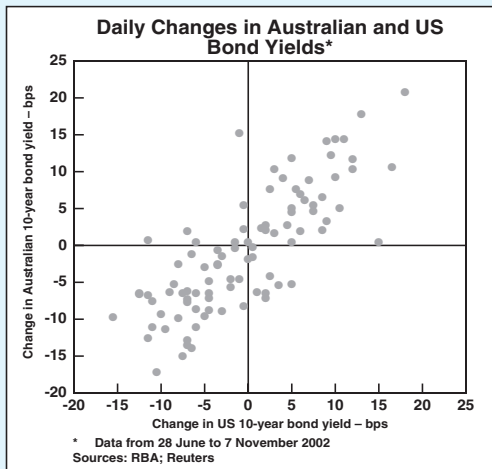


## Box B: The Australian-US 10-year Spread

Movements in Australian bond yields on a day-to-day basis are heavily influenced by movements in US bond yields (Graph B1). Moreover, a significant share of the daily movement in Australian yields tends to occur overnight. Since June, for example, the absolute daily change in Australian 10-year bond yields has averaged almost 6 basis points during the overnight trading session. The comparable figure for the Australian day session is less than 3 basis points. And even movements during the Australian day often track very closely movements in US Treasuries traded in Tokyo.

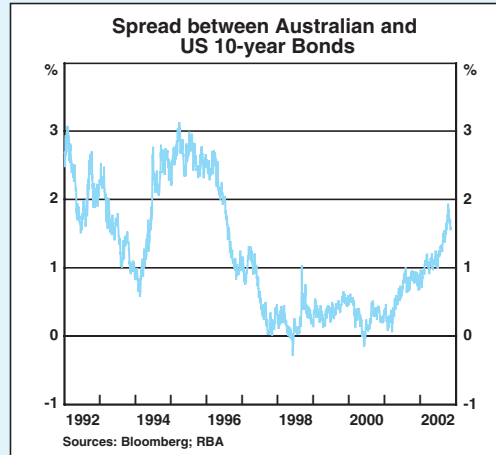
**Graph B1**



Despite this close correlation, the spread between Australian and US yields has widened considerably over the course of 2002. At one point in October it reached almost 200 basis points, after having been around 90 basis points at the beginning of the year (Graph B2). In early November the spread narrowed somewhat to around 165 basis points.

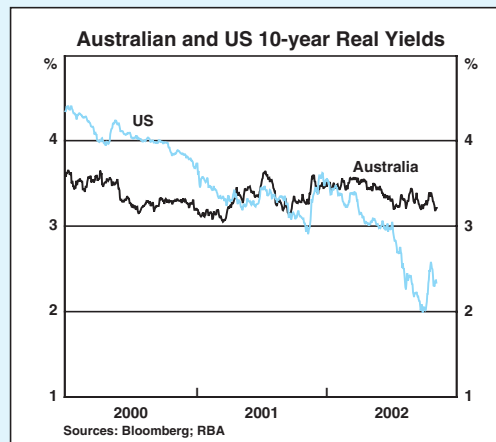
The widening of the spread can be attributed largely to the difference in the growth outlook for the two countries. This is suggested by movements in real bond

**Graph B2**



yields obtained from 10-year indexed government bonds (Graph B3). In the United States real yields fell by around 1 percentage point between June and early October, to a low of just 2 per cent. This fall can be presumed to reflect one or both of two factors: concerns about future growth prospects for the US economy, which would imply that market interest rates would be low for an extended period; and/or a reduced tolerance for risk, with greater appetite by investors to hold 'riskless' assets.

**Graph B3**



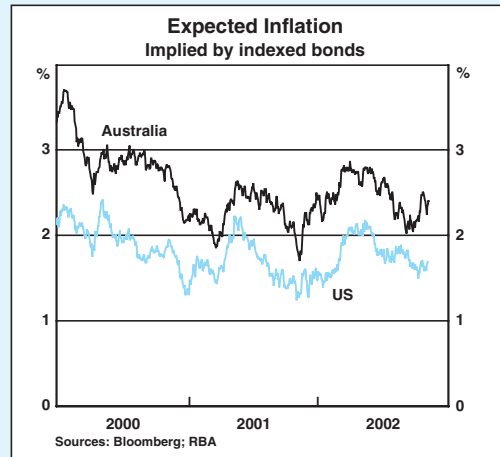
While real rates rose in the second half of October on the back of relatively positive corporate earnings announcements, they remain significantly below their levels earlier in the year. In contrast, real yields in Australia have been much more stable. The resulting widening of the real yield spread accounts for all the widening of the nominal spread.

Interestingly, most of the movement in the Australian–US spread has occurred in the overnight trading session, rather than in the Australian day (Table B1). This reflects the recent tendency for Australian bond yields to fall by less than US yields on days that US yields decline. This is consistent with the stronger economic indicators in Australia relative to those in the United States. In net terms, the spread has moved little during the Australian trading day since the end of June.

The previous occasion on which the yield spread increased by a significant amount for a sustained period was in the first half of 1994. In contrast to the current episode, on that occasion it was concern about the inflation outlook in Australia that was largely

responsible; during the course of 1994 the expected inflation rate (calculated from bond yields) rose by almost 2 percentage points to nearly 5 per cent. In the current episode, expected inflation has, in net terms, changed little (Graph B4); while it declined from end June to early September, it has subsequently increased back to around 2½ per cent, a level consistent with the Bank’s medium-term inflation target. ↗

**Graph B4**



<b>Table B1: Movements in Bond Yields</b>			
Cumulative change in basis points between 2 January and 7 November 2002			
	<b>Australian day session</b>	<b>Australian night session<sup>(a)</sup></b>	<b>Total</b>
10-year CGS	2	-30	-28
10-year US Treasury	41	-143	-102
10-year spread	-39	+113	+74

(a) Includes trading between the Australian close and the US open  
Sources: RBA; Reuters