STATEMENT ON MONETARY POLICY

6 NOVEMBER 2009

CONTENTS

Statement on Monetary Policy Enquiries

Media Office

Tel: (612) 9551 9720

Facsimile: (612) 9551 8033

E-mail: rbainfo@rba.gov.au

The material in this *Statement on Monetary Policy* was finalised on 5 November 2009. The next *Statement* is due for release on 5 February 2010.

The *Statement on Monetary Policy* is published quarterly in February, May, August and November each year. All the *Statements* are available on the Reserve Bank's website when released. Expected release dates are advised ahead of time on the website. For copyright and disclaimer notices relating to data in the *Statement* see the Bank's website.

ISSN 1448–5133 (Print)

ISSN 1448–5141 (Online)

STATEMENT ON MONETARY POLICY

The global economy is growing again after contracting sharply late last year and in the early part of 2009. There has been some recovery in world trade and most of the major economies now look to be expanding. The risk aversion that was so evident earlier in the year, particularly in financial markets, has abated and confidence is gradually returning.

Asia is at the forefront of the global recovery. The region's financial systems have not experienced the same dislocation as elsewhere, and the economies are benefiting from a recovery in domestic demand, underpinned by stimulatory settings of both monetary and fiscal policy. Growth in China and India has been particularly strong.

Most of the advanced economies look to have grown in the September quarter, after the earlier sharp falls. The dynamics of the inventory cycle are working to boost growth, and there has been a modest recovery in private final demand in some countries. Notwithstanding this, there is still a long way to go before conditions could be described as normal and monetary policy is expected to remain very accommodative for some time yet. Many of the advanced economies are operating with a high level of excess capacity and face significant medium-term fiscal challenges. Measures of core inflation are low in most countries.

The general improvement in the economic data and the decline in risk aversion have seen most equity markets record strong gains over recent months. Recent earnings results, both in the United States and Australia, have on average exceeded analysts' expectations. Credit conditions continue to normalise, with spreads on corporate paper as well as emerging-market government debt narrowing considerably. Corporate bond issuance has picked up and the issuance of government-guaranteed bank debt has declined markedly as it has become more cost-effective to issue unguaranteed paper. In some countries, debt guarantee schemes are being wound back and central bank programs designed to support market functioning have also been terminated as usage has declined. Housing markets have improved in a range of countries, with prices rising reasonably strongly in some markets. Commodity prices have also generally moved higher over the past six months.

These outcomes are better than those thought likely earlier in the year and forecasts for global growth have been revised up, with growth in Australia's trading partners expected to be close to trend in 2010. The large downside risks that were evident six months ago have also diminished. Significant risks, nevertheless, remain. Activity has recently been boosted by temporary fiscal measures and a slowing in the pace of inventory run-down, with the durability of the pick-up in growth remaining uncertain. Banking systems in a number of countries are still some way from full health and further bad news in the financial sector cannot be ruled out. Dealing with fiscal challenges is also likely to be a constraint on growth over the medium term in some of the advanced economies. In contrast, prospects for the Asian economies are noticeably better and downside risks appear to be lower.

Economic conditions in Australia have also been stronger than expected. In contrast to other developed economies, the Australian economy is estimated to have expanded, albeit modestly, over the first half of the year and recent data suggest that this expansion has continued into the second half. Confidence has improved and spending has been supported by stimulatory settings for both monetary and fiscal policy. The Australian economy has also benefited from the strong bounce-back in Asia, particularly in China, with export volumes remaining broadly unchanged during a period in which global trade fell markedly.

Investment in Australia has also held up reasonably well, underpinned by a strong expansion of the resources sector and various fiscal measures. While the latter have brought forward the timing of some spending on plant and equipment, investment over the coming year is likely to be stronger than earlier expected. Investment in the resources sector is at historically high levels and is expected to increase further, particularly as the LNG sector expands. This expected rise in investment – which is already at a high level relative to GDP and compared with other developed economies – should further boost the supply side of the Australian economy, although as it takes place, short-term capacity constraints could again emerge in parts of the economy.

One area of continuing weakness in the business sector is commercial property, where financing constraints remain a significant issue. The effect of this weakness on overall construction activity is, however, being partly offset at the moment by increased building in the education sector as the result of fiscal measures. More broadly, there has been a substantial shift in the structure of business financing over the past year, with many large firms raising external equity to reduce their leverage in an environment of tighter lending standards. Reflecting this, business credit has fallen over the course of the year although, unlike in the early 1990s when business credit last fell, the level of investment remains high.

Growth in household spending has been slower over the second half of 2009 than it was over the first half, when disposable incomes were boosted by government transfer payments. Nevertheless, spending has held up reasonably well, supported by high levels of consumer confidence and rising household wealth from higher asset prices. Housing prices have strengthened considerably over the course of the year, with prices in most areas now above their previous peaks. Lending approvals have risen noticeably, although the same pick-up is not evident in housing credit growth as many borrowers have taken advantage of low mortgage rates to pay down their mortgage more quickly than in the past.

A recovery in housing construction is now clearly under way, with leading indicators of house building well above the levels of late 2008, although financing issues are constraining activity in the apartment market. There are, however, likely to be ongoing pressures in the housing market over the next few years, with the Australian population growing at its fastest rate since the 1960s. Addressing these pressures will require further steps to improve the supply side of the housing market.

Conditions in the labour market have generally not been as weak as earlier forecast, with the unemployment rate steady at around 5¾ per cent for the past five months. While there has been no growth in employment over the past year, the rise in unemployment has been contained by greater flexibility in the labour market – with many firms and workers agreeing to reduce working hours as the economy slowed – as well as a decline in the participation rate. The general softness in labour demand over the past year has led to a significant slowing of wage growth, particularly in the private sector, and some further slowing is expected over the period ahead, notwithstanding tentative signs that the demand for labour is picking up again.

In underlying terms, inflation continues to decline gradually, broadly in line with the Bank's expectations. Over the year to the September quarter, the Bank's assessment is that underlying inflation was around 3½ per cent, compared with a little more than 4½ per cent a year earlier. In contrast, the CPI increased by just 1.3 per cent over the year, held down by earlier declines in petrol prices and the ABS measure of the cost of deposit and loan facilities used by the household sector. The slowdown in wage growth and lower prices for imported goods resulting from the recent appreciation of the currency suggest that a further moderation in underlying inflation is likely over the period ahead.

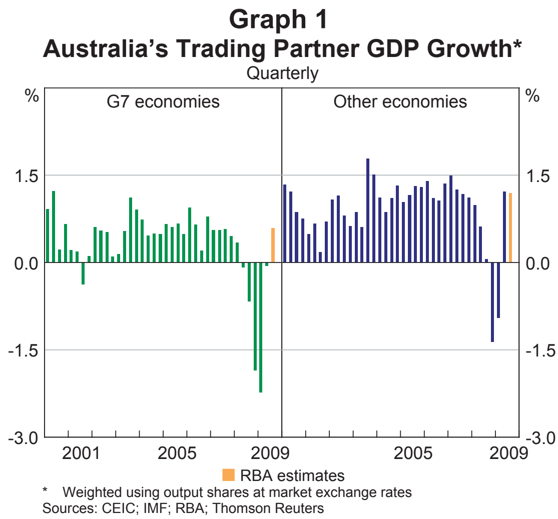
Given the resilience of the economy, GDP is now expected to increase by a little more than 2 per cent over the year to mid 2010, a considerably better outcome than thought likely earlier in the year. The central forecast is then for the economy to expand by 3¼ per cent over the year to mid 2011, with growth gradually increasing over the remainder of the forecast period. Growth in business investment and exports is expected to be strong, underpinned by the ongoing expansion of the resources sector. The outlook for Australia's terms of trade has also improved, with some increase now expected over the next year or so. The various fiscal stimulus measures are also likely to continue to support the level of GDP in 2010, although their maximum effect on growth is likely to have already passed. One additional factor shaping the outlook is the appreciation of the exchange rate, which has occurred against the backdrop of brighter prospects for the overall economy and the recent lift in commodity prices, but is affecting prospects for some trade-exposed sectors of the economy.

As noted, underlying inflation is expected to moderate further over the year ahead as the lagged effects of the economic slowdown and the appreciation work their way through. The central forecast is for underlying inflation to decline to around 2¼ per cent by late 2010, before gradually increasing to around 2½ per cent over 2011. Year-ended CPI inflation is likely to rise over coming quarters as temporary factors that have held it down fade, and is expected to be similar to underlying inflation in 2010.

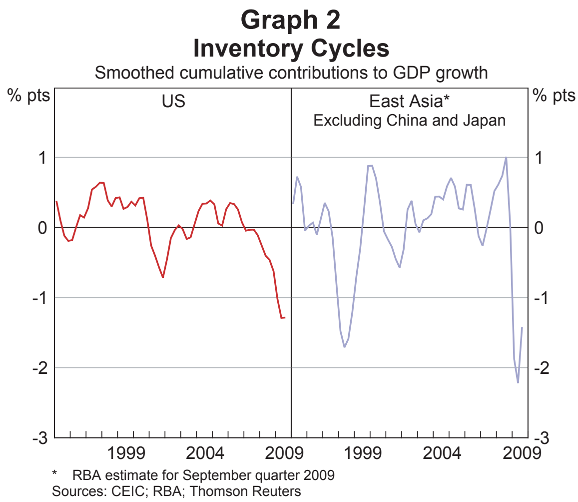
Conditions in the global and Australian economies are significantly better than was expected when the Board lowered the cash rate to 3 per cent earlier in the year. The Australian economy is operating with less spare capacity than earlier thought likely, and the outlook for the next few years has improved. Given this assessment, the Board has judged it prudent to lessen the degree of monetary stimulus that was put in place when the outlook appeared much weaker, increasing the cash rate by 25 basis points at both its October and November meetings. The cash rate remains at a low level, and a further gradual lessening of monetary stimulus is likely to be required over time if the economy evolves broadly as expected. The Board will continue to monitor developments closely and set monetary policy so as to promote sustainable growth in the Australian economy and keep inflation consistent with the medium-term target.

International Economic Developments

Conditions in the world economy have continued to improve over recent months, with global output now growing again following very large falls in late 2008 and early 2009. Growth is strongest in the Asian region, and activity in a number of Latin American economies also appears to be bouncing back solidly. Conditions in most of the major advanced economies have begun to pick up after the earlier sharp declines (Graph 1).



The current strengthening in global activity in part reflects the gradual unwinding of the marked pessimism that took hold in late 2008 as well as the progression of the inventory cycle. In many economies, inventories were run down sharply in late 2008 and the first half of 2009 in response to the dramatic decline in demand, increase in uncertainty, and disruption to credit markets around that time (Graph 2). The period of acute inventory adjustment now seems to be over and a slowing in the pace of de-stocking has probably lifted production levels in many countries in the September quarter.

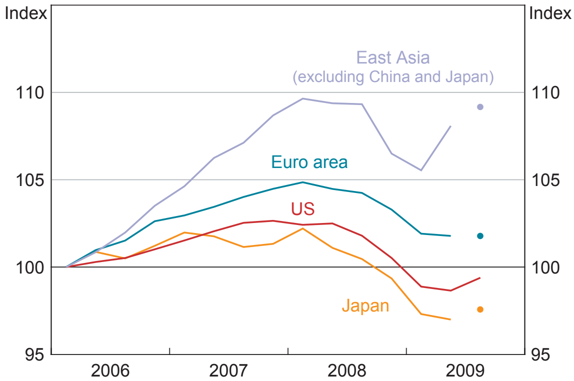


While this adjustment should continue to boost global growth in coming quarters, in the advanced economies a further pick-up in underlying final demand is required for a sustained recovery to take hold. In this regard, stimulatory monetary and fiscal policy around the world is helping to boost growth. Domestic final demand has stabilised or begun to rise in most economies, and there are signs of solid growth in some parts of the world, particularly in Asia, where demand picked up strongly in the June quarter and appears to have risen again in the September quarter (Graph 3). The economies of Asia have not experienced the severe disruptions

Graph 3

Domestic Final Demand*

March quarter 2006 = 100



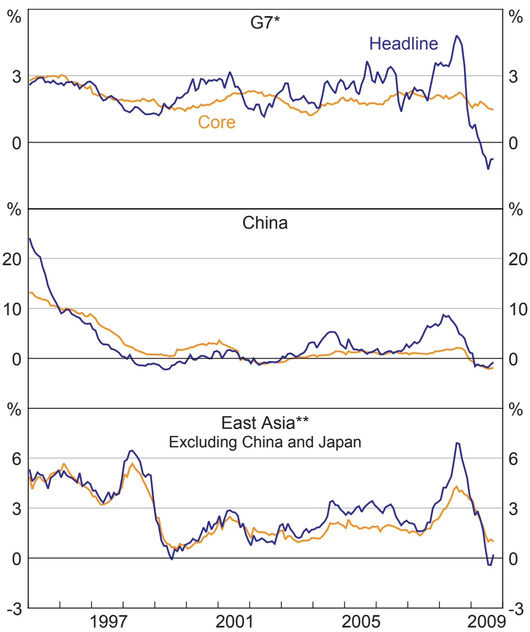
* Dots represent RBA estimates for September quarter 2009

Sources: CEIC; RBA; Thomson Reuters

Graph 4

Consumer Price Inflation

Year-ended



* Weighted by GDP at PPP exchange rates; excludes Japan

** Weighted by GDP at PPP exchange rates; excludes Indonesia

Sources: CEIC; RBA; Thomson Reuters

to their financial systems witnessed in some advanced North Atlantic countries and typically face fewer medium-term fiscal challenges.

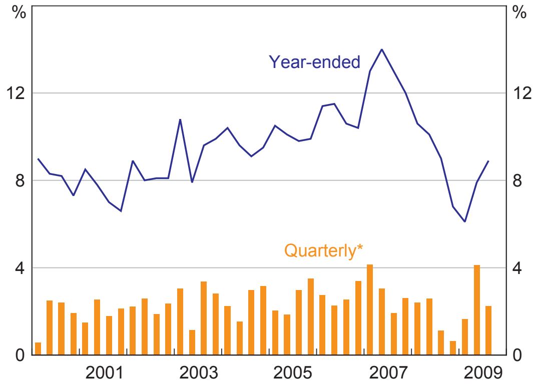
Official interest rates remain very low in all the major advanced economies. Notwithstanding these accommodative settings, and the fact that core inflation has generally fallen only modestly to date in many of these countries (Graph 4), further declines in core inflation appear likely given the considerable excess capacity built up over the past 12 to 18 months. The IMF estimates that the major advanced economies are currently operating at around 5 per cent below their potential level of output, with little reduction in this degree of slack expected in 2010. In China and elsewhere in east Asia, further near-term declines in core inflation appear less likely in view of the strong rebounds in activity under way in these economies. In headline terms, year-ended consumer price inflation is currently negative or very subdued in the bulk of both advanced and developing economies, although this largely reflects the sharp falls in oil and other commodity prices in late 2008.

The recent recovery in activity has been most pronounced in the Chinese economy, where GDP rose by around 2¼ per cent in the September quarter, after growing by 4 per cent in the June quarter, to be around 9 per cent higher over the year (Graph 5). While a quarterly breakdown of growth by expenditure components is not available, monthly indicators suggest growth has become more broad-based in the September quarter (Graph 6). Nominal urban fixed-asset investment rose by 3 per cent in the quarter, following two quarters of exceptional strength, with investment in the residential construction sector particularly strong, consistent with the earlier sharp recovery in sales of residential property. Retail sales continued to grow robustly, partly boosted by fiscal incentives, while Chinese external trade has also begun to grow strongly again after falling sharply in late 2008 and the early part of 2009. Export volumes are estimated to have risen by around 10 per cent in the September quarter, and imports to have grown by around 7 per cent. A more detailed discussion of the recent recovery in trade in east Asia is provided in 'Box A: The Recovery in Asian Trade'.

Strong growth in credit continues to be an important factor supporting the recovery in the Chinese economy, although credit growth has slowed from the extraordinary pace seen earlier in the year. While much of this earlier expansion in credit flowed to businesses, growth in lending to this sector moderated in the September quarter, but household borrowing has picked up. Overall, the amount by which credit has expanded in the first nine months of this year exceeds the corresponding increase in 2008 by around 5 trillion renminbi, or more than 15 per cent of annual nominal GDP, far outstripping the scale of fiscal expansion.

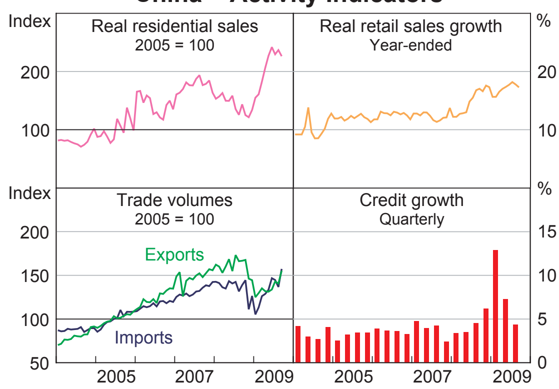
A solid recovery also appears to be under way in the Indian economy after what was only a relatively mild slowdown. Industrial production increased by 8 per cent over the three months to August, following little growth over the first half of the year (Graph 7). The services sector continues to grow solidly, and it

Graph 5
China – GDP Growth



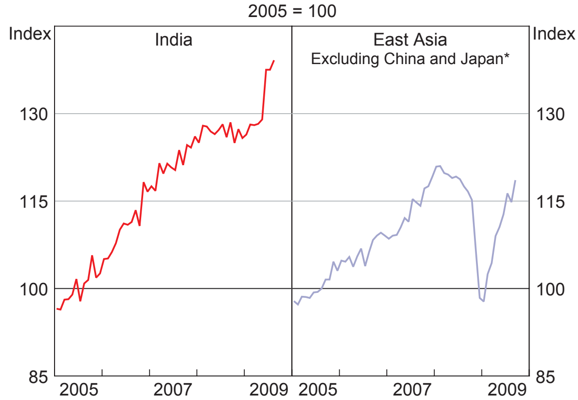
* RBA estimates
Sources: CEIC; RBA

Graph 6
China – Activity Indicators*



* RBA estimates
Sources: CEIC; RBA

Graph 7
Asia – Industrial Production
2005 = 100

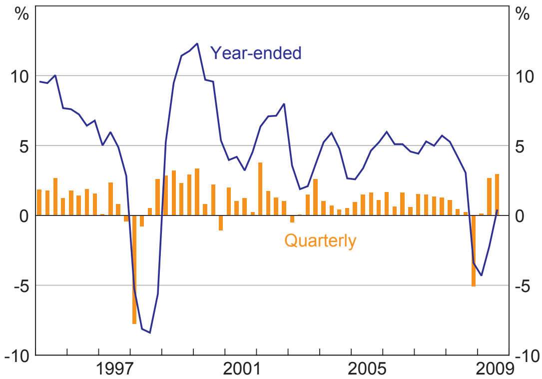


* Also excludes Hong Kong; RBA estimate for September 2009
Sources: CEIC; RBA

now appears that agricultural output – which still constitutes one-sixth of the economy – may be somewhat less adversely affected by deficient monsoon rainfall in key growing areas than feared some months ago.

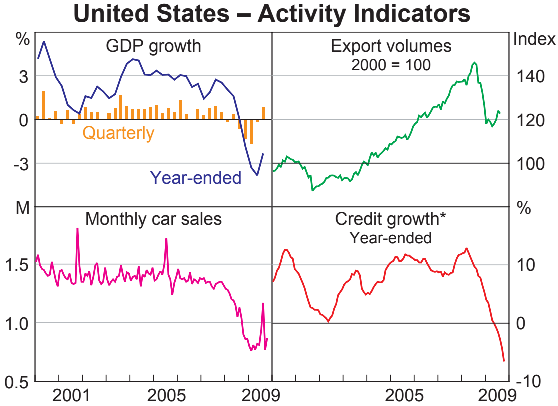
Elsewhere in Asia, conditions also continue to improve. Industrial production fell modestly in August across the region after earlier significant rises, but looks to have increased strongly again in September. GDP rose by nearly 3 per cent in Korea in the September quarter, in large part driven by a turnaround in inventories, which contributed more than 2½ percentage points to growth after subtracting 7½ percentage points over the preceding three quarters (Graph 8). Domestic final demand also increased solidly in the September quarter, after rising strongly in the June quarter, and exports continued to recover.

Graph 8
South Korea – GDP Growth



Source: CEIC

Graph 9
United States – Activity Indicators



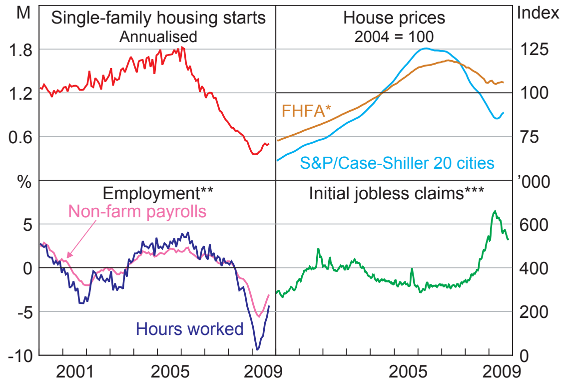
* RBA estimates of credit extended to the non-financial private sector by commercial banks
Sources: Board of Governors of the Federal Reserve System; RBA; Thomson Reuters

In the advanced economies, output growth also generally appears to have resumed, although greater uncertainty remains about both the pace and durability of recovery once the effects of fiscal stimulus and the likely near-term boost to activity from the inventory cycle fade. In the United States, GDP expanded by 0.9 per cent in the September quarter, the first increase since the June quarter 2008, but is still down by 3 per cent from its peak (Graph 9). A slowing in the pace of de-stocking accounted for ¼ percentage point of this growth. Household consumption rose by 0.8 per cent in the quarter, although more than one-third of this reflected the 20 per cent increase in auto sales associated with the Federal Government's car scrappage program, which operated from late July to late August. Business investment fell again in the quarter, to be nearly 20 per cent lower over the year, and the ongoing contraction in credit to the private sector suggests that firms and consumers remain intent on reducing their debt levels.

While recent data have been mixed, a mild recovery in the US housing market, both in prices and activity, appears to be under way (Graph 10). Although the pick-up in housing starts remains very modest, dwelling investment increased solidly in the September quarter for the first time since late 2005. In addition, the recent small rise in house prices should, together with share price gains, have seen household wealth record a second solid increase in the September quarter, providing some support to household sentiment and consumption. Conditions in the labour market, however, remain very weak. Employment fell at an annualised rate of 3 per cent over the six months to September, with a larger decline in total hours worked, and the unemployment rate has risen to 9.8 per cent, the highest rate since 1983. While weekly initial jobless claims have fallen markedly from their peak in late March, they remain well above the level that has in the past been associated with a stabilisation in employment.

Graph 10

United States – Housing and Labour Indicators

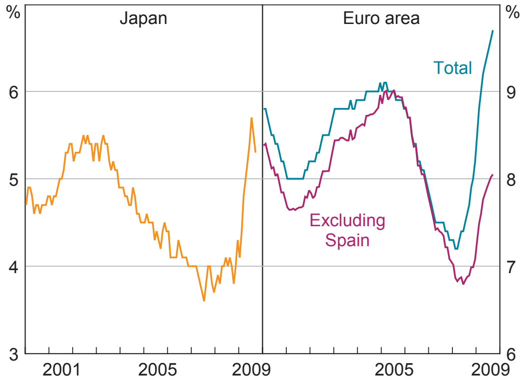


* Federal Housing Finance Agency
** Six-month-ended annualised growth
*** Four-week moving average
Sources: Standard & Poor's; Thomson Reuters

The advance estimate of UK GDP for the September quarter was weaker than expected and suggests that output contracted by a further 0.4 per cent, the sixth successive decline, to be down by nearly 6 per cent from its peak in March quarter 2008. In contrast, near-term growth prospects for the euro area and Japan appear to have improved somewhat. Both Germany and France recorded modest increases in activity in the June quarter, and seem likely to have grown again in the September quarter; industrial production (excluding construction) in the euro area was 1.7 per cent higher in July and August relative to the June quarter; and business and consumer sentiment continue to improve, although the volume of retail sales fell in the September quarter. The Japanese economy also appears to have recorded its second consecutive quarter of growth in the September quarter, driven by a continued revival in exports and a modest further pick-up in household consumption.

Notwithstanding these signs of improvement, there is considerable excess capacity in both Japan and the euro area that is likely to weigh on business investment for some time. In Japan, the unemployment rate reached a record high of 5.7 per cent in July, although it has since fallen back with employment increasing modestly in recent months. In the euro area, the unemployment rate has risen by around 2½ percentage points since its trough in March 2008, with a large part of this increase reflecting developments in Spain, where the unemployment rate has risen by around 10 percentage points to reach 19 per cent (Graph 11). Excluding Spain, the unemployment rate has increased by around 1¼ percentage points – a very different outcome from the United States, where the corresponding rise has been more than 5 percentage points even though the peak-to-trough GDP decline has been smaller. A substantial part of this difference is explained

Graph 11
Unemployment Rates



Sources: RBA; Thomson Reuters

by government incentives in various European countries, including Germany and Italy, to encourage firms to retain workers on reduced hours rather than dismiss workers. Accordingly, the difference between the United States and euro area in terms of the decline in total hours worked during the current episode is much smaller.

Forecasts

In its latest forecasts, released in early October, the IMF again revised up its outlook for global growth in 2010. Following an expected contraction in output in 2009 of just over 1 per cent in year-average terms – which would be by far the worst annual outcome for at least the past 50 years – the IMF now forecasts world output to expand by a little more than 3 per cent in 2010 (Table 1). This is around 1¼ percentage points stronger than the IMF expected six months earlier, but would still represent relatively weak global growth by pre-crisis standards. The IMF then expects slightly above-trend world growth of a little more than 4 per cent in 2011. These forecasts are a little weaker than those of the RBA staff for 2009 and 2010, which are outlined in the 'Economic Outlook' chapter.

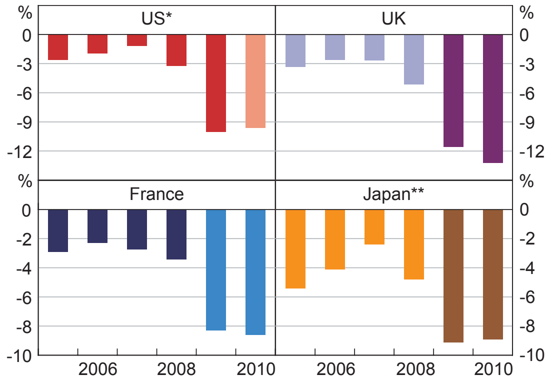
Table 1: World GDP Growth
Year-average, per cent[(a)]

	2008	2009	2010
		IMF forecasts[(d)]	
United States	0.4	–2.7	1.5
Euro area	0.7	–4.2	0.3
Japan	–0.7	–5.4	1.7
China	9.0	8.5	9.0
Other east Asia[(b)]	2.7	–1.2	3.8
India	7.3	5.4	6.4
World	**3.0**	**–1.1**	**3.1**
Australia's trading partners[(c)]	2.7	–0.8	3.7

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Weighted using GDP at market exchange rates
(c) Weighted using merchandise export shares
(d) Forecasts from the October *World Economic Outlook*
Sources: CEIC; IMF; RBA; Thomson Reuters

Notwithstanding the recovery now under way, the outlook for global growth in 2010 remains subject to considerable uncertainty. On the one hand, recoveries from previous recessions in the major advanced economies have often been quite strong. On the other hand, in many countries balance-sheet and financial-sector problems may constrain the pace of the rebound in activity in this episode more than in earlier ones. Abstracting from these considerations, one key influence on the sustainability and speed of medium-term recovery in many countries is likely to be the pace of fiscal consolidation. Among the major advanced economies, the IMF projects budget deficits to have increased by around 5½ percentage points of GDP in 2009 relative to 2008, to 10 per cent of GDP, and to remain elevated at around 9 per cent of GDP in 2010 (Graph 12). As a result, net debt levels in these countries are forecast to rise by around 20 percentage points of GDP between late 2008 and late 2010, to reach almost 80 per cent of GDP, with further significant increases in prospect in subsequent years. In some countries, concerns about fiscal sustainability may require governments to take additional steps to put their public finances on a sounder footing.

Graph 12
Fiscal Balances – Selected Economies
Per cent of GDP



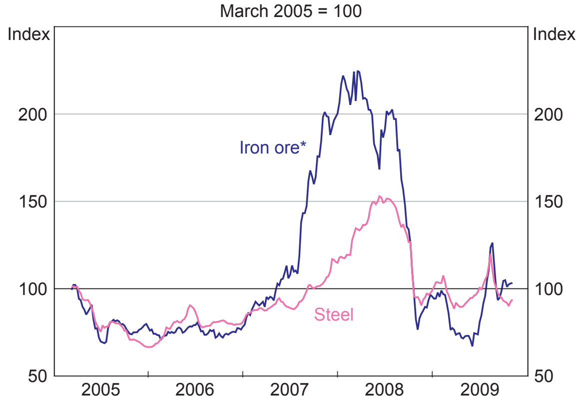
* US Treasury and Congressional Budget Office (CBO) data (fiscal years); federal government fiscal balance only
** Excluding social security
Sources: CBO; IMF; US Department of the Treasury

Commodity prices

Commodity prices have risen substantially from their levels earlier in the year, but have been broadly flat over the past few months. Prices of exchange-traded commodities have mostly been steady or somewhat stronger since the August *Statement*. Spot prices for the bulk resource commodities have tended to soften somewhat, but expectations for upcoming contract negotiations have generally been revised upwards. Australia's terms of trade are estimated to have fallen somewhat in the September quarter, after large falls in the first half of the year.

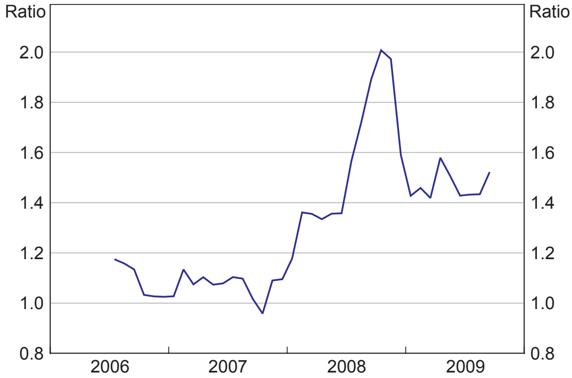
Prices for iron ore on the spot market fell significantly in August but have recovered somewhat recently, to be around 18 per cent below the levels of mid August. This has occurred in the context of falls in Chinese spot market prices for steel (Graph 13). These price falls have reportedly reflected a run-up in steel inventories to relatively high

Graph 13
China – Spot Iron Ore and Steel Prices
March 2005 = 100



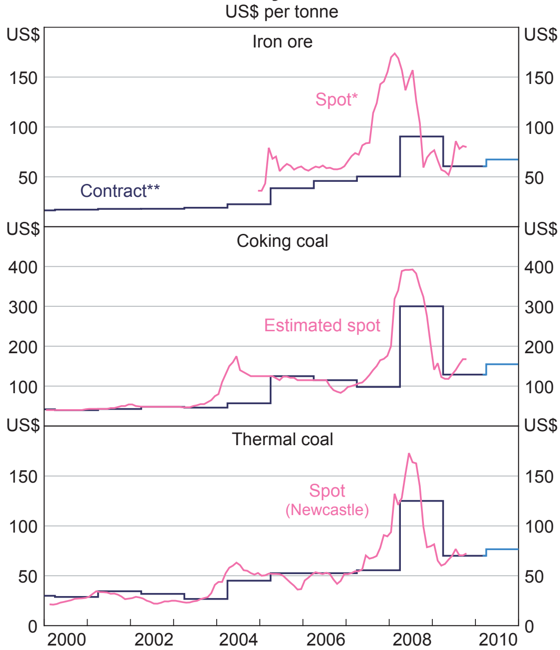
* Calculated using the spot import price in China less the spot freight rate from Australia to China
Sources: Bloomberg; RBA

Graph 14
China – Iron Ore Inventories at Ports
Relative to monthly steel production



Sources: Bloomberg; CEIC

Graph 15
Bulk Commodity Contract Prices
US$ per tonne



* Calculated using the spot import price in China less the spot freight rate from Australia to China

** Average of market analyst forecasts for 2010 contract

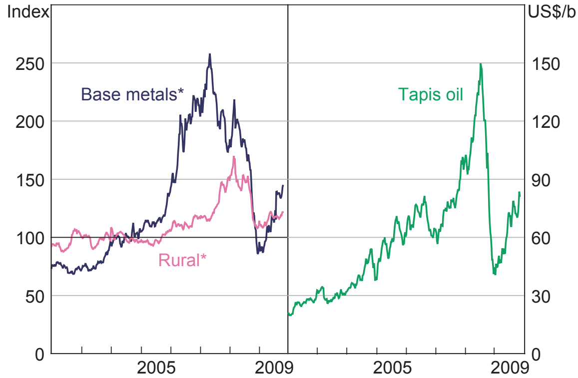
Sources: ABARE; AME Mineral Economics; Bloomberg; Citigroup; Consensus Economics; Macquarie Bank; RBA

levels, and production restarts by previously-idled Chinese iron ore mines. However, Chinese inventories of iron ore appear to have grown at a more modest pace and have not increased relative to steel production (Graph 14).

Despite the fall in spot prices, expectations of contract prices for Australian exports of bulk commodities have risen (Graph 15). Private-sector forecasters expect that Australian producers will negotiate higher contract prices in 2010/11 with major steel mills across Asia. Market analysts are forecasting around a 10 per cent rise in iron ore and thermal coal contract prices and a 20 per cent increase for coking coal, although it is possible that there will be a gradual shift away from the system of annual contracts. Negotiations for 2009/10 iron ore contracts between Australian producers and major Chinese steel mills remain unresolved, although 'provisional' contracts are reportedly in place, with prices in line with those settled with Japanese and Korean mills.

Base metals prices are broadly unchanged from early August, having fluctuated on news regarding the pace of growth in demand and inventory-building in China (Graph 16). Although inventories of both crude oil and refined products are currently at relatively high levels, crude oil prices have recently risen to around US$80 per barrel, boosted by an improved outlook for global demand and a weaker US dollar. Rural commodity prices have been more mixed; wheat prices have fallen due to favourable Northern Hemisphere harvests and a modest improvement in the outlook for the Australian crop, while sugar prices have risen, due to current and expected supply difficulties in Brazil and India.

Graph 16
Commodity Prices
Weekly



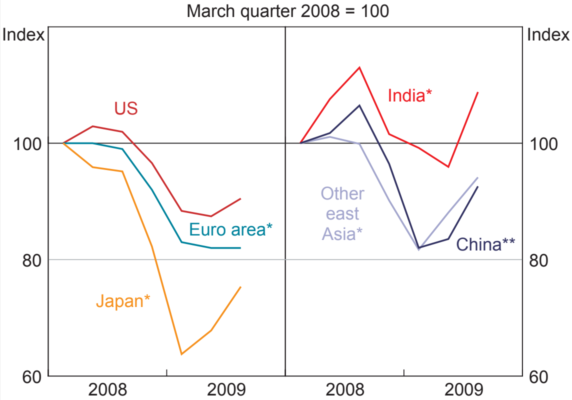
* 2004 = 100, SDR terms
Sources: Bloomberg; RBA

Box A: The Recovery in Asian Trade

Graph A1

Export Volumes

March quarter 2008 = 100



* RBA estimates for September quarter 2009

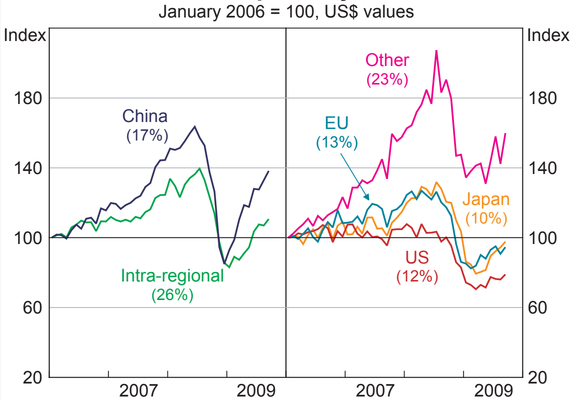
** Refers to merchandise exports only

Sources: CEIC; RBA; Thomson Reuters

Graph A2

East Asia* – Exports by Destination

January 2006 = 100, US$ values



* Excluding China and Japan. Figures in brackets show share of each destination in 2008.

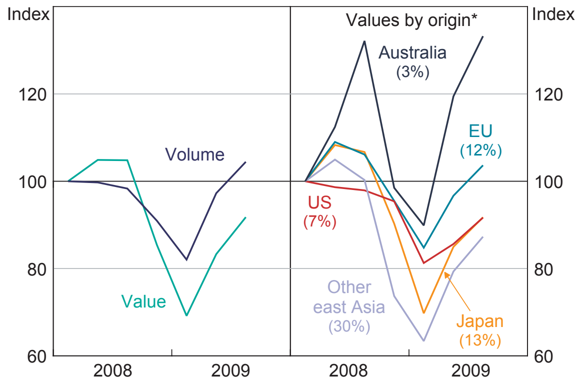
Sources: CEIC; RBA

The sharp downturn in the global economy was associated with a large contraction in world trade as demand for consumer durables and capital goods declined. Over the past six months, however, international trade has begun to pick up, with this turnaround being most pronounced in east Asia (Graph A1). Exports from China, Japan and the smaller economies of the region have all increased over recent months, after earlier sharp falls. Indian exports have also recovered strongly in the September quarter, after contracting over the first half of 2009. In contrast to developments in Asia, exports from the United States and the euro area remained weak over the first half of 2009 and have risen only modestly since then.

The rise in exports from many of the economies of east Asia since the early part of the year has been underpinned by strong demand from China as well as a rebound in intra-regional trade (Graph A2). This is consistent with the recovery in domestic final demand in the region, which has reflected the generally sounder conditions in these economies (including their financial systems) and the substantial policy stimulus that has been put in place, most notably in China (see 'Box B: Some Aspects of China's Recent Growth' in the August *Statement)*. The recovery in the Chinese economy over the past six months has been sufficiently strong to bring import volumes back above their earlier peak (Graph A3). While this increase in Chinese imports has benefited all of China's major trading partners, it has been imports from Australia, Japan and elsewhere in east Asia that have experienced the most rapid rebounds. Trade elsewhere in east Asia also appears to have been boosted by a shift in inventory dynamics, both in the region and elsewhere around the world, just as the unintended build-up in inventories during 2008 exacerbated the earlier fall in trade.

The pick-up in trade across Asia is evident in a wide range of goods. In the case of China, the rise in exports in the September quarter was broad-based, although exports of electrical equipment (including consumer electronics) have been particularly strong recently. In the case of the higher-income economies in the region, electronic components and consumer durables also appear to have played a particularly prominent role in driving the rebound. In Korea, for example, exports of motor vehicles and semi-conductors have recovered very strongly following sharp falls over the second half of 2008 (Graph A4). Korean exports of motor vehicles have benefited from car scrappage schemes in the United States and several European countries, although the increase in auto exports has been broad-based across destinations. Semi-conductor exports are estimated to have doubled since January, with a large part of this increase reflecting demand from China. While some of this is accounted for by robust final demand from China itself, the strength also reflects apparent rebuilding of stocks and China's role in the assembly of consumer electronic goods for re-export.

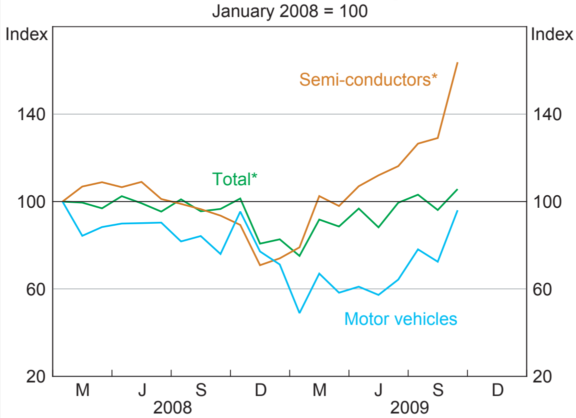
Graph A3
China – Merchandise Imports
March quarter 2008 = 100



* Figures in brackets show each region's share of China's total imports in 2008

Sources: CEIC; RBA; Thomson Reuters

Graph A4
South Korea – Merchandise Export Volumes
January 2008 = 100



* RBA estimates for September 2009

Sources: CEIC; RBA

Elsewhere in the region, the recovery in export volumes in the ASEAN economies has been relatively modest to date, but the value of exports from these countries has posted a more solid increase. A relatively high share of exports from these economies consists of energy commodities, particularly in the case of Indonesia and Malaysia, the prices of which have generally risen strongly over the past six months following sharp falls in late 2008. ✮

International and Foreign Exchange Markets

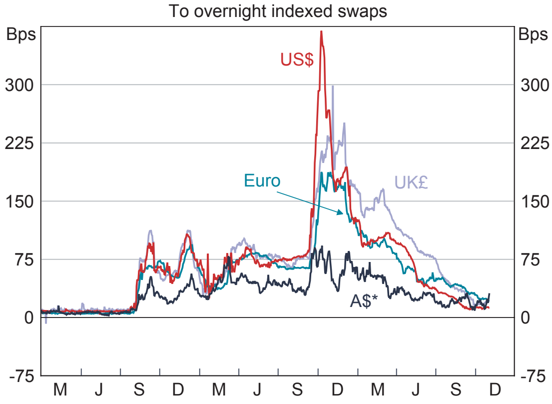
Credit markets

Conditions in credit markets have continued their improvement that began in mid March. In money markets, spreads between LIBOR and the expected cash rate for the major currencies have narrowed substantially and are well below those prevailing throughout most of the financial crisis (Graph 17). Notably, US dollar LIBOR spreads are currently around where they were prior to the crisis. With policy rates at historically low levels in many countries, these narrower spreads imply that the absolute level of these rates is also at historic lows.

Graph 17

3-month LIBOR Spreads

To overnight indexed swaps



* Bank bills to overnight indexed swaps

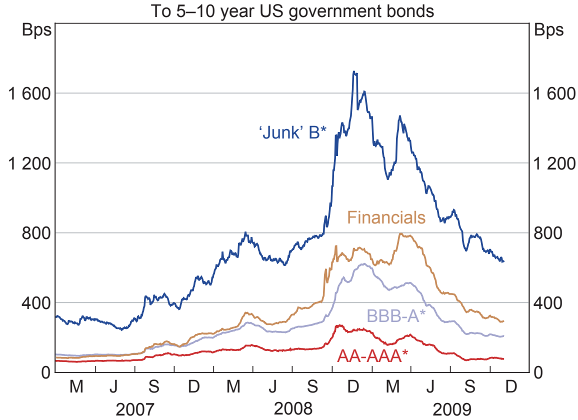
Sources: Bloomberg; Thomson Reuters; Tullett Prebon (Australia) Pty Ltd

Spreads on corporate bonds issued by US financials and lower-rated ('junk') corporates have also continued to narrow and are at their lowest levels since mid 2008, while spreads on highly-rated debt issued by non-financials have stabilised at levels comparable to those prevailing prior to the crisis (Graph 18). In the United States, spreads between yields on housing agency debt and US Treasuries are near pre-crisis lows. Again, given the low level of government bond yields, many of these borrowing rates are also at historically low levels.

Graph 18

US Corporate Bond Spreads

To 5–10 year US government bonds

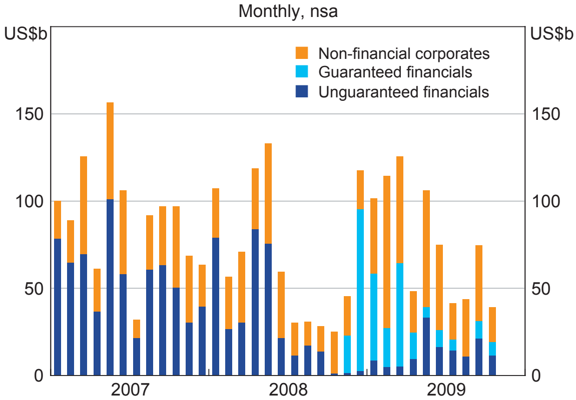


* Industrial corporates

Sources: Bloomberg; Merrill Lynch

Over the past six months, aggregate corporate bond issuance has moderated in the United States (Graph 19). Similar trends are evident in Europe and the United Kingdom. Issuance by non-financial corporates in the United States has

Graph 19
US Bond Issuance
Monthly, nsa



Sources: RBA; Thomson Reuters

returned to pre-crisis levels, partly reflecting the relative ease with which US corporates can directly access debt markets compared with intermediated borrowing.

For financial institutions, increased issuance of unguaranteed bonds has not been enough to offset reduced guaranteed issuance. The decline in aggregate issuance by financials reflects, in part, the large volume of guaranteed issuance early in the year and reduced total funding requirements because of slower balance sheet growth. The increased issuance by financial institutions of unguaranteed bonds partly reflects the fact that it has become increasingly cost-effective: the improvement in credit market conditions has seen spreads on unguaranteed debt for many institutions decline further than spreads between yields on government-guaranteed bonds and government securities. The shift away from guaranteed debt issuance also partly reflects the determination of many major banks, particularly in the United States, to demonstrate their ability to issue unguaranteed debt and raise new capital from private sources in order to be allowed to exit various government programs.

Reflecting the decreased need for government guarantees, a number of authorities, including the Federal Deposit Insurance Corporation (FDIC), have signalled that their programs will expire as planned or will be extended to only cover institutions for which issuing unguaranteed debt remains exceptionally expensive. In the United States, the government guarantee on senior unsecured debt expired at the end of October 2009, but the FDIC will provide guarantees in exceptional circumstances for a further six months for a fee of 300 basis points. Ireland and Sweden have also extended their bank bond guarantees but, in Ireland's case, at a higher fee.

Credit default swap (CDS) premia on bank debt and a range of other assets have also declined further in recent months, reflecting the ongoing abatement of the severe risk aversion that characterised credit markets during the worst of the crisis. CDS premia on investment-grade and more risky corporate debt such as leveraged loans have continued to fall.

While spreads on US commercial mortgage-backed securities (CMBS) have also narrowed from their peaks, their prices remain well below the levels prevailing before the Lehman Brothers default in September 2008 (Graph 20). Prices on sub-prime residential mortgage-backed securities (RMBS) have shown relatively little improvement and remain less than half their pre-crisis levels, reflecting their higher expected likelihood of default.

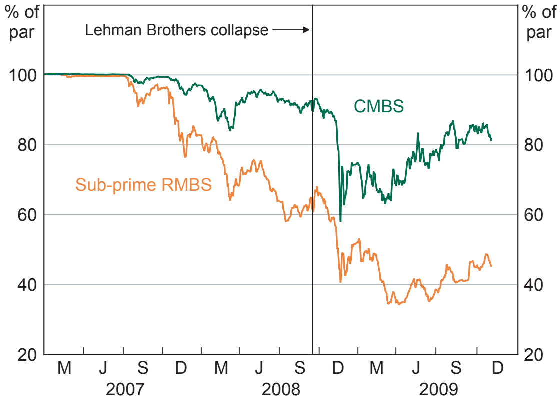
Central bank policy

A number of central banks have continued to ease monetary policy through lower interest rates in the case of emerging economies or outright asset purchases in the case of some advanced

Graph 20

US AAA ABS Prices

Average across 2006–2008 vintages of CDS indices



Source: JPMorgan Chase & Co.

economies. However, the rate at which monetary conditions are being eased has slowed and the demand for liquidity offered by central banks is receding.

Central banks in most economies have lowered policy rates substantially since the beginning of their easing phases but, in many cases, rates have remained unchanged (near their lower bounds) for at least six months (Table 2).

Table 2: Policy Rates

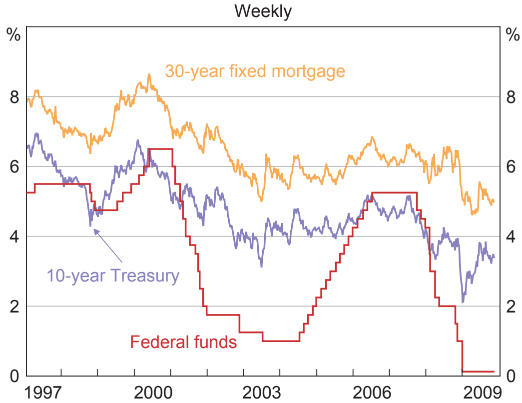
	Current level Per cent	Most recent change	Change over easing phase Basis points
Euro area	1.00	↓ May 09	↓ 325
Japan	0.10	↓ Dec 08	↓ 40
United States	0.125	↓ Dec 08	↓ 513
Brazil	8.75	↓ Jul 09	↓ 500
Canada	0.25	↓ Apr 09	↓ 425
China	5.31	↓ Dec 08	↓ 216
India	4.75	↓ Apr 09	↓ 425
Indonesia	6.50	↓ Aug 09	↓ 300
Israel	0.75	↑ Aug 09	↓ 375
Malaysia	2.00	↓ Feb 09	↓ 150
Mexico	4.50	↓ Jul 09	↓ 375
New Zealand	2.50	↓ Apr 09	↓ 575
Norway	1.50	↑ Oct 09	↓ 450
Russia	9.50	↓ Oct 09	↓ 350
South Africa	7.00	↓ Aug 09	↓ 500
South Korea	2.00	↓ Feb 09	↓ 325
Sweden	0.25	↓ Jul 09	↓ 450
Switzerland	0.25	↓ Mar 09	↓ 250
Thailand	1.25	↓ Apr 09	↓ 250
Turkey	6.75	↓ Oct 09	↓ 1 000
United Kingdom	0.50	↓ Mar 09	↓ 525

Sources: Bloomberg; Thomson Reuters; central banks

Financial market pricing suggests that policy rates in the United States and euro area are not expected to begin increasing until the middle of 2010; the Fed has indicated that it will maintain its policy rate at the lower bound for a considerable period. The Bank of Canada (BoC), Reserve Bank of New Zealand (RBNZ) and Sveriges Riksbank have also reiterated their commitments to keep policy rates around their current low levels until at least the second half of 2010. In contrast, the Bank of Israel and Norges Bank have recently raised their policy rates by 25 basis points in response to rising inflation expectations.

In the United States, the Fed has continued to ease monetary policy through outright purchases of US Treasuries, agency RMBS and agency debt. The Fed completed its program of purchasing US Treasury securities at the end of October and announced that it will slow the pace of agency RMBS and agency debt purchases by extending the completion date of this program by three months to the end of March 2010. The Fed also reduced its target for agency debt purchases from US$200 billion to around US$175 billion. To date the Fed has acquired around US$980 billion in agency RMBS, US$140 billion in agency debt and US$300 billion in Treasuries – of an ultimate target of around US$1 725 billion. These operations appear to have placed some downward pressure on mortgage rates (Graph 21), although this has had little impact on household debt servicing in the United States (see Box B).

Graph 21
US Interest Rates
Weekly



Source: Bloomberg

The Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ) and Swiss National Bank (SNB) have also continued to ease monetary conditions through outright asset purchases:

- The BoE expanded its target for asset purchases by £50 billion to £175 billion at its August meeting, in an attempt to further ease strains in financial markets and boost nominal economic activity. The target was reached in November, as scheduled, with the majority of purchases having been gilts.
- The ECB has purchased approximately €20 billion of euro-denominated covered bonds with the aim of acquiring €60 billion of such bonds by June 2010. Purchases of these securities have helped spreads in the secondary market to fall and have supported issuance in the primary market.
- The BoJ has continued its outright purchases of Japanese government bonds, commercial paper and corporate bonds, but the ongoing improvement in corporate financing markets has resulted in the pace of commercial paper and corporate bond purchases slowing. The BoJ also continued to make small purchases of stock in financial institutions.

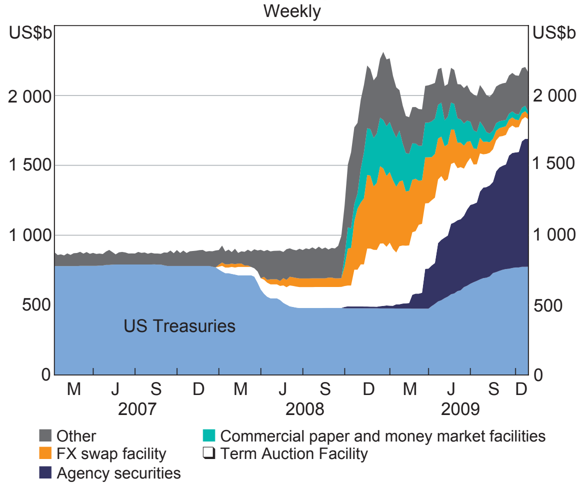
- The SNB has continued to ease monetary conditions through its purchases of private sector bonds and foreign exchange, with the latter having the publicly stated intention of preventing an appreciation of the Swiss franc against the euro.

Ongoing improvements in financial market conditions since March have led to a gradual decline in demand for liquidity offered by central banks. Funds outstanding through the Fed's Term Auction Facility (TAF) and the US dollar swap facility with other central banks have returned to around pre-Lehman Brothers levels. As a result, the Fed is scaling back TAF operations while several central banks including the ECB, BoE, SNB, BoJ and Reserve Bank of Australia have wound back or ceased auctioning US dollars under swap (see 'Box E: Normalisation of Domestic Market Dealing Operations'). In addition, there has been a gradual unwinding of facilities aimed at improving the functioning of commercial paper markets and, after increasing for a number of months, demand for funds through the Term Asset-backed Securities Loan Facility (TALF) has recently fallen. Despite this, the Fed extended asset-backed and legacy commercial mortgage-backed TALF operations to the end of March 2010. Nonetheless, the Fed's balance sheet has expanded modestly in recent months as the fall in liquidity facilities has been more than offset by the rise in securities held outright as a result of asset purchases (Graph 22).

Graph 22

Federal Reserve – Composition of Assets

Weekly



Source: Board of Governors of the Federal Reserve System

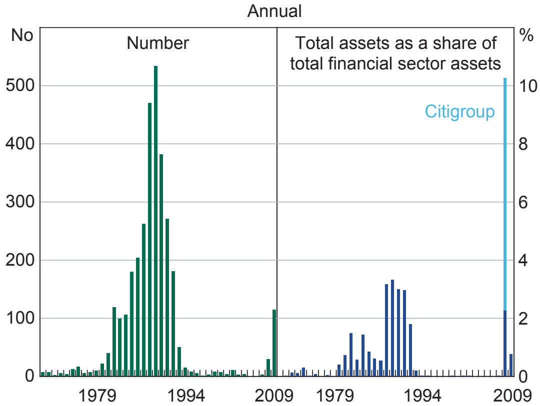
Demand for additional liquidity offered by the ECB has also fallen. Following the successful June operation, the ECB conducted its second 12-month refinancing operation in September, providing all the liquidity demanded at a fixed rate of 1 per cent. The amount allocated and the number of institutions participating fell significantly. The effective overnight rate in the euro area has remained around 0.4 per cent since settlement of the June operation. The BoC and RBNZ have also begun to scale back emergency liquidity facilities as conditions in financial markets improve.

Government financial policy actions

As conditions in financial systems normalise, the focus of government financial policies has shifted away from emergency measures and towards longer-term initiatives designed to support stability and improve regulatory oversight, including in financial markets such as the over-the-counter derivatives market.

Graph 23

Failed and Assisted FDIC-insured Institutions*



* 2009 data are year to date

Sources: Federal Deposit Insurance Corporation (FDIC); Thomson Reuters

Since the beginning of the year, over 100 FDIC-insured financial institutions have failed in the United States. While many more institutions failed during the Savings and Loans (S&L) crisis in the late 1980s and early 1990s, the average size of banks that failed or received assistance in the recent crisis has been much bigger and more concentrated in time (Graph 23). The FDIC announced that to replenish its deposit insurance fund, which has been depleted by bank closures, banks will be required to pre-pay the next three years of insurance premia (amounting to US$45 billion). The FDIC currently has US$22 billion in liquid assets to meet the cost of bank failures, and expects to face a shortfall in its liquid assets in the first quarter of 2010 if no action is taken. The FDIC has also extended its transaction account guarantee program by six months until end June 2010, with participating institutions subject to increased fees during the extension period. As noted above, the FDIC has amended its guarantee on bank debt.

Reflecting the normalisation in global financial market conditions, a number of US institutions have repaid their obligations to the US Government. Most notably, Bank of America agreed to pay almost US$½ billion to terminate a guarantee on a pool of assets associated with its acquisition of Merrill Lynch. However, the housing agency Fannie Mae reported second-quarter losses of around US$15 billion, resulting in further capital injections of senior preferred stock from the US Treasury as part of the terms of its conservatorship, taking the total contribution to around US$50 billion. In contrast, the housing agency Freddie Mac recorded a second-quarter profit of US$0.8 billion, leaving its total funding from the US Treasury unchanged at US$51 billion. A number of other government support programs, such as the US Treasury's money market fund guarantee program, have been unwound over recent months.

In the United Kingdom, the Government announced changes to its financial arrangements with Lloyds and Royal Bank of Scotland (RBS). Lloyds will no longer participate in the Government's Asset Protection Scheme (APS) in return for raising additional private sector capital and paying a fee for the implicit protection provided to date. The Government will also provide further capital, although its shareholding will stay at 43 per cent. RBS will participate in the APS under revised terms that see it bear a larger share of losses on assets covered. The Government will provide a further capital injection which will result in its voting rights increasing from 70 per cent to 75 per cent. In France, three large banks have raised debt and equity capital in order to repay their obligations to the Government.

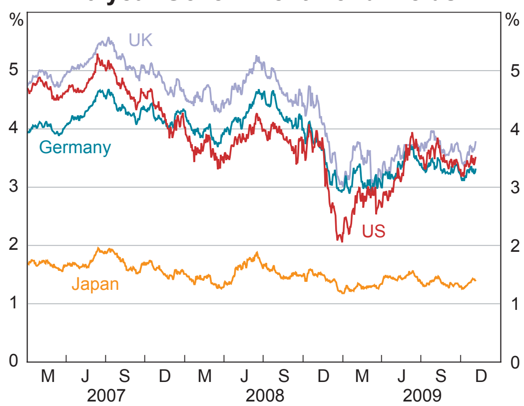
Ireland announced further details of its bad bank program in September. The National Asset Management Agency (NAMA) will remove riskier real estate loans from banks' balance sheets by purchasing loans with book value of around €77 billion at a discount of 30 per cent (though at an estimated 15 per cent premium to market value). The Government will provide institutions with additional capital if they are unable to raise sufficient amounts privately after transferring their impaired assets to NAMA. Most loan transfers are expected to be completed by mid 2010.

Sovereign debt markets

Shorter-term bond yields in the United States, Japan and Germany have been relatively stable over the past six months as policy rates in most economies are expected to remain low for an extended period. In contrast, shorter-term yields in the United Kingdom have tended to move lower. Longer-term bond yields have shown little net change over recent months, but remain above their troughs recorded at the beginning of the year (Graph 24). These movements have occurred alongside strength in equities and improving economic data. In Europe, spreads between sovereign debt issued by most European Monetary Union member countries and German government debt have been little changed and are well below the peaks experienced at the end of 2008. Greece is one exception, with spreads on its sovereign debt widening after Fitch downgraded it to A- from A. Fitch also downgraded Ireland's sovereign rating by two notches, to AA– from AA+, citing concern about the Irish banking sector and fiscal position.

Graph 24

10-year Government Bond Yields



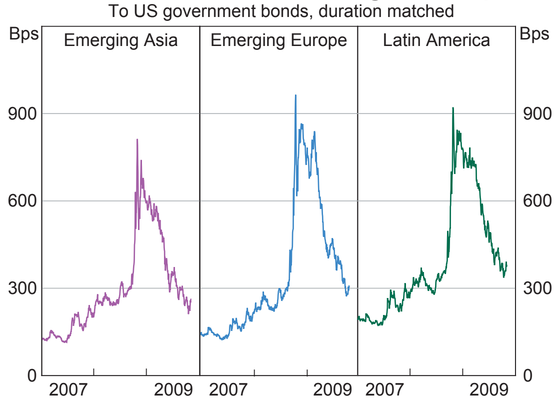
Sources: Bloomberg; Thomson Reuters

Spreads of emerging market US dollar-denominated debt to US Treasuries have narrowed further from their peaks reached in October last year (Graph 25). Moody's has upgraded both Brazil and Indonesia's sovereign credit ratings, citing resilience to the global recession, while Fitch has removed its negative outlook for South Korea and S&P has upgraded its outlook for Indonesia to positive. In a further signal of improving global financial conditions, a number of emerging economies including Brazil, Mexico, Poland and the Philippines have recently issued US dollar-denominated debt. On the other

Graph 25

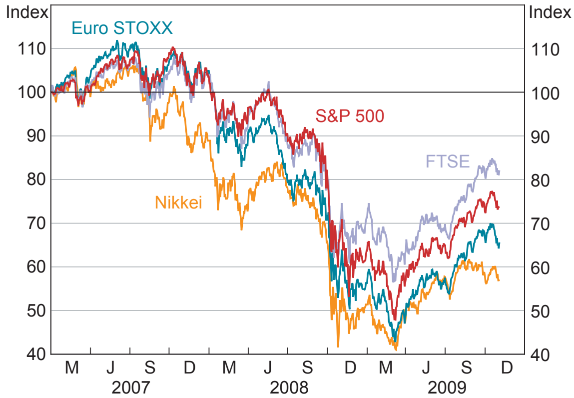
US Dollar-denominated Sovereign Debt Spreads

To US government bonds, duration matched



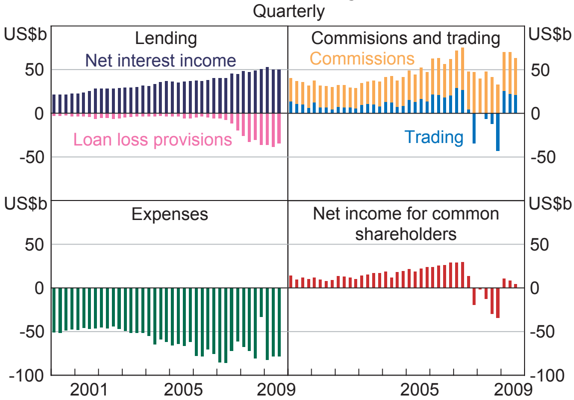
Source: Thomson Reuters

Graph 26
Major Share Price Indices
1 January 2007 = 100



Source: Bloomberg

Graph 27
Net Income of US Major Banks*
Quarterly



* Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase & Co., Morgan Stanley and Wells Fargo. Major acquisitions by these banks since 2007 are also included.

Sources: Bloomberg; RBA

hand, S&P downgraded Latvia and Estonia, and Moody's downgraded Lithuania, citing depressed economic conditions and the pressure that their fixed exchange rates are placing on public finances.

Equities

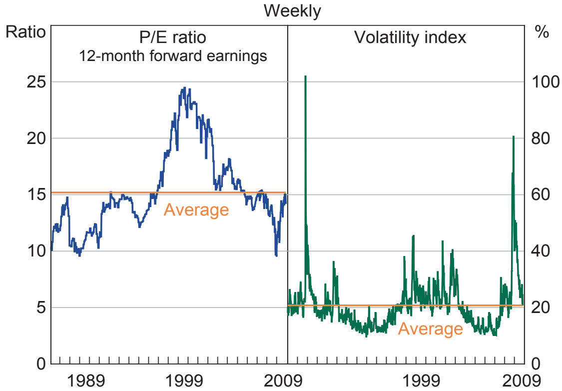
Major share indices reached 12-month highs in October, supported by positive macroeconomic data and improved optimism as financial sectors returned to profitability (Graph 26). Company earnings reported since the previous *Statement* in the United States and Europe were, on average, above expectations, most notably in the financial and information technology sectors. Japanese equity markets have underperformed in recent months: auto manufacturers and other exporters were adversely affected by the appreciation of the yen and negative earnings results.

Indicative of the significant recovery in financial markets since the lows posted in early March, financial sector earnings reports have continued to generally highlight investment banking operations as the main source of profit (Graph 27). In contrast, retail-oriented operations of financial institutions have continued to record losses or substantially reduced income, reflecting further large loan-loss provisions as a result of the poor state of the macroeconomy. Correspondingly, those banks whose operations are more heavily oriented toward investment banking, such as JPMorgan and Goldman Sachs, have posted stronger results than banks focused on retail lending, such as Bank of America.

Although there are some concerns regarding possible overvaluation, the forward-looking price-to-earnings (P/E) ratio remains broadly in line with its long-term average (Graph 28). At the same time, option-implied volatility in equity markets fell to around its long-run average in October, although it has since picked up a little.

Equity markets in emerging countries, with the exception of China, have continued to track movements in developed markets with prices reflecting positive macroeconomic data and investor sentiment. The strong rise in commodity prices has seen equity markets in Latin America and Russia outperform those in most major economies (Table 3). After rising steadily in August on positive economic data, Chinese equities fell sharply in September amid concerns that the recent rapid expansion in credit may be curtailed. Despite the fall in prices, Chinese equities have risen by over 70 per cent in the year to date, outperforming equity markets in all major economies.

Graph 28
S&P 500
Weekly



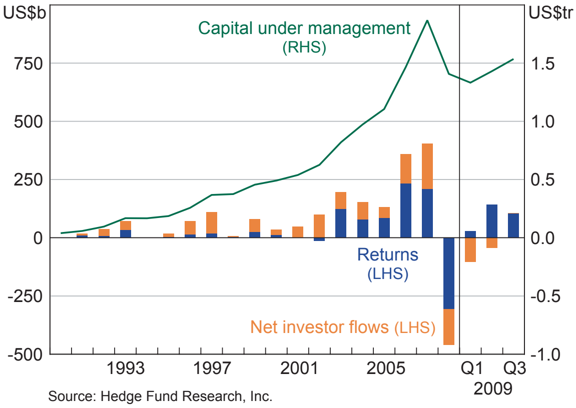
Sources: Bloomberg; Thomson Reuters

Table 3: Changes in Global Share Prices
Per cent

	Peak to recent trough	Since recent trough	Since previous *Statement*
United States			
– Dow Jones	–54	50	6
– S&P 500	–57	55	4
– NASDAQ	–56	62	3
Euro area			
– STOXX	–62	53	6
United Kingdom			
– FTSE	–48	45	10
Japan			
– Nikkei	–61	40	–4
Canada			
– TSE 300	–50	46	0
China			
– China A	–72	83	–9
Australia			
– ASX 200	–54	44	6
MSCI indices			
– Emerging Asia	–61	86	4
– Latin America	–57	87	9
– Emerging Europe	–71	82	9
– World	**–56**	**49**	**3**

Source: Bloomberg

Graph 29
Global Hedge Fund Capital
Annual



Source: Hedge Fund Research, Inc.

Graph 30
US Nominal TWI
March 1973 = 100

Source: Board of Governors of the Federal Reserve System

Hedge funds

Following large losses during the crisis period, hedge funds reported an average return of 7 per cent for the September quarter, partly as a result of the continued recovery in equity markets, particularly those in emerging markets. Total capital under management in the industry has picked up from the trough in the March quarter but remains around 20 per cent below the peak in June 2008 (Graph 29). The improvement in performance has seen a slowing in redemptions and a small net inflow of investor funds in the September quarter following sizeable outflows over the past year.

Foreign exchange

In general, exchange rates have followed their trends since March, broadly reflecting the ongoing improvements in financial market sentiment. The US dollar has continued to depreciate against most currencies over recent months (Graph 30, Table 4). In trade-weighted terms, the US dollar is around 15 per cent lower than its recent peak in March and only 6 per cent above its historical low in March 2008. Volatility in foreign exchange markets is well below its peak recorded late last year, although it remains above longer-run average levels.

Increases in commodity prices have contributed to an appreciation of the currencies of some commodity-exporting economies in recent months, including Australia (see below), Brazil, Canada, New Zealand and South Africa (Graph 31). These currencies have recorded some of the largest appreciations against the US dollar since March. The trend appreciation of the Canadian dollar was halted after the BoC expressed concern regarding the impact that persistent strength in the currency may have on the domestic economy. The appreciation of the Brazilian real was partly reversed in October when the Ministry of Finance announced capital controls in the form of taxes on inflows of portfolio capital aimed at alleviating the upward pressure on the exchange rate.

Table 4: Change in US Dollar against Other Currencies

Per cent

	Past year	Since recent peak (March 2009)
Mexican peso	6	–15
Chinese renminbi	0	0
Taiwan dollar	0	–7
Indian rupee	–1	–9
Philippine peso	–2	–2
Malaysian ringgit	–3	–8
British pound	–4	–17
Thai baht	–4	–8
Singapore dollar	–5	–10
Korean won	–6	–24
Canadian dollar	–8	–18
Swedish krona	–8	–24
Japanese yen	–9	–8
Indonesian rupiah	–13	–21
Swiss franc	–13	–12
Euro	–13	–15
New Zealand dollar	–17	–32
Brazilian real	–18	–28
South African rand	–21	–31
Australian dollar	–23	–31
Majors TWI	–9	–15
Broad TWI	–5	–12

Sources: Bloomberg; Board of Governors of Federal Reserve System

The Chinese renminbi has remained essentially unchanged against the US dollar, whereas some other currencies in the region have appreciated significantly since March this year. As a result, the renminbi has depreciated considerably on a trade-weighted basis (Graph 32).

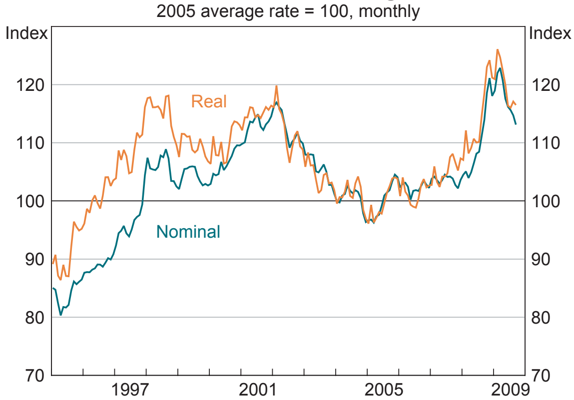
Graph 31

Selected Currencies against US Dollar

1 January 2007 = 100

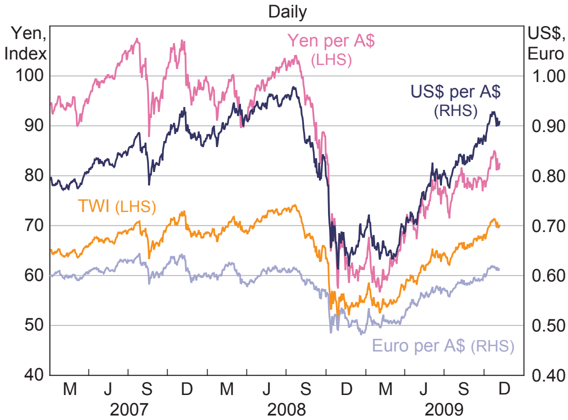
Source: Bloomberg

Graph 32
China – Effective Exchange Rates



Source: BIS

Graph 33
Australian Dollar



Sources: RBA; Thomson Reuters; WM/Reuters

Australian dollar

The Australian dollar has appreciated further against all major currencies in recent months, continuing the trend from around March 2009 (Graph 33; Table 5). The Australian dollar is now close to its July 2008 peak and is around 20 per cent above its post-float average in trade-weighted terms. It is significantly above average against the US dollar, Chinese renminbi and pound sterling, but remains below average against the euro and the Japanese yen. Rising commodity prices and improving investor sentiment have continued to underpin the appreciation in recent months. From March to September, almost all of the appreciation occurred during overnight trading, when global rather than domestic factors are likely to be more influential. More recently, the increase in near-term interest rate expectations in Australia relative to those abroad has also underpinned the currency, which appreciated sharply at the time of domestic data announcements on several occasions.

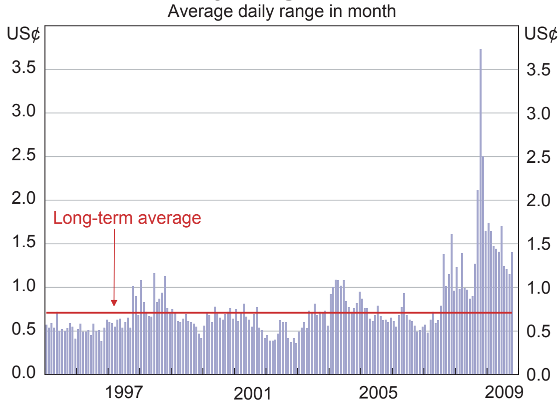
Volatility in the exchange rate of the Australian dollar against the US dollar remains above its long-run average, but well below levels seen in late 2008 (Graph 34).

Table 5: Australian Dollar against Selected TWI Currencies
Percentage change

	Since recent peak (July 2008)	Since recent trough (March 2009)	Deviation from post-float average
British pound	12	24	24
Korean won	8	6	56
Indian rupee	2	31	62
Euro	0	22	–7
Malaysian ringgit	–1	32	40
Canadian dollar	–1	20	3
New Zealand dollar	–2	–2	2
Indonesian rupiah	–3	14	135
Singapore dollar	–4	29	2
South African rand	–6	7	57
Thai baht	–6	33	29
US dollar	–7	44	26
Chinese renminbi	–7	44	33
Swiss franc	–7	25	–13
Japanese yen	–21	34	–12
TWI	**–5**	**30**	**19**

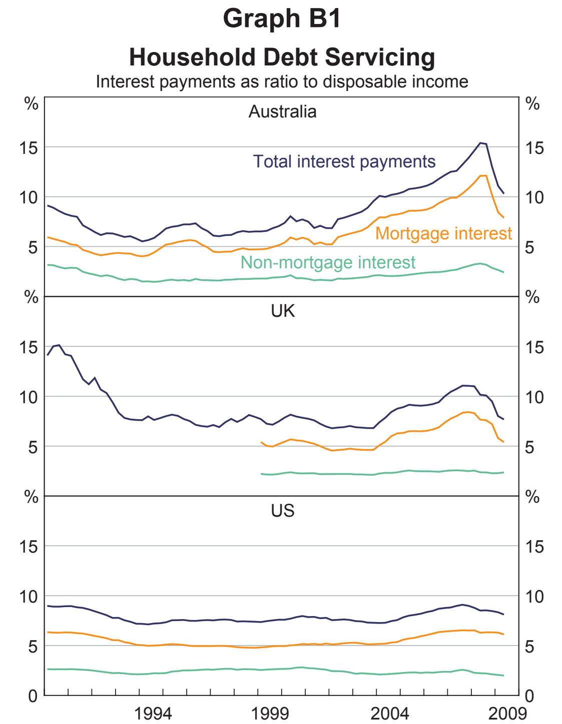
Sources: RBA; Thomson Reuters; WM/Reuters

Graph 34
Intraday Range in A$/US$
Average daily range in month



Source: Bloomberg

Box B: The Effect of Policy Rate Changes on Household Debt Servicing



Sources: ABS; Bureau of Economic Analysis; Office for National Statistics; RBA; central banks

The responsiveness of household debt servicing to changes in central bank policy rates depends in part on the prevalence of variable rate loans. In Australia and the United Kingdom, where mortgage-related interest payments are a large share of debt servicing and home loans are predominantly extended on variable rate terms, the recent policy easings have significantly lowered household debt servicing (Graph B1). However, in countries such as the United States where mortgages are mainly at long-term fixed rates, household debt servicing has fallen by relatively little.[1]

In Australia, household debt servicing fell by around 5 percentage points over the 12 months to June 2009 (Table B1). This reflects the sharp decline in mortgage rates in response to policy easing and, to a lesser extent, the decline in interest payments on non-mortgage debt. Total levels of mortgage and non-mortgage debt outstanding were little changed over this period, while nominal household disposable income grew modestly. Similarly, in the United Kingdom, household debt servicing has fallen by around 3 percentage points since peaking in the fourth quarter of 2007. Again, this mainly reflects the decline in mortgage rates over this period and moderately higher disposable income.

1 *In Australia and the United Kingdom, three-quarters and one-half of outstanding housing loans are at variable rates; in the United States, all but a quarter of loans are at long-term fixed rates.*

Table B1: Household Debt Servicing
Percentage point change of ratio to disposable income, since recent peak

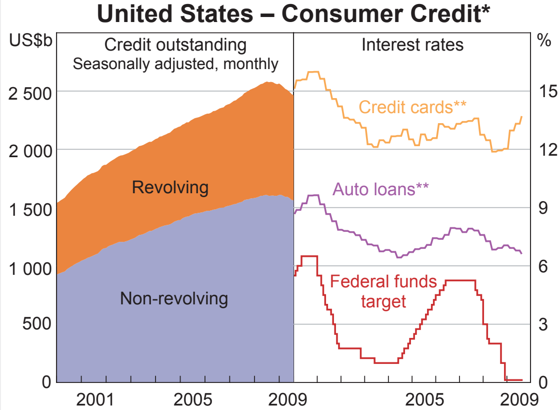
	Australia (peak: June 2008)	United Kingdom (peak: December 2007)	United States (peak: September 2007)
Debt-servicing ratio	–5.1	–3.1	–1.0
Contributions from			
Mortgage interest	–3.9	–2.6	–0.1
Non-mortgage interest	–0.8	0.0	–0.5
Disposable income	–0.4	–0.5	–0.4

Sources: National Sources; RBA

Recent developments in the United States have been somewhat different. There was a much more subdued rise in household debt servicing prior to the onset of the financial crisis and a relatively modest decline of 1 percentage point since its peak in the third quarter of 2007. In further contrast to Australia and the United Kingdom, the decline in household debt servicing in the United States has been predominately driven by a decline in non-mortgage related interest payments on credit cards, auto loans and other non-real estate related debt. Although mortgage interest payments in the United States are also the largest component of household debt servicing, mortgage rates have fallen by significantly less than in other countries, despite the policy easing of more than 500 basis points.[2] Furthermore, even though mortgage rates have declined to some extent in the United States, households have not been able to take full advantage of this, as the decline in house prices has hindered refinancing of existing mortgages.

The fall in non-mortgage interest payments in the United States can be attributed to a decline in the level of debt outstanding, a change in the composition of this debt and slightly lower interest rates on some types of credit. The level of non-mortgage related consumer credit outstanding has declined steadily since mid 2008, led by a fall in revolving credit (mainly credit card debt), while non-revolving credit (mainly auto loans) has remained little changed (Graph B2). The decline in credit card debt in the United States can partly be attributed to an increase in the household saving rate and is likely to have been influenced by the sharp rise in the delinquency rate on credit card repayments that has led

Graph B2
United States – Consumer Credit*



* Non-mortgage related
** Data are released quarterly
Source: Board of Governors of the Federal Reserve System

2 *For more information see 'Box B: An International Comparison of Pass-through of Policy Rate Changes to Housing Loan Rates',* Statement on Monetary Policy, *February 2009, pp 57–58.*

to an increase in charge-offs, which are almost 10 per cent of outstanding balances. As the composition of consumer credit has shifted away from credit card debt, on which a relatively high interest rate is payable, towards auto loans where interest charges are lower and falling, debt servicing has declined.

Domestic Economic Conditions

Over the past year, the Australian economy has performed better than was widely expected. While activity contracted around the turn of the year – as it did in all advanced economies – a range of indicators, including private-sector surveys and information from the Bank's liaison program, suggest that the economy has expanded at a moderate pace over the past six months or so (Graph 35, Table 6).

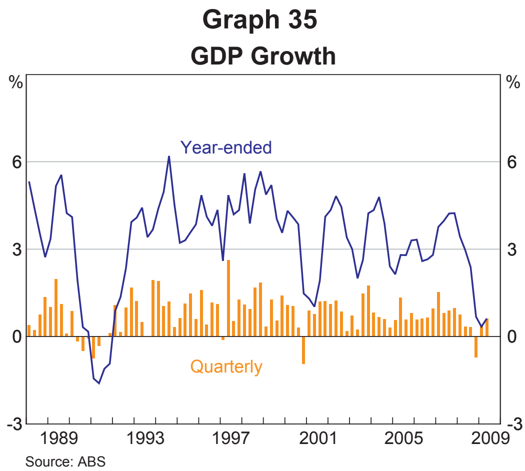


Table 6: Demand and Output Growth
Per cent

	March quarter 2009	June quarter 2009	Year to June quarter 2009
Domestic final demand	–1.1	0.8	0.7
GNE	–0.9	1.0	–0.4
Net exports[a]	2.2	–0.2	3.3
Statistical discrepancy[a]	–0.9	–0.1	–2.3
GDP	0.4	0.6	0.6
Non-farm GDP	0.5	1.1	0.5
GDP adjusted for changes in the terms of trade	–1.4	–1.1	–2.1

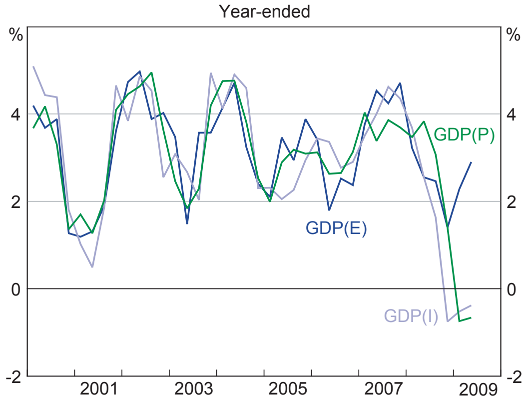
(a) Contribution to GDP growth
Source: ABS

This relatively good performance in what has been a very difficult international environment reflects a number of factors. These include the significant easing of both monetary and fiscal policy, the healthy state of the Australian financial system and the depreciation of the currency in the second half of last year. The comparatively strong performance of some of Australia's major trading partners in Asia has also been important, with Australia's export volumes consequently remaining broadly unchanged during a period when global trade has fallen sharply.

Notwithstanding these favourable factors, the Australian economy has experienced a period of significantly below-trend growth and is operating a little below its full capacity. Assessments of the exact rate of growth over the past year, however, have been complicated by large differences

Graph 36

GDP Growth Measures



Source: ABS

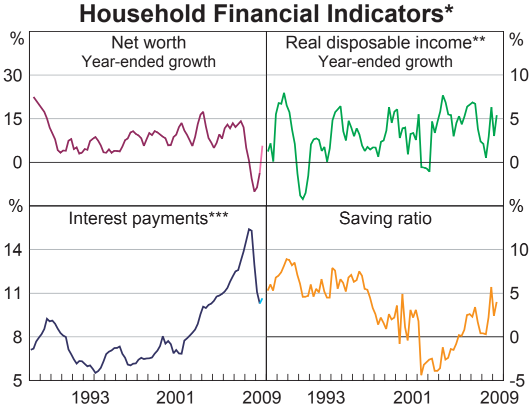
in the various measures of GDP. While the ABS estimates that GDP expanded by 0.6 per cent over the year to the June quarter, the income and production measures suggest a significantly weaker outcome and the expenditure measure suggests a significantly stronger outcome (Graph 36). In addition, measures of domestic income, as opposed to output, have contracted significantly over recent quarters, reflecting the 17 per cent fall in the terms of trade. Recently, the terms of trade appear to have stabilised, so the wide divergence between growth of domestic income and GDP is likely to narrow in the period ahead.

Household sector

While Australian households have taken a more cautious approach to their finances over the past year or so, household spending has been relatively resilient, and the housing market has shown renewed strength. The better-than-expected economic conditions – including in the labour market – have helped support consumer confidence, and household spending has also been supported by a rise in household wealth, with both housing and equity prices recording significant gains over recent months after earlier falls (for details on recent developments in confidence, see 'Box C: The Recovery in Confidence').

Graph 37

Household Financial Indicators*



* Net worth and saving ratio include unincorporated enterprises; RBA estimates for September quarter 2009

** Income is after interest payments and smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002

*** Per cent of household disposable income before the deduction of interest payments

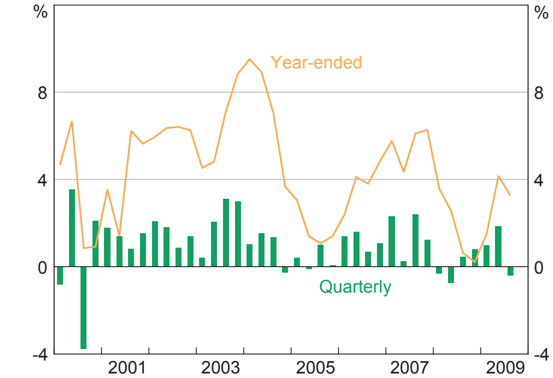
Sources: ABS; RBA

In the first half of the year, household spending grew reasonably solidly, with household finances boosted by the Federal Government's payments to households and, for indebted households, a significant decline in mortgage rates. Over the year to June, real household disposable income increased by 5.4 per cent, despite declines in labour and property income, and over the six months to the September quarter household wealth is estimated to have risen by 12 per cent, largely reversing the decline over the previous year or so (Graph 37).

Some slowing in spending growth is now in train as the boost to household incomes from the earlier fiscal stimulus is not repeated, although the slowing appears so far to have been less marked than earlier thought likely. While the volume of retail sales contracted by around ½ per cent in the September quarter, the level of spending was still around 3 per cent above its pre-stimulus level (Graph 38). The Bank's liaison with retailers in October indicated mixed trading conditions, while sales of motor vehicles to households fell slightly in the month, to be 8 per cent above their trough.

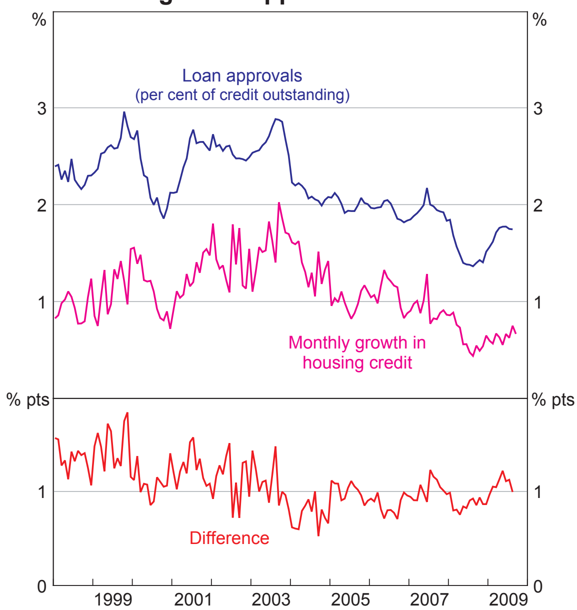
Many households have used the boost to disposable incomes over the past year to increase saving and pay down debt, strengthening their balance sheets. On a year-average basis, the household saving ratio was 3.6 per cent in 2008/09, up from 0.7 per cent in 2007/08. Households with mortgages have increased their repayments, partly by maintaining the level of their payments when interest rates declined. As a result, the pace of monthly growth in housing credit has been broadly unchanged over the past year despite a noticeable increase in new housing loan approvals (Graph 39).

Graph 38
Real Retail Sales Growth



Source: ABS

Graph 39
Housing Loan Approvals* and Credit

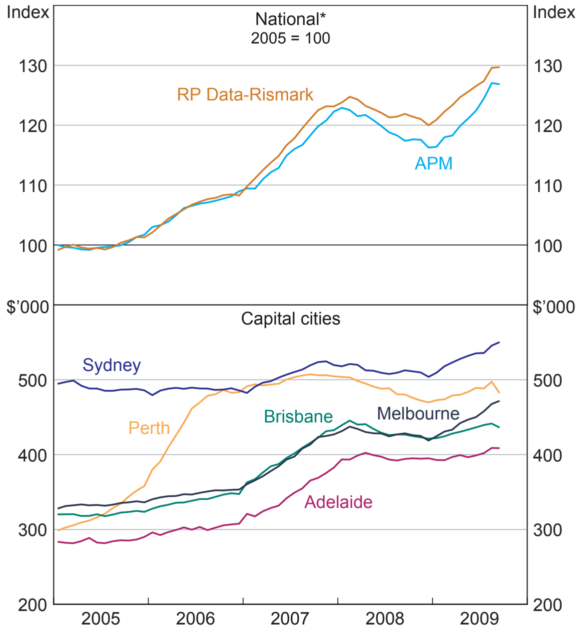


* Excludes owner-occupier refinancing and investor approvals for new construction

Sources: ABS; RBA

Conditions in the housing market have firmed notably since earlier in the year, with prices in most parts of the country now above their earlier peaks (Graph 40, Table 7). In the year to September, nationwide dwelling prices are estimated to have increased by between 6 and 8 per cent, depending on the measure used. The increases have been broad-based across detached houses and apartments, and across capital cities, with particularly strong growth in Melbourne. Price growth has also recently been seen in both higher- and lower-priced suburbs, suggesting that low interest rates and broader economic forces have been boosting the housing market in addition to the effect from first-home buyer grants. The latter were reduced at end-September

Graph 40
Dwelling Prices



* Weighted average of houses and apartments in capital cities
Sources: APM; RBA; RP Data-Rismark

and will return to their original levels at end-December.

There are also indications of a pick-up in dwelling construction, after the earlier sharp declines. Commencements of houses increased in the June quarter and building approvals for detached houses are now around 30 per cent higher than their late-2008 trough, boosted by low interest rates, the temporary increase in grants paid to first-home buyers and strong population growth (Graph 41). Other indicators of construction activity – including loan approvals for new construction – have also picked up since the start of the year. Over coming quarters, activity will be boosted by the almost 20 000 new homes to be built under the Federal Government's Social Housing Initiative.

Table 7: National Dwelling Price Growth
Per cent

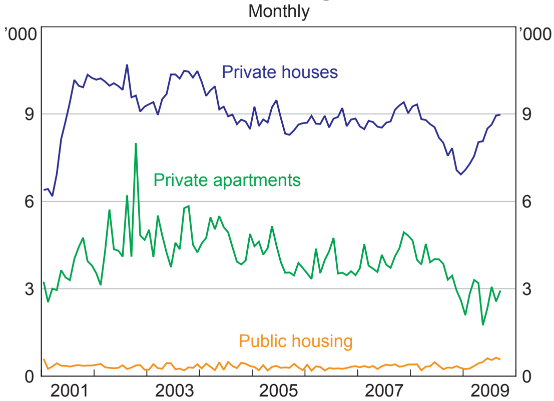
	June quarter 2009	September quarter 2009	Year to September quarter 2009
House prices			
ABS	4.2	4.2	6.2
APM	3.6	3.7	6.5
RP Data-Rismark	2.7	2.7	5.5
Apartment prices			
APM	2.9	3.3	8.2
RP Data-Rismark	2.5	2.2	7.1

Sources: ABS; APM; RBA; RP Data-Rismark

In contrast to the pick-up in the construction of houses that is clearly underway, data on approvals for apartment buildings have, to date, remained weak. This is particularly apparent for high-rise apartments (buildings greater than three storeys) and for holiday-related developments outside the state capitals, consistent with liaison reports that developers continue to find it difficult to access finance for large-scale property developments.

Taking account of both houses and apartments, housing commencements in the first half of the year were running at an annual rate of around 125 000 dwellings, well below estimates of what is required if the average number of people living in each household is not to increase. While building approvals are picking up, it appears that the general underbuild in dwellings will continue over the year or so ahead, unless the recovery in housing construction turns out to be much stronger than currently thought likely.

Graph 41
Residential Building Approvals
Monthly

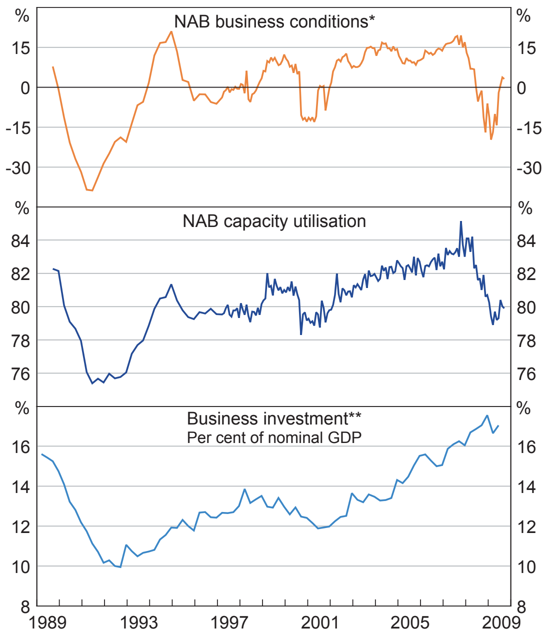


Source: ABS

Business sector

Business confidence and conditions have continued to improve, and firms report that capacity utilisation has stabilised (Graph 42). Overall, business investment spending is now expected to fall only modestly from its recent peak, and to remain high as a share of GDP compared with investment in other countries and with past experiences in Australia. However, there are differences in the outlook at the sectoral level, with mining investment likely to be very strong and investment in commercial property likely to be weak.

Graph 42
Business Sector Indicators



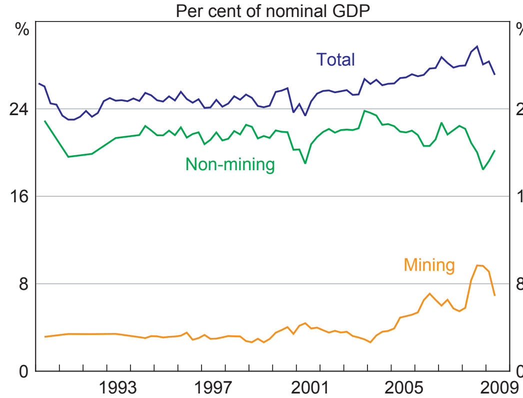
* Net balance; deviation from long-run average
** Excludes second-hand asset transfers between the private and other sectors. No adjustments have been made for privatisations.
Sources: ABS; NAB; RBA

More broadly, conditions in the business sector have improved since earlier in the year. Following the extreme risk aversion of late 2008 – which led to cut-backs in production and imports in anticipation of a sharp fall in domestic demand – survey measures of new orders and production have recovered. Survey measures of business conditions and confidence are currently at, or above, long-run average levels. This improvement in sentiment has been fairly broad-based, with conditions in the

Graph 43

Private Non-financial Profits*

Per cent of nominal GDP



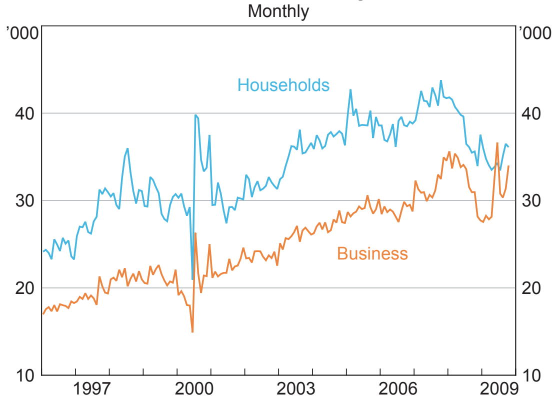
* Combined profits of both the incorporated and unincorporated sectors. Mining and non-mining data prior to 1994 from annual national accounts.

Sources: ABS; RBA

Graph 44

Motor Vehicle Sales by Sector

Monthly



Sources: FCAI; RBA

retail and wholesale sectors having been particularly strong, although conditions in the manufacturing sector have remained below average.

The strength in surveyed business conditions and the relative resilience in investment spending reflect a number of factors, including the improving outlook for the resources sector and the stimulatory settings of both monetary and fiscal policy. Profits of non-mining companies increased solidly in the first half of the year, although mining profits fell sharply as commodity prices pulled back from their record highs (Graph 43). The level of machinery & equipment investment in the June quarter was strong, especially motor vehicle sales that were boosted by the temporary tax deductions for new tangible depreciating assets (Graph 44). After rising sharply in June, motor vehicle sales to businesses have eased, but remain at a higher level than earlier in the year, supported by the 50 per cent tax deduction for small businesses that will continue until year-end, along with the broader recovery in business sentiment.

Engineering construction in the first half of 2009 was strong, especially in the mining sector. Furthermore, the medium-term outlook for this type of investment has improved significantly, with the joint-venture partners in the Gorgon liquefied natural gas (LNG) project committing to spend $43 billion over the next four to five years. More generally, the robust outlook for China and other trading partners in Asia suggests that demand for Australian bulk commodities will continue to underpin a high level of engineering construction in the period ahead (for further details, see 'Box D: Investment in the Resources Sector').

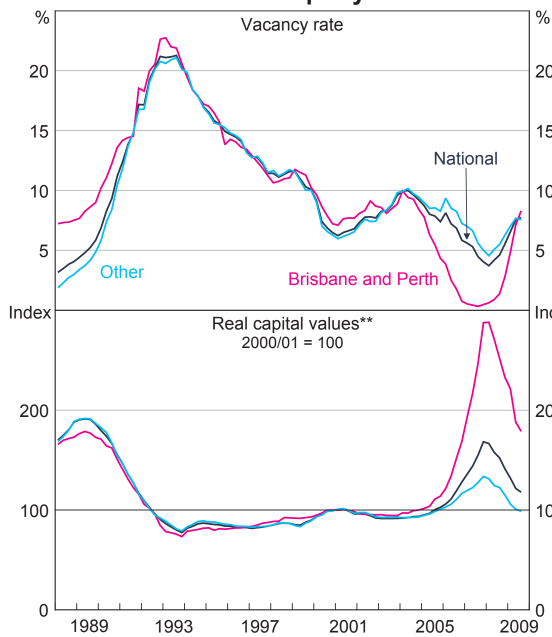
In contrast, private non-residential building activity has declined noticeably due to difficult financing conditions faced by developers and a modest rise in vacancy rates (Graph 45). Capital values are estimated to have fallen by 30 per cent in real terms since their late 2007 peak, although this is still a significantly smaller fall than the 60 per cent real decline seen in the early 1990s. While non-residential building approvals have increased sharply in recent months, this is entirely due to approvals associated with the Federal Government's education infrastructure package (Graph 46).

Government

Fiscal policy has provided a significant boost to output over the past year. While the $21 billion of cash payments to households provided the initial stimulus, spending is now being boosted by public investment, notably for school buildings and public housing. The peak effect on growth of these discretionary measures is estimated to have been in the June quarter 2009 – at almost 1 percentage point in that quarter. Thereafter, the estimated effect of fiscal policy is expected to fall back as these measures run their course; the stimulus measures in aggregate are expected to subtract from quarterly growth in 2010, although they would still be boosting the level of GDP.

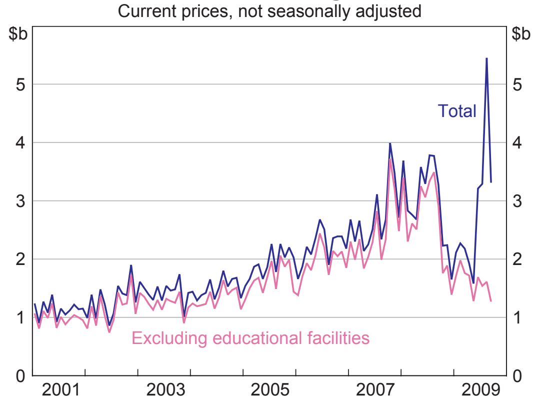
Reflecting the improvement in the economic outlook, updated budget figures released in the *Mid-Year Economic and Fiscal Outlook* show that budget deficits over the next few years are expected to be smaller than projected at the time of the May Budget. While the underlying cash deficit in 2009/10 is expected to be broadly unchanged (at $57.7 billion and 4.7 per cent of GDP; Graph 47), thereafter the stronger outlook for the economy is projected to boost revenue. In line with the lower expected deficits, the projected profile for net debt now peaks at 10 per cent of GDP in 2013/14, compared with the peak of 13.8 per cent projected in the May Budget.

Graph 45
National Office Property Indicators*



* Capital city CBDs (excluding Hobart)
** Deflated by trimmed mean CPI
Sources: Jones Lang LaSalle; Property Council of Australia; RBA

Graph 46
Non-residential Building Approvals*
Current prices, not seasonally adjusted

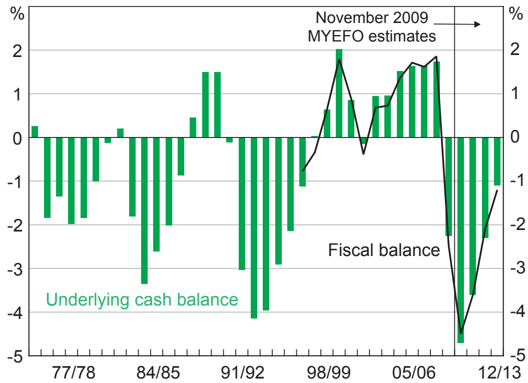


* Total private and public
Source: ABS

Graph 47

Australian Government Budget Balance

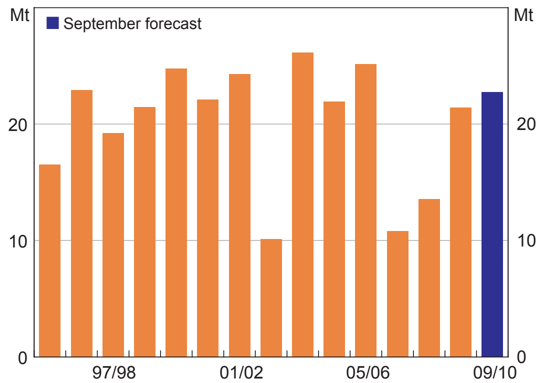
Per cent of GDP



Source: Australian Treasury

Graph 48

Wheat Production



Source: ABARE

Farm sector

The Australian Bureau of Agricultural and Resource Economics (ABARE) is forecasting a wheat crop of around 22½ million tonnes in 2009, up modestly from last year's crop, although conditions vary across the country (Graph 48). South Australia, Victoria and Western Australia have generally experienced average to above-average rainfall, while Queensland and New South Wales have experienced fairly dry conditions with consequent reduced yields and some crop failures. Total farm output is expected to increase in 2009/10, with modest growth in crop production and livestock partly offset by lower production of dairy products and wool. Inflows into the Murray Darling basin have risen significantly since June, but remain well below long-run averages. There are recent indications of the emergence of a weak El Niño weather pattern, which would impact negatively on future farm output.

External sector

After increasing by 3 per cent in the first half of the year, export volumes are estimated to have increased slightly in the September quarter. This pattern stands in contrast to developments in many other economies, where export volumes fell very sharply in late 2008/ early 2009, but have since partially recovered. Australia's relatively good performance reflects both the lesser reliance on exports of manufactured goods and the strong recovery in a number of Australia's major trading partners in Asia.[1]

Resource export volumes appear to have increased in the quarter and values have largely stabilised as the impact of lower contract prices has largely worked its way through. As noted in previous *Statements*, China's demand for resources has been an important factor explaining the overall resilience of Australia's export volumes during the global recession. While China remains Australia's largest destination for resource exports, demand from other countries

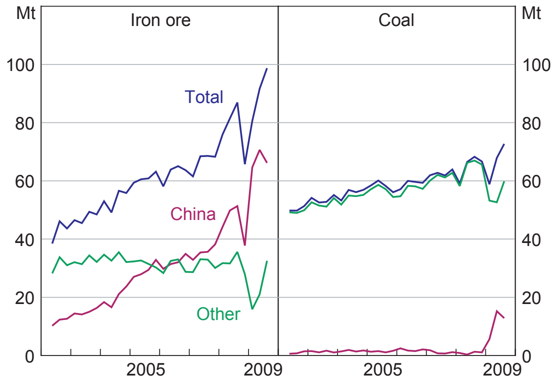
1 *For further details, see discussion in the 'Domestic Economic Conditions' chapter in the May 2009* Statement on Monetary Policy, *pp 37–39.*

has recovered noticeably in recent months (Graph 49). Exports of iron ore and coal to Japan are back near the levels prior to the start of the global recession in 2008, while iron ore export volumes to Korea have also grown. These outcomes are in line with a recent pick-up in steel production outside of China. More broadly, following the increase in Australian production over the year to date, exports of some key commodities appear to be again near capacity. As discussed in Box D, the large amount of investment in the mining sector is significantly increasing capacity, providing the opportunity for strong export growth now and in the years to come.

Rural and service exports have been broadly stable this year despite the global recession, while manufactured exports have fallen significantly, in line with developments in global manufactures trade (Graph 50).

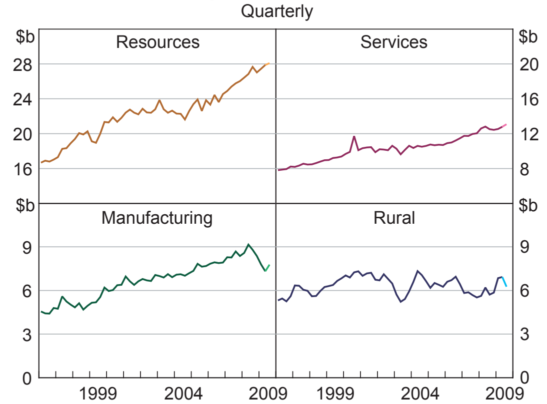
Import volumes are estimated to have increased strongly in the September quarter, following a 2 per cent rise in the June quarter. This marks a substantial turnaround from the 15 per cent fall in import volumes in the six months to March. Recent growth in import volumes has partly reflected growth in domestic demand, some rebuilding of inventories, as well as the appreciation of the exchange rate. Travel service imports have been particularly strong, with short-term resident departures up 17 per cent since January (Graph 51).

Graph 49
Resource Export Volumes and Destination
Quarterly



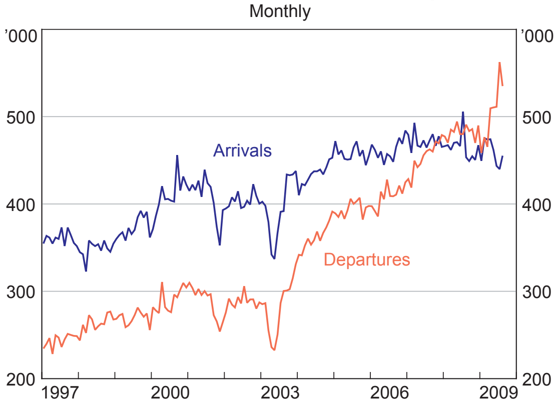
Sources: ABS; RBA

Graph 50
Export Volumes*
Quarterly



* Excludes RBA gold transactions; RBA estimates for September quarter 2009
Sources: ABS; RBA

Graph 51
Short-term Visitor Arrivals and Departures
Monthly



Source: ABS

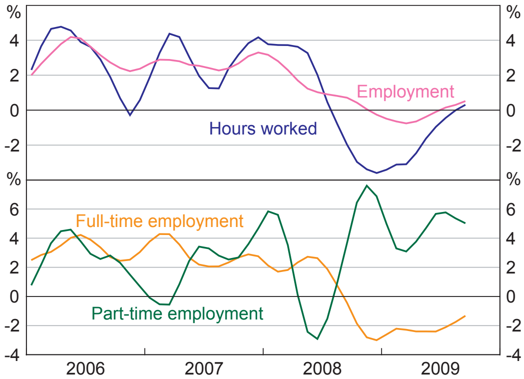
Labour market

The labour market has held up better than had been expected earlier in the year and there are indications that conditions are starting to improve. Aggregate employment has been broadly flat over the past year. While full-time employment has been weak, declining by 2½ per cent over the year to the September quarter, part-time employment has grown by nearly 6 per cent over the same period.

Graph 52

Growth in Labour Input

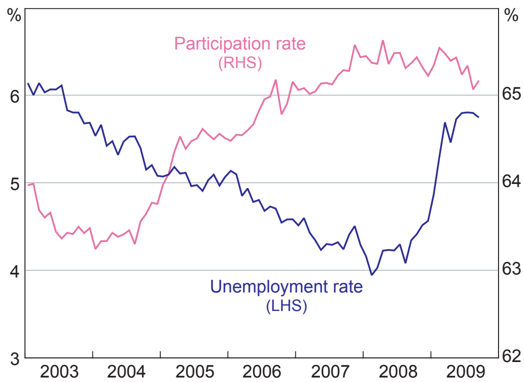
Annualised monthly trend



Sources: ABS; RBA

Graph 53

Labour Force



Source: ABS

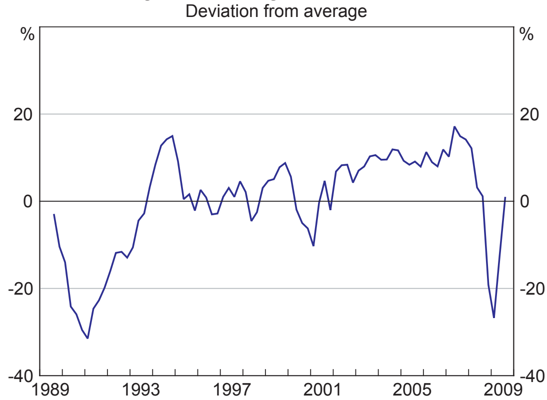
Much of the adjustment in the labour market during the current downturn has occurred through a reduction in average hours worked. Flexibility in the labour market has enabled firms and workers to reduce working hours in an effort to lower labour costs while retaining employees, a trend also observed in some other advanced economies. There are, however, signs that total hours worked has stabilised in recent months (Graph 52).

While the unemployment rate increased sharply in early 2009, it has been steady at around 5¾ per cent for the past five months, 1¾ percentage points above the low point reached in early 2008 (Graph 53). This recent stability of the unemployment rate in the face of flat employment but ongoing strong population growth in part reflects a fall in labour force participation. Nevertheless, the participation rate remains high by historical standards and compared with trends seen during previous downturns.

Forward-looking measures point to a gradual improvement in labour market conditions. The Bank's liaison with firms indicates that hiring intentions have picked up after the decline in confidence around the start of the year. This is consistent with a range of other indicators, such as job advertisements and business surveys, which also point to a pick-up in labour demand (Graph 54).

Graph 54

Survey of Employment Intentions*



* Expectations for following quarter, net balance
Sources: NAB; RBA

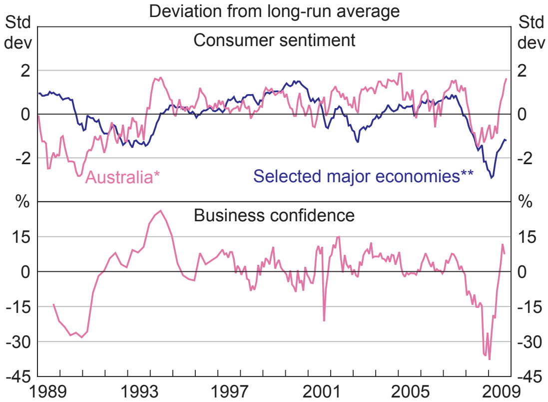
Box C: The Recovery in Confidence

The contraction in the global economy late last year and earlier this year was characterised by a sharp increase in risk aversion and a collapse in business and consumer confidence. Risk premia in financial markets rose markedly and firms and households delayed their spending plans – particularly for capital and durable goods – as they became more cautious. Recently, the extreme risk aversion evident earlier in the year has abated and there has been some recovery in business and household confidence around the world.

Graph C1

Sentiment Indicators

Deviation from long-run average



* Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index

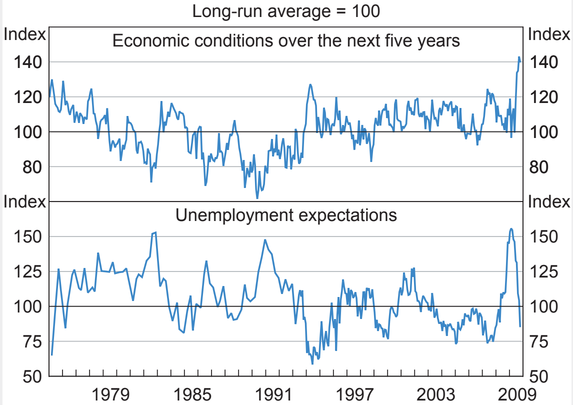
** GDP-weighted average of euro area, Japan, UK and US

Sources: IMF; Melbourne Institute and Westpac; NAB; RBA; Roy Morgan Research; Thomson Reuters

Graph C2

Consumer Sentiment

Long-run average = 100



Sources: Melbourne Institute and Westpac; RBA

These trends have also been evident in Australia, although confidence did not fall to levels as low as in many other countries and the rebound has been much sharper (Graph C1). While indices of consumer sentiment fell considerably through 2008, they remained less negative in Australia than in the early 1990s recession and have since recovered to near-record levels. The improvement in sentiment is particularly evident in the forward-looking measures, with more individuals reporting that they are optimistic about medium-term prospects for the economy than has been the case since the consumer sentiment survey commenced in 1973 (Graph C2). There has also been a marked reduction in households' concerns about unemployment; earlier this year, reported concerns about unemployment were at their highest level for more than three decades.

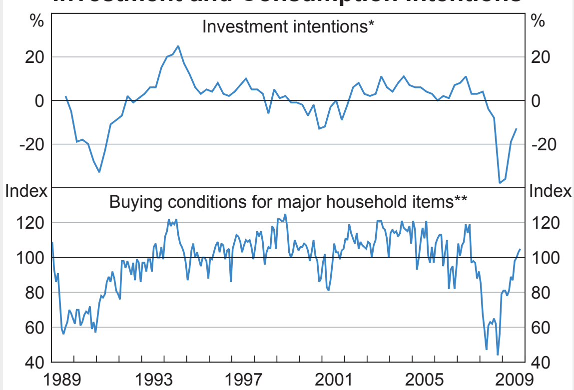
Measures of business confidence also declined markedly last year, particularly around the global financial market turmoil in September. They have, however, risen since the beginning of the year. For Australia, the NAB survey measure of business confidence is around its highest level since 2003, while measures in other business surveys have also risen over recent quarters, to be well above long-run averages. The rise in confidence has been seen across all industries and states.

In comparison with the significant pick-up in measures of business confidence, measures of current conditions for firms have shown a less marked rise, with most surveys reporting that current conditions are around or only slightly above average. Similarly, despite the high reported level of confidence, firms' stated investment intentions over the coming year remain below average (Graph C3). The difference in measures of confidence and current conditions is also evident in the consumer surveys; while their level of confidence is high, when consumers are asked about current buying conditions for major household items, their responses are only just above average.

Interpreting the recent rise in confidence is complicated by a lack of historical precedents for such large swings in business and consumer confidence over a short period of time. Earlier research by the Bank found that sentiment measures in Australia have some predictive content in regard to the future level of economic activity and that they can provide useful information about current conditions, especially since they are available on a timelier basis than some other measures of activity.[1] However, there have been earlier episodes – most obviously the sharp fall in business confidence following the terrorist attacks in the United States in September 2001 – when large swings in confidence were not closely linked to subsequent developments in the economy. To some extent the recent recovery in confidence may partly reflect a sense of relief that the very bad outcomes thought possible earlier in the year have not materialised, with the Australian economy in particular performing better than was widely expected. If so, the recent sharp rise in confidence may not translate fully into future household and business spending.

Graph C3

Investment and Consumption Intentions



* Net balance; deviation from long-run average
** Long-run average = 100
Sources: Melbourne Institute and Westpac; NAB

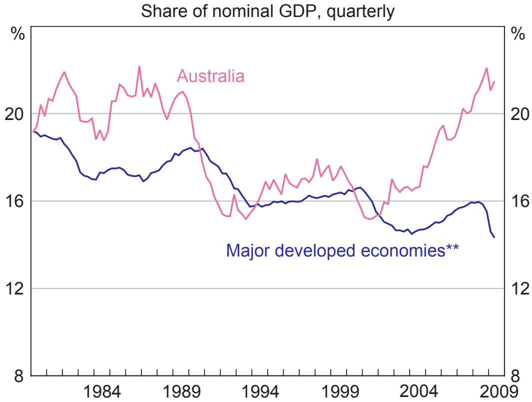
1 *See Roberts I and J Simon (2001), 'What Do Sentiment Surveys Measure?', RBA Research Discussion Paper No 2001-09 and Aylmer C and T Gill (2003), 'Business Surveys and Economic Activity', RBA Research Discussion Paper No 2003-01.*

Box D: Investment in the Resources Sector

Graph D1

Non-residential Investment*

Share of nominal GDP, quarterly



* Total private and public investment

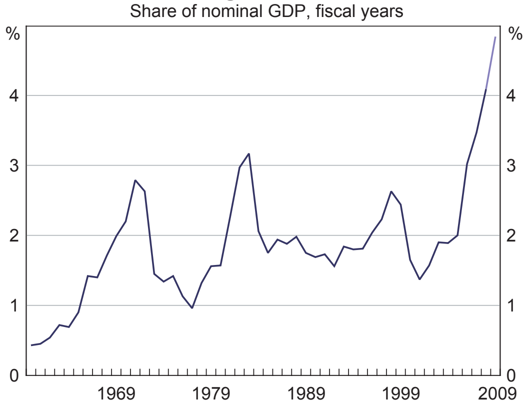
** Canada, euro area, Japan, UK and US; euro area data based on selected countries prior to 1995; GDP-weighted at average market exchange rates in 2006–2008

Sources: ABS; Eurostat; RBA; Thomson Reuters

Graph D2

Mining Investment

Share of nominal GDP, fiscal years



Sources: ABS; RBA

Australia has experienced strong investment growth since the early 2000s, with the share of non-residential investment in GDP rising from around 15 per cent to nearly 22 per cent in 2008/09 (Graph D1). This is in contrast to the experience of most other advanced economies, where investment ratios are at or near historically low levels.

This increase in large part reflects investment in the resources sector, which as a share of GDP has been significantly higher over recent years than during the mining booms of the late 1960s/early 1970s and early 1980s (Graph D2). With resource export prices now at very high levels by historical standards, mining investment is around 5 per cent of GDP, up substantially from just 1½ per cent early this decade.

Information from the Bank's liaison with mining companies suggests that further significant increases in mining investment and output are likely over the years ahead. The outlook for iron ore and coal remains strong, with investment expected to remain at its current high level, or increase further, as a share of GDP. However, the industry that is likely to see the largest increase in investment is liquefied natural gas (LNG). In addition to the two LNG plants already in operation, two major new projects have been initiated: the $43 billion Gorgon project that received final investment approval from its three joint venture partners in September; and the $12 billion Pluto project that has been under construction since 2007 and is due to ship its first LNG in early 2011. In addition, there are several proposed large offshore LNG projects in Western Australia and the Northern Territory, as well as 'coal seam gas to LNG' projects in Queensland, that are aiming for final investment approval in the next 18 to 24 months. While any projections on future investment are subject to considerable uncertainty, it is plausible that investment in this sector could increase from around ½ per cent of GDP currently, to around 2½ per cent within the next four or five years.

While the extent to which the large number of projects under consideration will translate into actual high levels of mining investment is uncertain – there are examples of previous episodes of optimism which quickly faded, leaving plans for expansion unfulfilled – the probability that many of these projects will be realised may be higher now than during past booms. This reflects three important considerations: the prospect of continued strong growth in China, India and other emerging economies in Asia; the fact that confirmed reserves of gas, iron ore and coal have already been discovered; and, for LNG, that projects generally lock in multi-decade contracts with buyers before construction commences.

If the increases in investment discussed above were to occur, output of the mining sector would rise substantially in the medium term. Over the past five years, iron ore output increased by around 70 per cent. However, growth in coal capacity has been relatively slow, largely reflecting problems with shared rail and port infrastructure for coal in Queensland and New South Wales. Over the next two years, if capacity comes on-line as planned, production of these bulk commodities could increase by around one-third, with further significant increases possible over the remainder of the next decade. LNG exports could increase significantly over the next two years following the completion of the Pluto project, but the largest expansions in capacity are projected to come on-line later, potentially leading to a three to fourfold increase in LNG exports. Production increases of this magnitude would likely see the value of LNG exports increase towards a similar share of total exports as for coal or iron ore.

Investment booms can present challenges for macroeconomic management, particularly when the economy is operating at a high level of capacity. While investment increases the economy's long-run productive capacity, it adds to short-run demand pressures within the economy. For example, during 2007 and early 2008, shortages of appropriate labour and some capital equipment resulted in an escalation in construction costs in the mining sector, prompting the delay or scaling back of some investment plans. Although the recent period of slower growth in demand has lessened some of the immediate capacity pressures in the economy, constraints could well emerge over coming years. More broadly, for the resource companies to implement their investment plans and for the mining sector to expand, capital and labour will have to shift from other areas of the economy. This process of structural change will present challenges. However, having flexible markets, including a floating exchange rate, will help facilitate the adjustment of the economy to these pressures.

Domestic Financial Markets

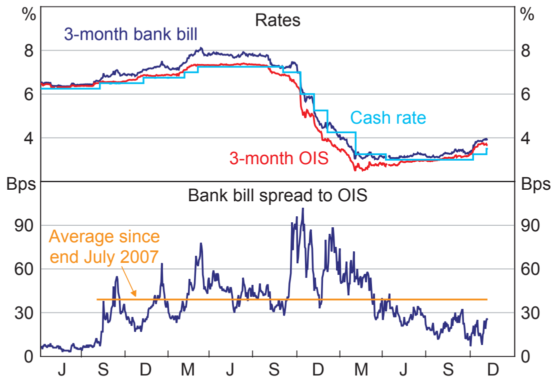
Money markets and bond yields

The Reserve Bank Board increased its target for the overnight cash rate by 25 basis points in both October and November, to 3.50 per cent. The strength of recent economic data has seen further increases in the cash rate priced into money market yields. Reflecting these developments, since the previous *Statement*, 3-month and 6-month bank bill rates have increased by over 60 basis points (Graph 55). Spreads between bill rates and the OIS curve have remained well below the crisis averages. This is indicative of the continued improvement in domestic financial conditions, which has seen the Bank normalise its dealings in its market operations (see 'Box E: Normalisation of Domestic Market Dealing Operations').

The expectation of a higher near-term cash rate has seen the yield curve flatten with the spread between 3-month and 10-year Commonwealth Government securities (CGS) narrowing by around 60 basis points (Graph 56). Although the yield on 10-year CGS has fallen slightly since the last *Statement*, the spread to US Treasuries has increased by 20 basis points. The widening in the spread appears to predominantly reflect the fact that the policy rate is expected to remain at very low levels in the United States for some time to come.

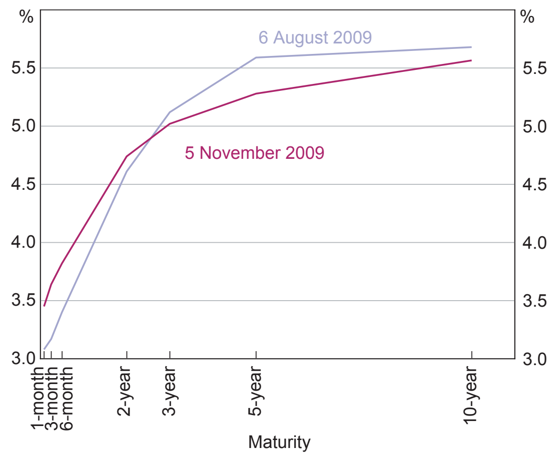
The issuance of CGS has slowed, after picking up substantially in the first half of the year. Total CGS outstanding has increased by \$4½ billion since the last *Statement* to \$110 billion. In October the Australian Office of Financial Management (AOFM) resumed issuance of longer-dated inflation-linked debt. The \$4 billion bond, maturing in 2025, was the AOFM's first issuance of inflation-linked debt since 2003 and followed the NSW Government's successful

Graph 55
Money Market Interest Rates



Sources: AFMA; RBA; Tullett Prebon (Australia) Pty Ltd

Graph 56
Government Yield Curve



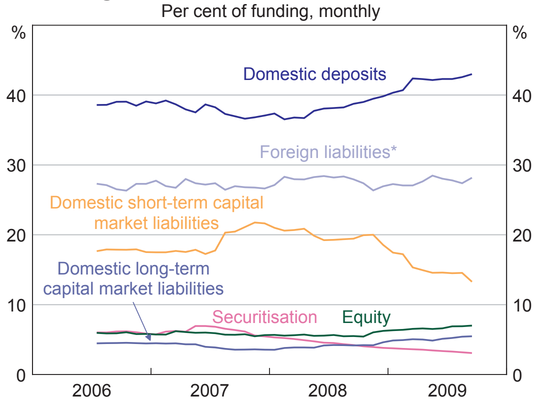
Source: RBA

index-linked raising. Rather than using a tender process, the AOFM opted to sell the debt via a syndicate, a method of debt distribution which has also been favoured by the state government authorities in recent times.

Financial intermediaries

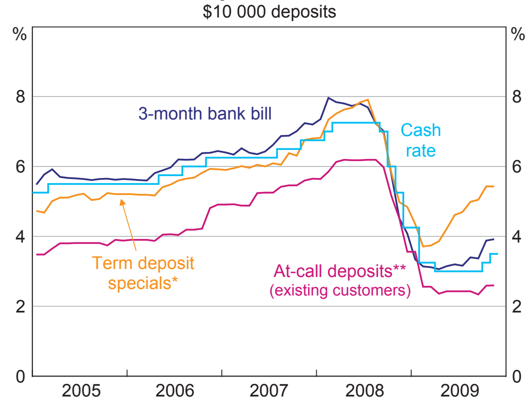
Following a marked change during 2008 and early 2009, the composition of financial intermediaries' funding has changed only a little in recent months. Competition for deposits remains strong, with the share of banks' funding from this source rising slightly to 43 per cent over the September quarter, having risen by 6 percentage points since December 2007 (Graph 57). The shares of banks' funding that come from long-term capital market debt and equity have also increased slightly over the September quarter as banks continued to manage their balance sheets conservatively. Banks' use of domestic short-term capital market debt declined further; by end September 2009 it accounted for 13 per cent of total funding liabilities, down from over 20 per cent in late 2007.

Graph 57
Funding Composition of Banks in Australia
Per cent of funding, monthly



* Adjusted for movements in foreign exchange rates
Sources: APRA; RBA

Graph 58
Deposit Rates
$10 000 deposits



* Average of the 'specials' rates for 1–12, 24-, 36- and 60-month terms at the major banks
** Average of online, bonus and cash management accounts at the major banks
Source: RBA

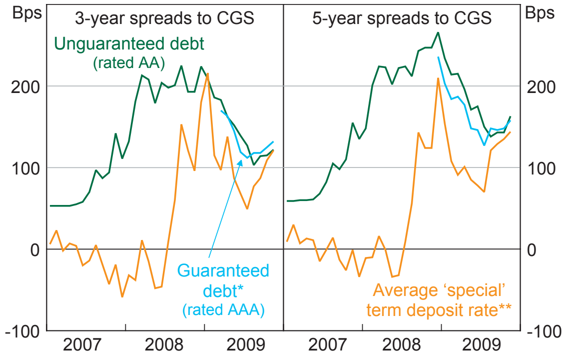
Over the past two years, there has been a significant shift in banks' pricing of deposits, with the average rate on major banks' outstanding transaction, at-call and term deposits now broadly in line with the cash rate, after being about 120 basis points below the cash rate up until March 2008 (Graph 58).

The change in pricing has been largest for term deposits. The average rate offered on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has risen by 72 basis points since end July to 5.43 per cent, and is up about 175 basis points since early 2009. Banks' overall cost of term deposits remains high relative to the cash rate, as they continue to target longer-dated term deposits and the yield curve is currently quite steep. The major banks' 3- and 5-year 'special' term deposit rates are currently only 0–20 basis points lower than the yields on their bonds of equivalent maturity (Graph 59). The smaller Australian banks' average 'special' term deposit rates have risen by 55 basis points since end July, and are currently in line with the rates offered by the major banks.

By end October, the average rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) had increased by 16 basis points since end July to 2.60 per cent, slightly less than the increase in the cash rate. This left the average rate on at-call deposits 65 basis points below the cash rate, compared with 100 basis points in mid 2007. At the time this *Statement* was finalised, the November increase in the cash rate had only just started to flow through to deposit rates.

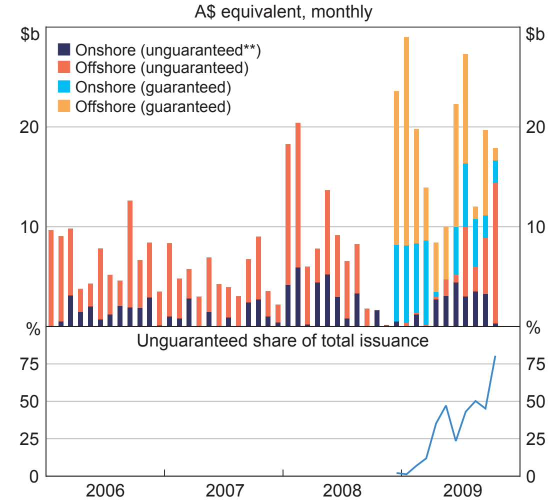
Bond issuance since the last *Statement* totalled around $55 billion across a diverse range of markets. Around two-thirds of these bonds were issued offshore, a little below the historical average. Australian banks have issued an increasing amount of unguaranteed bonds in recent months as investor appetite for bank credit has returned (Graph 60). In the December quarter to date, around 80 per cent of bonds issued have been unguaranteed, the highest share since the Government guarantee was introduced last October.

Graph 59
Major Banks' Pricing of Term Deposits and Bonds
A$ debt, term deposit 'specials'



* Includes fee for guaranteed issues
** Prior to September 2008 it is the 24-month spread
Sources:Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

Graph 60
Australian Banks' Bond Issuance*
A$ equivalent, monthly

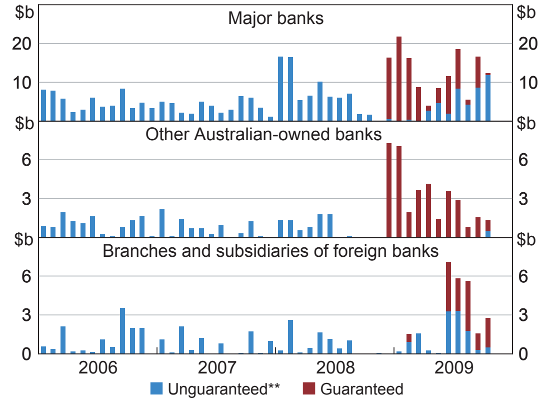


* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** Unguaranteed issuance includes A$3.25 billion of issuance guaranteed by the UK government
Source: RBA

The increasing amount of unguaranteed bond issuance has been underpinned by the major banks for whom unguaranteed debt is now mostly cheaper than guaranteed debt. There are signs that other Australian-owned banks are also able to issue unguaranteed bonds, with one A-rated bank issuing an unguaranteed pound sterling bond offshore in October. Foreign-owned banks have issued relatively large volumes of guaranteed bonds (Graph 61).

Secondary market spreads on guaranteed and unguaranteed bonds issued by the major banks have risen by around 20 basis points since the last *Statement*, but remain well below the levels prevailing earlier in the year (Graph 62). Consequently, at the 3-year maturity, Government-guaranteed debt (including the cost of the guarantee fee) is currently trading at 130 basis points over CGS, compared with 120 basis points for unguaranteed debt. Overall, since the last *Statement*, yields on the major

Graph 61
Australian Banks' Bond Issuance*
A$ equivalent, monthly

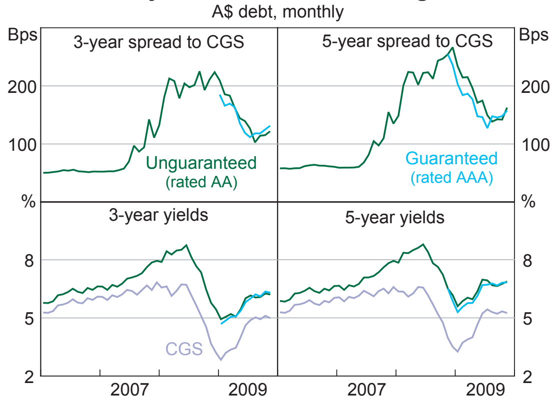


* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme

** Unguaranteed issuance includes A$3.25 billion of issuance guaranteed by the UK government

Source: RBA

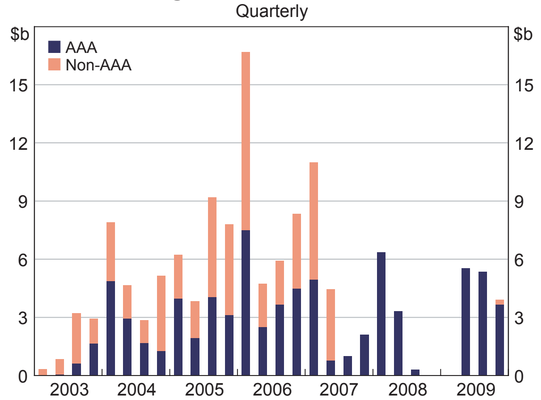
Graph 62
Major Banks' Bond Pricing*
A$ debt, monthly



* Includes fee for guaranteed issues

Sources: RBA; UBS AG, Australia Branch

Graph 63
Kangaroo Bond Issuance
Quarterly



Source: RBA

banks' bonds have remained broadly unchanged.

Banks continue to look to lengthen the maturity of their bonds, with the average tenor issued in recent quarters at 4½ years. The increase largely reflects the ability of the major banks to issue unguaranteed bonds with longer maturities, including beyond the five-year limit of the Guarantee Scheme.

The relatively high share of banks' bond issuance offshore in recent months has occurred despite cross-currency basis swap spreads remaining at elevated levels, adding to the cost of issuance when proceeds are swapped back into Australian dollars. Conversely, this elevated spread reduces the final cost of domestic Australian-dollar bond issues by non-resident entities – Kangaroo bonds – and so has contributed to the solid issuance which totalled $5½ billion in the September quarter (Graph 63). A further $3½ billion has been issued so far in the current quarter, including an issue by a non-AAA-rated institution. This is the first such issue since the onset of the financial crisis, and is a further sign that investor risk aversion is easing.

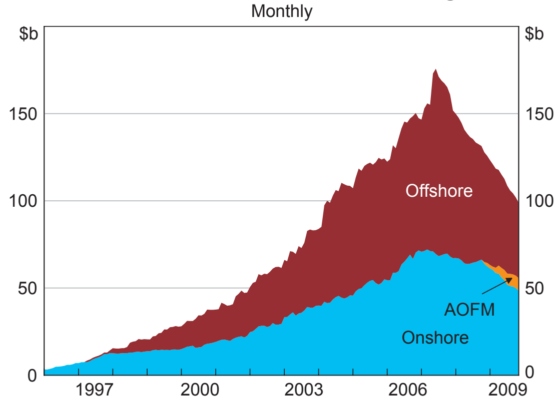
In addition to accessing a wide range of bond markets, Australian banks have had good access to other types of capital market funding. During the September quarter, banks raised $7½ billion of equity – the second largest quarterly amount on record – predominantly through the issuance of new shares to retail and institutional investors. Investor demand for the additional shares was very strong – underpinned by the modest discount to prevailing market prices at which shares could be purchased – with deals upsized or investor allocations scaled back. A couple of Australian banks have also recently issued hybrid securities, raising nearly $3 billion.

Conditions in Australian securitisation markets have improved considerably in recent months. For the first time in a year, there were successful issues of residential mortgage-backed securities (RMBS) without the support of the AOFM, as well as several non-RMBS securitisations. The two RMBS issued without AOFM support totalled $1.5 billion, with strong investor demand leading both deals to be oversubscribed and upsized. Since the last *Statement*, a further four deals amounting to $2.2 billion have been issued with the AOFM as a cornerstone investor purchasing $850 million. With the AOFM's purchases of RMBS now amounting to $7½ billion of the $8 billion initially allocated, and securitisation volumes remaining low by pre-crisis standards, the Treasurer announced in mid October that the Government would allocate up to an additional $8 billion to RMBS to support competition in the mortgage market.

Reflecting a relatively low volume of issuance and the ongoing amortisation of principal (i.e. mortgage repayments), the value of Australian RMBS outstanding has continued to fall, to around $100 billion, more than 40 per cent below its peak in June 2007 (Graph 64). Australian RMBS outstanding offshore has declined by nearly 60 per cent, because there has been no offshore issuance, while paper outstanding onshore has fallen around 20 per cent. The AOFM's holdings amount to around 7 per cent of all Australian RMBS outstanding, and 12 per cent of the domestic market.

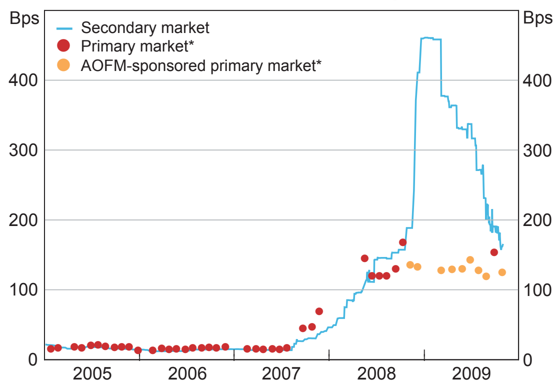
The AAA-rated tranches of the prime RMBS issued over recent months that have involved the AOFM as a cornerstone investor have priced at 120–130 basis points above BBSW. Deals that did not involve AOFM support have been priced a little higher. The pick-up in investor demand for RMBS in recent months has been evident in a decline in secondary market spreads, which have fallen to be only a little above primary market spreads (Graph 65). The narrowing suggests that the market has worked through much of the overhang of supply in the secondary market created by the deleveraging of structured investment vehicles – these entities used to account for a significant share of the RMBS investor base.

Graph 64
Australian RMBS Outstanding
Monthly



Sources: Bloomberg; RBA; Standard & Poor's

Graph 65
AAA-rated Prime RMBS Spreads



* Primary RMBS spreads are face value weighted monthly averages of AAA-rated RMBS with conservative average LVRs

Sources: RBA; Royal Bank of Scotland

With the decline in the stock of RMBS outstanding, the narrowing of secondary market spreads, and the first non-AOFM sponsored issuance, the outlook for further RMBS issuance has improved.

Conditions in short-term securitisation markets have also improved. While asset-backed commercial paper (ABCP) outstanding has roughly halved since its peak in mid 2007, the pace of decline has eased in recent months. Indeed, in July – the latest comprehensive data available – modest declines in onshore outstandings were offset by an increase in offshore issues, partly reflecting the first pound sterling issuance in a year. Market participants report that they now have little difficulty rolling over paper, including at longer maturities. The improving conditions in the ABCP market have been reflected in declining spreads. Since their peak, spreads have fallen by around 15 basis points, to 50 basis points above BBSW, and are now around the same level as in February 2008.

Household financing

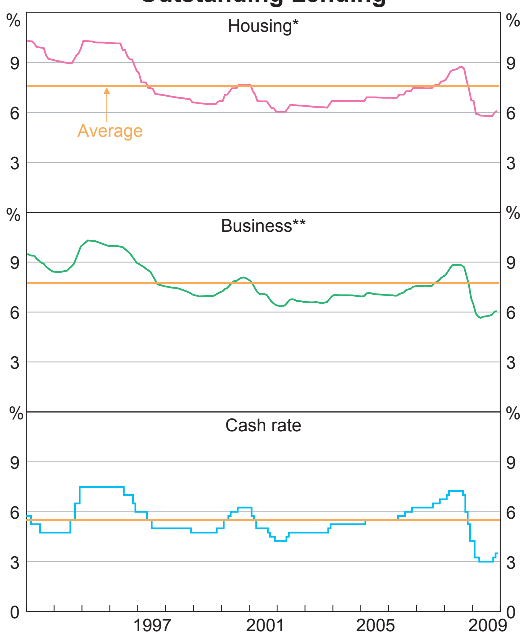
Financial intermediaries have largely passed on the October and November cash rate increases to variable housing rates. Interest rates on new fixed-rate housing loans have also risen, reflecting the increases in capital market yields.

Variable interest rates on prime full-doc housing loans have largely risen in line with the cash rate since end July, with the major banks passing on the full 50 basis point increase, although many smaller lenders are yet to adjust their rates in response to the November increase (Table 8). The major banks' interest rates on new 3-year and 5-year fixed-rate housing loans have increased by around 75–110 basis points since end July to average 7.60 per cent and 7.95 per cent respectively. With fixed rates currently around 2–2½ percentage points higher than variable rates, the share of owner-occupier loan approvals at fixed rates has drifted lower over recent months to 6 per cent, about half its decade average.

Overall, the average interest rate on all outstanding housing loans (variable and fixed) is estimated to have risen by 30 basis points since end July, to 6.10 per cent (Graph 66).

Graph 66

Average Interest Rates on Outstanding Lending



* RBA estimates prior to 2000
** RBA estimates
Sources: ABS; APRA; Perpetual; RBA

Table 8: Intermediaries' Variable Lending Rates
Per cent

	Current level	Change since:	
	4 November 2009	Jul 2009	Aug 2008
Cash rate	3.50	0.50	–3.75
Housing loans			
Prime full-doc	5.61	0.43	–3.37
Prime low-doc	6.09	0.20	–3.40
Personal loans			
Margin loans	8.16	0.15	–2.42
Standard credit cards	18.12	0.21	–1.81
Low-rate credit cards	12.09	0.13	–0.84
Unsecured term loans	13.77	0.25	–1.13
Home equity loans	6.21	0.30	–3.37
Small business			
Term loans			
Residentially secured	7.48	0.38	–2.61
Other security	8.27	0.38	–2.43
Overdraft			
Residentially secured	8.30	0.38	–2.61
Other security	9.19	0.38	–2.40
Average actual rate[a]	7.51	0.36	–2.78
Large business			
Average actual rate, variable and bill funding[a]	5.54	0.36	–3.07

(a) RBA estimate
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

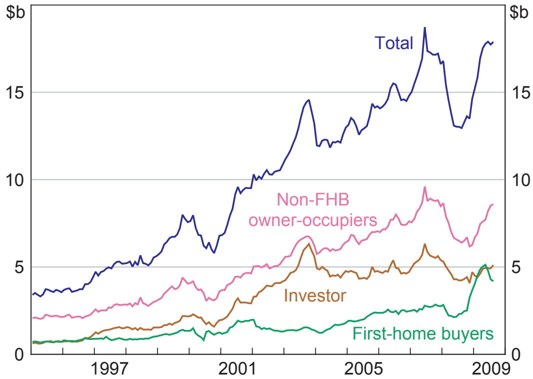
This is about 150 basis points below its post-1993 average, and close to the low earlier this decade when the cash rate was at its previous cyclical low.

After rising significantly over the year to June 2009, the value of housing loan approvals has levelled out in recent months (Graph 67). Demand from first-home buyers peaked in May, following a substantial rise over the first half of the year in response to the government incentives available to first-home buyers and lower interest rates. However, a pick-up in housing loan approvals to investors and other owner-occupiers has offset this decline in first-home buyer approvals.

The five largest banks' share of gross owner-occupier loan approvals has stabilised at about 82 per cent over the past few months, up from 60 per cent just before the onset of the financial market turbulence in mid 2007 (Graph 68). The market shares of the smaller banks, credit unions and building societies and wholesale lenders have also been little changed over recent months.

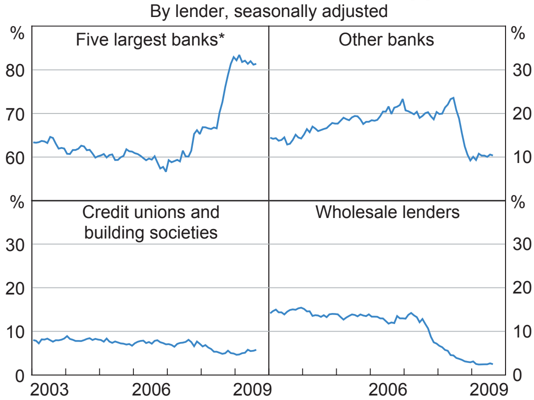
Housing credit grew at a monthly average rate of 0.7 per cent in the quarter, a similar pace to that seen over the previous year, with the higher level of new approvals largely offset by higher repayments (see the 'Domestic Economic Conditions' chapter; Table 9; and Graph 69). Owner-occupier housing credit continues to grow at a much faster pace than investor housing credit.

Graph 67
Housing Loan Approvals*
Seasonally adjusted



* Excludes owner-occupier refinancing, alterations and additions, and investor approvals for new construction and by 'others'
Sources: ABS; RBA

Graph 68
Share of Owner-occupier Loan Approvals
By lender, seasonally adjusted



* Includes Bankwest from December 2008
Sources: ABS; APRA

Financial institutions' rates on variable personal loans have risen by an average of 20 basis points since end July, with the October increase in the cash rate largely being passed through, but lenders yet to adjust rates in response to the November increase. Average rates on unsecured personal loans, credit cards, home equity loans and margin loans have increased by 15–30 basis points.

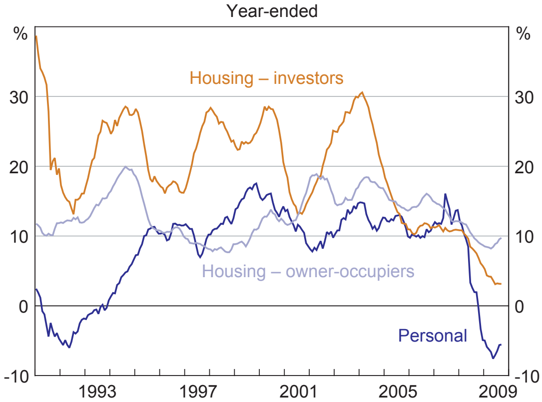
The stock of personal credit, which is a small component of household credit, was unchanged during the September quarter. The stabilisation of personal credit in part reflects the levelling out in margin lending which had fallen sharply during 2008. Stronger equity markets meant that the incidence of margin calls declined to a low 1.0 calls per day per 1 000 clients in the September quarter (Graph 70). Borrowers' gearing levels declined by 5 percentage points to a new historical low of 34 per cent as the value of their collateral rose by 17 per cent.

Table 9: Credit Aggregates
Average monthly growth, per cent

	December quarter 2008	March quarter 2009	June quarter 2009	September quarter 2009
Total credit	0.2	0.2	0.1	0.1
Household	0.4	0.5	0.5	0.6
– Owner-occupier housing	0.7	0.8	0.8	0.8
– Investor housing	0.2	0.3	0.2	0.4
– Personal	–1.0	–0.4	–0.5	0.0
Business	–0.1	–0.1	–0.6	–0.8

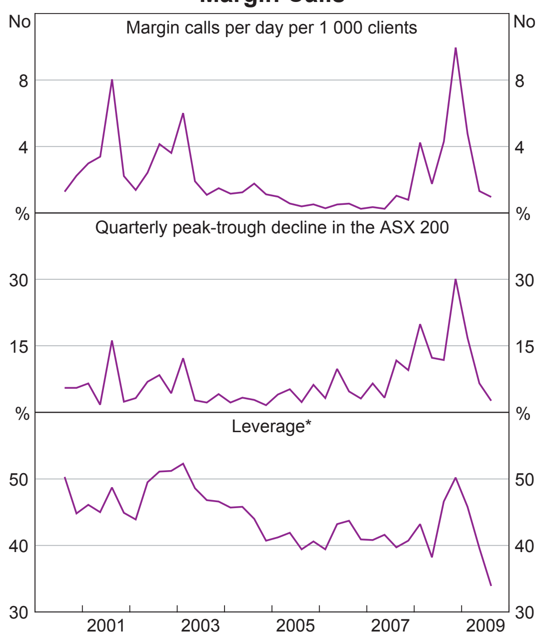
Source: RBA

Graph 69
Household Credit Growth



Source: RBA

Graph 70
Margin Calls



* The total value of margin loans outstanding divided by the total value of the underlying securities

Sources: Bloomberg; RBA

Business financing

Interest rates on business lending have risen since end July, reflecting the increases in the cash rate and market rates.

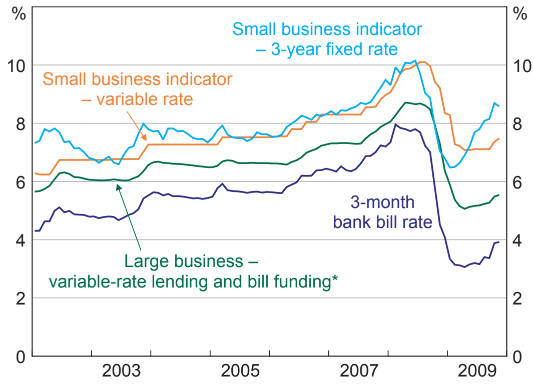
The major banks passed through the October cash rate increase in full to their variable indicator rates on small businesses lending (Graph 71). To date, not all lenders have adjusted their rates in response to the November increase; overall pass-through has only been partial for those that have. Rates on new 1–5 year fixed-rate loans have risen by 40–125 basis points, a little more than the increases in capital market yields.

Variable interest rates on banks' outstanding large business loans (those greater than $2 million) are estimated to have increased by an average of 35 basis points since end July. This reflects rising bank bill rates and a small increase in average risk margins as the outstanding loans are gradually repriced at the current higher spreads.

The average interest rate on all outstanding business lending (variable and fixed) is estimated to have increased by about 30 basis points since end July, to 6.05 per cent. This is about 170 basis points below its post-1993 average.

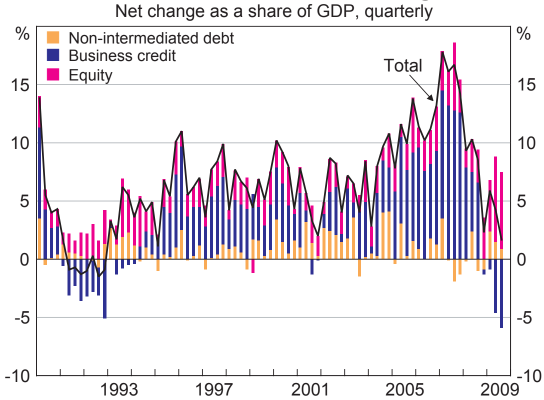
Companies' internal funding (cash profits) has been resilient during the financial crisis, enabling companies to reduce their reliance on external funds (see 'Australian Corporates' Sources and Uses of Funds', RBA *Bulletin*, October 2009). The stock of business net external funding increased modestly over the September quarter (Graph 72). A sharp fall in business credit was more than offset by strong equity raisings. In large part, the decline in business credit this year appears to reflect the repayment of bank loans by listed corporates, as they have sought to reduce their gearing significantly. Companies scaled back their use of debt during the financial crisis as interest margins increased and banks tightened their lending standards. While the strong

Graph 71
Business Lending Rates



* RBA estimates
Sources: APRA; RBA

Graph 72
Business External Funding
Net change as a share of GDP, quarterly



Sources: ABS; ASX; Austraclear Limited; RBA

equity raisings have been primarily undertaken to reduce gearing by paying down debt, some corporates have announced their intention to use the proceeds to fund acquisition and investment activity. Aggregate debt levels of listed companies are estimated to have fallen by around 20 per cent over 2009 so far, with the decline broad-based across sectors.

Over the September quarter, intermediated business credit contracted at an annualised rate of 9 per cent, with the weakness broadly based across industry sectors, and evident for banks and non-bank financial institutions. The contraction in business credit over recent quarters has been more pronounced for large businesses than for small businesses, likely reflecting large businesses having better access to new equity capital to pay down debt.

Approvals data suggest that the business sector still has reasonable access to intermediated funding. Commercial loan approvals have been broadly steady since the beginning of the year after falling significantly in 2008. There were $16 billion of syndicated loan approvals to Australian businesses in the September quarter, the largest in the past few quarters. Refinancing continues to be the predominant use of funds.

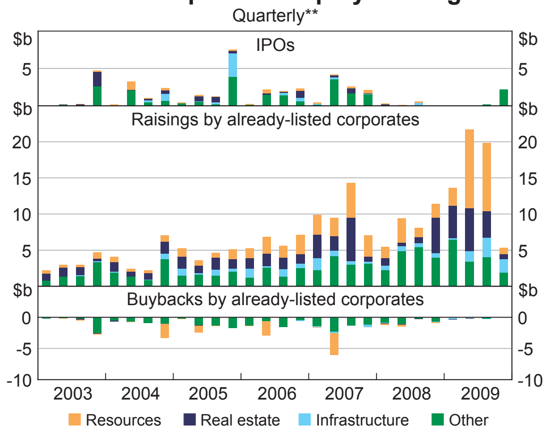
Equity raisings remain the dominant form of external finance. Equity raisings by already-listed corporates (i.e. excluding IPOs) in the September quarter amounted to a strong $20 billion, the second highest quarterly amount on record. While nearly half of this was raised by resource companies – partly driven by the Australian component of Rio Tinto's equity raising ($4 billion) – issuance of equity by real estate and infrastructure and other companies was also solid (Graph 73). Equity raisings have remained strong in the December quarter. The bulk of equity has been raised through placements and rights issues to institutional investors (mostly fund managers), often followed by smaller issues to retail investors. Investor demand has been solid, with many issues oversubscribed, partly because investors could usually purchase the new shares at a modest (and in a few cases, large) discount to prevailing market prices. Equity raisings have historically been offered at a discount to market prices, with the discount typically higher if the raising is large relative to the company's existing market capitalisation. These trends were also evident for equity raisings undertaken this year, though the average discount was a little larger than has been the case historically, at around 20 per cent.

Buybacks by already-listed companies remain subdued, with corporates preferring to retire debt or retain cash at this time. As market conditions have improved in recent months, there has been a pick-up in IPO activity, with the completion of the first two IPOs of size since July 2008 and other IPOs being prepared.

The equity raisings undertaken by listed corporates this year have had a large impact on their gearing. The aggregate gearing ratio – the ratio of the book value of debt to equity – is estimated to have declined by around 20 percentage points since end 2008, to be around the historical average of 65 per cent (Graph 74). The fall in leverage has been broadly based across sectors. Resource companies' gearing has fallen almost 20 percentage points to around 40 per cent. The bulk of this reflects the unwinding of Rio Tinto's prior increase in leverage from its takeover of Alcan. While more highly leveraged corporates, such as real estate and infrastructure companies, have recorded declines in gearing, these have been partly offset by asset writedowns. These companies' gearing is still above pre-crisis levels, with many continuing to restructure their balance sheets, including the negotiation of asset sales and bank loan extensions. The gearing of other corporates – which include companies in the retail, manufacturing, telecommunications, information technology and healthcare sectors – has also fallen, to be around the lower end of its historical range.

Graph 73

Listed Corporates' Equity Raisings*



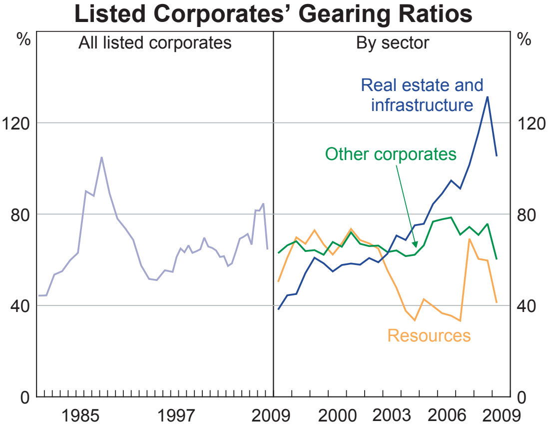
* Excludes hybrid conversions which are a very small component of listed corporates' equity raisings (less than $0.5 billion per quarter)

** Data for December quarter 2009 estimated from company announcements

Sources: ASX; RBA

Graph 74

Listed Corporates' Gearing Ratios



* Gross debt/shareholders' equity at book value; excludes foreign companies. Most recent observation adjusts for large equity raisings conducted to repay debt.

Sources: ABS; Morningstar; RBA; Statex

Corporate bond issuance remained solid in the September quarter, with $5½ billion raised by nine corporates. A further $3½ billion has been raised in the December quarter so far. While issuance earlier in the year was limited to larger corporates with an established presence in capital markets, more recently, as investor risk aversion has started to ease, the range of borrowers has broadened with a number of medium-sized entities also issuing bonds. The increase in investor demand has also been evident in declining spreads on corporate bonds in secondary market trading. Secondary market spreads on domestically-issued BBB-rated corporate bonds have fallen to around 330 basis points – around 245 basis points below their peak in March, but still well above the pre-crisis average of less than 100 basis points.

Equities

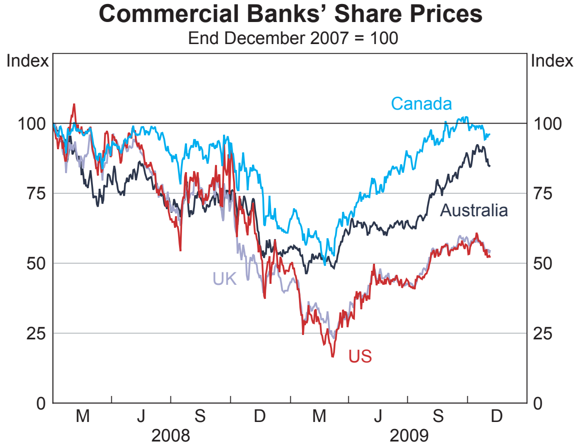
The ASX 200 has risen by around 5 per cent since the last *Statement* to be 45 per cent higher since the trough in early March and at its highest level since October last year (Table 10). Despite these gains, the ASX 200 remains around 35 per cent below its peak in November 2007.

Table 10: Sectoral movements in the ASX 200

	Per cent change since		
	November 2007 peak	March 2009 trough	Previous *Statement*
Resources	–25	35	–1
Financials	–39	67	10
Other	–34	30	4
ASX 200	–34	44	5

Source: Bloomberg

Graph 75
Commercial Banks' Share Prices



Sources: Bloomberg; RBA; Thomson Reuters

Financials' share prices have increased particularly sharply, to be up around 65 per cent from their trough earlier in the year. This has largely reflected solid increases in banks' share prices, which have outperformed their global peers, reflecting their ongoing profitability and the soundness of the Australian financial system (Graph 75). Despite the gains in Australian banks' share prices since the trough, they remain nearly 25 per cent below their peak in November 2007.

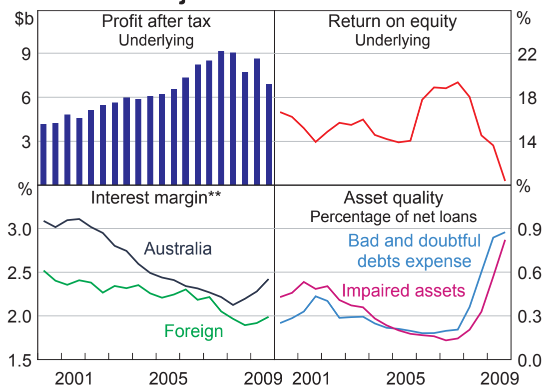
While profits announced by ASX 200 companies during the recent reporting season declined, they were a little better than expected. Underlying profits – which exclude significant items and asset revaluations/sales – for the second half of the 2009 financial year were around 20 per cent lower than the corresponding period last year. This brought the fall in profits for the entire 2009 financial year to around 20 per cent, the largest fall since the early 1990s. Headline profits fell by around 70 per cent in the half-year as a result of large asset writedowns by real estate and resource companies. Writedowns were particularly prevalent among real estate companies, which reported downward asset revaluations of around $7 billion. Dividend cuts continued as companies conserved cash. Around 60 per cent of reporting companies announced cuts to dividends in the second half, with companies that cut dividends in the first half more likely to announce cuts for the second half. More than one-third of companies cut dividends by more than 50 per cent.

The fall in aggregate underlying profit was due to resource companies, which reported a decline in profits of around 40 per cent compared with the corresponding period of 2008 due to falls in revenues from lower commodity prices and lower production volumes. Financials' profits fell slightly, with falls in banks' profits partly offset by increases in the underlying profits of insurance and real estate companies. Other companies' profits increased by nearly 10 per cent, consistent with the comparative resilience of the domestic economy.

The major banks' underlying, after-tax profit for the second half of the 2009 financial year was $6.9 billion, 11 per cent lower than in the second half of 2008 and 25 per cent below the peak in 2007 (Graph 76). The banks' return on equity fell by 4 percentage points to 10 per cent, below the 19 per cent recorded in 2006 and 2007, as the banks raised additional shareholder equity to strengthen their balance sheets.

Graph 76

Major Banks' Results*



* From 2006, figures are under AIFRS

** Four largest banks prior to the first half of 2009

Sources: RBA; banks' financial reports

The banks' Australian operations continued to perform well, with solid balance sheet growth and a 24 basis point rise in the net interest margin as higher lending spreads more than offset the increased cost of deposits. However, the banks' overseas operations (mainly in the United Kingdom and New Zealand) recorded significantly lower profits.

The banks' bad and doubtful debt expense (as a share of outstanding loans) rose by 0.3 percentage points to about 0.9 per cent. This largely reflected higher specific provisions for business loans in Australia and offshore. Net impaired assets as a percentage of lending assets more than doubled to 0.8 per cent.

The major banks reduced their half-year dividends per share by 23 per cent, to help further boost their very strong capital ratios.

Analysts have slightly revised up their forecasts of ASX 200 companies' earnings over the past few months. Earnings are expected to fall by 2½ per cent in 2009/10, but to increase by over 20 per cent in 2010/11, in large part because of a pick-up in resource companies' earnings of over 35 per cent as global economic growth picks up. Over the past couple of months there has been some moderation in the dispersion of analysts' forecasts, suggesting that uncertainty about the outlook has declined compared with earlier in the year.

Reflecting the falls in profits recently reported by listed companies, the Australian trailing P/E ratio has increased by 4 percentage points since end August, to 23 – its highest level since the early 1990s. This ratio has now increased 13 percentage points since its February low, with over half of the rise reflecting the lower earnings figures. Trailing P/E ratios have historically risen around the end of recessions, as the market incorporates the expected improvement in earnings. Incorporating these expectations, the forward P/E ratio – which is based on earnings forecasts for the next 12 months – is currently at 16, a little above its long-run average.

The dividend yield of the Australian share market is unchanged since end September, and is slightly above its long-run average of 3.9 per cent. Since its January peak, the dividend yield has fallen 3½ percentage points, with around 40 per cent of this fall due to firms cutting dividends in order to retain cash.

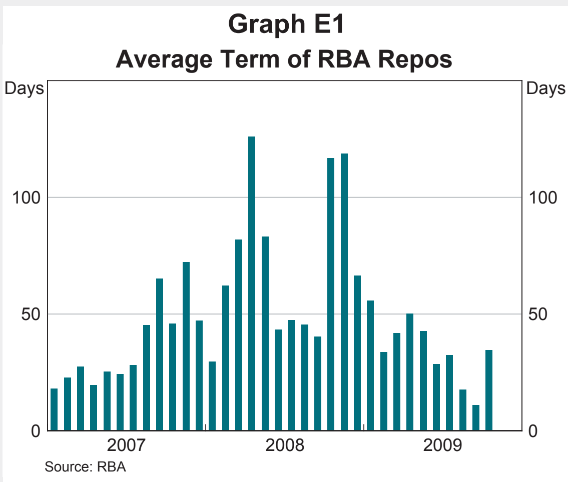
Box E: Normalisation of Domestic Market Dealing Operations

In response to the financial crisis the Reserve Bank made a number of modifications to dealing operations within its existing framework.[1] To maintain liquidity in term money markets, and to provide greater certainty of funding for financial institutions, the Bank:

- increased the average maturity of the repos contracted with counterparties and shifted the composition of the securities it held on repo from government-related securities towards private securities such as bank bills and certificates of deposit (CDs) (Graph E1);
- expanded the range of private securities that it was willing to purchase on repo to include securities from distressed markets, such as residential mortgage-backed securities (RMBS) and asset-backed commercial paper (ABCP). Over time, the range of eligible securities was expanded to cover all highly-rated private debt securities;
- began accepting related party, or self-securitised, RMBS around the peak of the financial crisis in October 2008 as it sought to expand the range of funding options for financial institutions; and
- began offering 6- and 12-month funding each day in its dealing operations.

Some of these repo purchases were accommodated by the Bank increasing Exchange Settlement Account (ES) balances significantly, as the financial turbulence increased demand for a risk-free, highly liquid asset (Graph E2). Throughout 2008, ES balances averaged $3.5 billion, well above the pre-crisis average of around $800 million. Further purchases of securities by the Reserve Bank were accommodated by offering term deposits to banks. These deposits were generally of one to two weeks duration and enabled the Bank to expand its dealing in the market without compromising its ability to keep the cash rate trading at the target.

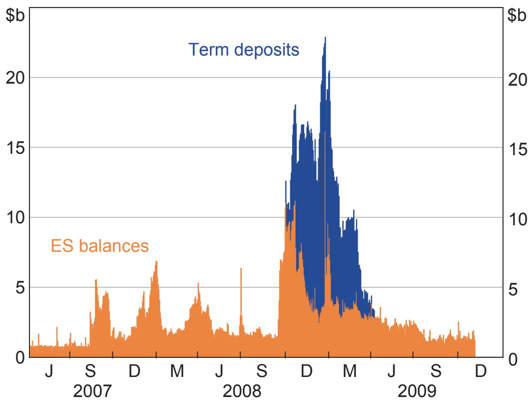
As was the case in offshore US dollar markets generally, the ability of institutions in Asian time zones to access US dollar funding became particularly strained during the latter part of 2008. To that end, the Reserve Bank implemented a



1 *See Guy Debelle, 'Some Effects of the Global Financial Crisis on Australian Financial Markets', March 2009, and 'Market Operations in the Past Year', October 2008 for additional background.*

Graph E2

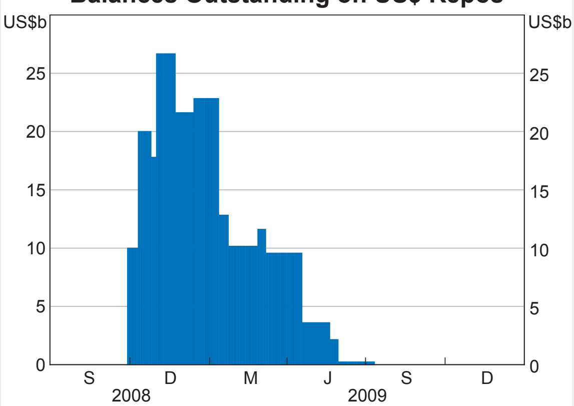
Balances Held at RBA



Source: RBA

Graph E3

Balances Outstanding on US$ Repos



Source: RBA

swap facility with the US Federal Reserve, enabling it to distribute US dollars to institutions operating in Australia against the receipt of Australian dollar securities. The amount outstanding under the facility peaked at around US$28 billion in late November 2008 (Graph E3).

As conditions in domestic financial markets have progressively improved, the Bank has normalised its dealings with market counterparties, whilst maintaining the range of securities that it accepts in its operations. Although the swap agreement with the Fed remains operative until February 2010, the Bank has not auctioned US dollars since May and all outstanding US dollar repos have matured. Similarly, the Bank has not offered term deposits since March. ES balances have declined, steadying at around $1¼ billion over recent months. This is well below the levels that prevailed for much of 2008. The Bank no longer offers 6- and 12-month funding on a daily basis, although it remains willing to contract for such terms when it suits its own liquidity management purposes.

While the Bank has continued to modify its existing dealing framework, the overriding goal of market operations has been to keep the cash rate at the monetary policy target. To that end, the cash rate has continued to trade at the target rate throughout the entire period.

Price and Wage Developments

Recent developments in inflation

Inflationary pressures continue to moderate, consistent with the slowdown in the domestic economy, although in underlying terms inflation remains relatively high. Wage growth slowed significantly over the first half of 2009, and upstream price pressures are subdued. The recent appreciation of the exchange rate is also starting to exert downward pressure on inflation in the tradables sector of the economy, and inflation expectations are broadly consistent with the Bank's medium-term inflation target.

The CPI increased by 1.0 per cent in the September quarter, to be 1.3 per cent higher over the year (Table 11, Graph 77). The main contributors to the quarterly rise were price increases for the major housing components, automotive fuel and deposit & loan facilities, which were partly offset by a seasonal decline in pharmaceuticals prices and lower prices for fruit & vegetables and other financial services.

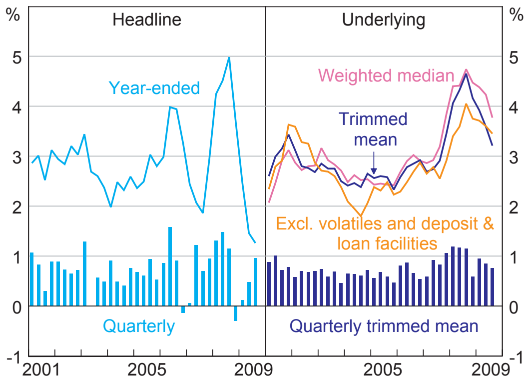
Table 11: Measures of Consumer Price Inflation
Per cent

	Quarterly		Year-ended	
	June quarter 2009	September quarter 2009	June quarter 2009	September quarter 2009
CPI	0.5	1.0	1.5	1.3
– Tradables	0.7	0.2	0.0	–0.5
– Tradables (ex food & fuel)	1.0	0.3	1.9	2.1
– Non-tradables	0.4	1.5	2.4	2.3
Selected underlying measures				
Weighted median	0.8	0.8	4.2	3.8
Trimmed mean	0.8	0.8	3.6	3.2
CPI ex volatile items[(a)] and deposit & loan facilities	0.8	0.9	3.6	3.5

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

Graph 77

Consumer Price Inflation



Sources: ABS; RBA

The Bank's medium-term inflation target is clearly expressed in terms of CPI inflation. However, from time to time the quarterly or annual rate of CPI inflation can be heavily influenced by movements in some prices that are not representative of the broader trend in inflation. This has been the case over the past year, with annual CPI inflation held down by very low quarterly outcomes of –0.3 per cent in the December quarter and 0.1 per cent in the March quarter, reflecting falls over these two quarters of 25 per cent in the price of fuel and 16 per cent in the ABS estimate of the price of deposit & loan facilities.

Accordingly, the RBA staff monitors a range of other measures of inflation to help gauge the underlying trend in inflation. These measures suggest that inflation has slowed in recent quarters from the high rates recorded in 2008, although underlying inflation remains above the medium-term target. The trimmed mean measure of inflation, which downweights the impact of unusual price changes in both directions, showed inflation of 0.8 per cent in the September quarter, while the CPI excluding fuel, fruit & vegetables and deposit & loan facilities rose by 0.9 per cent. Based on a range of measures monitored by the Bank, our assessment is that underlying inflation over the past year was around 3½ per cent, compared with its peak of just over 4½ per cent a year earlier. The large divergence between the estimates for year-ended underlying and headline CPI inflation at present is largely accounted for by the sizeable declines referred to above in the prices of fuel and deposit & loan facilities.

Tradables prices (excluding food and fuel) rose by a modest 0.3 per cent in the September quarter, compared with increases of around 1 per cent in the previous two quarters. Although partly reflecting seasonal effects, this moderation is also due to the effects of the currency appreciation that has occurred since March 2009. Non-tradables inflation increased by around 1½ per cent in the quarter largely due to price increases for housing-related items, though in year-ended terms non-tradables inflation (excluding deposit & loan facilities) has slowed from 5.3 per cent a year ago to 4.1 per cent in September.

Utilities prices rose by 10 per cent in the quarter due to seasonal price increases as well as large additional price rises to help fund the upgrade of infrastructure (Graph 78). Rent inflation remained firm at 1.2 per cent in the quarter, but this has slowed from an average quarterly rate of 2 per cent in 2008. There is some evidence (including from new rental tenancy agreements) to suggest that rent inflation may ease further over coming quarters, although the extent of the moderation may be limited while rental vacancies remain at very low levels. House purchase costs increased strongly in the quarter, although in year-ended terms growth was relatively modest at 1.7 per cent; abstracting from the effects of the First Home Owners Boost, year-ended house purchase inflation is estimated to be around 2½ per cent.

Food prices have fallen in each of the past two quarters, after a period of quite strong growth over the previous couple of years (Graph 79). Fruit & vegetable prices have fallen by 12 per cent over the past six months. Prices for other food items were broadly unchanged in aggregate over the period, after increasing at an annualised pace of 5 per cent over the previous three years. This largely reflects lower prices for fresh foods such as meat and dairy products, offset by an increase in the price of restaurant meals and takeaway food.

Costs and margins

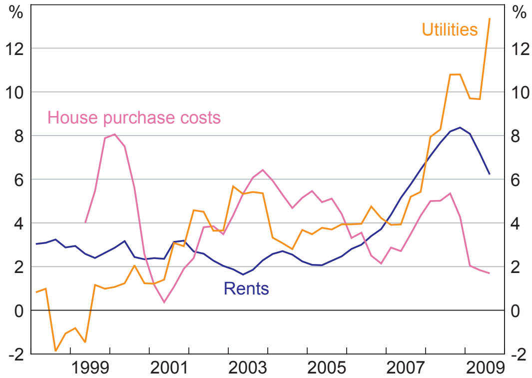
Growth in labour costs slowed over the first half of 2009, largely reflecting an easing in private-sector wage growth. More timely indicators suggest that wage growth has remained moderate in recent months, reflecting the weakness in the labour market.

The wage price index (WPI) increased by 0.8 per cent in each of the March and June quarters, which are below-average outcomes for this series. In year-ended terms, WPI growth slowed markedly to 3.8 per cent, which was its slowest pace in around three years. Private-sector wage growth has fallen to its lowest year-ended rate since 2004 (Graph 80). Most industries have recorded a reduction in year-ended WPI growth, particularly mining. Growth in public-sector wages remained around its decade average in quarterly terms.

Graph 78

Housing Cost Inflation*

Main components, year-ended



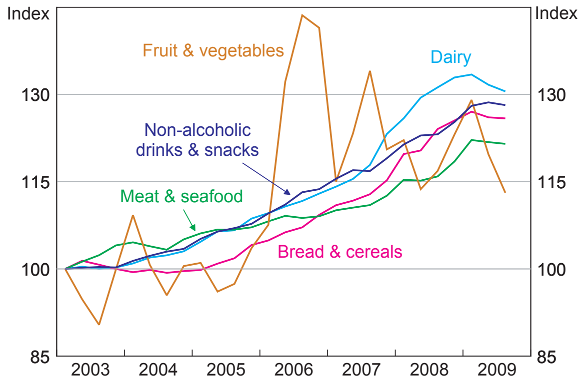
* Adjusted for the tax changes of 2000

Sources: ABS; RBA

Graph 79

Food Price Indexes

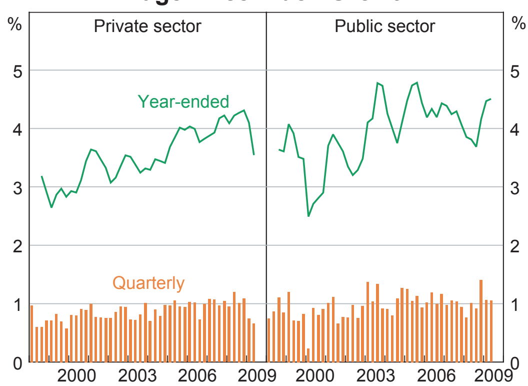
March 2003 = 100



Sources: ABS; RBA

Graph 80

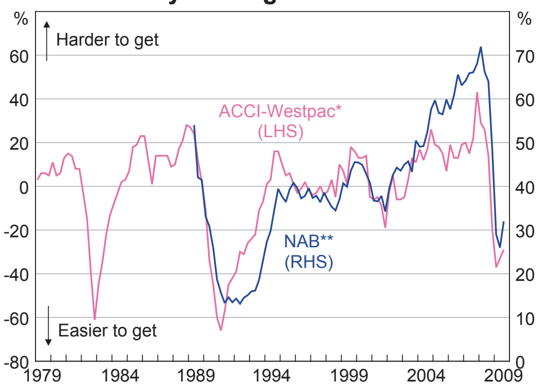
Wage Price Index Growth



Source: ABS

Other measures have also been consistent with an easing in wage growth. For example, the national accounts measure of average earnings per employee fell in the June quarter for the second consecutive quarter, to be 1.7 per cent higher over the year. Much of this weakness reflected a decline in average hours worked, with growth in average earnings per hour worked slowing over the first half of 2009, to be 4.2 per cent over the year. Growth in ordinary time earnings, as measured by the average weekly earnings survey, also eased over the first half of the year to quarterly rates of around 1¼ per cent. The average annualised wage increase in new federal enterprise bargaining agreements fell to 3.9 per cent in the June quarter, from more than 4 per cent in the previous four quarters.

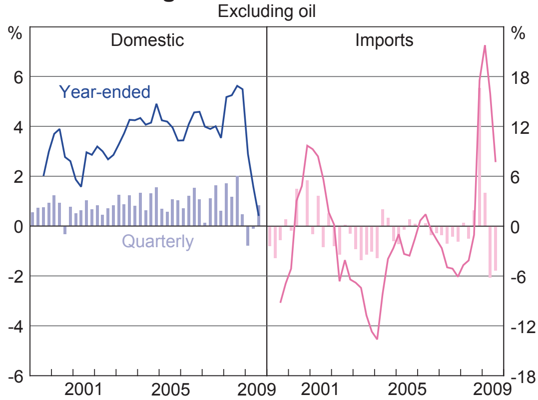
Graph 81
Difficulty Finding Suitable Labour



* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI-Westpac; NAB

More timely indicators suggest that wage growth is likely to remain relatively low in the near term. The Bank's liaison suggests that a lower-than-usual proportion of businesses expect to increase wages over the next 12 months, although this proportion has increased significantly from earlier in 2009. Business surveys indicate that firms are generally having little difficulty obtaining suitable labour at the moment (Graph 81).

Graph 82
Final Stage Producer Price Inflation
Excluding oil



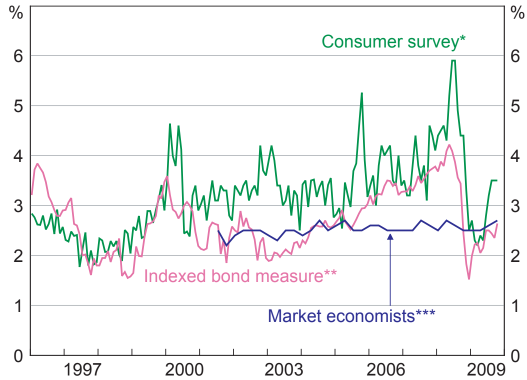
Sources: ABS; RBA

Upstream price pressures remained subdued in the September quarter (Graph 82). Following large falls in the June quarter, preliminary-stage producer prices fell by 1.9 per cent and final-stage prices declined by 0.1 per cent in the September quarter (both excluding oil). At the final stage, import prices fell by more than 5 per cent after a similarly large fall in the June quarter, but remained nearly 8 per cent higher over the year, largely reflecting movements in the exchange rate. Final-stage domestic prices increased by 0.8 per cent in the quarter, with almost all of the increase attributable to rising utilities prices.

Inflation expectations

Graph 83

Indicators of Inflation Expectations



* Median expectation of average annual inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
*** Median expectation of annual inflation 2 years ahead
Sources: Melbourne Institute of Applied Economic and Social Research; RBA

Measures of inflation expectations remain broadly consistent with the Bank's medium-term inflation target, although there is some variation across the different measures (Graph 83). Consumer inflation expectations, as measured by the Melbourne Institute survey, have remained broadly unchanged in recent months at around the average level of the past decade. Measures of longer-term inflation expectations derived from financial markets have also been steady in recent months, at around 2½ per cent. The inflation forecasts of market economists surveyed by the Bank are little changed relative to a quarter earlier, and their two-year-ahead forecasts remain well-anchored at around the mid-point of the target band, as they have since the survey began in 2001. Business surveys generally suggest that inflation expectations have stabilised in recent months at below-average levels, while union officials have revised down their near-term inflation expectations (Table 12).

Table 12: Median Inflation Expectations

Per cent

	Year to June 2010			Year to June 2011	
	May 2009	August 2009	November 2009	August 2009	November 2009
Market economists[(a)]	2.3	2.3	2.3	2.5	2.5
Union officials[(b)]	2.5	2.5	2.0	3.0	3.0

(a) RBA survey
(b) Workplace Research Centre

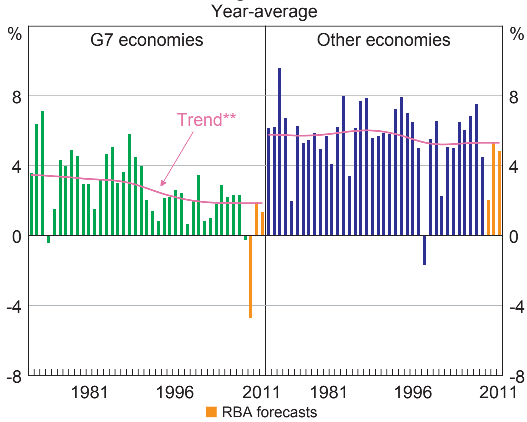
Economic Outlook

The international economy

The outlook for the world economy has strengthened since the August *Statement*. Global financial markets have continued to recover, confidence has generally increased and most economies have now seen a return to growth. After falling sharply in the second half of 2008 and the first quarter of 2009, global output (with countries weighted by GDP at purchasing power parity exchange rates) is now expected to grow at an annualised rate of around 4 per cent in the second half of 2009 (but to contract by around 1 per cent in year-average terms reflecting the weakness earlier in the year). Global output is projected to grow by around 3½ per cent in 2010, still somewhat below its trend pace. Average growth in Australia's major trading partners is expected to be a little stronger and close to its trend rate (Graph 84).

Graph 84

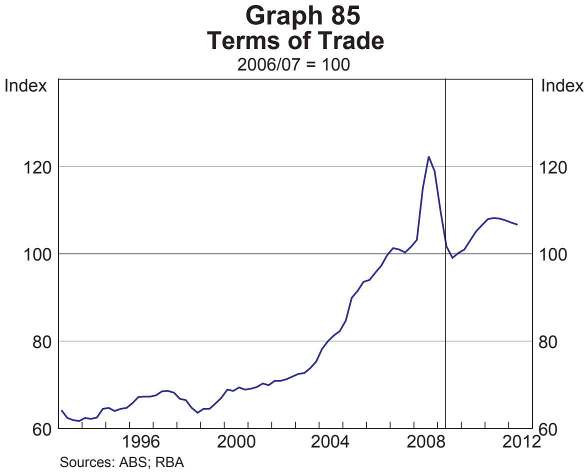
Australia's Trading Partner GDP Growth*



* Weighted using merchandise export shares at market exchange rates
** Estimated using a Hodrick-Prescott filter
Sources: CEIC; IMF; RBA; Thomson Reuters

While output is now expanding again in North America and most countries in Europe, many of the advanced economies face significant medium-term challenges in dealing with weak financial sectors and balance sheet problems in both the public and private sectors. As a consequence, the pace of recovery in the G7 countries and other advanced economies looks likely to remain subdued. However, growth is expected to be much stronger in China, India and across other east Asian economies (excluding Japan), which have higher trend growth rates and have been less affected by the problems the large advanced economies are experiencing. While subdued growth in the advanced economies will weigh on exports from the emerging economies, the latter have significant scope for continued expansion underpinned by growth in domestic demand.

The projected strong economic performance in Asia is likely to boost Australia's terms of trade over the forecast horizon. Consistent with the improved global outlook, spot prices for a range of commodities have increased significantly since earlier in the year, supported by a structural increase in demand from China and a recovery in demand from Japan, Korea and Taiwan. As a consequence, after falling by 17 per cent in late 2008 and the first half of 2009, the terms of trade are expected to rise over the next couple of years, a stronger outlook than at the time of the August *Statement* (Graph 85).



Domestic activity

As discussed in earlier chapters, the recent flow of data suggests that the domestic economy is growing, benefiting from the rebound in growth in Asia, the stimulus delivered by fiscal and monetary policies, and strong growth in the population and capital stock (for further discussion, see 'Box F: Growth in the Factors of Production'). Consumer and business confidence are both high, consumption has been fairly resilient and, while business investment fell in the first half of the year, the outlook has improved considerably, driven in part by the resources sector.

The central forecasts are summarised in Table 13. In year-average terms, GDP growth is expected to be around 1½ per cent in 2009/10, 3 per cent in 2010/11 and 3½ per cent in 2011/12. These forecasts have been prepared using the technical assumption that the cash rate increases gradually. As noted in the August *Statement*, this technical assumption for the cash rate should in no way be viewed as a commitment by the Board to any particular path for policy. In addition, the exchange rate is assumed to remain unchanged at current levels, while oil prices are assumed to move broadly in line with near-term futures pricing.

Table 13: Output Growth and Inflation Forecasts[(a)]
Per cent, over year to quarter shown

	June 2009	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011	June 2012
GDP growth	0.6	1¾	2¼	3¼	3¼	3¼	3½
Non-farm GDP growth	0.5	1¾	2	3¼	3¼	3¼	3½
CPI inflation	1.5	2	2½	2¼	2¼	2½	2½
Underlying inflation	3¾	3¼	2½	2¼	2¼	2½	2½

(a) Actual GDP and inflation data for June 2009. For the forecast period, technical assumptions include A$ at US$0.91, TWI at 70, WTI crude oil price at US$85 per barrel and Tapis crude oil price at US$88 per barrel.
Sources: ABS; RBA

The economy is expected to record growth of around 2¼ per cent over the year to the June quarter 2010, a significant upward revision from the time of the August *Statement*. This upward revision reflects both the generally stronger-than-expected data over the past three months and a broader reassessment of the outlook for the economy. Although consumption growth has moderated relative to the first half of 2009, following the end of the fiscal payments to households, spending appears to have been relatively resilient. Business investment is no longer expected to fall sharply, with spending supported by the improvement in business conditions, growth in Asia, the positive outlook for the resources sector and the fiscal stimulus measures. Homebuilding will gradually pick up and some rebuilding of inventories is likely. Export volumes are also expected to be relatively firm.

The economy is forecast to grow by around 3¼ per cent over the year to the June quarter 2011, with a continuing recovery across the various components of private expenditure offsetting an unwinding of the impact of the fiscal stimulus measures. GDP growth is expected to pick up further towards the end of the forecast period. Growth is expected to be particularly strong in the resources sector as discussed in 'Box D: Investment in the Resources Sector'. Growth outside the mining sector is forecast to be more moderate, reflecting the reallocation of resources within the economy. The recent appreciation of the exchange rate will be one of the factors contributing to this reallocation.

Employment growth is expected to be subdued over the next couple of quarters, before picking up from around mid 2010. With much of the recent downturn in the labour market occurring through reduced working hours rather than redundancies, hours worked are initially expected to recover at a faster pace than the number of employees. That said, the outlook for the labour market has improved since the August *Statement*, reflecting the recent better-than-expected employment outcomes and a pick-up in leading indicators of labour demand such as business surveys and job advertisements.

Inflation

Underlying inflation has been declining gradually in year-ended terms for the past year, but at around 3½ per cent over the year to the September quarter, is still above the Bank's medium-term target. Looking ahead, inflation is expected to moderate further, reflecting the easing in capacity pressures over the past year and growth in labour costs. In addition, the recent appreciation of the exchange rate has unwound the upward pressure on tradables prices from the depreciation over the second half of 2008. The easing in underlying inflation is, however, expected to be gradual, given that price pressures in the non-tradables component have been significant and broad-based in recent years.

Overall, the forecast is for year-ended underlying inflation to decline to around 2¼ per cent by late 2010, before rising modestly to be around the middle of the target band by mid 2012. The near-term profile for year-ended CPI inflation is noticeably different from that for underlying inflation, given that CPI inflation, at 1.3 per cent over the year to the September quarter, is currently running well below underlying inflation. This reflects large movements in a few CPI components in earlier quarters, particularly automotive fuel prices and the ABS estimate of deposit & loan facilities prices. However, CPI inflation is projected to move broadly in line with underlying inflation from mid 2010, once these factors have dropped out of the calculation of the annual rate.

Risks

There are a number of risks to these central forecasts. On the downside, there remains the possibility that the recent global recovery in activity and financial markets may falter, with a weakening in the outlook for commodity markets. It is also possible that the domestic expansion seen to date proves to be mostly a reflection of the policy stimulus that has occurred, and that private sector demand growth will be weaker than is currently expected. In this event, GDP growth would be lower, the labour market weaker and inflation would fall further.

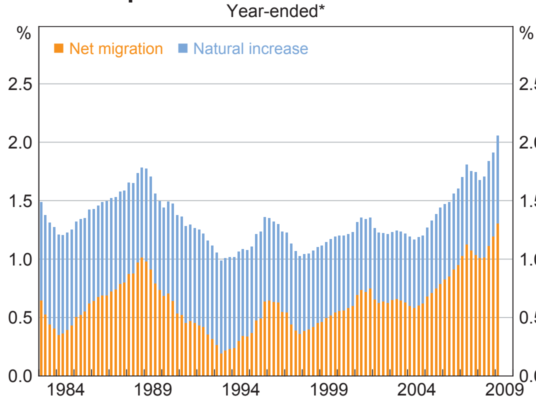
On the upside, with measures of global household and business confidence suggesting that the extreme pessimism that took hold in late 2008 has eased noticeably, it is possible that the pace of growth in activity in the advanced economies in particular will recover more rapidly than expected. Domestic investment in the resources sector could also prove to be significantly stronger than in the central forecast, in which it is assumed that not all currently planned projects proceed. While this would have positive implications for longer-term potential growth of the economy, the higher level of investment spending and flow-on to the broader economy could see capacity pressures re-emerging in the near term and further appreciation of the exchange rate. In this event, underlying inflation would be expected to decline by less than in the central forecast.

Box F: Growth in the Factors of Production

Growth in GDP over the longer term depends on growth in the labour force and capital stock, and the change in productivity (the way labour and capital are used). This box discusses recent trends in these key variables.

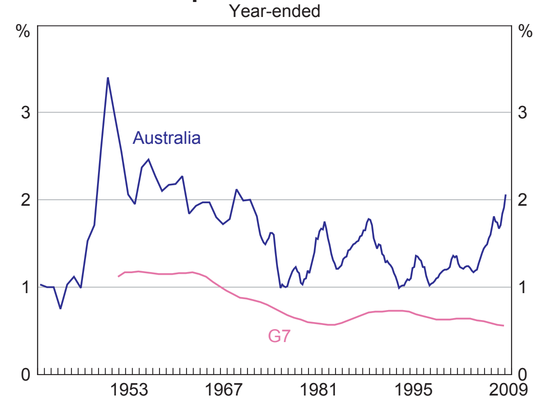
Over recent years, the rate of population growth in Australia has picked up noticeably, with the population estimated to have increased by a little more than 2 per cent over the year to the March quarter 2009 (Graph F1). This is the fastest rate of growth since the 1960s and ¾ percentage point faster than the average of the past 20 years. It is also significantly faster than that in all of the major advanced economies (Graph F2). The recent pick-up in Australia's population growth is largely due to a substantial rise in the rate of immigration, which accounted for almost two-thirds of the increase in population over the period, although the rate of natural increase has also risen a little. The recent stronger population growth has translated into relatively strong growth in the labour force, with the participation rate having also tended to rise over recent years.

Graph F1
Population Growth in Australia
Year-ended*



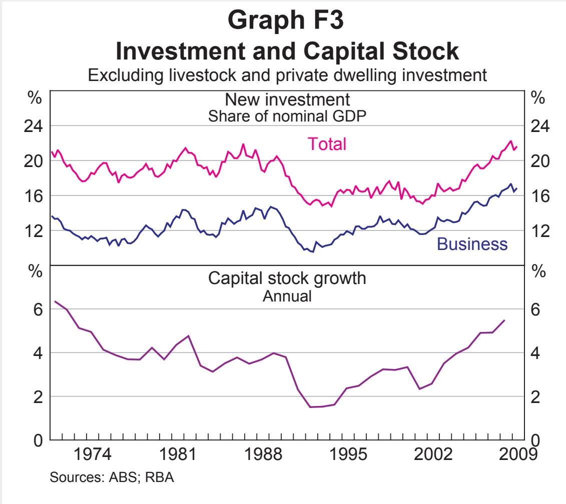
* Net migration includes a small discrepancy prior to 2006, caused by revisions to aggregate population growth in line with Census data.
Sources: ABS; RBA

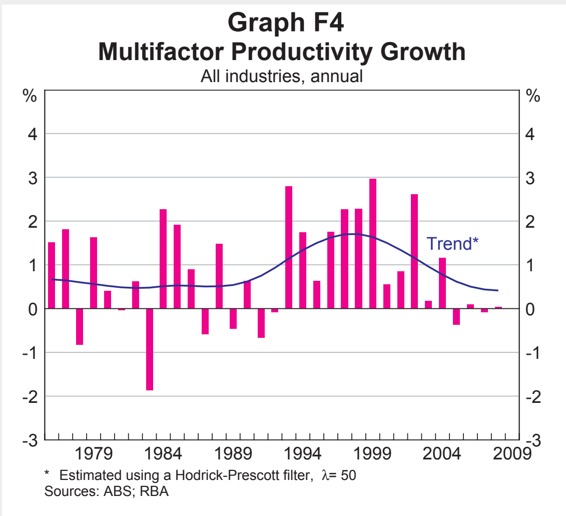
Graph F2
Population Growth*
Year-ended



* Data for Australia are annual to 1972 and quarterly thereafter; G7 data are annual.
Sources: ABS; Foster RA (1996), 'Australian Economic Statistics 1949–50 to 1994–95', RBA Occasional Paper No 8, rev 1997; OECD

Growth in Australia's capital stock (excluding dwellings and livestock) has also risen strongly recently, with the share of investment in GDP around its highest levels in recent decades (Graph F3). The capital stock is not measured directly, but is estimated by the ABS based on cumulated investment flows less depreciation, with assumptions made about the useful life of assets and the rates at which they lose value. Based on this approach, the capital stock is estimated to be currently growing at





more than 5 per cent a year, around double the average pace of growth in the 1990s, with a considerable share of this growth in the resources sector. Again, this is a significantly faster rate of increase than that occurring in the G7 economies.

Capital services are estimated to represent around 40 per cent of total factor inputs into GDP, with labour accounting for around 60 per cent. Faster rates of labour and capital growth should therefore over time lead to a faster rate of GDP growth, although trends in multifactor productivity (MFP) are also important. Assessments of trend growth in MFP are notoriously difficult, reflecting measurement problems and natural cyclical variation, as well as true changes in underlying productivity growth over time. Over recent years, MFP growth has tended to be quite weak (Graph F4). There are a number of potential reasons for this. One possibility is that it has partly reflected some natural slowing in productivity growth as the economy reached high levels of resource utilisation in the late stages of the expansion phase of the business cycle. It might also partly reflect the often long lags between investment and output in the resources sector. Measurement problems may also be part of the explanation. Notwithstanding the difficulties in explaining recent developments, if current rates of factor accumulation were to continue, and there was even modest growth in MFP, growth in potential output in the immediate period ahead is likely to be above the standard estimates of recent years.