because profitability can be one indication of whether the intervention has contributed towards stabilising the exchange rate, as profits will result when intervention involves buying when the exchange rate is low and selling when it is high. This is explained more fully in an earlier study of intervention, reported in a Research Discussion Paper, *Reserve Bank Operations in the Foreign Exchange Market: Effectiveness and Profitability* (1994).

Operations Undertaken for Balance Sheet Management

The second type of operation undertaken is that directed at managing the Bank's portfolio of assets. These assets underpin monetary policy operations. They consist of domestic securities and foreign currency assets, the latter being held mostly in securities issued by overseas governments and deposits with highly rated foreign commercial banks. These holdings of foreign assets comprise the bulk of Australia's official reserves.

In 1996/97, the Bank's balance sheet grew by about $14 billion. This was an unusually large increase, due mainly to the strong rise in balances in Exchange Settlement Accounts, noted earlier. The latter rise has already been largely reversed in the new financial year as banks have anticipated the effect of the recently announced reduction in interest rates on these balances and have sought alternative outlets for these funds. There was also a temporary run-up in Commonwealth Government deposits of $2.6 billion in 1996/97, due mainly to the year-end receipt of funds from the Telstra "special" dividend.

Movement in Reserve Bank balance sheet in 1996/97

($ million)

Liabilities		Assets	
Notes & coin on issue	882	Gold and foreign exchange	4 529
Deposits of banks		Domestic government securities	9 254
– Non-callable deposits	439	of which:	
– Exchange Settlement Accounts	9 226	– Treasury notes	567
Deposits of Commonwealth		– Treasury adjustable bonds	1 515
Government	2 602	– Treasury indexed bonds	21
Deposits of other clients	-304	– Treasury bonds	2 720
Other liabilities		– Net buy repos	4 431
(incl. capital and reserves)	1 122	Overnight settlements and	
		other assets	184
Total	13 967	Total	13 967

The expansion in liabilities was absorbed between official reserve assets (an increase of $4.5 billion) and holdings of domestic securities (an increase of $9.3 billion); the latter included $4.4 billion of Commonwealth Government and State Government securities bought under repo. This allocation between foreign and domestic assets was the outcome of market operations for monetary and exchange rate reasons, and was not an objective in its own right.

The Bank's assets carry very little credit exposure because of the high quality of the issuers, but they are subject to a large amount of "market" risk, i.e. the risk of capital losses due to a rise in market yields or a rise in the exchange rate of the Australian dollar. While asset revaluation reserves (which reflect unrealised gains made on assets since they were purchased) can provide some buffer to falls in asset values, the losses could potentially be large enough to negate the Bank's underlying earnings (which have averaged around $1.6/$1.7 billion a year in recent years). The Bank therefore seeks to manage its exposure to market risk, within the constraints imposed by its monetary policy responsibilities.

Management of the domestic securities portfolio

The Bank has very little scope for active management of its domestic securities portfolio. For one thing, the overall size of this portfolio is essentially determined by its monetary policy operations and cannot be managed independently of them. In addition, the large size of the portfolio – about $20 billion or almost 20 per cent of all Commonwealth Government securities on issue – would mean that any attempt to engage in active trading could disrupt market conditions more generally.

At the margin, there is some scope, however, to manage the composition of assets. Over the past year, there was a shift in the portfolio to short-term assets such as repos, Treasury notes and Treasury adjustable bonds. This was done to limit the maturity mismatch between the additional liabilities the Bank took on (which were mainly of overnight maturity) and the corresponding assets; otherwise, the expansion in the balance sheet would have resulted in a significant increase in interest rate risk carried by the Bank. There was also some shortening of the bond portfolio.

The overall result of the above operations was that the duration of the domestic securities portfolio declined to 1.4 years, from 2.5 years twelve months earlier. Thus, even though the balance sheet grew strongly over the year, the overall risk of the portfolio, measured in terms of the potential loss for each basis point rise in yields, fell from $3.7 million to $2.7 million.

As well as initiating its own transactions, the Bank also responds to market initiatives, particularly proposals from the market for stock lending. This is done to improve the liquidity and efficiency of the Australian bond market. Stock lending allows market participants to access particular stocks in the Bank's portfolio in exchange for other lines of stock, helping to alleviate temporary shortages in supply. Because of the size and diversity of its bond portfolio, the Bank is a natural counterparty for these transactions, which earn a fee. In 1996/97, a total of $12 billion in stock was lent compared with $17 billion the previous year, the lower turnover mainly reflecting an increase in the term of the loans of stock.

Management of foreign currency assets

Foreign exchange reserves are held mainly to enable the Bank to intervene in the foreign exchange market. They represent, on average, about half the Bank's assets although this proportion tends to vary in response to intervention.

Unlike the domestic bond portfolio, the Bank has greater freedom to manage these foreign currency assets since, in overseas markets where these operations are undertaken, it is simply another participant. Nonetheless, care is always taken to avoid any transactions which could disrupt markets. Within constraints imposed by the need to keep a high degree of liquidity and minimise credit risk, foreign assets are managed to achieve the best possible combination of risk and return.

In line with best market practice, the Bank uses a benchmark as a yardstick against which to assess its performance in reserves management. This is a portfolio of assets which, on average over the long term, satisfies the Bank's investment objectives regarding credit risk, liquidity, market risk and return. For 1996/97, as in earlier years, the benchmark portfolio has been composed of securities issued by the United States, German and Japanese governments, and some deposits with highly rated commercial banks. Weights are decided on the basis of, among other factors, statistical research on past patterns of risk and return in the different markets. The major benchmark characteristics are shown below.

Benchmark composition

	US dollars	Yen	German marks
Asset allocation (% of total)	40	30	30
Currency allocation (% of total)	40	30	30
Duration (months)	30	30	30

In previous years, the benchmark had specified a shorter duration for US dollar assets as a way of increasing US dollar liquidity. Greater use of repo markets, however, now permits the Bank to raise cash just as easily against assets of longer duration; in October 1996, benchmark duration of the US dollar portfolio was increased to reflect this.

In 1996/97, the return on the benchmark portfolio, in SDR terms, was 4.2 per cent. The actual return on reserves was a little above this, at 4.5 per cent. Most of the difference arose in the second half of the year, when the decision to reduce the proportion of US assets and their duration ensured that the negative effect of rising US interest rates was smaller for the actual portfolio than for the benchmark. Through most of the second half, a currency allocation to the US dollar was maintained above the benchmark 40 per cent; this "overweight" position contributed to earnings as the US dollar rose against both the Japanese yen and the German mark. On the other hand, the decision to reduce the duration of the Japanese bond portfolio worked against performance. The Bank took the view early in the year that yields on longer-term Japanese bonds below around 3 per cent did not represent adequate value for a 10-year investment and carried a heavy risk of large capital losses if yields were to rise. In the event, yields in Japan continued to fall, with the benchmark long bond ending the year at 2.4 per cent; the short duration position therefore reduced the return on Japanese investments relative to that on the benchmark.

Actual and benchmark returns

	Rates of return (in SDRs) (per cent)		Value of difference between actual and benchmark returns ($A million)
	Actual	Benchmark	
1991/92	9.8	8.9	165
1992/93	16.3	11.6	420
1993/94	4.0	3.8	31
1994/95	5.2	7.4	–331
1995/96	4.0	3.7	40
1996/97	4.5	4.2	34

Gold

During the past year, the Bank reduced its gold holdings from 247 tonnes to 80 tonnes. This was done through a process of gradual sales over the second half of the year. The sales were undertaken forward, with 125 tonnes being delivered in June and the remainder to be delivered in August and September. In carrying out these sales, the Bank took care not to disrupt market conditions, and there was no discernible impact on the price of gold as the sales were being made. To further minimise the impact on the market, the Bank delayed announcement of the sales until early July when the first deliveries had taken place. By this time all sales had been completed, and the Bank's media release noted that there were no plans for further sales. Nonetheless, on the announcement, the price of gold fell from about US$332 per ounce to a low of US$317 per ounce, before recovering about half this fall in late July.

The fall in price in the days after the announcement was larger than expected, given the relatively small size of the Bank's sales, and elicited strong protests from the gold mining industry. As noted, however, the fall was substantially reversed subsequently and should be seen in a longer perspective. For example, the net fall in the price since the Bank's announcement is small relative to the fall of US$80 per ounce that had taken place over the previous year.

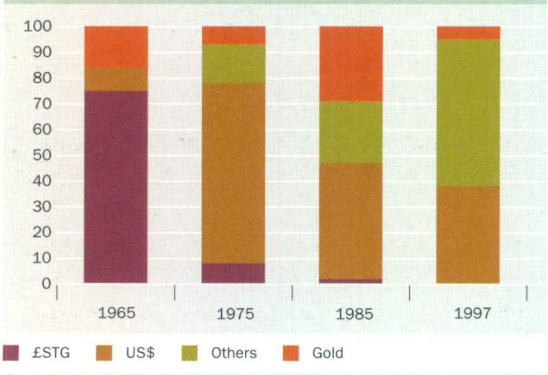
The sales crystallised a large portion of the unrealised gains on gold holdings; details are given in "The Bank's Earnings". Under the Bank's normal arrangements for distributing profits, these gains would have been paid to the Commonwealth Government, which would also have had the effect of reducing official reserve assets. To avoid this, the Treasurer gave his approval for the Bank to retain the proceeds. The Government will, of course, receive an ongoing benefit from the additional profit the Bank will generate from the reinvestment of these proceeds.

Changes in the Composition of Official Reserves

The sale of gold and reinvestment of the proceeds in foreign exchange is not the first time the Bank has rebalanced the composition of its official reserve assets.

- Prior to 1971, official reserves consisted mainly of assets denominated in sterling (which accounted for an average of about 70 per cent over the 1960s) and gold (which accounted for an average of about 15 per cent). The remainder was mainly US dollars. In the first half of the 1970s, however, the Bank switched the bulk of its foreign currency assets into US dollars, away from sterling, reflecting the diminishing role of the latter currency in the international monetary system.
- Through the late 1970s and 1980s, the composition of foreign currency reserves was gradually diversified, with holdings of other major currencies, such as the Japanese yen and German mark, increasing. By 1985, the Japanese yen and German mark accounted for almost 30 per cent of the foreign currency component of reserves, while the US dollar share was about 65 per cent.
- In 1991, the Bank moved to a more even composition of reserves, and formally adopted a benchmark in which the foreign currency component of reserves consisted of 40 per cent US dollars, 30 per cent Japanese yen and 30 per cent European currencies.
- In the past year, the proportion of reserves held in gold was reduced to about 5 per cent. There had been large swings in the split of official reserves between foreign currency and gold over the previous 20 years or so. The Bank had ceased to buy gold in the early 1970s, but the rise in the gold price in the second half of the 1970s caused the proportion of reserves held as gold to rise to a peak of 80 per cent in 1980. Thereafter, it fell back to an average of around 20 per cent between the late 1980s and the sale of gold this year.

Composition of foreign reserves – As at end June



The proceeds of the June deliveries were immediately invested in foreign exchange (government securities denominated in US dollars, Japanese yen and German marks). As a result, the gold sales have not resulted in a reduction in official reserve assets. Similar steps will be taken when the final deliveries take place.

The Bank will continue to lend its remaining gold holdings to market participants. During the past year, revenue from gold loans was about $35 million.

Transactions on Behalf of Clients

The Bank also undertakes transactions in financial markets on behalf of clients. By far the most important are foreign exchange transactions on behalf of the Commonwealth Government. In addition, transactions in government securities and foreign exchange are undertaken for other central banks, particularly those seeking to hold Australian-dollar investments as part of their official reserves. These are mainly central banks from the Asian and Pacific regions though some European central banks and international organisations are also involved. Total Australian-dollar investments held by these bodies were $6.3 billion at end June 1997, up $1.7 billion from a year earlier.

The Commonwealth Government has an ongoing need for foreign exchange of around $3-4 billion a year to cover its overseas expenditure. In some years, including the one just ended, the net need is lower because of foreign exchange raised through the swaps program which it undertakes as part of its financing transactions.

All transactions between the Bank and the Commonwealth are carried out at market prices. The Commonwealth advises the Bank of its needs on a daily basis and the Bank quotes an exchange rate at which it is prepared to deal, based on rates in the market at the time. As is the case with any bank transacting with a customer, the Bank then decides whether to carry the position or cover it in the market. For the most part, the Bank covers in the market. In periods such as the early 1990s, however, when the Bank was intervening in the market to support the Australian dollar, such an approach would have offset a significant part of the Bank's intervention. In these circumstances, the Bank meets the Government's needs directly from its foreign reserves for a time, though in due course the transactions are covered in the market as exchange rate conditions allow.

In 1996/97, the Bank's foreign exchange transactions with the Government involved sales of about $4 billion and purchases of about $3 billion. These figures are within the range of other recent years. With the exchange rate well above its early 1990s lows, the Bank covered in the market the net sales of $1 billion that it made to the Government; effectively, it added this amount to the market purchases it was undertaking on its own account to replenish reserves.

Reserve Bank foreign exchange transactions with the Commonwealth Government
($A million)

	Sales of foreign exchange to Government	Purchases of foreign exchange from Government	Total transactions with Government
1990/91	4 672	0	4 672
1991/92	3 191	402	3 592
1992/93	3 454	1 265	4 719
1993/94	3 368	3 889	7 257
1994/95	3 624	2 902	6 526
1995/96	5 024	163	5 187
1996/97	4 010	2 976	6 986

Surveillance of the Financial System

The Bank conducts a range of policies concerned with the stability of Australia's financial system, with the goal of reducing the likelihood of financial shocks and strengthening the system's resilience. These responsibilities are exercised by supervising each bank with an authority to conduct business in Australia, by close involvement in the payments and settlement system, and by co-ordination with other financial regulators to promote the general soundness of the financial system.

Bank Supervision

The Australian banking sector did not experience any significant difficulties in 1996/97. In this environment, the Bank's supervisory efforts concentrated on detecting any early signs of weaknesses in credit standards and on further improvements to the supervisory framework. Work associated with the Financial System Inquiry (the Wallis Committee) also absorbed considerable resources.

Financial System Inquiry

The Bank welcomed the Government's decision to hold an inquiry into the Australian financial system and provided a detailed submission to the Wallis Committee in September 1996. This submission contained an assessment of key trends in the financial system to help the Committee in its consideration of where the structure of the system may be heading; a description of the present regulatory structure and an assessment of its strengths and weaknesses; an analysis of the main issues in the future development of Australia's payments system; and information on international regulatory practice.

In its submission, the Bank emphasised that the public dealing with financial institutions faces two distinct types of risk, which call for different approaches to regulation. The first risk arises where an institution offering a product promises to repay funds in full on demand or on maturity (for example, bank deposits and some insurance products). Institutions offering such products are candidates for prudential supervision because their ability to honour the promises depends on their continuing solvency. The second type of risk is associated with investment products where an institution manages the public's funds on a "best endeavours" basis; here the investor, not the institution, bears the risk of a fall in the value of the investment. These products need to be regulated through disclosure to the public of the nature of the risks being taken.

The submission also addressed the issue of whether bank supervision should be carried out in the central bank or by a separate authority. The Bank's strong view was that bank supervision should remain in the central bank because there were major synergies between monetary policy, financial system stability and bank supervision. If it were segregated, there would be difficulties in drawing the line between responsibility for financial system stability and responsibility for bank supervision. There would probably be duplication and/or difficulty in co-ordination between regulators if there were a need to act because a bank failure was imminent.

In January 1997, the Bank made a supplementary submission which set out how it saw the financial system developing over the next ten years; discussed the implications of technology, financial innovation and the entry of new competitors; and considered alternative approaches to achieving depositor protection. These issues had been highlighted in the Committee's discussion paper published the previous November.

The Wallis Report was released in April 1997. In its initial response, the Government agreed to the recommendation to abolish the "six pillars" policy which, since 1990, had imposed a blanket ban on mergers between the four major banks and the two largest life offices. The Government also made clear that it would not permit mergers among the four big banks at this time, but would review this issue when satisfied that competition in the financial system had increased sufficiently. The Government also announced the removal of the blanket prohibition on a foreign takeover of any of the major banks. Any such proposal will in future be assessed on its merits, but against the Government's view that a large-scale transfer of Australian ownership of the financial sector to foreign hands would be contrary to the national interest.

Other recommendations in the Wallis Report aim to increase competition by reducing barriers to entry to the banking and payments system, and propose far-reaching changes to the design of Australia's regulatory system, including the establishment of a single prudential supervisor for deposit-takers, insurance companies and superannuation funds. The Government will be responding to these recommendations over coming months.

Approach to supervision

During 1996/97, the Bank's supervisory emphasis continued to shift towards greater reliance on banks' own risk management systems, provided these systems meet certain objective requirements. The major examples, discussed in more detail below, were:

- adjustments to capital adequacy standards, announced in January 1997, which allow banks to use their own risk measurement models to calculate capital requirements for market risk in their trading portfolios;
- reforms announced in May 1997 which make boards and chief executives of banks clearly accountable to the Bank for the identification, measurement, management and control of key risks facing their institutions; and
- changes to liquidity arrangements in June 1997 involving a reduction in the Prime Assets Requirement (PAR) of banks, counterbalanced by a greater reliance by the Bank on the liquidity management systems used by individual banks.

Capital

Capital provides an essential buffer to absorb losses that might arise in a banking business. Monitoring banks' capital positions is therefore a key task of bank supervisors. Since the 1988 Capital Accord, there has been a uniform approach internationally to calculating capital ratios and an acceptance that such ratios should not fall below eight per cent. All Australian banks comfortably meet this requirement. The aggregate risk-weighted capital ratio for Australian banks reached a peak of just over 12 per cent around the end of 1994 as banks repaired balance sheets weakened by the recession. More recently, banks have judged that capital ratios well above the minimum requirement were inconsistent with maximising returns on shareholders' funds and they have become more active in managing their capital positions. The aggregate ratio has fallen to a little above 10 per cent as banks have expended capital on acquisitions, introduced schemes for buying back shares in the market and enjoyed stronger asset growth. The Bank consults closely with any bank which proposes a capital reduction to ensure that its ability to comply with the minimum capital ratio is not prejudiced over the longer run.

Banks' risk-weighted capital ratio – Average of all banks

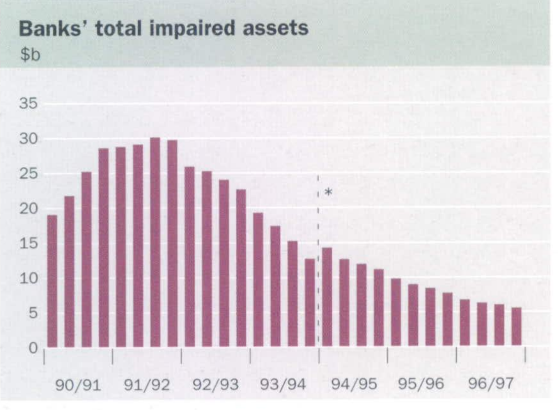
Market risk

A major reform of the Capital Accord will become effective from the beginning of 1998, when capital requirements will be adjusted to capture market risk on banks' trading activities, that is, the risk of losses as a result of movements in interest rates, equity prices, exchange rates or commodity prices. The new guidelines are the product of consultation between banking supervisors and banks, domestically and internationally, over several years, under the aegis of the Basle Committee on Banking Supervision. The guidelines for Australian banks were issued as Prudential Statement C3 in January 1997. Their key feature is the scope for banks to use their own risk measurement models in the calculation of capital requirements, provided these models are technically sound and the broader risk management environment in which they are used meets stringent tests. The recent losses in derivatives activities experienced in the United Kingdom by National Westminster Bank are further testament to the consequences of inadequate risk control systems.

Each bank wishing to use its own risk measurement model for calculating capital must have that model recognised by the Bank. Some 10 to 12 banks plan to seek "internal model status" by early 1998. The Bank's supervision staff will visit the trading operations of each of these banks to assess the adequacy of the models and the risk management environment. These visits will be complementary to the program of on-site reviews of market risk management, which began in 1994 and involved 18 visits to banks in 1996/97. The Bank's aim is to assess each bank's systems at least once every two years.

Credit risk

The Bank's other program of on-site reviews covers banks' systems for managing credit risk. These visits are designed to test that such systems meet acceptable standards and are being used effectively; they also provide opportunities to discuss, with specialist bank staff, where pressures in lending markets might be emerging. During 1996/97, 20 credit risk visits to banks were made.



* Break in series

Impaired assets of banks continued to decline in 1996/97, a reflection partly of the strict lending criteria imposed by banks in the wake of their asset quality problems in the early 1990s. It is the quality of loans being made now, however, which will determine the future scale of problem assets. Anecdotal evidence points to some lowering of lending standards in the past year or so, as competition for new business has whittled away interest margins and led to less onerous conditions on borrowers. Measuring lending standards is a more complex task than measuring the level of bad loans. In the housing and personal loan markets, simplistic measures such as loan-to-valuation ratios and comparisons between loan repayments and income can be used to assess standards. However, as loans increase in size, the range and complexity of loan conditions also increases and their appropriateness differs from loan to loan. While it is difficult to reach firm judgments, the Bank believes that some current lending practices do risk sowing the seeds of future credit quality problems, and it has cautioned banks to be conscious of this possibility.

External auditors

In May 1997, the Bank announced changes in its relationship with banks and their external auditors which provide a further discipline on risk management systems. Rather than looking to the external auditor for a general assurance about the systems operating in a bank, the Bank will now receive an annual attestation from the chief executive, endorsed by the board, that risks have been identified, systems designed to manage those risks are adequate and working effectively, and the descriptions of these systems held by the Bank are current.

The external auditors retain their responsibility to provide the Bank with assurances about each bank's observance of prudential requirements and about the reliability of information it provides. In addition, each year external auditors will review a particular area of banks' operations. In 1997, the focus is the systems used to keep a bank's chief executive, board committees and board informed about the management of credit, market, liquidity and operational risk. The auditors are expected to comment on matters such as:

- the frequency and timeliness of the relevant information flows;
- processes in place to check the accuracy and integrity of that information; and
- the usefulness of the relevant reports for monitoring compliance with the bank's risk management policies.

Liquidity management

The PAR arrangements have required banks to hold a minimum level of Commonwealth Government securities, notes and coin and balances with the Bank. It was becoming clear that these arrangements could become the source of market tensions in coming years as the supply of Commonwealth Government securities diminishes. A similar problem had arisen in the late 1980s when the Government budget last moved into surplus; at that time the Bank reduced the minimum PAR ratio from 12 per cent of banks' liabilities (excluding capital) to 6 per cent. On this occasion (June 1997), the ratio was reduced to 3 per cent and the range of eligible assets widened to include Australian dollar-denominated securities issued by the central borrowing authorities of State and Territory Governments.

Prime assets are a source of liquidity for banks in an emergency. The reduction in the PAR ratio did not reflect any lessening in the need for a bank to be prepared for a run on liquidity; the PAR arrangements form only one element of liquidity management. As part of its annual cycle of consultations, the Bank discusses with banks their plans for meeting predictable day-to-day needs for liquidity, as well as for handling unexpected strains on their cash flows. The Bank will be placing greater emphasis on banks' internal management practices; in some cases, the Bank may require a bank to hold liquid assets (more broadly defined than for PAR) in excess of the PAR ratio. Its assessments will also take into account how banks manage their liabilities, including maturity structure, the wholesale/retail split and access to international markets.

Year 2000 problem

In addition to the risks discussed above, banks face a range of operational risks, many of which stem from increasing reliance on computers for customer servicing, information processing and control. One risk of growing prominence is the so-called "Year 2000 problem", which arises from the fact that much computer software and hardware uses only two digits to represent calendar years (e.g. 97 for 1997) and will not be able to recognise the change to the new century. If not addressed, the consequence would be incorrect calculations and comparisons, destruction of data and the potential for serious disruption to the financial system. The Bank has sought assurances from Australian banks that they are giving the Year 2000 problem the high priority it warrants. Banks have been asked to complete a questionnaire on their progress in identifying the size of the problem for their operations, in drawing up a management program to fix the problem and in assigning the necessary resources. Banks will also need to ensure that their major customers are taking the appropriate corrective actions.

Institutional developments

Australia has 50 authorised banks, little changed from the previous year.

Authorised banks in Australia

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

During 1996/97, banking authorities were granted to the German bank, West LB, and to the Royal Bank of Canada to operate as foreign bank branches. The banking authorities of Bank SA, Challenge Bank and St George Partnership Bank were relinquished as a result of mergers, and that of Bank of Singapore following the transfer of business to a branch of the parent, the Oversea-Chinese Banking Corporation. The Australian branch of Bank of New Zealand will soon relinquish its authority following the transfer of all business to the National Australia Bank.

The takeovers of the Queensland Industry Development Corporation and Suncorp by Metway Bank, and Advance Bank by St George Bank, were consummated in 1996/97. ABN AMRO bought Lloyds Bank NZA, the Australian banking subsidiary of National Bank of New Zealand. Westpac's bid for Bank of Melbourne received official clearance in July 1997, and will be considered by Bank of Melbourne shareholders in September.

Legislation was enacted in the Tasmanian Parliament in 1996/97 to enable the corporatisation and eventual privatisation of Trust Bank.

Other Financial Institutions

Apart from banks, the Bank's only other direct supervisory responsibility is for authorising and overseeing foreign exchange dealers in Australia. At 30 June 1997, there were 73 authorised dealers, the same number as a year ago. The Bank meets regularly with ACI Australia (formerly the Australian Forex Association) to exchange information, discuss matters of mutual interest and keep abreast of issues relevant to the market from the participants' point of view. The Wallis Report agreed with the Bank's suggestion that the separate authorisation of foreign exchange dealers by the Bank should be discontinued.

Payments System

Real-time gross settlement

The Bank has been working with the finance industry over recent years to introduce "real-time" settlement in the payments system. This important reform will make the system safer, more efficient and more competitive, and bring it into line with international best practice.

Under the current system of "deferred settlement", each member of the payments system accumulates the various cheques and other payments received during the day, and it is only on the next day that the net balances are finally settled, using Exchange Settlement Accounts at the Bank. In the unlikely event that a member of the payments system was unable to meet its payments obligations, other members could face serious losses and many of the payments made on the previous day would be thrown into doubt. The problem could become serious enough to cause widespread financial disruption. The risks to the financial system are remote but the amounts involved are large. The total value of payments made between banks each day in Australia is a little over $90 billion, around 20 per cent of annual GDP.

The problem arises because there is a one-day delay built into the settlement system. To reduce this settlement risk, large payments will be settled individually, as they are made, in "real time"; hence the new system is called a real-time gross settlement (RTGS) system. High-value payments will be fed into the RTGS system continuously throughout the day, and each member operating in this system must have sufficient funds in its Exchange Settlement Account to meet payment obligations as they are processed. This new system has the great advantage that any problem would be quickly identified, before it could cumulate into a system-wide problem. It will improve the safety of the payments system and make it easier to achieve delivery-versus-payment in financial markets.

Real-time settlement already exists for some limited transactions between banks. The aim is to extend this further, giving priority to high-value payments, where the largest risks arise. These will include payments to settle trades in Commonwealth, State and private sector securities, the Australian dollar leg of foreign exchange transactions and large corporate payments. Large-value payments currently made by cheques, including bank cheques, and direct entry systems will be encouraged to migrate to the RTGS system. When RTGS is fully operational, planned for April 1998, around two-thirds of the total amount of interbank settlement risk will have been eliminated.

The project is a complex and ambitious one, and has required a large commitment of the Bank's resources and extensive co-ordination with the banking and finance industry. Within the Bank, the project has been managed by a Policy Board chaired by a Deputy Governor and involving several of the Bank's most senior officers. More than 50 Bank staff, from most of the Bank's functional areas, have worked on the project.

Implementing RTGS has involved the co-ordination of a variety of payment and securities settlement systems. To form the core of the new system, the Bank has built on the Reserve Bank Information and Transfer System (RITS), its existing system for settlement of Commonwealth Government securities. The Bank has also worked closely with Austraclear on securities settlements and with the Australian Payments Clearing Association, whose members will use a commercial financial message service (SWIFT, which has become, worldwide, the standard channel for international financial transactions) to deliver payments to the system. The Bank has also consulted the Australian Financial Markets Association on changes to dealing arrangements and system liquidity management. These changes were discussed earlier in "Operations in Financial Markets". Aspects of this work have been co-ordinated through a Cross-Project Steering Committee chaired by one of the Bank's Deputy Governors.

This project has also required members of the payments system to make substantial commitments to upgrading their own systems. In particular, RTGS will require participants to have much more detailed control over their within-day liquidity. One important element of the project has been to ensure that all those involved are familiar with the demands which the RTGS system will place on them. Since July, when the core of the new system began operating, members of the payments system have been able to see the effect that transactions sent to the RTGS system would have had on their Exchange Settlement Accounts if they had been posted in real time, although settlement continues to take place the following morning. This "dry run" or shadow system allows members of the payments system to understand their intraday payments patterns and likely liquidity requirements of operating in an RTGS environment.

The core development work for the new system has been completed and tested and some elements have begun to operate; the remaining parts will do so over the course of 1997. All of the relevant transactions are expected to have moved to the new system by February 1998. Limits will then be placed on the settlement exposures that can be generated. These limits will be progressively lowered; by April 1998, members of the payments system will be expected to run their shadow positions continuously in credit. Once that point has been reached, high-value payments between banks will be processed and settled in real time.

While the new system will require banks to keep their Exchange Settlement Accounts in credit in the face of a continuing flow of transactions, the system does include a number of features designed to help participants to manage their payments flows more easily. The Bank will provide a facility whereby members of the payments system can obtain liquidity during the day through repurchase transactions in eligible securities. Banks may use securities held to satisfy their PAR ratio in this way, provided they restore their PAR holdings by the end of the day. These transactions will not incur any interest charges and may be undertaken at the banks' discretion or by using an automatic facility.

The Government is considering legislative changes needed to underpin RTGS and other payments system reforms. The most important of these will remove the risk that RTGS could be rendered void by a "zero hour" ruling that would date the insolvency of a bank from the midnight before it was declared. A number of other countries have introduced similar legislation to support their RTGS systems.

An important element in the process of introducing RTGS has been explaining to banks and their customers the background to the system and its likely impact on their operations. Senior Bank staff have spoken on these matters at a number of conferences and meetings, including some organised by the Australian Society of Corporate Treasurers, the Securities Institute, the Custodial Services Group and the International Banks and Securities Association.

The new system will not only strengthen the safety of the payments system; it also opens opportunities for more efficient payments by allowing customers the potential to arrange final payments to coincide exactly with critical points of their own transactions. An important change is that all institutions with Exchange Settlement Accounts will be able to

RTGS Cross-Project Steering Committee meeting, chaired by Deputy Governor Graeme Thompson and comprising representatives of the payments industry

provide real-time high-value electronic payments to their customers – in the past, this business has been dominated by a small number of large banks, and smaller banks have had to rely on agency arrangements with larger banks. All banks will now be able to compete on an equal basis for this business. The result should be more competition, better service and keener pricing for users of high-value payments services.

International payment and settlement system linkages

The introduction of RTGS will eliminate the risks arising because of the delay between clearing and settlement of high-value Australian dollar payments between banks. Similar risks arise in foreign exchange transactions, mainly because they are settled as two separate payments in their respective domestic payment systems, usually many hours apart. This gives rise to the risk that one party to a foreign exchange transaction will pay the currency it sold but not receive the currency it bought, because of the intervening failure of the counterparty. The Bank is encouraging Australian banks to achieve efficiencies in their foreign exchange settlements, including their arrangements with correspondent banks, so as to reduce the length of time they are exposed to such settlement risk. The Bank has recently surveyed a number of foreign exchange dealers in Australia, both banks and non-banks, about their foreign exchange settlement practices; the information provided will help to identify "best practice" in this area.

The Bank is supporting a proposed amendment to the Corporations Law, drafted by the Companies and Securities Advisory Committee, intended to remove doubts as to whether the netting of transactions would be legally enforceable. This amendment would allow banks, with legal certainty, to offset obligations arising from their foreign exchange dealings, significantly reducing the magnitude of settlement risk. Demonstrating legal enforceability is also a precondition for a bank's admission to ECHO, a private sector company based in the United Kingdom providing an infrastructure for netting foreign exchange transactions. Two of the major Australian banks have formally signalled their intention to join ECHO once the necessary legal framework is in place. During the past year, the Bank provided facilities for representatives of ECHO and FXNet, another UK company providing netting services, to inform the Australian markets about their products.

A group of major international banks (the so-called G20) is developing a proposal for simultaneous, or near simultaneous, settlement of foreign exchange transactions across countries, to address the problem of different time zones. The G20 and the next tier of banks (the G40), which includes the major Australian banks, have also been discussing the pooling of resources on this project. An RTGS system for high-value payments is a prerequisite to participating in international solutions to foreign exchange settlement risk.

The Bank is building closer international links in securities settlement arrangements with the announcement by the Hong Kong Monetary Authority and the Bank, in April 1997, that the Central Moneymarkets Unit in Hong Kong will join RITS. This will facilitate cross-border settlement of transactions in money market and debt securities and provide the basis for exploring further reciprocal arrangements.

Supervisory Co-ordination

The Bank works closely with other agencies involved in the supervision of the financial system to ensure that it is able to carry out its broad responsibilities for financial system stability.

The focal point of high-level co-ordination is the Council of Financial Supervisors, which the Governor chairs. The other members are the Australian Securities Commission (ASC), the Insurance and Superannuation Commission (ISC) and the Australian Financial Institutions Commission (AFIC); together, these four main regulatory bodies oversee institutions managing about 97 per cent of financial system assets in Australia.

The Council has sponsored legislative amendments to facilitate information-sharing among its members, and, where appropriate, with other bodies such as overseas supervisory agencies. These amendments were passed in June 1997. They provide the basis, in particular, for a co-ordinated approach to supervising financial conglomerates. The Bank and the ISC, with Council endorsement, have developed proposals which would allow special-purpose holding companies to own financial institutions such as banks and insurance companies, subject to controls on the ownership of the holding company and the provision of access to group information. Under this approach one agency would act as "convenor" or lead regulator for a financial conglomerate. The Wallis Report also recommended acceptance of holding company structures.

Co-operation with law enforcement agencies on matters connected with the Australian financial system is also a priority. The Bank is a member of the Australian Co-ordinating Committee of the Financial Action Task Force. Australia's anti-money laundering efforts received a favourable report from a team of international experts organised by the Financial Action Task Force, following a visit late in 1996. In addition, assistance was provided in the preparation of a report, for the Commonwealth Law Enforcement Board, on the development and law enforcement implications of electronic commerce. The Bank also contributed to the formation, in February 1997, of the Asia-Pacific Group on Money Laundering with initial membership of thirteen regional countries.

The Bank maintains extensive contacts with users as well as providers of payments and banking services. This is achieved through the Australian Payments System Council, which the Bank chairs, and through direct relationships with consumer and business organisations. The Bank is on the board of the Australian Banking Industry Ombudsman Scheme and of Tradegate ECA, an industry body promoting electronic commerce.

Internationally, close contact has been maintained with the Joint Forum on Financial Conglomerates, a group established in 1996 by the Basle Committee on Banking Supervision, in conjunction with the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors, to address regulatory problems posed by the emergence of large financial conglomerates. The Joint Forum met in Sydney in April 1997.

On a broader front, links with overseas bank supervisors and with the Basle Committee remain strong. During the past year, the Bank attended three meetings of a bank supervision study group formed by EMEAP (Executive Meeting of East Asia and Pacific Central Banks) and hosted a seminar on market risk for EMEAP countries in June 1997. The Bank has also participated in the payments activities of EMEAP and of the Committee on Payment and Settlement Systems at the Bank for International Settlements (BIS). It has been active in a joint BIS/IOSCO project to develop a disclosure framework for securities settlement systems. This culminated in the publication, in March 1997, of a questionnaire for system operators to complete and make public, with the aim of ensuring that participants understand fully the risks involved.

A program of secondments continued during the year, with staff placed with the Bank of England, the International Monetary Fund and AFIC, while an officer from the ISC was employed at the Bank.

Legal actions – Farrow group

The Bank had been drawn into a number of legal actions arising from the failure in 1990 of the Farrow group of companies, including Pyramid Building Society. It was a defendant or third-party defendant in various actions seeking recovery of losses by investors in the group. The Victorian Government had also initiated claims against the Bank seeking indemnity for claims from depositors and non-withdrawable shareholders of the Farrow group, as well as damages and costs. For reasons outlined in earlier *Annual Reports,* the Bank believed these actions were without foundation and intended to defend them. It had not been prudential supervisor of any companies in the group.

Late in 1996/97, the Victorian Government withdrew its action against the Bank; the other actions have also been withdrawn. There have been no findings of any liability against the Bank. Nor has the Bank made payment toward any settlement of these cases.

Customer Services

The Bank is engaged in providing a range of commercial services to customers. They involve banking services to the Commonwealth Government and other customers; a registry of Commonwealth Government and other securities; electronic transfer and settlement of securities; and a specialised currency distribution service for banks. (Note printing, a separate commercial activity by Note Printing Australia, is discussed on pages 60 to 62).

Of these activities, current arrangements for handling the Commonwealth Government's cash balances are central to the conduct of the Bank's domestic market operations. The other commercial activities are not "core" functions of a central bank, which are generally limited to monetary policy, financial system surveillance and currency note issue. Nonetheless, the Bank has developed substantial expertise in these activities and they provide valuable synergies with the Bank's broader policy roles. The Bank's involvement in transactional banking, for example, has enabled it to give impetus to payments system reform in Australia and will assist in the smooth functioning of the new real-time gross settlement (RTGS) system. The activities are all run as discrete businesses which seek to recover their full costs, and earn a return on notional capital, through fees and charges.

In 1996/97, revenues from commercial activities were $40.7 million compared with costs of $36.3 million. The latter includes direct and indirect costs, commercially based rents and fully allocated overheads in line with competitive neutrality principles. Revenues and costs for specific commercial activities are set out below.

During the year, the Bank's commercial activities were reviewed by the Competitive Neutrality Taskforce, established by the Commonwealth Government to implement competitive neutrality principles in all government business enterprises. The Bank was able to demonstrate that it has a clear accounting separation between its commercial and other activities and that competitive neutrality standards are being met.

In addition to its commercial activities, the Bank is responsible for the design, issue and integrity of Australia's currency notes. This is a core function of the Bank and, with limited exception, is provided to the community free of charge.

Strong competitive pressures, technological change and the pursuit of a sharper commercial focus lay behind a reorganisation of the Bank's Business Services Group in 1996/97 along business unit lines, rather than the traditional departmental/branch structure. Activities are now divided into two major streams:

- Banking and Settlement Services – comprising government banking, registry and settlement operations; and
- Note Issue – comprising currency research, currency operations and gold activities (the latter are discussed in "Operations in Financial Markets").

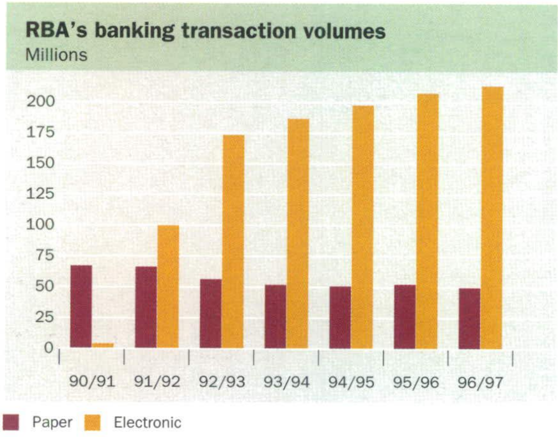
The reorganisation has resulted in significant staff reductions, which are being addressed under a redundancy program, and in the decision to close the Bank's Darwin branch because of insufficient business volumes.

Banking and Settlement Services

Government banking

The Bank manages the Commonwealth Public Account through which major flows to and from the Commonwealth Government pass. In addition, it provides transactional banking services to a small range of customers through its network of capital city branches. Along with the Commonwealth Government and its departments, these include several State Governments and government instrumentalities, and a number of overseas official institutions. To meet their specific needs, the Bank has developed specialised banking systems in partnership with its customers; these systems interface with customers' own systems to ensure efficient and cost-effective services on a "whole of government" basis. Where appropriate, the Bank also draws on third-party suppliers such as international banks and Australia Post to augment the services it provides.

The volume of customer business continues to grow. In 1996/97, electronic transactions processed through the Bank's Government Direct Entry System (GDES) rose by 2.9 per cent, to 214 million. This system has now been extended to enable the Commonwealth Government to make overseas payments electronically, making use of the global banking network of Citibank NA.



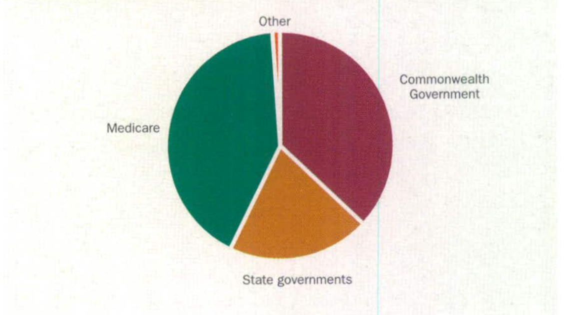
The Bank's financial electronic data interchange (EDI) facility processed just over 121 000 transactions in 1996/97, 16 per cent more than the previous year. The Department of Finance is the major user, making interagency payments and disbursements from the Commonwealth to the States. The Commonwealth Government's commitment to settling a wider range of commercial transactions electronically will provide impetus to the spread of this type of facility among financial institutions.

The number of customers using *ReserveLink*, the Bank's PC-based banking package, grew from 195 to 278 during 1996/97. The growth was mainly due to the devolution of responsibility for day-to-day banking operations from State Treasuries to individual budget agencies.

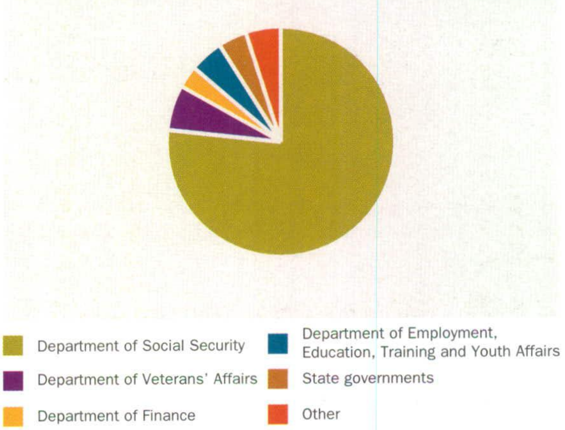
In contrast to the growth in electronic banking, paper-based transactions processed by the Bank fell in 1996/97 from 53 million to 50 million, resuming the downward trend of recent years. Such transactions, nonetheless, remain important to the banking needs of some government agencies, particularly those receiving low-value, high-volume payments from the general public, many of whom wish to make payments in person. To expedite such transactions, the Bank has engaged Australia Post as an agent to provide a payment service for government bills – extending existing arrangements for tax payments – as well as a deposit-taking and cheque-encashment facility for government agencies.

Also in response to customer demand, the Bank has introduced a cheque printing and mailing service using the facilities of EDI POST, an Australia Post service. Under these arrangements, customers' payment instructions are delivered electronically to the Bank each day, aggregated and sent via electronic file to EDI POST for cheque production and mailing.

Paper-based banking transactions – 1996/97



Electronic banking transactions – 1996/97



The scope for outsourcing the processing of cheques is currently being reviewed. The sorting and clearing of cheques is subject to significant economies of scale which the Bank, being a relatively small player, is unable to exploit. As the shift from paper-based to electronic transactions gathers pace, a more general industry rationalisation of the cheque processing business seems inevitable.

During 1996/97, the South Australian Government reconfirmed its longstanding banking relationship with the Bank after reviewing its banking needs and service delivery options. Under new arrangements the Bank has assumed the role of prime contractor for that Government's banking services. Where it can provide these services competitively as a sole provider, it will do so; where it does not offer the services required – e.g. purchase cards – or where third-party suppliers are more competitive, the Bank will select a provider through a tender process and manage the outsourcing relationship.

The Bank also acts as adviser to the Commonwealth Government and its agencies on payments and collections systems. The aim is to encourage "best practice" electronic processing and cash management arrangements by the Commonwealth, irrespective of whether banking services are provided directly by the Bank or through third-party suppliers. In this context, the Bank assisted the Department of Finance during 1996/97 with the further improvement of cash management arrangements. In a similar vein, the recent initiatives with Australia Post have resulted in a speedier flow of payments to the Commonwealth.

Government banking: net earnings
(1996/97, $ million)

Total revenues	23.8
Total costs	21.0
Net earnings	2.8

Paper Versus Electronic Payments

The impact on the economy of advances in communications and information technology has been profound. The substantial productivity gains available are nowhere better exemplified than in the case of electronic direct entry, which is taking over from traditional paper-based systems. Payment by paper-based means is costly, labour intensive, requires significant capital investment and often results in delays in the receipt of payments.

This can be illustrated by comparing the number of steps involved in a payment made by cheque with the same payment made by direct entry. The example below shows social security payments made by the Bank to pensioners on behalf of the Department of Social Security (DSS). The first step in both cases is for the Department to construct the list of recipients and the amounts to which they are entitled. The Bank is only involved in the actual payments (and the interbank transactions which underlie these).

Payments made by cheque	**Payments made by direct entry**
1. List of recipients established by DSS	1. List of recipients established by DSS
2. Cheques prepared	2. File containing recipients' account details and amount of entitlement sent to RBA
3. Cheques posted to private addresses	3. RBA sorts and sends payment file electronically to individual financial institutions. RBA credits accounts of financial institutions and debits DSS's account.
4. Recipients take cheque to their financial institution	4. Financial institutions credit recipients' accounts
5. Funds credited to recipients' accounts	
6. Cheque returned to RBA so that recipients' financial institution can be credited and DSS's account debited	
7. Details of cheques paid returned to DSS for reconciliation against cheques issued	
8. Cheques stored for up to seven years	

Not only is direct entry much more efficient and cheaper to provide, it is clearly a better product for the consumer. Unlike payments by cheque, funds received electronically are immediately available. Electronic payment is also more reliable, does not require the recipient to take a trip to their bank and makes fewer demands on transport, postal systems, etc.

Registry services

The Bank provides registry services for the Commonwealth Government, borrowing authorities of the governments of South Australia and Western Australia, and several other local and foreign official institutions. Services are provided through the Bank's branches and include issuance of securities, maintenance of ownership records, payment of interest and redemption of securities at maturity.

Registry activities fell slightly in 1996/97. This mirrored the experience of debt registry business generally, one that is a declining area of the financial services industry and subject to strong competitive pressures. Rapid advances in electronic data processing and communications offer substantial economies of scale; at the same time, however, registry volumes are declining as issuers contract in number and have greater recourse to cheaper and more flexible funding available in wholesale markets.

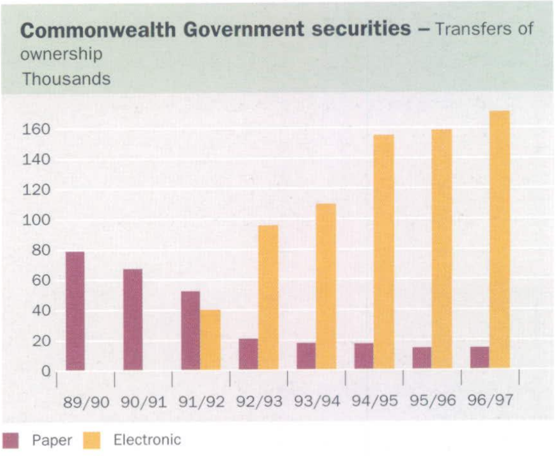
Registry services: net earnings
(1996/97, $ million)

Total revenues	4.1
Total costs	2.9
Net earnings	1.2

Settlement services

The centrepiece of the Bank's settlement services is the Reserve Bank Information and Transfer System (RITS), which allows members to settle electronically their transactions in Commonwealth Government securities. Some 222 organisations are represented on the system, much the same as a year earlier. RITS handles over 98 per cent of turnover in the professional market, and has $97 billion of securities lodged in it.

Other services provided by RITS include electronic tendering for Treasury bonds, notes and adjustable rate bonds; the automatic payment of interest and maturity proceeds in respect of securities held in the system; provision for members to use securities in RITS to secure loans and to settle reciprocal purchase transactions; a capacity to make high-value payments; and a facility for simultaneous settlement of interbank obligations arising from the settlement of equity transactions

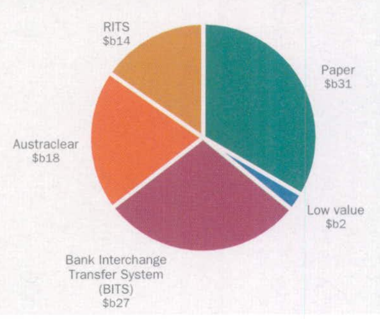


RITS (Reserve Bank Information and Transfer System) office

on CHESS, the Australian Stock Exchange's electronic settlement facility. The excellence of RITS has again been confirmed in the 1996 international survey of global custodians by Global Securities Consulting Services (a UK company), which ranked Australia number one in fixed-interest securities settlement for the third year in succession.

As noted already, RITS has been substantially upgraded to provide the basis of the new RTGS system for high-value interbank payments. The Bank is also intending to develop reciprocal arrangements with the Central Moneymarkets Unit, the securities settlement system of the Hong Kong Monetary Authority.

Daily average of gross payments exchanged between direct clearers – February 1997



In the interbank settlement process, the Bank acts as collator for the Australian Payments Clearing Association (APCA). Each day, the Bank collates details of each bank's obligations arising from transactions in the various clearing systems and calculates the net amount owed to or by each bank for settlement to Exchange Settlement Accounts on RITS at 9.00 am the next morning. Gross settlement flows average a little over $90 billion per day, of which $59 billion come from high-value electronic systems, $31 billion from paper clearing (mainly cheques) and around $2 billion from low-value electronic systems. To improve the efficiency and security of the interbank settlement process, the Bank is planning to introduce an automated facility for banks to communicate with the collator, replacing the existing fax-based system.

The Bank also has settlement responsibilities arising from its own activities in the foreign exchange and domestic securities markets, and from the activities of the Commonwealth Government and overseas official institutions. These high-value transactions currently take place across RITS and Austraclear's system and some will take place across the SWIFT message service when it becomes available with RTGS. Like others, the Bank has been reassessing its SWIFT connections in anticipation of RTGS and has further automated its SWIFT-related activities.

RITS: net earnings
(1996/97, $ million)

Total revenues	4.9
Total costs	2.1
Net earnings	2.8

Note Issue

The Bank's note issue activities cover research into and development of note designs and security features; storage and issue of new and reissuable notes; and the processing of notes returned from circulation for quality control purposes. In addition, the Bank currently provides a specialised cash distribution service to banks.

Research and development

Following the introduction of a full series of polymer-based notes in Australia, the Bank's current research efforts are directed at enhancing the security of currency notes against counterfeiting. These efforts are shared with Note Printing Australia and with Securency Pty Ltd, a joint venture company established with the Belgium-based manufacturer, UCB Films PLC, to market polymer substrate internationally.

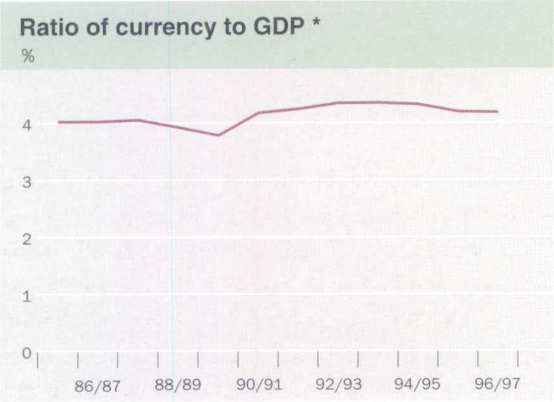
Australia's polymer notes incorporate a range of security features which have helped to reduce the rate of counterfeiting, particularly "casual" counterfeiting involving use of a colour photocopier. However, polymer notes cannot eliminate counterfeiting altogether. The Bank's research program gives priority to the development of new security features which can be used only with polymer notes.

The Bank also continues to seek improvements in the durability and handling characteristics of polymer.

Benefits of polymer

Experience to date with the new note series has revealed that:

- polymer notes last around four times as long as their paper counterparts, cutting the Bank's new note requirements to around 150 million pieces a year or about one quarter of the requirements for paper notes;
- their improved durability and security mean that the Bank does not need to examine polymer notes for fitness and authenticity as frequently as paper notes. Steps are under way to reduce the level of note processing carried out by the Bank by around 30 per cent, with substantial cost savings;
- the added cleanliness of polymer notes has increased the efficiency of, and reduced the maintenance requirements for, machine processing of notes, such as in ATMs; and
- the production of polymer substrate is significantly more energy-efficient and less polluting than the production of specialised banknote paper. Polymer notes no longer fit for circulation are granulated and the residue is recycled, whereas paper notes were disposed of either by burning or through landfill.



* GDP for 1996/97 is an estimate.

Currency operations

Notwithstanding the strong growth in electronic payments mechanisms such as EFTPOS and direct entry, the public's demand for currency notes continues to grow broadly in line with the economy. In 1996/97, the value of notes on issue rose by 4.6 per cent, faster than in the previous year. The high denomination $50 and $100 notes continue to account for about 85 per cent of the value of notes on issue, the $50 note now absorbing the largest share in response partly to the needs of ATMs. The vast majority of notes in circulation is now polymer-based.

The Bank issued into circulation around $68 billion in notes during 1996/97 and had around $67 billion in notes returned. Nearly half of these flows went through a specialised note-bag distribution service to banks' branches, for which a full charge has been made from 30 September 1996. The remaining flows were on a bulk or wholesale basis and attract only a nominal charge.

Value of notes on issue

($ million)

At end June	$1	$2	$5	$10	$20	$50	$100	Total	Increase (per cent)
1992	42	71	261	585	1 836	5 724	6 660	15 180	2.6
1993	42	70	297	591	1 813	6 284	7 269	16 367	7.8
1994	21	69	313	634	1 795	6 837	7 907	17 577	7.4
1995	20	49	332	614	1 848	7 193	8 482	18 538	5.5
1996	19	48	337	583	1 868	7 928	8 399	19 182	3.5
1997	19	47	351	601	1 837	8 912	8 297	20 064	4.6

The note-bag service is not a core activity for the Bank and its competitive outlook is poor. It has also tended to inhibit the development of more efficient currency distribution methods. Gross flows to and from the Bank are excessive and not well co-ordinated with the public's specific needs, resulting in higher transportation, insurance and processing costs and greater security risks. As a consequence, the Bank has informed banks that it intends to cease the note-bag service around the middle of 1998. Some staff redundancies at the Bank will be involved.

Note-bag service: net earnings

(1996/97, $ million)

Total revenues	4.2
Total costs	4.6
Net earnings	-0.4

During 1996/97, the Bank processed 1.4 billion used notes through its high-speed note processing machines, which were enhanced by the installation of fitness detectors developed especially for polymer technology. Of the total, about 87 per cent were passed fit for reissue, a percentage which has been growing in recent years because of the durability and cleanliness of polymer notes. Experience confirms that polymer notes can be processed more efficiently than paper notes; the reduction in the cost of processing each 1 000 notes from $9.40 when paper notes were in circulation to $7.90 currently, reflects in part the switch to polymer.

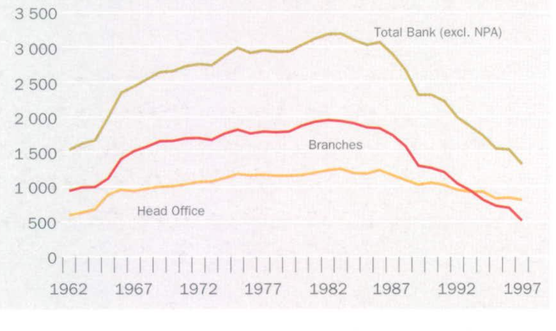
Management of the Bank

The Bank is organised into five major functional groups, each under the direction of an Assistant Governor; three smaller units provide additional internal support. This management structure reflects policy, business and administrative responsibilities. The resourcing and activities of each functional group are reviewed on a regular basis, and adjusted where necessary to meet changing requirements and improved efficiency.

1996/97 was a year of such adjustment, after an earlier brief settled period. Changes on this occasion centred on the Bank's business and "corporate" (or internal support) services and were a response to the strong competitive pressures facing the Bank's commercial activities. The Business Services Group was reorganised along business unit lines to strengthen management control and sharpen efficiency (see page 39); as a consequence, over 100 staff positions will be shed in coming months, mostly in the support and processing areas of branches. In the corporate services area, an ongoing process of "benchmarking" Bank costs and efficiency against private-sector suppliers has led to decisions to outsource the cleaning and guarding of Head Office and branch buildings, and the provision of catering services in Head Office (branch catering had already been outsourced). Improved technology and changing work flows have also produced staff savings in accounting, auditing and facilities management functions. In all, staff numbers in corporate areas will fall by around 250; most of these departures have already taken place. Staff numbers in the Bank's policy areas are little changed.

In contrast to previous restructurings, where surplus staff were handled mainly through a series of voluntary redundancy and early retirement programs, the latest round has necessarily involved compulsory redundancies. To enable it to handle staff surpluses more efficiently, the Bank has negotiated new redundancy and retrenchment arrangements with staff and the Bank's major unions; these provide for greater management discretion in the selection of staff for retrenchment and more streamlined exit procedures.

Staff numbers – As at 30 June

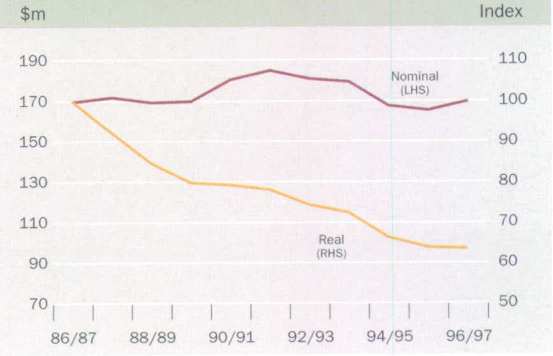


Staff numbers (excluding Note Printing Australia) have fallen from their peak of 3 186 in 1983 to 1 304 in June 1997; when the current restructuring has run its course, they will fall to around 1 140. This is a decline of around 65 per cent overall but an even sharper decline in the branches, which are now only one-quarter of their size in 1983. Though the loss of some Bank functions was an early factor behind the decline, the main explanation lies in the impact of technology – particularly on clerical and processing functions – and rigorous scrutiny of the Bank's staffing needs, especially in those non-core areas where the Bank has no comparative expertise. In many of these areas, benchmarking confirmed that the Bank's cost structure and work practices were well out of line with industry, offering scope for substantial cost savings through outsourcing. The benchmarking process has not been all one way, however. The Bank decided to retain mainframe computing services in-house after market testing against commercial suppliers. The Bank also "insourced" the management of its workers' compensation arrangements after assessment of its claims experience against the premia charged by Comcare, the Commonwealth agency with which the Bank had previously been required to insure its liabilities in this area.

The increasingly specialised nature of the Bank's activities makes it essential that staff be equipped with the necessary skills and technology. A range of in-house training courses, including a new senior management development program, is supplemented by external courses in Australia or with overseas central banks and international organisations. In addition, the Bank currently provides study assistance to around 10 per cent of its staff, with most of the recipients pursuing post-graduate qualifications. Because of changing skills needs, the Bank has made greater use of specialist contract staff in certain areas (particularly information technology) to augment its staff resources.

The Bank's "underlying" operating costs (which exclude lumpy expenditures on redundancies and certain other one-off items) rose moderately in 1996/97, the first increase in five years. The restructuring under way within the Bank and Note Printing Australia will reflect in lower operating costs in 1997/98 and beyond. Since their peak in 1991/92, there has been substantial reduction in staff and other costs in nominal terms, and a bigger reduction in real terms.

'Underlying' operating costs



Operating costs
($ million)

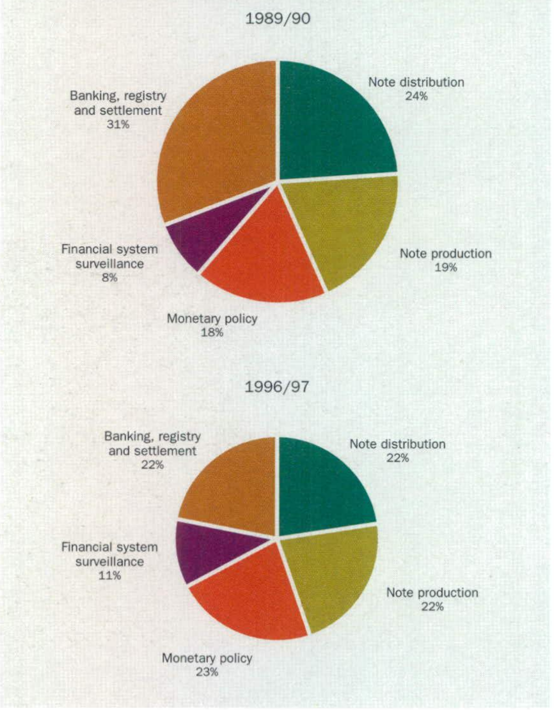
	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
Staff costs#	116.4	112.3	111.7	108.0	106.6	111.9
Other costs*	68.6	68.7	67.7	59.6	58.8	58.0
"Underlying" operating costs	185.0	181.0	179.4	167.6	165.4	169.9
Cost of redundancies	18.8	2.7	9.8	18.1	1.3	12.9

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

* Includes premises and equipment (including depreciation), but excludes IMF maintenance of value payment

The Bank's "core" functions – monetary policy, financial system surveillance and note issue – have absorbed a growing share of operating costs over recent years. In 1996/97, their share was around 56 per cent compared with about 50 per cent in 1989/90; the share for "non-core" functions – note production and commercial activities – has fallen commensurately. The latest round of restructuring will accentuate this change in distribution.

Distribution of operating costs



The Bank's investment in technology and in the skills of its staff has enabled it to meet substantial increases in activity in various areas, notwithstanding the general contraction in its resources. Though the "output" of a central bank is inherently difficulty to quantify, the indicators presented in the accompanying table suggest strong productivity gains over recent years as far as the processing of different types of transactions is concerned. The largest gain is in respect of foreign government securities and reflects the more active approach to the management of official reserve assets described earlier, although other measures are used to assess the effectiveness of these dealings (see "Operations in Financial Markets"). Measuring the output and the quality of the Bank's policy-related activities is, of course, much more difficult.

Indicators of output
(Percentage change from 1990/91 to 1996/97)

Banking and registries	
Banking transactions (including GDES)	270
Bank accounts maintained	75
Registry transactions (including RITS)	360
Transactions in domestic and foreign markets	
Foreign exchange transactions	110
Transactions in foreign government securities	400
Domestic market operations	190

The Bank in the Community

Larry Ball, visiting US economist (Johns Hopkins University), talking with staff of the Bank's Economic Group – January 1997

Communications

The Bank seeks to enhance the community's understanding of its responsibilities and its monetary and banking policies through a broad communications program. The primary vehicle is the monthly *Bulletin*. This contains the *Semi-Annual Statement on Monetary Policy*, a key element in the new monetary policy arrangements, and detailed assessments of economic and financial developments in the intervening quarters. Articles of policy or analytical interest are also included on a regular basis; in 1996/97, these covered bank branch trends in Australia and overseas, managing market risk in banks, measuring wages, recent developments in small business finance, and supervisory aspects of options pricing.

The appearance of senior officers before the House of Representatives Standing Committee on Financial Institutions and Public Administration provides another important opportunity to account publicly for the conduct of Bank policy. The first appearance under the new monetary policy arrangements was in May 1997, the next is scheduled for November 1997.

Speeches and presentations are the other main avenues through which the Bank explains its views to the community. Each year, the Governor and senior officers give a number of major speeches to a wide range of audiences, locally and overseas; in 1996/97, these included the Asialink Group, the Australia-Israel Chamber of Commerce, the Committee for Economic Development of Australia (CEDA), the Conference of Economists, the Economic Society of Australia, the Europe/East Asia Economic Summit, the International Swaps and Derivatives Association, the Securities Institute of Australia and The Sydney Institute. Most major speeches are reproduced in the *Bulletin*. In addition, less formal addresses are made to different groups of financial market participants and other sectors of the financial community.

In the educational field, the Bank regularly provides speakers for courses run by the Securities Institute of Australia and by Australian universities, and to seminars organised by teachers' associations and related groups in several States. In May 1997, it also held a Seminar for Teachers in Sydney and in Melbourne. These Seminars included presentations on the role/framework of monetary policy, domestic market operations, foreign exchange market operations, prudential supervision of financial institutions, and an overview of current economic conditions. This material is being published for use by other teachers and students at both secondary and tertiary levels.

In July 1996, the Bank hosted the ninth in its series of annual economics conferences, on the theme of "The Future of the Financial System". The Proceedings were published in September 1996. The tenth economics conference, in July 1997, focused on "Monetary Policy and Inflation Targeting"; the Proceedings will be published shortly. Economic Group published 10 Research Discussion Papers in 1996/97; this series aims to share with economists outside the Bank the results of current work-in-progress by staff. Bank researchers also made a number of contributions to professional journals, both in Australia and overseas, and gave presentations on their research to conferences organised by academic institutions and other central banks.

In May 1997, the Bank conducted its first conference on matters relevant to bank supervision, the topic chosen being "Credit Risk in Banking". A conference volume will be published shortly.

The Economic and Financial Research Fund (EFRF) is a longstanding arrangement under which the Bank provides support for university projects relevant to the Bank's broad responsibilities. During 1996/97, the EFRF contributed $39 380 to six projects at five Australian universities. The Bank also continued its financial support for the monthly survey of inflationary expectations undertaken by the University of Melbourne's Institute of Applied Economic and Social Research and, in the international sphere, for the Group of 30's study program.

The Bank is developing a web site on the Internet, which will offer a range of information about the Bank's functions and operations as well as the text of important documents published elsewhere by the Bank (including the *Semi-Annual Statement on Monetary Policy*, speeches and media releases).

Rick Mishkin (Federal Reserve Bank of New York) addressing the annual Economic Conference hosted by the Bank at the Coombs Centre for Financial Studies, Kirribilli – July 1997

Other involvement in the community

The Bank has a range of other contacts with the financial and wider community. It is, for example, the convenor of the Small Business Finance Panel, which meets annually. This Panel, established in 1993, comprises members from a broad spectrum of industries and provides advice to the Bank to improve its understanding of finance issues affecting small businesses.

The Bank has begun planning for a new Australian currency note which will be issued in 2001 to commemorate the centenary of Federation. It will be seeking the views of a panel of community representatives on the themes to be portrayed on this note.

The Bank makes modest donations to a number of charitable institutions Australia-wide; in 1996/97, the amount provided was $22 000. The Governor is also Chairman of the Financial Markets Foundation for Children, the financial community's charity organisation which raises funds for research into medical and social problems affecting children.

As part of its general community relations, the Bank lends some of its artworks to Australian public galleries and similar institutions. During 1996/97, the Bank lent paintings to the Art Galleries of New South Wales and Western Australia, for extended exhibitions which toured

The Governor with Zhu Rongji, Vice Premier of the State Council of the People's Republic of China – Sydney, May 1997 nationally, and to the National Library of Australia for an exhibition in Old Parliament House in Canberra. The Bank also makes available for public viewing a small number of artworks and historic photographs from its collection in its Currency Display Centre in Head Office.

Contacts with other central banks

In recent years the Bank has strongly endorsed the pursuit of closer ties among central banks of the Asian region. The vehicle has been an existing group of central banks known as the Executive Meeting of East Asia and Pacific Central Banks (EMEAP). Membership of EMEAP comprises the central banks and monetary authorities of eleven countries: Australia, People's Republic of China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand.

Previously a forum for regular meetings at senior level, the EMEAP arrangements took on a more formal structure in 1996/97. The first meeting of EMEAP Governors was held in Tokyo in July 1996 and the second in Shanghai in July 1997. EMEAP Deputies – at Deputy Governor or equivalent level – also met twice during the year, in Kuala Lumpur in October 1996 and in Hong Kong in March 1997. Three working/study groups have been established covering payments systems and other financial market developments, central bank operations (focusing on reserves management issues and institutional arrangements for closer co-operation), and prudential supervision. The Bank is active in all three groups and has also provided the chairman for the working group on central bank operations. Each group has met several times during the year and produced papers for the meetings of EMEAP Deputies. The groups have also sponsored international seminars on issues related to their particular interests. The Bank participated in an EMEAP reserves management seminar in Singapore in February 1997 and hosted an EMEAP conference on market risk in Sydney in June 1997. In this same month, a joint BIS/EMEAP central bank workshop on interbank clearing and settlement systems was held in Indonesia, jointly hosted by Bank Indonesia and the Bank for International Settlements; two Bank staff gave presentations.

In 1996/97, the Bank signed its sixth bilateral repurchase agreement with EMEAP members, this time with the Bank of Korea. These arrangements (involving agreements to buy and sell back US government securities) are a means for generating additional liquidity in times of need. The other repurchase agreements are with Hong Kong, Indonesia, Japan, Malaysia and Thailand.

In August 1997, the Commonwealth Government agreed to a request by the International Monetary Fund that Australia participate in an international financing package for Thailand. A number of other countries in the Asian region have also agreed to participate. The total package is for about US$15 billion, of which Australia's contribution is up to US$1 billion, in keeping with the contribution of most other countries. The Bank has agreed that the Australian contribution will be in the form of a foreign exchange swap between itself and the Bank of Thailand. Terms and conditions are to be negotiated with the Bank of Thailand, but the swap will be at market-related interest rates and exchange rates.

The Bank's second formal bilateral meeting with the Hong Kong Monetary Authority was held in Sydney in April 1997. These meetings are held on an annual basis, alternating between Australia and Hong Kong.

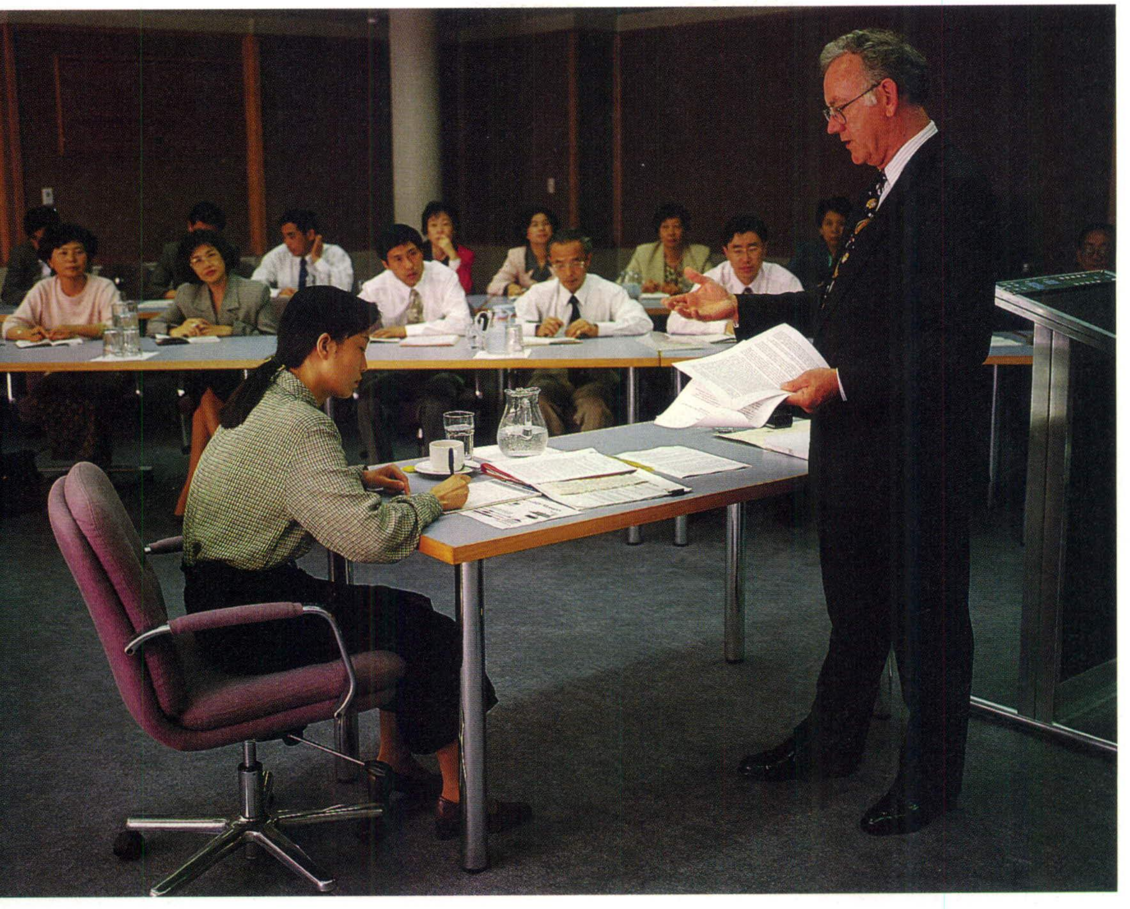
The Bank also participated in other high-level meetings in the region. These included the SEANZA (South East Asia, New Zealand and Australia) Governors' Symposium in Beijing in November; the annual South Pacific Central Bank Governors' meeting in Wellington in December; two APEC Finance Ministers' meetings in Manila; the SEANZA Forum of Banking Supervisors in Shanghai in June; and the Four Markets Meeting (also involving Hong Kong, Japan and Singapore) in Hong Kong in November. In March, this latter group met in Tokyo in an expanded format styled the Six Markets Meeting, which also included the People's Republic of China and the United States. The group has decided to meet in both formats on an alternating basis.

The Governors have continued their program of regular attendances at the monthly meetings of the Bank for International Settlements (BIS) in Basle. In addition, the Governor has been invited to join Governors from six other BIS member central banks on a BIS steering group on "central bank governance", which will address issues related to the scope of central banking and the costs and efficiency of various central bank functions. Two meetings of this group were held during 1996/97 in conjunction with the regular BIS meetings.

The provision of technical assistance, in various forms, is an important ongoing element of the Bank's relations with other central banks, particularly those in the Asia/Pacific region. In December 1996, the Bank arranged a two-week study tour to Australia for about 30 officers from People's Bank of China, sponsored by the IMF; this group's particular interest was centralising and modernising China's public accounting and its debt and cash management systems. The Bank also received visitors from a number of other central banks for short-term training attachments and provided longer training programs for officers from Bank of Papua New Guinea, Maldives Monetary Authority and Reserve Bank of Zimbabwe.

The Bank provided lecturers for a number of overseas courses and training programs. These included presentations to the South Pacific Central Banks Banking Supervision Workshop (Fiji); an IMF Workshop on Organisation and Human Resource Management (Thailand); the SEANZA Central Banking Course (People's Republic of China); a SEACEN (South East Asian Central Banks) Course on Policies and Open Market Operations of Financial Markets (Taiwan); a SEACEN Seminar on the Role of Central Banks in Payment Systems in the SEACEN Countries (Korea); and an IMF Payments System Workshop for countries of the former Soviet Union (Austria).

Bank officers also visited a number of other central banks to provide technical assistance, including Bank of Papua New Guinea (auditing), State Bank of Vietnam (accounting and auditing), National Reserve Bank of Tonga (bank supervision), Monetary and Foreign Exchange Authority of Macau (review of bank supervisory practices), Bank of Thailand (domestic market and liquidity forecasting operations, as part of an IMF Technical Assistance Mission) and Central Bank of Egypt (review of foreign exchange operations, also in conjunction with the IMF). Three officers are on long-term secondments, two with the IMF in Washington and one with Central Bank of Yemen, under the auspices of the IMF.



Alan Moore, from the Bank's Business Services Group, addressing a course (on government accounting and debt and cash management practices) at the Coombs Centre for Financial Studies, Kirribilli, organised for a group from People's Bank of China – 30 November to 14 December 1996

Statutory obligations

Equal Employment Opportunity (Commonwealth Authorities) Act

During the year, the Bank developed its fifth plan for activities related to equal employment opportunity. As required under the Equal Employment Opportunity (Commonwealth Authorities) Act 1987, a report for 1995/96 on the Bank's equal employment opportunity program was tabled in Parliament in November 1996.

Freedom of Information Act

Section 8 statement

The Bank is an exempt agency under the Freedom of Information Act 1982 in respect of documents concerning banking operations (including individual open market operations and foreign exchange dealings) and exchange control matters.

Organisation and functions: The Bank is Australia's central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the Reserve Bank Act 1959, the Banking Act 1959, the Financial Corporations Act 1974 and in Regulations made under those Acts. The Bank's organisation chart appears at the end of this Report.

Categories of documents: Lists of publications, including speeches, articles, occasional papers, information booklets, conference volumes, regular media releases and other publications, are published from time to time in the Bank's monthly *Bulletin*. Other documents held by the Bank are in the form of working notes and files covering policy and operational matters, statistical data, personnel, premises and general administration.

Facilities for access and Freedom of Information procedures: Inquiries under the Freedom of Information Act, including requests for access to documents, should be directed to the Secretary, Head Office, or the Managers of branches, or the Managing Director at Note Printing Australia. Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available in the Bank's branches.

Section 93 statement

Two requests for access to documents under the Act were received in 1996/97, compared with eight in the previous year. Details for the latest year are set out below:

Requests received	
On hand at 1 July 1996	1
Received during year	2
Action on requests	
Access granted in full	–
Access granted in part	–
Access refused	–
Requests withdrawn or lapsed	3
Current at 30 June 1997	–
Internal review	
Applications	1
Review by Administrative Appeals Tribunal	
Outstanding at 1 July 1996	1
New applications	–
Withdrawn	–
Fees and charges collected	
Application fees	$100
Charges	Nil

The result of the above review by the Administrative Appeals Tribunal was handed down in June 1997; it affirmed the Bank's decision not to grant access to certain documents.

The cost to the Bank of administering the Act in 1996/97 is estimated to have been approximately $67 100, compared with approximately $32 800 in the previous year.

Note Printing

The printing of Australia's currency notes is carried out by an autonomous division of the Bank called Note Printing Australia (NPA), which is based at Craigieburn in Victoria. NPA is overseen by a Board, the Chairman of which is GJ Thompson, Deputy Governor. The other members are FM Bethwaite, Managing Director of RGC Limited, RFE Warburton, a non-executive member of the Reserve Bank Board and RL Larkin, Managing Director of NPA. This Board reports regularly to the Bank Board.

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

Polymer notes have demonstrated significant advantages over paper in both security and durability. As an example, Australia's paper $5 note had an average life in circulation of six months; by contrast, its polymer successor first issued in 1992 is lasting at least two years. One result of this greater durability has been a steady decline in the required annual production of Australian notes. This has, in turn, freed capacity at NPA for other opportunities.

Consequently, the enterprise has been working to develop an export market for polymer notes for some time and has made notable progress in recent years. In addition to printing 195 million Australian notes in 1996/97, NPA produced 132 million notes for other countries, up from 50 million in the previous year. The major component was an order for Thailand, but notes were also produced for Brunei, Papua New Guinea and Western Samoa. For 1997/98 to date, NPA has secured export orders for Thailand and Sri Lanka. It is discussing the issue of polymer notes with several other countries. In March 1997 the one billionth polymer note was delivered off the presses. Of this total, approximately 14 per cent have been for export.

NPA markets a number of related technologies and, during the year, fulfilled a contract with a major overseas country for the supply of a high-level authentication system for the validation of notes returned from circulation. It is likely that further export sales will follow. NPA also operates a profitable numismatic business on behalf of the Bank.

In recognition of its overseas success, NPA won the Export category in the Prime Minister's Inaugural Awards for Innovation in the Public Sector.

Notwithstanding the inherent advantages of polymer, and its current leading position in this technology, the Bank believes that NPA will have long-term success as an exporter only if it becomes more efficient and commercially oriented. In pursuit of this objective, NPA has put much effort into refining and upgrading its management and quality assurance systems. Its

Robert Larkin, Managing Director of NPA, with then Governor of the Bank of Thailand, Rerngchai Marakanond, discussing polymer notes produced by NPA for Thailand – May 1997

progress in this was recognised in June 1997 by the award of ISO 9001 certification. NPA is also working to reduce its costs and increase productivity. Management has commenced a program to outsource non-core activities, where this is the more cost-effective option. It is also looking at opportunities to automate further NPA's processes and has a substantial capital investment program to modernise the facility. A new enterprise bargaining agreement is currently under negotiation with NPA's unions and a streamlined management structure is being instituted.

In June 1997, NPA employed 267 staff, compared with 552 ten years ago. Numbers will decline to near 200 in the latter part of 1997.

In May 1997 NPA's workers' compensation insurers, Comcare Australia, conducted an audit of NPA's occupational health and safety management system. The report congratulated NPA on its commitment and achievements, and suggested that the organisation was an excellent example to other Commonwealth agencies of the successful implementation of a risk management approach to health and safety in the workplace.

Robert Larkin, Managing Director of NPA, with the Prime Minister, on the occasion of the presentation of the Prime Minister's Award and a High Commendation in the 'International Export' category of the 1997 Inaugural Prime Minister's Awards for Innovation in the Public Sector – Parliament House, Canberra, February 1997

Early in 1996 the Bank, through NPA, formed a joint venture company with UCB Films PLC, a Belgium-based manufacturer of polypropylene films, to market and supply specialised polymer substrate to countries which have their own printing plants. The joint venture company, Securency Pty Ltd, is now well-established and has made contact with many potential customers. It has organised machine trials of polymer substrate with a substantial number of printers around the world. Securency has its head office in Australia and is also represented in Europe.

NPA and UCB are also working, together with the Bank's Note Issue Department, on an extensive program of research and development, with the aim of further improving the security and handling properties of polymer notes. Significant progress has been made on some highly innovative security features.

UCB has purchased land from the Reserve Bank adjacent to NPA's printing works for a manufacturing plant. This will produce specialised polymer film for use in note printing, as well as manufacture other UCB products for export to Asia.

The Bank's Earnings

The Bank's substantial holdings of domestic and foreign currency assets are the source of large profits in most years. However, the Bank does not pursue profit maximisation as a narrow goal and, as noted earlier, has only limited discretion to take actions to increase the return on its assets. For these reasons, the level of profits in any year is not an indication of the Bank's performance in meeting its monetary and banking policy objectives.

In 1996/97, the Bank's balance sheet was boosted by a sharp increase in balances in Exchange Settlement Accounts held by banks, and by some large year-end flows into the Commonwealth Government's accounts (see page 20 of "Operations in Financial Markets"). Some of this balance sheet growth has been unwound in the first months of 1997/98.

The Bank's profits in 1996/97 amounted to $3 705 million, the second highest result recorded. Of this, $1 637 million represented realised gains on gold sales. The remaining $2 068 million derived from the Bank's normal operations and was very close to the average result over the past decade.

Sources of Reserve Bank earnings
($ million)

	Underlying earnings	Realised gains and losses*	Net operating earnings
1987/88	1 508	18	1 526
1988/89	971	–554	417
1989/90	1 248	–153	1 095
1990/91	1 322	391	1 713
1991/92	1 516	1 038	2 554
1992/93	1 760	2 803	4 563
1993/94	1 556	–48	1 508
1994/95	1 649	123	1 772
1995/96	1 784	702	2 486
1996/97	1 715	1 990	3 705
[of which: gold]		[1 637]	[1 637]
Average	1 503	631	2 134

* The charges to earnings in 1993/94 and 1995/96, when the market value of traded assets fell below cost (and the charges to provisions in the three years to 1989/90), are recorded here as capital losses.

There are two components to the Bank's profits – "underlying" earnings, and the capital gains (and losses) on its holdings of financial assets. Underlying earnings reflect the margin between the interest received on assets and the interest paid on liabilities, less the Bank's operating expenses. The largest source of liabilities is currency notes on issue, on which no interest is paid; the recent growth in Exchange Settlement Account balances, however, means that more of the Bank's liabilities pay market-related rates of interest. In 1996/97, underlying earnings amounted to $1 715 million, a little below the previous year because of lower average yields prevailing in domestic and foreign markets.

Capital gains (and losses), the more volatile component of profits, normally arise in one of two ways. First, the capital value of domestic and foreign securities in the Bank's portfolio changes as interest rates change. When interest rates fall, for example, the value of securities in the Bank's portfolio rises, and vice versa. Capital gains and losses are reflected, in the first instance, in the appropriate asset revaluation reserve but, as the securities are sold, the gains and losses are realised and reflect in profits. The net decline in bond yields over the course of 1996/97 generated realised gains of $226 million from sales of securities.

Secondly, gains (and losses) can occur through changes in the Australian-dollar value of foreign-currency-denominated securities held in official reserve assets, as a consequence of exchange rate movements. If, for example, the Australian dollar falls against the currency in which securities are denominated, the value of those holdings in Australian dollars rises. In 1996/97, realised foreign exchange gains totalled $127 million. The recent decline in the Australian dollar also led to unrealised gains which returned the foreign currency revaluation reserve to surplus. The previous year, in contrast, a rise in the Australian dollar had generated substantial unrealised losses, which more than extinguished the unrealised gains built up in this reserve over earlier years. This required a charge (of $1 010 million) against 1995/96 earnings which was not repeated in 1996/97.

Reserve Bank profits and payments to Government
($ million)

	Net operating earnings	Transfers to reserves	Balance available for Commonwealth	Final payment from previous year	Interim payment from current year	Total payment
1987/88	1 526	740	786	1 599	300	1 899
1988/89	417	277	140	486	–	486
1989/90	1 095	520	575	140	300	440
1990/91	1 713	210	1 503	275	400	675
1991/92	2 554	200	2 354	1 103	400	1 503
1992/93	4 563	750	3 813	1 954	600	2 554
1993/94	1 508	–	1 508	3 213	–	3 213
1994/95	1 772	–	1 772	1 508	200	1 708
1995/96	2 486	150	2 336	1 572	200	1 772
1996/97	3 705	2 005	1 700	2 136	–	2 136
1997/98				1 700		

In 1996/97, the major source of capital gains was gold sales. The realised gains represented the difference between the market price of the gold sold and the former official price of US$35 per ounce at which it had been purchased many years earlier. Taken together, realised gains from gold sales and from sales of financial assets resulted in a net capital gain for the year of $1 990 million. This brought the Bank's net operating earnings to $3 705 million, an increase of $1 219 million on the previous year.

The Bank's profits are paid to the Commonwealth Government, after any transfers to the two reserve funds which the Bank maintains to deal with contingencies. With the Treasurer's approval, realised gains on gold sales have been retained in the Reserve Bank Reserve Fund and a modest transfer was made to the Reserve for Contingencies and General Purposes. The Bank's dividend out of 1996/97 profits is $1 700 million, to be paid in August.

The Bank's 1996/97 Financial Statements are presented in the following pages.

Balance Sheet as at 30 June 1997
Reserve Bank of Australia

Liabilities	**1996 $'000**	**1997 $'000**
Capital	40 000	40 000
Reserves:		
Reserve Bank Reserve Fund (Notes 1(f), 3)	643 890	2 281 380
Reserve for Contingencies and General Purposes (Notes 1(f), 3)	2 955 699	3 322 946
Asset revaluation reserves (Notes 1(f), 3)	3 606 344	2 390 715
Capital and reserves	7 245 933	8 035 041
Australian notes on issue (Note 1(h))	19 181 932	20 063 976
Deposits by:		
Banks:		
Non-callable deposits	3 922 379	4 361 441
Exchange settlement accounts	9 169	9 235 175
Government and government instrumentalities:		
Commonwealth	2 562 281	5 164 193
State	205 230	317 676
Foreign governments, foreign institutions and international organisations	569 450	83 213
Other depositors	50 475	120 013
Other liabilities:		
Profit distribution payable to Commonwealth of Australia	2 135 807	1 700 000
Provisions (Notes 1(g), 4)	64 841	77 004
Other (Note 5)	1 010 239	1 767 359
Total	36 957 736	50 925 091

Balance Sheet as at 30 June 1997
Reserve Bank of Australia

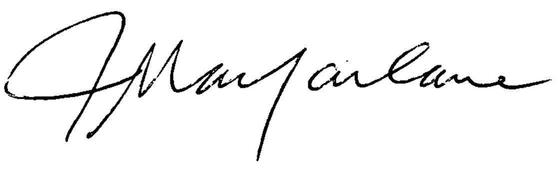
Assets	**1996 $'000**	**1997 $'000**
Gold and foreign exchange (Note 1(b)):		
Gold	3 825 366	1 757 281
Foreign exchange (Note 8)	14 992 813	21 590 124
Domestic government securities (Note 1(c), 8):		
Treasury notes	3 622 958	4 190 285
Other securities	12 529 337	21 216 380
Loans, advances and bills discounted	98 514	107 049
Bank premises and other durable assets (Notes 1(e), 6)	258 699	268 211
Clearing items (remittances in transit, cheques and bills of other banks) (Note 7)	1 371 785	1 591 013
Australian notes and coin	79 778	79 040
Other assets (Note 9)	178 486	125 708
Total	36 957 736	50 925 091

IJ MACFARLANE
Chairman, Reserve Bank Board – 7 August 1997

Profit and Loss Appropriation Statement for year ended 30 June 1997

Reserve Bank of Australia

	1996 $'000	1997 $'000
Net Profits (after deducting amounts written off Bank premises and amounts provided for contingencies and general purposes)	2 385 807	3 337 490
Total (Note 2)	2 385 807	3 337 490
Net Profits appropriated as follows:		
Reserve Bank Reserve Fund	50 000	1 637 490
Commonwealth of Australia	2 335 807	1 700 000
Total	2 385 807	3 337 490



IJ MACFARLANE

Chairman, Reserve Bank Board – 7 August 1997

Notes To and Forming Part of the Financial Statements

30 June 1997 Reserve Bank of Australia

Note 1 Summary of accounting policies

The financial statements have been prepared in accordance with the Reserve Bank Act and are based on the form prescribed by the Reserve Bank Regulations. The statements are a general purpose financial report prepared in accordance with Australian Accounting Standards, to the extent that they do not conflict with the Reserve Bank Act and are relevant to a central bank. Unless otherwise stated, the accounting policies and practices followed in these statements are consistent with those followed in the previous year.

All amounts are expressed in Australian dollars unless another currency is indicated. Current market values are used for the Bank's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises and shares in international financial institutions; the implications for the relevant asset revaluation reserves are shown in Note 3. In other cases, an historical cost basis of accounting is used.

Income measurement is based on *realised* gains/losses passing through the profit and loss account; unrealised gains/losses are passed to/from revaluation reserves provided market price is greater than cost. That part of the Investments Revaluation Reserve and/or Foreign Currency Revaluation Reserve relating to investments and/or currencies disposed of in the course of the financial year is transferred to the profit and loss account for inclusion in the calculation of net operating earnings (see Note 3). This treatment, which differs from AAS 10 and AAS 20, allows all realised gains to be distributed in terms of the Reserve Bank Act. Revenue and expenses are brought to account on an accrual basis.

(a) Note Printing Australia The operations of Note Printing Australia (NPA) are conducted as a separate business enterprise. NPA, however, is not a separate legal entity and most of its output is purchased by the Bank; its assets, liabilities and profit and loss account are included in the Bank's financial statements, after elimination of transactions internal to NPA and the Bank.

(b) Gold and foreign exchange Gold holdings (including gold on loan to other institutions) are valued at the Australian dollar equivalent of the 3 p.m. fix in the London gold market on the last business day of June, except for gold holdings contracted for sale which are valued at the contract price.

Foreign exchange holdings are invested mainly in government securities and bank deposits. Marketable securities other than those contracted for sale under repurchase agreements are reported at market values on the last business day of June; unrealised gains and losses arising from changes in market valuations during the year are taken to the appropriate asset revaluation reserve. Earnings on foreign currency investments are converted to Australian dollars using the exchange rate of the date they are received.

Notes 1 continued

The Bank uses interest rate futures contracts on overseas exchanges in its reserves management operations. The Bank also uses foreign currency swap contracts in its foreign exchange operations. Neither type of contract is shown on the balance sheet. Foreign exchange holdings contracted for sale beyond 30 June 1997 under swap contracts have been valued at contract exchange rates, with a corresponding adjustment to the Foreign Currency Revaluation Reserve.

Assets and liabilities denominated in foreign currency, other than those subject to swap contracts, are converted to Australian dollar equivalents at exchange rates ruling on the last business day of June. Gains or losses realised on sale of foreign currency are taken to profit and loss on settlement of the sale transaction. Unrealised gains and losses arising from exchange rate fluctuations during the year are taken to the Foreign Currency Revaluation Reserve.

(c) Domestic government securities These securities consist of Commonwealth Government securities and Australian dollar-denominated securities issued by the central borrowing authorities of State and Territory Governments. Except when contracted for sale under repurchase agreements, securities are valued at market prices on the last business day of June; unrealised gains or losses resulting from changes in market valuations during the year are taken to the Investments Revaluation Reserve.

(d) Repurchase agreements In the course of its financial markets operations, the Bank engages in repurchase agreements involving foreign and domestic marketable securities. As from 1 July 1996, the Bank changed its accounting policy for such agreements.

Securities sold but contracted for purchase under repurchase agreements are reported on the balance sheet within the relevant investment portfolio and are valued at market prices; the counterpart obligation to repurchase is included in "Other liabilities". The difference between the sale and repurchase price is recognised as interest expense in the profit and loss account over the term of the agreement.

Securities held but contracted for sale under repurchase agreements are reported within the relevant investment portfolio at contract amount. The difference between the purchase and sale price is recognised as interest income over the term of the agreement.

Prior to 1 July 1996, repurchase agreements had been treated as outright sales and purchases subject to a contract to reverse the transactions at a future date. The balance sheet at 30 June 1996 has been restated to reflect the change in accounting policy.

(e) Bank premises and other durable assets A formal valuation of the Bank's premises is conducted on a triennial basis. The most recent valuation was at 30 June 1995, when Australian premises were valued by officers of the Australian Valuation Office and overseas premises were valued by local independent valuers. Valuations are updated annually for developments in the property markets where the Bank's assets are held. Annual depreciation is based on market values and assessments of useful remaining life.

Notes 1 continued

Other durable assets are recorded at cost less depreciation, which is calculated at rates appropriate to the estimated useful life of the relevant assets. Depreciation rates are reviewed annually, and adjusted where necessary to reflect the most recent assessments of the useful life of assets.

In the opinion of the Board, values of durable assets in the financial statements do not exceed recoverable values.

Details of annual net expenditure, revaluation adjustments and write-off/depreciation of these assets are included in Note 6.

(f) Reserves Reserves are maintained to cover the broad range of risks to which the Bank is exposed. The Reserve Bank Reserve Fund is a general reserve which provides for potential losses arising from fraud, support of the financial system and other non-insured losses. The Treasurer determines each year, after consultation with the Board, the amount to be credited to the Reserve Fund.

The Reserve for Contingencies and General Purposes provides cover against risks relating to events which are contingent and non-foreseeable. The major risks in this category arise from movements in market values of the Bank's holding of domestic and foreign securities. Amounts set aside for this Reserve are determined by the Board, with the Treasurer's approval, in terms of section 78 of the Reserve Bank Act.

Asset revaluation reserves reflect the impact of changes in the market values of the Bank's assets.

(g) Provisions The Bank maintains provisions for accrued annual leave, calculated on salaries prevailing at balance date and including associated payroll tax. The Bank also maintains provisions for long service leave and post-employment benefits, in the form of health insurance and housing assistance, and associated fringe benefits tax; these provisions are made on a present value basis in accordance with AAS 30. In addition, the Bank makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(h) Australian notes on issue The Bank assesses regularly the value of notes still outstanding at least five years after the note issue ceased which are judged to have been destroyed and therefore unavailable for presentation. No amount was written off Australian notes on issue in 1996/97 or 1995/96.

	1996 $'000	1997 $'000
Note 2 Net Operating Earnings (and Net Profits)		
Revenues		
Net earnings on overseas investments (Note 1(b))	595 687	839 572
Net earnings on domestic government securities (Note 1(c))	1 527 220	1 798 534
Net gains from sales of foreign currency (Note 1(b))	1 681 751	126 847
Net gains from sales of gold	–	1 637 490
Interest on loans, advances, etc.	18 837	4 343
Net interest from overnight settlements systems	3 193	3 319
Reimbursement by Commonwealth for loan management and registry expenses	2 851	2 698
Banking services fees received from Commonwealth	10 496	14 871
Income from rental of Bank premises (incl. cleaning/ maintenance fees)	4 424	5 721
Commission on gold loans	20 641	35 125
Sales of numismatic and other note products	10 019	17 049
Earnings on shares in Bank for International Settlements (Note 9)	2 108	2 067
Maintenance of Value payment from International Monetary Fund	39 297	19 147
Other	13 237	17 148
Total Revenues	3 929 761	4 523 931
Less: Expenses		
Interest on deposit liabilities	253 182	628 310
Staff costs	120 308	119 354
Special redundancy/retirement payments (Note 11)	1 317	12 912
Amounts written off Bank premises (depreciation) (Note 6)	6 872	7 091
Depreciation of durable assets (Note 6)	6 975	6 864
Premises	10 128	10 467
Equipment	10 864	11 281
Stores and stationery	1 511	1 280
Materials used in note production	9 578	9 469
Travel	1 834	1 706
Consultants' fees (Note 13)	992	1 672
Telecommunications	1 192	1 320
Reference materials	1 845	1 881
Net unrealised losses on foreign currency holdings (Note 1(e))	1 010 302	–
Other	7 054	5 587
Total Expenses	1 443 954	819 194
Net Operating Earnings	2 485 807	3 704 737
Amounts provided for contingencies (Notes 1(e), 3) in terms of section 78 of the Reserve Bank Act	100 000	367 247
Net Profits in terms of the Reserve Bank Act	2 385 807	3 337 490

	1996 $'000	1997 $'000
Note 3 Reserves		
Changes in the Bank's various Reserves are shown below.		
Reserve Bank Reserve Fund (Note 1(f))		
Opening balance	593 890	643 890
Appropriation from profits in terms of section 30 of the Reserve Bank Act	50 000	1 637 490
As at 30 June	643 890	2 281 380
Reserve for Contingencies and General Purposes (Note 1(f))		
Opening balance	2 855 699	2 955 699
Transfer from earnings in terms of section 78 of the Reserve Bank Act (Note 2)	100 000	367 247
As at 30 June	2 955 699	3 322 946
Asset Revaluation Reserves (Note 1(f))		
Gold		
Opening balance	3 965 109	3 472 670
Net revaluation adjustments	(492 439)	(246 517)
Transfers to earnings – realised (gains)/losses	–	(1 637 490)
As at 30 June	3 472 670	1 588 663
Foreign currency		
(Covers effects of exchange rate movements on investments held in foreign currencies)		
Opening balance	1 987 501	Nil
Net revaluation adjustments	(1 316 563)	555 796
Transfers to earnings – realised (gains)/losses	(1 681 240)	(127 602)
– unrealised losses (end year) (Notes 1(f), 2)	1 010 302	–
As at 30 June	Nil	428 194

	1996 $'000	1997 $'000
Note 3 continued		
Investments		
(Covers changes in prices of securities in their local market)		
Opening balance	80 463	211
Net revaluation adjustments	44 952	479 515
Transfer to earnings as realised (gains)/losses	(125 204)	(245 490)
As at 30 June	211	234 236
Shares in international financial institutions (Note 9)		
Opening balance	90 769	75 510
Net revaluation adjustments	(15 259)	(7 312)
As at 30 June	75 510	68 198
Bank premises		
(Notes 1(e), 6)		
Opening balance	57 323	57 953
Net revaluation adjustments	165	13 471
Transfers to earnings as realised (gains)/losses	465	–
As at 30 June	57 953	71 424
Total Asset Revaluation Reserves		
Opening balance	6 181 165	3 606 344
Net revaluation adjustments	(1 779 144)	794 953
Transfers to earnings – realised (gains)/losses	(1 805 979)	(2 010 582)
– unrealised losses (end year) (Notes 1(f), 2)	1 010 302	–
As at 30 June	3 606 344	2 390 715

Note 4 Other liabilities – provisions (Note 1(g))

	1996 $'000	1997 $'000
Salaries and wages accrued	1 557	2 513
Provision for accrued annual leave	7 401	8 073
Provision for long service leave	20 690	23 908
Provision for post-employment benefits	35 153	42 140
Provision for workers' compensation	40	370
As at 30 June	64 841	77 004

	1996 $'000	1997 $'000

Note 5 Other liabilities – other

	1996 $'000	1997 $'000
Amounts outstanding under repurchase agreements (contract price)	960 659	1 521 497
Remittances in transit	–	173 113
Interest accrued on deposits	19 827	56 012
Other	29 753	16 737
As at 30 June	1 010 239	1 767 359

Note 6 Bank premises and other durable assets (Note 1(e))

Premises

	1996 $'000	1997 $'000
Opening balance	234 652	232 669
Net expenditure in year	4 724	(129)
	239 376	232 540
Depreciation prior to revaluation	(6 872)	(7 091)
Book valuation prior to revaluation	232 504	225 449
Net revaluation adjustments (Note 3)	165	13 471
As at 30 June	232 669	238 920

The last triennial revaluation of Bank premises was at 30 June 1995; those valuations were updated as at 30 June 1997. Amounts written off Bank premises in terms of section 78 of the Reserve Bank Act (ie depreciation) totalled $7.091 million ($6.872 million in 1995/96).

Other durable assets

	1996 $'000	1997 $'000
Opening balance	90 604	95 350
Additions less disposals at cost	4 747	9 229
Fully depreciated and disposed of	(1)	(6 741)
	95 350	97 838
Accumulated depreciation	(69 320)	(68 547)
As at 30 June	26 030	29 291

Note 7 Clearing items

This includes net amounts of $1 591 million owed to the Bank for overnight clearances of financial transactions through the clearing houses, Austraclear and Reserve Bank Information and Transfer System (RITS). (An amount of $1 372 million was owed to the Bank at 30 June 1996.)

	1996 $'000	1997 $'000

Note 8 Investments

Foreign exchange

	1996 $'000	1997 $'000
Securities sold under repurchase agreements (market value)	368 930	1 172 022
Securities held under repurchase agreements (contract price)	3 454 067	3 264 609
Other securities	11 053 978	16 957 028
Accrued interest receivable	115 838	196 465
Total	14 992 813	21 590 124

Domestic government securities

	1996 $'000	1997 $'000
Securities sold under repurchase agreements (market value)	588 570	331 912
Securities held under repurchase agreements (contract price)	1 674 687	6 107 354
Other securities	13 591 995	18 503 220
Accrued interest receivable	297 043	464 179
Total	16 152 295	25 406 665

At 30 June 1997, about 3 per cent of the Bank's foreign currency reserves (excluding gold) were hedged through interest rate futures contracts. At that same date, the Bank was contracted to sales of $11 072 million of foreign currencies and purchases of $8 407 million in respect of which settlement was not due until after balance date; these included undelivered spot transactions.

At 30 June 1997, the Bank's total gold holdings included an amount of $610 million (contract price) contracted for sale in August and September 1997. The remainder of gold holdings is valued at the end-year market price (Note 1(b)). About 89 per cent of the Bank's total gold holdings were extended as gold loans at 30 June (46 per cent at 30 June 1996).

Note 9 Other assets

	1996 $'000	1997 $'000
Shareholding in Bank for International Settlements	77 843	70 532
Remittances in transit	8 964	–
Gold coin	16 157	14 976
Other	75 522	40 200
	178 486	125 708

Note 10 Contingent liabilities and other items not included in the balance sheet

Contingencies

The Bank has a contingent liability, amounting to $62.8 million at 30 June 1997 ($67.8 million at 30 June 1996), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

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

Other items

The Reserve Bank is a defendant in civil litigation before the Federal Court relating to a loss allegedly suffered by a firm over the issue of the new series currency notes, and in two common law matters. The Bank is an appellant in a case regarding a payroll tax assessment and is a respondent or third party before the Administrative Appeals Tribunal in three matters concerning workers' compensation. All cases in which the Bank is involved are being defended, and none is judged likely to have a materially adverse effect on the activities, financial condition or operating results of the Bank.

The Bank carries its own insurance risks except where administrative costs are estimated to be excessive. Experience with self insurance claims, including workers' compensation claims from 1 May 1996, is as follows:

	Number of Claims on Bank	
	1996	**1997**
0 – $10 000	15	64
$10 001 – $20 000	–	1
$40 001 – $50 000	–	1

Note 11 Special redundancy/retirement payments

The Bank's expenses in 1996/97 include $12.9 million amounts paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 1995/96 totalled $1.3 million. Staff leaving the Bank in 1996/97 under these arrangements numbered 195 (4 in 1995/96).

Note 12 Cost of executives

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

Remuneration band	Number 1996	Number 1997
$100 000 – $109 999		1
$110 000 – $119 999	2	
$120 000 – $129 999	4	6
$130 000 – $139 999	3	5
$140 000 – $149 999	8	4
$150 000 – $159 999	1	2
$160 000 – $169 999	2	
$170 000 – $179 999	5	1
$180 000 – $189 999	1	6
$190 000 – $199 999	2	3
$200 000 – $209 999	1	1
$210 000 – $219 999	2	
$220 000 – $229 999	3	2
$230 000 – $239 999		1
$240 000 – $249 999		1
$250 000 – $259 999		1
$260 000 – $269 999		1
$300 000 – $309 999	1	
$310 000 – $319 999	2	
$340 000 – $349 999		2
$380 000 – $389 999		1
$400 000 – $409 999		1
$460 000 – $469 999	1	

Total remuneration received or due and receivable by these executives amounted to $7.435 million ($6.948 million in 1995/96). Remuneration includes cash salary, the Bank's contribution to superannuation, housing assistance, motor vehicles and health insurance and the fringe benefits tax paid or payable on these benefits. The corresponding table in previous Annual Reports was prepared on a basis which did not include fringe benefits tax paid or payable.

Note 13 Remuneration of auditor

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services to the Bank totalled $295 000 in 1996/97 ($285 750 in 1995/96). They are included in "Consultants' fees" in Note 2, which also covers legal fees and payments made to specialists for "review and advice" services.

Note 14 Related party and other disclosures

The Remuneration Tribunal determines the remuneration appropriate to the Bank's non-executive Board members. In 1996/97, payments totalled $181 804 ($199 805 in 1995/96). In addition, $39 523 was paid for the services of members of the Board of Note Printing Australia who are not employees of the Bank ($36 947 in 1995/96).

Payments made by the Bank to a prescribed superannuation fund in connection with the retirement of members of the Board totalled $367 011 in 1996/97 ($142 320 in 1995/96) and are included in staff costs in Note 2. They represent payments made in respect of executive members of the Board on the same bases as for other employees, and for non-executive members in terms of the Superannuation Guarantee Charge.

The Bank is not empowered to lend to non-executive members of the Board. Loans to the Governor and Deputy Governors are permitted only in terms of section 71 of the Reserve Bank Act; at 30 June 1997, there are three such loans (aggregating to $433 340 (two loans aggregating to $391 134 at 30 June 1996)) which have been made for homes in which the officers reside, and are on the same terms and conditions as for other officers of the Bank.

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

Superannuation funds Two superannuation funds are operated pursuant to the Reserve Bank Act: the Reserve Bank of Australia Officers' Superannuation Fund (OSF) and the Reserve Bank of Australia UK Pension Scheme. A small part of the assets of the OSF are held by the Bank as nominee for the trustees of the OSF; such assets are not included in these statements. Payment of the funds' current and future benefits is funded by member and Bank contributions and the funds' existing asset bases. The Bank's contributions to the OSF in accordance with the Reserve Bank (Officers' Superannuation) Rules, and to the UK Pension Scheme in accordance with the UK Trust Deed, are included in staff costs in Note 2. Administration and other operational costs (eg salaries, overheads, legal costs and valuation fees) incurred by the Bank for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the Bank and the funds during 1996/97.

At 30 June 1997, the OSF had a surplus of assets over accrued benefits of $160 million ($132 million at 30 June 1996). The UK Pension Scheme had a surplus equivalent to $3.0 million ($1.9 million at 30 June 1996). During 1996/97, the Bank contributed $5.3 million to the OSF and the equivalent of $0.1 million to the UK Pension Scheme.

Note 14 continued

Details of the Funds as at 30 June 1997 are as follows:

	1996 $'000	1997 $'000
Reserve Bank Officers' Superannuation Fund		
Accrued benefits	443 951	446 361
Net market value of assets	575 966	606 729
Surplus	132 015	160 368
Vested benefits	435 811	448 079
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	13 630	15 560
Net market value of assets	15 513	18 588
Surplus	1 883	3 028
Vested benefits	15 297	16 615
Total Superannuation Funds		
Accrued benefits	457 581	461 921
Net market value of assets	591 479	625 317
Surplus	133 898	163 396
Vested benefits	451 108	464 694

Accrued benefits refer to the present value of future benefits payable to current fund members, taking into account assumed future salary increases. Vested benefits are the benefits payable if all current members were to terminate their fund membership at balance date.

Note 15 Segment reporting

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

Note 16 Cash flow statement

The following cash flow statement appears as a matter of record to meet the requirements of AAS 28; in the Bank's view, it does not shed any additional light on the Bank's financial results. For the purpose of this statement, cash includes the notes and coin held at the Reserve Bank and overnight settlements system account balances with other banks.

Statement of Cash Flows for the financial year ended 30 June 1997

	1996 Inflow/(outflow) $'000	1997 Inflow/(outflow) $'000
Cash flow from operating activities		
Interest received on investments	2 238 558	2 164 899
Interest received on loans, advances, etc. and on net overnight settlements systems	22 184	7 527
Loan management reimbursement	2 851	2 698
Banking service fees received from Commonwealth	10 445	13 763
Rents received	4 424	5 721
Net payments for and proceeds from sale of investments	(893 106)	(12 214 314)
Interest paid on deposit liabilities	(195 093)	(592 125)
Staff costs	(115 250)	(120 103)
IMF Maintenance of Value adjustment	(33 512)	61 998
Premises, equipment and stores	(31 637)	(22 851)
Other	12 891	38 006
Net cash provided by operating activities	1 022 755	(10 654 781)
Cash flows from investment activities		
Net expenditure on premises and durable assets	(837)	(9 996)
Net cash used in investing activities	(837)	(9 996)
Cash flows from financing activities		
Profit payment to Commonwealth	(1 772 064)	(2 135 807)
Net movement in clearing items	574	89
Net movement in deposit liabilities	429 851	11 962 727
Net movement in Special Reserve – IMF SDRs	(36 451)	(15 470)
Net movement in loans and advances	(1 455)	(8 619)
Net movement in notes on issue	643 861	882 044
Other	(83 203)	198 392
Net cash provided by financing activities	(818 887)	10 883 356
Net increase/(decrease) in cash	1 203 031	218 579
Cash at beginning of financial year	1 248 443	1 451 474
Cash at end of financial year	1 451 474	1 670 053

Note 16 continued

Reconciliation of Cash	**1996 $'000**	**1997 $'000**
Cash	79 778	79 040
Overnight settlements system	1 371 696	1 591 013
	1 451 474	1 670 053

Reconciliation of net cash provided by operating activities to Net Profits in terms of the Reserve Bank Act

	1996 $'000	1997 $'000
Net Profits in terms of Reserve Bank Act	2 385 807	3 337 490
S78 transfers to reserves	100 000	367 247
Increase in interest payable	58 172	36 185
Increase in interest receivable	72	(135)
Gain on sale of foreign currency	(1 681 751)	(126 847)
Gain on sale of investments	(29 956)	(1 862 921)
Unrealised loss on foreign currency	1 010 302	–
Increase in income accrued on investments	145 607	(247 776)
Amounts written off Bank premises	6 872	7 091
Depreciation of durable assets	6 975	6 864
IMF Maintenance of Value adjustment (including accrual to end June)	(72 809)	42 851
Increase in accrued expenses	1 788	–
Net payments for and proceeds from sale of domestic and foreign investments	(893 106)	(12 214 314)
Other	(15 218)	(516)
Net cash provided by operating activities	1 022 755	(10 654 781)

IJ MACFARLANE
Chairman, Reserve Bank Board – 7 August 1997

INDEPENDENT AUDIT REPORT

TO THE TREASURER

Scope

I have audited the financial statements of the Reserve Bank of Australia (the Bank) for the year ended 30 June 1997. The statements comprise:

(a) balance sheet,
(b) profit and loss appropriation statement, and
(c) notes to and forming part of the financial statements.

The Bank's Board is responsible for the preparation and presentation of the financial statements and the information they contain. I have conducted an independent audit of the financial statements in order to express an opinion on them to the Treasurer.

The audit has been conducted in accordance with the Australian National Audit Office Auditing Standards, which incorporate the Australian Auditing Standards, to provide reasonable assurance as to whether the financial statements are free of material misstatement. Audit procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion whether, in all material respects, the financial statements are presented fairly in accordance with applicable Accounting Standards, other mandatory professional reporting requirements and statutory requirements so as to present a view which is consistent with my understanding of the Bank's financial position, the results of its operations and its cash flows.

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

Qualification

Note 1 to the financial statements indicates that income measurement for the period, for gold stocks and for both domestic and foreign investments, is based on *realised* gains/losses passing through the profit and loss account. Consistent with longstanding policy, unrealised gains/losses are passed to/from revaluation reserves provided market price is greater than cost. Under the *Reserve Bank Act 1959*, net profits are to be paid as dividend to the Government.

I agree that the policies adopted by the Reserve Bank, which reflect the prudent view that a central bank should make available for distribution to a central government all realised gains but not unrealised gains, are suitable to the operations of a central bank under the existing legislation.

Australian National Audit Office

GPO Box 707 CANBERRA ACT 2601 Phone (06) 203 7500 Fax 273 5355

These policies are, however, in breach of Australian Accounting Standard AAS 10 'Accounting for the Revaluation of Non-Current Assets' because of the transfer from revaluation reserves to Net Profit of realised gains relating to gold stocks and to investments in Australian government securities, and in breach of AAS 20 'Foreign Currency Translation' because of the use of a revaluation reserve to hold unrealised gains on investments in foreign government securities. For AAS 10 the amount transferred in 1996-97 was $1,811.8 million, and for AAS 20 the balance of the reserve at 30 June 1997 was $451.0 million. A detailed analysis of these transfers and reserves is at Note 3 to the accounts. If these Standards had been followed, the Bank's Net Operating Earnings, as shown in Note 2, would have been $2,343.9 million and the "Net Profits in Terms of the Reserve Bank Act" would have been $1,976.6 million.

This necessitates separate audit opinions on the fairness of the presentation of the financial statements in accordance with statutory requirements and on the fairness of the presentation in accordance with applicable Accounting Standards.

Audit Opinion

In accordance with subsection 81(2) of the Reserve Bank Act, I now report that the financial statements are in agreement with the accounts and records of the Bank and in my opinion:

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

(ii) the financial statements show fairly in accordance with statutory requirements the financial operations and cash flows for the year ended 30 June 1997 and the state of the affairs of the Bank at that date.

Qualified Audit Opinion

In my opinion, except for the effects on the financial statements of the matter referred to in the Qualification section, the financial statements present fairly, in accordance with applicable Accounting Standards and other mandatory professional reporting requirements, the financial transactions and results, and cash flows, for the year ended 30 June 1997 and the state of affairs of the Bank as at that date.

P.J. Barrett
Auditor-General

Sydney

7 August 1997

Reserve Bank Board

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

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

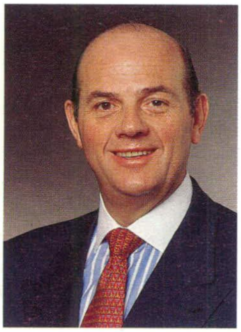
GJ Thompson
Deputy Governor since
8 February 1993
Present term expires
7 February 2000

EA Evans
Secretary to
the Treasury
Member since
10 May 1993

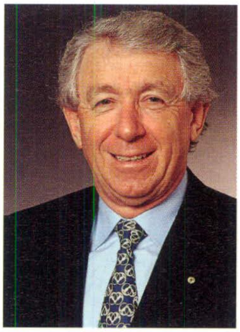
Reserve Bank Board

JL Holmes à Court, AO
Member since
19 August 1992
Present term expires
18 August 1997
Chairman,
Heytesbury Pty Ltd

AR Jackson, AO
Member since
29 January 1991
Present term expires
28 January 2001
Chairman, Australian
Trade Commission
Chairman and Chief
Executive, Austrim Limited



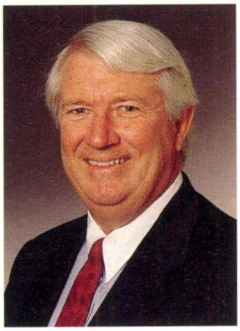
S Lew
Member since
19 August 1992
Present term expires
18 August 1997
Director, Coles Myer Ltd



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

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

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



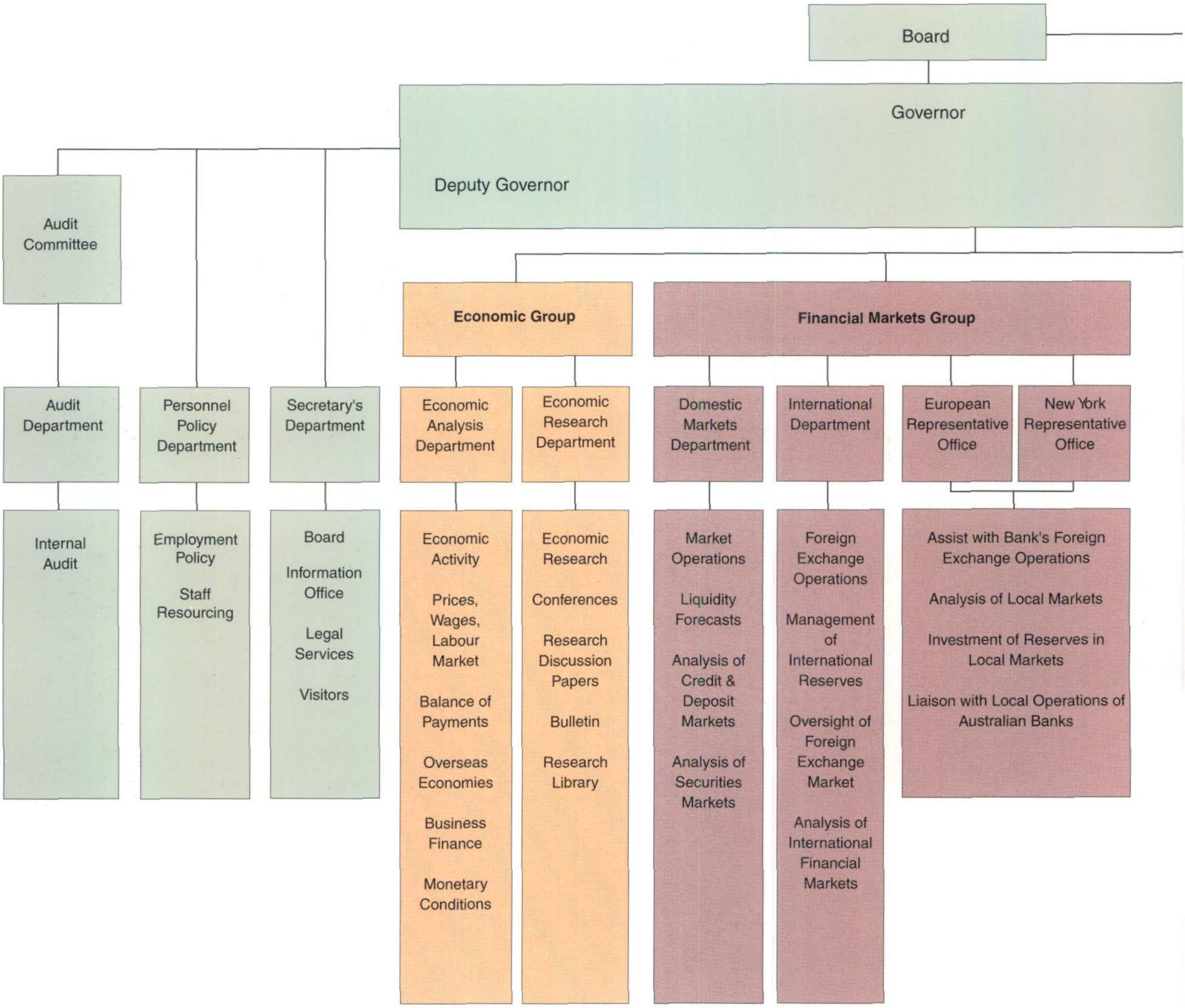
RFE Warburton
Member since
22 December 1992
Present term expires
21 December 1997
Chairman, Wool
International

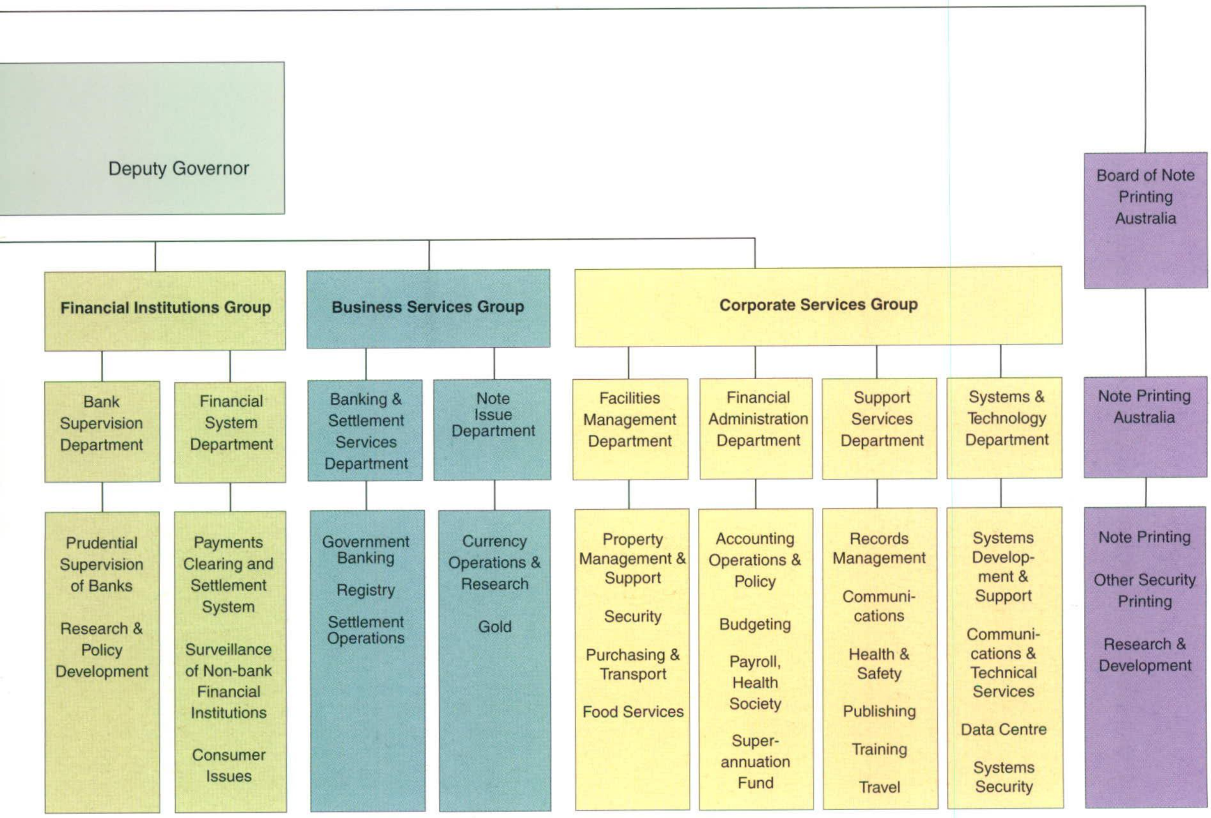
Audit Committee

The Audit Committee is chaired by SA Grenville; other members are JL Holmes à Court and two executives of the Bank – LJ Austin, Assistant Governor (Financial Institutions) and GH Board, Assistant Governor (Business Services).

The Bank's Organisation

30 June 1997




Deputy Governor
Board of Note Printing Australia
Financial Institutions Group
Business Services Group
Corporate Services Group
Bank Supervision Department
Financial System Department
Banking & Settlement Services Department
Note Issue Department
Facilities Management Department
Financial Administration Department
Support Services Department
Systems & Technology Department
Note Printing Australia
Prudential Supervision of Banks
Research & Policy Development
Payments Clearing and Settlement System
Surveillance of Non-bank Financial Institutions
Consumer Issues
Government Banking
Registry
Settlement Operations
Currency Operations & Research
Gold
Property Management & Support
Security
Purchasing & Transport
Food Services
Accounting Operations & Policy
Budgeting
Payroll, Health Society
Super-annuation Fund
Records Management
Communi-cations
Health & Safety
Publishing
Training
Travel
Systems Develop-ment & Support
Communi-cations & Technical Services
Data Centre
Systems Security
Note Printing
Other Security Printing
Research & Development

Head Office Management

Governor: Ian Macfarlane

Deputy Governors: Stephen Grenville
Graeme Thompson

Economic Group

Assistant Governor: Glenn Stevens

Economic Analysis Department
Head: Malcolm Edey
Chief Economist: David Gruen

Economic Research Department
Head: Philip Lowe

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