Statement on Monetary Policy

MAY 2012

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Reserve Bank

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Overview

Global economic growth slowed late in 2011, but that has not developed into a major downturn and a number of indicators suggest that, outside of Europe, conditions have stabilised over recent months. The US economy has continued to expand at a moderate pace over the year to date and there are tentative signs that activity in east Asia is continuing to pick up after the effects of the natural disasters of 2011. Growth has slowed to a more sustainable pace in China, largely reflecting the effect of tighter domestic policies, which has helped to ease inflationary pressures. Nonetheless, the Chinese economy still grew by about 8 per cent over the year to March.

Conditions in Europe, in contrast, remain very difficult. Some progress has been made in addressing fiscal imbalances and implementing structural reforms, but much work remains to be done. Activity in Europe is still contracting, with a negative feedback loop between fiscal consolidation and growth evident in a number of countries. This is weighing on business and consumer confidence across the region.

Notwithstanding the ongoing problems in Europe, the recent flow of information has, at least for the time being, ended the sequence of downward revisions to expectations of global growth, and some forecasters have in fact increased their estimates a little. Global growth is now expected to be around 3½ per cent in 2012 and around 4 per cent (about trend) in 2013. As has been the case over recent years, emerging market economies, particularly in Asia, are expected to be the main driver of global growth. Activity in the advanced economies is likely to be subdued given the need for fiscal consolidation and the ongoing effects of deleveraging by the private sector. It remains the case that, given the nature of the challenges faced by many advanced economies, the risks to global growth remain on the down side. Global inflationary pressures remain moderate, despite some boost to headline measures from elevated oil prices.

This outlook for near-term global growth – below trend growth, but not a major slump – is broadly consistent with developments in commodity prices. The spot price for iron ore has moved a little higher since the start of the year, consistent with signs of a recovery in Chinese steel production and some earlier disruptions to supply in Australia and Brazil. Coking coal prices have eased as supply from Queensland has recently returned to its level prior to the flooding in early 2011. Prices for base metals and rural commodities have declined more recently, but they remain at historically high levels. After peaking in the September quarter 2011, the terms of trade are estimated to have declined, though they remain high. The terms of trade are expected to continue to decline gradually over coming years, as significant investments under way in Australia and elsewhere boost the supply of bulk commodities, but to remain well above their longer-term average.

Global financial market sentiment has generally improved over the year to date. This was underpinned by further European Central Bank actions to bolster liquidity and the restructuring of Greek public debt held by the private sector. More recently there has been some widening of spreads on government

bonds for vulnerable countries. Nevertheless, in contrast to the situation towards the end of last year, so far this year capital markets have been supplying funding to corporations and highly rated banks. This has enabled sizeable issuance of bonds by Australian banks. Moreover, at the margin, wholesale funding costs have declined over recent months, although they remain higher (relative to benchmark rates) than in mid 2011. At the same time, elevated competitive pressures have kept deposit rates in Australia high relative to the cash rate.

Although three months ago a range of indicators were suggesting that economic growth was close to trend, the outcome for 2011 as now reported was, in fact, somewhat weaker than that. Domestic demand in 2011 increased by close to what had been expected, and grew at its fastest pace for four years, but its composition has progressively shifted, with even more mining sector investment than anticipated a year ago, and less non-mining activity. Moreover, more demand may be spilling abroad via imports. As a result, labour market conditions have continued to be on the soft side to date, with large increases in employment in mining and some service industries roughly offset by declines in the manufacturing, hospitality and retail sectors.

Over 2012 to date, partial indicators and liaison suggest that the economy has been growing modestly, but with activity continuing to vary significantly across industries. The mining sector remains exceptionally strong, with work progressing on the very large pipeline of committed projects and capital imports rising. Mining production, though, has been disrupted recently by adverse weather and industrial action.

Growth in household spending moderated at the end of 2011 and partial indicators suggest that it remained soft in early 2012. There has been very low growth in the value of retail sales in particular, though this has been weaker than overall consumption for some time. The housing market and residential building activity also remain weak. Demand for new housing finance has eased slightly in recent months, despite interest rate reductions late last year. There are tentative signs that dwelling prices have declined more gradually than was the case in late 2011, but to date the market for established dwellings has remained subdued. At this stage, the available forward-looking indicators suggest that a recovery in housing construction is unlikely in the near term. But with mortgage servicing costs falling relative to incomes, rental yields rising and ongoing population growth, some important conditions for a recovery in construction are in place. What remains is for buyers to reach a point where they have sufficient confidence to commit to contracts for construction of new dwellings, and for the supply side of the housing market to be responsive to demand. Under those conditions, a soundly based recovery in construction could be expected.

Employment growth picked up a little in the March quarter of 2012, after the flat outcome in 2011. The softness over the past year includes the net effect of structural change, with mining and some service industries expanding, while firms in many other industries have reduced employment to contain costs and improve productivity in the face of modest growth in demand. Leading indicators, such as surveys and job vacancies, paint a mixed picture but are generally consistent with ongoing modest employment growth in the near term. A key issue over the next couple of years will be how effectively growing vacancies in some sectors can be filled with labour displaced from other areas.

The growth of wages appears to have moderated slightly over 2011. In the private sector, wages grew at a pace that was a little below the elevated rates seen over 2005–2008; wage growth softened by more than this in the public sector. Business surveys and liaison suggest that private sector wage pressures may have eased a little further in the March quarter, consistent with the generally subdued demand for labour outside the resource sector.

A year ago, underlying inflation had reached a low point of about 2¼ per cent and was forecast to increase to be close to the top of the inflation target

range by the end of 2011, in line with the positive outlook for the economy. Inflation did pick up a bit initially, but began to moderate in the second half of the year, as weakness in demand in some key domestic sectors of the economy put pressure on margins. The fall in prices for fruit and vegetables that had been affected by natural disasters in early 2011 occurred largely as expected. Accordingly, CPI inflation fell very sharply.

Inflation in the March quarter was unusually low, with various measures indicating underlying inflation was around ¼ per cent in the quarter. On a year-ended basis, underlying inflation declined to 2–2¼ per cent. The headline CPI fell by 0.2 per cent in the quarter on a seasonally adjusted basis, to be 1.6 per cent higher over the year. There was a large fall in fruit prices, especially of bananas, which subtracted 0.3 percentage points from quarterly inflation. The prices of a range of other tradable items, including some household goods, clothing and overseas holidays, also declined – reflecting both softness in consumer demand and some further pass-through of the earlier exchange rate appreciation. Non-tradables price rises were also a little softer, increasing by 0.7 per cent in the quarter and by 3½ per cent over the year. Within non-tradables, the prices of new dwellings and domestic travel & accommodation declined, although there were still quite strong increases in a number of services prices. The slowing inflation in some non-tradables prices, and some part of the decline in tradables prices, suggests pressure on margins, probably reflecting relative softness in demand in some non-mining sectors.

The Bank's central forecasts for the aggregate economy have been revised marginally lower. GDP is expected to grow by about 3 per cent over 2012 and 2013, and by a little bit more than that over the year to mid 2014. Employment growth is expected to remain subdued in the near term.

Over the forecast period, growth in domestic demand is expected to slightly exceed its long-run average. This reflects the ongoing boom in mining investment, the outlook for which has been revised higher. This strength is anticipated to provide some stimulus to a number of other sectors and in regions where the mining investment is most concentrated. At the same time, however, the assumed high level of the exchange rate and a weak short-term outlook for building construction are expected to result in subdued growth outside of the mining sector in the near term, though there are reasonable grounds to expect stronger growth in the non-mining sector over a medium-term horizon. Public demand is expected to decline over the year ahead. Exports have been revised lower, largely reflecting a reassessment of the ability of mining companies to utilise new transport and port capacity fully in the near term, along with weaker manufacturing exports.

The most significant external risk to this outlook is the possibility that sovereign debt problems in Europe could intensify and derail the upswing in the global economy. While the likelihood of this occurring in the near term has eased somewhat in recent months, partly because of the actions of authorities in Europe, the situation remains fragile. A substantial deterioration of conditions in Europe would be likely to have flow-on effects to the rest of the world through trade, financial and confidence channels. A sharp slowdown in global activity, particularly if it flowed through to east Asia, would have significant implications for commodity prices and demand for Australian exports, while a major flight from risk in global capital markets would see a marked deterioration in credit conditions and confidence. Even so, Australia remains relatively well placed to respond in such circumstances given the scope to adjust macroeconomic policies, the flexible exchange rate and a robust financial system.

In terms of risks on the domestic front, there is the possibility that in the near term, labour shedding across a range of industries outside of the mining sector accelerates as firms continue to adjust to the high exchange rate, weakness in the property market and the effects of weaker public demand.

Over the medium term, however, as mining projects progress into the more labour-intensive phase of construction, there is a risk that labour demand could pick up more than forecast.

The outlook for inflation has also been revised down. Underlying inflation (excluding the effect of the carbon price) is forecast to stay close to recent rates over the next one to two years. The key features of this forecast are: a decline in domestically generated inflation pressure; at the same time, the decline in tradables prices observed recently diminishes, given that the exchange rate has been little changed for a year now and is assumed not to change in the forecast period. The decline in domestically generated inflation rests on a couple of important judgements: that growth of nominal wages will moderate somewhat in a period of soft labour market conditions, and that productivity growth picks up, as firms respond to heightened competitive pressures in an environment of subdued demand and the high exchange rate.

The profile for headline inflation will be affected by a number of one-off factors in the next few quarters. Year-ended headline inflation will remain below underlying inflation given the sharp falls in fruit prices in recent quarters. The introduction of the carbon price in July is expected to boost headline inflation by around 0.7 percentage points over the year to June 2013. The effect on underlying inflation is expected to be less than this, at around ¼ percentage point over the same period. A key assumption made here is that there are no second-round effects owing to higher margins or wage claims.

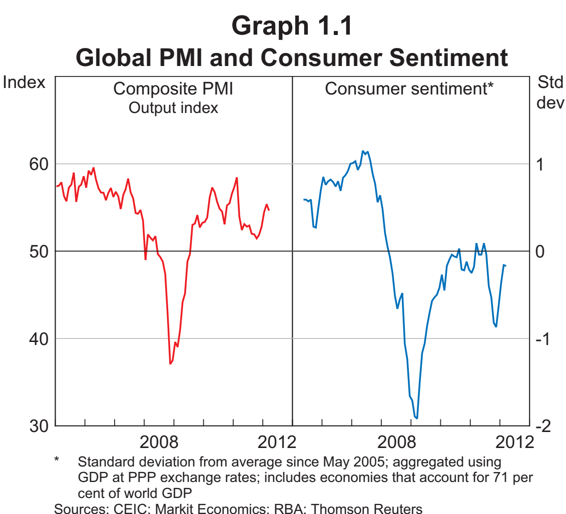
The Board reduced the cash rate twice in late 2011, which took rates for most borrowers back to about their medium-term average levels. Those rates then retraced a little of that decline during the past few months, as lenders recouped increases in funding costs relative to the cash rate. At its first couple of meetings in 2012, the Board held the cash rate steady, but noted that the inflation outlook would provide scope for easier monetary policy, if needed, to support demand. The data coming to hand over the past two months suggested that it was appropriate for a further step in that direction. Accordingly, at its May meeting, the Board decided on a further reduction in the cash rate. In deciding the size of the adjustment, the Board judged that it was desirable for financial conditions to be easier than those which had prevailed in December, and that this required a 50 basis points reduction in the cash rate, on this occasion, in order to deliver the appropriate level of borrowing rates.

The Board will continue to monitor information on economic and financial conditions and adjust the cash rate as necessary to foster sustainable growth and low inflation. ✠

1. International Economic Developments

Global growth slowed in late 2011. At that time, heightened concerns about sovereign debt problems in Europe and global growth prospects more generally led to some deterioration in confidence and activity. Most indicators suggest that the slowdown was mild, and it was certainly nowhere near as severe as the downturn in 2008–2009 (Graph 1.1). Following further action by the European Central Bank (ECB), the restructure of Greek government debt held by the private sector and further evidence of continued growth in the United States, global business and consumer confidence has recovered somewhat and business activity indicators have generally improved. In the euro area, however, confidence and activity remain weak and recent indicators suggest that conditions have deteriorated again in April. In response to tighter policy, growth in China has slowed to a more sustainable pace, while activity in the rest of east Asia is recovering from the natural disasters in 2011.

Forecasts of global growth in 2012 have been revised up a little in recent months, the first upward revisions since around mid 2011. The International Monetary Fund expects global output to grow by 3.5 per cent in 2012 and by 4.1 per cent in 2013, with the forecasts for each year revised up by 0.1–0.2 percentage points from three months ago, but with the risks still skewed to the downside. Although many economies are forecast to grow at a below-trend pace, particularly in 2012, the increasing weight of the faster growing Asian economies means that global growth is expected to be at or above long-run average levels.

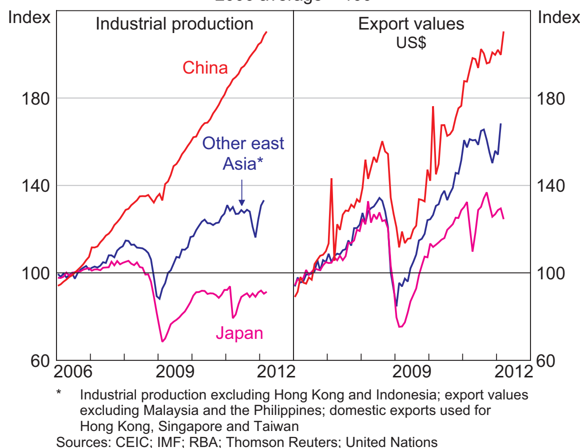


Although global economic conditions overall have improved, the recovery remains fragile. Public and, to a lesser extent, private debt remain elevated in the advanced economies, and continued deleveraging will weigh on growth for the foreseeable future. Although European leaders have made significant efforts to improve public finances and, in a number of countries, to enhance competitiveness, more progress is needed and securing public support for ongoing reform is proving difficult. Hence, Europe is likely to be a source of global uncertainty and financial market volatility for some time to come. Persistently high oil prices, if they reflect concerns about supply, could also slow the recovery in global activity.

Asia

Growth in China moderated further in early 2012, while growth in the rest of east Asia has started to pick up after a noticeable slowing at the end of 2011. This pick-up reflects the beginning of the reconstruction effort in Japan and a partial recovery in regional supply chains that were disrupted by flooding in Thailand in late 2011 (Graph 1.2). Exports have also picked up from the lows seen in late 2011, in part supported by demand from the United States. Business and consumer confidence have generally increased, in line with the improving global outlook.

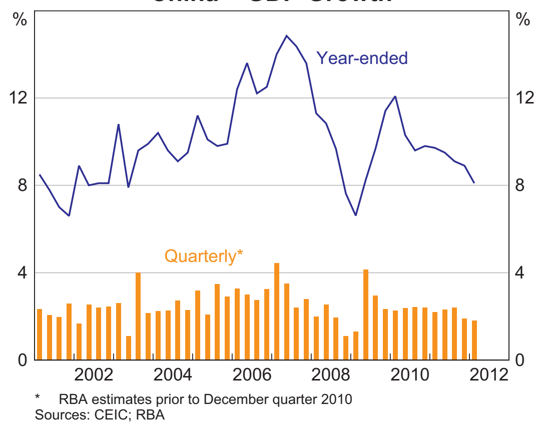
Graph 1.2
East Asia – Production and Exports
2006 average = 100



* Industrial production excluding Hong Kong and Indonesia; export values excluding Malaysia and the Philippines; domestic exports used for Hong Kong, Singapore and Taiwan
Sources: CEIC; IMF; RBA; Thomson Reuters; United Nations

In China, economic growth continued to moderate in the March quarter. GDP grew by 1.8 per cent to be 8.1 per cent higher over the year (Graph 1.3). The recent slowing in Chinese GDP growth has mainly resulted from tighter domestic policies, although weaker external demand has also weighed on growth. Exports to the European Union have contracted over the past year and those to Japan have been subdued. However, this has been partially offset by the ongoing modest expansion in exports to the United States, where economic conditions continue to improve. Exports to the rest of east Asia have strengthened in recent months, reflecting the ongoing recovery in the region from recent production disruptions.

Graph 1.3
China – GDP Growth

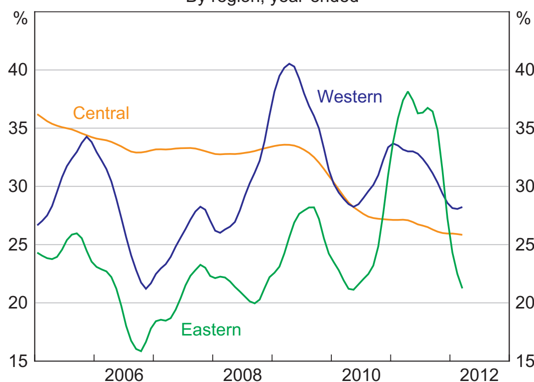


* RBA estimates prior to December quarter 2010
Sources: CEIC; RBA

Growth in domestic demand in China has eased, but there are tentative signs that conditions are stabilising. Growth in retail sales volumes has risen, supported by subsidies for rural residents and strong growth in urban disposable incomes. Notwithstanding weaker growth in external demand, investment by the manufacturing sector has continued its strong expansion, in part reflecting the increasing domestic orientation of manufacturing in recent years. In contrast, real estate investment has slowed and conditions in the property market are weaker. Nevertheless, construction growth remains relatively robust. The strength in real estate investment is, in part, owing to support from the Chinese Government's affordable housing program. Ongoing controls have weighed on residential property turnover and resulted in a modest fall in apartment prices. Much of the weakness in sales volumes has been recorded in coastal provinces, where the property controls have been more pervasive; turnover in inland provinces has remained broadly unchanged at a high level. The regional differences in conditions across property markets are also evident in relatively stronger growth in construction activity in central and western provinces (Graph 1.4).

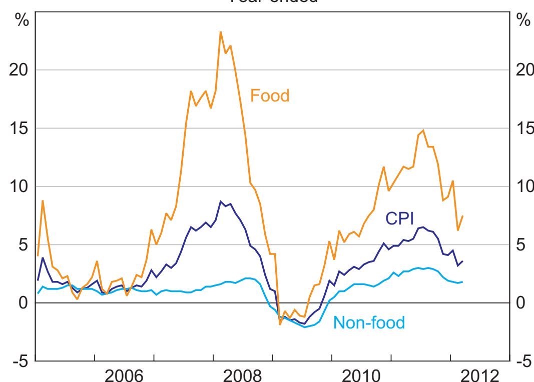
Industrial production growth has slowed over the past year, consistent with the broad trends in the manufacturing PMIs for China. The HSBC PMI, which

Graph 1.4
China – Construction Investment Growth*
By region, year-ended



* Smoothed
Sources: CEIC; RBA

Graph 1.5
China – Consumer Price Inflation
Year-ended



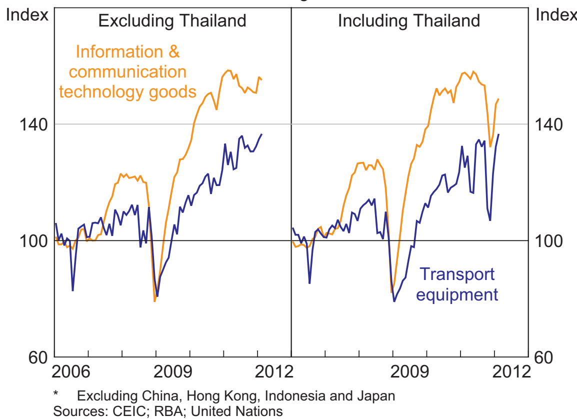
Source: CEIC

is currently lower than the official PMI and includes a higher share of smaller firms, has stabilised at a level just below 50. This level suggests that manufacturing activity has continued to grow, though slightly below its trend growth rate; the official PMI suggests that growth is somewhat stronger. Manufacturing of machinery and equipment, which accounts for a significant share of Chinese exports, is growing less rapidly than in 2011, although this is also the result of a significant slowing in domestic equipment investment. However, there are tentative signs that growth in industrial production has stabilised more recently. There has been a recovery in the production of key construction materials, including cement, steel and plate glass, after production fell towards the end of 2011.

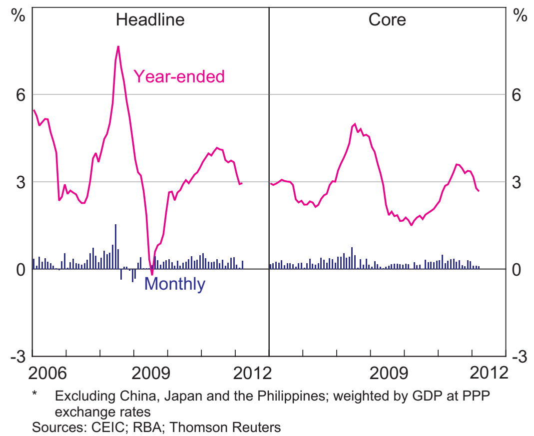
There has been a clear moderation in inflationary pressures in China since mid 2011, in line with the slowing growth of activity (Graph 1.5). Food prices have contributed significantly to the lower inflation outcomes. Meat prices have eased, particularly for pork, although this has been offset somewhat by rapid increases in fresh vegetable prices, with adverse weather conditions having affected vegetable production earlier in 2012. Non-food price inflation has also fallen, with housing cost inflation falling largely as the result of the moderation in rents and property prices from weaker conditions in the housing market. Earlier falls in commodity prices have been reflected in the prices of some household items and have resulted in a fall in producer prices.

Credit conditions appear to have eased recently. This follows a period of tighter liquidity between the end of January and mid February when market interest rates had increased. To ease liquidity conditions, the People's Bank of China (PBC) cut banks' reserve requirement ratios by 50 basis points. Further, to stimulate the supply of credit, the banking regulators increased the maximum loan-to-deposit ratio for two of China's five largest banks and cut reserve requirements for a large number of branches of the Agricultural Bank of China. Also, from 1 April, reserve requirements for some localised financial institutions were lowered by 100 basis points for one year. The PBC recently encouraged banks to offer lower loan rates for first home buyers to provide some support to housing demand. Overall then, financial policy settings are expected to be more supportive of growth in 2012. This is expected to be accompanied by an easing of fiscal policy, with growth in government spending projected to be strong, and the recent moderation in inflationary pressures has provided scope for an easing in monetary policy should there be a marked deterioration in economic conditions.

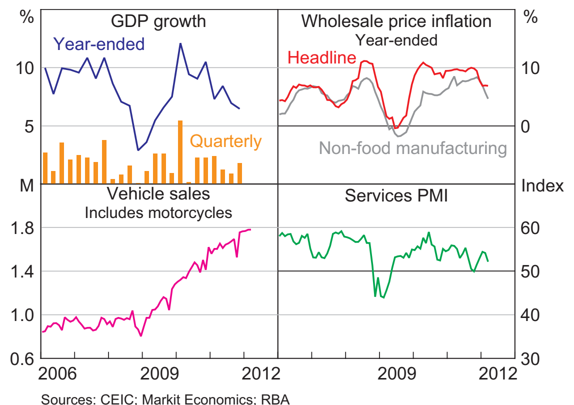
The easing of supply-chain disruptions from recent natural disasters, and some recovery in activity in the advanced economies, are starting to support activity in other parts of east Asia. The production of information and communication technology goods and motor vehicles has increased, particularly in Thailand where these industries were greatly affected by recent flooding (Graph 1.6). Exports of motor vehicles have also picked up, especially to the United States where motor vehicle sales have been strong recently. These factors have supported a pick-up in business and consumer confidence in most economies in the region, most notably in the higher-income economies that are more exposed to activity in the advanced economies and to regional supply chains. Indicators of domestic demand have been somewhat mixed; retail sales are likely to have fallen in the March quarter, while indicators of investment have picked up and credit growth has remained relatively firm.



In line with the step down in the rate of growth in the region, and consistent with an earlier tightening in monetary conditions, inflation pressures have eased since 2011. Core inflation has moderated noticeably, to be below 3 per cent over the year (Graph 1.7). Oil price rises have not yet flowed through to retail prices, partly reflecting the slow adjustment of administered prices in some economies.



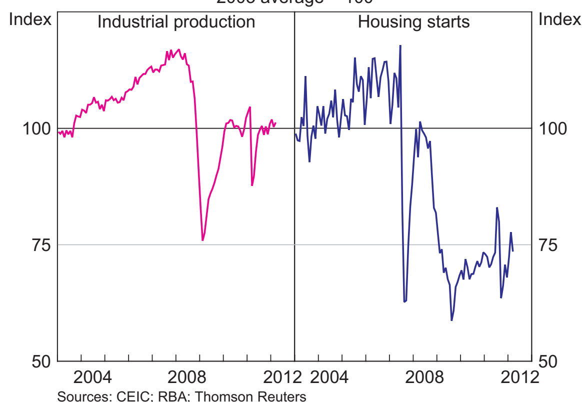
In India, GDP growth slowed in the December quarter to a year-ended rate of 6½ per cent, but conditions have stabilised in recent months (Graph 1.8). While private and public consumption continued to expand at a strong pace towards the end of 2011, investment contracted over the year, weighed down by tighter monetary conditions and greater uncertainty. More recently, growth in industrial production has lifted, supported by a recovery in coal production and strength in motor vehicle production. Cement production has continued to grow at a firm pace, underpinned by construction activity. Reflecting the recent improvement in production and demand, freight volumes and imports have also picked up. Conditions in the



services sector remain firm, with the services PMI at a level suggesting above-trend growth.

As domestic demand in India has slowed, inflationary pressures have eased. Inflation in non-food manufactured goods prices (an indicator of core inflation for India) is now at its lowest level since early 2010. The moderation in core inflation has been broad based, with electrical and transport equipment prices falling. The recent fall in food price inflation, however, appears to have been short-lived, with food price inflation surging in March, driven in part by supply-side constraints. With growth in activity having slowed and inflationary pressures having abated, the Reserve Bank of India (RBI) cut its policy rate by 50 basis points at its recent meeting. However, the RBI has suggested that the extent of the easing of policy will be limited by inflationary pressures coming from the recent depreciation of the rupee and the rising cost of fuel.

Activity in Japan has recovered from natural disasters that affected the region in 2011, with industrial production and exports both back to around their levels prior to the Japanese earthquake and tsunami in March (Graph 1.9). Indicators of household consumption have also picked up, consistent with a rise in consumer confidence. Although indicators of equipment investment have tracked sideways, there are signs that the boost to investment from the reconstruction effort has commenced, with housing starts growing strongly in the earthquake-affected regions in recent months. However, the risk of much more subdued output growth in the summer months remains, with the reluctance of local authorities to restart nuclear power stations likely to contribute to electricity supply shortages (see 'Box A: Electricity Supply in Japan').

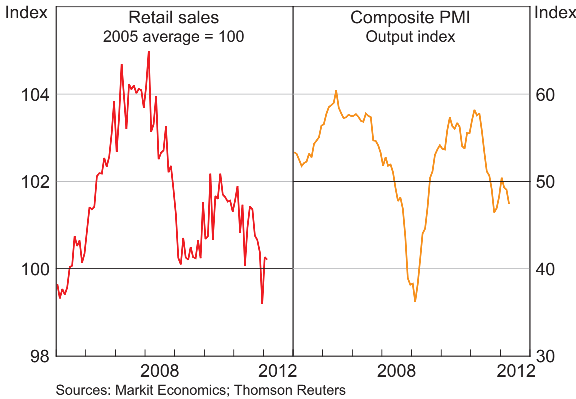


Europe

Economic activity in the euro area continues to be affected by ongoing concerns about sovereign debt and the competitiveness of a number of European economies. Over recent months, measures of activity, confidence and sentiment in financial markets have tended to move together, with early signs of conditions having deteriorated again in April after some improvement in the first few months of the year. With financial market sentiment fragile and fiscal consolidation ongoing, economic activity will remain weak in the euro area for some time.

In the March quarter, euro area exports picked up, retail sales and indicators of investment stopped falling, and there was a slight improvement in sentiment (Graph 1.10). Activity in Germany and France continues to be a little stronger than conditions in the troubled euro area economies, though growth remains weak overall. Industrial production and orders stopped falling in Germany in January and February, although retail sales have fallen a little further since the beginning of the year. In contrast with other German economic indicators, the labour market continues to strengthen, with the unemployment rate at its lowest level since Germany's reunification in the early 1990s. In France, domestic demand picked up modestly, abstracting from volatility in motor vehicle sales related to tax changes; retail sales increased and indicators of investment improved in recent months. The unemployment rate in France remains elevated. Although these two larger economies are performing better than others in the euro area, they continue to be affected by concerns about other euro area countries, with the composite PMIs falling in France and Germany in April.

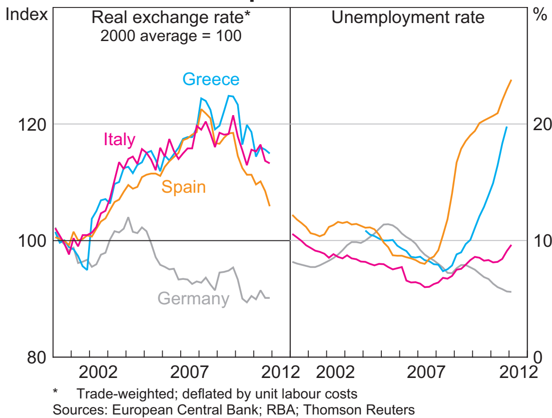
Graph 1.10
Euro Area – Economic Indicators



Sources: Markit Economics; Thomson Reuters

Conditions in euro area economies with significant competitiveness and sovereign debt issues remain difficult, with the negative feedback loop between fiscal consolidation and growth clearly evident. Domestic demand continues to fall and labour markets are very weak. Unemployment rates are very high and still rising (Graph 1.11). Some of these economies are progressing with structural reforms, but it will be some time before these translate into improved economic performance. Although competitiveness has improved somewhat over the past year, reflecting both the depreciation of the euro and declines in unit labour costs, most of these economies remain less competitive than they were a decade ago.

Graph 1.11
Euro Area – Competitiveness and Labour



* Trade-weighted; deflated by unit labour costs
Sources: European Central Bank; RBA; Thomson Reuters

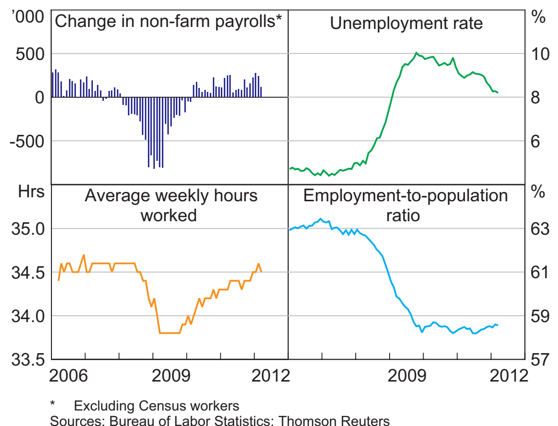
Consistent with the substantial spare capacity in the euro area, core inflation remains contained. However, recent rises in oil prices are resulting in elevated rates of headline inflation and, if oil prices remain high, may create more generalised inflationary pressures.

United States

The United States has continued to grow at a moderate pace so far in 2012. Payrolls data suggest that employment increased by an average of over 210 000 in the first three months of the year (Graph 1.12). The unemployment rate has declined by 0.8 percentage points over the past six months, although this partly reflects some decline in the participation rate; the employment-to-population ratio has increased only slightly over the same period. Average hours worked have also picked up and are around their early 2008 levels. Forward-looking indicators of employment continue to improve with initial jobless claims trending lower, despite some recent volatility, and survey measures of employment still positive. Nonetheless, employment remains well below its previous peak, and the long-term unemployment rate is still very high.

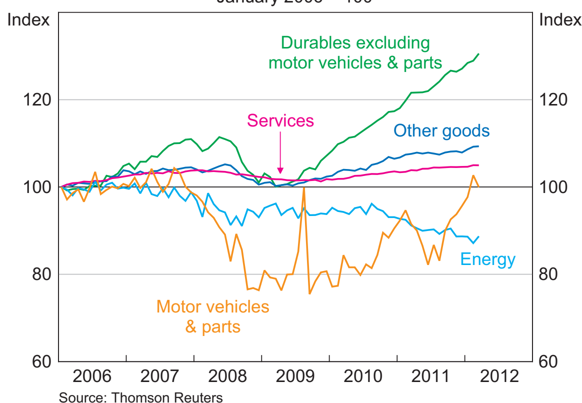
The improvements in the labour market have helped to support consumption. Household consumption increased by 2½ per cent in annualised terms over the six months to March, slightly below its long-run

Graph 1.12
United States – Labour Market Indicators



* Excluding Census workers
Sources: Bureau of Labor Statistics; Thomson Reuters

average pace. Purchases of motor vehicles have accounted for more than one-third of this increase, reflecting a catch up from very low motor vehicle sales over the past four years and the easing of supply-chain disruptions in east Asia (Graph 1.13). Spending on other durables has been increasing at around its average pace. However, the large contraction in the budget deficit legislated for early 2013 is likely to reduce household disposable income, and the uncertainty about its size and composition may weigh on household expenditure this year and next.



Although indicators of housing market activity have picked up a little in recent months, including some signs of stabilisation in house prices, they remain very weak. There is considerable uncertainty about the outlook for the housing market. Even though construction remains at low levels, the large number of mortgages in foreclosure will make a substantial contribution to the stock of homes for sale over the next couple of years. At the same time, the population continues to grow steadily, the labour market is improving and rents are rising, all of which will help to support demand for housing. Nonetheless, with many households still owing more on their houses than they are worth, the housing market will continue to weigh on economic activity for some time.

In contrast to the generally improving household indicators, business sector indicators have been less positive in the first few months of 2012. After increasing rapidly through the first two years of the recovery, growth in business investment appears to have slowed, with core capital goods orders only modestly higher over the six months to March. Industrial production has been broadly flat over the first few months of 2012, although the ISM manufacturing index is a little above its December level.

Consumer price inflation in the United States remains contained, with core inflation at 2 per cent over the year to March (based on personal consumption expenditure). However, headline inflation has picked up again in recent months, reflecting the flow-through of higher oil prices to petrol prices.

Commodity Prices

The RBA's Index of Commodity Prices (in SDR terms) is broadly unchanged since the February *Statement* (Table 1.1). The index remains at a historically high level, but is around 9 per cent lower than its peak in mid 2011. In general, commodity prices have been supported by the gradual pick-up in global economic activity since the start of the year, though increases in some prices have been partially retraced over April (Graph 1.14). Spot prices for iron ore and base metals have all increased, while spot prices for both thermal and coking coal have declined in recent months, largely reflecting increased supply. Australia's terms of trade are estimated to have declined further in the March quarter, as average export prices for bulk commodities continue to decline gradually from their September 2011 peak.

Global oil prices have increased sharply over recent months. The price of Brent crude oil rose to its highest level in US dollar terms since mid 2008 but has since fallen a little (Graph 1.15). The increase in oil prices reflects, in large part, supply-side constraints, with a tightening of sanctions on the Iranian oil trade and political tensions in South Sudan, Syria and Yemen. There has been a shift towards using Brent as the

Table 1.1: Commodity Price Growth[a]

SDR, per cent

	Change since previous *Statement*	Change over the past year
Bulk commodities		
– Iron ore	1	–18
– Coking coal	–1	–31
– Thermal coal	–16	–16
Rural	–5	–9
– Beef	1	7
– Cotton	–5	–41
– Wheat	–10	–21
– Wool	–8	–13
Base metals	–6	–15
– Aluminium	–7	–22
– Copper	–2	–6
– Lead	–1	–11
– Nickel	–20	–33
– Zinc	–5	–6
Gold	–5	12
Oil[b]		
– US$ terms	2	–4
RBA ICP	–1	–8

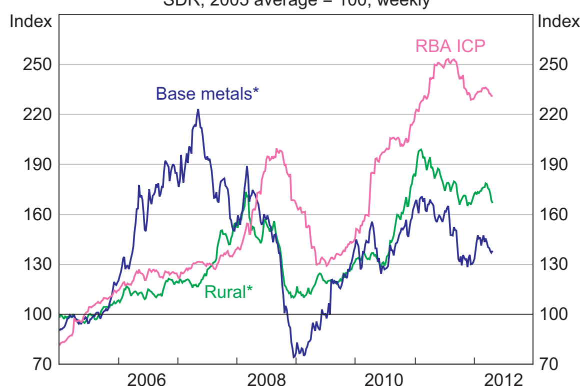
(a) RBA Index of Commodity Prices (ICP) components except oil and bulk commodities, which are spot prices; latest available

(b) Average of Brent and Tapis crude oil prices

Sources: Bloomberg; RBA

Graph 1.14
Commodity Prices

SDR, 2005 average = 100, weekly



* RBA Index of Commodity Prices (ICP) sub-indices

Source: RBA

Graph 1.15
Brent Crude Oil Price

Weekly

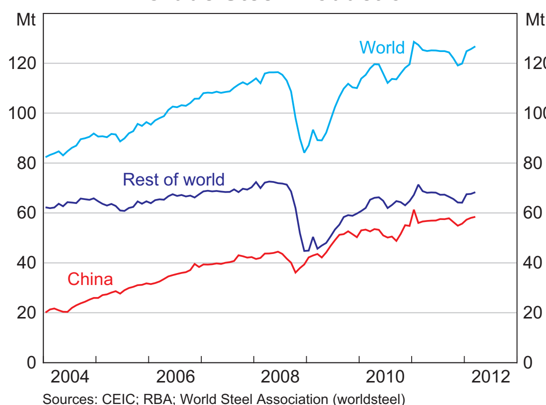
Source: Bloomberg

global benchmark for oil, with two-thirds of traded crude oil varieties now reportedly benchmarked to Brent. Other oil price benchmarks have also risen strongly over recent months.

The spot price for thermal coal has fallen by around 16 per cent since the February *Statement*. The contract price for the Japanese Fiscal Year 2012 has recently been finalised by producers and Japanese utilities at around US$115 per tonne, which is higher than the current spot price and is around 12 per cent below the previous year's contract price.

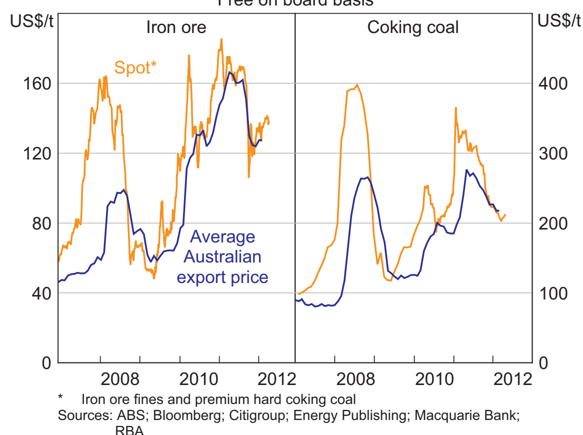
World steel production edged higher over the March quarter, with steel production in China increasing following a small drop in production in late 2011 (Graph 1.16). This, together with weather-related supply disruptions in Australia and Brazil, is likely to have provided some support to spot prices for iron ore in recent months. Since the beginning of the year, the spot price has increased by around 8 per cent but remains below the peak reached in September last year (Graph 1.17). The average Australian export price will be more closely aligned with the spot price (and less dependent on quarterly contract prices) than in previous years, reflecting the larger share of coal being sold at spot prices. Spot prices for coking coal appear to have stabilised in recent months but are around 5 per cent lower since the end of last year, which is largely the result of production in Queensland returning to around

Graph 1.16
Crude Steel Production



Sources: CEIC; RBA; World Steel Association (worldsteel)

Graph 1.17
Bulk Commodity Prices
Free on board basis



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

its levels prior to the flooding in early 2011. The benchmark quarterly contract price was recently settled at around US$210 per tonne, 11 per cent below the previous quarter, which is broadly in line with the current spot price.

Base metal prices have drifted lower since February but are still higher than they were at the start of the year. Prices have generally been supported by the pick-up in global economic activity, while supply disruptions may have provided some support to the price of copper. In contrast, the aluminium spot price is currently at a level that is low enough to induce further reductions in aluminium production outside of China. The spot price of nickel has declined substantially, in part reflecting strong growth in supply. The price of gold and silver has increased over 2012 to date.

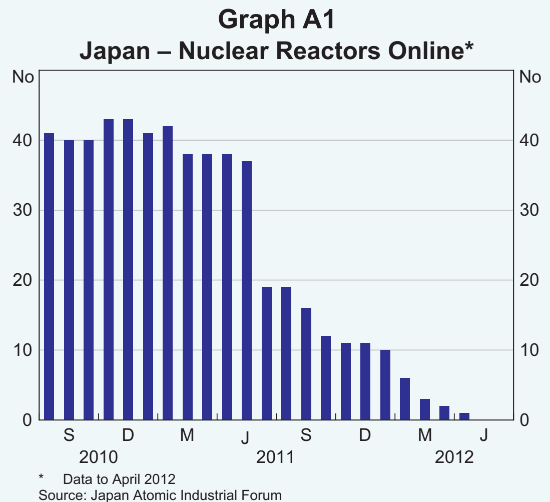
Global food prices have remained at high levels since the start of 2012. Nevertheless, they are considerably lower than the peaks in late 2010/early 2011 that were associated with supply disruptions. Recent trends among agricultural commodities have been divergent, with favourable supply conditions in the United States lowering prices for wheat, whereas canola and barley prices have risen.

Box A

Electricity Supply in Japan

Japan is Australia's second largest trading partner, and the primary destination for exports of coal and liquefied natural gas (LNG), both used in thermal power generation. Over recent years, Japan relied on thermal energy sources for around 60 per cent of its electricity generation and nuclear power for around 30 per cent. However, since the nuclear crisis at Fukushima, almost all Japanese nuclear power plants have been shut down, so the share of thermal energy sources in electricity generation is now around 90 per cent. Assuming it is sustained, this shift away from nuclear power generation is likely to continue to boost demand for coal and LNG. In the near term, uncertainty about electricity supply poses a significant risk for economic growth in Japan. There is a considerable chance that the electricity generation capacity currently in use will not be sufficient to meet the increase in demand ordinarily experienced in the Japanese summer months.

Since the nuclear crisis at Fukushima that followed the March 2011 earthquake and tsunami, concerns about the safety of nuclear power plants throughout Japan have led to a steady decline in the number of plants operating (Graph A1). Plants have not restarted after routine maintenance, even after passing new stress tests in some cases, and at this stage none of Japan's 54 nuclear plants have been approved to operate over the summer months; the only plant still operating is scheduled to be shut down in early May. It is uncertain when, and how many, nuclear plants will be restarted. There has been an expansion of other forms of electricity generation, but this is unlikely to fully compensate for reduced nuclear power. The capacity to meet demand for electricity over the summer, when demand is strongest, is also uncertain as electricity



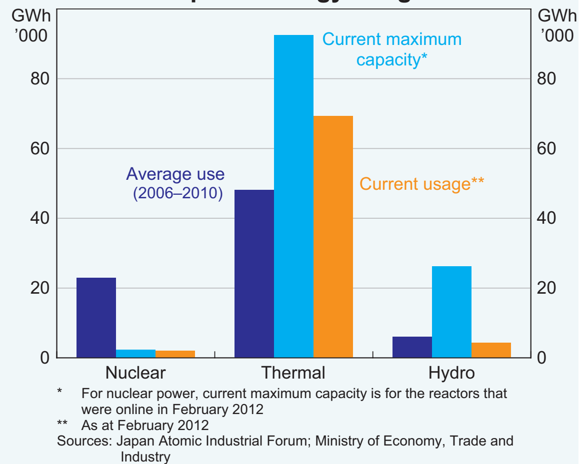
demand will depend on how hot summer will be this year. How businesses and households respond to the reduction in capacity and uncertainty about the extent of any shortfall relative to demand could have implications for economic growth.

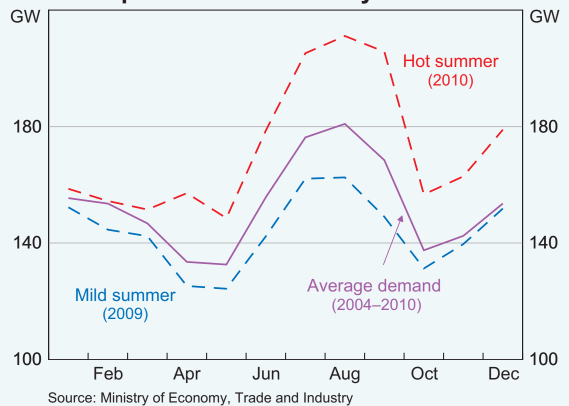
To date, local governments have not authorised the reopening of any nuclear plants in the face of public distrust of nuclear power. More stringent standards for nuclear power plants have been introduced since the earthquake and further tests are being conducted. Nevertheless, given public concern over safety, it is unclear whether, following the completion of the second round of testing, local governments will approve the reopening of any plants before the coming Japanese summer.

The loss of nuclear capacity has been offset somewhat by having fewer thermal power stations offline for maintenance and by recommissioning older plants. The most important factor helping to support supply, however, is the more intensive use of thermal power stations, particularly LNG and

oil-fuelled stations. Because these stations have high generating costs but are relatively easy to start up, they usually operate only when demand is high; the average utilisation rate in normal times for these stations is around 40 per cent (Graph A2). In recent months, these power stations have been used much more in order to satisfy demand. This has resulted in a large pick-up in imports of thermal fuels, particularly LNG. At the margin, increased use of private generators has also boosted electricity capacity (though this is not reflected in the official statistics). Overall, if nuclear plants are not reopened, aggregate generation capacity could be around 18 per cent below what is usually available (although nuclear plants account for 24 per cent of authorised generation capacity in Japan, typically one-quarter are offline at any time for maintenance).

Japan experienced energy supply shortages in the summer of 2011, but these were mainly limited to the Kanto (including Tokyo) and Tohoku regions, which were directly affected by the earthquake and tsunami. Many nuclear power plants in the rest of Japan were still operating. But now, with nuclear plants shut down across the country, electricity shortages are expected to be more widespread during the coming summer if nuclear plants are not reopened. From July to September, peak demand for electricity from the 10 regional electricity companies is around 20 per cent higher, on average, than at other times of the year, and up to 50 per cent higher if the weather is particularly warm (Graph A3). With little scope to further increase output at thermal plants, there is likely to be a shortage of electricity in the summer months if there is a strong increase in demand. The maximum supply of electricity could be as low as 160 gigawatts in the summer months, around what was required in the mild summer of 2009, although it could be somewhat higher if private electricity generation increases in response to the expected shortfall.





Any electricity shortages during the summer months are unlikely to affect all regions of Japan equally as there is only limited scope to transfer electricity between regions. Those regions that have traditionally been more reliant on nuclear power for electricity generation, such as Kansai, Kyushu and Shikoku, are likely to be most affected. These three regions account for around 30 per cent of all manufacturing production in Japan.

Demand management targets, some of which were voluntary, were effective in limiting the impact of electricity supply shortages on economic activity

in the Kanto and Tohoku regions last summer, and are likely to be applied again this summer if a large number of nuclear stations are not restarted. These targets focused on reducing electricity used by households and businesses. They were flagged well in advance of summer, enabling businesses to mitigate the effect on output by shifting production to weekends, holidays and nights to avoid peak demand times and by carrying out more electricity-intensive production in June, before the peak summer period. Although there is widespread acknowledgement of the risks to energy supply over the coming summer, very few businesses have openly stated that they are increasing production ahead of the peak demand period this year. Further, a business survey has found that around 15 per cent of firms may be less willing to save as much energy this summer as they did last summer. If demand management measures fail to compensate for any shortfall, it is likely that areas will be subject to rolling blackouts, as occurred in the Kanto region directly after the 2011 earthquake. Rolling blackouts (and even an increased risk of unscheduled blackouts) could reduce output substantially, particularly in industries such as electronics and chemicals that need a reliable supply of electricity.

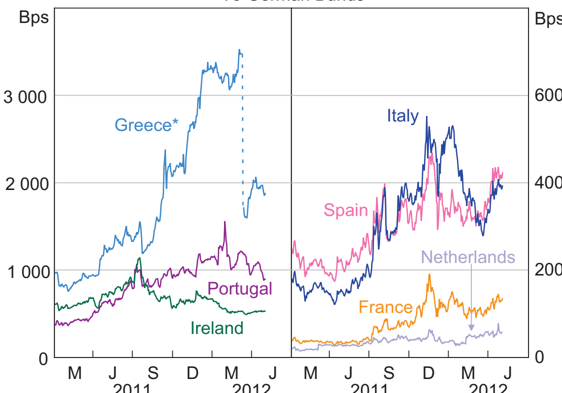
The rapid increase in generation from thermal power plants has increased the cost of electricity. For example, the cost to the Tokyo Electric Power Company (TEPCO) – one of the 10 regional electricity companies – of generating electricity has reportedly increased by around 20 per cent. Electricity rates paid by households, which are set by the government, are due to rise a little in June across Japan. TEPCO has already raised its rates to large users by 17 per cent. If firms perceived this to be long-lived, it would be likely to lead to higher prices and reduced economic activity. Persistently higher energy costs would also be likely to accelerate the relocation of Japanese production to elsewhere in the Asian region, particularly for industries where energy makes up a large share of production costs. ✠

2. International and Foreign Exchange Markets

Sovereign Debt Markets

Global market sentiment improved noticeably in the early part of 2012, due to large-scale lending to banks by the European Central Bank (ECB), the approval of a second assistance package for Greece and generally better-than-expected US economic data. This was reflected in a sharp narrowing in spreads between yields on euro area 'periphery' government bonds and German Bunds between November last year and March 2012 (Graph 2.1). Spreads have since widened again as the state of euro area public finances has come under renewed scrutiny but, at this stage, markets are not showing the degree of strain they were in late 2011.

The approval of Greece's second assistance package by the European Union (EU) and the International Monetary Fund (IMF) in March followed agreement on the restructuring of private holdings of Greek government debt, and resolved the uncertainty about whether Greece could meet its near-term debt payments. The package provides €130 billion in financial support, in addition to the remaining €34 billion that had not yet been disbursed under the first assistance package. As part of the package, most private holders of Greek bonds participated in a debt swap, under which they agreed to a haircut by swapping their existing Greek bonds for newly issued debt. See 'Box B: The Greek Private Sector Debt Swap' for further details.



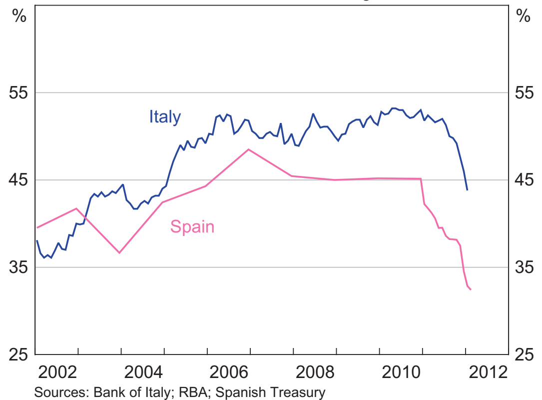
The net result of the debt restructuring and additional public support is that Greece's government debt-to-GDP ratio is expected to be little changed in the near term. Over a longer horizon, the debt-to-GDP ratio is projected to fall to around 120 per cent by 2020. However, this itself does not ensure debt sustainability and the IMF has noted that the projection is subject to significant uncertainties, including those surrounding the economic outlook and the challenges that Greece faces in implementing the agreed reforms.

Outside of Greece, much of the focus in European sovereign debt markets has been on developments in Italy and Spain. Spanish yields are now higher than those on Italian government debt, whereas the opposite was the case for much of the previous six months. After falling markedly earlier in 2012, yields on long-term Spanish government bonds rose to more than 6 per cent in April for the first time since November last year (Graph 2.2). The recent rise reflects concerns about Spain's ability to achieve its fiscal deficit target amid weakening domestic

Graph 2.2
10-year Government Bond Yields

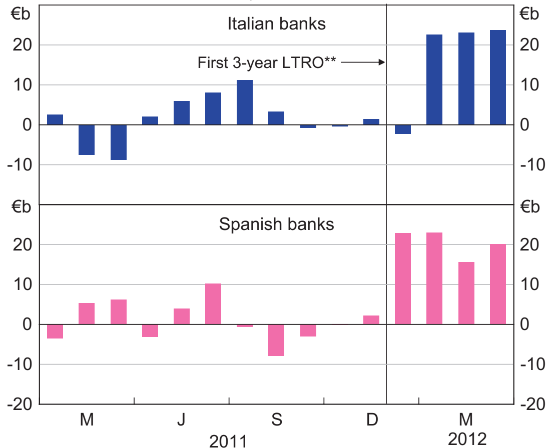
Source: Bloomberg

Graph 2.3
Foreign Holdings of Central Government Debt Securities
Share of total outstanding



Sources: Bank of Italy; RBA; Spanish Treasury

Graph 2.4
Net Purchases of European Government Debt Securities
By banks*



* Monetary financial institutions
** Longer-term refinancing operation
Source: European Central Bank

economic activity. The Spanish Government's fiscal deficit target for 2012, agreed with the European Commission, is now 5.3 per cent of GDP, from the previously agreed 4.4 per cent. In late April, Standard & Poor's downgraded Spain's sovereign credit rating two notches from A to BBB+. At around 4 per cent of GDP, Spanish central government bond maturities for the remainder of the year are lower than the equivalent ratios for some other euro area members, and the Spanish Government has already raised half of its anticipated 2012 long-term funding requirements. Italian government bond yields also remain elevated. Yields had declined from their 2011 peaks as investors showed some confidence in the new Italian Government's fiscal reforms, before partly retracing this fall.

The composition of ownership of Italian and Spanish government bonds has shifted considerably, with the share of foreign holdings falling over recent quarters (Graph 2.3). The rapid shift in these shares suggests that foreign investors have been selling government securities, as well as letting their existing positions mature. In contrast, Italian and Spanish banks have purchased a large volume of government securities since the ECB's first 3-year loan operation in December (Graph 2.4). Spanish banks purchased around €80 billion of European government securities in the four months to March, while Italian banks purchased around €65 billion. This compares with gross issuance of €85 billion and €165 billion by the Spanish and Italian central governments over the same period.

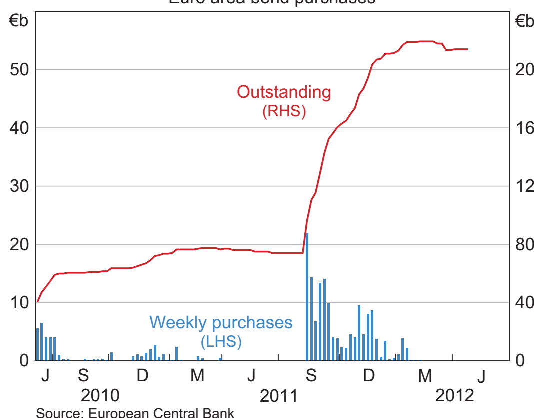
Officials from the IMF and European Commission have completed their third review of Portugal, noting that the program is on track overall but risks remain. One of these is the ability of Portugal to regain market access in 2013, as is currently assumed under its assistance package. Spreads between yields on Portuguese government bonds and German government bonds are lower than they were at the beginning of the year, but remain elevated.

French government bond spreads have widened recently, partly because of uncertainty about the political situation. The French presidential election is to be held on 6 May. In the Netherlands, spreads widened briefly after the coalition government resigned amid difficulty negotiating austerity measures intended to reduce the budget deficit to 3 per cent of GDP by 2013.

Even though spreads in the euro area have widened recently, the ECB has not purchased sovereign debt under its Securities Markets Program since early March. Purchases were reduced significantly after the ECB's 3-year loan operations (Graph 2.5).

Euro area policymakers have continued to increase the amount of financial assistance that could potentially be provided to member states. The joint lending capacity of the European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM) was increased to €700 billion, from €500 billion. In effect, the €500 billion in lending capacity of the ESM has been added to existing EFSF commitments of €200 billion for the assistance programs in Greece, Ireland and Portugal. In addition, a further €100 billion has already been committed by European governments through the bilateral Greek loan facility and the European Financial Stabilisation Mechanism (EFSM). Euro area members have also committed to provide €150 billion in additional bilateral contributions to the IMF.

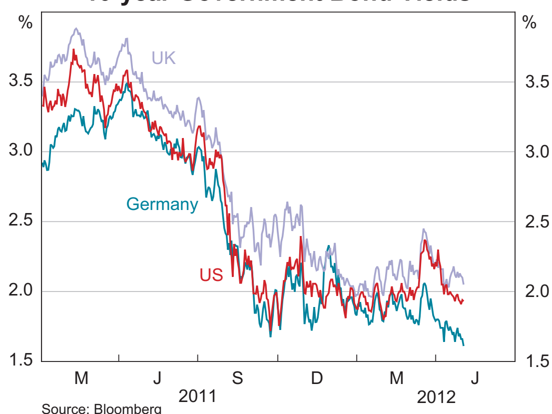
Graph 2.5
ECB Securities Markets Program
Euro area bond purchases



Source: European Central Bank

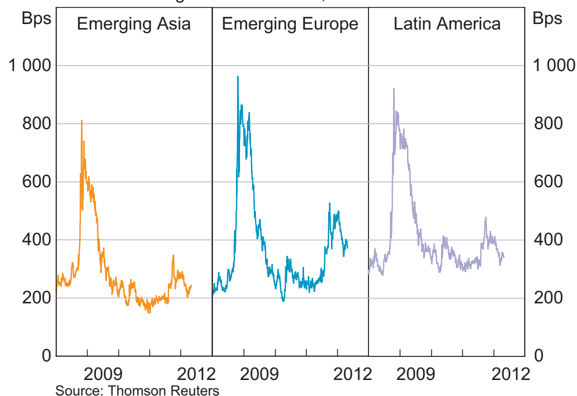
Government bond yields in the major advanced economies remain at historically low levels (Graph 2.6). Yields on 10-year US and UK government bonds are back around 2 per cent, after temporarily rising in March. German 10-year government bond yields have fallen to a historical low, and short-term German government paper continues to trade at yields of around zero. Spreads on US dollar-denominated debt issued by emerging market sovereigns have narrowed over the past few months, but have not fully unwound the sharp rise from August last year (Graph 2.7).

Graph 2.6
10-year Government Bond Yields



Source: Bloomberg

Graph 2.7
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched



Source: Thomson Reuters

Central Bank Policy

A number of central banks have eased monetary policy in recent months (Table 2.1). The Central Bank of Brazil lowered its policy rate target by 75 basis points on two occasions, bringing the cumulative reduction to 350 basis points since August 2011. The Reserve Bank of India (RBI) reduced its policy rate by 50 basis points, to 8 per cent, which was the first cut in around three years. In addition, the People's Bank of China (PBC) and the RBI lowered banks' reserve requirement ratios, following similar moves in late 2011/early 2012.

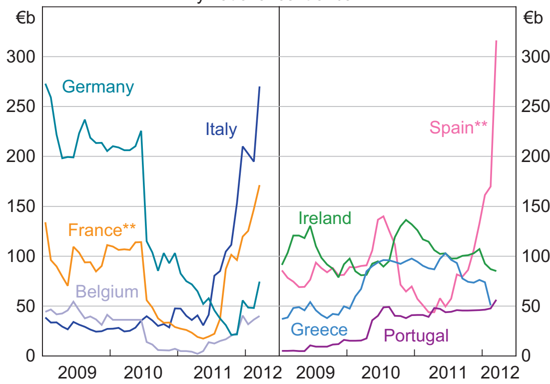
The ECB provided €530 billion of 3-year loans to banks at its policy rate in February (of which around €200 billion represented maturities and extensions of much shorter loans). This was the second of the two scheduled 3-year lending operations by the ECB, with the total amount supplied to banks under the two operations surpassing €1 trillion. Prior to the second operation, the ECB announced a further temporary broadening of eligible collateral to include some lower-rated securities and bank loans in some instances. These measures were adopted in seven euro area countries and are estimated to have increased banks' effective funding capacity by around €200 billion.

Lending through the national central banks of Italy and Spain has increased particularly sharply, with a significant increase in lending also recorded by the French central bank (Graph 2.8). However, not all

Table 2.1: Policy Rates

	Current level Per cent		Most recent change	Change from 2011 peak Basis points
Euro area	1.00	↓	Dec 11	–50
Japan	0.05	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Brazil	9.00	↓	Apr 12	–350
Canada	1.00	↑	Sep 10	–
China	6.56	↑	Jul 11	–
India	8.00	↓	Apr 12	–50
Indonesia	5.75	↓	Feb 12	–100
Israel	2.50	↓	Jan 12	–75
Malaysia	3.00	↑	May 11	–
Mexico	4.50	↓	Jul 09	–
New Zealand	2.50	↓	Mar 11	–50
Norway	1.50	↓	Mar 12	–75
Russia	8.00	↓	Dec 11	–25
South Africa	5.50	↓	Nov 10	–
South Korea	3.25	↑	Jun 11	–
Sweden	1.50	↓	Feb 12	–50
Switzerland	0.00	↓	Aug 11	–25
Taiwan	1.875	↑	Jun 11	–
Thailand	3.00	↓	Jan 12	–50
United Kingdom	0.50	↓	Mar 09	–

Source: central banks



of the lending by individual national central banks has gone to locally owned banks, particularly in the periphery. It appears that some banks have increased borrowing from central banks in countries in which they have subsidiaries, whereas previously they would typically have borrowed from the central bank in the country where their head office is located. As discussed above, some banks in euro area periphery countries appear to have used ECB funding to purchase sovereign debt, placing downward pressure on government bond yields for those countries. Banks also made significant use of the funds to meet redemptions of maturing debt.

The US Federal Reserve has purchased around US$315 billion of longer-term US Treasuries as part of its US$400 billion Maturity Extension Program, which is due to be completed by the end of June. The Bank of England has completed the £50 billion expansion of its Asset Purchase Facility, bringing total gilt purchases under the facility to £325 billion. The Bank of Japan (BoJ) also expanded its Asset Purchase Program by a total of ¥15 trillion to ¥70 trillion (US$870 billion). The BoJ has so far purchased around ¥50 trillion of assets under the program, which is due to be completed in June 2013.

Government Financial Policy

The Federal Reserve announced the results of the latest stress tests for large US financial institutions. Of the 19 participating institutions, 15 passed the exercise, indicating that they would meet minimum capital ratios under stressed market conditions. The capital plans, including planned dividend payments and share buybacks, of most institutions were approved. However, a few banks' plans were rejected, including Citigroup. These banks were required to submit new capital plans for approval.

The five largest mortgage servicers in the United States (JPMorgan, Citigroup, Bank of America, Wells Fargo and Ally Financial) reached a US$25 billion settlement with the federal and almost all state governments to address mortgage servicing and foreclosure abuses. The banks will transfer around US$20 billion to mortgage borrowers through principal reductions and other forms of relief, as well as refinance some loans in negative equity. The remainder will be paid to the governments to cover costs resulting from mishandled foreclosures and to help fund programs to aid troubled borrowers. The banks did not receive immunity from further legal action.

The US Government sold approximately US$6 billion of its common equity stake in the insurer AIG. The Government has divested stock when AIG's share price exceeds the price at which it was acquired. The sale reduced the Government's ownership stake from 77 per cent to 70 per cent. AIG has also paid the US Treasury US$8.5 billion to retire preferred shares. The Federal Reserve has completed the sale of the Maiden Lane II portfolio (a special purpose vehicle created to remove mortgage-backed securities from AIG's balance sheet) to private investors, resulting in a US$2.8 billion net profit to the US Government. The Federal Reserve also sold part of its Maiden Lane III collateralised debt obligations portfolio.

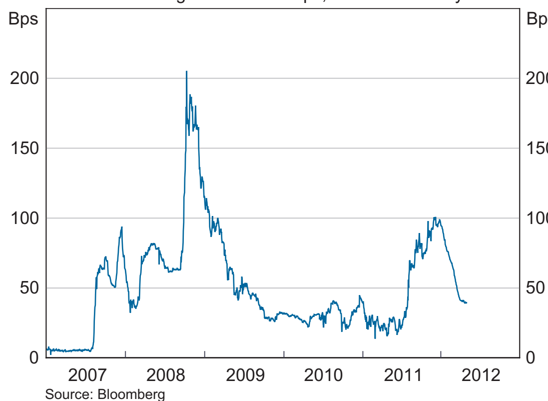
Credit Markets

In contrast to sovereign debt markets, conditions in private credit markets have improved consistently over the past few months, bolstered by the significant increase in liquidity provided by the ECB's 3-year lending operations. The cost of borrowing euros in short-term unsecured interbank markets has fallen to the lowest level since August 2011 (Graph 2.9).

The cost of swapping euros into US dollars in the foreign exchange market (relative to the cost of unsecured interbank funding) has continued to fall (Graph 2.10). In addition, US money market funds, which are significant providers of US dollar liquidity, have slightly increased their holdings of euro area bank debt over recent months. These holdings had fallen significantly over the second half of 2011 (Graph 2.11). At the same time, banks' recourse to central bank US dollar liquidity facilities has declined to around US$30 billion, from US$110 billion earlier in the year. In part, these developments have reflected both an easing of credit quality concerns and the fact that demand for US dollars from European banks has declined as they have shed US dollar assets.

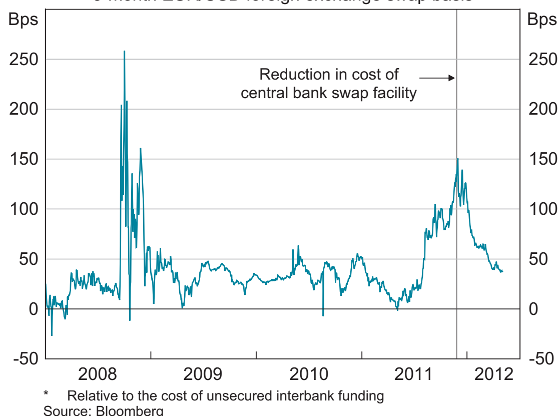
As sentiment towards euro area banks improved following the ECB's 3-year lending operations, banks re-entered the bond market in order to help finance sizeable maturities in early 2012. Euro area banks have issued US$230 billion of bonds so far this year (Graph 2.12). While this is already more

Graph 2.9
Euro Unsecured Interbank Borrowing Spread
To overnight indexed swaps, 3-month maturity



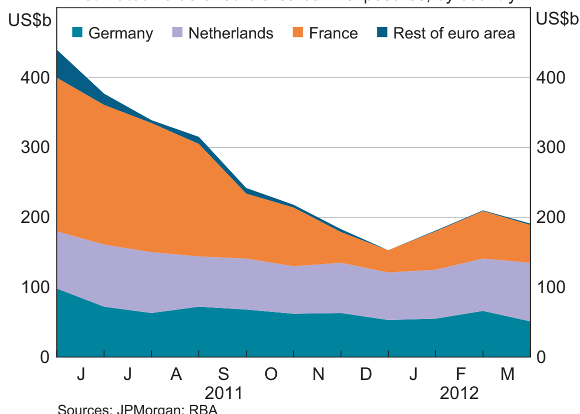
Source: Bloomberg

Graph 2.10
Cost of Swapping Euros into US Dollars*
3-month EUR/USD foreign exchange swap basis



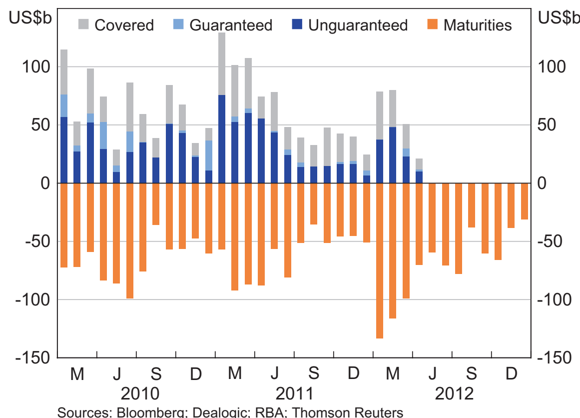
* Relative to the cost of unsecured interbank funding
Source: Bloomberg

Graph 2.11
US Prime Money Market Funds
Estimated value of euro area bank exposures, by country



Sources: JPMorgan; RBA

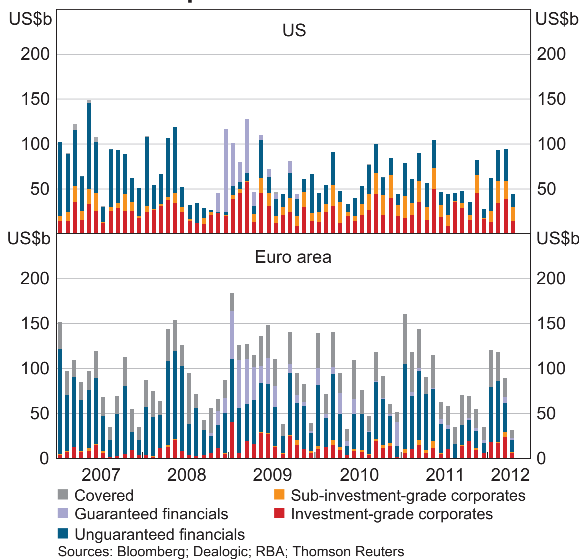
Graph 2.12
Euro Area Bank Bond Issuance

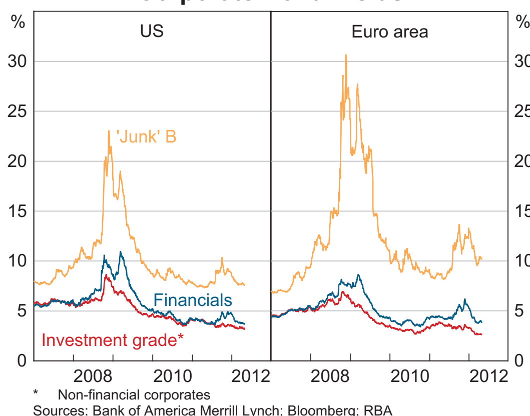


Sources: Bloomberg; Dealogic; RBA; Thomson Reuters

than the amount issued in the second half of 2011, it compares with around US$420 billion in maturing bonds. As noted above, banks made substantial use of the ECB's lending operations to finance maturities.

Corporate bond issuance more broadly also picked up in the March quarter in both the United States and the euro area, with US issuance the strongest in three years (Graph 2.13). The increased issuance is consistent with lower US and euro area bond yields across a range of sectors and classes of risk (Graph 2.14).





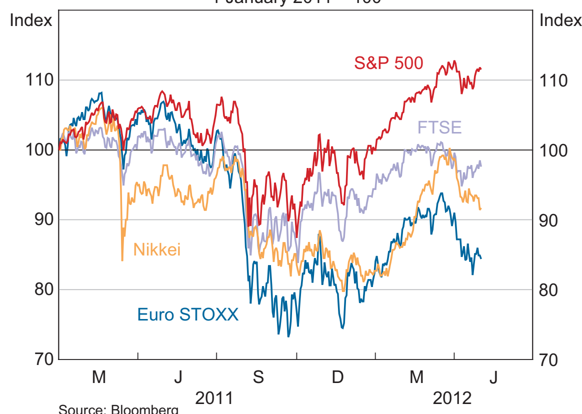
Equities

Equity prices rose strongly in the first few months of the year as market sentiment improved, supported by better-than-expected US data, before declining more recently on renewed European sovereign debt concerns and a winding back of expectations of further monetary policy easing in the United States. Global equity prices have increased by 9 per cent so far this year, after falling by 9 per cent over 2011 (Table 2.2, Graph 2.15). Euro area equity prices have underperformed in 2012, partly because of recent weakness in financial stocks (see below). In contrast, Japanese markets have outperformed over 2012 to date as the yen depreciated, but share prices there have also fallen in recent weeks.

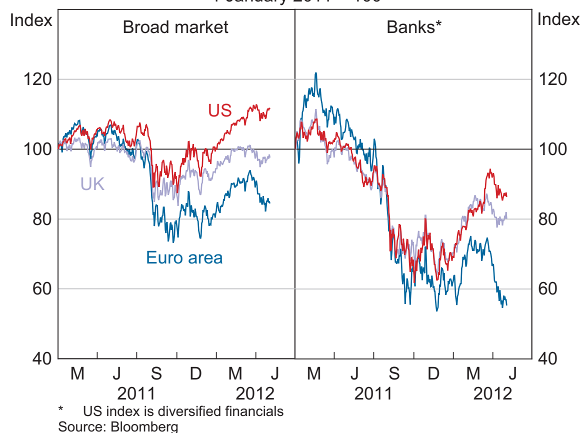
Table 2.2: Changes in International Share Prices
Per cent

	Over 2011	Since end 2011
United States		
– Dow Jones	6	9
– S&P 500	0	12
– NASDAQ	–2	17
Euro area		
– STOXX	–18	3
United Kingdom		
– FTSE	–6	3
Japan		
– Nikkei	–17	11
Canada		
– TSE 300	–11	2
Australia		
– ASX 200	–15	9
China		
– China A	–22	11
MSCI indices		
– Emerging Asia	–16	12
– Latin America	–13	8
– Emerging Europe	–19	5
– World	**–9**	**9**

Source: Bloomberg



Banking sector share prices have been particularly sensitive to shifts in sentiment, with an initial improvement in 2012 giving way to steep falls more recently (Graph 2.16). Euro area bank share prices rose by around 20 per cent between the end of last year and early February 2012, but have unwound this increase in recent months. Despite recent falls, US bank share prices have outperformed the broader market since the start of the year, partly due to increased confidence in the sector after the Fed announced its latest bank stress test results (see section on 'Government Financial Policy'). Earnings of large US banks in the March quarter were generally better than the market had expected, with strong

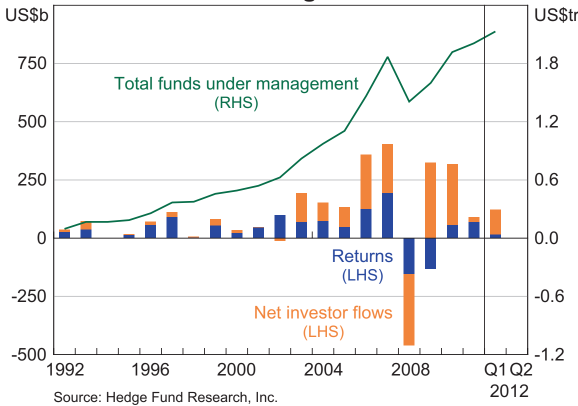


trading revenues and an increase in mortgage-related earnings at a number of banks offset by accounting losses on their own debt and derivative positions. Mergers and acquisitions earnings remain notably weak. Large European banks' earnings reported for the March quarter were mixed.

Chinese share prices have performed better than those in other emerging markets in recent months, after underperforming both developed and emerging markets in 2011 (Graph 2.17). Concerns about slower Chinese growth appear to have been offset by speculation about further monetary policy easing. In Latin America, equity prices fell in Brazil as the government extended a tax on capital inflows.

Hedge Funds

Global hedge funds recorded an average loss on investments of 2 per cent over the year to March, with a positive average return in the March quarter only partly offsetting losses recorded in mid to late 2011. Hedge funds have continued to underperform equity markets, which recorded positive total returns (including dividends) over the year. Funds under management increased to US$2.1 trillion over the March quarter, reflecting the combination of positive investment returns and an increase in investor contributions following a very small withdrawal in the December quarter (Graph 2.18).

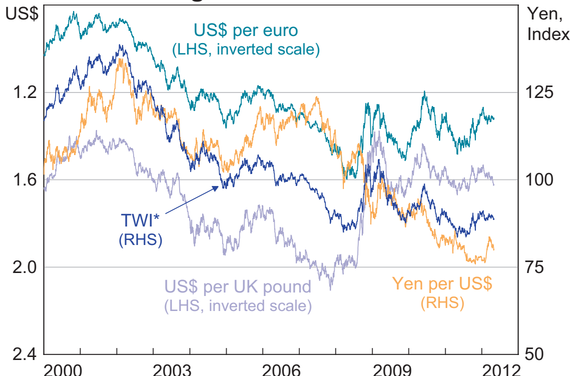


Source: Hedge Fund Research, Inc.

Foreign Exchange

Although global risk sentiment generally improved in the early part of 2012, the recently renewed concerns about the sustainability of European fiscal positions and uncertainty about China's growth outlook have generally weighed on emerging market and commodity currencies and supported the US dollar (Table 2.3). Overall, the US dollar is broadly unchanged in trade-weighted terms since the beginning of the year (Graph 2.19).

The euro had depreciated in late 2011 on increased concerns about the prospects for an orderly resolution to the euro area debt crisis, reaching a low point in mid January prior to the agreement on the



* Indexed to 1 January 2007 = 100
Sources: Bloomberg; Board of Governors of the Federal Reserve System

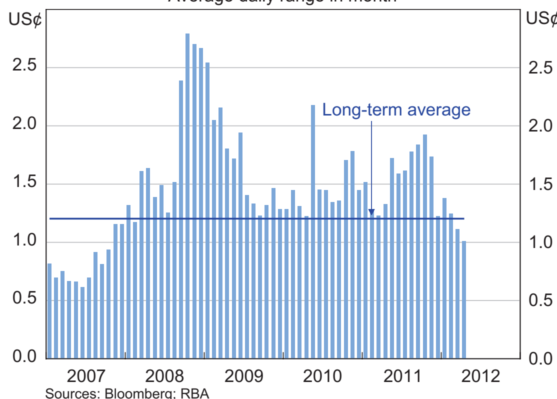
Greek debt package. Since then, notwithstanding renewed concerns about fiscal sustainability in certain euro area countries, the euro has traded within a fairly limited range against the US dollar and intraday volatility has declined to its lowest level since late 2007 (Graph 2.20).

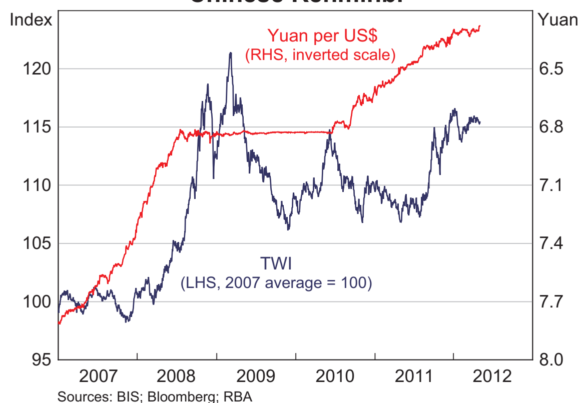
After trading close to its previous high reached in late October, the Japanese yen depreciated by around 9 per cent against the US dollar between early February and mid March, largely in response to the BoJ's decision to increase the size of its Asset Purchase Program and implement an explicit

Table 2.3: Changes in the US Dollar against Selected Currencies
Per cent

	Over the past year	Since previous *Statement*
Brazilian real	21	12
Indian rupee	19	8
Australian dollar	6	4
Japanese yen	–1	4
Indonesian rupiah	8	4
New Zealand dollar	–1	3
South African rand	17	2
Mexican peso	12	2
South Korean won	6	2
Swedish krona	12	2
European euro	13	1
Malaysian ringgit	2	1
Thai baht	3	0
Swiss franc	6	0
Philippine peso	–1	0
Chinese renminbi	–3	0
Singapore dollar	1	–1
New Taiwan dollar	2	–1
Canadian dollar	4	–1
UK pound sterling	3	–2
Majors TWI	**6**	**1**
Broad TWI	**5**	**1**

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





medium-term inflation goal. More recently, a renewal of safe-haven flows into the yen has resulted in around half of the earlier depreciation being retraced. The yen's nominal effective exchange rate is still high by historical standards although in real terms it remains around the centre of its range over the past three decades.

Some renewal in safe-haven flows is also evidenced by the Swiss franc trading increasingly close to the 1.20 francs per euro ceiling imposed by the Swiss authorities last September. The Swiss National Bank (SNB) reiterated its commitment to enforce this ceiling in early April, after a small number of isolated transactions took place above the ceiling between market participants who did not have trading agreements with the SNB. On each occasion, a segmented market could be observed for a very short-lived period, as the banks that purchased Swiss francs for less than the 1.20 francs per euro rate did not receive the best market price.

The pace of appreciation in the Chinese renminbi has slowed in recent months, with the exchange rate broadly unchanged against the US dollar and slightly lower on a trade-weighted basis since the start of the year (Graph 2.21). This has coincided with a softer economic outlook for China and a narrowing in China's trade surplus. The renminbi remains around its highest level since 1994 in real effective terms, reflecting relatively high inflation in China. In April, the PBC widened the renminbi's daily trading band against the US dollar to 1 per cent above or below the daily reference rate (from 0.5 per cent), citing a desire to increase flexibility in the exchange rate in both directions as one reason for the decision. Pricing of non-deliverable forward contracts currently suggests little change in the renminbi against the US dollar in the near term.

China reported an increase in its foreign exchange reserve holdings over the March quarter to US$3.3 trillion (Table 2.4). While the increase is likely to have included a modest valuation effect, it suggests that the PBC resumed its purchases of foreign exchange after indications that it sold foreign exchange in the final quarter of 2011 to support the renminbi.

In late March, the Reserve Bank and the PBC signed a three-year bilateral local currency swap agreement valued at A$30 billion (CNY 200 billion), the main purpose of which is to support trade and investment between Australia and China, particularly in local currency terms.[1] The PBC also signed a three-year bilateral local currency swap agreement with Turkey (valued at CNY 10 billion/US$1.6 billion), and extended and expanded existing swap agreements with Malaysia and Mongolia.

1 This was announced in an RBA Media Release on 22 March. Available at <http://www.rba.gov.au/media-releases/2012/mr-12-08.html>.

Table 2.4: Foreign Currency Reserves
As at end March 2012

	Three-month-ended change		Level
	US$ equivalent (billions)	Per cent	US$ equivalent (billions)
China[(a)]	124	3.9	3 305
Japan	–10	–0.8	1 210
Russia	15	3.4	450
Taiwan	8	2.2	394
Brazil	12	3.6	355
South Korea	10	3.3	308
India	–3	–1.1	260
Thailand	4	2.2	168
Indonesia	0	–0.1	103
Turkey	2	2.6	79
Chile	–2	–6.1	38

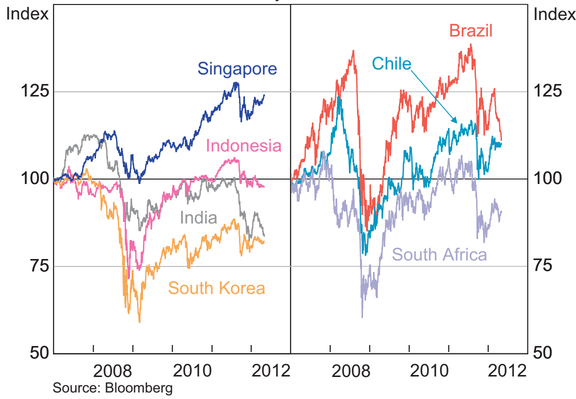
(a) Foreign exchange reserves (includes foreign currency and other reserve assets)
Sources: Bloomberg; CEIC; IMF; RBA

In other developments designed to further the process of internationalising the renminbi, the Chinese authorities significantly increased the total size of foreign investment permitted in Mainland listed bond and equity markets under both the Qualified Foreign Institutional Investors (QFII) scheme for investment using foreign currency and the equivalent scheme for investment using renminbi obtained in the offshore market (RQFII). The authorities also extended the renminbi trade settlement scheme to include all Chinese exporters (the scheme was previously available only to selected Chinese exporters). At a summit held in late March, the BRICS nations (Brazil, Russia, India, China and South Africa) agreed to promote lending by their respective development banks in local currency terms, which would include the China Development Bank offering renminbi loans to the other BRICS nations.

After appreciating modestly earlier in the year, most other emerging Asian currencies have depreciated against the US dollar over recent months and generally remain below their mid 2011 peaks. In contrast, the Singapore dollar has appreciated modestly, supported by the Monetary Authority of Singapore's decision to increase the pace of appreciation in the nominal effective exchange rate. The Indian rupee depreciated relatively sharply, reflecting ongoing concerns about growth and India's reliance on external funding as well as a greater-than-expected monetary policy easing. The currency is now around 17 per cent below its 2011 peak, and only 2 per cent above the multi-decade low it reached in mid December (Graph 2.22). Consistent with the ongoing weakness in the rupee, India's foreign currency reserves declined further over the March quarter, in contrast to the modest reserve accumulation recorded in most other emerging Asian economies.

The currencies of most Latin American countries have also depreciated in recent months. The Brazilian real has depreciated particularly sharply, falling by 12 per cent since late February to be 20 per cent below its mid 2011 peak. The real's sharp depreciation has been partly driven by policy measures including central bank purchases of US dollars in the foreign exchange market and the extension of an existing tax on capital inflows, as well as monetary policy easing.

Graph 2.22
Selected Currencies against the US Dollar
1 January 2007 = 100

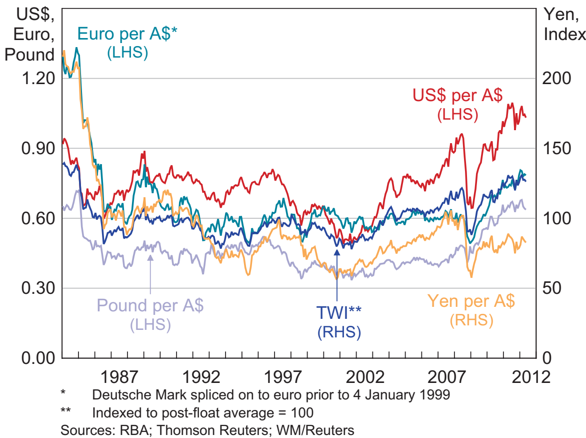


Source: Bloomberg

Australian Dollar

The Australian dollar remains at a high level by historical standards, supported by the continued high level of the terms of trade and strong foreign demand for Commonwealth Government securities (CGS) (Graph 2.23).

Graph 2.23
Australian Dollar



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

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

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

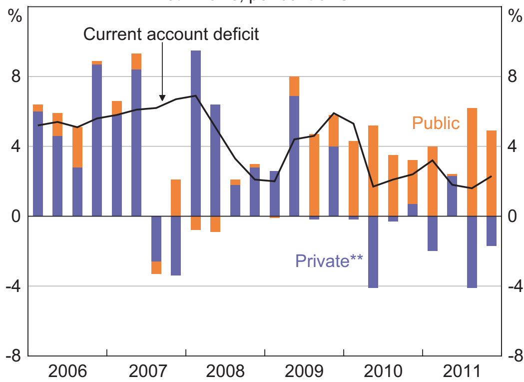
Sources: Bloomberg; Thomson Reuters; WM/Reuters

The currency remains around levels seen at the start of the year (Table 2.5) notwithstanding a likely further decline in the terms of trade in the March quarter (after falling by around 5 per cent in the December quarter), increased concerns about a possible slowdown in commodities demand from China and lower domestic interest rates. Consistent with developments in other currency markets, volatility in the Australian dollar has been well below the levels observed during the second half of 2011.

Capital Flows

Net capital inflows in the December quarter were directed largely towards the public sector, consistent with the trend over the past two years (Graph 2.24). This reflected continued strong foreign demand for CGS, with around three-quarters of the stock of CGS on issue currently held by non-residents. This net inflow to the public sector was partly offset by a small net outflow from the private sector, reflecting a sizeable net outflow from the Australian banking sector.

Graph 2.24
Australian Capital Flows*
Net inflows, per cent of GDP



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

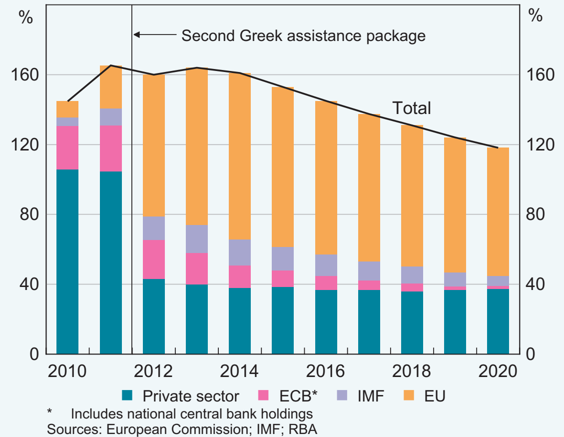
The net outflow from Australian banks in the December quarter was the result of a net reduction in foreign deposits that followed inflows in previous quarters and the net repayment of loans and maturing portfolio debt to foreign investors. In contrast, there were strong debt and equity inflows to Australian private non-financial corporations, with both the mining and non-mining sectors receiving net inflows in the quarter.

Box B

The Greek Private Sector Debt Swap

A key element of the second Greek assistance package of €130 billion was private sector involvement (PSI) in a Greek government debt exchange. Nearly 97 per cent of private sector bondholders participated in the exchange of their Greek government bonds for short-term European Financial Stability Facility (EFSF) notes and new long-term Greek government bonds, which equated to a reduction of 53.5 per cent in nominal terms and around 75 per cent in net present value terms. The majority of bondholders voluntarily participated in the exchange and the Greek Government activated collective action clauses (CACs) to compel most remaining holders to participate. The International Swaps and Derivatives Association (ISDA) subsequently ruled that the activation of CACs constituted a 'credit event' for credit default swaps (CDS) referencing Greek sovereign debt.

The debt swap reduced the amount of Greek government debt outstanding by around €100 billion, although Greece's debt-to-GDP ratio is expected to be little changed in the near term given the additional public support provided under the second package (Graph B1). The composition of outstanding Greek government debt has, however, changed significantly. The private sector now holds 25 per cent of Greek debt, equivalent to around 45 per cent of GDP, compared with 105 per cent of GDP in 2011. Official sector creditors (including the European Union (EU), European Central Bank (ECB) and International Monetary Fund (IMF)) have increased their claims to around 115 per cent of GDP. Greek government debt is projected by the IMF to fall to around 120 per cent of GDP by 2020.



The Debt Swap Deal

Of the €356 billion of Greek government debt outstanding prior to the bond swap, €206 billion was eligible for the PSI (Table B1). This included €177 billion of bonds governed by Greek law and €29 billion of foreign-law bonds and government-guaranteed securities. The remaining €150 billion of outstanding Greek debt comprised short-term bills, official sector loans, and the ECB's holdings of Greek bonds, all of which were exempt from the swap. After lengthy negotiations, private holders of Greek government bonds were able to swap their existing bonds for a package of new bonds. For every €100 of bonds swapped, holders received:

- New long-term Greek government bonds with a face value of €31.5 and maturities ranging from 11 to 30 years. These bonds have coupon payments that will increase from 2 per cent initially to a maximum of 4.3 per cent in 2022 and beyond.

Table B1: Greek Government Debt Holdings
As at end 2011

	€ billion	Share of total Per cent
Total	**356**	**–**
of which:		
PSI eligible	206	58
– Greek law bonds	177	50
– Foreign-law bonds and government-guaranteed securities	29	8
Other	150	42
– ECB bond holdings	57	16
– EU loans	53	16
– IMF loans	21	6
– Bills and other	19	5

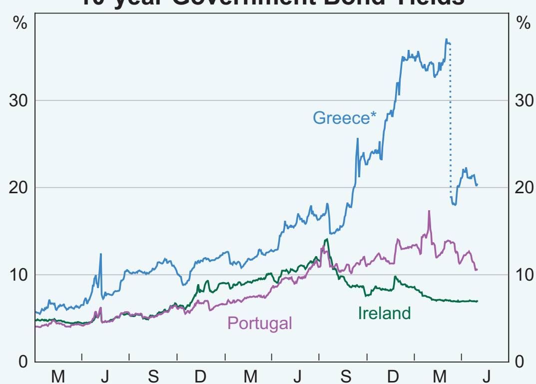
Sources: European Commission; RBA

- €15 in short-term EFSF notes.
- Detachable GDP-linked securities, which provide an additional coupon payment should future Greek GDP exceed current projections.

Around 85 per cent of eligible holders of bonds governed by Greek law agreed to participate in the debt swap. The Greek Government then activated CACs that had been retroactively inserted into the contracts for these bonds, compelling the remaining Greek law bondholders also to participate. In addition, more than 70 per cent of foreign-law bondholders have taken part, increasing the overall participation rate in the bond swap to 97 per cent. The participation rate was at the upper end of market expectations, and alleviated earlier concerns that the PSI may not be successful and that Greece would therefore not receive the additional official assistance.

The net present value loss accepted by private sector bondholders was around 75 per cent based on market pricing immediately following the bond exchange, although the losses will have varied according to the exact bond that investors held prior to the exchange. New Greek government bonds began trading in mid March at yields of around 18 per cent and have since risen to around 20 per cent, noticeably above yields on bonds issued by other euro area governments that have received EU/IMF assistance packages (Graph B2).

Graph B2
10-year Government Bond Yields



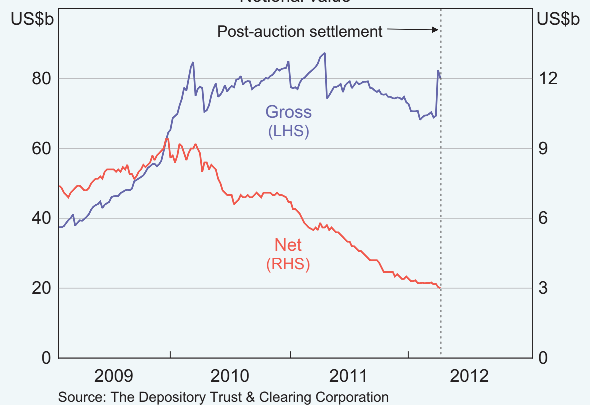
* Data from 12 March 2012 are yields on Greek bonds post private sector debt swap
Source: Bloomberg

Greek Sovereign CDS Credit Event Auction

As noted above, the activation of CACs constituted a 'credit event' for CDS referencing the Greek sovereign. Credit event auctions are the standard mechanism used in the settlement of CDS contracts after a credit event has been declared. The auction process establishes a uniform recovery value of the defaulted debt, which is then used to determine the payment from sellers of CDS to buyers. The recovery value is akin to a secondary market price of a claim on the defaulted entity.

Market participants conducted the Greek auction on 19 March but as the old Greek law bonds had already been exchanged, the securities used in the auction included the newly issued bonds. The payout rate was determined to be 78.5 per cent; that is, the buyer of a US$10 million CDS contract would have received a payment of US$7.85 million from the protection seller. In the event, CDS payouts were broadly sufficient to cover the losses that bondholders who had purchased CDS incurred in the private sector debt swap and the result was in line with market expectations.

Despite earlier fears, the market response to the auction was muted. This reflects the fact that Greece's debt restructuring was widely anticipated and that the net value of Greek sovereign CDS outstanding was relatively small. Although the gross value of outstanding CDS contracts referencing the Greek sovereign was around US$80 billion at the time of the auction, actual (net) exposures were much smaller, at around US$3 billion, once the value of offsetting transactions between counterparties was taken into account (Graph B3). Payments on Greek sovereign CDS were completed in late March. ✠



3. Domestic Economic Conditions

Output grew at a below-average pace of 2.3 per cent over 2011, as the surge in mining investment was offset by softer growth in other parts of the economy (Graph 3.1, Table 3.1). With work under way on a number of large-scale mining projects, investment in the mining sector is estimated to have grown by more than 60 per cent over 2011; close to half of this is estimated to have been imported. Household consumption grew at an around trend pace, supported by growth in household incomes. However, the high level of the exchange rate, along with weaker international conditions, weighed on other parts of private demand, and public demand also declined.

The available partial indicators and liaison suggest that the domestic economy has been growing at a modest pace in early 2012. Measures of business and consumer sentiment remain around, or a little below, long-run average levels. Employment growth picked up modestly in the March quarter, but outside of the mining industry, growth in labour demand remains subdued. Conditions faced by non-mining firms are soft, with the exception of those servicing the mining sector. Indicators of future building activity remain at low levels, while the high level of the exchange rate continues to weigh on import-

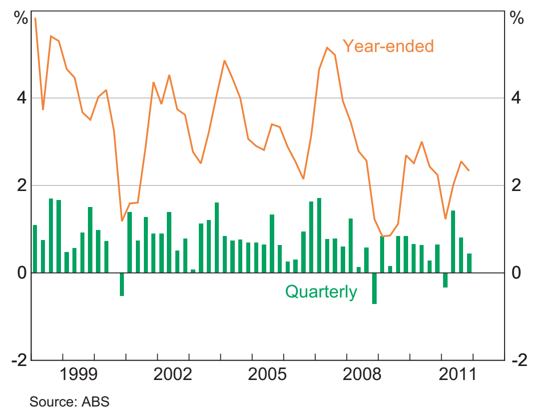
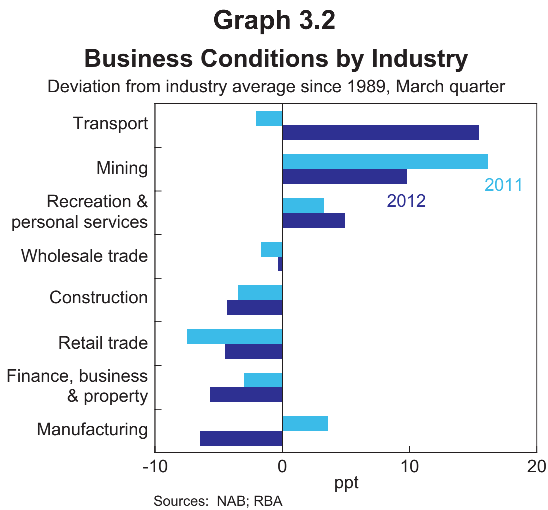


Table 3.1: Demand and Output Growth
Annualised, per cent

	January–June 2011	July–December 2011
Domestic final demand	4.2	4.7
– Private demand	4.9	7.3
– Public demand	2.0	–3.6
Change in inventories[(a)]	0.6	–0.2
GNE	5.3	4.2
Net exports[(a)]	–1.9	–0.6
GDP	2.2	2.5
Nominal GDP	7.4	3.8
Real GDI	5.7	2.0

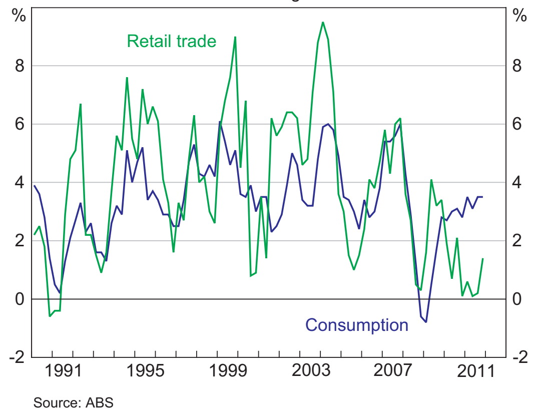
(a) Contribution to GDP growth
Source: ABS

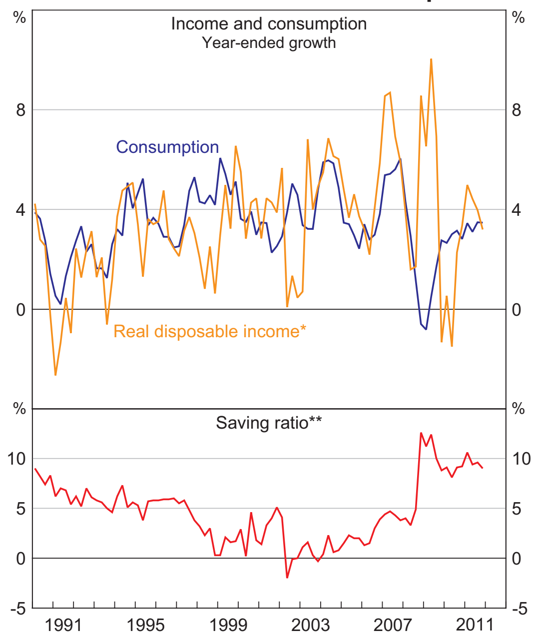
competing and exporting firms across a range of industries (Graph 3.2). Mining production was temporarily disrupted in early 2012 by a range of factors including adverse weather. Nevertheless, work has continued on the very large pipeline of committed mining projects, with the most recent ABS capital expenditure survey providing further evidence of very strong investment intentions in 2012/13.



Household Sector

Consumer spending grew by around 3½ per cent over 2011, supported by income growth and notwithstanding a decline in wealth and confidence over the year. Data from the national accounts show that growth in total consumption was considerably stronger than growth in retail trade volumes over 2011, which accounts for around one-third of consumption (Graph 3.3). This reflected stronger growth in spending on household services and spending by Australians overseas. Consumer spending grew at around the same pace as household disposable income over 2011, implying a largely unchanged household saving ratio of around 9–10 per cent of income (Graph 3.4). In real terms, household disposable income grew by 3¼ per cent over 2011 as average growth in labour income offset soft growth in interest receipts and dividends and a decline in small-business income.





The pace of growth in consumer spending eased in the December quarter, and the available indicators suggest that the expansion in the March quarter was also modest. The value of retail sales increased slightly in January and February, while motor vehicle sales to

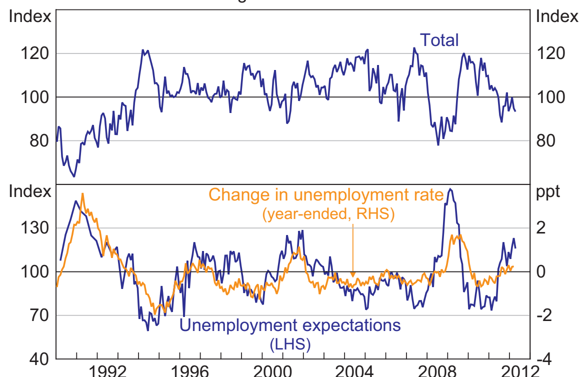
households declined in the March quarter. Among goods retailers, spending in department stores and clothing, footwear & accessories outlets weakened over 2011 – to some extent reflecting competition from offshore online retailers – but appears to have picked up somewhat in recent months.

While the empirical relationship between consumption growth and consumer sentiment is relatively weak, the softer pace of growth in household spending in recent months is consistent with survey measures, which suggest that consumer sentiment is a little below long-run average levels. In particular, households' assessments of their own current and future personal finances are at low levels, weighed down by soft conditions in the labour market, with concerns about unemployment remaining elevated (Graph 3.5). Confidence is also likely to have been diminished by a decline in net wealth over the year, notwithstanding an estimated small rise in the March quarter as strong growth in financial assets was offset somewhat by a fall in dwelling prices.

The return of the saving ratio over recent years to levels that existed prior to the 1990s has contributed to strong growth in deposits, with household deposits increasing by 9 per cent in 2011. Credit growth has also fallen in recent years, from an annual rate of around 15 per cent during the mid 2000s to around 5 per cent recently, which is slightly slower than nominal income growth. Demand for housing finance has eased in recent months, following a rise in loan approvals in late 2011. This increase was largely driven by first home buyers responding to some stamp duty exemptions in New South Wales that expired on 31 December 2011.

The slower growth in housing debt has been associated with weakness in the housing market. Weak demand has been reflected in a fall in Australian capital city dwelling prices of around 6 per cent since their peak in early 2011 and low housing turnover (Graph 3.6, Table 3.2). Notwithstanding this, it appears that in recent months dwelling prices might have been declining at a slower rate. With declines in dwelling prices, the ratio of dwelling prices to income is back around its 2002 level.

In contrast to dwelling prices, the various measures of rents grew by 4 to 5 per cent over the year (Graph 3.7). Reasonably strong rental growth, together with falling dwelling prices, has lifted rental yields to around ½ percentage point above their mid-2000s level. Rental vacancy rates have been around 2 per cent since 2009, above the very low levels seen in 2006–2008 but still low by historical standards.



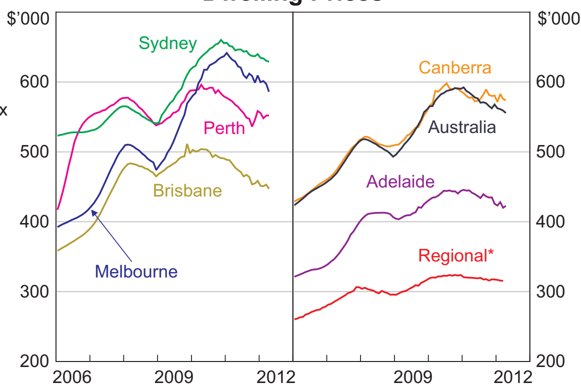
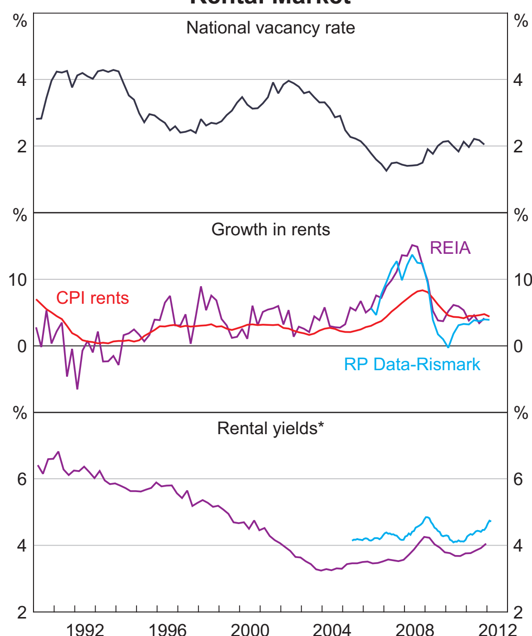


Table 3.2: National Housing Price Growth
Per cent

	6 months to September 2011	6 months to March 2012	Year to March 2012
Capital cities			
ABS[(a),(b)]	–2.9	–1.7	–4.5
APM[(b)]	–2.4	–0.1	–2.5
RP Data-Rismark	–2.6	–1.9	–4.4
Regional areas			
APM[(b)]	–0.9	0.9	0.0
RP Data-Rismark[(a)]	–0.6	–0.8	–1.4

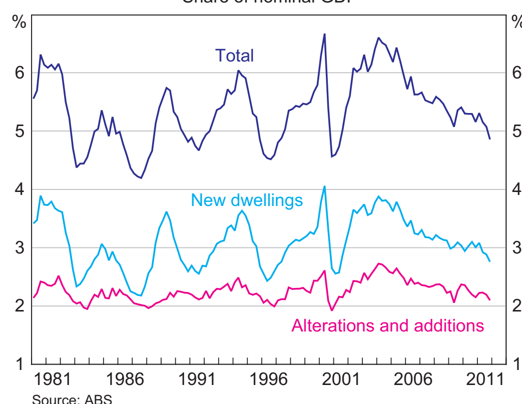
(a) Detached houses only
(b) Quarterly measures
Sources: ABS; APM; RBA; RP Data-Rismark

Graph 3.7
Rental Market



* REIA series uses an unmatched sample of rents and prices; RP Data-Rismark series uses a matched sample
Sources: ABS; RBA; REIA; RP Data-Rismark

Graph 3.8
Private Dwelling Investment
Share of nominal GDP

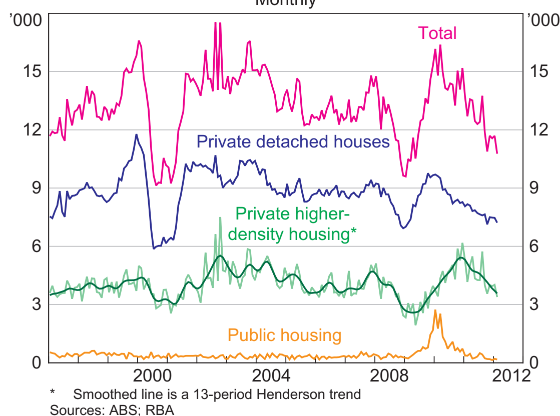


Source: ABS

Residential building activity fell over 2011 to be around the lows of some earlier cycles in dwelling investment (Graph 3.8). The weakness in residential building activity reflects a number of factors. According to liaison, declines in established dwelling prices have made households reluctant to commit to new contracts to build. Also, in recent years, the lengthy planning processes and arrangements for infrastructure provision have increased the cost of new dwellings. A range of initiatives have been undertaken by state governments to address these issues, including reviews of planning systems, the release of infrastructure plans and caps on infrastructure charges.

Despite recent decreases in housing prices relative to income and increased rental yields, forward-looking indicators suggest that there is little prospect of an imminent recovery in housing construction. Approvals for new dwellings have continued to trend downwards in early 2012, especially for higher-density housing (mainly

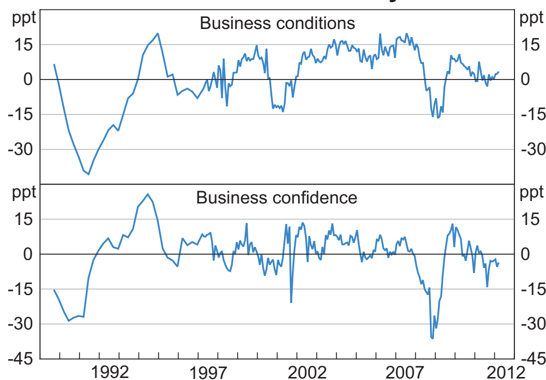
apartments) (Graph 3.9). This follows the run-up in approvals in 2010 that was concentrated in Victoria. Approvals for detached houses are at low levels in all mainland states, notwithstanding a recent increase in Queensland that can be partly attributed to the state government's Building Boost Grant for new dwellings.

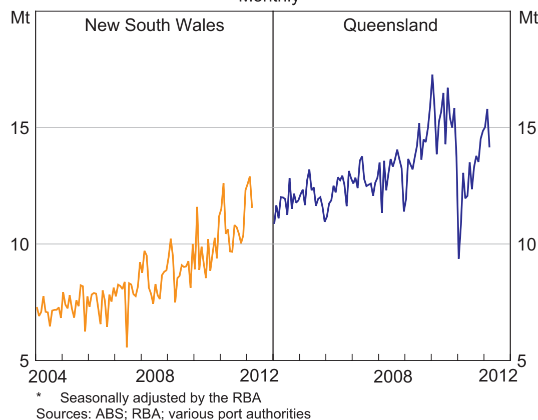


Business Sector

Survey measures of business conditions are generally around long-run average levels, but remain below the higher levels that prevailed through much of the 2000s (Graph 3.10). The strength of activity continues to vary across industries, with mining firms and firms servicing the mining sector experiencing strong conditions, while conditions remain weak in parts of the construction, retail, and manufacturing industries. Survey measures also suggest that conditions have softened in the business services sector since mid 2011, consistent with low turnover in property markets and general weakness outside of mining and related activities.

Resource exports grew modestly over the year to December 2011, as solid growth in iron ore exports was partially offset by declines in coal, oil and, to a lesser extent, liquefied natural gas (LNG) exports (for more detail, see 'Box C: Resource Exports in 2011'). More recently, coal export volumes are estimated to have increased in seasonally adjusted terms in the March quarter (Graph 3.11). However, wet weather in New South Wales and Queensland, a shortage of explosives at some coal mines due to the temporary closure of Orica's Ammonia Plant in Newcastle, and industrial action at the BHP Billiton Mitsubishi Alliance mines have all affected coal production to some extent. Iron ore production was adversely affected by cyclone activity in the March quarter, with exports likely to have fallen in the quarter. Over the next few years, both iron ore and coal production and exports are expected to grow strongly due to significant expansions to mines and transport infrastructure.





The outlook for investment in the mining sector remains extremely strong. The ABS survey of firms' capital expenditure plans points to very large rises in mining investment in 2011/12 and 2012/13 (Graph 3.12). Construction is continuing on numerous large LNG projects, valued at around $165 billion in total, while investment in iron ore and coal mines and related infrastructure also remains strong. As a result, mining investment is projected to rise to around 9 per cent of GDP in 2012/13.

Conditions in some other parts of the economy are subdued, and investment intentions in the non-mining sector remain weak. The capital expenditure survey points to little change in non-mining investment in 2011/12 and 2012/13, while survey measures of investment intentions generally remain well below average levels.

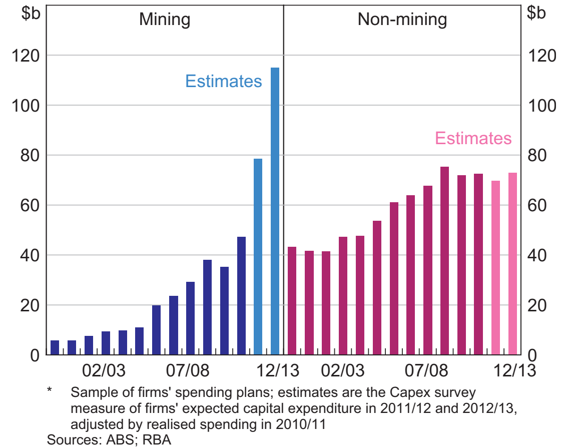
Following a large spike in non-residential building activity in the September quarter 2011, conditions in this sector have been much more subdued. The national CBD office vacancy rate was unchanged in the March quarter at 7.2 per cent, a little below the decade average. The office vacancy rate is likely to remain around this level over the next few years, with demand for, and supply of, new office space both relatively muted. This is consistent with forward-looking indicators of office building activity, with approvals remaining low as a share of GDP (Graph 3.13).

The divergence in conditions between the mining and non-mining sectors is also evident in company profits. Mining profits remain at a high level relative to GDP, not far below historical highs (Graph 3.14). In contrast, non-mining profits as a share of GDP are a little below the decade average, with profit results mixed among industries; manufacturing profits in 2011 were down by 12 per cent from 2010, with profits as a share of GDP slightly below the previous trough of late 2008.

Graph 3.12

Capital Expenditure*

Capex survey, nominal

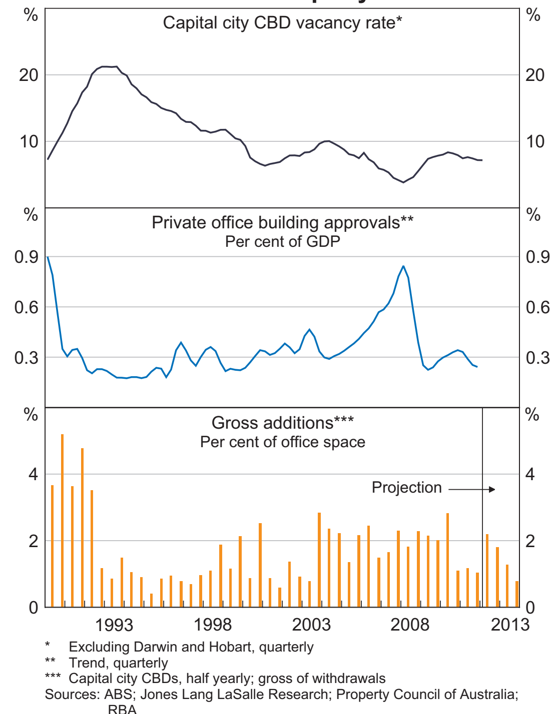


* Sample of firms' spending plans; estimates are the Capex survey measure of firms' expected capital expenditure in 2011/12 and 2012/13, adjusted by realised spending in 2010/11

Sources: ABS; RBA

Graph 3.13

Office Property



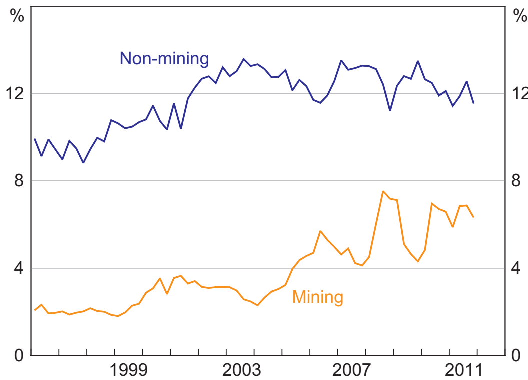
* Excluding Darwin and Hobart, quarterly

** Trend, quarterly

*** Capital city CBDs, half yearly; gross of withdrawals

Sources: ABS; Jones Lang LaSalle Research; Property Council of Australia; RBA

Graph 3.14
Private Non-financial Corporation Profits*
Share of nominal GDP

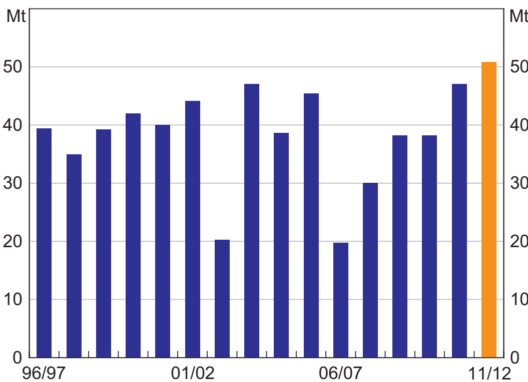


* Gross operating profits; inventory valuation adjusted
Sources: ABS; RBA

Farm Sector

After growing by around 6 per cent over 2010/11, farm production is expected to have grown by around 4 per cent over 2011/12 according to the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES). The strong performance of the farm sector reflects record crop production, and coincides with above-average rainfall in the cropping regions in the eastern states due to the La Niña weather system and favourable climatic conditions in Western Australia (Graph 3.15). Above-average rainfall has replenished subsoil moisture and increased the availability of irrigation water and should provide further support to crop yields in the near term. Overall, the prospects for the farm sector generally are positive (see 'Box D: Conditions in the Farm Sector').

Graph 3.15
Crop Production
Annual*



* ABARES forecast for 2011/12
Source: ABARES

External Sector

Exports in 2011 were much weaker than had been anticipated, growing by 1 per cent over the year. While rural exports grew strongly, in line with farm production, resource exports increased only slightly. This was largely due to the weakness in coal exports as the recovery following the Queensland floods was more protracted than expected (for further discussion, see 'Box C: Resource Exports in 2011'). Furthermore, the high level of the exchange rate and softer trading partner growth weighed on the growth of other exports. Manufacturing export volumes fell slightly, while services exports fell further over 2011 to be back around their 2006 levels, with the change to student visa policies, and the high exchange rate, contributing to the sharp decline in recent years. In early 2012, export volumes have been affected by the disruptions to coal and iron ore production reflecting adverse weather and some other factors.

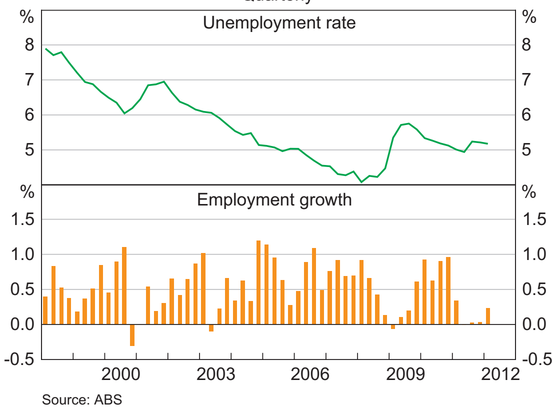
Imports grew by 13 per cent over the year to December 2011, reflecting very strong growth in mining investment and the appreciation of the exchange rate.

Labour Market

There was modest employment growth in the March quarter, but the unemployment rate remained around 5¼ per cent with the participation rate declining slightly (Graph 3.16). Although employment growth picked up in the quarter, average hours worked fell, suggesting that growth in aggregate demand for labour remains subdued (Graph 3.17). Overall, the decline in the participation rate over the past year, and weakness in average hours worked more recently, suggest that there has been some increase in spare capacity in the labour market despite the unemployment rate remaining broadly unchanged since mid 2011.

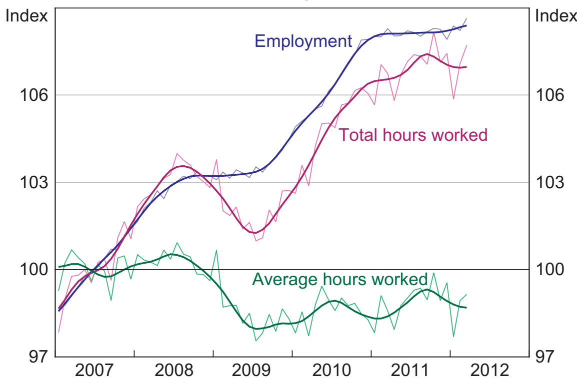
The slower employment growth over the past year followed a period of rapid hiring in 2010, possibly as firms prepared for an anticipated increase in domestic demand growth. However, the slower employment growth also masks the effect of structural change as the mining sector grows in relative importance and other sectors adjust to the high level of the exchange rate and softness in some components of domestic activity. According to the Bank's liaison program, outside of the mining industry, weaker-than-expected demand has led employers to be more cautious about hiring new staff. Moreover, in the parts of the economy most adversely affected by the forces of structural change, many firms have reduced employment to contain costs and improve productivity. In contrast, the outlook for employment remains buoyant in industries and regions directly linked to the mining boom.

Graph 3.16
Labour Market
Quarterly



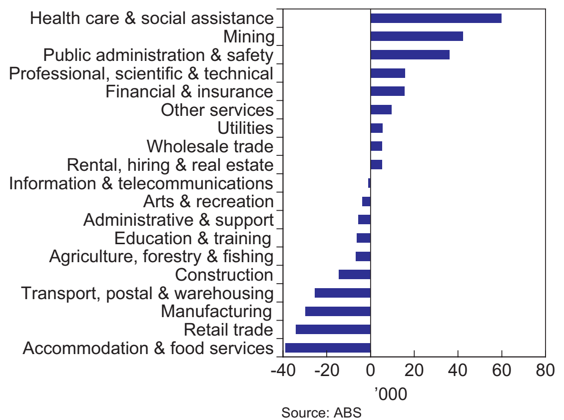
The industry employment data show that there have been job losses in a number of relatively large goods-related industries, including manufacturing, transport and retail trade, and also in the accommodation & food services industry, over the past year (Graph 3.18). Many firms in these industries, particularly in manufacturing and parts of tourism, have been exposed to heightened international competition as a result of the strong Australian dollar. In contrast, mining employment grew by more than 20 per cent over the year to the March quarter and contributed 0.4 percentage points to aggregate employment growth. Mining employment has expanded by over 40 per cent since late 2008, with mining employment picking up in all states and its share of total employment rising from about 1½ per cent to 2¼ per cent over this period (Graph 3.19). The pick-up in investment activity in the mining sector is also supporting construction employment, although total construction employment declined slightly owing to the drag on activity from the slowdown in residential and commercial construction activity. There were sizeable increases in health care and public administration employment.

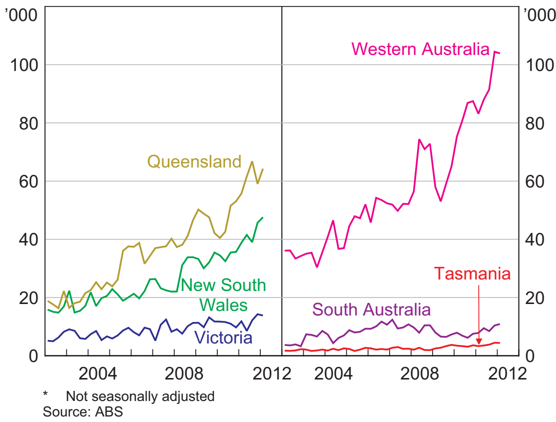
Graph 3.17
Employment and Hours Worked*
2007 average = 100



* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

Graph 3.18
Contributions to Employment Growth
Year to February 2012, trend

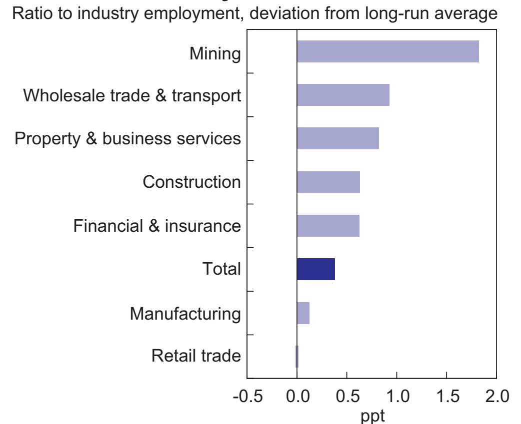




The mixed developments in employment across industries are reflected in divergent employment trends across the states. Over the year, employment growth has been concentrated in Western Australia and Queensland, while employment has contracted in Victoria and Tasmania and has been broadly flat in the other states. The strength of employment growth in Western Australia primarily reflects the significance of mining in the state, with spillover effects to activity in non-mining industries also contributing to employment growth. While mining employment growth has also been strong in Queensland, employment is more diversified in the state and so this has been somewhat offset by weaker growth in other sectors. In contrast, employment has fallen in Victoria reflecting the relative significance of manufacturing and retail employment for that state. Nevertheless, the dispersion of unemployment rates across regions remains within its historical range.

Leading indicators suggest that these patterns of employment growth are likely to continue. While the ABS measure of job vacancies remains at a relatively high level – only a little below the peaks in 2008 and late 2010 when job creation was particularly strong – there are differences across industries and states. Vacancy rates are at very high levels for mining positions and above average for construction and property & business services roles but around average for other industries (Graph 3.20). Reflecting these industry patterns, the vacancy rate is particularly high in Western Australia but only moderately above average in the other states.

The ANZ measure of job advertisements has picked up in recent months. However, over the past year these leading indicators have tended to overestimate net employment growth, possibly because they do not account for the pick-up in job losses associated with increased structural change in the economy. Firms in a range of industries continue to indicate that they are cautious about hiring more staff, and some liaison contacts expect to reduce headcount. Overall, the vacancy data and survey measures continue to point to modest employment growth in the period ahead.

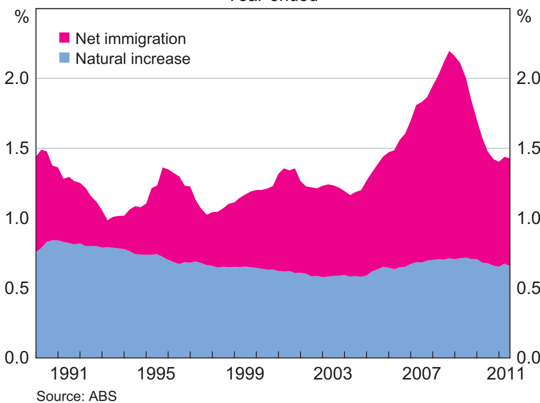


Slower population growth and a decline in the participation rate have seen the growth of labour supply slow from the historically rapid pace in the late 2000s (Graph 3.21). Working-age population growth has slowed from a peak of around 2¼ per cent in late 2009 to around 1½ per cent. This reflects a sharp turnaround in net immigration associated with fewer international students in recent years,

many of whom participate in the labour market on a part-time basis. The most recent data suggest that the number of international arrivals has stabilised and a gradual pick-up in net immigration is expected over the next few years as the number of student and worker arrivals picks up.

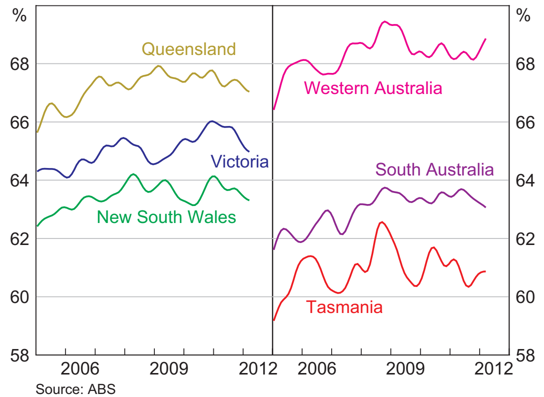
The decline in the labour market participation rate has also reduced the labour supply, although, in part, this is likely to be a response to softer labour demand over the past year and so could be reversed if faster employment growth encourages greater participation. The participation rate has declined by 0.6 percentage points since its record high in late 2010 to be a little below its average level since 2007. The cycle in the participation rate over the past two years has been most pronounced in New South Wales and Victoria, while participation in Western Australia has been trending upwards in recent months, broadly consistent with the strength of the respective state labour markets (Graph 3.22). Although the fall in the national participation rate implies a small increase in latent spare capacity in the labour market, it may also indicate a temporary fall in the economy's potential supply of labour as workers affected by structural change are likely to face a range of difficulties, including the need to retrain or relocate, before they can take advantage of employment opportunities in expanding industries or regions.

Graph 3.21
Population Growth
Year-ended



Source: ABS

Graph 3.22
State Participation Rates
Trend



Source: ABS

Box C

Resource Exports in 2011

Resource exports, which include metal ores, coal and other mineral fuels, metals and gold, make up around 60 per cent of the total value of exports (Table C1). The value of resource exports rose by 16 per cent over 2011, contributing 2 percentage points of the 5½ per cent growth in nominal GDP over the year to December (Graph C1). The strength in resource export values reflected large increases in prices, with export volumes rising by only 1 per cent (contributing less than ¼ percentage point to real GDP growth of 2¼ per cent).

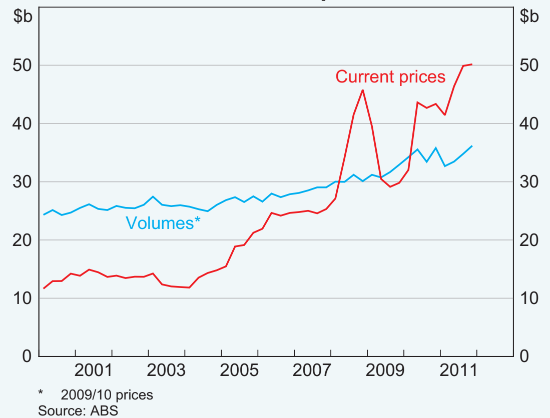
Over the year to the September quarter 2011, export prices for iron ore and coal were supported by growth in global steel production and supply disruptions in Australia and elsewhere. This took the terms of trade to their highest level on record in the September quarter, though subsequent falls in commodity prices saw the terms of trade decline in the December quarter. In contrast, the modest growth in resource export volumes over 2011 compares to average annual growth of around 3¾ per cent over the past decade, and Bank forecasts for growth of over 10 per cent at the time of the February 2011 *Statement on Monetary Policy*. The modest growth in export volumes reflects a number of factors including: a sluggish recovery in coal production from the floods in early 2011; ongoing infrastructure bottlenecks and congestion along the coal production chain; and, to a lesser extent, weather-related disruptions to production of liquefied natural gas (LNG) and crude oil.

Table C1: Resource Exports
Per cent

	Share of total export values in 2011	Volumes growth over 2011
Metal ores and minerals	28	7.9
– Iron ore	20	10.6
Coal	15	–2.3
'Other' mineral fuels	8	–11.2
Gold[(a)]	5	–3.3
Other metals	4	3.6
Total	**60**	**1.1**

(a) Imported gold represented 37 per cent of gold exports
Sources: ABS; RBA

Graph C1
Resource Exports

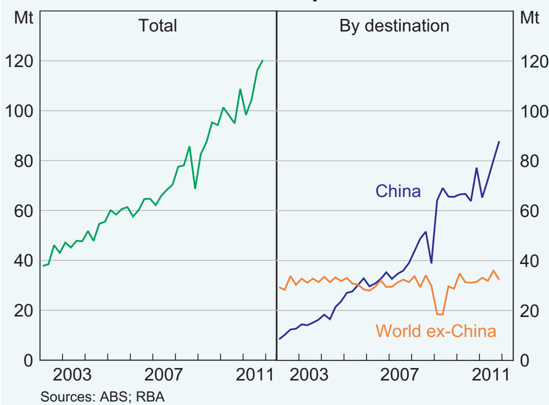


* 2009/10 prices
Source: ABS

Iron Ore

Iron ore is Australia's most significant export, accounting for around 20 per cent of total export values in 2011. The primary destination of Australia's iron ore exports is China, which accounted for around 70 per cent of iron ore export volumes in 2011, while Japan and Korea imported most of the remaining 30 per cent. Iron ore volumes grew by 10½ per cent over 2011, which is slightly slower than the average

annual pace of growth over the past decade (Graph C2). In early 2011, iron ore export volumes fell owing to production disruptions from a higher-than-average number of cyclones in the north of Western Australia. However, iron ore export volumes recovered strongly over the rest of the year to reach new highs, reflecting expansions in the capacity of mines and rail as well as some improvements in the utilisation of port facilities.

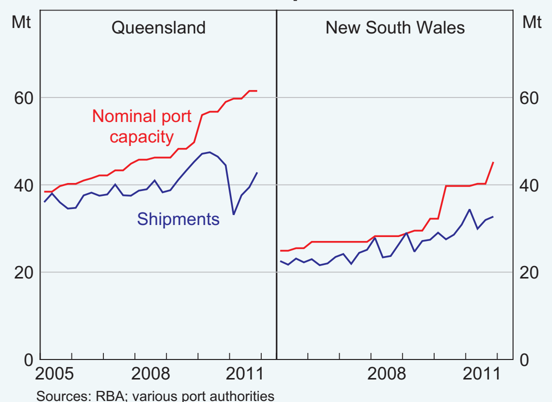


Coal

Coal exports accounted for around 15 per cent of the total value of exports in 2011. While the value of coal exports rose by 22 per cent over the year, export volumes fell by around 2¼ per cent. The fall in production and the sharp jump in coal prices were largely owing to the flooding of Queensland's Bowen Basin coalfields (which account for over half of Australia's coal exports) in late 2010 and early 2011. A number of mining companies and ports operated well below capacity during this time, with many mining companies declaring *force majeure*, which released them from liability associated with not meeting contracts due to circumstances beyond their control.[1] This resulted in coal export volumes falling by 13 per cent in the March quarter 2011 and subtracting around ½ percentage point from real GDP growth in the quarter.

As has been widely noted, the recovery in Queensland coal exports from the flooding was much slower than expected. Initially, liaison contacts expected coal production to return to pre-flood levels in mid 2011, but this was delayed due to the difficulties associated with removing water from coal pits in flood-affected mines. As a result, coal shipments from Queensland only returned to their 2010 average levels in February 2012.

In addition to the flooding of mines in Queensland, ongoing supply-chain problems seem to have affected growth in coal exports over 2011. Liaison contacts suggest that disruptions caused by congestion, unanticipated bottlenecks and maintenance of transport infrastructure have constrained growth in coal volumes over 2011, and are likely to continue to do so over the next few years. These problems follow large capacity expansions at ports and reflect the growing size and complexity of transport networks (Graph C3). Nevertheless, coal export volumes are expected to grow solidly over the forecast period as a result of improvements in port utilisation rates and continued investment in coal mines and transport infrastructure.



1 See 'Box B: An Update on the Impact of the Natural Disasters in Queensland', *Statement on Monetary Policy*, May 2011, pp 40–43.

Other Resource Exports

The performance of other resource exports – which account for a little less than half of total resource exports and one-quarter of total export values – were mixed over 2011. Export volumes of 'other' mineral fuels, which include LNG and crude oil, declined sharply over 2011 following disruptions to production. This largely reflected cyclone activity in early 2011 and planned maintenance of the North West Shelf facilities in the second half of the year. While exports of LNG are expected to grow strongly in future years following large-scale investments in production capacity, oil exports are expected to decline in line with lower production from maturing fields.

The value of Australian gold exports increased over 2011, as demand from investors attempting to find a safe haven in the face of heightened uncertainty about global economic prospects pushed gold prices to historically high levels. While gold exports accounted for around 5 per cent of total export values in 2011, it should be noted that over one-third of gold exports are re-exports of imported gold. This reflects the role of the Perth Mint, which is accredited by the London Bullion Market Association, in refining gold for global markets.

Metals export volumes increased over 2011, with an increase in base metal exports offsetting declines in exports of iron and steel. The increase in base metal exports was in line with reports of higher copper and nickel production in 2011.

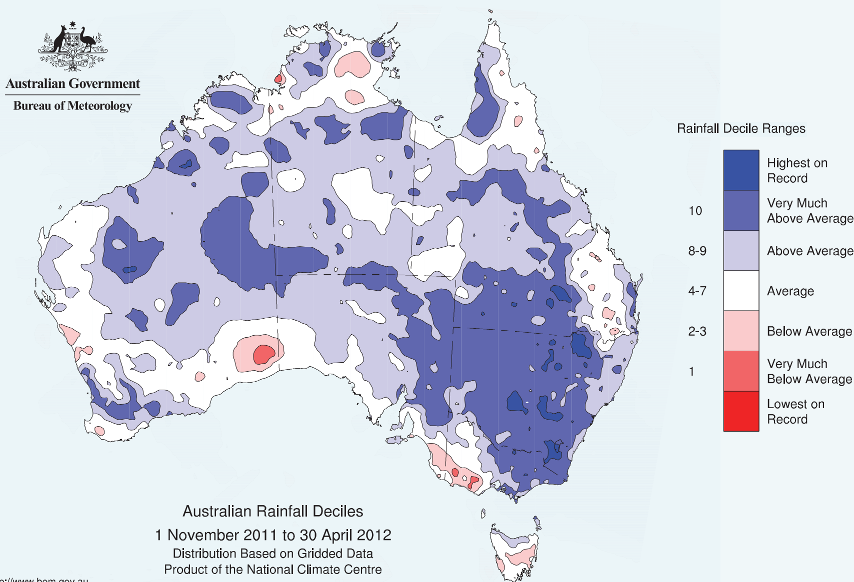
Box D

Conditions in the Farm Sector

Over the past six months, much of Australia has experienced above-average rainfall associated with the La Niña weather system (Graph D1). While this has resulted in flooding in some parts of eastern Australia, with associated damage to property, infrastructure and some summer crops, it has also provided more water for crops, increased subsoil moisture and replenished dams and irrigation supplies. This box outlines the effect that recent weather conditions have had on farm production and summarises current conditions in the farm sector.

Despite the damage to infrastructure and crops from flooding, the La Niña weather system has been associated with record crop production. The winter crop for 2011 is expected to be at a record level, largely reflecting a bumper wheat harvest. This was driven by a substantial increase in Western Australia's wheat crop, as above-average rainfall in late 2011 boosted yields following a drought-affected 2010. However, while above-average rainfall tends to have a positive effect on wheat production, it has also resulted in some of the crop being downgraded to feed quality, reducing the prices received by farmers. The increase in subsoil moisture and increased availability of irrigation water should also support crop yields in the near-term. The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) estimates that the summer crop (including cotton, sorghum and rice) is likely to be at a record level in 2011/12. In contrast, livestock

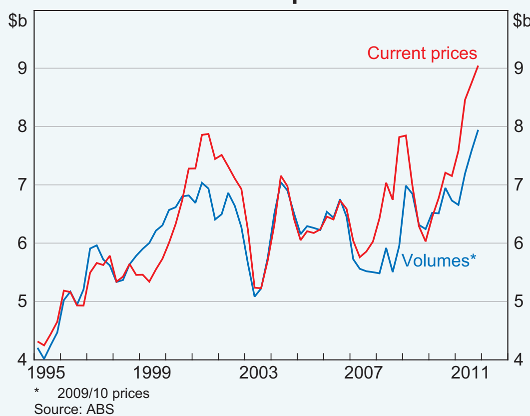
Graph D1
Australian Rainfall Deciles
1 November 2011 to 30 April 2012



Source: Bureau of Meteorology

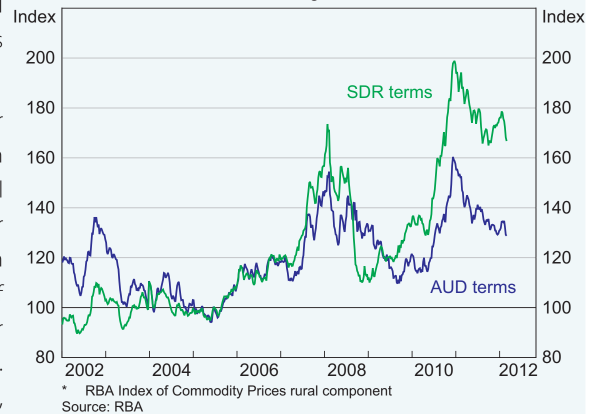
production, which accounts for a little less than half of farm production, is expected to remain largely unchanged in 2011/12 since favourable seasonal conditions will encourage farmers to rebuild herds at the expense of slaughtering.

The high levels of farm production over the past year have led to strong growth in rural exports, which accounted for around 10 per cent of the value of total exports in 2011. Rural export volumes grew by 18 per cent over 2011, with particularly large increases in grain exports (Graph D2). Despite the high level of farm production, there has been a reported 8 per cent fall in agricultural employment over 2011. Although the fall in employment was broad based, the largest falls were recorded in New South Wales and Western Australia, where the sector may be competing for labour with the mining industry.



Farm Prices and Incomes

Global prices for agricultural commodities have generally eased over the past year, but remain at high levels. Rural export prices are also relatively high in Australian dollar terms, although the increase over recent years has been less pronounced than in global prices reflecting the appreciation of the Australian dollar over this period (Graph D3).



The longer-term increase in agricultural prices has been driven in large part by rising global demand; for example, food consumption per capita has increased strongly in developing countries such as China in response to rising incomes.[1] The demand for grains has also risen strongly because of their use in animal feed and biofuels.

Supply-side factors have also significantly influenced price movements in recent years, with adverse weather conditions in major cropping regions of the world having temporarily bolstered some rural prices. While the La Niña weather system increases rainfall in Australia, it tends to reduce rainfall in other major wheat-producing regions. Droughts in other parts of the world during 2010 and 2011 reduced wheat production putting upward pressure on prices. More recently, however, global supply has recovered and prices have eased.

Reflecting the strong level of both production and prices, real farm incomes in Australia increased strongly in 2010/11 and are expected to remain at a high level in 2011/12. ABARES forecasts that farm profits will be positive across all states and all farming industries in 2011/12, the first time this

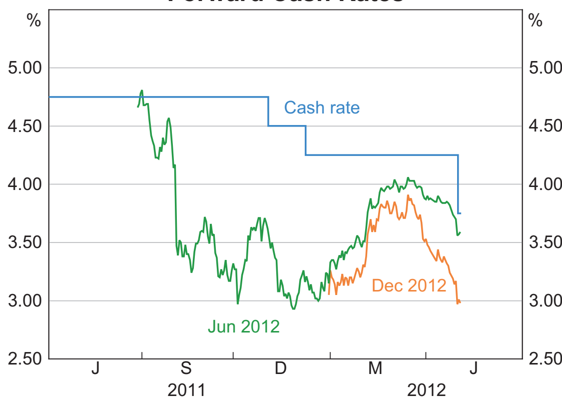
1 See Rayner V, E Laing and J Hall (2011), 'Developments in Global Food Prices', RBA *Bulletin*, March, pp 15–21.

will have occurred in over 30 years. The increase in farm incomes is being offset to some extent by the upward pressure on the cost of farming inputs such as fertiliser.

While the farm sector is a relatively small part of the Australian economy, the large swings in farm production mean that it remains an important source of variation in the aggregate economy. Annual output growth in the farm sector is on average over eight times more volatile than non-farm output growth. Farm GDP grew by over 7 per cent in year-average terms in 2010/11, contributing around ¼ percentage points to GDP growth of 2 per cent. Output in the farm sector is anticipated to remain at high levels over the next few years.

4. Domestic Financial Markets

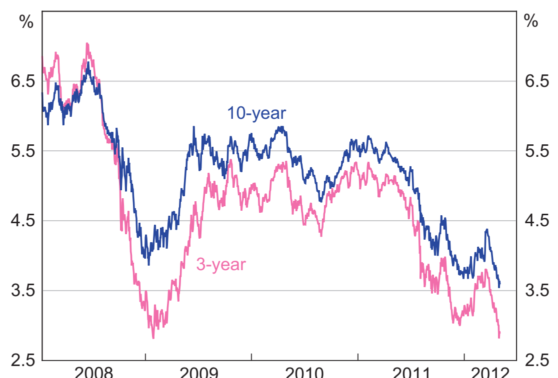
The Reserve Bank Board lowered its target for the cash rate by 50 basis points in May, to 3.75 per cent. Prior to this, money market yields had been pointing to an expectation of easier monetary policy, although the amount of easing anticipated by market participants had moved in quite a wide range (Graph 4.1). Rates on overnight indexed swaps (OIS) currently imply an expectation of a cash rate of around 3 per cent at the end of 2012.



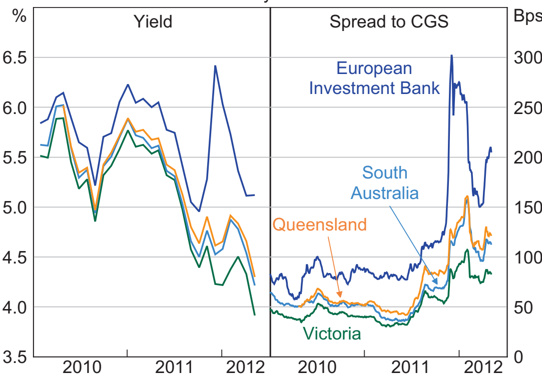
Rates on short-term bank bills and certificates of deposit (CDs) have also declined in line with the movement in cash rate expectations. As a result, spreads between bank bill and OIS rates have been reasonably stable. At around 25 basis points, the 3-month spread is considerably narrower than it was at the beginning of this year.

Long-term government bond yields have fallen since the previous *Statement* with the yield on 10-year Commonwealth Government securities (CGS) reaching a 60-year low of 3.54 per cent in early May (Graph 4.2). While the bond market remains sensitive to news about sovereign debt problems in the euro area and economic data in the United States and China, the recent decline in Australian yields largely reflects the easier stance of domestic monetary policy. There continues to be strong demand from offshore investors for CGS, with around 75 per cent of CGS on issue now held by non-residents. Relative to swap rates, yields on Australian government debt are noticeably lower than for other countries (for more details, see 'Box E: Yields on Sovereign Debt').

The improvement in market conditions for other government-related issuers, evident at the time of the last *Statement*, has largely been maintained. It has been driven by improved investor sentiment in the wake of Greece's sovereign debt restructuring and the European Central Bank's second 3-year

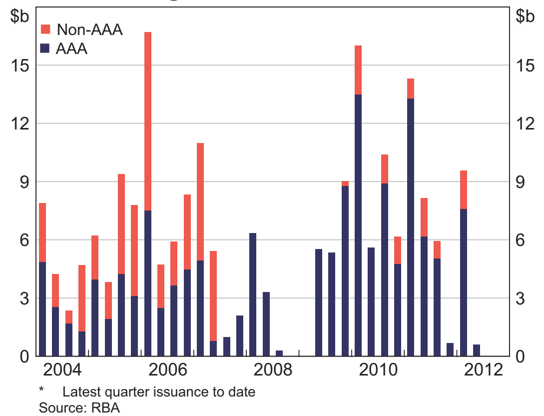


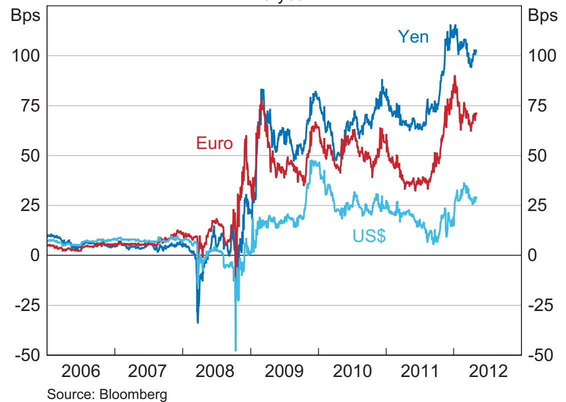
longer-term refinancing operation. Primary market issuance by the Australian states and territories was particularly strong in February as they took advantage of the improvement in financial markets. Most of the states have now largely completed their funding tasks for the current fiscal year. Notwithstanding the increased issuance, spreads to CGS continued to narrow through February and March, though they have widened a little more recently as concerns about sovereign issuers within the euro area have re-emerged (Graph 4.3). Yields are currently around their historical lows for the various state borrowers.



Also reflecting the generally improved conditions in financial markets, Kangaroo bond issuance has picked up substantially since the previous *Statement* after a six-month lull (Graph 4.4). Around $8 billion of Kangaroo bonds have been issued over the past three months, compared with around $4 billion in the previous six months. Spreads between Kangaroo bonds and CGS have narrowed from their peaks reached late last year. The substantial issuance of Kangaroo bonds over the March quarter has placed some downward pressure on the cross-currency basis swap spread, which has reduced costs for Australian borrowers raising funds offshore (Graph 4.5).

Two Australian fixed income exchange-traded funds (ETFs) based on UBS and Deutsche Bank indices have been launched on the ASX. This follows a change to the ASX operating rules that allowed ETFs based on fixed income securities to trade in Australia and reflects growing interest in the fixed income asset class. The underlying physical bonds in the available ETFs comprise a mix of government, sovereign supranational agency and corporate bonds.





Financial Intermediaries

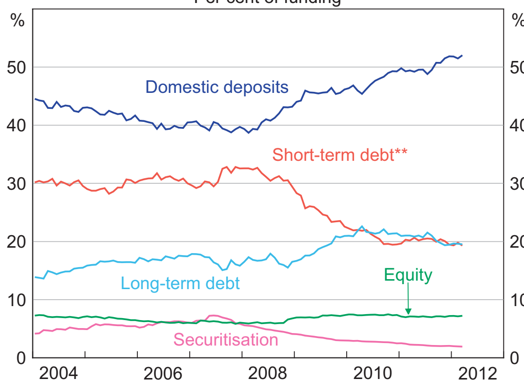
The composition of bank funding was little changed over the March quarter, though the deposit share of total funding has increased by 3 percentage points over the past year. Deposits now account for

52 per cent of total bank funding (Graph 4.6). Within bank deposits, there has been a marked shift towards term deposits. With investors attracted by relatively high interest rates, term deposits now account for about 45 per cent of bank deposits, compared with 30 per cent in the middle of 2007. A detailed discussion of developments in bank funding costs is in the March 2012 RBA *Bulletin*.[1]

Graph 4.6

Funding Composition of Banks in Australia*

Per cent of funding



* Adjusted for movements in foreign exchange rates

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

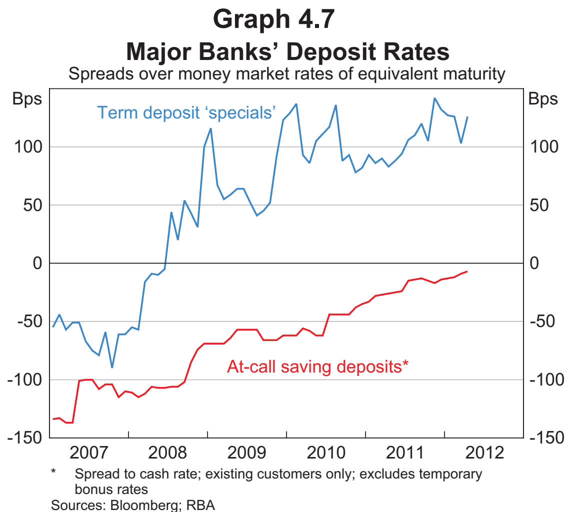
Competition for deposits has remained strong in 2012, with the average interest rate on the major banks' at-call deposits – including online savings, bonus saver and cash management accounts – rising slightly relative to the cash rate (Graph 4.7). The spread of term deposit 'specials' to equivalent duration market rates has fallen slightly, but remains very high by historical standards. Households, businesses, and superannuation and managed funds continue to take advantage of the high term deposit rates.

Australian banks issued around $52 billion of bonds in the March quarter (Graph 4.8). Over these months, however, there has been a shift away from the issuance of covered bonds to unsecured issuance, which totalled $15 billion in March, its highest monthly level in more than two years. Net issuance

Graph 4.7

Major Banks' Deposit Rates

Spreads over money market rates of equivalent maturity



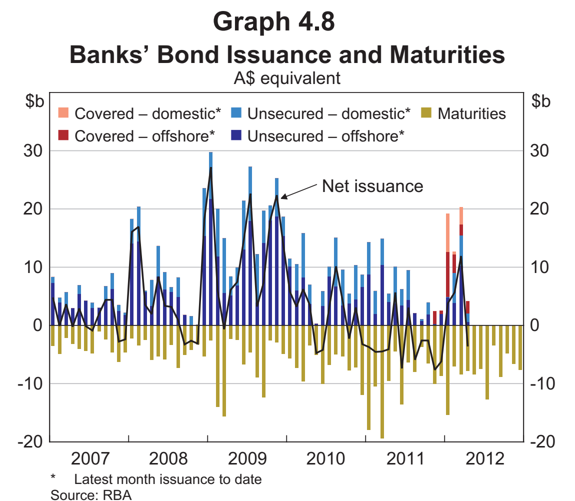
* Spread to cash rate; existing customers only; excludes temporary bonus rates

Sources: Bloomberg; RBA

Graph 4.8

Banks' Bond Issuance and Maturities

A$ equivalent



* Latest month issuance to date

Source: RBA

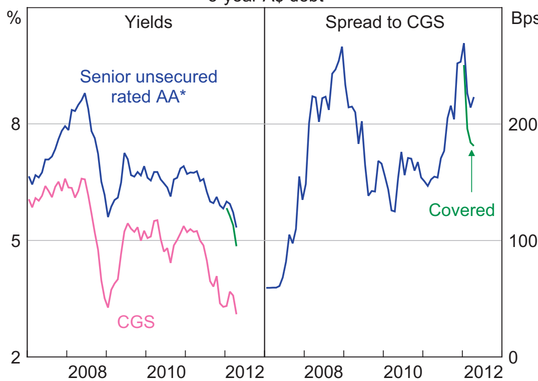
also reached its highest level in over two years in March as bank bond maturities declined following large redemptions in January. The major banks drew on a range of currencies and maturities but were also active in the domestic market. A number of foreign banks accessed the domestic market for the first time through their local branches, including the Bank of China, Bank of Tokyo-Mitsubishi UFJ and ING Bank NV.

The improvement in market conditions has led to unsecured and covered bank bond spreads relative to CGS declining substantially over recent months, despite the substantial increase in issuance

1 See Deans C and C Stewart, 'Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March, pp 37–43.

(Graph 4.9). NAB issued a large 5-year unsecured bond in the domestic market at a spread not much wider than where covered bonds were issued in the second half of January, while Australian dollar-denominated 5-year covered bond spreads to CGS have fallen by about 70 basis points from mid January. Since the previous *Statement,* the decline in 5-year senior unsecured and covered bank bond spreads relative to CGS has been about 30 basis points. Notwithstanding this fall, unsecured bank bond spreads remain around 55 basis points higher than in mid 2011.

Graph 4.9
Major Banks' Bonds
5-year A$ debt



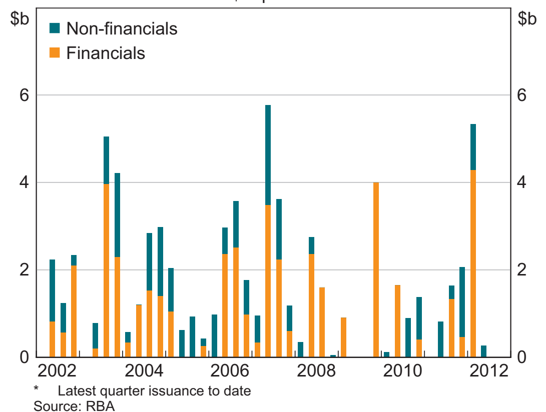
* S&P downgraded the major Australian banks to AA- in December 2011
Sources: Bloomberg; RBA; UBS AG, Australia Branch

In contrast to bank bond issuance, activity in the securitisation market has remained subdued over recent months. There have been two residential mortgage-backed securities (RMBS) transactions by ING and ME Bank, as well as a $530 million transaction from Macquarie Leasing backed mainly by car loans and leases. The RMBS issues amounted to $1.8 billion in aggregate and pricing of the senior tranches was around 10 to 15 basis points wider than similar issuance in November last year. ME Bank issued just under half of its transaction in US dollars with the remainder pricing in the domestic market. The Australian Office of Financial Management (AOFM) participated in both transactions, purchasing a total of $325 million. In March the AOFM sold $50 million of its RMBS holdings in the market as part of its portfolio management activity and to provide some pricing guidance to the market.

Several issuers, including major financial institutions, have been active in the hybrid bond market, with issuance totalling around $6 billion over recent months (Graph 4.10). Hybrid bonds, which combine debt and equity characteristics, usually pay a fixed rate of return or dividend until a certain date, at which point the holder may have a number of options including converting the securities to ordinary shares. Some of the hybrid bonds issued over recent months convert to ordinary shares at a specified time or on a capital event trigger, while others are subordinated debt instruments that are more senior in the capital structure than convertible issues. These hybrid securities are generally intended to receive recognition as equity from credit rating agencies, or to qualify as regulatory capital.

Banks' outstanding funding costs relative to the cash rate are estimated to have increased by about 20 basis points since mid 2011. This partly reflects the effects of ongoing competition for deposits. In addition, while spreads on bank bonds have fallen since the previous *Statement*, the cost of these newly issued bonds is still around 20 basis points higher than the average cost of banks' outstanding bonds. Consistent with this, most of the major banks reported, on average, narrower net interest

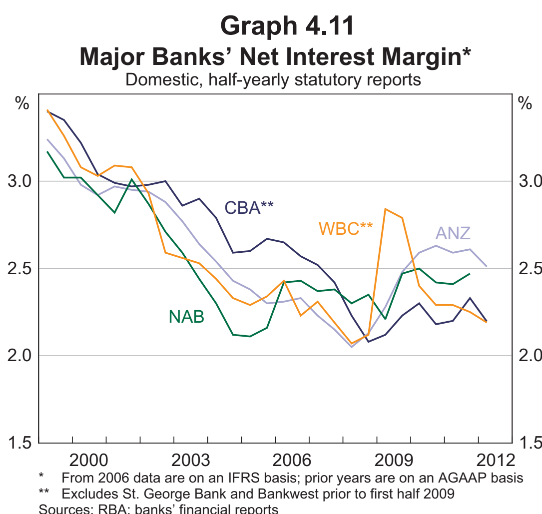
Graph 4.10
Hybrid Issuance by Australian Entities*
A$ equivalent



* Latest quarter issuance to date
Source: RBA

margins in the first half of their 2012 financial years (Graph 4.11). Despite the narrower net interest margins, underlying profits generally increased, reflecting stronger trading and investment income.

Fitch downgraded its long-term credit ratings of three of the four Australian major banks as part of its global banking review, citing the major banks' reliance on offshore wholesale funding. It now rates all the Australian major banks AA-, as do Moody's and Standard & Poor's (S&P). Moody's and Fitch lowered the credit ratings on Macquarie Bank and Macquarie Group by one notch to S&P's equivalent of A and A-, respectively, as part of their broad reviews of the global banking industry. Suncorp-Metway was upgraded one notch to A+ by Fitch, reflecting Fitch's reassessment of support from Suncorp Group.



Household Financing

Most bank and non-bank lenders increased their variable housing loan indicator rates over the three months to the end of April, by between 5 and 15 basis points (Table 4.1). Furthermore, the average discount on housing loans fell over this period, with some individual institutions reducing discounts by up to 15 basis points. The changes in discounts and indicator rates increased overall rates on new variable-rate housing loans by an average of 14 basis points.

At the time of writing, a number of banks had announced reductions in their indicator rates on their variable-rate housing loans following the reduction in the cash rate at the Reserve Bank's May Board meeting. The announced reductions were between 30 and 40 basis points.

Table 4.1: Intermediaries' Variable Lending Rates
Per cent

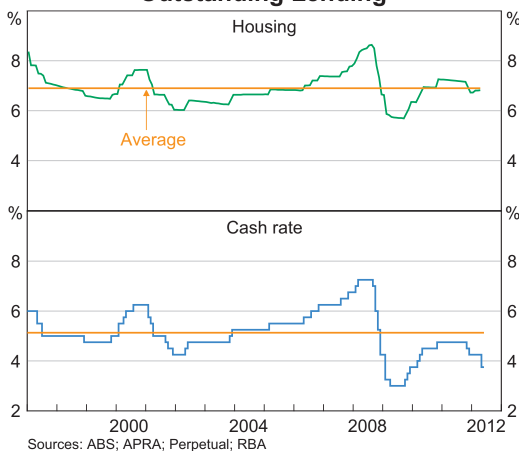
		Change since:	
	Level at 30 April 2012	February *Statement*	End October 2011
Housing loans[(a)]	6.72	0.14	–0.30
Personal loans	13.17	0.07	–0.04
Small business			
Residentially secured			
– Term loans	8.62	0.10	–0.37
– Overdraft	9.48	0.10	–0.37
Average rate[(b)]	8.43	0.10	–0.30
Large business			
Average rate[(b)] (variable-rate and bill funding)	6.41	–0.15	–0.50

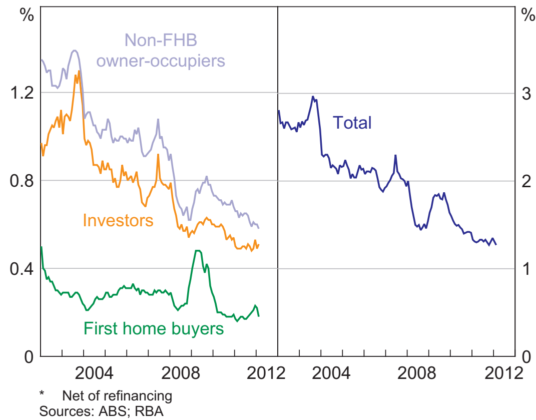
(a) Average of the major banks' discounted package rates on $250 000 full-doc loans
(b) Rates on outstanding, as opposed to new, business lending
Sources: ABS; APRA; RBA

Rates on new fixed-rate loans increased slightly in the three months to the end of April. However, fixed rates were still around 35 basis points lower than variable rates. The share of housing loans approved at fixed rates, at around 15 per cent, is now above its long-run average. Overall, the average interest rate on outstanding housing loans (fixed and variable) increased by around 10 basis points, to be around 8 basis points below its post-1996 average (Graph 4.12).

The value of housing loan approvals decreased over the three months to February, following the recent expiry of some first home buyer stamp duty exemptions in New South Wales (Graph 4.13). Abstracting from this, approvals data suggest only modest growth in credit. Housing credit increased at an average rate of 0.4 per cent over the March quarter – similar to the average rate of growth over the past year.

Most interest rates on variable personal loans – including credit card loans, home equity loans and margin loans – rose over the three months to the end of April. The amount of personal credit outstanding has also been little changed, with falls in margin and credit card lending being offset by a rise in 'other personal' lending (which includes loans for motor vehicles, holidays and household effects).





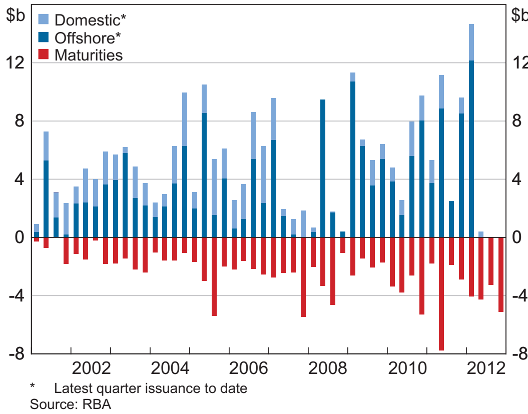
Business Financing

Corporate bond issuance has been strong in 2012. Around $14 billion of corporate bonds have been issued over the past three months, with more than 80 per cent issued in offshore markets (Graph 4.14). Resource companies such as BHP Billiton, Rio Tinto and Fortescue Metals were the main Australian participants in the US dollar market with maturities of up to 30 years. Issuers in the domestic market included Wesfarmers and Woolworths, both rated A-, who placed 7-year bonds at a cost equivalent to where AA- rated Australian major banks have been pricing their shorter maturity unsecured issuance.

Intermediated business credit grew at an annualised rate of around 3½ per cent over the three months to March. Credit extended to financial corporations increased most quickly, but tends to be volatile; credit extended to private trading corporations and unincorporated businesses also rose, albeit only slightly. Business lending by Asian bank branches and subsidiaries grew faster than the system average over the quarter, and has been doing so since late 2009.

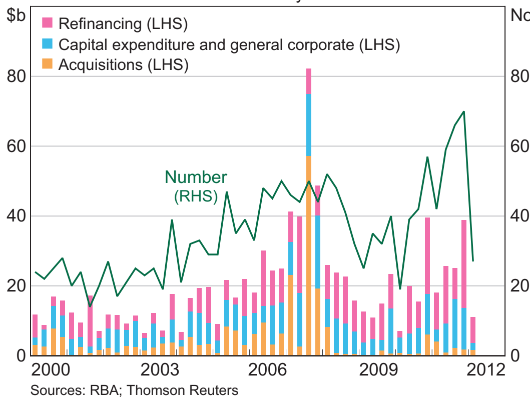
Activity in the Australian syndicated lending market softened in the March quarter, and by more than is typical at the start of the calendar year (Graph 4.15). The decline in activity was broad based across domestic and foreign lenders; lending by Asian institutions again grew faster than the system average.

Graph 4.14
Australian Corporates' Bond Issuance



* Latest quarter issuance to date
Source: RBA

Graph 4.15
Syndicated Loan Approvals
Quarterly



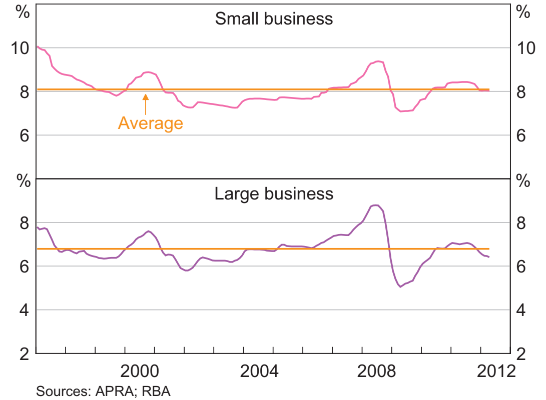
Sources: RBA; Thomson Reuters

The cost of new intermediated business borrowing declined modestly over the three months to the end of April. Interest rates for small businesses rose, while for large businesses they declined by 14 basis points, reflecting falls in benchmark rates for large business lending (Graph 4.16). Accordingly, rates on small business and large business loans were 6 basis points and 38 basis points below their post-1996 averages at the end of April 2012.

At the time of writing, a few banks had announced reductions of between 30 and 40 basis points to their indicator rates on variable-rate small business loans following the reduction in the cash rate at the Reserve Bank's May Board meeting.

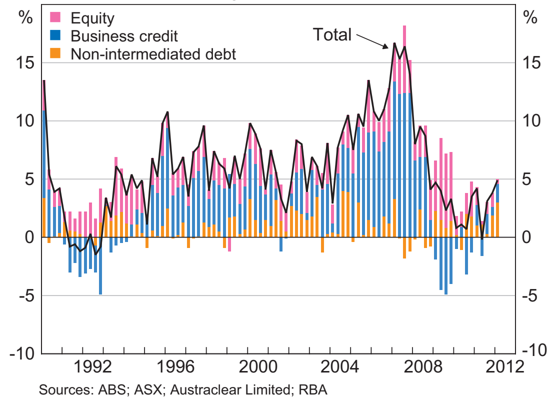
Reflecting these trends, the rise in business external funding was equivalent to 4.9 per cent of GDP in the March quarter (Graph 4.17). Growth in non-intermediated debt increased to its highest level since March 2007.

Graph 4.16
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

Graph 4.17
Business External Funding
Net change as a share of GDP



Sources: ABS; ASX; Austraclear Limited; RBA

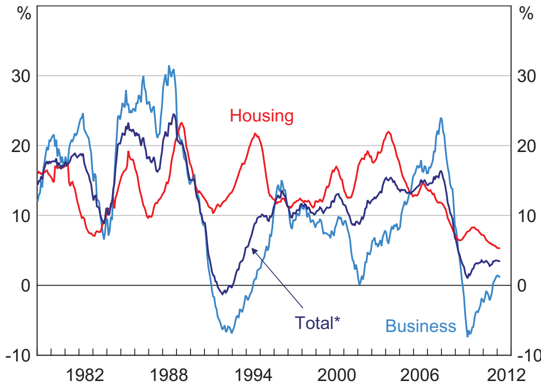
Aggregate Credit

Total outstanding credit grew at an annualised rate of 4.4 per cent over the March quarter, with modest growth in household and business credit (Graph 4.18). Growth in broad money continued to outpace credit growth over the March quarter, partly reflecting an ongoing preference by households and businesses to hold their assets in deposits, especially term deposits (Table 4.2).

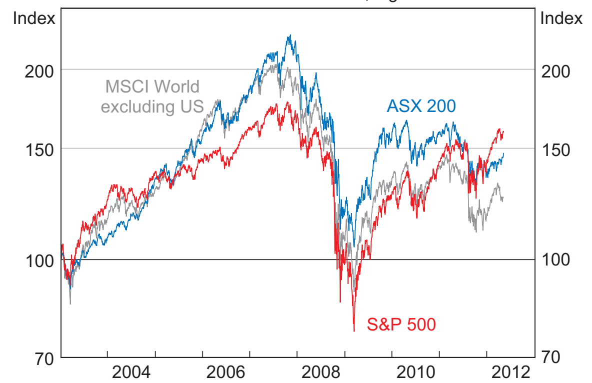
Table 4.2: Financial Aggregates
Percentage change

	Average monthly growth		
	December quarter 2011	March quarter 2012	**Year to March 2012**
Total credit	0.3	0.4	3.4
– Owner-occupier housing	0.5	0.4	5.5
– Investor housing	0.3	0.5	4.8
– Personal	–0.1	0.1	–1.5
– Business	0.1	0.3	1.3
Broad money	0.5	0.5	7.1

Source: RBA



* Includes housing, personal and business credit
Source: RBA

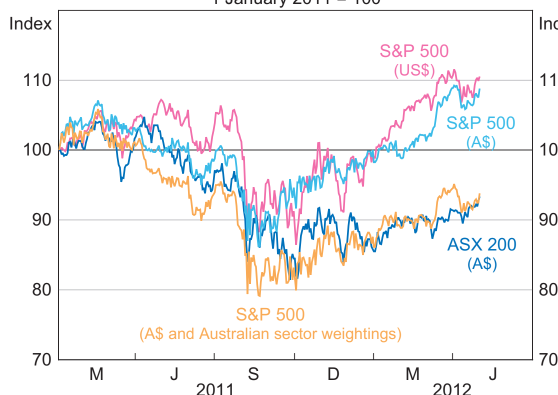


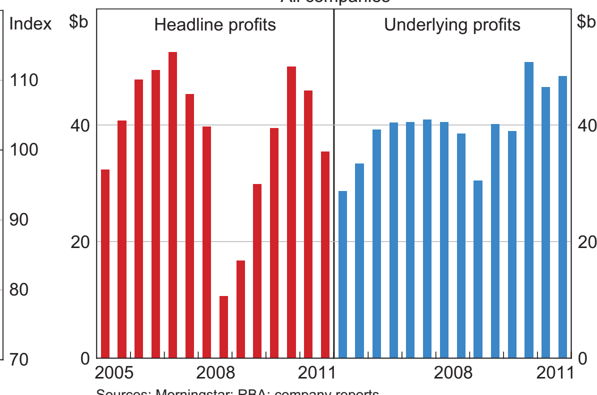
Source: Bloomberg

Equity Markets

Australian equity prices have increased since the previous *Statement* with the ASX 200 rising by around 4 per cent, while market volatility has been below average (Graph 4.19). Resources shares underperformed the broader market amid concerns over slower economic growth in China. Mining shares, in particular, have been adversely affected with prices down 6½ per cent since the previous *Statement*. Share prices of financial corporations rose by 7 per cent reflecting an improvement in investor sentiment for the sector.

The Australian share market has underperformed the US share market since the beginning of the year (Graph 4.20). The relative underperformance vis-a-vis the US market mostly reflects differences in sectoral composition as the mining and financial sectors, which have underperformed the overall market, account for around two-thirds of the ASX 200 but less than one-fifth of the S&P 500. Earnings expectations for the other non-financial and resource sectors have also deteriorated more sharply in Australia than in the United States.





Listed companies with June and December balance dates reported their earnings for the December half 2011. Aggregate underlying profit, which excludes gains and losses from asset revaluations and other significant one-off factors, rose by 2 per cent compared with the June half 2011. In contrast, headline profits declined by 23 per cent from the June half, mainly reflecting an unusually large impairment cost reported by Rio Tinto, worth $8.6 billion, relating to the company's global aluminium operations (Graph 4.21).

By sector, resource company profits declined by 3 per cent from the June half of 2011 reflecting weaker base metals prices, especially for copper and aluminium, and disruptions to offshore copper production. Financial sector profits increased by 5 per cent driven by strong profit growth of commercial banks, while diversified financial and insurance company profits declined by 12 per cent and 26 per cent, respectively. Profits from the other non-financial sector companies increased by 2 per cent in the half and by 10 per cent from the corresponding period a year earlier. The industrial and consumer discretionary sectors reported strong results compared with both the June 2011 and December 2010 halves, with strength in media companies' profits offsetting weaker results from some retailers. Profit growth in consumer staples was driven by a pick-up in profits at Woolworths and Wesfarmers.

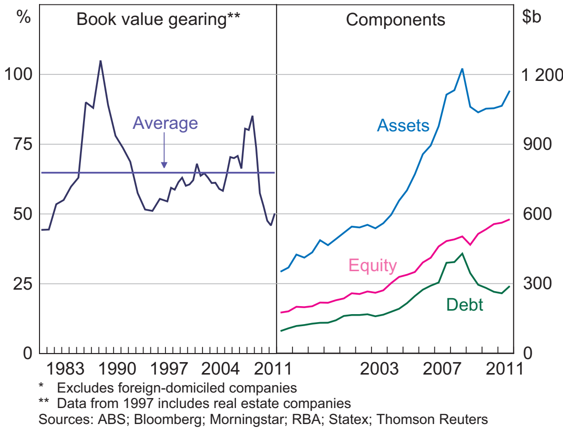
Shareholder distributions – the sum of buybacks and dividends – declined substantially in the December 2011 half when compared with the same period a year earlier. This was mainly due to a sharp decline in buybacks owing to the near completion of earlier buybacks by Rio Tinto and BHP Billiton; dividends also decreased by 1½ per cent. The lower dividend payments reflected lower earnings, as the payout ratio was unchanged.

Corporate balance sheets expanded by around 6 per cent in the December half 2011. To fund this growth, corporates increased their debt by 12 per cent, over half of which was sourced from offshore – including syndicated loans and bonds. Equity funding increased by 2½ per cent, largely as a result of retained earnings.

Reflecting these developments, corporate gearing – the ratio of debt to the book value of equity – rose by 4 percentage points to 50 per cent over the December half 2011. Nonetheless, the gearing ratio remains at a low level (Graph 4.22).

The liquidity position of listed corporations declined over the December half with cash balances decreasing by 6 per cent, while short-term debt

Graph 4.22
Listed Corporates' Gearing Ratio*



* Excludes foreign-domiciled companies
** Data from 1997 includes real estate companies
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

rose by 20 per cent. The result was largely driven by developments in the resource sector; outside this sector, corporations are now more liquid in aggregate compared with the average over the past decade.

Around $16 billion in merger and acquisition activity has been announced over the past three months. Some of the larger deals involve companies in the energy sector. AGL Energy announced that it had entered into conditional agreements worth $2.9 billion to acquire Great Energy Alliance, owner of Loy Yang A, Victoria's largest power station, and an adjacent brown coal mine. The deal requires approval from the Australian Competition and Consumer Commission. In the mining sector, a consortium consisting of Korean firms Posco and STX Corporation, along with Japanese firm Marubeni Corporation, will acquire a 30 per cent stake in the Roy Hill iron ore project owned by Hancock Prospecting for $3.2 billion. The consortium will pay $750 million up front with the balance provided after debt financing commitments for the rest of the project's costs have been secured. On 1 May, Woodside announced that it will sell a $2 billion stake in its Browse Basin project (LNG) to a Japanese joint venture.

Box E

Yields on Sovereign Debt

In recent months, interest rates on Australian government securities have declined to historically low levels. The yield on 10-year Commonwealth Government securities (CGS), for example, is around its lowest level in more than 60 years. This is indicative of the overall interest rate structure in Australia – the overnight cash rate is currently at 3.75 per cent, with market participants expecting further declines. Anchored by the low policy interest rate, and in line with global developments, bond yields for a range of issuers including the states and territories and many corporate issuers are also at historically low levels.

A standard benchmark for comparing yields on debt securities is the interest rate swap curve. Interest rate swaps are contracts whereby one party exchanges fixed (swap) rate payments on a notional amount for receipts determined by a floating (or reference) rate applied to the same amount. Within the Australian market, bank bill swap reference rates (BBSW) are generally used to determine floating rate payments. For example, a 5-year floating rate corporate bond may pay a coupon every six months where that coupon is set at a specific margin above (or below) 6-month BBSW.

Table E1 shows yields on a range of sovereign debt, as well as spreads on sovereign debt when swapped against 6-month interbank rates in the respective local currencies. For most countries the absolute level of yields is lower than for Australian government debt reflecting the abnormally low interest rate structures prevailing in these currencies. Relative to swap rates, however, yields on Australian government debt are noticeably lower than in other countries.

Several factors are likely to have contributed to this outcome. First, although the supply of CGS has expanded significantly since 2008, the level of debt issued by the Australian Government remains very low by international standards (Graph E1). The Australian Government also has a AAA credit

Table E1: 10-year Government Bond Yields
2 May 2012

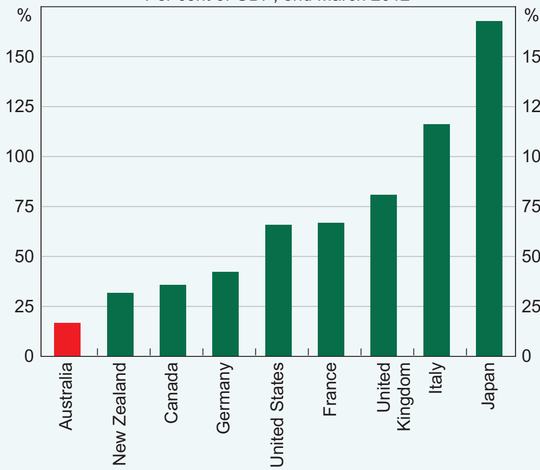
	Credit rating[(a)]	Yield	Spreads to swap
		Per cent	Basis points
Australia	**AAA**	**3.64**	**–83**
Canada	AAA	2.02	–43
Germany	AAA	1.61	–52
United Kingdom	AAA	2.05	–32
France	AA+	2.96	82
New Zealand	AA+	3.71	–25
United States	AA+	1.93	–13
Japan	AA-	0.89	–2
Italy	BBB+	5.53	324

(a) Minimum long-term local currency issuer rating from Moody's, Standard & Poor's and Fitch
Source: Bloomberg

Graph E1

Gross Central Government Debt Securities

Per cent of GDP; end March 2012



Sources: Agence France Tresor; AOFM; Bank of Canada; Deutsche Finanzagentur; IMF; Ministry of Economics and Finance Italy; Ministry of Finance Japan; New Zealand Debt Management Office; United Kingdom Debt Management Office; US Department of the Treasury

rating with each of the three major ratings agencies (for both local and foreign currency issuance) while many other sovereign issuers have been downgraded in recent years. This status appears to have attracted new international investors to the market, such as central banks and sovereign wealth funds. As at the end of 2011, 75 per cent of CGS were held by non-residents, up from 60 per cent five years earlier. To date, the strong demand for CGS relative to their supply seems to have only brought about a reduction in yields and does not appear to have impaired trading conditions within the market, which remains very liquid. ✠

5. Price and Wage Developments

Recent Developments in Inflation

Consumer price inflation eased noticeably in the March quarter. In part this was due to the sharp fall in fruit prices from the high levels that followed the floods and Cyclone Yasi a year ago, but it also reflected a broad-based easing in non-tradables and tradables inflation. In seasonally adjusted terms the consumer price index (CPI) fell by 0.2 per cent in the March quarter, to be 1.6 per cent higher over the year (Table 5.1, Graph 5.1). The various measures indicate underlying inflation was around ¼ per cent in the March quarter and between 2–2¼ per cent over the year (Graph 5.2). The recent run of quarterly data, while somewhat volatile, suggest that the momentum in underlying inflation has eased since the first half of 2011.

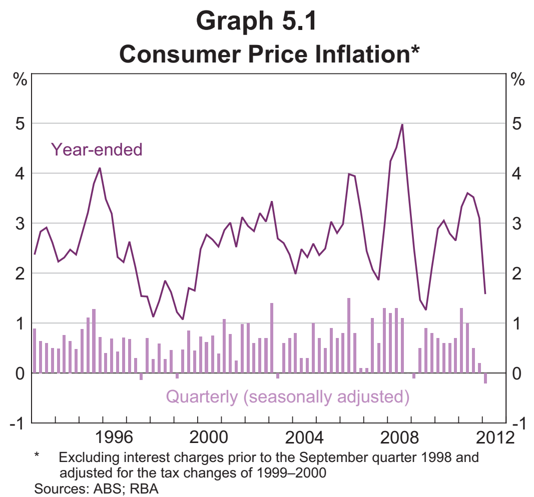
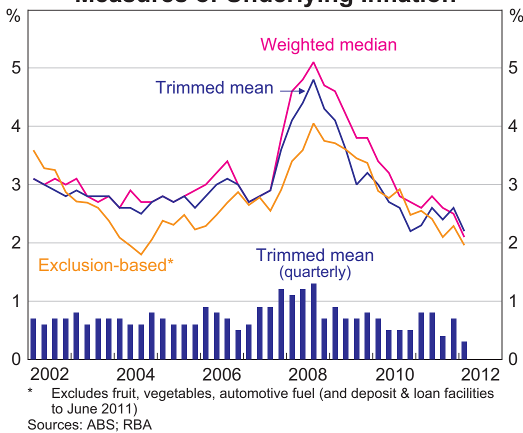


Table 5.1: Measures of Consumer Price Inflation
Per cent

	Quarterly[(a)]		Year-ended[(b)]	
	December quarter 2011	March quarter 2012	December quarter 2011	March quarter 2012
CPI	0.0	0.1	3.1	1.6
Seasonally adjusted CPI	0.2	–0.2	3.1	1.6
– Tradables	–1.0	–1.6	1.8	–1.5
– Tradables (excl food, fuel and tobacco)	–0.6	–0.9	–1.1	–1.7
– Non-tradables[(c)]	1.0	0.7	3.6	3.5
Selected underlying measures				
Trimmed mean	0.7	0.3	2.6	2.2
Weighted median	0.6	0.4	2.5	2.1
CPI excl volatile items[(c), (d)]	0.5	0.2	2.3	2.0

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data
(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median
(c) Excludes deposit and loan facilities to June 2011
(d) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

There was a modest easing in the quarterly pace of non-tradables inflation in the March quarter following relatively strong inflation in the December quarter. In seasonally adjusted terms, non-tradables prices rose by 0.7 per cent in the March quarter to be 3.5 per cent higher over the year (Graph 5.3). Although there were larger-than-usual increases in some administered prices, such as urban transport fares and secondary education fees, and quite strong rises in rents and financial services prices, these increases were partly offset by falls in the prices of domestic travel & accommodation and new dwellings. Liaison contacts in the residential construction industry are reporting that pricing for new building work remains subdued as customers are reluctant to commit to purchases. Inflation in a broad range of other market services also slowed in the quarter.

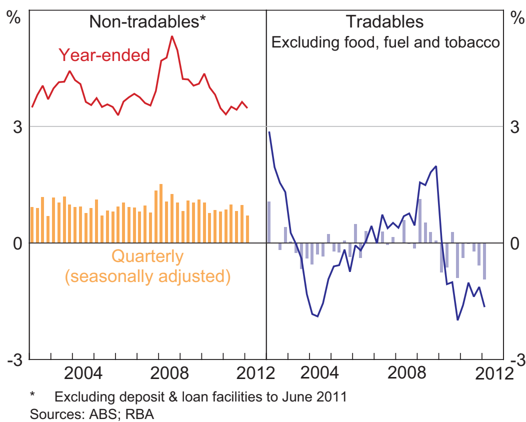


* Excludes fruit, vegetables, automotive fuel (and deposit & loan facilities to June 2011)

Sources: ABS; RBA

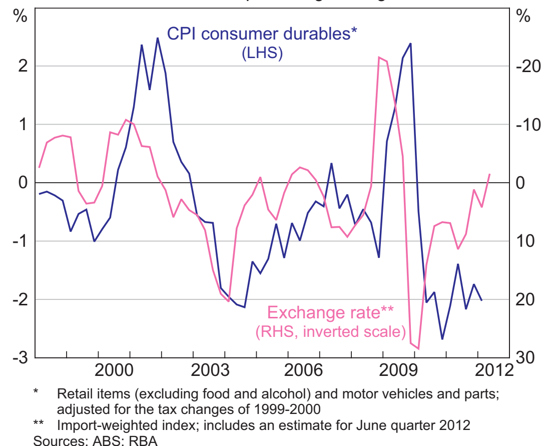
Tradables prices fell sharply in the March quarter, following a relatively large decline in the December quarter. Excluding food, fuel and tobacco, tradables prices declined by 0.9 per cent in the quarter to be 1.7 per cent lower over the year. The fall in the quarter was driven by large declines in the prices of audio visual & computing equipment and overseas travel & accommodation. There were also broad-based declines in the quarter across a range of consumer durables prices, including clothing, motor vehicles and furniture. The fall in durables prices over the past year was greater than implied by the historical relationship with the exchange rate, which is little changed from its level in early 2011. This suggests that there has been some compression of margins for these goods (Graph 5.4).

The decline in banana prices, following the recovery in supplies from the disruptions in early 2011, drove a further fall in food prices in the March quarter, with fruit prices falling by 26 per cent. Excluding fruit and vegetable prices, food price inflation remains subdued with prices rising by 1 per cent over the year



* Excluding deposit & loan facilities to June 2011

Sources: ABS; RBA

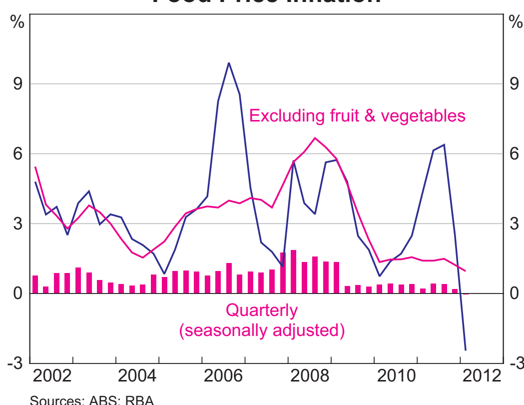


* Retail items (excluding food and alcohol) and motor vehicles and parts; adjusted for the tax changes of 1999-2000

** Import-weighted index; includes an estimate for June quarter 2012

Sources: ABS; RBA

(Graph 5.5). There has been relatively soft inflation in most grocery food items over recent years. This continued in the March quarter with prices falling in a range of grocery food categories including meat & seafood and some cereal-based items.



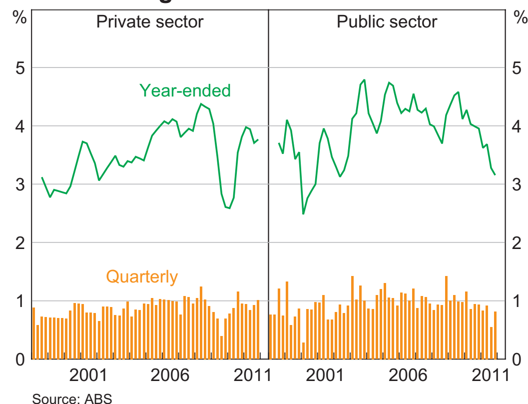
Costs

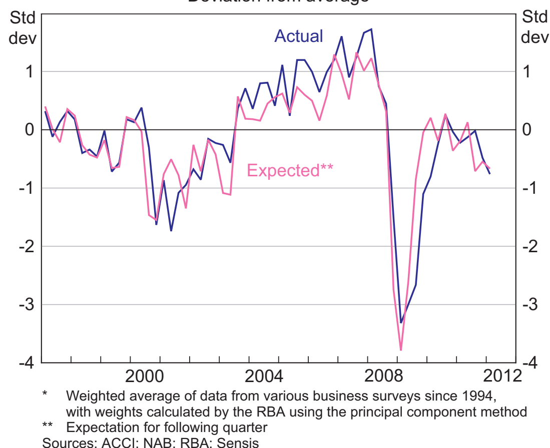
The pace of aggregate wage growth appears to have moderated slightly over 2011. Private sector wage growth was little changed over 2011 despite soft momentum in employment growth. The private sector wage price index increased by 1 per cent in the December quarter, to be 3.8 per cent higher over the year (Graph 5.6). However, business surveys and the Bank's liaison with firms suggest a slight easing in private sector wage pressures in the March quarter (Graph 5.7). This is consistent with firms generally reporting that they are not experiencing significant difficulty finding suitable labour, except for in some mining-related industries and occupations.

Public sector wage growth was relatively subdued over 2011. Although delays in the finalisation of new public sector enterprise agreements have likely overstated the extent of the slowdown in public sector wage growth, there is some genuine downward pressure on wage growth in the sector.

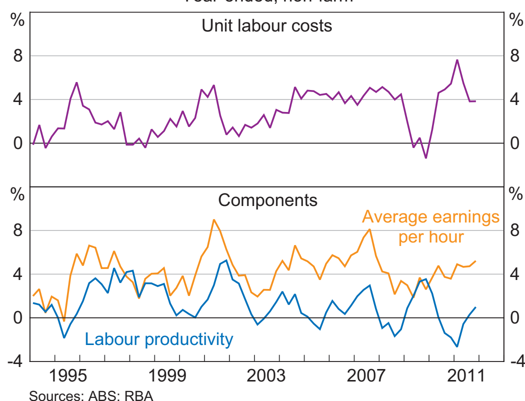
Data from the national accounts indicate that growth in unit labour costs – the average cost of labour per unit of output – has eased somewhat from the spike in early 2011, owing to some recovery in labour productivity growth (Graph 5.8). Nonetheless, the growth of unit labour costs, as measured, remained relatively high over 2011. The national accounts measure of average hourly earnings grew by around 5¼ per cent over the year, partly reflecting strong average earnings growth in Western Australia.

ABS data on industrial disputes – which capture stop-work meetings, strikes and employer-initiated lockouts – suggest that the number of disputes picked up slightly in the December quarter, although the number of working days lost nevertheless fell in the quarter. In 2011, there were 192 disputes, down from





Graph 5.8
Unit Labour Costs Growth
Year-ended, non-farm



227 disputes in 2010. Working days lost picked up in 2011, compared with the low level in the previous few years, although days lost remained low relative to history.

Producer price data suggest that upstream price pressures eased further in the March quarter. Final-stage producer prices (excluding oil) fell slightly in the quarter, following a modest rise in the December quarter, to be 1.2 per cent higher over the year. The decline in the quarter was driven by falls in import and fruit prices. Abstracting from the large fall in fruit prices, final-stage domestic prices rose modestly, held down by further weakness in output price inflation for construction and manufacturing. Import prices fell at all stages of production, largely due to the small appreciation of the exchange rate in the quarter.

Inflation Expectations

Most measures of inflation expectations remain consistent with the Bank's target. Financial market expectations of inflation fell a little following the release of the March quarter inflation data after rising earlier in the year (Graph 5.9). Market economists and union officials have also revised down their forecasts for inflation over 2012 and 2013, with both groups expecting inflation to be around the middle of the target range over 2013 (Table 5.2). In contrast, the somewhat volatile measure of consumer inflation expectations for the year ahead rose to 3.3 per cent in April, although the survey took place before the release of the inflation data. Survey measures suggest that business expectations for near-term selling price inflation remain below average. ✠

Graph 5.9
Indicators of Inflation Expectations

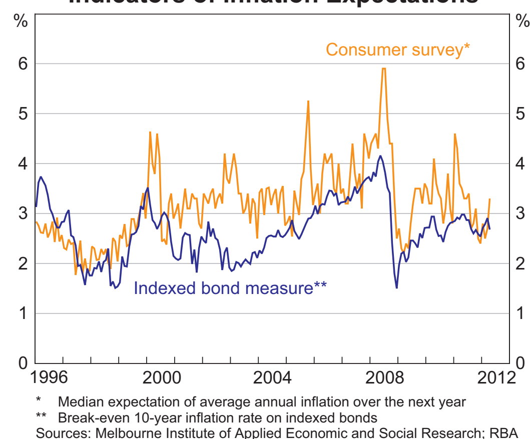


Table 5.2: Median Inflation Expectations(a)
Per cent

	Year to December 2012			Year to December 2013	
	November 2011	February 2012	May 2012	February 2012	May 2012
Market economists	2.9	2.5	2.2	2.7	2.6
Union officials	3.4	3.0	2.3	3.0	2.5

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

6. Economic Outlook

The Bank's Forecasts over the Past Year

Growth through 2011 was weaker than had been expected by the Bank a year ago. As recorded by the latest national accounts, real GDP grew by 2.3 per cent over the year to the December quarter 2011, compared with the 4¼ per cent forecast in the May 2011 *Statement*, with the forecast being revised down through the year as new information became available. The lower outcome than initially forecast largely reflected weak export growth, with some smaller forecast errors in both directions for other components of activity.

As described in the 'Domestic Economic Conditions' chapter, exports in 2011 were held back by a number of factors, including the flooding of Queensland coal mines and the impact of the high level of the exchange rate on manufacturing and services exports. At the time of the May 2011 *Statement*, it was expected that coal producers would be able to remove the excess water from mines and resume full production by the September quarter. While the Australian dollar over 2011 was not too different to the level assumed in the forecasts, the effect of the persistence of the exchange rate at levels not seen for many years is having an impact on manufacturing and services exports, which were weaker than expected. The lower-than-anticipated growth in the global economy also weighed on exports. Imports were slightly stronger than forecast, partly reflecting the stronger-than-expected mining investment, which is particularly import intensive for some projects. Overall, the contribution of net exports to GDP growth over 2011 – a subtraction of 2½ percentage points – was much weaker than had been expected, with around half of the forecast error attributable to the slow recovery of coal exports.

In contrast, overall domestic demand expanded by only a little less than was forecast. While public spending was softer than expected, private demand grew roughly as anticipated, with consumption outcomes close to the forecast, dwelling investment slightly weaker and business investment slightly stronger. Within business investment, non-resource investment was weaker than forecast but resource investment was even stronger than the rapid pace of growth that had been expected. Gross national expenditure expanded by 4.8 per cent, which was in line with the forecast last May.

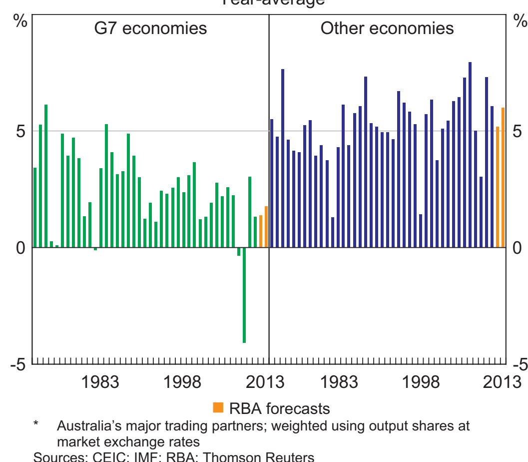
A year ago, it had been expected that employment growth would pick up in the second half of 2011, and that the rate of unemployment would gradually decline. But with output growth lower than expected, and with businesses and households evidently becoming more cautious about the outlook during the second half of the year, conditions in the labour market remained soft. Employment barely grew over the year to March 2012, with large increases in jobs in mining and some service industries roughly offset by declines in manufacturing, accommodation & food services, and retail. Although the rate of unemployment was little changed and at a relatively low level, a decline in labour force participation and average hours worked suggests a degree of weakness in labour demand.

This combination of outcomes affected the path of inflation. A year ago, underlying inflation looked to have reached a low point of about 2¼ per cent, and was starting to rise. The forecast of strengthening output and a tightening labour market meant that inflation was forecast to increase further, to be close to 3 per cent in underlying terms by December 2011, and to stay around that level over the remainder of the forecast period. While inflation did initially pick up a bit further in the June quarter, it then began to moderate in the second half of the year, as a high exchange rate and ongoing changes in household behaviour put pressure on profit margins in some key domestic sectors. The fall in prices for fruit and vegetables, which had been affected by flooding and cyclones in early 2011, occurred more or less as expected. Hence headline CPI inflation fell very sharply, from about 3½ per cent at its peak in mid 2011, to a little over 1½ per cent in early 2012.

In summary, some components of the economy exceeded expectations while others underperformed over the past year, but overall, economic growth was weaker than expected. The generally softer outcomes translated into weaker price pressure in key sectors of the economy. Some of the forces that shaped the performance of particular parts of the economy, such as the strength in mining investment, will continue to be important over the current forecast period, while others, such as the disruption to coal production, will pass.

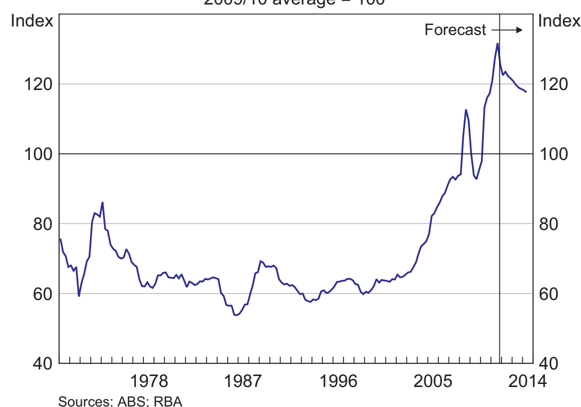
The International Economy

The global economy is expected by most forecasters to grow at a below-trend pace in 2012. Fiscal consolidation and private sector deleveraging, as well as the continued uncertainty stemming from the sovereign debt and competitiveness problems in Europe, are expected to weigh on growth in the advanced economies (Graph 6.1). Global growth is expected to pick up to around trend in 2013. The Bank's central outlook, for world output to expand by around 3½ per cent in 2012 and by around 4 per cent in 2013, is in line with the forecasts from the International Monetary Fund (IMF) published in mid April. Economic conditions remain weak in Europe, with the negative feedback loop between fiscal consolidation and growth still evident in a number of countries in the region. The US economy has continued to expand at a moderate pace, and growth is expected to increase slowly to around its trend pace over the next year. In China, output growth is expected to grow at a slower, and more sustainable, pace in 2012 than in recent years, while growth in much of the rest of Asia is expected to pick up a little, but to remain somewhat constrained by subdued trade with the advanced economies.



After falling by around 5 per cent in the December quarter, the terms of trade are estimated to have declined further in the March quarter. The Bank continues to assume that the terms of trade will decline gradually, with the significant amount of investment under way globally boosting production of the bulk commodities over the forecast period (Graph 6.2).

Graph 6.2
Terms of Trade
2009/10 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed. The exchange rate is assumed to remain at its current level over the forecast period (A$ at US$1.03, TWI at 76), which is around 3 per cent lower than assumed in the February *Statement*. The price of Tapis oil is assumed to remain at US$125 per barrel over the forecast period, similar to the assumption in February. The cash rate is assumed to be unchanged over the forecast period at 3.75 per cent. Finally, the forecasts assume that growth in the working-age population will pick up slightly and average 1½ per cent over the forecast period.

The available indicators for the March quarter suggest that the economy grew at a modest pace. Measures of business and consumer sentiment are at, or slightly below, long-run average levels, while indicators of future building activity remain at low levels. Employment growth picked up modestly in the March quarter, but outside of the mining industry, growth in labour demand remains subdued. Mining production has been temporarily disrupted in early 2012 by a range of factors, including adverse weather. Work has continued, however, on the very large pipeline of committed mining projects.

The domestic economy is expected to grow by about 3 per cent over 2012 and 2013, and around trend over the year to mid 2014 (Table 6.1). This profile is marginally softer than forecast at the time of the February *Statement*. Over the forecast period, domestic demand is expected to grow at a slightly stronger pace than its long-run average, with rapid growth in mining investment not completely offset by weak building activity and soft government spending. Export growth has been revised lower, although it is still expected to be at an above-trend pace, as a result of high current and future investment in mine and transport infrastructure.

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

	Year-ended					
	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013	June 2014
GDP growth	2.3	2¾	3	2½–3½	2½–3½	3–4
Non-farm GDP growth	2.5	2¾	3	2½–3½	2½–3½	3–4
CPI inflation	3.1	1¼	2½	2½–3½	2–3	2–3
Underlying inflation	2½	2	2¼	2–3	2–3	2–3
CPI inflation (excl carbon price)	3.1	1¼	1¾	2–3	2–3	2–3
Underlying inflation (excl carbon price)	2½	2	2	2–3	2–3	2–3
	Year-average					
	2011	2011/12	2012	2012/13	2013	2013/14
GDP growth	2.0	2¾	3	3–3½	3–3½	3–4

(a) Technical assumptions include A$ at US$1.03, TWI at 76, Tapis crude oil price at US$125 per barrel
Sources: ABS; RBA

The outlook for mining investment has been revised higher since the February *Statement*. Information from liaison indicates that some projects previously considered only possible now look more likely to go ahead than had been previously assumed, and that work on some other projects is progressing at least as fast as was expected. Data for the December quarter 2011 also suggest that there is a larger pipeline of work yet-to-be-done in iron ore and coal projects, and surveyed mining investment intentions for 2012/13 also highlight the strong outlook for mining investment (even accounting for the likelihood that not all of this intended investment will occur). Putting all this together, mining investment is expected to rise to around 9 per cent of GDP in 2012/13 compared with a 50-year average of 2 per cent.

At the same time as the upward revision to mining investment, the Bank's expectation for total export growth has been revised lower over the forecast period. This partly reflects a softer outlook for manufacturing exports, and a reassessment of the extent to which resources companies can utilise new port and transport capacity over the next few years. In particular, liaison indicates that it will take coal companies longer than originally envisaged to fully utilise the higher port capacity, due to coordination issues affecting rail networks and port facilities and differences in the timing of the expansion of transport and mine capacity. Despite the lower profile for export growth, it is still expected to be well above average over the forecast period. Exports are likely to continue to record strong growth beyond the forecast horizon as LNG projects under way will increase capacity significantly.

The near-term outlook for residential building activity has been revised lower, with recent data suggesting that there are few signs of an imminent turnaround in demand. Liaison contacts cite three main reasons for subdued housing activity: poor sentiment regarding job security, notwithstanding recent low levels of unemployment; softness in established housing markets, consistent with expectations of flat or declining house prices; and relatively tight credit conditions for developers. It is expected that residential building activity will in time pick up, as lower purchase costs, higher rental yields, population growth and pent-up demand following an extended period of weak growth in building activity combine.

Outside of the mining sector, survey measures and liaison suggest that business investment intentions remain weak at present. Public final demand is also expected to grow at well below-trend rates over the forecast period as both Federal and state governments undertake fiscal consolidation. Growth in household spending moderated a little in late 2011 and early 2012, in line with softer income growth and concerns about unemployment. However, there has been little change to the consumption profile since the February *Statement*, and the saving ratio is expected to remain at around its current level.

Employment growth is forecast to be fairly subdued in the near term, as it has been over the past year. Despite relatively high vacancy rates, firms continue to express caution about hiring and many firms are indicating that they will need to reduce staffing levels to improve productivity and competitiveness.

Given the outlook for the labour market, growth in the wage price index is expected to moderate slightly from the current pace to average 3½ per cent over the forecast period, around ½ percentage point below the elevated rates seen over 2005–2008.

Inflation

The outlook for inflation is somewhat lower than that published in the February *Statement*.

Data for the March quarter indicate that year-ended underlying inflation fell to around 2–2¼ per cent. Inflation is expected to remain close to this rate over the next year before picking up a little later in the forecast period. The forecasts anticipate that domestically generated inflation will moderate

owing to slower growth in unit costs, as a result of softer growth in nominal wages and an assumption that productivity growth picks up as firms, particularly in the non-mining sectors, respond to heightened competitive pressures in an environment of relatively subdued demand and the high exchange rate. This will largely be offset by the disinflationary pressure from tradables prices abating as the effect of the earlier appreciation of the Australian dollar on import prices dissipates.

The profile for headline CPI inflation will be affected by a number of one-off factors over the first half of the forecast period. Reflecting sharp falls in fruit prices in the December and March quarters, year-ended headline inflation will remain below underlying inflation at least until the second half of 2012. Following this, the introduction of the carbon price from the start of the September quarter will boost headline inflation by around 0.7 percentage points over the year to June 2013, for which most households will have received compensation in mid 2012. Measures of underlying inflation will be less affected by the introduction of the carbon price and are expected to be around ¼ percentage point higher than otherwise over the year to June 2013.

Risks

Although the near-term risk of a severe contraction in global activity from an intensification of the sovereign debt problems in Europe has eased somewhat over recent months, it remains the most obvious risk to the global growth forecasts. Since February, the restructure of Greek government debt held by the private sector and the second 3-year longer-term refinancing operation by the European Central Bank have helped to support global business and consumer sentiment a little after some deterioration at the end of 2011. Nevertheless, the situation in Europe remains fragile and, in the past few months, periods of heightened uncertainty have increased demand for safe assets and pushed spreads on some European sovereign bonds higher. As has been the case for some time, the central forecast assumes that a severe contraction in activity in Europe is avoided, but that episodes of heightened uncertainty and financial market volatility will continue to occur for some time.

Persistently high oil prices resulting from supply disturbances are also a downside risk to growth. IMF modelling suggests that a 50 per cent increase in oil prices from a reduction in global supply would lower global output by around 1¼ per cent, although the short-run effect could be larger if it also affected financial conditions and confidence more broadly.

Risks to output growth in the rest of the world are more balanced, but probably slightly tilted to the downside. In the United States, the forecasts assume that only part of the substantial fiscal consolidation that is legislated for 2013 actually occurs, although a larger consolidation would seem to be a downside risk to growth. In Asia, the cycle in information and communication technology (ICT) goods, which dampened growth in the region in the second half of 2011, could turn around more quickly than anticipated. In China, the government's intention is to engineer a further moderation in property prices and maintain a strong overall growth rate, albeit at a lower rate than in recent years. This is a difficult balance to strike, and so Chinese growth could easily be either above or below the central outlook.

For Australia, there are both upside and downside domestic risks to the outlook for activity. Labour shedding in a number of relatively employment-intensive industries, including manufacturing, retail trade and residential construction, may accelerate as firms continue to adjust to the higher level of the exchange rate, shifting patterns in consumption demand and the weak near-term outlook for dwelling investment. Further out, there is a risk that the demand for labour exceeds forecasts in 2013 given the very large pipeline of mining investment projects.

Downside risks to the inflation forecasts primarily reflect the risks of lower global and domestic growth. Weaker employment growth could also result in a sharper slowing in wage growth than anticipated.

On the other side, there is also a risk that the easing in underlying inflation over recent quarters will not be sustained. Over the past couple of years, the inflation outcomes have benefited from the disinflationary effect of lower tradables prices associated with the sharp appreciation of the exchange rate in 2009 and 2010. With the exchange rate broadly unchanged over the past year, tradables deflation is not expected to continue to subtract from overall inflation to the same extent.

While inflation in non-tradables prices eased somewhat in the March quarter, prices of many non-traded items are still increasing at a firm rate. Sustained moderation in domestic cost pressures will therefore be necessary to keep non-tradables inflation contained. This is likely to require a further easing in growth in labour costs and other costs and/or a pick-up in productivity growth. If the anticipated productivity benefits associated with structural adjustment take longer than expected to flow through to lower domestic cost pressures, or are offset by other costs, then activity would be weaker and inflation higher than otherwise. Inflation may also turn out to exceed the forecast if demand growth is higher than expected and firms use this as an opportunity to rebuild margins after a period of margin compression in some industries.