International and Foreign Exchange Markets

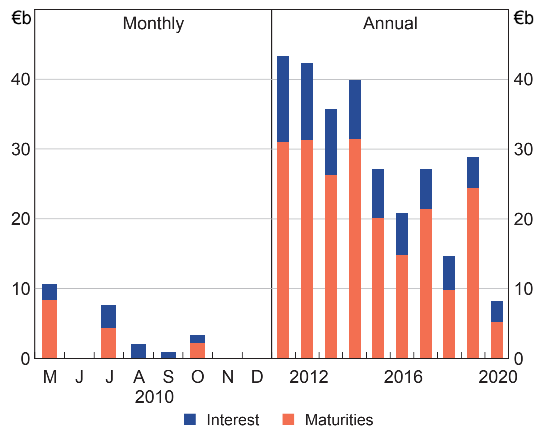
Sovereign Debt Markets

Concerns about the Greek Government's public finances have been at the forefront of developments in financial markets this year. Greece has a large funding requirement, reflecting both its sizeable budget deficit (13½ per cent of GDP in 2009 and likely to be at least 8 per cent of GDP in 2010) and the need to refinance large volumes of maturing debt (outstanding debt at end 2009 was 115 per cent of GDP) (Graph 12). During April, Greece's credit rating was downgraded by all three rating agencies; S&P downgraded Greece in late April to below investment grade. All rating agencies have Greece under review for a further downgrade. Several Greek banks also had their credit ratings downgraded because of the poor economic outlook and their large holdings of Greek government debt.

In early May, the Greek Government agreed to the terms of financial support from other euro area countries and the IMF. Under the three-year program, €80 billion in bilateral loans will be provided by euro area countries and €30 billion by the IMF; up to €30 billion will be provided in 2010 by euro area countries at interest rates reportedly around 5 per cent, which is well below recent market rates for Greek government debt (see below). The Greek Government aims to reduce its budget deficit to 3 per cent of GDP by 2014 by reducing government spending and increasing revenue.

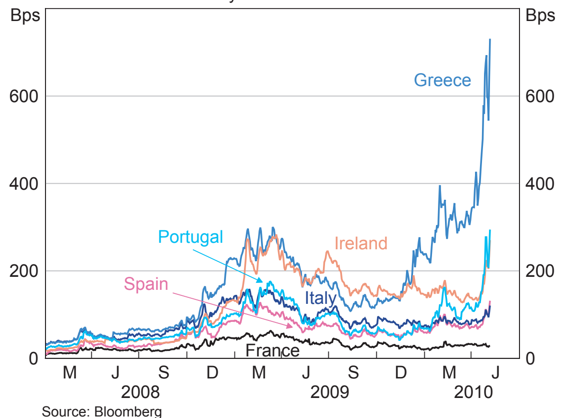
The concerns about Greece saw spreads between yields on Greek and German sovereign debt widen to be the highest of any euro area country since the European Monetary Union was formed in 1999 (Graph 13). With the caveat that the market has become very illiquid and pricing is at best indicative, in early May the yields on 2-year and 10-year Greek bonds were around 15 per cent and 10 per cent, respectively.

Graph 12
Greece – Central Government Debt Maturities*

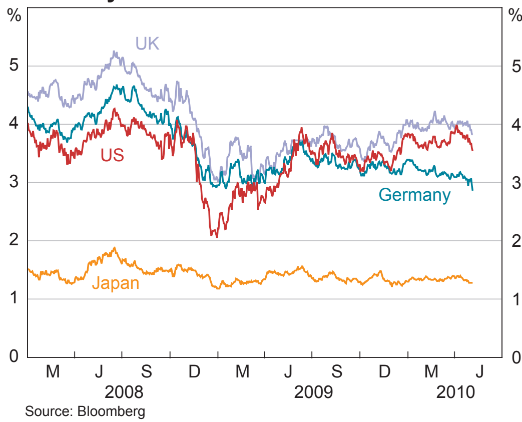


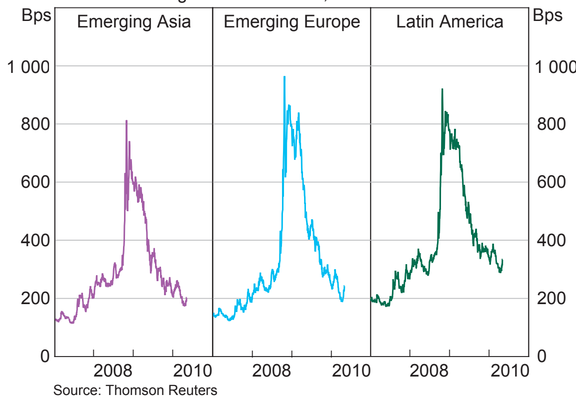
* Based on debt outstanding as at 5 May 2010
Source: Bloomberg

Graph 13
European Government Bond Spreads
To 10-year German Bunds



Source: Bloomberg





Sovereign bond spreads for several other euro area countries with large budget deficits have also widened recently. Fitch and S&P downgraded Portugal's credit rating in recent months, citing increased medium-term fiscal challenges. Subsequently, the Government brought forward additional measures to cut its budget deficit in 2010. In late April, S&P also downgraded Spain's credit rating. In addition, Ireland's budget deficit for 2009 was revised higher by 2½ percentage points.

Longer-term bond yields in the United States and United Kingdom had risen in recent months to the top of their trading range over the past year, reflecting in part the better macroeconomic outlook (Graph 14). Recently, however, yields in major bond markets have fallen, reflecting safe-haven demand due to concerns over sovereign credit risk in some euro area countries. Short-term government bond yields in the major economies have remained low as policy rates are expected to remain low for some time.

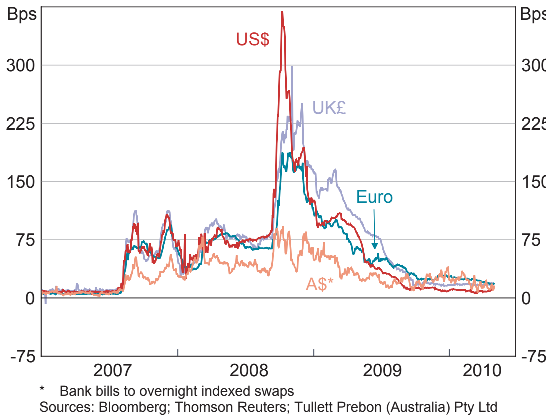
Spreads of emerging market debt have only been modestly affected by the concerns about some euro area countries and have narrowed considerably over the past year or so as these economies have improved (Graph 15). Spreads are now similar to, or lower than, those prevailing prior to the collapse of Lehman Brothers in September 2008 and are well below their decade average. In mid April, Argentina announced a debt restructuring plan for around US$20 billion of bonds outstanding from the Government's 2001 debt default.

In emerging Asia, Moody's upgraded South Korea's credit rating from the equivalent of A to A+, citing its ongoing resilience to the financial crisis. S&P revised India's credit rating outlook from negative to stable citing its fiscal consolidation. A number of emerging European countries also had their credit outlooks raised.

Credit Markets

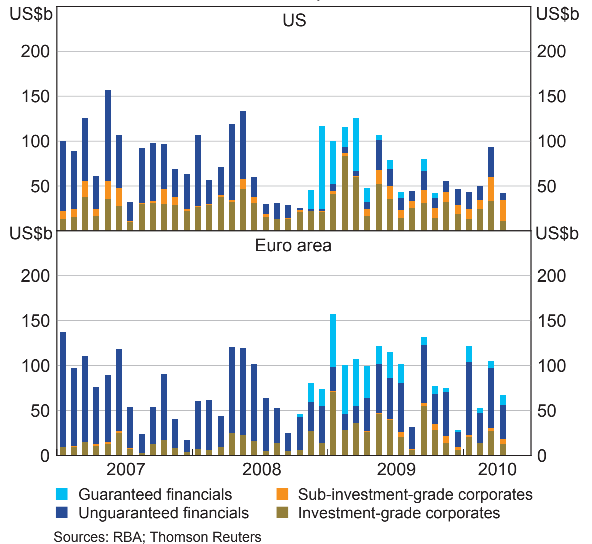
In money markets, spreads between LIBOR and the expected cash rate (a measure of bank risk) have remained broadly stable since mid to late 2009 (Graph 16). Conditions in other credit markets have generally improved further in recent months, despite having experienced some repercussions from the deterioration in several euro area sovereign debt markets. Reflecting the improvement in global economic conditions, the global corporate speculative-grade default rate has declined from its peak in December 2009.

Graph 16
3-month LIBOR Spreads
To overnight indexed swaps



* Bank bills to overnight indexed swaps
Sources: Bloomberg; Thomson Reuters; Tullett Prebon (Australia) Pty Ltd

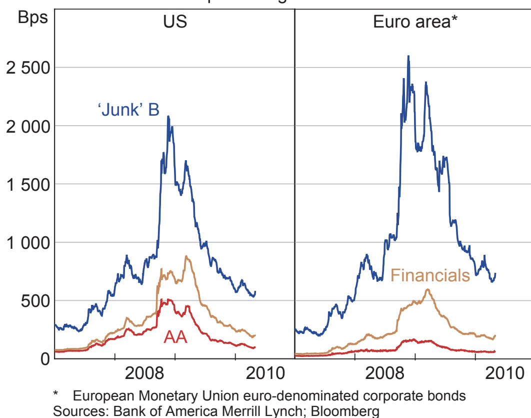
Graph 18
Corporate Bond Issuance
Monthly



Sources: RBA; Thomson Reuters

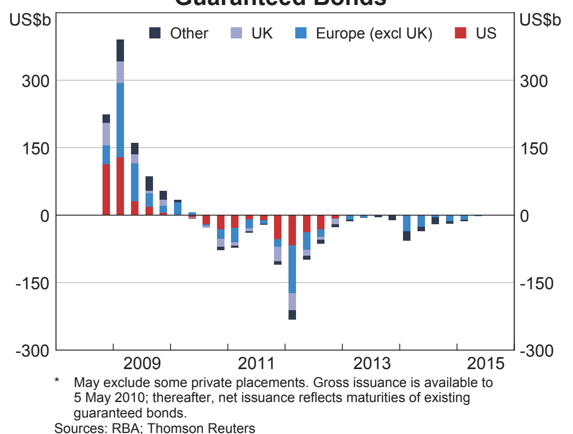
Although corporate bond spreads in the United States and euro area have widened slightly in recent weeks, they remain around low levels (Graph 17). Bond issuance by US non-financial corporates, including by those rated below investment grade, has strengthened a little in recent months, although issuance by non-financial corporates in the euro area has moderated after being strong in 2009 (Graph 18). In recent months, bond issuance by financial institutions has been around its average of recent years in the euro area but below average in the United States. Some Irish, French and Spanish financial institutions continue to issue government-guaranteed bonds, although aggregate issuance has continued to decline (Graph 19). The aggregate stock of government-guaranteed bonds in the United States, United Kingdom and Europe is likely to begin falling this year as bonds start to mature, although the majority of government-guaranteed bonds will mature in 2011 and 2012.

Graph 17
Corporate Bond Spreads
To equivalent government bonds



* European Monetary Union euro-denominated corporate bonds
Sources: Bank of America Merrill Lynch; Bloomberg

Graph 19
Net Issuance of Government Guaranteed Bonds*



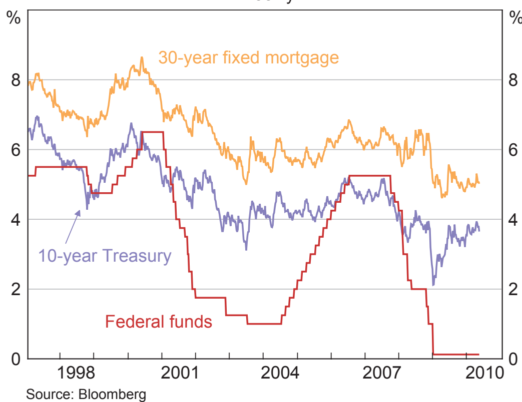
* May exclude some private placements. Gross issuance is available to 5 May 2010; thereafter, net issuance reflects maturities of existing guaranteed bonds.
Sources: RBA; Thomson Reuters

Table 2: Policy Rates

	Current level Per cent		Most recent change
Euro area	1.00	↓	May 09
Japan	0.10	↓	Dec 08
United States	0.125	↓	Dec 08
Brazil	9.50	↑	Apr 10
Canada	0.25	↓	Apr 09
China	5.31	↓	Dec 08
India	5.25	↑	Apr 10
Indonesia	6.50	↓	Aug 09
Israel	1.50	↑	Mar 10
Malaysia	2.25	↑	Mar 10
Mexico	4.50	↓	Jul 09
New Zealand	2.50	↓	Apr 09
Norway	2.00	↑	May 10
Russia	8.00	↓	Apr 10
South Africa	6.50	↓	Mar 10
South Korea	2.00	↓	Feb 09
Sweden	0.25	↓	Jul 09
Switzerland	0.25	↓	Mar 09
Thailand	1.25	↓	Apr 09
Turkey	6.50	↓	Nov 09
United Kingdom	0.50	↓	Mar 09

Sources: central banks

Graph 20
US Interest Rates
Weekly



Source: Bloomberg

Central Bank Policy

Central banks in most advanced economies have kept their policy rates unchanged at low levels (Table 2). Financial markets continue to expect that the major central banks will not raise rates until at least the end of the year, with the exception of the Bank of Canada which is expected to tighten policy in coming months.

Monetary policy has been more of a mixed picture outside the major advanced economies. A number of Asian central banks (China, India, Malaysia and Singapore) have tightened monetary policy in recent months as the economic outlook has improved and/or as inflation has risen. The Bank of Israel raised its policy rate by 25 basis points in March, taking its cumulative tightening to 100 basis points since August 2009. The Central Bank of Brazil increased its policy rate by 75 basis points in April. The Central Bank of Norway increased its policy rate by 25 basis points in May. In contrast, several central banks in emerging Europe have further reduced their policy rates. The South African Reserve Bank also lowered its policy rate by a further 50 basis points in March.

In the United States, the Fed has completed its asset purchases designed to ease monetary policy and support the US mortgage market. Final purchases of agency mortgage-backed securities and agency debt occurred in March. Spreads on these securities to US Treasuries as well as 30-year fixed mortgage rates have remained relatively low following the completion of asset purchases (Graph 20).

The European Central Bank (ECB) has purchased more than four-fifths of its target of €60 billion of covered bonds, which will be completed by end June 2010. The Bank of England has maintained the stock of financial assets it purchased at £200 billion since reaching this target in early 2010.

Most central banks have closed the majority of their temporary liquidity facilities, reflecting falling

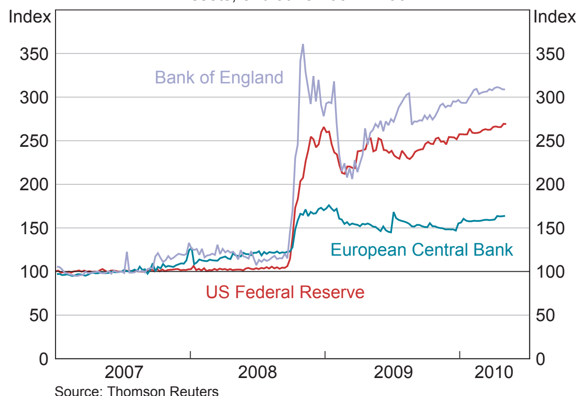
demand in line with the improvements in credit market conditions. In the United States, the sole remaining facility, the Term Asset-backed Securities Loan Facility, which aims to support issuance of commercial mortgage-backed securities, will end by 30 June. The Fed also increased the interest rate (the 'discount rate') it charges on emergency loans to banks by 25 basis points to 0.75 per cent in February and reduced the term of such loans to overnight. The Fed emphasised that this was not a tightening of monetary policy but rather a normalisation of its liquidity operations.

In March, the ECB announced that it will keep the minimum allowable rating on collateral accepted for its market operations at investment grade (BBB– or equivalent), rather than reverting to A– at the end of 2010 as previously anticipated. Subsequently, the ECB suspended the application of the minimum credit rating threshold to Greek government debt used as collateral. The ECB has also announced other changes to the collateral framework for its market operations: from 1 January 2011 higher haircuts will be imposed on certain private-sector securities while some other securities, including those not denominated in euros, will cease to be eligible collateral.

The Bank of Japan announced at its March policy meeting that it will double, to ¥20 trillion, the amount of liquidity provided at the policy rate through its 3-month loan operations, with a view to lowering longer-term money market interest rates.

Consistent with the scaling-back or completion of asset purchases and liquidity facilities, central bank balance sheets are close to peaking (Graph 21).

Graph 21
Central Bank Balance Sheets



Source: Thomson Reuters

Government Financial Policy

In the United States, negotiations over financial reform legislation are close to resolution. Key proposals contained in the current draft legislation include: new capital and leverage requirements for financial institutions; the ability to break up large companies if they pose a threat to financial stability; a study of the feasibility of the proposed 'Volcker rule' restricting banks' proprietary trading activities; greater use of centralised clearing and exchange trading for derivatives currently traded over the counter; and the creation of a new consumer protection agency. In April, the Securities and Exchange Commission also proposed new rules for issuing asset-backed securities, aimed at providing better protection for investors.

The US Treasury continues to unwind its assistance to financial institutions under the Troubled Asset Relief Program (TARP). Over 70 per cent of the banking-sector support programs have been repaid, and the US Treasury ultimately expects to earn a profit on these investments. However, reflecting the large losses expected from assistance to insurer American International Group and the auto industry, as well as the cost of the housing affordability program, the Congressional Budget Office estimates that the total cost of the TARP will be more than US$100 billion in present value terms. The US Treasury also announced

it will sell its 27 per cent stake in Citigroup during 2010, subject to market conditions. At current market prices, the Government's profit on these shares would be around US$7 billion.

The housing finance agency Freddie Mac reported further losses in the March quarter, resulting in a request for an additional capital injection of more than US$10 billion from the US Treasury as part of the terms of its conservatorship. This would take the total contribution from the US Treasury to more than US$60 billion. Fannie Mae's total funding from the US Treasury at the end of 2009 was around US$75 billion.

The IMF has approved measures to ensure that it has adequate resources to lend to member countries through its crisis prevention and resolution measures. The Executive Board approved a significant expansion of the IMF's New Arrangements to Borrow – where participants commit resources to IMF lending when needed to supplement the IMF's regular quota resources – from around US$50 billion to almost US$600 billion.

The IMF has also discussed two proposals in which additional taxes on the financial system might be levied: a Financial Stability Contribution that would be predominantly based on specific liabilities of financial institutions; and a Financial Activities Tax that would be levied on the remuneration and 'excess' profits of financial institutions. Responses to these proposals have been mixed, with many countries not seeing a need for a special tax on their financial institutions.

A number of governments and regulators have proposed banning 'naked' credit default swap (CDS) transactions referencing sovereign debt where the protection buyer does not own the underlying asset. Activity in the sovereign CDS market, however, is much smaller than the underlying market for government bonds (Table 3).

Ireland's National Asset Management Agency, set up to buy non-performing loans, began its first loan purchases in March. Loans with a nominal value of €16 billion are being purchased at an average discount of nearly 50 per cent. In total, €81 billion of loans (6 per cent of credit institutions' assets) are expected to be purchased by end 2010. Several institutions will be required to raise capital to offset the effects of the loan write-downs.

Table 3: Selected Sovereign Credit Default Swaps
April 2010

		Outstandings (US$ billion)		
	S&P credit rating	Gross CDS contracts	Net CDS contracts	Government debt[(a)]
Italy	A+	224	25	1 892
Spain	AA	105	14	614
Greece	BB+	79	8	377
Germany	AAA	71	14	1 341
Portugal	A–	62	9	149
France	AAA	55	10	1 517
Ireland	AA	35	5	115
United States	AAA	13	2	8 430
Australia	AAA	7	1	124

(a) Central government; May 2010
Sources: Bloomberg; Depository Trust & Clearing Corporation; RBA; S&P; US Treasury

Table 4: Changes in International Share Prices

Per cent

	2007/08 peak to recent trough	Since recent trough	2007/08 peak to current	Since previous *Statement*
United States				
– Dow Jones	–54	66	–23	6
– S&P 500	–57	72	–26	6
– NASDAQ	–56	89	–16	10
Euro area				
– STOXX	–62	51	–42	–3
United Kingdom				
– FTSE	–48	52	–21	2
Japan				
– Nikkei	–61	57	–39	6
Canada				
– TSE 300	–50	57	–21	4
China				
– China A	–72	67	–53	–5
Australia				
– ASX 200	–54	49	–32	1
MSCI indices				
– Emerging Asia	–61	93	–25	3
– Latin America	–57	92	–17	–3
– Emerging Europe	–71	105	–41	–1
– World	**–56**	**63**	**–28**	**4**

Source: Bloomberg

Equities

Global equity prices reached a 19-month high in mid April, supported by generally better-than-expected earnings reports for the March quarter and steady improvements in the global economic outlook (Table 4, Graph 22). However, recent developments in the euro area have resulted in global equity prices falling by around 5 per cent and European equity prices by around 10 per cent. Global equity prices remain well below their peak in October 2007.

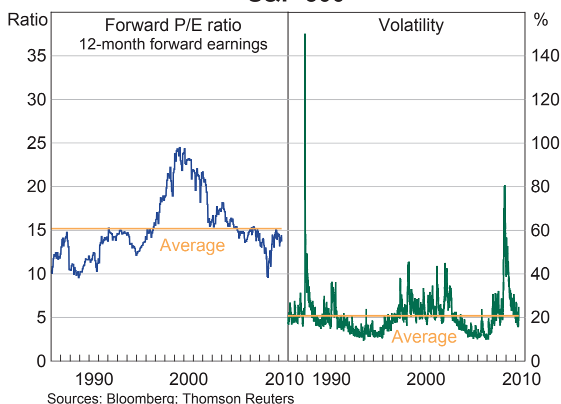
In the United States, first-quarter earnings reports from major US financial institutions continued to show investment banking and trading operations, particularly fixed-income activities, as the main sources of profit. Net income from retail operations was a little higher as loan-loss provisions, which peaked in mid 2009, declined further due to reported

Graph 22
MSCI Global Share Price Indices

Source: Bloomberg

improvements in credit quality. While US financial institutions' earnings have improved significantly, they remain below their pre-crisis levels. Reported profits of non-financial companies also improved in the March quarter compared with a year earlier.

Equity prices have not increased at the same rate as expected earnings with the result that the forward-looking price-to-earnings (P/E) ratio has fallen to be slightly below its long-run average (Graph 23). Volatility in the US equity market has recently increased to be slightly above its long-run average.



Equity prices in most emerging economies have broadly tracked those in advanced economies this year, with the notable exception of China where uncertainty surrounding the pace of policy tightening and the effect of measures implemented by authorities to cool property market activity have weighed on equity prices.

Hedge Funds

The continuing improvement in financial markets has been reflected in global hedge funds' returns, which averaged 3 per cent in the March quarter and 23 per cent over the year. Hedge funds as a group have recovered the sharp losses suffered in 2008, with unit values now around levels seen before the financial crisis. Despite this recovery in returns, funds under management in the industry are still 14 per cent below the peak in mid 2008, reflecting large redemptions during the crisis.

Foreign Exchange

Developments in major foreign exchange markets have primarily been driven by the sovereign debt concerns in Europe, while emerging Asian and South American currencies have generally appreciated in line with the relative strength of economic recovery in these regions. With the exception of heightened volatility in the euro, foreign exchange markets have been relatively stable in recent months with volatility around its long-run average and well below the peaks recorded in 2008.

In trade-weighted terms, the US dollar has appreciated since the previous *Statement*, and at the end of April was around 12 per cent above the record lows in March 2008 and around 10 per cent below its peak in March 2009 (Graph 24, Table 5).

The dollar has appreciated against the other major currencies, owing largely to the response of investors to the sovereign debt problems in the euro area, but has depreciated against emerging market and commodity currencies, which have been buoyed by the strengthening global recovery and capital inflows.

Concerns over the fiscal position of a number of euro area countries, particularly Greece but also Ireland, Spain and Portugal, have seen the euro depreciate by around 15 per cent against the US dollar since late 2009 (Graph 25). Despite this, the euro remains over 10 per cent above its long-run average in effective terms. The UK pound sterling has continued to depreciate, affected by economic and political uncertainty in the country. In effective terms the UK pound sterling remains around its lowest level for at least 30 years. The Swiss National Bank has continued to intervene at times to constrain appreciation of the Swiss franc against the euro.

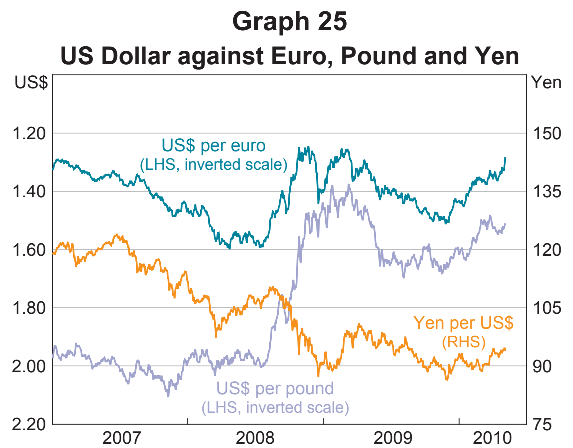
Despite market discussion of a possible revaluation of the Chinese renminbi, the current peg to the US dollar, in place since July 2008, remains unchanged. The non-deliverable forward market suggests that market participants have expected an upward revaluation of the renminbi relative to the US dollar since late last year. Although Premier Wen cautioned that the currency will remain basically stable in the near term, Chinese President Hu stated recently that China will move towards a floating exchange rate regime. In effective terms the Chinese exchange rate has appreciated from the start of 2010. It is around 8 per cent below its peak in February 2009, but remains around 20 per cent above its trough in 2005 (Graph 26).

Table 5: US Dollar against Other Currencies
Percentage change

	Past year	Since previous *Statement*
European euro	4	8
Chinese renminbi	0	0
UK pound sterling	0	5
Swiss franc	–1	6
Mexican peso	–4	–2
Swedish krona	–5	4
New Taiwan dollar	–5	–1
Japanese yen	–5	3
Singapore dollar	–6	–1
Philippine peso	–6	–3
Thai baht	–8	–2
Malaysian ringgit	–8	–5
Indian rupee	–9	–2
South African rand	–9	2
South Korean won	–10	0
Indonesian rupiah	–11	0
Canadian dollar	–12	–3
Brazilian real	–16	–2
Australian dollar	–18	–3
New Zealand dollar	–19	–2
Majors TWI	**–3**	**3**
Broad TWI	**–3**	**1**

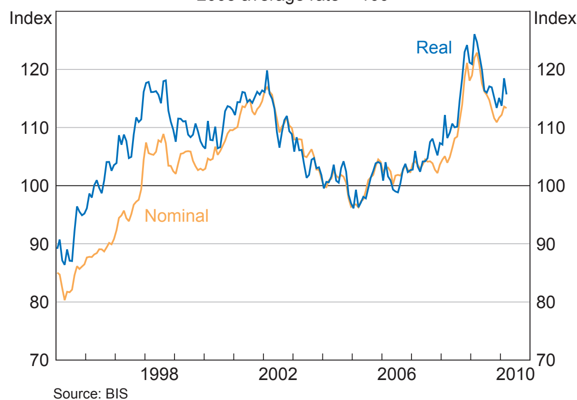
Sources: Bloomberg; Board of Governors of the Federal Reserve System

Graph 25
US Dollar against Euro, Pound and Yen



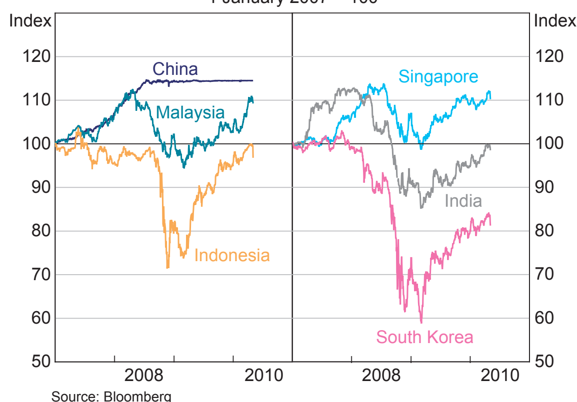
Source: Bloomberg

Graph 26
China – Effective Exchange Rates
2005 average rate = 100



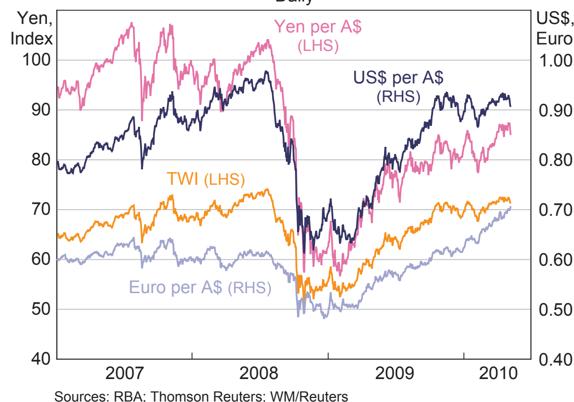
Source: BIS

Graph 27
Selected Asian Currencies against US Dollar
1 January 2007 = 100



Source: Bloomberg

Graph 28
Australian Dollar
Daily



Sources: RBA; Thomson Reuters; WM/Reuters

Other emerging Asian currencies have generally appreciated against the US dollar since the beginning of the year, consistent with strong capital inflows and the strength of the recovery in the region (Graph 27). The Malaysian ringgit has experienced a particularly strong appreciation in response to strong trade data and higher domestic interest rates. Most currencies in the region with flexible exchange rates appreciated following the decision by the Monetary Authority of Singapore to raise the target band for the Singapore dollar and to allow the currency to gradually appreciate. In early May, however, most emerging Asian currencies depreciated in response to sovereign debt concerns in some euro area countries.

Australian Dollar

The Australian dollar has appreciated against most major currencies in recent months, reflecting the general strength in commodity prices and associated strength of the domestic economy (Graph 28, Table 6). On a trade-weighted basis the Australian dollar has appreciated by over 35 per cent since the trough in February 2009 and is just 4 per cent below the post-float high achieved in July 2008. It has reached a new high against the euro of over 70 euro cents and a decade high against the NZ dollar. Intraday volatility in the Australian dollar has declined sharply in recent months to its lowest level since mid 2007.

Table 6: Australian Dollar against Selected TWI Currencies
Percentage change

	Past year	Since previous *Statement*	Deviation from post-float average
European euro	26	11	7
UK pound sterling	21	8	34
Chinese renminbi	21	3	32
US dollar	21	3	25
Swiss franc	20	8	–5
Japanese yen	16	6	–10
Singapore dollar	15	1	1
Thai baht	12	1	24
South African rand	11	4	54
Malaysian ringgit	11	–3	31
Indian rupee	10	0	52
South Korean won	10	2	51
Indonesian rupiah	8	3	124
Canadian dollar	7	0	0
New Zealand dollar	–1	1	3
TWI	**16**	**4**	**20**

Sources: Bloomberg; RBA; Thomson Reuters; WM/Reuters

Capital Flows

Private capital flows have largely returned to their pre-crisis configuration. Official data to the end of 2009 show that, following a short period of repatriation flows during the crisis, both foreign investment in Australia and Australian investment abroad have returned to levels similar to those seen prior to the crisis (Graph 29). Net equity inflows, which rose sharply following the crisis, reflecting repatriations and domestic equity raisings, have declined recently, while strong offshore debt financing by banks and other corporates has seen a recovery in net debt inflows.