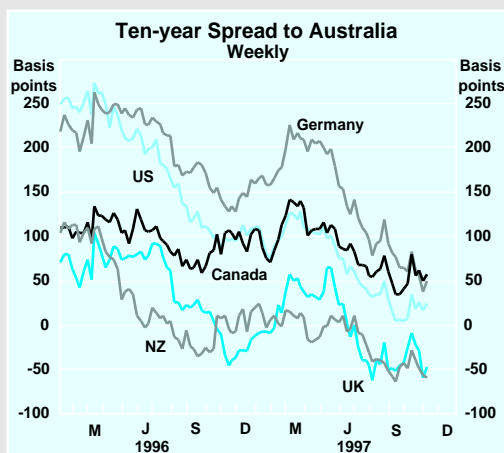


Box A: Differentials in Bond Yields

Over the past six months, bond yields in Australia have continued to fall relative to those in other countries, as markets have become more accepting of the sustainability of Australia's low inflation (Graph A1). While the improvement has been evident against the broad range of countries, the key market against which Australian yields are judged is the US.

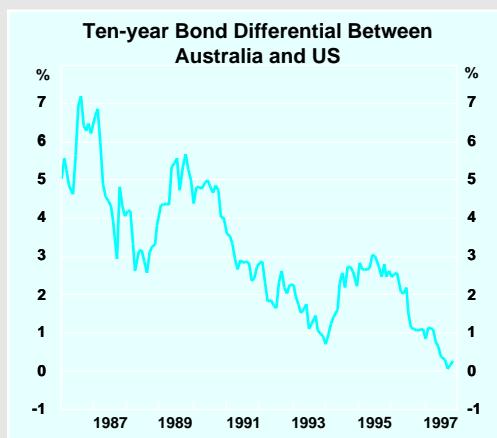
Graph A1



The spread between Australian 10-year bond yields and corresponding US yields has fallen to an average of about 10 basis points in recent months. The fall in this spread continues the trend evident for much of the 1990s, the abrupt setback during the bear market of 1994 aside: in the second half of the 1980s, the spread of 10-year bonds in Australia to US treasuries averaged about 4.5 percentage points (Graph A2).

The sharp narrowing of the spread, to the point where it has almost closed, has occurred because Australia's better inflation performance relative to the US in the 1990s (2.7 per cent a year versus 3.4 per cent) is working to offset other factors which would normally result in a premium for Australian yields over US yields. These include Australia's lower credit standing and the lesser liquidity of the Australian bond market.

Graph A2



Differences in the cyclical position of the Australian and US economies have also contributed to the narrowing of spreads over the past year or so. The US economy is further advanced in its economic cycle, and therefore likely to be closer to experiencing upward pressure on inflation and monetary tightening, factors which would be helping to lift bond yields there relative to those in Australia.

Much of the yield curve in Australia has moved to a position below that in the United States in recent months (Graph A3).

Graph A3

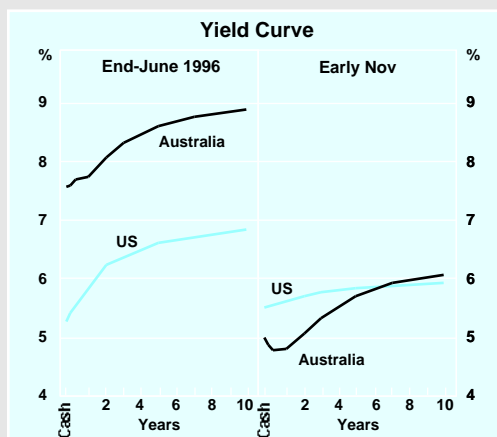


Table A1: 10-year Bond Yields
Per cent, per year

	Level of yields		Spreads to United States	
	1980s ^(a)	Current	1980s ^(a)	Current
United States	10.6	5.8
United Kingdom	11.3	6.5	0.7	0.7
Canada	11.7	5.5	1.1	-0.3
Australia	13.5	6.0	2.9	0.2
New Zealand	14.0	6.7	3.4	0.9
Germany	7.6	5.6	-3.0	-0.2
France	11.7	5.6	1.1	-0.2
Italy	14.5	6.3	3.9	0.5
Sweden	12.1	6.4	1.5	0.6
Netherlands	8.2	5.6	-2.4	-0.2
Belgium	10.6	5.7	-	-0.1
Switzerland	4.6	3.6	-6.0	-2.2
Spain	14.4	6.0	3.8	0.2
Japan	6.7	1.6	-3.9	-4.2

(a) Decade average

In mid 1996, before the latest easing in inflation and wage pressures, the yield curve in Australia was well above that in the United States at all maturities.

As well as domestic considerations, the narrowing of the bond spread reflects the international setting: most countries' spreads to the US have narrowed (Table A1). Australia's performance should be assessed against those of other previously high inflation countries, such as Italy and Spain, which have also done about as well. Apart from the United Kingdom, New Zealand and Sweden – on the high side – and Japan and Switzerland – on the low side – most industrial countries' bond yields are currently in a band around 5.5 and

6.0 per cent. The main factor in this convergence is that inflation is universally low, although progress in reducing budget deficits in most countries, including Australia, has also helped.

Acknowledging the progress of other countries does not diminish the benefits that have flowed to the local bond market as a result of the return to low inflation in Australia. While bond spreads will no doubt continue to fluctuate, Australia's record on inflation in the 1990s, good prospects that this performance will be sustained and the program of Budget consolidation have put Australia in a much better position to withstand market pressures on bond yields that may arise from time to time. ↗