STATEMENT ON MONETARY POLICY

13 NOVEMBER 2006

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STATEMENT ON MONETARY POLICY

The recent period has seen continued growth in demand and output in Australia as the expansion now moves into its sixteenth year. Labour market conditions have remained tight, and underlying inflationary pressures are higher than they were a year ago. These developments have taken place against the backdrop of strong international growth and high commodity prices.

Most expectations are that the world economy will continue to grow at an above-average pace in the year ahead, albeit not quite as strongly as in 2006. While growth in the United States has moderated recently, strong economic conditions are generally prevailing in other parts of the world. Growth in the Chinese economy has remained above 10 per cent and there has been a significant improvement in conditions in the euro area since the beginning of the year. The expansion in Japan is continuing, and strong growth rates are being seen in a range of emerging economies in Asia and elsewhere. Overall the global expansion appears broadly based, and observers generally expect it to remain robust in the face of the moderate slowing now underway in the United States.

The strong global growth over a number of years has added to demand for commodities and contributed to significant upward pressure on a wide range of resources prices. While world oil prices have declined from their peaks over recent months, other resources prices have remained high, with base metals prices on average around 60 per cent higher than at the beginning of the year. These levels of commodity prices are continuing to have a significant expansionary effect on the Australian economy, having boosted Australia's terms of trade by more than 30 per cent over the past three years. The impact of higher commodity prices over this period has only partly been moderated by the rise in the exchange rate of the Australian dollar.

With this background of global expansion, the world's major central banks are at varying stages in the process of lifting their policy interest rates back to more normal levels. In the United States, short-term interest rates are now around historical averages. The European Central Bank and, more particularly, the Bank of Japan, started this process later than the US, and are generally expected to continue on their path of raising interest rates gradually over the period ahead. World equity markets have continued to strengthen in recent months, reflecting a general view that the global business environment is likely to remain favourable, even with higher short-term interest rates. The Australian equity market has been a little stronger than those in other countries, partly as a result of renewed strength in commodity prices. The market has also been boosted by a number of company-specific events including merger and acquisition announcements.

As has been the case for some time, growth of the Australian economy over the past year has been led by domestic spending, which has continued to be boosted by the effect of the rising terms of trade. Business investment again expanded at a double-digit pace over the year to the June quarter, with mining investment particularly strong. In combination with moderate growth in household spending, this has meant that the overall growth in domestic demand has remained relatively strong, albeit below the exceptional pace of a few years ago. A significant part of the additional demand has continued to be met by imports (and, in the latest quarter, by a run-down in inventories) resulting in somewhat lower recorded growth in total output, estimated at around 2 per cent over the past year.

The overall strength in domestic spending has been broadly reflected in the demand for finance, which has seen total credit growing rapidly over the past year at a rate of 14 per cent. There are some signs that this may now be starting to moderate. Housing loan approvals have declined in recent months, after a period of strength around mid year. Growth in credit outstanding to the household sector eased a little in the September quarter, though it remains quite strong at an average rate of around 1 per cent per month, which is about the same pace as in the March quarter. Demand for credit in the business sector also remains high, despite some recent moderation, with the amount outstanding increasing by 16 per cent over the past year.

Australia's economic expansion has now reached a mature stage in which previously unused productive resources have been substantially re-employed. In these circumstances, it is not surprising that the economy's growth rate in recent years has tended to be a little lower than was typical earlier in the expansion. Even so, employment has been increasing at a rate well above trend over the past year and the unemployment rate has reached 30-year lows. The strong demand for labour has also been evident from liaison reports and other indicators such as the high level of job vacancies and the high proportion of firms in surveys reporting difficulty obtaining suitable labour.

On its face, this combination suggests that there may have been some underlying slowdown in productivity, either of a cyclical or structural nature, though its extent is difficult to explain. What does seem clear, however, from several sources of information, is that the economy is operating with very limited spare capacity. In addition to the evidence of strong labour market conditions and shortages of suitable labour, business surveys and liaison reports continue to indicate that capacity utilisation in the non-farm economy is at cyclically high levels.

The combination of strong global conditions, rising commodity prices and tight capacity domestically has contributed to a pick-up in inflationary pressures since the start of the year. Producer price indices showed further strong increases in prices at all stages of production in the September quarter, with pressures evident across most industries. Measures of aggregate wages, though not accelerating further, have continued to grow at a pace that is higher than the average of recent years. Reports of significant increases in non-wage labour costs have continued over recent months.

Measures of consumer price inflation reflect these pressures. The CPI rose by 0.9 per cent in the September quarter and by 3.9 per cent over the year. The annual CPI figure continues to be influenced by the sharp rise in banana prices and by increases in petrol prices earlier in the year (though the latter have now started to fall). Estimates of underlying inflation, which abstract from these and other temporary influences, have in recent quarters been running at an annualised pace of about 3 per cent, compared with 2½ per cent at the end of last year. This outcome has been associated with increases in a range of measures of inflation expectations.

In its policy deliberations in recent months the Board took careful note of the effects of the drought, which will lower the supply of rural produce, reduce farm incomes and may temporarily affect some food prices. At this point, these developments appear unlikely to affect significantly the medium-term inflation outlook. The Board also took into account that the earlier interest rate increases this year could be expected to have some dampening effect on borrowing and spending in due course. Nevertheless, the Board's assessment, given the evidence of stronger inflation pressures since the start of this year, was that a somewhat more restrictive stance of monetary policy would be required in order to achieve average inflation outcomes of between 2 and 3 per cent over time. Hence it decided to raise the cash rate to 6.25 per cent at the November meeting. The decision was widely anticipated and caused little reaction in financial markets.

Looking ahead, and taking into account the likely effects of the changes to monetary policy this year, the Bank's assessment is that domestic demand can be expected to record moderate growth over the next year or two, with continued expansion in consumer spending, a noticeable easing in investment growth and a gradual pick-up in housing construction. Exports should pick up as capacity expansions in the resources sector come on stream, and will contribute more to overall growth than in recent years. These forces are expected to produce a gradual return to trend growth for the non-farm economy, associated with the easing of some capacity constraints. In the short term, GDP growth will be significantly affected by the drought, as the farm sector is unable to supply its normal level of production. Farm output could fall by around 20 per cent, which would directly reduce GDP growth in the year ahead by around half a percentage point, with some additional indirect effects flowing on to other parts of the economy.

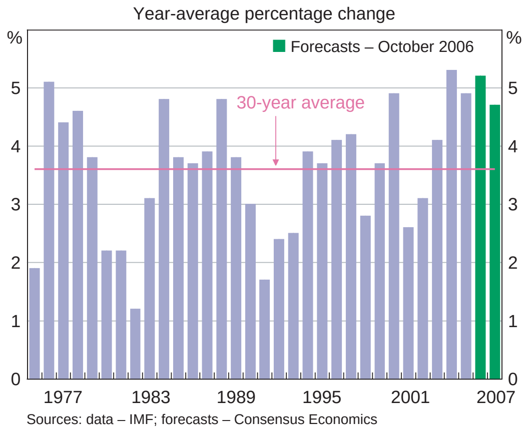
There will be some significant fluctuations over the next eighteen months in the headline inflation rate. In particular the unwinding of earlier increases in petrol and banana prices will see the annual headline rate declining sharply over the next year, before rising again by the first half of 2008. The drought may add to some food prices in the short term, though the experience of previous drought episodes suggests that the net effect on the CPI should be fairly small. In setting monetary policy, the Board will continue to abstract from these short-term fluctuations, just as it did when temporary factors were adding to headline inflation.

Recent information suggests little reason to change the Bank's earlier assessment that in the near term, underlying inflation will continue to run at about 3 per cent. Longer term, prospects for some moderation in underlying inflation have been improved by the policy actions taken this year. The Board will continue, over the months ahead, to assess whether these actions will prove sufficient to achieve the objective of 2–3 per cent inflation over time.

International Economic Developments

Global economy

Graph 1



The world economy has been expanding strongly. Growth is estimated at above 5 per cent for 2006, around the fastest rate in recent decades (Graph 1). The outlook for 2007 is for some moderation in growth in all major regions, but overall growth is still forecast to be above average. Some of this moderation already appears to be underway, including in the United States and in parts of east Asia. Growth in the euro area has picked up, rapid growth in China is continuing, and growth in other emerging economies has generally been firm. Despite these strong growth outcomes, oil prices have eased from peaks of over US$75 per barrel in July to below US$60 recently.

One question currently being asked is whether a greater-than-expected slowing in the US economy would have a major effect on global growth. Many commentators seem to be suggesting that the global expansion is sufficiently broad-based that it should be fairly resilient to the effects of such a slowdown. One key element in this has been the strong rate of growth in the Asian region. The pattern of Australia's international trade has shifted significantly towards Asia, and especially China and India, in recent years. Asia now accounts for over 60 per cent of Australia's exports (see Box A: 'The Changing Country Composition of Australia's Trade' for more details). Accordingly, demand in this region is now a more important determinant of the impact of the global economy on Australia than had been the case in previous cycles.

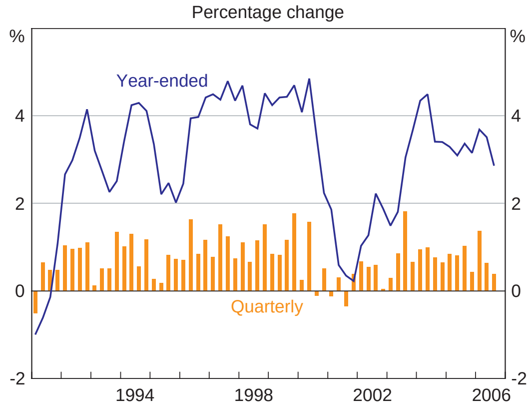
United States

The US economy is operating at close to full capacity following strong growth in previous years, but growth has moderated somewhat since the beginning of 2006. Real GDP expanded by a below-trend 0.4 per cent in the September quarter, while year-ended growth declined to 2.9 per cent (Graph 2). The recent slowing mainly reflected the downturn in residential investment, which fell by almost 8 per cent over the year to the September quarter.

Recent falls in new housing starts and permits suggest that further falls in residential investment are in prospect, and conditions in the existing housing market have also weakened (Graph 3). Home sales have fallen significantly since late 2005 and in September the stock of

Graph 2

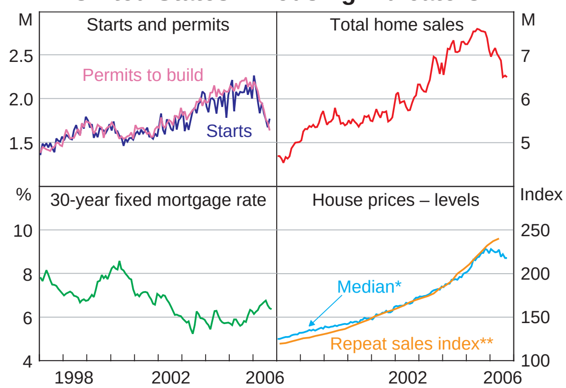
United States – GDP



Source: Thomson Financial

Graph 3

United States – Housing Indicators



* Monthly
** Quarterly
Sources: Bloomberg; Thomson Financial

unsold existing and new houses was at just under seven months of current monthly sales, around the highest ratio since October 1992. This has put downward pressure on house price growth; in the June quarter, growth in the Office of Federal Housing Enterprise Oversight (OFHEO) repeat-sales house price index was the lowest in three years. Median house prices, which do not control for compositional change, fell slightly over the year to September. However, mortgage rates have fallen in recent months, retracing more than half of the rise in the first part of the year, which should provide some support to housing demand. There are tentative signs that new mortgage applications and home sales have stabilised since August, after falling over the preceding year.

The softening of conditions in the housing market has removed an important stimulus to consumer spending; easing house price growth has been associated with slower growth in households' wealth and less housing equity withdrawal. Nonetheless, the recent fall in petrol prices, as well as a tight labour market, appear to be supporting solid growth in spending and reducing the impact of the housing downturn. Recent employment and wages data indicate the labour market has been firm; the payrolls measure of employment grew by 1.5 per cent over the year to October, and at 4.4 per cent in the month of October, the unemployment rate was at its lowest reading in five years.

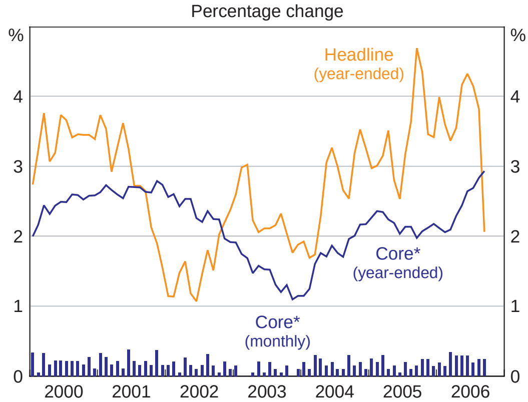
Business conditions remain healthy, with growth in business investment picking up to around 2 per cent in the September quarter. Equipment investment grew solidly, following a weak June quarter outcome, and continued growth in core capital goods orders suggests this strength should be maintained. Conditions for business investment are favourable: capacity utilisation is high; the corporate profit share reached its highest level since the early 1960s in the September quarter; and long-term bond yields have fallen in recent months. Although business sentiment is well down from recent peaks on most measures, it is at levels that have traditionally been associated with a moderate expansion in activity.

Core inflation has picked up, and reached an annualised rate of 3.6 per cent over the three months to June. This gave rise to concerns that price increases for oil and other raw materials were feeding through into more generalised inflation, although these concerns have eased somewhat as core inflation moderated to an annualised 2.7 per cent over the three months to September. Headline inflation has been volatile, recently falling significantly, from 3.8 per cent over the year to August to 2.1 per cent in September, reflecting recent declines in oil prices and base effects from the impact of Hurricane Katrina on oil prices in 2005 (Graph 4).

Graph 4

United States – Consumer Prices

Percentage change



* Excluding food and energy
Source: Thomson Financial

Asia-Pacific

Japan

The Japanese economic expansion has been sustained for several years now, with solid growth in demand across the business, household and external sectors. GDP increased by 2.5 per cent over the year to the June quarter and more timely indicators remain positive.

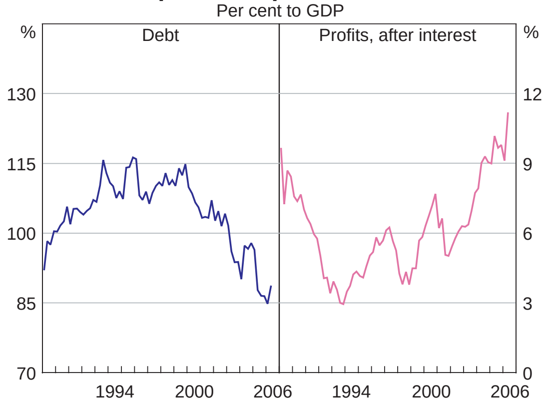
Business investment increased in the June quarter, lifting year-ended growth above 9 per cent, and recent data point to continued investment growth. Corporate balance sheets are much stronger than they were for many years, reflecting solid profits and historically low debt levels, and business borrowing has been increasing over the past year (Graph 5). Year-ended growth in industrial production has been running at rates around 5 per cent in recent months, and capacity utilisation remains high. In the September quarter Tankan survey, reported business conditions were at their highest level in almost 15 years, and investment intentions were again revised up.

Conditions also remain favourable in the household sector. Consumption increased by 1.8 per cent over the year to the June quarter, supported by continued strength in the labour market. The unemployment rate was around an eight-year low at 4.2 per cent in September and the job-offers-to-applicants ratio is around a 14-year high. Surveys show that both employers and employees report positive sentiment about future employment conditions.

Graph 5

Japan – Corporate Sector

Per cent to GDP



Sources: CEIC; Thomson Financial

Overall consumer prices continue to increase modestly in year-ended terms. Headline CPI inflation was 0.6 per cent over the year to September. Core inflation, as measured by the CPI excluding food and energy, was still negative following the updating of the CPI weights in August. Upstream price pressures remain, with year-ended growth in corporate goods prices picking up to 3.6 per cent in September.

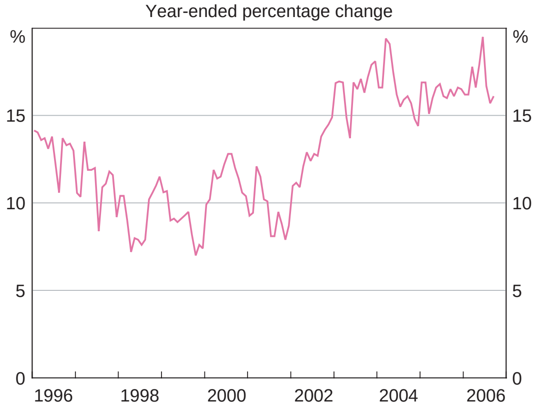
China

The Chinese economy has continued to grow rapidly. Year-ended growth in real GDP was reported at 10.4 per cent in the September quarter, down a little from the exceptionally high rate of 11.3 per cent recorded in the previous quarter. Year-ended growth in fixed-asset investment and industrial production slowed in the September quarter, though both series still recorded rates similar to those seen over the past couple of years (Graph 6). The slight decline in year-ended rates of growth may indicate that measures taken by the government to cool the pace of investment growth are having some effect. Most recently, these measures have included increases in property-related taxes and banks' required reserves. The People's Bank of China also raised both deposit and lending rates by 27 basis points in August, although financial conditions still appear stimulatory. Despite some moderation, growth in the money supply and credit remains relatively high.

Graph 6

China – Industrial Production

Year-ended percentage change



Sources: CEIC; RBA

The external sector continues to support Chinese growth. Year-ended growth in exports was about 30 per cent in September, compared with around 20 per cent for imports. As a result, the trade surplus widened to a record US$45 billion in the September quarter, from US$26 billion a year earlier. In contrast, the pace of Chinese accumulation of foreign reserves has been moderating, suggesting that net capital inflows have slowed.

Input cost pressures have persisted, with rapid wage growth, especially for skilled workers; growth in urban incomes has been in the 12–15 per cent range for some time. Despite this, consumer price inflation remained modest at 1.5 per cent over the year to September. Rapid productivity growth appears to be helping to keep inflation under control. Chinese export prices appear to be growing only modestly, with prices of goods re-exported through Hong Kong increasing by around 1 per cent over the year to the June quarter.

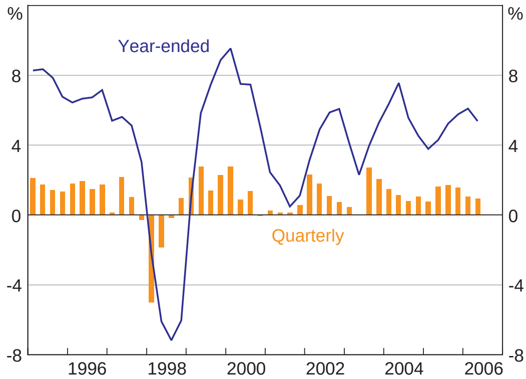
Other Asia-Pacific

Growth in the rest of east Asia has eased somewhat; real GDP growth in the region moderated over the first half of 2006, to be 5.4 per cent over the year to the June quarter (Graph 7). Investment growth has been subdued and growth in ITC-related exports has eased. Growth in world semiconductor sales has eased a little recently and the US semiconductor equipment book-to-bill (orders-to-sales) ratio fell in the September quarter. Domestic demand in the region is being supported by private consumption and strong growth in government expenditure, although Taiwan is an exception following the credit card problems earlier in the year. A pick-up in growth in non-ITC exports has been recorded across the region, and year-ended growth in total merchandise exports was around 17 per cent in August. Low unemployment rates are supportive of household demand and real interest rates are fairly low in most countries in the region despite earlier tightenings in monetary policy. Consensus forecasts for growth in Thailand and in the region have been little affected by recent political developments.

Graph 7

East Asia* – GDP

Percentage change



* Excluding China and Japan
Source: CEIC

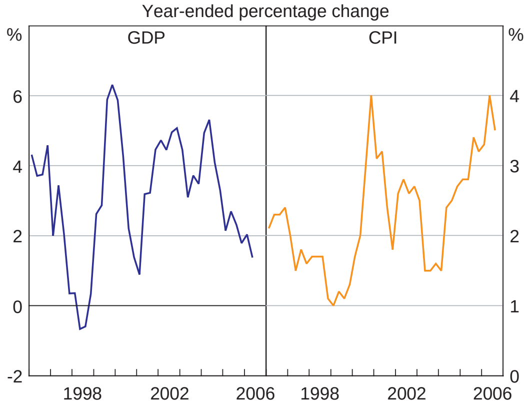
Growth remains strong in the Indian economy, driven by domestic demand. GDP increased by 8.9 per cent over the year to the June quarter. Although growth in industrial production has softened in recent months, it was still 10 per cent over the year to August, and business confidence remains high. India's imports and exports have been expanding rapidly as the country continues to integrate with the rest of the world economy; this has been particularly evident in its trade with Australia (see Box A). Wholesale price inflation in India has picked up recently, driven largely by food prices, to be 5.4 per cent over the year to September.

In New Zealand, GDP growth slowed to 0.5 per cent in the June quarter, to be 1.4 per cent in year-ended terms (Graph 8). Nevertheless, the labour market remained tight in the September quarter, with the unemployment rate close to record lows and year-ended growth in labour costs high. Although consumer confidence picked up in the September quarter, it is still below its long-run average and growth in retail sales remained relatively soft in August, at 2.8 per cent in year-ended terms. Similarly, business confidence remains well below the long-run average, although it picked up in the

Graph 8

New Zealand – GDP and Prices

Year-ended percentage change



Sources: Statistics New Zealand; Thomson Financial most recent readings. Consumer prices increased by 0.7 per cent in the September quarter, to leave year-ended inflation at 3.5 per cent.

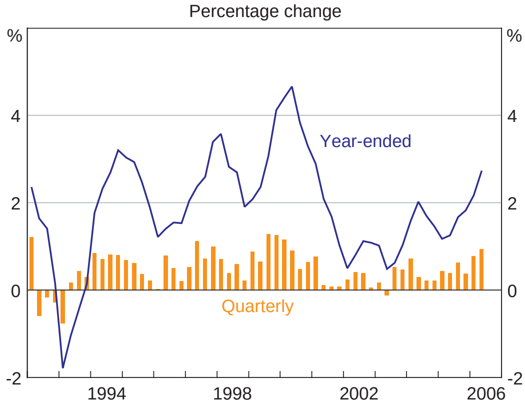
Europe

GDP growth in the euro area picked up in the first half of 2006, with the year-ended rate reaching 2.7 per cent in the June quarter (Graph 9). Much of the strength in the June quarter was driven by investment, and indicators of business conditions suggest that the outlook for investment remains positive. Industrial production continues to grow solidly, increasing by 5.1 per cent over the year to August and measures of business sentiment remain at high levels. The positive conditions in the business sector have fed through to improvements in the labour market. The unemployment rate declined from 8.5 per cent to 7.8 per cent over the year to September, and area-wide employment has been growing solidly. Strong external demand appears to have been a factor behind the positive business sentiment in the euro area, although year-ended growth in exports has softened recently.

Graph 9

Euro Area – GDP

Percentage change



Source: Thomson Financial

Demand from the household sector has been slow to recover, despite the improvement in the labour market. Consumption growth eased to 0.3 per cent in the June quarter. This largely reflected weakness in Germany, where consumption fell by 0.4 per cent in the quarter, and slowing growth in Italy. In contrast, consumption remained robust in France and Spain, as strong house price growth over recent years has boosted household wealth. Indicators of consumption for the euro area as a whole remain positive; growth in retail sales remains solid, and consumer confidence has risen further above its long-run average.

Headline inflation has fallen noticeably in the euro area recently, to be 1.6 per cent over the year to October, reflecting the easing in world oil prices. Core inflation, which excludes the effects of energy prices, has remained contained at around 1½ per cent.

Growth in the United Kingdom picked up further in the September quarter, with GDP expanding by 2.8 per cent over the year. Consumption spending has recovered solidly, supported by rising house prices and above-average levels of consumer sentiment. Employment has been growing moderately, but this has been outstripped by a significant expansion in the labour force due to immigration and increased participation by female and older workers, so the unemployment rate has risen over the past year.

Box A: The Changing Country Composition of Australia's Trade

The pattern of Australia's international trade flows has shifted towards Asia in recent years. Asia's share of both exports and imports has increased, mainly at the expense of North America. China and India have had particularly important roles in this shift, driven by their growing demand for resource commodities, and to a lesser extent, services.

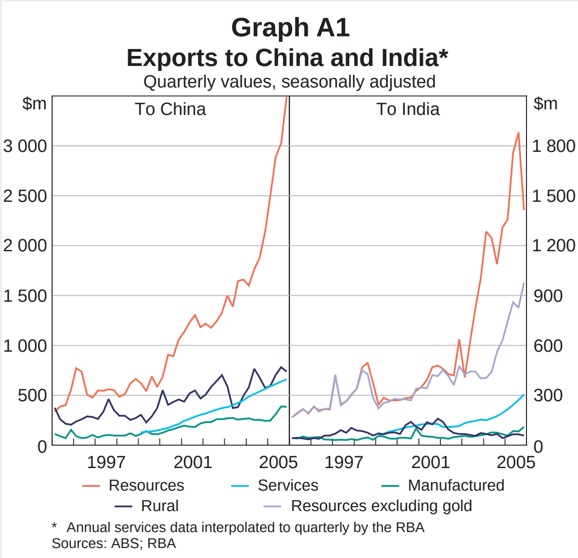
Japan has long been Australia's most important export destination, accounting for 18 per cent of total goods and services export values in 2005 (Table A1). The Asian region as a whole has gained importance of late, with the share of exports going to Asia rising from 57 per cent in 2000 to 62 per cent in 2005. This is a fairly large shift in share compared with previous five-year periods. The rise was mainly driven by the 23 per cent annual increase in exports to China, which overtook the United States to become Australia's second-largest export destination in 2005. Exports to the US fell 4 per cent annually over the same five-year period, taking its share from 12 per cent to around 8 per cent, although this partly reflects the fall from the unusually high level of export revenues from tourism and television rights during the Olympics.

Table A1: Australia's Exports of Goods and Services by Destination

	Share of total exports 2005, per cent	**Average annual growth** 2000–2005, per cent	**Rank in 2000**
Japan	17.9	4.4	1
China	10.6	22.5	7
United States	7.8	–3.9	2
Korea	6.9	4.5	3
New Zealand	6.7	6.1	4
United Kingdom	5.2	4.5	6
India	4.5	28.8	13
Singapore	3.6	–3.9	5
Taiwan	3.4	–0.2	8
Thailand	2.6	13.8	12
– North America	9.6	–2.3	
– European Union	12.9	3.5	
– Asia	62.0	5.9	
Total		**4.2**	

Source: ABS

The surge in the value of exports to China has been the result of China's extraordinarily strong demand for raw materials, coupled with the related large rises in the prices of some of these commodities. Resource exports accounted for 18 percentage points of the 23 per cent annual average rise in total exports to China over the past five years (Graph A1). In 2005 alone, the value of resource exports to China rose by 62 per cent. The bulk of the rise came from metal ores, while coal, non-ferrous metals and gold also made small contributions. The value of service



exports to China has also grown strongly from a low base. In 2005, service exports to China increased by 19 per cent and they have risen at an average annual rate of 28 per cent since 2000. Around four-fifths of this increase came from education-related travel services. While Australia runs a trade deficit with China, the sharp rise in the value of exports in 2005 reduced it by around a third to $3.9 billion, its lowest level since 2001.

India has also become an increasingly important export market in recent years, jumping from Australia's 13th largest export market in 2000 to 7th largest in 2005. Annual growth of exports to India has averaged close to 30 per cent since 2000, propelled by India's ongoing integration into the world economy. Again, much of the increase resulted from strong Indian demand for Australia's resource exports. The earlier phase of the increase was driven by exports of gold, with some contribution from coal and metal ores, but the sharp rise in 2005 was largely due to higher coal exports. In addition, service exports made a sizeable contribution to growth in total exports to India in 2005, rising by more than 50 per cent in the year. As with China, this was mainly driven by the education component.

Asia is also becoming a more important source of imports, with its share rising from 44 per cent to 49 per cent over the past five years, while North America has experienced a corresponding decline (Table A2). The US nonetheless remains the largest source of Australia's imports. Since 2000, the value of imports from China has more than doubled, with China overtaking Japan as the second largest source in 2004. Around 90 per cent of imports sourced from China are manufactured goods, reflecting its comparative advantage in low-cost manufacturing and assembly. Resource imports from China also rose solidly in 2005, largely because imports of iron and steel more than doubled.

Table A2: Australia's Imports of Goods and Services by Origin

	Share of total imports 2005, per cent	Average annual growth 2000–2005, per cent	Rank in 2000
United States	14.4	–1.4	1
China	11.6	18.1	4
Japan	9.8	2.0	2
Singapore	5.9	14.7	7
United Kingdom	5.3	–1.0	3
Germany	5.1	7.6	5
New Zealand	3.8	3.8	6
Malaysia	3.5	6.1	8
Thailand	3.0	10.8	13
France	2.9	15.8	14
– North America	16.1	–1.0	
– European Union	23.3	6.6	
– Asia	48.7	7.8	
Total		**5.4**	

Source: ABS

International and Foreign Exchange Markets

International financial markets

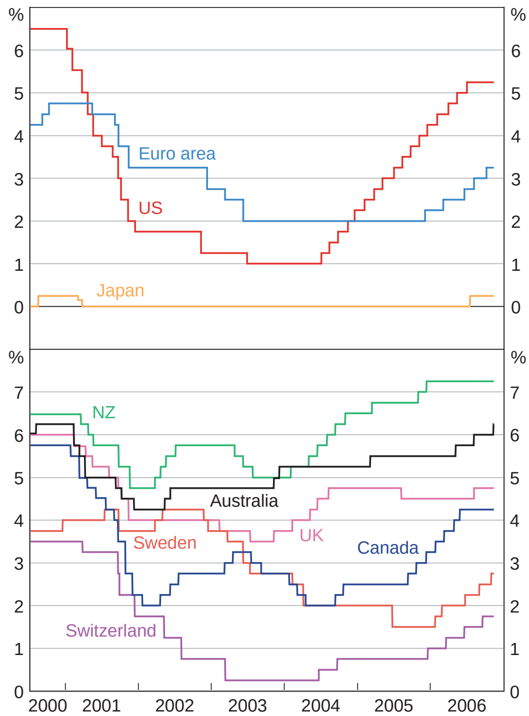
Official interest rates

The three major central banks remain at quite different stages of their monetary cycle (Graph 10). In the US, the first phase of the cycle appears to be complete, with the Fed having left its policy rate unchanged for the past three meetings. This follows 17 consecutive increases of 25 basis points, which lifted the rate from 1 per cent in July 2004 to 5¼ per cent currently, a level which is broadly in line with long-run averages. In its recent statements, the Fed has indicated that upside risks to inflation remain but financial markets are currently pricing in some probability of an easing in policy in the first quarter of 2007 (Table 1).

The European Central Bank's (ECB) tightening phase has continued, increasing the policy rate by 25 basis points at both its August and October meetings, to bring the

Graph 10

Cash Rates



Source: central banks

Table 1: Changes in Monetary Policy

	Current level Per cent	Most recent change	Expectations for next 6 months
United States	5.25	↑ Jun 06	No change
Euro area	3.25	↑ Oct 06	↑ 50 bps
Japan	0.25	↑ Jul 06	↑ 25 bps
United Kingdom	4.75	↑ Aug 06	↑ 50 bps
Canada	4.25	↑ May 06	No change
New Zealand	7.25	↑ Dec 05	↑ 25 bps

Sources: central banks; Bloomberg; Reuters rate to 3¼ per cent. Economic growth in the euro area has strengthened, and the ECB continues to see some upside risks to the inflation outlook. Currently, the market anticipates the ECB will raise rates by a further 50 basis points in the next six months.

The Bank of Japan (BoJ) only commenced its tightening cycle in July this year when it raised official interest rates to 0.25 per cent; it has since kept its policy rate unchanged. Market expectations of the timing of the next increase were pushed back in August after revisions to consumer price data revealed that inflation was lower than previously thought. Markets expect the next tightening by the BoJ to be early next year.

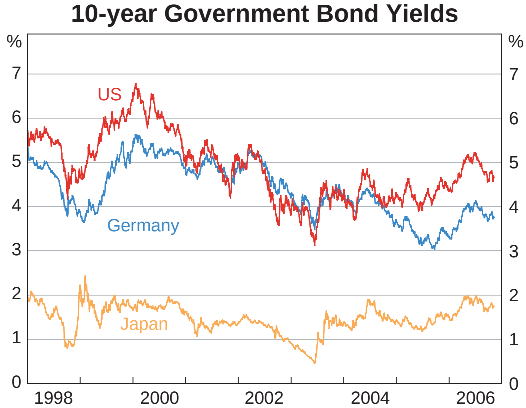
The Bank of England surprised markets by raising rates by 25 basis points in August, and further tightening is expected in the coming months. Monetary policy was also tightened in Sweden, Switzerland and Norway. Rates in these countries, particularly Switzerland, were previously at unusually low levels. In contrast, policy has not been changed in Canada and New Zealand over the past quarter, though some further tightening is expected in the latter in the coming months.

Monetary conditions have been tightened in China to curtail the growth in money and credit, which is being boosted by the People's Bank of China's foreign exchange intervention. The benchmark lending and deposit rates were raised in August while the required reserves ratio for banks was increased in November. The lending rate was previously raised in April, while the required reserves ratio on banks had already been increased twice this year. These measures have had some success; monetary growth slowed in August and September to just above the official target of 16 per cent.

In other emerging markets, there have been divergent trends in monetary policy reflecting differences in the outlook for inflation and growth. Monetary policy was tightened on inflation concerns in the Czech Republic, Hungary, India, Korea, Taiwan and South Africa. In contrast, Bank Indonesia continued to ease policy, bringing the cumulative easing since May to 250 basis points reflecting its assessment that inflation pressures in Indonesia are easing. For similar reasons, official interest rates were lowered in Brazil for the 11th time in the current cycle. In Israel, the policy rate was reduced by 25 basis points, having been raised twice earlier in the year, with inflation now projected to fall below target.

Graph 11

10-year Government Bond Yields



Source: Bloomberg

Bond yields

Government bond yields in the three major economies (Graph 11) have fallen since the last *Statement*, mainly due to the market's assessment that the risks of a more pronounced slowdown in the US economy have increased. Yields are well below their peaks earlier in 2006.

US long-term yields are currently around 4.65 per cent, compared with 5 per cent three months ago. With the policy rate at 5¼ per cent, the yield curve is noticeably inverted. While structural factors such as excess global savings may still be depressing long-term interest rates, the negative slope in the yield curve nonetheless implies that markets see some possibility of a Fed easing in the year ahead.

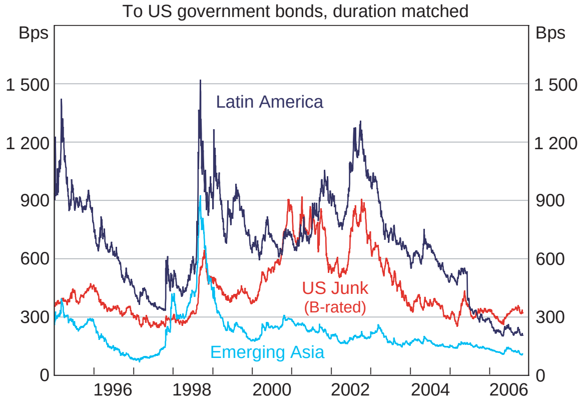
In Germany and Japan, yields have fallen to a lesser extent than US yields, primarily as a result of data suggesting generally favourable economic conditions in both regions, and expectations of further monetary policy tightening. Several rating agencies downgraded Italy's sovereign credit rating in October, reflecting concerns about the fiscal outlook. Despite this, Italian yields remain only around 25 basis points higher than in Germany.

Spreads on high-yielding corporate debt and emerging-market debt narrowed since the last *Statement*, when markets were still being affected by the risk-reduction trades over May and June (Graph 12). Emerging-market debt spreads are at historically low levels. The increased risk of a slowdown in the US economy has seen spreads on low-rated corporate debt in the US rise somewhat, as such an outcome could damage corporate finances. However, to date default rates remain low.

Graph 12

Market Spreads

To US government bonds, duration matched



Sources: Bloomberg; RBA; Thomson Financial

Equity markets

Global equity markets have posted steady gains since the last *Statement*, boosted by lower oil prices, and a pause in US policy rates (Table 2). The declines in the oil price had differing impacts

Table 2: Changes in Major Country Share Prices
Per cent

	Since 2000 peak	2006 to date	Since previous *Statement*
United States			
– Dow Jones	4	14	8
– S&P 500	–9	11	8
– NASDAQ	–53	8	14
Euro area			
– STOXX	–17	17	12
United Kingdom			
– FTSE	–10	11	7
Japan			
– TOPIX	–9	–3	2
Canada			
– TSE 300	9	10	4
Australia			
– ASX 200	62	15	9

Source: Bloomberg

on global equity markets, with markets where the energy sector has a relatively high weight, such as in Canada and Russia, tending to underperform. Nevertheless, most equity markets have recorded solid rises over the year to date. One exception has been the Japanese market which is little changed from the beginning of the year. Price-earnings ratios remain around their historical averages, with the rise in share prices broadly matched by higher earnings.

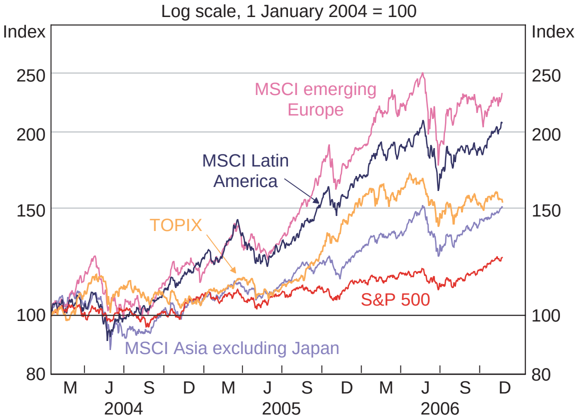
The technology-dependent NASDAQ index, which experienced a large decline in the June quarter, has led the strength in US equities since the last *Statement*. In early October, the blue-chip Dow Jones index broke through its previous peak reached in January 2000.

In line with developments in the major markets, emerging equity markets of Asia and Latin America have continued to recover from the losses sustained mid year (Graph 13). The markets which suffered the largest losses, such as those in Indonesia and India, have been particularly strong, rising by around 20 per cent since the last *Statement* to more than recoup earlier losses. Asian equity markets, with the exception of South Korea, have improved over 2006, continuing the rally in place since 2003. Chinese equities, which were relatively unaffected by the events mid year have been very strong, rising by more than 60 per cent in 2006 to date.

Graph 13

Share Price Indices

Log scale, 1 January 2004 = 100

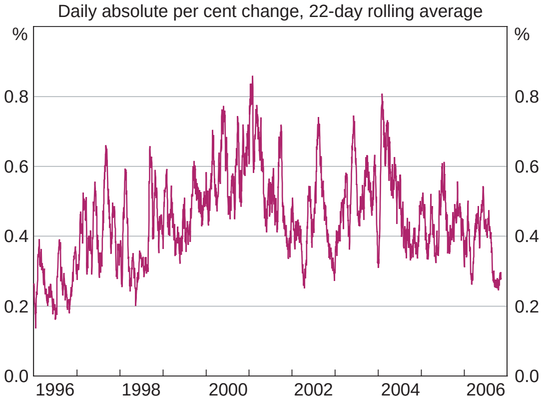


Source: Bloomberg

Graph 14

US$ per Euro Volatility

Daily absolute per cent change, 22-day rolling average



Source: RBA

Exchange rates

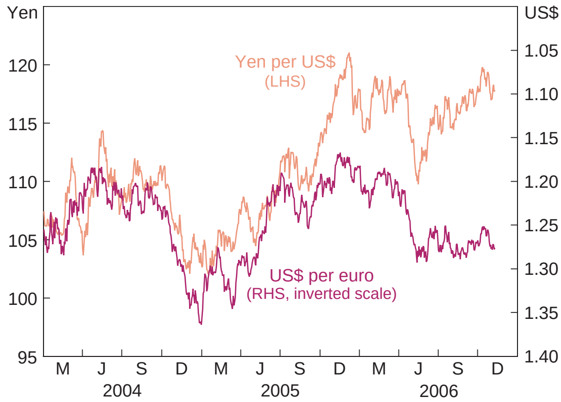
Foreign exchange markets have been relatively subdued over recent months, with daily volatility for major currencies now at its lowest level in almost a decade (Graph 14). The US dollar has not changed much against the euro over the past three months, notwithstanding the decision of the US Federal Reserve to leave monetary policy on hold and the further policy tightening in Europe (Graph 15, Table 3). The most notable development in recent months has been the gradual depreciation of the yen. One factor contributing to this may be the restoration of carry trades following an assessment that, despite the end of the zero interest rate policy, rates will remain low in Japan for some time to come. Another factor appears to be a greater appetite for portfolio diversification into foreign assets by

Japanese investors. As the Japanese economy continues to recover, they are becoming more confident in taking on the foreign exchange risk that comes from buying offshore assets. Part of this shift to offshore investments has been by Japanese households. In comparison with households in many other countries, they have in the past been very conservative in their investments, holding the bulk of their financial wealth in the form of domestic bank deposits. But the ongoing low return on these investments is encouraging Japanese households to diversify into other assets, including offshore assets. In real effective terms, the yen is at its lowest level since 1985 (Graph 16).

The gradual appreciation of the Chinese renminbi has continued in recent months (Graph 17). Daily volatility in the renminbi has increased over the period, but remains low compared to other major currencies. As part of the gradual program of reform, a foreign exchange swap market has been created and a trial of a full convertibility zone is being conducted in the port of Tianjin. This would allow residents and firms in that region to freely trade in foreign currencies, and qualified institutions to expand their foreign investment activity there.

Most emerging-market currencies have made modest gains against the US dollar over the past three months. These gains have been achieved in a number of countries despite negative political events such as the Thai military coup, Brazilian corruption scandal and civil unrest in Hungary. One notable exception has been the South

Graph 15
US Dollar Exchange Rates



Source: Bloomberg

Table 3: US Dollar against Other Currencies
Percentage change

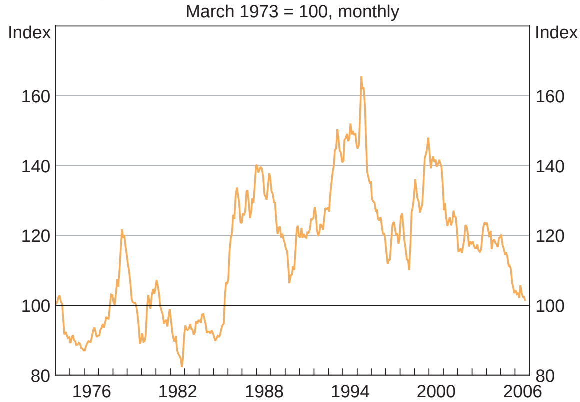
	2006 to date	Since previous *Statement*
Thailand	–11	–3
United Kingdom	–10	0
Sweden	–10	0
Brazil	–8	–2
Indonesia	–7	0
Euro area	–7	1
South Korea	–7	–3
Philippines	–6	–3
Singapore	–6	–1
Switzerland	–5	2
Australia	–5	–1
Malaysia	–4	–1
Canada	–3	0
China	–3	–1
India	–1	–4
Japan	0	3
Taiwan	0	0
Mexico	2	0
New Zealand	3	–6
South Africa	16	7
Majors TWI	**–5**	**1**
Broad TWI	**–4**	**0**

Source: RBA

Graph 16

Japan – Real Effective Exchange Rate

March 1973 = 100, monthly

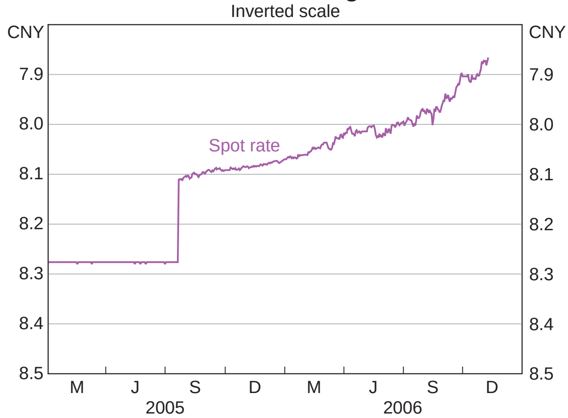


Source: Bank of Japan

Graph 17

Renminbi Exchange Rate

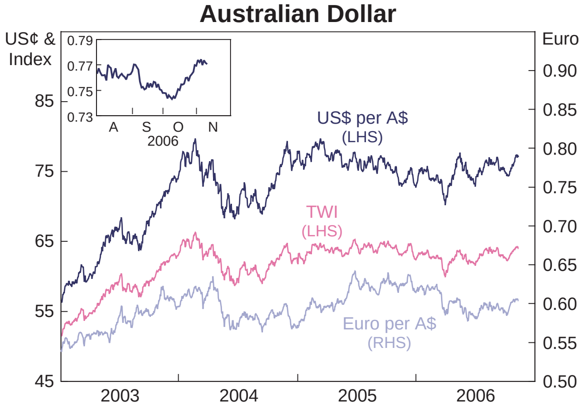
Inverted scale



Source: Bloomberg

Graph 18

Australian Dollar



Sources: RBA; Reuters

African rand which has depreciated by around 7 per cent over the period with its trade position adversely affected by the decline in gold prices.

Australian dollar

The Australian dollar has appreciated against the US dollar recently, but remains in the relatively narrow range it has traded in over the past two years (Graph 18, Table 4). The exchange rate has also been relatively stable on a trade-weighted basis, although it has risen to its highest level against the yen in nearly 10 years, reflecting the weakness of the yen on global markets described in the previous section. The overall stability of the currency is demonstrated by the fact that realised volatility in the Australian dollar over recent months has been well below its post-float average (Graph 19). Volatility implied from option prices has also fallen to its lowest level since 1997.

Sentiment towards the Australian dollar remains positive, with A$ eurobond issuance at moderate levels and net speculative positioning in Australian dollar futures on the Chicago Mercantile Exchange rising to a record long position.

With the exchange rate remaining within its recent range, the Reserve Bank has kept its foreign exchange purchases to those sufficient to cover sales to the Government. Net reserves are around $30½ billion. The Bank's holdings of foreign exchange under swap agreements, which are largely determined by liquidity management operations, have fallen by $4 billion, to $35 billion, since the last *Statement*.

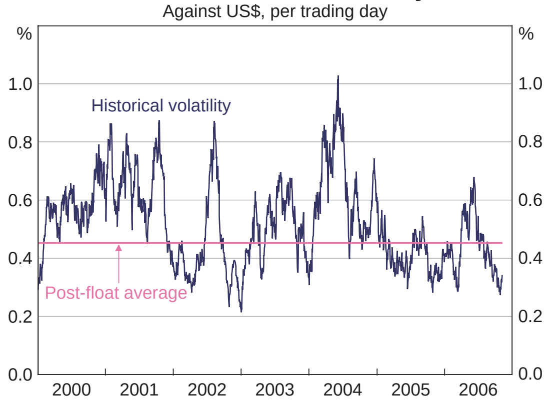
Table 4: Australian Dollar against Selected TWI Currencies
Percentage change

	2006 to date	Since previous *Statement*
South Africa	21	2
New Zealand	8	–1
Japan	6	1
Taiwan	5	1
US	5	1
PNG	2	1
China	2	0
Canada	2	3
Switzerland	0	2
Philippines	–1	–1
Singapore	–1	0
Euro area	–2	1
South Korea	–3	–2
Indonesia	–3	1
Sweden	–5	–1
UK	–5	1
TWI	**2**	**0**

Source: RBA

Graph 19

Australian Dollar Volatility
Against US$, per trading day



Source: RBA

Domestic Economic Conditions

The data released over the past three months suggest that economic activity has expanded at a solid pace. Employment has grown strongly and business surveys suggest reasonably buoyant trading conditions. The latest quarterly GDP data, which are for the June quarter, were somewhat weaker (Table 5); the first estimates suggested that GDP increased by 0.3 per cent in the quarter and by 1.9 per cent over the year (though more recent annual GDP data suggest the possibility of some upward revision to these initial estimates). The June quarter accounts showed moderate growth in household spending, some slowing from the earlier rapid growth of business spending, and a modest pick-up in exports. Although domestic final demand expanded by a solid 3.8 per cent over the year, the June quarter output data were noticeably lower than had been expected, and the weakness can only partly be explained by factors such as a surprisingly large rundown in inventories.

Table 5: Demand and Output
Percentage change

	March qtr 2006	June qtr 2006	Year to June qtr 2006
Domestic final demand	0.4	1.2	3.8
Change in inventories[a]	0.0	–0.8	–0.8
GNE[b]	0.8	0.5	3.1
Net exports[a]	–0.1	–0.2	–1.2
GDP	0.7	0.3	1.9
Memo item:			
Real GDP adjusted for changes in the terms of trade	0.6	0.7	3.3

(a) Contributions to GDP growth
(b) Includes the statistical discrepancy
Source: ABS

The recorded slowdown in output growth has coincided with continuing firm conditions in the labour market. As a consequence, estimated productivity growth – given by the difference between the rates of growth of output and employment – has been low. While several factors have been advanced to explain the slowdown – as outlined below – at this stage none seems adequate to fully account for its apparent magnitude.

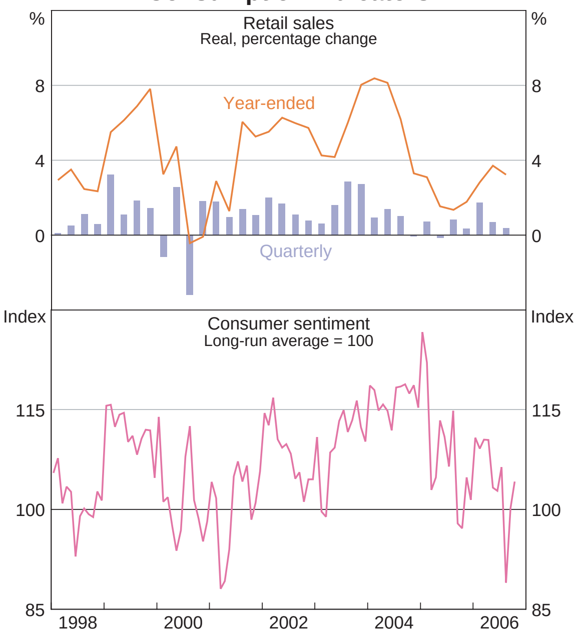
The recent flow of data continues to suggest that the economy is operating at close to full capacity. Available indicators of household consumption point to an increase in spending in the September quarter, backed by further strength in the labour market. Looking ahead, consumption growth is expected to remain moderate while the pace of business investment continues to ease. Growth in exports is expected to pick up due to the substantial increase in capacity in the resources sector and firm growth in the world economy. However, the outlook for the rural sector has deteriorated due to the exceptionally dry conditions.

Household sector

Household spending has continued to expand in recent months. Real household consumption increased by 1.5 per cent in the first half of the year, up from 1.1 per cent in the second half of 2005. More recently, spending has been supported by the strong labour market and the tax cuts that took effect in July 2006. In the September quarter, the volume of retail sales increased by 0.4 per cent, to be 3.2 per cent higher over the year (Graph 20), and the Bank's liaison with retailers indicates that recent spending growth has been fairly broad-based. Motor vehicle sales to households have also been higher than earlier in the year. The Westpac-Melbourne Institute measure of consumer sentiment was modestly above its long-run average in October, although the index is significantly lower than the levels seen in the past several years.

Graph 20

Consumption Indicators



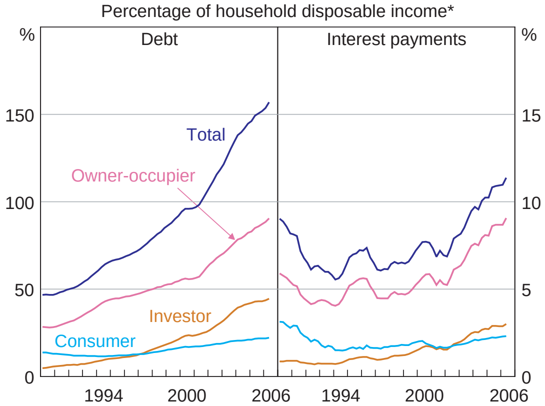
Sources: ABS; Melbourne Institute and Westpac

Household debt increased by 3.9 per cent in the June quarter, and the ratio of interest payments to disposable income rose to 11.4 per cent (Graph 21), although debt has increased at a more moderate pace in the most recent months. The solid growth in household debt in recent years appears to reflect not just households' confidence in their current and future financial circumstances, but also easier access to debt. During this time, the value of equities, superannuation holdings and deposits has increased strongly, and households' net financial wealth – the difference between financial assets and liabilities – is now close to its historical high relative to disposable income.

Graph 21

Household Debt and Interest Payments

Percentage of household disposable income*



* Household sector excludes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.

Sources: ABS; RBA

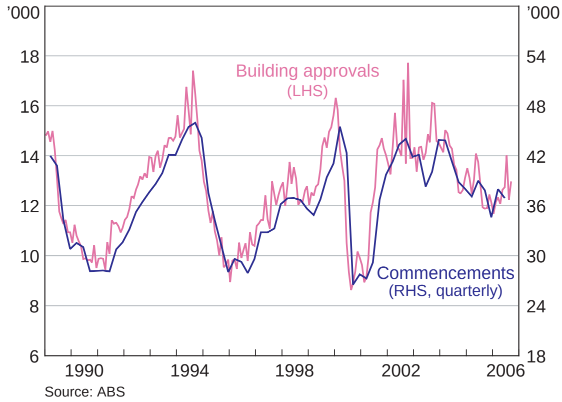
Housing

Although recent liaison suggests that the increases in interest rates this year have slowed the pace of recovery in the dwelling construction sector, most available data suggest that activity has been running above the troughs seen around the end of 2005. After declining by around 10 per cent over the two years to the March quarter 2006, dwelling investment increased by 3.7 per cent in the June quarter, with higher spending on both new construction and alterations & additions. Forward-looking indicators suggest a gradual pick-up in construction over the next year. In the September quarter, the number of house building approvals was 7 per cent higher than at the end of 2005, while approvals for medium-density dwellings increased by 8 per cent over the same period (Graph 22).

Conditions in residential rental markets remain tight, with the nationwide rental vacancy rate around its lowest level since the 1980s (Graph 23). According to the state real estate institutes, vacancy rates have remained lowest in Adelaide and Perth and have fallen significantly in Sydney and Melbourne over the past year. Consistent with movements in vacancy rates, rents for houses and units have increased in most capital cities. The low vacancy rate should lend support to dwelling construction over the medium term.

Graph 22

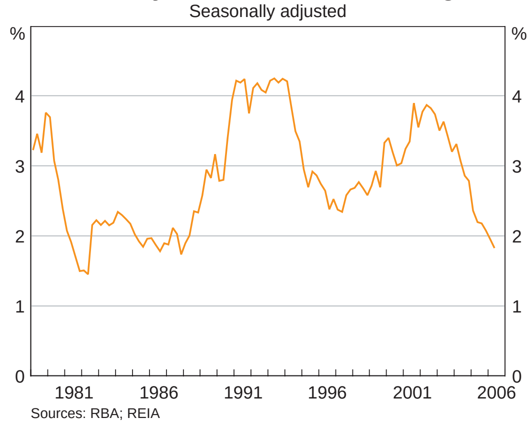
Housing Construction



Graph 23

Vacancy Rate for Rental Dwellings

Seasonally adjusted



House prices picked up in the first half of 2006, but appear to have stabilised more recently. The APM mix-adjusted measure of house prices was broadly flat in the September quarter, and 7 per cent higher over the year (Graph 24, Table 6). Price indices constructed by Residex using a repeat-sales methodology suggest similar developments. Much of the recent growth in prices has been recorded in Perth, where house prices rose by around 30 per cent over the year, although prices also increased moderately in most other state capitals. Apartment prices were broadly flat over the year to the September quarter, with soft conditions in the larger markets of Melbourne and Sydney offset by growth in other capitals. Over recent months, auction clearance rates in Sydney and Melbourne have been lower than earlier in the year, possibly reflecting the increases in the cash rate in May and August.

Table 6: House Prices

Percentage change

	APM		REIA		Residex		ABS
	Sep qtr 2006	Year to Sep qtr	Sep qtr 2006[a]	Year to Sep qtr	Sep qtr 2006	Year to Sep qtr	Year to Jun qtr
Sydney	–0.9	0.3	1.2	0.6	0.7	1.4	–0.5
Melbourne	–0.1	3.0	3.0	6.3	–0.4	5.1	5.5
Brisbane	0.2	6.0	..	..	0.0	5.5	4.5
Adelaide	–0.3	6.3	0.8	3.6	0.3	2.3	7.3
Perth	4.9	38.5	..	..	–2.2	24.1	35.4
Canberra	–1.4	2.8	1.8	7.2	0.7	8.7	6.7
Hobart	0.8	5.0	2.5	8.8	..	..	7.4
Darwin	4.7	18.2	..	..	0.5	5.3	18.7
Australia	**0.4**	**6.8**	**..**	**..**	**–0.2**[b]	**7.0**[b]	**6.4**

(a) Seasonally adjusted by the RBA

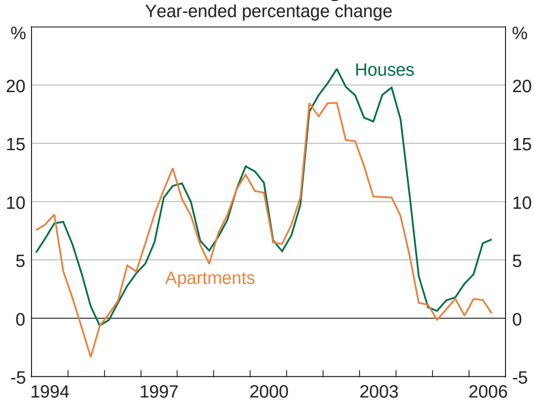
(b) Excludes Hobart

Sources: ABS; APM; REIA; state REIs; RBA; Residex

Graph 24

Australian Dwelling Prices

Year-ended percentage change



Sources: APM; RBA

Business sector

Business conditions in the non-farm economy are favourable overall, though differences are evident across sectors. Output in the services sector has grown at a robust pace over the past year, with particular strength in industries supplying business services, while output in the goods sector has grown more slowly. Overall, private-sector surveys indicate that business conditions in the September quarter were a little above their long-run average level (Graph 25). In addition, according to the NAB survey, capacity utilisation tightened further in the September quarter, and stands at its highest level in the 17-year history of the series. In the manufacturing sector, which has a relatively high trade exposure, conditions remain weaker than in the rest of the economy, but were reported to have improved recently.

High levels of capacity utilisation and corporate profitability continue to prompt higher rates of business investment, although the pace of growth is moderating from the earlier rapid rates. In the June quarter, year-ended growth in business investment slowed to 12 per cent, reflecting developments in both machinery & equipment and non-residential construction. In the past financial year, investment growth was concentrated in resource-related industries, with mining investment increasing by over 50 per cent (Graph 26); non-mining investment grew by around 9 per cent in the same period.

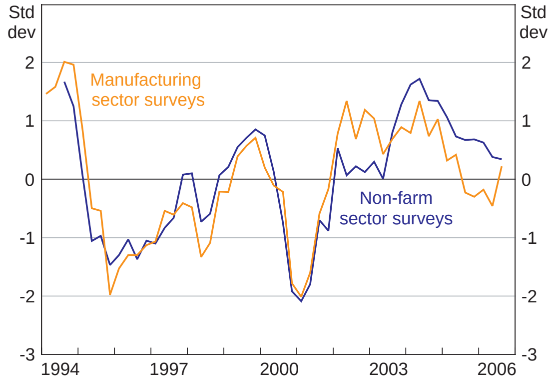
Forward-looking indicators of non-residential construction suggest that activity will remain strong over coming quarters, with the pipeline of work yet to be done bolstered in the June quarter by a pick-up in commencements of engineering projects (Graph 27). However, labour and equipment shortages and rising construction costs could slow the progress of some projects. With regard to machinery & equipment investment, the June quarter capital expenditure (Capex) survey suggests that in 2006/07 firms intend to moderate the pace of growth, while the latest Rabobank survey indicates that investment intentions for farm equipment (which are not covered in the Capex survey) have fallen.

Total private-sector profits have continued to grow at a solid rate, with the national accounts measure increasing by 7.6 per cent over the year to the June quarter, and the profit share at a record high of over 30 per cent of GDP (Graph 28). While this was significantly below the recorded growth rate in profits of listed companies, this is partly explained by differences in coverage, with the profits of listed companies including offshore profits and overweighted towards the mining sector. Both the national accounts and share market data suggest that profit growth has been strongest in the mining sector,

Graph 25

Actual Business Conditions*

Deviation from average



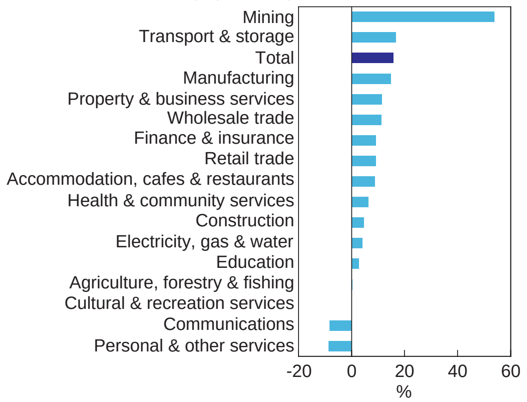
* Weighted average of data from various business surveys, with weights determined by the principal component method

Sources: ACCI; AIG; NAB; SAI Global; Sensis; St. George Bank; Westpac

Graph 26

Investment by Industry – 2005/06*

Annual average per cent growth, chain volumes



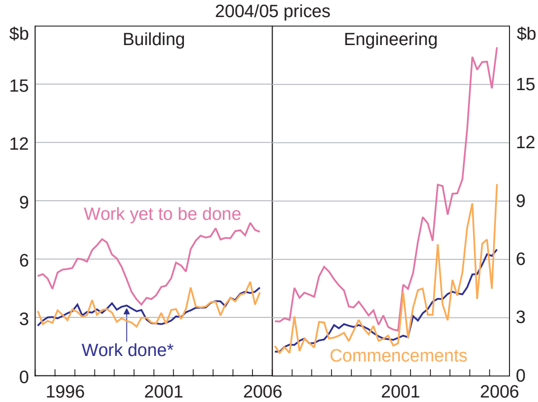
* Includes transfers of second-hand assets between the business and other sectors

Sources: ABS; RBA

Graph 27

Non-residential Construction Indicators

2004/05 prices



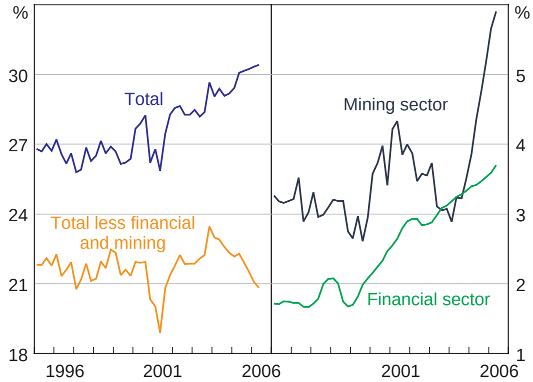
* Seasonally adjusted

Sources: ABS; RBA

Graph 28

Profits*

Per cent of nominal GDP



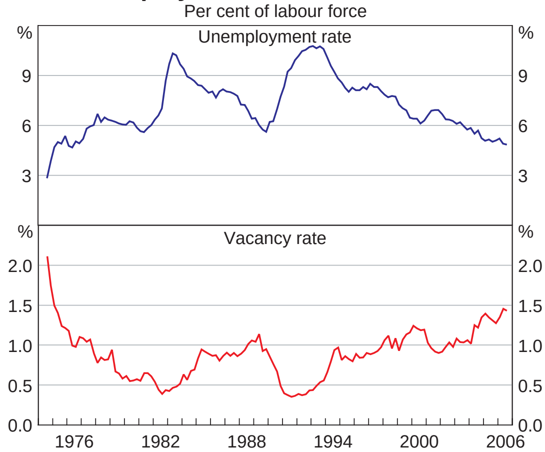
* Combined profits of both the incorporated and unincorporated sectors

Sources: ABS; RBA

Graph 29

Unemployment and Job Vacancies

Per cent of labour force



Source: ABS

although this now appears to be moderating somewhat. Outside of the mining and financial industries, the national accounts measure of profits fell slightly over the year to the June quarter, as businesses' margins contracted due to rising material and labour costs. Nonetheless, business surveys indicate profit expectations remain around or above long-run average levels.

Labour market

Employment outcomes have been strong in 2006. Employment is estimated to have grown by 0.2 per cent over the three months to October and by 2.5 per cent over the year. The unemployment rate was estimated at 4.6 per cent in October, down from 5.2 per cent a year earlier, while the participation rate was 64.7 per cent. Employment growth has been broad-based across all sectors except the household services sector, with the goods sector and the business services sectors making strong contributions to year-ended employment growth.

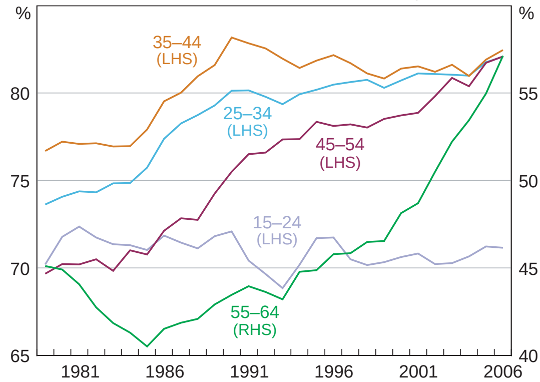
Businesses are reporting firm hiring intentions and significant difficulty in finding suitable labour. ABS data show that the nationwide job vacancy rate is around its highest level since the mid 1970s, which is the last time the unemployment rate was also at similar levels (Graph 29). Liaison indicates that while labour shortages remain most pronounced among skilled workers in the non-residential construction, resource and business services sectors, shortages are widespread across most industries and skill levels.

Recent strong labour demand has coincided with a trend increase in participation. Examining the participation of different age groups, much of this is explained by those aged 55–64 years (Graph 30). Both male and female participation in this age group has been rising sharply in recent years, likely reflecting in part a greater awareness by workers of the need to save for retirement. For younger cohorts, gradual declines in male participation have generally been offset by increases in female participation, leading to approximate stability in the total participation rates for those age groups. The exception is those aged 45–54 years, where female participation has increased especially strongly during the past two decades.

Graph 30

Labour Force Participation by Age

Per cent of labour force, annual average



Source: ABS

Regional economic developments

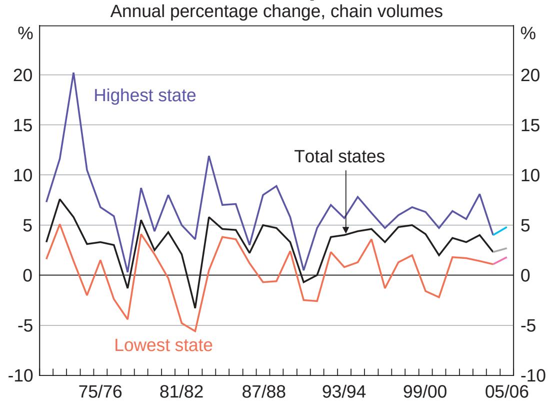
At the state level, activity has remained strongest in the resource-rich states. Final demand in Queensland and Western Australia expanded rapidly in the June quarter, to be around 10 per cent higher over the year, driven in large part by resource-related investment. In contrast, final demand growth in the other states has generally slowed. However, it is likely that divergences in the growth rates of output are smaller than those in final demand. In particular, part of the surge in spending in the resource-rich states will have been met by imports from either foreign countries (e.g. imported investment goods) or other states (e.g. financial services and manufactured goods from the south-eastern states). The state accounts for Queensland, the only full set of accounts yet available, confirm this, indicating that growth in gross state output over the year to June 2006 was significantly below that of state final demand. ABS data on 2005/06 gross state product for all states were scheduled to be released the day after this document was finalised. However, preliminary estimates for state product from state budgets released around mid year suggested that divergences in output growth in 2005/06 were no larger than has been typical in the past (Graph 31), nor larger than in other countries and regions.

Other indicators provide a broadly consistent picture of differences in state activity. The NAB survey indicator on business

Graph 31

State Output*

Annual percentage change, chain volumes



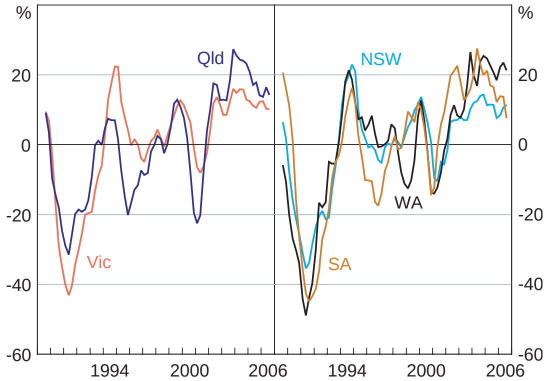
* 2005/06 based on state Treasury Department estimates

Sources: ABS; RBA; state Treasury Departments

Graph 32

Business Conditions by State*

Net balance; deviation from long-run average



* Seasonally adjusted, smoothed (two-quarter average)

Sources: NAB; RBA

conditions in the non-farm sector showed that, while conditions in Western Australia and Queensland in the September quarter were stronger than those in other states, conditions in all states were above their long-run averages and the dispersion across states was lower than usual (Graph 32). The strength of the labour market is also evident across all mainland states, with current unemployment rates generally close to the national average (Table 7).

Table 7: Labour Market by State

Per cent

	Employment growth		Unemployment rate	
	Three-month-ended October 2006	Year-ended October 2006	October 2005	October 2006
NSW	0.3	1.9	5.4	5.1
Victoria	0.9	2.2	5.4	4.8
Queensland	1.6	3.8	5.0	4.0
WA	0.3	1.4	4.0	3.7
SA	1.2	3.2	5.1	4.6
Tasmania	–1.4	0.9	7.4	6.5
Australia	0.7	2.5	5.2	4.6

Source: ABS

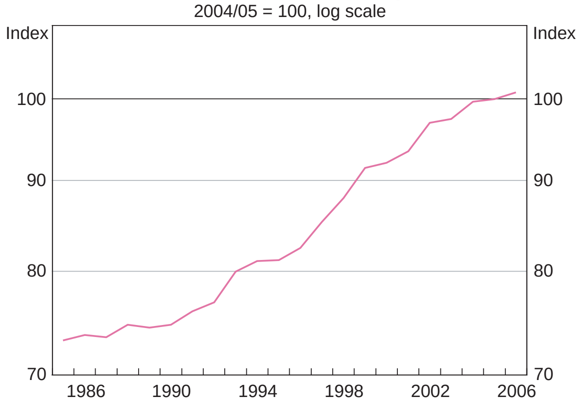
Productivity

As noted above, recent data showing real GDP growing below trend are somewhat difficult to reconcile with strong employment growth, and imply that labour productivity growth has been low, at 0.6 per cent per annum over the two years to 2005/06 (Graph 33). However, periods of weak productivity growth are not unusual by past standards. Over the past two decades, there have been a number of episodes at roughly five-year intervals where labour productivity has remained broadly flat for around one to two years at a time.

The reasons for the current slowdown in estimated productivity are difficult to determine. Much of the apparent weakness has been concentrated in the mining sector, where labour productivity is estimated to have declined by around 12 per cent per annum in the past two years, lowering overall productivity growth by around ¼ percentage point per year. Three developments in the mining sector appear to have played a significant role in this outcome. First, production of oil and gold – which accounts for around one-third of mining industry value added – has declined significantly as some existing fields have been exhausted, with no commensurate reduction in total industry employment. Second, efforts to boost capacity in the mining sector may have disrupted normal operations, particularly for coal and iron ore producers. Third, with significant construction of new mining capacity occurring, some employees may be recorded as being in the mining sector rather than in the construction sector, thereby depressing measured productivity in mining. However, with a large number of mining projects coming on line this year, including the Enfield oil project, mining output and productivity growth are expected to rise in the coming quarters, although the increases in production would have to be very large to offset the apparent decline in mining productivity seen in recent years.

Graph 33

All Industries Productivity per Hour



Source: ABS

More broadly, recent developments may be consistent with the pattern of adjustment that would be expected when capacity constraints are encountered. Demand in some sectors has been especially strong over a number of years, reflecting the growth of the domestic and international economies. If firms cannot bring new factories or mines immediately on line when capacity constraints become binding, they may decide to hire more labour to work their existing production processes more intensively. This would lead to strong employment growth, but also a fall in the growth rate of average labour productivity because only relatively modest additional output can be produced by hiring more labour without additional capital. In the longer term, however, as new capacity comes on stream, output and labour productivity would be expected to pick up. However, while this may explain some aspects of recent experience, it would require a very large impact of the new workers on the productivity of those already employed in order to generate the weak productivity growth recorded over recent years.

Other possible reasons for the productivity slowdown have also been advanced. In liaison some firms have attributed the slowdown to higher rates of labour market turnover, with new entrants initially less efficient than the staff they replace and training costs of new staff increasing. However, a recent survey by the ABS suggests that the rate of labour market turnover is not appreciably higher now than it has been in the past.

Another possible explanation is that the slowdown in measured aggregate productivity growth might be the result of sectoral shifts in the economy. It is possible to shed some light on this by separating the change in aggregate productivity into the movement implied by productivity growth in each industry and the effect implied by shifts in employment between industries with high and low productivity. Two caveats with this type of decomposition are that productivity data by industry are notoriously noisy over relatively short periods, and that the characterisation of high or low-productivity industries masks significant differences within industries. Subject to these issues, the results of such analysis using the most recently available annual data indicate that shifts in employment between industries (for example, between the 'market' and 'non-market' sectors) cannot explain the weak overall average performance (Table 8). Indeed, employment shifts alone would have actually boosted average productivity by around ½ percentage point per annum, with the effect concentrated in the shift toward employment in the mining sector, which traditionally has had a high average level of labour productivity due to its high level of capital intensity. Instead, the weak aggregate productivity outcome of the past two years apparently reflects low productivity growth within a number of industries in both the market and non-market sectors, including the mining and utilities industries in particular.

Table 8: Industry Contributions to Labour Productivity

Two years to 2005/06

	Annual productivity growth Per cent	**Annual growth in employment (hours worked)** Per cent	**Implied employment effect on productivity[a]** Percentage contribution
Agriculture	5.9	–4.2	0.1
Mining	–11.7	14.6	0.9
Manufacturing	0.0	–0.7	0.0
Electricity, gas & water	–5.1	6.8	0.1
Construction	1.4	5.1	–0.1
Wholesale trade	4.4	–1.2	–0.1
Retail trade	1.0	1.6	0.1
Accommodation & restaurants	3.2	0.6	0.1
Transport & storage	1.9	1.8	0.0
Communication	1.8	3.1	0.0
Finance & insurance	0.0	3.8	0.1
Property & business services	–0.8	3.3	0.0
Cultural & recreational	–2.0	6.5	–0.1
Government & other	–0.6	–5.6	–0.1
Total			1.1

(a) Over whole period

Sources: ABS; RBA

Alternatively, the low recorded pace of productivity growth may reflect unavoidable measurement errors, with recent GDP growth underestimated and/or employment growth overestimated. Leads and lags in the output and employment data can also affect the measured rate of productivity growth depending on the period selected. Overall, it is likely that no single explanation fully accounts for the magnitude of the recorded productivity slowdown and that a combination of factors is at work. Developments in coming quarters may be informative in resolving these issues.

The Drought

Australia is presently being affected by a serious drought. Recently, it has intensified in many agricultural districts and the outlook for the farm sector has deteriorated significantly. The current drought follows a severe one in 2002, with the persistence of dry conditions making the present period exceptional by historical standards. At this stage, farm output is forecast to fall by around 20 per cent in 2006/07 and directly subtract around one-half of a percentage point from GDP growth; this is similar to previous major droughts, but somewhat less than that in 2002, with livestock production currently expected to be less affected than grain. Allowing for flow-on effects to the rest of the economy, the total impact on economic growth should be slightly larger. The reduced supply of farm produce is also likely to place upward pressure on some prices, though the price effects in aggregate are likely to be relatively small.

The nature of the drought

The Bureau of Meteorology records two main indicators of the severity of drought: its geographic spread and its degree of dryness. Geographic spread is gauged by the proportion of land with rainfall in the lowest 10 per cent of historical experience. The degree of dryness is gauged by mean rainfall in a given period compared with historical experience. While it is usual to consider these indicators across the whole country, when assessing the economic implications of the drought, it is more instructive to focus on rainfall deficiencies in major agricultural districts and water storage areas. Rainfall data compiled by the Bureau of Meteorology are examined for the prime agricultural districts in eastern, southern and western parts of the country.[1]

When the share of prime agricultural land with a rainfall deficiency this year is compared with that in each previous year, the current drought ranks well behind others – in particular, the severe droughts at the time of Federation, in the 1940s, early 1980s and in 2002. However, it follows a drought in 2002 that was extremely severe, limiting the scope for recovery in growing conditions and water storage. One way the Bureau accounts for the persistence of dry conditions is to look at five-year average data; on this basis, the area of agricultural land recording a rainfall deficiency in the current drought is exceeded only by the drought of the mid 1940s (Graph 34).

Mirroring these developments, it is also the case that mean rainfall this year is not as low as in many previous droughts. However, looking at five-year average data, mean rainfall over the period to September was the lowest on record. Furthermore, it was accompanied by a steady increase in average temperature, which now exceeds what the Bureau deems to be normal by close to one degree.[2] This is reducing sub-soil moisture and increasing the evaporation of surface water.

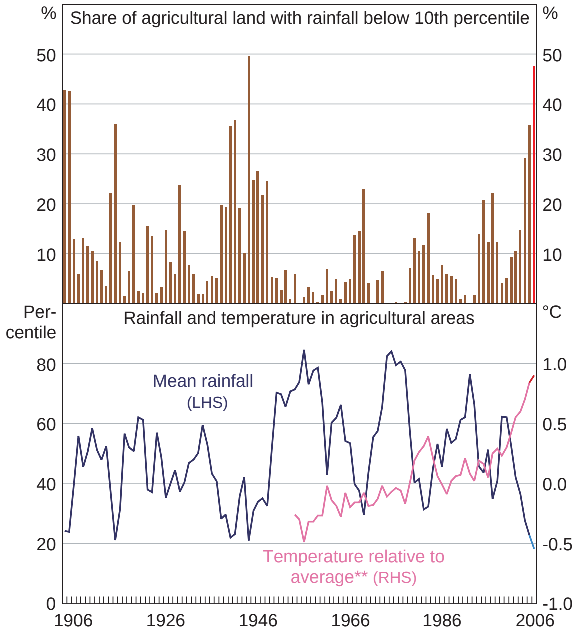
1 *Specifically, these are wheat, wheat-sheep and high-rainfall zones. Areas of central and northern Australia are excluded, even though they comprise pastoral districts, as the data do not readily identify pastoral districts separately from desert in some cases. However, rainfall is not deficient in these areas at present.*

2 *The Bureau of Meteorology uses the average of temperatures from 1961 to 1990 as the benchmark from which it judges temperature anomalies.*

Graph 34

Nature of the Drought

5-year-ended average*



* 2006 observation estimated using data to September

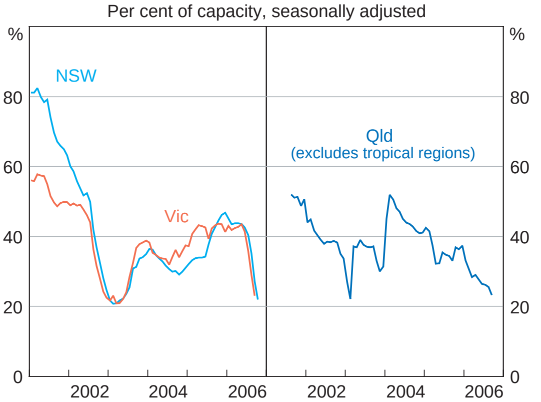
** Average is 1961–1990

Sources: Bureau of Meteorology; RBA

Graph 35

Non-metropolitan Water Storage

Per cent of capacity, seasonally adjusted



Sources: RBA; various state water authorities

With the Bureau indicating that current weather patterns are probably being caused by an El Niño event, spring and summer are likely to be drier than average, and rainfall deficiencies will probably become more acute. In combination with high average temperatures, this is likely to further deplete stored water, which is already at critically low levels, having not been fully replenished from the previous drought. This is especially so in New South Wales, Victoria, and southern Queensland (Graph 35). But while drought conditions are acute in areas where most agricultural activity and water storage takes place, some pastoral areas in northern Australia have experienced a significant increase in their average rainfall over the past decade, including more recently.

Economic effects

Based on the latest Australian Bureau of Agricultural and Resource Economics (ABARE) forecasts of farm production and information from other organisations, the Bank estimates that farm output is likely to fall by around 20 per cent in 2006/07 (Graph 36). This expected decline is somewhat less than in the 2002/03 drought, owing to a smaller fall in livestock production than previously. With output in the farm sector accounting for a little less than 3 per cent of total production, the drought will directly subtract around one-half of a percentage point from growth in GDP in the current financial year. This will reflect a reduction in agricultural supply rather than of demand in the economy.

Much of the expected decline in farm output reflects a sharp fall in crop production, particularly wheat (Graph 37, Table 9). The biggest fall in wheat production is forecast to occur in New South Wales, which is especially drought-affected, though a substantial fall is also expected in Western Australia, which is the largest wheat-producing state. However, with wheat inventories at relatively high levels, rural exports are not expected to decline by as much as production.

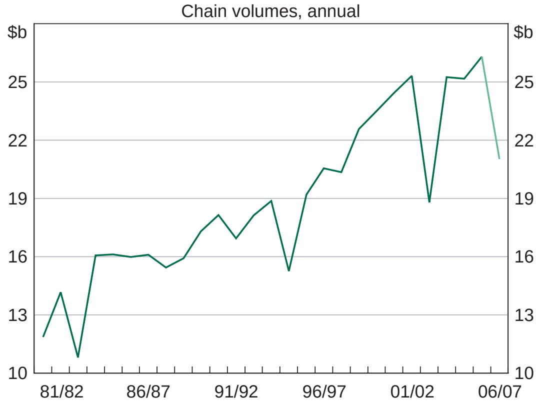
In contrast to crop production, overall meat and livestock production is likely to be little affected by the drought. Meat production should be boosted initially, as farmers in drought-affected regions increase slaughter rates in response to rising feed costs. However, offsetting this effect, livestock production is likely to fall, as farmers tend to breed fewer livestock during droughts. In addition, declining sheep numbers and falling wool yields owing to the drought are expected to result in wool production falling by around 7 per cent in 2006/07.

Real farm incomes are expected to decline substantially to around their lowest level since 1994/95 as farm costs are unlikely to fall by

Graph 36

Farm GDP*

Chain volumes, annual

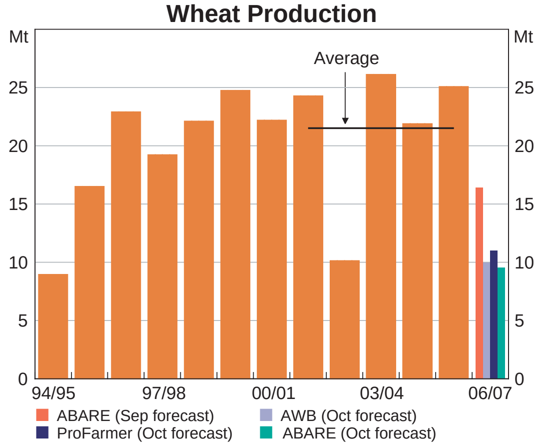


* Chain volume estimates of farm GDP data are unavailable prior to 1984/85. Prior to this time, agricultural value-added data are used.

Sources: ABS; RBA

Graph 37

Wheat Production



Sources: ABARE; AWB; ProFarmer

Table 9: Volume of Farm Production

Per cent

	Share of gross production	Growth	
	2005/06	2002/03	2006/07(f)
Crops	**45**	**–29**	**–31**
Cereals	18	–55	–60
Non-cereal crops	27	–12	–13
Livestock products	**45**	**–8**	**–3**
Meat and livestock	32	–8	–2
Wool	5	–6	–7
Dairy	8	–7	–3
Gross production[a]		**–19**	**–16**
Farm GDP[b]		**–26**	**–20**

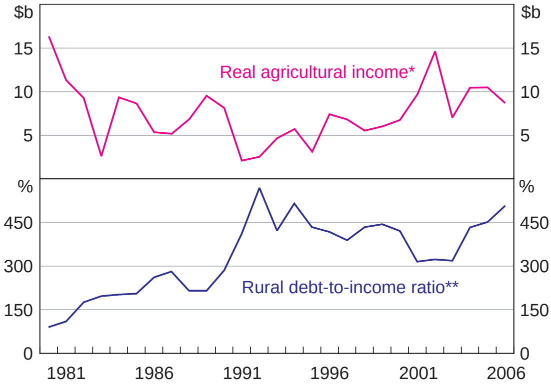
(a) Includes services to agriculture

(b) Gross farm production less farm inputs

Sources: ABARE; ABS; RBA

Graph 38

Agricultural Income and Debt



* Deflated by CPI at June 2006 prices
** Income smoothed using a 3-year moving average
Sources: ABS; RBA

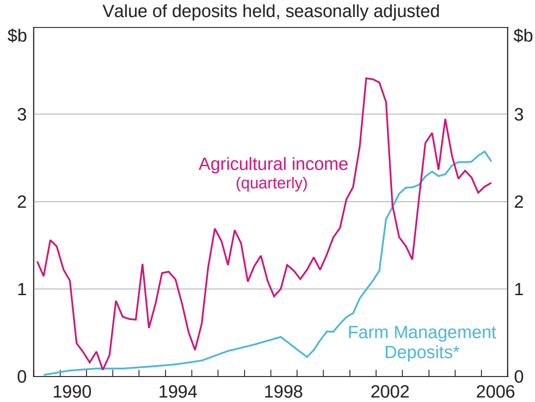
as much as production (Graph 38). While spending on feed for livestock is set to be much higher (with grain and hay prices rising sharply), expenditure on other activities (such as cropping and maintenance) is likely to fall, given the failure of crops or the decision in some cases not to plant. The prospective fall in real farm income will further increase the ratio of rural debt to income.

However, a number of schemes will enable some smoothing and supplementation of rural incomes. The Farm Management Deposit (FMD) scheme smooths farmers' disposable incomes by allowing them to make deposits when earnings are high and withdrawals when earnings are low, thereby paying a lower tax rate. FMDs are currently at high levels, reflecting deposits by grain growers following the large harvests of recent years and earlier strength in cattle prices (Graph 39). With the onset of drought and the prospect of falling income, farmers in all states have begun drawing on these deposits; noticeable draw-downs have been made by grain farmers and those in mixed farming, though intensive livestock producers, who are very reliant on stored water, are also drawing on FMDs. Furthermore, Exceptional Circumstances Relief Payment is being provided to farmers in severely drought-affected areas, with a key aspect of these relief payments being interest rate subsidies.[3] And state governments are providing assistance, mainly in the form of transport subsidies for the movement of water, fodder and stock (and in the case of Victoria, rebates on water bills to irrigators).

Graph 39

Farm Income Equalisation Schemes

Value of deposits held, seasonally adjusted



* Data before 1999 relate to Income Equalisation Deposits and Farm Management Bonds
Sources: ABS; DAFF; RBA

In addition to these direct effects on the farm sector, the drought is likely to have a significant effect on other industries that supply inputs to the farm sector or distribute farm output. These effects are likely to be concentrated in rural communities. More generally, there will also be flow-on effects to the rest of the economy as farmers' consumption

3 *Exceptional Circumstances are declared in regions where the effects of an event (usually drought) are deemed sufficiently rare (once in 20–25 years) and severe to warrant special assistance. The event must restrict farm income over a prolonged period for a significant number of farmers in an area. The event cannot be predictable or part of an industry re-structuring process.*

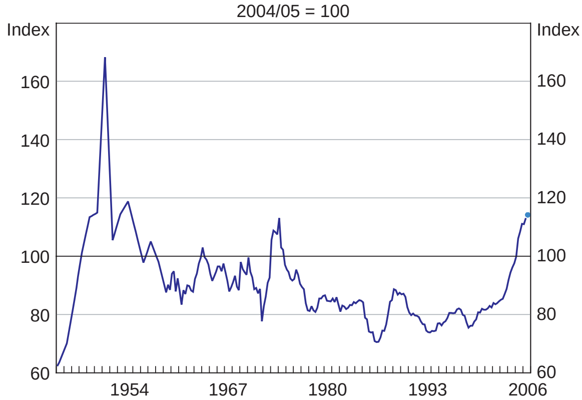
and investment spending is reduced, though the greater ability of farmers to smooth income than in earlier droughts may partly mitigate these effects. Accounting for these indirect effects, the total effect of the drought is likely to reduce GDP growth by around three-quarters of a percentage point in 2006/07. While the real effects of the drought will be significant, the overall effect on consumer prices is likely to be less pronounced. In fact, historically, the net effect of droughts on the CPI tends to be relatively small, as discussed in the chapter on 'Inflation Trends and Prospects'.

Foreign Trade and Capital Flows

Commodity prices and the terms of trade

Recent increases in mineral resources prices have brought Australia's terms of trade to their highest level since the wool boom of the 1950s, although developments in commodity markets suggest that the upswing might not have much further to run (Graph 40). The terms of trade have risen 33 per cent over the past three years, including an estimated increase of around 1 per cent in the September quarter. This upswing has mainly resulted from the sharp increases in prices of Australia's main resource exports, such as coal, iron ore and base metals. Over the next couple of years, an expansion in the global supply of some resources is expected to put downward pressure on their prices, and together with growth in import prices, this is likely to result in some easing in the terms of trade. Nevertheless, the terms of trade are likely to remain at a very high level in the near term, as there is little sign of much slowing in demand for commodities, and it is likely to take some time for much of the additional global supply to be brought on line.

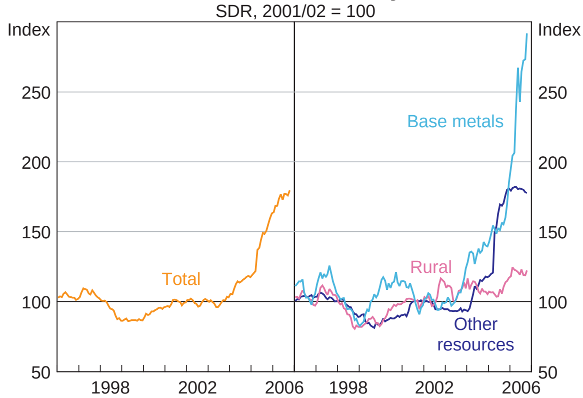
Graph 40
Terms of Trade
2004/05 = 100



Sources: ABS; RBA

The RBA's index of commodity prices (ICP) rose by 0.9 per cent over the three months to October, driven by an increase in base metals prices (Graph 41, Table 10). In contrast, rural commodity prices fell slightly over this period, and have increased much less than minerals prices over the past few years. The recent increase in the base metals component of the ICP was driven in particular by a 25 per cent increase in nickel prices. The price of nickel rose 160 per cent over the year to October, around double the increase in the base metals component overall. This reflects disruptions in nickel

Graph 41
RBA Index of Commodity Prices
SDR, 2001/02 = 100



Source: RBA

Table 10: Commodity Prices
Percentage change; SDR

	Three months to October 2006	Year to October 2006
RBA Index	0.9	14.9
Rural	–0.7	7.4
– Wheat	4.7	19.3
– Beef & veal	6.8	8.1
– Wool	1.4	10.0
– Sugar	–27.2	–6.4
Base metals	10.4	82.2
– Aluminium	6.0	34.8
– Copper	–2.7	81.3
– Nickel	24.6	156.9
Other resources	–2.4	0.1
– Coking coal[a]	–7.2	–10.9
– Steaming coal[a]	0.3	–7.1
– Iron ore[a]	3.5	19.5
– Gold	–7.1	22.5
Memo item		
Oil in US$[b]	–20.9	–5.6

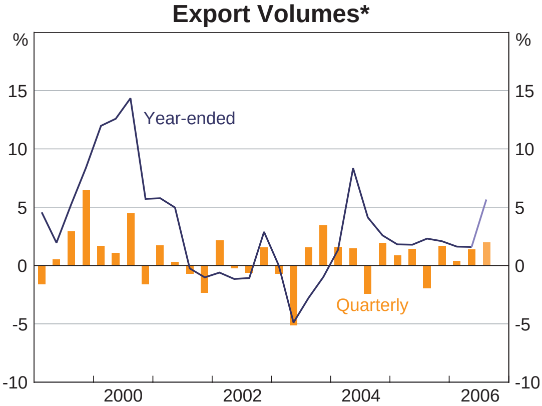
(a) Latest available data are for September.
(b) Oil prices are not included in the RBA Index.
Sources: ABS; AWB; AWEX; Bloomberg; Meat and Livestock Australia; RBA

supply, which have compounded the effects of buoyant world demand and low global inventory levels that have been supporting most base metals prices for some time.

Prices of other resources have been more stable. As noted in previous *Statements*, 2006/07 contract prices for iron ore and coking coal were settled effective from the start of April. Data to September indicate that essentially all of the 19 per cent increase in iron ore prices and most of the 18 per cent fall in coking coal prices have now passed through to export prices. However, contract prices for steaming coal are still not finalised, although it is likely that the agreed prices will be little changed or slightly down from last year.

Rural commodity prices have been broadly steady in aggregate for most of 2006. Sugar prices are at high levels, but have fallen substantially over recent months in reaction to expectations that global supply will outstrip demand in the coming year. In contrast, wheat prices have risen lately, as poor weather conditions in many wheat-growing countries have led to downward revisions to global production. The deterioration in growing conditions in Australia has had a noticeable effect on world wheat prices over the past three months.

Graph 42
Export Volumes*



* RBA estimate for September quarter 2006
Sources: ABS; RBA

International trade

Export values have increased strongly in recent periods, although growth in volumes has been more contained (Graph 42). Resource export volumes appear to have been broadly flat in the September quarter, although they were up by 6 per cent over the year. Exports of iron ore and LNG increased solidly over the year. Resources export earnings were almost 30 per cent higher over the year, reflecting earlier increases in prices. Volumes are likely to strengthen in coming quarters given that a number of resource projects have recently been completed or are about to be completed. For example, the Enfield oil development, which has a capacity to produce up to 100 000 barrels per day, started production on 24 July, with its first exports being delivered in the quarter. Similarly, the Darwin LNG compression plant, which commenced operations in February, is still ramping up its production.

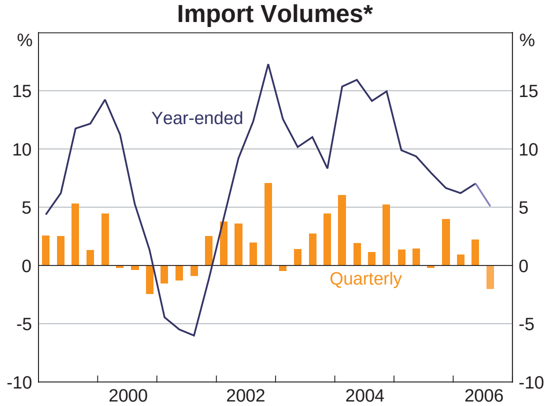
The volume of manufactured exports is estimated to have increased solidly in the September quarter, and by around 3 per cent over the year. Growth in this category of export earnings has been more subdued in recent years than in the 1990s, due to intense competition from developing nations. Prospects are for continued moderate growth in manufactured exports, given the favourable outlook for world growth and thus demand.

Rural export volumes, which account for around one-sixth of Australia's exports, are estimated to have risen in the September quarter, taking growth to around 10 per cent over the year. However, the outlook for rural exports has worsened significantly, due to continuing dry seasonal conditions. As discussed in the chapter on the drought, ABARE has lowered its forecasts of the 2006/07 wheat crop from 16.4 million tonnes in September to 9½ million tonnes, which would constitute a 60 per cent decline from the previous year. The fall in exports should be somewhat smaller, given that inventories can be drawn down from their current high level. In contrast, the volume of meat exports is likely to rise, as foreign demand for Australian beef remains strong and slaughter rates are rising in the face of drought in some cattle-raising regions.

The volume of service exports is estimated to have risen by around 4 per cent over the year to the September quarter, supported by solid demand for travel services. This category of exports has been constrained in recent years by the appreciation of the exchange rate and competition from other tourist destinations. The emergence of low-cost airlines in Asia and Europe seems to have encouraged intra-regional travel at the expense of travel elsewhere. This can be seen in the departures data for countries such as Japan, showing that travel to China and Thailand has generally increased more strongly than travel to other destinations, such as Australia. In addition, a few years ago there was a noticeable decline in the average expenditure of visitors to Australia that is yet to be reversed.

Both the value and volume of imports fell in the September quarter, particularly imports of capital goods (Graph 43). Annual growth in total imports has now eased to around 10 per cent for values and 5 per cent for volumes. This is well down from the 10–15 per cent pace recorded in import volumes in recent years, when domestic demand growth was stronger and imports growth was

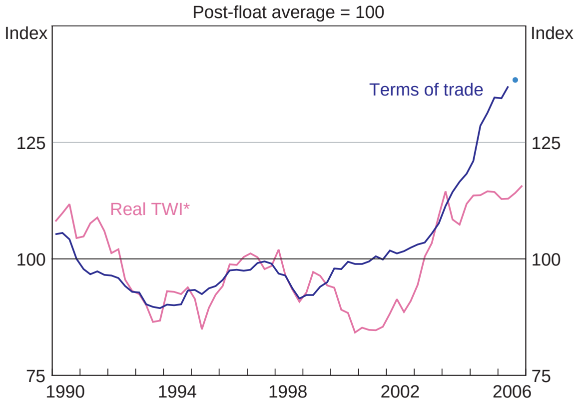
Graph 43
Import Volumes*



* RBA estimate for September quarter 2006
Sources: ABS; RBA

Graph 44

Real Exchange Rate and Terms of Trade

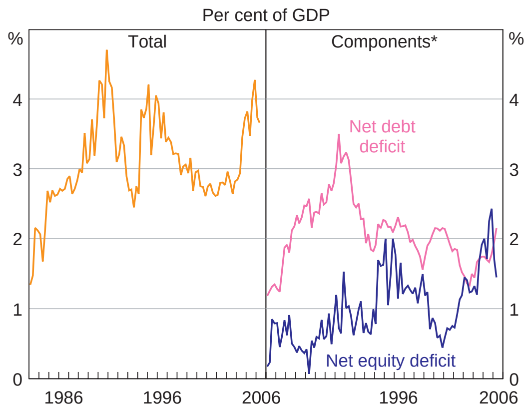


* December quarter 2006 observation assumes that the nominal bilateral exchange rates on 8 November are maintained for the remainder of the quarter, and uses the latest core inflation rates.

Sources: ABS; RBA

Graph 45

Net Income Deficit



* Excluding net compensation of employees

Sources: ABS; RBA

being boosted by the appreciation of the exchange rate in 2002–2003.

In real trade-weighted terms, the Australian dollar is around 16 per cent above its post-float average and has been broadly steady for the past two years (Graph 44). At this level, it is likely that the exchange rate is restricting activity in some trade-exposed sectors. However, for the economy as a whole and especially the non-tradables sector, the boost to income from the increased terms of trade is probably more than offsetting this effect.

Current account

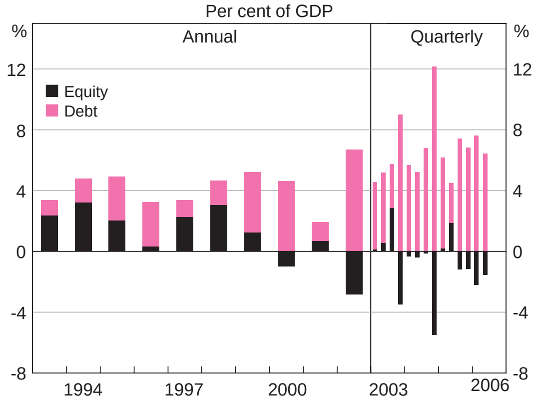
In line with the recent marked narrowing in the trade deficit, the current account deficit is expected to have fallen to around 4¼ per cent of GDP in the September quarter. This assumes that the net income deficit (NID) stays close to its June quarter level of around 3.7 per cent of GDP (Graph 45). The NID stands at a high level relative to its history, as both debt and equity payments have increased significantly in recent years. Payments on equity investments in Australia have largely reflected the sharp increase in profitability of resource companies, while interest payments have risen in line with increases in world interest rates and in the stock of Australia's foreign debt.

Capital account

National investment continues to exceed saving, in part due to the strong growth in private business investment, and dwelling investment that is still at a high share of GDP compared with its history. This excess has been accompanied by strong foreign demand for claims on Australian entities. As a result, the stock of net foreign liabilities has risen over recent years to more than 56 per cent of GDP. This has been driven by the steady increase in Australia's net foreign debt; nearly all of the net capital inflow since 2000 has gone into foreign purchases of Australian debt securities (Graph 46). Much of these foreign purchases have been of asset-backed securities and bonds issued by financial companies, which largely fund lending for housing. In contrast, Australia's net equity liabilities as a share of GDP have fallen over the past year. Foreign equity investment in Australia has been fairly strong, but it has been more than offset by Australian investment overseas. The available evidence for the September quarter suggests that debt inflows have remained solid, particularly borrowing by financial intermediaries (see the chapter on 'Domestic Financial Markets and Conditions' for more details).

Graph 46

Net Capital Inflow



Sources: ABS; RBA

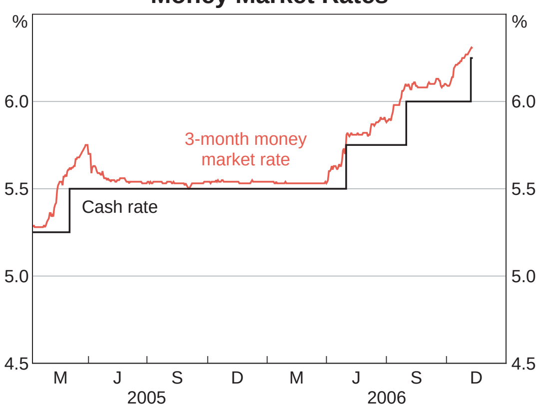
Domestic Financial Markets and Conditions

Money and bond yields

From the time of the August tightening of monetary policy, financial markets generally held the view that it was more likely than not that official interest rates would be increased again. In line with this, short-term market yields traded a little above the cash rate of 6 per cent for most of the period (Graph 47). During October, however, expectations of monetary tightening became more pronounced, particularly after the CPI data were released. By the end of the month, a tightening at the November Board meeting was fully factored into market pricing. The subsequent announcement of an increase in the cash rate to 6.25 per cent had little further impact on financial markets.

Graph 47

Money Market Rates

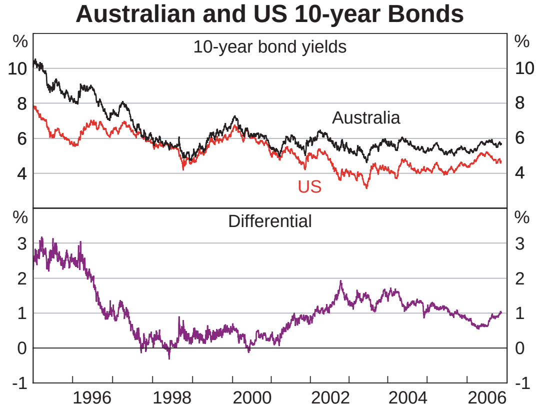


Source: Tullet Prebon (Australia) Pty Ltd

Yields on long-term bonds have followed a more varied path, falling initially – in line with US yields – but rising from mid October, again partly due to the rise in US yields (Graph 48). However, the recent rise in Australian yields has been more pronounced. As a result, the differential between Australian and US 10-year bond yields is now around 100 basis points, its highest level since October last year.

Graph 48

Australian and US 10-year Bonds



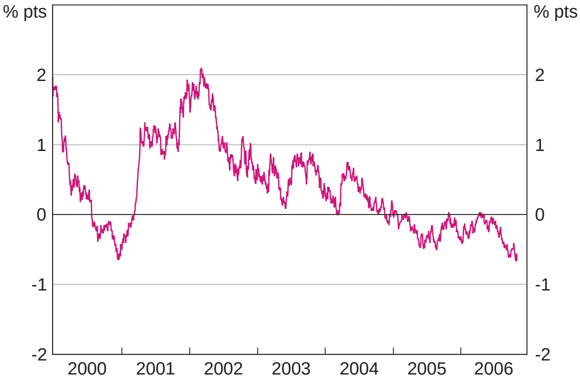
Source: RBA

Despite the recent increases in bond yields, the Australian yield curve has remained more inverted than at any time since late 2000 (Graph 49). An inverted yield curve has, on some past occasions, foreshadowed a period of slower economic growth, moderating inflation and an easing in

Graph 49

Yield Spread

10-year bond yield less 3-month money market rate

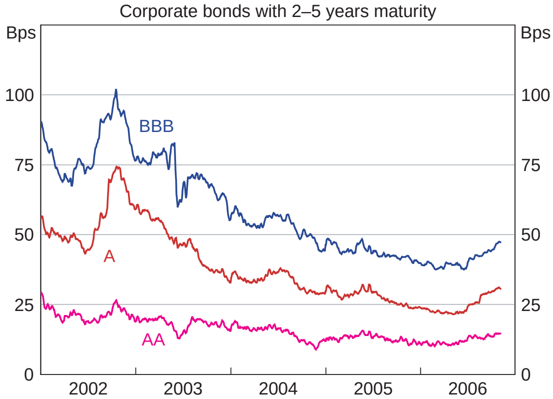


Source: RBA

Graph 50

Corporate Bond Spread to Swap

Corporate bonds with 2–5 years maturity



Sources: Bloomberg; RBA; UBS AG, Australia Branch

monetary policy. But the significance of a negative yield curve appears to have become less clear in recent years, as long-term bond yields have been held down by structural forces affecting global markets. The Australian yield curve has been inverted for much of the past two years, a period during which the market has typically not expected any easing in monetary policy.

Spreads on corporate bonds have widened a little since their trough in mid year but remain at low levels. Lower-rated bonds have seen the most movement, with spreads on A and BBB-rated bonds currently about 10 basis points higher than around mid year (Graph 50). Spreads on lower-rated debt issued by some non-financial corporates have widened as a result of recent merger and acquisition activity – both actual and anticipated. This is because the potential gearing up of these firms would increase debt-servicing burdens and hence the possibility of default.

Intermediaries' interest rates

Following the 25 basis point increase in the cash rate in early August, most lenders raised their variable indicator rates on housing loans by a similar amount. As was the case following the policy tightening in May, these increases were mostly passed on to existing borrowers within a week of the announcement. Between then and early November, most intermediaries' variable housing indicator rates were unchanged, with the exception of a few reductions by smaller lenders. At the time of writing, most lenders were yet to raise rates in response to the November tightening.

During the current tightening cycle, which began in May 2002, the target cash rate has been increased by 25 basis points on eight occasions, making a cumulative increase of 200 basis points. Assuming full pass-through of the November tightening, the major banks' standard variable indicator rate will have increased by the same amount over this period, but actual rates paid by new borrowers will have risen by a little less than 180 basis points. In part this is due to some non-banks offering housing loans with indicator rates lower than those offered by the major banks, and also some borrowers choosing to take out cheaper, basic loans. Mostly, however, it reflects borrowers' ability to obtain loans from banks at rates well below their indicator rates. The combined effect is that the average borrower now pays around 60 basis points less than the majors' standard rate, compared with 35 basis points less in early 2002.

Consistent with this, actual mortgage rates will be about 80 basis points higher than their decade average (assuming full pass-through of the recent tightenings), despite the cash rate being 100 basis points above its average (Table 11). That said, the fact that the current tightening cycle has been relatively long, and that housing credit has grown strongly over much of this period, means a relatively high proportion of current borrowers are paying a higher rate on their mortgage than when they took it out.

Table 11: Interest Rates
Per cent, November

	Cash rate	Actual rate on new housing loans[(a)]	Actual business rate[(a)]
Levels	6.25	7.50	7.85
Deviation from decade average	1.00	0.80	–0.10

(a) Assumes full pass-through of August and November tightenings
Sources: APRA; RBA

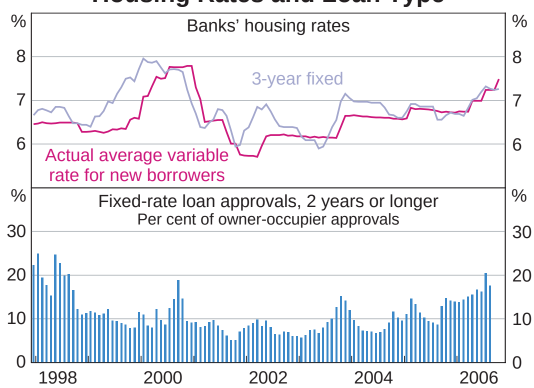
Rates on fixed-rate housing loans have been broadly unchanged since the time of the August tightening, in line with the cost of funding fixed-rate loans having been relatively steady (Graph 51). The major banks' average 3-year fixed housing rate is around 7.25 per cent. In recent months this rate has been at a similar level to the average actual rate on variable-rate loans. In August and September (the latest data available) almost 20 per cent of new owner-occupier housing loans extended were at fixed rates – the highest share since 1998.

Following the August (and May) tightening, most lenders also increased the interest rates on their personal loans and standard credit cards. Once again, however, increased competition in the market for 'low-rate/no-frills' cards saw a few providers delay increasing their rates on these cards until early October and, even then, not pass on the full increase in the cash rate.

With regard to business rates, intermediaries increased their indicator rates on variable-rate loans by 25 basis points following the August tightening, as was the case following the cash rate increase in May. However, competitive pressures in the business loan market in recent years have meant that the weighted-average rate actually paid on variable-rate business loans – incorporating risk margins – is still a

Graph 51

Housing Rates and Loan Type



Sources: ABS; RBA

little below its decade average (Table 11). Over the past few years, fixed rates actually paid on small business loans have tended to be lower than their variable-rate counterparts.

Interest rates on most online savings accounts rose by 25 basis points after the August tightening, reflecting the strong competition in this market, but rates on the majors' regular interest-bearing deposits rose by less.

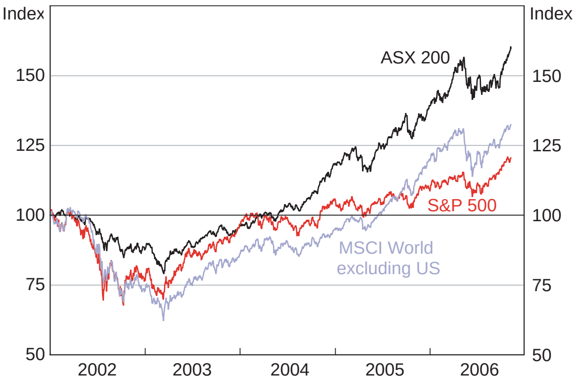
Equity markets

The Australian share market has risen strongly over recent months, and has now more than retraced all of the decline experienced in the middle of the year. The ASX 200 index is currently 15 per cent higher than at the beginning of the year, similar to the gains in overseas share markets over this period (Graph 52).

Graph 52

Australian and World Share Price Indices

End December 2001 = 100

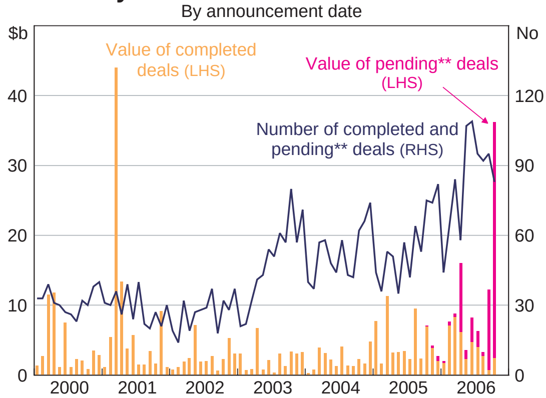


Source: Thomson Financial

Graph 53

Mergers and Acquisitions by Listed Australian Entities*

By announcement date



* Excludes real estate transactions
** Transactions announced since October 2005 but not yet completed
Source: Thomson Financial

Some of the recent strength in the share market has been driven by announcements of, and speculation about, merger and acquisition (M&A) activity. While some of these individual transactions have been large, in aggregate the number and value of deals actually finalised in recent months has not been particularly big in comparison with the past few years (Graph 53). However, several large M&A deals are pending. Moreover, the proportion of M&A activity that has been in the form of leveraged buy-outs (LBOs) by private equity funds has picked up significantly.

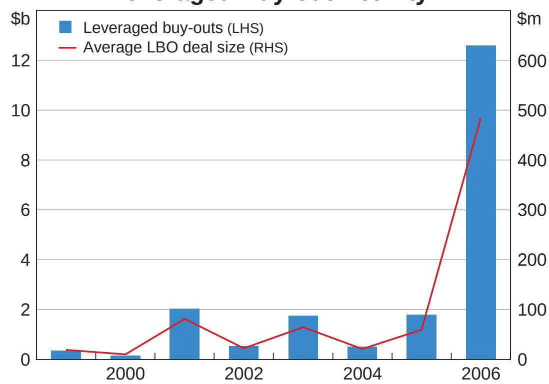
The available evidence suggests that the value of domestic LBO activity – including both the debt and equity funding – has increased to $13 billion so far this year, after averaging around $1½ billion over the past five years (Graph 54). In 2006 to date, LBOs by private equity firms have accounted for around 15 per cent of all corporate merger and acquisition activity where the bought-out company was an Australian entity. This compares with less than 5 per cent in previous years. Most of the pick-up has reflected an increase in the average deal size, with several deals in excess of $1 billion each. It is worth noting that, despite the increase in activity, LBOs in 2006 to date still account for less than 1 per cent of the value of the corporate sector as a whole. That said, LBOs typically result in a significant increase in the gearing of the bought-out company, potentially making it more sensitive to economic fluctuations. In recent years, for example, LBO deals in Australia have often resulted in the bought-out company having a debt-equity ratio several times higher than before the takeover. Companies which consider themselves under threat of an LBO may also gear up in defence.

For listed non-financial companies as a whole, the gearing ratio – the ratio of the book value of debt to equity – has increased in recent years, reversing the fall earlier in the decade (Graph 55). Despite this increase, the aggregate gearing ratio, at 64 per cent, remains a little below its long-run average.

It appears that the recent increase in the gearing ratio owes to an increase in leverage by companies that previously had low levels of gearing (Graph 56). Companies that had no debt in June 2004 have increased their gearing ratio by an average of 7 percentage points; those with gearing ratios from 1–25 per cent in 2004 have increased their leverage by an average of 12 percentage points. Importantly, companies that had gearing ratios above 50 per cent in 2004 have, on average, reduced

Graph 54

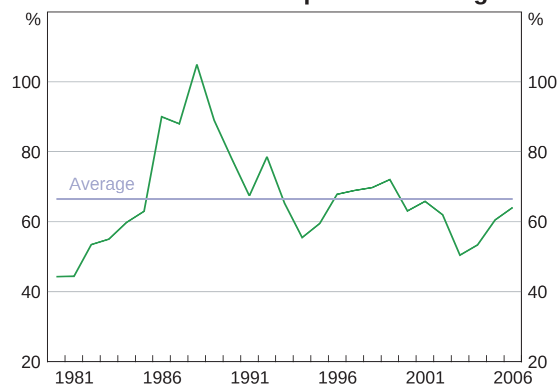
Leveraged Buy-out Activity*



* LBOs in Australia by domestic and offshore private equity funds. Includes debt and equity funding for completed and pending deals. Data for 2006 are to the end of October.
Sources: *Australian Venture Capital Journal*; RBA; Thomson Financial

Graph 55

Listed Non-financial Companies' Gearing Ratio*

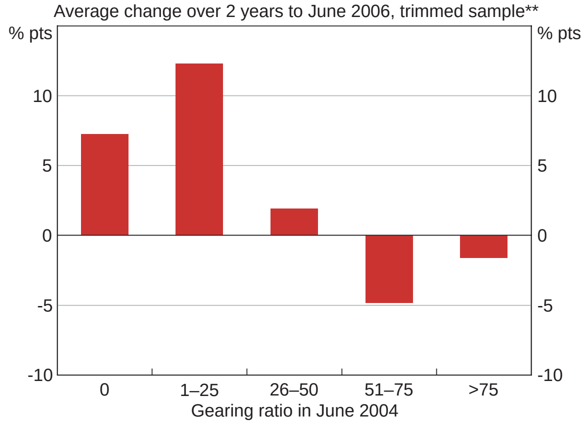


* Gross debt/shareholders' equity
Sources: ABS; Aspect Huntley; RBA; Statex

Graph 56

Changes in Gearing Ratios*

Average change over 2 years to June 2006, trimmed sample**



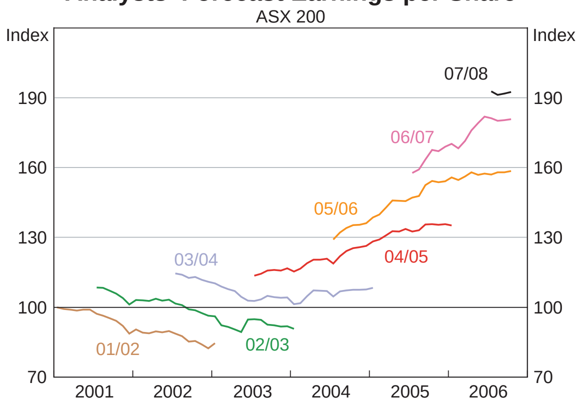
* Gross debt/shareholders' equity
** Companies with June and December balancing dates
Sources: Aspect Huntley; RBA

their gearing over the past two years. Falls have tended to be particularly sharp for resource companies. Mostly, this reflects the strength of their profitability and retained earnings, which boosts equity in the company.

Recent profit results for ASX 200 companies with June and December year-ends have been strong, generally in line with analysts' expectations. Aggregate underlying profits (which exclude significant items such as write-downs and gains and losses from asset revaluations or asset sales) of these companies were 35 per cent higher than in the June half of 2005. This growth was again largely driven by the resources sector, which reported underlying profit growth of 72 per cent compared with the previous corresponding period. Profitability of other companies was more moderate, but still reasonably strong in most cases: financials reported underlying profit growth of 19 per cent in the latest half year, while companies outside of the resources and financial sectors reported underlying profit growth of 3 per cent, but 13 per cent if companies in the telecommunications sector are excluded.

Graph 57

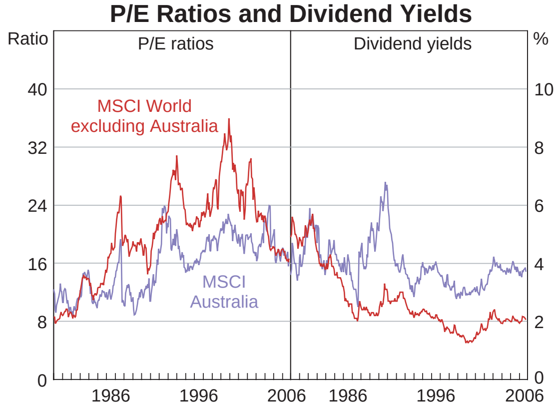
Analysts' Forecast Earnings per Share



Source: Thomson Financial

Graph 58

P/E Ratios and Dividend Yields



Sources: RBA; Thomson Financial

Over the first half of 2006, analysts continually revised upwards their forecasts for resource company earnings per share in 2006/07, with expected annual growth revised from around 15 per cent to around 35 per cent, where it has since remained. The level of earnings in the following year is expected to be slightly higher. For non-resource companies, there has been a fairly consistent expectation that earnings growth for both the current and next financial years will be around 8 per cent. For resource and non-resource companies combined, earnings are expected to grow by around 15 per cent in 2006/07 and a further 6 per cent in 2007/08 (Graph 57).

Aggregate measures of equity market valuation have shown little change in 2006. The MSCI Australia trailing price-to-earnings (P/E) ratio is 16½, which is around its long-run historical average and also around the current P/E ratio for overseas equity markets (Graph 58). The Australian dividend yield has been around its post-1987 average of just below 4 per cent for most of the past few years.

Intermediated financing

After growing rapidly in the first half of the year, total credit has grown at a slightly more moderate rate in recent months (Table 12). The increase of 14 per cent over the past 12 months, however, remains high relative to the growth of nominal GDP. The recent slowing has been more marked for business credit, which earlier this year had recorded its fastest growth since the late 1980s. The slowing in business credit growth has been broadly in line with the moderation in aggregate business investment seen over the recent period.

Table 12: Financial Aggregates
Percentage change

	Average monthly growth		Year to September
	First half of year	September quarter	
Total credit	1.2	1.0	14.4
Household	1.1	1.0	13.6
– Housing	1.2	1.1	14.2
– Personal	0.8	0.7	9.5
Business	1.2	1.0	15.9
Broad money	1.0	1.1	11.2

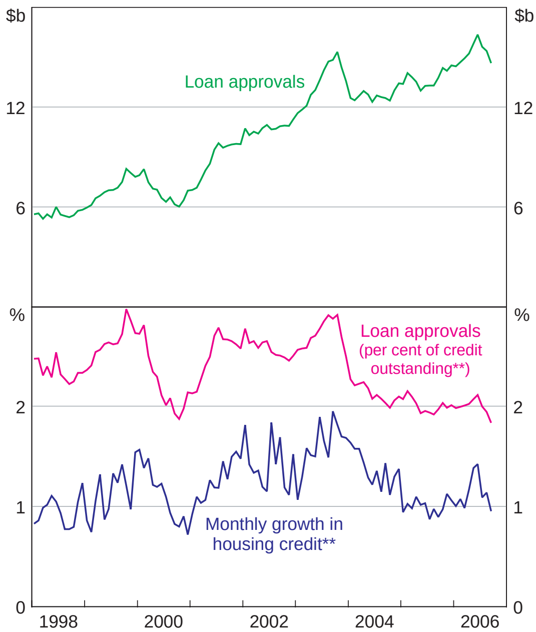
Source: RBA

After slowing through 2004, growth in lending for housing was broadly stable in 2005 and early 2006 before briefly picking up around the middle of the year (Graph 59). While special factors may have contributed to the up-tick around mid year, it should be noted that the subsequent easing is consistent with the cash rate increases in May and August having a modest dampening effect on demand for housing credit.

Personal credit has been growing more slowly than housing credit, increasing by 9½ per cent over the year to September. Within personal credit, growth in margin lending for the purchase of shares and managed funds moderated in the September quarter (Graph 60). Over the year, however, margin lending rose by 39 per cent, driven mainly by an

Graph 59

Housing Loan Approvals* and Credit Growth

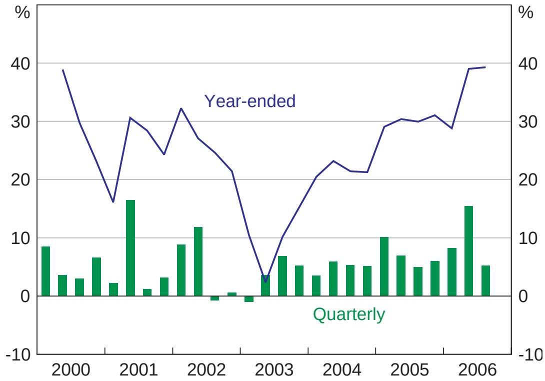


* Excludes approvals for new construction by investors
** Includes securitised loans
Sources: ABS; RBA

Graph 60

Margin Lending

Percentage change



Source: RBA

increase in the average loan size, which rose to around $166 000.

Indicators of the riskiness of borrowers' margin loan positions, including the average gearing level and the proportion of available credit limits used, increased in the September quarter. In line with this and more frequent negative movements in share prices, the September quarter saw a small increase in the average frequency of margin calls. Despite these changes, these indicators of risk remain low by historical standards.

Non-intermediated financing

Bond raisings by Australian non-government entities reached a new high in the September quarter, with $53 billion of new bonds issued (Table 13). Around two-thirds of the debt was issued offshore, most of which was accounted for by financial institutions, although securitisation vehicles and non-financial corporations also had a strong quarter. This large volume of offshore

Table 13: Non-government Bond Issuance by Sector

$ billion

Sector	2003	2004	2005	2006	
				June half	September quarter
Bond issues by Australian entities					
Onshore					
Financial institutions	9.9	14.5	20.9	9.8	5.7
Non-financial corporations	5.6	8.0	8.9	4.3	3.2
Asset-backed	20.7	25.0	32.2	22.7	9.5
Total	***36.1***	***47.5***	***62.1***	***36.8***	***18.4***
Offshore					
Financial institutions	51.5	64.9	52.3	37.6	20.2
Non-financial corporations	14.7	13.6	16.4	2.4	5.4
Asset-backed	24.3	29.8	25.6	11.5	8.6
Total	***90.5***	***108.2***	***94.3***	***51.4***	***34.2***
Total	**126.6**	**155.7**	**156.4**	**88.2**	**52.6**
A$ bond issues by non-resident entities					
Onshore	7.1	21.3	26.5	20.6	6.1
Offshore	24.8	21.6	14.1	7.6	2.1
Total	**31.9**	**42.9**	**40.6**	**28.2**	**8.2**

Source: RBA

issuance was supported by the prevailing levels of the cross-currency basis swap spread. The basis swap is part of the cost of borrowing in foreign currency and converting the loan to A$ and reflects the net demand to convert loans between A$ and foreign currency. It had been pushed down by a period of very strong A$ issuance by non-residents, who typically convert these raisings into foreign currency loans. This decline in the basis swap made it more attractive for domestic borrowers to issue bonds offshore in foreign currency and swap the proceeds into A$, rather than to issue directly in Australia; the subsequent issuance of such offshore bonds has moved these swap rates higher (Graph 61).

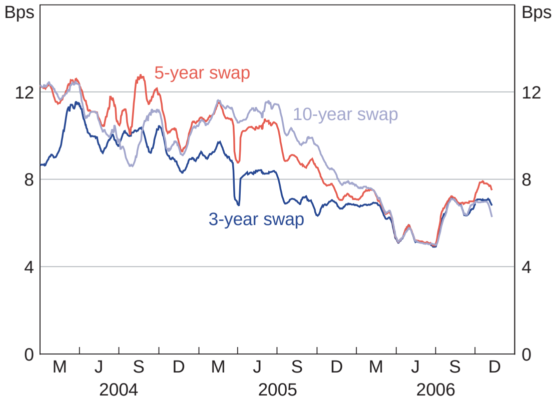
Outstandings of non-government bonds, both in the domestic and offshore markets, have grown very strongly for several years, with the latest quarter being no exception. There are now $300 billion of non-government bonds outstanding in the domestic market, with outstandings of asset-backed securities as great as the combined outstandings of the Commonwealth and State governments.

Total net capital raisings – debt, hybrids and equity – by financials and securitisation vehicles were very strong in the first three quarters of 2006 (Graph 62). For non-financials, net capital raisings picked up in the September quarter, following a couple of quarters that were relatively subdued.

Graph 61

A$–US$ Basis Swap Spreads

10-day moving average

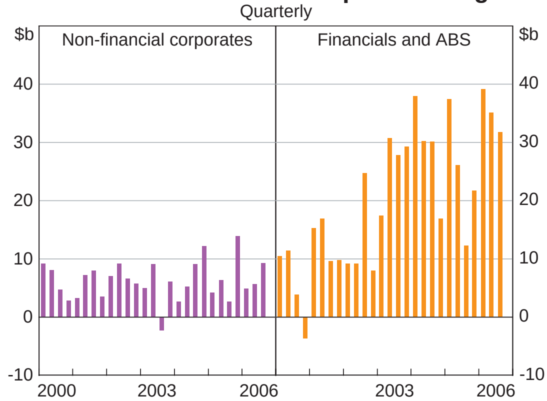


Source: Bloomberg

Graph 62

Net Non-intermediated Capital Raisings*

Quarterly



* Equity, hybrids, bonds, and short-term debt

Sources: APRA; ASX; Austraclear; RBA

Inflation Trends and Prospects

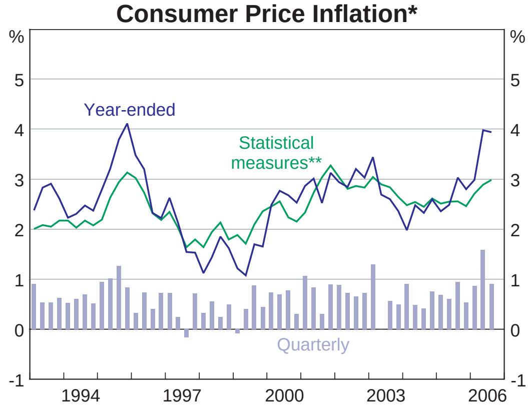
Recent developments in inflation

The Consumer Price Index (CPI) rose by 0.9 per cent in the September quarter and by 3.9 per cent over the year (Graph 63, Table 14). While headline inflation was boosted by further increases in banana and other fruit prices due to the impact of Cyclone Larry, there were also significant increases in property rates & charges and water & sewerage prices. Although prices fell for some items, such as vegetables, petrol and pharmaceuticals, the proportion of items growing above an annual rate of 2.5 per cent stood at over 60 per cent (Graph 64). Based on a range of measures, the Bank's assessment is that underlying inflation was around ¾ of a per cent in the September quarter and 3 per cent over the year to the September quarter, up from a rate of around 2½ per cent through 2005.

Non-tradables inflation has remained above its medium-term average rate, running at around 3½ per cent over the year to the

Graph 63

Consumer Price Inflation*



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

Table 14: Measures of Consumer Prices
Percentage change

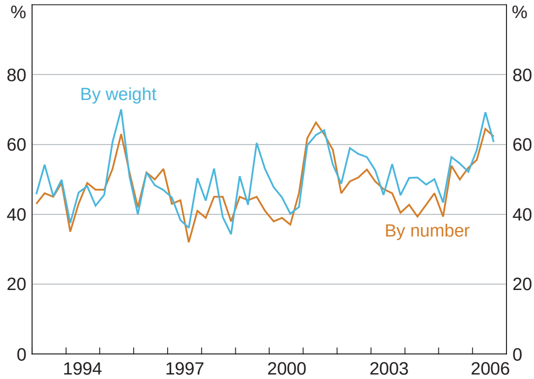
	Quarterly		Year-ended	
	June quarter 2006	September quarter 2006	June quarter 2006	September quarter 2006
CPI	1.6	0.9	4.0	3.9
– Tradables	2.7	0.8	4.8	4.4
– Tradables (ex food and petrol)	0.1	0.4	0.2	0.4
Non-tradables	0.8	1.0	3.4	3.6
Underlying measures				
Weighted median	0.9	0.8	3.0	3.2
Trimmed mean	0.9	0.7	2.8	2.9
CPI ex volatile items[(a)]	0.6	0.8	2.4	2.6

(a) Volatile items are fruit, vegetables and petrol
Sources: ABS; RBA

Graph 64

CPI Items Rising Faster than 2.5 Per Cent*

Proportion of all CPI groups



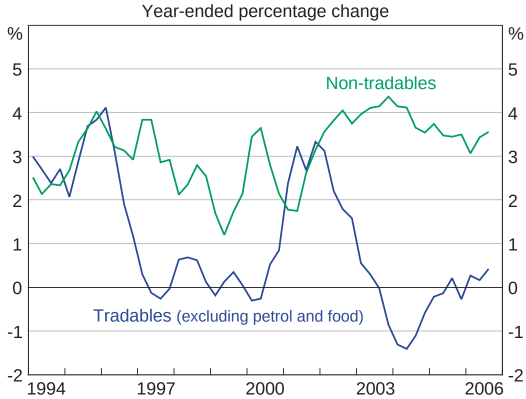
* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent.

Sources: ABS; RBA

Graph 65

Tradables and Non-tradables Prices*

Year-ended percentage change



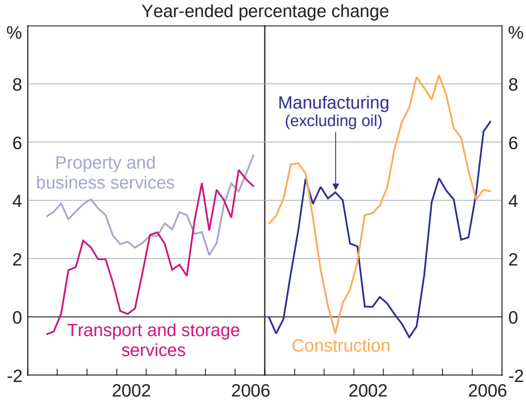
* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 66

Producer Prices

Year-ended percentage change



Source: ABS

September quarter (Graph 65). This is somewhat lower than the peak reached in 2003 when house-building costs were growing rapidly, but in recent quarters non-tradables inflation appears to have stopped falling. Excluding the effects of food and petrol, tradables inflation was 0.4 per cent in the year to the September quarter. It has gradually increased over the past two years, and is no longer being held down by the appreciation of the exchange rate over 2002 and 2003. It is possible that the pick-up also reflects some waning in global disinflationary forces.

Producer price data suggest that upstream inflation pressures remain strong. Final-stage prices rose by 1.0 per cent in the quarter, to be 4.0 per cent higher over the year. Year-ended manufacturing price inflation (excluding oil) remained high (Graph 66). Output prices were also firm for the construction and transport sectors, and picked up in the property & business services sector.

Labour costs

Recent indicators show that wage growth remains above its average of recent years, though it has not accelerated further in the latest year despite high labour demand. The wage price index (WPI) grew by 1.1 per cent in the June quarter, and by 4.1 per cent over the year, similar to the growth observed over the previous year (Graph 67). In addition, weighting new agreements by each industry's share of overall employment, the average annualised wage increase for federal enterprise bargaining agreements (EBAs) certified in the June quarter was little changed from recent quarters. In the private sector, wages growth in the mining, construction and utilities industries has picked up of late, consistent with robust activity in those areas of the economy.

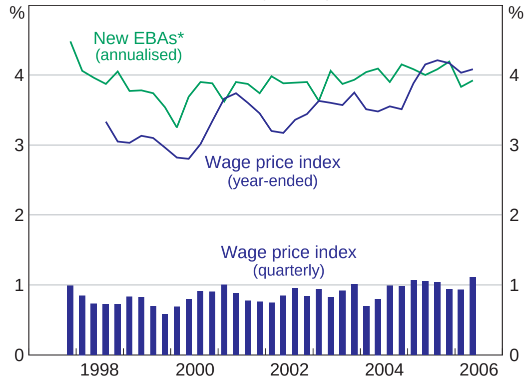
The Australian Fair Pay Commission announced its first wages decision on 26 October. It awarded an increase of around $27 a week to the federal minimum wage and award wage workers earning less than $700 per week, and $22 for award workers earning over that amount, starting from December 2006. This is equivalent to an annualised increase of around 3¾ per cent for minimum wage earners, and around 2¾ per cent for all award workers, once the 18-month period since the last wage increase is taken into account.

Business surveys and the Bank's liaison program continue to point to high labour demand and shortages of skilled labour. According to the NAB survey, concerns about the availability of suitable labour intensified further in the September quarter and this remains a greater constraint on firm activity than the more traditional concern of lack of demand (Graph 68). These conditions are prompting firms to offer a range of non-wage incentives to attract and retain staff.

Graph 67

Wage Indicators

Percentage change

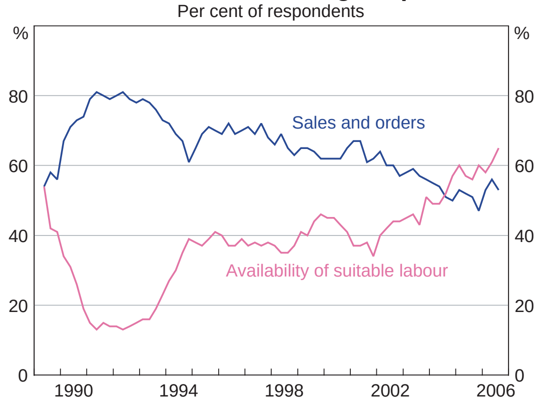


* Re-weighted to reflect wage price index weights
Sources: ABS; DEWR

Graph 68

Factors Constraining Output

Per cent of respondents



Source: NAB

Inflation expectations

Recent business surveys suggest that the proportion of businesses expecting to increase their prices is significantly above the long-run average. While it is difficult to draw strong conclusions about inflation expectations from these data given their high volatility, they suggest price pressures are firm.

Market economists surveyed by the Bank following the release of the September quarter CPI mostly left their forecasts unchanged for the year to the June quarter of 2007, with a median forecast of 2.7 per cent (Table 15). They also continue to expect headline inflation to be in the middle of the target band in June 2008. Union officials have reduced their expectations somewhat, but expectations still remain above their longer-term average.

Table 15: Median Inflation Expectations
Per cent

	Year to June 2007			Year to June 2008	
	May 2006	August 2006	November 2006	August 2006	November 2006
Market economists[(a)]	2.7	2.7	2.7	2.5	2.5
Union officials[(b)]	3.5	4.2	4.0	4.0	3.5

(a) RBA survey
(b) Workplace Research Centre

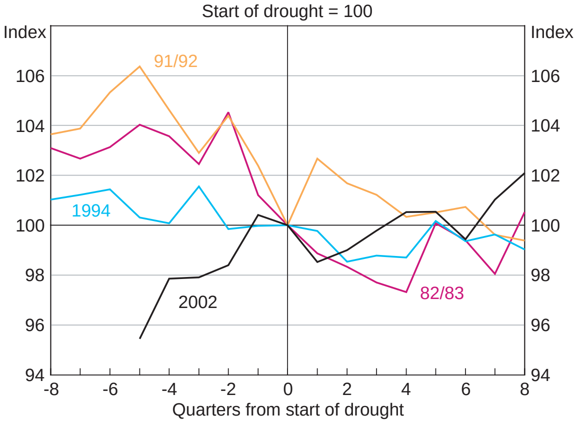
According to the Melbourne Institute survey of households, the median expectation for consumer price inflation over the coming year fell back to 3.4 per cent in October. Although this is slightly higher than the average over the inflation-targeting period, it is lower than its June quarter high, in line with the recent easing in fuel prices. The implied medium-term inflation expectations of financial market participants, as measured by the difference between nominal and indexed bond yields was around 3¼ per cent in early November. However, as noted in previous *Statements*, this measure can be affected by factors unrelated to expectations about inflation, such as changes in institutional demand for indexed securities.

The effect of the drought

Wheat prices have risen recently due to forecasts of reduced crop sizes in Australia and elsewhere. Reports have suggested that the prices of a range of foods will be driven up by the drought, including products that rely on wheat as an input, and fruit and vegetables that rely on irrigation. However, historically, the net effect of droughts on the CPI has been relatively small. Over the four previous droughts, average food prices did not rise by more than the prevailing rate of inflation (Graph 69).

Graph 69

Relative Food Prices*
Start of drought = 100



* Food relative to CPI excluding food (exclusive of interest charges)
Sources: ABS; RBA

There are several reasons why droughts have historically had relatively small effects on consumer price inflation. First, many food items can be imported in the event of shortfalls in domestic production, limiting the effect on domestic prices. Second, the contribution of commodity prices to final retail food prices is often small. For example, in the 2002/03 drought there was a significant run-up then a significant fall in wheat prices but the movements in bread prices were much smaller. Finally, while cereal prices generally rise during a drought, meat prices tend to fall initially as slaughter rates rise in response to the dry conditions; the latter effect could, however, diminish as a drought persists. At this stage, the net effect on the CPI from the current drought is expected to be fairly small in coming quarters.

Inflation outlook

While headline inflation remained close to 4 per cent over the year to the September quarter, this rate was significantly boosted by earlier sharp increases in petrol and fruit prices. Nonetheless, looking through the volatility in these prices, underlying quarterly inflation outcomes in 2006 have been above the levels seen in 2005. The proportion of CPI items rising by more than the mid-point of the target band has remained high and business surveys indicate that a larger-than-average share of firms are reporting increasing prices.

The Bank's forecasts assume that oil prices and the exchange rate remain around current levels through to the end of the forecast period (December quarter 2008), and that global growth remains above trend but slows in line with the path implied by Consensus forecasts. The terms of trade are expected to gradually decline by around 10 per cent over the forecast period. The forecasts envisage GDP growth will be held down somewhat by the drought over the next year, with a modest pick-up to around 3¼ per cent thereafter. While exports of raw materials should grow strongly, and the house-building sector is expected to recover gradually, growth in consumer demand is expected to remain moderate and growth in investment is expected to slow from recent very high rates.

With only a modest easing in capacity constraints expected over the forecast period, the generalised price pressures currently evident in the economy are likely to continue in the near term. The central forecast is that underlying inflation will remain at around 3 per cent over the next year. Thereafter, it may decline slightly but is likely to remain near the top of the target band. This forecast takes into account the November cash rate increase and assumes some easing in world inflationary pressures reflecting the recent decline in oil prices and the modest slowing in global growth. On the domestic side, wage growth is expected to remain around current rates. However, the recent interest rate increases should contribute to containing demand and inflation pressures, and a pick-up in productivity growth should help to expand capacity and contain unit labour costs. Headline inflation will be significantly reduced by movements in petrol and fruit prices over the next year, with petrol prices having fallen markedly in the December quarter to date and fruit prices expected to fall significantly with the return to more normal banana supply from around the end of the year. It should then rise again to be the same as underlying inflation by the middle of 2008.

The risks to the inflation outlook on the external side include the possibility of a larger-than-expected slowing in the global economy. On the other hand, there is some upside risk to domestic price pressures as the economy continues to operate at close to capacity. In addition, there is some risk that the current high level of headline inflation will result in a sustained higher level of inflation expectations, although the recent increases in the cash rate and the projected decline in headline inflation in coming quarters should mitigate this risk.