Statement on Monetary Policy

MAY 2013

Contents

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Overview

Moderate growth in the global economy has continued, though indicators have been somewhat mixed in recent months. Growth in the Chinese economy was a bit slower in the March quarter, but over the past year or so has been in line with the Chinese authorities' stated target. Infrastructure investment and demand for residential property continue to be important drivers of growth. In Japan, there is increased optimism regarding the outlook for the economy following fiscal and monetary policy initiatives, with measures of sentiment and forward-looking indicators of activity improving in early 2013. Elsewhere in east Asia, growth has generally eased a little in recent months following a noticeable pick-up in the December quarter. The US economy continues to grow at a moderate rate, notwithstanding the ongoing effects of fiscal consolidation. Information available to date suggests that the gradual improvement in US economic activity has not stalled following the cuts to public expenditure that came into force in early March. The euro area remains in recession and the unemployment rate across the region is high. The weak state of some key private sector balance sheets and government finances will weigh on activity in the euro area for some time and leave economies vulnerable to further adverse shocks. In recent months, there has been a decline in inflation in most regions of the world. Monetary policy settings globally are very accommodative.

The outlook for global economic activity is little changed. World GDP is expected to grow at a bit over 3¼ per cent in 2013, slightly below its long-run average, before picking up to 4 per cent in 2014. Growth in China is expected to remain around the rates seen in the second half of last year and provide a measure of support to activity in east Asia. The outlook in Japan has improved, while other advanced economies are expected to experience only a gradual improvement in economic conditions. Growth of Australia's major trading partners is expected to continue to exceed that of the world, reflecting the faster growth of Australia's trading partners in Asia.

Most commodity prices have declined over the past few months but remain at historically high levels. A decline in the spot price of iron ore had been expected after substantial gains in the latter part of last year. Nevertheless, the steady growth of investment in China should continue to underpin demand for steel and hence for iron ore. Prices for coking and thermal coal have declined, and many other commodity prices are also lower. The increase in the spot price of iron ore late last year contributed to an increase in Australia's terms of trade in the first part of this year but, with large increases in the global supply of bulk commodities still in train, the terms of trade are expected to resume their decline from their current very high level.

Financial markets have continued to be affected by significant policy initiatives of various central banks. In particular, the new policy measures announced by the Bank of Japan have contributed to a further depreciation of the yen and affected other asset markets. Equity prices in Japan have increased by more than 30 per cent this year, following gains at the end of last year of a similar magnitude. Prices in other equity markets have also increased. Globally, yields are at historically low levels for both sovereigns and corporations.

The Australian economy grew at an around trend pace over 2012. Growth was a bit below trend in the second half of the year, with growth of consumption slowing and public demand recording a sizeable contraction. For the March quarter, growth in consumer spending looks to have recovered, with a strong pick-up in retail sales early in the year and measures of consumer sentiment above their long-run average. Sales of motor vehicles to households have declined over recent months, but remain at a high level following substantial increases last year.

There are signs of an increasing appetite for borrowing in the household sector, with approvals for housing and personal loans increasing over recent months. This coincides with improved conditions in the housing market. Dwelling prices are around 4 per cent above their low point of mid 2012 and auction clearance rates have also increased to be at, or above, long-run average levels. Higher house prices, low borrowing rates and a tight rental market should support a recovery in dwelling investment. Notwithstanding a decline in building approvals for higher-density housing in the March quarter, forward-looking indicators suggest that demand for new housing is gradually strengthening. This is also apparent in the Bank's business liaison, with firms noting that enquiries from prospective purchasers and visits to display homes have increased.

Meanwhile, near-term indicators of growth in business investment remain soft; capital imports declined in recent months, office vacancy rates have increased and indicators of capacity utilisation are a little below long-run average levels. Measures of current business conditions remain below average and the growth of business debt has been more modest in the early part of 2013. Also, the Bank's liaison continues to suggest that firms remain cautious about undertaking significant expansion. Nevertheless, the most recent ABS capital expenditure survey implies a moderate increase in investment in 2013/14.

Export volumes are estimated to have grown at a more moderate rate in the March quarter after strong growth of resource exports in the December quarter. Flooding in Queensland in early 2013 disrupted coal exports, but by much less than was the case in 2011. Rural exports have remained high following earlier strength on the back of what had been reasonable rainfall across much of the country for the past three years. Given the current dry conditions in some parts of the country, prospects for the 2013 winter crop depend heavily on rainfall in the near term. Services exports have increased a little of late, helped by growth in tourism arrivals from Asia, particularly China.

Labour market conditions remain somewhat subdued. With growth in employment below that of the working-age population, the unemployment rate has drifted higher over recent quarters. Leading indicators of employment growth have been mixed recently. The quarterly ABS measure of vacancies continued to decline up to February, while more timely indicators of job advertisements suggest stabilisation, albeit at low levels. The Bank's liaison suggests that firms remain cautious about hiring staff. Patterns of employment growth across industries and states have been consistent with the changing nature of growth in the Australian economy. In particular, employment has begun to shift away from mining and business services, towards construction and goods distribution.

Growth in wages in the December quarter continued at around the same rate seen in the September quarter, which was lower than that of recent years, in line with softer conditions in the labour market over the past year.

Consumer price inflation slowed in the March quarter. The low quarterly outcome (0.1 per cent on a seasonally adjusted basis) was partly attributable to falls in the volatile prices of fruit, vegetables and automotive fuel. It also reflected a decline in prices for a broad range of tradable items, particularly for consumer durables. These declines have occurred despite the relative stability of the exchange rate over the past couple of years and highlight the pressures on domestic costs and margins relevant to tradable goods and services. In contrast, non-tradables inflation has increased a little over the past year, although part of this reflects the introduction of the carbon price (and changes to the private health insurance rebate).

The various measures suggest that underlying inflation was a little under ½ per cent in the March quarter, which was a touch softer than had been expected, and a little under 2½ per cent on a year-ended basis.

The outlook for economic growth overall is little changed from that published in the February *Statement*. GDP growth is expected to be a little below trend over 2013, before picking up through 2014 to be around trend pace. The approaching peak in resource investment, the high level of the Australian dollar and ongoing fiscal consolidation are all likely to weigh on growth over the next year or so, while at the same time the low level of interest rates is helping to support demand. The outlook for non-mining business investment remains relatively weak over the next few months, with indicators of investment intentions for the near term remaining below average. Further out, firms' stated capital expenditure plans for 2013/14 imply a gradual increase in non-mining business investment. Resource sector investment looks to be near its peak, although with many projects currently underway it is expected to remain at a high level for the next year or so.

With growth of economic activity forecast to be a little below trend, employment growth is expected to be moderate in the near term. Accordingly, the unemployment rate is expected to continue to edge higher for the next year or so, before a return to trend output growth gradually supports some improvement in labour market conditions.

In the near term, the forecasts for year-ended inflation are a little lower than those published in the February *Statement*, at close to 2 per cent through this year. To a large extent this reflects the fact that inflation in the March quarter was a bit lower than had been expected. Non-tradables inflation is expected to ease somewhat, given the improvement in productivity growth and recent moderate wage outcomes. But as deflation in tradables items is expected to pass, overall inflation is forecast to return to the middle of the inflation target by mid next year.

The risks to the global growth outlook appear to be broadly balanced for most economies, but still tilted to the downside in Europe, where banking and fiscal problems remain significant. As was the case in the February *Statement*, risks to the US economy appear balanced; while fiscal consolidation is weighing on growth, the repair of private sector balance sheets is progressing and monetary policy remains expansionary. The risks to the outlook for China also seem to be balanced, with growth of economic activity currently around the growth rate of the productive capacity of the economy. In Japan, there remains considerable uncertainty about the effectiveness of the policies to stimulate demand and raise inflation, and outcomes could be weaker or stronger than assumed in the forecasts.

For the domestic economy, the forecasts continue to embody a gradual shift in growth from investment in the resource sector towards exports, non-mining investment and household demand. This rebalancing appears to be beginning, but inevitably there remains considerable uncertainty about exactly how it will unfold.

Risks to the outlook for inflation appear broadly balanced. Inflation could be lower than expected if the labour market weakens by more than anticipated and wages are more responsive to this than they have been to date. Similarly, the sustained high level of the exchange rate could lead to further downward pressure on tradables prices. However, non-tradables inflation has not slowed and it could persist at higher levels than implied by the forecasts. Furthermore, the fall in the participation rate over the past couple of years may reflect more persistent determinants of labour supply, in which case there may be less spare labour than otherwise.

Over 2012, the Board reduced the cash rate by 125 basis points, bringing it to 3 per cent and borrowing rates close to their previous lows. Since then, signs have emerged that the economy has been responding to the low level of interest rates. Savers have been changing their portfolios towards assets with higher expected returns, asset values have risen and some interest-sensitive areas of spending have increased. On the other hand, the exchange rate has been little changed at a historically high level over the past 18 months, which is unusual given the decline in export prices and interest rates during that time. Moreover, the demand for credit has thus far remained relatively subdued.

Over the earlier part of this year, the Board held the cash rate steady while carefully assessing economic developments and noting that the inflation outlook would afford scope to ease further, should that be necessary to support demand. At its May meeting, with inflation a little lower than had been expected, and growth of economic activity likely to remain below trend into next year, the Board judged that a further reduction in the cash rate would help to support sustainable growth in the economy, and would be consistent with achieving the inflation target. The Board will adjust the cash rate as appropriate to foster sustainable growth and low inflation.

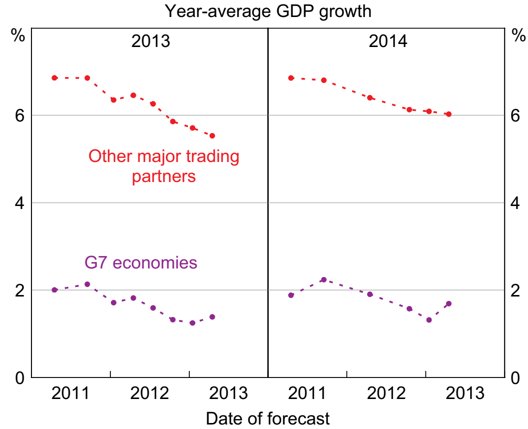
1. International Economic Developments

Global economic indicators have been somewhat mixed in early 2013, and suggest that growth in the March quarter was not as strong as it was in the December quarter. Growth in the Chinese economy slowed a little in the early part of this year, but indications are that growth will continue to be supported by strong investment in infrastructure and real estate. The outlook for growth in the Japanese economy has improved following policy initiatives there. Elsewhere in east Asia, conditions have eased a little. The US economy grew at a moderate pace, while the euro area remains in recession.

On balance, growth of the global economy in 2013 is expected to be slightly below its average pace, and to strengthen a little in 2014 (Graph 1.1). Activity in the advanced economies continues to be restrained by ongoing balance sheet repair and fiscal consolidation but is expected to pick up gradually through 2014. Growth in developing economies is also expected to be stronger in 2014 and is forecast to remain considerably higher than in the advanced economies. Australia trades more with developing economies, which are currently experiencing better economic conditions. As a result, growth in Australia's major trading partners is expected to be around its average pace and continue to exceed that for the world as a whole.

Overall, inflation is well contained in all the major regions and commodity prices generally declined in recent months. In most economies, monetary conditions remain very accommodative. This is especially so in the major advanced economies, including Japan where significant further monetary expansion was announced in April.

Graph 1.1
IMF Forecast Revisions*
Year-average GDP growth

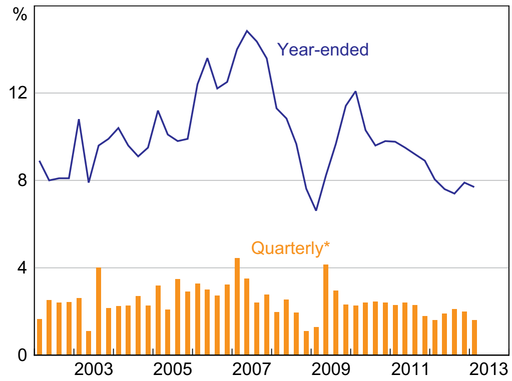


* Aggregates based on Australia's export shares
Sources: ABS; IMF; RBA

Asia

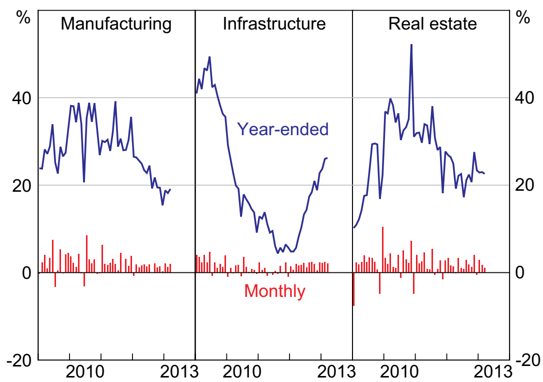
Growth in the Chinese economy slowed a little in the first quarter of 2013 to 1.6 per cent, with output 7.7 per cent higher over the year (Graph 1.2). Although it is below the rapid pace of growth achieved through much of the late 2000s, this is a more sustainable pace of growth for China. The easing in the quarter primarily reflects softer consumption growth, in part owing to government efforts to rein in some forms of public expenditure, while growth in household income was also a little lower. At the same time, investment growth remains stable overall – with strong growth in infrastructure – and may pick up following strength in financing activity in recent quarters (Graph 1.3).

Graph 1.2
China – GDP Growth



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

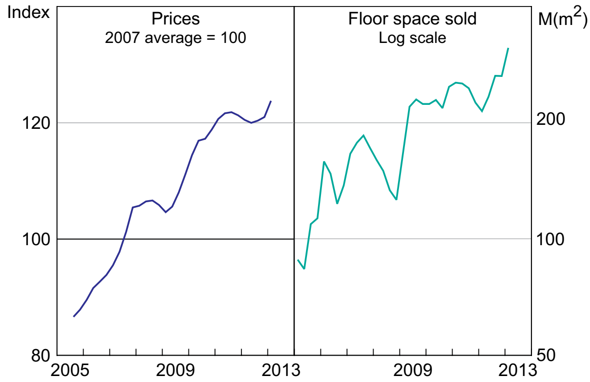
Graph 1.3
China – Growth in Nominal Investment*



* RBA estimates
Sources: CEIC; RBA

Demand for residential property has continued to strengthen in recent months, which is likely to support investment in the real estate sector. Sales of property have increased, and in the March quarter property prices increased by 3.1 per cent, the largest quarterly increase since 2009 (Graph 1.4). Indeed, in response to ongoing concerns about housing affordability, authorities announced a tightening of restrictions on the purchase of property and introduced a number of other measures, including increases in capital gains taxes. Reports suggest that this has temporarily boosted sales activity, as some buyers have pulled forward purchases to avoid the implementation of the tighter restrictions.

Graph 1.4
China – Residential Property Market*

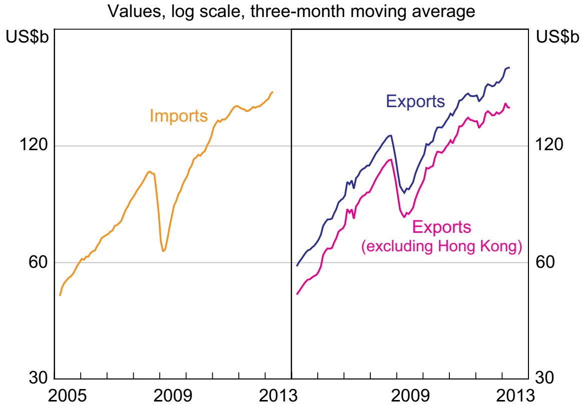


* RBA estimates
Sources: CEIC; RBA

Growth in industrial production slowed over the year, but has stabilised in recent months. Growth in investment in the manufacturing sector has also been stable following a steady decline since the end of 2011.

Exports are reported to have grown strongly over the first few months of 2013 (Graph 1.5). However, exports to some economies have been much stronger than implied by the corresponding data on imports from China. This is most significant for Hong Kong which is a large destination for Chinese exports. Import values grew strongly in the month of March after a period of relatively subdued growth; the value of resource imports stabilised in March after contracting earlier in the year.

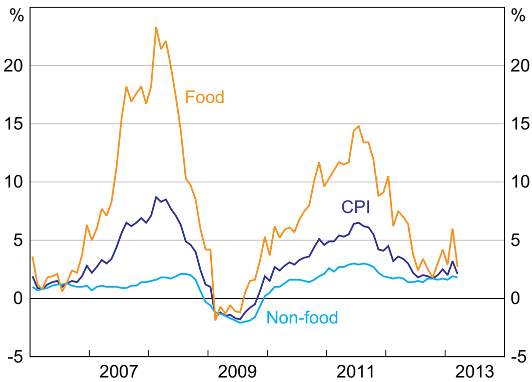
Graph 1.5
China – Merchandise Trade*
Values, log scale, three-month moving average



* Seasonally adjusted
Sources: CEIC; RBA

Inflationary pressures in China remain contained, with recent consumer and producer price data suggesting some easing (Graph 1.6). The earlier pick-up in food price inflation has reversed recently, owing in part to weaker demand for meat following concerns about diseased pigs. Also, vegetable prices declined, reversing the earlier spike associated with especially bad weather in January. Producer prices declined in the first quarter, after previous signs of stabilisation. The People's Bank of China has not adjusted reserve requirements or benchmark interest rates since the previous *Statement*.

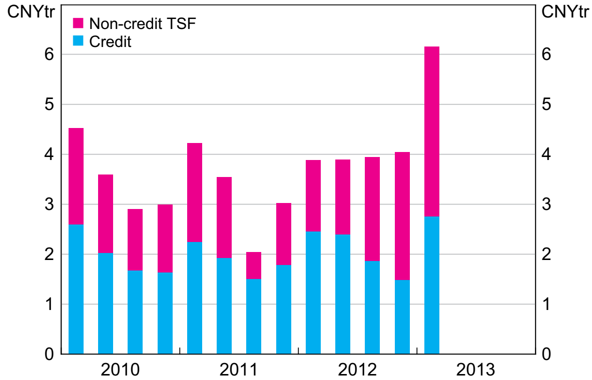
Graph 1.6
China – Consumer Price Inflation
Year-ended



Source: CEIC

In the March quarter, bank credit recorded strong growth, consistent with its usual seasonal pattern, while non-credit total social financing grew at an even faster pace (Graph 1.7). The strength in non-credit total social financing has been broadly based across components, with particularly substantial corporate bond issuance since late last year. At the end of March, in response to concerns about the quality of credit, authorities announced measures to increase the transparency of wealth management products and placed restrictions on where these funds can be invested.

Graph 1.7
China – Total Social Financing
Quarterly flows

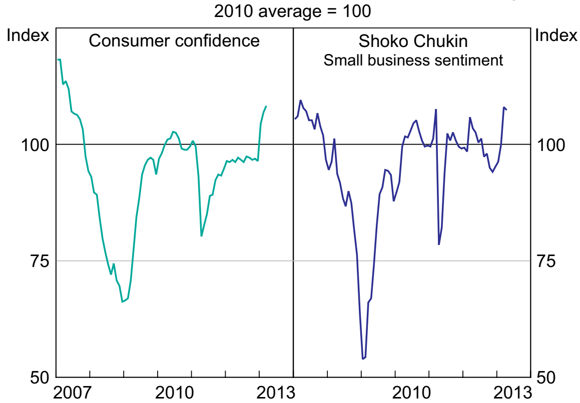


Sources: CEIC; People's Bank of China; RBA

In Japan, indicators of sentiment and economic activity picked up in early 2013, following the announcements of fiscal expansion and changes to monetary policy (see the 'International and Foreign Exchange Markets' chapter for more detail). Equity prices and business and consumer sentiment have been rising since late 2012, and the sentiment indicators are now at their highest levels since 2007 (Graph 1.8). Indicators of household expenditure also increased in early 2013. The additional fiscal stimulus will increase transfer payments from April 2013 and includes an expansion in public works.

Survey data for March and April indicate a sharp rise in new orders from both domestic and foreign customers (Graph 1.9). The substantial depreciation of the yen in recent months is expected to provide some support to Japanese exports in the period ahead. However, because a large share of

Graph 1.8
Japan – Consumer and Business Surveys
2010 average = 100



Sources: CEIC; Thomson Reuters

Graph 1.9
Japan – Manufacturing PMI

Source: Markit Economics

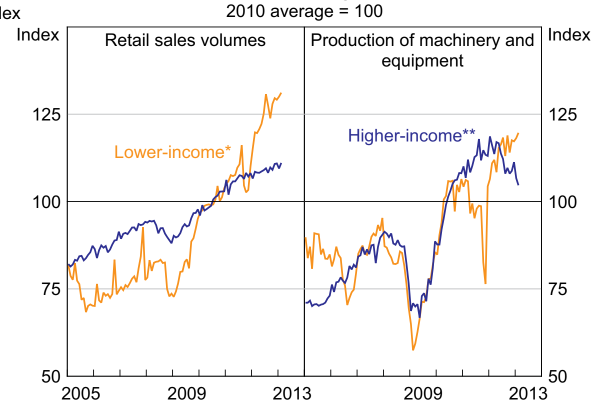
manufactured exports in Asia is tied to supply chains across multiple countries, this may take some time to take effect. With the export share of GDP in Japan relatively low, at around 15 per cent, an increase in export demand is likely to have a relatively moderate effect on aggregate demand overall.

In the rest of east Asia, economic activity appears to have grown at a slightly below-average pace in the March quarter, with falling industrial production and weak external demand. Conditions continue to vary between the higher- and lower-income economies in the region. Consumer confidence, growth of retail spending and production of machinery and equipment have been stronger in the lower-income economies (Graph 1.10). Exports slowed in the March quarter, following strong growth in the December quarter 2012. In Korea, growth in economic activity in 2012 was relatively low but it picked up a little in the December quarter and by a lot more in the March quarter. In April, the Korean Government announced fiscal stimulus measures aimed at job creation.

Inflationary pressures in east Asia remained contained, although food prices are exerting some upward pressure in lower-income economies. In Japan, prices continued to decline, but indicators of inflation expectations have risen significantly following the announcement of further monetary stimulus.

Graph 1.10
East Asia – Activity Indicators

2010 average = 100



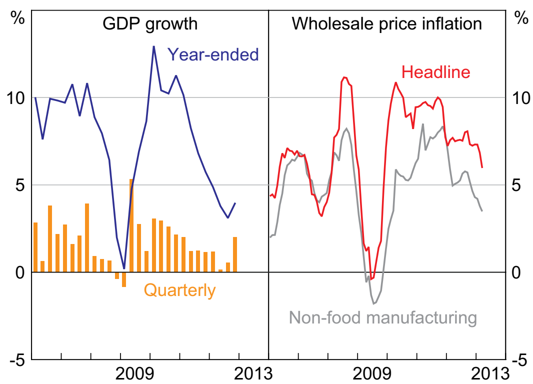
* Indonesia and Thailand for retail sales; Malaysia, Philippines and Thailand for production

** Hong Kong, Singapore, South Korea and Taiwan; excluding Hong Kong for production

Sources: CEIC; IMF; RBA

In India, GDP growth rebounded in the December quarter, with a pick-up in both consumption and investment (Graph 1.11). Growth was stronger in spite of cuts in government spending implemented to meet fiscal targets. Industrial production has also picked up in recent months, driven by manufacturing. Headline wholesale price inflation and non-food manufacturing inflation both fell noticeably over the past three months. In response to this, the Reserve Bank of India cut interest rates at both its March and May meetings.

Graph 1.11
India – Economic Indicators



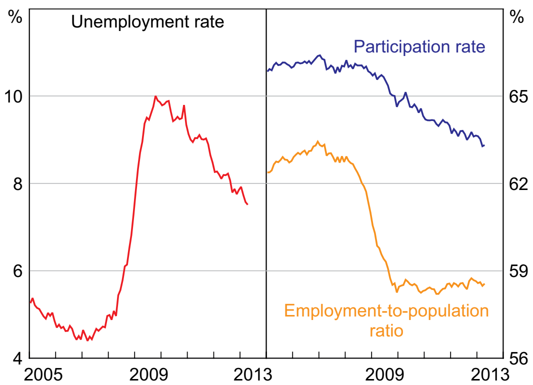
Sources: CEIC; RBA

United States

Economic conditions in the United States have generally continued to improve in recent months. GDP expanded at a moderate pace in the March quarter, following little growth in the December quarter, with growth in private demand offsetting falls in public demand. Inflationary pressures have continued to ease over the past few months, with both headline and core measures of inflation remaining well below 2 per cent in year-ended terms.

Labour market conditions have continued to improve in recent months, with employment growing at a moderate pace and the unemployment rate declining further (Graph 1.12). Nevertheless, both the participation rate and the ratio of employment to population remain around their lowest levels in the past two decades, in part reflecting an increase in the number of discouraged workers as well as the effect of the ageing of the population.

Graph 1.12
United States – Labour Market



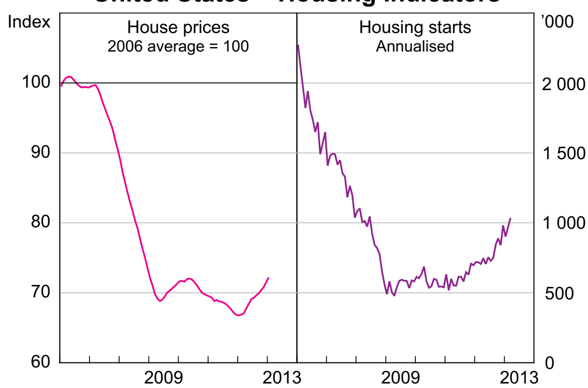
Source: Thomson Reuters

Monetary policy remains highly accommodative and this is having an effect on financing activity, with lending standards for low-risk borrowers being eased somewhat and non-mortgage credit growing.

In March, automatic federal government spending cuts (the so called 'sequester') came into force. These will weigh on both public demand and household consumption as spending on government programs is reduced and public sector wage payments decline. A range of forecasters have estimated that these spending cuts will subtract around half a percentage point from GDP growth in 2013. While household consumption growth was resilient to the increases in the payroll tax rate in the March quarter, the effect of the sequester on household incomes is yet to be seen.

Conditions in the housing market have improved further in 2013, with house prices and housing starts continuing to rise (Graph 1.13). While the increase in housing starts has contributed to a pick-up in residential investment over the past six months, it remains low as a share of GDP. The rise in housing activity has led to an increase in employment in the construction industry. The stock of distressed and foreclosed homes has continued to decline from high levels, while the increase in house prices, along with higher equity valuations, has seen household wealth continue to rise, which is expected to support consumption spending.

Graph 1.13
United States – Housing Indicators



Sources: Standard & Poor's; Thomson Reuters

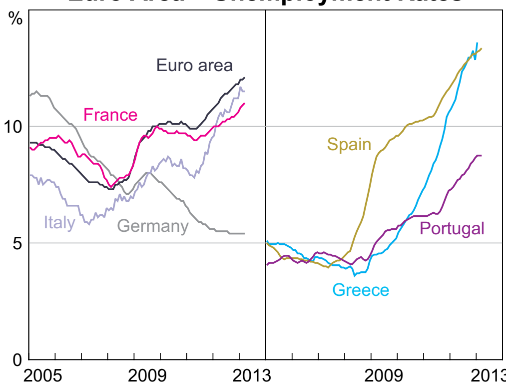
Europe

Economic conditions remain weak in the euro area. Industrial production was little changed in the first two months of the year, after contracting sharply in the December quarter, while exports remain flat. Household consumption appears to have stabilised, following significant falls in late 2012, with retail sales increasing slightly in the March quarter. Nevertheless, indicators of sentiment remain well below average, suggesting that consumer spending is likely to remain weak.

The crisis economies are still contracting as fiscal consolidation, high unemployment and tight funding conditions continue to weigh on domestic demand. Labour market conditions deteriorated further across the euro area with unemployment rates increasing, with the exception of Germany where the unemployment rate has been steady (Graph 1.14).

Inflation has declined further over recent months, to well below 2 per cent. Inflation pressures are expected to remain subdued, in line with the weakness in domestic demand.

Graph 1.14
Euro Area – Unemployment Rates



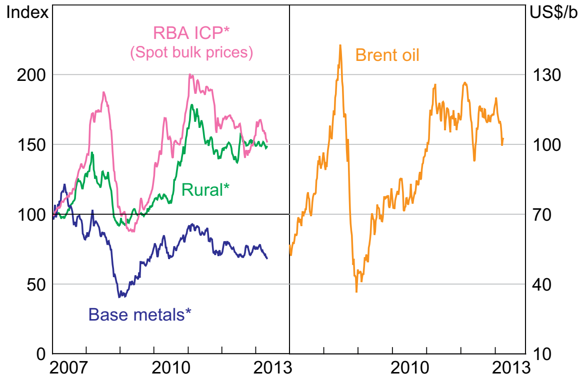
Source: Thomson Reuters

Commodity Prices

Commodity prices have generally fallen since the February *Statement*. The RBA Index of Commodity Prices, based on spot prices for the bulk commodities, has decreased by around 10 per cent in SDR terms. Most major components have fallen (Graph 1.15, Table 1.1).

The spot price for iron ore in US dollar terms has fallen by 17 per cent since the previous *Statement*. Price declines had been anticipated given the unexpectedly large rise around the turn of the year (Graph 1.16). The spot price remains above the levels seen for most of the second half of 2012; iron ore

Graph 1.15
Commodity Prices
Weekly



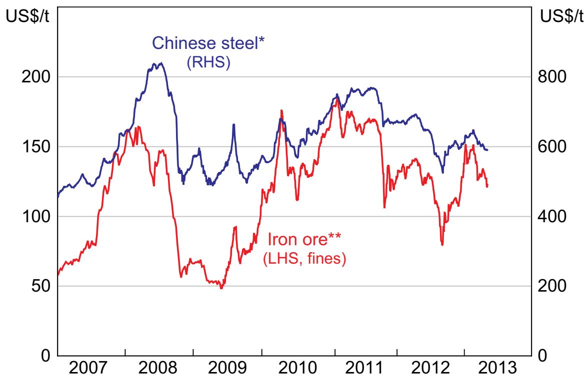
* RBA Index of Commodity Prices (ICP) and sub-indices; SDR terms; January 2007 average = 100
Sources: Bloomberg; RBA

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

	Change since previous *Statement*	Change over the past year
Bulk commodities	–13	–13
– Iron ore	–15	–7
– Coking coal	–7	–27
– Thermal coal	–7	–10
Rural	–3	5
– Beef	–1	0
– Cotton	8	3
– Wheat	–2	29
– Wool	–14	–16
Base metals	–10	–7
– Aluminium	–9	–6
– Copper	–10	–10
– Lead	–15	–1
– Nickel	–16	–11
– Zinc	–13	–5
Gold	–10	–6
Brent oil[(b)]	–11	–7
RBA ICP	–1	–6
– using spot prices for bulk commodities	–10	–9

(a) RBA Index of Commodity Prices (ICP) components; prices of bulk commodities are based on spot price movements
(b) In US dollars
Sources: Bloomberg; RBA

Graph 1.16
Chinese Steel and Iron Ore Spot Prices

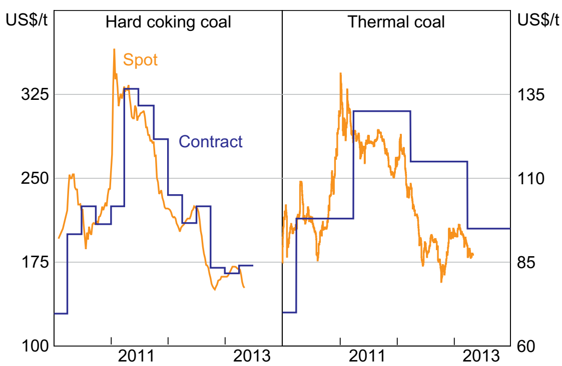


* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; RBA

inventories at Chinese ports are at low levels relative to steel production and growth in Chinese steel production in early 2013 is likely to have provided some support for iron ore prices. While the spot price for hard coking coal declined by 9 per cent in US dollar terms since the February *Statement*, the June quarter benchmark contract price was settled at 4 per cent above the March quarter contract price (Graph 1.17).

The declines in most other major commodity prices coincided with the release of some weaker-than-expected data on economic activity in China, the United States and Europe. Base metal prices have fallen by 10 per cent since the February *Statement*, while the prices of precious metals have fallen sharply over recent months from very high levels, with the spot price of gold back to the levels of early 2011.

Graph 1.17
Coal Prices
Free on board basis



Sources: BREE; Citigroup; Energy Publishing; globalCOAL; Macquarie Bank; RBA

Energy prices are lower than three months ago, with declines in both crude oil prices and global spot prices for thermal coal, which is used in electricity generation. The spot price for Newcastle thermal coal declined by 9 per cent in US dollar terms over the past three months; the 2013 Japanese Fiscal Year contract price for Newcastle thermal coal is 17 per cent lower than the 2012 contract. The falls in thermal coal prices since early 2012 reflect a number of factors, such as subdued demand from importing countries and low natural gas prices in the United States, which has reduced demand for thermal coal.[1] Despite some recovery in US natural gas prices since mid 2012, thermal coal prices have increased only modestly, suggesting that demand for thermal coal remains soft.

There have been divergent trends in rural prices since the February *Statement*. Grain prices are little changed, but are substantially lower than the elevated levels in the second half of last year, cotton prices have increased, while wool prices have declined. ✠

1 See RBA (2013), 'Box A: Thermal Coal Prices', *Statement on Monetary Policy*, February, pp 13–15.

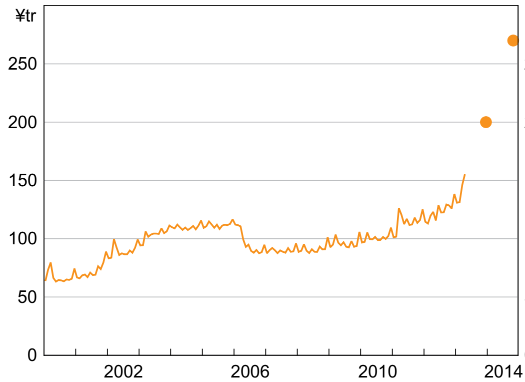
2. International and Foreign Exchange Markets

Policy actions by major central banks continue to have a significant effect on global financial markets. In particular, new policy measures announced by the Bank of Japan at the beginning of April have had a significant impact on a number of asset prices and contributed to a further depreciation of the Japanese yen. Developments in Europe also remain a source of potential market volatility, although the crisis in Cyprus and the political uncertainty in Italy generated little lasting market reaction.

Central Bank Policy

The Bank of Japan (BoJ) announced a range of major policy measures, characterised as 'quantitative and qualitative monetary easing', that were significantly more expansionary than expected. The BoJ has shifted its operational target from a short-term interest rate to the money base (currency in circulation plus banks' deposits at the BoJ), and will conduct monetary operations to increase the money base at an annual pace of ¥60–70 trillion (US$600–700 billion) for at least the next two years. As a result, the money base will nearly double in size by the end of 2014 (Graph 2.1). Much of the targeted growth will be achieved through purchases of Japanese government bonds (JGBs), although an increase in loan support programs and small purchases of other assets will also contribute. The BoJ will increase its holdings of JGBs by around ¥50 trillion per year (US$500 billion) and the average maturity of purchases will more than double to about seven years. Monetary easing will be maintained for as long as necessary to achieve the price stability target of 2 per cent in a 'stable manner'. The BoJ has indicated that the announced measures are expected to achieve this target in about two years.

Graph 2.1
Japanese Money Base

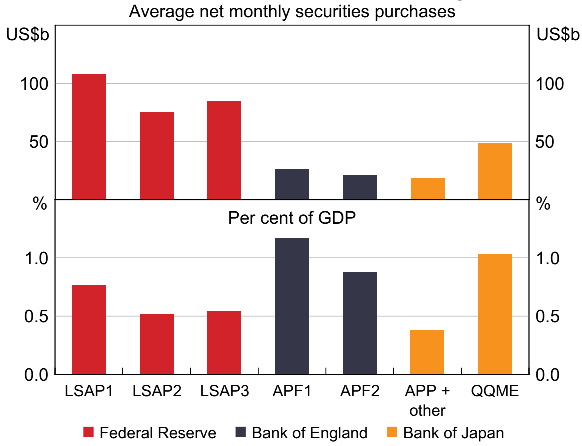


Source: Bank of Japan

The planned expansion of the BoJ balance sheet is larger than that previously announced for 2013, and significantly larger than any of the BoJ's previous expansions. Over the remainder of 2013 and 2014, the BoJ will purchase on average ¥5 trillion (US$50 billion) in securities each month in net terms. In comparison, the Fed is currently purchasing securities at a monthly pace of US$85 billion in net terms (Graph 2.2). Relative to the size of the domestic economy, however, the monthly pace of purchases is much larger than the Fed's program and broadly equivalent to the Bank of England's asset purchases.

Initial market commentary around the BoJ announcement suggested that the lower returns available on domestic securities would prompt some Japanese investors (who hold around 95 per cent of the stock of JGBs outstanding) to allocate more

Graph 2.2
Central Bank Asset Purchase Programs
Average net monthly securities purchases



Programs: Large Scale Asset Purchases, Asset Purchase Facility, Asset Purchase Program, Quantitative and Qualitative Monetary Easing
Sources: RBA; Thomson Reuters; central banks

funds to offshore securities (Table 2.1). However, it is possible that many large holders will take some time to adjust their portfolios. In fact, Japanese investors have been net sellers of foreign bonds and equities since elections were announced in mid November as investors have sought to realise profits resulting from the lower yen. That said, a small shift in the asset allocation of Japanese investors offshore could constitute a large flow for the recipient country.

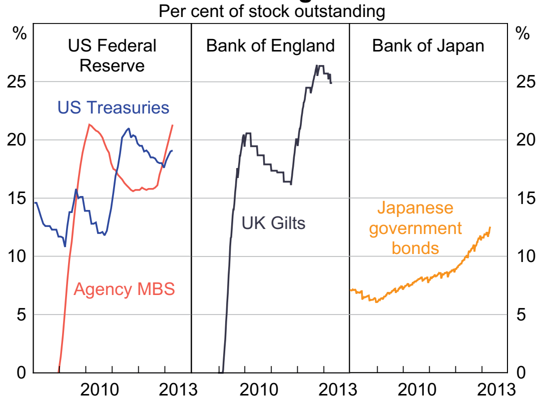
Table 2.1: Holders of Japanese Government Bonds
Per cent of stock outstanding, end 2012[(a)]

Insurance companies	23
Banks	21
Japan Post Bank	17
Pension funds	12
Bank of Japan	12
Other financial companies	5
Foreign	4
Households	3
Other	2

(a) Figures do not sum due to rounding
Sources: Bank of Japan; Japan Post Bank

As mentioned, the US Federal Reserve continues to purchase US$85 billion in longer-term securities each month. The Fed currently holds US$1.8 trillion in US Treasuries and US$1.2 trillion in agency mortgage-backed securities (MBS), accounting for around 20 per cent of the outstanding stock in each market (Graph 2.3). At its most recent meeting, the Fed indicated it could increase as well as decrease its monthly purchases, as conditions warrant.

Graph 2.3
Central Bank Holdings of Securities
Per cent of stock outstanding



Sources: RBA; Securities Industry and Financial Markets Association; Thomson Reuters; central banks

European Central Bank (ECB) lending to banks has declined by almost a third since August, to be around €850 billion. The decrease is primarily due to the early repayment of funds borrowed under the ECB's three-year lending operations conducted in December 2011 and February 2012. Partial data on ECB lending by national central banks indicate that banks from Spain and France have accounted for a significant proportion of the early repayments, although banks from Germany, Belgium, the Netherlands and Austria have repaid more as a share of loans outstanding (Graph 2.4). In contrast, lending via the Bank of Italy has remained broadly unchanged since the beginning of the year.

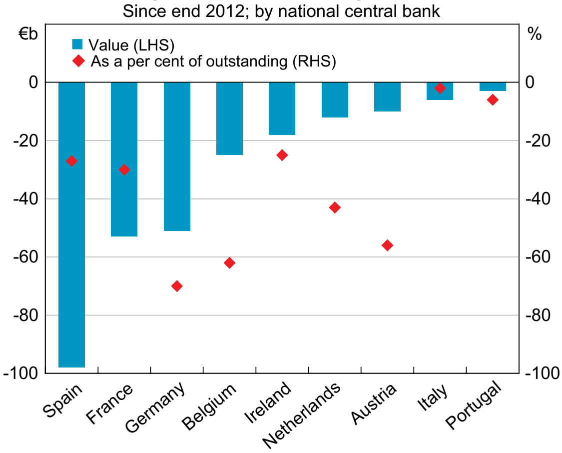
Meanwhile, the ECB cut its policy rate by 25 basis points at its meeting on 2 May. Similarly, central banks in India, Mexico and South Korea have reduced their policy rates in recent months. In contrast, the central bank of Brazil increased its policy rate by 25 basis points (Table 2.2).

Table 2.2: Policy Rates

	Current level Per cent		Most recent change	Change from 2011 peak Basis points
Euro area	0.50	↓	May 13	–100
Japan[(a)]	0.10	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Australia	2.75	↓	May 13	–200
Brazil	7.50	↑	Apr 13	–500
Canada	1.00	↑	Sep 10	–
China	6.00	↓	Jul 12	–56
India	7.25	↓	May 13	–125
Indonesia	5.75	↓	Feb 12	–100
Israel	1.75	↓	Dec 12	–150
Malaysia	3.00	↑	May 11	–
Mexico	4.00	↓	Mar 13	–50
New Zealand	2.50	↓	Mar 11	–50
Norway	1.50	↓	Mar 12	–75
Russia	8.25	↑	Sep 12	–
South Africa	5.00	↓	Jul 12	–50
South Korea	2.50	↓	May 13	–75
Sweden	1.00	↓	Dec 12	–100
Switzerland	0.00	↓	Aug 11	–25
Taiwan	1.875	↑	Jun 11	–
Thailand	2.75	↓	Oct 12	–75
United Kingdom	0.50	↓	Mar 09	–

(a) Since April 2013, the Bank of Japan's main operating target has been the money base
Source: central banks

Graph 2.4
Change in ECB Lending to Banks
Since end 2012; by national central bank

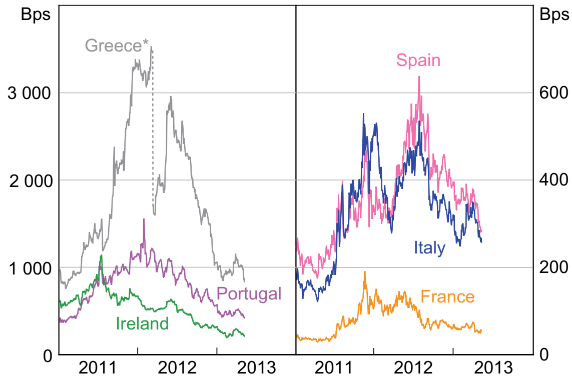


Sources: RBA; central banks

Sovereign Debt Markets

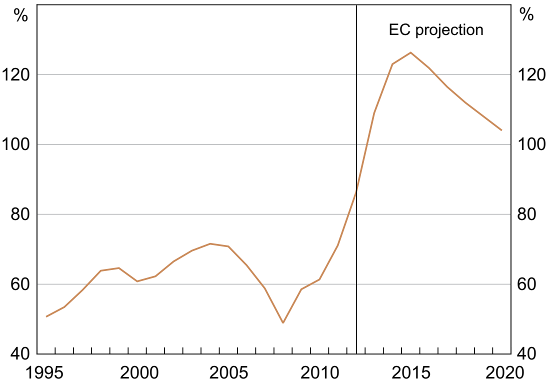
Spreads between yields on long-term euro area periphery government bonds and German Bunds have declined since the end of 2012 (Graph 2.5). Peripheral spreads had risen notably in February, especially for Italian bonds amid heightened political uncertainty, but have since retraced on the formation of a coalition government in Italy and progress towards resolving the crisis in Cyprus. Indeed, Italian 2-year bond yields are around historically low levels while 10-year yields have fallen below 4 per cent. Meanwhile, the BoJ's announcement of additional asset purchases in April provided some support to euro area government bonds on expectations that Japanese investors will alter their investment

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



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

Graph 2.6
Cypriot Government Debt
Per cent of GDP



Sources: European Commission; IMF

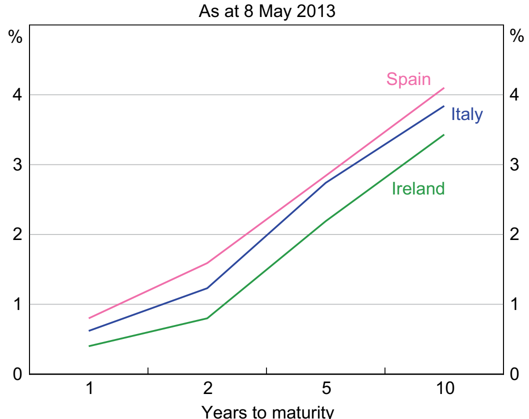
allocations, although, as noted above, to date there has not been any evidence to suggest Japanese investors have increased their purchases of foreign securities.

Cyprus has reached agreement with the 'troika' of official agencies on a financial assistance package of up to €10 billion (60 per cent of GDP) as part of a three-year macroeconomic adjustment program aimed at redressing the nation's fiscal position and recapitalising its large banking sector. Under the agreement with the troika, the Cypriot debt-to-GDP ratio is projected to increase to around 125 per cent in 2015 before declining gradually (Graph 2.6).

Central to the Cypriot adjustment program is a bank restructuring whereby shareholders, bondholders and large depositors are expected to contribute around €10 billion to bank recapitalisations. The country's second largest bank, Laiki Bank, has been wound up and insured deposits (those less than €100 000) and 'good' assets have been transferred to the country's largest bank, the Bank of Cyprus. Uninsured deposits at Laiki Bank are likely to face heavy losses, while up to half of uninsured deposits at the Bank of Cyprus will be converted into equity in that bank. Temporary controls to limit cash withdrawals and other deposit outflows have been implemented during the restructuring process. An initial proposal for a one-time levy on all bank deposits in Cyprus, including insured deposits, was rejected by the Cypriot Parliament.

Irish government bond yields have declined considerably over the past year, and are currently trading below equivalent Spanish and Italian debt (Graph 2.7). In March, Ireland raised €5 billion in its first long-term bond issue since 2010. The Irish finance minister has suggested Ireland needs to raise only a further €1.5 billion to be fully funded to the end of 2014. Despite signs of improved access to bond markets for both Ireland and Portugal in 2013, concerns remained around the size of government

Graph 2.7
Euro Area Government Bond Yield Curves
As at 8 May 2013

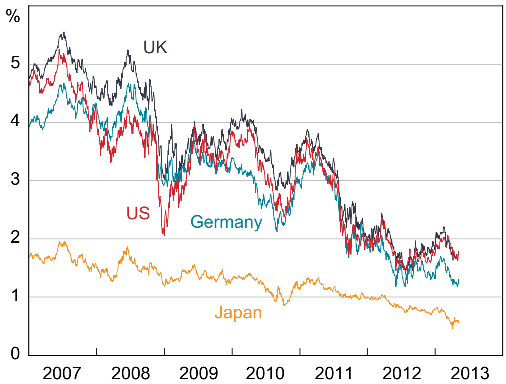


Source: Bloomberg

debt maturities in years following the end of their external assistance programs. In response to these concerns, euro area finance ministers have agreed to extend the average maturities of loans to both nations by seven years. The Portuguese extension is contingent on its government passing alternative austerity initiatives for a series of measures recently struck down by the nation's Constitutional Court.

Major market government bond yields have decreased over recent months (Graph 2.8). Yields on 10-year US government bonds have fallen by around 20 basis points since early February, while 10-year German government bond yields have decreased by around 35 basis points to be close to their historic lows.

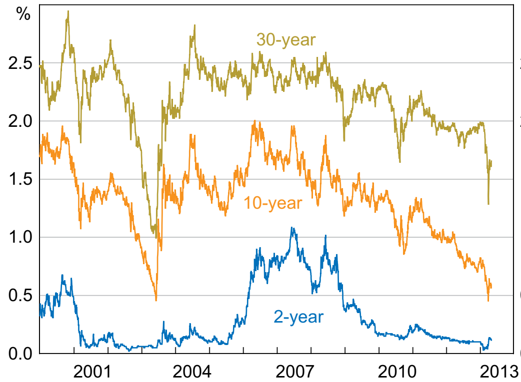
Graph 2.8
10-year Government Bond Yields



Source: Bloomberg

In Japan, anticipation of further asset purchases by the BoJ contributed to a decline in government bond yields over February and March, with longer-term yields reaching their lowest levels since 2003 (Graph 2.9). Yields have since increased, although longer-term yields remain below the level recorded late last year. Volatility in the Japanese government bond market increased markedly following the BoJ announcement, reflecting investor uncertainty around the implications of the measures for government bond yields.

Graph 2.9
Japanese Government Bond Yields

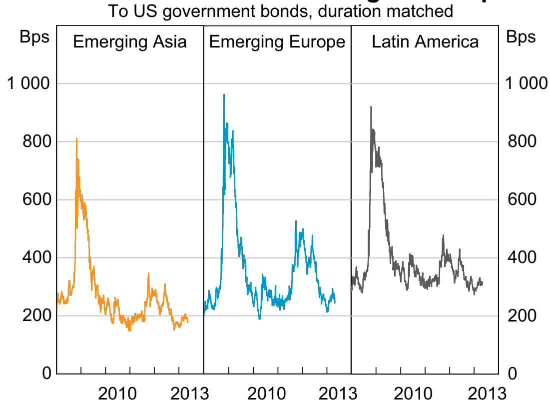


Source: Bloomberg

Moody's and Fitch have downgraded the United Kingdom's sovereign credit rating to AA+ (S&P equivalent), from AAA, noting the United Kingdom's weak growth and fiscal outlook. Yields on UK government bonds were broadly unaffected by the announcements, and have declined by around 30 basis points since early February.

Spreads on US dollar-denominated debt issued by emerging market sovereigns have widened marginally since the start of the year, although they remain at low levels (Graph 2.10).

Graph 2.10
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched

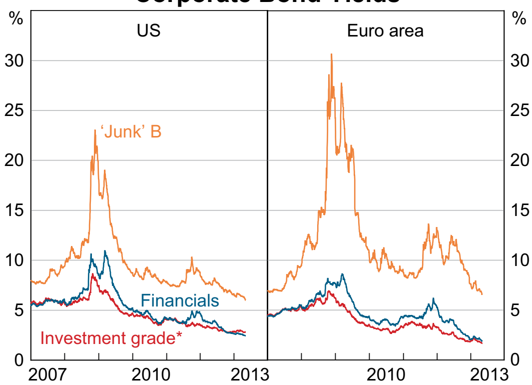


Source: Thomson Reuters

Credit Markets

Credit market conditions for non-financial corporates remain favourable as investors continue to seek higher-yielding investments amid historically low sovereign bond yields. Corporate bond yields have fallen to record lows across a number of market segments, most notably in the euro area and among sub-investment grade corporates (Graph 2.11).

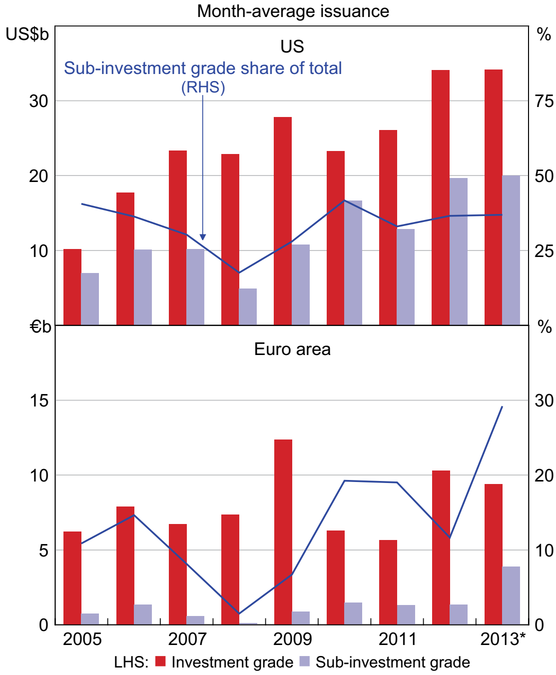
Graph 2.11
Corporate Bond Yields



* Non-financial corporates
Sources: Bank of America Merrill Lynch; Bloomberg; RBA

Non-financial corporate bond issuance has remained strong so far in 2013 (Graph 2.12). In the euro area, the share of sub-investment grade bond issuance has increased substantially as a result of the favourable issuance conditions, as well as in response to reduced access to intermediated credit. In contrast, financial corporates' bond issuance in the major markets remains subdued. US banks' bond issuance has offset maturities in 2013 to date, while euro area banks' net bond issuance remains negative. Peripheral euro area banks have issued very few bonds since January.

Graph 2.12
Non-financial Corporate Bond Issuance
Month-average issuance



* Year to date
Sources: Dealogic; RBA

Government Financial Policy

The Dutch Government nationalised the country's fourth-largest bank, SNS Reaal, following losses on the bank's real estate assets. The government will inject €2.2 billion in new capital, write off €700 million of the bank's real estate assets and forgive €800 million that the bank still owes from previous government assistance. Part of this cost will be recouped by a one-off €1 billion levy to be imposed on Dutch banks in 2014.

In the United Kingdom, the government announced two new programs to support mortgage lending for properties worth less than £600 000. The first program will provide home buyers who are unable to raise a sufficient deposit with a loan of up to 20 per cent of the value of a newly built owner-occupier home; £3.5 billion has been made available to finance the loans, which will be interest free for the first five years. Under the second program, from January 2014 the UK Treasury will provide lenders with an option to buy a guarantee against some of the losses on mortgages with a loan-to-value ratio of between 80 per cent and 95 per cent. The government will compensate lenders for losses occurring over the first seven years of the loan, up to 20 per cent of the purchase price of the home (though lenders will pay a fee and still be liable for 5 per cent of losses on the protected amount).

The Bank of England (BoE) and the UK Treasury announced a one-year extension of the Funding for Lending Scheme (FLS) until January 2015. Under the FLS, participating banks can borrow UK Treasury bills (against eligible collateral) from the BoE worth up to 5 per cent of their stock of existing lending to the real economy, plus any net expansion of lending that occurs between June 2012 and December 2014. To provide support to small- and medium-sized enterprises (SMEs), the new rules allow banks to draw down on the FLS up to ten times the amount that net lending to SMEs increases over the remainder of 2013, and up to five times the net increase in 2014. Additionally, lending to certain non-bank credit providers will now also contribute to drawdown limits.

Equities

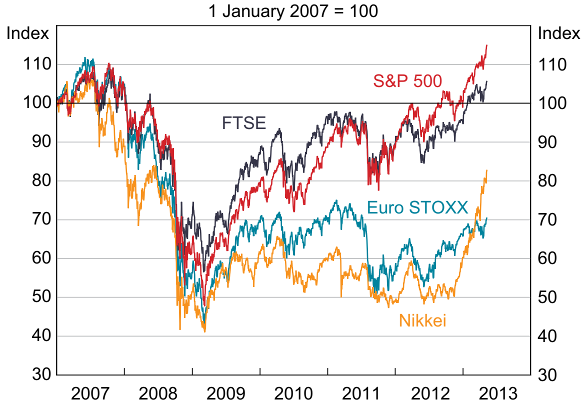
Global equity prices have risen by 13 per cent so far this year, while measures of equity market volatility remain below their long-term averages (Table 2.3). In the United States, the S&P 500 has surpassed its earlier peak in 2007, although markets in other countries remain some way below their peaks. In Japan, share prices have increased by nearly 40 per cent since the start of the year and by more than 70 per cent since the middle of last year in the lead up to, and following, further policy easing by the BoJ (Graph 2.13). The rise in Japanese equities has occurred alongside large foreign investor inflows into the Japanese market and a substantial increase in trading activity.

Table 2.3: Changes in International Share Prices
Per cent

	Over 2012	Since end 2012
United States		
– Dow Jones	7	15
– S&P 500	13	14
– NASDAQ	16	13
Euro area		
– STOXX	16	7
United Kingdom		
– FTSE	6	12
Japan		
– Nikkei	24	37
Canada		
– TSE 300	4	1
Australia		
– ASX 200	15	12
China		
– China A	3	–1
MSCI indices		
– Emerging Asia	15	2
– Latin America	9	–3
– Emerging Europe	13	1
– World	**13**	**13**

Source: Bloomberg

Graph 2.13
Share Price Indices
1 January 2007 = 100

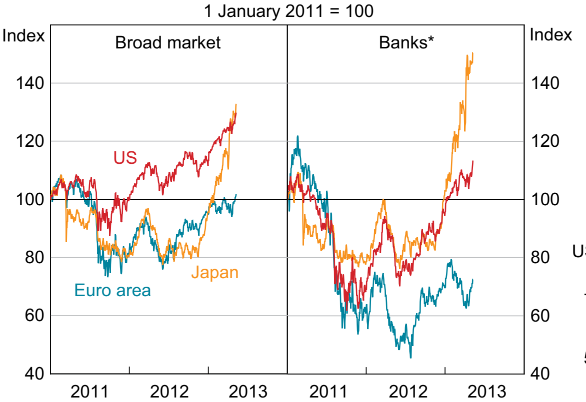


Source: Bloomberg

The largest US banks reported generally better-than-expected earnings for the March quarter, supported by investment banking revenues and declines in loan-loss provisions and other expenses. However, most banks' share prices fell following their earnings announcements as investors focused on compressions of net interest margins and weaker-than-expected trading revenues. The share prices of most major US banks rose after Federal Reserve approval of their capital plans. However, the capital plans of Goldman Sachs and JPMorgan only received conditional approval, with these banks required to submit new plans by the end of September.

In the euro area, equity prices have underperformed since the start of the year. Financial sector equity prices have been particularly weak, with banking sector share prices falling around 10 per cent from their January highs as political uncertainty in several peripheral countries weighed on the sector (Graph 2.14). Large European banks reported better-than-expected earnings for the March quarter, supported by ongoing reductions in expenditure and growth in investment banking revenues.

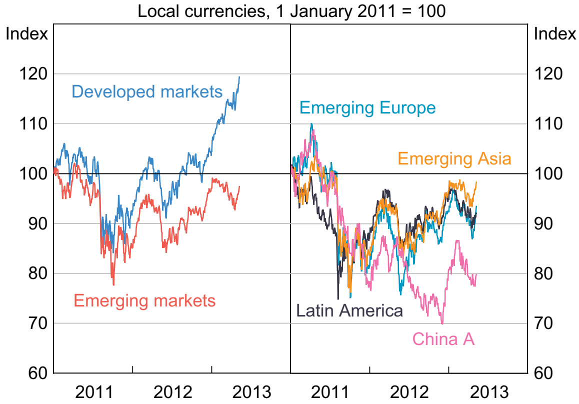
Graph 2.14
Share Price Indices
1 January 2011 = 100



* US index is diversified financials
Source: Bloomberg

Share prices in emerging markets have underperformed those in developed markets in 2013 (Graph 2.15). In China, equity prices rose early in the year in anticipation of policy reforms following the leadership transition. However, Chinese share

Graph 2.15
Share Price Indices
Local currencies, 1 January 2011 = 100



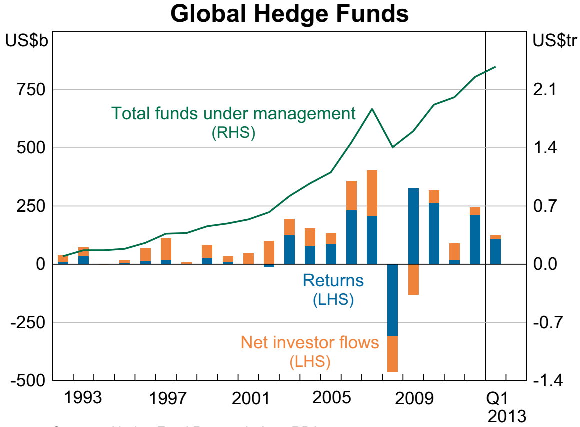
Sources: Bloomberg; MSCI

prices have fallen by 8 per cent over recent months, weighed down by weaker-than-expected economic data, further controls on property prices and regulatory tightening of 'shadow banking' activities. Latin American share prices have continued to decline, with Brazilian share prices falling by 8 per cent so far this year amid concerns around domestic growth.

Hedge Funds

Global hedge funds recorded an average return on investments of 5.5 per cent over the year to March, which was less than the total return from equity markets (which include dividends) over the period (Graph 2.16). Funds under management increased by

Graph 2.16
Global Hedge Funds



Sources: Hedge Fund Research, Inc.; RBA

5.4 per cent over the March quarter to US$2.4 trillion, largely reflecting the accumulation of positive returns, with only a modest injection of new capital.

Foreign Exchange

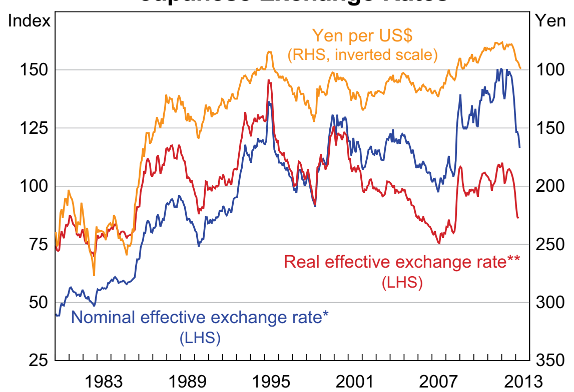
Foreign exchange markets have primarily been influenced by developments in Japanese monetary policy. The Japanese yen has depreciated by a further 7 per cent on a nominal effective basis since the BoJ's policy announcement in early April and by 19 per cent since mid November, but remains relatively high compared with its average over the past 30 years (Graph 2.17). In real effective terms, the yen is well below its average since 1980, though not outside the range observed over that time. Although policymakers in some other economies remain concerned about the relative strength of their currencies, the G20 has described Japan's policy actions as being 'intended to stop deflation and support domestic demand'. The developments in Japanese monetary policy have led to an increase in the intraday ranges of both the US dollar and the euro against the Japanese yen, with both measures rising from the very low levels reached in late 2012 (Graph 2.18).

The US dollar is little changed on a broad trade-weighted basis over 2013 to date, and remains at a historically low level (Graph 2.19, Table 2.4). The euro has depreciated by 2 per cent on a trade-weighted basis since early February, consistent with increased market expectations of further monetary policy easing by the ECB. Notwithstanding the recent political uncertainty in Italy and market concerns about Cyprus, the euro remains 7 per cent higher than the 10-year low it reached in mid 2012 on a trade-weighted basis.

The Chinese renminbi (RMB) has appreciated by a further 1 per cent against the US dollar since the beginning of 2013 to be 4 per cent higher than its July 2012 trough, remaining in the upper part of its +/–1 per cent daily trading band. In part reflecting the depreciation of the Japanese yen, the RMB has appreciated by 6–7 per cent on a real and nominal

Graph 2.17

Japanese Exchange Rates



* Average since January 1980 = 100

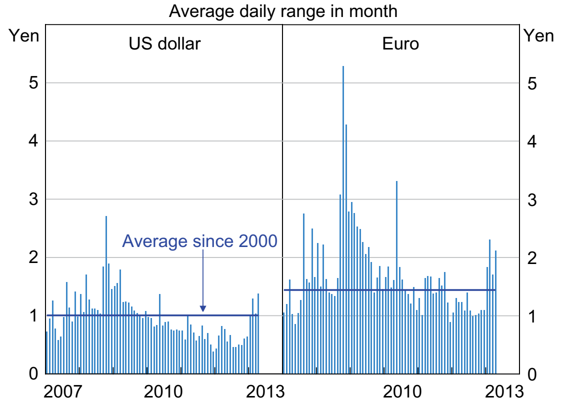
** Average since January 1980 = 100; data up to end March 2013

Sources: BIS; Bloomberg; RBA

Graph 2.18

Intraday Ranges against the Japanese Yen

Average daily range in month

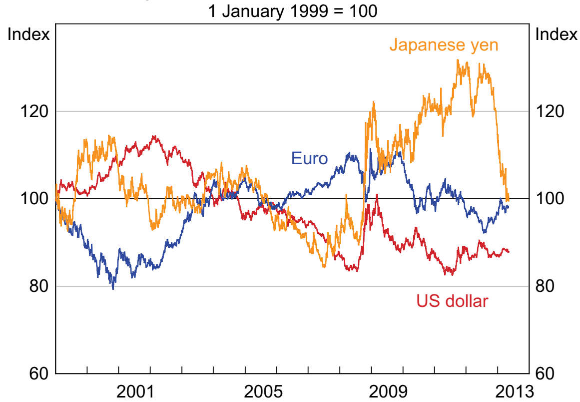


Source: Bloomberg

Graph 2.19

Major Currencies' Nominal TWI

1 January 1999 = 100



Sources: Bloomberg; RBA

Table 2.4: Changes in the US Dollar against Selected Currencies

Per cent

	Over 2012	Since end 2012
Japanese yen	13	14
South African rand	5	6
UK pound sterling	–4	5
Australian dollar	–2	2
Swiss franc	–2	2
South Korean won	–8	2
Canadian dollar	–3	1
New Taiwan dollar	–4	1
Singapore dollar	–6	0
European euro	–2	0
Swedish krona	–6	0
Indonesian rupiah	8	–1
Philippine peso	–6	–1
Indian rupee	3	–1
New Zealand dollar	–6	–1
Chinese renminbi	–1	–1
Brazilian real	10	–2
Malaysian ringgit	–3	–3
Thai baht	–3	–4
Mexican peso	–8	–7
Majors TWI	**0**	**3**
Broad TWI	**–1**	**1**

Source: Bloomberg

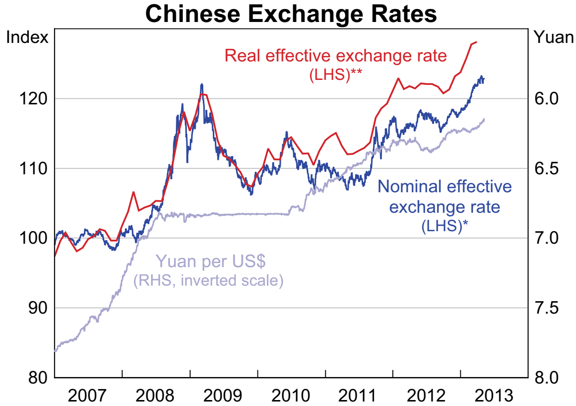
One exception has been Bank Indonesia, which actively sold foreign currency reserves early in the year in order to increase US dollar liquidity in the onshore market.

The Chinese authorities continue to take steps towards internationalising the RMB, including relaxing restrictions on inward investment and signing additional or expanded local currency swap agreements with other central banks. In addition, 'direct trading' between the Australian dollar and the RMB – that is, trading between these two currencies without the use of the US dollar as an intermediate currency – commenced in Mainland China's interbank market on 10 April. The Australian dollar is effective basis since mid September and is at a historically high level on both measures (Graph 2.20).

Chinese foreign exchange reserves increased by US$131 billion (around 4 per cent) over the March quarter, after being broadly unchanged over the previous three quarters (Table 2.5). This reflects net purchases of foreign exchange reserves totalling US$157 billion, which were partly offset by negative valuation effects (Graph 2.21). This is in contrast to the more subdued purchases seen in recent quarters, but is consistent with strong capital inflows.

Other Asian central banks' holdings of foreign exchange reserves have generally been little changed (in US dollar terms) over recent months.

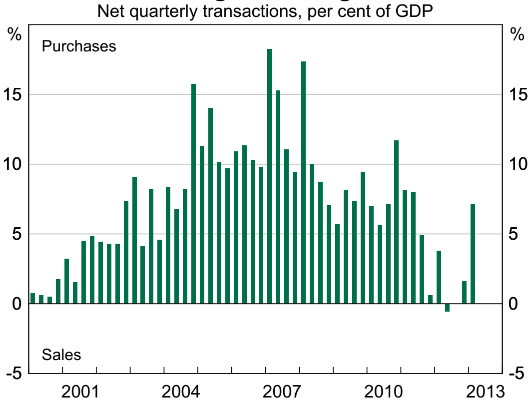
Graph 2.20
Chinese Exchange Rates



* Indexed to 2007 average = 100
** Indexed to 2007 average = 100; monthly data up to end March 2013
Sources: BIS; Bloomberg; RBA

Graph 2.21
Chinese Foreign Exchange Reserves

Net quarterly transactions, per cent of GDP



Sources: CEIC; RBA; WM/Reuters

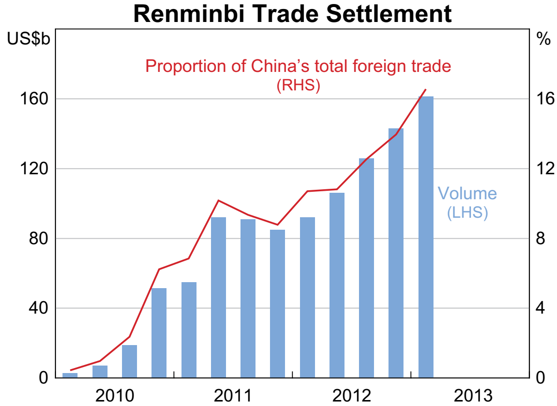
Table 2.5: Selected Asian Foreign Currency Reserves
As at end April 2013

	Change since end 2012		Level
	US$ equivalent (billions)	Per cent	US$ equivalent (billions)
China[(a), (b)]	131	4	3 443
Taiwan[(a)]	2	1	405
South Korea	1	0	319
Hong Kong[(b)]	–14	–4	292
India	2	1	264
Singapore	2	1	259
Thailand[(b)]	–3	–2	167
Malaysia	1	1	127
Indonesia	–5	–5	100
Philippines	0	0	71

(a) Foreign exchange reserves (includes foreign currency and other reserve assets)
(b) End March
Sources: Bloomberg; CEIC; Hong Kong Monetary Authority; IMF; RBA

the fifth currency to be approved for direct trading against the RMB in the Chinese market, alongside the US dollar, Japanese yen, Russian rouble and Malaysian ringgit. Over time, direct trading should promote greater use of the RMB as an invoicing currency for bilateral trade between Australia and China. While the use of RMB for trade payments between Australia and China is currently very small, data from the People's Bank of China suggest that China's total RMB-denominated trade settlement increased further in the March quarter, accounting for more than 16 per cent of China's total foreign trade (although a significant portion reflects China's trade with Hong Kong) (Graph 2.22).

Graph 2.22
Renminbi Trade Settlement

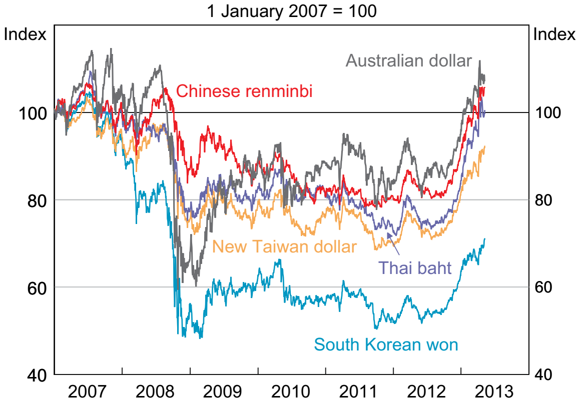


Sources: Bloomberg; CEIC

Other Asian currencies have continued to appreciate against the Japanese yen, to be around 29 per cent higher, on average, since the end of September (Graph 2.23). However, Asian currencies have been more mixed against the US dollar over recent months, partly reflecting differences in relative economic performance within the region. The South Korean won has depreciated by 2 per cent against the US dollar since the end of December, in part reflecting market concerns about a potential loss of external competitiveness to Japan. In contrast, the Thai baht has appreciated by 4 per cent against the US dollar over the same period, reflecting an improved domestic economic outlook and reports of strong capital inflows.

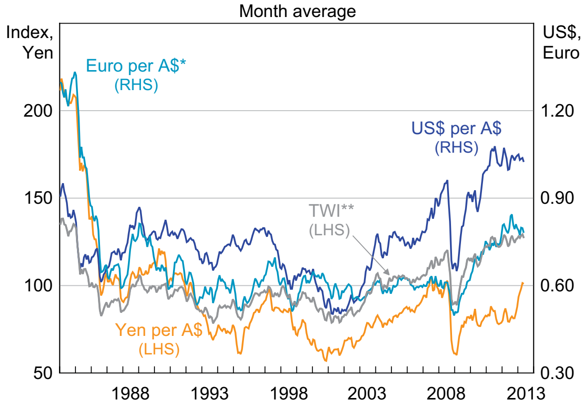
Latin American currencies have generally appreciated against the US dollar over 2013 to date. The Mexican peso has appreciated by a further 7 per cent against the US dollar since the beginning of the year to be 20 per cent higher than its mid 2012 low, supported by recent and proposed structural

Graph 2.23
Selected Currencies against the Yen
1 January 2007 = 100



Source: Bloomberg

Graph 2.24
Australian Dollar
Month average



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

reforms across a range of sectors. The Brazilian real has appreciated modestly over 2013 to date, with the Brazilian authorities intervening in foreign exchange markets to limit volatility as required. The authorities in a number of other Latin American countries have expressed concerns about appreciation pressures on their currencies, with some adjusting capital control measures and/or intervening in foreign exchange markets in response.

Australian Dollar

The Australian dollar has appreciated by around 5 per cent on a trade-weighted basis since early October 2012, largely reflecting a 26 per cent appreciation against the Japanese yen, but there has been little net change so far this year (Graph 2.24, Table 2.6). After briefly reaching its highest level since 1985 on a trade-weighted basis in early April, the Australian dollar has since depreciated against most currencies. Nevertheless, it remains at a high level by historical standards, notwithstanding the decline in export prices and interest rates.

Table 2.6: Changes in the Australian Dollar against Selected TWI Currencies
Per cent

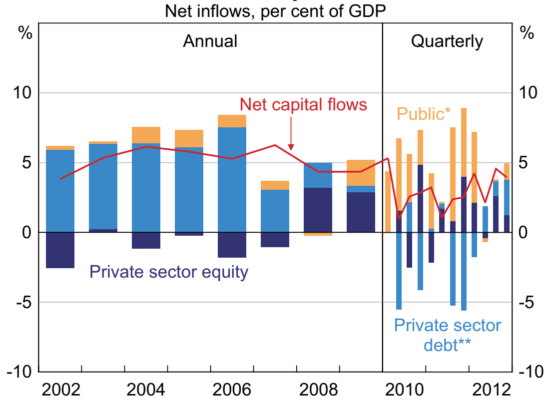
	Over 2012	Since end 2012
Japanese yen	15	12
South African rand	7	4
UK pound sterling	–3	2
Swiss franc	–1	0
South Korean won	–7	0
Canadian dollar	–1	–1
Singapore dollar	–4	–2
European euro	0	–2
US dollar	2	–2
Indonesian rupiah	10	–3
Indian rupee	5	–3
New Zealand dollar	–4	–3
Chinese renminbi	1	–4
Malaysian ringgit	–2	–5
Thai baht	–1	–6
TWI	**2**	**0**

Sources: Bloomberg; Thomson Reuters; WM/Reuters

Capital Flows

Consistent with the previous two quarters, net capital inflows to the Australian economy were largely directed to the private sector in the December quarter (Graph 2.25). The net inflow primarily reflected inflows of debt and equity to private non-financial corporates, particularly to the mining sector, continuing a trend that has been evident over recent years.[1] The banking sector also recorded a small net inflow driven by net deposit inflows and foreign investment in bank debt, though this was partially offset by an increase in bank lending to non-residents. There was also a net inflow of capital to the public sector, though it remained well below levels seen throughout most of the 2009–2011 period and was less than new issuance. Accordingly, foreign ownership of Commonwealth Government securities declined slightly to around 70 per cent in the December quarter from 72 per cent in the September quarter. ✠

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



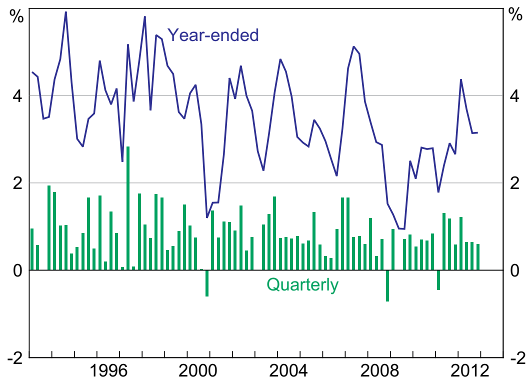
* Excludes official and other RBA flows
** Adjusted for the US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

1 See Arsov I, B Shanahan and T Williams (2013), 'Funding the Australian Resources Investment Boom', RBA *Bulletin*, March, pp 51–61.

3. Domestic Economic Conditions

The Australian economy expanded at an around trend pace over 2012, although growth was slower in the second half of the year than in the first half (Graph 3.1, Table 3.1). Growth in consumption spending slowed somewhat in the latter part of the year and there was a very large fall in recorded public demand over the same period. Resource sector (mining) investment remained at a very high level, although growth slowed. In contrast, resource export volumes grew strongly in the last months of the year and dwelling investment began to recover after declining over 2011/12. Growth in national income was weak over 2012, reflecting a decline in the terms of trade.

Graph 3.1
GDP Growth



Source: ABS

The latest partial indicators and liaison suggest that growth in economic activity may have picked up slightly in the March quarter. Despite recent growth in employment remaining moderate, growth in consumer spending looks to have increased, consistent with stronger consumer sentiment and rising asset prices. Dwelling investment is likely to have risen further in the quarter, while growth in

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

	First half 2012	Second half 2012
Domestic final demand	6.4	0.6
– Private demand	5.8	4.1
– Public demand	8.0	–10.4
Change in inventories[(b)]	–0.7	0.0
Gross national expenditure	5.6	0.6
Net exports[(b)]	–0.4	1.7
GDP	3.8	2.5
Nominal GDP	3.2	0.8
Real gross domestic income	1.3	–1.0

(a) Growth over two quarters, annualised
(b) Contribution to GDP growth
Source: ABS

mining investment is likely to have continued to slow. Surveys suggest that business conditions and capacity utilisation generally remained a little below long-run averages in the early part of 2013. Non-mining investment is expected to remain subdued in the near term, although firms' surveyed capital expenditure intentions point to a gradual pick-up in the second half of this year and into the next.

Household Sector

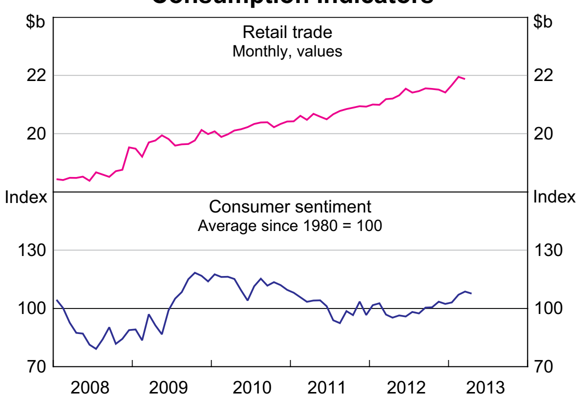
Growth in household consumption slowed in the second half of 2012, in line with somewhat subdued conditions in the labour market. The saving ratio remained at around 10 per cent of income, which is similar to the rate of saving in the mid 1980s and well above the levels prevailing during the 1990s and 2000s. Growth of household debt, at around 4 per cent over 2012, is broadly in line with growth in income. Consequently, the ratio of debt to income has been little changed, at close to 150 per cent.

Indications are that growth in household consumption strengthened in the early months of 2013. After having slowed considerably late last year, the value of retail sales – which primarily captures sales of goods – picked up strongly in the March quarter, to be 3¾ per cent higher over the year (Graph 3.2). Growth in the quarter was broad based, with sales increasing for all categories of retailers. The volume of retail sales also grew strongly, and by a little more than values as retail prices fell slightly in the quarter. Information from the Bank's liaison suggests that retail sales rose further in April. The strengthening in sales growth this year coincided with consumer sentiment being above average levels. Consumers' expectations of unemployment have also fallen from recent peaks, while reported buying conditions for dwellings and motor vehicles remain around their highest levels for a decade. Consistent with this, motor vehicle sales to households have remained at a high level in early 2013; although sales fell over the four months to April, they were 10 per cent higher than a year ago. The high value of the Australian dollar, along with continued strong competition, has kept motor vehicle prices low and helped to stimulate sales.

Despite some weakness in consumption in the December quarter, consumption imports were boosted by motor vehicle imports, which increased by almost 14 per cent over 2012. Consumption imports grew in the March quarter, once again reflecting growth in motor vehicle imports.

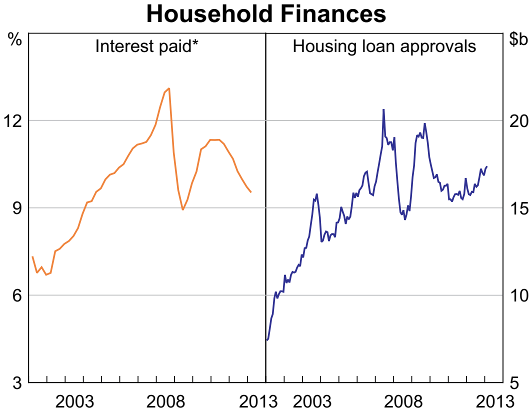
Reductions in interest rates late last year have lowered households' interest payments further, to around 9½ per cent of household disposable income in the March quarter, close to the lowest share of income in recent years (Graph 3.3). There are signs of an increasing appetite for borrowing in the household

Graph 3.2
Consumption Indicators



Sources: ABS; Melbourne Institute and Westpac; Roy Morgan Research

Graph 3.3
Household Finances



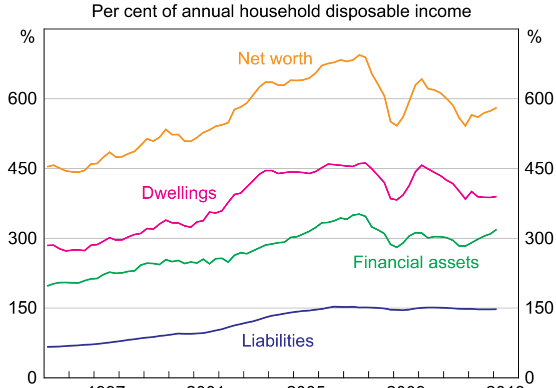
* Per cent of household disposable income; household sector excludes unincorporated enterprises; disposable income is after tax and before the deduction of interest payments; RBA estimate for March quarter 2013

Sources: ABS; APRA; RBA

sector, with approvals for both housing and personal loans increasing over recent months, although loan approvals to first home buyers remain subdued (see the 'Domestic Financial Markets' chapter for details).

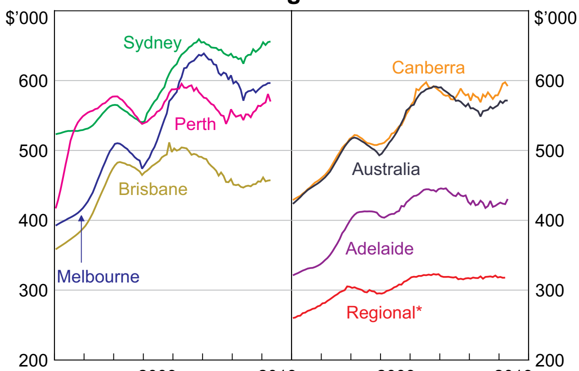
Sentiment in the household sector has been boosted by strong growth in household net worth over the past year, driven by large rises in equity prices and moderate dwelling price inflation (Graph 3.4). Household net worth grew by 1½ per cent in the December quarter to be around 9 per cent higher over the year, and is estimated to have risen by a further 3 per cent in the March quarter.

The improvement in conditions in the established housing market since mid 2012 has continued in early 2013 (Graph 3.5, Table 3.2). Australian capital city dwelling prices rose by around 1 per cent over the three months to March and are around 4 per cent above their low point of mid 2012. Price rises have been relatively broad based, with most state capitals recording increases over the first few months of the year. Auction clearance rates have also increased substantially over the past year, and are now well above average in Sydney and around average levels in Melbourne.



* Household liabilities exclude the liabilities of unincorporated enterprises; disposable income is after tax and before the deduction of interest payments; RBA estimates for March quarter 2013

Sources: ABS; RBA; RP Data-Rismark



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

Sources: RBA; RP Data-Rismark

Table 3.2: National Housing Price Growth

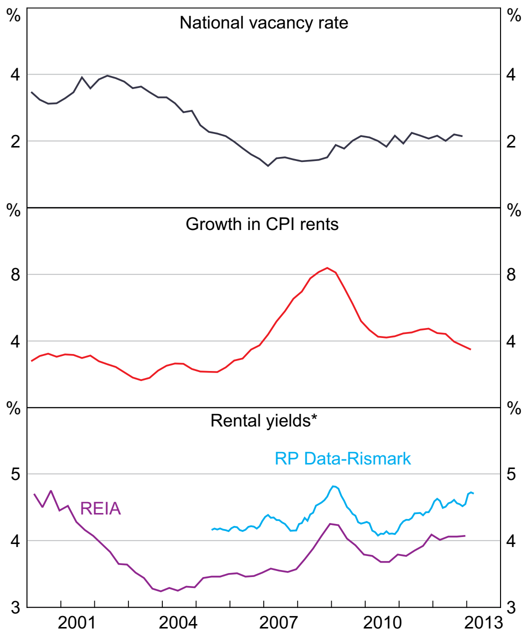
Per cent

	3 months to December 2012	3 months to March 2013	Year to March 2013
Capital cities			
ABS[(a), (b)]	2.0	0.1	2.6
APM[(b)]	1.9	0.9	2.4
RP Data-Rismark	0.3	1.2	2.4
Regional areas			
APM[(b)]	0.9	1.6	1.8
RP Data-Rismark[(a)]	–0.5	–0.1	0.1

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

The pick-up in dwelling prices is likely to have been supported by the relatively tight rental market. Nationwide, rental vacancy rates in the December quarter were a little over 2 per cent, around where they have been for the past 3½ years and quite a bit lower than their average over the 1990s and early 2000s (Graph 3.6). In line with relatively low vacancy rates, rents have been rising at an annual rate of around 4 per cent for some time and rental yields are around their highest levels for several years. Rental yields and growth in rents are particularly high in Perth, and to a lesser extent in Sydney, while the rental market is a little softer in Adelaide and Melbourne.

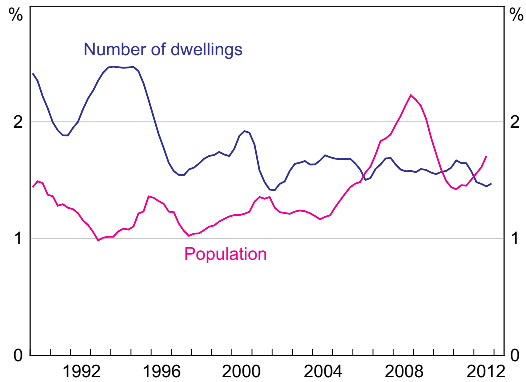
Graph 3.6
Rental Market



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

The tight rental market, together with rising dwelling prices and low lending rates, have contributed to a recovery in dwelling investment from relatively low levels. Over recent years, growth in the dwelling stock has been weak relative to growth in the population, which has picked up recently (Graph 3.7). After falling over 2011/12, residential construction

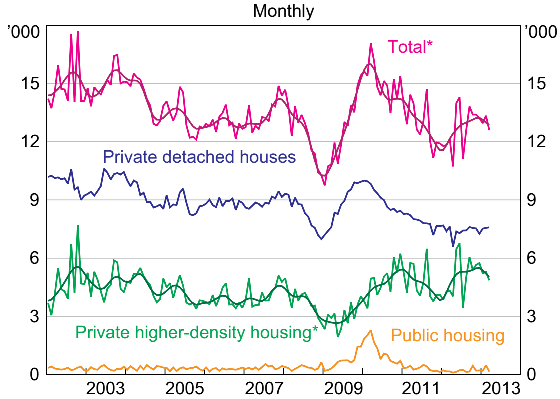
Graph 3.7
Dwelling and Population Growth
Year-ended



Sources: ABS; RBA

activity increased over the second half of 2012, to be 3 per cent higher than its trough in the June quarter 2012. The increase in private residential building approvals over the past year points to some further rise in activity in the near term, although approvals have eased a little recently (Graph 3.8). Unlike in previous upswings, however, the pick-up in building approvals to date has been concentrated in higher-density housing, notwithstanding a small fall over the past few months. Detached housing approvals are yet to show clear signs of recovery. There has also been notable variation across regions (for further details, see 'Box A: Regional Developments in Dwelling Approvals').

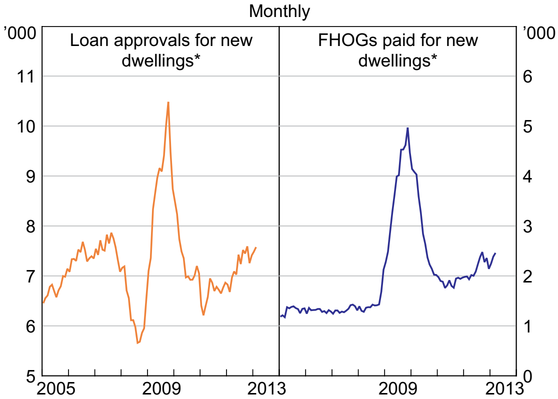
Graph 3.8
Residential Building Approvals
Monthly



* Smoothed lines are ABS trend measures
Source: ABS

A number of other forward-looking indicators point to a further recovery in dwelling investment over the months ahead. Notwithstanding a fall in late 2012, loan approvals – and first home owner grants – for new dwellings have increased over the past year or so (Graph 3.9). This has been particularly evident in recent months in Western Australia, New South Wales and Queensland. Activity in the latter two states appears to be benefiting from changes by state governments to direct their support for first home buyers towards purchases of new, rather than existing, dwellings. The Bank's business liaison also suggests that demand for new housing is improving from low levels, with enquiries from prospective purchasers and visits to display homes increasing.

Graph 3.9
Indicators of Dwelling Investment
Monthly



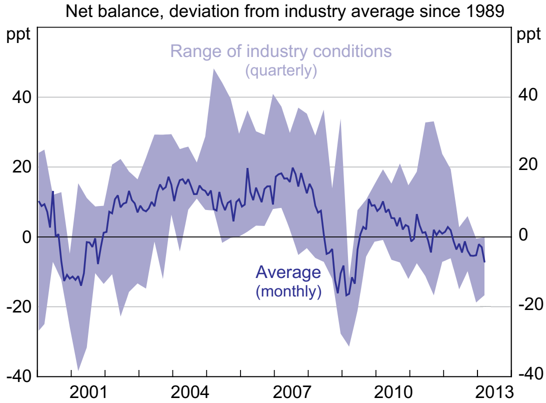
* Includes both new construction and newly erected dwellings
Sources: ABS; NSW Office of State Revenue; RBA

Business Sector

Growth in business investment eased in the December quarter, reflecting a fall in machinery and equipment investment and slower growth in engineering construction. Business investment, however, remained at an elevated level as a share of GDP, as further growth in mining investment largely offset weakness in non-mining investment. In line with some deterioration in survey measures of business conditions, company profits declined in the quarter. This was driven by a fall in mining profits as earlier falls in spot prices flowed through to prices received by Australian exporters. Profits in the non-mining economy also declined slightly, particularly in the manufacturing and wholesale trade sectors. Indicators for the March quarter suggest that business conditions remained a little below their long-run average levels.

Following some improvement early in the year, survey measures of business conditions fell in March and remain somewhat below long-run average levels (Graph 3.10). In contrast, forward-looking indicators of business confidence have picked up recently to around average levels. Business surveys suggest that expectations of investment growth have also picked up a little, though they remain at low levels. Other timely indicators of near-term growth in business investment remain subdued. Capital imports have fallen and indicators of capacity utilisation are a little below long-run average levels. Liaison continues to suggest that the reluctance of some firms to invest reflects concerns about the strength of demand, general uncertainty about the economic outlook and a focus on containing costs.

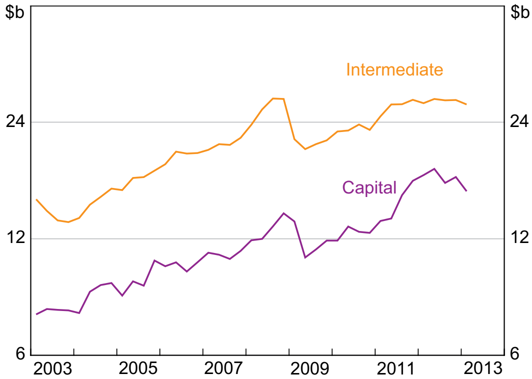
Graph 3.10
Business Conditions by Industry
Net balance, deviation from industry average since 1989



Sources: NAB; RBA

In line with weaker demand from businesses, growth in imports eased in the second half of 2012, driven by declines in capital imports (Graph 3.11). The fall in capital imports in part owes to weakness in volatile components related to large 'lumpy' mining-related investment. Also, there has been little growth in

Graph 3.11
Import Values*
Log scale, Quarterly



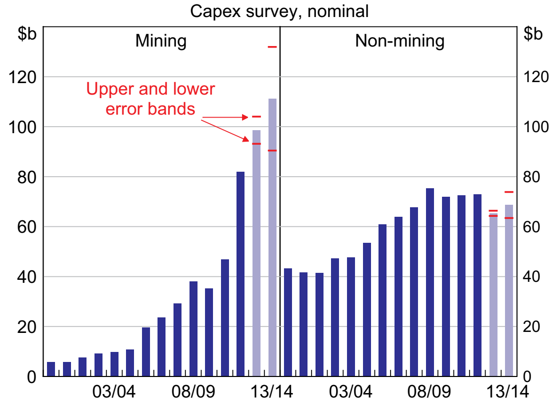
* March quarter observations based on monthly data
Source: ABS

intermediate imports over the past year. Weakness in the growth in overall import volumes is estimated to have continued into the March quarter. This reflects both continued weakness in capital imports and falls in intermediate imports, although the latter largely reflects oil imports, which tend to be volatile.

As discussed in the 'Domestic Financial Markets' chapter, business funding has been subdued recently, consistent with the weakness in non-mining investment. Business credit has been little changed over the past six months, although there has been some growth in other debt funding. Growth in equity funding has been generally subdued recently, compared with above-average growth in late 2011 and early 2012. In contrast, internal funding has remained only a little below its decade average as a share of GDP, in line with developments in business profits. Overall, businesses appear to be in a position to fund additional investment, with large holdings of cash and other liquid assets on their balance sheets, and generally good access to external sources of funds.

Despite some weakness in the near-term indicators of business investment, the latest ABS capital expenditure (Capex) imply that investment is likely to grow in 2013/14 (Graph 3.12). These data actually suggest that the increase in investment may be largest in the mining sector, with further growth in building and structures offsetting falls in machinery and equipment investment. However, the early releases for the Capex survey tend to be a less reliable guide for mining investment than for non-mining business investment. Given the uncertainty around these estimates, and that information from company statements and the Bank's liaison suggest that mining companies have scaled back their investment intentions since the middle of last year, it seems likely that mining investment in 2013/14 will remain around current levels. This reflects the large stock of resource projects already committed to, which is expected to keep mining investment at an elevated level for some time.

Graph 3.12
Capital Expenditure Intentions
Capex survey, nominal

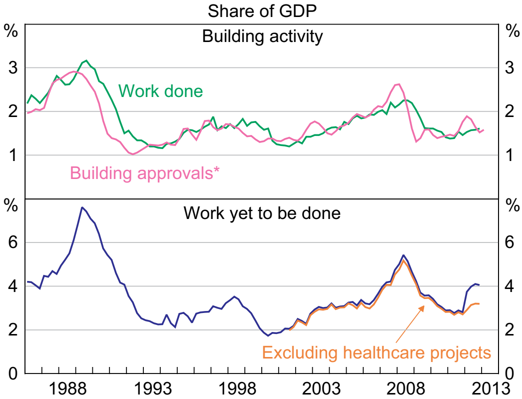


* Error bands are based on the mean absolute error of growth rate for each estimate of investment intentions compared with the final outcome for investment in each year
Sources: ABS; RBA

The Capex survey suggests that non-mining investment will increase in 2013/14, with growth in both machinery and equipment investment and buildings and structures investment. This expectation is also subject to a degree of uncertainty. Other indicators of private non-residential building investment, particularly for the near term, remain subdued. Building approvals have trended lower over much of the past year, although they were boosted in early 2012 by two large healthcare projects, which also account for much of the increase in the stock of work yet to be done (Graph 3.13).

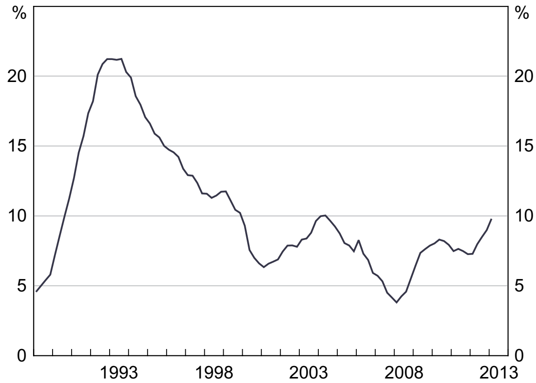
Conditions in the office property market continue to weigh on non-residential building activity. While there was a large increase in office approvals in March, this was concentrated in Queensland. Vacancy rates in all major markets have increased over the past year, and the national vacancy rate is now 2½ percentage points above its decade average and at the highest level since mid 2004 (Graph 3.14). Conditions in other commercial property markets also remain subdued, with real rents little changed or lower over the past year.

Graph 3.13
Non-residential Building Work
Share of GDP



* 7-period Henderson trend; RBA estimate for March quarter 2013
Sources: ABS; RBA

Graph 3.14
National Office Vacancy Rate
Excluding Darwin and Hobart

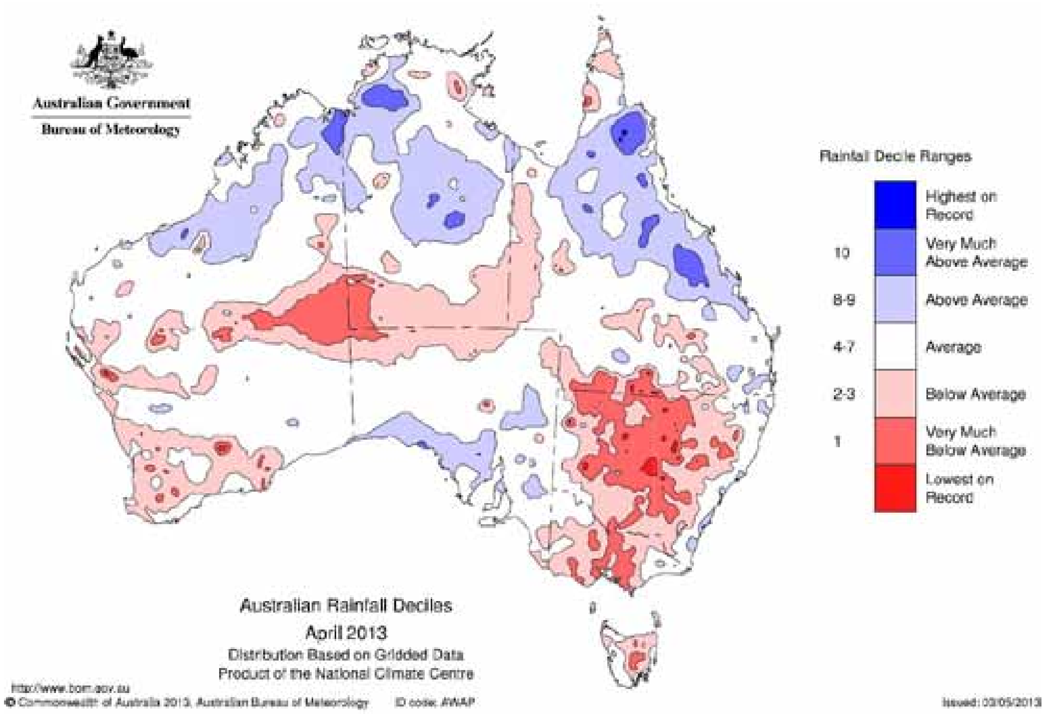


Source: Jones Lang LaSalle Research

Farm Sector

The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects farm incomes to decline in 2012/13, but to remain at a high level by historical standards. The decline in incomes in the year reflects lower prices as well as a fall in crop production. Prices for livestock and livestock products (such as wool) are estimated to be 9 per cent lower in 2012/13. The winter crop in 2012 is expected to have been more than 20 per cent lower than the crop in 2011. Despite this fall, the 2012 winter crop is estimated to have been around the average level of the past decade, with the record crop of the previous year having been boosted by rainfall that was well above average. Currently, conditions in some cropping regions are dry, and rainfall in coming weeks will be necessary to enable successful sowing of the winter crop (Graph 3.15).

Graph 3.15
Australian Rainfall
April 2013

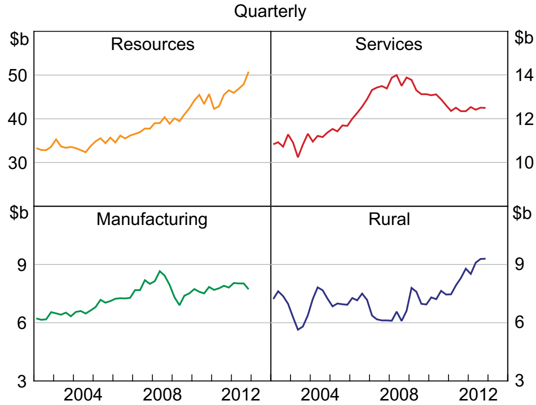


Source: Bureau of Meteorology

External Sector

Exports made a sizeable contribution to growth in the December quarter, largely reflecting strong growth in resource exports (Graph 3.16). Coal exports rose sharply owing to increased demand from China, in addition to a recovery from earlier supply disruptions to coking coal production. Iron ore export volumes also grew noticeably, as the utilisation of expanded mine, rail and port infrastructure increased. Outside of resource exports there was little growth. There was a broad-based decline in manufactured goods exports, while rural exports increased marginally, despite a fall in wheat exports, as wool and meat exports increased. Services export volumes were flat in the quarter, and were only slightly higher over the past year as declines in education-related exports have largely offset rises in tourism exports.

Graph 3.16
Export Volumes*
Quarterly



* 2010/11 prices
Sources: ABS; RBA

Export volumes are estimated to have grown moderately in the March quarter. Growth in resource exports appears to have slowed, reflecting both a fall in crude oil exports and more subdued growth in coking coal volumes due to floods in Queensland in early 2013, although the disruptions have been smaller than occurred in 2011. Iron ore exports are estimated to have increased at a pace similar to the past three quarters, as producers continue to ramp up production. Outside the resource sector, services exports appear to have grown in the quarter. The number of overseas arrivals has softened recently, although liaison suggests that tourism exports in 2013 are likely to continue to be boosted by growth in arrivals from China. Liaison also indicates that education exports have stabilised. Rural and manufactured exports appear to have been little changed in the quarter.

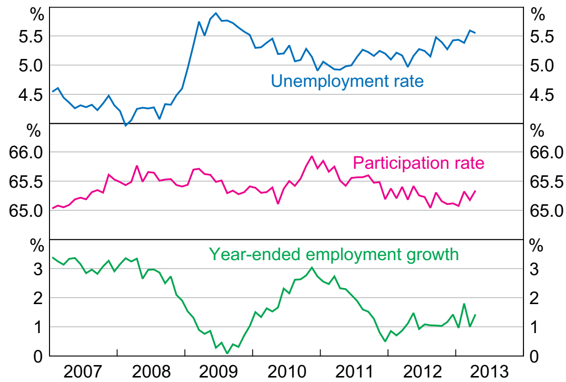
Labour Market

Labour market conditions have remained somewhat subdued over recent months. The unemployment rate has risen a little further and trend employment growth has remained below the rate of growth in the working-age population (Graph 3.17). After declining from its peak in late 2010, the participation rate has been broadly stable over the past year, owing to a stabilisation in the participation rate of prime-age males. Average hours worked have remained at a relatively low level and most of the increase in aggregate employment over the past six months can be attributed to growth in part-time employment.

There has been a further shift in employment growth away from mining and business services, with employment in these industries remaining below the peaks reached in 2012 (Graph 3.18). In contrast, the household services sector, which includes health care and education, has continued to make a significant contribution to aggregate employment growth. There has also been a pronounced rise in employment in the goods distribution sector over the past year, driven by strong employment growth in the wholesale trade and transport, postal & warehousing industries. Over the six months to February, employment picked up in the construction industry, consistent with the beginning of a recovery in dwelling investment. The level of employment in manufacturing has been little changed over the past 18 months, after having declined by around 10 per cent over the preceding decade.

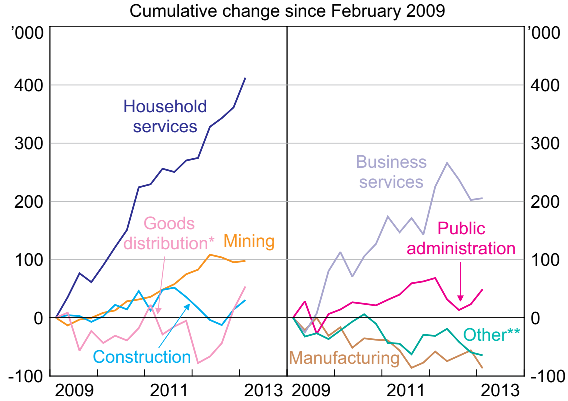
The pace of aggregate employment growth across the states has also been shifting (Graph 3.19). In Western Australia, employment growth has slowed

Graph 3.17
Labour Market



Sources: ABS; RBA

Graph 3.18
Employment by Industry
Cumulative change since February 2009

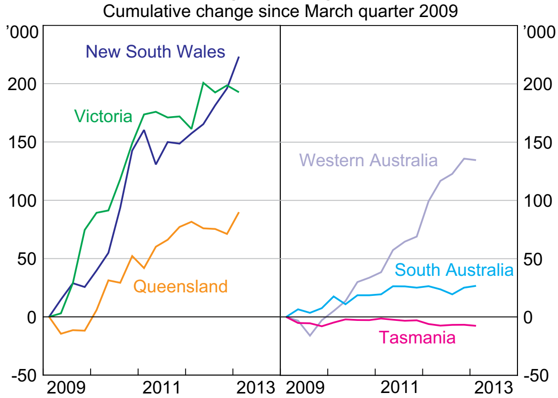


* Retail trade, wholesale trade and transport, postal & warehousing
** Agriculture and utilities
Source: ABS

in recent months, reflecting the weaker conditions in the mining industry. Employment growth has continued to pick up in New South Wales, while labour market conditions in Queensland look to have improved after a period of weakness. Conditions have stabilised in South Australia, but remain subdued in Victoria and Tasmania.

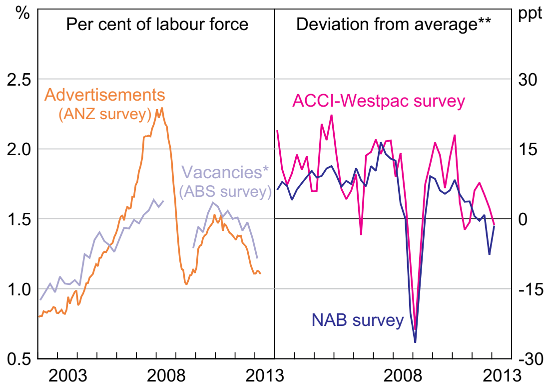
Leading indicators of employment growth have been mixed recently, although they remain at relatively low levels (Graph 3.20). The quarterly ABS measure of job vacancies fell in the three months to February, to be around 18 per cent lower over the year. On the other hand, after pronounced declines in 2012, measures of job advertisements have been relatively stable since the start of the year. Business survey measures of hiring intentions remained at or slightly below average levels in the March quarter, while reports from the Bank's liaison suggest that firms remain cautious about hiring staff.

Graph 3.19
Employment by State
Cumulative change since March quarter 2009



Source: ABS

Graph 3.20
Labour Market Indicators



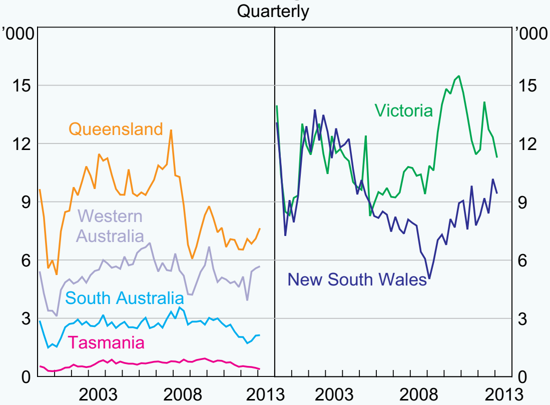
* This survey was suspended between May 2008 and November 2009
** Net balance of surveyed hiring intentions for the following quarter; deviation from average since 1989
Sources: ABS; ACCI; ANZ; NAB; RBA; Westpac

Box A

Regional Developments in Dwelling Approvals

Dwelling approvals have increased since their trough in early 2012, leading to a recovery in dwelling activity over recent quarters. However, there have been pronounced regional differences in the growth in approvals, both between and within the states. Dwelling approvals have picked up noticeably in New South Wales, while increases have also been recorded in Western Australia, Queensland and South Australia (Graph A1). In Victoria, approvals have been on a downward trend but remain at high levels. These differences reflect variation in factors such as economic conditions, population growth, government incentives for home buyers, sentiment in the established housing market and supply-side constraints.

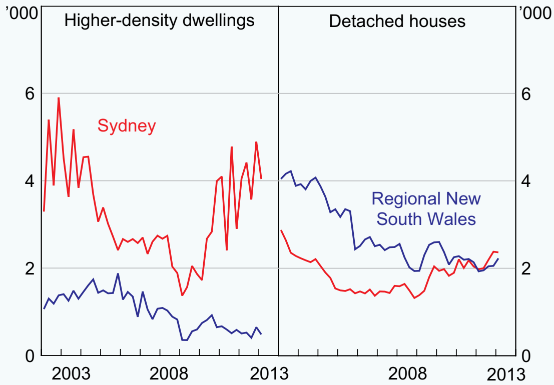
Graph A1
Private Dwelling Approvals
Quarterly



Source: ABS

Dwelling approvals in New South Wales have been rising since 2009, following an extended period during which the population grew by more than the dwelling stock. The increase in approvals has been concentrated in Sydney, particularly in higher-density dwellings (Graph A2). The increase in higher-density

Graph A2
Private Dwelling Approvals – NSW
Quarterly



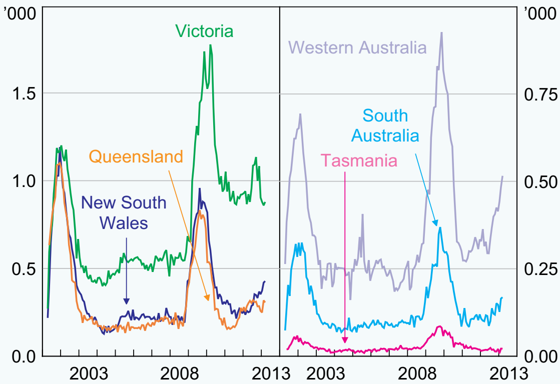
Sources: ABS; RBA

approvals has been broad based across Sydney, but is largest in the suburbs of the inner and middle rings of the city; liaison with developers suggests that for the inner city in particular, demand has been supported by foreign investors. Approvals for detached dwellings have also increased, driven by activity in the outer regions of Sydney, particularly in the south west. Elsewhere in New South Wales, dwelling approvals have remained at a relatively low level. For the state as a whole, there has been an increase in demand from first home buyers, which is likely to reflect the increase in government incentives to first home buyers purchasing new homes relative to the incentives available for purchases of established homes (Graph A3).

In Victoria, dwelling approvals have remained at a relatively high level over the past year or so, albeit below that recorded during 2010. Approvals for higher-density dwellings in Melbourne have been elevated for several years, particularly in inner Melbourne (Graph A4). Liaison suggests that foreign

Graph A3
Number of FHOGs Paid for New Dwellings*

Monthly

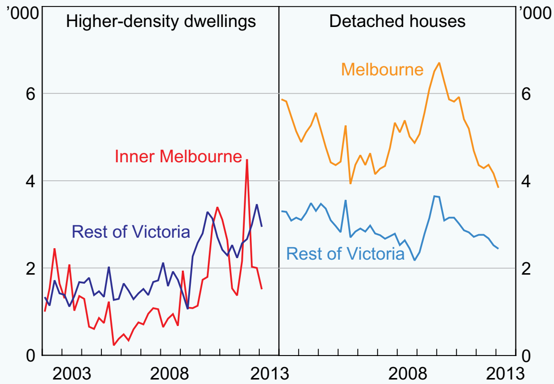


* First home owner grant; includes newly constructed dwellings and dwellings in the process of construction

Sources: NSW Office of State Revenue; RBA

Graph A4
Private Dwelling Approvals – Victoria

Quarterly



Sources: ABS; RBA

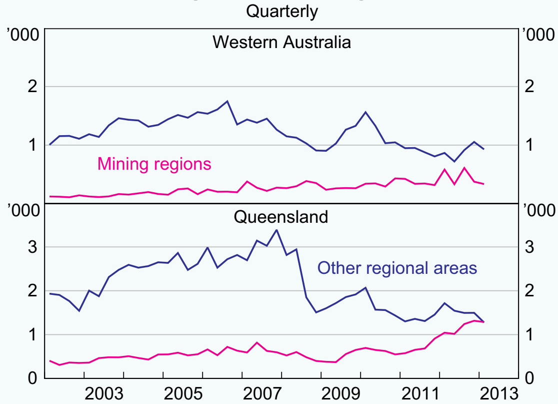
investors have been active in this market, while the availability of inner-city sites previously used for commercial property has facilitated development. In contrast, approvals for detached houses have fallen for a number of years across the state, but particularly in outer Melbourne where approvals had been at a high level. Total approvals for detached houses in Victoria are now around their lowest level in over a decade. This decline follows some demand being brought forward in 2009 and 2010 as a result of government stimulus measures that had increased assistance payments for the purchase of new dwellings. Approvals in regional Victoria, which are largely for detached houses, have also fallen to relatively low levels.

In Western Australia, the increase in dwelling approvals over the past year or so has been driven by a pick-up in approvals for detached houses in Perth, particularly in the outer regions of the city. Approvals for higher-density dwellings have also increased over the past year, although these types of dwellings make up a much smaller proportion of new housing than in the eastern states. Liaison with builders and developers suggests that the pick-up in demand for new dwellings has been primarily driven by first home buyers.

In both Western Australia and Queensland, dwelling approvals in mining regions have declined since late last year, but remain close to the historically high levels of recent years, which were in line with the large increase in employment owing to mining investment (Graph A5).

Graph A5
Private Regional Dwelling Approvals

Quarterly

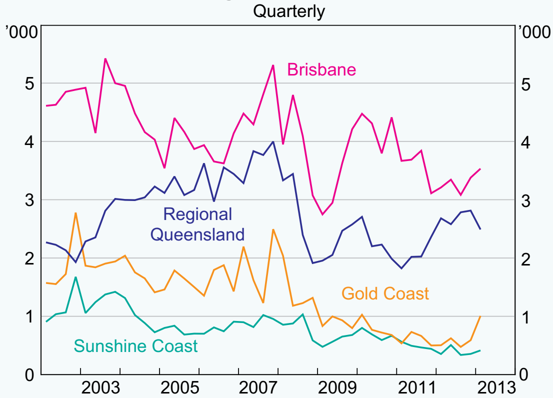


Sources: ABS; RBA

In contrast, approvals in Queensland outside of mining regions have remained subdued, despite some flood-related reconstruction activity. While approvals for Brisbane and the Gold Coast have picked up modestly, they remain weak there and for the Sunshine Coast, weighed down by subdued economic conditions (Graph A6). Despite some pick-up in recent quarters, dwelling approvals in Queensland overall have remained at low levels over the past year or so, reflecting slower population growth and the expiry of the state government's Building Boost Grant in April last year.

While approvals in South Australia have increased over the past year, they remain at low levels, with broadly similar trends in Adelaide and regional areas. Nonetheless, demand in South Australia is likely to have been supported by a shift in the focus of home buyer incentives towards new homes (particularly for first home buyers). Dwelling approvals in Tasmania have fallen over the past few years, with slowing population growth and subdued economic conditions weighing on new housing demand in that state. ✠

Graph A6
Private Dwelling Approvals – Queensland
Quarterly



Sources: ABS; RBA

4. Domestic Financial Markets

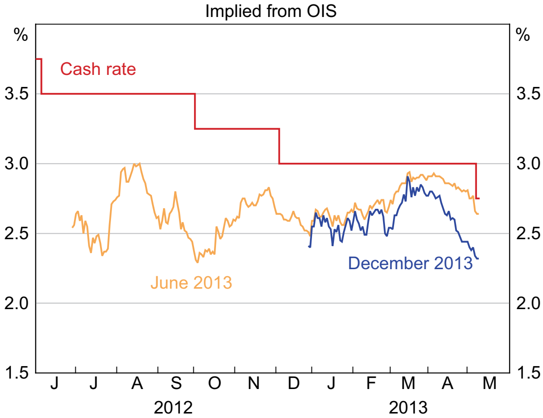
Money Markets and Bond Yields

The Reserve Bank Board reduced the target for the cash rate from 3 per cent to 2.75 per cent at its May meeting. Within financial markets, the expectation of a further easing in monetary policy had varied over the preceding months with the release of domestic and offshore economic data. Rates on overnight indexed swaps (OIS) currently imply an expectation of a reduction in the cash rate target to 2.5 per cent in the second half of the year (Graph 4.1).

Rates on 3-month bank bills and certificates of deposit (CDs), which had been largely unchanged since the previous *Statement*, declined by about 10 basis points on the easing announcement. In general, issuance of bills and CDs into the interbank market remains low, contributing to the narrow spread between these instruments and OIS rates (Graph 4.2).

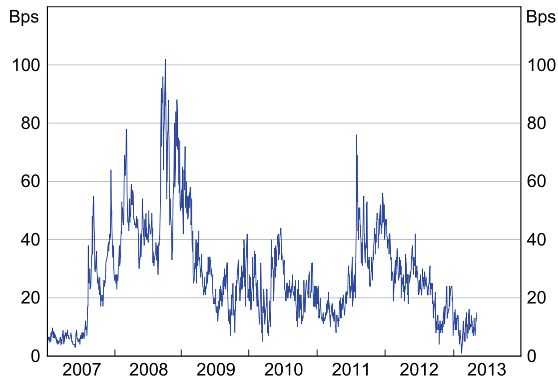
A range of positive global and domestic economic data saw long-term bond yields rise during March, with rates on 10-year Commonwealth Government securities (CGS) reaching a high of 3.70 per cent. Since that time, however, bond yields have tended to fall globally as economic data, particularly for the United States and China, have been a bit weaker than expected (Graph 4.3).

Graph 4.1
Cash Rate Expectations
Implied from OIS



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Graph 4.2
Spread of 3-month Bank Bills to OIS



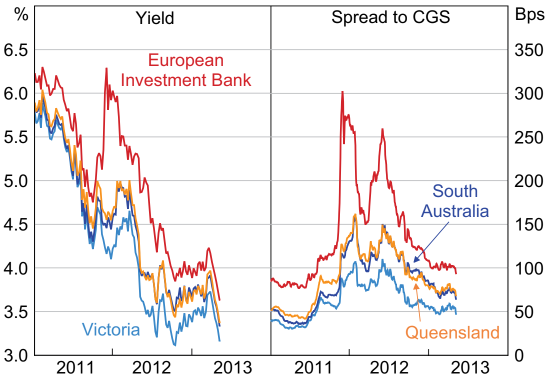
Sources: AFMA; Tullett Prebon (Australia) Pty Ltd

Graph 4.3
Australian Government Bond Yields

Source: RBA

Yields on state and territory government securities ('semis') have largely followed movements in CGS yields, with spreads little changed as a result. Issuance on behalf of the state and territory governments has remained robust since the previous *Statement*. Unlike earlier periods of heightened sovereign risk within the euro area, the events in Cyprus during March and April had little impact on spreads between CGS and other debt instruments, including semis (Graph 4.4).

Graph 4.4
5-year State Government and Supranational Debt

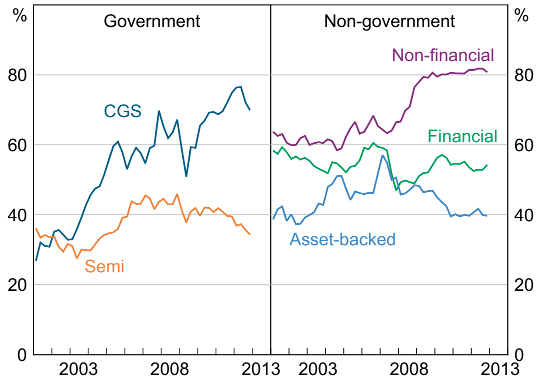


Sources: RBA; Yieldbroker

The December quarter Financial Accounts showed that foreign holdings of CGS and semis were little changed during the second half of 2012, with the bulk of the increase in government debt during that period absorbed by the domestic banks. With the stock of CGS outstanding rising over the second half of 2012, the share of CGS held by foreigners declined from a peak of 77 per cent in mid 2012, to 70 per cent in December (Graph 4.5).

Following strong activity at the start of the year, issuance of domestic bonds by non-resident entities ('Kangaroos') has totalled around $5 billion since the previous *Statement*. Secondary market spreads of these bonds to CGS have been relatively stable, while the cost of hedging Australian dollar issuance into foreign currencies has been broadly unchanged.

Graph 4.5
Foreign Ownership of Australian Bonds
Share of outstandings

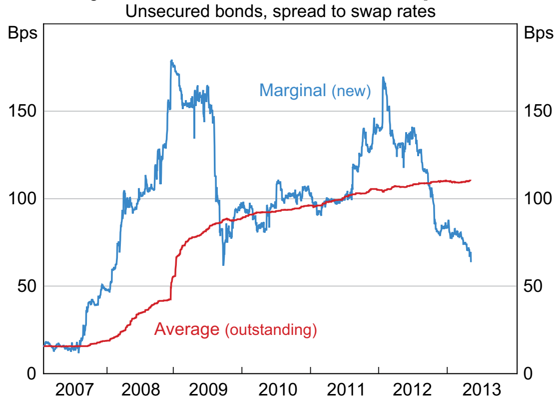


Sources: ABS; RBA

Financial Intermediaries

Average funding costs on banks' outstanding liabilities are estimated to have been broadly unchanged since early February, despite a further reduction in wholesale market spreads. To date, the fall in the cost of issuing long-term bonds has had only a limited impact on banks' outstanding long-term wholesale funding costs (Graph 4.6). This reflects the long time to maturity of the bonds, reduced issuance and the fact that a portion of the outstanding stock of debt was issued prior to the financial crisis at much lower spreads.

Graph 4.6
Major Banks' Domestic Bond Spreads
Unsecured bonds, spread to swap rates



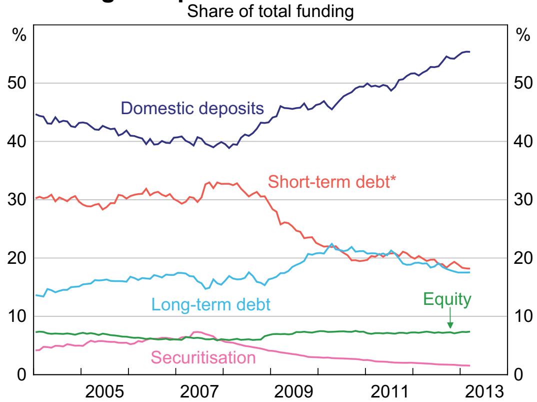
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Strong competition for deposit funding has continued over the past quarter, although a number of banks have reduced the premium offered on some term deposit 'specials'. With the banks funding new lending with deposits, the share of deposit funding has continued to increase, and deposits now account for 55 per cent of total bank funding liabilities (Graph 4.7). Since the middle of 2012, however, there has been a noticeable reallocation away from term deposits and towards at-call savings deposits (Graph 4.8). This predominantly reflects the relatively higher interest rates offered on some at-call savings accounts, particularly bonus saver accounts, compared with term deposits. Given the relatively fast repricing of these products, developments in the deposit market have a more immediate effect on overall funding costs than developments in wholesale funding markets.

A number of banks have reported an increase in underlying profit over the past few months. Although deposit costs continued to weigh on margins, most banks reported an increase in their domestic net interest margins reflecting the effects of loan repricing (Graph 4.9). Owing to the strength of their results, most banks also reported an increase in interim dividends compared with the first half of 2012. In particular, Westpac announced a one-off special dividend of 10 cents due to its strong capital position, while a number of other banks also increased the ratio of dividends to cash earnings.

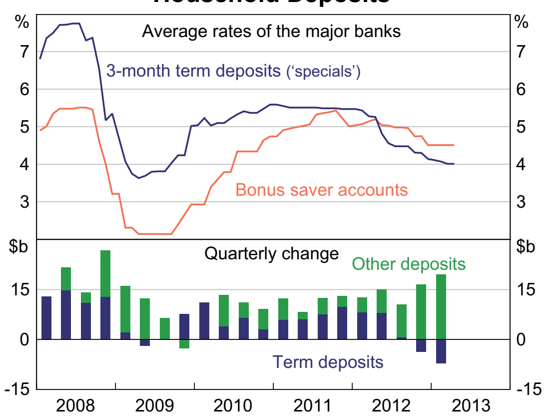
As noted previously, bond issuance by Australian banks has remained relatively subdued, reflecting their preference for deposit funding. While around $18 billion of bank bonds has been issued since the previous *Statement*, the stock of outstanding bonds has declined by $11 billion (Graph 4.10). Around two-thirds of recent bank issuance has been in offshore markets and around 75 per cent in unsecured form. Hybrid issuance by financial institutions has totalled $3.5 billion since the previous *Statement*. This includes $2.8 billion in securities that qualify as Tier 1 capital under Basel III, and $700 million in Tier 2 compliant securities.

Graph 4.7
Funding Composition of Banks in Australia
Share of total funding



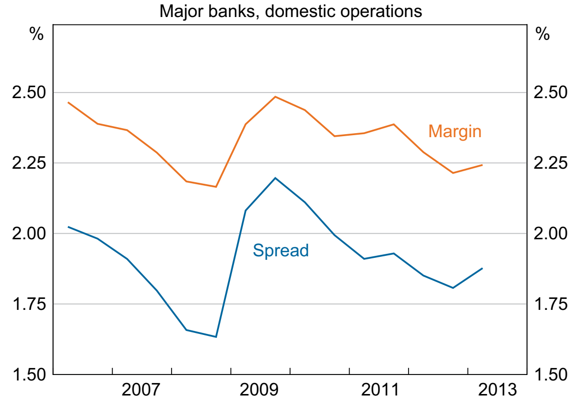
* Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.8
Household Deposits



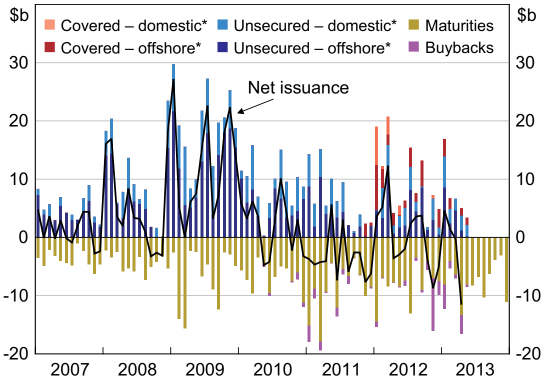
Sources: APRA; RBA

Graph 4.9
Net Interest Margin and Spread*
Major banks, domestic operations



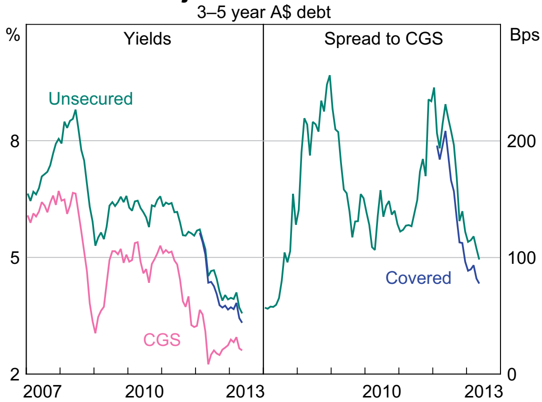
* From 2006 data are under AIFRS; margin and spread estimates based on group figures where domestic data are unavailable
Sources: RBA; banks' financial reports

Graph 4.10
Banks' Bond Issuance and Maturities
A$ equivalent



* Latest month issuance to date
Source: RBA

Graph 4.11
Major Banks' Bonds
3–5 year A$ debt



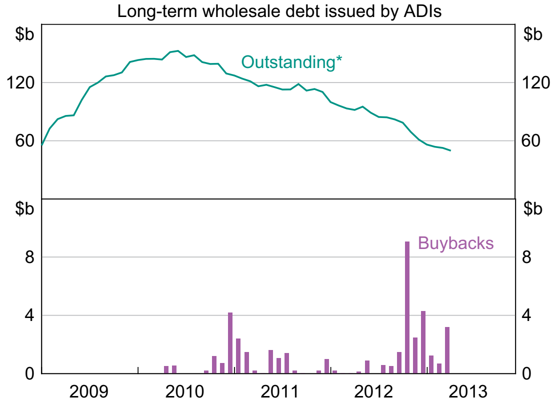
Sources: Bloomberg; RBA; UBS AG, Australia Branch

The major banks' unsecured and covered bond spreads relative to CGS have declined by 10 to 20 basis points since the previous *Statement* (Graph 4.11). Secondary market spreads are 140 basis points lower than at the peak of concerns about European sovereign debt in the middle of 2012. Unsecured spreads are now close to their lowest level since the start of the global financial crisis.

With bank spreads narrowing further, buybacks of government-guaranteed bank debt have continued in recent months, totalling $5 billion since the previous *Statement* (Graph 4.12). Suncorp-Metway, ING Direct and Macquarie Bank each recently repurchased around one-quarter to one-third of their outstanding securities. The stock of outstanding debt securities issued by banks that is guaranteed by the Australian Government has declined to below $50 billion.

There has also been a significant improvement in the market for residential mortgage-backed securities (RMBS) over recent months, with around $9 billion in new debt issued since the previous *Statement*. Around two-thirds of this issuance has been by banks, including large deals by Westpac and the Commonwealth Bank, each in excess of $2 billion. Non-bank issuers have also been active, with seven deals issued over this period, including three non-conforming RMBS. Issuance spreads on the senior RMBS tranches have declined by around 30 basis points since late last year, with the recent deals priced at the lowest spreads since the early stages of the global financial crisis (Graph 4.13). While RMBS issuance spreads have declined, the interest rate on the mortgages in the collateral pool relative to market reference rates has remained broadly unchanged. As a result, the residual income stream, net of fees, has increased to some of the highest levels on record and hence issuers, who receive this income, are finding RMBS to be a profitable source of funding.

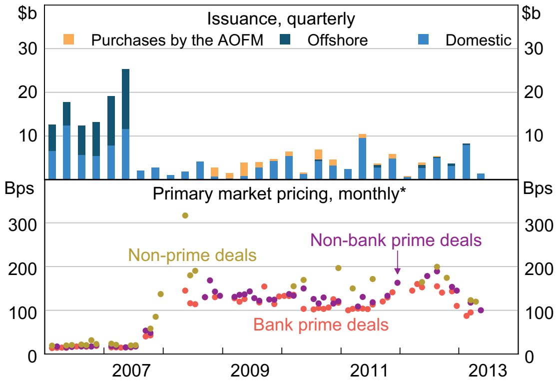
Graph 4.12
Australian Government Guaranteed Debt
Long-term wholesale debt issued by ADIs



* Adjusted for monthly exchange rate movements
Source: RBA

In response to the improvement in market conditions, in April the Australian Government announced that it will make no further purchases of RMBS through

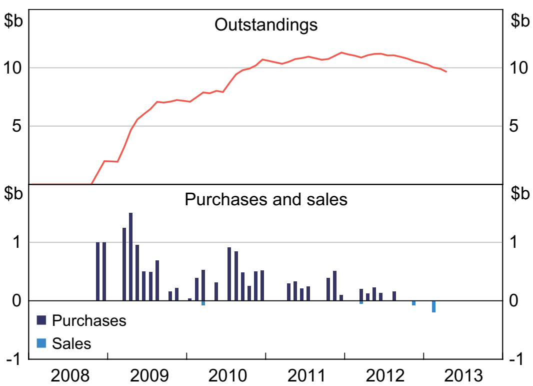
Graph 4.13
Australian RMBS



* Primary market spreads are face-value weighted monthly averages of AAA-rated RMBS
Source: RBA

the Australian Office of Financial Management (AOFM). Since the inception of its program in 2008, the AOFM has purchased a total of $15.5 billion in RMBS securities, although no purchases have been made since August 2012 owing to the improved demand from private investors (Graph 4.14). The AOFM does not intend to sell its existing stock of RMBS (currently worth $10 billion) in the near future, although it has said that it may engage in periodic sales to assist in the price discovery process. To date, the AOFM has sold $400 million of its holdings in six separate transactions.

Graph 4.14
AOFM Investment in RMBS



Sources: AOFM; RBA

In February, Moody's concluded its ratings review of 95 Australian RMBS tranches, downgrading a number of mainly non-senior tranches with a combined outstanding value of $2.3 billion (around 3 per cent of the total market). The downgrades followed the publication of Moody's revised methodology for evaluating credit support provided by lenders mortgage insurers (LMI) to Australian RMBS and the downgrade by Moody's of QBE's and Genworth's Australian LMI operations.

Household Financing

At the time this *Statement* was finalised, a significant number of lenders had announced that they will reduce their standard variable housing loan rates by 25 basis points. Interest rates on new three-year fixed-rate loans have fallen by around 10 basis points over recent months and are now at their lowest level in over two decades (Table 4.1). However, this has had little effect on the average interest rate on housing loans as variable-rate loans constitute by far the largest share of the Australian mortgage market. The average housing loan rate will be around its 2009 low when the reductions in standard variable housing loan rates become effective (Graph 4.15).

Other indicators suggest that competition for housing loan customers has increased a little. In particular, a number of banks have increased the discounts offered on certain variable-rate mortgage products by up to 30 basis points. Some lenders have either introduced or extended other measures to attract customers, including application fee waivers and cash-back offers.

The value of total housing loan approvals has increased in recent months to be around 10 per cent higher over the year (Graph 4.16). The increase in approvals over the past year has been underpinned by loans to repeat-buyer owner-occupiers and investors. In contrast, first home buyer approvals have decreased further and are yet to show signs of recovery following a number of changes to first home buyer incentives by some state governments last year, which has refocused assistance on purchases of new homes.

Despite the recent lift in loan approvals, the stock of housing credit has continued to grow at around

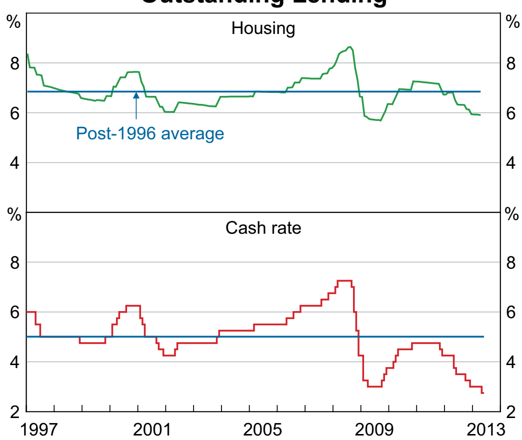
4½ per cent over the year to March. Investor credit, the smaller component of housing credit, has grown at a faster rate than owner-occupier credit. While there has been a pick-up in owner-occupier loan approvals in recent months, this increase has been driven by repeat-buyer owner-occupiers who generally need to repay an existing mortgage and therefore do not contribute as much to credit growth compared with first home buyers. In addition, households have accelerated their mortgage prepayments, which has reduced credit growth.

Table 4.1: Intermediaries' Lending Rates
Prior to the May cash rate reduction

	Level at 30 April 2013	Change since end October 2011
	Per cent	Basis points
Housing loans		
– Standard variable rate[(a)]	6.44	–135
– Package variable rate[(b)]	5.63	–140
– Fixed rate[(c)]	5.44	–108
Personal loans		
– Variable rate	11.88	–68
Small business (variable rates)		
Residentially secured, advertised		
– Term loans	7.60	–140
– Overdraft	8.47	–138
Average rate[(d)]	7.20	–143
Large business		
Average rate[(d)] (variable rate and bill funding)	5.12	–191

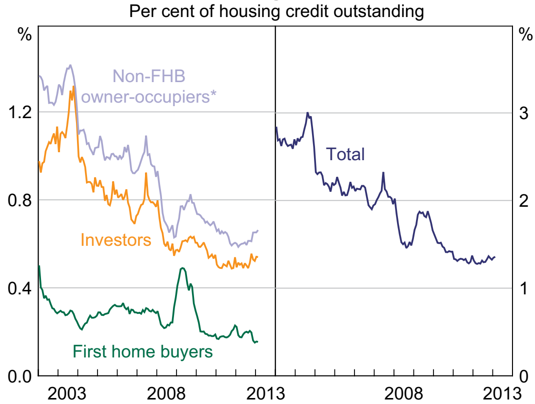
(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package variable rates on new, $250 000 full-doc loans
(c) Average of the major banks' three-year fixed rates
(d) Rates on outstanding business lending (including discounts)
Sources: ABS; APRA; RBA

Graph 4.15
Average Interest Rates on Outstanding Lending



Sources: ABS; APRA; Perpetual; RBA

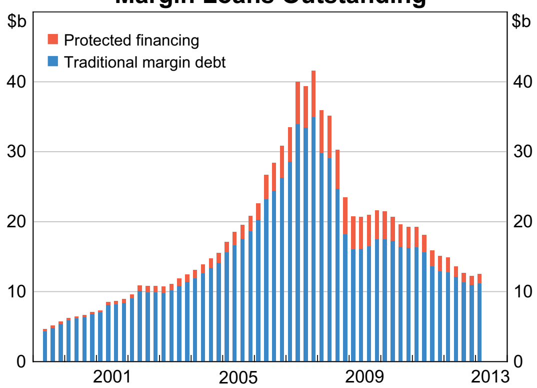
Graph 4.16
Value of Housing Loan Approvals
Per cent of housing credit outstanding



* Net of refinancing
Sources: ABS; RBA

Personal credit grew modestly over the March quarter, driven by an increase in the value of fixed-term loans and total credit card balances. Although motor vehicle sales were softer in the March quarter, some of the recent increase in the value of fixed-term loans has been due to growth in lending by car finance companies. Consistent with the improvement in equity markets over the latter part of 2012 and early 2013, preliminary data suggest that the value of margin loans outstanding increased by about 2 per cent over the March quarter, the first quarterly increase since 2009 (Graph 4.17). However, the level of margin loans outstanding remains less than one-third of its pre-crisis peak and is a very small share of the overall stock of household credit.

Graph 4.17
Margin Loans Outstanding



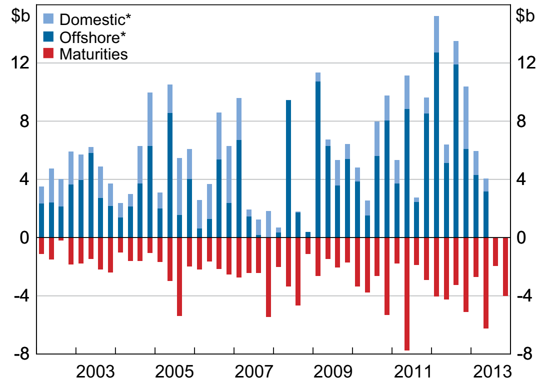
Source: RBA

Business Financing

Activity in the corporate bond market has increased, with corporates issuing $9 billion in bonds since the previous *Statement* (Graph 4.18). Around three-quarters of this issuance has been in offshore markets.

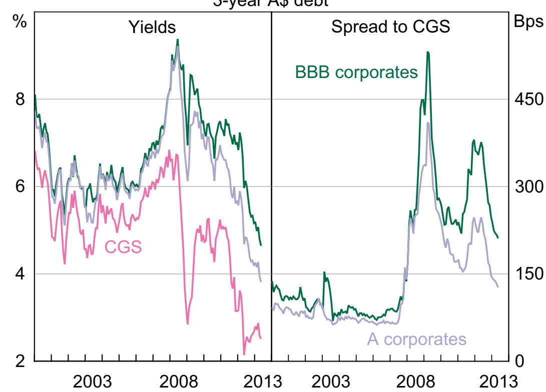
Secondary market spreads between corporate bonds and CGS have contracted by a further 20 to 30 basis points over the past three months, and are around their lowest levels since the early stages of the global financial crisis (Graph 4.19). Given the modest decline in CGS yields, corporate bond yields are at their lowest levels since at least the early 2000s.

Graph 4.18
Australian Corporates' Bond Issuance
A$ equivalent



* Latest quarter issuance to date
Source: RBA

Graph 4.19
Australian Corporates' Bond Pricing
3-year A$ debt

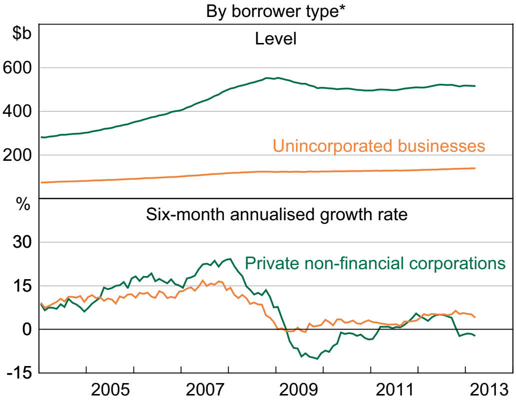


Sources: RBA; UBS AG, Australia Branch

Hybrid issuance by corporations has been subdued in recent months, totalling $600 million since the previous *Statement*. Standard & Poor's has revised its criteria for assessing the equity content of hybrid securities issued by corporates, making it more difficult for a hybrid security, particularly one with a maturity date, to be assessed as having a high level of equity.

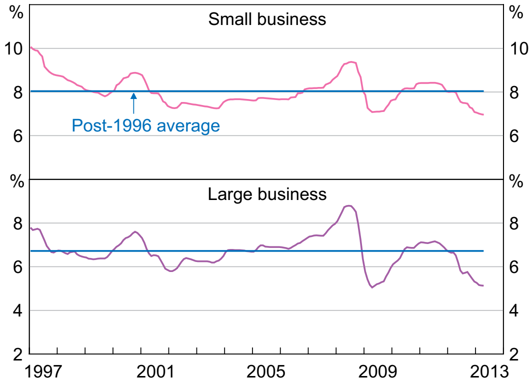
Intermediated business credit declined by 0.2 per cent over the March quarter, in part due to reduced lending to private non-financial corporations (Graph 4.20). The softness in business credit growth since mid 2012 partly reflects some substitution towards non-intermediated debt, which remains

Graph 4.20
Business Credit
By borrower type*



* Excludes securitised loans
Sources: APRA; RBA

Graph 4.21
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

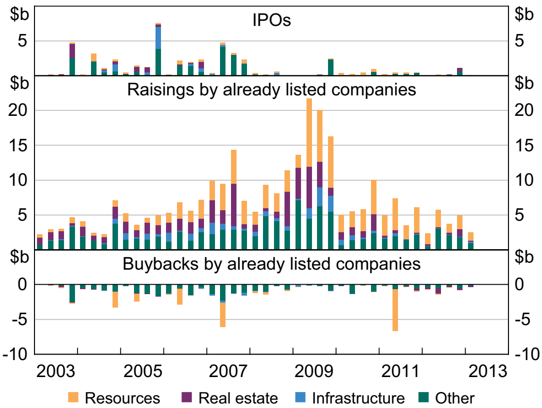
a relatively cheap source of funding for many corporations. In contrast, lending to unincorporated businesses – which tend to be smaller businesses that have limited direct access to debt markets – continued to grow modestly over the March quarter.

The value of syndicated loan approvals, which tend to be volatile and seasonal, fell significantly in the March quarter and was at its lowest level in three years. While the decline in lending was broad based, Asian banks continued to increase their share of the market, whereas lending by European banks contracted further.

The cost of intermediated business borrowing continued to decline prior to the cash rate reduction, with average interest rates on outstanding bank loans to small and large businesses falling by about 10 and 20 basis points, respectively (Graph 4.21). This largely reflected the ongoing repricing of fixed-rate and bill-financed lending. The average rates for small and large business lending remain around their April 2009 troughs.

Net equity raisings totalled $2.3 billion in the March quarter, with resource sector companies continuing to account for a reasonably large share (Graph 4.22). Initial public offerings (IPOs) accounted for less

Graph 4.22
Listed Corporates' Equity Raisings*

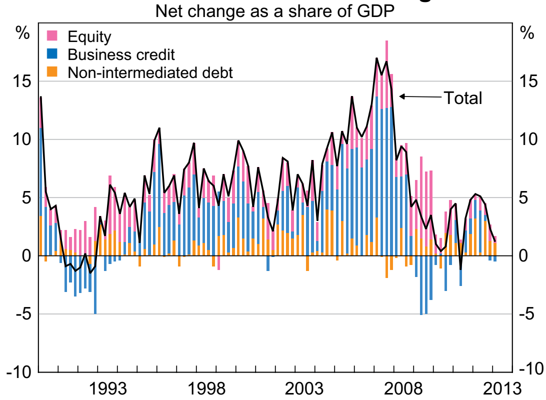


* Excludes privatisations and hybrid conversions, which are very small
Sources: ASX; RBA

than $100 million during the quarter. Merger and acquisition activity has also been limited, declining to its lowest level since the 1990s, with only $4.9 billion in transactions announced by listed corporates since the last *Statement*.

Overall, total business external funding increased by the equivalent of 1.2 per cent of GDP in the March quarter (Graph 4.23). Growth in external finance was primarily through non-intermediated debt. Intermediated debt funding contracted for the second consecutive quarter.

Graph 4.23
Business External Funding
Net change as a share of GDP

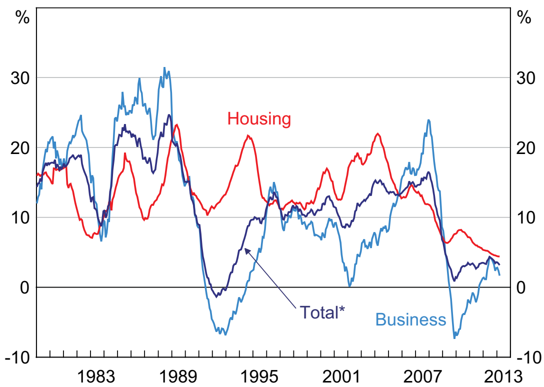


Sources: ABS; APRA; ASX; RBA

Financial Aggregates

Growth in outstanding credit slowed to an annualised rate of around 2½ per cent in the March quarter (Graph 4.24). Broad money continued to grow at a faster rate than credit. Strong inflows into saving and transaction deposit accounts were behind much of the growth in broad money, although there were modest declines in household term deposits and CDs held by non-bank institutions.

Graph 4.24
Credit Growth
Year-ended

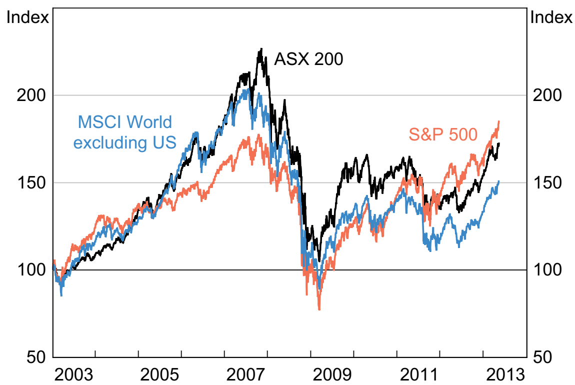


* Includes housing, personal and business credit
Source: RBA

Equity Markets

Australian equity prices have risen by around 5 per cent since the previous *Statement*, with much of the increase due to strong growth in share prices of companies in the financial sector. Bank share prices have risen by around 15 per cent over the past three months, owing to positive earnings reports, increased dividends and ongoing investor support for high-yielding equities. The Australian equity market overall has generally matched movements in developed equity markets, notwithstanding ongoing share price declines in the resources sector, which accounts for a larger share of the local market than is the case generally elsewhere (Graph 4.25).

Graph 4.25
Share Price Indices
End December 2002 = 100

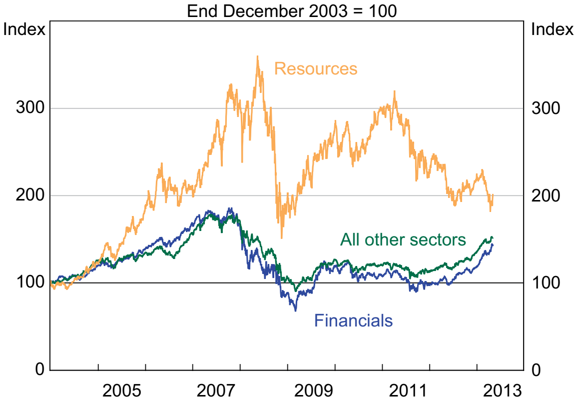


Sources: Bloomberg; Thomson Reuters

Largely reflecting declines in commodity prices, resource sector share prices have fallen by 9 per cent since the last *Statement* and are around their lowest level since early 2009 (Graph 4.26). Gold miners have significantly underperformed the rest of the market, with share prices for these companies declining by 31 per cent since the last *Statement* alongside sharp falls in precious metals prices.

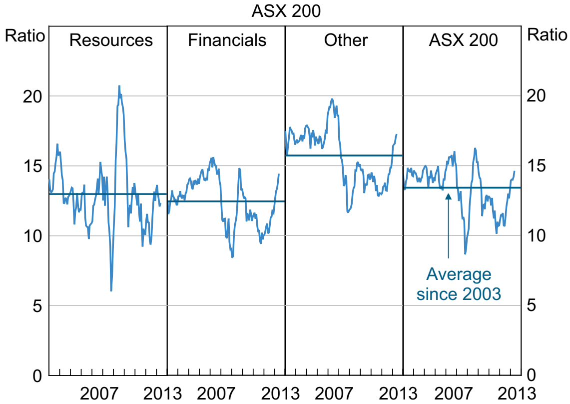
Outside of the resources sector, earnings expectations and valuations, as measured by forward price earnings (PE) ratios, have risen modestly and are slightly above their long-run averages (Graph 4.27). The forward PE ratio of the resource

Graph 4.26
Australian Share Price Indices
End December 2003 = 100



Sources: Bloomberg; RBA

Graph 4.27
Australian Forward Price-earnings Ratios
ASX 200



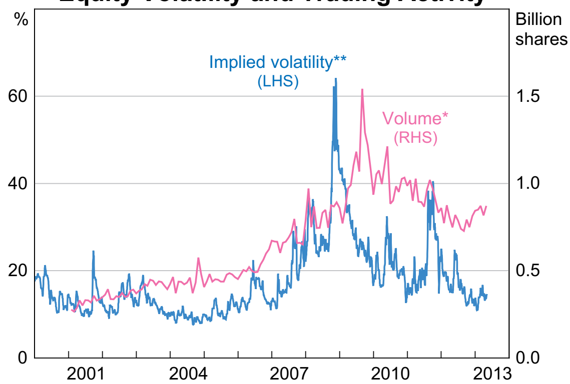
Sources: RBA; Thomson Reuters

sector has declined as the fall in share prices since January has outpaced downwardly revised earnings expectations.

The volatility of Australian equity prices has been broadly unchanged since the previous *Statement* (Graph 4.28). Trading volume in the market has continued to increase from its trough in late 2012.

Listed companies with June and December balance dates reported their December 2012 half earnings during February. Headline earnings fell by 34 per cent from the previous comparable period, mainly because of large impairment charges recorded by Rio Tinto and, to a lesser extent, BHP Billiton.

Graph 4.28
Equity Volatility and Trading Activity



* ASX 200 average daily volume per month traded on the ASX and Chi-X exchanges, seasonally adjusted

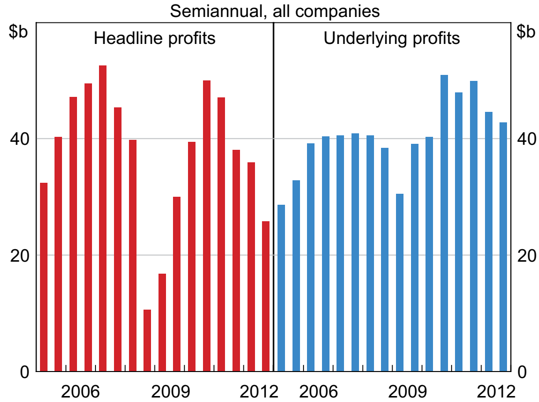
** 5-day moving average, ASX VIX from 2008, implied volatility from ASX SPI options prior to 2008

Sources: ASX; Bloomberg; RBA; Thomson Reuters

These impairments were largely in line with earlier guidance. More generally, earnings were supported by cost containment initiatives.

Aggregate underlying earnings declined by 15 per cent from the previous comparable half in December 2011 (Graph 4.29). The resources sector, whose underlying earnings fell by 38 per cent, accounted for a large share of the decline as the lower commodity prices in the second half of 2012, particularly for iron ore, weighed on revenue. Financial sector underlying earnings were stable in the December half, although more recent profit

Graph 4.29
ASX 200 Company Profits
Semiannual, all companies

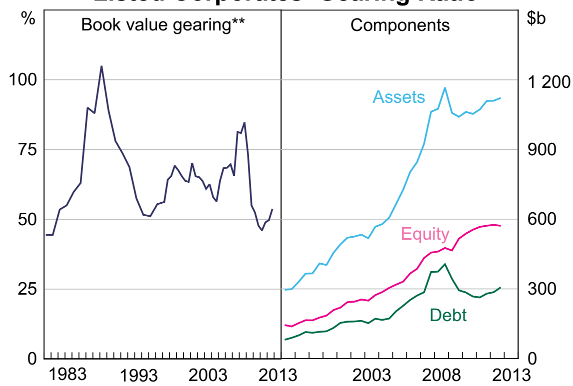


Sources: Morningstar; RBA; company reports

reports from banks have generally shown improved earnings. Diversified financial corporations and insurers also reported higher profits, although QBE was adversely affected by its exposure to natural disasters in the United States. Underlying earnings of other non-financial companies increased by 8 per cent from the previous comparable period. This was driven by the healthcare sector and the consumer staples sector where earnings rose by 18 per cent and 6 per cent, respectively. The industrial sector reported underlying profit growth of 21 per cent from the previous comparable period, driven by the completion of construction projects which had suffered earlier cost overruns. In contrast, earnings of consumer discretionary stocks fell 24 per cent as the sector contends with structural challenges.

Listed corporates' balance sheets expanded by 1 per cent in the December half 2012 (Graph 4.30). The funding mix shifted towards a higher share of debt, with total debt increasing by 8 per cent over the half. This was predominantly due to resources companies financing more of their committed capital expenditure with debt, especially bond issuance. Equity declined by 1 per cent as lower commodity prices reduced retained earnings in the resources sector and was exacerbated by Rio Tinto's asset writedowns. As a result, gross book value gearing increased by 5 percentage points to 54 per cent. Despite this increase, gross leverage remains well below its historical average. ✠

Graph 4.30
Listed Corporates' Gearing Ratio*



* Excludes foreign-domiciled companies listed on the ASX
** Data from 1997 includes real estate companies
Sources: Morningstar; RBA; Statex

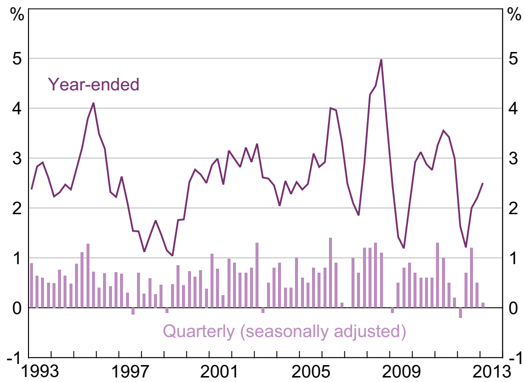
5. Price and Wage Developments

Recent Developments in Inflation

The quarterly rate of inflation slowed in the March quarter. On a seasonally adjusted basis, the consumer price index (CPI) rose by 0.1 per cent, to be 2.5 per cent higher over the year (Graph 5.1, Table 5.1). The low March quarter outcome was in part due to declines in the prices of fruit, vegetables and automotive fuel, which are relatively volatile. However, it also reflected a more broad-based decline in tradables prices, with pronounced falls in the prices of consumer durables and a range of traded food items. In contrast, new dwelling cost inflation picked up in the quarter.

Taken together, the various measures suggest that underlying inflation in the quarter was slightly lower than had been expected, at a little under ½ per cent. In year-ended terms, underlying inflation

Graph 5.1
Consumer Price Inflation*



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

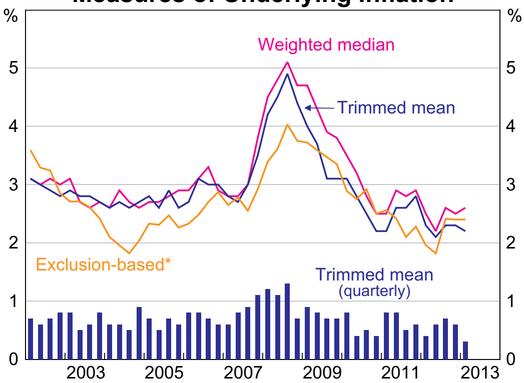
Table 5.1: Measures of Consumer Price Inflation
Per cent

	Quarterly(a)		Year-ended(b)	
	December quarter 2012	March quarter 2013	December quarter 2012	March quarter 2013
Consumer Price Index	0.2	0.4	2.2	2.5
Seasonally adjusted CPI	0.5	0.1	2.2	2.5
– Tradables	–0.2	–1.1	–0.4	–0.2
– Tradables (excl volatile items and tobacco)(c)	–0.4	–1.1	–0.7	–1.4
– Non-tradables	0.9	0.9	3.9	4.2
Selected underlying measures				
Trimmed mean	0.6	0.3	2.3	2.2
Weighted median	0.6	0.5	2.5	2.6
CPI excl volatile items(c)	0.5	0.3	2.4	2.4

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

was a little under 2½ per cent in the March quarter, unchanged from the December quarter (Graph 5.2). These outcomes are broadly consistent with earlier expectations that the introduction of the carbon price would have only a modest effect on underlying inflation, although it is not possible to identify this effect precisely (see August 2012 *Statement*).

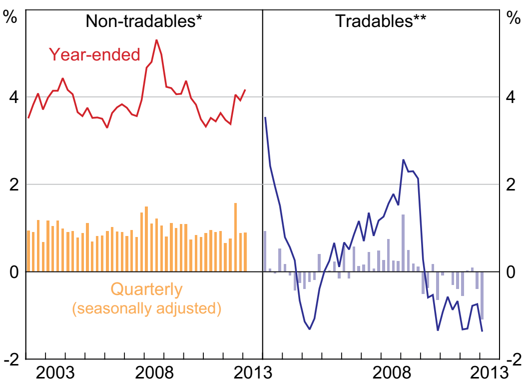
Graph 5.2
Measures of Underlying Inflation



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

The decline in tradables prices over the past couple of years has continued, despite the relative stability of the exchange rate during this period. In the March quarter, tradables prices (excluding volatile items and tobacco) declined by 1.1 per cent (Graph 5.3). The decline in tradables prices largely reflected a substantial fall in consumer durables prices (see 'Box B: The Recent Deflation in Consumer Durables Prices'). Price falls were particularly pronounced for clothing & footwear, and large declines were also recorded in the prices of motor vehicles, audio, visual & computing equipment and other household appliances. Tradable food prices also declined, with the weakness evident across a range of items.

Graph 5.3
Non-tradables and Tradables Inflation



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

Overall, food prices (excluding fruit and vegetables) declined by 0.3 per cent in the quarter, consistent with reports that supermarket competition continues to place downward pressure on prices. Notable price declines were recorded for non-alcoholic beverages and dairy products, as well as for meat & seafood products, bread & cereals and a range of packaged items. Fruit and vegetables prices declined by 5.3 per cent in the quarter; to date, the floods in early 2013 in agricultural regions of Queensland and northern New South Wales appear to have had little effect on fresh food prices.

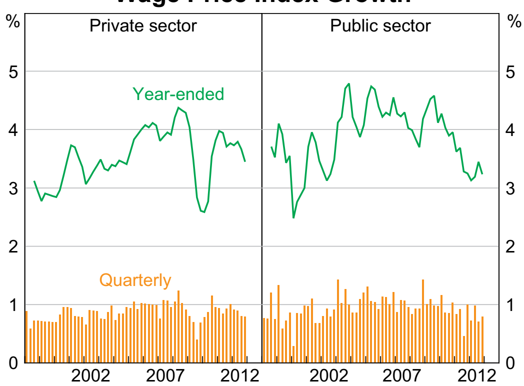
Quarterly inflation in the prices of non-tradable goods and services remained slightly above its average pace over the inflation-targeting period. Non-tradables inflation in the March quarter was 0.9 per cent, with a pick-up in housing inflation offset by softer outcomes for market services and non-traded food items. The increase in housing inflation was driven by a sharper increase in new dwelling costs than might ordinarily be associated with the moderate upturn in housing activity, with a particularly large rise recorded in Melbourne. In contrast, inflation in rents and utilities prices eased in the quarter, with electricity price inflation in some cities lower than the March quarter increases of previous years. Inflation for a range of market services also eased in the quarter, including a slowing in insurance & financial services inflation.

Costs

The pace of wage growth was little changed in the December quarter and in line with the relatively subdued conditions in the labour market observed since the middle of last year.

The wage price index rose by 0.8 per cent in the December quarter, to be 3.4 per cent higher over the year. Private sector wages grew at a below-average pace in the second half of 2012, consistent with information on wages coming from business surveys and the Bank's liaison with firms (Graph 5.4). Public sector wage growth in the December quarter also remained below its average of the past decade or so. Fiscal restraint continues to keep public sector wages contained, with year-ended growth in public sector wages near or below 3 per cent in all states except Western Australia.

Graph 5.4
Wage Price Index Growth



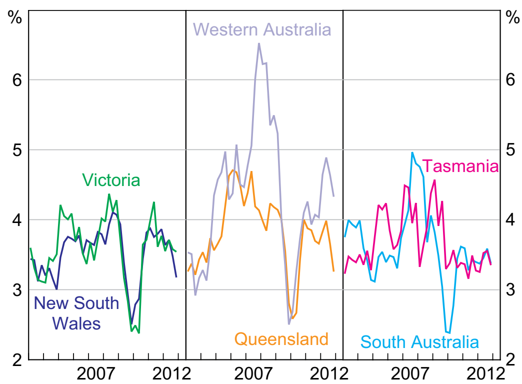
Source: ABS

Data from business surveys suggest that wage growth has remained steady in early 2013 at a below-average pace, and that shortages of labour have not been widespread. Liaison with firms also suggests that wage pressures remained moderate in the March quarter, with skills shortages easing in the resources sector in particular.

The year-ended pace of wage growth eased in most industries over 2012. Following relatively strong growth over most of 2011 and 2012, wage growth in industries such as professional services and wholesale trade appears to have softened more recently. Wage growth has eased further or remained at low levels in industries more directly exposed to consumer demand, such as retail trade and accommodation & food services.

The easing in private sector wage growth over 2012 was also broadly based across the states (Graph 5.5). While wage growth in Western Australia remains higher than in the other states, it has declined noticeably over the past two quarters, consistent with an easing in labour demand associated with resource and resource-related activity. Wage growth in Queensland has also fallen sharply over this period, reflecting the relatively soft labour market conditions in that state over 2012. Wage growth is reported to have slowed in New South Wales, while it has remained relatively steady in the other states.

Graph 5.5
Private Wage Price Index Growth by State
Year-ended



Source: ABS

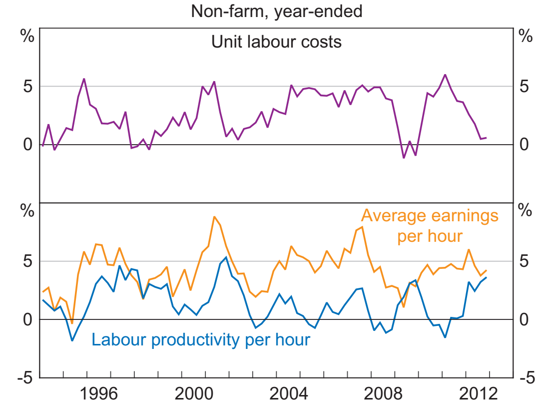
Despite a pick-up in the December quarter, growth in unit labour costs remained relatively slow over 2012, reflecting continued strong growth in labour productivity (Graph 5.6). Measured non-farm labour productivity growth over 2012 was well above its average of the past 20 years.

Producer price data suggest that domestic inflation pressures were modest across all stages of production over the year to the March quarter.

ABS data indicate that the number of working days lost per employee as a result of industrial disputes in the December quarter fell back to a very low level

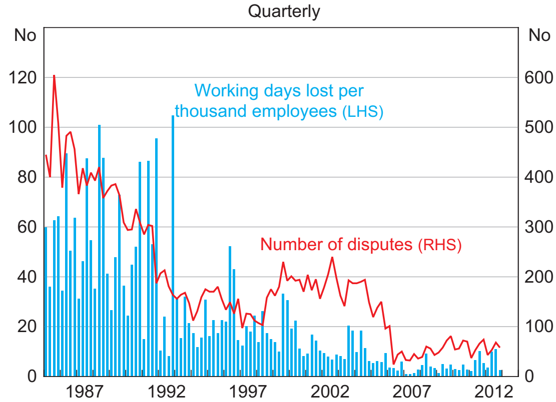
(Graph 5.7). The fall in the quarter mostly reflected a reduction in the average number of employees involved per dispute and the average duration of disputes, while the decline in the number of disputes was more modest. The number of working days lost fell in most industries.

Graph 5.6
Unit Labour Costs Growth
Non-farm, year-ended



Sources: ABS; RBA

Graph 5.7
Industrial Disputes
Quarterly

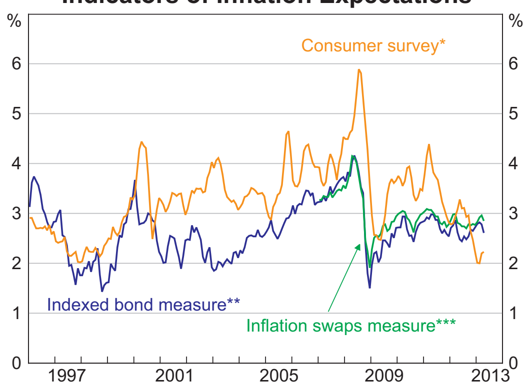


Source: ABS

Inflation Expectations

Measures of inflation expectations remain consistent with the inflation target (Graph 5.8). Since the February *Statement*, market economists have revised down their expectations for inflation over 2013, largely reflecting the low outcome in the March quarter, while union officials' forecasts for inflation over 2014 have increased a little (Table 5.2). Financial market measures of inflation expectations are slightly below their historical average levels. The Melbourne Institute's measure of consumer inflation expectations, which tends to be volatile, remains low compared with its history.

Graph 5.8
Indicators of Inflation Expectations



* Three-month moving average of the trimmed mean expectation of inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
*** Expectations of average annual inflation over the next 10 years
Sources: Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA

Table 5.2: Median Inflation Expectations
Per cent

	Year to December 2013			Year to December 2014	
	November 2012	February 2013	May 2013	February 2013	May 2013
Market economists	2.6	2.6	2.3	2.7	2.7
Union officials(a)	2.5	2.5	2.5	2.5	2.8

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

Box B

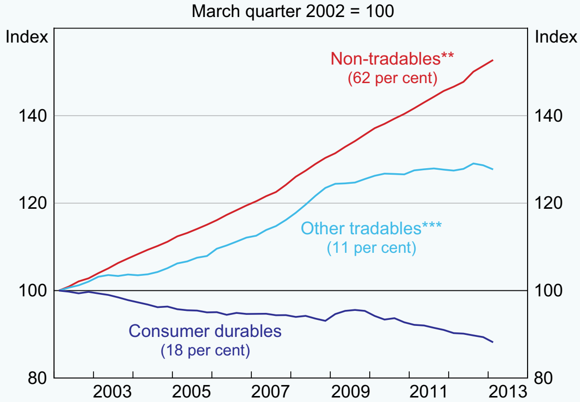
The Recent Deflation in Consumer Durables Prices

Durable goods are a large component of the Consumer Price Index (CPI), accounting for nearly one-fifth of the CPI basket. Since 2010, the prices of these goods have fallen by around 5 per cent, which has contributed to the weakness in tradables prices observed over this period; inflation in the prices of other tradables has also moderated over recent years (Graph B1). As consumer durables are typically either imported or exposed to import competition, exchange rate movements tend to be a significant driver of their domestic retail prices. Much of the deflation in consumer durables prices over the 2000s can be explained by the appreciation of the exchange rate over that period.[1] However, while the exchange rate has been at a high level, it has not appreciated significantly over the past two years. So the deflation in consumer durables prices over this period does not appear to be directly attributable to exchange rate movements.

Changes in the exchange rate affect retail prices of traded items in two stages. First, exchange rate movements have a direct effect on the Australian dollar price of imports as measured when they arrive in the country (i.e. 'across the docks'). Second, changes in the prices of imported goods affect the retail prices paid by consumers.

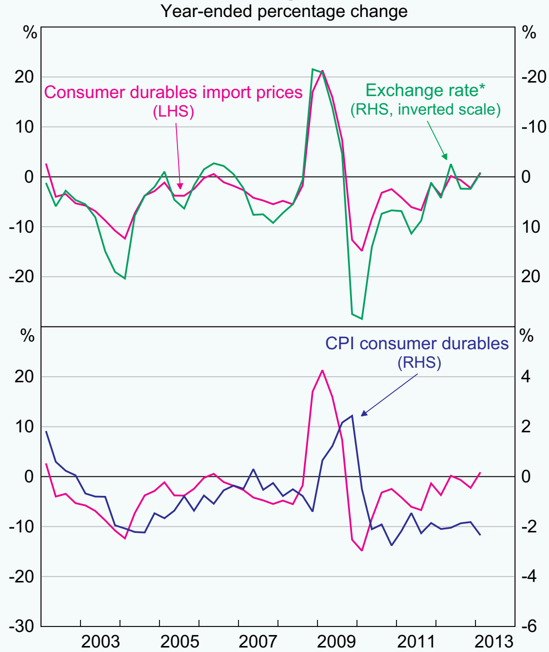
In recent years, prices at the first stage appear to have been consistent with historical behaviour, with both the exchange rate and import prices remaining relatively stable (Graph B2). Rather, it is

Graph B1
Consumer Prices*
March quarter 2002 = 100



* CPI effective weights as at March quarter 2013 shown in brackets
** Excluding deposit & loan facilities to June 2011
*** Excluding volatile items (fruit, vegetables and automotive fuel) and tobacco
Sources: ABS; RBA

Graph B2
Consumer Durables Prices and the Exchange Rate
Year-ended percentage change



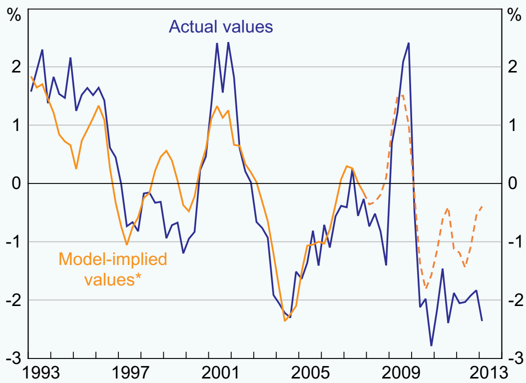
* Import-weighted index
Sources: ABS; RBA

1 For empirical estimates, see Chung E, M Kohler and C Lewis (2011), 'The Exchange Rate and Consumer Prices', RBA *Bulletin*, September, pp 9–16.

the second stage of the relationship that appears to have deviated from historical norms, with retail price deflation continuing for an unusually long period beyond the stabilisation of import prices.

A number of factors aside from import prices can affect the retail prices of traded goods, including domestic costs and margins that influence the prices facing consumers. However, even when account is taken of changes in domestic labour costs and productivity, the recent decline in consumer durables prices has been more pronounced than that implied by estimates based on historical relationships (Graph B3).[2] This suggests that the recent decline in consumer durables prices has been due to other factors that contribute to retail prices, such as the non-labour costs of doing business and margins earned by retailers, wholesalers and domestic producers. This is consistent with the Bank's liaison, which suggests that these factors have had an important role in explaining the fall in consumer durables prices in recent years.[3]

Graph B3
Consumer Durables Price Inflation
Year-ended



* The model is estimated from 1990:Q1 to 2007:Q4; model-implied values, using actual data for the independent variables (unit labour costs, import prices and inflation expectations), are shown from 2008:Q1 to 2013:Q1

Sources: ABS; RBA

Declines in the prices of household electrical items have made a particularly large contribution to the recent deflation in consumer durables (Graph B4). There has been rapid deflation of import prices for these goods for some time because of the earlier appreciation of the exchange rate and ongoing improvements in technology.[4] However, the rate of deflation in the retail prices of household electrical items has been greater than that implied by the historical relationship between the retail prices and the import prices of these goods. Changes in import prices typically lead to substantially smaller changes in the prices paid by consumers because of the domestic costs in final prices. Even so, over the past two years, the average rate of deflation in the consumer prices of these items has been greater than the average rate of import price deflation. This has also been the case for a number of other consumer durables such as toys, books & leisure goods and motor vehicles & parts. Similarly, for some items, such as furniture and textiles, clothing & footwear, consumer prices have declined or remained flat while import prices have risen.

There are a number of possible explanations for the apparent shift in the relationship between the import prices and the retail prices of these goods, most of which are not easy to gauge. In particular, liaison with businesses suggests that competitive pressures have been particularly pronounced in the past few years, which may in turn be partly attributable to the increasing presence of online vendors, based in Australia and overseas. One possibility is that retailers have responded by seeking to improve efficiency, for instance by streamlining distribution,

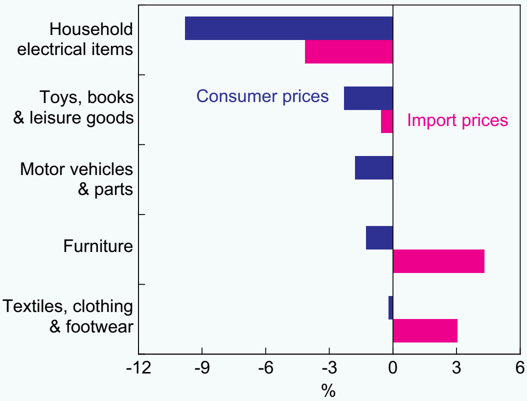
2 One way of controlling for these influences is to use a mark-up modelling framework. In Graph B3, consumer durables prices are modelled as a mark-up over costs, which include unit labour costs (average labour costs per unit of output) as well as import prices (see Chung *et al* (2011)). As illustrated, there have been other episodes in the past where consumer durables price inflation deviated from such models.

3 For details on the role of costs and margins, see D'Arcy P, D Norman and S Shan (2012), 'Costs and Margins in the Retail Supply Chain', RBA *Bulletin*, June, pp 13–22.

4 As the import and consumer price series are quality adjusted, quality improvements in household electrical items reduce the measured growth in their prices.

negotiating lower rents, or cutting other overheads. These pressures may have also led to declines in the margins earned by retailers, as well as producers and distributors of goods and services further up the domestic supply chain. ✠

Graph B4
Consumer Durables Price Inflation
Average annualised inflation since March quarter 2011



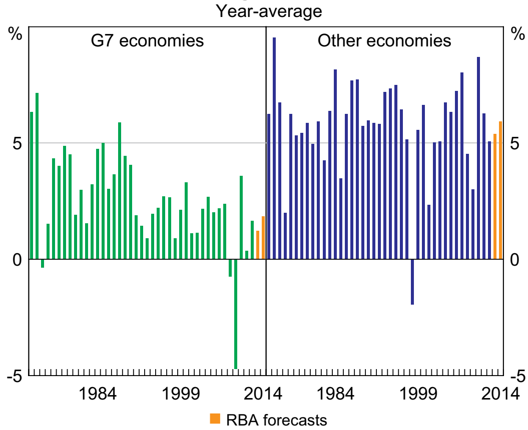
Sources: ABS; RBA

6. Economic Outlook

The International Economy

The overall outlook for growth of Australia's major trading partners (MTP) is little changed from the February *Statement*, despite changes for some individual countries. MTP growth is expected to remain close to its decade average of around 4 per cent in 2013 and then pick up through 2014, to 4½ per cent (Graph 6.1). These forecasts are broadly similar to those published by other forecasters.

Graph 6.1
Australia's Trading Partner GDP Growth*
Year-average

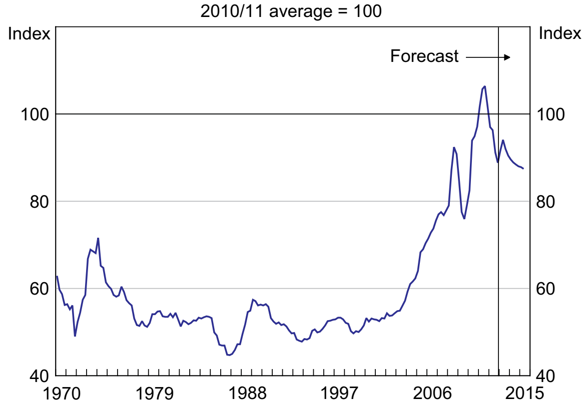


* Weighted using Australian export shares
Sources: ABS; CEIC; RBA; Thomson Reuters

By country, an upward revision to the outlook for Japan following recent policy changes has been largely offset by slightly lower-than-expected growth in the March quarter in China. Despite the slower growth in the quarter, over the forecast period growth in China is expected to average around the rates seen over the second half of 2012. The improvement in Indian growth looks set to be sustained, although growth is not expected to be as strong as it was in the December quarter 2012. The outlook for growth in east Asia is largely unchanged. Growth is forecast to pick up gradually in the United States, supported by gradual improvements in the labour market, an easing in the pace of fiscal tightening and rising household wealth. Conditions in the euro area are expected to remain weak in 2013.

The terms of trade are estimated to have picked up in the March quarter and are likely to rise again in the June quarter, but are then forecast to resume their decline as the global supply of bulk commodities increases (Graph 6.2). Although the profile is similar to that expected in the February *Statement*, the increase in the first half of 2013 is slightly stronger than was previously forecast, as iron ore prices at the start of the year remained at a relatively high level for longer than had been anticipated. Further out, the forecast for the terms of trade has been lowered a little.

Graph 6.2
Terms of Trade
2010/11 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed, as usual. The exchange rate is assumed to remain at its current level over the forecast period (A$ at US$1.02 and the TWI at 77, which is little changed from the February *Statement*). The forecasts are based on the price for Brent oil remaining at US$103 per barrel, lower than the assumption in February. The cash rate is assumed to be unchanged over the rest of the forecast period at 2.75 per cent. (This profile is slightly higher than market expectations, which currently imply a further reduction in the cash rate over 2013.) Given this low level of the cash rate, variable borrowing rates are around their lows in 2009. Finally, the forecasts assume that annual growth in the working-age population will pick up gradually to 1.8 per cent over the forecast horizon, slightly higher than was the case in the previous *Statement*, reflecting the recent increase in the rate of net immigration and forecasts by the Department of Immigration and Citizenship.

The Australian economy expanded at an around trend pace over 2012, although growth was slower in the second half of the year than in the first. Consumer spending looks to have increased relatively strongly in the March quarter, following slow growth in the second half of last year. This is consistent with the rise in asset prices and more positive consumer sentiment despite the labour market remaining somewhat subdued. Dwelling investment has started to recover in recent quarters and this is likely to have continued in the March quarter. At the same time, however, mining investment, though still at a high level, is likely to have grown more slowly as the peak in investment approaches. Also, surveys suggest that business conditions and capacity utilisation generally remained a little below long-run averages in the early part of this year, and non-mining investment is expected to have grown only modestly. Import volumes fell in the quarter, driven by lower imports of capital goods. Exports growth slowed a little in the March quarter following strong growth in the December quarter. Public final demand, as measured in the national accounts, fell sharply in the second half of 2012, and is likely to experience only very moderate growth over the forecast horizon given the fiscal consolidation underway.

GDP growth is expected to be a bit below trend at around 2½ per cent over 2013, before picking up to an around trend pace (Table 6.1). Overall, the subdued outlook over the next year or so continues to reflect the approaching peak in mining investment, ongoing fiscal consolidation and the high level of the Australian dollar. These forecasts are essentially unchanged since the February *Statement* and are broadly in line with those published by Consensus Economics.

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

	Year-ended					
	Dec 2012	June 2013	Dec 2013	June 2014	Dec 2014	June 2015
GDP growth	3.1	2½	2½	2–3	2½–3½	2½–4
Non-farm GDP growth	3.4	2¾	2½	2–3	2½–3½	2½–4
CPI inflation	2.2	2¼	2	2–3	2–3	2–3
Underlying inflation	2½	2¼	2¼	2–3	2–3	2–3
	Year-average					
	2012	2012/13	2013	2013/14	2014	2014/15
GDP growth	3.6	3	2¾	2–3	2¼–3¼	2½–3½

(a) Technical assumptions include A$ at US$1.02, TWI at 77 and Brent crude oil price at US$103 per barrel
Sources: ABS; RBA

The forecast for consumption spending has been revised a little higher since the February *Statement*, as the prospects for household demand appear slightly more positive. Retail sales have increased strongly over recent months and measures of consumer sentiment have been above average. Conditions and confidence in the established housing market have continued to improve, pointing to further growth in household wealth, while recent strong growth in both housing and personal loan approvals may provide some additional impetus to spending. In contrast, moderate employment growth in the near term and slower growth in wages than in recent years is expected to continue to restrain growth in labour income. Over the next couple of years, consumption spending is expected to grow at around its long-run average pace, broadly in line with real income growth. The forecast of continuing recovery in residential construction investment reflects lower interest rates, rising rental yields and the improvement in conditions in the established housing market having created a more favourable environment for investment.

The contribution to growth from net external trade has also been revised higher from three months ago. Notwithstanding little change to forecast growth in aggregate domestic spending, growth in imports is expected to continue to be somewhat softer than earlier expected. At the same time, the outlook for exports remains strong. Given the significant investment that has occurred to date, and that is still in the pipeline, the Bureau of Resources and Energy Economics expects bulk commodity exports to increase at an annual rate of around 10 per cent over the next six years. The increase in liquefied natural gas (LNG) exports is particularly large, and LNG is expected to account for almost one-fifth of resource exports by 2017/18, up from 6 per cent currently. The increase in exports is expected to be supported by continued demand from China and other developing economies. With infrastructure needs in China remaining large – including to accommodate the growing high-density urban population – steel consumption is likely to continue to grow, albeit a good deal more slowly than in the past decade. However, given the substantial increase in the size of the Chinese economy, the lower growth rate of the economy (compared with the past) can still generate a large increase in the demand for steel.

In the case of business investment outside the resources sector, the most recent ABS Capital Expenditure Survey suggested that there would be modest growth in 2013/14. For machinery and equipment investment, forecasts have been reduced given the continued weakness in a number of indicators of near-term investment. Notably, business surveys remain below average while business funding and capital imports have been subdued. Forecasts for investment in non-residential building have been revised up a little in the near term, reflecting a reassessment of the flow-through to investment from the large healthcare projects approved in early 2012. Despite this, the forecast for growth of non-residential building investment has been lowered further out in the period, as approvals remain at low levels and there are few signs that conditions in the office property market are improving. Nevertheless, the continued growth in consumer spending and above-average population growth are likely to support investment growth over the medium term.

The outlook for engineering investment is little changed from the February *Statement*, with continuing high levels of mining investment. The profile of projects that underlie this outlook has not changed significantly, as projects recently shelved had already been judged unlikely to proceed in the February forecasts. Survey data indicate that capital expenditure in 2013/14 will remain at a high level. With little change to the engineering investment forecast, mining investment is still expected to be close to its peak and is likely to remain elevated for some time, reflecting the large stock of projects already committed. Beyond the end of the forecast period, there is little conclusive information about probable or possible projects, but it is likely that mining investment will decline.

Growth in public demand is expected to be subdued over the next two years or so, as fiscal consolidation at both the state and federal levels is assumed to continue. The outlook for public demand is a little softer than at the time of the February *Statement* (although some rebound in the first half of 2013 is possible given the unusually sharp fall recorded in the second half of last year).

Conditions in the labour market remain somewhat subdued in line with the previous outlook. As usual, conditions differ across sectors. There have been some tentative signs of a firming in labour demand in the construction industry since mid last year as the outlook for residential building activity has improved, while demand in the resources sector, and some other sectors, has weakened. Overall, leading indicators of employment have been somewhat mixed and, while a number of the measures have stabilised after declines last year, they remain at relatively low levels. With firms more focused on seeking productivity gains, employment growth is expected to be moderate in the near term. The unemployment rate is expected to continue drifting higher until mid next year; thereafter, a return to trend output growth is expected to support an improvement in conditions.

The lower growth of wages over recent quarters has become a little more widespread across industries. Wage growth in the public sector has been modest for some time now. With the unemployment rate having risen over the past year and further increases anticipated, wage growth is expected to remain moderate at 3¼ per cent over the forecast period.

Inflation

The outlook for inflation is a little softer in the near term than the forecasts published in the February *Statement*. To a large extent, this reflects that underlying inflation in the March quarter was a bit lower than expected, at a little under ½ per cent in the quarter, and a little under 2½ per cent over the year. The year-ended rate of underlying inflation is expected to ease a little in the near term, before returning to around the middle of the target range for the remainder of the forecast period.

Tradable items in the CPI have continued to experience deflation in recent quarters, with a particularly large price fall in the March quarter, notably for consumer durable goods (see 'Box B: The Recent Deflation in Consumer Durables Prices'). This deflation has occurred despite the exchange rate having been stable for some time now and appears to reflect declines in the domestic component of these prices. The pace of deflation in these goods is expected to slow over the forecast period, albeit by slightly less than was previously assumed given the apparent pressure on reducing domestic costs and margins in recent quarters. Non-tradables inflation has been a bit above the average of the inflation-targeting era, though it appears that this largely reflects the temporary impact from major policy measures, including the introduction of the carbon price. The forecasts anticipate that domestically generated inflation pressures will remain contained as the labour market remains somewhat subdued in the near term.

The profile for headline inflation will be affected by a number of one-off factors in the first half of the forecast period. Year-ended headline inflation is expected to remain slightly above underlying inflation in the June quarter, largely because of the effects of the introduction of the carbon price on utilities prices last year. Once these effects pass, headline inflation is expected to fall temporarily below underlying inflation, reflecting recent falls in fruit and vegetables prices.

Risks

Overall, the risks to the international outlook appear to be broadly as they were at the time of the February *Statement*, that is, roughly balanced across most economies, but still tilted to the downside in Europe. In particular, in the euro area current conditions remain fragile and so the anticipated recovery later in the year could fail to materialise. While spillovers from recent banking problems have been minimal, the downside risk remains that banking and fiscal problems could escalate and spread further within the region.

In the United States, there is still much to be resolved around fiscal policy and government spending, and thus a degree of uncertainty remains. If the downside risks from fiscal policy were realised, this could break the building momentum of the US economy's recovery. However, if these risks do not materialise, it is possible that growth could accelerate given the progress of balance sheet repair in the private sector and the expansionary stance of monetary policy.

The policy actions announced in Japan since the election in December have led to upward revisions to forecasters' outlook for the economy. But very little is known at this stage about how effective the policies are going to be in stimulating real output growth and achieving the new inflation target.

Developments in the Chinese economy have added to the challenges of macroeconomic management that exist in a rapidly developing and evolving economy. The fast pace of credit growth in the March quarter has led to heightened medium-term concerns about the nature and distribution of borrowing. Adding to the challenges is the recent increase in house price appreciation, although affordability concerns may lead to a larger social housing program to alleviate supply issues, which could boost demand for resources.

The forecasts for the Australian economy continue to embody a gradual shift in growth from mining investment towards exports, non-mining business investment and household spending. While there are signs that this rebalancing is beginning, there remains considerable uncertainty about how it will proceed. In particular, there remains a large degree of uncertainty surrounding the exact profile for mining investment, especially given the general caution in the industry and continued focus on reducing costs. For non-mining business investment, the recent ABS data on firms' capital expenditure plans for 2013/14 were positive. Nevertheless, other, near-term indicators of investment remain subdued, despite conditions generally being favourable for investment overall.

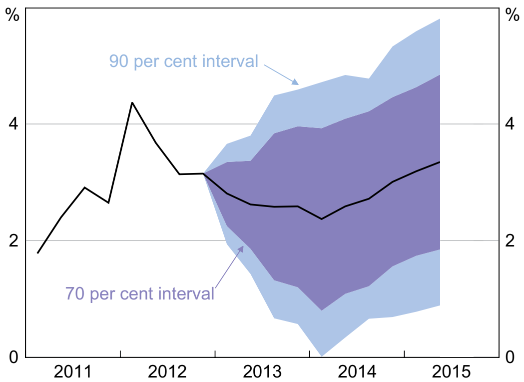
In the household sector, a key risk is that established dwelling prices rise more quickly than assumed, spurred by low interest rates. The associated boost to wealth and sentiment could in time generate stronger-than-expected consumption growth. If this were accompanied by a return to increasing household leverage, it would raise concerns from a financial stability perspective. But given the outlook for relatively subdued growth in employment and so for moderate wage inflation, it is possible that growth in labour income and spending could be weaker than currently envisaged. While the preconditions for an ongoing recovery in dwelling investment remain in place, there remains uncertainty about the breadth and strength of such a recovery.

Considerable uncertainty remains around the outlook for public spending given weaker-than-expected revenue and the fiscal consolidation at a state and federal level. The possibility of policy changes over the course of the year adds to the uncertainty.

Inflation could turn out to be lower than forecast if the labour market was to weaken more than anticipated, and wages were to prove more responsive to this than they have been to date. The sustained high level of the exchange rate may have a longer-lasting effect on pricing behaviour than the historical experience suggests, especially as firms remain focused on cost reductions and seeking efficiency gains. Indeed, the slowing in inflation to date has been in tradable goods and services, while non-tradables inflation, which tends to be less variable, has remained at a higher rate. Some moderation of non-tradables inflation will be required for aggregate inflation to remain in line with the forecasts if the disinflationary pressures on the price of tradable items wane, especially if the exchange rate depreciated significantly. Moreover, somewhat subdued conditions in the labour market over the past year appear to have been borne in part by a fall in the participation rate. If this fall in participation were to prove more permanent than expected, then the anticipated recovery in activity could meet with less spare capacity in the labour market than expected, resulting in a build-up of wage and inflationary pressures later in the forecast period.

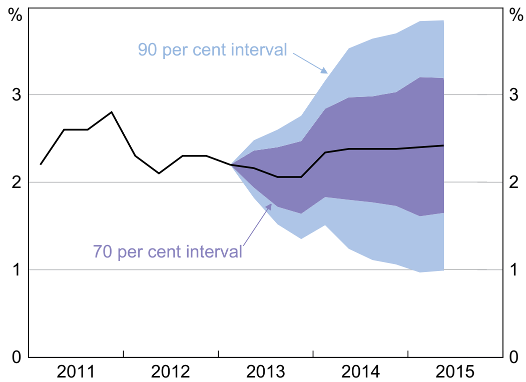
These identified, and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented. Confidence intervals based on historical forecast errors provide one way of gauging the uncertainty surrounding the GDP and inflation forecasts (Graph 6.3 and Graph 6.4).[1] ✠

Graph 6.3
GDP Growth Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

1 This is based on recent Bank research; see Tulip P and S Wallace (2012), 'Estimates of Uncertainty around the RBA's Forecasts', RBA Research Discussion Paper No 2012-07 and RBA (2013), 'Box E: Forecast Confidence Intervals', *Statement on Monetary Policy*, February, p 68, for further details.