STATEMENT ON MONETARY POLICY

The Australian economy has performed strongly in the recent period, with favourable outcomes being recorded on several fronts. Output growth has picked up and this has been accompanied by continued strength in incomes and falling unemployment. At the same time, despite high levels of capacity utilisation and tight labour market conditions, there has been some moderation in underlying inflation.

These developments have taken place against a background of continued strength in the global economy. Most expectations are that growth of the world economy this year will again be above average, though a little below last year's pace. The US economy is now in a period of more moderate growth, with activity being dampened by a downturn in the housing sector. There remain uncertainties over the US outlook, particularly relating to developments in the sub-prime mortgage market, but the indications to date are that the spillover from the housing downturn has been limited. In other parts of the world, conditions have generally remained strong. China's rapid growth has continued, with the pace increasing further in the March quarter. The euro area is now recording its fastest growth for some time and the Japanese expansion is proceeding at a good pace, though growth in other parts of east Asia seems to have eased recently.

The global expansion has provided continued support to international commodity prices. Oil prices have firmed over recent months, though they are below the peaks reached in the middle of last year. Contract prices for Australia's bulk commodity exports have remained at very high levels after their sharp increases in the past two years, and base metals prices have risen further. How long the strength in commodity prices might persist is unknown. At some point, increased supply from major commodity producers can be expected to limit price increases, but forecasts of any such dampening effect have generally been pushed further into the future as prices have continued to rise. Reflecting the increases in resources prices, Australia's terms of trade have risen over the past four years by around 40 per cent. This is providing a substantial boost to incomes, spending and activity.

Financial markets around the world have been fairly buoyant in recent months. Although there was a bout of nervousness in late February and early March, markets have regained confidence since then. The major equity markets have recorded further net price gains since the start of the year, following on from their strong performances in 2006. Emerging-market risk spreads, which were also affected by the earlier nervousness, have fallen back to around the low levels prevailing at the start of the year. The Australian share market has reflected these recent international developments although, as was the case in 2006, it has posted larger overall price gains than in most of the other major markets. In foreign exchange markets, the US dollar has depreciated against the major currencies other than the yen, mainly reflecting softer prospects for growth in the US compared with other parts of the world. The Australian dollar has appreciated by around 5 per cent on a trade-weighted basis since the time of the last *Statement*, reflecting stronger domestic economic data and rising commodity prices.

Recent data on economic activity in Australia have provided a more consistent picture of an economy where output and employment have been strengthening since around the middle of last year. Non-farm GDP is estimated to have grown by 3½ per cent over the year to the December quarter 2006, a result which has gone some way towards resolving the apparent conflict between relatively weak output and stronger employment growth reported earlier last year. Information pertaining to the most recent period, including business surveys, labour market data, and indicators of private spending, suggests that a good deal of momentum has been carried forward into 2007.

The farm sector continues to be severely affected by the drought. At this stage the fall in farm output appears likely to reduce overall GDP growth in the current financial year by around ¾ percentage point. A return to more normal seasonal conditions in 2007/08 would see a significant recovery in farm output, but there remains a risk that this does not occur.

Growth continues to be driven mainly by domestic demand. Consumer spending growth picked up during the second half of last year, and the indications are that this firmer pace has continued in early 2007, supported by growth in employment and real wages, rising household wealth and a high level of consumer confidence. Other components of private spending have contributed more modestly to growth, with housing construction relatively flat and business investment growth moderating from the double-digit pace of the previous few years. The level of private business investment nonetheless remains high, and is resulting in strong growth in the capital stock. Growth of public sector spending has picked up over the past year to an above-average pace, led by investment. The net effect of these somewhat disparate movements has been that the growth of domestic demand in total was a little above trend over the past year, though well down from the clearly unsustainable pace seen earlier in the decade.

Last year's increases in interest rates have brought housing loan rates to a level that is a little above their medium-term average, and this has had a dampening effect on the demand for finance in the household sector. Household credit growth and housing loan approvals both moderated through the second half of last year, though this trend does not seem to have continued into 2007. At the same time, borrowing by the business sector has continued to expand rapidly. Business appetite for debt is being stimulated by favourable economic conditions and high levels of investment, though there is also a more general mood in the business sector in favour of greater leverage, as evidenced by the range of corporate takeover proposals now in train.

Australia's lengthy period of expansion has brought the economy in recent years to a position of high capacity utilisation and tight labour market conditions. Unemployment has declined to generational lows, and a range of business surveys and anecdotal reports indicate that labour scarcity has increased. The tight labour market has contributed to some pick-up in aggregate wages growth over the past couple of years. Wages at the end of 2006 were growing at a rate that was at the top end of the range seen over recent years, though they did not appear to be accelerating further. Given the overall momentum in domestic demand and the prospect of some pick-up in exports, it appears likely that growth of the non-farm economy will remain relatively strong in the period ahead. While ongoing increases in labour supply and high levels of business investment will be adding to productive capacity, this outlook implies that the economy will continue to operate at a position close to full employment of available resources.

Despite the general strength in demand and activity, the evidence from producer and consumer price indices is that inflation has moderated recently. Producer price indices in the March quarter recorded lower rates of increase at all stages of production than six months ago. In part this has been driven by some temporary factors including fluctuations in fuel and food prices along with recent declines in import prices, but there was also some moderation in core prices of domestically produced outputs. The underlying CPI inflation rate has also moderated. The Bank's estimates of underlying inflation were ½ per cent for the March quarter and 2¾ per cent over the past year, with the two latest quarterly increases noticeably below those in the two previous quarters. The headline year-ended CPI inflation rate eased more markedly, principally reflecting falls in fuel and food prices over recent quarters.

Since late last year, the Bank's assessment has been that inflation in underlying terms would decline gradually from the peak of around 3 per cent reached in the September quarter 2006. In recent months the decline appears to have been a little faster than originally expected, and it now seems likely that underlying inflation will be about 2½ per cent, or possibly a little lower, during 2007. Inflation as measured on a year-ended basis by the CPI will fall below 2 per cent over the next couple of quarters.

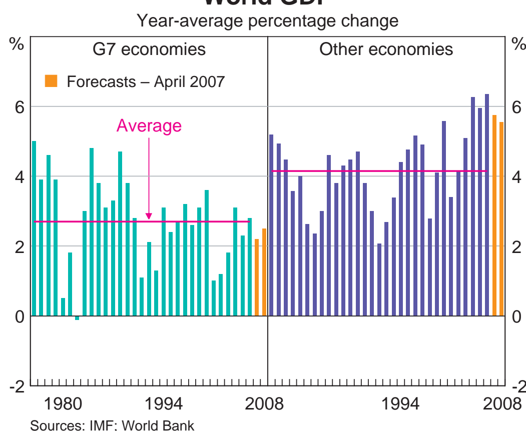
Longer term, it seems unlikely that inflation will continue to decline. All available data suggest high capacity utilisation, a tight labour market and strong demand growth. Based on these trends, inflation is forecast to return to the top half of the target during 2008.

In its policy deliberations in recent months, the Board has focused in particular on the evidence of greater strength in domestic demand and activity, on possible risks to the global economy, and on the recent domestic prices data. While uncertainties about the international situation remain, recent information has pointed to continued global expansion. A range of domestic data over recent months confirmed that demand and activity had strengthened towards the end of last year, and indicated that this strength had continued into 2007. However, the March quarter prices data, which became available for the Board's May meeting, suggested that inflation was running at a somewhat lower rate than previously expected.

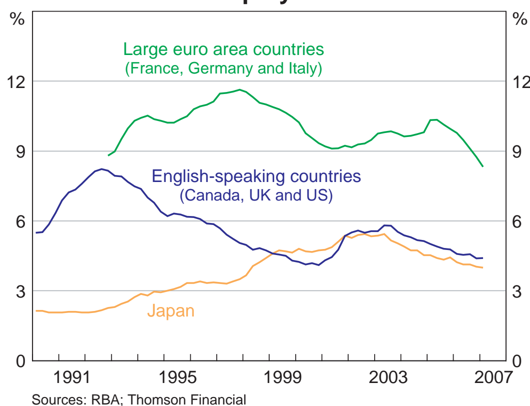
In weighing up all this information, the Board considered that the broad forces at work – a strong world economy, strong demand growth and limited spare capacity – were still likely, if they persisted, to result in some upward pressure on inflation over time. But an appreciable tightening of policy had already been implemented during 2006, and the more benign recent inflation outcomes also lowered the starting point from which any future pick-up in inflation would occur. Hence the Board judged, at its May meeting, that maintaining the current mildly restrictive stance of policy would leave adequate time to respond as needed to the possibility of higher medium-term inflation. The Board will continue to monitor developments and make such adjustments to the policy setting as may be required in order to promote sustainable growth of the economy consistent with the inflation target. ✣

International Economic Developments

The world economy grew at its fastest rate in more than 30 years in 2006, and has continued to grow at a firm pace in early 2007. The expansion has been quite broad-based, with an upturn in Europe and Japan and ongoing strength in China and India. In its April *World Economic Outlook*, the IMF forecasts world growth to ease only modestly in 2007 and 2008, to around 5 per cent. Emerging economies are forecast to continue to grow strongly in 2007 while weaker growth is expected for the major developed countries (the G7 economies), mainly reflecting a slowdown in the United States (Graph 1). However, most forecasters are expecting that the US slowing should be reasonably temporary and are assuming that the current headwinds from the housing sector will not spread too much to other sectors or countries. East Asia, which receives more than half of Australia's exports by value, is expected to account for around two-fifths of global growth in 2007.



Sustained global GDP growth in recent years has boosted capacity utilisation, as borne out in surveys of business conditions and by the tightness of labour markets. Unemployment rates have fallen significantly in most major developed economies. In the English-speaking countries and Japan, unemployment has been declining for the past three to four years. The decline in the major countries in the euro area is more recent, but unemployment has now fallen to its lowest rate in more than a decade (Graph 2). The continued absorption of global capacity has seen core inflation drift upward in several major countries, and central banks remain concerned about upside risks to inflation.



One effect of the sustained strong growth in the world economy has been the sharp rise in commodity prices over the past few years, reflecting in part China's increased

contribution to world growth and the relatively resource-intensive stage of its development. Commodity prices have risen further in the past three months and market participants are now expecting commodity prices will stay high for longer. As Australia is a large producer of commodities, the stronger outlook for commodity prices has been one of the reasons that the Australian dollar exchange rate has recently reached a 22-year high on a real trade-weighted basis (for more details on recent movements in the Australian dollar, see the 'International and Foreign Exchange Markets' chapter).

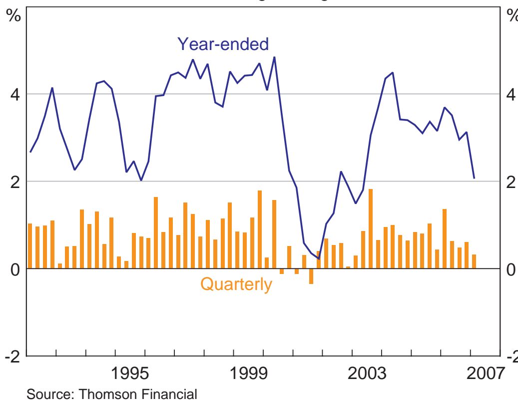
Major developed economies

Growth in overall activity in the major developed economies is expected to weaken somewhat in 2007, as the pace in North America moderates to below trend. However, growth in Japan is expected to continue at around the same rate as last year and the expansion in Europe is forecast to continue, albeit less rapidly than in 2006.

Graph 3

United States – GDP

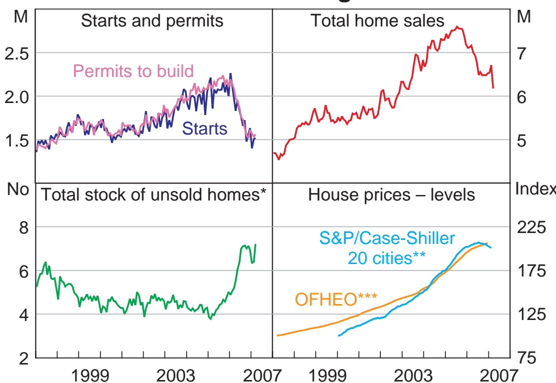
Percentage change



Source: Thomson Financial

Graph 4

United States – Housing Indicators



* Months' supply of houses for sale
** Monthly
*** Office of Federal Housing Enterprise Oversight (OFHEO), quarterly
Sources: MacroMarkets LLC; Thomson Financial

Growth in the US economy has already slowed, due mostly to a downturn in housing construction and auto-related manufacturing. Real GDP increased by 0.3 per cent in the March quarter, and by 2.1 per cent over the year (Graph 3). The recent slowdown follows several years of above-trend growth in the United States, during which excess labour and capital resources were re-absorbed, and the recent moderation should help to reduce the inflation pressures that were building early last year.

Activity in the US housing market has continued to weaken in early 2007. Residential investment declined by 4.6 per cent in the March quarter and by 17 per cent over the year. The supply of unsold houses has remained high, and there has been a slowing in the growth of house prices (Graph 4). In response to the recent increase in loan delinquencies, many lenders have tightened credit standards, although there are few indications that creditworthy borrowers are being affected and

payment distress appears to be largely confined to the sub-prime market (for further details, see the 'International and Foreign Exchange Markets' chapter). Recent indicators suggest housing demand is still weak, with home sales falling in March and housing starts and permits remaining at low levels since the start of the year. Residential investment is expected to decline further.

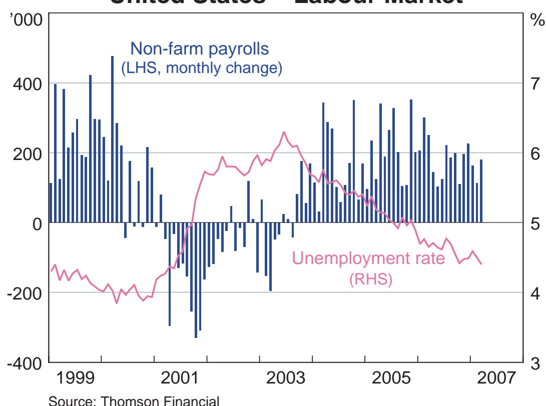
Household consumption increased by 0.9 per cent in the March quarter and by 3.4 per cent over the year. Consumption has been supported by growth in household incomes and has remained firm, despite slowing house price growth. Household income growth has been supported by the strong labour market, with payrolls employment rising by 180 000 jobs in March and the unemployment rate returning to a cyclical low of 4.4 per cent (Graph 5).

Business investment increased slightly in the March quarter, to be 3.2 per cent higher over the year. Equipment investment has been surprisingly weak, given that capacity utilisation is at high levels. Corporate profits remain high, balance sheets are healthy and the cost of capital is low, suggesting that financing conditions are supportive of continued growth in investment.

Reflecting movements in energy prices, CPI inflation slowed through the second half of 2006 and has recently picked up a little, to be 2.8 per cent over the year to March (Graph 6). Over the same period, core inflation has eased, to a year-ended rate of 2.5 per cent. While the Federal Reserve continues to forecast that inflation will ease as activity and growth in housing costs soften, it remains concerned about possible upside risks to that outlook, especially given the tightness of the labour market.

Graph 5

United States – Labour Market

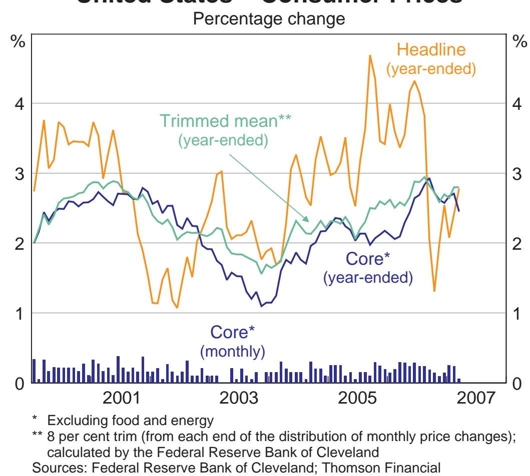


Source: Thomson Financial

Graph 6

United States – Consumer Prices

Percentage change

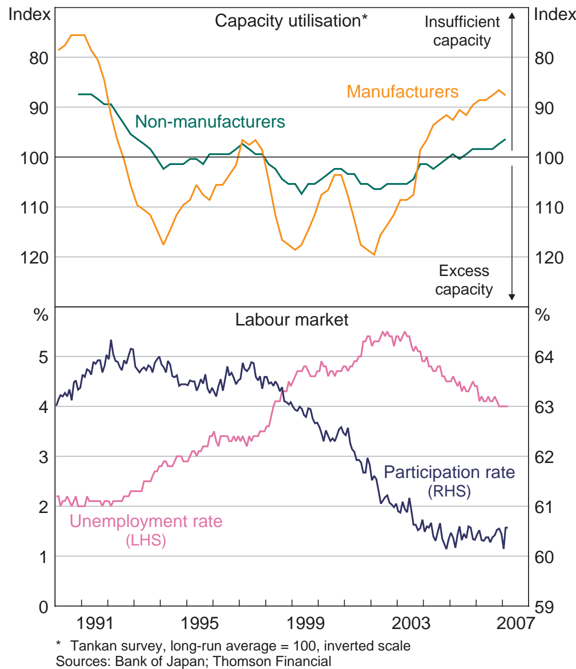


* Excluding food and energy
** 8 per cent trim (from each end of the distribution of monthly price changes); calculated by the Federal Reserve Bank of Cleveland
Sources: Federal Reserve Bank of Cleveland; Thomson Financial

The expansion in Japan has continued at a solid rate and growth has been broad-based. GDP increased by 1.3 per cent in the December quarter and by 2.5 per cent over the year, with a strong pick-up in domestic demand and a contribution to growth from exports. Growth in consumption has been supported by the conditions in the labour

Graph 7

Japan – Capacity Indicators

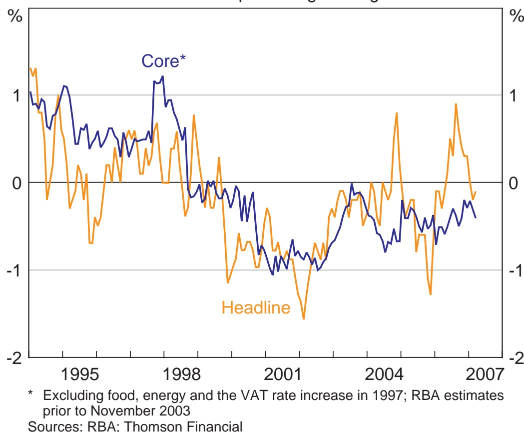


* Tankan survey, long-run average = 100, inverted scale
Sources: Bank of Japan; Thomson Financial

Graph 8

Japan – Consumer Prices

Year-ended percentage change



* Excluding food, energy and the VAT rate increase in 1997; RBA estimates prior to November 2003
Sources: RBA; Thomson Financial

market; the unemployment rate was at an 8-year low of 4.0 per cent in March, and surveyed employment indicators suggest the outlook remains positive (Graph 7). Growth in business investment has been strong and capacity utilisation was at a high level in the March quarter, particularly for the manufacturing industry. Given healthy corporate balance sheets, investment growth for medium and large firms is expected to be solid in 2007 according to the Tankan survey.

Despite strong growth, a tight labour market and indications that the economy is operating at high levels of capacity utilisation, consumer price inflation remains negative (Graph 8). Excluding food and energy, year-ended inflation was –0.4 per cent in March. Upstream price pressures have moderated in recent months, with year-ended growth in corporate goods prices easing to 2.0 per cent in March.

In Europe, economic growth was strong in 2006, although its pace may have slowed a little recently. GDP in the euro area increased by 0.9 per cent in the December quarter to be 3.3 per cent higher over the year, the fastest rate of year-ended growth in six years (Graph 9). Growth was fairly well distributed across the region. In particular, there has been a marked improvement in growth in both Germany and Italy, with growth over the year to the December quarter of 3.7 per cent and 2.8 per cent, compared with average growth of around ½ per cent for both economies over the previous four years.

Consumer spending slowed in Germany in early 2007, following a pull-forward of sales into late 2006 ahead of January's increase in the VAT. However, improving labour market conditions and consumer sentiment are expected to support consumption in the period ahead. The euro area

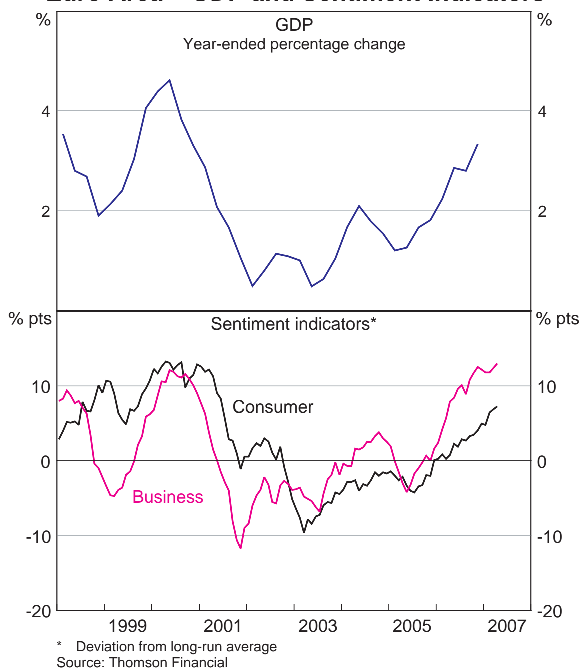
unemployment rate has continued to decline, reaching 7.3 per cent in February. Business conditions also remain positive, with the European Commission measure of business sentiment at its highest level since the survey began in 1985, helped by ongoing strong export demand.

Headline inflation has been steady at just below the ECB's 2 per cent reference value (Graph 10). Core inflation has continued to trend upward, to be 1.9 per cent over the year ended in March. At its March meeting, the ECB raised its repo rate by 25 basis points to 3.75 per cent and noted that the risks to inflation remained on the upside, citing in particular risks associated with the current round of wage negotiations.

Growth in the United Kingdom was solid in the March quarter, with GDP rising by 0.7 per cent. More generally, household spending and buoyant business investment have been leading demand growth in recent periods. Consumption has been supported by increases in house prices and a tight labour market. Headline inflation rose to 3.1 per cent in March, above the Bank of England's target range, but is expected to fall back.

Graph 9

Euro Area – GDP and Sentiment Indicators

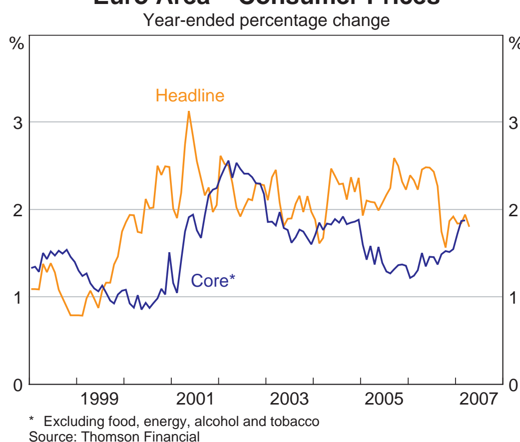


* Deviation from long-run average
Source: Thomson Financial

Graph 10

Euro Area – Consumer Prices

Year-ended percentage change

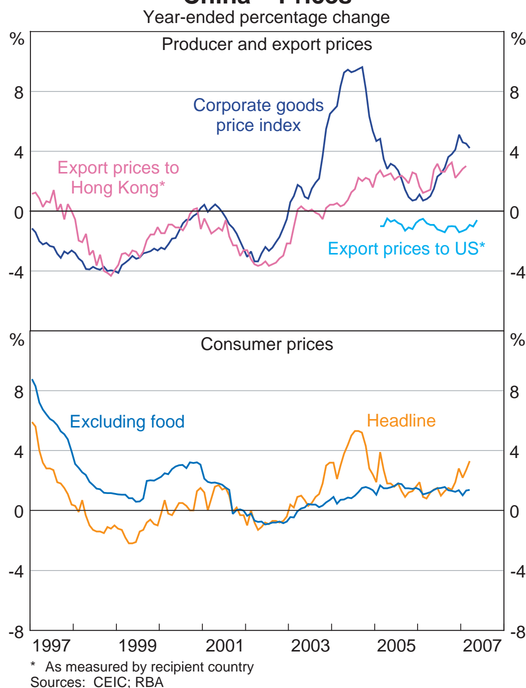


* Excluding food, energy, alcohol and tobacco
Source: Thomson Financial

Other economies

Growth in Australia's other major trading partners is expected to continue to be strong in 2007, due mainly to continued rapid growth in China and India and solid growth in the rest of east Asia.

In China, GDP increased by 11.1 per cent over the year to the March quarter. Growth in investment has picked up and appears to have been a major contributor to recent GDP growth. Exports also increased sharply in the March quarter, as a change in export tax rebates



from April caused a pull-forward of exporting activity. In response to the continued strong demand conditions, the People's Bank of China tightened policy again in March and April, raising the reserve requirement ratio and the benchmark lending and deposit interest rates.

Growth in corporate goods prices has continued to run ahead of consumer and export price inflation. Over the year to March, corporate goods prices increased by 4.2 per cent, reflecting a pick-up in raw materials prices, strong growth in labour costs and an increase in food prices due to drought conditions in China (Graph 11). Consumer prices increased by 3.3 per cent over the year to March, although excluding food (one-third of the index) consumer inflation is estimated to have been only 1.4 per cent. Evidence on Chinese export prices is more mixed, with Hong Kong data suggesting that prices of imports from China have grown by around 3 per cent over the past year, while US data suggest that prices of imports from China are still falling. Overall, the limited pass-through of corporate goods price inflation to China's non-food consumer and export prices reflects continued strong productivity growth, rapidly increasing capacity and global competition.

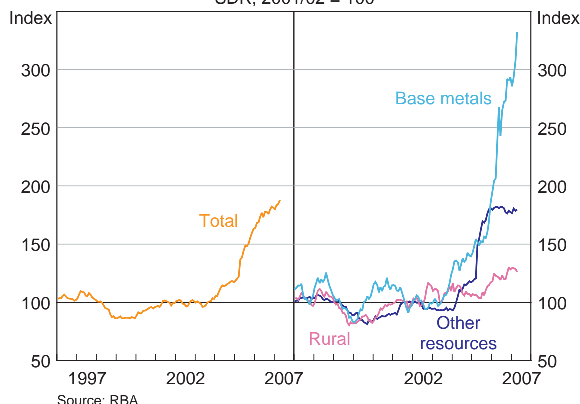
GDP in the rest of east Asia (excluding Japan) increased by 4.8 per cent over the year to the December quarter, with firm growth in domestic demand and a small contribution from exports. Growth in industrial production and exports appears to have slowed a little recently, with growth in both ITC-related and capital goods exports easing in line with slower growth in business investment in the United States (Graph 12). However, favourable labour market conditions are expected to support growth in consumption in the region, and business investment is also expected to remain firm. Preliminary estimates of March quarter GDP for Korea and Singapore show these economies have continued to expand at a solid pace. Inflationary pressures remain contained, with year-ended inflation for the region at 2.5 per cent over the year to March.

Growth in India has been strong with real GDP increasing by 8.6 per cent over 2006, reflecting strength in domestic demand. Upstream price pressures have increased; at 6.5 per cent over the year to March, wholesale price inflation was around its highest rate in two years. Concerns about capacity constraints led the Reserve Bank of India to tighten policy further in April.

In New Zealand, GDP increased by 0.8 per cent in the December quarter, driven by a strong pick-up in domestic demand. Consumption growth was solid in the quarter, buoyed by lower petrol prices, renewed strength in the housing market and continued favourable labour market conditions. Growth in dwelling and business investment also picked up. More recently, retail sales were reported to have increased by 6.3 per cent over the year to February and house price growth has continued to be strong. Year-ended consumer price inflation held broadly steady at 2.5 per cent in the March quarter, although most of the Reserve Bank of New Zealand's (RBNZ) measures of underlying inflation were running at higher rates. The RBNZ tightened monetary policy at its March and April meetings, citing concerns about the recent pick-up in domestic demand.

Commodity prices and the terms of trade

Commodity prices have remained high in 2007 so far, as supply has struggled to keep up with the strong global demand for commodities. The RBA's index of commodity prices (ICP) increased by 4.5 per cent (in SDR terms) over the three months to April, bringing the increase over the past four years to around 90 per cent (Graph 13, Table 1). The persistent strength in base metals prices continues to be the main driver of the increase in the ICP; the base metals price index has risen by 16 per cent over the past three months, and has more than trebled over the past four years. High commodity prices have continued to boost the terms of trade, which are estimated to have increased by around 2 per cent in the March quarter.



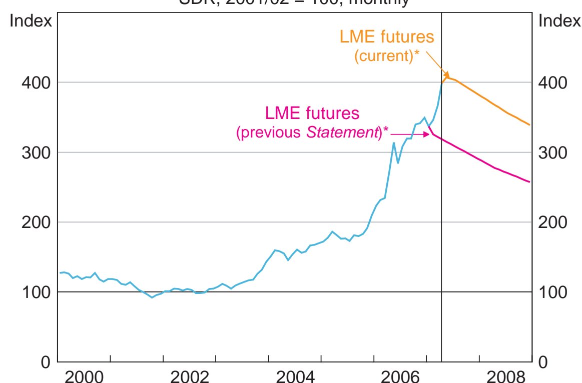
As has been the case for several years, base metals prices over the past three months have been much stronger than had been expected by most analysts. While futures markets continue to suggest that prices are likely to soften over the next two years, this has translated

Table 1: Commodity Prices
Percentage change; SDR

	Three months to April 2007	Year to April 2007
RBA index	4.5	8.4
Rural	–2.5	3.3
– Wheat	1.2	6.1
– Beef & veal	–6.2	0.2
– Wool	4.3	38.3
– Sugar	–10.4	–43.1
Base metals	16.4	39.8
– Aluminium	–1.0	2.6
– Copper	32.9	15.3
– Nickel	34.5	165.9
– Zinc	–8.1	10.6
Other resources	1.8	–1.4
– Coking coal[(a)]	–1.9	–18.6
– Steaming coal[(a)]	4.1	–1.4
– Iron ore[(a)]	1.7	14.9
– Gold	6.0	6.0
Memo item		
Oil in US$[(b)]	16.7	–8.0

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

Graph 14
RBA Index of Base Metals
SDR, 2001/02 = 100, monthly



* Aggregate LME futures curves are based on futures prices for each of the five base metals, compiled using RBA Index of Commodity Prices weights
Sources: Bloomberg; RBA

into expectations that prices will be higher than previously forecast in the medium term (Graph 14). The recent price increases reflect the tightness in base metals supply, with global stocks at very low levels. Global growth is expected to remain buoyant, which could see base metals prices remain at high levels for some time yet, notwithstanding the anticipated supply coming on line.

Nickel and copper prices have driven the increase in base metals prices over the past three months, both rising by nearly 35 per cent (Graph 15). The rise in nickel prices has reflected strong demand, delays in a number of supply projects and low global stocks, which now cover three weeks of consumption compared with an average of around nine weeks over the 1990s. Stocks of copper have also declined.

The oil price (for West Texas Intermediate) rose by 17 per cent over the three months to April, and is currently trading around US$65 per barrel. The rise was driven by strong demand for petrol and concerns over possible supply disruptions from the Middle East and Nigeria.

Since the previous *Statement*, steaming coal benchmark contract prices for 2007/08 have been settled at a premium of around 5 per cent over 2006/07 prices, in line with the higher spot prices since the start of the year (Graph 16). Soft coking coal contract prices were also settled higher than last year's prices. However, the overall effect of the bulk contract negotiations on the ICP and the terms of trade in 2007 is expected to be roughly neutral, as the rise in steaming and soft coking coal contract

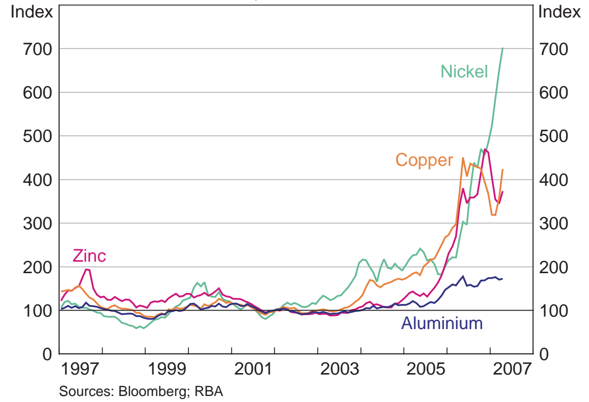
prices and the 9½ per cent increase in iron ore prices will be offset by the 15–20 per cent fall in hard coking coal contract prices.

Rural commodity prices fell by 2.5 per cent over the three months to April, as beef prices declined due to seasonally weak demand from Japan. Partially offsetting this was a rise in wool prices, reflecting in part continuing concerns about the impact on production of the drought in Australia.

Graph 15

Base Metals Prices

SDR, 2001/02 = 100

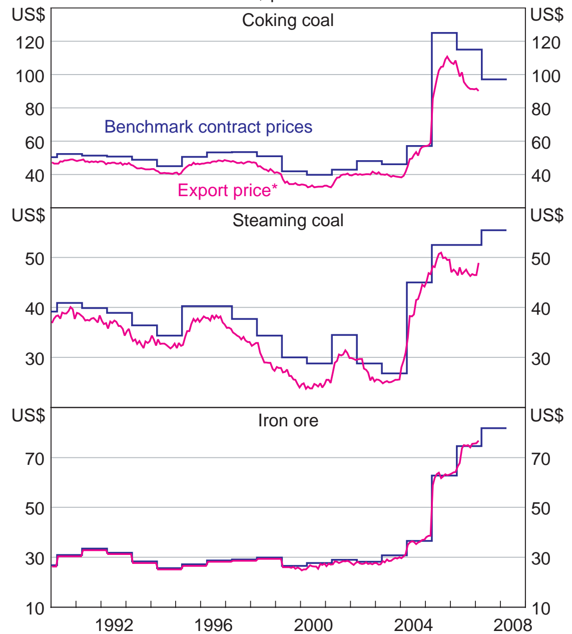


Sources: Bloomberg; RBA

Graph 16

Bulk Commodity Prices

US$ per tonne



* Data up to February 2007

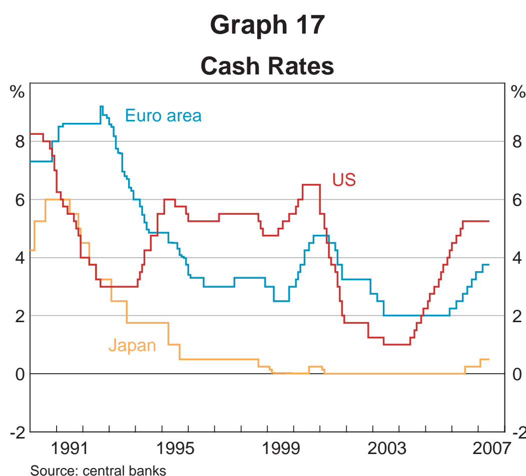
Sources: ABARE; Bloomberg; RBA

International and Foreign Exchange Markets

International financial markets

Official interest rates

Most major central banks have tightened monetary policy settings over the past three months, or are expected to do so in the period ahead (Table 2, Graph 17). The notable exception has been the US Federal Reserve which has kept interest rates steady at 5¼ per cent since June last year. Over this period the Fed has clearly stated that inflation is its primary concern, but in contrast to the Fed's assessment about the balance of risks, financial markets have been more focused on the uncertain outlook for US growth. Markets continue to place a greater likelihood on the next move by the Fed being an easing rather than a tightening. Earlier in the year, general weakness in housing and concern over the rising rate of mortgage delinquencies in the sub-prime sector (see below) led markets to fully price in a rate cut by the middle of the year. However, ongoing strength in the US labour market and the limited spillover of the sub-prime problems have seen markets push back the expected timing of the rate cut until late in the year.



The European Central Bank (ECB) raised its policy rate at its March meeting and has subsequently stated that monetary conditions

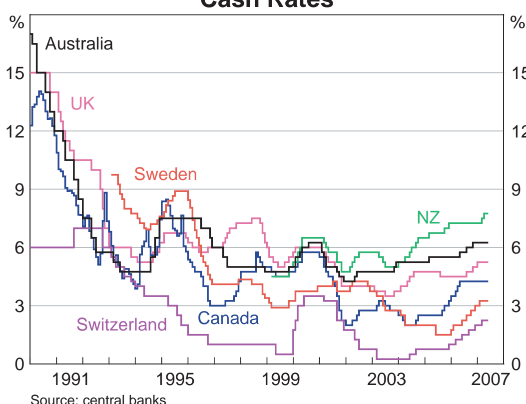
Table 2: Changes in Monetary Policy

	Current level Per cent	Most recent change	Expectations for next 6 months
United States	5.25	# Jun 06	No change
Euro area	3.75	# Mar 07	# 50 bps
Japan	0.50	# Feb 07	# 25 bps
United Kingdom	5.25	# Jan 07	# 50 bps
Canada	4.25	# May 06	No change
New Zealand	7.75	# Apr 07	No change

Sources: central banks; Bloomberg; Reuters

remain accommodative and has continued to emphasise the upside risks to inflation. Markets are currently expecting two further 25 basis point increases in European rates in the next six months. The Bank of Japan (BoJ) has also signalled its intention to continue to tighten monetary policy, albeit at a very gradual pace, following its second 25 basis points increase since it ended its zero interest rate policy in July last year. With Japanese inflation expected to fluctuate around zero in the near term, the market believes that the BoJ will not lift rates until later in the year.

Both the Bank of England (BoE) and the Reserve Bank of New Zealand (RBNZ) have raised rates this year in response to increasing inflation pressures (Graph 18). The BoE has increased rates by 25 basis points to 5¼ per cent, and the RBNZ raised rates twice by 25 basis points from 7¼ per cent to 7¾ per cent. The markets expect the BoE to raise rates at least once more in the next six months. Policy rates in Sweden, Switzerland and Norway have also been increased this year from unusually low levels and the market expects further rate increases in each country. However, the Bank of Canada, which has left rates unchanged over the past year, is expected by markets to continue to maintain its policy rate at 4¼ per cent for the foreseeable future.



Monetary conditions continue to be tightened in China in an effort to curtail the growth in money and credit. Following several actions last year, in the first four months of 2007 the People's Bank of China (PBoC) has raised the reserve requirement for banks by 50 basis points on three occasions to 11 per cent and raised the official one-year lending and deposit rates by 27 basis points to 6.39 per cent and 2.79 per cent, respectively. Despite these measures, growth in the money supply has accelerated since late last year, remaining above the PBoC's target range.

Elsewhere in Asia, changes in monetary policy have been more varied. Monetary conditions continue to be tightened in India and Taiwan. In contrast, after cutting rates by a total of 375 basis points over its past nine meetings as inflation declined, Bank Indonesia left rates on hold in April at 9 per cent. In Thailand, monetary policy has been eased by 100 basis points in the past six months in an effort to boost domestic demand. Policy rates have also been reduced further in Brazil and Israel since the previous *Statement*.

Bond yields

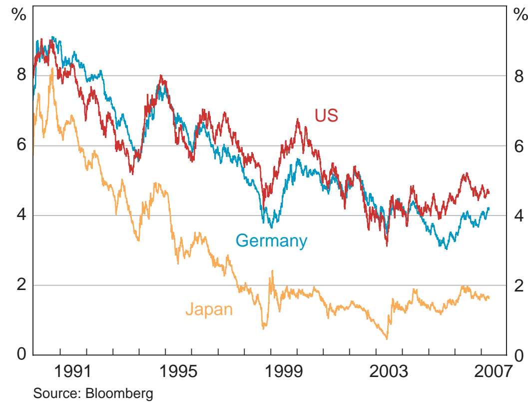
There have been somewhat divergent trends in government bond yields among the major markets since the last *Statement* (Graph 19). In the US, there was initially a sharp increase in yields following strong employment data, which led market participants to wind back their expectations of a policy easing. However, subsequently softer inflation and housing data saw yields drift lower, with markets again focused on the possibility of an easing by the Fed later this year. German government

bond yields were supported by strong economic data and comments from the ECB. Consequently, the interest rate differential between the US and Germany has continued to narrow, reflecting the relative growth prospects of the two countries. In Japan, yields on government debt are somewhat lower than at the time of the last *Statement*.

Spreads on emerging-market and low-grade US corporate debt temporarily rose as a result of the increase in risk aversion associated with equity market volatility in late February (Graph 20). Most affected were spreads on US low-grade 'junk' debt, which increased by 36 basis points over the first half of March. Subsequently, the market appears to have regained its appetite for risk and spreads on low-grade US corporate debt have fallen back to levels below those prevailing at the time of the previous *Statement*. Spreads on emerging-market debt have also unwound their sharp spike in late February to be back at historically low levels. Spreads on high-rated US corporate debt were only marginally affected by the changes in risk preference and have barely moved in recent months.

Graph 19

10-year Government Bond Yields

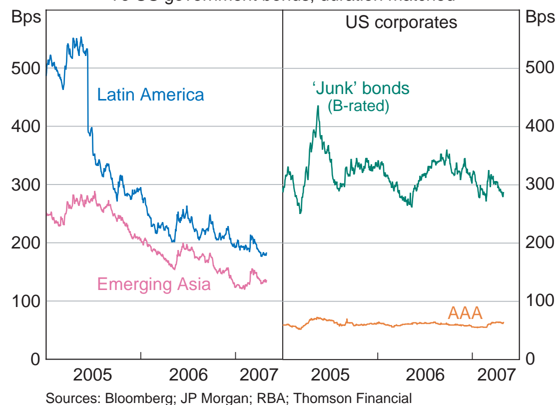


Source: Bloomberg

Graph 20

Market Spreads

To US government bonds, duration matched

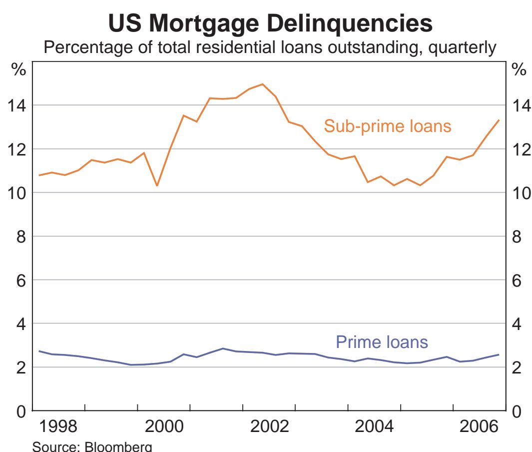


Sources: Bloomberg; JP Morgan; RBA; Thomson Financial

Developments in the US sub-prime mortgage market[1]

One of the most-publicised developments in financial markets in recent months has been those in the US sub-prime mortgage markets. Sub-prime mortgages are typically those where the borrower has an impaired credit history. The borrowers are therefore considered to have a higher risk of defaulting on their loan and face higher interest rates than prime borrowers. With variable interest rates at historical lows in 2003 and 2004, these loans were particularly attractive to marginal borrowers. In addition, these mortgages often had a two-year introductory (teaser) rate that reduced the borrowing rate to close to that of prime borrowers.

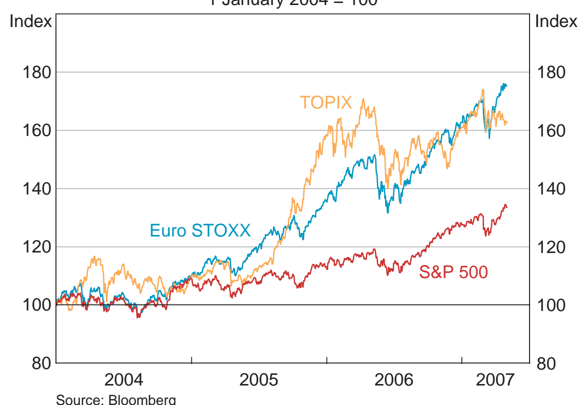
1 *See also 'Box A: Developments in the US Sub-prime Mortgage Market', RBA* Financial Stability Review, *March 2007, pp 23–25.*



While low variable interest rates encouraged the initial rise in sub-prime lending, the surge in the share of the sub-prime mortgages in 2006 appears primarily to have reflected a loosening of credit standards to maintain loan volumes as demand from prime borrowers slowed. The combination of this decline in standards along with the rise in variable rates and the expiry of the two-year introductory discounts contributed to the marked rise in delinquency rates in the latter part of 2006 (Graph 21). It is noteworthy that the rise has occurred even though the unemployment rate remains low. Delinquency rates among prime borrowers and those with fixed-rate loans have remained little changed.

To date, more than 20 sub-prime lenders have closed. Other financial intermediaries with exposure to this market have also been affected, most notably the investment banks that have extended lines of credit to sub-prime mortgage lenders, have their own sub-prime lending subsidiaries or hold an investment position in related securities.

There are varying views as to the potential effect of these developments on the broader US economy. Three main risks have been identified: a generalised tightening in credit standards leading to a 'credit crunch'; an overly aggressive regulatory response by state and federal agencies which could also cause a decrease in credit provision; and a deepening of the ongoing contraction in residential construction and stagnation in house prices. At this stage, the problems appear to be confined to the sub-prime market with little evidence of spillover to other areas. Moreover, a number of institutions are coming forward to buy the sub-prime loan books of some of the troubled lenders at a discount, regarding it as a reasonable buying opportunity.



Equities

Notwithstanding sharp declines in late February and early March following the sharp fall in Chinese share prices, global equity markets have posted modest net gains since the previous *Statement* (Graph 22,

Table 3). Markets have been supported by the continued strength in the global economy as well as increased merger and acquisition activity. Larger gains have been recorded in European markets, where growth prospects are assessed to be far more favourable, than in the US, where developments in the sub-prime lending market and concerns about the housing sector more generally have weighed on some share prices.

In emerging markets, share prices in Asia and Latin America have also recorded net gains since the previous *Statement* (Graph 23), although this masks some large movements in both directions over the period. Emerging-market share prices were particularly affected by the volatility in late February, with some markets experiencing double-digit declines. However, most markets have recovered their losses and subsequently have continued to post gains. Most notably, China's local-currency-denominated A shares, which fell by 9 per cent on 27 February, have subsequently rebounded to be around 25 per cent above their peak recorded just prior to the drop.

In addition to the ongoing strength in the global economy, the rapid recovery in global markets may be partly attributable to the fact that there are few signs of significant misalignment in most equity markets. Price-to-earnings

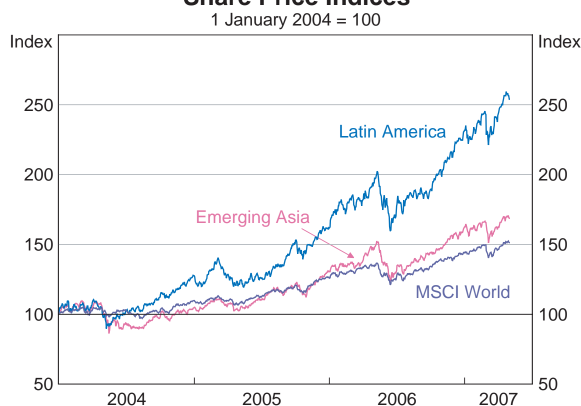
Table 3: Changes in Global Share Prices
Per cent

	Since 2000 peak	2007 to date	Since previous *Statement*
United States			
– Dow Jones	12	5	4
– S&P 500	–3	5	3
– NASDAQ	–50	5	2
Euro area			
– STOXX	–9	8	4
United Kingdom			
– FTSE	–7	3	1
Japan			
– TOPIX	–4	1	–2
Canada			
– TSE 300	18	4	2
Australia			
– ASX 200	82	8	4
MSCI Emerging Asia	31	4	2
MSCI Latin America	204	8	4
MSCI World	3	5	2

Source: Bloomberg

Graph 23

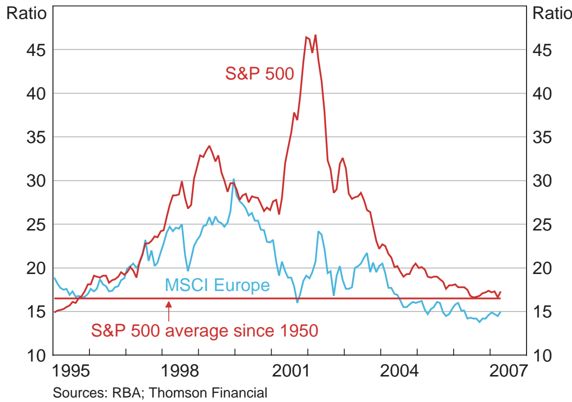
Share Price Indices
1 January 2004 = 100



Sources: Bloomberg; RBA

Graph 24

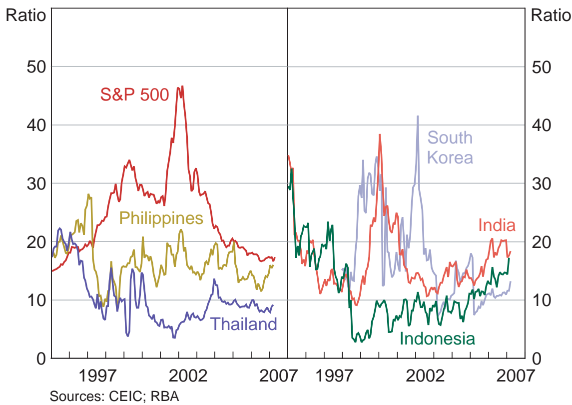
P/E Ratios – US and Europe



Sources: RBA; Thomson Financial

Graph 25

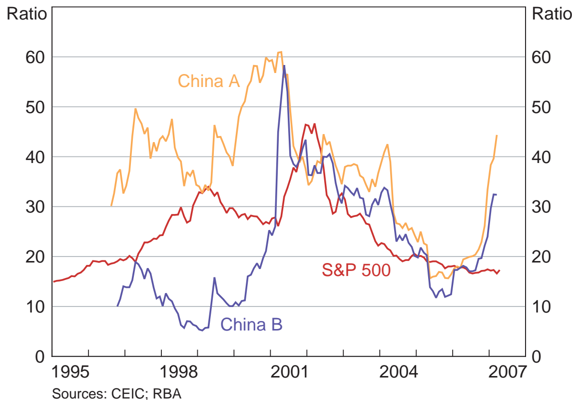
P/E Ratios – Asia and US



Sources: CEIC; RBA

Graph 26

P/E Ratios – China and US



Sources: CEIC; RBA

(P/E) ratios for major equity markets do not suggest any obvious overvaluations, with the S&P 500 and MSCI Europe P/E ratios close to their historical averages (Graph 24). However, it should be noted that the profit share is at historically high levels in most countries and earnings forecasts generally assume it will remain around these levels. Similarly, despite the sharp rise in prices among emerging Asian equity markets in recent years, the information available on P/E ratios also does not appear to be signalling any major imbalances (Graph 25). The exception to this may be the rapid increase in the P/E ratio in the Chinese stock markets since early 2006, where prices appear to be running ahead of fundamentals (Graph 26).

Exchange rates

The US dollar has depreciated against all major currencies in the period since the last *Statement* (Table 4). On a trade-weighted basis against the major currencies, the US dollar is at its lowest level in over 30 years, although in real terms it is still around 10 per cent above its historic low (Graph 27). The main factor weighing on the dollar over the period has been a reassessment of growth prospects in the US, with negative developments in the sub-prime lending market particularly affecting sentiment. In contrast, growth in the euro area has continued to be favourable, creating expectations that long- and

short-term interest rate differentials with the US will continue to narrow. The appreciation in the euro against the US dollar has taken European currencies to their highest level against the dollar since late 1992.

Following higher-than-expected inflation data, the UK pound rose to its highest level against the US dollar since 1981 and remains near its recent 20-year high in trade-weighted terms. The New Zealand dollar has appreciated by 8 per cent against the US dollar since the last *Statement* to be at its highest since 1982, and the Canadian dollar has appreciated by 6 per cent.

The notable exception to the general appreciation against the US dollar has been the Japanese yen (Graph 28). Despite the recent revival in Japan's economic growth following a prolonged period of stagnation, several factors have tended to depress the yen. These include the fact that inflation and interest rates remain low in Japan. This has encouraged the continuation of capital outflows, both as a result of carry trades financed out of Japan, and overseas investment by Japanese households. While households' holdings of foreign portfolio assets amounted to only 3 per cent of their total financial assets in 2002, this share almost doubled to around 6 per cent as at the end of 2006. Over the past three months, volatility in the yen has been relatively high as the influence of these factors has fluctuated. In particular, as a result

Table 4: Change in US Dollar against Other Currencies

Per cent

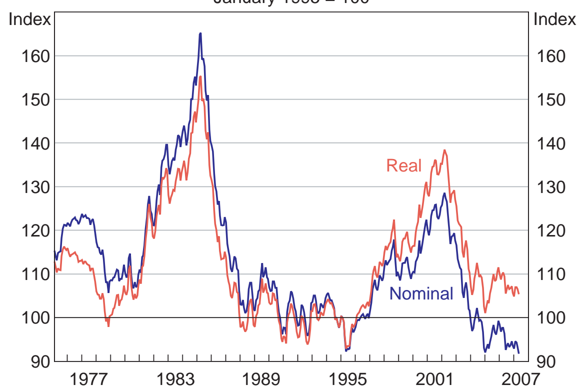
	2006	Since previous *Statement*
Sweden	–14	–4
Thailand	–12	–3
United Kingdom	–12	–2
Euro area	–10	–4
Brazil	–9	–3
Indonesia	–9	0
Philippines	–8	–2
Singapore	–8	–1
South Korea	–8	0
Malaysia	–7	–2
Australia	–7	–6
Switzerland	–7	–2
China	–3	–1
New Zealand	–3	–8
India	–2	–7
Taiwan	–1	1
Canada	0	–6
Japan	1	–1
Mexico	2	0
South Africa	11	–2
Majors TWI	**–5**	**–4**
Broad TWI	**–4**	**–3**

Source: RBA

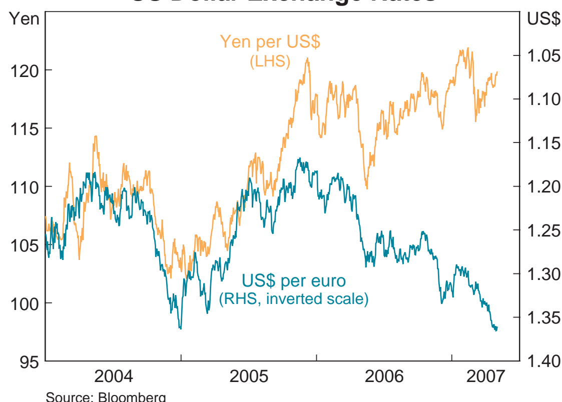
Graph 27

US Major TWI

January 1995 = 100



Source: Board of Governors of the Federal Reserve System

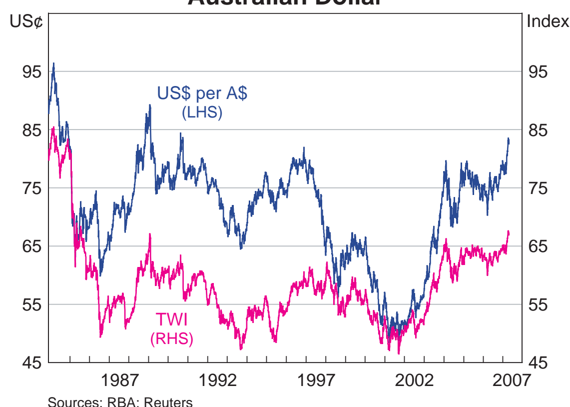


of the increased risk aversion that followed the share market falls in late February, carry trade positions were unwound and the yen appreciated sharply. However, as the market's risk appetite has risen again and share markets have recovered, carry trades have been re-established and the yen has reversed its earlier appreciation.

Emerging-market currencies have also generally appreciated against the US dollar since the last *Statement*. Although currencies such as the Korean won and Indonesian rupiah fell after the stock market declines of late February, they soon rose back in line with the recovery in these markets. The Thai baht has also appreciated over the period and is now above the level of December last year when the central bank imposed controls on short-term capital inflows.

The pace of appreciation in the Chinese renminbi against the US dollar appears to have slowed, with the currency little changed in recent months. Pricing in the non-deliverable forward market indicates expectations for the renminbi to appreciate by around 6 per cent against the US dollar over the next year. Given the broad-based depreciation of the US dollar, the renminbi has remained little changed in trade-weighted terms over the past 18 months.

To stem the appreciation of the renminbi the PBoC accumulated US$136 billion of foreign exchange reserves in the first quarter of 2007, with total reserves now exceeding US$1 200 billion. In recent months, China has announced plans for a new state investment agency to purchase around US$200 to US$300 billion in official foreign reserves from the central bank to invest in a wider range of assets. Authorities have indicated that one of the agency's initial investments might be in strategic resource companies and that it may operate on a mandate similar to GIC in Singapore.



Australian dollar

The Australian dollar has appreciated strongly since the last *Statement*, reaching a 17-year high of 83.92 cents against the US dollar and a 22-year high of 67.9 on a trade-weighted basis (Graphs 29 and 30, Table 5). A large

part of the appreciation reflects the general US dollar depreciation (see above). Continued strength in base metals prices, particularly copper and nickel, has also helped underpin the appreciation. As noted in the chapter on 'Domestic Economic Conditions', Australia's terms of trade have risen to their highest level since the 1950s, significantly outpacing the appreciation of the exchange rate. Market expectations of a domestic interest rate increase have at times also supported the currency.

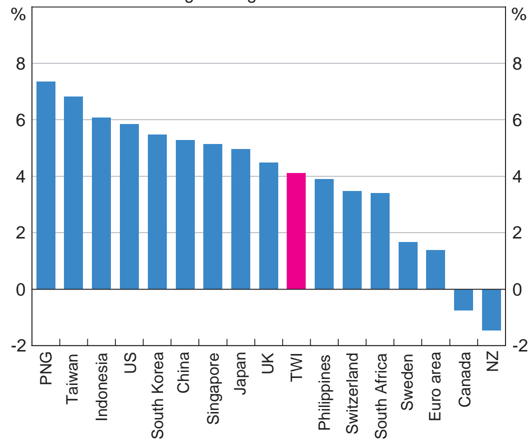
Capital flows into Australia remain strong (Graph 31). Large inflows have been recorded in bank and money market instruments and bonds, indicative of flows associated with carry trades. These flows have been encouraged by the relatively high yields in Australia. In recent years there has been a modest net outflow of equity capital as inflows of equity capital from abroad have been more than offset by equity capital outflows from both large direct investments by Australian companies and portfolio flows from Australian funds managers.

In line with the recent positive sentiment towards the Australian dollar, net long speculative positions in Australian dollar futures on the Chicago Mercantile Exchange remain at elevated levels, and only slightly below the peaks reached at the end of last year (Graph 32).

Graph 30

A$ against Selected Currencies

Percentage change from last *Statement*



Sources: RBA; Reuters

Table 5: Australian Dollar against Selected TWI Currencies

Percentage change

	2006	2007 to date	Since previous *Statement*
South Africa	19	5	3
Japan	9	5	5
US	8	5	6
Canada	8	0	–1
Taiwan	7	7	7
PNG	6	6	7
New Zealand	5	0	–1
China	4	3	5
Switzerland	1	4	3
Philippines	0	1	4
South Korea	0	5	5
Singapore	–1	4	5
Indonesia	–1	5	6
Euro area	–3	1	1
UK	–5	3	4
Sweden	–7	2	2
TWI	4	4	4

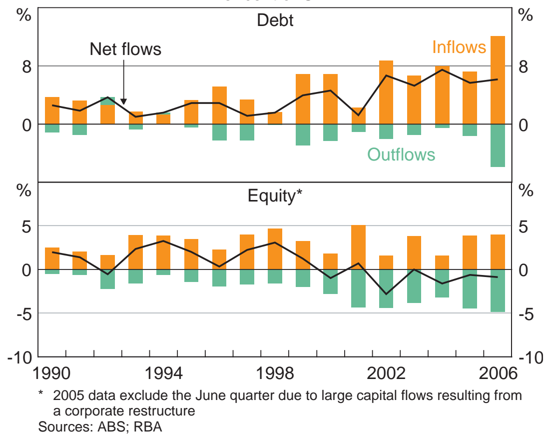
Source: RBA

The Reserve Bank has been buying foreign exchange since 2002 to replenish sales made to support the Australian dollar between 1997 and 2001. With the Australian dollar at multi-year highs, the Bank has stepped up its purchases of foreign exchange in recent months. Net

Graph 31

Capital Flows

Per cent of GDP



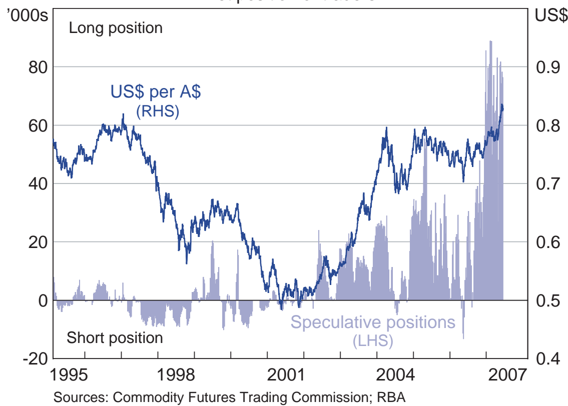
* 2005 data exclude the June quarter due to large capital flows resulting from a corporate restructure

Sources: ABS; RBA

Graph 32

Trading in Australian Dollar Futures in Chicago

Net position of traders



Sources: Commodity Futures Trading Commission; RBA

purchases over the year to date have totalled just over $1 billion. With revaluations following the appreciation partially offsetting recent purchases and earnings, net reserves currently stand at around $32 billion. The Bank's holdings of foreign exchange under swap agreements, which are used for domestic liquidity management purposes, increased to $49½ billion.

Domestic Economic Conditions

Growth in the non-farm economy ended 2006 at a relatively strong pace. Non-farm GDP was estimated to have risen by 1.4 per cent in the December quarter, lifting year-ended growth to 3.5 per cent (Graph 33, Table 6). The strength in output growth implied a pick-up in measured productivity growth after an extended period of apparent weakness. Recent data suggest that the economy has continued to grow in the early part of 2007. Retail trade rose at a firm pace in the first two months of the year, and employment also expanded at a healthy rate. Business surveys show strong trading conditions in the March quarter. One area of weakness is the farm sector, where the drought has resulted in sharply lower production and incomes. Farm GDP is estimated to have fallen by around 20 per cent over the second half of 2006, directly subtracting 0.6 percentage points from overall GDP growth, while farm incomes have fallen even more significantly. Growth in the resource-rich states of Western Australia and Queensland has continued to outpace that in the rest of the country though the gap may be narrowing (see 'Box A: Regional Economic Performance and Population Flows').

Graph 33

GDP Growth

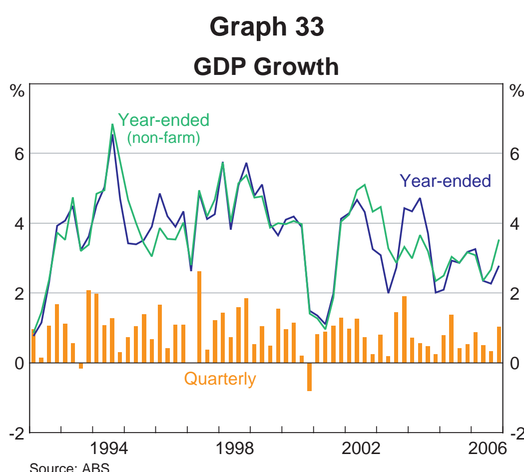


Table 6: Demand and Output

Percentage change

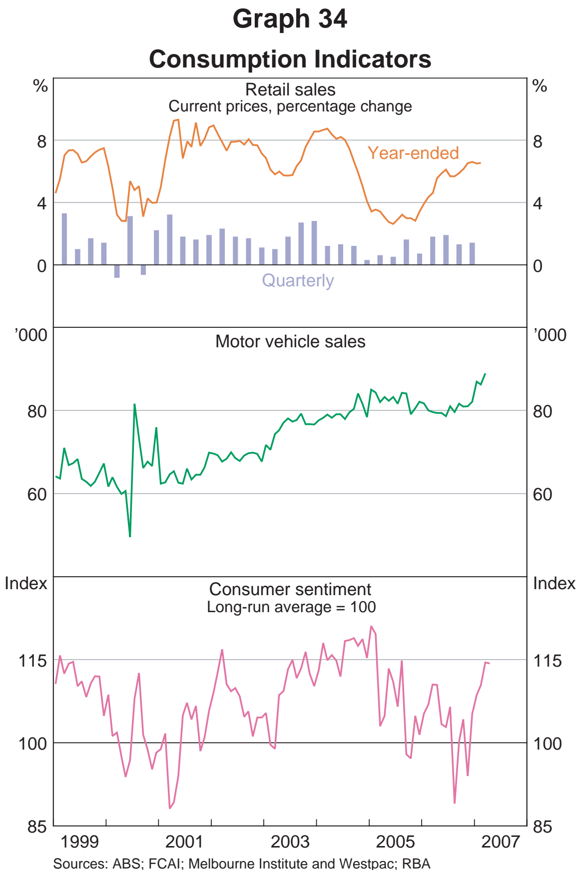
	September qtr 2006	December qtr 2006	Year to December qtr 2006
Domestic final demand	0.3	1.3	3.7
Change in inventories[(a)]	0.0	0.7	–0.2
GNE[(b)]	0.1	2.2	4.0
Net exports[(a)]	0.2	–1.3	–1.4
GDP	0.3	1.0	2.8
Non-farm GDP	0.7	1.4	3.5
Farm GDP	–11.5	–11.2	–22.8
Memo item:			
Real GDP adjusted for changes in the terms of trade	0.8	1.4	4.2

(a) Contributions to GDP growth
(b) Includes the statistical discrepancy
Sources: ABS, RBA

While some further weakness in farm production is expected in the near term, weather forecasters are expecting a return to at least average rainfall, which would help support some recovery in farm output in 2007/08. Elsewhere in the economy, conditions are generally expected to remain strong. Growth in household consumption seems likely to remain firm, supported by strong labour market conditions, recent increases in household wealth and strong consumer confidence. While housing construction may decline further in the next couple of quarters, it is expected to begin to pick up towards the end of 2007 given low vacancy rates and other indications that housing construction has been running below underlying demand for some time. Business investment is expected to grow at a modest pace compared with the rapid rates seen in recent years, but given its high level should continue to provide a considerable boost to the capital stock. The completion of several large mining projects and continued strength in world demand should see additional growth in resource exports, although a further fall in rural exports is expected in the near term.

Household sector

Growth in household spending picked up noticeably towards the end of 2006, but remained well below the rapid pace of a few years ago. Household consumption increased by 1.2 per cent in the December quarter, to be 3.8 per cent higher over the year. More timely data indicate that retail spending has continued to grow at a firm pace in early 2007, with nominal retail sales in January and February 1.6 per cent higher than in the December quarter and 6.7 per cent higher over the year (Graph 34). Motor vehicle sales to households were particularly strong in early 2007, after gradually gaining strength through 2006, rising by 6 per cent in the March quarter. Liaison with retailers and household service providers also suggests that broad-based growth across classes of expenditure has continued in 2007. Measures of consumer sentiment have recovered strongly in recent months to be well above long-run average levels.



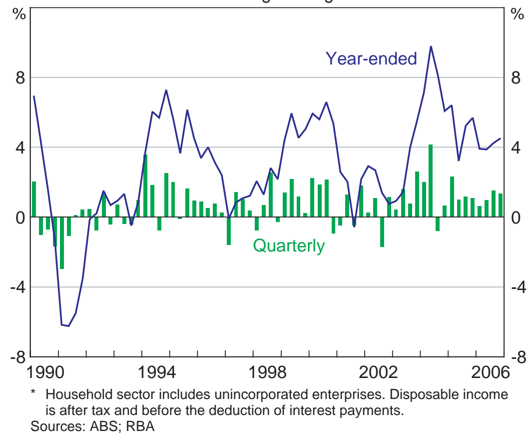
Sources: ABS; FCAI; Melbourne Institute and Westpac; RBA

Household spending has been supported by strong conditions in the labour market and increases in wealth. Robust growth in employment and real earnings

has contributed to growth in total real household disposable income over recent quarters, more than offsetting the impact on the incomes of rural households of the drought (Graph 35). The net worth of households – the difference between their assets and liabilities – has continued to increase as buoyant financial markets have boosted the value of households' equities and superannuation holdings, and house prices have shown moderate growth. Household debt growth picked up slightly in the March quarter, though it remains below the rates recorded in the middle of last year. Nevertheless, as discussed in the March 2007 *Financial Stability Review*, the majority of households are coping well with the higher levels of debt.

Graph 35

Real Household Disposable Income*



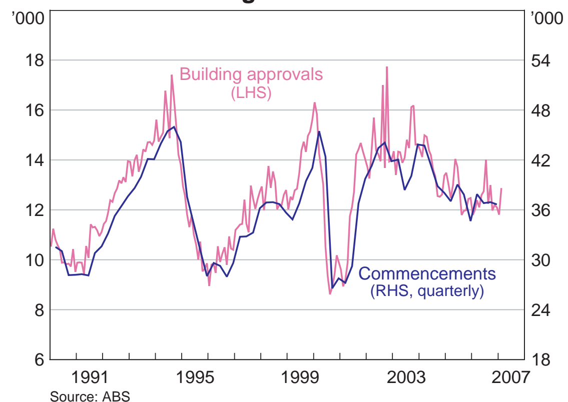
* Household sector includes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.
Sources: ABS; RBA

Housing

After a mild downturn starting in mid 2004, dwelling investment showed a modest recovery in the second half of last year. The pick-up mostly reflected growth in alterations & additions, with a moderate recovery in house construction and further falls in building of units. In the latter part of last year, building approvals weakened, and point to the likelihood of renewed declines in housing investment in the next couple of quarters (Graph 36). However, a number of factors suggest that dwelling investment is likely to be somewhat stronger than indicated by the number of building approvals. First, alterations & additions, which account for nearly half of total dwelling investment, are not showing the same signs of weakness. Robust growth in household income and wealth is underpinning spending on upgrading the quality of the existing housing stock, just as it has boosted consumption spending. In addition, with the run-up in housing prices, transaction costs associated with moving have risen, which has increased the attractiveness of renovating relative to moving. Second, houses being built now are on average larger and of a higher quality than in the past, so a given number of approvals now leads to a greater volume of construction work.

Graph 36

Housing Construction

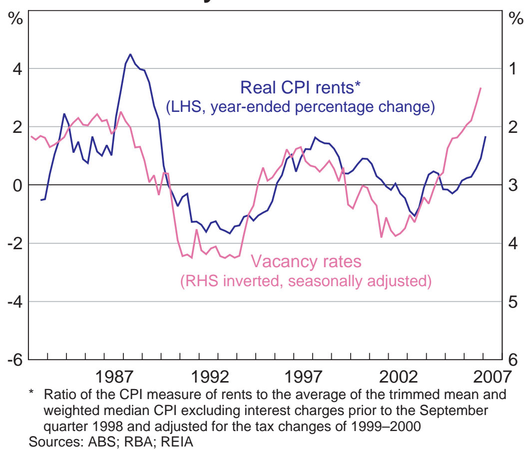


Source: ABS

For the past couple of years the number of houses and units being built has not kept pace with the underlying demand for new housing that results from factors such as population growth, declining household size and demolitions. In 2006, 142 000 dwellings were built, with a similar number likely to be built this year. This compares with estimates for underlying demand that are typically around 160 000–175 000 a year, although these estimates of underlying demand might be overstated to the extent that the increased cost of housing has dampened demand. The effect of the shortfall in the construction of new dwellings is most clearly evident in the rental market. According to data from the state Real Estate Institutes, the rental vacancy rate has fallen from nearly 4 per cent in 2002 to around 1.3 per cent at the end of 2006. This is the lowest level since data were first collected in 1978, and compares with an average vacancy rate of just under 3 per cent over this period. The growing shortage of available rental dwellings is contributing to faster growth in rents, which in turn should help lift returns to investors and hence add to dwelling construction over the medium term. The CPI measure of nationwide rents increased by 1.4 per cent in the March quarter, and by 4.4 per cent over the year, faster than the overall rate of inflation (Graph 37).

Graph 37

Vacancy Rates and Rents



* Ratio of the CPI measure of rents to the average of the trimmed mean and weighted median CPI excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

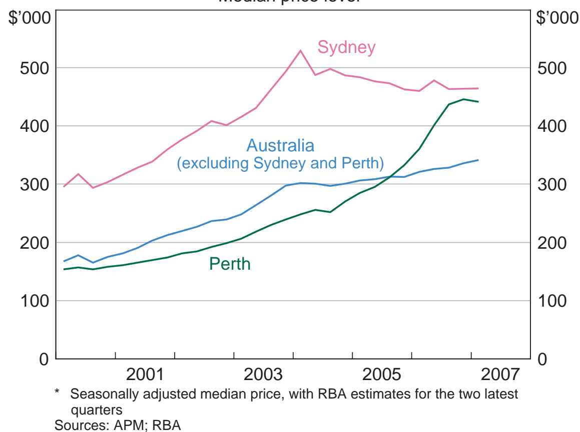
Sources: ABS; RBA; REIA

Average nationwide housing prices have continued to show modest growth, with house prices growing slightly faster than unit prices. The APM mix-adjusted measure indicates that average metropolitan housing prices were broadly unchanged in the March quarter although they were 5 per cent higher over the year (Table 7). Recent data indicate that the median house price in Perth has edged closer to that in Sydney, which remains the most expensive in Australia despite falling by 8 per cent since its peak (Graph 38). However, Perth prices appear to have stabilised following an extended period of strong gains. Other housing price series constructed using different methods currently show broadly similar movements nationwide. The Residex measure, which tracks repeat sales of individual properties,

Graph 38

Australian House Prices

Median price level*



* Seasonally adjusted median price, with RBA estimates for the two latest quarters

Sources: APM; RBA

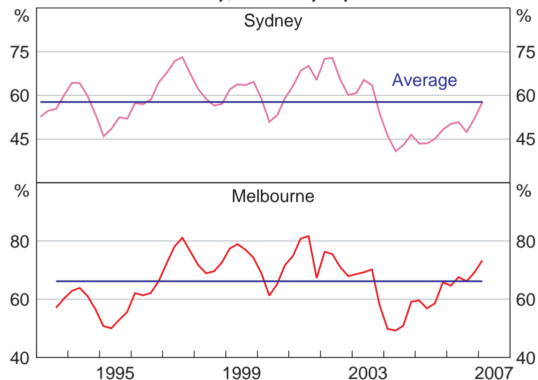
Table 7: Housing Prices[(a)]
Percentage change

	APM (Mix-adjusted index)		Residex (Repeat-sales index)		RP Data/Rismark (Hedonic index)	
	Mar qtr 2007	Year to Mar qtr	Mar qtr 2007	Year to Mar qtr	Mar qtr 2007	Year to Mar qtr
Sydney	–1	–1	2	2	1	1
Melbourne	2	4	5	7	1	5
Brisbane	1	7	2	8	2	9
Adelaide	2	8	2	5	3	7
Perth	–1	21	–1	13	–1	23
Canberra	0	5	1	7	0	6
Hobart	0	4	–1	3	..	..
Darwin	–1	16	2	–1	–2	11
Australia	**0**	**5**	**2**	**7**	**1**	**5**

(a) Houses and units except for APM data for Canberra, Hobart and Darwin which are houses only
Sources: APM; RBA; Residex; RP Data/Rismark

rose by 2 per cent in the quarter and by 7 per cent over the year. The recently developed hedonic index from RP Data/Rismark, which takes into account the characteristics of each property sold (such as the location, and the number of bedrooms and bathrooms), suggests that nationwide housing prices rose by 1 per cent in the March quarter, to be 5 per cent higher over the year. Auction clearance rates have increased in Sydney and Melbourne in recent months, presenting a slightly stronger perspective of the housing market than is apparent in the price data (Graph 39). This may partly reflect the relative strength in the top-end of the market in which auctions are more common; disaggregated price data for both of these cities suggest that the more expensive suburbs have been experiencing stronger price trends than the less expensive ones.

Graph 39



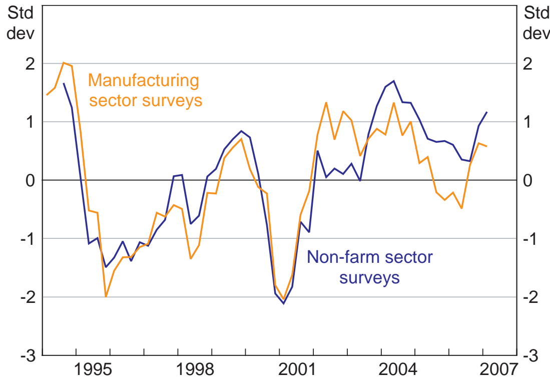
* Adjusted for withdrawals where possible
Sources: APM; RBA; REIV

Business sector

Business conditions in the non-farm sector have remained favourable. Private-sector surveys suggest that across sectors and firm sizes, aggregate conditions were above long-run average levels in the March quarter (Graph 40). Surveys report that business conditions in the non-farm sector generally picked up in the quarter, though conditions in the manufacturing sector

Graph 40

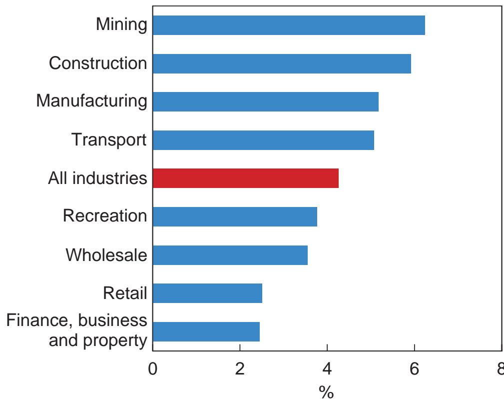
Actual Business Conditions*



* Weighted average of data from various business surveys, with weights calculated by the RBA using the principal component method
Sources: ACCI; AIG; NAB; SAI Global; Sensis; St. George Bank; Westpac

Graph 41

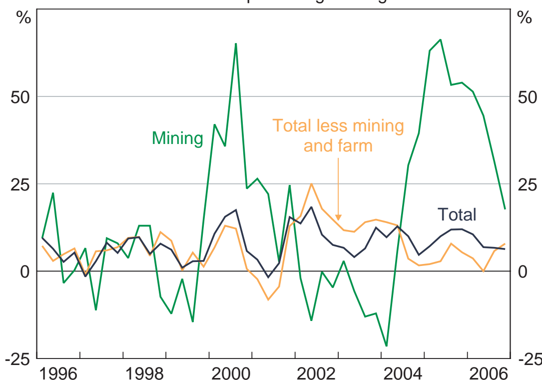
Capacity Utilisation by Industry



Sources: NAB; RBA

Graph 42

Profits*



* Combined profits of both the corporate and unincorporated sectors
Sources: ABS; RBA

apparently eased slightly. Firms also continue to report high levels of capacity utilisation in most industries (Graph 41).

According to the national accounts, business profits grew by 6.3 per cent over the year to the December quarter (Graph 42). The profit share – at 30 per cent of GDP – remained close to its 30-year high. Notwithstanding this, business profit growth has moderated over the past year, predominantly reflecting an easing in mining profit growth from the exceptional rates recorded in 2005. While demand for resources remains strong, rising materials and labour costs and slower growth in resource prices have begun to weigh on earnings growth (Graph 43). In addition, a sharp fall in farm income due to the drought has subtracted from aggregate business profits. Outside of the mining and farm sectors, profit growth strengthened in the second half of 2006, in line with the pick-up in household demand and a slight moderation in input cost growth from its recent highs. Business surveys generally indicate that firms' expectations of profit growth remain around long-run averages, and equity analysts expect reasonable growth in earnings for non-mining companies over the full financial year (for details see the 'Domestic Financial Markets and Conditions' chapter).

Businesses appear well placed to fund investment given the high level of profits, supportive financial conditions and, as discussed in the March 2007 *Financial Stability*

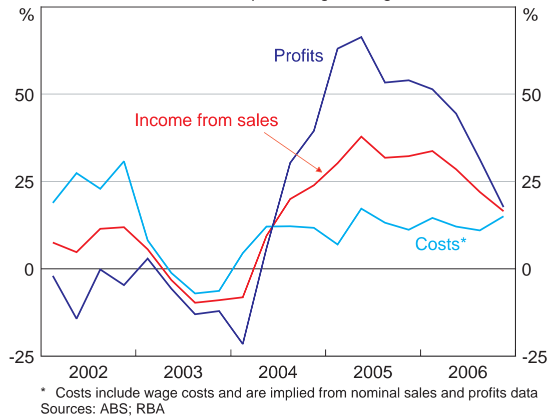
Review, the generally good shape of business balance sheets. Although growth slowed to 2 per cent over 2006, business investment is at a very high level as a share of GDP following average growth of 16 per cent over the four years to the end of 2005 (Graph 44). While growth in non-residential construction has slowed from the rapid rates recorded in recent years, it is at its highest share of GDP in the almost 50 years for which data are available, to a large extent reflecting the expansion in mining infrastructure in response to higher mineral prices. In contrast, machinery & equipment investment has contracted somewhat, with drought conditions prompting a sharp fall in spending by the farm sector in recent quarters, combined with a decline in spending by manufacturers and a lull in lumpy items such as new aircraft.

Looking ahead, the capital expenditure (Capex) survey's first estimate of spending plans for 2007/08 points to moderate growth. In addition, forward-looking indicators suggest that non-residential construction activity will remain firm in the coming quarters. The pipeline of work yet to be done is at a high level relative to the current pace of activity, particularly for engineering construction (Graph 45). Public investment has also been growing rapidly, both at the Commonwealth and state & local government levels. However, labour and equipment shortages combined with rising construction costs continue to hamper progress on

Graph 43

Mining Sector – Sales and Costs

Year-ended percentage change



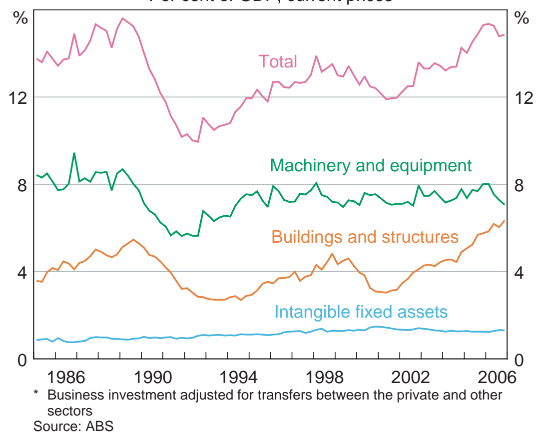
* Costs include wage costs and are implied from nominal sales and profits data

Sources: ABS; RBA

Graph 44

Investment*

Per cent of GDP, current prices



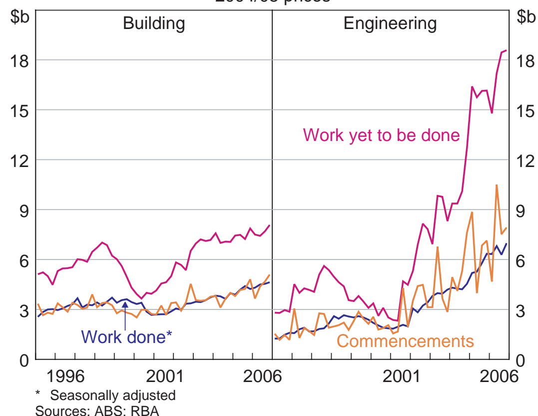
* Business investment adjusted for transfers between the private and other sectors

Source: ABS

Graph 45

Non-residential Construction Indicators

2004/05 prices



* Seasonally adjusted

Sources: ABS; RBA

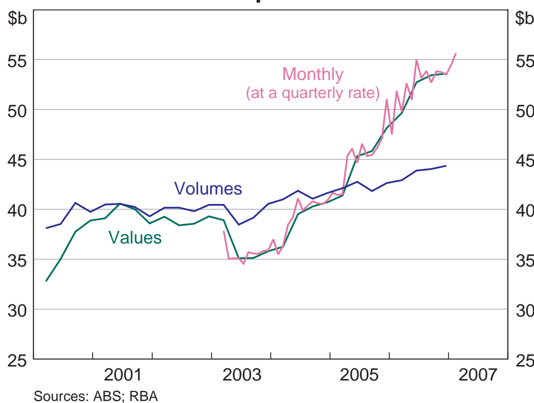
some projects. Overall, the high level of investment together with favourable business conditions should support continued strong growth in the capital stock and help to ease capacity constraints in some sectors.

Farm sector

Conditions in the rural sector remain difficult. The Australian Bureau of Agricultural and Resource Economics (ABARE) is forecasting farm output for 2006/07 to fall by around 20 per cent, driven by a 60 per cent decline in the 2006/07 winter crop. Most agricultural areas remain drought-declared, water storage levels are at historic lows and water allocations to irrigators in the Murray-Darling basin may need to be cut further. However, most agricultural districts have recorded around average rainfall since the start of the year, and there are some early indications that weather conditions may improve over the course of 2007. Weather forecasters have suggested that there is a slightly higher than usual chance of a La Niña event developing in coming months, which would typically bring with it above-average rainfall across the eastern half of the country. In previous droughts output has rebounded strongly once seasonal conditions have returned to normal, but given the extended period of low rainfall, and low soil moisture and stored water levels, any recovery on this occasion may be more muted.

External sector

Export earnings rose in the first two months of 2007, to be 2½ per cent higher than in the December quarter and 11 per cent higher over the year (Graph 46). All major components of exports increased, except for rural goods, which have been affected by the drought. There is likely to have been some weakness in exports during the month of March owing to cyclone-related disruptions to iron ore and oil exports. Overall, with export prices estimated to have risen only slightly, export volumes appear to have increased firmly in the March quarter, following growth of around 4 per cent over 2006.



Recent increases in resource exports largely reflect increases in the volume of iron ore, coal, LNG and metals (Graph 47). This continues the gradual recovery in the volume of resource exports, with annual average growth picking up from 1.3 per cent in the five years from 2000 to 2004, to 4.4 per cent in the past two years (Table 8). As foreshadowed in a special chapter on resource exports in the February 2005 *Statement*, much of this pick-up in growth has been due to increases in the production of commodities that had contributed most to the weakness in the early 2000s.

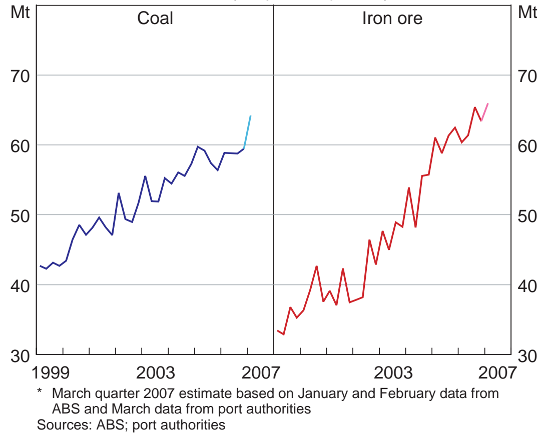
Some resource exports – notably oil, LNG, metals and gold – have seen firm growth as additional supply capacity has come on line. Recent increases in mining capacity – including in the Pilbara in Western Australia and Bowen Basin in Queensland – should boost exports of iron ore and coal in the coming quarters. However, overall resource export volumes have grown only moderately in recent years despite the strength of global demand and mining investment. In part this seems to have reflected a number of disruptions to production due to bad weather and various accidents, as well as existing operations needing to be shut down in order for new capacity to be brought on line. In addition, depletion of reserves at existing operations has been an issue for some commodities, most notably in the case of oil.

Nevertheless, resource export growth has been broadly comparable to the corresponding stage of the mining boom in the late 1970s and early 1980s. On that occasion, mining investment rose for six years, but it took a further one to two years after the peak in investment before there was significant growth in resource export volumes (Graph 48). In the current boom, mining investment has increased for five consecutive years, with increases in mine capacity and transport infrastructure expected to result in a significant lift in aggregate resource exports over the next two years – in particular metal ores, metals, coal and oil.

Graph 47

Bulk Resource Export Volumes*

Seasonally adjusted, quarterly



* March quarter 2007 estimate based on January and February data from ABS and March data from port authorities

Sources: ABS; port authorities

Table 8: Recent Trends in Resource Export Volumes

Average annual growth, per cent

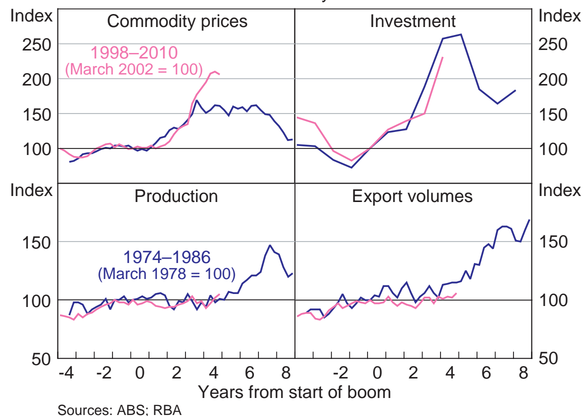
	2000 to 2004	2005 to 2006
Total resources	1.3	4.4
– Metal ores & minerals	6.0	5.0
– Coal, coke & briquettes	5.8	1.7
– Other mineral fuels	–0.9	10.5
– Gold	–6.7	2.9
– Metals	–4.2	1.7

Sources: ABS; RBA

Graph 48

Mining Sector Activity

Quarterly

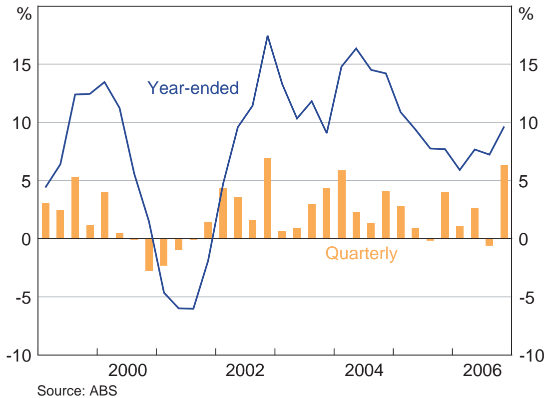


Sources: ABS; RBA

Manufactured and service export earnings increased strongly over the year to February. Surveys and liaison also indicate that manufacturing exports are growing at a firm pace. However, rural exports have been weighed down by the drought. Recent data point to further weakness in rural exports in the March quarter, largely reflecting lower exports of cereals. After declining by more than 30 per cent in the December quarter, the volume of wheat exports has fallen by a further 25 per cent in the first two months of this year.

Graph 49

Import Volumes



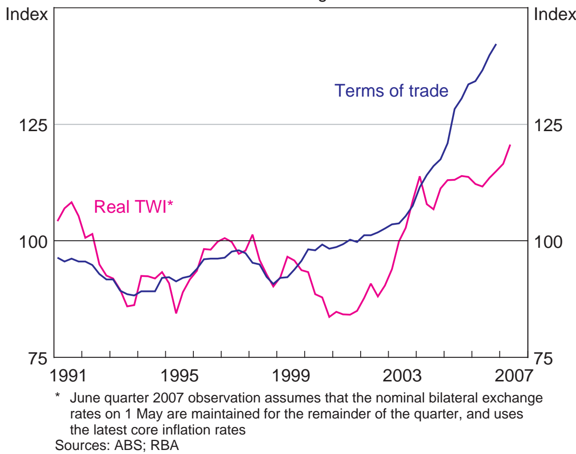
Source: ABS

Import volumes increased strongly in the December quarter and over 2006, driven by firm growth in domestic demand (Graph 49). Recent data indicate that the value of imports continued to rise in the March quarter. The strength in imports in the past two quarters has been broad-based, with imports of consumption goods picking up further in the March quarter, consistent with the recent retail trade figures.

Graph 50

Real Exchange Rate and Terms of Trade

Post-float average = 100



* June quarter 2007 observation assumes that the nominal bilateral exchange rates on 1 May are maintained for the remainder of the quarter, and uses the latest core inflation rates

Sources: ABS; RBA

The recent appreciation of the Australian dollar has brought the real exchange rate to around 21 per cent above its post-float average (Graph 50). By itself, this would be expected to be contractionary for the economy, restraining growth of exports and boosting import growth. However, the appreciation has taken place in the context of a strong world economy and a marked increase in Australia's terms of trade. For the economy as a whole the restrictive effects of the high real exchange rate are likely to be more than counterbalanced by the boost to national income from the high terms of trade, which at the end of 2006 were 42 per cent above their post-float average.

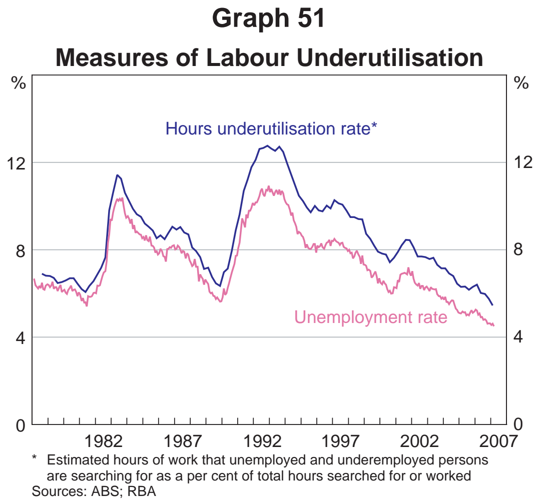
The current account deficit widened to 5.9 per cent of GDP in the December quarter reflecting increases in both the trade deficit, resulting from strong import growth, and the net income deficit (NID). At 4.4 per cent of GDP, the NID stood at its highest level since 1990. Interest payments on debt owed abroad have increased strongly reflecting rises in both interest rates and the stock of Australia's foreign debt, while equity payments remain high due to strong

profitability of fully or partly foreign-owned enterprises operating in Australia, mainly in the resource sector.

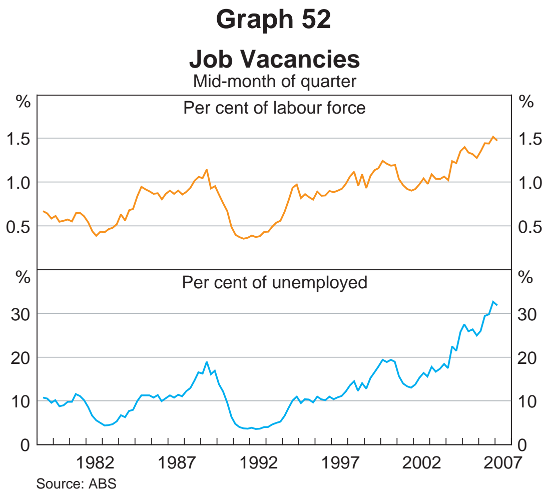
Labour market

Employment grew by an above-average 2.7 per cent over the year to March. Growth was concentrated in full-time employment and was broad-based across industries, with construction, wholesale trade, hospitality and finance & insurance making especially strong contributions over the past year. As discussed in previous *Statements*, a significant part of the increase in demand for labour has been accommodated by an increase in the participation rate. An additional source of labour supply has been migration. Box B: 'Developments in Labour Supply' discusses the contribution of these factors to employment growth in recent years.

The unemployment rate was at a generational low of 4.5 per cent in March. This conventionally-measured unemployment rate does not take into account the willingness of employed people to work more hours. An hours-based measure of underemployment, or labour underutilisation, accounts for this by combining the additional hours that both the unemployed and the underemployed would like to work. This broader measure of underemployment is higher than the standard unemployment rate, as usual, though it has followed a similar trend in recent years and has also reached its lowest level in over 25 years, reflecting the tight labour market conditions (Graph 51).

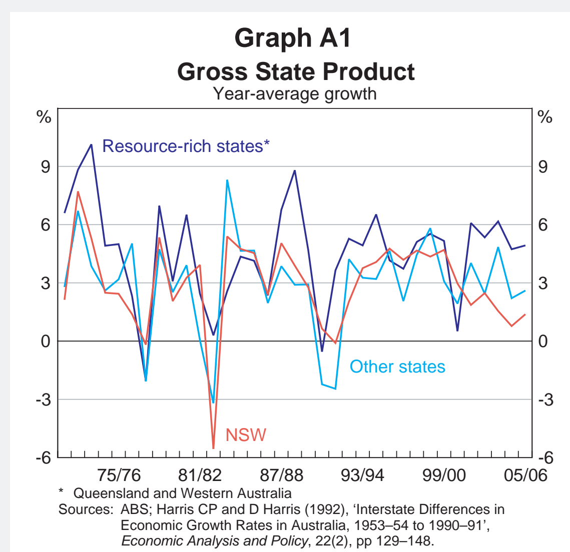


Another indicator of labour-market tightness is the number of job vacancies reported by the ABS (Graph 52). This series, which is from a survey of businesses rather than a count of advertisements that might be subject to double-counting, confirms the current tightness of the labour market. The recent increases in the vacancy rate are consistent with indications from liaison contacts that labour shortages have intensified further in recent quarters and, in some cases, are constraining output.



Box A: Regional Economic Performance and Population Flows

As noted in previous *Statements*, the economic performance of the states has diverged somewhat since the early 2000s. Western Australia and Queensland (the 'resource-rich states') have grown the most rapidly, and New South Wales has grown more slowly than the other non-resource states (Graph A1). Although there have been early signs in recent quarters that the divergence in growth may be narrowing, the resource-rich states are likely to continue to experience faster growth in 2007.

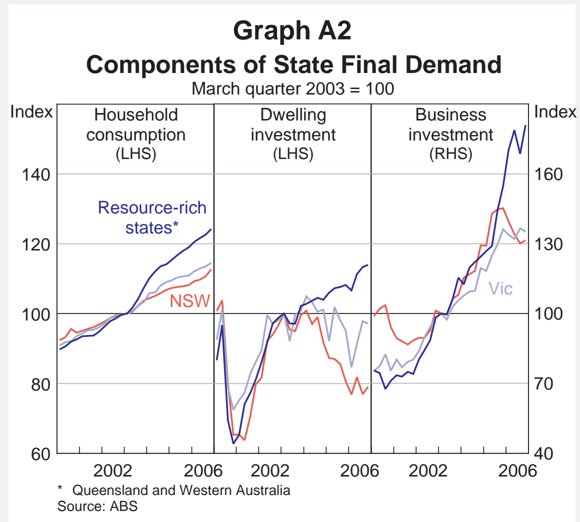


* Queensland and Western Australia
Sources: ABS; Harris CP and D Harris (1992), 'Interstate Differences in Economic Growth Rates in Australia, 1953–54 to 1990–91', *Economic Analysis and Policy*, 22(2), pp 129–148.

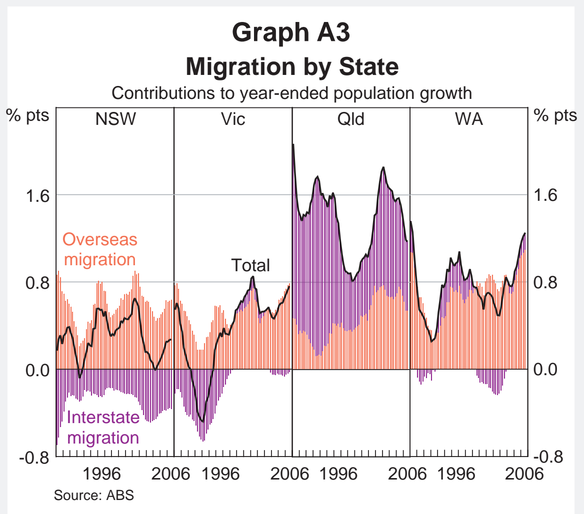
In recent years, much of the divergence can be directly linked to the effect of the large rise in commodity prices and Australia's terms of trade. The associated increase in national income has benefited all states through such channels as higher dividend payments to shareholders, increased demand by the resource-rich states for goods and services from the other states, and higher government revenues.[1] However, the resource-rich states, where mining accounts for a larger share of output, have seen the greatest direct benefits as the prospect of higher returns in resource and related industries has attracted both capital and labour. Since 2003 Western Australia and Queensland have experienced large increases in mining-related investment, as well as strong growth in employment, household incomes, consumption and house-building (Graph A2). In contrast, activity in the states where manufacturing has a relatively high share of output such as Victoria and South Australia has been less robust, in part because of the strength of the Australian dollar associated with the increase in Australia's terms of trade. The lower growth in New South Wales since 2003 relative to the other non-resource states in large part appears due to the relative weakness in household consumption and dwelling investment associated with falling house prices and slower population growth.

1 *See 'Commodity Prices and the Terms of Trade', Reserve Bank of Australia* Bulletin, *April 2005, pp 1–7, for a more detailed discussion of the channels through which an increase in the terms of trade stimulates activity.*

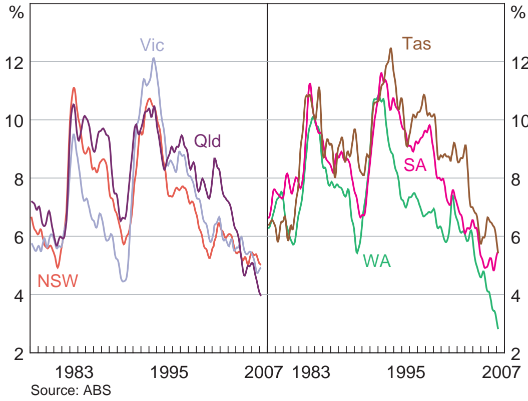
While there are other aspects to migration decisions, including factors such as lifestyle choices and housing affordability, the sharp rise in labour demand and incomes seen in the resource-rich states has contributed to a change in migration patterns, which has further accentuated the divergence in economic performance among the states. Net inward migration to Western Australia has increased significantly over the past couple of years, reflecting increases in net flows from both overseas and other states (Graph A3). In addition, anecdotal reports suggest there has been a flow of temporary workers to Western Australia that may not be captured by the official statistics. Net inward migration has also been very strong over recent years in Queensland, although the effect of the commodity boom is less apparent due to large swings in interstate migration over the past decade due to other factors. In contrast, net inward migration to New South Wales remains subdued, despite a modest recovery in 2006, with continued net interstate outflows partly offsetting relatively strong net inward overseas migration.



The movement of capital and the changes in migration patterns associated with relative labour demand reflect the process of shifting resources to those parts of the economy where returns are highest. This is an important equilibrating force in a flexible economy, allowing national economic growth to be higher than would be the case if resources were not able to move.



Overall, while it is clear that some states have benefited more than others from the increase in commodity prices, economic



conditions are relatively strong across the nation. This is evident in unemployment rates being around the lowest levels since the 1970s in all states and territories (Graph A4) and surveyed business conditions being at above-average levels across the nation. ✠

Box B: Developments in Labour Supply

The strong growth in employment over the past decade and a half has contributed to a significant fall in the unemployment rate. However, it has also been associated with an increase in labour supply from several other sources. This box discusses both the role of increasing labour force participation by people who were not previously in the labour force and the increasing role of migrants in the growth in employment.

Increased labour force participation by residents

Between 1992 and 2006, the proportion of the civilian population aged between 15 and 69 years in employment increased from 62.7 per cent to 70.6 per cent. This significant growth in employment was associated with large changes in the labour market status of different groups (Table B1). Most prominently, the proportion of the working-age population that was unemployed fell from 7.5 per cent to 3.6 per cent.[1] But the growth in employment was also associated with a large decline in the proportion of the working-age population classified as not being in the labour force.

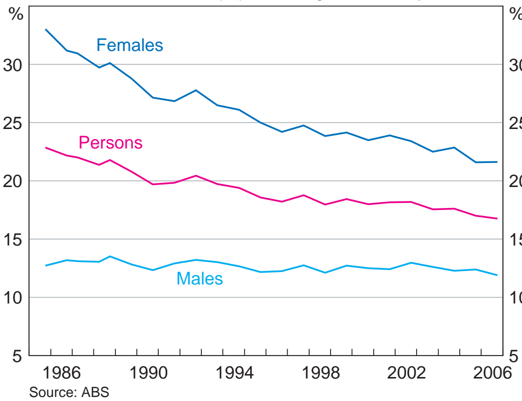
Table B1: Labour Force Status
Per cent of civilian population aged 15 to 69

	September 1992	September 2001	September 2006
Labour force	**70.2**	**72.2**	**74.2**
Employed	62.7	67.3	70.6
Unemployed	7.5	4.9	3.6
Not in the labour force	**29.8**	**27.8**	**25.8**
Marginally attached	6.9	6.0	5.1
– Discouraged job seekers	*1.2*	*0.6*	*0.4*
Not marginally attached	22.9	21.8	20.7
– Do not want to work	*20.4*	*18.1*	*16.8*

Source: ABS

Among people classified as not in the labour force, the largest group is those who do not want to work, for example because they are retired or care full-time for their families. This group has also accounted for the majority of the increase in labour force participation during the current economic expansion. The largest single contributor has been the trend increase in female labour force participation (Graph B1). With respect to age groups, there has been a noteworthy increase in the participation of those aged between 45 and 64 years. Given that people aged between 55 and 64 years have a lower participation rate than the rest of the working-age population, the increase in the share of the population in this age group – primarily the first wave of the baby

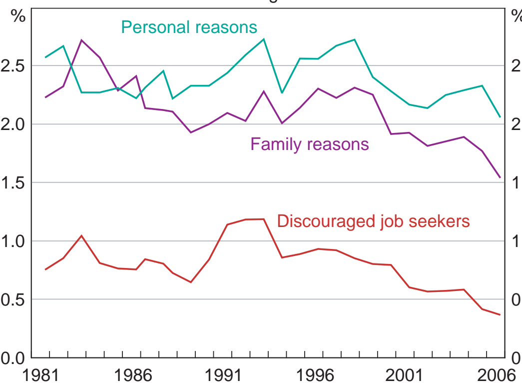
1 *This proportion of unemployed persons is measured in terms of the total population aged 15 to 69 whereas the standard unemployment rate is measured in terms of the labour force aged 15 and over.*



boomer generation who are nearing traditional retirement age – could have been expected to increase the share of the population who do not want to work. However, since the participation rate of these older workers has increased markedly in recent years, this age group has in fact been a declining share of persons who do not want to work.

A second group of persons, who are outside the conventionally defined labour force but more readily available for employment, are known as 'persons with marginal attachment to the labour force'. This group includes people who are willing to work, but are either not actively looking for work or are not available for work immediately. The share of this group in the population was roughly stable at around 7 per cent for most of the 1980s and 1990s, as a trend decline amongst females offset a trend increase amongst males. Since the late 1990s, however, the size of this group has fallen significantly.

The two predominant explanations people in this marginally attached group give for not actively looking for work are 'personal reasons' (especially education) and 'family reasons' (most commonly caring for children). The proportion of people giving each of these explanations has fallen in recent years (Graph B2). The recent decline has been more pronounced for women, some of whom may have benefited from the trend towards greater flexibility in working arrangements that has helped address the family-related reasons that were keeping women out of the labour force.

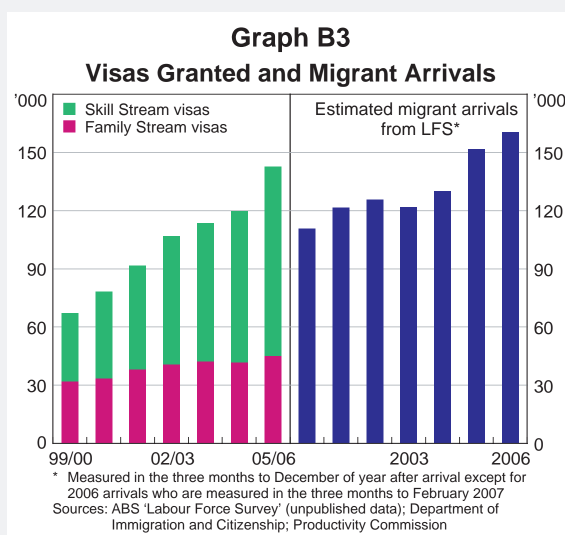


Another category within the 'marginally attached' is the group who would be available to work but have given up looking for employment. The number of 'discouraged jobseekers' in the labour force has fallen significantly over the current expansion, and now constitutes only 0.4 per cent of the working-age population, or around 50 000 persons.

Increased labour force participation by migrants

Another source of potential labour supply, which has received much attention recently, is migration. Available evidence suggests that the number of migrant arrivals, especially those on Skill Stream visas, has increased over the past six years (Graph B3).[2] While immigration contributes to aggregate demand in the economy and hence to demand for labour, an issue not specifically addressed here, immigrants also represent an additional source of labour supply.[3]

Unpublished data from the ABS Labour Force Survey (LFS) provide some evidence on the contribution of recently arrived migrants to the Australian labour market. These data suggest that since 2000 there has been a 45 per cent increase in annual migrant arrivals, and also a significant increase in the proportion of recent migrants who find employment. In recent years, the annual flow of migrant arrivals into employment has been equivalent to around one-third of the annual increase in aggregate employment.

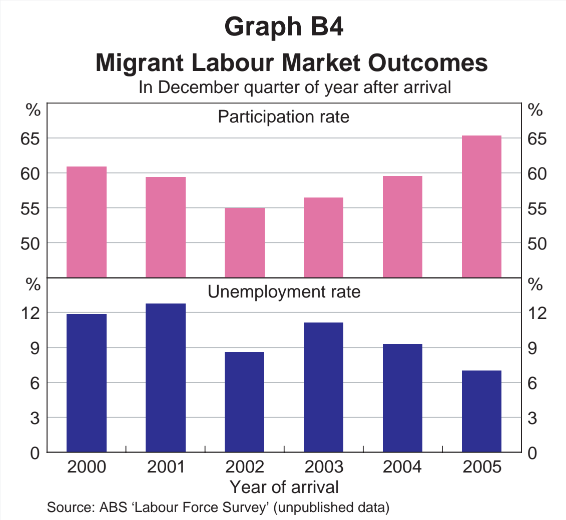


The labour force participation rate and the unemployment rate can give a rough indication of the interaction of migrants with the labour market. In order to account for the time it takes for recent migrants to settle, Graph B4 shows the employment characteristics of migrants in the December quarter in the year after they arrived. On this basis, the participation rate of recent migrants has gradually increased over the past few years, so that the participation rate for those who arrived during 2005 was virtually equal to the economy-wide rate by the end of 2006.

Traditionally, recent migrants have had higher unemployment rates than the population as a whole. However, over the past two years the unemployment rate of recent migrants has declined at a somewhat faster rate than for the population as a whole, so that their unemployment rate is now closer to the economy-wide rate within two years of the migrants arriving in Australia.

2 *The data in the two panels of the graph are not strictly comparable for several reasons, although the trends are broadly similar. The data on visas granted do not include migrants from New Zealand, the humanitarian program or temporary visas. The LFS data include migrants aged 15 years and over who are staying in Australia for more than 12 months in total. Therefore, the LFS data would include many migrants on Temporary Business (Long Stay) visas (subclass 457) which allow migrants to reside in Australia for up to four years. The main groups excluded from the LFS data and the analysis here are working holiday makers (subclass 417 visas) and business visitors.*

3 *For further analysis, see Productivity Commission,* Economic Impacts of Migration and Population Growth, Final Report, *April 2006.*



The stronger labour market experience of recent migrants compared with those who arrived earlier in the decade is likely to reflect both demand and supply factors. As a result of the increase in the Skill Stream visa category, recent migrants may have skills better matched to the Australian labour market. But the strength of the domestic labour market has also provided migrants with better employment opportunities. Reflecting the resources boom, Western Australia has had the tightest labour market in Australia, with high employment growth and shortages of skilled workers. It is perhaps not surprising that Western Australia received a disproportionately large share of migrant arrivals in 2006 compared with the other Australian states, and that the participation and employment rates for migrants in Western Australia have been stronger than for migrants settling in other states (see 'Box A: Regional Economic Performance' for state-level immigration data).

Domestic Financial Markets and Conditions

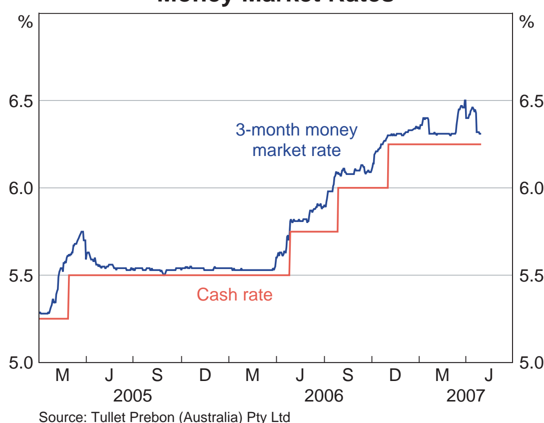
Interest rates and equity prices

Money and bond yields

Short-term interest rates have fluctuated over the past few months, though, in net terms, have shown little change since the last *Statement* (Graph 53). Three-month money market rates rose in March as market participants revised upward their expectations for further tightening in monetary policy in the light of indicators of stronger economic activity. By late March, markets were expecting a rise in the cash rate, to 6½ per cent by mid year. Those expectations were significantly reduced following the release of the lower-than-expected March quarter CPI figures in late April. The market currently expects around a 50 per cent chance of a tightening of monetary policy by the end of the year.

Graph 53

Money Market Rates



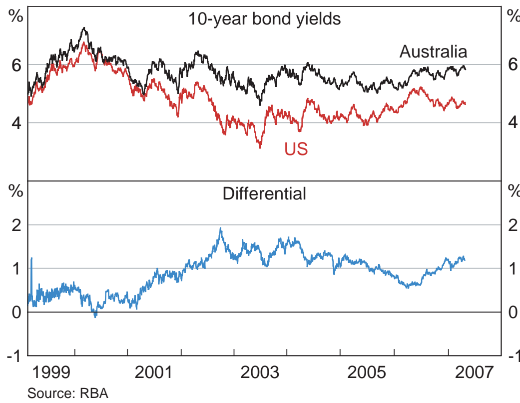
Source: Tullet Prebon (Australia) Pty Ltd

Long-term interest rates have also fluctuated but shown little net change since the last *Statement* (Graph 54). Those on 10-year nominal bonds are now around 5.8 per cent, despite having initially fallen to 5.6 per cent in early March. While developments in US markets continued to have the major influence on local yields, the relative strength in domestic indicators has seen the spread between Australian and US yields widen to around 120 basis points from around 100 basis points at the time of the last *Statement*.

Yields on inflation-indexed bonds are also unchanged in net terms since early February, with implied inflation expectations remaining a little above 3 per cent. Yields on inflation-indexed bonds have in recent years been lower than they otherwise would have been due to the lack of new issuance and institutional factors which have boosted demand. This has reduced the usefulness of these yields in providing information about movements in inflation expectations.

Graph 54

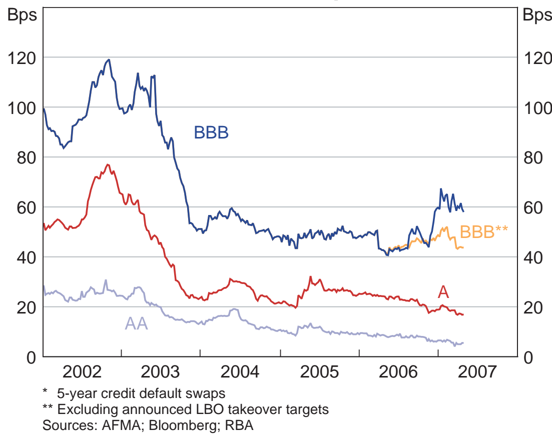
Australian and US 10-year Bonds



Source: RBA

Graph 55

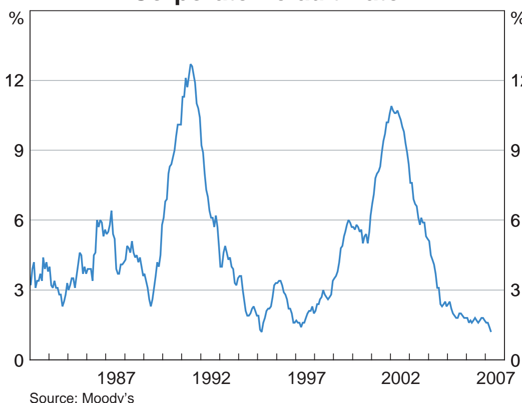
Credit Default Swap Premia*



* 5-year credit default swaps
** Excluding announced LBO takeover targets
Sources: AFMA; Bloomberg; RBA

Graph 56

Moody's Global Speculative Grade Corporate Default Rate



Source: Moody's

Market perceptions of corporate credit risk have been broadly unchanged over the year so far and generally remain low (Graph 55). However, the premia on credit default swaps (CDS) – which are financial derivatives that provide insurance against defaults on corporate debts – for companies that are leveraged buyout targets have been volatile and remain at elevated levels. This reflects the likelihood that the debt-servicing burden of the bought-out company would increase, thereby increasing the default risk.

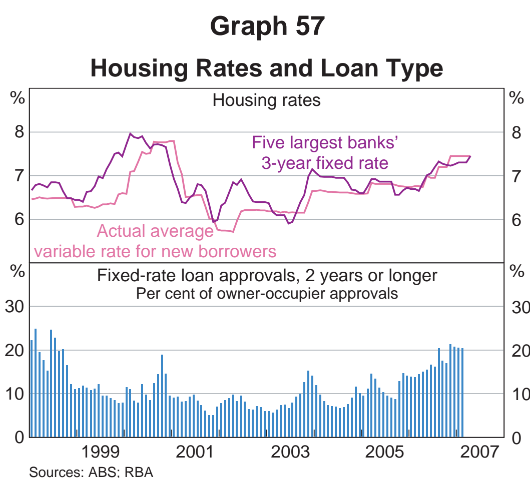
The generally low level of corporate bond spreads and CDS premia in part reflects low default rates in Australia and globally. In Australia, the most recent default of a rated corporate bond occurred in mid 2004, while the global speculative-grade default rate, at less than 2 per cent in April, remains close to its historical low (Graph 56). Changes to corporate credit ratings also indicate that credit quality generally remains high in Australia; Standard and Poor's announced more upgrades than downgrades in the March quarter. This is a continuation of last year's positive rating experience, and is favourable compared with history and on a global basis. In recent months, Standard and Poor's upgraded the four major banks, citing stronger risk management and very good asset quality.

Market perceptions of the quality of Australian sub-prime RMBS do not appear to have been affected by the recent stress experienced in the US sub-prime lending sector (see the 'International and Foreign Exchange Markets' chapter). Sub-prime loans in Australia are offered by a few specialist non-deposit taking lenders and account for just 1 per cent of all outstanding mortgages compared with 15 per cent of outstanding mortgages in the US. Subsequent to the developments in the US, $1.4 billion of Australian sub-prime RMBS have been issued, with one-third of these loans in the underlying mortgage pools to people with a documented record of loan default. Strong demand from investors meant that these RMBS issues were oversubscribed and sold at spreads that were low relative to initial expectations and history.

The share of Australian sub-prime loans in arrears has risen in recent years to around 6 per cent in early 2007, less than half the equivalent arrears rate on sub-prime loans in the US. To date, these arrears have not resulted in any losses to RMBS investors as defaults have been covered by property sales and securitisation vehicles' profits.

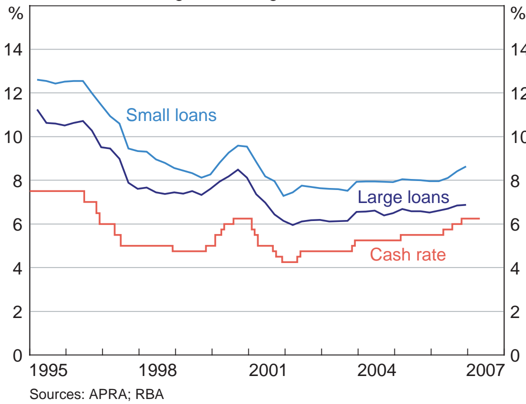
Intermediaries' interest rates

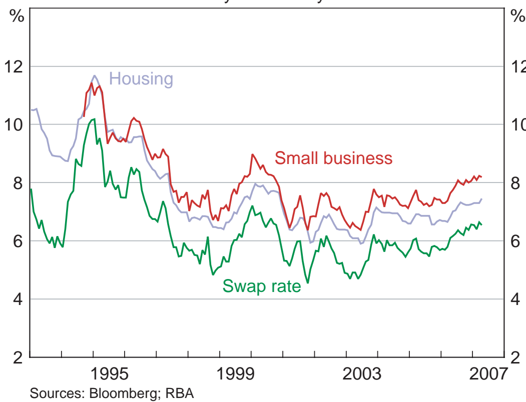
Most financial intermediaries' variable housing loan indicator rates have not changed since the time of the last *Statement*, consistent with there having been no change in the cash rate (Graph 57). After taking into account interest rate discounts, which are now received by almost all borrowers, the average actual variable housing rate paid by new borrowers is currently 7.45 per cent.



The five largest banks' average 3-year fixed rate on housing loans is also around 7.45 per cent, 15 basis points higher than at the time of the last *Statement*, although two major banks are currently offering discounts of up to 20 basis points on their 3-year fixed rate loans. The share of owner-occupier loan approvals that are at fixed rates has been stable at around 20 per cent over the three months to February (the latest data available). The higher-than-average share of housing loan approvals at fixed rates reflects a combination of borrower concern about the prospect of further rises in interest rates, fixed rates having been lower than variable rates and increased competition between banks to supply fixed-rate loans.

Over the past few months, several schemes have been launched by state governments and financial institutions to help first-home buyers (mainly those with low incomes) purchase a dwelling. These have been established either as shared-appreciation loans, where the lender receives a share of any capital gains or losses on the dwelling in lieu of interest, or as shared-equity schemes, where another party, usually the sponsoring institution or a friend or relative of the owner-occupier, separately owns and finances a share of the dwelling.

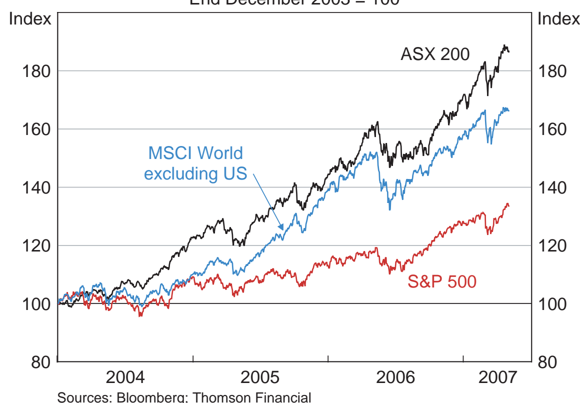




Competitive pressures continue to be evident in the business loan market (Graph 58). Despite the 25 basis point increase in the cash rate in November, the weighted-average interest rate paid on large variable-rate business loans rose by only 5 basis points in the December quarter (the latest period for which data are available). Over the whole of 2006, the weighted-average interest rate rose by 35 basis points, about half the 75 basis point increase in the cash rate. In contrast, the weighted-average interest rate on small variable-rate business loans rose by 20 basis points in the December quarter, and by 65 basis points over the whole of 2006.

The average 3-year fixed rate on small business loans was little changed over the past quarter at 8.2 per cent (Graph 59). The 3-year bank swap rate, which approximates the cost of funding these loans, was unchanged over the period.

Equity markets

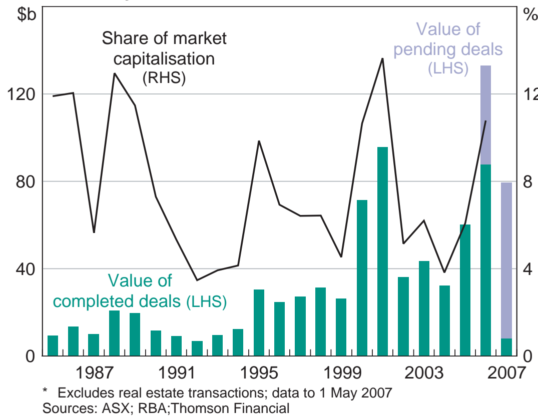


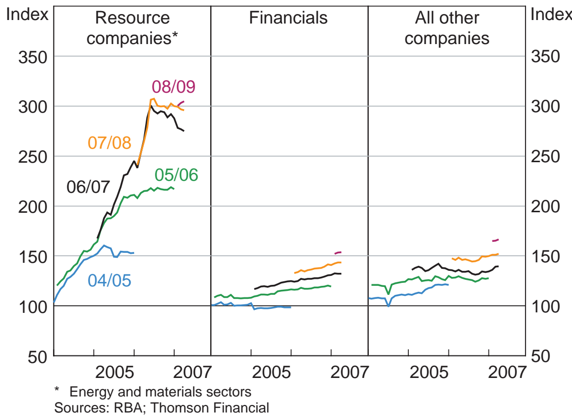
The ASX 200 has continued to outperform overseas share markets, rising by almost 10 per cent so far this year (Graph 60). This follows four consecutive years of very strong returns, and three consecutive years of outperformance. The rise in the share market has been broadly based, as was the case in 2006.

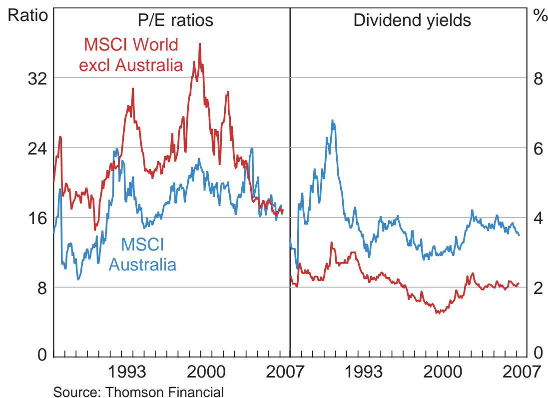
Following the turmoil in overseas share markets in late February (described in the 'International and Foreign Exchange Markets' chapter), the ASX 200 fell almost 3 per cent – the largest fall in a day since September 2001. The decline, however, proved to be short-lived and the share market quickly regained the losses experienced in late February/early March. It is now about 10 per cent above the trough reached in early March, having recorded successive highs over the past month or so.

Share prices have been supported by strong profit reports – around two-thirds of those ASX 200 companies that reported recently had stronger-than-expected profits. Underlying profits for reporting companies (which exclude significant items such as write-downs and gains and losses from asset revaluations/sales) were 26 per cent higher in the December half-year than in the corresponding period of 2005. While the growth rate in the resource sector moderated, growth in underlying profits of other companies accelerated. Nevertheless, resource companies' underlying profits increased by around 40 per cent, while the financials sector reported underlying profit growth of 22 per cent. For the banking sector, the profit outcome reflected strong balance sheet growth and restrained growth in costs which were partially offset by falling interest margins.

Recent takeover activity, both announced and speculated, has probably also provided support to equity prices. The value of merger and acquisition (M&A) activity in 2006 was relatively high, at about 10 per cent of the capitalisation of the local share market, although still below that in the late 1980s and in 2001 (Graph 61). This buoyancy has continued into the first few months of 2007, with around $80 billion of deals announced so far. Leveraged buyouts (LBOs) have accounted for much of the M&A activity in 2007 to date, with $37 billion of LBOs announced. The cumulative value of LBOs announced since the start of 2006 is $61 billion, which is equivalent to 3 per cent of the Australian non-financial corporate sector.







Analysts expect the earnings of resource companies to grow by 21 per cent in 2006/07. While growth in resource companies' earnings is expected to slow over the next couple of years to 7 per cent in 2007/08 and 3 per cent the following year, this still leaves the level of earnings per share at an historically high level. Growth in financials' and other companies' earnings are forecast to be broadly steady, averaging about 7–10 per cent per year, over the next three financial years (Graph 62).

The P/E ratio – the ratio of share prices to actual earnings per share – continues to be close to its historical average after taking account of the latest profit results (Graph 63). The forward P/E ratio – which is calculated using forecast earnings for the next financial year – is also close to average. The dividend yield remained at 3.5 per cent in April, slightly below its post-1987 average of 3.8 per cent.

Financing activity

Intermediated financing

Credit growth has picked up in recent months, following a period of moderation in the second half of 2006; credit growth was around 15 per cent over the year to March (Table 9). The recent pick-up in growth mostly reflects developments in business credit (Graph 64). Growth in borrowing by both unincorporated and incorporated entities has been strong, with the latter boosted by the recent significant

Table 9: Financial Aggregates
Average monthly growth, percentage change

	June quarter 2006	September quarter 2006	December quarter 2006	March quarter 2007
Total credit	1.2	1.2	1.0	1.3
Household	1.3	1.2	0.8	1.0
– Owner-occupier housing	1.3	1.3	1.0	1.1
– Investor housing	1.3	0.8	0.6	0.9
– Personal	1.0	1.2	0.7	1.0
Business	1.1	1.1	1.3	1.6
Broad money	0.9	1.0	0.8	1.2

Source: RBA

increase in debt-funded mergers and acquisitions activity.

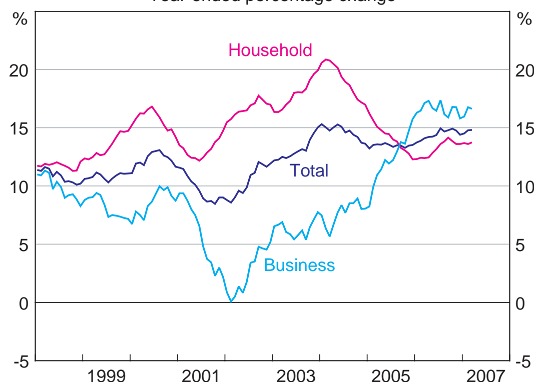
The demand for funds associated with LBO activity is starting to have an impact on the syndicated lending market. In the March quarter of 2007, $28 billion of syndicated loans were approved, of which around a quarter were used to fund LBOs (Graph 65). Some of these loans are now being bought by institutional investors; this is common practice in the US and Europe.

Also in line with international developments, 'covenant-lite' packages for the senior debt funding have become more common in the Australian LBO market. Covenant-lite loans pay a slightly higher interest rate in return for fewer loan covenants (such as maximum debt-to-earnings multiples and minimum loan amortisation rates). These funding arrangements allow the bought-out company greater flexibility in meeting debt obligations, but increase the credit risk for lenders. Overall, however, as discussed in the latest *Financial Stability Review*, Australian banks'

Graph 64

Credit Growth*

Year-ended percentage change

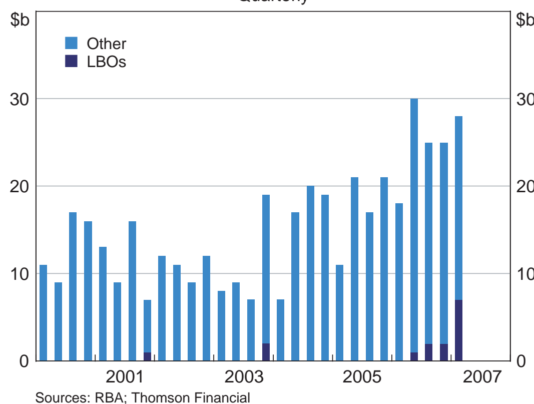


* Includes securitised loans
Source: RBA

Graph 65

Syndicated Loan Approvals

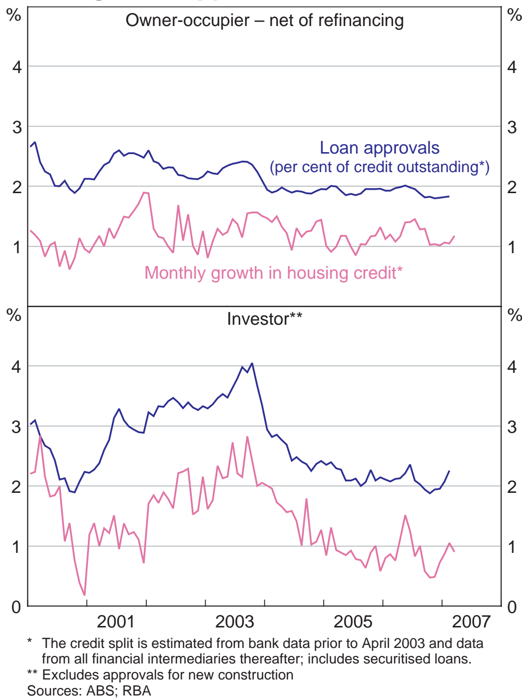
Quarterly



Sources: RBA; Thomson Financial

Graph 66

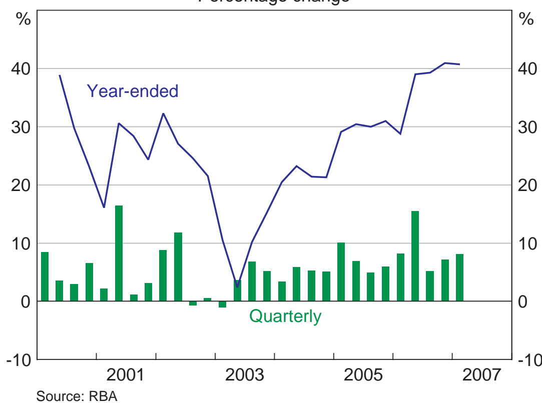
Housing Loan Approvals and Credit Growth



* The credit split is estimated from bank data prior to April 2003 and data from all financial intermediaries thereafter; includes securitised loans.
** Excludes approvals for new construction
Sources: ABS; RBA

Graph 67

Margin Lending
Percentage change



Source: RBA

exposures to leveraged loans remain small.

After slowing over the second half of 2006, housing credit growth appears to have steadied in recent months. Housing credit increased by around 3 per cent over the three months to March, a little faster than over the three months to December, and broadly in line with early 2006. Credit growth to owner-occupiers has stopped slowing, while investor credit growth has picked up slightly (Graph 66). Similar patterns have also been seen in new loan approvals to owner-occupiers and investors.

Personal credit grew by 12 per cent over the year to March, up from rates of around 10 per cent during the first half of 2006. Within personal credit, growth in margin lending for the purchase of shares and managed funds grew by 8 per cent in the March quarter to $30 billion (Graph 67).[1] Over the year to March 2007, margin lending has risen by 41 per cent, driven by large increases in both the number of loans and the average loan size. Indicators of the riskiness of borrowers' margin loan positions, such as the average gearing level, were little changed in the March quarter and remain low by historical standards.

1 *Some margin loans are made to businesses and trusts, and hence are captured in business credit rather than personal credit.*

Non-intermediated financing

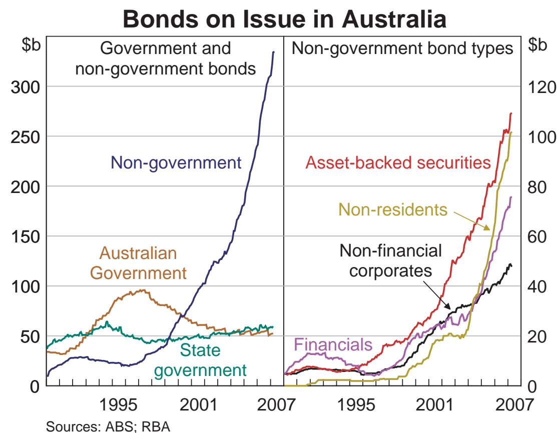
Net issuance of bonds by Australian non-government entities increased in the March quarter to $24 billion, around the average level recorded over the past few years (Table 10). The pick-up largely reflected an increase in net issuance by non-financial corporates and asset-backed vehicles. While a large share of non-financial corporate net issuance was offshore, this mostly reflected strong raisings by a couple of large companies. Offshore issuance continued to be supported by favourable conditions in currency swap markets that made it attractive to raise bonds offshore in foreign currency and swap into Australian dollars.

Non-residents' issuance of A$ bonds in the domestic bond market – kangaroo bonds – remained strong in the March quarter, continuing the trend seen over recent years. The outstanding value of these bonds totals over $100 billion (Graph 68).

Net non-intermediated capital raisings – debt, hybrids and equity – by the Australian non-government sector were $48 billion in the March

Graph 68

Bonds on Issue in Australia

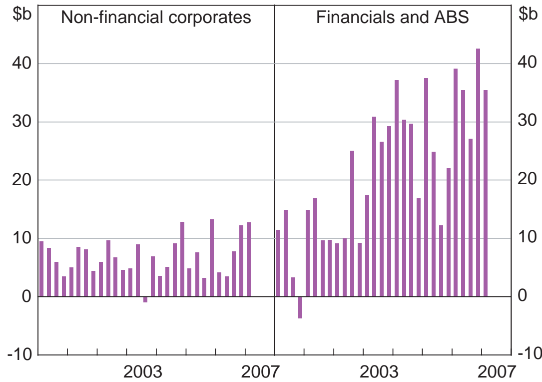


Sources: ABS; RBA

Table 10: Non-government Net Bond Issuance by Sector
$ billion

Sector	2003	2004	2005	2006	2007 March quarter
Bond issues by Australian entities					
Onshore					
Financial institutions	3.8	8.8	16.6	16.8	4.7
Non-financial corporates	2.8	4.4	3.9	6.9	1.3
Asset-backed	10.7	6.7	15.5	19.6	7.3
Total	***17.3***	***19.8***	***36.0***	***43.3***	***13.3***
Offshore					
Financial institutions	26.2	36.5	26.1	33.2	4.6
Non-financial corporates	9.7	11.6	9.4	5.3	5.6
Asset-backed	8.8	14.6	6.4	8.6	1.0
Total	***44.6***	***62.7***	***41.9***	***47.2***	***11.2***
Total	**61.9**	**82.5**	**78.0**	**90.5**	**24.5**
A$ bond issues by non-resident entities					
Onshore	2.6	18.0	22.9	26.9	10.8
Offshore	23.1	18.1	5.4	–2.4	–1.3
Total	**25.7**	**36.1**	**28.2**	**24.5**	**9.5**

Source: RBA

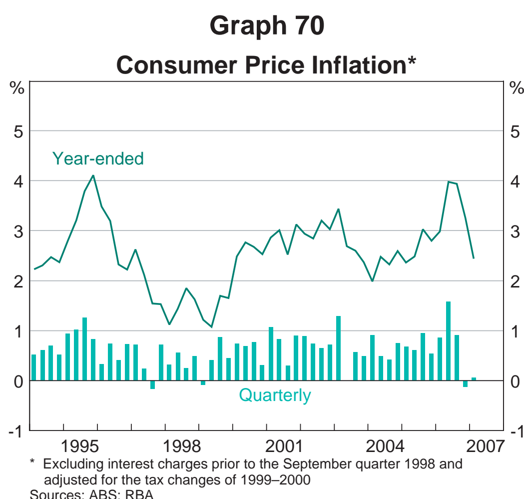


quarter, up slightly from the average of the previous year (Graph 69). Net raisings by non-financial corporates have picked up recently, after being relatively subdued over the first half of last year. This mostly reflects strong bond issuance, as discussed above, although their non-IPO equity raisings have also picked up.

Inflation Trends and Prospects

Recent developments in inflation

The consumer price index (CPI) rose by 0.1 per cent in the March quarter, and by 2.4 per cent over the year (Graph 70, Table 11). The largest single contributor to the low headline CPI outcome was a fall in fruit prices, reflecting the further unwinding of the mid-2006 increase in banana prices: this effect is estimated to have subtracted 0.5 percentage points from inflation in the quarter. However, a range of other items also contributed to the low outcome. Petrol prices made only a relatively small positive contribution to inflation in the quarter.



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

Tradables prices continue to grow at a substantially slower pace than non-tradables prices (Graph 71). Abstracting from food and petrol, tradables prices were unchanged in the March quarter and higher by 0.4 per cent over the year. The ongoing low rate of tradables inflation has reflected price falls for a range of manufactured goods – for example, clothing

Table 11: Measures of Consumer Prices
Percentage change

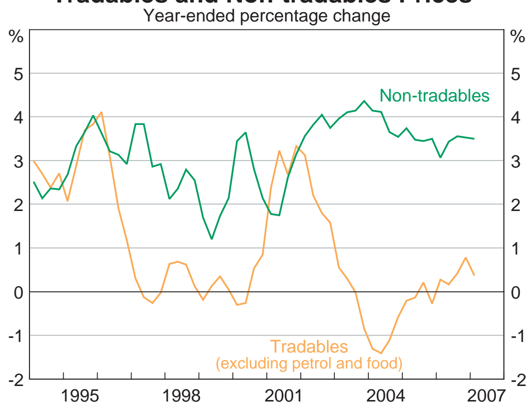
	Quarterly		Year-ended	
	December quarter 2006	March quarter 2007	December quarter 2006	March quarter 2007
CPI	–0.1	0.1	3.3	2.4
– Tradables	–1.4	–1.0	2.9	1.0
– Tradables (ex food and petrol)	–0.1	0.0	0.8	0.4
Non-tradables	0.8	0.9	3.5	3.5
Underlying measures				
Weighted median	0.5	0.5	3.0	2.7
Trimmed mean	0.5	0.5	2.9	2.7
CPI ex volatile items[(a)]	0.5	0.6	2.7	2.5

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

Graph 71

Tradables and Non-tradables Prices*

Year-ended percentage change



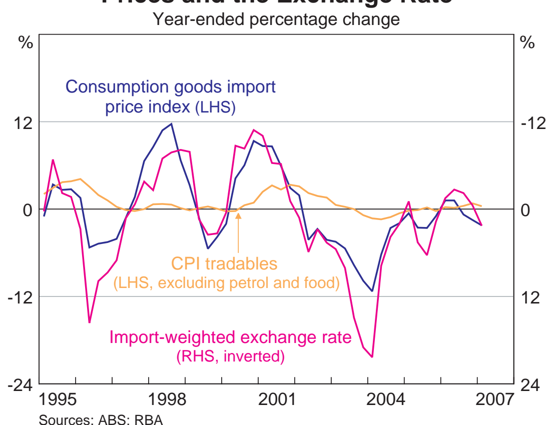
* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 72

Prices and the Exchange Rate

Year-ended percentage change



Sources: ABS; RBA

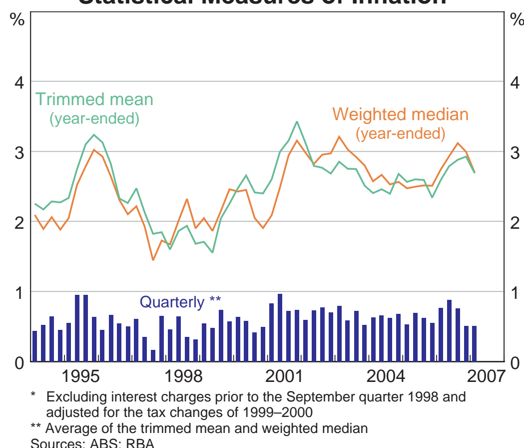
& footwear, household contents such as furniture, and audio, visual & computing equipment – that are mostly imported and for which world prices are being held down by the expansion of supply from China and other emerging markets. Tradables inflation has not been significantly affected by movements in the exchange rate in the past year or so. However, there was a noteworthy strengthening in the currency near the end of the March quarter and early in the June quarter: this would not have had a significant effect in the March quarter, but is likely to have an effect in coming quarters if the higher exchange rate is sustained (Graph 72).

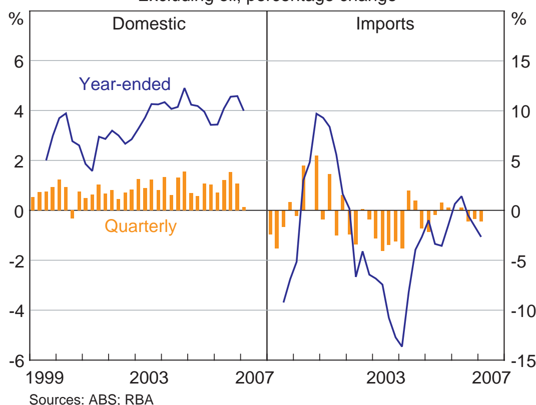
Non-tradables prices rose by 0.9 per cent in the March quarter and by 3.5 per cent over the year. The quarterly increase partly reflected seasonal increases in prices for education and health-related expenditures, although there was also a pick-up in rents and house purchase costs. Rents increased by 1.4 per cent in the quarter and by 4.4 per cent over the year, the strongest increases seen since 1991. With ongoing indications of a tight rental market, it is likely that the rate of rental inflation will remain high for some time.

Based on a range of measures, the Bank estimates that the pace of underlying inflation was around ½ per cent in the March quarter and 2¾ per cent over the year (Graph 73). Over the two quarters to March, underlying inflation appears to have been running at an annualised rate of around 2¼ per cent, compared with 3¼ per cent over the previous two quarters. The easing in the two most recent quarters has been reasonably broad-based: although traded goods inflation has eased more, after accounting for seasonality in some CPI items there has also been some slowing in non-tradables inflation. While there is some uncertainty in assessing these trends, they may in part reflect a slowing in cost pressures from raw materials, most notably the indirect effects of the fall in oil prices that occurred around September 2006; this fall however was partly reversed around the end of the March quarter, so oil prices may add to inflation in the June quarter. It is also possible that the apparent improvement in productivity growth in the latest

national accounts and the implied slowing in growth in unit labour costs has helped to temper the pace of recent price increases.

Producer price data suggest an easing in upstream inflation pressures. Final-stage prices were unchanged in the March quarter, and the annual rate of increase slowed to 2.8 per cent. Part of this slowing was due to a fall in the price of bananas: excluding the 'other agriculture' component, the quarterly change was an increase of 0.4 per cent. The slowing also partly reflected movements in the prices of imported items, which have fallen by nearly 3 per cent over the past year. Inflation in domestically produced goods has been running at a much stronger rate, at around 4 per cent (Graph 74). However, the data for the March quarter also suggested a slowing: excluding the effects of oil and agricultural prices, prices of domestically produced items increased by 0.6 per cent in the quarter, about half the rate seen in the previous three quarters.

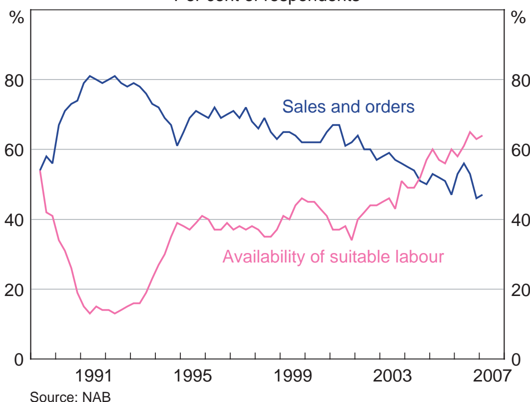


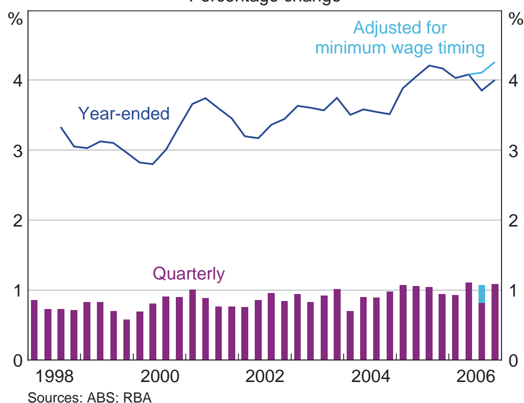


Labour costs

As discussed in the 'Domestic Economic Conditions' chapter, the labour market has remained tight and the unemployment rate is at a generational low. Business surveys and the Bank's liaison program confirm the tightness of current labour market conditions; according to the NAB survey, the share of firms reporting that the availability of suitable labour is constraining output remains around the highest levels in the 18-year history of the series (Graph 75).

Strong labour market conditions have been associated with a pick-up in aggregate wages growth over the past couple of years. In addition, information obtained through the Bank's liaison suggests the total growth of labour costs may be running somewhat higher than measured wages growth, reflecting businesses' increased use of non-wage remuneration to attract and keep staff in the current tight labour market. The wage price index (WPI) grew by 1.1 per cent in the December quarter, and by 4.0 per cent over the year (Graph 76). Interpretation of recent wage data needs to take account of the change in timing of the minimum wage decision last year, with the increase in minimum wages becoming effective from December rather than June





as in earlier years. As a result of this departure from the usual seasonal pattern, the data for the second half of 2006 understate somewhat the annual growth in wages. After adjusting for this effect, the growth of the WPI over the year to the December quarter appears to have remained in the upper end of the historical experience for this series, at around 4¼ per cent, compared with around 3½ per cent prevailing a few years ago. However, the pace is not significantly above that seen since mid 2005. Care will also need to be taken in interpreting the reported quarterly increase for the March quarter (which will become available in mid May). This figure will be boosted by the particular timing of the minimum wage decision, and is therefore likely to overstate the level of underlying wage increases for that quarter.

Recent data for enterprise bargaining agreements (EBAs) should have been unaffected by the timing of the minimum wage decision. Adjusted for industry composition, the average annualised wage increase for federal EBAs certified in the December quarter was 3.9 per cent, around its average level of recent years. Overall, while these and other indicators continue to suggest that the pace of wages growth is running higher than the average seen over the past 10–15 years, there is little evidence of further acceleration in recent quarters.

Inflation expectations

The various measures suggest that inflation expectations in the economy generally remain relatively high. According to business surveys, the proportion of businesses expecting to increase prices in the near term is above long-run averages, though it must be noted that an above-average proportion also reported increasing their prices in the March quarter, which appears somewhat at odds with the PPI and CPI data.

According to the Melbourne Institute survey of households, the median expectation for consumer price inflation over the year ahead increased to 3.8 per cent in April, returning close to the levels seen over most of 2006. This is above the average expectation over the inflation-

targeting period, of 3.0 per cent. The implied medium-term inflation expectation of financial market participants, as measured by the difference between nominal and indexed bond yields, was also somewhat elevated in early May, at a little over 3 per cent. However, as has been noted in previous *Statements,* this measure may overstate inflation expectations given the relative shortage of indexed securities.

Market economists surveyed by the Bank following the release of the March quarter CPI have lowered their inflation forecasts. The median expectation for headline inflation over the year to the December quarter 2007 is now 2.0 per cent, down from 2.5 per cent in February (Table 12). Over the year to December 2008, the median inflation expectation remained at 2.5 per cent. Union officials have also reduced their inflation expectations.

Table 12: Median Inflation Expectations

Per cent

	Year to December 2007			Year to December 2008	
	November 2006	February 2007	May 2007	February 2007	May 2007
Market economists[(a)]	2.7	2.5	2.0	2.5	2.5
Union officials[(b)]	3.9	3.5	3.0	3.5	3.0

(a) RBA survey
(b) Workplace Research Centre

Inflation outlook

The data that have become available recently suggest there has been some easing in the trend in inflation, with consumer price inflation remaining low for the second quarter in a row and producer price inflation also easing in the March quarter.

The Bank's forecasts assume that oil prices and the exchange rate remain around current levels through to the end of the forecast period (June quarter 2009), and that global growth slows modestly but remains above its long-run average rate, in line with Consensus forecasts. The terms of trade are assumed to decline by around 7 per cent over the forecast period. In line with recent data that suggest a modest strengthening in activity, the outlook for growth in demand and activity has been revised up slightly, with non-farm GDP now expected to grow by around 3¼–3½ per cent per annum. Domestic demand is expected to grow at a rate close to trend, while resource exports should increase more rapidly over the forecast period as the recent strength in mining investment has expanded capacity. The drought will weigh on growth in the short term, but assuming a return to average seasonal conditions, the farm sector should add to growth thereafter.

The near-term inflation forecast has been revised downward slightly relative to the forecasts contained in the previous *Statement*, reflecting the recent lower outcomes for underlying inflation. The central forecast is for year-ended underlying inflation – which was around 2¾ per cent over the year to the March quarter – to fall back to around or a little below 2½ per cent in the next few quarters (Table 13). Headline CPI inflation is still expected to fall to a little below 2 per cent in mid 2007, largely reflecting the unwinding of the increase in banana prices

that occurred during 2006. The recent appreciation of the exchange rate could contribute to some modest downward pressure on prices over coming quarters, although the experience from earlier movements in the exchange rate is that the effects on inflation have been relatively small and drawn out. The drought is not expected to have a significant effect on food prices in the CPI, although the longer it persists, the more likely it is that there would be some upward effect.

Longer term, underlying inflation is expected to rise a little, to about 2¾ per cent in 2008 and 2009, with headline CPI inflation expected to follow a similar path. The forecast gradual pick-up in inflation reflects the expectation of firm growth in demand and output and that capacity utilisation in the economy will remain high. Ongoing labour market tightness is also likely to keep overall wages growth at a firm pace. Risks to these forecasts appear to be broadly balanced.

Table 13: RBA Inflation Forecasts[(a)]
Percentage change over year to quarter shown

	June 2006	Dec 2006	June 2007	Dec 2007	June 2008	Dec 2008	June 2009
Consumer price index	4.0	3.3	1¾	2¼	2½–3	2½–3	2½–3
Underlying inflation	2.9	3.0	2½	2½	2½–3	2½–3	2½–3

(a) Actual data to March 2007. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.83, TWI at 67, cash rate at 6.25 per cent, and WTI crude oil price at US$65 per barrel.

Sources: ABS; RBA