Statement on Monetary Policy

NOVEMBER 2012

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Reserve Bank

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Overview

Following weaker global economic conditions through the middle of the year, the recent economic data have generally been a little more positive. In the United States, growth is continuing at a moderate pace and there are now signs that growth may have stabilised in China, helped by a pick-up in infrastructure investment. In Europe, although economic activity across the region remains weak, reflecting in part the impact of fiscal consolidation, recent policy announcements have helped to stabilise financial conditions. Economic activity in east Asia has been weighed down by slower growth of global trade and consequently monetary and fiscal policies have been eased a little in some countries in the region.

World GDP growth is currently expected to be around 3¼ per cent in 2012 and to pick up gradually to 3½ per cent in 2013, which is around the long-run average. A modest recovery in the euro area during next year and a continuation of moderate US growth are expected to help boost growth in the east Asian economies to around its trend pace. This is likely to be supported by a gradual pick-up in growth in China in response to the earlier easing in financial conditions and a further modest easing in fiscal policy. While conditions are expected to improve gradually across the globe, activity in the euro area and the United States is expected to remain below potential for some time.

Prices for Australia's iron ore and coking coal exports fell sharply over July and August, driven by a moderation in Chinese demand for steel. Since then, iron ore and steel prices have partially recovered, although spot prices for coking coal have declined further. Thermal coal prices have also fallen significantly since the middle of the year. In contrast, global food prices are higher than earlier in the year and base metals prices have remained broadly unchanged. By the end of 2012, Australia's terms of trade are expected to have fallen by around 15 per cent from their peak in September 2011, a little more than had earlier been expected. Some recovery in bulk commodity prices in the early part of 2013 is forecast on the expectation that Chinese demand for steel picks up a little. But further out, prices are expected to continue to decline gradually given the expansion in supply generated by the very high levels of resource investment globally.

Actions by major central banks, and signs of progress in addressing Europe's fiscal and banking problems, have underpinned an improvement in global financial market conditions since the middle of the year. Conditions in euro area sovereign debt markets improved markedly following announcements by the European Central Bank about its willingness to take decisive actions to preserve the euro. Long-term interest rates faced by highly rated sovereigns, including Australia, remain at exceptionally low levels. Capital markets remain open to corporations and well-rated banks, and Australian banks have had no difficulty accessing funding, including on an unsecured basis. Australian banks continue to shift away from wholesale liabilities towards domestic deposits.

The national accounts show that, after especially strong growth in the March quarter, Australia's GDP

growth was closer to trend in the June quarter. More recent indicators of activity suggest that the economy continued to grow moderately in the September quarter.

Mining investment has continued to grow rapidly in recent quarters. Work on the substantial pipeline of liquefied natural gas (LNG) projects is continuing. However, in response to the decline in prices for iron ore and coal, rising costs and a still high level of the exchange rate, mining companies have scaled back their investment plans. Exports are estimated to have grown moderately in the September quarter, with coal exports affected by lingering disruptions to supply from Queensland as well as weaker global demand.

Outside of the resources sector, indicators of private non-residential investment remain subdued, although business credit has picked up over the past year as interest rates have come down.

Household consumption rose strongly in the first half of the year, due in part to some temporary factors. The value of retail sales declined in July but has been rising since then. Sales of motor vehicles to households have been strong in recent months.

While household dwelling investment continued to decline over the first half of the year, there have been signs in recent months of a prospective improvement, partly in response to reductions in interest rates. Private residential building approvals, dwelling prices and auction clearance rates have all increased. The overall demand for housing finance has been broadly stable over the course of the year and many home owners are taking advantage of lower borrowing rates to pay off their loans more quickly.

After employment growth picked up in the first half of 2012, it slowed over recent months and the unemployment rate increased slightly. There has been a substantial fall in employment in the construction industry over the past year, partly reflecting a delayed response to the decline in total building work done; industry liaison suggests that this process of adjustment may now be coming to an end. More broadly, leading indicators of labour demand have declined further over recent months and point to only modest near-term employment growth and to the unemployment rate edging a little higher.

While the labour market has softened through the year, wage growth as measured has so far been little changed. In the June quarter, wage growth edged higher in year-ended terms, but remained close to the average of the past decade, and still well below the pace seen over 2005–2008 when the unemployment rate was lower than it is currently. Wage growth in the private sector remains higher than in the public sector, driven by mining and professional & scientific services, offset in part by softer wage growth in retail and household services. Business surveys and liaison suggest that private sector wage growth may have softened a little over more recent months.

Inflation picked up in the September quarter from the low level recorded in the June quarter. The September quarter outcome was affected by the introduction of the carbon price and means testing of the private health insurance rebate. Non-tradables inflation increased in the September quarter even abstracting from the one-off policy-induced effects. This owed in part to a rise in new dwelling price inflation and a broad-based increase in food price inflation, while inflation in the prices of a range of market services remained subdued. Over the past two quarters, there have been small increases in tradables prices (excluding volatile items such as fruit and vegetables), suggesting that the downward pressure on these prices from the earlier appreciation of the exchange rate is waning.

The various measures suggest that underlying inflation was around ¾ per cent in the September quarter and around 2½ per cent over the year. This is close to ½ percentage point higher than the rate of underlying inflation three months ago.

The outlook for the Australian economy is a little weaker than that presented in the August *Statement*. Over the year to June 2013, GDP growth is expected to be a little below 2¾ per cent before gradually picking up to just under 3 per cent over 2014. Most of this revision to the outlook is accounted for by a change in the profile for mining investment, which is now forecast to peak a little earlier and at a lower level than had earlier been expected (around 8 per cent of GDP rather than around 9 per cent). This change reflects the reappraisal of spending plans in the coal and iron ore sectors as well as a reassessment of the profile for spending on some large and complex LNG projects. Exports are still forecast to grow substantially over the forecast period given the increase in capacity resulting from the large pipeline of resource investment projects.

Lower interest rates, rising rental yields and an improvement in conditions in the established housing market are expected to support rising dwelling investment. Business investment outside of the resource sector, which has been low, is likely to gradually recover over the next two years, though business surveys and liaison point to muted growth in the near term. Consumption is anticipated to grow at an around-trend pace over the forecast horizon. Public spending is expected to subtract from growth over 2012/13 owing to fiscal consolidation at state and federal levels.

Forecasts for inflation remain largely unchanged from the August *Statement*. Underlying inflation is expected to remain within the inflation target range over the next two years. Although the rate of inflation was a little higher than had earlier been expected, the effect of this on the inflation forecast is offset by the slightly weaker outlook for domestic economic activity and employment. This softer outlook is expected to help contain domestic inflationary pressures over the forecast period. In line with the stability in the exchange rate over the past year, tradables prices are expected to remain broadly flat. Underlying inflation is expected to be close to 2½ per cent over most of the forecast period. The combination of the carbon price effect and earlier volatility in fruit and vegetable prices is expected to see headline inflation rise above 3 per cent in year-ended terms in the first half of 2013, before declining to around 2½ per cent thereafter.

The risks to the global outlook remain tilted to the downside, primarily reflecting the risks associated with the banking and fiscal problems in the euro area. While the policy announcements in Europe over the past few months have helped to improve financial market conditions, much work remains to be done to repair private and public sector balance sheets and enhance prospects for sustainable growth.

Elsewhere in the world, the risks are more balanced. For the United States, the forecasts anticipate that only around half of the sharp fiscal contraction embedded in existing legislation occurs. But there remains uncertainty surrounding the timing and nature of new legislation and, hence, the extent of the fiscal consolidation that will actually take place. In China, while the near-term risks to growth look to have declined, some uncertainty regarding the policy outlook remains.

On the domestic front, the outlook for growth is sensitive to prospects for mining investment and the timing and extent of the anticipated recovery in both dwelling and business investment outside of the resource sector. Investment plans of iron ore and coal miners remain dependent upon the prices of bulk commodities, which will in turn depend on the strength and nature of growth in China. Also, the exact timing of spending on committed investment projects in the resource sector is inevitably uncertain given their size and complexity. The current level of the exchange rate could also have a more contractionary effect on output than anticipated.

The outlook for inflation depends on whether soft demand in some parts of the economy helps to contain domestic cost pressures as the effects of the earlier rise in the exchange rate are now waning. Some slowing in wage growth is likely to be necessary to maintain inflation around its

current rate. Further growth of productivity will also be needed to keep inflation consistent with the medium-term inflation target. A strong pick-up in demand could add to inflationary pressures just as the disinflationary impact of the earlier exchange rate appreciation wanes, resulting in higher-than-expected inflation.

The Board reduced the cash rate twice in late 2011 and twice again in mid 2012, bringing interest rates for borrowers to below their medium-term averages. Subsequently, the outlook for global growth weakened a little, the prices for Australia's bulk commodity exports fell significantly and yet the exchange rate remained higher than might have been expected. The sharp fall in spot prices of bulk commodities has led to a change in the spending plans of firms in the resource sector and it now appears that the peak in investment in the resource sector is likely to occur a bit earlier and at a lower level than had previously been expected. Accordingly, at its October meeting, the Board judged that, with the growth outlook for next year looking a little weaker and inflation expected to be consistent with the target, it was appropriate for the stance of monetary policy to be more accommodative.

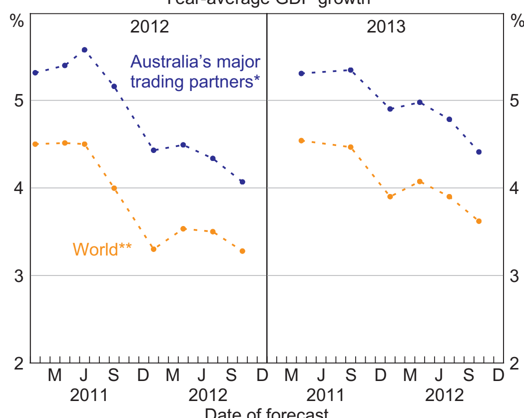
As a result of this sequence of reductions in the cash rate, interest rates for borrowers are clearly below their medium-term averages and savers are facing increased incentives to look for assets with higher returns, though the exchange rate remains higher than might normally be expected. While the impact of monetary policy changes takes some time to work through the economy, there are signs that easier conditions have been having some of the expected effects, and further effects can be expected over time. At the November meeting, with the more recent positive news on the international economy and with inflation a little higher than expected, though still likely to be consistent with target over the year ahead, the Board judged that the stance of monetary policy remained appropriate, for the time being.

Over the period ahead, as the peak in resource investment approaches, the Board will be monitoring the strength of other components of demand, as well as trends in costs and prices. The Board will adjust the cash rate as appropriate to foster sustainable growth and low inflation. ✠

1. International Economic Developments

Growth in the global economy appears to have remained subdued in the September quarter, notwithstanding slightly better news more recently from some countries. The soft conditions over the year to date have led most forecasters – including the IMF – to again revise down their global outlook (Graph 1.1). In many advanced economies there continues to be an adverse feedback loop between private and public balance sheet consolidation and economic growth, particularly in the euro area. Despite some improvement in financial conditions in the euro area, consumer and business sentiment across the region has deteriorated further.

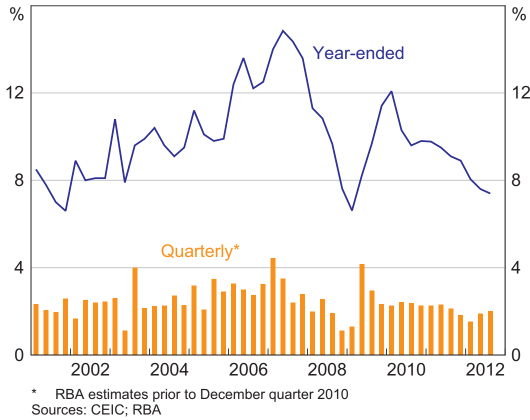
The problems in the euro area have affected activity and sentiment in the rest of the world. The effect on trade and activity in Asia has been increasingly evident and, combined with domestic factors in some economies, has led to downward revisions to growth in Australia's major trading partners in recent months. While most economies are forecast to experience below-average growth in 2012 and 2013, with the contribution to growth from the faster-growing Asian economies continuing to increase, world and major trading partner growth are forecast to be only a little below their long-run averages in 2012 and around average in 2013.



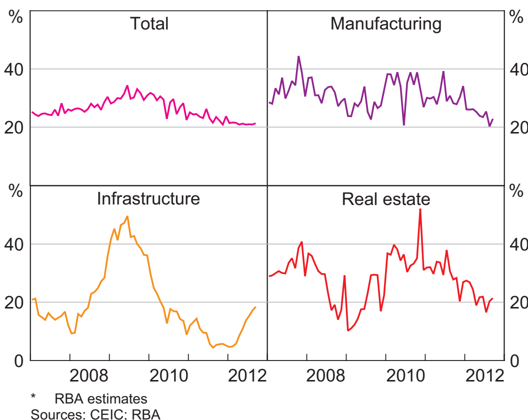
In response to weaker-than-expected economic activity, many policymakers have announced additional stimulus to boost economic growth and improve financial market conditions. The European Central Bank (ECB) announced its Outright Monetary Transactions program and the US Federal Reserve and the Bank of Japan announced further quantitative easing (see the 'International and Foreign Exchange Markets' chapter for further details on these measures). There has been some easing of fiscal and monetary policies in China and South Korea. Other emerging market economies, such as Brazil, continue to put further stimulus in place.

Asia

Overall, indicators suggest that economic conditions in China have improved in recent months, although growth is noticeably lower than it had been in early 2011. GDP expanded by 2.2 per cent in the September quarter, to be 7.4 per cent higher over the year, and has been supported by an easing in fiscal policy and a modest easing of monetary conditions (Graph 1.2).



Growth in nominal fixed asset investment has stabilised during 2012 (Graph 1.3). Construction investment has been stronger in recent months despite a further slowing in residential building. Much of the acceleration in overall investment can be attributed to a pick-up in infrastructure spending. Looking ahead, the approval of a series of large transportation and utilities projects is expected to support infrastructure spending. However, the extent of new stimulus provided by these projects in the near term is unclear, as many of the announced projects have a relatively long construction phase and financing remains uncertain for some. Manufacturing investment has slowed a little during 2012 as production growth slows.



Conditions in the real estate market have recovered modestly. Housing prices and the amount of floor space sold have generally turned up over recent months. While dwelling construction activity has remained subdued, recent trends in floor space completed suggest that the slowing in dwelling investment may have come to an end. The relative weakness in dwelling investment partly reflects the desire of developers to sell unsold stock, while administrative restrictions on house purchases continue to weigh on investor demand for property. Further, tight financing conditions for property developers have limited their ability to engage in new projects. Construction of affordable housing, however, has offset some of the weakness in private residential building. In the first three quarters of 2012, 4.8 million affordable housing units were completed. In the absence of comparable restrictions, office and commercial property construction has grown strongly, partly offsetting the weakness in residential building activity.

With recent strength in non-residential construction activity, growth in industrial production has shown signs of stabilising. The pace of growth of production of key construction materials such as cement and steel has increased slightly since the previous *Statement*. However, steel prices and production have been volatile, reflecting conditions that are specific to the steel industry (see 'Box A: China's Steel and Iron Ore Sector'). Growth in electricity production has been noticeably lower since early 2012, which may reflect the shift in the composition in industrial production, with a more protracted slowing in electricity-intensive heavy industry production occurring over the past year.

Chinese exports have continued to grow over recent months despite demand from the advanced economies – in particular the euro area – remaining soft. While there was also a softening in demand from the United States and Japan around the middle of the year, exports to these destinations have strengthened in recent months. By contrast, exports to east Asia (excluding Japan and Hong Kong)

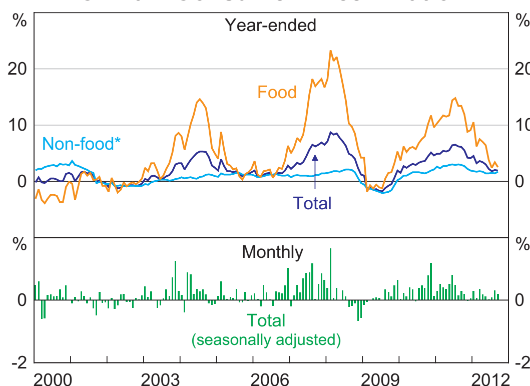
continue to record strong growth. This has been especially the case for exports to lower-income economies in the region, where domestic demand has been relatively strong. Exports to Latin America and Africa, which now account for 10 per cent of China's exports, have also been growing at a fairly rapid pace.

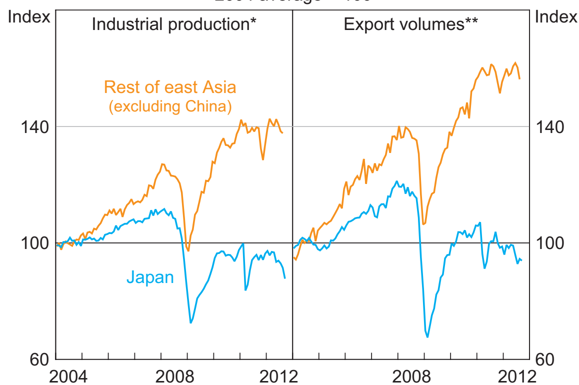
Inflationary pressures in China have remained contained after easing through the first half of 2012. Consumer price inflation is currently around 2 per cent, reflecting generally lower food price inflation (Graph 1.4). However, upward pressure on food prices is likely to emerge over the coming months, with global grain prices rising due to production shortages and pork prices rising gradually after having fallen by 15 per cent since their peak in mid 2011. Non-food inflation remains muted, reflecting subdued outcomes across most non-food components, although prices have increased slightly in the past couple of months as regulated increases in electricity and fuel prices have come into effect. Upstream price pressures remain very weak, with producer prices falling further in line with softer demand and weakness in non-food commodity prices.

Monetary and credit conditions have been stable in recent months. Credit growth has been steady, with household credit growth rising in line with the pick-up in residential property sales and non-household credit growth slowing marginally. The stability in overall credit growth has been accompanied by a noticeable rise in other forms of financing, especially in non-intermediated debt, mainly through the issuance of corporate bonds, as well as in non-bank loans. The People's Bank of China has not adjusted reserve requirements or benchmark interest rates since the previous *Statement*, although it has been more active in its use of open market operations to support liquidity in the banking system more generally.

Weaker demand from the advanced economies is also weighing on the other economies in east Asia (Graph 1.5). Export volumes have fallen by around 10 per cent in Japan, and by 3 per cent in the other east Asian economies over the past year, with the value of electronics and transport equipment exports especially weak. This has spilled over to weakness in industrial production, particularly in Japan where electronics production has fallen by 4 per cent over the three months to September and transport equipment has fallen by over 10 per cent, although this may have been exacerbated by the territorial dispute with China.

Domestic demand has also weakened a little in Japan in recent quarters. Car sales dropped significantly given the expiry of the tax incentives for purchasing fuel-efficient vehicles. The impetus to demand from



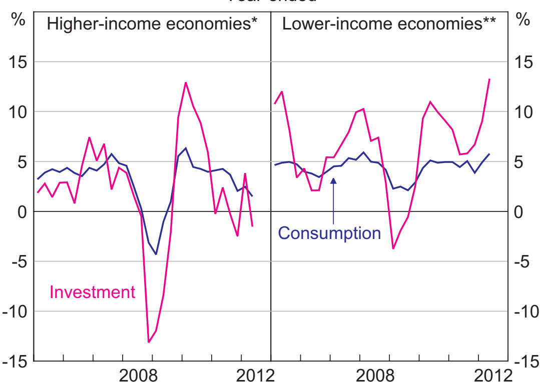


reconstruction also appears to be waning; indicators of public investment, which had risen significantly over the first half of 2012, have softened recently.

Domestic demand conditions are relatively weak in the other higher-income east Asian economies but quite strong in the lower-income east Asian economies, with particularly pronounced differences in investment growth (Graph 1.6). The weakness in investment in the higher-income economies has been concentrated in South Korea and Taiwan, following a strong rebound in investment in 2010. Consumption growth has also eased, consistent with some softening in wage and employment growth. In South Korea, house price growth has slowed and the ratio of household debt to income has turned down after rising significantly over most of the past decade. The strength in investment in the lower-income economies partly reflects the larger role of government in investment spending as well as the expansion of productive capacity for commodities. Consumption in these economies continues to be supported by low unemployment rates and rising household wealth.

Inflation in east Asia has eased noticeably over the past year, and remains lower in the higher-income economies where domestic demand has been weaker.

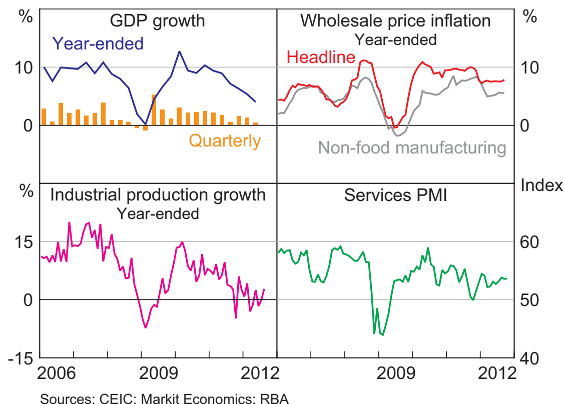
Graph 1.6
East Asia – Domestic Demand Growth



* Hong Kong, Singapore, South Korea and Taiwan
** Indonesia, Malaysia, Philippines and Thailand
Sources: CEIC; IMF; RBA; Thomson Reuters

In India, GDP growth continued to slow in the June quarter (Graph 1.7). At 4 per cent over the year, GDP growth is well below the average of the past decade. Growth in both investment and household consumption has been subdued, while the depreciation of the rupee over the past year has supported growth in exports and contributed to a slowing in imports. Industrial production remains weak; production in the mining and manufacturing sectors has been flat for much of the past two years. Over that time, the production of electricity had been rising, but it has fallen significantly since June, in part reflecting the blackouts in northern India in late July. In contrast, conditions in the services sector have held up, with service exports growing strongly as a result of the weaker rupee.

Graph 1.7
India – Economic Indicators

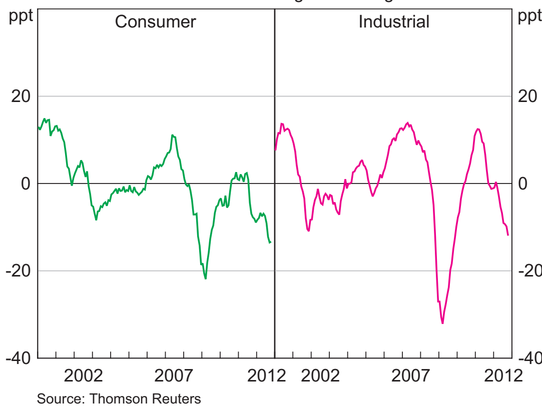


Sources: CEIC; Markit Economics; RBA

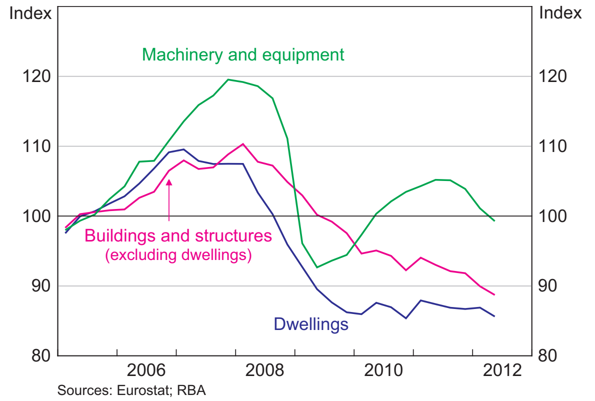
While Indian inflation is lower than the double-digit rates recorded during 2011, wholesale price index inflation has increased a little over recent months. The depreciation of the rupee and higher oil prices have pushed up the cost of the government's subsidies for fuel. In response, fuel subsidies were reduced and fuel prices increased. Although this is not expected to raise the rate of inflation permanently, higher fuel prices may have second-round effects on inflation in the near term. With inflation remaining high despite the slowing in economic activity, the Reserve Bank of India has not lowered its policy rate further, although it has cut its cash reserve ratio by 50 basis points since the previous *Statement*.

Europe

Timely indicators of activity and confidence in the euro area continue to deteriorate, despite some recent improvement in financial markets (Graph 1.8). Economic conditions remain weakest in Greece, Italy, Portugal and Spain, where activity has been contracting at average rates of up to 1½ per cent per quarter. Many of these economies continue to miss targeted reductions in their fiscal deficits and, in response, additional fiscal consolidation measures have been announced. Even the stronger economies in the region have shown signs of deterioration. The French economy has barely grown since March 2011, and there are signs that growth in the German economy is slowing further. In contrast, in the United Kingdom GDP grew in the September quarter, after contracting in the previous three quarters, although a number of one-off factors contributed to this outcome.

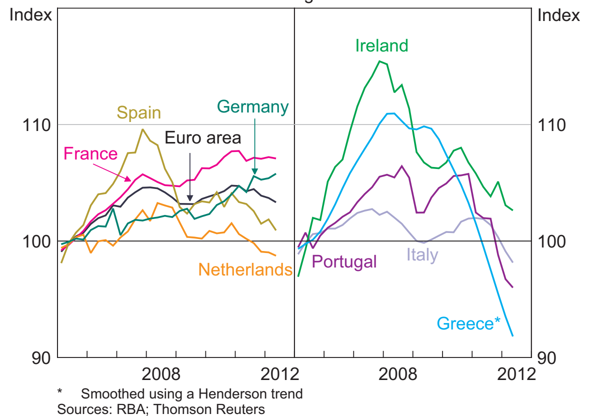


Investment activity in the euro area remains very weak (Graph 1.9). Residential investment has been flat since the end of 2009 following a 20 per cent fall over the previous two years, consistent with the large correction in housing markets in a few countries. Although machinery and equipment investment had recovered somewhat from its 2009 trough, particularly in Germany, it has softened since mid 2011.



Consumption in the euro area has been in decline since the beginning of 2011, with indicators of consumption remaining weak into the September quarter (Graph 1.10). As with other indicators, consumption has been weakest in the crisis economies, consistent with the very low levels of consumer sentiment and high unemployment rates, which remain around 25 per cent in Greece and Spain. Reflecting its significantly stronger labour market, consumption in Germany has continued to grow.

The external sector remains the primary source of growth in the euro area. Export volumes rose by almost 4 per cent over the year to July, assisted by



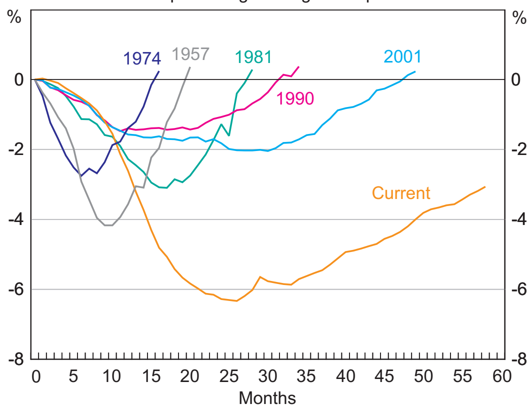
a significant real depreciation, and export values suggest that there was further growth in August. Exports from Germany continue to grow, and it appears that, with exports to China softening a little, exports of machinery and equipment to the Americas have become an important source of growth more recently. Reflecting weak domestic activity, euro area import volumes have been more subdued.

Annual headline inflation, at 2.5 per cent, is above the ECB's target, reflecting high rates of inflation in petrol and other energy prices. However, consistent with weak activity, core inflation in the euro area is much lower, at 1.5 per cent.

United States

The recovery in the United States has continued at a moderate pace, with GDP growing at an annualised rate of 2 per cent in the September quarter. Although indicators of activity have been a little more positive recently, including employment growth, the level of employment is still more than 3 per cent below its pre-crisis peak (Graph 1.11). The pace of growth is consistent with the more protracted recovery generally experienced after financial crises. The state of the labour market was a key reason behind the Federal Open Market Committee's announcement of additional quantitative easing measures at its September meeting.

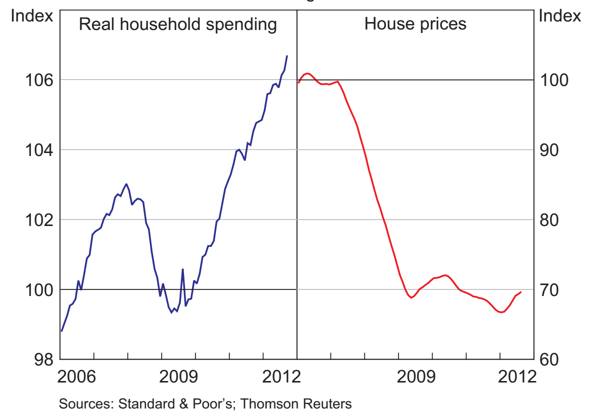
Graph 1.11
United States – Non-farm Payrolls
Cumulative percentage change from peak month



Source: Thomson Reuters

Household consumption growth has picked up recently after slowing through the first half of the year (Graph 1.12). Recent trends in consumption growth have largely reflected purchases of motor vehicles, which have recovered following earlier disruptions to supply chains in Asia. Purchases of other durable goods have also continued to grow at an above-trend pace. The recent turnaround in consumption growth is consistent with the improvement in employment growth and consumer sentiment over the past few months.

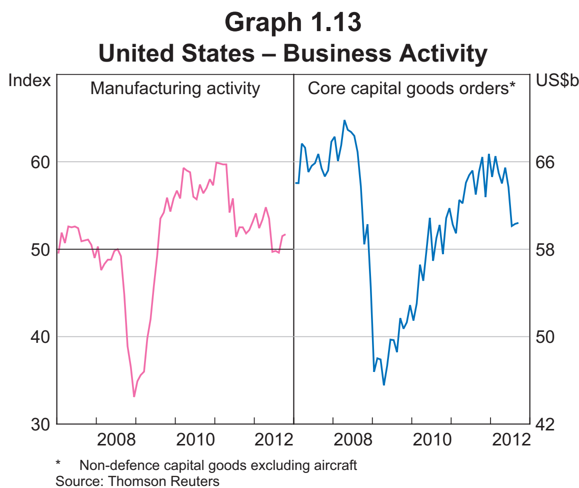
Graph 1.12
United States – Household Activity
2006 average = 100



Sources: Standard & Poor's; Thomson Reuters

Housing market developments have been reasonably positive and no longer appear to be weighing on growth in economic activity. House prices have risen steadily since the beginning of the year. Applications for mortgage refinancing have increased noticeably in recent months, though mortgage applications for new purchases remain at depressed levels, suggesting that households remain unwilling or unable to take on much additional debt. Builder confidence has risen to levels not seen since mid 2006, although this seems to have run somewhat ahead of housing-related activity, as indicated by the more moderate pick-up in housing starts.

Timely indicators of business activity have improved in recent months from weaker levels seen earlier in the year. Both the manufacturing and non-manufacturing ISM surveys show an improvement in conditions over September and October (Graph 1.13). Industrial production partly recovered in September from its large, hurricane-affected fall in the previous month; it is too early to tell the extent to which Hurricane Sandy in late October has affected activity. However, forward-looking indicators of investment remain weak. Core capital goods orders, which are a leading indicator of equipment and software investment, have fallen noticeably since the middle of the year and indicators of non-residential construction activity remain subdued.

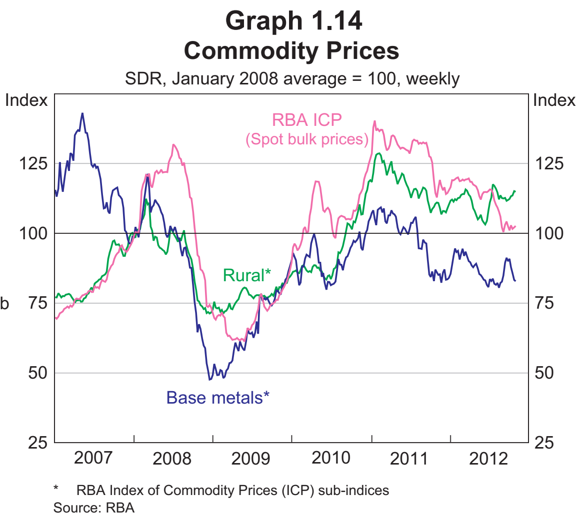


While the modest improvement in employment, consumption and the housing market bodes well for the pace of the recovery, the large fiscal consolidation legislated for the beginning of 2013 remains a significant risk (see 'Box B: Fiscal Consolidation in the United States' for a detailed discussion).

Spare capacity in the economy continues to place downward pressure on inflation. Year-ended rates of both headline and core inflation for personal consumption expenditures are below the Federal Reserve's stated 2 per cent goal. Core inflation has trended down since the beginning of the year.

Commodity Prices

Developments in global commodity markets have been mixed in recent months. The RBA Index of Commodity Prices (ICP) has fallen since the August *Statement*, as declines in prices for coking and thermal coal have only been partly offset by increases in the prices of rural commodities and gold (Graph 1.14; Table 1.1).



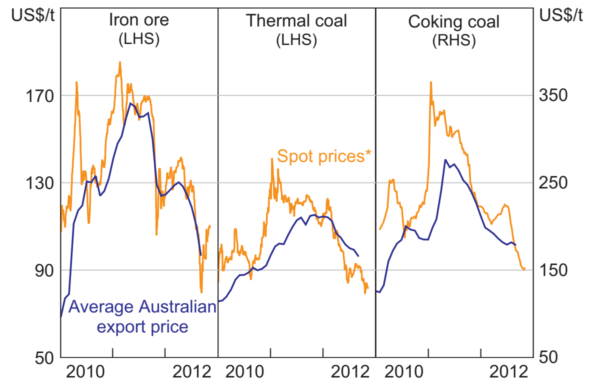
There has been significant volatility in the spot price of iron ore in recent months. After falling sharply over July and August, the spot price of iron ore has risen from its early September low, although it remains around 21 per cent lower than its recent peak in April (Graph 1.15). The spot price of premium hard coking coal has declined, and the benchmark contract in the December quarter has reportedly been settled at US$170 per tonne, which is the lowest contract price settled since 2009/10. Lower prices of both iron ore and coking coal over recent months largely reflect developments in the Chinese steel sector, which is a major source of demand for both commodities (for more detail, see 'Box A: China's Steel and Iron Ore Sector'). The recent approval of infrastructure projects in China may have contributed to some of the unwinding of the sharp falls in the spot price of iron ore more recently, although the spot price of coking coal has not rebounded. The trend to

Table 1.1 Commodity Price Growth[(a)]
SDR, per cent

	Change since previous *Statement*	Change over the past year
Bulk commodities		
– Iron ore	3	0
– Coking coal	–21	–33
– Thermal coal	–14	–29
Rural	1	4
– Beef	0	1
– Cotton	–8	–24
– Wheat	4	30
– Wool	1	–13
Base metals	2	–2
– Aluminium	1	–7
– Copper	1	1
– Lead	13	13
– Nickel	3	–12
– Zinc	0	–2
Gold	4	–1
Brent oil[(b)]	–6	–7
RBA ICP	–6	–14
– using spot prices for bulk commodities	–5	–10

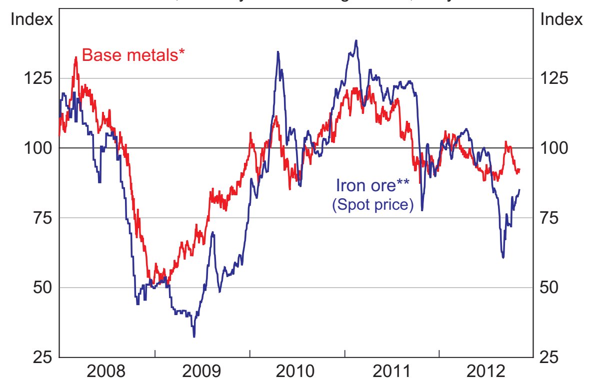
(a) RBA Index of Commodity Prices (ICP) components except oil and bulk commodities prices, which are spot prices; latest available
(b) US dollar terms
Sources: Bloomberg; RBA

Graph 1.15
Bulk Commodity Prices
Free on board basis



* Iron ore fines, Newcastle thermal coal and premium hard coking coal
Sources: ABS; Bloomberg; Citigroup; Energy Publishing; globalCOAL; Macquarie Bank; RBA

Graph 1.16
Base Metals and Iron Ore Prices
SDR, January 2012 average = 100, daily



* RBA Index of Commodity Prices sub-index
** Iron ore fines; free on board basis
Sources: Bloomberg; RBA

shorter-term pricing arrangements in both the iron ore and coking coal markets means that recent changes in these spot markets have flowed through more quickly to prices received by producers.[1]

In recent years, there has been a relatively close relationship between iron ore spot prices and base metals prices, reflecting the influence on both of Chinese demand (Graph 1.16). However, in contrast to iron ore, base metals prices were temporarily boosted by the approval of further infrastructure projects in China and the announcement of quantitative easing in the United States, and are broadly unchanged since earlier in the year.

Energy price developments have been mixed since the August *Statement*. Spot prices of thermal coal – which is principally used in electricity generation – have continued to decline. In part, this reflects increased supply of thermal coal from Indonesia and Australia over the past year, but, perhaps more importantly, exports of thermal coal from North and South America have increased. There has been reduced demand for thermal coal in US electricity

1 See RBA (2012), 'Box B: Iron Ore Pricing', *Statement on Monetary Policy*, August, pp 15–16.

generation in response to the increase in the supply, and hence reduction in the price, of natural gas in the United States. While there has been some increase in natural gas prices in the United States and high-cost American coal producers have started to cut production, the spot price for thermal coal has continued to decline. The price of Brent crude oil has drifted lower since the August *Statement*.

Prices of some rural commodities, such as wheat, soya beans and corn, have been at high levels since late June due to dry conditions in the Black Sea and US cropping regions. Recent rainfall in the United States has led to some moderation in the prices for soya beans and corn, although wheat prices remain elevated.

Box A

China’s Steel and Iron Ore Sector

There has been considerable volatility and a noticeable decline in steel and iron ore prices over the past few months (Graph A1). This contrasts with other commodity prices, which have been relatively stable over recent months. Since China produces around 45 per cent of steel globally, the fall in steel and iron ore prices has focused attention on developments in China.

Graph A1
Chinese Steel and Iron Ore Spot Prices

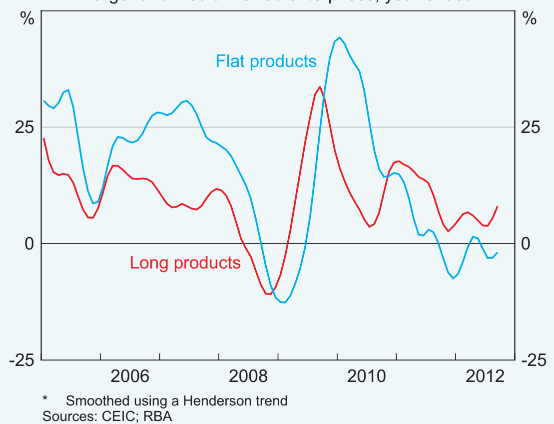
* Average of hot rolled steel sheet and steel rebar prices
** Includes cost of freight to China
Sources: Bloomberg; RBA

The Slowing in Steel Demand

Demand for Chinese steel has slowed since early 2011, in part due to a range of government policies and sector-specific factors. The withdrawal of the fiscal stimulus from late 2010 reduced the growth of infrastructure investment, which contributed to the slowing in construction activity. Government restrictions on the purchase of residential property and on the availability of credit for property development reduced sales of apartments and constrained the cash flows of many property developers, slowing the growth of dwelling construction. However, the reduction in steel demand owing to these factors has been partly offset by the government’s affordable housing program. Construction of affordable housing has made a significant contribution to new residential floor space in China since the beginning of the year. Furthermore, non-residential building construction has been growing at a rapid pace.

Weaker demand for steel for construction activity has been evident in the slower growth in sales of long steel products since 2011 (Graph A2). But the slowing in steel demand has been even more pronounced for flat steel products, which are typically used in manufacturing. The decline in the sales of flat steel products since the beginning of 2012 has been driven by a fall in domestic sales of household appliances – such as refrigerators and washing machines – and weaker growth in exports of business equipment. Growth in both car sales and sales of flat steel products to shipbuilders have also slowed noticeably. Weaker domestic sales of

Graph A2
China – Steel Sales Growth*
Large- and medium-sized enterprises, year-ended



* Smoothed using a Henderson trend
Sources: CEIC; RBA

appliances and cars reflected the expiration of some of the measures introduced to stimulate demand at the onset of the global financial crisis, such as a subsidy scheme for rural buyers of home appliances and a trade-in scheme for urban citizens.

As growth in the demand for steel declined during 2011 (in China and across the world more generally), the production of steel products did not adjust immediately, resulting in a build-up of inventories. This accumulation of inventories was more pronounced for long steel products, whereas the production of flat steel products adjusted more quickly in response to softer sales. The increase in inventories was in part due to the technologies involved in Chinese steel production, which is reliant on blast and basic oxygen furnaces. Blast furnaces, in particular, cannot be shut down easily due to the risk of explosion during cooling and it takes a long time for a blast furnace to become fully operational after being deactivated. Consequently, firms tend to keep these furnaces operating out of the concern that there are large costs of adjusting production, and that delays in restarting furnaces may result in the loss of customers if demand recovers more quickly than they had originally anticipated.

Over recent months, weaker demand conditions in the steel market and rising costs have eroded the profitability of China's steel industry and many steel producers have been reporting very thin margins. This, along with warnings from China's banking regulators, has reportedly led banks to restrict steelmakers' access to credit, particularly for smaller producers. This credit is typically used to cover their purchases of raw materials and ongoing running costs.

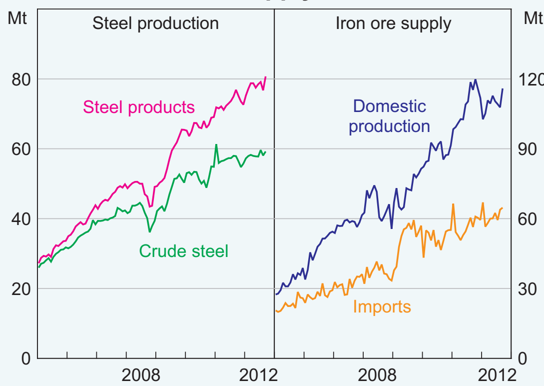
Some delayed adjustment to production in response to the decline in steel prices since September 2011 has now taken place, with many steel mills suspending production and bringing forward routine maintenance on plant and equipment. According to the China Iron and Steel Association, crude steel production capacity reached 850 Mt in December 2011. However, production was much less than this at only 680 Mt in 2011. Growth in production in 2012 has been very modest and so there remains excess capacity. The combination of a very competitive environment and excess capacity in China's steel industry has depressed steel prices and profit margins. In the past, the use of crude steel had grown strongly enough to justify capacity running ahead of current demand. However, crude steel production is not expected to grow as strongly as it has in the past.

Excess capacity and the relatively large number of firms engaged in steel production may both be affected by recent changes in government regulation, which are aimed at increasing the efficiency of steel production and reducing its environmental costs. The Chinese Government announced a new set of regulations, effective from 1 October this year, imposing stricter controls on the quality of steel products, energy consumption and emissions, and higher technology standards. It has banned the production of a number of steel products, including hot rolled silicon steel, for example, which is used in the manufacturing of generators. The government has also put minimum requirements on the size of furnaces. Accordingly, firms with steel-making capacity below certain thresholds will be forced to merge or shut down.

The Effect on the Iron Ore Market

The weakness in steel demand and the reduction in steel production have translated into a fall in the demand for iron ore and exerted downward pressure on iron ore prices, which was magnified by existing high levels of iron ore inventories held by steel mills and traders at ports. As mentioned earlier, tighter access to credit has limited the ability of some firms to purchase iron ore, while it has been reported that some have been forced to sell existing iron ore inventories to cover cash shortfalls.

The reduction in Chinese demand for iron ore has been borne mainly by relatively high-cost iron ore producers in China. High iron ore prices from early 2010 to mid 2011 resulted in a rapid expansion in the domestic production of iron ore by Chinese firms. The lower prices for iron ore since late 2011 had resulted in a cut in China's iron ore production as higher-cost producers scaled back their production (Graph A3). Some mines had reportedly scaled back operations to around 60 per cent of capacity as the price of iron ore fell below the break-even point for many domestic mines. At the same time, substitution towards foreign-produced iron ore has seen imports of iron ore continue to grow, particularly from Australia and Brazil, where the larger miners produce high quality iron ore at low cost. The recent rebound in prices, however, appears to have supported an increase in iron ore production in China.



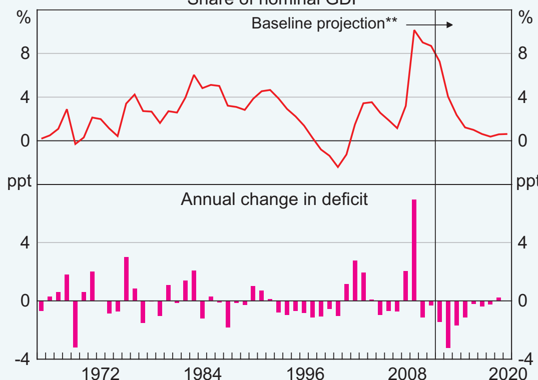
Recent increases in steel prices and production suggest that China's demand for steel is recovering somewhat. The National Development and Reform Commission approved a number of infrastructure projects that will provide some support to steel demand in the near term and the government announced another year-long subsidy scheme to encourage purchases of energy-saving household appliances. Looking further ahead, China's demand for steel is likely to continue to grow. The ongoing urbanisation process will underpin the demand for high-density dwelling construction. Recent research published by the Bank also suggests that higher incomes will result in increased demand for higher quality apartments and more amenities, such as underground car parks, which tend to increase the steel intensity of these buildings.[1] Also, the growing urban population will require more infrastructure and increase the demand for household appliances and cars.

1 For more details, see Berkelmans L and H Wang (2012), 'Chinese Urban Residential Construction to 2040', RBA Research Discussion Paper No 2012-04.

Box B

Fiscal Consolidation in the United States

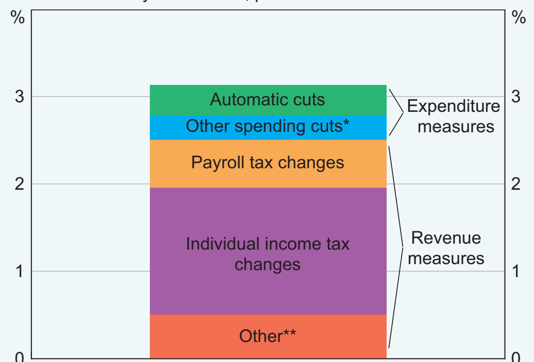
Under current legislation in the United States, significant fiscal consolidation is set to occur in January 2013. This sharp tightening, which has come to be known as the 'fiscal cliff', would be the result of tax rate increases and spending cuts. These measures would reduce the federal budget deficit by more than 4 percentage points of GDP in the 2013 calendar year or by 3¼ percentage points in the 2013 fiscal year according to Congressional Budget Office estimates. If it proceeds in this way, it would be the largest reduction in the federal budget deficit in a single fiscal year since 1969 (Graph B1). It is estimated that such rapid fiscal consolidation would result in annual average growth in the United States 3–4 percentage points lower than otherwise in 2013, with output contracting in the first half of the year.



Components of the Consolidation

The fiscal cliff largely reflects the expiry of a number of budget measures that were initially legislated to be temporary. Some have been in place for many years, such as various individual income tax provisions enacted in 2001 and 2003 (usually referred to as the 'Bush-era tax cuts') and subsequently extended. Others were part of fiscal stimulus measures enacted in 2009 and 2010 to support economic growth. These include the reduction in the employees' payroll tax rate by 2 percentage points and the extension of unemployment benefits to those who have been out of work for more than 26 weeks (and up to 99 weeks). The individual income tax provisions (the majority of which are the Bush-era tax cuts) make up the largest component of the fiscal cliff, while the extended unemployment benefits and payroll tax cuts are a smaller part (Graph B2).

A small share of the fiscal cliff is accounted for by automatic spending cuts from the *Budget Control Act 2011*. These cuts were originally legislated as a default mechanism to reduce the deficit if, by November 2011, a special Congressional committee (the Joint Select Committee on Deficit Reduction) could not agree on measures that would reduce the



deficit by at least US$1.2 trillion over the following decade. Because the Committee was unable to produce legislation within the deadline, cuts in spending, evenly split between defence and non-defence items, are now automatically set to occur in each fiscal year over the next decade, starting in January 2013.

Timing of Key Events

Given the significant economic contraction implied by the fiscal cliff, most forecasters assume that it will not proceed to its full extent. However, to avoid the full impact of consolidation on economic growth, new legislation would need to be enacted before major revenue measures are due to expire at the end of December and major reductions in outlays are scheduled to occur in early January (Table B1). This will require agreement across the major political parties, something that has been difficult to achieve to date. If new legislation is not passed by the end of December, the new Congress could enact retroactive legislation sometime after it first sits in January to minimise the economic impact of the fiscal cliff. ✠

Table B1: Timeline of Key Legislative and Political Events

Year	Date	Event
2012	6 November	Federal elections for: – President and Vice-President – All seats in the House of Representatives – One-third of the seats in the Senate The existing Congress returns for a final session of government before the new Congress is sworn in
	31 December	Expiry of various individual income tax measures Expiry of the temporary reduction in payroll tax
2013	2 January	End of extended (emergency) unemployment benefits Automatic spending cuts from the *Budget Control Act 2011* take effect
	3 January	New Congress sworn in
	21 January	Inauguration ceremony for elected President

Sources: Congressional Budget Office; Department of Labor; Joint Congressional Committee on Inaugural Ceremonies

2. International and Foreign Exchange Markets

Central Bank Policy

Policy actions by major central banks have underpinned a significant improvement in global market sentiment since the middle of the year. The avoidance of some key risks in Europe and generally better-than-expected global economic data have also supported markets.

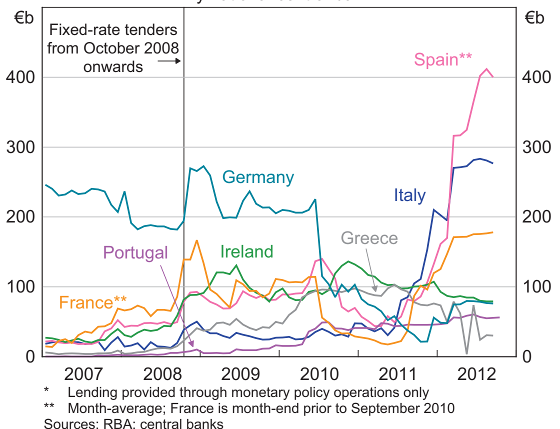
At its 6 September meeting, the European Central Bank (ECB) confirmed its willingness to purchase shorter-term sovereign bonds in secondary markets, through a new program of Outright Monetary Transactions (OMT). The existing Securities Markets Program, which had not been used to purchase sovereign debt since March 2012, was terminated. The aim of OMT is to safeguard the transmission of monetary policy in the euro area by addressing what the ECB assesses to be the 'severe distortions' in euro area government bond markets, particularly those arising from 'unfounded' fears of a euro area break-up. Key features include:

- Purchases will focus on bonds with a residual maturity of between one and three years.
- No limit has been set on the size of purchases.
- Before any ECB action occurs, governments must first request an official assistance program under which 'strict and effective' conditionality is imposed.
- For countries already under an adjustment program, such as Ireland and Portugal, the ECB will consider purchases once these countries regain full market access.
- In assessing whether purchases are warranted, the ECB will not target a particular level of yields; rather, it will examine a range of market indicators, including yields, CDS spreads, bid-ask spreads, liquidity and volatility.

Conditions in euro area sovereign debt markets improved considerably when ECB President Draghi indicated in late July that the ECB was prepared to take decisive action to preserve the euro, and improved further after the OMT program was confirmed (see 'European Sovereign Debt Markets'). With bank funding conditions also improving, ECB lending to banks for monetary policy purposes has fallen by about 5 per cent since the end of August, to be around €1.1 trillion. A reduction in lending via the Bank of Spain has accounted for much of the overall decline (Graph 2.1).

In the United States, at its September meeting, the Federal Reserve announced additional measures to ease monetary policy by expanding its asset purchases and extending its forward rate guidance.

Graph 2.1
ECB Lending to Banks*
By national central bank



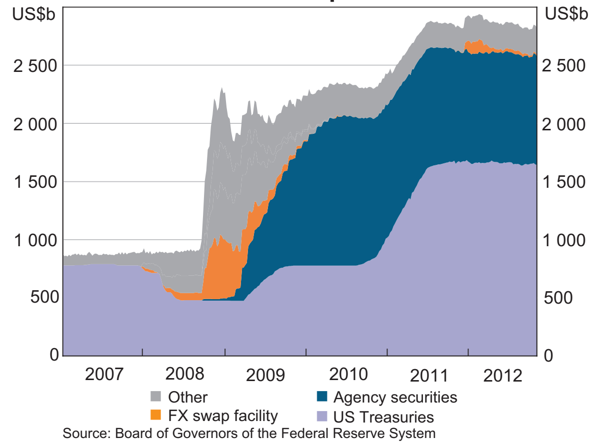
* Lending provided through monetary policy operations only
** Month-average; France is month-end prior to September 2010
Sources: RBA; central banks

It also explicitly linked its policy outlook to economic outcomes.

The Fed will purchase additional agency mortgage-backed securities (MBS) at a pace of US$40 billion per month. Purchases began in mid September and will continue until a 'substantial improvement' in the outlook for the labour market is seen. It was also noted that further policy action, including additional asset purchases, may be warranted. The Fed emphasised that it expects a highly accommodative stance of monetary policy to remain appropriate for a considerable time after the economic recovery strengthens and anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least until mid 2015 (previous guidance was late 2014).

The policy of reinvesting principal repayments from its holdings of agency debt and MBS into agency MBS will also be maintained. In total, around US$65–70 billion of agency MBS will be purchased on a monthly basis, equivalent to roughly half the average gross monthly issuance of agency MBS (Graph 2.2). The Fed already held around US$850 billion of agency MBS, purchased as part of its first round of large-scale asset purchases (Graph 2.3). The Fed will also continue its Maturity Extension Program as planned through to the end of the year; to date, the Fed has purchased about US$585 billion of longer-term US Treasuries – funded by the sale of short-term securities – as part of the US$667 billion program.

Graph 2.3
Federal Reserve – Composition of Assets

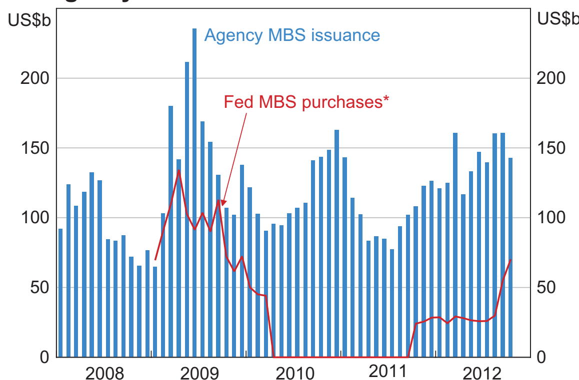


Source: Board of Governors of the Federal Reserve System

The Bank of Japan increased the size of its Asset Purchase Program in September and October by a total of ¥21 trillion, to ¥91 trillion; planned purchases will now be completed by the end of 2013 (an extension of six months). The Bank also established the 'Stimulating Bank Lending Facility' which will provide funds at its policy rate to banks (against eligible collateral) that increase lending. The Bank of England has completed purchases under the £375 billion Asset Purchase Facility.

A number of other central banks have eased policy by lowering policy rates in recent months (Table 2.1). The central banks of Israel, Korea, Sweden and Thailand all cut their policy rates by 25 basis points. The Central Bank of Brazil lowered its policy rate by a total of 75 basis points, to 7.25 per cent, bringing the cumulative reduction to 525 basis points since August last year. In contrast, the Central Bank of the Russian Federation increased rates by 25 basis points to 8.25 per cent.

Graph 2.2
Agency MBS Issuance and Fed Purchases



* Net of sales, dollar rolls and coupon swaps
Sources: Bloomberg; Fannie Mae; Federal Reserve Bank of New York; Freddie Mac; Ginnie Mae; RBA

European Sovereign Debt Markets

Yields on euro area 'periphery' government bonds have fallen markedly since ECB President Draghi indicated in late July that the ECB would do 'whatever it takes to preserve the euro'. Yields on shorter-dated

Table 2.1: Policy Rates

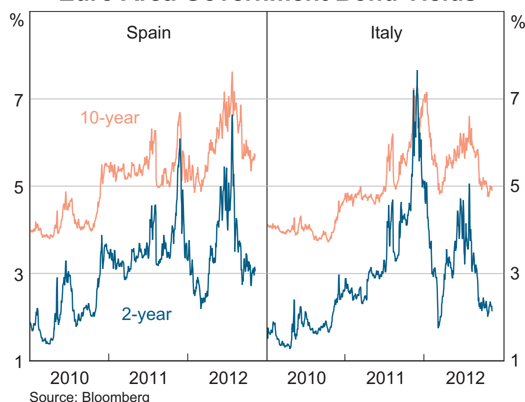
	Current level Per cent		Most recent change	Change from 2011 peak Basis points
Euro area	0.75	↓	Jul 12	–75
Japan	0.05	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Australia	3.25	↓	Oct 12	–150
Brazil	7.25	↓	Oct 12	–525
Canada	1.00	↑	Sep 10	–
China	6.00	↓	Jul 12	–56
India	8.00	↓	Apr 12	–50
Indonesia	5.75	↓	Feb 12	–100
Israel	2.00	↓	Oct 12	–125
Malaysia	3.00	↑	May 11	–
Mexico	4.50	↓	Jul 09	–
New Zealand	2.50	↓	Mar 11	–50
Norway	1.50	↓	Mar 12	–75
Russia	8.25	↑	Sep 12	–
South Africa	5.00	↓	Jul 12	–50
South Korea	2.75	↓	Oct 12	–50
Sweden	1.25	↓	Sep 12	–75
Switzerland	0.00	↓	Aug 11	–25
Taiwan	1.875	↑	Jun 11	–
Thailand	2.75	↓	Oct 12	–75
United Kingdom	0.50	↓	Mar 09	–

Source: central banks

Spanish government bonds have fallen particularly sharply, with the 2-year yield declining by around 350 basis points from its recent peak, to be around the lowest level since early 2012 (Graph 2.4). Spanish 10-year government bond yields have fallen by around 200 basis points from their peak of over 7½ per cent in July. Italian government bond yields have also fallen sharply, particularly at the short end of the yield curve. More generally, spreads between yields on all periphery government bonds and German bunds have narrowed in recent months (Graph 2.5).

Notwithstanding the decrease in sovereign bond yields, investors remain concerned about the situation in Spain. There is ongoing uncertainty surrounding a potential request by the Spanish

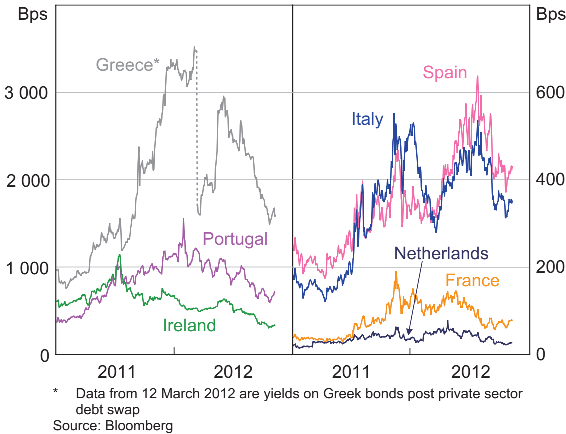
Graph 2.4
Euro Area Government Bond Yields



Source: Bloomberg

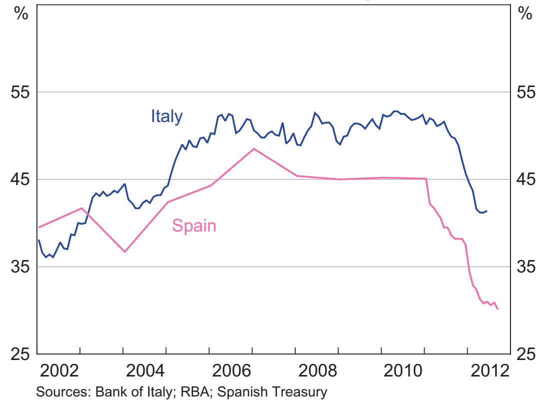
Government for a precautionary financial assistance program from European authorities which, as

Graph 2.5
Euro Area Government 10-year Bond Spreads
To German Bunds



* Data from 12 March 2012 are yields on Greek bonds post private sector debt swap
Source: Bloomberg

Graph 2.6
Foreign Holdings of Central Government Debt Securities
Share of total outstanding



Sources: Bank of Italy; RBA; Spanish Treasury

noted above, is one of the prerequisites for the ECB to purchase Spanish sovereign debt under the OMT program. On the presumption that Spain will request official assistance, Moody's affirmed Spain's sovereign credit rating in October at BBB- (Standard & Poor's equivalent), the lowest investment-grade rating. The fact that Moody's did not downgrade Spain to sub-investment grade alleviated concerns that such a move would force some bond index funds that invest only in investment-grade securities to sell their holdings of Spanish government debt. Recent data suggest that foreign holdings of Spanish and Italian debt securities have stabilised at lower levels (Graph 2.6).

The results of the independent 'bottom-up' audits of the Spanish banking sector were published in late September. In aggregate, banks are assessed as needing nearly €60 billion in additional capital under an adverse macroeconomic scenario, in line with estimates from 'top-down' stress tests published in June. Half of the 14 banks reviewed will be required to raise additional capital. Most of these banks are partly state-owned, through Spain's Fund for Orderly Bank Restructuring. Government officials have indicated that Spain may need to borrow €40 billion from the European Stability Mechanism (ESM) (rather than the full €60 billion capital shortfall), after taking into account transfers of impaired assets to a 'bad bank', private sources of capital, and imposing losses on subordinated debtholders. This would increase Spain's government debt-to-GDP ratio by around 4 percentage points.

Problems with Spanish regional governments' finances have contributed to pressure for the central government to seek further financial assistance. Nine Spanish regional governments have sought around €17 billion in financial aid from the central government's €18 billion regional liquidity fund.

In Greece, the first report on the second assistance package by the 'troika' of official agencies has been delayed by several months. Greek officials have indicated that the Greek Government will struggle to meet its payment obligations beyond mid November in the absence of ongoing official support. The review is now expected to be concluded in November. The recent Greek budget indicated that sovereign debt will peak at around 190 per cent of GDP in 2014, rather than around 170 per cent in 2013 as projected by the IMF back in March. Greek sovereign bond yields recently fell to their lowest level since August 2011 (though they remain at a very high level).

The troika completed its latest review of the Irish assistance package, noting that all fiscal targets were being met despite challenging macroeconomic

conditions. Yields on Irish sovereign bonds have fallen sharply since the beginning of the year and are broadly comparable to those in Spain and Italy.

European finance ministers have agreed to give Portugal an extra year (until 2014) to bring its deficit below the European Union's (EU) 3 per cent of GDP target; the 2012 deficit is expected to be 5 per cent of GDP. Portugal has introduced new tax increases and spending cuts to meet the targets. The next disbursement of funds to Portugal under its assistance program has been approved. In addition, Portugal made its first step towards re-establishing bond market access, by exchanging €4 billion of bonds maturing in September 2013 for securities maturing in 2015. The bond exchange will reduce the size of the September 2013 maturity, which is unfunded under the current assistance program, to €6 billion (from €10 billion).

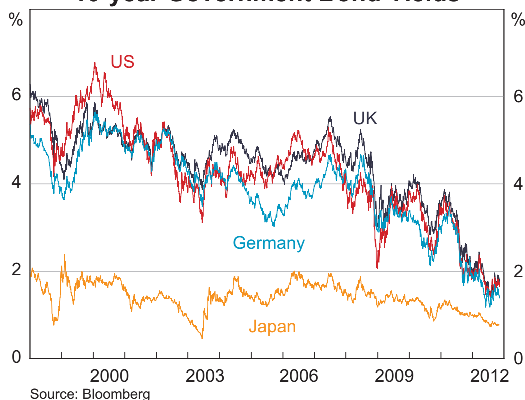
The ESM was officially launched in October. The ESM will become the euro area's main financial assistance mechanism with a peak lending capacity of €500 billion by 2014. To ensure that €500 billion is available for new programs in the interim, the temporary European Financial Stability Facility will remain available for new lending until July 2013 (as well as for the ongoing support for Greece, Ireland and Portugal).

Other Sovereign Debt Markets

Government bond yields in the major advanced economies have increased over recent months, though they remain at very low levels (Graph 2.7). Yields on 10-year German, US and UK government bonds have increased by around 20–30 basis points since late July. Yields on shorter-term government debt have also increased modestly, although 2-year government bond yields in Germany remain negative.

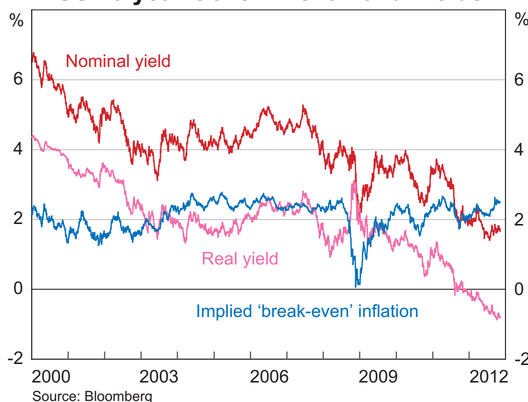
In the United States, yields on 10-year inflation-linked bonds fell to a record low of –0.9 per cent in early October, which implies a 10-year 'break-even' inflation rate of around 2½ per cent (Graph 2.8). The slight rise in this market-based measure of inflation expectations was consistent with the announcement of additional policy stimulus by the Fed.

Graph 2.7
10-year Government Bond Yields



Source: Bloomberg

Graph 2.8
US 10-year Government Bond Yields



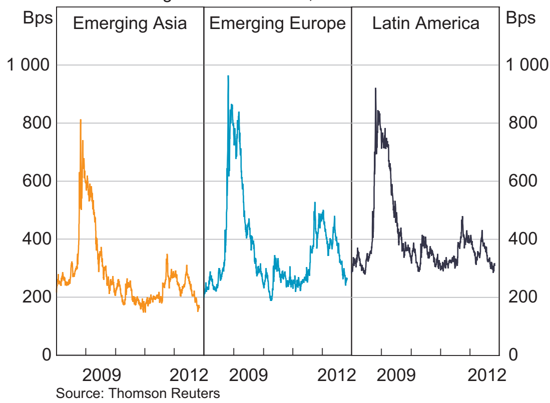
Source: Bloomberg

Spreads on US dollar-denominated debt issued by emerging market sovereigns have narrowed considerably since late July to be around their lowest levels since the onset of the financial crisis (Graph 2.9). South Korea's sovereign credit rating was upgraded by all three major credit rating agencies, based on strong fiscal fundamentals and reduced vulnerability of the Korean banking sector. In contrast, South Africa's sovereign credit rating was cut by one notch by both S&P and Moody's.

Graph 2.9

US Dollar-denominated Sovereign Debt Spreads

To US government bonds, duration matched



Source: Thomson Reuters

Government Financial Policy

In September, the European Commission (EC) released proposals for a single supervisory mechanism (SSM) for banks in the euro area, which followed the announcement of plans for centralised bank supervision at the June EU Leaders' Summit. At their October summit, European leaders committed to agreeing on the legislative framework for the SSM by 1 January 2013, with work on the 'operational implementation' to take place in the course of 2013. While a number of aspects of the SSM are still being debated, the proposals involve the ECB gaining additional responsibilities for bank supervision, which would be carried out in cooperation with national supervisors.

The SSM is a precondition for the ESM to be given the ability to potentially recapitalise banks directly, rather than channelling funds via the sovereign. This would avoid an ESM-funded bank recapitalisation increasing the sovereign's debt. There remains a debate about whether sovereign debt that has already been used to recapitalise banks – which is relevant for Ireland and Spain – could be retrospectively shifted to the ESM once the SSM is established.

In the United States, the US Treasury announced changes to the way the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac will repay the financial support they were provided by the government. Instead of making a preferred dividend payment each quarter, and potentially having to request additional funds from the government to make the payment, from 2013 the GSEs will instead transfer their profits to the US Treasury in an effort to expedite the repayment of financial assistance. The GSEs' combined obligations to the US Treasury are around US$190 billion.

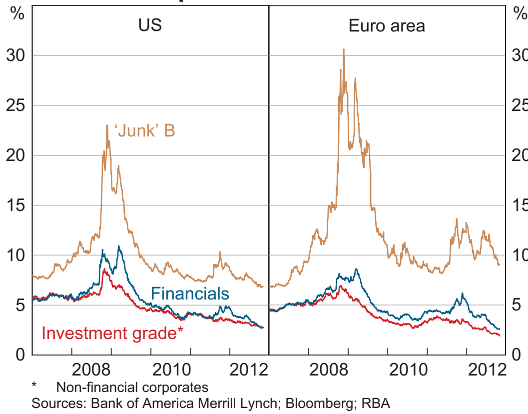
Credit Markets

Conditions in credit markets have improved since the middle of the year, though some strains remain in European markets. Corporate bond spreads have declined and yields are at record low levels for many issuers (Graph 2.10). Corporates have responded to the favourable conditions by refinancing existing debt and reducing their use of short-term funding. Bond issuance by US non-financial firms has been particularly strong, with around US$550 billion of bonds having been issued so far this year. In contrast, gross issuance by US financials remains subdued and has been less than the value of maturing bonds for a number of years (Graph 2.11). Euro area periphery banks' access to unsecured funding remains limited, though issuance by Spanish and Italian non-financial corporates has picked up recently.

Spreads on unsecured interbank borrowing in the euro area have fallen to their lowest levels since mid 2007, while spreads in other major markets have also declined. The cost of swapping euros into US dollars in the foreign exchange market (relative to the cost of unsecured interbank funding) has fallen in recent months.

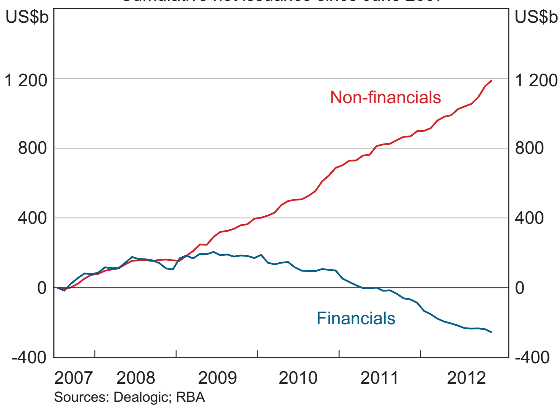
In the United States, the Fed announcement of additional agency MBS purchases led to a decline in agency MBS yields to record lows, though yields have since partly reversed those falls (Graph 2.12) There has also been a small decline in mortgage rates, with 30-year fixed rates falling by around 15 basis points since the Fed's decision, to be around 3½ per cent. However, the spread between primary mortgage rates and agency MBS yields remains elevated

Graph 2.10
Corporate Bond Yields



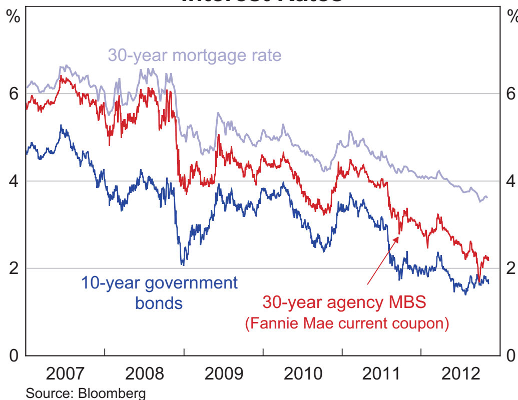
Sources: Bank of America Merrill Lynch; Bloomberg; RBA

Graph 2.11
US Corporates' Net Bond Issuance
Cumulative net issuance since June 2007



Sources: Dealogic; RBA

Graph 2.12
US Treasury, MBS and Mortgage Interest Rates



Source: Bloomberg

relative to history and households with lower-rated credit scores still face limited access to credit.

Equities

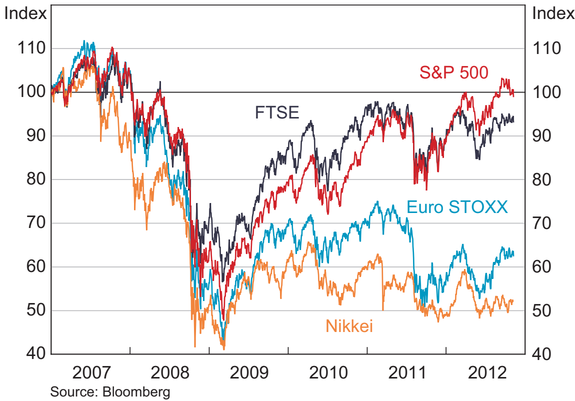
Global equity prices have risen in recent months, to be around 10 per cent higher since the start of the year (Table 2.2; Graph 2.13). As in other asset markets, sentiment has been supported by central bank actions, with better-than-expected economic data also contributing recently. Since late July, share prices have risen by around 15 per cent in the euro area and by around 5 per cent in the other major developed markets. US equities rose to around their highest level since January 2008, but have

Table 2.2: Changes in International Share Prices
Per cent

	Since end 2011	Since late July
United States		
– Dow Jones	6	2
– S&P 500	11	5
– NASDAQ	13	3
Euro area		
– STOXX	9	13
United Kingdom		
– FTSE	4	5
Japan		
– Nikkei	6	7
Canada		
– TSE 300	2	6
Australia		
– ASX 200	11	10
China		
– China A	–4	–1
MSCI indices		
– Emerging Asia	11	10
– Latin America	5	5
– Emerging Europe	8	7
– World	**9**	**6**

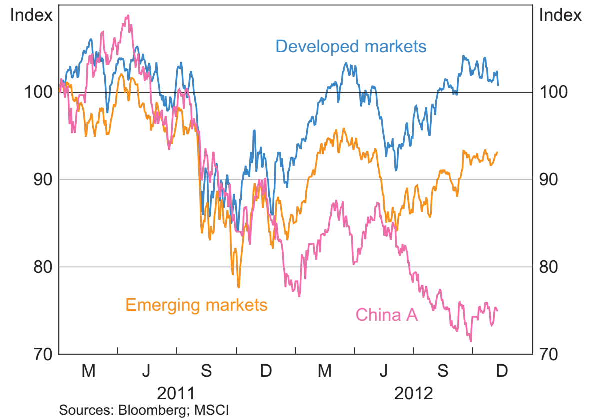
Source: Bloomberg

Graph 2.13
Share Price Indices
1 January 2007 = 100



Source: Bloomberg

Graph 2.14
Share Price Indices
Local currencies, 1 January 2011 = 100



Sources: Bloomberg; MSCI

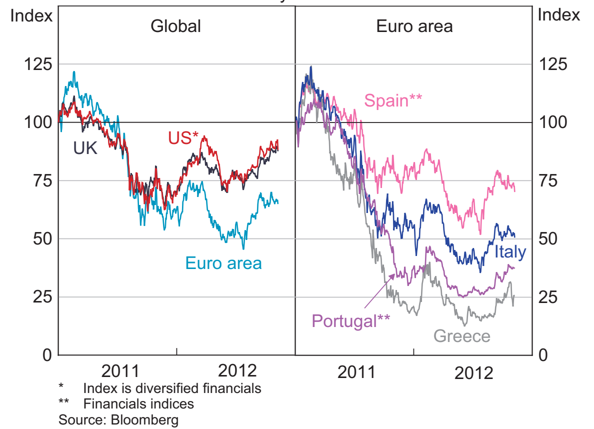
fallen from recent highs, in part due to some mixed corporate earnings results. In contrast, share prices in Japan and the euro area remain well below their pre-crisis levels.

Consistent with the improvement in sentiment, share market volatility has fallen to low levels in the United States and Europe, and global equity issuance has been firm. Furthermore, the amount of shares traded in equity markets has picked up a little recently, after volumes had declined in August to the lowest level in a number of years alongside uncertainty about key policy decisions in Europe and the United States.

Chinese equity prices have underperformed global equity markets since the middle of the year, having fallen by around 20 per cent between their May peak and late September (Graph 2.14). Much of the underperformance was due to concerns about China's economic outlook. More recently, some better-than-expected economic data and continued speculation about government policy actions have seen share prices retrace some of the decline.

Bank share prices have risen by around 20 per cent in the United States and United Kingdom from their recent lows (Graph 2.15). European bank share prices have now risen by around 45 per cent since ECB President Draghi's comments in late July, with the strength broad based across the region. US banks

Graph 2.15
Bank Share Price Indices
1 January 2011 = 100



* Index is diversified financials
** Financials indices
Source: Bloomberg

reported better-than-expected earnings for the September quarter: revenues were supported by an improvement in conditions in the US housing market, in particular a pick-up in refinancing activity, while investment banking revenues were also generally firm. Banks' mortgage lending practices continue to attract attention, with the US Department of Justice recently filing a lawsuit against Bank of America, alleging that the bank's Countrywide subsidiary committed fraud by selling poor-quality mortgages to government-sponsored enterprises.

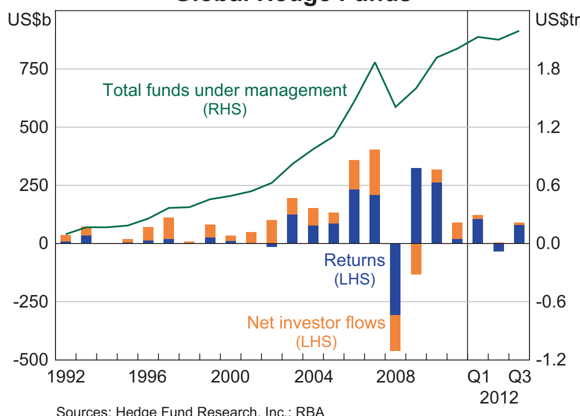
September quarter earnings reported by European banks have been mixed. Several banks have

announced plans to cut costs, including by scaling back their investment banking activities. Increased provisions for non-performing property loans continue to weigh on the profits of Spanish banks. Claims on British banks relating to the mis-selling of payment protection insurance continue to affect profit results.

Hedge Funds

Global hedge funds recorded an average return on investments of 6 per cent over the year to September, which was substantially smaller than the return recorded by global equity markets on a total return basis (that is, including dividends) over the same period (Graph 2.16). Nevertheless, monthly returns from hedge funds have continued to be less volatile than equity market returns. Funds under management by the global hedge funds industry increased to US$2.2 trillion over the September quarter, reflecting both the positive average investment return and a small injection of new capital.

Graph 2.16
Global Hedge Funds

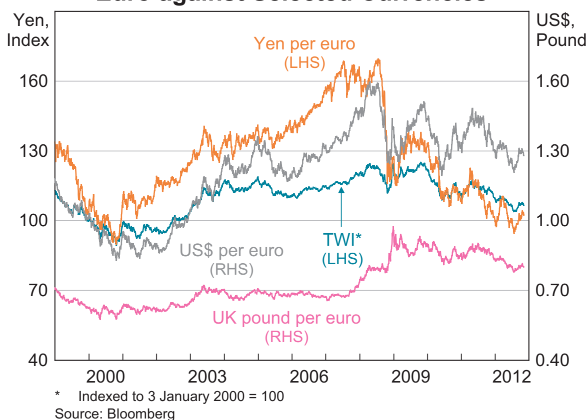


Sources: Hedge Fund Research, Inc.; RBA

Foreign Exchange

Foreign exchange markets have also been influenced by recent central bank policy measures announced in Europe and the United States. Markets interpreted the ECB's OMT program as alleviating some of the near-term risks associated with the outlook for the euro area, and this has contributed to the euro appreciating by around 2 per cent on a trade-weighted basis from the 10-year low it reached in July (Graph 2.17). The appreciation over recent months has been broad based, with the euro rising not only against the US dollar, but also against the currencies of highly rated sovereigns, such as Australia, Canada and Sweden. Since the start of the year, the euro is moderately lower against both the US dollar and on a trade-weighted basis.

Graph 2.17
Euro against Selected Currencies

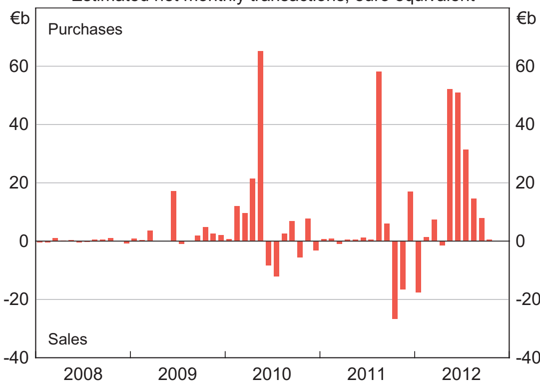


* Indexed to 3 January 2000 = 100
Source: Bloomberg

The reduction in near-term risks associated with the outlook for the euro area has led to a moderation in safe-haven flows into the Swiss franc, which has depreciated slightly against the euro since early September after trading very close to its ceiling of 1.20 francs per euro since the start of the year. This has also been reflected in a scaling back in recent months of foreign currency purchases by the Swiss National Bank (SNB) to defend the ceiling (Graph 2.18). The reserves data published by the SNB suggest that a significant amount of the euros purchased have since been exchanged for other currencies.

The anticipated announcement by the Federal Reserve of a third round of asset purchases weighed on the US dollar, which has depreciated by around 3 per cent on a trade-weighted basis since its peak in late July (Graph 2.19). The recent broad-based

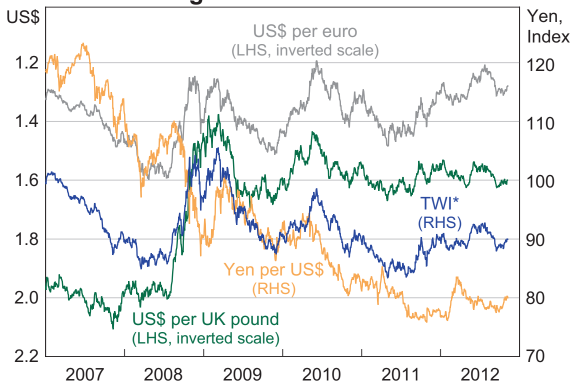
Graph 2.18
Swiss Foreign Exchange Reserves*
Estimated net monthly transactions, euro equivalent



* Transactions estimated based on changes in gross reserves and the SNB's documented currency composition

Sources: Bloomberg; RBA; Swiss National Bank

Graph 2.19
US Dollar against Selected Currencies



* Indexed to 1 January 2007 = 100

Sources: Bloomberg; Board of Governors of the Federal Reserve System; RBA

depreciation of the US dollar reverses its broad-based appreciation during the period of heightened market uncertainty in May, leaving the trade-weighted index unchanged over 2012 to date and not far above its historical low (Table 2.3).

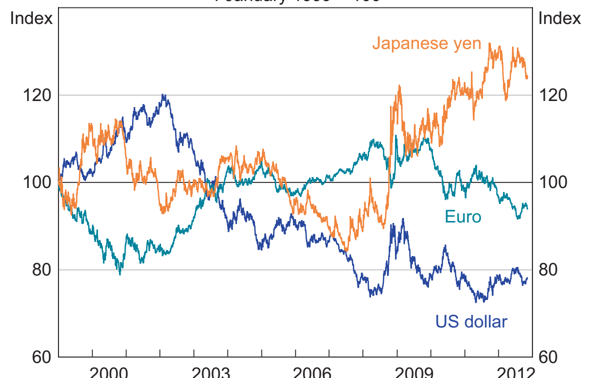
Consistent with a reduction in safe-haven and repatriation flows, the yen depreciated by 2 per cent in trade-weighted terms between late July and early October, depreciating in particular against the strengthening euro (Graph 2.20). Nonetheless, with the yen not far below the multi-decade highs it reached in 2011 against the US dollar and on a trade-weighted basis, the Japanese authorities reiterated

Table 2.3: Change in US Dollar against Selected Currencies
Per cent

	Since end 2011
Brazilian real	9
South African rand	7
Indonesian rupiah	6
Japanese yen	4
Indian rupee	2
European euro	1
Swiss franc	1
Chinese renminbi	–1
Australian dollar	–2
Canadian dollar	–2
Thai baht	–3
UK pound sterling	–3
Swedish krona	–3
Malaysian ringgit	–3
New Taiwan dollar	–4
Singapore dollar	–6
South Korean won	–6
New Zealand dollar	–6
Mexican peso	–6
Philippine peso	–7
Majors TWI	**0**
Broad TWI	**–1**

Sources: Bloomberg; Board of Governors of the Federal Reserve System

Graph 2.20
Major Currencies' Nominal TWI
4 January 1999 = 100



Sources: Bank of Japan; Bloomberg; Board of Governors of the Federal Reserve System; RBA

their willingness to curtail further appreciation if required. The Japanese yen has since depreciated by a further 2 per cent against the US dollar and in trade-weighted terms, in part reflecting the Bank of Japan's decision to increase the size of its asset purchase program. Nevertheless, the yen remains around its long-run average in real effective terms.

The Chinese renminbi (RMB) has appreciated by around 2 per cent against the US dollar from its trough in July, to be slightly stronger than its early May peak (Graph 2.21). The widening of the official trading band for the RMB against the US dollar in April has led to greater flexibility in the exchange rate. Over recent months, the RMB has traded over the full range of its +/–1 per cent daily trading band against the US dollar, appreciating from the lower bound of the band in late July to the upper bound of the band in October. On a trade-weighted basis, the RMB has appreciated since mid September, but still remains slightly below its late May peak.

The recent appreciation of the RMB has coincided with a rise in China's foreign exchange reserves (in US dollar terms) over the September quarter (Table 2.4). Official data suggest that the increase primarily reflects valuation effects (related to the appreciation of the euro) with negligible net purchases of foreign exchange reserves over the quarter, despite the appreciation pressure on the renminbi over this period. This is in contrast to the June quarter, when depreciation pressures on the RMB were accompanied by rare net sales of foreign exchange by the People's Bank of China to support the currency.

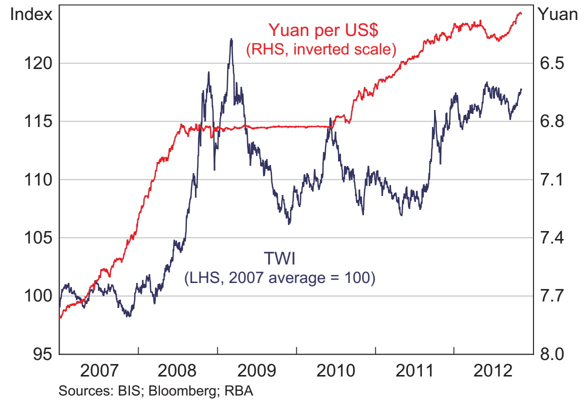


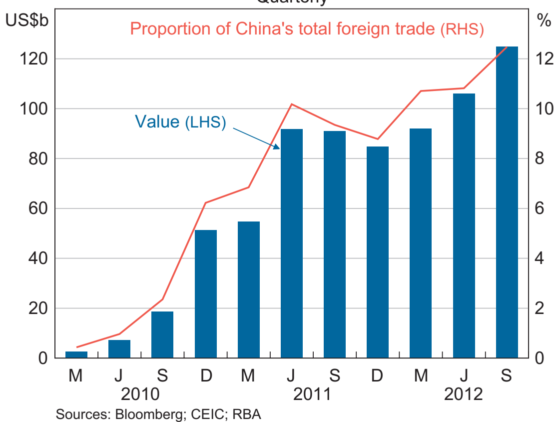
Table 2.4: Foreign Currency Reserves
As at end October 2012

	Three-month-ended change		Level
	US$ equivalent (billions)	Per cent	US$ equivalent (billions)
China[(a),(b)]	45	1	3 285
Japan	–1	0	1 197
Switzerland	36	9	455
Russia	10	2	453
Taiwan[(a)]	8	2	399
Brazil[(c)]	1	0	368
South Korea	9	3	315
Hong Kong[(a)]	11	4	302
India	4	2	260
Thailand[(b)]	8	5	172
Indonesia	4	4	103

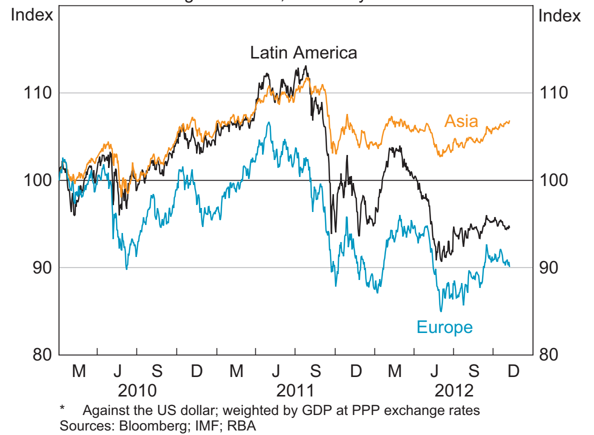
(a) Foreign exchange reserves (includes foreign currency and other reserve assets)
(b) End September
(c) Excludes intervention using currency swaps
Sources: Bloomberg; CEIC; IMF; RBA; central banks

Other central banks in Asia and Latin America also accumulated reserves (in US dollar terms) over recent months, consistent with market reports of intervention to counter appreciation pressure on local currencies, although valuation effects will have also played some role. In October, for the first time since December 2009, the Hong Kong Monetary Authority intervened in the foreign exchange market to cap the rise in the Hong Kong dollar, purchasing a total of US$2.6 billion in foreign exchange.

RMB-denominated trade settlement increased further in the September quarter, accounting for around 12½ per cent of China's total foreign trade (Graph 2.22). In order to further promote the use of the RMB in cross-border transactions, the Chinese authorities have taken additional steps to develop the offshore RMB market over recent months. Notably, China and Taiwan signed a Memorandum of Understanding to establish a clearing and settlement mechanism for RMB-denominated trade between the two jurisdictions. The proposed arrangement will include the establishment of an offshore RMB clearing bank in Taiwan (similar to the current arrangement in Hong Kong) and the establishment of a Taiwanese dollar clearing bank in Mainland China. In addition, a number of restrictions governing the Qualified Foreign Institutional Investors (QFII) scheme were eased, including allowing investment in the domestic interbank bond market and the purchase of larger stakes in domestic listed companies.



After depreciating between February and early June, most other Emerging Asian currencies have since appreciated gradually against the US dollar (Graph 2.23). The Indonesian rupiah and Indian rupee are two exceptions, and in each case the authorities have introduced measures designed to encourage net capital inflows. Although the Indian rupee appreciated sharply in late September in response to the announcement of some recent reforms, both the rupee and the rupiah remain 8–10 per cent below their late January/early February peaks.



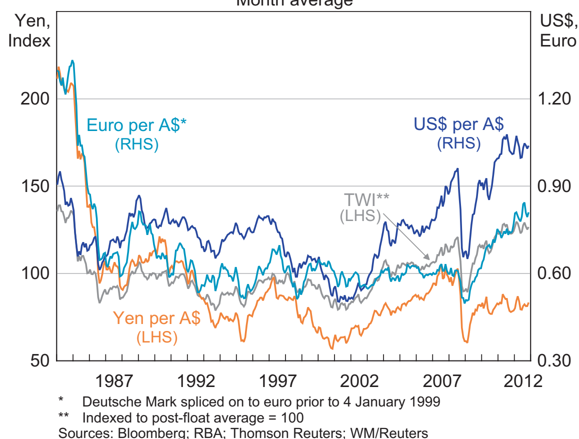
In Latin America, the Brazilian real has appreciated modestly against the US dollar since its trough in late May, with the authorities intervening in the foreign exchange market to counter appreciation pressures on the currency. In contrast, both the Mexican and Chilean pesos have appreciated by around 6 per cent against the US dollar over the same period.

The currencies of emerging European economies generally experienced relatively pronounced appreciations against the US dollar between early June and early October, reflecting improved market sentiment towards the euro area, particularly following the announcement of the ECB's OMT program.

Australian Dollar

The Australian dollar is little changed since the beginning of the year on a trade-weighted basis and remains at a high level by historical standards, notwithstanding the decline in Australia's terms of trade and softer global outlook (Graph 2.24; Table 2.5).

Graph 2.24
Australian Dollar
Month average



* Deutsche Mark spliced on to euro prior to 4 January 1999
** Indexed to post-float average = 100
Sources: Bloomberg; RBA; Thomson Reuters; WM/Reuters

Table 2.5: Change in Australian Dollar against Selected TWI Currencies
Per cent

	Since end 2011
South African rand	9
Indonesian rupiah	8
Japanese yen	6
Indian rupee	5
European euro	4
Swiss franc	3
US dollar	2
Chinese renminbi	1
Canadian dollar	0
Thai baht	–1
UK pound sterling	–1
Malaysian ringgit	–1
Singapore dollar	–4
New Zealand dollar	–4
South Korean won	–4
TWI	**2**

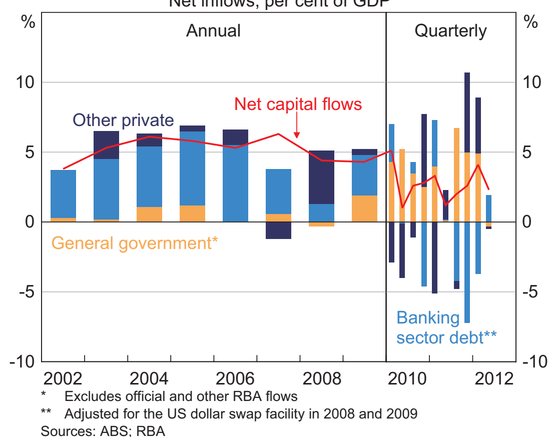
Sources: Bloomberg; Thomson Reuters; W/M Reuters

Consistent with developments in other currencies, the Australian dollar has depreciated against the euro over recent months, to be around 5 per cent below its mid August peak. Intraday volatility in the Australian dollar has been below the level of recent years.

Capital Flows

In contrast to the trend over the past few years, net capital inflows in the June quarter were directed to the private sector, with the public sector recording a small net outflow (Graph 2.25). Nevertheless, non-residents continue to hold around 77 per cent of the stock of Commonwealth Government securities on issue. The net outflow from the public sector may have been related to a large Commonwealth Government bond maturing during the quarter and another coming due for maturity in a year's time, which for some foreign investors is a trigger to roll out of these positions and possibly into bank deposits. This scenario would be consistent with the observed increase in non-resident deposits with Australian banks in the June quarter, which was a key driver of the net private capital inflow. Ongoing net equity inflows to Australian corporates – particularly the mining sector – also contributed to the net inflow of private capital.

Graph 2.25
Australian Capital Flows
Net inflows, per cent of GDP



* Excludes official and other RBA flows
** Adjusted for the US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

3. Domestic Economic Conditions

GDP grew at an above-trend pace over the year to June, though growth in the June quarter itself was slower but still not far from trend pace (Table 3.1; Graph 3.1). Over the year, the strength reflected the surge in mining investment and strong growth in household consumption while non-mining investment remained weak. In the June quarter, both consumption and business investment growth slowed from the rapid pace seen in the March quarter. Over the past year, falls in the terms of trade have weighed on growth in national income.

The latest information suggests that GDP growth in the September quarter was moderate. Consumer spending overall appears to have grown at around the same rate as in the June quarter. After picking up earlier in the year, employment growth softened in the September quarter, which is likely to have weighed on the growth of incomes and spending.

Mining investment appears to have continued to grow at a strong pace in recent quarters. Work underway on over $180 billion of committed liquefied natural gas (LNG) projects is continuing, although there are concerns about delays in terms of

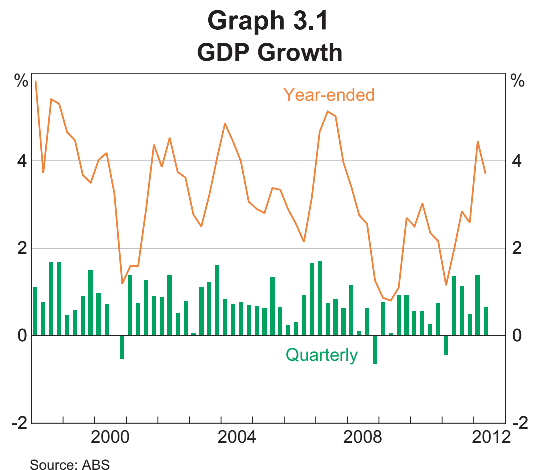


Table 3.1: Demand and Output Growth[(a)]
Per cent

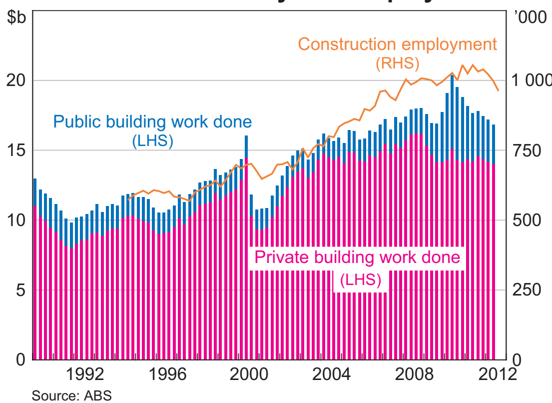
	June quarter 2012	March quarter 2012	Year to June quarter 2012
Domestic final demand	0.9	2.1	5.8
– Private demand	0.4	2.4	6.8
– Public demand	2.3	1.2	2.7
Change in inventories[(b)]	–0.3	0.0	–0.3
Gross national expenditure	0.6	2.0	5.4
Net exports[(b)]	0.3	–0.4	–0.8
GDP	0.6	1.4	3.7
Nominal GDP	1.0	0.4	3.2
Real gross domestic income	0.6	0.4	2.1

(a) Based on the June quarter 2012 national accounts release, rather than the 2011/12 annual national accounts
(b) Contribution to GDP growth
Source: ABS

the rate of progress on some projects. The declines in iron ore and coal prices since earlier in the year have affected the outlook for mining investment over the next few years. Mining companies have announced both a scaling back of investment intentions and plans to restrain spending where possible to preserve cash flows. The terms of trade have continued to decline; in the September quarter they are estimated to have been around 13 per cent below the peak reached a year earlier.

At the same time, investment intentions outside of the mining industry remain relatively subdued. The elevated level of the exchange rate, and weak housing market activity, are still weighing on the outlook for some sectors. In particular, the construction industry has shed labour as the boost from spending on government-funded projects unwinds, and activity in private building construction remains weak (Graph 3.2). Leading indicators do, however, provide tentative signs of a recovery in residential building.

Graph 3.2
Construction Activity and Employment



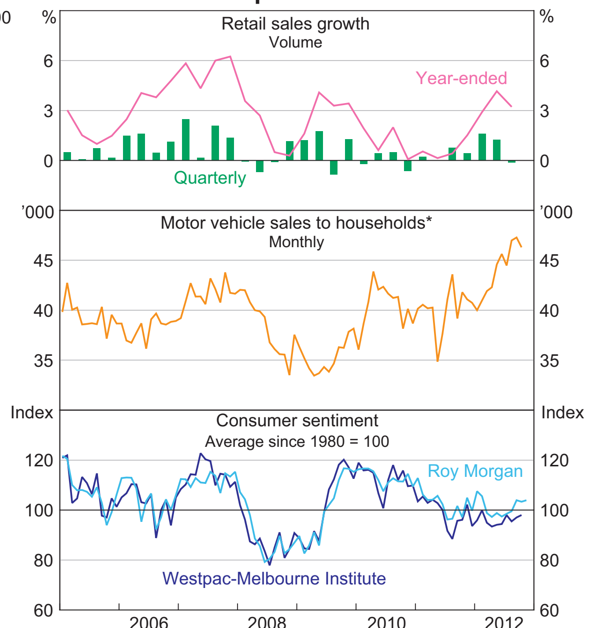
Source: ABS

Household Sector

Consumer spending increased strongly in early 2012, in line with income growth associated with stronger employment growth. Consumption growth slowed in the June quarter from the very strong growth in the March quarter and was supported by various government payments to households made in May and June associated with the introduction of the carbon price and assistance for families with school-age children. Growth in spending on goods was noticeably stronger than on services, reflecting a reversal of the trend seen through much of 2011. In line with this pattern of spending, the volume of retail sales – which primarily captures sales of goods – increased quite rapidly over the first half of this year (Graph 3.3). Sales volumes improved for most types of retailers, although for some this was driven by aggressive discounting earlier in the year. While estimates suggest that online spending by Australian households at both domestic and overseas retailers is only a small fraction of total consumption, it is growing rapidly and so it may have weighed on sales for some other retailers in recent years.

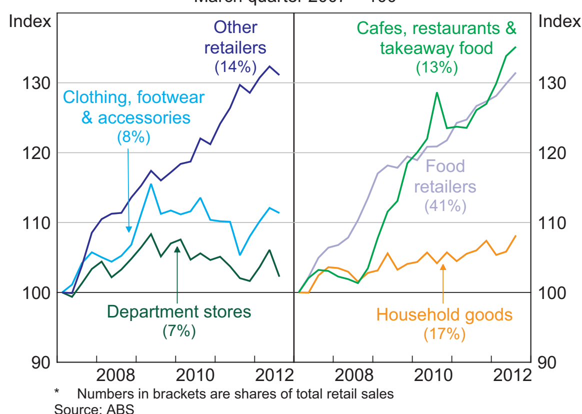
Most indicators suggest that growth in consumption spending continued in the September quarter, but at a pace slightly below trend after the unusual strength earlier in the year, as the impetus to sales from heavy discounting in early 2012 and the government payments to households in the previous quarter unwound. At the same time, growth in labour income is likely to have been reduced

Graph 3.3
Consumption Indicators

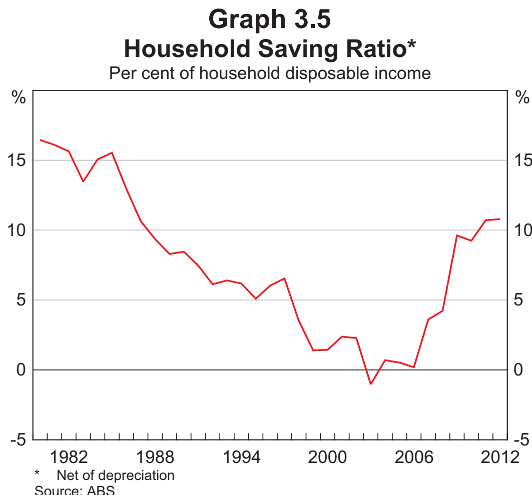


* Seasonally adjusted by the RBA
Sources: ABS; FCAI/VFACTS; Melbourne Institute and Westpac; RBA; Roy Morgan Research

by slower growth in employment and a decline in average hours worked. The value of retail sales grew moderately in the September quarter, underpinned by growth at food-related and household goods retailers (Graph 3.4). However, this reflected higher prices in the quarter, with the volume of retail sales falling slightly. Sales of motor vehicles to households continued to rise in the September quarter. Consumer survey respondents report that now is a good time to purchase a motor vehicle, perhaps as the high level of the exchange rate has made imported vehicles more affordable than in the past. Indeed, the recent strength in car sales has been driven by sales of imported vehicles, with sales of domestically produced vehicles declining over the past six months.

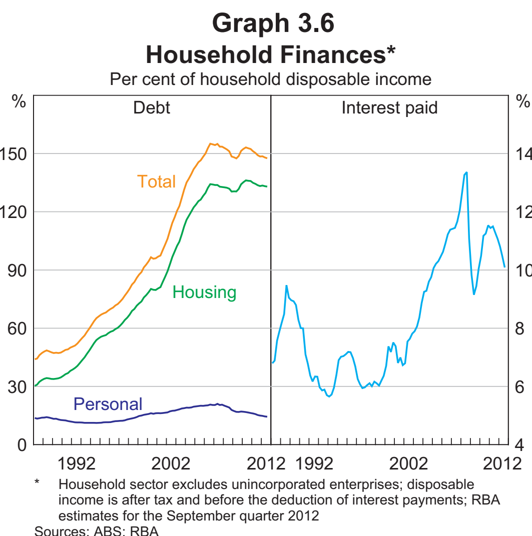


Over the past few years, growth in consumption was broadly in line with household income growth. Consequently, the household saving ratio remained at around 10 per cent of disposable income (Graph 3.5).



Demand for housing finance has remained broadly unchanged as a share of credit; over the past six months, the value of housing loan approvals has risen by around 5 per cent (annualised), driven by owner-occupiers. These new loans have been sufficient to keep aggregate outstanding housing debt growing broadly in line with household incomes despite some increase in loan prepayments (Graph 3.6). The growth of overall household debt has slowed from an annual rate of 5 per cent a year ago to around 4 per cent currently, largely reflecting the increase in prepayments of housing loans and the decline in personal debt outstanding. Lower average interest rates over the June quarter resulted in a fall in households' interest payments as a share of income. Interest payments are estimated to have fallen further following the reduction in the cash rate in October.

Household net worth in the June quarter was about 2 per cent lower than a year earlier, reflecting lower average dwelling prices and higher liabilities,



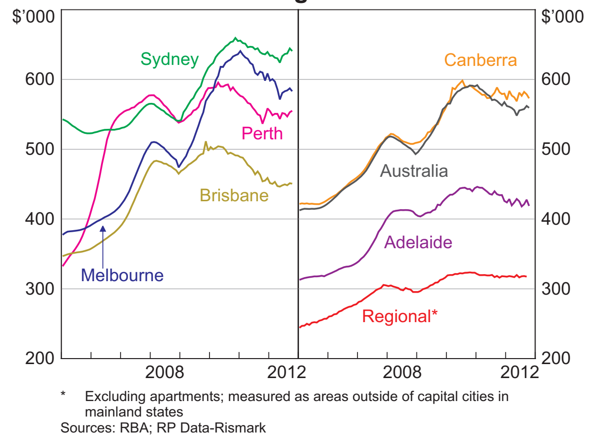
offset somewhat by an increase in financial asset holdings. Net worth is, however, estimated to have risen strongly in the September quarter driven by a rebound in equity and dwelling prices.

Australian capital city dwelling prices have risen by around 2 per cent since their May 2012 trough, although they are still around 5 per cent below their January 2011 peak (Table 3.2; Graph 3.7). Recent price rises have been broad based, with prices in almost all state capitals increasing since May. Despite the increase in dwelling prices, and an increase in auction clearance rates, housing turnover has remained close to the low level of the early 1990s.

Rents have continued to grow strongly, with rental vacancy rates around 2 per cent and remaining near their historical lows. Nationwide, rents have increased by around 4 per cent over the past year. Given more modest growth in house prices, average rental yields have risen to almost 5 per cent, from around 4½ per cent a year ago. Perth in particular has seen very strong growth in rents.

Residential construction activity continued to decline over the first half of the year, to reach low levels as a share of GDP. There are tentative signs, however, that demand for new housing is beginning to improve as falls in mortgage interest rates, higher rental yields and the recent turnaround in established housing prices have increased the attractiveness of new housing investment. Building approvals appear

Graph 3.7
Dwelling Prices



* Excluding apartments; measured as areas outside of capital cities in mainland states

Sources: RBA; RP Data-Rismark

to have reached a trough mid year, supported by a pick-up in higher-density housing (Graph 3.8). While approvals for detached houses have increased by less than total building approvals, typically it can take several quarters for falls in interest rates to spur recovery in this market. In addition, uncertainties in Western Australia associated with the introduction of a new building approvals process are yet to be fully resolved. Loan approvals to owner-occupiers for new construction have increased over 2012, although investor loan approvals for new construction remain subdued (Graph 3.9). Among owner-occupiers, first home buyer demand has increased noticeably, with first home owner grants (FHOGs) for new dwellings increasing quite strongly over the past six months.

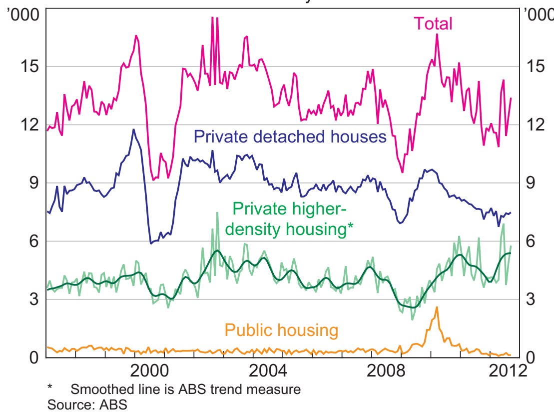
Table 3.2: National Housing Price Growth
Per cent

	3 months to June 2012	3 months to September 2012	Year to September 2012
Capital cities			
ABS[(a), (b)]	0.6	0.3	0.3
APM[(b)]	–0.2	–0.4	–0.3
RP Data-Rismark	–0.6	1.2	–1.3
Regional areas			
APM[(b)]	–1.0	–0.1	–0.3
RP Data-Rismark[(a)]	–0.4	0.4	–0.3

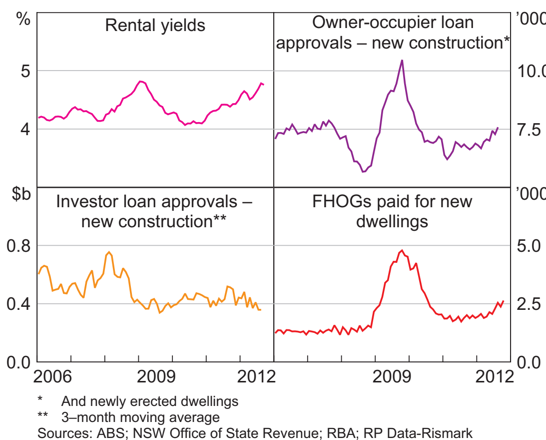
(a) Detached houses only
(b) Quarter-on-quarter growth rate
Sources: ABS; APM; RBA; RP Data-Rismark

While this partly reflects demand in Victoria being brought forward owing to the expiry of the First Home Bonus scheme, the increase in assistance to first home buyers purchasing new dwellings in New South Wales and South Australia may support demand in the period ahead.

Graph 3.8
Residential Building Approvals
Monthly



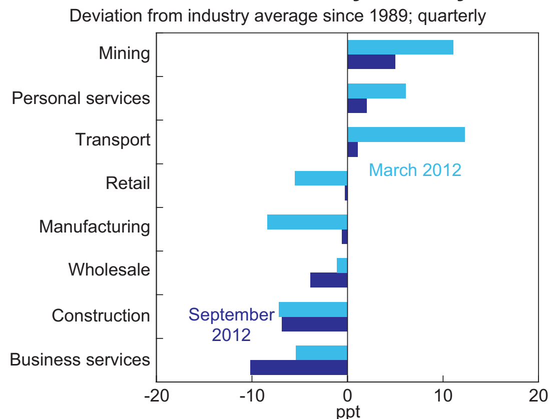
Graph 3.9
Indicators of Dwelling Investment



Business Sector

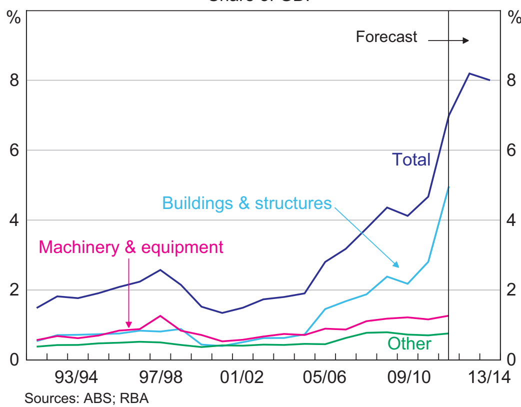
Private sector surveys and liaison with firms suggest that business conditions remain close to their longer-run average, albeit quite a bit softer than the buoyant conditions seen through much of the 2000s. Across industries, a notable change over the past six months has been the large fall in conditions in the mining and transport industries (Graph 3.10). The business services sector has also seen declines while conditions have improved for retail and manufacturing. Business services and building construction continued to report weaker-than-average conditions.

Graph 3.10
Business Conditions by Industry
Deviation from industry average since 1989; quarterly



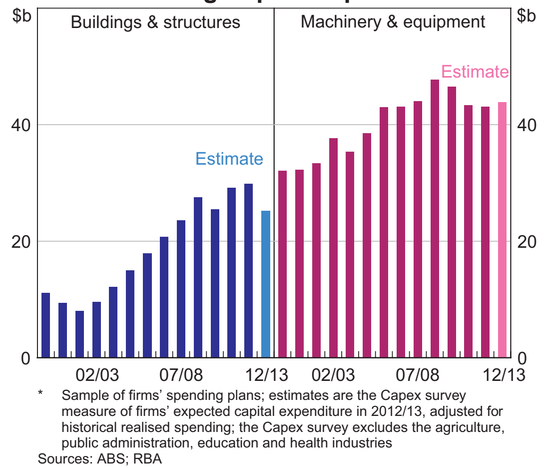
Weaker conditions in the mining industry are consistent with the recent falls in iron ore and coal prices, which have prompted a reassessment of mining investment projects that have been under consideration. Lower prices have reduced mining companies' cash flows and reduced their appetite for investment spending. Sentiment has also been weighed down by the high exchange rate and rising cost pressures. As a result, a number of large uncommitted projects have been deferred, companies are slowing the pace of spending on some committed projects, and some older, higher-cost coal mines have been closed. Liaison with the industry suggests that exploration and feasibility work outside the petroleum sector has been scaled back significantly, partly reflecting reduced access to funding for junior miners. There are also signs that plans for spending on machinery and equipment have been pared back. Despite these developments, investment in the coming year is still expected to rise, underpinned by construction on a number of

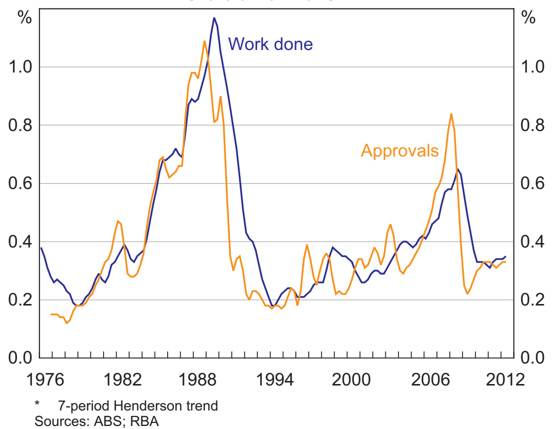
very large LNG projects. LNG investment continues to ramp up as these projects have not been adversely affected by the shift in sentiment elsewhere in the resources sector. Nevertheless, there is uncertainty about the timing of work for some LNG projects. Overall, after surging by around 55 per cent in 2011/12, mining investment looks set to rise further (albeit at a slower rate), and the level of investment in the mining sector is expected to peak some time during 2013 (Graph 3.11).



Outside the mining industry, investment intentions remain relatively soft. After little change in 2011/12, the latest ABS survey of firms' capital expenditure plans (Capex) points to a decline in nominal non-mining investment in 2012/13 (Graph 3.12). Machinery and equipment investment is expected to be broadly unchanged this financial year, although motor vehicle purchases by businesses – which account for around one quarter of total machinery and equipment investment – have been relatively strong since June. Spending on buildings and structures is expected to remain subdued, with private non-residential building approvals, while volatile, little changed overall over the past six months.

Approvals for new office construction have also been relatively stable over the past six months and industry estimates point to a slowing in new office supply in 2013 (Graph 3.13). CBD office vacancy rates





rose slightly in most capital cities in the September quarter. The vacancy rate for cities overall remains around 8 per cent, slightly above the average over the past decade.

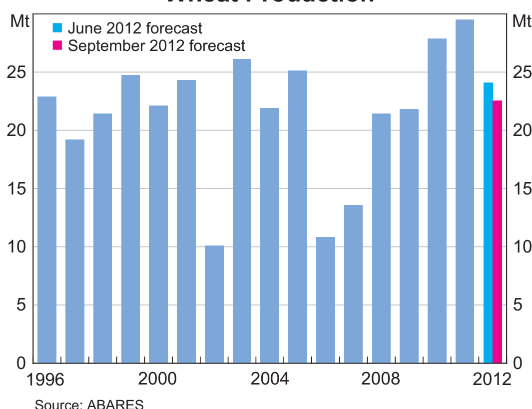
Company profits fell by 5 per cent over the year to June, driven by a 15 per cent fall in mining profits. Although lower than a few years ago, profits remain relatively high as a share of GDP. As discussed in the Domestic Financial Markets chapter, overall, businesses have high levels of internal funds and have also increased their use of external funding recently, indicating that they have adequate funding available for investment.

Government Sector

In the October Mid-Year Economic and Fiscal Outlook (MYEFO), the Australian Government forecasts an underlying cash surplus of $1.1 billion (0.1 per cent of GDP) in 2012/13 – following an estimated deficit of 3 per cent in 2011/12 – and expects the budget position to remain in surplus in 2013/14. State and territory governments' budgets indicate a widening of their consolidated deficit position in 2012/13 and then a narrowing in subsequent years to be broadly in balance in 2014/15. Together, the federal and state budget outlooks imply a significant fiscal consolidation over the coming two years. Recent falls in public sector employment suggest that consolidation is having some dampening effect on activity.

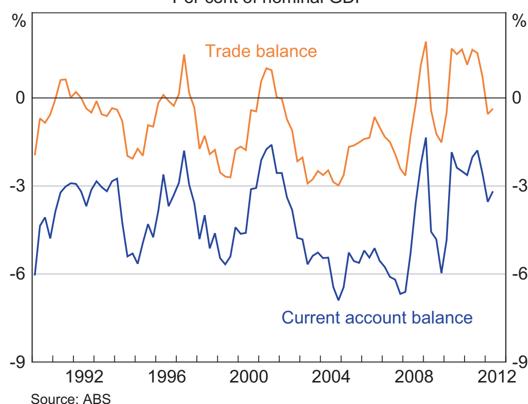
Farm Sector

Conditions in the farm sector are mixed. High prices for wheat and some other crops are supporting farm incomes. However, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) has revised down its forecasts of the 2012 winter crop to levels that are around 20 per cent below the record crop achieved last year (Graph 3.14). This largely stems from below-average winter rainfall in Western Australia.

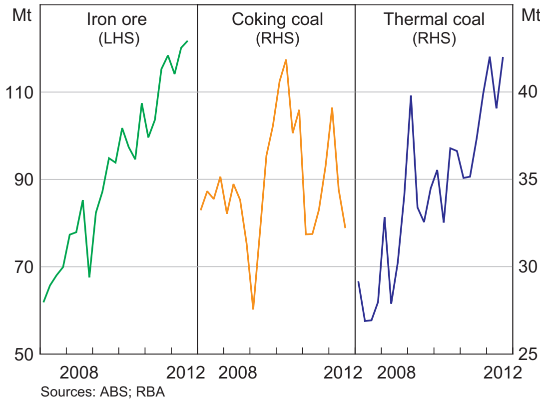


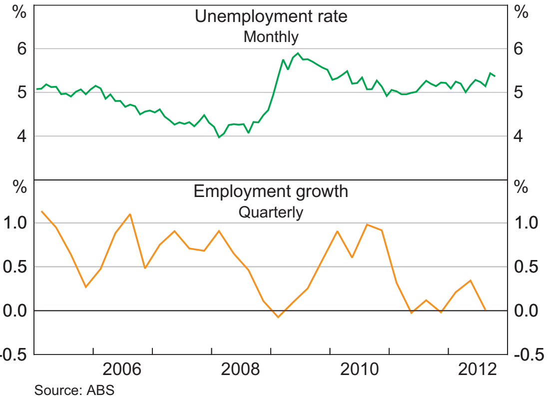
External Sector

Export volumes rose in the June quarter, as strong growth in iron ore, gold and rural exports offset a fall in coal exports. The growth in iron ore exports reflected a recovery from the cyclone-related disruptions in the March quarter. Rural exports were supported by the continued drawdown of wheat stocks following large harvests in 2010 and 2011. Import growth was driven by capital goods related to ongoing resource investment. After posting surpluses in recent years, the trade balance has returned to a deficit in 2012 as prices received for bulk commodity exports have come off their peaks (Graph 3.15).

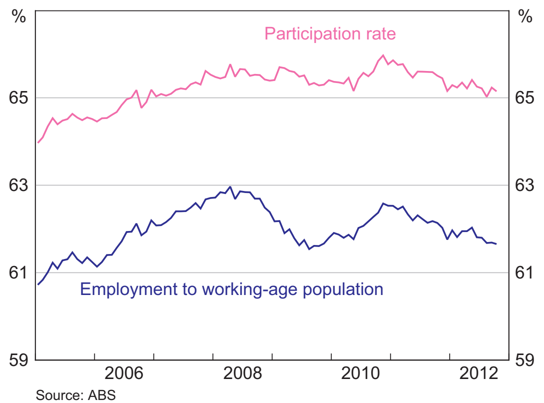


In the September quarter, export volumes are estimated to have increased moderately, while import volumes are estimated to have been unchanged. Iron ore export volumes appear to have increased in the quarter, while data on coal exports were mixed. Coking coal exports (primarily from Queensland) have declined, whereas there was modest growth in thermal coal exports (Graph 3.16). Liaison contacts suggest that global demand for coal has been weak. It is also likely that there has been some rebuilding of stockpiles following the end of industrial action at BHP Billiton Mitsubishi Alliance (BMA) mines. The earlier-than-expected closure of some older, higher-cost mines – in response to





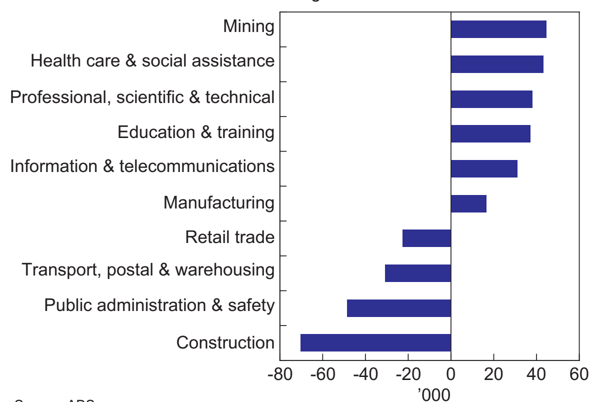
lower spot prices and concerns about high costs – has resulted in some cuts to employment in coal mining and related services. However, the impact on export volumes in the near term is expected to be limited as the mines being closed are generally small producers.



Labour Market

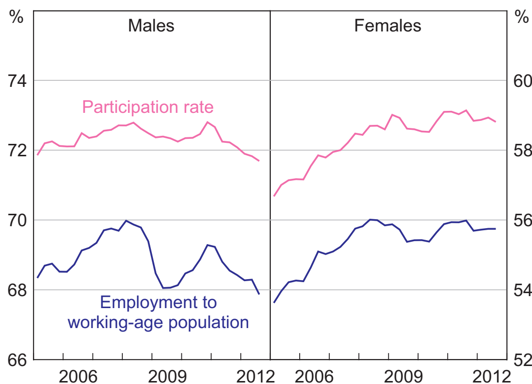
Labour market conditions have softened in recent months, following signs of stronger growth in the first half of 2012. Employment growth slowed and the unemployment rate has risen slightly (Graph 3.17). In line with these softer outcomes, the participation rate and the employment-to-population ratio have both declined over the past year (Graph 3.18).

The Labour Force Survey data reveal a relatively wide dispersion of employment outcomes across different industries (Graph 3.19). Over the past year, most states have seen a particularly pronounced decline in demand for labour in the construction industry. Nationally, the slowdown in building activity has led to a decline in employment in construction of around 7 per cent. Falls in public administration employment have also been significant. Despite strong growth over the past year, mining employment recorded a small decline in the three months to August, its first quarterly decline since mid 2009. As discussed above, this reflects in part the closure of some older



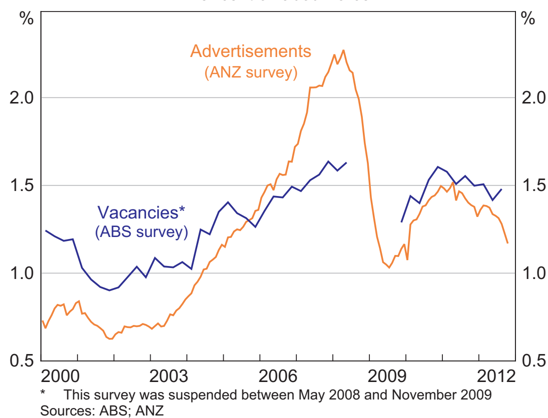
coal mines, while the Bank's business liaison also indicates that some firms in the iron ore and coal industry are reducing employment more generally to contain costs. Employment growth has remained relatively strong in a number of business and household services industries, including professional services, health care and education. Recent data also suggest that manufacturing employment has increased slightly over the past year after falling sharply during the first half of 2011.

The weakness in overall employment growth has been especially pronounced among male workers. Total male employment has been little changed over the past two years, and the ratio of male employment to male working-age population has fallen to around the same level as its trough in mid 2009 (Graph 3.20). This has coincided with a decline in the participation rate of both prime working-age males and males aged 15 to 24 years. Consistent with this, employment has been particularly soft in male-dominated industries such as construction and transport, postal & warehousing. In contrast, female employment has grown in line with the female working-age population in recent years. Some of the recent weakness in youth employment may be due to ongoing softness in industries exposed to discretionary spending, such as retail trade and accommodation & food services, which tend to employ a higher proportion of younger workers.



Labour market conditions continue to vary across states. Trend employment growth has slowed in Western Australia and Victoria since earlier in the year. In Queensland, the level of employment has fallen since the start of 2012, while it appears to have stabilised in South Australia and Tasmania. Employment growth has picked up a little in New South Wales from the low levels seen earlier in the year.

Leading indicators of labour demand have generally remained subdued, and point to only modest employment growth in coming months. The ANZ job advertisements series fell for the seventh consecutive month in October, to be around 15 per cent lower over the year (Graph 3.21). In contrast, the ABS measure of job vacancies increased in the three months to August, though this only partly reversed a fall in the previous three months. Reports from the Bank's liaison suggest that businesses in many industries are cautious about hiring more staff. ✠

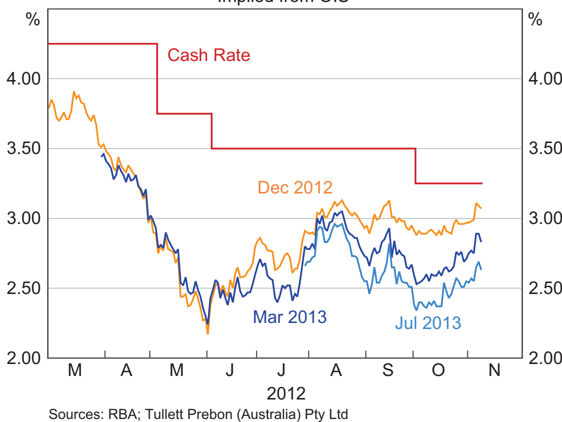


4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank Board lowered its target for the cash rate by 25 basis points in October, to 3.25 per cent. Within financial markets, expectations for further easing in monetary policy over the next 12 months or so have remained broadly unchanged over the past couple of months. Rates on overnight indexed swaps (OIS) currently imply a cash rate target of 3 per cent by early 2013 and around 2.75 per cent by mid 2013 (Graph 4.1).

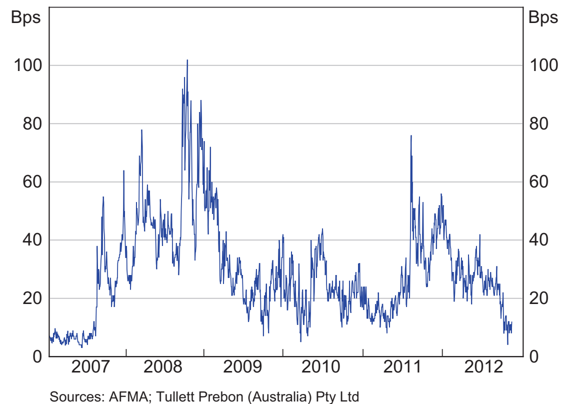
Graph 4.1
Cash Rate Expectations
Implied from OIS



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Interest rates on 90-day bank bills and certificates of deposit (CDs) have declined by 35 basis points since the previous *Statement*, to around 3.25 per cent, their lowest level since mid 2009. With the major Australian banks reducing their issuance of short-term debt, as well as minimal credit concerns, the spread of bank bills over OIS narrowed to less than 10 basis points, its lowest level since June 2007 (Graph 4.2).

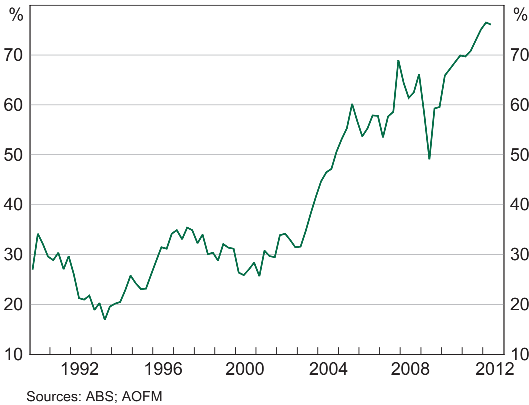
Graph 4.2
Spread of 3-month Bank Bills to OIS



Sources: AFMA; Tullett Prebon (Australia) Pty Ltd

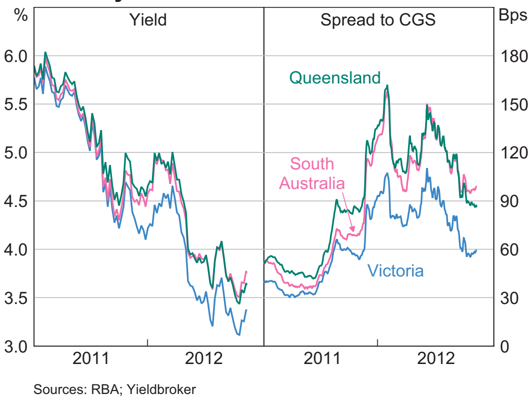
The yield on 10-year Commonwealth Government securities (CGS) is broadly unchanged since the previous *Statement*, and at around 3.10 per cent, it remains very low by historical standards. CGS yields remain underpinned by strong demand from international investors for AAA rated sovereign debt. The most recent data show that the share of CGS held by foreign residents was stable in the June quarter at around 77 per cent (Graph 4.3).

Following the release of the Australian Government's Mid-Year Economic and Fiscal Outlook in late October, the Australian Office of Financial Management (AOFM) announced that it would extend the average maturity of its debt raisings by reducing issuance of short-term Treasury Notes in favour of longer-term Treasury Bonds. Earlier that month, the AOFM extended its conventional yield curve by selling $3¼ billion of a new 2029 bond through a syndication.



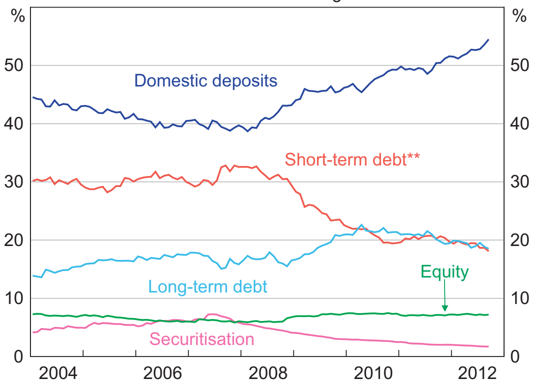
Long-term credit ratings for Queensland, Tasmania and South Australia have all been lowered in recent months, while New South Wales and Western Australia have been put on negative outlook by the ratings agencies. These actions have had little effect on the states' ability to access wholesale debt markets. Spreads between 5-year CGS yields and those on state government debt ('semis') have narrowed slightly since the previous *Statement* and, in absolute terms, yields on semis remain around their historic lows (Graph 4.4).

Non-resident entities have issued $7 billion worth of 'Kangaroo' bonds domestically since the last *Statement*. Reflecting the general improvement in financial market sentiment, secondary market spreads on Kangaroo bonds have fallen to their lowest levels since late 2011. Around half of the recent issuance has come from financial institutions or other corporates, including some first-time issuers who have benefited from strong investor appetite for highly rated paper from non-European issuers. There has been less issuance by European-based supranational agencies, in part reflecting less advantageous hedging costs associated with swapping Australian dollars into euros.



Financial Intermediaries

In recent months, the shift in the composition of bank funding away from both short- and long-term wholesale liabilities towards domestic deposits has continued. Deposits now account for 54 per cent of total bank funding liabilities (Graph 4.5). Over the past quarter, growth in at-call deposits has been somewhat stronger than growth in term deposits reflecting the number of at-call products with yields above those on term deposit rates, particularly bonus saver accounts. In part, this reflects the inverted yield curve for maturities out to 12 months. Term deposits currently account for about half of total deposits. Within long-term wholesale debt, there has been a general lengthening by banks of the term of newly issued wholesale debt over recent years.

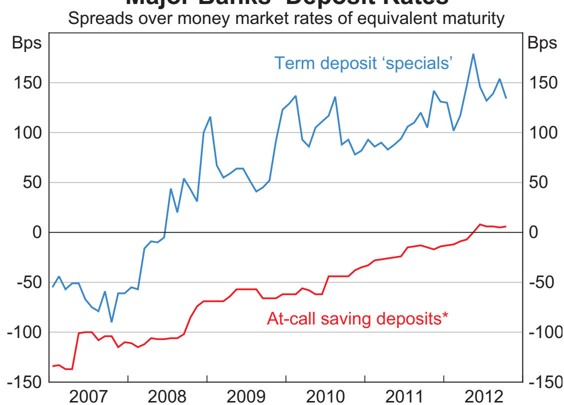


Bank funding costs – relative to the cash rate – have risen by about 50 basis points over the past year, but are estimated to have been broadly unchanged since the previous *Statement*. In absolute terms, interest paid by banks is declining (as is interest received). The rise in bank funding costs relative to the cash rate over the past year largely reflects the increased cost of deposits. The interest in deposits is largely in response to pressure from banks, investors and regulators globally to secure notionally more stable funding sources.

More recently, the average quoted rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) has fallen by around 25 basis points since the previous *Statement*, in line with the reduction in the cash rate (Graph 4.6). Average interest rates on new term deposit 'specials' at the major banks remain well above those on equivalent bank wholesale funding instruments (Graph 4.7).

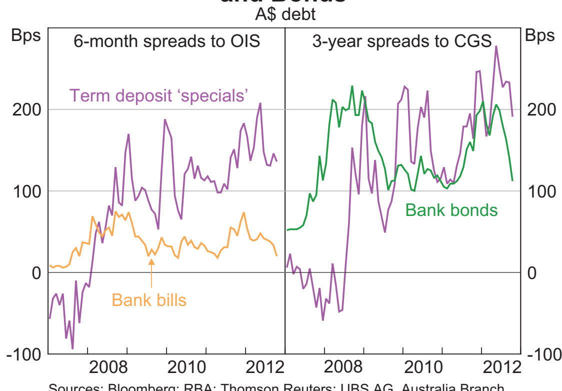
A number of banks have recently reported profit results for their 2012 financial years. Higher funding costs contributed to a small decline in net interest margins. Over the past few years, the major banks' average net interest margin has fluctuated in a relatively narrow range (Graph 4.8).

Graph 4.6
Major Banks' Deposit Rates
Spreads over money market rates of equivalent maturity



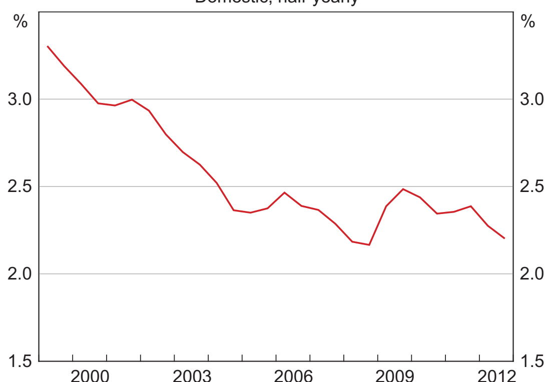
* Spread to cash rate; existing customers only; excludes temporary bonus rates
Sources: Bloomberg; RBA

Graph 4.7
Major Banks' Pricing of Term Deposits and Bonds
A$ debt



Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

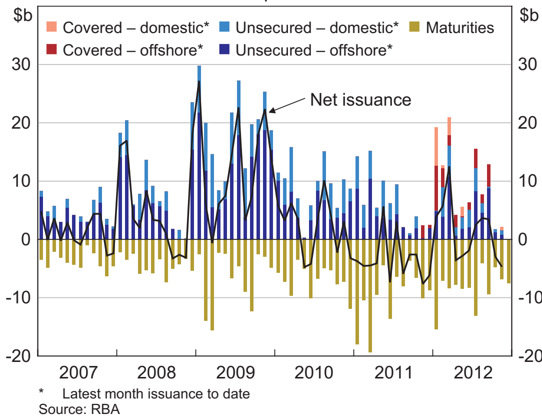
Graph 4.8
Major Banks' Net Interest Margin*
Domestic, half-yearly



* From 2006 data are on an IFRS basis; prior years are on AGAAP basis; excludes St George Bank and Bankwest prior to the first half of 2009
Sources: Banks' financial reports; RBA

Australian banks have taken advantage of the improvement in market sentiment associated with policy developments in the US and the euro area to issue long-term debt. Since the previous *Statement*, around $23 billion of bank debt has been issued, with primary market pricing tightening considerably. Banks have generally used wholesale markets to roll over maturing debt or retire existing government-guaranteed debt, while funding balance sheet growth with increases in deposits.

Unlike earlier in the year, a large share of the wholesale issuance has been in offshore markets and in unsecured form (Graph 4.9). Much of this

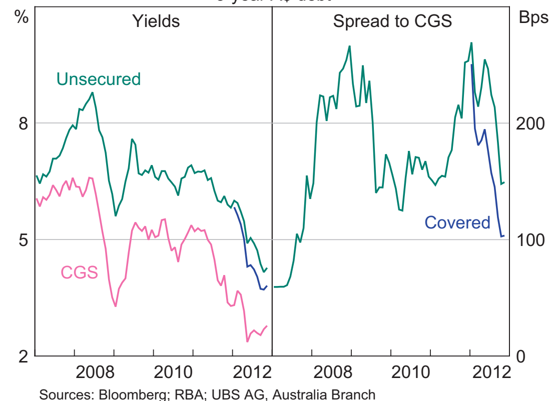


issuance has been in US dollars and for terms of 3 to 5 years. This contrasts with unsecured issuance around the turn of the year, which was primarily for shorter terms as wholesale funding conditions were particularly difficult. There has been some small onshore issuance, including Bendigo and Adelaide Bank's 3-year floating-rate bond worth $400 million, its first public unsecured wholesale issue since the two entities merged in November 2007.

Around $6 billion of covered bonds have been issued since the previous *Statement*. Two of the major banks issued securities for terms of 14 and 15 years in sterling and euros, benefiting from the dearth of issuance by European banks that have used self-securitised securities as collateral to borrow from European central banks. Suncorp-Metway also issued $600 million in 5-year covered bonds, its second such issue. The Australian banks have sought to retain some capacity to issue these bonds; currently, the major banks have utilised around 20–35 per cent of their covered bond issuance capacity.

Banks have issued around $2 billion in hybrid securities since the last *Statement*. This issuance has continued the trend since late 2011 facilitated by clarification of the nature of forthcoming regulatory changes (see 'Box C: Recent Trends in Hybrid Issuance').

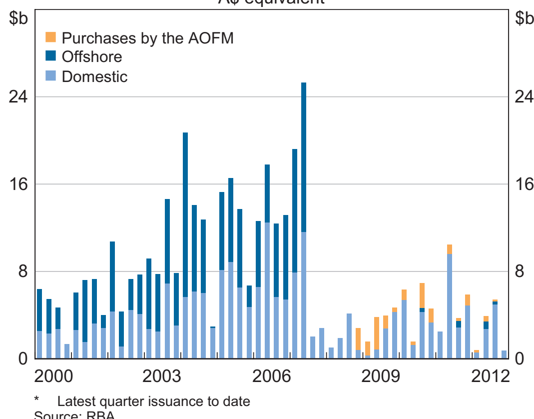
The improvement in financial market sentiment since the previous *Statement* has caused major banks' unsecured and covered bond spreads to tighten by over 50 basis points relative to CGS in the secondary market (Graph 4.10). These spreads are at their lowest level since the intensification of euro area concerns in mid 2011. Yields on bank bonds are at historically low levels.



Conditions in the Australian securitisation market have also improved in recent months, with a number of residential mortgage-backed securities (RMBS) and other asset-backed securities (ABS) transactions executed at spreads that were 10–15 basis points narrower than those achieved on similar deals priced earlier in the year. Around $5 billion RMBS and $2 billion in other ABS have been issued since the previous *Statement* (Graph 4.11). Among other drivers, the continuing decline in covered bond spreads has helped entice investors back into the RMBS market. Reflecting strong demand from the private sector, the AOFM has had only minimal participation in recent deals.

Moody's has revised the way in which it evaluates lender's mortgage insurance (LMI) in Australian RMBS. The new methodology will likely reduce its estimate of the ratings support from LMI. In October, Standard & Poor's (S&P) changed the ratings outlook on the

Graph 4.11
Australian RMBS Issuance*
A$ equivalent



* Latest quarter issuance to date
Source: RBA

mortgage insurer Genworth Australia (rated AA-) to negative following the ratings downgrade of its US parent. Notwithstanding the change in outlook, a subsequent review of outstanding Australian RMBS by S&P saw ratings on numerous subordinated tranches raised to AAA, reflecting the strong collateral performance and build-up of credit support within these structures.

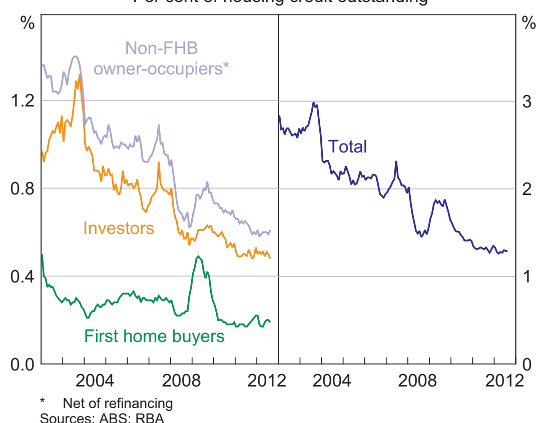
The Reserve Bank announced its intention to require issuers to provide more information on asset-backed securities if they are to remain eligible for the Bank's market operations. In addition to assisting the Bank to more precisely value the securities, the changes are designed to improve transparency in the RMBS market – as a condition of eligibility, the information will have to be available to the public and kept up to date.

APRA also announced possible changes to securitisation regulations, with implementation planned for 2014. APRA proposes to simplify securitisation structures by allowing only two levels of subordination – senior and junior notes. Authorised deposit-taking institutions will be required to retain at least 20 per cent of the junior notes in order to ensure that they have some 'skin in the game'.

Household Financing

Growth in housing credit continued over the September quarter at an annualised rate of around 4½ per cent. There is some evidence of customers increasing prepayments over the past year as lending rates have declined. Housing loan approvals increased slightly over the three months to August. As a share of housing credit, there has been little change in approvals over the past year and a half, suggesting a continuation of the current growth rate of housing credit in the period ahead (Graph 4.12).

Graph 4.12
Value of Housing Loan Approvals
Per cent of housing credit outstanding



* Net of refinancing
Sources: ABS; RBA

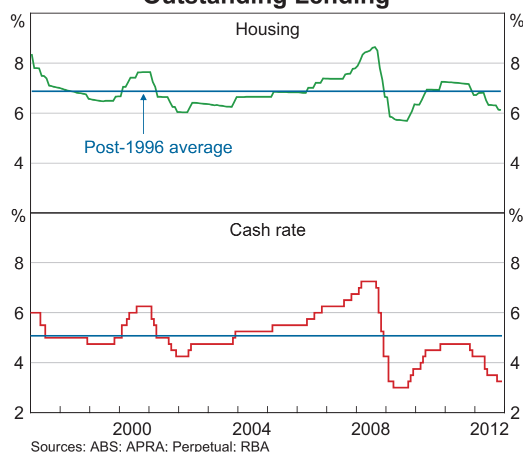
Following the 25 basis point reduction in the cash rate in October, most lenders reduced their indicator rates on variable-rate housing loans by around 20 basis points (Table 4.1). Rates on new, three-year, fixed-rate mortgages have also fallen, and are about 30 basis points below advertised variable rates. Overall, the average interest rate on outstanding housing loans (fixed and variable) is estimated to be around 75 basis points below its post-1996 average, having fallen by around 100 basis points over the past year (Graph 4.13).

Some lenders have increased the discounts offered on certain variable-rate mortgage products by between 5 and 20 basis points. One major bank introduced a temporary offer to undercut the fixed rates of the other major banks. A number of

Table 4.1: Intermediaries' Variable Lending Rates
Per cent

	Level at 8 November 2012	Change since: End July 2012	End October 2011
Housing loans			
– Standard variable rate[a]	6.64	–0.19	–1.15
– Package rate[b]	5.85	–0.29	–1.18
Personal loans	12.91	–0.07	–0.36
Small business			
Residentially secured, advertised			
– Term loans	7.80	–0.20	–1.20
– Overdraft	8.67	–0.20	–1.18
Average rate[c]	7.50	–0.20	–1.13
Large business			
Average rate[c] (variable-rate and bill funding)	5.46	–0.13	–1.56

(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package rates on $250 000 full-doc loans
(c) Rates on outstanding, as opposed to new, business lending
Sources: ABS; APRA; RBA



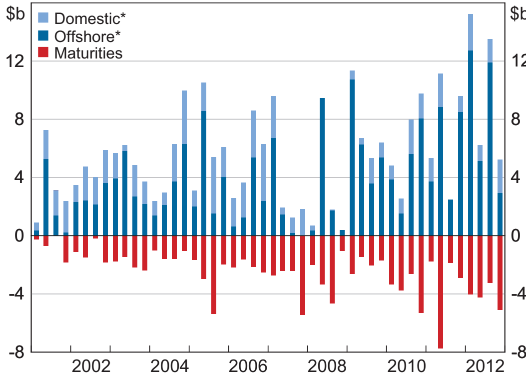
lenders also introduced temporary cash-back offers, or temporarily waived or reduced some of their mortgage application fees.

The value of outstanding personal credit fell slightly in the September quarter owing to a decline in revolving credit facilities, including credit card lending and lending secured by residential mortgages. Rates on personal loans have fallen since the end of July, primarily driven by rate reductions on home equity loans and unsecured personal loans.

Business Financing

Corporate bond issuance has been strong in recent months, with around $16 billion issued since the previous *Statement* (Graph 4.14). The bulk of this issuance was through a few large offshore deals by resources companies, including a US$3 billion issue by Rio Tinto and a A$5.2 billion transaction by BHP Billiton in euros and sterling. The BHP Billiton deal was the second largest single-day issuance by an Australian company. BHP Billiton also issued its first bond in the domestic market since 2001, raising $1 billion for five years, which is the largest non-credit wrapped issue in the Australian market by a corporate issuer. Fortescue Metals completed a major refinancing of its bank loans after a fall in iron ore prices raised concerns about its earnings-related debt covenants. The five-year deal was completed

Graph 4.14
Australian Corporates' Bond Issuance
A$ equivalent

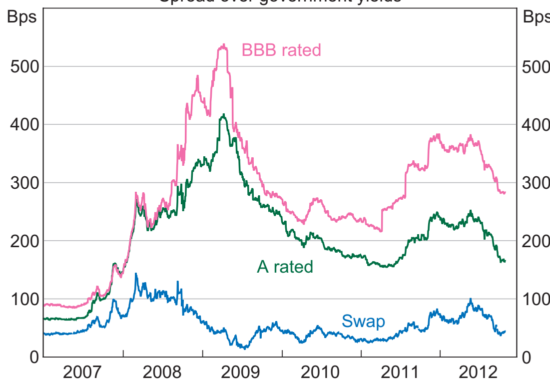


* Latest quarter issuance to date
Source: RBA

in a short time and suggests that larger companies are facing few difficulties in obtaining debt funding. Corporate bond spreads have tightened by around 40 to 50 basis points since the previous *Statement* and are now around mid 2011 levels (Graph 4.15).

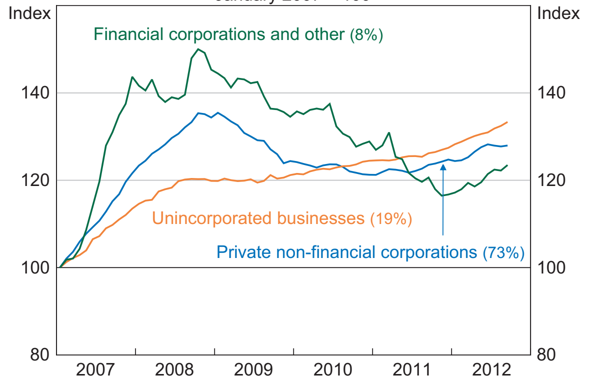
Intermediated business credit continued to grow in the September quarter, but at a somewhat slower pace than the growth witnessed over the first six months of 2012. While lending to unincorporated, and generally smaller, businesses continues to grow at a moderate pace, lending to non-financial corporations was broadly unchanged in recent months (Graph 4.16).

Graph 4.15
Australian Non-financial Corporate Bond Spreads*
Spread over government yields



* Swap spreads are for 3-year maturity; corporate bond spreads are a weighted average of senior bonds with remaining maturities of 1 to 5 years
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 4.16
Business Credit by Borrower*
January 2007 = 100

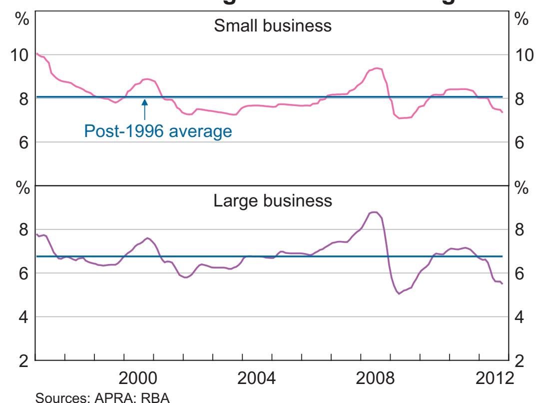


* Excludes securitised loans
Sources: APRA; RBA

The cost of intermediated business borrowing has declined over the past three months, with the average interest rates on outstanding small and large business loans both falling by around 10 to 20 basis points (Graph 4.17). These declines broadly reflected movements in wholesale benchmark rates, although spreads on business rates increased modestly over the period. Rates on small business and large business loans are now around 75 and 125 basis points, respectively, below their post-1996 averages, to be at their lowest level since September 2009.

Activity in the Australian syndicated lending market softened in the September quarter and the volume of new loans is well below the level of a year ago.

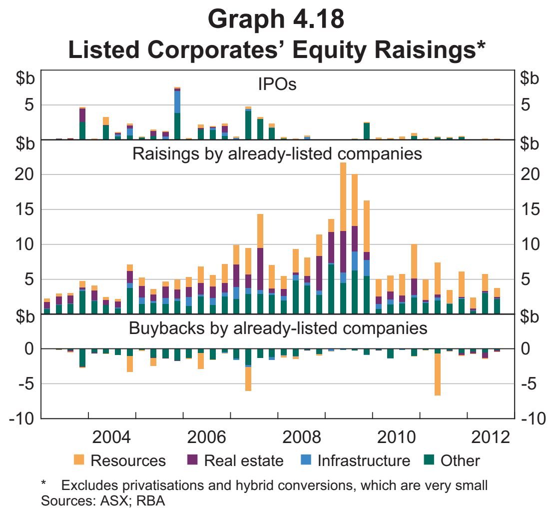
Graph 4.17
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

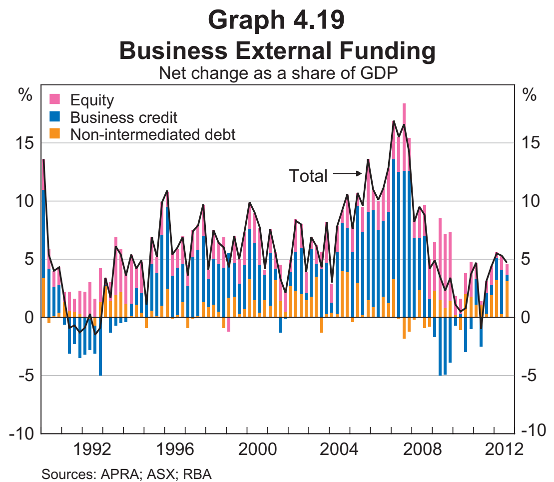
Over the past three months, the value of outstanding syndicated lending has declined by 4 per cent. This has coincided with reduced lending activity by both domestic and European financial institutions.

The weakness in equity capital raisings that has been evident since the end of 2009 continued in the September quarter. Only $3.7 billion was raised by already-listed corporates in the quarter, about half the decade's average. Initial public offerings (IPOs) were also very low at only $170 million (Graph 4.18). In aggregate, equity raisings this year have been the weakest since 2005 in dollar terms and the second weakest since at least 1990 relative to GDP. This subdued activity is due to a combination of factors, including persistent weak global economic growth and uncertainty and low corporate gearing in Australia that has limited the need for equity raisings.



* Excludes privatisations and hybrid conversions, which are very small
Sources: ASX; RBA

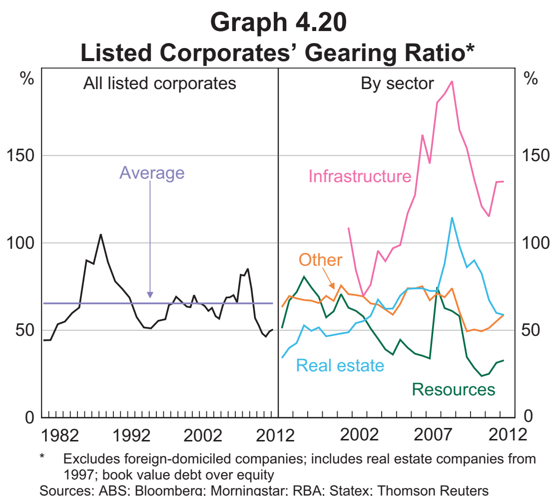
The number of mergers and acquisitions (M&A) announcements has increased recently, reflecting a large number of low-value deals in the resources sector. By value though, M&A remains subdued, with $9.4 billion in M&A deals involving listed companies pending or completed since the last *Statement*. The largest deal outside of the resources sector was a $2.7 billion offer for GrainCorp. In aggregate, $30 billion in M&A deals have been announced this year, the lowest level since 2004.



Sources: APRA; ASX; RBA

Total business external funding grew by 4½ per cent of GDP in the September quarter. Unlike the June quarter, funding was sourced almost completely from capital markets, particularly from non-intermediated debt (Graph 4.19). Growth over the past year has been considerably stronger than in the two preceding years.

Data for the first half of 2012 show that listed corporates' balance sheets continued to grow at a moderate pace. The growth in balance sheets was largely funded through debt and retained earnings amid the ongoing weakness in equity raisings. Despite a small increase in gearing ratios, book value gearing – the ratio of debt to shareholder equity – remains close to its multi-decade lows at around 50 per cent (Graph 4.20). The increase in gearing

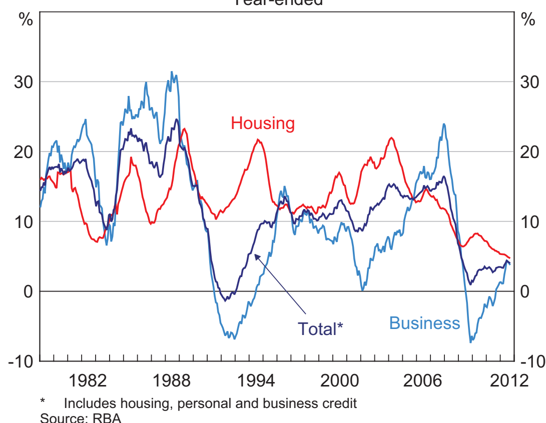


* Excludes foreign-domiciled companies; includes real estate companies from 1997; book value debt over equity
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

was driven by the resources, utilities and consumer discretionary sectors.

Aggregate Credit

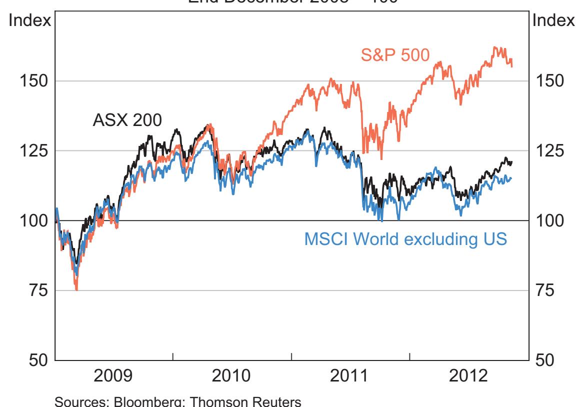
Credit growth slowed to an annualised rate of around 3 per cent in the September quarter (Graph 4.21). Broad money growth has outpaced credit growth for each of the past five years. This growth reflects changes not only in the composition of banks' assets and liabilities, but also the preferences of households and businesses to hold a greater share of their assets as deposits.

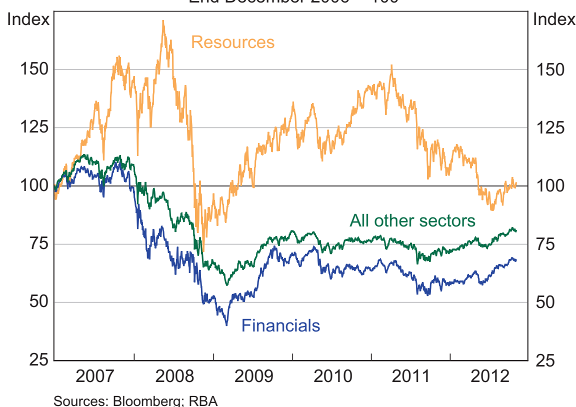


Equity Markets

The general improvement in risk appetite has seen Australian equity prices rise by 5 per cent since the last *Statement*. Since reaching a low in June, the Australian market has increased by 13 per cent, similar to increases in the major offshore markets (Graph 4.22).

The recent increase in domestic share prices has been broad based (Graph 4.23). The share prices of resource companies came under pressure in early September as concerns over the Chinese growth outlook intensified and spot commodity prices, particularly for iron ore, experienced sharp declines. However, as iron ore prices recovered from their sharp decline, so did the share prices of most resource companies.

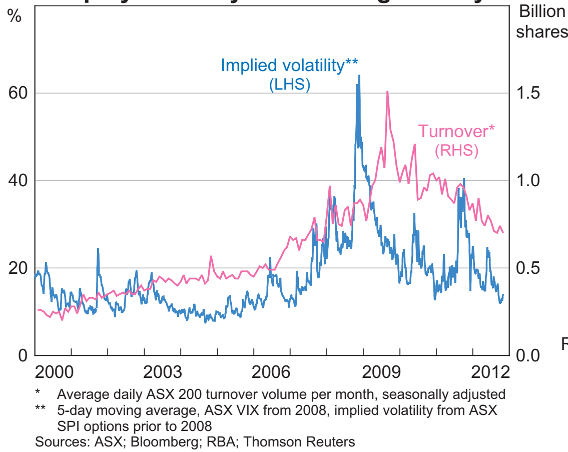


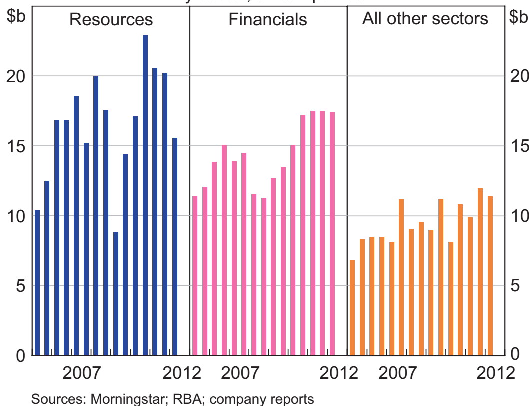


In line with global trends, equity market trading activity in Australia has been relatively subdued recently, with turnover falling to levels last seen in late 2007. Equity market volatility has also been relatively low and close to its levels prior to the global financial crisis (Graph 4.24).

ASX 200 listed corporates reported a decline in profits during the June reporting season, with underlying net earnings, which exclude gains and losses from asset revaluations and other significant one-off items, falling by 9½ per cent from a year earlier. Headline profits fell by 28 per cent over the same period owing to significant impairment charges reported by BHP Billiton and Fairfax. The decline in

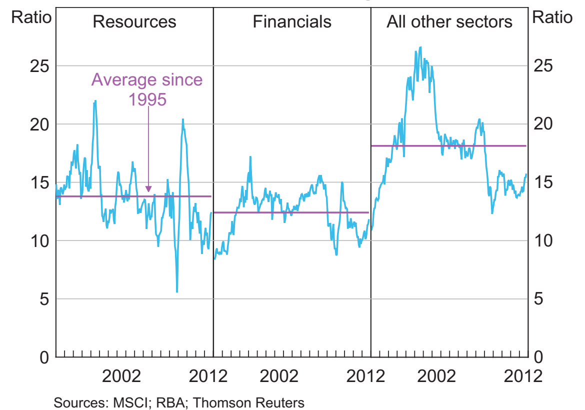
profits was largely due to a decline in resources sector earnings, with underlying net profits of the sector falling 30 per cent over the year (Graph 4.25). Miners' earnings were affected by lower commodities prices, despite record iron ore production, with higher costs also contributing to the fall in profits.





Financials' earnings have been little changed in aggregate over the past two years. Outside the resource and financial sectors, underlying profits have generally increased over the year, largely driven by higher earnings in sectors such as consumer staples and health care.

Dividends were modestly higher during the June 2012 half, increasing by 4½ per cent. This mostly reflected dividends paid by the major banks. High dividend paying stocks, such as financials, telecommunications companies and health care, have generally outperformed the rest of the market in 2012. Forward price-to-earnings ratios have begun to retrace from their recent lows, but remain below average across all sectors (Graph 4.26).



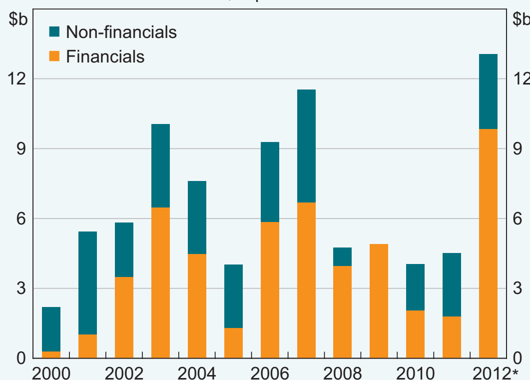
Box C

Recent Trends in Hybrid Issuance

Issuance of hybrid securities by Australian entities has been strong over the past year, reaching levels not seen since before the global financial crisis (Graph C1). The increase in issuance has been driven primarily by Australian banks preparing for more stringent capital requirements introduced by the Australian Prudential Regulation Authority (APRA) in Australia as part of the revised international bank regulatory framework (Basel III). In contrast, issuance by non-financial corporates has been only marginally higher than in recent years.

Hybrid securities are instruments that have characteristics of both debt and equity, typically giving the issuer the ability to at least postpone interest payments. Domestically issued hybrids – the majority of the recent issuance – are usually listed on the Australian Securities Exchange (ASX) and are held predominately by retail investors. Hybrids are attractive to retail investors because they typically offer higher coupon rates than senior debt or term deposits, although they are riskier and often have very long contractual maturities. Banks have historically been the largest issuers of hybrid securities, using them to help satisfy regulatory capital requirements.

Graph C1
Hybrid Issuance by Australian Entities



* Includes deals that have been launched, but not completed
Source: RBA

APRA imposes minimum capital requirements on banks and other regulated financial institutions, with an emphasis placed on those forms of capital with the greatest ability to absorb losses ('Tier 1' capital, comprising common equity and Tier 1 hybrids). Tier 1 hybrids are similar to equity and allow an issuer to miss coupon payments without an obligation to honour the unpaid amounts later; usually, these securities are convertible into common equity and have no fixed maturity date. Tier 2 capital is a lower quality form of regulatory capital, and includes Tier 2 hybrids, which are similar to subordinated debt.

The global financial crisis revealed a number of weaknesses in the ability of some forms of non-common equity capital to absorb losses. In response, the revised international capital standards under Basel III impose more stringent qualification requirements on regulatory capital coming from sources other than common equity, with a view to increasing the permanency and loss-absorption capacity of this type of capital.[1] The key changes to capital eligibility requirements, which were finalised in September 2012, include:[2]

- tightening the prohibition on issuer incentives to redeem the security prior to maturity (e.g. specifically excluding step-up provisions that

1 In addition, Basel III increased the size of the required common equity component and the overall quality of Tier 1 capital and reduced reliance on Tier 2 capital.

2 For details, see APRA (2012), 'APRA Releases Final Basel III Capital Reform Package', Media Release No 12.23, 28 September.

require the issuer to increase the coupon rate if the security is not redeemed by a certain date)

- restrictions on the ability of the issuer to call the security in the first five years
- inclusion of a capital trigger forcing the conversion of a Tier 1 hybrid security into common equity if the Common Equity Tier 1 capital ratio of the issuer falls below a specified amount[3]
- the inclusion of a non-viability trigger for both Tier 1 and Tier 2 hybrids allowing APRA to require the security's conversion into common equity or to require its write-off.

Australian banks have re-entered the hybrid market over the past year and a half as APRA has provided more information about what will qualify as capital under Basel III. Since May 2011, when APRA's interim guidance was first announced, gross issuance has amounted to around $9.4 billion (Table C1). Accounting for the redemption of existing hybrids, the issuing banks have raised $2.9 billion in net new Tier 1 capital, which is equivalent to 0.3 per cent of their risk-weighted assets. However, not all of this will qualify as Tier 1 capital under the new regulatory regime. In addition to Australian banks' legacy Tier 1 hybrids, capital recognition of those Tier 1 hybrids issued between May 2011 and September 2012 will be gradually phased out starting in 2013 as part of APRA's transitional arrangements.[4] Australian banks have also issued over $4 billion in Tier 2 hybrids this year, largely to satisfy investor demand for higher yielding debt-like securities.

Table C1: Recent Hybrid Issuance by Australian Banks

Date	Issuer	Market	Issuance amount (A$ billion)	Issuance spread (bps over BBSW)	Reason for issuance as stated[(a)]
			Tier 1 Hybrid Securities		
Sep 11	ANZ[(b)]	Domestic	1.3	310	General
Feb 12	Westpac[(b)]	Domestic	1.2	325	General
Mar 12	Macquarie[(b)]	Offshore	0.2	n/a	n/a
Sep 12	CBA	Domestic	2.0	380	Redemption; general
Sep 12	Bendigo and Adelaide	Domestic	0.3	500	Redemption; general
			Tier 2 Hybrid Securities		
Feb 12	ANZ	Domestic	1.5	275	General
May 12	NAB	Domestic	1.2	275	General
Jul 12	Westpac	Domestic	1.7	275	General

(a) 'General' refers to general corporate purposes; 'redemption' refers to redemption of existing hybrid securities
(b) At minimum interim rules
Sources: RBA; company announcements

3 This requirement only applies if the security is classified as a liability under Australian Accounting Standards.

4 Legacy hybrids, and hybrids issued between December 2010 and March 2012, qualify for 90 per cent recognition in regulatory capital calculations in 2013, with the recognised amount reduced by 10 percentage points in each subsequent year. Hybrids issued after March 2012 that do not meet final capital eligibility requirements are not to be counted as regulatory capital after their first call date.

Non-financial corporates have issued $3 billion in hybrids in 2012, which is similar to the average over the previous decade. The favourable capital and tax treatment of these securities makes them attractive for issuers because the rating agencies treat up to 100 per cent of the capital raised as equity when calculating a company's level of indebtedness, while coupon payments are treated as a tax deductible expense.[5]

Recent hybrid issuance has been well received by investors, with most issues upsized and issued at spreads at the lower end of their indicative ranges.[6] However, the highly structured nature of many hybrids can make it difficult for retail investors to properly assess the investment risks in these securities. The Australian Securities and Investments Commission (ASIC) has issued multiple warnings about these risks in recent times, pointing out that investors are taking equity-like risks but only receiving bond-like returns. ASIC has also highlighted that hybrids won't necessarily be redeemed earlier than their legal maturity, which is often many decades into the future, despite this being expected by some investors.[7] The Bank of Queensland recently chose not to redeem a hybrid security on its first call date, instead giving holders the option of exchanging their investment for a new hybrid security. ✠

5 Recently, Standard & Poor's (S&P) announced a review of its global methodology for determining the equity content of certain hybrids issued by non-financial corporates. The outcome of the review may reduce the extent to which hybrids are counted as equity capital in S&P's calculation of the issuer's indebtedness.

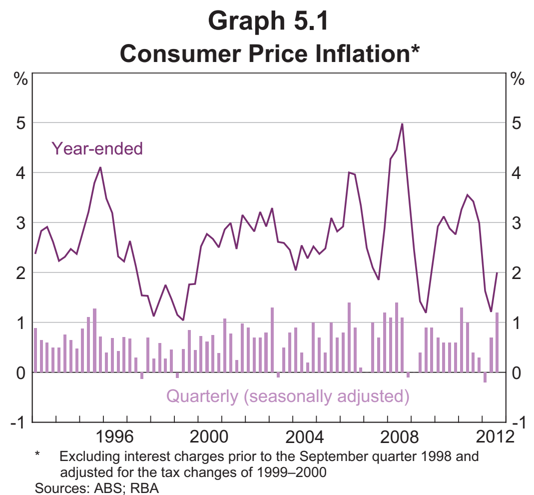
6 On average, the bank hybrids issued since September 2011 raised 250 per cent of their initial offer amount due to the strong investor demand.

7 See ASIC (2012), 'ASIC's Hybrids Warning: Don't be Dazzled, be Wary of the Risks', Media Release 12-207, 27 August.

5. Price and Wage Developments

Recent Developments in Inflation

The rate of inflation picked up in the September quarter from the low level recorded in the June quarter. On a seasonally adjusted basis, the consumer price index (CPI) rose by 1.2 per cent in the quarter, to be 2.0 per cent higher over the year (Table 5.1; Graph 5.1). Some of the strength in the quarterly outcome can be attributed to one-off policy changes, in particular the introduction of the carbon price and the means testing of private health insurance rebates. Volatile items made a small positive contribution to the headline outcome, with a large increase in fruit and vegetable prices partly offset by a decline in the price of automotive fuel. The quarterly rate of inflation also picked up for a broad range of food items and for new dwelling prices.



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

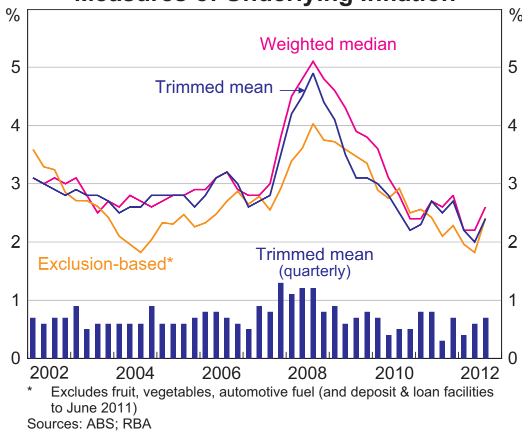
Table 5.1: Measures of Consumer Price Inflation
Per cent

	Quarterly(a)		Year-ended(b)	
	June quarter 2012	September quarter 2012	June quarter 2012	September quarter 2012
Consumer Price Index	0.5	1.4	1.2	2.0
Seasonally adjusted CPI	0.7	1.2	1.2	2.0
– Tradables	0.6	0.7	–2.0	–1.2
– Tradables (excl volatile items and tobacco)(c)	0.2	0.1	–1.3	–0.8
– Non-tradables	0.7	1.5	3.4	4.0
Selected underlying measures				
Trimmed mean	0.6	0.7	2.0	2.4
Weighted median	0.7	0.8	2.2	2.6
CPI excl volatile items(c)	0.6	1.0	1.8	2.4

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS
(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median
(c) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

The published measures of underlying inflation were around ¾ per cent in the September quarter, while revisions due to seasonal adjustment suggest that underlying inflation in the year to the June quarter was also a little stronger than previously indicated. The rate of underlying inflation over the past year is assessed to have been around 2½ per cent (Graph 5.2). This is ½ percentage point higher than the assessment of underlying inflation three months ago.

Graph 5.2
Measures of Underlying Inflation

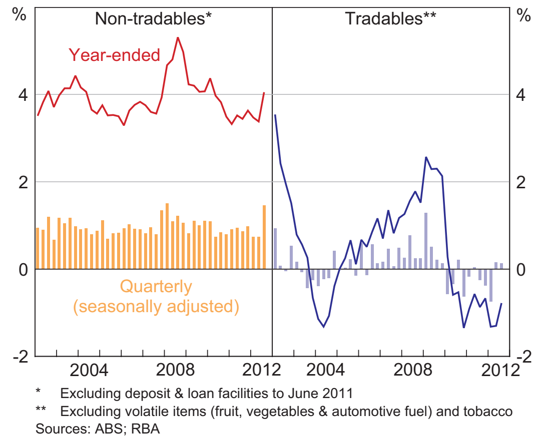


* Excludes fruit, vegetables, automotive fuel (and deposit & loan facilities to June 2011)
Sources: ABS; RBA

The prices of non-tradable goods and services increased by 1.5 per cent in the quarter, with the year-ended pace picking up to 4 per cent (Graph 5.3), reflecting the effect of the carbon price on utilities prices and the policy changes for health insurance. Abstracting from these effects, the pace of non-tradables inflation appears to have picked up slightly in the quarter. Faster increases in the prices of new dwellings and some non-traded food items were only partly offset by slower growth in rents and the prices of some services, including domestic travel and child care.

Housing costs rose sharply in the quarter, with a particularly large increase in utilities prices, while inflation in new dwelling prices picked up from the very soft outcome in recent quarters. The increase in utilities prices reflected large increases in electricity and gas prices, in part due to the introduction of the

Graph 5.3
Consumer Price Inflation



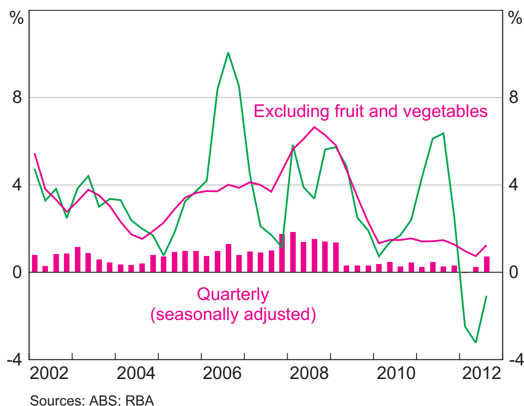
* Excluding deposit & loan facilities to June 2011
** Excluding volatile items (fruit, vegetables & automotive fuel) and tobacco
Sources: ABS; RBA

carbon price, but also as a result of ongoing increases in other costs (see 'Box D: Recent Developments in Utilities Prices'). New dwelling price inflation picked up in the quarter despite continued softness in residential building activity. Liaison suggests that the increase in new dwelling prices only partly reflects the pass-through of higher costs due to the carbon price. In contrast to the other housing items, rent inflation, which has been strong for some time and tends to be quite persistent, slowed unexpectedly in the quarter.

Tradables prices (excluding volatile items and tobacco) rose by 0.1 per cent in the September quarter. Consistent with previous episodes, the increases in tradables prices over the past two quarters provide some confirmation that the deflationary effect of the earlier exchange rate appreciation has waned, although inflation in tradables prices overall remains subdued. International holiday travel and accommodation prices increased substantially in the September quarter, along with the prices of a few traded food items. The pace of tradables inflation continued to be weighed down by soft consumer durables prices in the quarter.

There was a sizeable increase in fruit and vegetable prices in the quarter owing to unfavourable growing conditions in some regions. There was also a

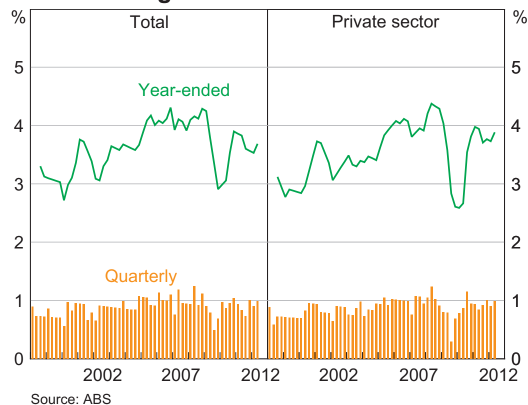
broad-based pick up in inflation for other food items in the quarter, with pronounced increases in the prices of bread & cereal products and dairy items (Graph 5.4). This pick-up is somewhat at odds with ongoing reports that major supermarkets have persisted with their discounting strategies.



Costs

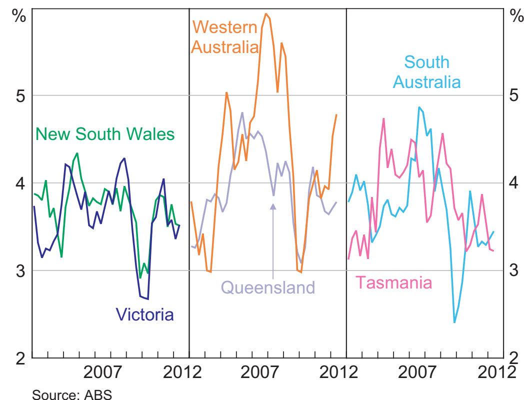
The pace of wage growth appears to be broadly unchanged over recent quarters, despite the slowing in the labour market seen over the past year or so. According to the wage price index, wages increased by 3.7 per cent over the year to the June quarter, around the average of the past decade (Graph 5.5). Wage growth in the private sector was 3.9 per cent over the year, driven by wage growth in industries such as mining and professional & scientific services, which was partly offset by slowing wage growth in retail and household services. The more subdued pace of wage growth in these latter industries, which are more directly tied to consumer demand, suggests that wage pressures that feed directly into consumer prices may be more muted than the aggregate wage outcomes suggest. Public sector wage growth picked up in the June quarter, but year-ended growth remained relatively subdued following softer outcomes in 2011.

Differences in labour market conditions between states continue to affect wage outcomes. Wages in



Western Australia have been growing faster than in the other states with the relative strength in wage growth in Western Australia broad based across industries (Graph 5.6). In other states, wage growth remained around or a little below the averages of the past decade.

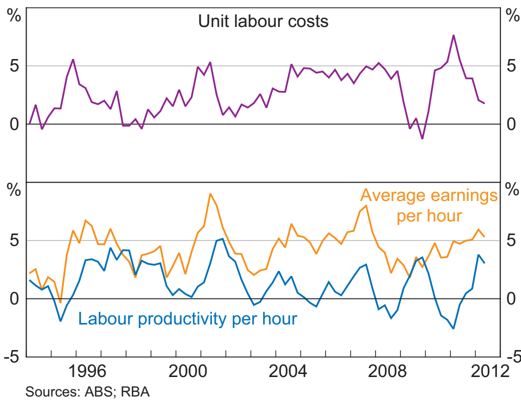
Data from business surveys suggest that the outlook for wage growth has moderated since early 2011, while labour shortages remain contained. Liaison with firms indicates that there was a slight easing in wage pressures in the September quarter. Although recent business surveys have reported a pick-up in wage growth, some of this is likely to be attributable to the annual award wage increase in July.

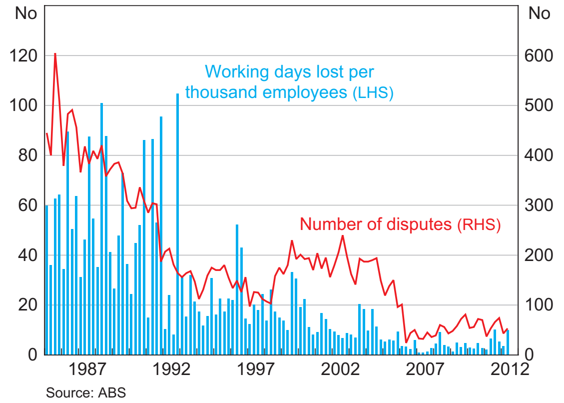


Growth in unit labour costs over the year eased slightly in the June quarter, to be close to average levels (Graph 5.7). The pace of growth in average earnings slowed in the June quarter, although year-ended growth remains relatively high. However, this has been offset by strong growth in labour productivity over the year.

Producer price data suggest that domestic inflation pressures rose moderately in the September quarter, with some of the pick-up in final stage domestic prices attributable to higher utilities prices.

ABS data on industrial disputes suggest that the number of working days lost per thousand employees increased in the June quarter, while there was a smaller pick up in the number of industrial disputes. Nevertheless, both series remain low relative to their longer history (Graph 5.8). Disputes in the education and healthcare industries accounted for around two-thirds of all working days lost, reflecting public sector disputes in Victoria and New South Wales.





Inflation Expectations

Measures of inflation expectations remain consistent with the inflation target. Since the August *Statement*, union officials surveyed by the Bank have revised up their near-term inflation expectations moderately, while market economists' inflation expectations have remained unchanged (Table 5.2). Surveys of businesses, which include producers and retailers, continue to point to subdued expectations for inflation in output prices. Consumer inflation expectations – as measured by the Melbourne Institute – have been below their average over the inflation-targeting period in recent months (Graph 5.9). Financial market measures increased slightly over the quarter.

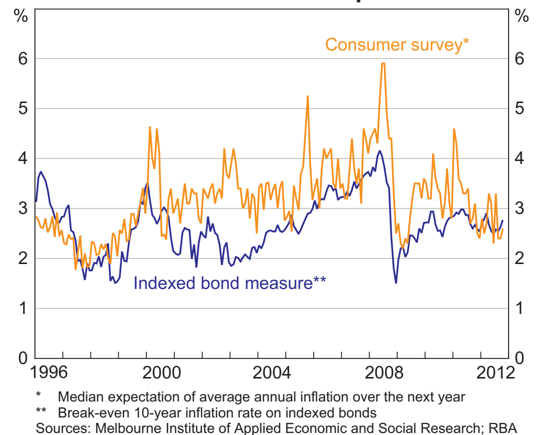


Table 5.2: Median Inflation Expectations
Per cent

	Year to June 2013			Year to June 2014	
	May 2012	August 2012	November 2012	August 2012	November 2012
Market economists	3.4	3.4	3.4	2.7	2.7
Union officials[(a)]	2.4	2.0	2.5	2.5	2.5

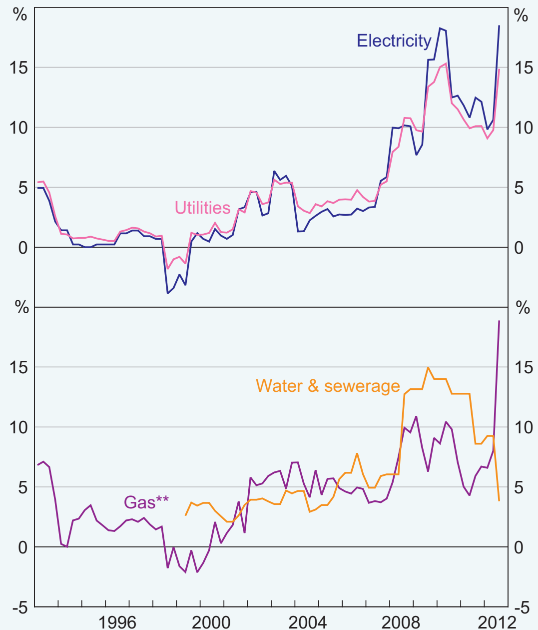
(a) Excluding carbon price
Sources: RBA; Workplace Research Centre

Box D

Recent Developments in Utilities Prices

Inflation in utilities prices has been higher than overall consumer price inflation over the past decade, with large increases in the prices of electricity, gas and water & sewerage (Graph D1). The run-up in utilities prices largely reflects the increase in capital costs associated with higher infrastructure investment.[1] Electricity network operators have made substantial investments to replace ageing assets, satisfy growing peak demand and meet more stringent reliability standards. A high level of investment has also been required to expand gas networks and to improve the reliability of urban water supply during drought periods like that experienced in the mid 2000s. The ongoing pass-through to consumers of significant capital expenditure costs underpinned the rise in utilities prices over the past year. The introduction of the carbon price on 1 July also contributed to utilities price increases, particularly for electricity and gas. In aggregate, utilities prices rose by 15 per cent over the past year. With utilities having a weight in the consumer price index (CPI) of around 4 per cent, these price increases contributed ½ percentage point to inflation over the year to the September quarter. The carbon price accounted for a little less than half of the total increase in utilities prices over the past year, with this effect on utilities prices contributing around ¼ percentage point to headline inflation.

Of the three utilities, electricity has the largest weight in the CPI, at 2½ per cent, while gas and water & sewerage both have weights of around 1 per cent. Turning to developments in each:



- Prices for electricity rose by 18½ per cent over the year to the September quarter. The introduction of the carbon price led to an increase in the cost of generating electricity. Household electricity prices are regulated in most states, and the higher generation costs have been taken into account in determining regulated price increases. State price regulators' public announcements imply that the carbon price accounted for around half of the increase in electricity prices over the year, in line with the effect anticipated by Treasury's modelling of the policy.[2] In addition to the effect of the carbon

1 See Plumb M and K Davis (2010), 'Developments in Utilities Prices', RBA *Bulletin*, December, pp 9–17.

2 See Commonwealth Treasury (2011), 'Strong Growth, Low Pollution: Modelling a Carbon Price'.

price, increases in network costs continued to contribute to the rise in retail electricity prices.

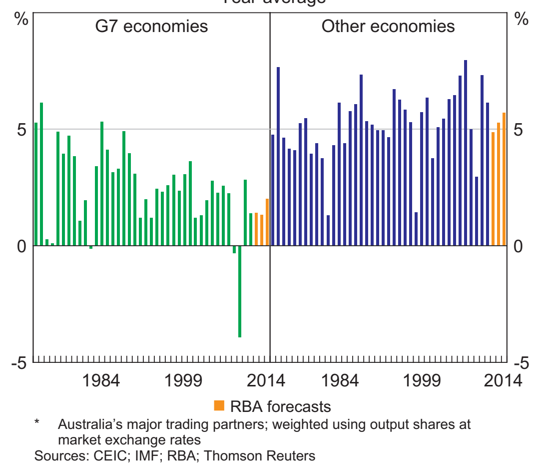
- Gas prices rose by 19 per cent over the past year. Ongoing growth in distribution costs contributed to the increase in gas prices in many states, although the importance of these costs varied across states. Based on information available from regulators and industry liaison, it appears that the carbon price accounted for less than half of the increase in gas prices in the year to the September quarter, which is also consistent with the impact anticipated by Treasury's modelling.
- Water & sewerage prices rose by 3.8 per cent over the past year. The rate of price increases has slowed recently, with much of the higher costs associated with earlier capital expenditure having already flowed through to retail prices. Compared with its impact on electricity and gas prices, the introduction of the carbon price has had only a small effect on water and sewerage prices. In some states, steps have been taken by state agencies to lessen the price rises faced by households by restricting price increases or by providing rebates.

6. Economic Outlook

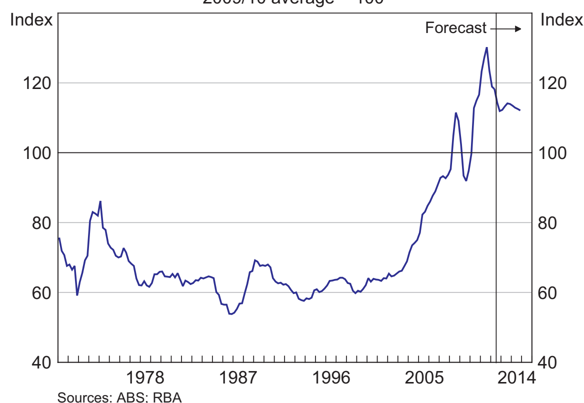
The International Economy

Since the August *Statement*, the forecasts for global growth in 2012 and 2013 have been revised down a little. World GDP growth is now expected to be around 3¼ per cent in 2012 and a little over 3½ per cent in 2013, broadly in line with forecasts from the International Monetary Fund (IMF) (Graph 6.1). For the euro area, the forecasts assume a gradual recovery in economic conditions beginning around mid 2013. The Bank's forecasts assume, along with most forecasters, that the full extent of the large fiscal consolidation currently legislated in the United States for the beginning of 2013 does not occur. On this basis, moderate US growth is expected to continue. A recovery in the euro area and ongoing moderate growth in the United States are expected to help boost growth in east Asian economies to around trend. In China, there are now signs that growth may have stabilised in response to the earlier easing in financial conditions and a further modest easing in fiscal policy.

Spot prices of iron ore and coking coal fell sharply over July and August, as Chinese demand for steel continued to moderate and steel mills ran down their inventories. Since then, iron ore prices have partially recovered, but spot prices for coking coal have declined further. Prices of most other commodities are largely unchanged over recent months, though the spot price for thermal coal has fallen significantly since the middle of the year.



While earlier forecasts embodied a gradual decline in bulk commodity prices, the large fall in recent months was faster than had been assumed, resulting in a downward revision to the terms of trade profile in the near term. By the end of 2012, the terms of trade are expected to have fallen by around 15 per cent from their September 2011 peak; this decline is slightly larger than expected at the time of the August *Statement* (Graph 6.2). In line with other forecasters, some recovery in prices for bulk commodities is expected in the first half of 2013, assuming that Chinese demand for steel picks up somewhat. Further out, prices are expected to gradually ease as the current resource investment boom adds to global supply (notwithstanding some scaling back of global mining investment intentions in recent months).



Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed as usual. The exchange rate is assumed to remain at its current level over the forecast period (A$ at US$1.04, TWI at 77), which is a 2 per cent depreciation since the August *Statement*. The forecasts are based on the price for Brent oil remaining at US$104 per barrel, a little lower than the assumption in August. The cash rate is assumed to be unchanged over the rest of the forecast period at 3.25 per cent, following the cut of 25 basis points since the August *Statement*. (This profile is higher than market expectations, which currently imply a further 50 basis points reduction in the cash rate by mid 2013.) The cash rate assumed for the forecasts is 185 basis points lower than its post-1996 average, while borrowing rates are currently 75–135 basis points below average. Finally, the forecasts assume that annual growth in the working-age population over 2013 and 2014 is 1.7 per cent, unchanged from the previous forecasts and in line with the recent pick-up in the rate of immigration.

The available data suggest that growth in the domestic economy has slowed over the second half of 2012 from the above-trend pace recorded earlier in the year. This slowing is evident in consumption growth, whereas growth in business investment is expected to have continued at a relatively strong pace, led by investment in large-scale resource projects. The Australian Government's fiscal consolidation appears to be weighing on growth over the second half of the year, while survey measures and liaison indicate that non-mining investment has remained subdued. Overall, GDP growth over 2012 is forecast to be around 3½ per cent, which is unchanged from the August *Statement* forecast (Table 6.1).

GDP growth is expected to be a little below 2¾ per cent over 2013 before picking up to just under 3 per cent over 2014. The forecasts have been revised down slightly since the August *Statement*, largely reflecting a downward revision to mining investment, which reduces expected GDP growth over 2013 by around ½ percentage point (net of imports).

The downward revision to mining investment reflects the effect of the recent decline in bulk commodity prices on mining companies' cash flows and their plans for spending. Spending plans of iron ore and coal miners have also been affected by the still high level of the exchange rate, rising costs and a softer outlook for world growth. Based on mining company announcements, liaison and market analysts' assessments, it appears that mining companies are more reluctant to commit to iron ore and coal projects still under consideration. Spending on mining machinery & equipment investment and exploration activity has also been scaled back. Further, work on some committed projects has been delayed or slowed. Notwithstanding the general conservatism in previous Bank forecasts about the likelihood of uncommitted projects going ahead, the profile of capital spending on iron ore and coal in 2013 and 2014 has now been revised lower. At the same time, and for unrelated reasons, the profile for spending on liquefied natural gas (LNG) projects over the next two years has also been revised lower. This change in the LNG investment profile reflects new information about some investment work, leading to the profile for investment spending being pushed out.

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	June 2012	Dec 2012	June 2013	Dec 2013	June 2014	Dec 2014
GDP growth	3.7	3½	2¾	2¼–3¼	2¼–3¼	2½–3½
Non-farm GDP growth	3.6	3½	3	2¼–3¼	2¼–3¼	2½–3½
CPI inflation	1.2	2½	3¼	2–3	2–3	2–3
Underlying inflation	2	2½	2¾	2–3	2–3	2–3
	Year-average[(b)]					
	2011/12	2012	2012/13	2013	2013/14	2014
GDP growth	3.4	3¾	3	2¼–3¼	2¼–3¼	2¼–3¼

(a) Technical assumptions include A$ at US$1.04, TWI at 77 and Brent crude oil price at US$104 per barrel
(b) Based on the quarterly national accounts release rather than the recent annual release
Sources: ABS; RBA

The outlook for the rest of the economy is mixed. After contributing to growth over the past year, public demand is expected to subtract from growth over the year to June 2013, as both the Australian and state governments embark on significant fiscal consolidation. A range of public estimates suggests that the move from a Federal budget deficit to surplus may subtract around ¾–1½ percentage points from growth in real GDP in 2012/13.

The effect of the unwinding of the earlier government stimulus has been clearly evident in the construction sector over the past year, with public construction declining significantly. Private residential and non-residential investment activity also remain weak. Non-residential construction is likely to recover gradually over the next two years due to the low level of investment in recent years and lower interest rates, though business surveys and liaison suggest that this recovery is likely to be relatively muted, particularly over the next year.

There are some tentative signs that investment in residential construction may have troughed in mid 2012, as lower interest rates, rising rental yields and an improvement in conditions in the established housing market have begun to create a more favourable environment for investment. For non-mining investment overall, the forecasts embody a gradual recovery over the forecast period.

The outlook for consumption is little changed since the August *Statement*. After strong growth earlier in the year, consumption is expected to grow at around trend pace, or a little below, given slower growth in labour income and the fading impetus from government payments to households in May and June. The consumption profile in the forecasts assumes that the saving ratio remains broadly unchanged at high levels.

Weaker employment growth in the September quarter, largely owing to the drag from the cyclical downturn in construction employment, has resulted in a small rise in the unemployment rate. For some time, the forecasts had contained a small rise in unemployment. The current forecasts anticipate only modest employment growth in the near term, given the softer outlook for demand growth, the high exchange rate and the resulting pressure on firms to boost competitiveness.

The unemployment rate is expected to rise a little further, with softer employment growth and a further small decline in the participation rate. Thereafter, employment growth is expected to gradually increase, as growth in activity in more labour-intensive sectors picks up and the cyclical upswing in productivity growth runs its course.

With labour market demand a little softer than in recent years, growth in the wage price index is expected to slow slightly to around 3½ per cent over the forecast period. This is around ½ percentage point below the elevated rates seen over 2005–2008 when the unemployment rate declined below 5 per cent.

Inflation

The outlook for inflation is largely unchanged from that published in the August *Statement*, reflecting offsetting influences. In light of the recent CPI data, the starting point for inflation is a little higher than had previously been expected, with underlying inflation assessed to be around 2½ per cent over the year to the September quarter. Working in the other direction, it appears that the current higher productivity growth will help to hold down unit labour costs in the near term. The slightly weaker outlook for domestic economic activity and demand for labour is also expected to help contain domestic inflationary pressures over the course of the next two years. At the same time, while tradables prices have increased a little over the past two quarters, they are expected to remain broadly flat in line with the stability of the exchange rate over the past year.

The introduction of the carbon price, which had an impact on headline inflation in the September quarter, is expected to make a further modest contribution to both headline and underlying inflation over the coming few quarters. However, most, if not all, of the direct effect of the carbon price on utilities prices was captured in the September quarter inflation data. CPI inflation, in year-ended terms, is expected to increase in the near term to over 3 per cent, before falling back to around the middle of the target range in a year's time when the September quarter increase in utility prices drops out of the year-ended inflation rate.

Risks

The risks to the global outlook remain tilted to the downside, primarily reflecting the risks associated with the banking and fiscal problems in the euro area. The recent policy announcements in Europe appear to have reduced somewhat, but by no means eliminated, these downside risks. The announcement of the European Central Bank's Outright Monetary Transactions program has improved sentiment and conditions in financial markets, particularly in the euro area.

Elsewhere, the risks are more balanced. In the United States, the Congress needs to pass legislation to avoid the sharp contractionary effects of the so-called 'fiscal cliff' (see 'Box B: Fiscal Consolidation in the United States'). The Bank's forecasts assume that not all of the legislated consolidation occurs, but the actual consolidation could be larger or smaller than assumed. In China, there is general uncertainty surrounding future policy settings given that the leadership transition in the government and state-owned enterprises will still take a couple of quarters to play out. While property controls in China are unlikely to be relaxed significantly, and could even be tightened following the recent improvement in property prices and sales, other pro-growth policies could be enacted by the new leaders next year. On balance, however, uncertainties over the near-term economic outlook in China have probably diminished somewhat. There are also challenges faced by policymakers in some economies in dealing with internal and external balance in light of the expansions in liquidity in advanced economies associated with quantitative easing.

Uncertainty around the extent and impact of public and private deleveraging in many economies around the world remains a risk to the outlook. It is possible that deleveraging will weigh on economic growth more than is forecast. Indeed, consistent with this the IMF recently revised up its estimates of

fiscal multipliers, which are relevant for considering the impact of public deleveraging, to take account of the exceptional nature of the current economic environment. At the same time though, the extent of further deleveraging by the household sector in the United States may be lessened if house prices rebound more quickly than is currently expected. If household wealth increases noticeably, and the number of people in negative equity declines, then consumer spending could be stronger.

Economic activity in Australia will be influenced by the path of growth in China and the likely consequences for the price of bulk commodities and, therefore, the terms of trade. Given the sensitivity of investment plans of iron ore and coal miners to prices, slower growth in China could see announcements of further cuts to mining investment plans while faster growth could lead to approval of projects that have recently been delayed or are currently considered unviable. If commodity prices declined further than expected, and the exchange rate did not depreciate, the traded goods and services sectors would not receive the boost that would otherwise be expected. Lower commodity prices would also reduce the revenue received by the Australian and state governments, and their response to this could have implications for domestic growth.

As usual, there is considerable uncertainty regarding the exact timing of capital spending on major mining projects given the lumpiness of spending and potential delays on these projects. This makes the task of predicting the timing and magnitude of the peak in mining investment particularly difficult. Another key risk to the forecasts is the profile for non-mining investment. The forecasts embody a recovery in both dwelling investment and non-mining business investment, after a period of considerable weakness. While the underlying drivers of investment suggest that such an outlook is warranted, the timing and strength of a pick-up in non-mining investment is uncertain.

The risks around the outlook for inflation reflect the usual uncertainty surrounding the outlook for demand and employment, and the possibility of a material change in the exchange rate. Recently, soft demand in some parts of the economy had put downward pressure on some prices. It is possible that this effect has dissipated, given the apparent pick-up in underlying inflation in the September quarter. Moreover, to date, nominal wage growth in the private sector has proved resilient to the slowing in employment growth. Some further slowing in wages is likely to be necessary to maintain inflation around its current rate. A strong pick-up in demand could add to inflationary impetus just as the disinflationary impact of the earlier exchange rate appreciation wanes, resulting in higher-than-expected inflation. Also, while productivity growth appears to have picked up substantially over the past year, there is considerable uncertainty around the prospects for ongoing productivity growth. If productivity growth were to slow, adding to pressure on unit costs, inflation could be higher than forecast. ✠