

---

# Statement on Monetary Policy

---

The period since mid 2003 has been marked by a significant pick-up in the global economy. The improvement has been led by the United States but also occurred in varying degrees in the other major economic regions. Associated with these developments the Australian economy has also strengthened during this period. These trends were evident at the time of the November *Statement* and have received further confirmation from the economic data in subsequent months.

The US economy has clearly gained strong momentum since around the middle of last year. Consumer spending continues to be an important driver of recovery, boosted by tax cuts, low interest rates and improving consumer confidence. At the same time, the recovery has become more broadly based over the recent period, with business investment now expanding, business confidence high and profits rebounding strongly. While conditions in the labour market have lagged behind other parts of the economy, there have been some more encouraging signs in that area recently as well. The US recovery is thus looking increasingly firmly established, and it continues to be supported by highly expansionary policy settings.

The east Asian economies have also experienced stronger conditions since mid 2003. The region is clearly benefiting from the recovery in the US but in addition is generating solid growth in domestic demand, with the Chinese economy taking on an

increasingly important role in driving growth across the region. In Japan the modest cyclical upswing over the past year appeared to gather pace towards the end of the year. Among the major economic regions of most importance to Australia, only the euro-area economy continues to under-perform, although a mild recovery now seems to be occurring there as well.

The global pick-up in demand and activity has generated strong upward pressure on a range of commodity prices over recent months, notably for oil, gold, base metals and a number of rural commodities. As discussed below, this is contributing to upward pressure on the Australian dollar. Reflecting its very rapid rate of expansion and low exchange rate, the Chinese economy now appears to be entering a period of rising inflation, albeit from a low starting point. Among the major economies, however, inflation remains subdued for the present.

Global financial markets entered 2004 in a bullish mood, with market sentiment underpinned by signs that the world economic recovery is gathering pace. Major equity markets have risen further, and appetite for risk has increased, with spreads on corporate and emerging market bonds falling to levels not seen for several years. Despite the pick-up in global growth, markets are not anticipating changes in official interest rates by the three major central banks in the months immediately ahead; however, some wording

changes in the Fed's late January announcement caused markets to believe that a tightening by the Fed may not be as far in the future as earlier thought. In Australia, the announcement in early December of the second increase in the cash rate target came as little surprise to financial markets, which had already priced in such a move.

Events in global foreign exchange markets have been dominated by the depreciation of the US dollar against all the major currencies that freely float against it. At the same time, Asian central banks have continued to intervene heavily in foreign exchange markets to prevent their currencies from appreciating against the US dollar. In this environment the Australian dollar has appreciated strongly against the US dollar and against currencies of the non-Japan Asian region over the past year, though it has been relatively stable against other major floating currencies. This has meant a significant appreciation of the Australian dollar in trade-weighted terms.

The more general forces that have influenced the exchange rate over the past year or so have been the relative strength of the Australian economy, the associated yield differential in favour of Australian dollar assets, and the continued improvement in Australia's terms of trade, which are now at their highest level in more than 25 years. On a trade-weighted basis, the exchange rate has appreciated by around 20 per cent over the past year. A significant part of that movement is a return to normal from an exceptionally low starting point. Nevertheless, the appreciation has continued to an extent that has in recent months brought the exchange rate noticeably above its long-run average. Hence the appreciation of the exchange rate is reducing the stimulus to the Australian economy from the other external forces currently at work.

In line with the improvement in global conditions, the Australian economy has picked up significantly since around the middle of last year. The national accounts recorded a strong pace of growth in the September quarter, and more recent information indicates that this strength has subsequently

been maintained. Consumer spending expanded at a pace well above average in the second half of 2003, and consumer confidence has remained high, rising further in January to its highest level since 1994. Most business surveys have continued to report above-average conditions, with the NAB survey of non-farm businesses reporting that conditions in the December quarter were at their strongest in a decade. Demand for labour has increased, with employment rising solidly over recent months and the unemployment rate continuing to trend down.

Overall, the growth of the economy has been driven by well-above-average growth in domestic spending, while the main factors that were holding back growth, particularly in the period up to around mid 2003, were the drought and the unfavourable international environment. These negative factors, however, are now being reversed. With improved rainfall in most areas, farm production is adding significantly to growth. Reflecting the strengthening international environment, Australia's export earnings have begun to increase gradually after their decline in the first half of 2003. In light of these trends and the more promising global outlook, the prospects are that the Australian economy will continue to grow at a strong pace during 2004. Exports are likely to continue their gradual recovery as a result of stronger trading-partner growth, even though progress in this area will be dampened to some extent by the higher exchange rate now prevailing, and also by capacity constraints in the resources sector. Domestic demand growth is likely to moderate a little but remain quite strong.

Australia's recent inflation performance has been marked by contrasting influences from domestic conditions and the exchange rate. In the December quarter the CPI increased by 0.5 per cent, and by 2.4 per cent over the year, down from an annual rate of around 3 per cent a year earlier. Inflation in the non-traded sector of the economy remains relatively high, at over 4 per cent, reflecting the overall strength of the domestic economy, strong demand conditions in the housing sector and continuing cost pressures in some

service industries. At the same time, the overall inflation rate is being held down by the gradual pass-through of the exchange rate appreciation, with prices of tradable items in the CPI declining slightly in recent quarters.

The experience of recent years has been that these exchange rate effects have tended to be smaller than initially expected, but even so, it is likely that the dampening effect from the exchange rate still has some way to run. As a result, inflation is likely to decline further over the coming year, and could fall as low as 1½ per cent, before returning to around 2½ per cent in 2005 and then continuing on a gradually rising trajectory. The monetary policy strategy needs to take this longer-term trajectory into account, since a continually rising exchange rate cannot be relied upon to hold inflation permanently below a rate consistent with its domestic determinants.

In its deliberations in the final months of 2003 the Board took into account the fact that policy had for some time been relatively expansionary. Interest rates were clearly below relevant averages and strong demand for credit confirmed that borrowers found these interest rates highly attractive. As economic conditions continued to strengthen, both in Australia and internationally, it became increasingly apparent that such an expansionary policy setting was no longer needed, and that it would add to medium-term inflation risks if maintained for too long a period.

An additional consideration in this environment was the risk to the economy posed by the build-up of household debt and the associated increases in house prices. While this was not the principal driver of policy, it did argue for avoiding undue delay when a case for moving to a less expansionary setting emerged on broader macroeconomic grounds. Given all these considerations, as explained in the November *Statement*, the Board decided at its November meeting to raise the cash rate by 25 basis points. At the time of its December meeting, the available information confirmed

the assessment that a less expansionary policy setting was needed, and the cash rate was therefore raised by a further 25 basis points, to 5.25 per cent.

In the period since the December meeting, the Board has continued to assess how developments in all these areas have influenced the balance of risks facing the Australian economy. The macroeconomic data becoming available since the December meeting have confirmed the assessments made at that time – namely, that the Australian economy is growing strongly, and that the global pick-up underway since mid 2003 has become more firmly established. In this environment the overall prospects are still for continued strong growth of the Australian economy in the year ahead.

Information from credit and asset markets during this period has provided some tentative indications that the pressures in these markets may be starting to ease. This has been evident both in a decline in housing loan approvals, and in a slowing of the growth in house prices and declining auction clearances. Even so, it is too early to be confident that this represents a definitive change in trend. A further development taken into account was the additional appreciation of the Australian dollar since December, including a period when it was rising particularly quickly in early January. The higher exchange rate will hold down inflation in the short term, though this effect will eventually wear off. At its February meeting the Board weighed up all of this information and its implications for the balance of risks for the economy and the medium-term inflation outlook. Although the bulk of the evidence was still suggesting that the stance of policy remained mildly accommodative, the Board decided to hold the cash rate unchanged at its February meeting while continuing to monitor how these various factors evolve over the period ahead. ✎

## International Economic Developments

Global economic conditions have continued to improve over recent months, with the run of news being generally positive. After successive upward revisions, the Consensus forecast is now for growth in the world economy to be above trend in 2004, with growth more synchronised across countries than has been the case for some time (Table 1). The pick-up in growth is particularly evident in the United States, where the expansionary macroeconomic policy settings of recent times are clearly having an effect. Conditions in east Asia have also improved, with China continuing to grow strongly and a resurgence in global ITC demand. The euro area continues to lag behind, but there too a modest pick-up in growth appears to be underway. Overall, Australia's trading partners are expected to grow by 4.1 per cent in 2004, around  $\frac{1}{2}$  a percentage point faster than the average of the past decade (Graph 1).

Graph 1



Table 1: World GDP Growth  
Year-average, per cent

	2002	2003	2004
		Consensus forecasts	
United States	2.2	3.1	4.6
Euro area	0.9	0.5	1.8
Japan	-0.4	2.3	2.1
China	8.0	9.1	8.3
Other east Asia <sup>(a)</sup>	4.4	3.4	5.1
G7 <sup>(b)</sup>	1.4	2.1	3.3
<b>Major trading partners<sup>(c)</sup></b>	<b>2.9</b>	<b>3.2</b>	<b>4.1</b>

(a) GDP weights

(b) PPP weights

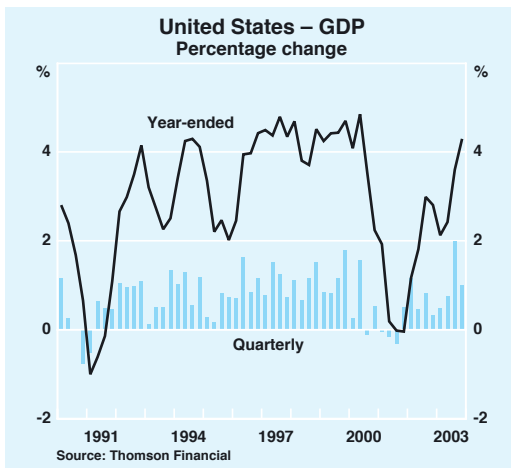
(c) Export weights

Sources: Consensus Economics; RBA

## United States

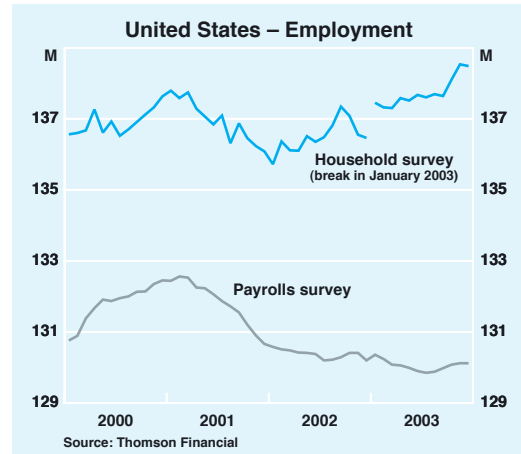
In the US, the pace of recovery from the 2001 recession picked up markedly in the second half of 2003. After recording growth of 1.3 per cent over the first half of the year, GDP rose by 3.0 per cent over the second half of the year (Graph 2). This acceleration is partly due to the very expansionary monetary and fiscal policy settings that have been in place for some time, with the federal funds rate at 1 per cent, and the federal fiscal balance swinging from a surplus of 2½ per cent of GDP in 2000 to a 3½ per cent deficit in 2003. The depreciation of the US dollar and increases in household wealth, arising from renewed strength in the stock market, have also played a role.

**Graph 2**



The main area of uncertainty is still the labour market, with the picture being clouded by conflicting data. On the one hand, the recovery in non-farm payrolls over recent months has been only modest and slower than has been the case in previous recoveries. On the other hand, new claims for unemployment benefits have declined and the household survey measure of employment has recorded reasonable gains (Graph 3). As a result, the unemployment rate, which is derived from the household survey, has fallen by about ½ a percentage point from its recent peak, although this decline is also partly explained

**Graph 3**



by a large fall in the participation rate. More forward-looking indicators, including surveys of hiring intentions, suggest that labour demand is likely to strengthen in the period ahead. Also, businesses are likely to find it increasingly difficult to continue to expand output at current rates without a pick-up in hiring.

Despite the weakness in the labour market, household spending has made a large contribution to economic growth over the past six months, with consumption increasing at an annual rate of 4.7 per cent over this period (Table 2). While tax cuts in the September quarter provided a significant boost, spending has also benefited from low mortgage interest rates and rising household wealth. The payment of tax refunds in the first half of 2004 should provide further impetus. Low interest rates have also helped residential building activity, which expanded at a rapid rate in the second half of 2003, to be 10 per cent higher than a year earlier. Forward-looking indicators suggest further growth in residential building activity in the near term, but an easing thereafter.

The improvement in the economy has led to a marked pick-up in business confidence and profits, as well as a recovery in business investment (Graph 4). Business sentiment in the manufacturing industry is at around 20-year highs, and has been accompanied by an expansion in production since mid 2003

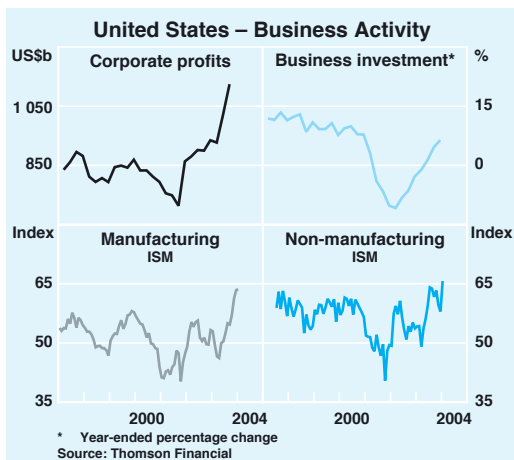
**Table 2: United States National Accounts**  
Percentage change

	September quarter 2003	December quarter 2003	Year to December 2003
Private consumption	1.7	0.6	3.8
Residential investment	5.1	2.5	10.1
Business investment	3.0	1.7	6.4
Public expenditure	0.4	0.2	2.4
Change in inventories <sup>(a)</sup>	0.0	0.1	-0.2
Net exports <sup>(a)</sup>	0.2	0.0	0.1
– Exports	2.4	4.5	6.1
– Imports	0.2	2.7	3.4
<b>GDP</b>	<b>2.0</b>	<b>1.0</b>	<b>4.3</b>

(a) Contribution to GDP growth

Source: Thomson Financial

**Graph 4**

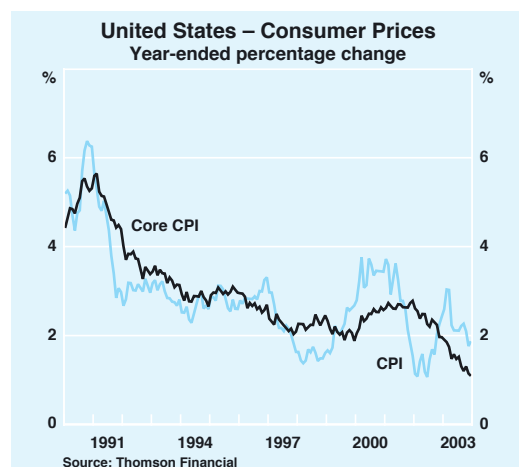


at around the same rate as occurred during the late 1990s. With a sharp rise in order backlogs and low levels of stocks, a further expansion is likely. Conditions have also improved in the services sector, with the ISM measure of sentiment at very high levels. Consistent with the strength of overall business confidence, business investment expanded by 1.7 per cent in the December quarter, to be 6.4 per cent higher than a year earlier.

Large gains in labour productivity, in combination with a slight decline in the

growth rate of labour compensation and relatively mild upstream price pressures, mean that overall inflationary pressures remain subdued. Consumer price inflation has eased in recent months, to 1.9 per cent over the year to December (Graph 5), and core consumer prices rose by just 1.1 per cent – the slowest pace in nearly 40 years. The core chain price (PCE) measure of inflation, favoured by the Federal Reserve, is even lower at around 0.7 per cent. Accordingly, the Fed has indicated that it ‘can be patient in removing its policy accommodation’.

**Graph 5**



## Asia-Pacific

### Japan

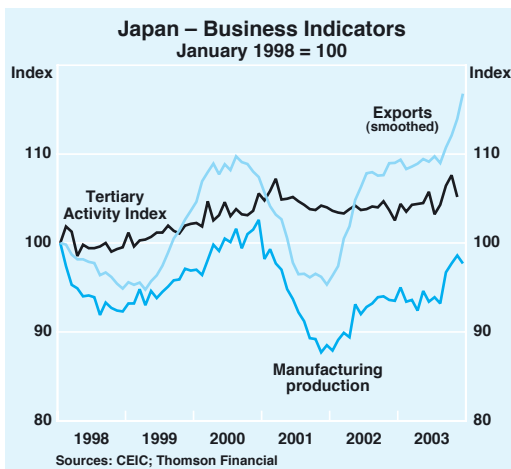
The Japanese economy has grown in each of the past six quarters, although at a relatively moderate pace so that spare capacity remains considerable. Real GDP is 1.8 per cent higher over the year to the September quarter (Graph 6), and more timely indicators point to further growth in the December quarter.

**Graph 6**



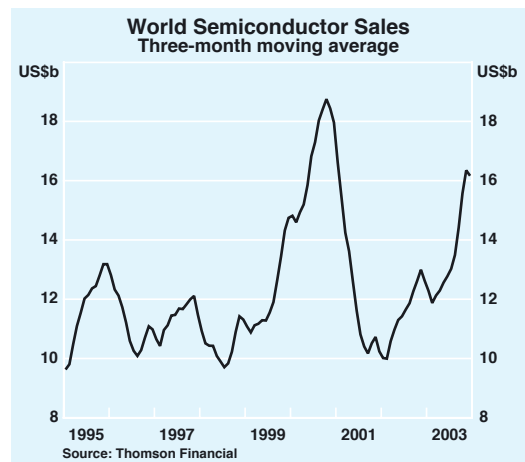
Exports, particularly to east Asia, have been a key factor behind the growth over the past year and a half, with China being an important source of demand (Graph 7). The recovery in world ITC demand has also contributed

**Graph 7**



to the strength in exports, as it has for exports from a number of countries in east Asia (Graph 8). With external demand picking up, business sentiment and profitability have also risen in Japan, and manufacturing production increased strongly over the latter part of 2003. Growth in business investment has also picked up over the year to September, and with machinery orders trending higher in late 2003, further increases in investment are likely. Better conditions are also evident in the services sector; the Tertiary Activity Index has trended higher in recent months, despite a decline in November, and is 1.4 per cent higher over the year. The brighter outlook is confirmed by a more positive tone to the Tankan and the Shoko Chukin business surveys.

**Graph 8**



In contrast to the improving conditions in the business sector, household spending has been flat over the past year, held back by a relatively subdued labour market. Employment has been broadly unchanged over this period, although with the participation rate having fallen, the unemployment rate has declined to around 5 per cent from its record high of 5½ per cent early in 2003. More recent indicators have been a little more positive, with job offers picking up, the rate of decline of wages slowing, and consumer sentiment rising.

In line with the improvement in economic conditions there has been some easing in deflationary pressures. Excluding the volatile fresh food component, consumer prices have been flat over the past year, compared with deflation rates of almost 1 per cent in recent years, although part of this improvement is attributable to increases in administered medical prices and tobacco taxes earlier in 2003. More recently, a rise in the price of rice (due to a poor harvest) has also played a role. The GDP deflator has fallen by a more sizeable 2.2 per cent over the year to the September quarter, in part reflecting difficulties in estimating the investment price deflator. This in turn implies that the estimates of real GDP growth may be overstated. Notwithstanding this measurement problem, the current conjuncture in Japan is brighter than it has been for some time.

### *East Asia*

After a difficult period in the first half of 2003, east Asian economies are growing strongly again (Table 3). The largest rebounds have been in Hong Kong, Singapore and Taiwan, all of which recorded strong growth following the SARS outbreak earlier in the year. China and India have also been growing

strongly, while the Korean economy appears to be picking up. A number of countries in the region whose currencies have been tied to the US dollar (including China, Hong Kong and Malaysia) have benefited from its decline, with real depreciations aiding export growth.

The Chinese economy continued to grow at a rapid pace over 2003, providing considerable impetus to the rest of the region, and boosting global commodity demand. China's economy grew by almost 10 per cent over the year to the December quarter, while industrial production increased by 18 per cent and investment by 23 per cent. Values of imports and exports soared, rising by around 50 per cent over the year to December as firms rushed to fill export orders ahead of the cut in export rebates on 1 January 2004 (Graph 9). While some easing may be expected in 2004, growth should still continue at a rapid rate, helped in part by a very competitive exchange rate.

Recent indicators for the rest of the region also point to continued strength in the December quarter. Industrial production and merchandise exports recorded further gains (Graph 10), following a robust September quarter result, and tourist arrivals have fully recovered from the effect of the SARS

**Table 3: East Asia GDP**  
Percentage change

	June quarter 2003	September quarter 2003	December quarter 2003	Year to latest quarter
China	–	–	–	9.9 <sup>(a)</sup>
Hong Kong	–3.7	6.4	–	3.9
India	2.1	4.0	–	8.3
Indonesia	1.9	1.0	–	3.9
Korea	–0.7	1.1	–	2.1
Malaysia	1.4	2.3	–	5.1
Philippines	0.8	2.2	1.6	4.4
Singapore	–2.5	4.1	1.9	3.7
Taiwan	–2.5	5.2	–	4.2
Thailand	0.9	2.0	–	6.5

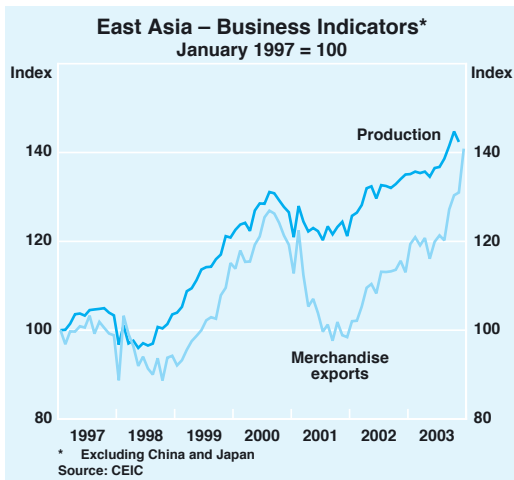
(a) Year to the December quarter

Source: CEIC

Graph 9



Graph 10



outbreak. The Korean economy seems to be recovering, with the jump up in global ITC demand sparking a resurgent export performance. Also, consumption has been a little stronger recently after being curtailed by policy measures to rein in expanding household debt, although ongoing balance sheet adjustment is likely to be a dampening influence for some time. In contrast, growth in India has remained well above trend, helped by a good monsoon season, but with stronger performance also apparent in the service and industrial sectors. Across the region, labour markets appear to have responded to improved growth and the unemployment rate has edged down in most countries.

Despite renewed strength in activity, consumer price inflation remains generally subdued in most countries across the region. An exception is China, where the inflation rate has climbed to 3.2 per cent – the fastest increase in prices since early 1997 – although this partly reflects one-off factors that saw food prices soar. While inflation of consumer prices has been low across east Asia, a number of countries have been experiencing pockets of significant asset-price inflation, associated with a pick-up in credit and money growth.

The New Zealand economy continues to grow strongly, underpinned by strong domestic demand, while net exports are still acting as a drag on growth. The overall strength of the economy has contributed to tight labour market conditions, with the unemployment rate down to 4.4 per cent, a level last seen 15 years ago. This performance has contributed to pressure on non-tradable consumer prices, which were up 4.6 per cent over the year to December. Overall CPI inflation was a more modest 1.6 per cent over the year, held down by weakness in the prices of internationally tradable goods flowing from the appreciation of the currency. Citing emerging domestic price pressures and stronger-than-expected household spending and housing market activity, the Reserve Bank of New Zealand raised its policy rate by  $\frac{1}{4}$  of a percentage point in January to  $5\frac{1}{4}$  per cent.

## Europe

A modest recovery in the euro area seems to have begun in the second half of 2003. After declining slightly over the previous three quarters, euro-area GDP rose by 0.4 per cent in the September quarter, to be 0.3 per cent higher over the year (Table 4). The pick-up was driven primarily by increased external demand while domestic demand remained weak, weighed down by flat household consumption and falling investment spending. Looking forward, euro-area exports will be helped by stronger economic growth elsewhere in the world, although the renewed appreciation of the euro in recent months will exert a dampening influence, and a sustainable

**Table 4: Europe GDP**  
Percentage change

	June quarter 2003	September quarter 2003	Year to September 2003
Euro area	-0.1	0.4	0.3
- Germany	-0.2	0.2	-0.2
- France	-0.4	0.4	-0.3
- Italy	-0.1	0.5	0.6
- Spain	0.7	0.7	2.4
- Netherlands	-0.6	0.0	-1.2
United Kingdom	0.6	0.8	2.1

Source: Thomson Financial

recovery in the euro area will require a return to growth in domestic demand.

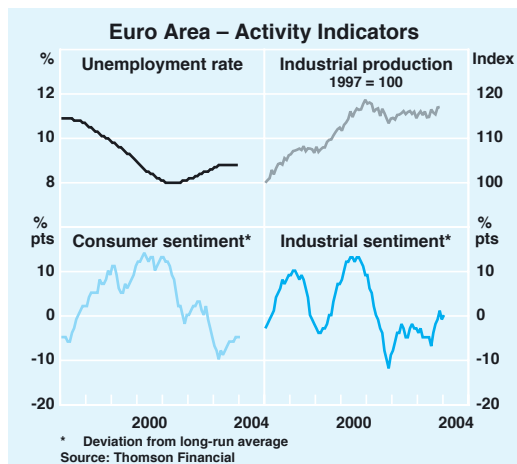
Along with better outcomes in the September quarter, indicators of confidence have picked up through the year (Graph 11). Measures of business confidence have risen steadily since mid 2003 to be back around more normal levels, and concurrently there has been a slight rise in the trend for industrial production. While consumer confidence has also been rising over this period, it remains considerably below average in most countries and there has yet to be an improvement in retail sales overall.

Headline inflation continues to hold at the ECB's 2 per cent reference value, despite the

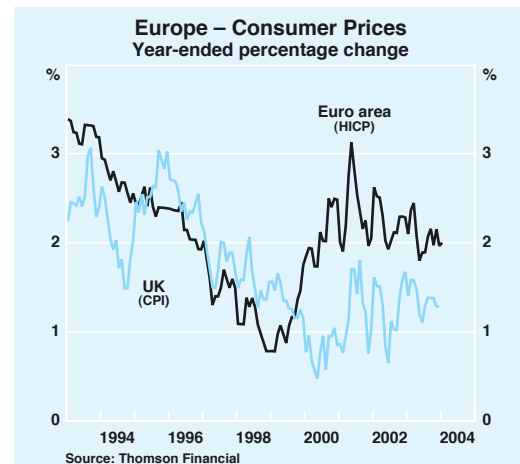
weakness in economic activity and the appreciation of the euro (Graph 12). This partly reflects the impact of higher food prices and rising indirect taxes, with underlying inflation a little under  $1\frac{3}{4}$  per cent. Also, to date, there has been only a modest slowing in labour costs from around  $3\frac{1}{2}$  per cent in 2002 to 2.9 per cent over the year to the September quarter. The ECB has left its policy rate unchanged since June 2003 at 2 per cent.

Despite rising real wages, and the weakness in activity, the unemployment rate remains steady at 8.8 per cent, well below its earlier peak of 11 per cent. Employment in the euro area as a whole has been flat over the past year, although outcomes have varied

**Graph 11**



**Graph 12**



considerably across countries, with Germany displaying notable weakness.

In contrast to the rest of Europe, the pace of growth of the United Kingdom economy has risen considerably through 2003; GDP grew by 0.9 per cent in the December quarter to be 2.5 per cent higher over the year. Household consumption continues to be a key contributor to overall growth, propelled by a relatively tight labour market and rising house prices, which are up by around 15 per cent over the past year. The Bank of England increased its policy rate by  $\frac{1}{4}$  of a percentage point in November to  $3\frac{3}{4}$  per cent, noting

the better global outlook and the unexpected strength of consumer spending and the housing market. The Bank of England has switched to targeting the harmonised Consumer Prices Index (CPI), and the inflation target was reduced from  $2\frac{1}{2}$  to 2 per cent to account for the difference between the old (retail price index) and new measures. Based on the CPI, inflation is currently 1.3 per cent (Graph 12), although the Bank of England expects upward pressure on inflation to build gradually over the medium term.

## International and Foreign Exchange Markets

Optimism in global financial markets has increased further over the past three months, as the US-led global economic recovery continues to gather pace. For a time, markets were also buoyed by the receding prospect of monetary tightening in G3 economies, although comments by the Fed in late January caused them to bring forward again their expectations of the first Fed tightening to around the middle of the year. Equity markets have rallied further, while credit spreads on bonds have narrowed. The US dollar has continued to depreciate against most of the major currencies that freely float against it. It has fallen only marginally against the Asian currencies, however, as a number of Asian central banks have continued to intervene heavily in foreign exchange markets to prevent their currencies from appreciating against the US dollar.

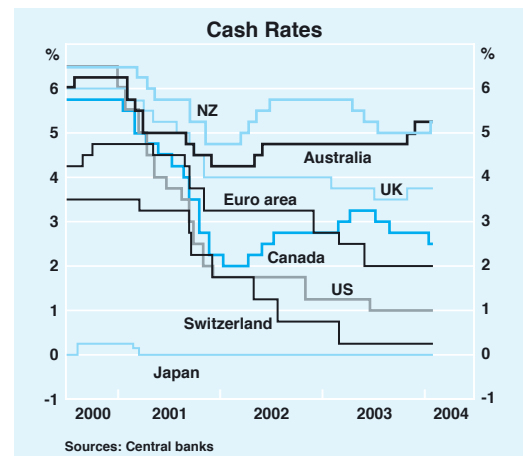
The Australian dollar has been part of the group of major floating currencies that has risen against the US dollar. It has been a little stronger than the other currencies in the group, as international investors have been attracted to the currency by the prospect of strongly rising commodity prices and the positive interest rate differential. The Reserve Bank has taken advantage of the higher exchange rate to continue to rebuild holdings of international reserves following the interventions that took place between 1997 and 2001.

### Money and bond yields

In the US, the Federal Reserve kept the fed funds rate at a 45 year low of 1.0 per cent over the second half of 2003, despite robust economic growth (Graph 13). Market expectations of monetary tightening by the Fed receded through most of December and January, particularly after the publication of weaker-than-expected employment data for December. These expectations were brought

forward again when the Fed dropped the reference to rates being on hold for a ‘considerable period’ in its late January monetary policy announcement, though financial markets are not pricing in a tightening until the middle of 2004.

**Graph 13**



Markets also expect the monetary authorities in the euro area and Japan to keep policy rates at their current low levels for some time. In the euro area the economic recovery continues to lag other regions, while some European Central Bank (ECB) officials have begun to express concern about the impact of the appreciating euro. In Japan the Bank of Japan continues to assert that it will not tighten policy until CPI inflation becomes consistently positive.

Among other central banks:

- the Bank of England increased its policy rate by 25 basis points to 3.75 per cent in November. The move was widely seen as unwinding the ‘precautionary’ cut in rates in July;
- The Reserve Bank of New Zealand raised its policy rate by 25 basis points in late January, citing domestic inflationary pressures; and

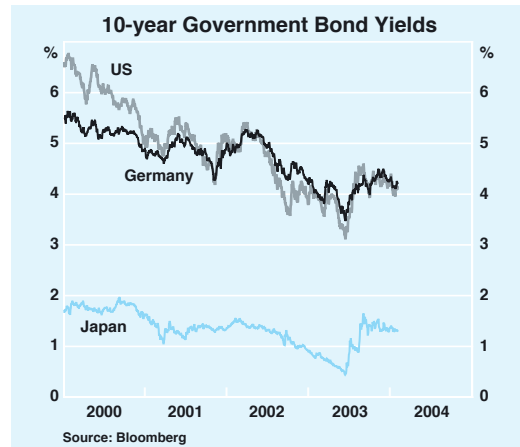
- the Bank of Canada lowered its policy rate by 25 basis points to 2.50 per cent in January after growth in economic activity in Canada had disappointed in the second half of 2003.

Asian central banks have generally held official interest rates steady over the past three months, at low levels. Together with the policy of allowing their exchange rates to fall with the US dollar, this has created very accommodative monetary conditions. In Latin America, Brazil reduced its policy rate by a further 2.5 percentage points to 16.5 per cent over November and December, taking the cumulative reduction since June 2003 to 10 percentage points. Chile's central bank lowered rates by 100 basis points to 1.75 per cent. Exchange rates in Latin America, like those in Asia, have not changed much against the US dollar in recent months, so monetary conditions there have also eased noticeably.

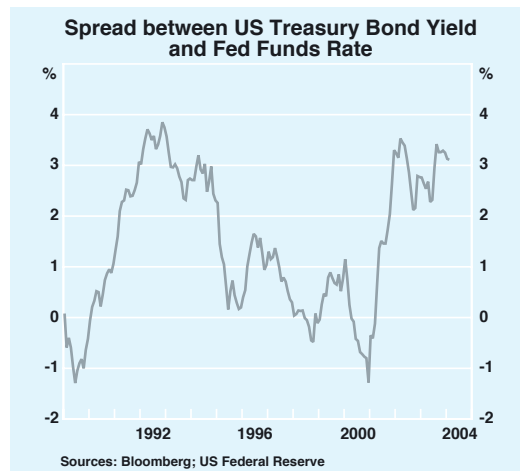
In the US, yields on 10-year Government bonds fell through most of December and January, to around 4 per cent; they had mostly been in the range of 4 $\frac{1}{4}$ –4 $\frac{1}{2}$  per cent through the second half of 2003. However, following the Fed's late January monetary policy announcement they rose to around 4.2 per cent (Graph 14). Throughout this period, continued demand for US securities from Asian central banks associated with foreign exchange intervention has served to keep downward pressure on yields. The slope of the yield curve in the US is steep by historical standards, with the spread between the Fed funds rate and 10-year bond yields at over 300 basis points, around the highest it has been since the early 1990s (Graph 15).

European yields have generally taken their lead from developments in the US over recent months, with yields on German 10-year government debt also falling toward 4 per cent in mid January, before increasing to 4.2 per cent after the Fed's late January monetary policy announcement. Yields on 10-year Japanese government debt have been relatively stable, averaging around 1.3 per cent.

Graph 14

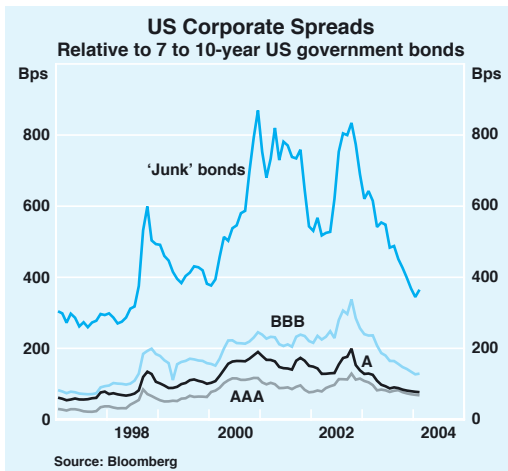


Graph 15

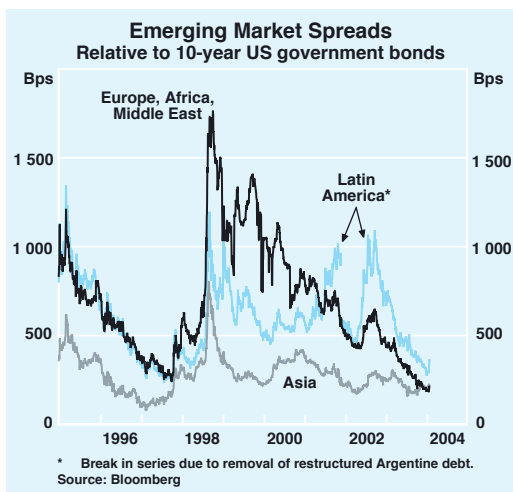


As optimism about the health of the global economy has increased, risk aversion (as observed in bond markets) has continued to decline. Both corporate and emerging market sovereign debt spreads are now quite tight compared to their historical averages. Spreads on US corporate debt have generally fallen to levels last seen before the 2001 US recession (Graph 16), while spreads on emerging market sovereign debt have returned to levels last prevailing in the months prior to the Asian crisis in 1997 (Graph 17). The reduction reflects improvements in economic prospects in emerging markets, and increased investor interest in higher-yielding debt, given the

Graph 16



Graph 17



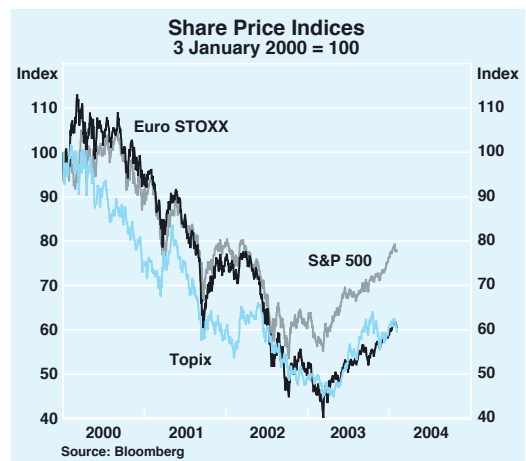
relatively low yields available in industrial countries.

The improvement in sovereign spreads in Latin America reflects an improvement in the outlook for Brazil. Standard and Poor's recently raised the ratings outlook on the country's debt following an earlier upgrade by Fitch. Spreads on European emerging market debt have also narrowed as investor concerns about political developments in Russia have subsided and the country's credit rating has been upgraded. Spreads in Asia, which were already at significantly lower levels than in other regions, have been relatively steady in recent months.

## Equity markets

Over the past year the major global share indices have staged a significant recovery (Graph 18 and Table 5), after falling for the previous three years. In the US the S&P 500 is up 7 per cent over the past three months and has gained 41 per cent from its March 2003 low. While this is a significant rebound, it is well within the historical norm following bear markets that lasted two years or longer.

Graph 18



Equity market gains have been supported by the low interest rate environment and the strong rebound in corporate profitability in the context of the recovery in US economic activity (see 'Box A: US Corporate Profits'). Analysts are expecting further strong growth in corporate earnings over the coming year.

The increases in profits and in equity prices over recent quarters have been similar, so the price-earnings ratio for the S&P 500 has been fairly steady, at a little under 30 (Graph 19).

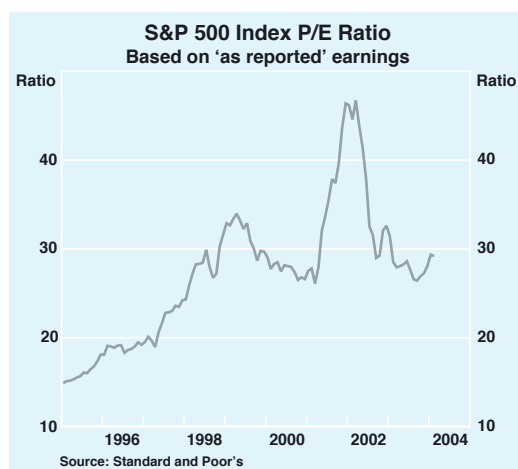
The rebound in European and Japanese equities has been similar to that seen in the US. The Euro STOXX index is up 9 per cent over the past 3 months and around 50 per cent since its March 2003 low. It is somewhat surprising that European share markets have risen as much as those in the US, given the recovery in European economic activity has not been as strong as that in the US. It continues a pattern seen since the mid 1990s where European share prices seem to mirror

**Table 5: Changes in Major Country Share Prices**  
Percentage change

	Change since 2000 peak	2002	2003	2004 to date	Change since 2003 trough
United States					
– S&P 500	–26	–23	26	2	42
– NASDAQ	–59	–32	50	3	62
Euro area					
– STOXX	–46	–35	18	3	52
United Kingdom					
– FTSE	–37	–24	14	–2	34
Japan					
– TOPIX	–41	–18	24	0	35
Canada					
– TSE 300	–25	–14	24	5	39

Source: Bloomberg

**Graph 19**



what is happening in US markets rather than developments in the local economy. The Japanese Topix is up 35 per cent from its 2003 low, and around 1 per cent over the past three months.

Stock markets in the emerging economies have also performed strongly over the past three months. Asian equity markets increased an average 7 per cent, while those in Latin America rose by 22 per cent. Average equity prices in Asia are now 52 per cent above their 2003 lows, while Latin American equity prices

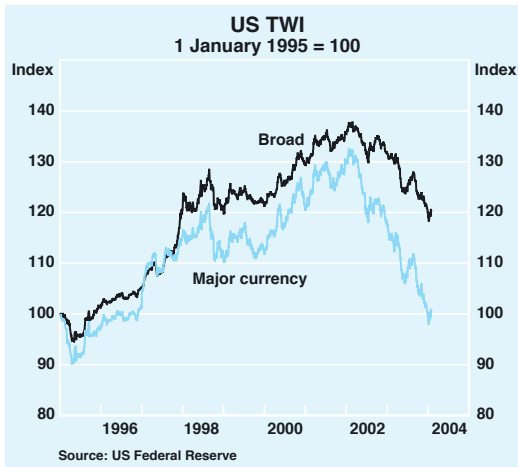
have shown the largest rises, up an average 120 per cent from recent lows. The out-performance reflects the benefits flowing to the Latin American region not only from low US interest rates (these countries have large US dollar borrowings) but also its exposure to stronger growth outcomes in the US, with strong rises in the prices of key commodity exports boosting the price of local mining companies.

### Exchange rates

The decline in the US dollar evident since early 2002 continued over the past three months (Graph 20). Since end October, the major currency trade-weighted measure of the US dollar has fallen by 4 per cent, while the broad-based measure of the TWI has fallen by 3 per cent. From its early 2002 peak, the US dollar has fallen by 24 per cent on the major currency TWI but only 13 per cent on the broader measure, which includes several currencies that are either directly linked to the US dollar or closely managed against it.

The fall of the US dollar has been particularly marked against the euro and some other European currencies. By mid January, the euro had risen to its highest level against the US dollar since its creation in 1999.

Graph 20

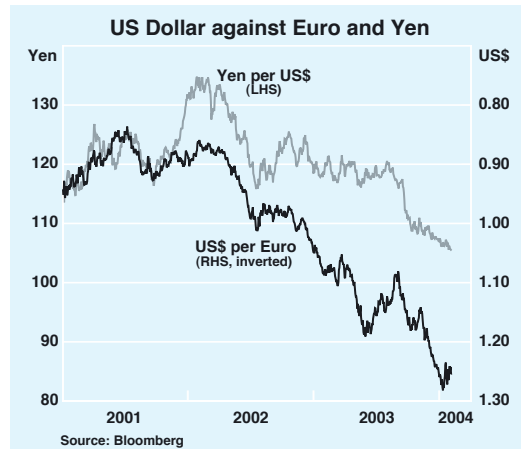


However, the continued appreciation prompted comments from several ECB officials, which seemed to slow the rise. The change to the Fed's policy statement in late January caused the US dollar to strengthen, and the euro is currently around 2 per cent below its early January peak (Graph 21).

The Japanese authorities have continued to heavily intervene in the foreign exchange market, capping the yen's rise against the US dollar over the past three months to 4 per cent, around half the rise experienced by the euro against the US dollar (Graph 21). The unprecedented scale of foreign exchange intervention saw Japan's foreign reserves increase by US\$204 billion over 2003, to a record high of US\$674 billion. The rate of intervention increased further in January.

Other Asian central banks have also continued to intervene heavily in foreign exchange markets, restricting the average Asian currency appreciation against the US dollar to less than 1 per cent since the last *Statement*. Official reserves of Asian countries (excluding Japan) rose by a further US\$40 billion during November and December, to a total of US\$1 200 billion. Asian countries (including Japan) now account for around two-thirds of the world's holdings of international reserves. South Korea took additional measures to restrict movements in its currency, implementing controls on non-deliverable forward contracts

Graph 21



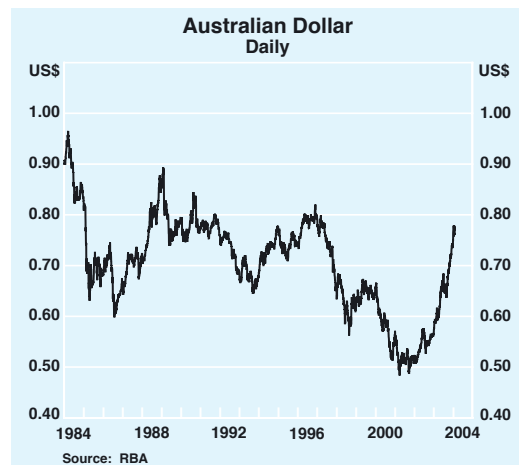
in mid January in an effort to curb speculation in the won.

Latin American currencies have on average been steady against the US dollar over the past three months.

### Australian Dollar

The big fall in the US dollar over the past year has been reflected in the bilateral AUD/USD exchange rate, which ended January at around US77 cents, a rise of 30 per cent over the past 12 months (Graph 22). This is a bigger increase than has occurred in any 12-month period since the Australian dollar was floated in 1983.

Graph 22

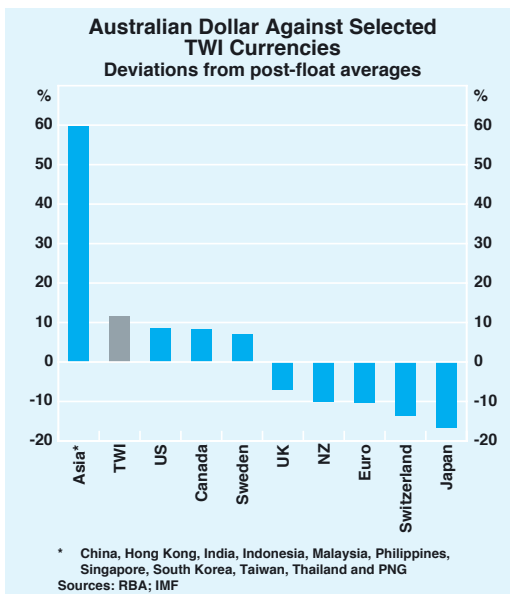


On a trade-weighted basis, the rise in the Australian dollar has also been quite substantial, since the TWI gives a high weight to a number of Asian currencies whose governments have chosen to depreciate with the US dollar. While the US dollar itself accounts for 14 per cent of the TWI, the total weight of the US dollar and those currencies which are either directly linked to it or closely managed against it is around 50 per cent. Hence, as a result first of large depreciations of a number of Asian currencies during the Asian crisis of 1997 and 1998, and then their more recent decline with the US dollar, the Australian dollar is now some 60 per cent higher than its post-float average against a group of Asian currencies (Graph 23). Against a number of other major currencies apart from the US dollar, such as the euro, pound sterling, Swiss franc and Japanese yen, on the other hand, the Australian dollar is currently below its post-float average.

which experienced a recession and a collapse of share prices in the early part of this decade. Exceptionally easy monetary policy in many of these countries meant that Australian interest rates which were, by Australian standards, quite low, were still relatively high compared with those abroad.

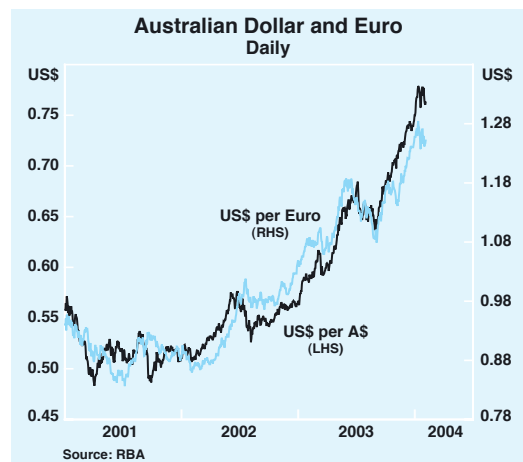
Even so, interest rate differentials do not explain much of the rise in the Australian dollar against the US dollar and the currencies of Asia over the past year. In that period, both the euro and, to a lesser extent, the yen have appreciated against the US dollar, even though European interest rates are only slightly higher than American rates, and Japanese rates are lower. While the Australian dollar has appreciated more than some of these other currencies, the additional appreciation is not that large (see Graph 24), and, as noted above, the Australian dollar remains below average levels against currencies such as the euro and yen.

Graph 23



One factor supporting the Australian dollar over the past couple of years has been that interest rates right across the yield curve in Australia, and perceived returns on other assets, have been higher than those in a number of other countries, particularly those

Graph 24



Over the most recent six months, it is likely that an increasingly important factor which has changed in favour of the Australian dollar has been a growing perception that the global economy is finally entering a period of stronger growth. Historically, it has been normal for such periods to be associated with firming commodity prices and, as a result, a tendency for international capital markets to find Australian-dollar assets attractive. This

relationship broke down in the early part of this decade, when strong global growth coincided with an unexpected weakening in the Australian dollar, but seems to have reasserted itself lately. Under these circumstances, it is not surprising that the Australian dollar has come under some upward pressure relative to most currencies, including the US dollar. What makes the current situation unusual is the degree of weakness of many currencies in Asia.

An additional factor which has, at the margin, increased the demand for Australian-dollar assets is demand from other central banks to hold Australian dollars as part

of their international reserves. Central banks in Asia have a long history of holding some Australian dollars. Recently, there has probably been a pick-up in their demand, but there has also been new demand from some central banks in other parts of the world.

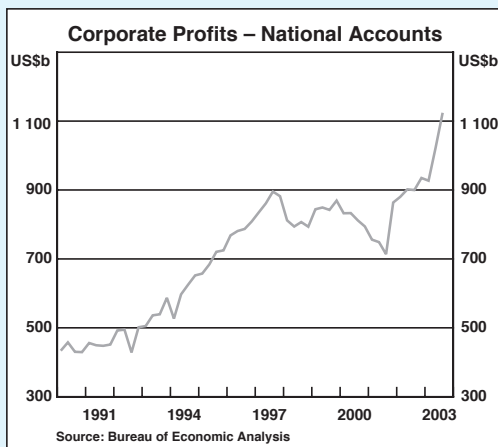
As the exchange rate has continued to rise, the Bank has continued its program of rebuilding reserves which were run down during the period between 1997–2001. At the more recent higher levels of the exchange rate, these purchases have been made at a somewhat faster rate than had been the case earlier.

## Box A: US Corporate Profits

A positive development in the global economy over the past couple of years has been the substantial rebound in US corporate profits. Although interpretation of earnings data remains difficult, due to methodological differences in the construction of the various measures (for details see Box A, *Statement on Monetary Policy*, February 2002), the rebound is evident in both national accounts and financial reporting-based estimates.

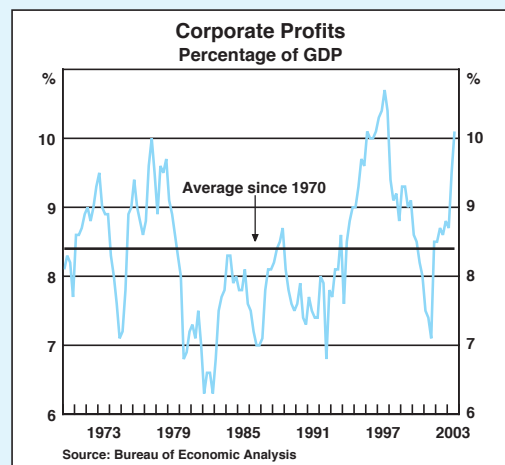
The national accounting estimate of profits remains the best available as it is consistent over time and captures all profits earned by US companies. After falling 20 per cent in the four years between September 1997 and September 2001, national accounts gross profits rebounded 58 per cent over the two years to September 2003 (Graph A1). Over the year to September last year (the most recent data available) gross profits grew by 25 per cent – a significantly stronger rise than seen in the recovery from the early-1990s recession.

**Graph A1**



As a consequence of this rise, the profit share of US output has also recovered (Graph A2). After falling to 7.1 per cent of GDP in the September quarter of 2001 (near historical lows), the profit share recovered to 10.1 per cent by the September quarter 2003 – well above the 8.4 per cent average since 1970.

**Graph A2**



The strong growth observed in the national accounting measure of profits has also been reflected in financial measures of corporate earnings such as ‘as reported’ earnings and ‘operating’ earnings (Graph A3).

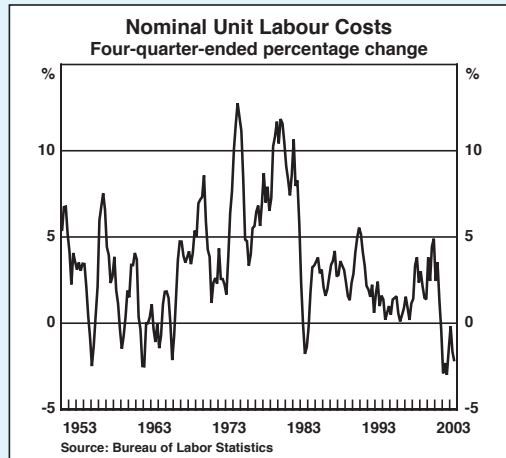
The profits recovery has been driven by continued strong productivity growth in conjunction with subdued compensation growth (due to the weak labour market), which has seen unit labour costs fall by 5 per cent since June 2001 – the largest fall on record (Graph A4).

The restoration of the profit share has been an important factor behind the recovery in investment spending seen over recent quarters. ✧

**Graph A3**



**Graph A4**



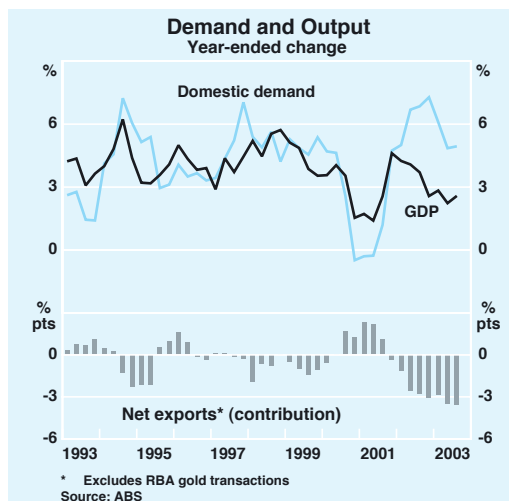
# Domestic Economic Conditions

## Introduction

The Australian economy has grown strongly since mid 2003, with forward-looking indicators pointing to continuing strength in the coming year. GDP increased by 1.2 per cent in the September quarter, and while GDP figures are not yet available for the December quarter, other data for this period are consistent with above-trend growth, and an economy entering 2004 with considerable momentum. This strong growth comes after a period of below-average outcomes, when the economy was weighed down by the effects of the drought and the weak global environment. Over the year to the September quarter, GDP expanded by 2.6 per cent (Table 6).

The past couple of years have been characterised by very strong growth in domestic demand, and this continued into the September quarter, with private final demand increasing by almost 2 per cent (Graph 25).

Graph 25



The strength has been broadly based, with consumption, dwelling investment and business investment all growing at above-trend rates and recording significant increases in the September quarter.

**Table 6: National Accounts**  
Percentage change

	September quarter 2003	Year to September quarter 2003
Private final demand <sup>(a)</sup>	1.9	5.5
– Consumption	1.7	4.4
– Dwelling investment	2.6	5.3
– Business investment <sup>(a)</sup>	2.0	11.0
Public final demand <sup>(a)</sup>	–1.1	2.8
Domestic final demand	1.2	4.9
Change in inventories <sup>(b)</sup>	0.1	1.4
Exports	1.5	–3.3
Imports	3.1	12.6
Net exports <sup>(b)</sup>	–0.5	–3.6
<b>Gross domestic product</b>	<b>1.2</b>	<b>2.6</b>
– Non-farm GDP	0.8	2.8
– Farm GDP	17.3	–4.3

(a) Excluding the effect of transfers between the private and other sectors

(b) Contribution to GDP growth

Source: ABS

In contrast to strong domestic demand, net exports have acted as a substantial drag on GDP growth over the past couple of years, although this drag has begun to diminish. According to the national accounts, exports picked up in the September quarter, while the farm sector has begun to recover from the drought in 2002/03, with farm output rising by 17 per cent in the quarter. Further increases in exports are expected in the period ahead, in line with the continuing recovery in the rural sector and the improving international economic climate. Imports are also likely to grow strongly, consistent with the robust outlook for the domestic economy and recent appreciation of the exchange rate.

### Household sector

A high rate of growth in spending by households has been an important factor sustaining the strong performance of the Australian economy. This spending has been underpinned by supportive financial conditions, with household wealth increasing at a brisk pace, driven by rapid increases in dwelling prices, and more recently, rising equity prices (Table 7). Firm growth in wages, a strong labour market, and a rebound in farm incomes have also played important roles.

The strong growth in spending is evident in the latest national accounts, which showed

an increase in consumption of 1.7 per cent in the September quarter, to be 4.4 per cent higher over the year. Growth in the quarter was broadly based across both goods and services. This strength was maintained into the December quarter, notwithstanding a modest decline in the value of retail sales in the month of December. The volume of retail trade increased by 2.6 per cent in the quarter, following similar growth in the September quarter (Graph 26). This outcome means that the increase in the volume of retail trade over the second half of 2003 was the fastest in any six-month period in at least the past 20 years. Sales of motor vehicles reached record levels in 2003, reflecting high levels of vehicle affordability, though sales have fallen in recent months.

Consistent with strong consumer spending, the Westpac-Melbourne Institute measure of consumer sentiment rose to its highest level in nine years in January. Sentiment about personal finances in the year ahead was its most positive in the 30-year history of the survey.

Household credit continues to grow rapidly, rising at an annualised rate of almost 23 per cent over the six months to December. As a result, the debt-servicing burden of households has continued its upward trend.

**Table 7: Household Assets<sup>(a)</sup>**  
September quarter 2003

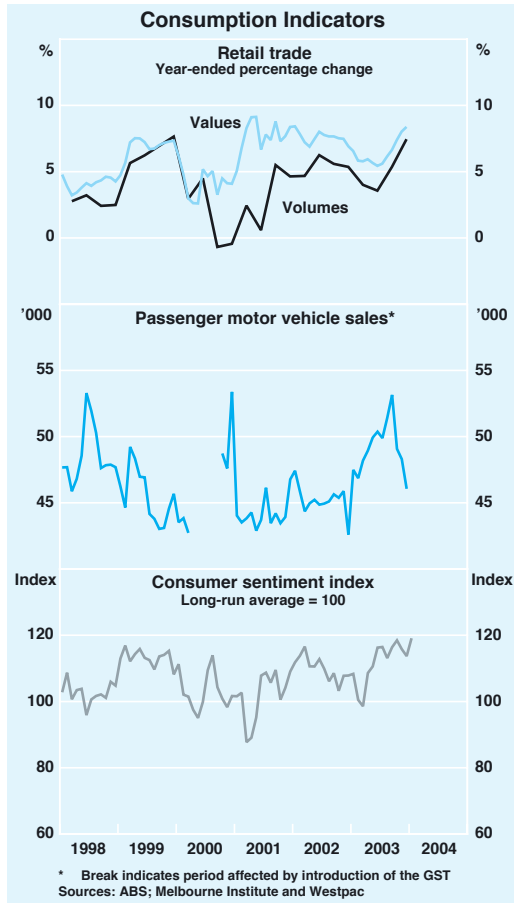
	Level \$billion	Share of total Per cent	Annual growth Per cent	
			Year to Sep 2003	Average Sep 1997 – Sep 2002
Housing	2 724	64.7	30.6	15.6
Consumer durables	143	3.4	5.1	4.4
Financial assets	1 340	31.9	9.0	6.8
– Superannuation and life offices <sup>(b)</sup>	679	16.1	8.1	6.4
– Equities and unit trusts	234	5.6	3.3	8.3
– Currency and deposits	339	8.1	10.9	7.2
– Other	88	2.1	28.3	4.6
<b>Total</b>	<b>4 207</b>	<b>100.0</b>	<b>21.9</b>	<b>11.8</b>

(a) Includes financial assets of unincorporated enterprises

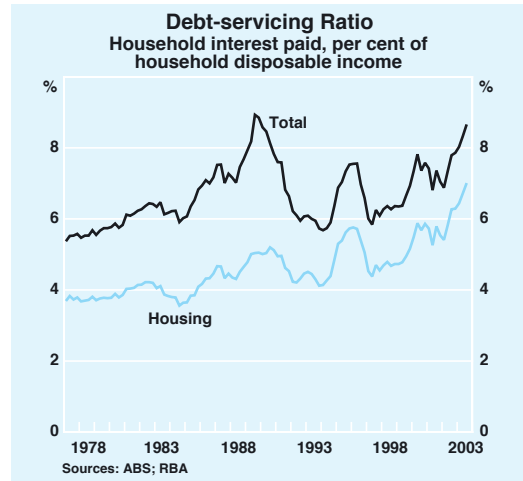
(b) Includes unfunded superannuation

Sources: ABS; RBA

Graph 26



Graph 27

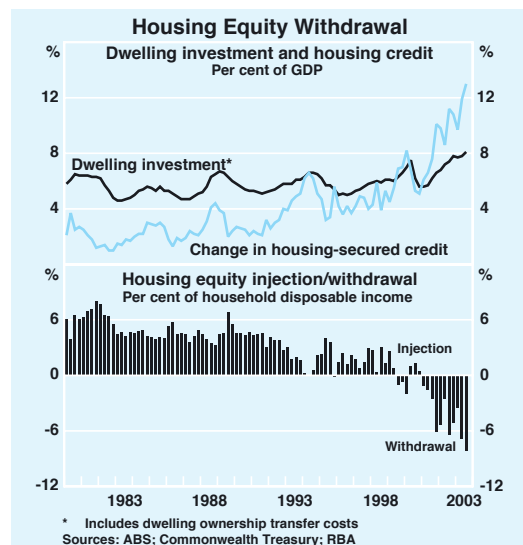


and, to some extent, the purchase of financial assets. Over the second half of last year, personal credit recorded a solid pace of growth, and revolving credit secured against residential mortgages increased at an annual rate of around 27 per cent. Moreover, in the September quarter, the expansion in housing-secured credit exceeded household dwelling investment by around 8 per cent of disposable income. This is well above the average difference in recent years, and suggests continued withdrawal of equity from the housing stock (Graph 28).

Revised data now suggest that the debt-servicing ratio reached 8.7 per cent of household disposable income in the September quarter, and it is likely to have surpassed its late-1980s peak in the December quarter (Graph 27; see 'Box B' for further discussion of the debt-servicing ratio). However, unlike in the late 1980s, the current increase in the ratio has been mainly driven by the decisions of households to increase their levels of debt, rather than by a significant and unexpected increase in interest rates. Consistent with this, indicators of financial stress for the household sector, such as loan arrears and personal bankruptcy rates, remain at relatively low levels.

The bulk of this increased borrowing has been for the purchase of housing, although it has also been used to support consumption

Graph 28



## Housing

### Activity

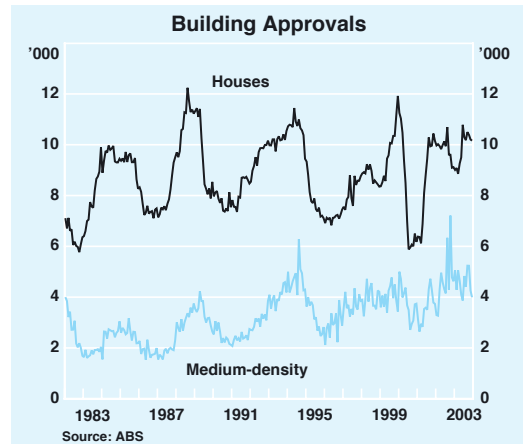
Following declines in the first half of 2003, dwelling investment rose by 2.6 per cent in the September quarter and by 5.3 per cent over the year. This is a considerably stronger outcome than expected in the early part of 2003. The strength appears to have been sustained into the final quarter of the year, and leading indicators suggest that residential building activity will remain at historically high levels as a share of GDP in early 2004. Further ahead, the fundamentals that have supported strong dwelling investment in recent years – expanding employment and relatively strong underlying demand for dwellings – are expected to remain broadly favourable for residential construction. In particular, renovation activity has been strong and is likely to remain so, with many households electing to renovate rather than move, given high house prices and transaction costs.

Building approvals data point to solid contributions to growth from new dwelling investment in the December and March quarters. Private residential building approvals rose strongly in the September quarter, especially in the medium-density sector. Although the latest readings are suggestive of some easing, largely driven by a sharp correction in medium-density approvals, total private-sector approvals remained at a high level in the December quarter as a whole and exceed the average of the past two years (Graph 29). Activity in the medium-density sector, which is expected to remain strong in the near term, is likely to tail off later in the year as the large number of apartments currently under construction are completed. More broadly, there has also been some softening in indicators reported by housing industry bodies, including contracts to build houses and display home traffic.

### Financing and prices

Lending for housing remains strong, though there are some tentative signs of a slowing recently. Over the six months to December,

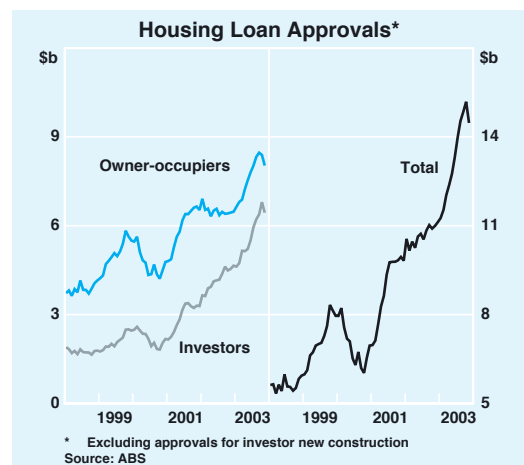
Graph 29



housing credit increased at an annualised rate of 25 per cent, compared with a rate of 22 per cent over the six months to June. Credit extended to investors has been growing particularly strongly, at an annualised rate of 33 per cent over the six months to December.

While the value of loan approvals remains very high, having increased by 32 per cent over the past year, approvals declined in November for the first time since 2002, with falls being recorded for both owner-occupiers and investors (Graph 30). Despite the recent decline, further significant falls in loan approvals will be required to return the rate of housing credit growth to a level that is sustainable in the medium term (see 'Box C' for further details).

Graph 30



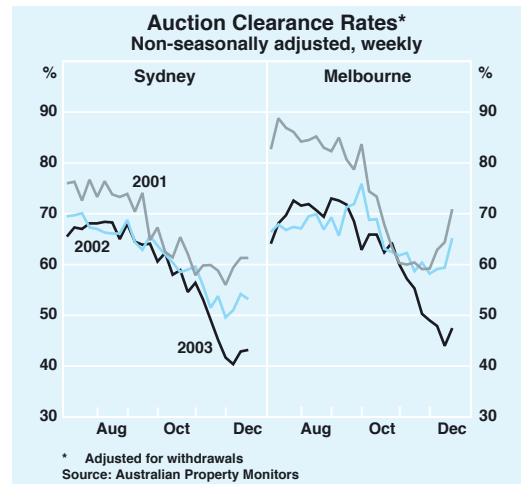
The broad national measures of house prices continue to show very strong growth. In the September quarter, both the REIA and ABS measures recorded increases in the range of 3–3½ per cent, with both series showing rises over the year of between 15 and 18 per cent (Table 8). These outcomes suggest a mild slowing in the pace of overall growth from that recorded earlier last year. The more timely, but more volatile, measure of prices provided by the CBA continues to record strong growth, with prices at the national level up by 4.4 per cent in the December quarter and by 25 per cent over the year, though the pace has come down a little from its peak in the September quarter (see ‘Box D’ for a discussion of alternative measures of house prices).

The moderation in the rate of growth in the national measures is accounted for by developments in Sydney and Melbourne. According to the REIA data, house prices in Sydney rose by 1.1 per cent in each of the June and September quarters, while the quarterly growth rate in Melbourne averaged 3 per cent over the same period, which is clearly below the peak of recent years.

More timely information on the housing market can be gained by looking at the results of auctions. These account for a significant proportion of sales in the two largest cities (up to a half in Melbourne and a quarter in

Sydney). One useful indicator is the auction clearance rate – that is, the number of properties sold as a proportion of properties offered (including those withdrawn prior to sale). An easing in demand in the housing market tends to be associated with declining clearance rates, as a result of vendors’ price expectations being unmet. This occurred in the Sydney and Melbourne markets in the final months of 2003. While there is a seasonal pattern in auction clearances, such that they tend to decline over the second half of the year, the fall in clearance rates in November and December 2003 was noticeably greater than in the previous two years (Graph 31).

Graph 31



**Table 8: House Prices**  
Percentage change

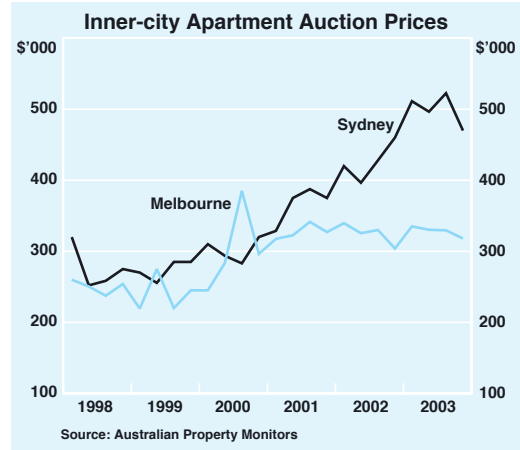
	ABS		REIA		CBA	
	Sep quarter 2003	Year to Sep quarter 2003	Sep quarter 2003	Year to Sep quarter 2003	Dec quarter 2003	Year to Dec quarter 2003
Sydney	2.2	16.5	1.1	12.7	2.2	19.0
Melbourne	1.9	11.6	2.5	11.2	7.4	25.0
Brisbane	6.4	27.8	9.0	27.5	5.3	43.9
Adelaide	4.1	22.8	2.3	25.0	-1.0	18.5
Perth	5.5	19.2	4.1	16.0	4.1	34.5
Canberra	5.4	24.4	2.0	30.7	24.7	48.1
Hobart	5.7	19.1	9.2	45.3	37.5	74.1
Australia	3.4	17.6	3.0	15.3	4.4	25.1

Sources: ABS; CBA; REIA; RBA

An easing in demand is also evident in auction prices during this period. The median prices of houses sold at auction in Sydney and Melbourne, while volatile from month to month and subject to seasonal influences, appear to have levelled out over 2003, with auction prices in December below their recent peaks (Graph 32). It is too early to tell, however, whether these auction outcomes are representative of the broader market and, given the seasonal pause in the real estate market over summer, whether they have continued into 2004.

In both cities, there is evidence of weakness in inner-city apartment prices. In Melbourne, auction prices for inner-city apartments (defined to include properties in the CBD and adjoining suburbs) have been broadly flat or declining since 2000 (Graph 33). Data on specific areas, while volatile, show that apartment prices in some localities have fallen well below their peaks. The inner-city market in aggregate has held up longer in Sydney than in Melbourne, although the latest auction price data recorded a fall. As in Melbourne, price declines have been seen in a number of

Graph 33

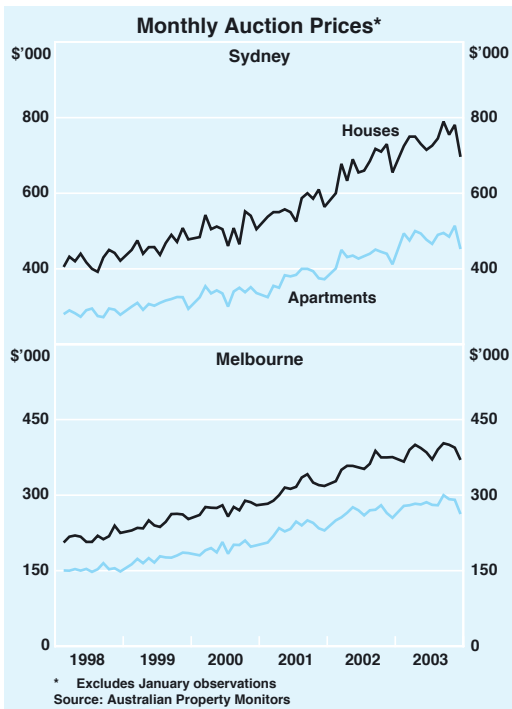


areas in inner Sydney, though at this stage they have not been as pronounced.

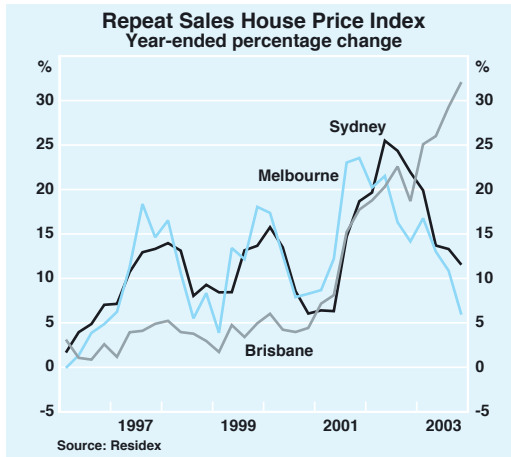
While the broad city-wide house price indices have continued to rise in Sydney and Melbourne, their rate of increase has clearly declined. In contrast, prices in other capitals have continued to rise rapidly. According to both the REIA and ABS data, prices in Adelaide, Brisbane, Canberra, Hobart and Perth have increased by around 20 per cent or more over the year. With the exception of Adelaide, the CBA data show this pattern continuing into the December quarter. Residex house price data for the December quarter, based on repeat sales of individual properties, similarly show an easing in the rate of increase of aggregate prices in Sydney and Melbourne, while the pace remains rapid in Brisbane (Graph 34).

The contrast between developments in the Sydney and Melbourne property markets and developments elsewhere is also evident in data on rental markets. Rents continue to rise at a subdued rate in Sydney and Melbourne, and have fallen in some areas. Vacancy rates in both cities have declined a little recently, but remain at high levels and could move higher as a large number of new apartments comes on stream. In contrast, rental growth remains robust in Brisbane, Adelaide and Canberra, where vacancy rates are relatively low. Despite this, rental yields even in these cities have declined

Graph 32



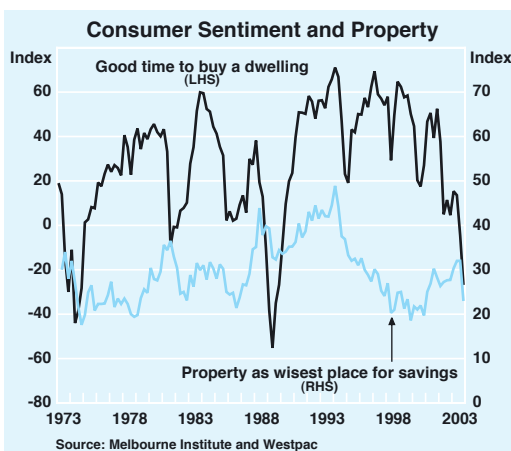
Graph 34



to levels that are low by international standards and past experience.

It remains to be seen to what extent the weakening in the inner-city property markets in Sydney and Melbourne will spread more widely across the national market. However, it is clear that sentiment about the property market has softened. According to the Westpac-Melbourne Institute survey of consumer sentiment, the number of people who view it as a good time to buy a dwelling has fallen to its lowest level since 1989 and the number reporting that property is their preferred destination for savings has fallen to its lowest level in three years (Graph 35).

Graph 35



## Business sector

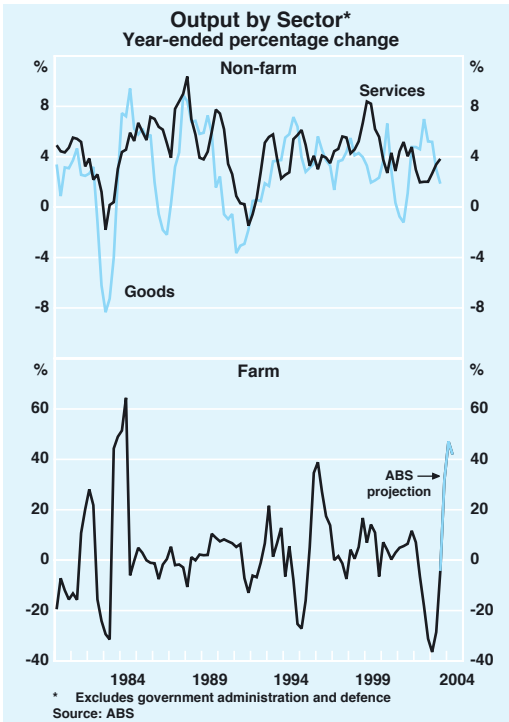
Business conditions are currently very favourable, with most industries experiencing solid growth in demand and strong profits. Business borrowing is expanding quite rapidly and measures of confidence are at a high level. The strength in demand has seen capacity utilisation increase to around the highest levels of the past decade, although a lack of capacity does not yet seem to be a significant constraint on expanding output for most industries.

Over the past year, output growth has been strongest in those industries exposed to domestic demand, such as construction and retail trade. More recently, business services and tourism-related industries have also seen stronger output growth. In contrast, growth has been weaker in export-oriented industries such as mining and parts of manufacturing, as well as in the farm sector and other industries that have been affected by the drought. These contrasts, however, are likely to diminish over the year ahead as the world economy recovers and the effects of the drought dissipate.

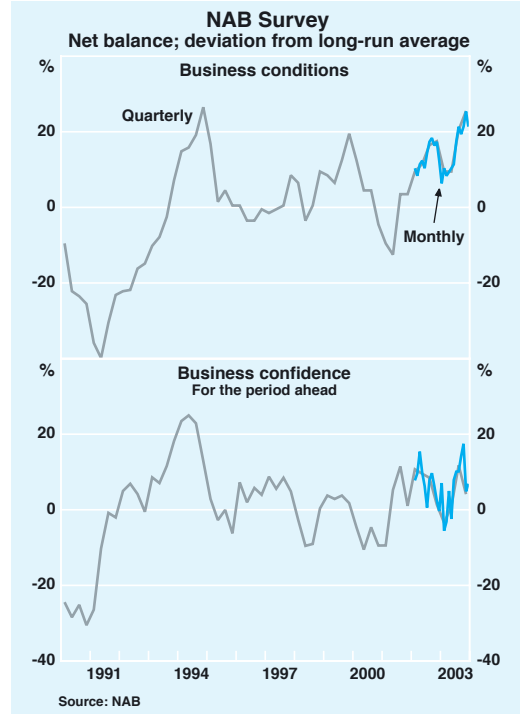
The recovery in farm output is now clearly underway, with a strong increase recorded in the September quarter and the ABS projecting growth of more than 40 per cent over the year to the June quarter 2004 (Graph 36). Consistent with this, the latest Rabobank survey suggests that expected business conditions in the farm sector are close to their pre-drought levels, despite concerns about the exchange rate appreciation. The recovery is likely to be driven almost entirely by cropping industries. The prospects for irrigated crop production and livestock industries are more subdued, with stored water levels still low in some states.

Conditions in the mining industry also look to be improving as the global recovery has gathered pace and commodity prices have risen strongly (see chapter on 'Balance of Payments' for more detail). One offset to this brighter outlook, though, is the appreciation of the exchange rate, which reduces the Australian dollar proceeds of foreign-currency export receipts. The appreciation is also having

**Graph 36**



**Graph 37**



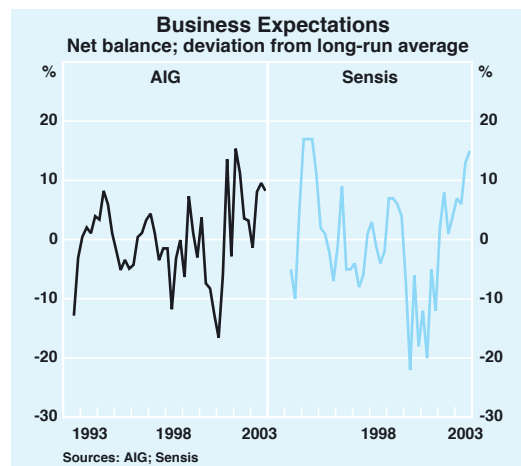
an impact on firms in the manufacturing sector. A recent AIG survey identified the movement of the currency as a significant factor inhibiting export earnings and intensifying competitive pressures from imports, with many firms reporting lower profits as a result.

Overall, business surveys are consistent with strong growth in demand. The NAB survey of the non-farm sector reported that business conditions in the December quarter improved, to be at their most favourable level since the peak reached in 1994 (Graph 37). In contrast to earlier in the year, the improvement in conditions has encompassed sectors linked to the international economy and agribusiness, while business conditions in residential construction and related services have eased a little from recent peaks. A range of other business surveys are also showing current business conditions to be well above long-run average levels.

Business confidence also appears to be quite strong, although some firms have recently become more cautious about the outlook. The

NAB survey suggests that business confidence remains above average, although it declined in the December quarter. The December quarter AIG survey of manufacturing, the ACCI survey and the Sensis survey of small businesses also reported above-average levels of confidence for the period ahead (Graph 38).

**Graph 38**



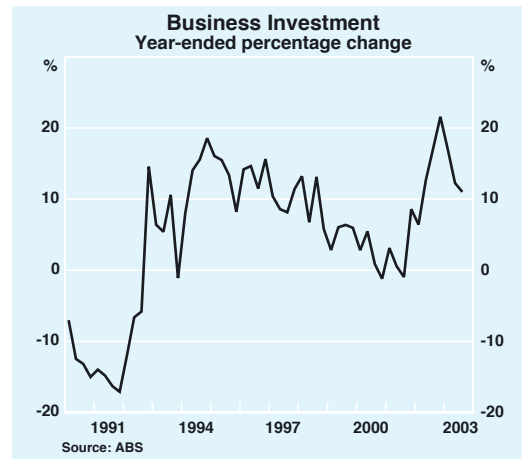
Corporate profit growth was robust over the first three quarters of 2003, with profits increasing at an annualised rate of 6½–7 per cent. Much of the strength was in sectors exposed to the domestic economy, such as retail and wholesale trade. Profitability has recovered in the manufacturing and property & business services sectors, in line with improved business sentiment, and farm profitability has experienced a sharp turnaround as the effects of the drought recede, while profitability in the mining sector remains relatively low. Looking forward, responses to the NAB business survey suggest continued solid growth in non-farm profits.

Firms have ready access to a range of funding sources to finance investment. Resilient profit growth has provided a strong base of internal funds. Moreover, in line with recovering investor sentiment, equity raisings by non-financial companies have risen strongly in recent months, following an extended period of weakness. Borrowing from financial intermediaries has also picked up strongly over recent months, growing at an annual rate of 13 per cent over the second half of 2003. Despite this, corporate gearing ratios remain low by historical standards.

The current strength in business investment appears likely to continue, supported by high levels of capacity utilisation and the healthy financial position of businesses. Business investment grew by 2 per cent in the September quarter and by 11 per cent over the year, though the pace of growth eased back from its late 2002 peak of just over 20 per cent (Graph 39). Consistent with strong capital imports, machinery and equipment investment rose by almost 4 per cent in the quarter. In contrast, the national accounts measure of buildings and structures investment fell by a surprisingly large 3.8 per cent in the September quarter, driven by a large reversal in the previously robust structures component. More recent data on construction activity published by the ABS suggest, however, that this component of investment will be revised up.

Indicators of investment intentions suggest that growth in business investment in the first

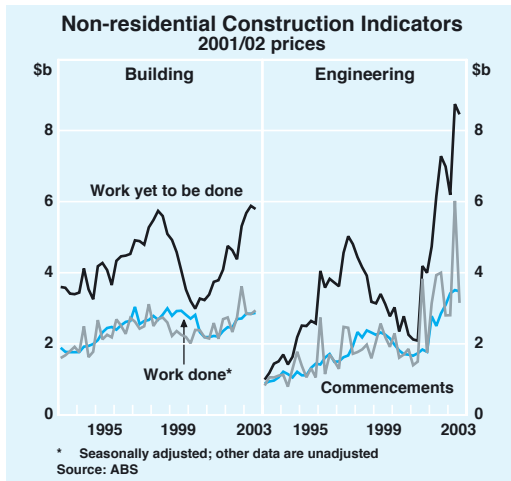
Graph 39



half of 2004 will remain healthy, although intentions have been downgraded slightly in the past three months. Assuming a five-year average realisation ratio, the September quarter ABS capital expenditure (Capex) survey implies a 4.6 per cent fall in nominal investment in machinery and equipment in 2003/04. However, the appreciation of the Australian dollar has reduced prices of imported capital equipment markedly, so this result points to solid growth in real terms. The mining and manufacturing sectors both upgraded their expenditure plans in the September quarter, and are expected to be the main sources of growth in nominal equipment investment in 2003/04, while other sectors tended to downgrade expectations. Survey and other evidence also indicate a rebound in investment expenditure in the farm sector, to be close to their pre-drought levels.

Forward-looking indicators of buildings and structures investment suggest that activity will pick up significantly in coming quarters, with construction work done likely to rebound strongly following the fall in activity in the September quarter (Graph 40). Despite the recent deferral and cancellation of a number of projects, the outlook for engineering construction activity remains strong, with the large amount of infrastructure and resource-related work still to be completed likely to sustain growth in activity over most

Graph 40



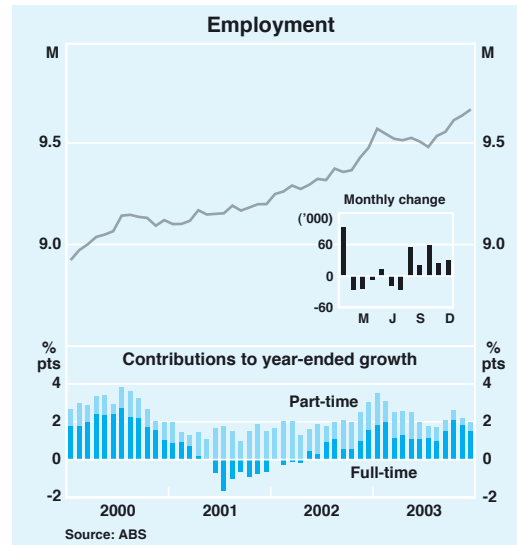
of 2004. Similarly, business surveys and a large stock of work in the pipeline suggest a strong outlook for non-residential building activity in the near term. Further ahead, the outlook is more uncertain, with the Access Economics *Investment Monitor* indicating a fall in the number of building projects proceeding from the planning stages.

### Labour market

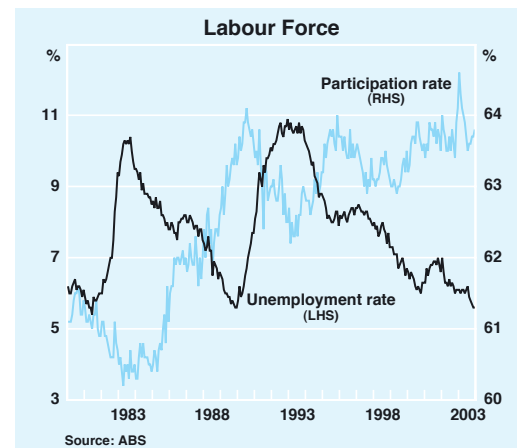
Employment has continued to grow strongly, with the average level of employment in the three months to December up by around 1.2 per cent on the previous three months and 2.3 per cent on levels a year earlier (Graph 41). Much of this growth has been in full-time employment, which has grown at above-trend rates over the past year. Part-time employment has also continued to grow, but at rates noticeably slower than the average of recent years.

The strong employment growth has lowered the unemployment rate to levels not recorded since the late 1980s. At the end of 2003, the unemployment rate stood at 5.6 per cent,  $\frac{1}{2}$  a percentage point lower than its level a year earlier (Graph 42). While the measured participation rate has been quite volatile over the past year, in recent months it has stabilised at around  $63\frac{3}{4}$  per cent, a little above the average of the past decade.

Graph 41



Graph 42



The gains in employment have been widespread, with the highest rates of increase occurring in Queensland and Tasmania. These states also recorded the largest falls in their unemployment rates over the past year (Table 9), with the Tasmanian unemployment rate converging noticeably on the national average.

Employment in the construction industry has continued to expand rapidly over the past year, in line with high levels of construction activity (Table 10). Service-

**Table 9: Labour Market by State**  
December quarter, per cent

	Employment growth		Unemployment rate	
	Quarterly	Year-ended	2003	2002
NSW	1.4	2.0	5.4	5.8
Victoria	0.9	1.5	5.4	5.7
Queensland	1.9	4.4	6.0	7.0
WA	1.3	1.9	6.0	6.1
SA	-0.5	2.0	6.4	6.0
Tasmania	0.6	4.6	6.9	8.5
Australia	1.2	2.3	5.6	6.1

Source: ABS

**Table 10: Employment by Industry**  
Per cent

Industries	Share of total 2003	Growth over year to December quarter 2003
Agriculture	3.9	1.7
Construction	8.1	10.1
Manufacturing	11.5	-7.9
Wholesale and retail trade	20.2	2.1
Health, education and community services	16.9	1.9
Other services	28.6	3.2
Other <sup>(a)</sup>	10.8	6.5
<b>Total</b>	<b>100.0</b>	<b>2.6</b>

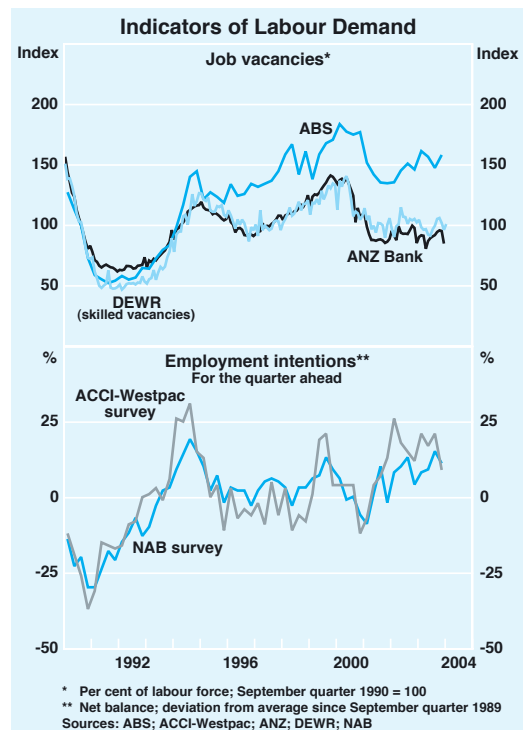
(a) Utilities, mining, transport and storage and public administration and defence

Source: ABS

sector employment has also risen strongly, and agricultural employment is up, following the easing of drought conditions in some areas. By contrast, employment in manufacturing has declined.

Forward-looking indicators generally suggest a continuation of strong, albeit slightly slower, employment growth (Graph 43). Major surveys of employment intentions are above their long-term averages, although the latest readings from the NAB and ACCI-

**Graph 43**



Westpac surveys have eased. In the December quarter, the ABS measure of job vacancies rose by 7.9 per cent and modest gains were evident in the print-based vacancy measures published by the ANZ Bank and the DEWR, with the DEWR series edging up further in January.

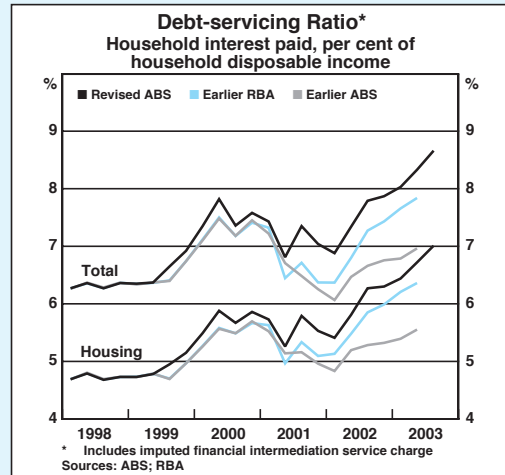
## Box B: Measuring Household Debt-servicing Costs – An Update

The primary measure of the household sector's debt-servicing burden is the ratio of aggregate interest payments to disposable income.<sup>1</sup>

In calculating this ratio over the past year, the RBA has been making two adjustments to the aggregate interest payments series published by the ABS. As discussed in Box C in the May 2003 *Statement*, the first adjustment has been to add back to the published series the imputed financial intermediation service charge deducted by the ABS. The second has been to adjust interest payments upwards from the December quarter 2000 onwards to correct for the fact that movements in the average interest rate implied by the published series appeared inconsistent with movements in market rates. Over 2002/03, this second adjustment increased the total debt-servicing ratio by around  $\frac{3}{4}$  of a percentage point, shifting the profile of the ratio from being relatively flat, to one that was trending upwards.

The ABS has recently reviewed the interest paid series and published substantial revisions in the September quarter 2003 national accounts (Graph B1). These revisions reflect the incorporation of new data from financial institutions. The new estimates confirm the upward trend in the debt-servicing ratio over recent years evident in the earlier RBA estimates, with movements in the implied average interest rate now consistent with those in market rates. As a result, the RBA will no longer make the second adjustment to the ABS's figures. It will however continue to make the adjustment for the imputed financial intermediation service charge, given that the

Graph B1



published data still exclude that part of interest payments attributed to this charge. The financial intermediation service charge currently increases the ratio by around 1.4 percentage points, of which around half is attributable to housing-related debt.

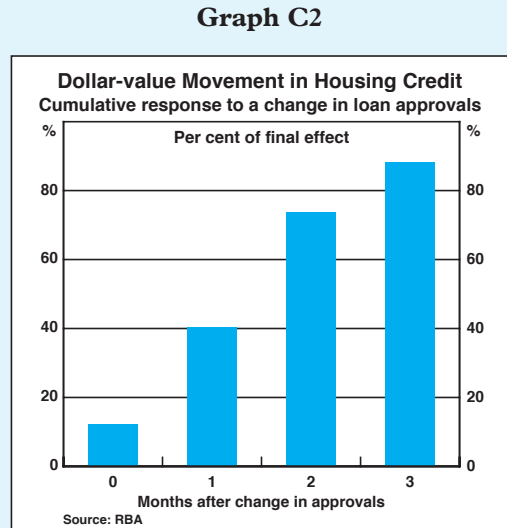
The revised data including the financial intermediation service charge suggest a slightly higher debt-servicing ratio over recent years than that indicated by the RBA's earlier estimates, with the revised ratio averaging  $\frac{1}{4}$ – $\frac{1}{2}$  of a percentage point higher over recent quarters. The implied average interest rate on housing debt in the September quarter 2003 was around  $6\frac{1}{2}$  per cent, around the same level as the banks' standard variable lending rate at the time. The overall implied interest rate on household debt is slightly higher, at around 7 per cent, reflecting relatively higher interest rates on households' consumer debt. ▽

1. For a further discussion of the household debt-servicing ratio see 'Do Australian Households Borrow Too Much?', RBA *Bulletin*, April 2003.

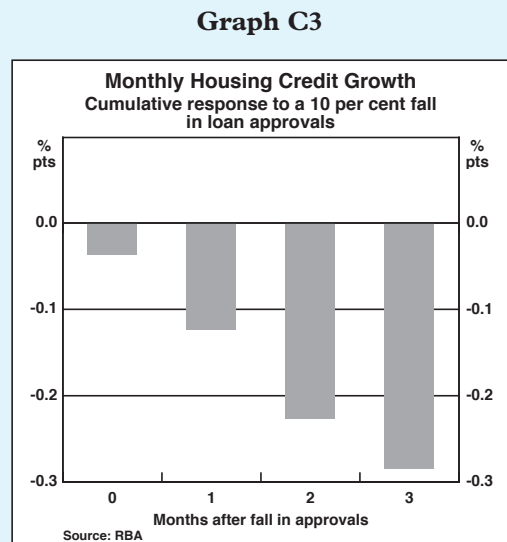
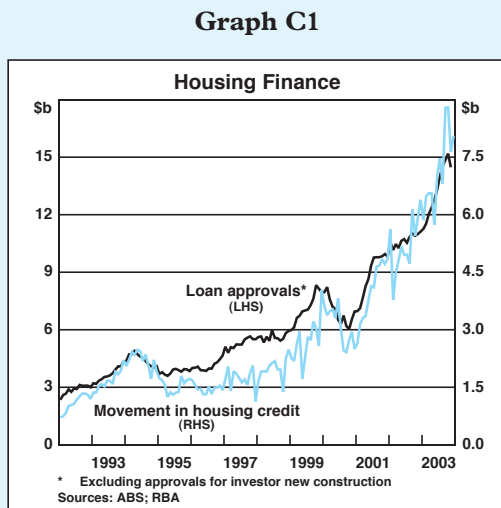
## Box C: Housing Loan Approvals and Housing Credit Growth

The value of housing loan approvals and movements in housing credit outstanding track one another closely (Graph C1), although the value of approvals is typically at least double the dollar value of the movement in credit, due to repayments of principal and drawdowns of existing facilities.<sup>1</sup> Typically there is a 6–10 week delay between when a loan approval is recorded and property settlement takes place, so movements in credit lag the level of approvals. Indeed, empirical work suggests that it can take up to four months for the effect of a change in the level of approvals to fully flow through into a change in the movement in credit, with around 40 per cent of the effect occurring within one month, and 75 per cent within two months (Graph C2).

Given the relationship between the level of housing loan approvals and the dollar-value movement in housing credit, it is possible to derive a relationship between the *percentage change* in approvals and the *growth*



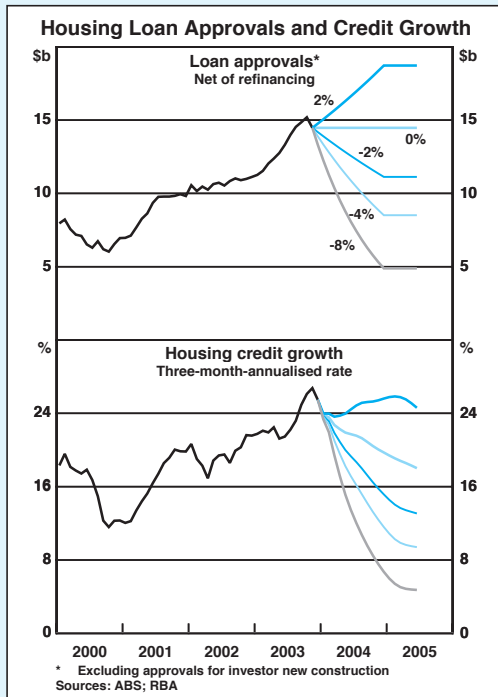
rate of credit. Again, empirical work suggests that, at current levels of approvals and credit growth, a once-only 10 per cent decline in approvals would reduce the monthly rate of credit growth by around 0.3 of a percentage point after about three months (Graph C3).<sup>2</sup>



1. Including redraws of excess repayments and drawdowns of home-equity loans.
2. The growth rate of credit would, however, continue falling over time due to the base effect from the rising level of the outstanding stock of credit. For any given growth rate of credit to be maintained, the level of approvals needs to increase over time to offset this effect.

To put these numbers into perspective it is useful to consider the likely impact on credit growth of the 5 per cent decline in the value of housing loan approvals recorded in November 2003. Assuming that approvals remain at their new lower level, housing credit growth would be expected to slow from a three-month-annualised rate of 25 per cent to a still rapid rate of around 18 per cent by mid 2005 (Graph C4).

**Graph C4**



It is also useful to look at the effect on credit growth of a number of other scenarios for loan approvals. If, for example, approvals were to fall by 2 per cent each month until the end of 2004, and remain constant thereafter, the rate of housing credit growth would be expected to slow to a three-month-annualised rate of 13 per cent by mid 2005. Under this scenario, approvals would fall by a cumulative 27 per cent from their October 2003 peak, to around the level recorded in early 2003.

If instead approvals were to fall by 4 per cent per month, housing credit growth would be expected to slow to a three-month-annualised rate of 9 per cent by mid 2005. Under this scenario, the cumulative decline in approvals would be 44 per cent, which, while large, would not be inconsistent with declines in previous cycles. If instead, however, approvals were to fall by 8 per cent per month until end 2004, housing credit growth would be expected to slow to around 5 per cent by mid 2005. Such a large decline in approvals is clearly outside the range of previous experience.

Finally, rather than falling, if the value of loan approvals was to grow by 2 per cent per month from the November 2003 level until the end of 2004, housing credit growth would be expected to remain at around its current rate of close to 25 per cent. ↗

## Box D: House Price Measures

At the national level there are three main sources of data on house prices: the ABS, the Real Estate Institute of Australia (REIA) and the Commonwealth Bank (CBA). All three sources provide price measures for the capital cities. The ABS also publishes an Australia-wide measure, while the RBA constructs national measures using the REIA and CBA city-based data, using the number of capital-city households as weights.

All three series are based on transaction prices (Graph D1). They are published quarterly, although some commercial data providers produce monthly equivalents for their clients. Of these three measures only the ABS series attempts to control for changes in the geographic composition of houses that are sold during the quarter. None of these three price indices adjusts for improvement in the average quality of houses through time.

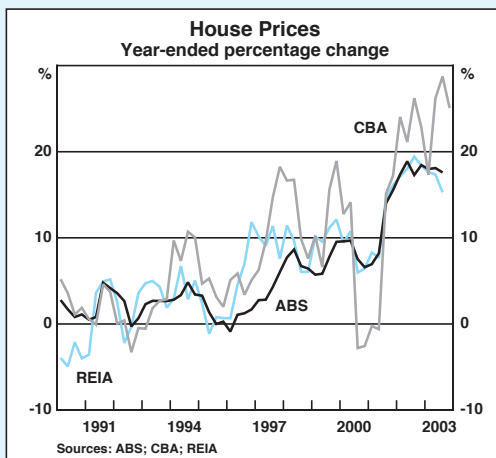
Residex, a commercial provider of house price data, constructs series for Sydney, Melbourne and Brisbane using data from repeat sales of individual properties. These repeat-sales indices control for compositional shifts in the stock of houses

sold in each quarter, and changes in the average quality of newer homes compared with older homes. They can therefore be useful for understanding longer-term trends. However, the series cannot adjust for the effects of renovations on the quality and price of existing homes, and recent observations can be subject to significant revisions.

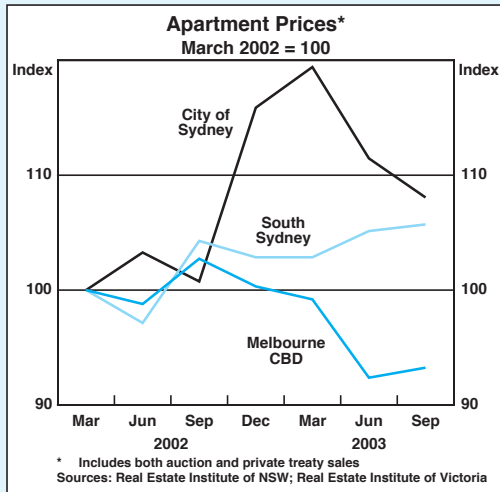
The ABS, Residex and REIA series record prices at settlement and are based on data provided to the land titles offices in each state, except in Victoria where the ABS and REIA use surveys of real estate agents. In contrast, the CBA series is derived from house purchases made by CBA home loan customers, with prices typically being recorded close to the date at which contracts are exchanged. It is available earlier than the other series, although given the smaller samples involved, it tends to be relatively volatile. Currently all three of the national series show prices rising at a relatively fast pace over the latest year for which data are available, though they also show that the rates of increase have come down from their most recent peaks.

Given that price movements can vary significantly across markets, it is also important to monitor price indices for specific geographical areas. Over the past year or so, particular attention has been paid to the inner-city apartment markets. Data for both private treaty and auction prices are available from a number of industry and commercial providers, although care needs to be exercised in interpreting movements because the samples can be quite small. While these data at times show marked differences across areas, they suggest that prices in a number of inner-city localities, including Melbourne's CBD and the City of Sydney, had come off their peaks by the September quarter (Graph D2). Whether this portends a lasting change in trend is unclear.

**Graph D1**



**Graph D2**



As noted above, most house price data are obtained from land titles offices, with prices recorded as at the time of settlement. The use of data from land titles offices means that there are significant lags between the time when sales occur and when a reliable median

of those prices can be estimated. This reflects the typical lag of at least six weeks between sale and settlement, as well as, in some states, significant reporting and processing lags.

A more timely indicator of price movements is provided by auction results, which are available from a number of commercial data providers soon after the auction takes place. These measures are most useful for Melbourne and Sydney markets, where auctions can account for up to a half and a quarter of all sales respectively. As discussed in the body of this *Statement*, recent auction data suggest that prices were relatively flat over the final months of 2003. In interpreting these data, however, it should be kept in mind that the samples are considerably smaller than those used to construct the quarterly price series discussed above, and that auctions tend to be concentrated in the higher-value end of the market. In Sydney, for example, the median auction price is close to double the median private treaty price. ↗

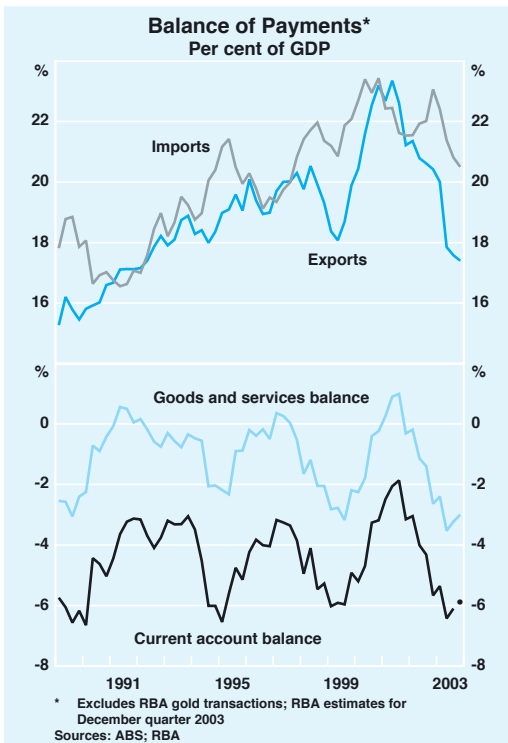
# Balance of Payments

The second half of 2003 saw a partial reversal of factors that had held back Australia's trade performance over the past couple of years. Over that period, slow growth in world demand and the effects of the drought had resulted in weak export outcomes. This, together with rapid growth in imports flowing from strong domestic demand, led to a substantial widening of the deficit on trade in goods and services (Graph 44). Since mid 2003, however, global demand has picked up and drought conditions have eased, which has resulted in a recovery in some components of the volume of exports. The global recovery has also boosted commodity prices, with the terms of trade increasing to levels not seen for the past quarter-century. These developments have led to a narrowing in the trade deficit from

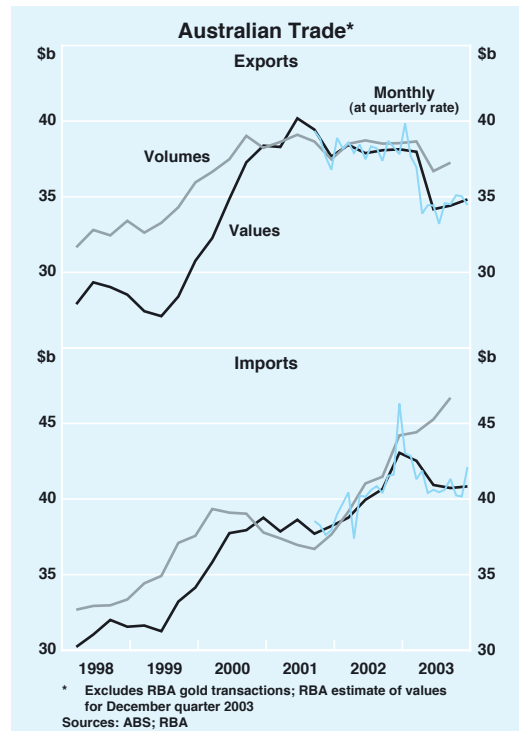
3½ per cent of GDP in the June quarter 2003 to around 3 per cent of GDP by the end of 2003. Assuming that the net income deficit remains constant as a share of GDP in the December quarter, the current account deficit would have narrowed accordingly, to around 6 per cent of GDP.

Recent data suggest that the tentative recovery in exports evident at the time of the previous *Statement* has continued (Graphs 45 and 46). Although the appreciation of the Australian dollar has dampened export prices in Australian dollar terms, the value of exports has edged higher since mid year, rising by around 1¼ per cent in the December quarter. This suggests that since mid 2003 export volumes have largely reversed the 5¼ per cent fall that occurred over the previous 12 months.

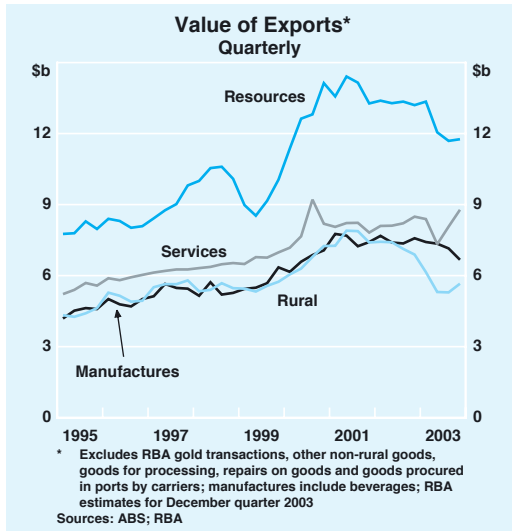
**Graph 44**



**Graph 45**



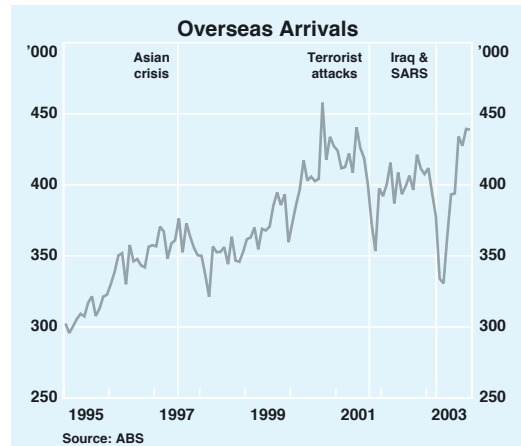
**Graph 46**



A key contributor to this recovery has been a revival in service exports. Earnings from services rebounded strongly in the September quarter following the containment of SARS, and rose a further 8<sup>3</sup>/<sub>4</sub> per cent in the December quarter. This result was boosted by tourist spending associated with the Rugby World Cup, but even abstracting from this short-term stimulus, both travel-related and other service exports have continued to expand at a healthy pace. Consistent with this, there has been a resurgence in short-term visitor arrivals over the past six months, to levels above those recorded prior to the SARS outbreak and the war in Iraq (Graph 47).

Rural export earnings have also begun to recover from their drought-induced weakness, with the value of rural exports rising by around 7 per cent in the December quarter. The value of cereals and meat exports rose sharply in the quarter, though these increases were partially offset by a fall in the value of wool and other rural exports. The overall recovery in rural exports is set to continue in coming quarters with the Australian Bureau of Agricultural and Resource Economics (ABARE) forecasting a large rise in farm production in 2003/04, despite a marginal downward revision recently. Cereals exports, particularly wheat, are expected to continue

**Graph 47**



to grow strongly as the winter crop, which has now largely been harvested, is exported. In contrast, herd re-stocking, following the easing of drought conditions in many areas, is expected to weigh on meat and live animal exports in the near term. The outlook for wool and cotton exports is also subdued, because of flock depletion and an ongoing shortage of irrigation water.

Earnings from resource exports appear to be stabilising after falling earlier in the year. In the December quarter, earnings increased by 1/2 per cent, although they remain around 11 per cent lower than a year earlier. The recent improvement is likely to reflect both higher global prices for resources and a pick-up in volumes due to stronger global industrial production, and has occurred despite the appreciation of the Australian dollar lowering prices in Australian dollar terms. The general weakness in resource exports over the past year has been most evident in exports of mineral fuels (excluding coal and related products), which in volume terms fell by almost 10 per cent over the year to the September quarter. In part, this weak outcome reflects supply constraints, as some of Australia's mature oil fields are approaching the end of their productive lives. The volume of metals exports (excluding gold) has also fallen over the past year. In contrast, exports of metal ores & minerals and coal have risen modestly, and the volume of gold exports was almost 20 per

cent higher. Looking forward, expansion in production capacity for some resource commodities, stronger commodity prices and the improvement in the global economy should provide a further boost to export earnings over the coming year (see section on commodity prices and the terms of trade).

Unlike the other broad categories of exports, the value of manufactured exports continued to trend downwards in the December quarter, posting its fourth consecutive quarterly fall. This stands in marked contrast to average annual growth of over 10 per cent in the 1990s. In contrast to world prices of commodities, the world prices for many manufactured goods have fallen recently. In addition, the appreciation of the Australian dollar is likely to have restrained export volumes, as well as lowering Australian dollar prices.

Strong growth in domestic spending continues to drive solid growth in import volumes. The decline in the relative price of imports resulting from the appreciation of the Australian dollar has also provided some impetus to growth. After moderating in the first half of 2003, the volume of imports expanded by 3<sup>1</sup>/<sub>4</sub> per cent in the September quarter, to be 12<sup>1</sup>/<sub>2</sub> per cent higher over the year, which is well above trend rates of growth. However, given the sharp declines in import prices, the value of imports has fallen over 2003 as a whole. The rise in import volumes in the September quarter was concentrated in service imports, driven by a recovery in travel-related imports following the war in Iraq and the containment of SARS. In contrast, growth in goods imports was more modest. Recent data suggest import volumes increased further in the December quarter, with strong growth in both goods and services imports.

The net income deficit recorded a slight rise in the September quarter to \$5.6 billion, though at 2.8 per cent of GDP, it remains around its average level of the past five years. The decline in world interest rates over the past few years has seen the servicing burden of foreign debt fall to around the levels of the early 1980s. However, this has been offset by rising dividend payments on foreign holdings

of Australian equity, flowing from the relatively strong profit performance of Australian companies. This strong performance is also likely to have encouraged net equity inflows into Australia, after several years of net equity outflows.

## Commodity prices and the terms of trade

The improvement in the global economy has led to a marked increase in commodity prices in SDR terms since the middle of 2003. The RBA Commodity Price Index rose by 3.8 per cent in SDR terms in the three months to January, to be nearly 10 per cent higher than its recent trough in May 2003 and nearly 23 per cent higher than the low levels prevailing in 1999 (Table 11; Graph 48). While the appreciation of the Australian dollar has reduced commodity prices in Australian dollar terms from their most recent peak, they remain close to their average of the past decade.

**Table 11: Commodity Prices**  
SDR terms; percentage change

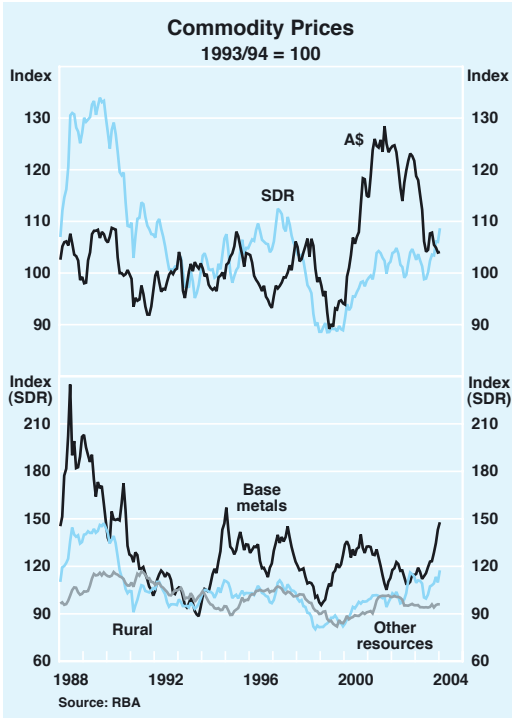
	Latest 3 months	Year to latest 3 months
<b>RBA Index</b>	<b>3.8</b>	<b>3.3</b>
<i>Rural</i>	4.2	0.0
– Wheat	2.5	–9.0
– Beef and veal	13.5	20.9
– Wool	–4.8	–19.2
<i>Base metals</i>	13.9	24.2
– Aluminium	3.3	4.3
– Copper	17.1	27.5
– Nickel	31.3	70.1
<i>Other resources</i>	0.2	–0.8
– Coking coal <sup>(a)</sup>	–2.4	–11.3
– Steaming coal <sup>(a)</sup>	–1.5	–6.8
– Gold	4.1	10.1
Memo item:		
Oil in US\$ <sup>(b)</sup>	7.9	9.3

(a) Latest available data are for December; other categories shown are to January.

(b) Oil prices are not included in the RBA Index.

Sources: Bloomberg; RBA

**Graph 48**

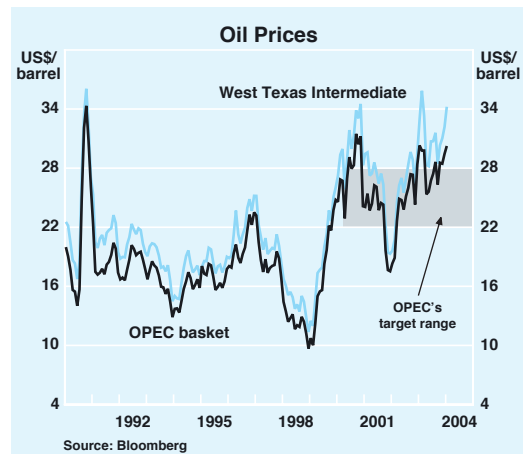


The increase in base metals prices has been particularly pronounced, with prices up by 15.3 per cent in SDR terms in the six months to January to be close to their highest levels in 15 years, and also up in Australian dollar terms. Nickel prices have been especially strong, rising by more than 70 per cent in SDR terms over the past 12 months and by nearly 170 per cent since their trough in late 2001, largely in response to robust demand from China's expanding stainless-steel industry. Copper prices have risen sharply in recent months amid tight supply and low worldwide inventory levels. The prices of other resource commodities have also increased in the three months to January, particularly alumina and gold. The recent annual contract negotiations between suppliers and Japanese steelmakers for iron ore delivered price increases of nearly 20 per cent in US dollar terms, with significant increases expected in contract negotiations for coal over coming months.

World prices for rural commodities have also increased steadily in the past six months. In both SDR and Australian dollar terms, they are higher than the trough in June 2003, but remain below the drought-induced peaks of 2002. Beef prices rose over the second half of 2003 as US demand recovered from earlier weakness. More recently, BSE-related restrictions on US beef imports in many countries have also boosted prices significantly. Cotton prices have increased substantially in the past three months following a poor crop in China, while wheat prices are also up since the middle of last year, following adverse weather conditions in Europe.

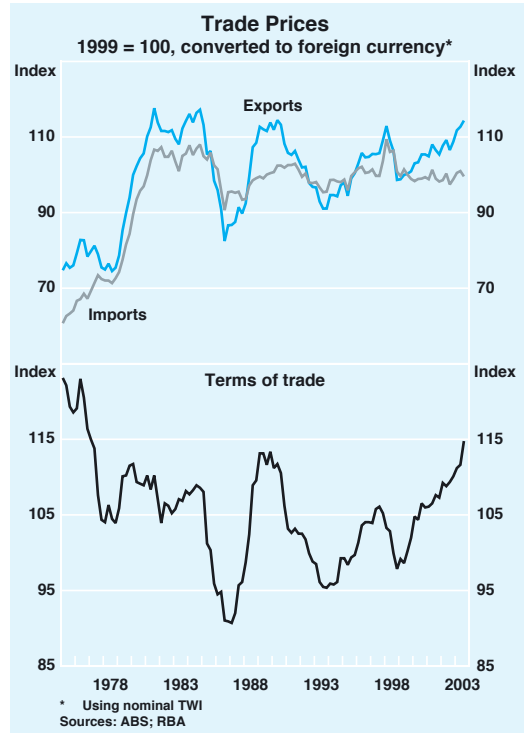
In the three months to January, the West Texas Intermediate crude oil price averaged around US\$32.50 per barrel, which is 8 per cent higher than the previous three months (Graph 49). This increase follows the reduction in OPEC's oil production quotas, effective from last November, and low oil inventories in the US. More recently, the depreciation of the US dollar has helped induce a sharp rise in prices to levels well above OPEC's target range; in Australian dollar terms, oil prices remain below recent averages.

**Graph 49**



Unlike in previous upswings in global demand and commodity prices, world prices of Australia’s imports, particularly manufactured goods, have remained quite weak. This largely reflects the rapid expansion in productive capacity in Asia, coupled with ongoing declines in the prices of information-technology products. The result has been a 5 per cent increase in Australia’s terms of trade over the year to the September quarter, to its highest level in over 25 years (Graph 50). Further increases are likely, given the recent upward pressure on commodity prices.

**Graph 50**



# Domestic Financial Markets

## Interest rates and equity prices

### Money and bond yields

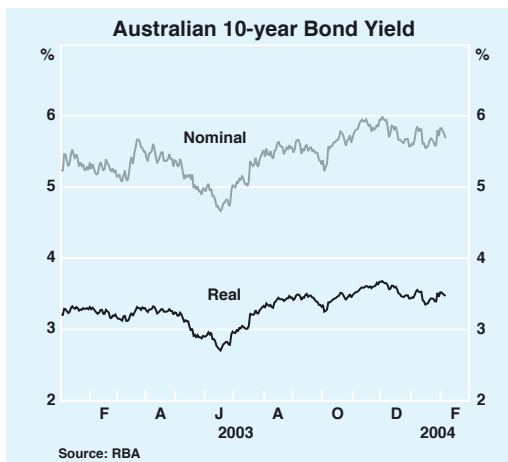
The increase in the cash rate target in early December came as little surprise to financial markets. At the time of the increase in the target from 5 to 5¼ per cent, markets had priced in not only that increase but a couple of further increases over the coming year. This outlook was underpinned by ongoing strength in the domestic economy and continuing evidence of improvement in the global economy.

Subsequently, expectations of further moves in monetary policy were scaled back somewhat, reflecting the rise in the Australian dollar and indications from the Federal Reserve that monetary policy in the United States was unlikely to be tightened in the near term. Money markets nevertheless still expect a further 25 basis point rise in the cash rate later this year (Graph 51).

Yields on 10-year bonds reached a 17-month high of 6.0 per cent in early December before falling back to around 5.7 per cent, albeit around 110 basis points higher than their trough in mid June 2003. Real yields have moved similarly to nominal

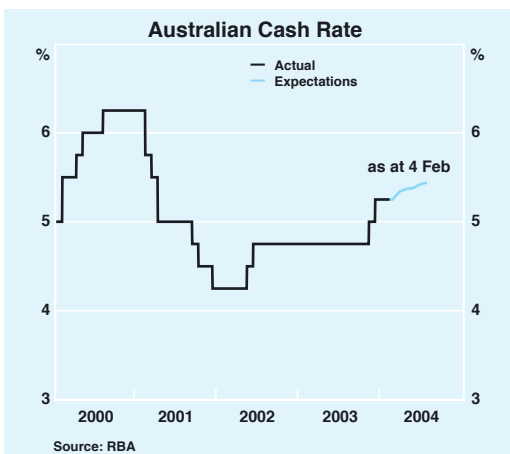
yields over the same period, with yields on 10-year inflation-linked bonds currently around 3.5 per cent (Graph 52).

**Graph 52**

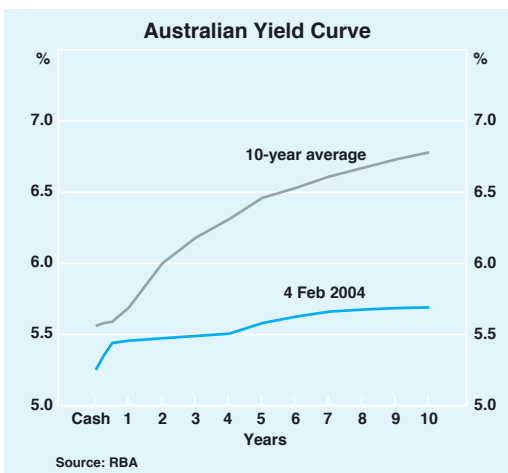


The yield curve has flattened since the release of the last *Statement*, reflecting the December tightening in monetary policy and the fall in longer-term yields (Graph 53). The spread between 10-year bond yields and the cash rate is currently around 45 basis points, compared with more than 100 basis points on average over the past decade (see the chapter on ‘Assessment of Financial Conditions’).

**Graph 51**

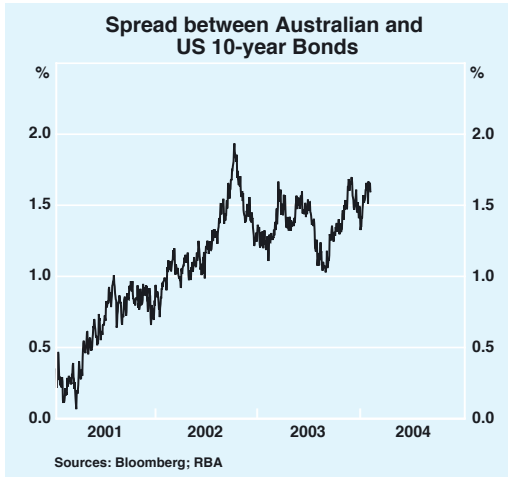


**Graph 53**



The spread between 10-year Australian and US bond yields has fluctuated around 150 basis points over the past few months, which is around 50 basis points above its average for the past few years (Graph 54).

Graph 54

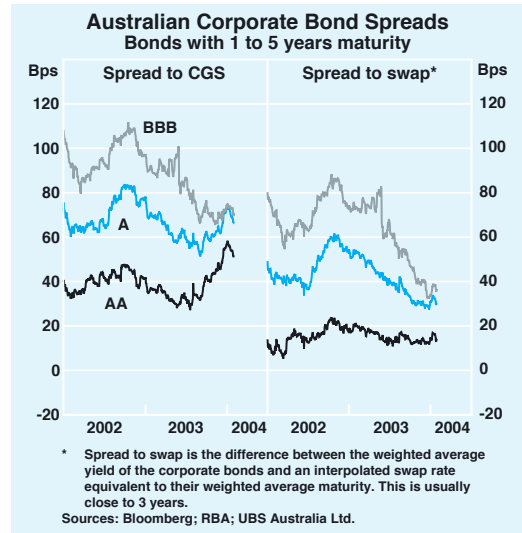


Spreads on corporate bonds (relative to government bonds) have risen a little in recent months, in contrast to the falls in many other countries. The available evidence suggests that this does not reflect a perceived deterioration in credit risk on these bonds. Rather, the increase in spreads appears to reflect both tightness in the Commonwealth Government bond market (where supply remains limited and demand by foreign investors appears to have increased) and upward pressure on swap rates (one benchmark against which corporate bonds are priced) as companies have sought to lock in fixed-rate borrowings due to expected increases in interest rates. Spreads between corporate bonds and swap rates have generally narrowed (Graph 55).

#### Intermediaries' interest rates

Indicator rates on variable-rate housing and business loans are 50 basis points higher than at end October, having increased in line with the 25 basis point increases in the cash rate in November and December last year (Table 12). The implementation lag of these increases for existing customers was around one week, similar to the experience of recent monetary policy changes. The predominant rate for banks' variable-rate housing loans is now

Graph 55



**Table 12: Indicator Lending Rates**  
Per cent

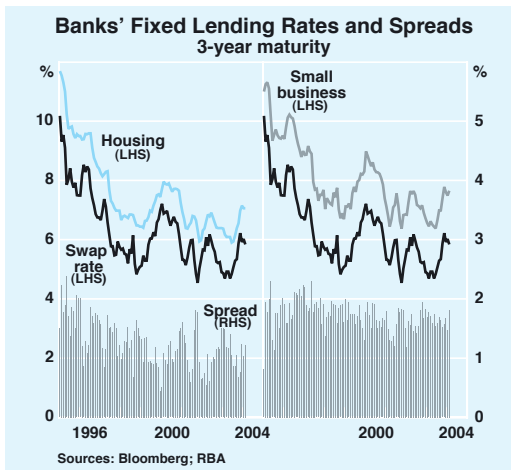
	Current level (4 February)	Change since end October 2003
<b>Variable rates</b>		
<b>Household</b>		
<i>Mortgages:</i>		
– Standard variable	7.05	+0.50
– Basic housing	6.50	+0.50
– Mortgage managers	6.70	+0.50
<i>Personal lending:</i>		
– Residential security	6.70	+0.50
– Credit cards	16.00	+0.50
<b>Small business</b>		
<i>Residential security:</i>		
– Overdraft	7.95	+0.50
– Term loan	7.25	+0.50
<i>Other security:</i>		
– Overdraft	8.85	+0.50
– Term loan	7.85	+0.50
<b>Large business</b>	8.85	+0.50
<b>Cash rate</b>	5.25	+0.50
<b>Fixed rates (3 years)</b>		
– Housing	7.05	+0.50
– Small business	7.65	+0.25
– Swap rate	5.85	..

Source: RBA

7.05 per cent, slightly above its average for the past five years.

Fixed rates on small business loans have increased by around 25 basis points since the time of the last *Statement*. Over the same period, fixed rates on housing loans have risen by around 50 basis points (Graph 56).

**Graph 56**

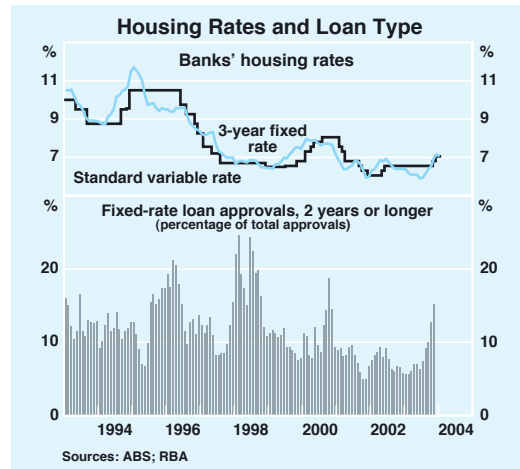


The larger increase in housing fixed rates may in part reflect banks moving to rebuild margins lost over most of the second half of 2003 (when fixed rates increased by less than fixed-rate wholesale funding costs), on the back of a marked increase in the demand for fixed-rate housing loans. The share of new housing loans taken out at fixed rates increased from a low of 6.3 per cent in June 2003 to 15.2 per cent in November (Graph 57). At present, interest rates on variable-rate housing loans are around the same as 3-year fixed rates.

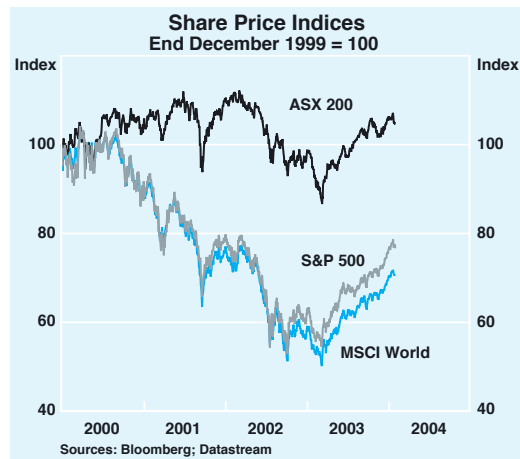
*Equity prices*

The Australian share market has shown little net change since the time of the last *Statement*, compared with some sizeable increases in overseas markets over the same period (Graph 58). The increase in the Australian dollar may be part of the reason for this, as investors assume the appreciation will have a negative effect on companies with offshore earnings. On the other hand, since the mid 1990s the Australian share market has

**Graph 57**



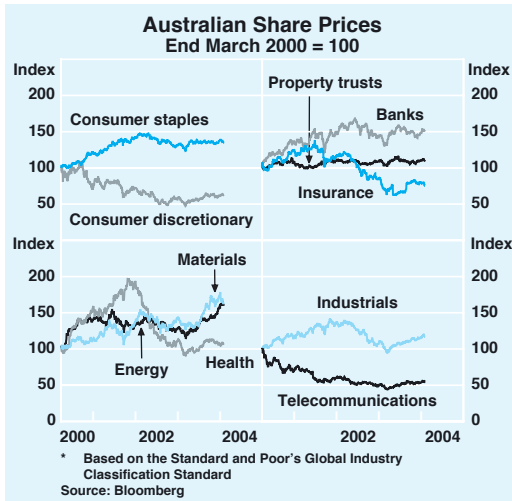
**Graph 58**



shown a consistent tendency to be more stable than major offshore markets (that is, fall less when overseas markets are falling and rise less when overseas markets are rising) and recent developments may simply be a continuation of that pattern. The Australian share market is only 7 per cent below its peak, a much stronger outcome than in any of the major industrial countries.

The performance of the sector indices since end October 2003 has been mixed (Graph 59). The energy sector has been the strongest performer, experiencing gains of 11 per cent due to favourable developments regarding increased sales of LNG to the US and the discovery of new oil fields. The

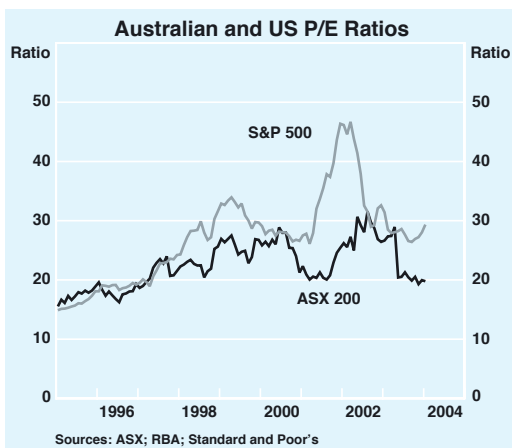
Graph 59



financials index has risen slightly, with increases in banks and real estate companies tempered by falls in insurers and diversified financials. The materials sector is 5 per cent lower than at end October and has shown considerable volatility during the period because of the conflicting effects of strong increases in metals prices and concerns about the appreciation of the Australian dollar. The share prices of export-oriented manufacturers have generally fallen.

The Australian price-earnings (P/E) ratio remains around 20 (Graph 60), a little higher than its long-run average. Australian dividend yields have remained steady over the past three months at around 4 per cent.

Graph 60



## Financing activity

### Debt markets

Bond issuance by private Australian entities was robust in the December quarter, with continued strong issuance in both the domestic and offshore markets totalling \$27 billion (Table 13). Financial institutions were the main issuers, accounting for almost half the quarterly total. Issuance of asset-backed securities eased in the December quarter, after a strong September quarter, but remained at high levels. Total gross issuance for all of 2003 increased by almost 40 per cent to \$124 billion.

Around two-thirds of Australian entities' issuance in the December quarter was into offshore markets, broadly consistent with that seen in previous quarters. As is usual, most offshore issuance by Australian borrowers was denominated in foreign currencies, with companies typically using swap markets to convert the proceeds back to Australian dollars. The share of foreign currency issuance denominated in US dollars remained low by historical standards at just over 50 per cent; financial institutions issued substantial amounts in euros, pounds sterling and Canadian dollars. Australian entities' offshore issuance is estimated to have included a record \$5.2 billion into the US private placement market in the December quarter.

Non-residents issued a total of almost \$7 billion of Australian dollar denominated debt in the December quarter. European and US financial institutions again dominated issuance in Australia, while supnationals and government agencies accounted for most of the offshore Australian dollar issuance.

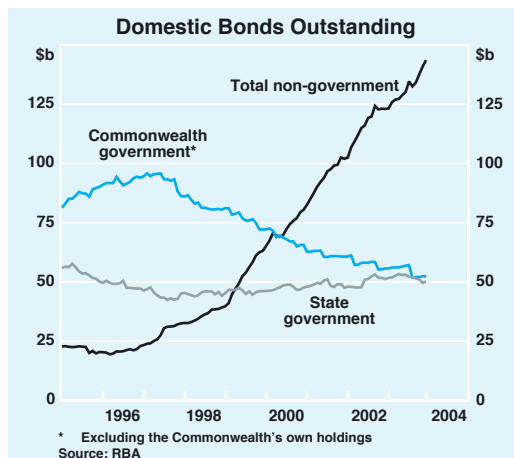
In January, Australian entities issued a further \$12 billion of bonds, mainly in offshore markets, and non-residents also continued to be active.

The total level of non-government debt outstanding in the domestic market increased by \$9 billion to \$144 billion in the December quarter (Graph 61). In contrast, Commonwealth Government bonds outstanding were little changed at \$52 billion,

**Table 13: Non-government Bond Issuance by Sector**  
\$ billion

Sector	2000	2001	2002	2003		2004
				of which December quarter	January	
<b>Bond issues by Australian entities</b>						
Onshore						
Financial institutions	5.1	6.0	7.4	9.8	2.6	0.6
Non-financial institutions	7.6	5.9	7.6	4.9	1.4	0.0
Asset-backed	11.3	15.0	19.3	21.2	5.7	0.1
<b>Total</b>	<b>24.1</b>	<b>26.9</b>	<b>34.3</b>	<b>35.9</b>	<b>9.8</b>	<b>0.7</b>
Offshore						
Financial institutions	23.2	29.3	31.8	49.6	10.0	7.4
Non-financial institutions	4.4	6.8	7.5	14.5	2.2	0.0
Asset-backed	8.9	14.3	16.5	24.0	4.8	3.4
<b>Total</b>	<b>36.6</b>	<b>50.4</b>	<b>55.9</b>	<b>88.0</b>	<b>17.0</b>	<b>10.9</b>
<b>Total</b>	<b>60.7</b>	<b>77.3</b>	<b>90.2</b>	<b>123.9</b>	<b>26.7</b>	<b>11.6</b>
<b>A\$ bond issues by non-resident entities</b>						
Onshore	3.5	7.8	3.1	7.1	2.7	1.9
Offshore	1.0	4.3	17.3	24.4	4.0	0.9
<b>Total</b>	<b>4.5</b>	<b>12.1</b>	<b>20.4</b>	<b>31.5</b>	<b>6.7</b>	<b>2.8</b>

Source: RBA

**Graph 61**

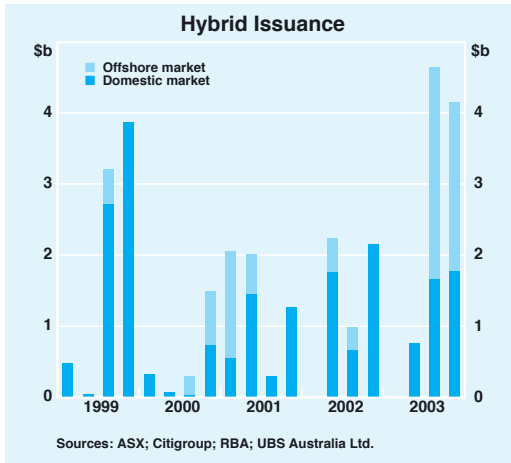
while state government bonds fell \$1 billion to \$50 billion.

There was some decline in the average credit quality of issuance by Australian entities in the December quarter, though it remained high by international standards. The decline reflected a moderation in asset-backed issuance, which is largely in the form of AAA-rated mortgage-backed securities, and a pick-up in A-rated issuance into offshore markets.

### *Hybrid securities*

Issuance of hybrid securities (securities which are a mixture of both debt and equity) remained solid in the December quarter, with \$4 billion issued, mainly in offshore markets (Graph 62). Almost \$9 billion of hybrid securities were issued in the second half of 2003, with the major banks being the biggest issuers.

**Graph 62**

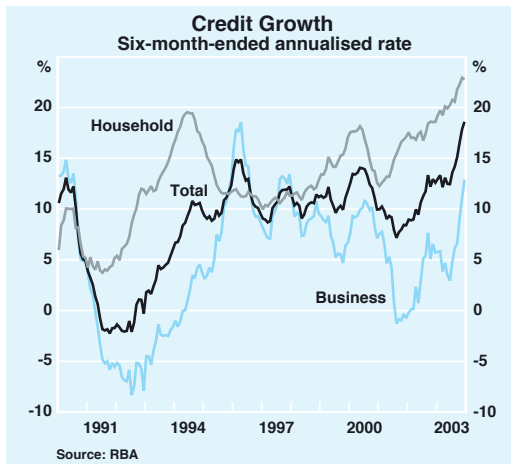


*Intermediated borrowing*

The growth rate of total credit increased further in the second half of 2003, reaching its highest level in more than a decade (Graph 63). Total credit grew by 15 per cent over the year to December, and at an annualised rate of 19 per cent over the second half of the year, reflecting strong growth in credit to both the household and business sectors.

Household credit increased at an annual rate of 23 per cent over the six months to December, and continues to be underpinned by strength in housing credit. Lending has

**Graph 63**



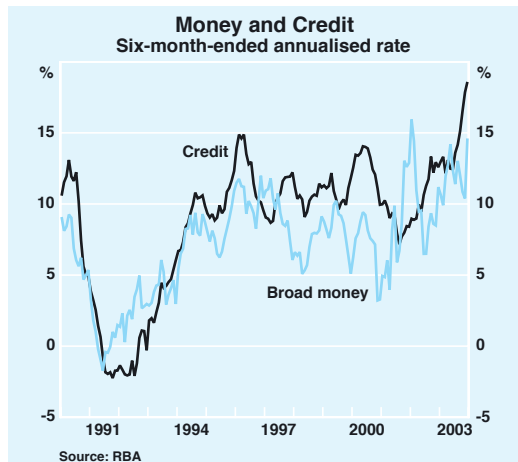
grown rapidly for owner-occupiers and even more so for investors – increasing at an annualised rate of 33 per cent over the six months to December. As noted above, growth in housing lending at fixed rates has picked up appreciably in recent months, reflecting the anticipation by borrowers of higher variable interest rates. In contrast to housing credit, the growth rate of personal credit has slowed somewhat over recent months, to an annualised rate of around 12 per cent over the six months to December, compared with 16 per cent over the six months to September; the slowdown in the growth rate of fixed-term and credit card lending was particularly marked.

A fall in housing loan approvals in November, and signs of a slowdown in the housing market, may presage some moderation in the pace of credit growth over coming months. However, the current high level of loan approvals suggests that housing credit growth will nonetheless remain very fast in the near term (see Box C in the chapter on ‘Domestic Economic Conditions’).

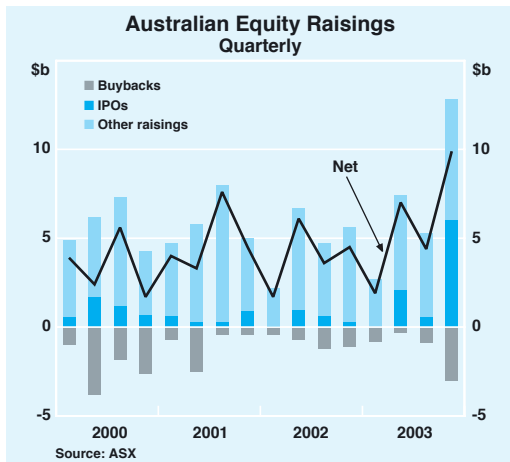
As with housing credit, the growth rate of business credit has picked up strongly since the middle of the year. This follows a period of two years in which business credit growth was unusually low. Over the six months to December, business credit increased at an annualised rate of 13 per cent, reflecting strong growth in commercial loans, commercial paper and promissory notes, and a modest recovery in bank bills on issue.

On the liability side of intermediaries’ balance sheets, the growth rate of the broader monetary aggregates has also risen in recent months, to an annualised rate of 15 per cent over the six months to December (Graph 64). Nevertheless, the difference between the rates of growth of credit and broad money has continued to widen, reflecting increased reliance on other funding sources, including offshore borrowing.

**Graph 64**



**Graph 65**



*Equity raisings*

Equity raisings were very strong in the December quarter, driven by record raisings through initial public offerings (Graph 65). Around 60 companies listed on the ASX for the first time in the December quarter, raising a total of \$6 billion. As well as some high-profile large issues, many smaller companies also listed, with more than one-half of the total number of listings being companies that raised less than \$10 million each. Several were small resource companies that were taking advantage of the current period of strong metals prices and buoyant equity markets.

Capital raisings from other types of equity issuance, which include rights issues,

placements and dividend reinvestment plans, were also strong in the quarter. Rights issues were dominated by AMP’s \$1.2 billion issue. December quarter placements were particularly strong for non-financials, while equity raised through dividend reinvestment plans was solid for both financial and non-financial companies.

The large amount of equity raised was offset to some extent by an increase in the value of buybacks in the quarter, which was at its highest level since June 2000. This result was driven by the large buybacks of Telstra and Foster’s Group Ltd in the month of December.

## Assessment of Financial Conditions

As discussed in earlier chapters, credit grew by 15 per cent over the year to December. This rate of growth is the fastest in over a decade and is considerably higher than that being recorded in most other countries. While the lagged effects of the increases in interest rates in November and December are yet to flow through, the continuing rapid pace of credit growth is prima facie evidence that financial conditions remain expansionary, especially when viewed in the context of lending rates that are still below the average of the past decade.

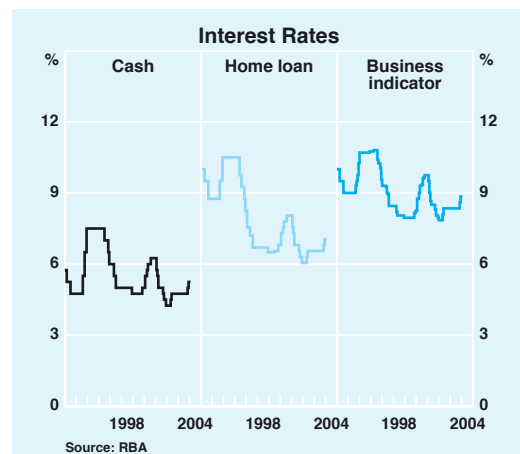
Credit expansion continues to be primarily driven by borrowing by the household sector, mainly for the purchase of housing. Over the year to December, total household credit was up by 21 per cent, with annualised growth over the final three months of the year at a slightly faster rate. The strong growth in household borrowing looks likely to continue at least into the early months of 2004, with housing loan approvals remaining at a very high level, despite falling in November for the first time in more than a year. While there have been some reports of financial institutions tightening lending requirements, particularly for loans to purchase inner-city apartments, finance generally remains readily available on attractive terms. There are few signs that the household sector is having difficulty meeting its financial obligations, with personal bankruptcies at relatively low levels and the share of households that have fallen behind in their mortgage repayments at around historical lows.

Business credit growth has also picked up over recent months, after being subdued for the previous two years. Over the second half of 2003, the level of business credit outstanding increased at an annualised rate of 13 per cent, the fastest pace for some years. The stronger outcomes are consistent with the generally positive readings of current business conditions and the recent robust growth in

business investment. While some businesses, particularly in the property sector, are reporting that finance has become more difficult to obtain, finance in general remains readily available. More broadly, financial conditions in the business sector are relatively favourable. Corporate balance sheets are in a healthy state, consistent with strong growth in profitability, relatively low levels of debt, a recent pick-up in equity raisings, and strong gains in share prices since March 2003. The healthy state of corporate balance sheets overall is also apparent in corporate bond spreads, which remain at relatively low levels.

The consistently strong credit growth suggests that the level of interest rates has not posed a significant hurdle to those households and businesses wishing to borrow over recent years. While the 25 basis point increases in November and December have brought the cash rate closer to its average level of the past ten years – a period in which the economy has recorded average annual growth of 3.9 per cent – the rate still remains slightly below the average over this period (Graph 66). Lending rates are also below average, reflecting both the level of the cash rate and the compression of interest rate margins over

Graph 66



the past decade. The same is true in real terms, with generally stable inflation expectations over this period.

While the combination of rapid credit growth and below-average interest rates suggests that financial conditions remain expansionary, the slope of the yield curve, as measured by the spread between the yield on 10-year bonds and the cash rate, suggests a somewhat different picture. With the cash rate up by 50 basis points in late 2003 and yields on 10-year bonds down a little over recent months, the spread has narrowed since early November to stand at around 50 basis points (Graph 67). By itself, this below-average spread might normally be taken to imply slightly tighter-than-average conditions, although a more likely interpretation is that bond yields have been held down by offshore bond-market developments reflecting expectations that short-term interest rates around the world will remain below average for some time.

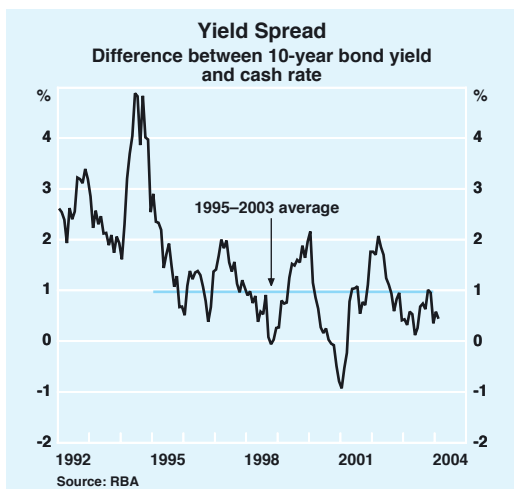
Another financial influence on economic conditions is the exchange rate. As discussed in the chapter on ‘International and Foreign Exchange Markets’, the Australian dollar has continued to appreciate over recent months, rising on a trade-weighted basis by 5 per cent since early November and 21 per cent over the past year. After adjusting for differences in inflation rates between Australia and its

trading partners, the level of the exchange rate in the December quarter was around 10 per cent above the average of the post-float period, and it has subsequently appreciated further.

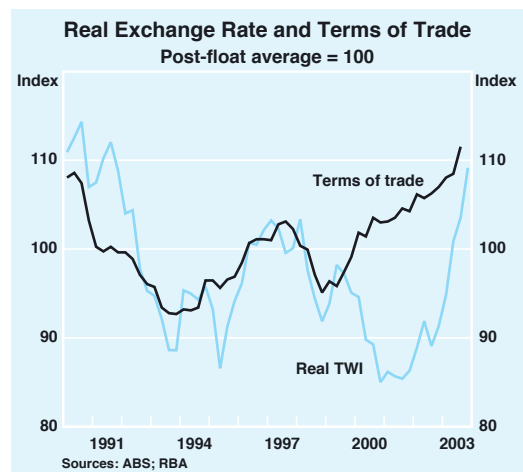
The appreciation has occurred against the backdrop of a recovery in the world economy and, importantly, a continuing increase in Australia’s terms of trade. In the September quarter, the terms of trade reached its highest level in 26 years, and it is likely to have risen further over recent months given the continued strength of international commodity prices. The appreciation over the past couple of years has returned the real exchange rate to a level broadly consistent with its historical relationship with the terms of trade, after a period of unusual weakness in the currency between 1999 and 2002 (Graph 68). All else equal, the stronger exchange rate would have a dampening influence on economic activity, although an important offset to this is the related improvement in the terms of trade and stronger global demand.

While the Australian dollar has appreciated against the currencies of most of Australia’s major trading partners, the appreciation has been particularly pronounced against the US dollar and the US-dollar-linked currencies of east Asia. In inflation-adjusted terms, the value of the Australian dollar is at a record level

Graph 67

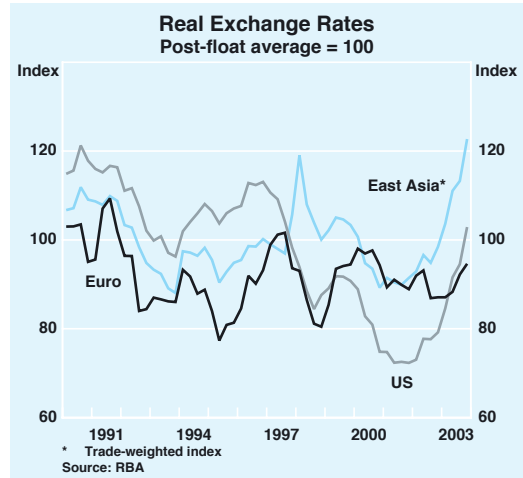


Graph 68



against a trade-weighted basket of east Asian currencies, with a number of these currencies having depreciated markedly at the time of the Asian crisis, and again more recently (Graph 69). The appreciation of the Australian dollar has been less marked against the euro, and the currencies of a number of countries that Australia competes with in international markets.

**Graph 69**



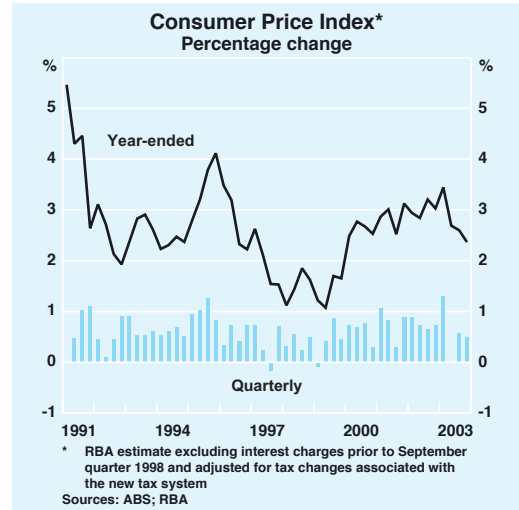
# Inflation Trends and Prospects

## Recent developments in inflation

### Consumer prices

The Consumer Price Index rose by 0.5 per cent in the December quarter, to be 2.4 per cent higher over the year. This represents a slowing in the rate of inflation from around 3 per cent a year ago (Graph 70). The various measures of underlying inflation recorded slightly lower outcomes in the quarter, although on a year-ended basis they show inflation at a similar rate to the headline measure (Table 14; Graph 71). The exception to this is the price index for market goods and services (excluding volatile items), which increased by 1.8 per cent over the year, reflecting weaker quarterly growth earlier in 2003 (relative to other measures). Overall, the Bank's assessment is that underlying inflation is at, or slightly below, 2½ per cent.

Graph 70



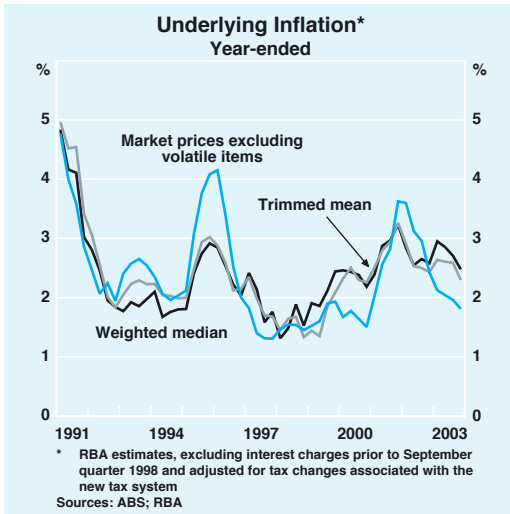
**Table 14: Measures of Consumer Prices**  
Percentage change

	Quarterly		Year-ended	
	September quarter 2003	December quarter 2003	September quarter 2003	December quarter 2003
CPI	0.6	0.5	2.6	2.4
– Tradables	–0.3	0.0	0.7	0.0
– Tradables (ex petrol and food)	–0.5	–0.5	0.0	–0.8
– Non-tradables	1.3	0.9	4.1	4.4
<i>Underlying inflation</i>				
Weighted median <sup>(a)</sup>	0.7	0.4	2.7	2.5
Trimmed mean <sup>(a)</sup>	0.6	0.4	2.6	2.3
CPI excluding volatile items	0.6	0.3	2.6	2.4
Market goods and services excluding volatile items	0.4	0.4	2.0	1.8

(a) For more information on these measures see 'Box D: Underlying Inflation' in the May 2002 *Statement on Monetary Policy*.

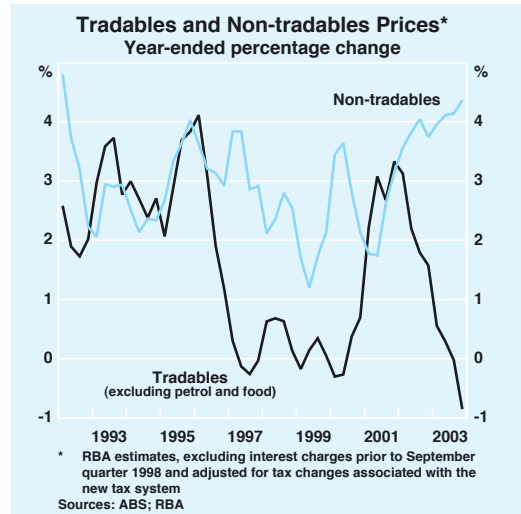
Sources: ABS; RBA

Graph 71



The slowing in all measures of inflation over the past year reflects the strong appreciation of the Australian dollar. This can be seen in the significant decline in the rate of inflation of the prices of tradable goods (Graph 72). Indeed, in the December quarter, tradables prices (excluding petrol and food) declined by 0.5 per cent, to be 0.8 per cent lower over the year, with downward pressure clearly evident in a broad range of expenditure categories. Most notable were the declines over the past year in prices of audio, visual and computing equipment (21 per cent), motor vehicles (2.6 per cent), men's clothing (1.8 per cent), footwear (3.2 per cent), and some components of household furnishings, supplies and services. The declines in the December quarter of prices of clothing and footwear (0.2 per cent), and household furnishings, supplies and services (0.1 per cent) were particularly noteworthy because the prices of these items typically rise towards the end of the year. The exchange rate appreciation also helped to offset an increase in international crude oil prices, so that in the December quarter retail fuel prices fell by around 0.9 per cent.

Graph 72



In contrast to the price of tradables, the price of non-tradable goods and services rose by almost 4½ per cent over the past year, the fastest growth rate in a decade. An important factor contributing to this outcome has been the increase in housing-related prices, which overall were up by 4.7 per cent in year-ended terms. This increase was largely attributable to house purchase costs – which rose by 1 per cent in the quarter, to be 6.4 per cent higher over the year – in turn reflecting higher costs of labour and materials. Cost pressures are also evident in a number of service industries, with the price of education, and some recreational and personal services having risen by around 4 per cent over the year, while the price of health services has increased at more than double this pace.

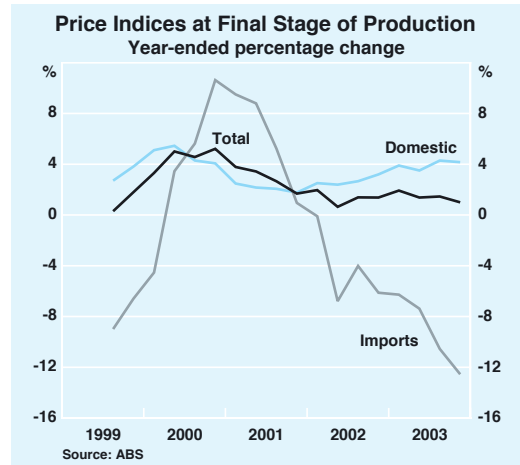
Another important, although more temporary influence on inflation recently has been a large rise in the price of food, which was up by 1.8 per cent in the December quarter, and by 3.4 per cent over the year. Adverse weather patterns in the eastern states contributed to especially sharp rises in both fruit and vegetable prices, which were up by over 10 per cent in the December quarter. There were also significant rises in the prices of some categories of meat.

## Producer prices

Producer price inflation remains modest with large declines in the prices of imported items offsetting the growth of domestic prices; overall final stage prices rose by 0.1 per cent in the December quarter, to be 1.0 per cent higher over the year (Table 15; Graph 73). The appreciation has led to significant price declines of imported items, with prices at all stages of production down by around 3 per cent in the quarter and almost 13 per cent over the year.

In contrast to import prices, recent outcomes for domestic prices have varied across the different stages of production. Upward pressures have been most evident at the final stage, where prices rose by 0.8 per cent in the quarter, to be 4.2 per cent higher over the year. Construction costs have been rising particularly strongly, increasing by 1.3 per cent in the quarter and 7.2 per cent over the year. Although the quarterly growth rate fell from September to December, construction costs remain under upward pressure from both materials and labour costs. Price pressures in food manufacturing and agriculture are also playing a role in pushing up domestic final stage prices.

### Graph 73



## Labour costs

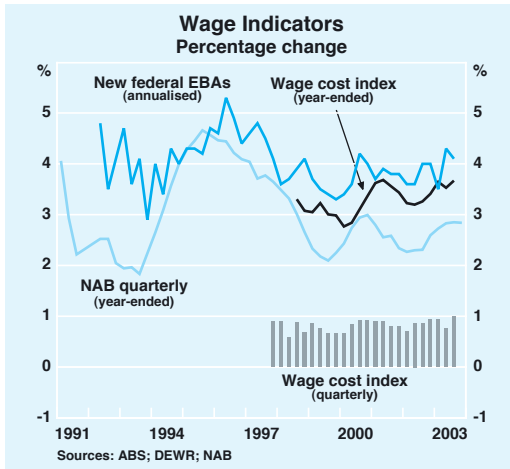
Most labour cost indicators suggest that wages growth edged up in the second half of 2003, consistent with signs that labour-market conditions remain firm. In the September quarter, the wage cost index (WCI) for total pay increased by 1.0 per cent, to be 3.7 per cent higher than a year earlier (Graph 74). The WCI for the public sector continues to rise more quickly (at a rate of 4.7 per cent in year-ended terms) than that for the private sector

**Table 15: Stage of Production Producer Prices**  
Percentage change

	December quarter 2003	Year to December quarter 2003	Year to September quarter 2003
<b>Preliminary</b>	<b>-0.4</b>	<b>-1.5</b>	<b>0.6</b>
- Domestic	-0.1	0.4	2.1
- Imported	-2.9	-12.5	-8.5
- Excluding oil	-0.4	-0.6	1.1
<b>Intermediate</b>	<b>-0.4</b>	<b>-1.1</b>	<b>0.8</b>
- Domestic	0.0	0.9	2.6
- Imported	-2.9	-12.6	-9.4
- Excluding oil	-0.3	-0.6	1.0
<b>Final</b>	<b>0.1</b>	<b>1.0</b>	<b>1.5</b>
- Domestic	0.8	4.2	4.3
- Imported	-3.1	-12.6	-10.5
- Excluding oil	0.1	1.0	1.4

Source: ABS

Graph 74



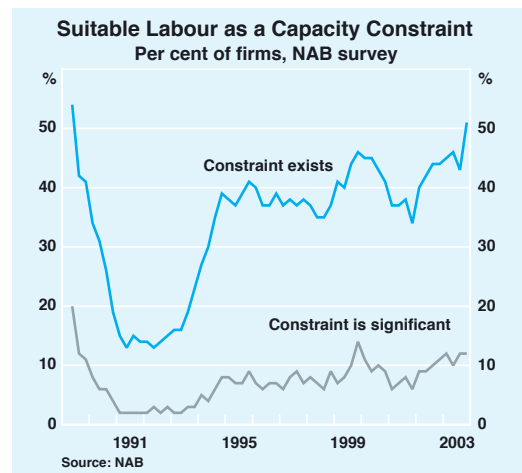
(3.2 per cent). This divergence has been partly driven by significant wage increases in the health and community services sector.

Forward-looking data on new wage agreements also point to firm wages growth, and suggest some narrowing of the gap between public and private sector wage outcomes. Data from the Department of Employment and Workplace Relations (DEWR) indicate that average annualised wages growth in certified new enterprise bargaining agreements (EBAs) was 4.1 per cent in the September quarter. This follows a 4.3 per cent reading in June and remains at the higher end of outcomes over the past few years. It was also above the average of wage increases for currently active agreements, which was 3.8 per cent over the year to the September quarter. Recent outcomes were similar in the public and private sectors, after a period in which public sector EBAs had delivered higher wage gains than in the private sector.

The latest NAB business survey shows total labour costs increasing at close to their fastest pace of the past five years, although still considerably slower than in the mid 1990s. The survey also reports that an increasing number of firms are having difficulty attracting suitable labour (Graph 75). This is consistent with results from the ACCI-Westpac survey of manufacturers and, more generally, the

decline in the unemployment rate to around the lowest levels of the past two decades. In the construction sector, subcontracting rates are continuing to rise significantly faster than measures of wages, placing upward pressure on labour costs in this industry. For office workers, data from Mercer's December Quarterly Salary Review show a slight firming in the growth rate of base salaries, to around 4.3 per cent in year-ended terms, compared with slightly less than 4 per cent earlier in 2003.

Graph 75



## Inflation expectations

Recent surveys of financial market economists and union officials both point to a decline in inflation expectations over the past three months. Results from the Bank's latest quarterly survey of financial market economists show that the median inflation forecast is 2.1 per cent over the year to June 2004, before picking up to 2.4 per cent over the year to June 2005; forecasts for both periods are lower than they were in November 2003 by 0.1 percentage points (Table 16). The inflation expectations of trade union officials are around  $\frac{1}{2}$  a percentage point higher than those of financial market economists in both years.

Business surveys also suggest a decline in inflation expectations. According to the NAB business survey, retail prices are expected to

**Table 16: Median Inflation Forecasts**  
Per cent

	Year to June 2004			Year to June 2005	
	August 2003	November 2003	February 2004	November 2003	February 2004
Market economists <sup>(a)</sup>	2.3	2.2	2.1	2.5	2.4
Union officials <sup>(b)</sup>	3.0	3.0	2.6	3.2	3.0

(a) RBA survey  
(b) ACIRRT survey

rise by 0.2 per cent in the March quarter, somewhat below the outcomes of recent years (Graph 76). In contrast, the volatile Melbourne Institute survey shows that the median expectation for consumer inflation over the coming year increased to 4.6 per cent in January, after falling over recent months to a six-year low in December. Looking through the volatility of the past few months, this

measure appears to be consistent with its average level of the inflation-targeting period.

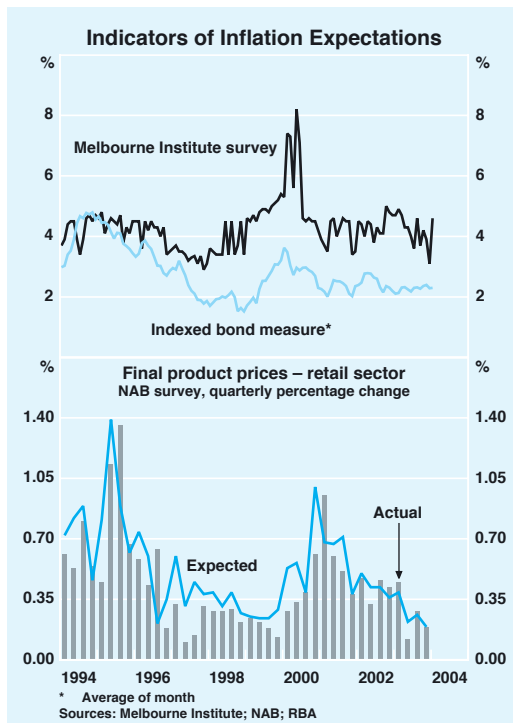
The longer-term expectations of financial market participants have been little changed over the past year and a half. Expectations of inflation, as measured by the difference between nominal and indexed 10-year bond yields, remain at around 2.3 per cent.

## Inflation outlook

As indicated above, the Bank judges the rate of underlying inflation to be at, or slightly below, 2½ per cent. This represents a slight fall from the year-ended rate in the September quarter, and is consistent with the expectation expressed at the time of the previous *Statement* that the appreciation of the exchange rate would gradually flow through into consumer prices. With the dampening effect of the appreciation on domestic inflation still having further to run, our current assessment is that underlying inflation will decline to around 1½ per cent during 2004 (assuming the exchange rate remains stable at around its current level). Then, as the effects of the appreciation begin to wane, inflation is forecast to rise to around 2½ per cent in 2005. Given the likely strength of the economy, domestically sourced price pressures are expected to remain relatively strong, with inflation projected to be on an upward trajectory through 2005.

Year-ended CPI inflation is likely to track underlying inflation relatively closely over the forecast horizon, although in the next two

**Graph 76**



quarters the year-ended outcomes for headline inflation will be affected by the volatility in oil prices during the first half of 2003.

Over recent months, the downside risks to inflation posed by developments in the global economy have eased considerably. While there are risks in both directions around the inflation forecast, the short-term risks appear weighted to the downside, while longer-term risks are more prominent on the upside. In the short run, the inflation rate could decline more than forecast if the exchange rate were to appreciate further, or if the degree of pass-through is greater than expected due to strong competition in the retail sector. Such outcomes could push inflation lower in 2004

or delay the anticipated pick-up in inflation further into 2005. The upside risks to the inflation outlook appear more prominent towards the end of the forecast horizon and relate to the strength of economic activity and the impact of this on upstream inflationary pressures and wage outcomes. The global pick-up in demand and activity could, in due course, start to provide upside risks to world inflation, further lifting commodity prices and prices of traded goods and services more generally. Also, if domestic economic activity and demand were to be even stronger than expected, given the existing strength of the labour market, upward pressure on labour costs could emerge, eventually pushing inflation higher. ↗