STATEMENT ON MONETARY POLICY

Economic data in Australia over recent months have signalled a pick-up in the pace of growth in demand and activity. Capacity utilisation is high after a lengthy period of expansion, and business and consumer confidence are strong. These conditions have been accompanied recently by higher-than-expected underlying inflation.

Growth of the Australian economy has for some time been assisted by favourable international conditions. Current expectations of official and private-sector observers are that the world economy will continue to grow at an above-average pace in both 2007 and 2008. These expectations have generally been revised upwards over recent months, with slower growth in the United States expected to be more than offset by stronger growth in China and the other major economies.

Notwithstanding the strong overall performance of the world economy, international financial markets have experienced significant volatility in recent weeks, primarily stemming from the sub-prime mortgage market in the United States. Delinquency rates in that market have been rising over the past year reflecting a marked decline in lending standards, particularly in 2006, and the expiration of discounted interest rates applying for the first two years of many of these loans. The mortgage-backed securities and the associated collateralised debt obligations based on these loans have suffered sharp falls in prices, exacerbated by a lack of liquidity in these markets. This in turn has generated problems for the holders of these products, particularly those who had used leverage.

There has been some flow-on through credit markets, where spreads have widened, particularly for low-rated paper. However, at this stage, the extent of the widening has only seen spreads rise back to more reasonable levels after a period when risk appears to have been under-priced. Yields on highly-rated government paper have declined, reversing much of the rise seen in May and June. Equity prices have also fallen, with the shares of financial institutions suffering the largest declines. Both bond and equity markets have experienced a marked increase in volatility following a number of years when volatility had been low.

The extent to which these financial events might affect global growth remains uncertain. The main risk would appear to stem from the possibility of an excessive withdrawal of the provision of credit, which could constrain growth in spending and output, particularly in the United States. At this stage, however, the evidence continues to point to strong growth in the global economy overall. While there has been a slowing in the United States, this has so far been largely confined to the housing sector, with the wider economy still growing at a reasonable pace. The US national accounts showed a pick-up in GDP growth in the June quarter, and employment has continued to expand at a pace broadly in line with the growth of the labour force. Indicators of performance in the manufacturing sector have picked up over recent months.

Strong conditions are generally prevailing in other parts of the world. China has reported a further step-up in its growth rate, to a pace of around 12 per cent. In Japan, although recent indicators have been quite volatile, a reasonable pace of expansion seems to have continued, with employment and business sentiment both remaining firm in the June quarter. The smaller east Asian economies for which June quarter national accounts are available have reported strong growth rates. There are also indications that industrial production and exports across the region have firmed in recent months in response to stronger demand from China and elsewhere. In the euro area, recent data suggest that growth has continued at a firm pace through the first half of the year, though conditions are not as strong as they were last year.

Consistent with the strength of the world economy, global commodity prices have remained high in recent months, and in some cases have strengthened further. Analysts' forecasts of contract prices for Australia's bulk commodity exports have generally been revised upward, reflecting further increases in expected demand from China. Oil prices have picked up further. The cumulative increase in world commodity prices over recent years remains an important source of stimulus to Australia's national income and spending.

The continued strength in commodity prices, together with higher interest rates in Australia than abroad, helped underpin the Australian dollar's rise to multi-year highs against the US dollar and on a trade-weighted basis in July, before the currency depreciated somewhat following the disturbances in credit markets. It has also contributed to the larger increase in the Australian stock market than in other major markets, as the share prices of resource companies have been particularly strong. While the Australian share market and bond market have largely tracked global markets in recent weeks, this had little impact on expectations of a change in the cash rate. Financial markets had attached a high probability to an increase in the cash rate at the August Board meeting since the release of the June quarter CPI.

Information on the Australian economy in recent months has confirmed that the pace of growth in demand and activity has strengthened since around the middle of last year. Non-farm GDP is estimated to have grown by 4.6 per cent over the year to the March quarter, with overall GDP growing by 3.8 per cent. While some allowance needs to be made for the inevitable quarterly volatility in these figures, the broad picture from the national accounts accords with a range of other information pointing to above-average growth in the non-farm economy. Labour market indicators have been strong, with employment continuing to expand at a fast pace over the past year while the unemployment rate has declined. Business surveys in recent months have continued to report very favourable conditions consistent with above-trend growth. Prospects for the farm sector have also improved this year following good rainfall in the eastern states over the past few months. Much will still depend on the extent of follow-up rains but, at this stage, ABARE forecasts released in June are for a significant recovery in farm output, which is expected to add about ½ percentage point to overall GDP growth in 2007/08.

Growth of the Australian economy is continuing to be driven by domestic demand. Consumer spending picked up noticeably over the year to the March quarter, and the most recent indications are that retail sales have remained firm and that consumer confidence is high. With the exception of housing construction, all the other main components of domestic spending have shown strong growth over the past two years. As has been the case for some time, a significant part of the growth in domestic demand has been met by growth in imports. Export growth has remained relatively modest in aggregate, partly as a result of the drought. There has been some pick-up in resource exports in recent quarters, though the main effects from capacity expansions in the mining sector are still to be seen.

Notwithstanding the increases in interest rates that took place last year, the demand for finance strengthened in the first half of 2007, particularly in the business sector. Over the six months to June, business credit outstanding grew at an annualised rate of 22 per cent, up from a rate of 15 per cent at the end of last year. Businesses have also had ample access to other sources of external finance through debt and equity markets, though it is too early to tell yet the extent to which this financing activity will be curtailed as a result of recent market volatility. In the household sector, information for the first five months of this year suggested a modest pick-up in demand for finance, with household credit rising at rates of around 1 per cent a month, a little higher than at the end of 2006. The rate of increase picked up sharply in June, though this appears to have been boosted by borrowing to fund superannuation contributions ahead of rule changes at the end of that month.

Conditions in the established housing market generally appear to be firming, though there remain significant variations across different parts of the country. A range of estimates of average house prices showed a pick-up in nationwide prices in the June quarter. Sydney prices increased moderately, and there were strong increases recorded in Melbourne, Brisbane and Adelaide. Perth prices have been broadly flat after their earlier sharp increases. Strength in the upper end of the Sydney and Melbourne markets is indicated by rising auction clearance rates, which have recently been above average in both cities.

The continuing expansion over recent years has brought the Australian economy to a position where surplus productive capacity is rather limited. Businesses have been reporting their highest levels of capacity utilisation since the late 1980s. Unemployment in recent months has reached a generational low and a range of indicators including job vacancies, business survey results and liaison reports point to a scarcity of suitable labour. High levels of business investment can of course be expected to add to the growth of productive capacity over time. Nonetheless, with the economy currently growing at a higher-than-average pace, capacity pressures are likely to persist in the near term. There is little sign yet that these pressures are leading to any generalised pick-up in wages growth, although strong wage increases are occurring in industries facing particular labour scarcity such as construction and mining. Prices data, however, have indicated a pick-up in inflation recently.

The consumer price index for the June quarter showed an increase in quarterly inflation in both headline and underlying terms. The headline CPI rose by 1.2 per cent in the quarter and by 2.1 per cent over the year. In interpreting these figures it is important to note that the CPI in recent quarters has been influenced by some sharp fluctuations in fuel and food prices, and so the headline figures at present are a poor guide to the underlying trend. The quarterly CPI increase was boosted by a rise in petrol prices, while the year-ended figure of 2.1 per cent was held down by a sharp fall in banana prices from their spike a year ago. The Bank's measures of underlying inflation, which seek to remove these temporary influences, show an increase of 0.9 per cent in the quarter and 2¾ per cent over the year, higher than was incorporated in the forecasts presented in the May *Statement*. The June quarter result reflected broad-based increases across a range of items in the CPI.

In its policy deliberations over recent months, the Board has recognised that stronger domestic conditions could be expected to put upward pressure on inflation in the medium term and that, as a result, further monetary policy tightening could be required. At the same time, prices data prior to receipt of the June quarter CPI were indicating some moderation of current inflation, allowing the Board time for further consideration. The June quarter result, which was available for the Board's August meeting, signalled that recent inflation had been higher than anticipated and prompted an upward revision to the expected path of inflation in the medium term.

At its August meeting the Board also gave careful consideration to recent developments in global financial markets. The Board noted that credit markets in the United States had experienced some difficulty in recent weeks and that if this persisted it could pose downside risks to the US economy. However, the information to hand suggested these developments were unlikely to cause a major change to the broader global outlook. Growth of the world economy remained strong, and in recent months official forecasts of global growth had been revised upward.

Weighing up all these considerations, the Board judged that a somewhat more restrictive monetary policy setting was required in order to contain inflation in the medium term. Given all the recent information, inflation appears likely to be somewhat higher than earlier expected. Taking into account the effects of the August policy decision, along with other factors including the dampening effect from the appreciation of the Australian dollar, underlying inflation is forecast to be around 3 per cent over the year to December 2007. Ongoing pressures are currently forecast to keep both underlying and CPI inflation near the top of the target range during 2008.

In assessing medium-term prospects it will remain important to keep a close watch on both domestic inflation risks and any further developments in international financial markets and their possible implications for the global economy. The Board will continue to monitor economic and financial market 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 has continued to expand strongly during the first half of 2007. Growth has been fairly broad-based across countries, with rapid growth in China and other emerging economies, and firm growth in Europe and Japan. The exception is the United States, where growth has been below trend for the past year. While forecasts for economic growth in the United States in 2007 have been lowered since earlier in the year, this has been more than offset by a stronger outlook for other major economies, and the IMF is forecasting that world GDP will grow at an above-trend pace of 5.2 per cent in 2007 and 2008 (Table 1). China and India, in particular, are expected to continue growing rapidly, accounting for two-fifths of projected global growth, measured on a purchasing power parity basis (for a discussion of alternative ways to calculate world GDP growth see 'Box A: Measuring Global Growth'). As yet, there are no indications that the recent turmoil in financial markets is having a significant effect on expectations for global growth.

Table 1: World GDP
Year-average percentage change[(a)]

	2005	2006	2007	2008
			IMF forecasts (July 2007)	
United States	3.1	2.9	2.0	2.8
Euro area	1.6	2.9	2.6	2.5
Japan	1.9	2.2	2.6	2.0
China	10.4	11.1	11.2	10.5
Other east Asia[(b)]	4.9	5.4	4.9	5.0
India	8.7	9.7	9.0	8.4
World	**4.9**	**5.5**	**5.2**	**5.2**
Australia's trading partners[(c)]	4.3	4.9	5.1	4.8

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Weighted by GDP at market exchange rates
(c) Weighted using merchandise export shares
Sources: CEIC; IMF; RBA; Thomson Financial

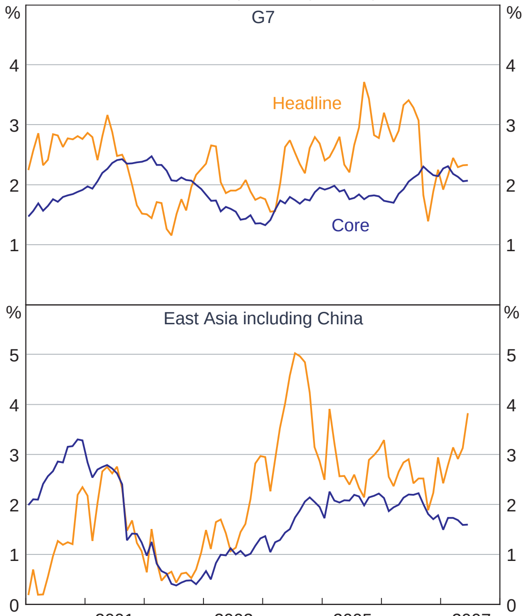
Headline inflation has picked up in the major developed economies and east Asia since late 2006 as a result of rising oil and food prices (Graph 1). Although 'core' measures of inflation have drifted lower, the combination of sustained strong global growth, high levels of capacity utilisation and tight labour markets have led to upside risks to the inflation outlook, and some central banks have expressed concern about the potential for rising food and oil prices to raise inflation expectations. During the past quarter, monetary policy has been tightened in the euro area, the United Kingdom, Canada, New Zealand and a number of east Asian economies.

Consistent with the strength of the world economy, global commodity prices have remained high over the past three months. Rural export prices have continued to increase, in line with the recent rises in world food prices. Base metals prices have been broadly unchanged, with

Graph 1

World Consumer Prices*

Year-ended percentage change



* Weighted by GDP at PPP exchange rates, excludes Japan

Sources: CEIC; RBA; Thomson Financial

the exception of a sharp fall in nickel prices from the extremely high levels they reached earlier this year. Continued strong world demand, particularly from China, has also underpinned a positive outlook for coal and iron ore prices, with many analysts now expecting contract prices to rise by around 15 per cent in 2008.

Major developed economies

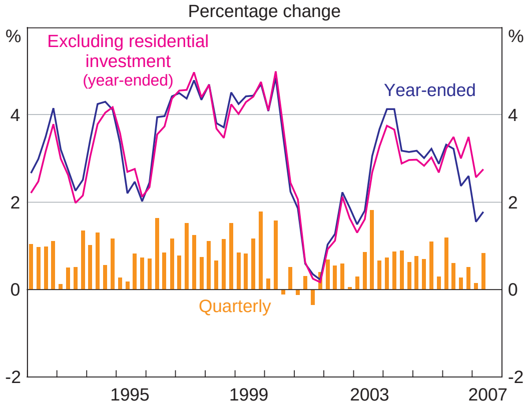
Most major developed countries continued to grow at a firm pace during the first half of 2007. Japan and the large European economies recorded solid GDP growth in the March quarter. The exception to this pattern was the US, where growth has slowed due to ongoing weakness in the housing sector.

In the US, real GDP increased by 0.8 per cent in the June quarter to be 1.8 per cent higher over the year, down from year-ended rates of around 3 per cent in the previous couple of years (Graph 2). Residential investment fell by 2.4 per cent in the June quarter and is down by 19 per cent since its peak in December 2005. Construction activity seems likely to fall further given recent weakness in forward indicators, such as housing permits and starts, and the high level of unsold new homes (Graph 3). A further decline in the number of home sales also points to a weakening in housing demand, and mortgage rates have increased. Growth in house prices has continued to slow, with the Office of Federal Housing Enterprise Oversight (OFHEO) purchase-only measure suggesting that nationwide house prices grew by 0.6 per cent in the March quarter and by 3 per cent over the year, which was the slowest annual pace of growth in almost a decade. Other more recent data suggest that house prices continued to weaken in the June

Graph 2

United States – GDP

Percentage change



Source: Thomson Financial

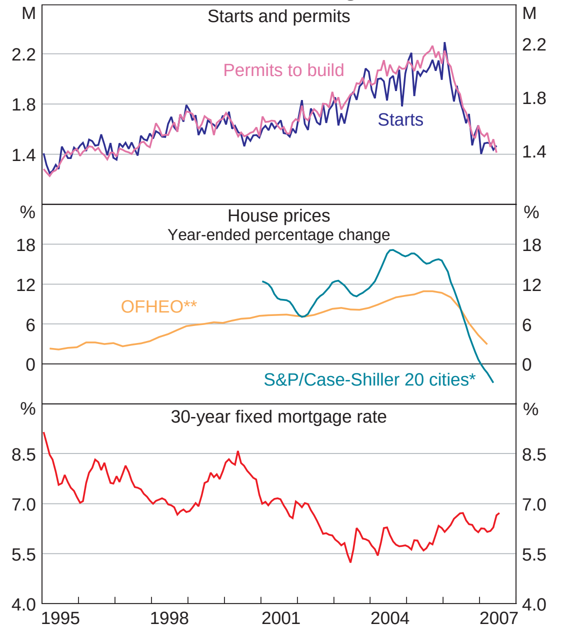
quarter. While mortgage repayment distress has been largely contained to the sub-prime market, conditions may deteriorate further as some loans are reset to higher interest rates over the coming year (for more details on recent developments in the US sub-prime market, see the 'International and Foreign Exchange Markets' chapter).

Despite the weakness in the housing market, household consumption has remained relatively resilient in the face of the housing downturn. While consumption growth slowed to 0.3 per cent in the June quarter, this followed a strong 0.9 per cent rise in the previous quarter. The slowing in the quarter partly reflected a rise in petrol prices of around 30 per cent. Over the year, growth was 2.9 per cent, supported by strong labour market conditions with firm growth in household incomes. Payrolls employment rose by 1.4 per cent over the year to July, and the unemployment rate remained low at 4.6 per cent.

Business investment rose solidly in the June quarter, to be 3.4 per cent higher over the year. Non-residential investment picked up strongly in the quarter, while equipment remained weak. The outlook for business investment is reasonably positive, with growth in core capital goods orders having firmed, high levels of capacity utilisation and surveys indicating stronger business conditions (Graph 4). Moreover, financing conditions have been generally favourable, with healthy corporate balance sheets and the cost of capital still relatively low despite the recent rise in corporate bond spreads (see the 'International and Foreign Exchange Markets' chapter for further details).

Graph 3

United States – Housing Indicators

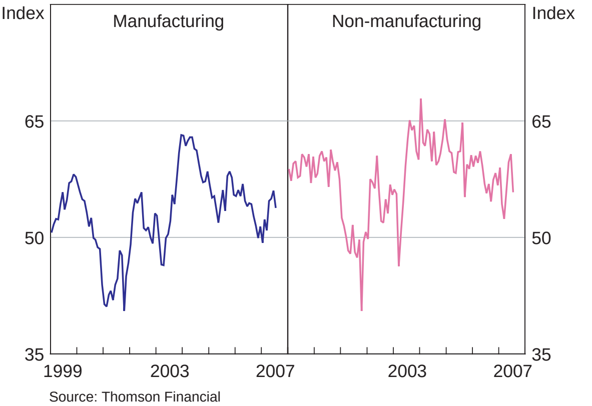


* Monthly
** Office of Federal Housing Enterprise Oversight (OFHEO), purchase-only; quarterly
Sources: Bloomberg; MacroMarkets LLC; Thomson Financial

Graph 4

United States – Business Sentiment

ISM survey



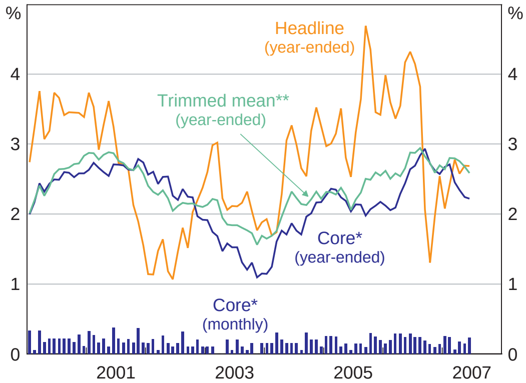
Source: Thomson Financial

Headline consumer price inflation has picked up since late last year, to be 2.7 per cent over the year to June (Graph 5). This mainly reflects higher energy prices, although food prices have also risen strongly. Over the same period underlying inflation has eased, in line with the slowing in the pace of activity. In June, core CPI inflation (which excludes food and energy) was 2.2 per cent for the year, down from around 2¾ per cent late last year. Core inflation is generally expected to moderate further as growth in housing costs continues to slow, although there is some upside risk to this outlook from the high levels of resource utilisation and rising import prices.

Graph 5

United States – Consumer Prices

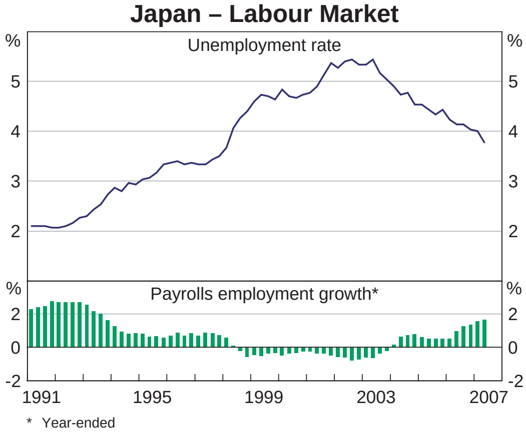
Percentage change



* 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

Graph 6

Japan – Labour Market



* Year-ended
Source: Thomson Financial

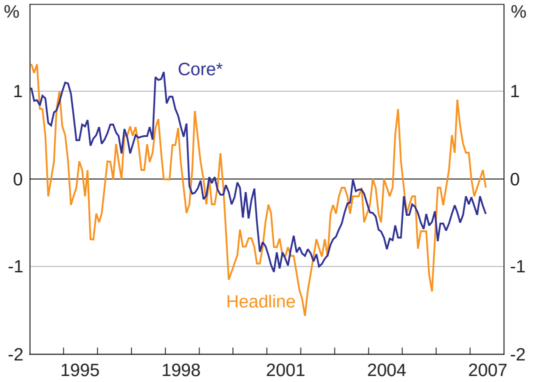
The Japanese economy has continued to expand at a relatively strong rate. Real GDP increased by 0.8 per cent in the March quarter, to be 2.7 per cent higher over the year, with consumption and exports growing strongly. Consumption has been supported by high levels of consumer confidence and favourable labour market conditions. Employment has grown by 1.7 per cent over the past year, which is the fastest rate of increase since the early 1990s, and the unemployment rate has fallen to a nine-year low of 3.7 per cent (Graph 6). In addition, indicators of labour demand, such as the jobs-to-applicants ratio and Tankan survey measure of employment intentions, remain positive. Growth in business investment has been firm and conditions remain supportive of further expansion. Capacity utilisation rates are high, particularly for large manufacturers, balance sheets are in good shape and corporate sector borrowing has continued to expand. According to the June quarter Tankan survey, Japanese firms are positive about overall business conditions and expect solid growth in investment in the coming year.

Upstream price pressures have strengthened in recent months, with year-ended growth in corporate goods prices increasing to 2.3 per cent in June, led by a pick-up in import prices. At the retail level, however, CPI inflation has not shown a clear direction; the core measure (which excludes food and energy prices) has gradually picked up over the past couple of years but remains below zero (Graph 7).

Graph 7

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

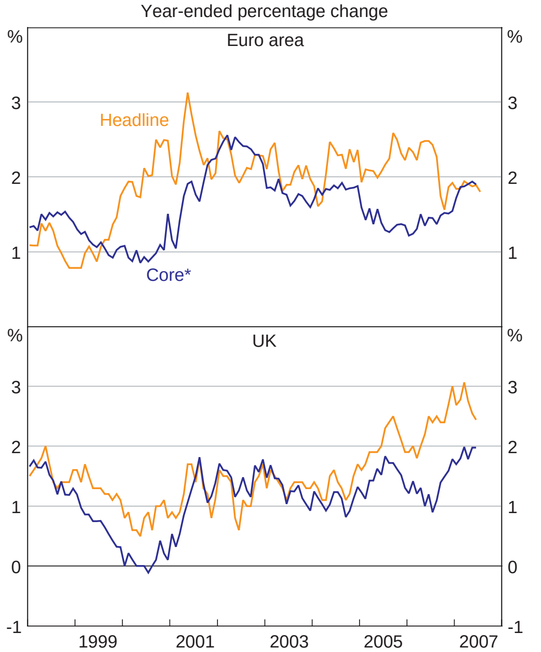
In Europe, economic growth has eased since late 2006, although it remains firm. Euro area GDP increased by 0.7 per cent in the March quarter, to be 3.1 per cent higher over the year. Business investment has been a key driver of growth in the euro area and is running at its fastest year-ended pace since the late 1990s. The outlook is also favourable, with capacity utilisation at high levels, business sentiment positive, and profits at healthy levels. The positive conditions in the business sector have been supported by strong external demand, particularly from eastern Europe.

Household consumption continued to grow in the March quarter in most of the major euro area economies, with the exception of Germany where it was affected by an increase in taxes. Euro area retail sales have been soft in the June quarter, although there are some positive signs, with rising consumer sentiment and a further improvement in labour market conditions. The unemployment rate was 6.9 per cent in June, which is its lowest level in more than 15 years.

Graph 8

Europe – Consumer Prices

Year-ended percentage change



* Excluding food, energy, alcohol and tobacco

Source: Thomson Financial

Headline inflation is in line with the ECB's target of below but close to 2 per cent (Graph 8). Core inflation (which excludes food, energy, alcohol and tobacco) has also levelled out recently after rising through 2006 and early 2007, to be 1.9 per cent over the year to June. The ECB raised its policy rate by 25 basis points to 4 per cent at its

June meeting, and noted that the risks to inflation are to the upside, owing to high levels of capacity utilisation and tight labour markets.

Growth has also remained firm in the UK, with GDP rising by 0.8 per cent in the June quarter, to be 3.0 per cent higher than a year ago. While headline inflation has eased in recent months, this is due largely to falls in regulated electricity and gas prices. Core inflation (which excludes food, energy, alcohol and tobacco) has been trending up and at 2.0 per cent remains close to a decade high (Graph 8). The Bank of England increased its policy rate by 25 basis points at each of its May and July meetings, noting that capacity utilisation is high and that pricing surveys are pointing to increasing inflationary pressure.

Other major trading partners

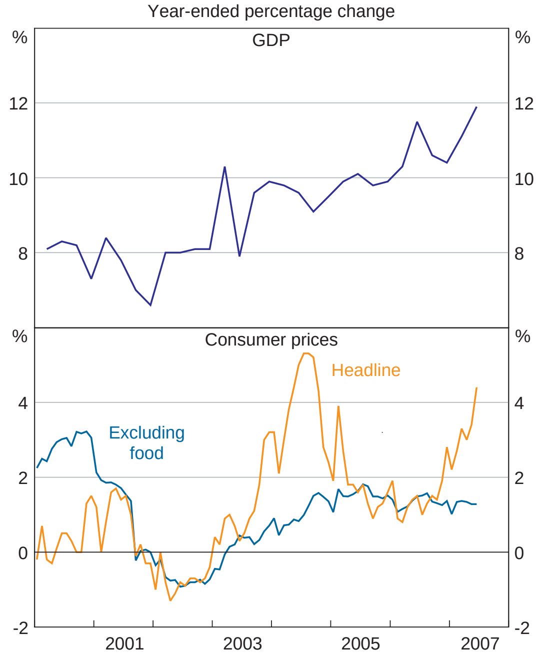
Growth in Australia's other major trading partners has remained strong in 2007, with continued rapid growth in China and India and solid growth in the rest of east Asia.

Growth in China has accelerated, with Chinese GDP increasing by almost 12 per cent over the year to the June quarter (Graph 9). Recent policy initiatives intended to rebalance growth away from exports and investment and towards household consumption seem to have had limited effect so far. Despite a range of policy changes designed to slow their growth, exports were still nearly 30 per cent higher over the year to the June quarter. Similarly, fixed-asset investment growth has remained strong, regaining momentum after a policy-induced slowdown late last year, to be nearly 30 per cent higher over the same period. Although growth in retail sales has picked up, consumption is still growing more slowly than investment.

Graph 9

China – GDP and Consumer Prices

Year-ended percentage change



Sources: CEIC; RBA

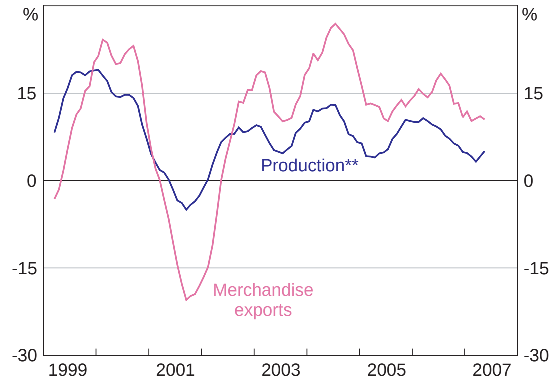
Corporate goods prices have continued to outpace consumer price inflation. Over the year to June, corporate goods prices increased by 5.4 per cent, partly driven by sharply higher agricultural and mining goods prices. Consumer price inflation has picked up, to be 4.4 per cent over the year to June, although excluding food, core consumer price inflation is estimated to have held steady at around 1¼ per cent. In response to very strong growth in activity and rising inflation, the People's Bank of China has continued to tighten policy, increasing its reserve requirement ratio and benchmark lending and deposit interest rates.

Elsewhere in east Asia (excluding Japan), GDP increased by 4.8 per cent over the year to the March quarter. Domestic demand growth moderated in the quarter, offset by a rebound in exports. After slowing through most of last year, growth in industrial production and exports has picked up a little recently, in line with stronger demand for capital goods (Graph 10). Labour market conditions remain favourable and are expected to continue to support solid growth in consumption in most of the region. Preliminary estimates of June quarter GDP for Korea and Singapore suggest strong growth in these economies. Inflationary pressures throughout the region remain contained. Headline inflation for east Asia excluding China and Japan has been around 2½ per cent since the end of 2006, while core inflation moderated to 2¼ per cent over the year to June.

Graph 10

East Asia* – Business Indicators

Year-ended percentage change, smoothed



* Excluding China and Japan
** Excluding Hong Kong and Indonesia due to data issues
Sources: CEIC; RBA

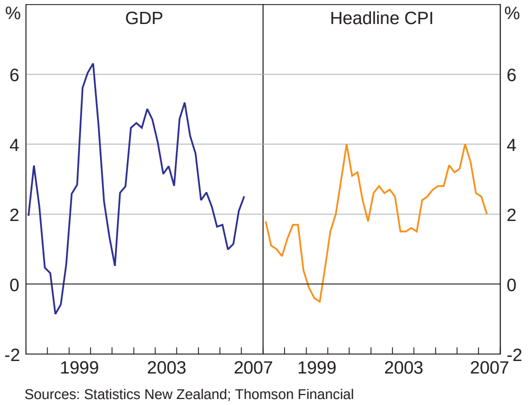
The Indian economy continues to grow strongly, with real GDP increasing by 2.7 per cent in the March quarter, to be 9 per cent higher over the year. Growth in the quarter was led by activity in the services sector, although manufacturing production also picked up. Inflationary pressures have moderated, with wholesale price inflation slowing to below the Reserve Bank of India's 5 per cent target rate.

In New Zealand, GDP increased by 1.0 per cent in the March quarter and by 2.5 per cent over the year, driven by strong growth in domestic demand (Graph 11). The terms of trade have continued to rise due to a sharp increase in the prices of dairy products. Dairy products account for one-fifth of New Zealand's merchandise exports and have more than doubled in price in US dollar terms since August 2006 (in New Zealand dollar terms they have risen by around 70 per cent). Although year-ended consumer price inflation eased to 2.0 per cent in the June quarter, most measures of underlying inflation are running at a faster pace. The RBNZ tightened monetary policy at its July meeting, citing concerns about the recent pick-up in domestic demand and the rising terms of trade.

Graph 11

New Zealand – GDP and Prices

Year-ended percentage change

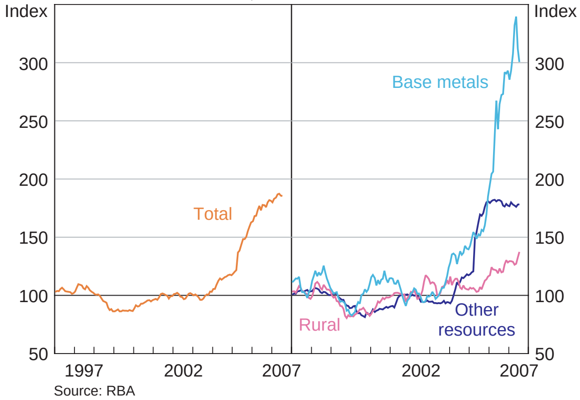


Sources: Statistics New Zealand; Thomson Financial

Graph 12

RBA Index of Commodity Prices

SDR, 2001/02 = 100



Source: RBA

Table 2: Commodity Prices

Percentage change; SDR

	Three months to July 2007	Year to July 2007
RBA index	–0.6	4.4
Rural	8.9	11.8
– Wheat	14.5	16.5
– Beef & veal	1.9	0.9
– Wool	3.2	38.1
– Sugar	11.4	–29.4
Base metals	–9.5	13.8
– Aluminium	–3.4	5.4
– Copper	2.8	–0.2
– Nickel	–33.8	23.3
– Zinc	–0.8	3.2
– Lead	53.8	181.9
Other resources	0.5	–2.0
– Coking coal[(a)]	–1.0	–12.8
– Steaming coal[(a)]	7.2	4.9
– Iron ore[(a)]	4.7	7.1
– Gold	–2.7	1.5
Memo item		
Oil in US$[(b)]		
– WTI	15.7	–0.5
– Tapis	6.2	2.7

(a) Latest available data are for June.

(b) Oil prices are not included in the RBA index.

Sources: ABS; AWB; AWEX; Bloomberg; Meat and Livestock Australia; RBA

Commodity prices and the terms of trade

Australia's terms of trade are estimated to have been broadly flat in the June quarter, having risen by around 40 per cent over the past four years. The RBA index of commodity prices (ICP) has risen by 90 per cent (in SDR terms) over the same period. The large run-up in the terms of trade, however, now appears to be slowing; the RBA's index of commodity prices rose by 4.4 per cent over the year to July, which is the slowest rate of increase since late 2003 (Graph 12, Table 2). Nonetheless, with the favourable outlook for global demand, in particular the resource-intensive growth of developing Asia, Australia's terms of trade are likely to remain at historically high levels over the next few years. While there are signs of increasing global supply for some commodities in response to the run-up in prices seen in recent years, at this stage it seems unlikely to be sufficient to result in significantly lower commodity prices overall.

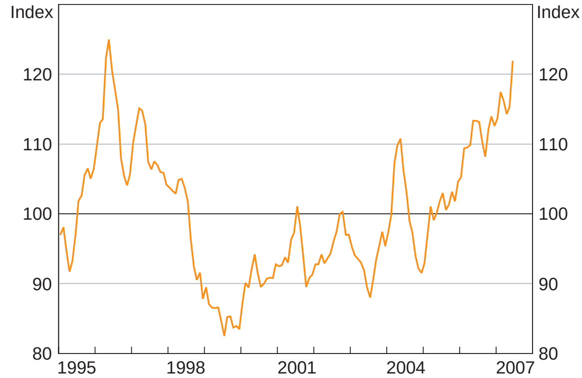
Rural commodity prices rose by 9 per cent over the three months to July, with increases across all of Australia's major exports. Wheat prices have risen by around 15 per cent, as northern hemisphere crop forecasts have been pared back, and wool prices have also risen strongly, to be almost 40 per cent higher than a year ago. The recent increases in rural export prices have been in line with rising food prices both in Australia and globally; the IMF Commodity Food Price Index rose by around 5 per cent over the three months to June, to be at its highest level since the mid 1990s (Graph 13).

The RBA index of base metals prices has fallen by nearly 10 per cent over the past three months, although it is still 4 per cent higher than at the beginning of the year. The recent fall in the base metals index reflects the sharp fall in nickel prices amidst signs of an easing in supply constraints and more moderate activity in the stainless steel industry (where nickel is a major input). While nickel prices have fallen by more than 30 per cent over the past three months, they are still more than double their price level at the start of 2006 (Graph 14). Abstracting from nickel, base metals prices rose modestly over recent months, as the markets for copper and lead continued to tighten, and current prices are near record levels. Looking forward, futures markets continue to point to a decline in most base metals prices over the next couple of years, although they are expected to remain at high levels.

Graph 13

IMF Commodity Food Price Index

SDR, 1995 = 100

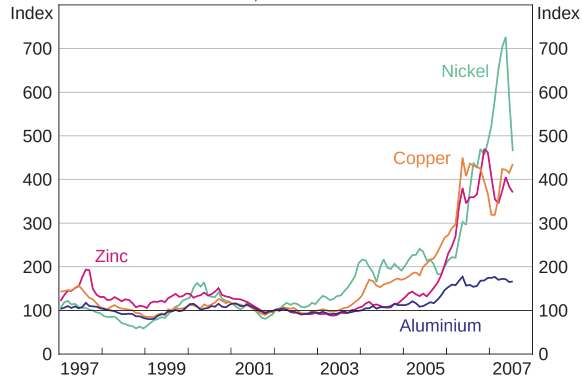


Sources: IMF; RBA

Graph 14

Base Metals Prices

SDR, 2001/02 = 100



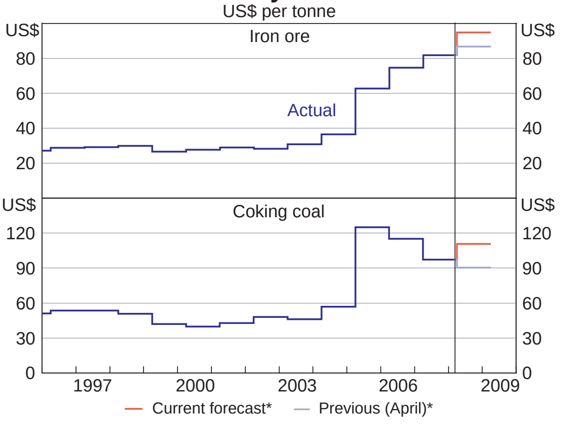
Sources: Bloomberg; RBA

Since the May *Statement*, the outlook for coal and iron ore prices has improved significantly and these commodities are now expected to provide a moderate boost to overall export prices in 2008. Coal markets have tightened considerably this year as China – the world's largest producer – has become a net importer, having historically been a net exporter of coal, and as supply constraints persist worldwide. Reflecting this, thermal coal prices on the spot market have risen sharply in 2007. Market analysts now expect hard coking coal contract prices to rise by around 15 per cent for the 2008/09 Japanese fiscal year, compared with an expectation three months ago that prices would decline by around 5 per cent (Graph 15). Demand for iron ore also remains strong, with Chinese imports continuing to increase at a rapid pace, driven by its buoyant steel industry and a shortage of low-cost iron ore in China. As a low-cost supplier of iron ore to China, Australia is well positioned to take advantage of this demand, and market analysts generally expect 2008/09 contract prices to also rise by around 15 per cent.

Oil prices have risen significantly since the start of the year to be currently trading close to record highs at US$75 per barrel. There has been solid growth in demand but little change in global production, given that OPEC has cut its production. Increased geopolitical tensions

Graph 15

Bulk Commodity Contract Prices



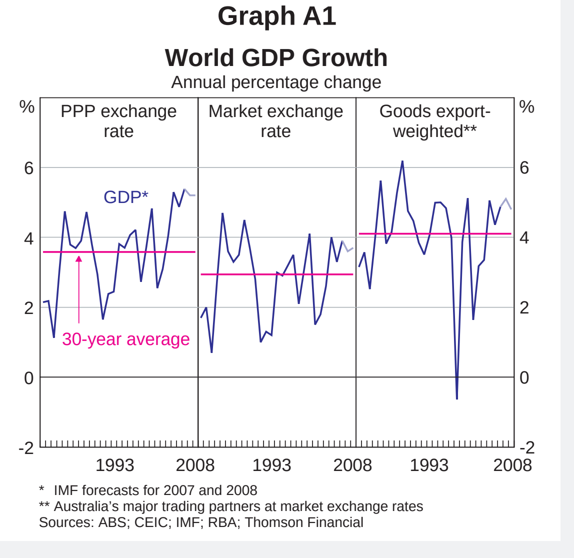
* Average of market analyst forecasts
Sources: ABARE; RBA

and indications of increased demand from financial market participants also appear to have contributed to higher oil prices. The price of West Texas Intermediate crude oil increased more sharply than for most other types of crude oil, such as Malaysian Tapis (which is the benchmark for Australian prices), as some special factors that had distorted the US oil market have been unwound (for more detail on oil prices see 'Box B: Recent Developments in Oil Prices').

Box A: Measuring Global Growth

Developments in the world economy can have a major impact on individual economies, so accurately measuring the rate of growth in world output is an important issue. In order to estimate the strength of global growth, each country's output needs to be weighted together appropriately. Two common ways used to determine country shares in world output are to convert each country's output into a common currency using purchasing power parity (PPP) exchange rates or using market exchange rates. In addition, to reflect demand for exports more specifically, the RBA calculates a measure that weights the output of Australia's major trading partners by Australia's trade share with each country.

These approaches can result in different shares for individual countries, with measures based on PPP exchange rates typically giving a high weight to emerging countries like China and India. Nonetheless, while each measure has its strengths – outlined in this box – they all show that world output has recently been growing at an above trend pace. Specifically, world GDP grew by 5½ per cent in 2006 according to the PPP measure (the fastest pace in more than 30 years) compared with 4 per cent using market exchange rates and 5 per cent using weights based on Australia's trading partners (Graph A1). Recent forecasts suggest that world growth will remain strong in 2007 and 2008, a result reflected in all the global growth measures.

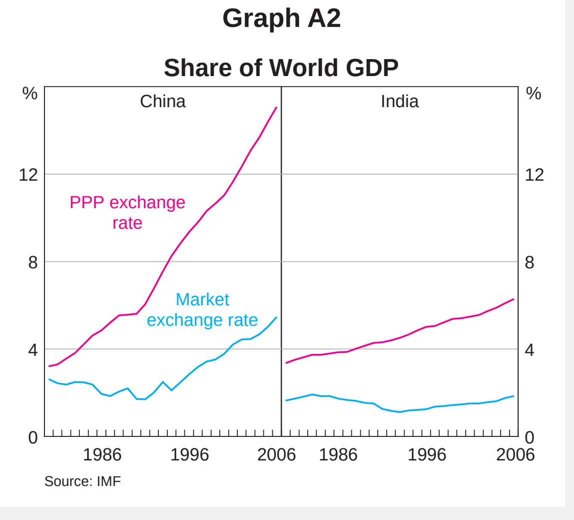


PPP exchange rates are based on the idea that when measured in a common currency, the same basket of goods and services should be valued at the same price anywhere in the world. In practice, the prices of many goods and services in developing countries – most notably labour-intensive non-tradables, with the most often cited example being haircuts – are lower than in industrial countries. PPP exchange rates reflect the price of a standardised 'typical' basket of goods and services in each country compared with the cost of purchasing the same basket in the reference country (typically the US).[1] Countries with relatively low non-tradables prices will usually have PPP exchange rates that are higher than their prevailing market exchange rate,

1 *Purchasing power parities are generated by the International Comparison Program based on price data for a basket of goods and services, and are recalculated approximately every five years, with a comprehensive update due later this year.*

and hence the value of their output – and their share in world GDP – will be larger when it is converted using PPP exchange rates.

During the past decade, annual growth in world output measured on a PPP basis has averaged around 4 per cent, while growth based on prevailing market exchange rates has averaged 3 per cent. China and India account for virtually all of this divergence due to their higher shares in world output when measured on a PPP basis and their rapid rates of growth. Specifically, China currently accounts for 15 per cent of the global economy on a PPP basis (the second largest behind the United States), whereas on a market exchange rate basis its share is only 5 per cent (the fourth largest economy; Graph A2). Similarly, India accounts for 6 per cent of the world economy using PPP exchange rates (the same size as Japan) but only 2 per cent based on market exchange rates (only slightly bigger than Australia). Together, over the past decade China and India have contributed an average of 1½ percentage points each year to world growth when measured in PPP terms, compared with ½ percentage point in market exchange rate terms.



Another way to measure the strength of the world economy is to weight the output of Australia's major trading partners (using market exchange rates) by the share of our exports going to each country. In recent years, the estimate of world growth using Australia's export-weighted trading partner growth has been quite similar to the PPP-weighted measures. This reflects the fact that both the PPP exchange rate and the export-weighted approaches give a comparatively high weight to output in east Asia, and a low weight to the US and Europe (Table A1). However, the very high weight of the 'other east Asia' group in the export-weighted measure means that trading partner growth fluctuated sharply at the time of the Asian crisis.

Each of these methods of estimating world output has its strengths, depending on the issue being considered. Estimating world output using PPP exchange rates is generally regarded as a better measure of changes in world economic well-being since it is based on a uniform price for goods and services regardless of where they are produced and since it is less affected by short-term exchange rate volatility. However, growth measures based on market exchange rates – either to aggregate world output or to weight by Australia's trade shares – can be more relevant when focusing on the implications of global growth for world or Australian transactions that occur at market exchange rates, such as trade and other financial flows.

Table A1: Share of World Activity
Selected economies, 2006, per cent

	GDP		Australia's exports[(a)]
	PPP exchange rates	Market exchange rates	
United States	20	28	6
Euro area	15	23	7
Japan	6	9	19
China	15	5	14
Other east Asia	7	5	24
India	6	2	6
Australia	1	2	na

(a) Merchandise exports, valued at market exchange rates

Sources: ABS; IMF; RBA

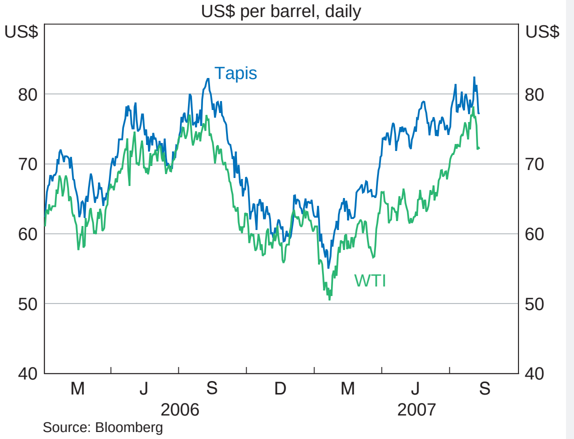
Box B: Recent Developments in Oil Prices

There are more than 160 types of crude oil traded globally, the prices of which are determined relative to various benchmark types, adjusted for differences in quality. The most widely cited benchmark is West Texas Intermediate (WTI) crude, although WTI accounts for less than 1 per cent of global oil production. The other major regional crude oil benchmarks are Brent (in Europe), Dubai (in the Middle East) and Tapis (in Asia). Pricing is based largely on the crude's chemical properties, particularly its sweetness (sulphur content) and weight (API gravity). A 'sweet and light' crude generally trades at a premium to a 'heavy and sour' crude, as the former is cheaper to process into high-value products, such as petrol. Historically, WTI, which is a sweet and light crude, has tended to trade at a premium to Brent and Dubai and at rough parity with Tapis, which is also a sweet and light crude.[1]

While the various benchmark crude prices typically move closely together, for much of this year there has been an unusually large gap between the price of WTI and that of other benchmark crudes, including Malaysian Tapis (Graph B1). Tapis is the most relevant measure for Australian petrol prices because the price of petrol in Australia tends to be based on the ex-refinery price of petrol in Singapore, which is refined from Tapis crude oil. From January to May, the price of Tapis increased by nearly 30 per cent, while the price of WTI increased by only half that rate. This saw the price differential between WTI and Tapis widen to unprecedented levels.

Graph B1

Benchmark Crude Oil Prices



Source: Bloomberg

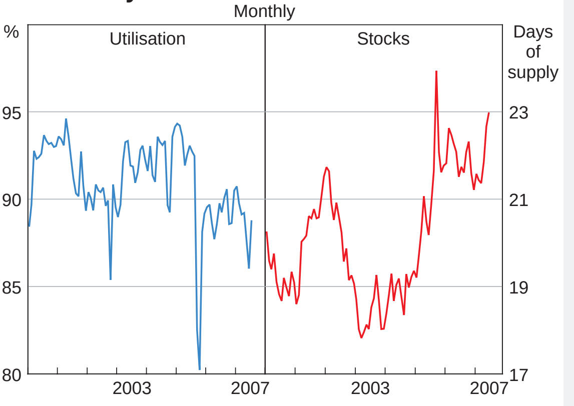
The price divergence seen this year appears to have been driven by special factors that have contained the price of WTI crude below that in other oil markets. In particular, unexpected outages and prolonged maintenance at US petroleum refineries temporarily reduced demand for WTI oil, and the consequent high level of US crude oil stocks and limited physical opportunities for export of WTI to other markets placed downward pressure on the WTI price (Graph B2). In contrast, conditions in other world oil markets have generally tightened since the beginning of the year,

1 *Tapis is a Malaysian oilfield and is the lightest and sweetest of the main types of crude oil, with an API gravity of 45.5 degrees and sulphur content of 0.1 per cent. By comparison, WTI has an API gravity of 39.6 degrees and sulphur content of 0.2 per cent, making it sweeter and lighter than Brent, which has an API gravity of 38.3 degrees and a sulphur content of 0.4 per cent.*

as a strong increase in oil demand (in part driven by increased US imports of petrol to cover the shortage in domestic refined petroleum) has coincided with broadly unchanged global supply. The latter has reflected announced cuts to OPEC production and further disruptions to Nigerian oil output that have largely offset supply increases from the Commonwealth of Independent States.

Graph B2

US Refinery Utilisation and Crude Oil Stocks*



* Seasonally adjusted by the RBA
Source: US Department of Energy

However, through June and July, the WTI crude price rose towards that of other crudes as US refinery utilisation returned to more normal levels, with the result that the price gap has now significantly narrowed. Nevertheless, this episode highlights that it is important to look at a range of measures to gauge developments in the world oil market as individual crude oil prices can periodically be affected by local factors. ✠

International and Foreign Exchange Markets

International financial markets

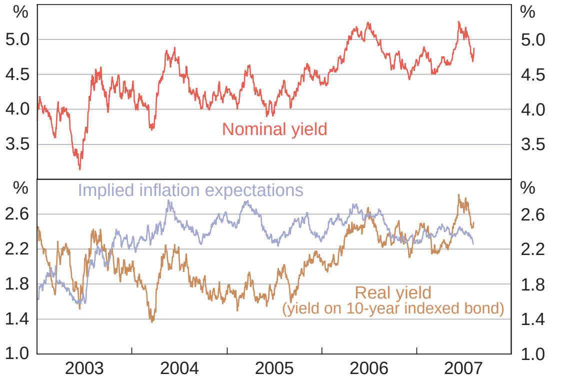
Bond yields

Since the last *Statement* there have been some sharp movements in government bond yields. In May and June, yields on US government debt rose markedly as investors became less pessimistic about the US economic outlook. Consequently, the rise was mainly evident in real yields with inflation expectations little changed (Graph 16). By mid June yields had risen by more than 60 basis points on the same period a month earlier to be at their highest since early 2002. This was the sharpest rise in yields since 2004, although much larger movements were recorded in the 1990s. At that point, the yield curve sloped upwards for the first time since June 2006.

Over the second half of June and into July, however, bond market sentiment changed significantly. The catalyst was the adverse news involving the US sub-prime mortgage market.

Graph 16

US 10-year Government Bond Yields



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

The underlying deterioration in the US sub-prime market was not in itself news. The delinquency rate on sub-prime mortgages has been rising for some time, from a rate of around 6 per cent in mid 2005 to about 14 per cent in early 2007. Much of this deterioration is attributable to the poor quality of loans that were originated in 2005 and especially 2006 – a period in which there was strong competition among mortgage lenders and a significant relaxation of lending standards. Many of the loans were adjustable-rate mortgages on which the interest paid in the first couple of years is relatively low, but is then subsequently adjusted upwards by as much as 500 basis points. As the interest rates on a large number of the poorer-quality 2006 vintage mortgages still have to be reset, it is likely that sub-prime mortgage defaults still have a way to rise yet. This was acknowledged by Chairman Bernanke in his testimony before the US Senate Banking Committee in July, when he estimated that financial losses on the defaults could be in the range of US$50 to US$100 billion. Nevertheless, while these losses are sizeable, he indicated that the Federal Reserve does not believe that the sub-prime issues will lead to wider systemic problems or that they will significantly inhibit overall economic growth in the US.

The news that particularly unsettled credit markets was the announcement in mid June by US investment bank Bear Stearns that two of its hedge funds were facing financial difficulty through their exposure to the sub-prime mortgage market. Since then, several other hedge funds that invested heavily in products based on sub-prime mortgages have suffered financial distress, including in Australia (see below). Rather than any sudden unexpected deterioration in the sub-prime mortgage market itself, the problems experienced in these funds appears to relate more to their leverage and the illiquidity of sub-prime related debt markets in times of stress. Uncertainties over the market value of sub-prime debt and the failure of funds to report accurately initial trading losses eventually led creditors to make sizeable margin calls and even to seize collateral, some of which was sold into the market. This had the effect of moving market prices further against leveraged and cash-strapped funds.

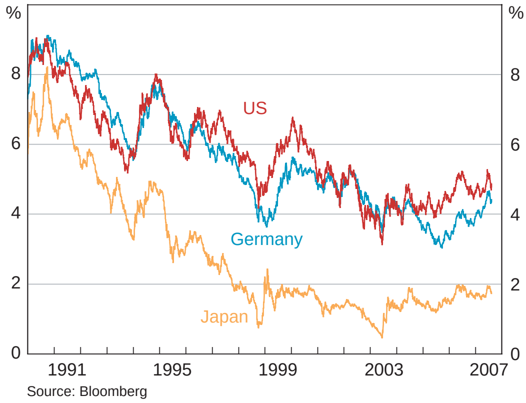
In mid July, the concerns about sub-prime mortgage debt were further heightened by the actions of the major credit rating agencies. Standard & Poor's was first to announce that it was considering downgrading the credit ratings of around 600 classes of sub-prime residential mortgage-backed securities (RMBS). This was followed almost immediately by a decision from Moody's actually to cut the ratings of 400 largely speculative grade sub-prime RMBS. Over the following days there was a spate of further ratings downgrades to sub-prime RMBS and also to a large number of collateralised debt obligations made up from sub-prime RMBS. Moody's also announced that it would examine credit ratings on securities backed by 'Alt-A' loans whose risk characteristics fall between prime and sub-prime loans.

These events triggered a flight out of riskier credit markets and into higher-quality paper, notably US government bonds. As a result, yields on major market government debt fell and virtually all of the earlier increases were reversed. For example, the yields on 10-year US Treasury bonds which rose by more than 60 basis points in May/June, to a high of 5.3 per cent, subsequently fell by over 50 basis points to below 4¾ per cent.

Other major bond markets largely took their lead from events in the US (Graph 17). In Germany yields rose as high as 4¾ per cent before similarly falling back by 40 basis points, while in Japan yields rose to nearly 2 per cent before also declining. These swings in market sentiment since the last *Statement* have been associated with an increase in volatility, which for US government bonds reached its highest level since May 2004. Volatility in German and Japanese government debt also increased, but by less than that observed in US paper.

Graph 17

10-year Government Bond Yields



Source: Bloomberg

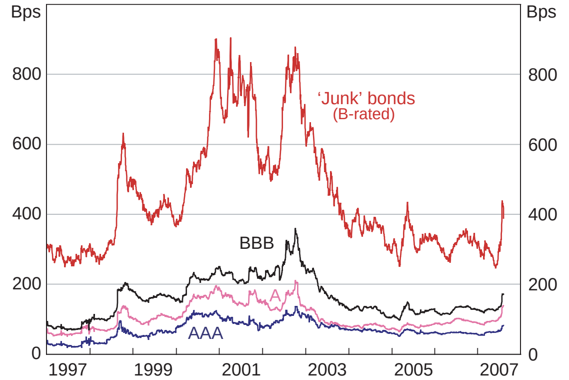
Heightened uncertainty in global credit markets also saw a widening of credit spreads for speculative-grade debt of around 130 basis points in July. Spreads are around their highs of recent years but are still well below the levels reached in the early part of the decade (Graph 18). Investor appetite for high-risk, high-yield debt has significantly diminished. This was illustrated by the difficulties that banks had in placing in the capital markets about US$20 billion worth of loans for two large private equity buy-outs involving Chrysler in the US and Alliance Boots in the UK. The concerns over credit quality also saw spreads on highly rated corporate debt increase to their highest level since 2003. This was partly driven by concerns over the potential exposure of banks to sub-prime debt markets. However, the concurrent decline in US Treasury yields has seen the level of yields on AAA-rated corporate debt actually decline.

The difficulties in the sub-prime market also generated some volatility in emerging market debt spreads. Spreads on emerging Asian and Latin American debt widened by around 50 basis points but still remain at low levels by historical standards, reflecting the strong fundamentals of these economies (Graph 19).

Graph 18

US Corporate Spreads

Relative to 7- to 10-year US government bonds

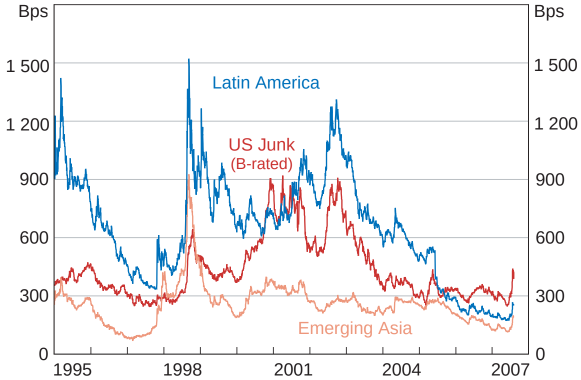


Source: Bloomberg

Graph 19

Market Spreads

To US government bonds, duration matched



Sources: Bloomberg; RBA; Thomson Financial

Australian hedge funds and US sub-prime markets

A small number of Australian hedge funds that invest in lower-rated US corporate debt and asset-backed securities have been affected by the turbulence in global credit markets. One fund, which had a large exposure to US sub-prime loans, is being wound up. Several other funds have also recorded losses on their investments in sub-investment grade corporate debt and in structured debt. Some of these funds have suspended investor redemptions because of a lack of liquidity in the underlying securities.

These funds have, in aggregate, about A$1½ billion in funds under management, around 2 per cent of funds managed by Australian hedge funds. It is too early to tell if other funds have been significantly affected. Only 10 of the 200 Australian hedge funds predominantly invest in fixed income, but funds of hedge funds and global macro funds may have some exposure to sub-investment grade debt.

Official policy rates

Since the last *Statement* both the US Federal Reserve and the Bank of Japan have left their policy rates unchanged, while most other major central banks have tightened monetary policy (Table 3, Graphs 20 and 21). The Fed has left the federal funds rate unchanged at 5¼ per cent since June last year. Earlier in the year, financial markets had been expecting at least two reductions in the federal funds rate during the course of 2007 based on pessimistic assessments about the US economic outlook. But these expectations were unwound in May and June as market participants moved more into line with the Fed's view that there are more upside risks to inflation from tight labour markets than downside risks to the broader economy from the weak US housing market. Following the turbulence in credit markets, however, financial markets are currently again pricing in a policy easing in the US by the end of the year, despite the Fed reaffirming its concerns about inflation following its August meeting.

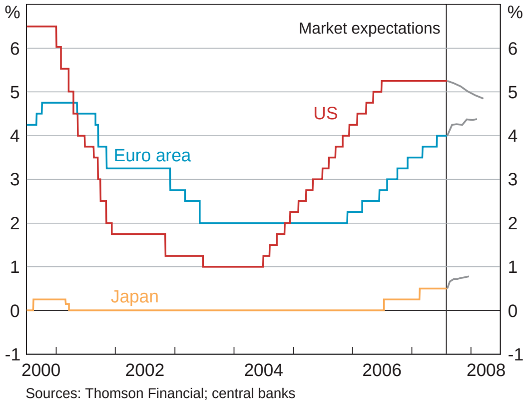
Table 3: Changes in Monetary Policy

	Current level Per cent	Most recent change	Expectations for next 6 months
United States	5.25	↑ Jun 06	↓ 25 bps
Euro area	4.00	↑ Jun 07	↑ 25 bps
Japan	0.50	↑ Feb 07	↑ 25 bps
United Kingdom	5.75	↑ Jul 07	↑ 25 bps
Canada	4.50	↑ Jul 07	↑ 25 bps
New Zealand	8.25	↑ Jul 07	No change

Sources: central banks; Bloomberg; Reuters

Graph 20

Policy Rates



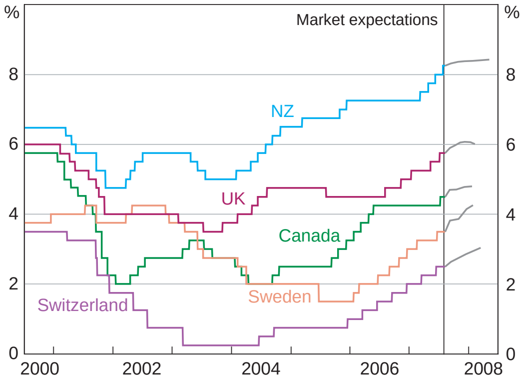
Sources: Thomson Financial; central banks

The Bank of Japan (BoJ) has kept its policy rate unchanged at ½ per cent for five consecutive monthly meetings. While it signalled its intention to tighten monetary policy further, this is expected to happen at a very gradual pace in line with developments in the economy and inflation. The market expects that the BoJ will lift rates by 25 basis points some time in the coming months.

The European Central Bank (ECB) raised its policy rate by 25 basis points to 4 per cent at its June meeting. The move had been widely anticipated and continued the gradual process of lifting euro area rates, which are now up by a cumulative 200 basis points since late 2005. With the ECB describing current conditions as remaining on the accommodative side and reiterating its inflation concerns, markets expect one further 25 basis point increase before year end.

Graph 21

Policy Rates



Sources: Thomson Financial; central banks

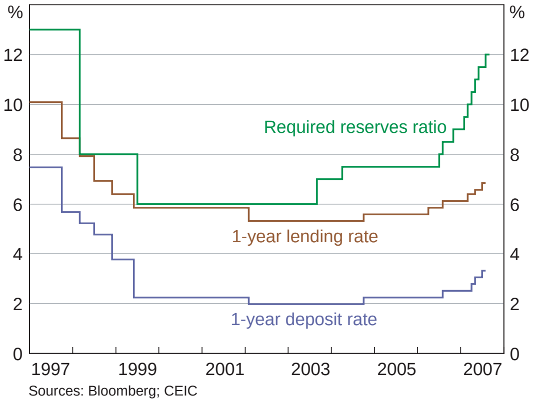
Over the past three months, the Bank of England (BoE) has raised its policy rate twice by 25 basis points, from 5¼ per cent to 5¾ per cent. The BoE has now increased interest rates by a cumulative 125 basis points over the past year, reflecting concerns over medium-term inflationary pressures. Elsewhere in Europe, the central banks of Switzerland, Sweden and Norway each tightened policy by 25 basis points to 2½ per cent, 3½ per cent, and 4½ per cent, respectively.

Both the Reserve Bank of New Zealand (RBNZ) and the Bank of Canada (BoC) also raised rates over the past three months in response to increasing inflation pressures. The RBNZ twice raised rates by 25 basis points, in June and July, citing strong domestic demand, partly due to positive income effects from a marked increase in dairy prices, as one of its main concerns. The BoC also lifted its policy rate by 25 basis points to 4½ per cent in July. This was the first policy change since May 2006 and markets currently expect another tightening later this year.

Monetary conditions continued to be tightened in China in an effort by the authorities to rein in rapid growth in domestic liquidity. Since the last *Statement*, the People's Bank of China (PBoC) has raised the required reserves ratio for banks twice by a total of 100 basis points to 12 per cent (Graph 22). The PBoC also lifted the official one-year lending and deposit rates by around 50 basis points, to 6.84 per cent and 3.33 per cent, respectively. China's State Council also announced a cut in taxation on interest income from 20 per cent to 5 per cent in an attempt to divert savings into the banking sector and away from the domestic equity market.

Graph 22

China – Monetary Policy Settings



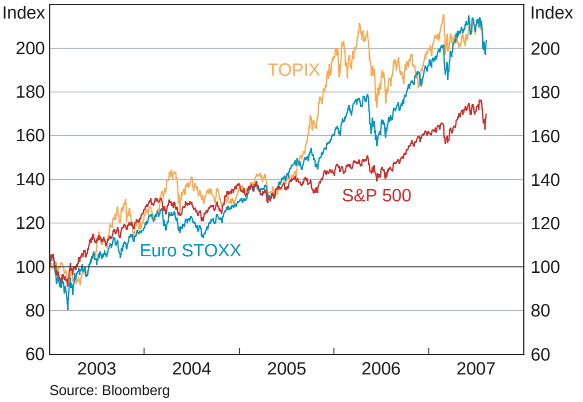
Sources: Bloomberg; CEIC

Elsewhere in emerging markets, a number of central banks including those in Korea, Taiwan, and South Africa have raised their policy rates since the last *Statement* in response to rising inflationary pressures. The Reserve Bank of India raised its reserve requirement on banks. In contrast, Bank Indonesia has reduced rates three times by 25 basis points, from 9 per cent to 8¼ per cent, and the Bank of Thailand has cut rates twice, from 4 per cent to 3¼ per cent as inflation pressures in those countries have eased. Brazil's central bank has also cut rates twice by 50 basis points, from 12½ per cent to 11½ per cent.

Graph 23

Share Price Indices

1 January 2003 = 100



Source: Bloomberg

Equities

Having recorded solid increases for much of the past three months, supported by the continued strength in the global economy, global equity markets declined sharply following the increased concern in credit markets (Graph 23, Table 4). Financial sector share prices have been most affected by the sub-prime fallout, with prices in that sector in the US falling by 8 per cent in July.

Table 4: Changes in Global Share Prices

Per cent

	Since 2000 peak	Over the past year	Since previous *Statement*
United States			
– Dow Jones	17	22	3
– S&P 500	–2	18	0
– NASDAQ	–48	27	2
Euro area			
– STOXX	–10	22	–2
United Kingdom			
– FTSE	–8	10	–1
Japan			
– TOPIX	–5	7	–2
Canada			
– TSE 300	21	15	1
Australia			
– ASX 200	75	21	–2
MSCI Emerging Asia	52	44	16
MSCI Latin America	234	43	9
MSCI World	4	19	0

Source: Bloomberg

In contrast, share prices in emerging markets have generally continued to post very strong gains. Local currency-denominated China A shares have increased by around 20 per cent since the last *Statement* (Graph 24), despite continued speculation that the authorities may impose trading restrictions in an effort to cool the share market.

Exchange rates

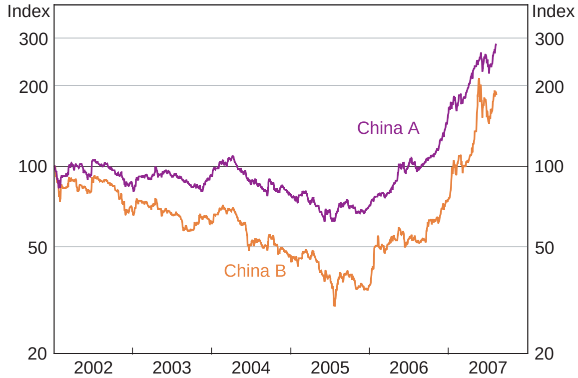
The US dollar continued to depreciate against most major currencies since the last *Statement* (Table 5). On a trade-weighted basis, the nominal exchange rate is now around its lowest level in over 30 years, although the real exchange rate is currently around 10 per cent above its 1995 trough (Graph 25). The depreciation has been broad-based with the US dollar posting multi-decade lows against several major currencies including the Australian dollar (see below). The decline in sentiment has also been reflected in the total amount of speculative short positions against the US dollar, which had risen to their highest level since November 2004.

The major exception to the general appreciation against the US dollar was the Japanese yen which continued its trend depreciation in May and June, before more than reversing this in July as credit concerns contributed to US dollar depreciation (Graph 26). On a trade-weighted basis the yen remains at a multi-decade low. The depreciation of the yen in part has reflected the decline in the home bias of Japanese investors as households have gradually diversified their portfolios into foreign assets

Graph 24

China – Share Price Indices

1 January 2002 = 100, log scale



Source: Bloomberg

Table 5: Change in US Dollar against Other Currencies

Per cent

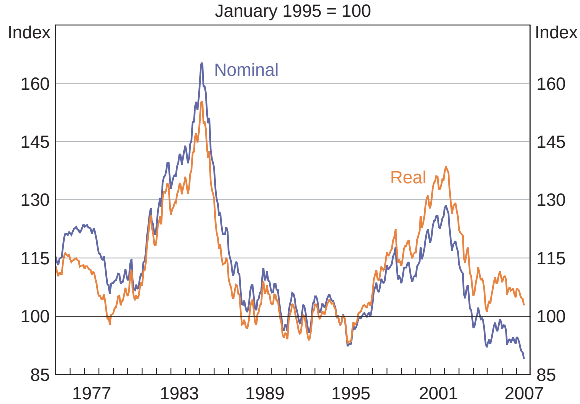
	Past year	Since previous *Statement*
New Zealand	–19	–4
Brazil	–13	–7
India	–13	–2
Philippines	–12	–5
Australia	–11	–3
Thailand	–10	–2
Euro area	–7	–1
Canada	–7	–6
Sweden	–6	0
Malaysia	–6	1
United Kingdom	–6	–2
China	–5	–2
Singapore	–4	–1
South Korea	–4	–1
Switzerland	–2	–1
Taiwan	0	–1
Mexico	0	0
Indonesia	2	2
South Africa	3	0
Japan	4	0
Majors TWI	**–5**	**–3**
Broad TWI	**–5**	**–2**

Source: RBA

Graph 25

US Major TWI

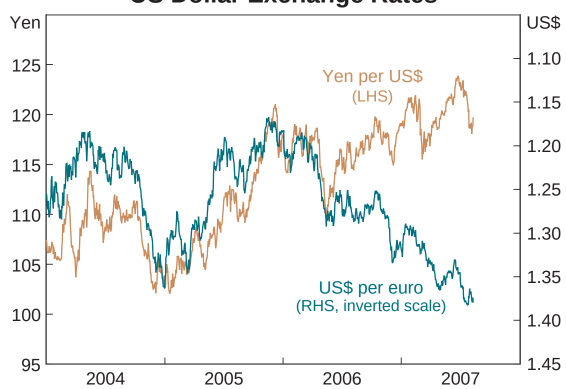
January 1995 = 100



Source: Board of Governors of the Federal Reserve System

Graph 26

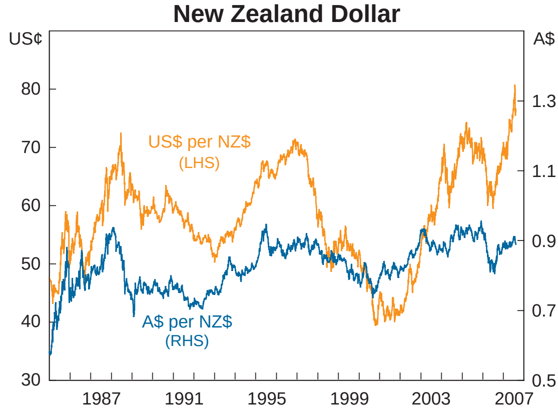
US Dollar Exchange Rates



Source: Bloomberg

Graph 27

New Zealand Dollar



Sources: RBA; Reuters

at a time when there is less offsetting portfolio equity inflow. Additionally, low interest rates in Japan have resulted in the yen being the primary funding currency for carry trades.

The New Zealand dollar appreciated strongly against the US dollar since the last *Statement* (Graph 27). The exchange rate has been buoyed by relatively high interest rates and rose further after the RBNZ unexpectedly raised official interest rates in early June. The central bank responded to the appreciation by intervening in currency markets to sell New Zealand dollars for the first time since the exchange rate was floated in 1985.

Most emerging market currencies have also appreciated against the US dollar in recent months. In particular, the Brazilian real, Thai baht, and Philippine peso rose strongly over the period. The Brazilian real was supported by improving economic fundamentals and a sovereign credit rating upgrade. The central bank has intervened in the currency market to limit upward pressure on the exchange rate.

The Chinese renminbi also appreciated further against the US dollar since the last *Statement*, with the pace of appreciation picking up in May and June to its fastest rate since the introduction of the new regime two years ago. In May, Chinese authorities announced a widening of the renminbi's daily trading band to 0.5 per cent from 0.3 per cent previously. This decision would, in principle, allow greater volatility and a faster rate of appreciation in the Chinese currency than before, although the limits of the earlier narrower band had not been utilised. Pricing in the non-deliverable forwards market indicates expectations for the renminbi to appreciate by a further 6 per cent against the US dollar over the next year.

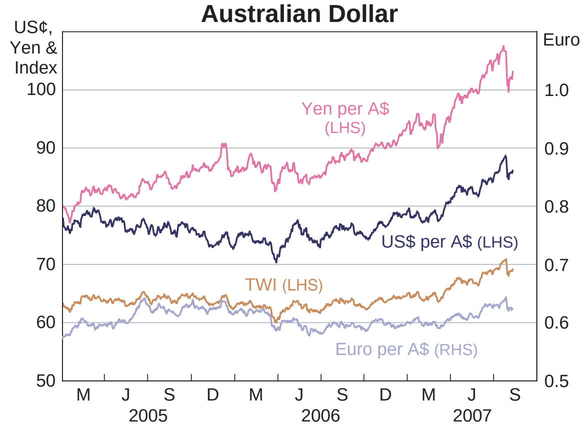
Australian dollar

The Australian dollar has appreciated since the last *Statement*, rising above 88½ US cents for the first time since February 1989, before retracing some of its gains in late July (Graph 28, Table 6). The gains only partly reflected the general depreciation of the US dollar (see above), as the Australian dollar has appreciated against the currencies of most of its major trading partners, with the trade-weighted exchange rate rising above 70 for the first time since 1985. The exchange rate is well above its post-float average against the US dollar and a number of Asian currencies, as well as on a trade-weighted basis (Graph 29), but it is still below its average against currencies such as the euro/deutschemark, pound sterling and the New Zealand dollar.

The broad-based strength of the Australian dollar is attributable to a number of factors. The terms of trade have risen to their highest level in 50 years. Also, the strength of the economy and the resulting level of yields compared to other major economies have provided support for the local currency. Positive interest rate differentials have meant that Australia continues to attract substantial capital inflows (Graph 30). Portfolio debt inflows increased substantially in the March quarter (the latest period for which

Graph 28

Australian Dollar



Sources: RBA; Reuters

Table 6: Australian Dollar against Selected TWI Currencies

Percentage change

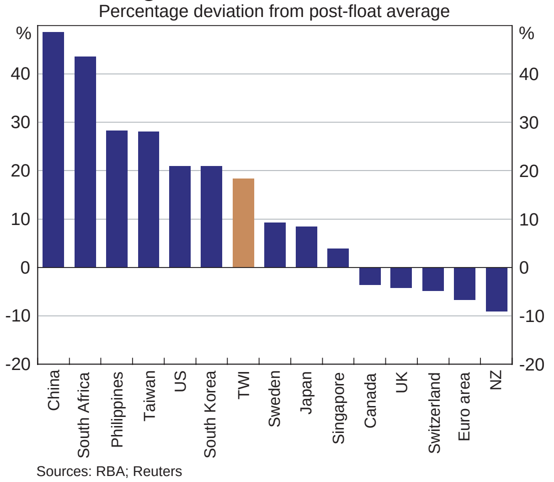
	Past year	Since previous *Statement*
Japan	18	5
South Africa	17	4
Indonesia	15	6
Taiwan	14	3
US	14	5
PNG	11	2
Switzerland	11	3
South Korea	10	4
Singapore	9	4
China	8	3
Canada	6	–1
Euro area	6	3
Sweden	6	4
UK	6	2
Philippines	0	–1
New Zealand	–7	0
TWI	**10**	**4**

Source: RBA

Graph 29

A$ against Selected Currencies

Percentage deviation from post-float average

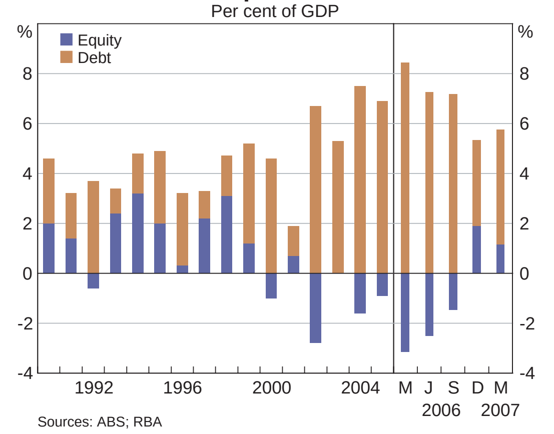


Sources: RBA; Reuters

Graph 30

Net Capital Inflows

Per cent of GDP

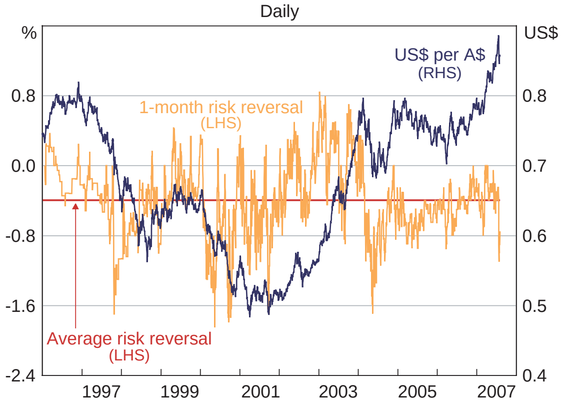


Sources: ABS; RBA

Graph 31

Australian Dollar and Risk Reversals*

Daily



* A risk reversal is an option portfolio consisting of two out-of-the-money options; a long call option and a short put option. The risk reversal's price is the price of the call option minus the price of the put option.

Source: JP Morgan

data are available), while bank and money market flows continue to account for the majority of net capital inflow in annual terms, despite a small net outflow in the first quarter of this year. Inflows of equity capital from abroad have more than offset equity outflows in the last two quarters.

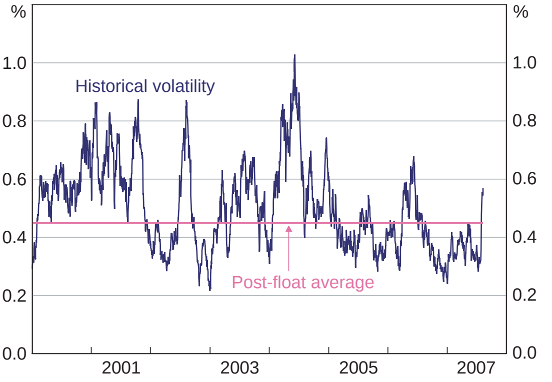
Sustained appetite for carry trades has probably contributed to a significant proportion of the debt market inflows, and as a result the Australian dollar appreciated particularly strongly against the low-yielding Japanese yen in the period to late July. However, in the last days of July, the credit market concerns triggered a general unwinding of carry trades (see above), which in turn led the Australian dollar to depreciate sharply against the yen, US dollar and in trade-weighted terms, reversing a significant proportion of the earlier gains.

Reflecting the generally positive investor sentiment towards the local currency in recent months, net long speculative positions in Australian dollar futures on the Chicago Mercantile Exchange have generally been maintained at high levels relative to past years. This had also been reflected in Australian dollar risk reversals, which provide a measure of the market's expectations of the future direction of the exchange rate. Up until very recently, Australian dollar risk reversals had been rising, indicating a declining probability of a sizeable future depreciation (Graph 31). However, in recent days, risk reversals indicate that this sentiment has changed, with participants more concerned about the prospect of a sizeable depreciation of the Australian dollar. After declining for most of the period since the last *Statement*, Australian dollar volatility spiked higher at the end of July, and is now above post-float average levels (Graph 32).

Graph 32

Australian Dollar Volatility

Against US$, per trading day



Source: RBA

With the Australian dollar reaching a multi-year high against the US dollar, the Reserve Bank continued its purchases of foreign exchange in recent months. Net purchases over the year to date have totalled $2¼ billion. Net reserves currently stand at around $33 billion, while the Bank's holdings of foreign exchange under swap agreements are around $47½ billion.

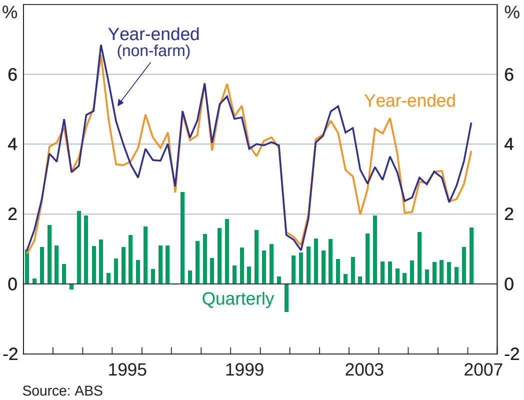
Domestic Economic Conditions

Economic activity has continued to grow strongly in recent quarters. Real GDP was estimated to have increased by 1.6 per cent in the March quarter, following growth of 1.1 per cent in the December quarter, to be 3.8 per cent higher over the year (Graph 33, Table 7). These data reflected broad-based strength in private demand. Growth in the non-farm sector was especially strong, at 4.6 per cent over the year; in contrast, farm output was around 20 per cent lower than a year earlier. The stronger-than-expected result for the March quarter, combined with robust growth in the December quarter, suggests a marked step-up in the pace of economic growth, after a period of softer outcomes over 2004/05 and 2005/06 during which growth ran at an average annual rate of 2.6 per cent. However, just as earlier growth estimates appeared to be understating the strength of output growth, it is likely that the data for the past two quarters somewhat overstate the true strength of growth.

Recent data suggest that economic activity remained firm in the June quarter, although GDP growth is likely to be more moderate than reported in the December and

Graph 33

GDP Growth



Source: ABS

Table 7: Demand and Output
Percentage change

	December qtr 2006	March qtr 2007	Year to March qtr 2007
Domestic final demand	1.2	1.5	4.5
Change in inventories[(a)]	0.7	0.5	0.6
GNE[(b)]	2.3	1.8	5.3
Net exports[(a)]	–1.3	–0.2	–1.6
GDP	1.1	1.6	3.8
Non-farm GDP	1.3	1.7	4.6
Farm GDP	–10.4	–0.2	–22.7
Memo item:			
Real GDP adjusted for changes in the terms of trade	1.4	1.9	5.4

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

March quarters. Retail trade was broadly flat and sales of motor vehicles increased modestly in the quarter, employment growth has remained solid and survey measures of business conditions have strengthened.

Looking forward, conditions in the non-farm economy are expected to remain strong. Household consumption will be supported by strong growth in household incomes – due to growth in employment and real wages along with the tax cuts announced in the Federal Budget – and rising household wealth. Housing construction may be weaker in the next quarter or so, but is expected to pick up gradually over time as the market responds to the growing shortage of dwellings. Business investment is expected to grow solidly and the high level of investment will continue to provide a sizeable boost to the capital stock. The completion of several new mining projects, combined with robust global demand and an easing in domestic infrastructure bottlenecks, should continue to support strong growth in resource exports. Rural exports are likely to remain weak in the near term, although recent rainfall throughout New South Wales, South Australia and Victoria, and the prospect of more normal rainfall over the second half of the year, should help support a recovery in farm production and exports in 2007/08.

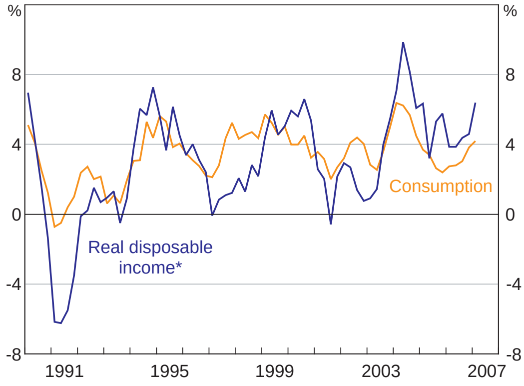
Household sector

The financial position of the household sector strengthened further during the first half of 2007. Real household disposable income grew by 2.1 per cent in the March quarter, and by 6.4 per cent over the year, mainly reflecting the firm growth in labour income. Households' net worth has continued to rise as the increase in the value of household assets has exceeded the increase in their debt; house price growth has been firm and despite the recent correction in the share market Australian equity prices were up by around 8 per cent for the year to date at the time the *Statement* was finalised. As discussed in the March 2007 *Financial Stability Review*, most households are coping well with their higher debt obligations. While there has been some increase in loan arrears and other indicators of financial distress, they are generally still at low levels.

Graph 34

Household Income and Consumption

Year-ended percentage change



* Household sector includes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.

Sources: ABS; RBA

The healthy financial position of households has been reflected in strong growth in household spending. Household consumption grew by 1.5 per cent in the March quarter, to be 4.2 per cent higher over the year, up from growth of 2.7 per cent over the previous year. Nonetheless, as it has since 2004, consumption grew more slowly than household disposable income, continuing the gradual reduction in the rate of household dissaving

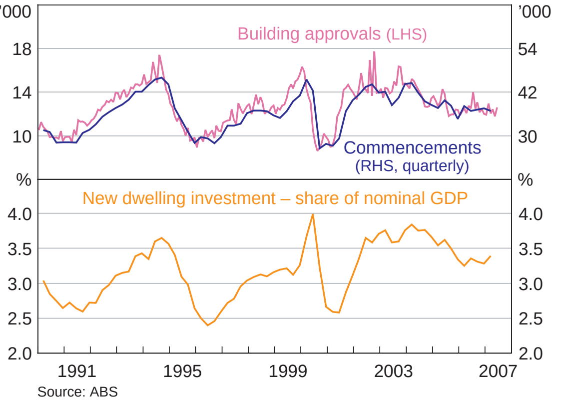
(Graph 34). More recent data suggest the pace of consumption growth softened somewhat in the June quarter, with real retail sales broadly flat in the quarter to be 3.6 per cent higher over the year. Motor vehicle sales to households rose modestly, increasing by 0.7 per cent in the quarter after a period of strong growth earlier this year. Liaison contacts continue to report broad-based growth in consumer spending, buoyed by the rises in labour income and wealth. The recent increase in petrol prices is reported to be having little dampening effect on spending, and consumer confidence has increased in recent months.

Housing

Dwelling investment has been broadly stable as a share of GDP over the past year, after a period of gradual decline since 2003 (Graph 35). While construction activity picked up in the March quarter, building approvals fell moderately in the first half of the year, which points to some weakness in dwelling investment over the next couple of quarters. However, in recent years dwelling investment has been stronger than would have been suggested by the number of building approvals.

Graph 35

Housing Construction and Investment



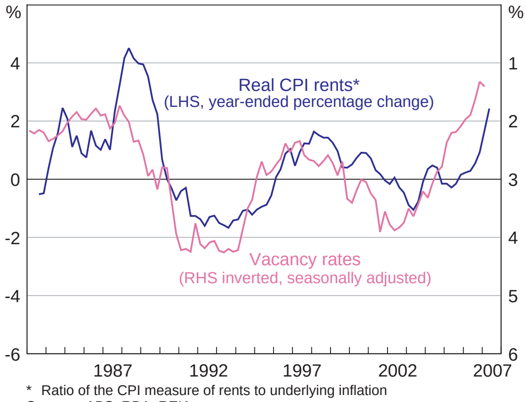
Source: ABS

Looking further ahead, the pace of residential construction activity is expected to gradually pick up, as the number of houses and units being built is currently well short of estimates of underlying demand for new housing. Over the year to the March quarter, 147 000 dwellings were completed. There is some uncertainty regarding the precise level of completions needed to meet the demand resulting from population growth, declining average household sizes and demolitions, although based on the recently released 2006 Census this underlying demand for new dwellings appears to be around 175 000. The growing shortfall in the construction of new dwellings is clearly evident in the rental market, where the vacancy rate, at 1.4 per cent, remains close to its lowest level for at least 30 years. The dwindling stock of vacant rental properties is contributing to rapid growth in rents. The 1.6 per cent increase in the CPI measure of rents in the June quarter was the largest since the late 1980s and the annual increase in rents, at 5.2 per cent, was well above the rate of underlying inflation (Graph 36). Data from industry sources point to growth in rents for new tenancies well above the average increase measured by the CPI. This increase in the growth of rents should provide support for dwelling construction activity in the medium term.

Average nationwide housing prices continued to grow at a firm pace in recent months, with stronger growth in house prices than in unit prices. According to ABS data, nationwide house

Graph 36

Vacancy Rates and Rents

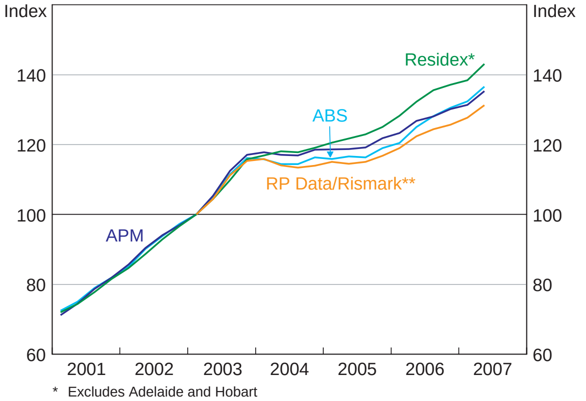


* Ratio of the CPI measure of rents to underlying inflation
Sources: ABS; RBA; REIA

Graph 37

Australian House Prices

March 2003 = 100



* Excludes Adelaide and Hobart
** Excludes Hobart; excludes Canberra and Darwin prior to March quarter 2004
Sources: ABS; APM; RBA; Residex; RP Data/Rismark

prices grew by 3 per cent in the June quarter to be 9 per cent higher over the year (Table 8). House prices increased in all of the state capitals, with the exception of Perth, where prices fell somewhat. The ABS data are broadly in line with other measures of house prices calculated using different methods (Graph 37). The APM mix-adjusted measure rose by around 7 per cent over the year, while the Residex repeat-sales indicator suggests that prices rose by 8 per cent. The RP Data/Rismark hedonic index, which takes into account the characteristics of each property sold (such as the location, and the number of bedrooms and bathrooms) also indicates that nationwide house prices rose by around 7 per cent over the year.

Auction clearance rates in Sydney and Melbourne have increased further over the first half of 2007 to be above their historical averages (Graph 38). The pick-up in clearance rates reflects the strength of the property market in the more expensive suburbs, in which auctions

Table 8: House Prices

Percentage change

	March qtr	June qtr	Year to June qtr
Sydney	0.1	2.3	3.0
Melbourne	1.7	5.0	11.5
Brisbane	4.2	6.5	15.7
Adelaide	2.2	5.7	11.7
Perth	1.3	–0.9	15.3
Canberra	1.3	2.9	9.0
Hobart	3.4	2.3	9.7
Darwin	2.5	–1.4	7.4
Australia	**1.4**	**3.2**	**9.2**

Source: ABS

are most prevalent. Auctions are less common in the other capital cities, but clearance rates in both Brisbane and Adelaide have also increased over the past 18 months in line with the pick-up in these property markets, while in Perth clearance rates have fallen over the past year paralleling the cooling property market.

Business sector

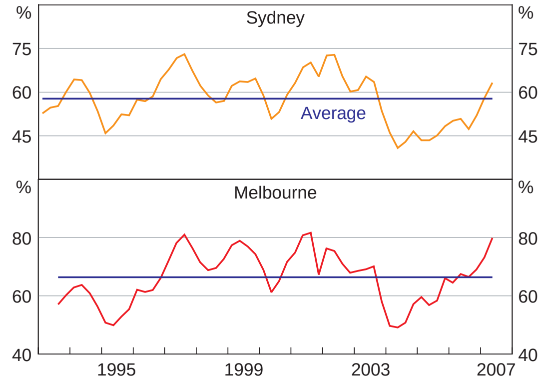
Business conditions in the non-farm sector have strengthened recently. Private-sector surveys suggest that across different sectors and firm sizes, aggregate conditions picked up in the June quarter, to be well above long-run average levels (Graph 39). Surveys and the Bank's liaison also indicate that capacity utilisation remains at a high level in most industries, particularly in the mining and construction sectors.

Recent data on private business profits and investment have been affected by the reclassification of Telstra from the public to the private sector in the March quarter following its sale, with offsetting changes in public sector profits and investment. Abstracting from this reclassification, the national accounts indicate that business profits grew by around 11 per cent over the year to the March quarter and, at 32 per cent of GDP, the profit share was at its highest level since the mid 1970s (Graph 40). Profit growth over the year was driven by non-mining corporations. While mining profits remained at a high level, their growth slowed considerably as commodity price growth eased and input costs rose. Farm sector profits weakened considerably over the year due to the drought. Overall, business surveys indicate that firms' expectations of profitability remain at or above long-run averages, and equity analysts estimate solid earnings growth for listed companies over the full financial year (for details see the 'Domestic Financial Markets and Conditions' chapter).

Graph 38

Auction Clearance Rates*

Seasonally adjusted, quarterly



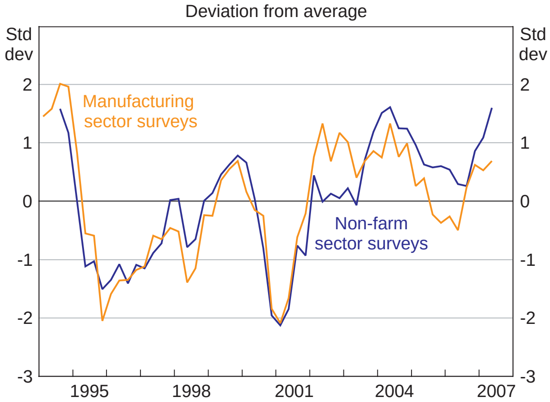
* Adjusted for withdrawals where possible

Sources: APM; RBA; REIV

Graph 39

Actual Business Conditions*

Deviation from average



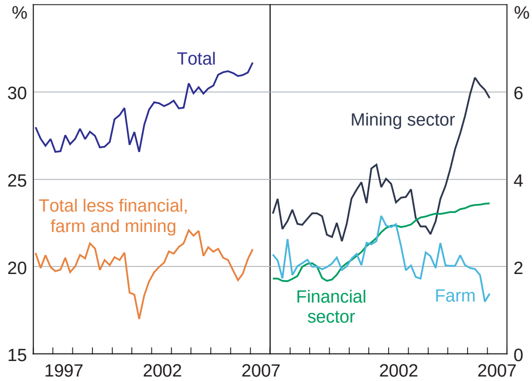
* Weighted average of data from various business surveys, with weights calculated by the RBA using the principal component method

Sources: ACCI; AIG; NAB; SAI Global; Sensis; St. George Bank; Westpac

Graph 40

Profits*

Per cent of nominal GDP



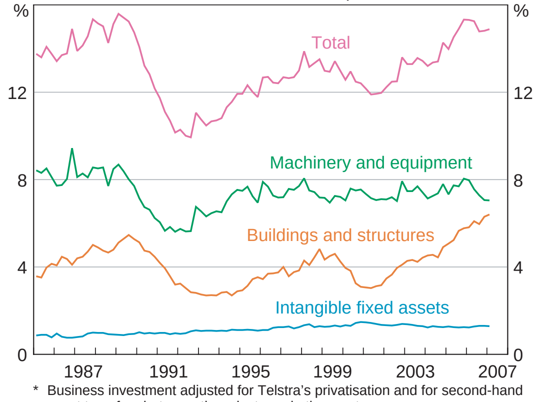
* Combined profits of both the incorporated and unincorporated sectors; adjusted for privatisations

Sources: ABS; RBA

Graph 41

Investment*

Per cent of GDP, current prices



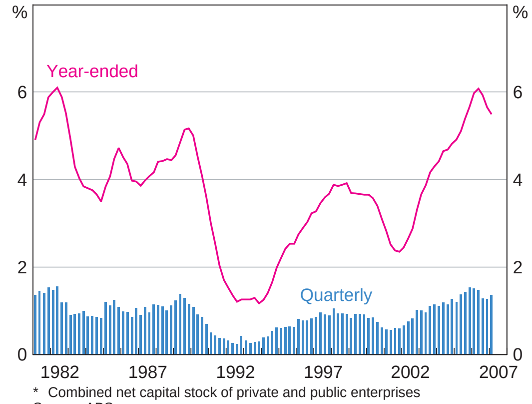
* Business investment adjusted for Telstra's privatisation and for second-hand asset transfers between the private and other sectors

Sources: ABS; RBA

Graph 42

Business Net Capital Stock*

Percentage change



* Combined net capital stock of private and public enterprises

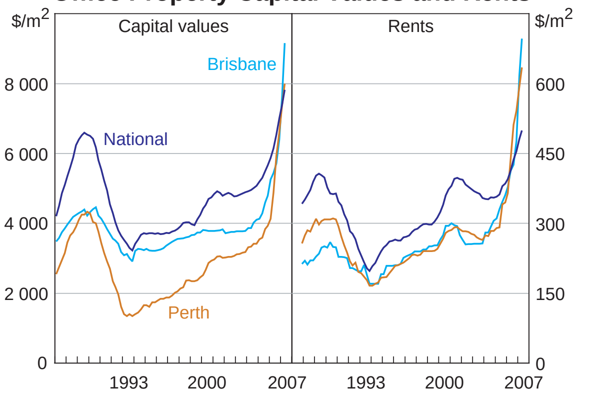
Source: ABS

Given the high level of profitability, supportive financial conditions and the healthy state of business balance sheets, firms have faced few restraints in funding their investment plans. Abstracting from the reclassification of Telstra, new business investment increased by around 3 per cent in the March quarter, to be 4¼ per cent higher over the year. The level of investment remains high as a share of GDP following average annual growth of 15 per cent over the previous four years (Graph 41). Hence, even with slower growth, the high level of investment should continue to support higher than average growth in the capital stock and hence add to the growth of productive capacity (Graph 42).

Looking ahead, the capital expenditure (Capex) survey's second estimate of firms' spending plans in 2007/08 indicates further moderate investment growth. Low prime office vacancy rates, especially in Brisbane and Perth, and sharp rises in rents and capital values indicate that there is strong demand for commercial property (Graph 43). Other forward-looking indicators also suggest that non-residential construction activity will remain firm in coming quarters. In addition, the recent rapid growth in public spending on construction could be further bolstered by budgeted increases in capital spending by public corporations. While the labour market has been able to accommodate strong growth in non-residential construction in recent years, reports of labour shortages and the expected recovery in housing construction cast some doubt as to whether all of the planned construction-related spending will be feasible. ('Box C: Developments in the Construction Sector' discusses recent trends in activity and employment in the construction sector in more detail.)

Graph 43

Office Property Capital Values and Rents



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

Government budgets

The Australian Government Budget for 2007/08, tabled in May, showed a significant upward revision to the estimated underlying surplus in 2006/07 relative to the mid-year estimates (Table 9). As with previous years, the upward revision largely reflected higher-than-expected individual and corporate tax revenues, which more than offset new expenditures. The surplus is expected to be a little lower in 2007/08 reflecting policy announcements. Collectively, the state Budgets, handed down over May and June, are projected to show a slightly larger deficit in 2007/08, due to increased infrastructure spending and slower growth in revenues. State government trading enterprises also plan to increase capital expenditures, particularly in New South Wales and Queensland.

Table 9: Fiscal Balance – General Government Sector(a)

Estimates, $ billion

	2006/07	2007/08
Federal government	12.8	11.0
– Per cent of GDP	1.2	1.0
State governments	–2.1	–5.7
– Per cent of GDP	–0.2	–0.5
Total – federal and state	10.7	5.3
– Per cent of GDP	1.0	0.5

(a) ABS Government Finance Statistics basis

Sources: Australian Treasury; RBA; state Treasuries

Farm sector

Conditions in the rural sector have improved noticeably in recent months. Most of the major cropping regions of south-eastern Australia have recorded above average rainfall so far this year, although rainfall in parts of Western Australia has been less favourable. Based on information from the Australian Bureau of Agricultural and Resource Economics (ABARE) and other rural organisations, farm output is expected to rise by around 20 per cent in 2007/08, mainly reflecting a recovery in the wheat crop and other cereals (Table 10, Graph 44).

The expected rebound in farm output is somewhat smaller than those following previous droughts, primarily reflecting the cumulative impact of several years of below average rainfall. This has led to water storage levels falling to historical lows, and water allocations for irrigators in the Murray-Darling Basin being reduced significantly. Despite the improvement

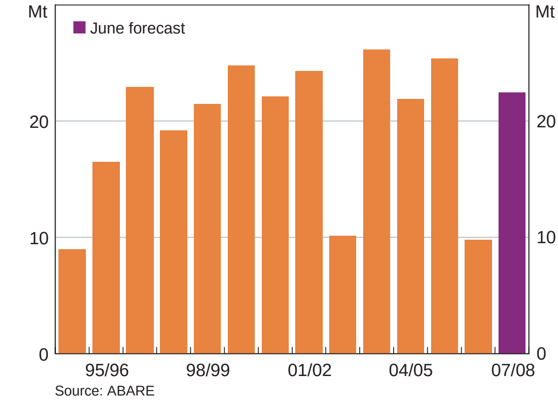
Table 10: Volume of Farm Production
Per cent

	Share of gross production	Growth[(a)]	
	2005/06	2006/07	2007/08
Crops	44	–31	40
– Cereals	17	–60	130
– Non-cereal crops	27	–13	15
Livestock products	46	–3	0
Farm GDP[(b)]		–21	20

(a) Estimate for 2006/07, forecast for 2007/08
(b) Gross farm production less farm inputs
Sources: ABARE; ABS; RBA

Graph 44

Wheat Production

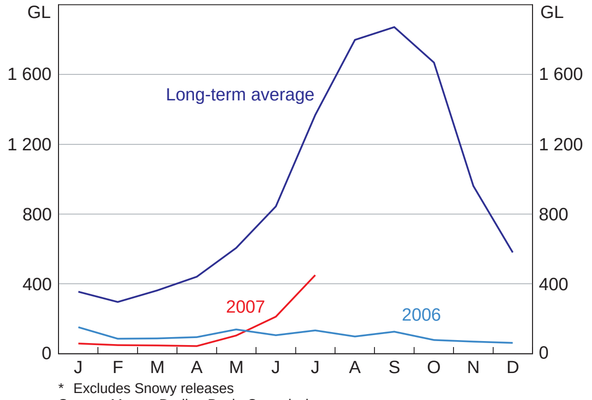


Source: ABARE

Graph 45

Murray River System

Monthly inflows*



* Excludes Snowy releases
Source: Murray-Darling Basin Commission

in rainfall so far this year, inflows to the Murray River system and non-metropolitan water storage levels have increased only modestly, in part because soil moisture levels had been low (Graph 45). However, with almost half the annual inflows to the Murray River system typically occurring between July and October, water allocations in the Murray-Darling Basin for 2007/08, and the size of the farm recovery, will depend heavily on rainfall and run-off in coming months.

External sector

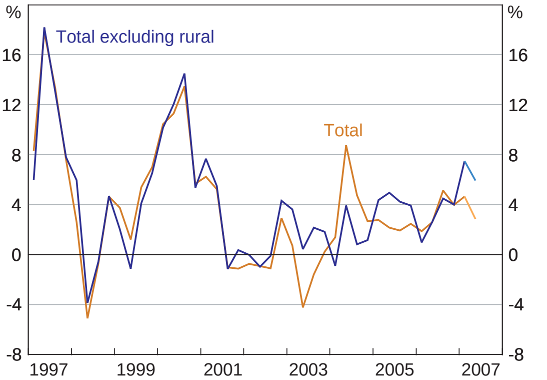
Export values and volumes are estimated to have been broadly flat in the June quarter, to be around 3 per cent higher over the year. The effects of the drought continued to weigh on rural export volumes, which fell by 15 per cent over the year. In contrast, notwithstanding a slowing in the June quarter, there has been broad-based growth in non-rural export volumes, which have been growing at an annual pace of around 6 per cent (Graph 46).

Resource export volumes have grown solidly in recent quarters. Iron ore export volumes rebounded in the June quarter, after cyclone-related disruptions in the Pilbara region in the March quarter (Graph 47). In contrast, coal exports fell by around 5 per cent in the June quarter due to severe storms in the Hunter Valley, although this followed a sharp rise in March quarter coal exports as the Poitrel mine in the Bowen Basin came online. More broadly, coal exports continue to be hindered by infrastructure and other problems. The growth in export volumes of LNG and oil has been robust in recent quarters, due to increased production from the Enfield oil project on the North West Shelf and the Darwin LNG plant. The completion of a number of new mining projects over the coming year, coupled with some easing of infrastructure bottlenecks, suggests further strong growth in resource export volumes in the period ahead.

Graph 46

Export Volumes*

Year-ended percentage change

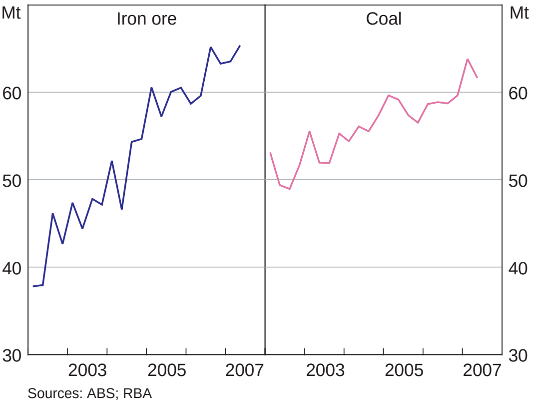


* RBA estimate for June quarter 2007
Sources: ABS; RBA

Graph 47

Bulk Resource Export Volumes

Seasonally adjusted, quarterly



Sources: ABS; RBA

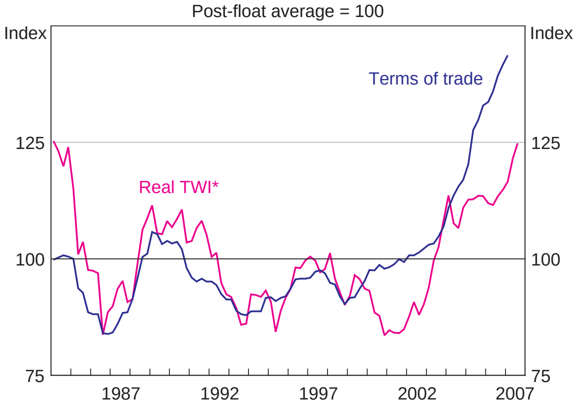
Following a period of protracted weakness over the first half of the decade, manufactured and services export volumes have been expanding since early 2006, led by strong growth in pharmaceuticals and travel services. Surveys suggest that sentiment has improved among manufacturers and the outlook for trading partner growth remains favourable. While the Bank's liaison with firms suggests the recent appreciation of the currency has not yet affected manufactured and services exports to a great degree, if sustained the higher exchange rate is likely to restrain exports in coming quarters.

Import volumes grew modestly in the June quarter, although this follows very strong growth in the December and March quarters. Over the past year, imports have increased by around 10 per cent due to solid domestic demand.

The current account deficit narrowed to 5.9 per cent of GDP in the March quarter, with the trade deficit declining slightly and the net income deficit (NID) remaining broadly steady at 4.5 per cent of GDP. The widening in the NID over recent years has reflected both higher net equity payments, due to the strong profitability of foreign-owned enterprises operating in

Graph 48

Real Exchange Rate and Terms of Trade



* September quarter 2007 observation assumes that the nominal bilateral exchange rates on 8 August are maintained for the remainder of the quarter and uses the latest core inflation rates

Sources: ABS; RBA

Australia, and higher net interest payments, due to rises in interest rates and the stock of net debt.

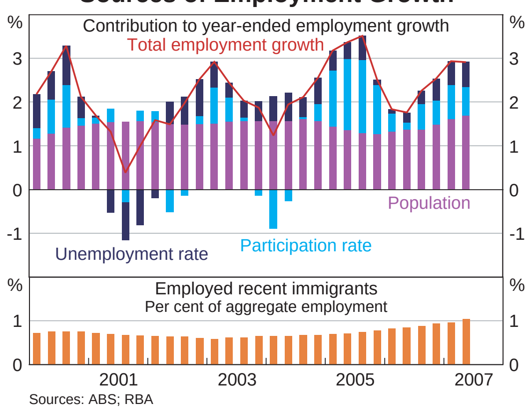
The real exchange rate is currently around 25 per cent above its post-float average (Graph 48). Other things equal, this would be expected to be contractionary for the economy, slowing exports as well as activity in import-competing sectors. However, the high exchange rate has coincided with a high level of the terms of trade, which in the June quarter were around 45 per cent above their post-float average. For the economy as a whole, the negative effects of the high level of the exchange rate are likely to be more than offset by the boost to national income (and hence demand) from the stronger terms of trade.

Labour market

Employment has continued to grow strongly, increasing by 2½ per cent over the year to July. Growth has been concentrated in full-time employment in 2007, and has been broad-based across industries. In July the participation rate was at its highest level in many decades, at 65 per cent, and the unemployment rate remained at a generational low of 4.3 per cent. Over the coming quarters, the new welfare-to-work policies may result in modest increases in both the labour force participation and unemployment rates as existing welfare recipients enter the workforce.

Graph 49

Sources of Employment Growth



Sources: ABS; RBA

Increases in employment can be drawn from the pool of unemployed persons, from an increase in the participation rate or from growth in the working age population. Given the significant decline in the pool of unemployed earlier in the current expansion, over recent years the rise in the participation rate has contributed more to employment growth than has the fall in the unemployment rate (Graph 49). The pace of growth in the working age population has also gradually increased in recent years, with migration playing an important role (see *Statement on Monetary Policy*, May 2007, 'Box B: Developments in Labour Supply'). Data from the Labour Force Survey suggest that employment of recent immigrants accounted for around one-third of aggregate employment growth over the year to the June quarter, the highest contribution since the late 1980s.

Labour market conditions continue to be robust across all the states (Table 11). In the three months to July, Western Australia and Queensland continued to have the highest participation rates and the lowest unemployment rates. However, the unemployment rates in all states were close to their lowest levels in the current expansion.

Table 11: Unemployment Rates by State
Per cent

	Three months ended	
	July 2006	**July 2007**
NSW	5.1	4.8
Victoria	5.1	4.6
Queensland	4.5	3.5
WA	3.2	3.4
SA	4.8	4.8
Tasmania	6.4	4.8
Australia	**4.8**	**4.3**

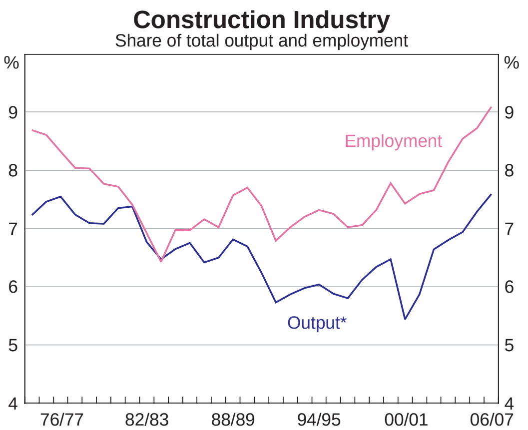
Source: ABS

The strength of the labour market is also evident in the high level of job vacancies. Nationally, the ABS measure of job vacancies reported an increase of 3.9 per cent in the three months to May and 9.0 per cent over the year, resulting in a vacancy rate of 1.5 per cent, the highest since the mid 1970s. Consistent with this, firms report in liaison that labour shortages have tightened over the past year and that these shortages are constraining output.

Box C: Developments in the Construction Sector

The construction industry has been an important contributor to economic growth in Australia over recent years. After experiencing relatively subdued growth from the early 1980s until 2002/03 – during which the construction sector's share of GDP fell from 7½ per cent to around 6 per cent – real activity in the sector has since grown by an average of almost 7 per cent per year, returning the industry's share of GDP to around 7½ per cent (Graph C1). The primary driver of this pick-up has been the non-residential construction sector, where real expenditure has increased at an average annual rate of around 10 per cent over the past four years, driven by both private and public investment, including spending by public trading enterprises (Table C1). In contrast, in the past few years, residential construction expenditure has been relatively subdued, with activity still slightly below the peak reached in 2003/04.

Graph C1



* Real construction value-added as a share of real gross value-added; 06/07 observation is an estimate

Sources: ABS; RBA

In line with the high level of activity in the sector, construction employment has grown rapidly in recent years. Employment has increased from 720 000 persons in 2002/03 to 940 000 persons currently, an average annual growth rate of almost 7 per cent, which according to the Bank's liaison program appears to have been concentrated in firms undertaking non-residential construction. The strong growth in activity and employment has resulted in a significant tightening in resource availability in the construction sector; according to the NAB survey, capacity utilisation in this sector is now further above its long-run average level than in all other industries. Not surprisingly, wages growth in the construction sector has recently also been higher than the national average. Although the industry-level data can be quite volatile, according to the wage price index construction wages growth since 2004 has averaged around one percentage point higher than growth in economy-wide wages (Graph C2). Anecdotal reports suggest that non-wage labour costs in the construction industry, and the prices paid to construction contractors, have also increased significantly over recent years.

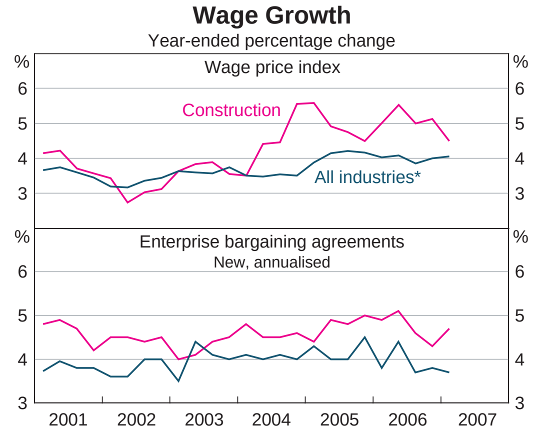
Table C1: Measures of Construction Activity[1]
Chain volumes, percentage change

	Value added(a)	Expenditure		Employment
		Non-residential	Residential	
2003/04	6.6	5.6	4.6	8.0
2004/05	4.8	10.2	–1.5	7.7
2005/06	8.3	16.9	–4.0	4.8
2006/07(b)	7.5	8.6	3.8	6.9
Average	**6.8**	**10.3**	**0.6**	**6.8**

(a) Gross value added at basic prices
(b) Estimate
Source: ABS

The strong demand for construction employment has been met from several sources. Both the Bank's liaison program and other sources suggest some movement of workers from other industries in response to strong labour demand in the resource-rich states and the non-residential construction sector more generally. Construction firms have also increased their hiring of apprentices and other younger staff. According to ABS data, the number of apprentices working in the construction industry has almost doubled since 2002 – accounting for more than half of the rise in total apprentice numbers – and the number of construction workers aged 15–24 years has increased by 10 per cent a year since 2002/03. In addition, the strong demand appears to have kept older workers in the industry for longer; the number of employees aged 55 years and over has increased by 12 per cent a year since 2002/03. Construction firms have also attracted additional labour through targeted migration.

Graph C2



* Data are seasonally adjusted
Source: ABS

Looking forward, there are reasons to expect that construction demand will remain relatively high over the next couple of years. Although growth in non-residential construction is likely to moderate from its recent rapid pace, the stock of private work yet to be done remains high, particularly in the mining sector, and data on business investment intentions point to further growth in activity. Public sector capital spending is also budgeted to continue to increase.

1 *Construction industry data are on a value-added basis. Data for residential and non-residential construction refer to expenditure as value-added data are not available.*

Furthermore, new dwelling construction looks set to rise, given that recent levels of new housing construction have been well below the underlying rate of household formation.

An important issue is the extent to which this demand can be met by the labour and other inputs available. Some additional labour to meet forecast demand could be available assuming some further increases in the participation rate and in migration and apprentice training. Nonetheless, it seems unlikely that construction employment can continue to grow over the medium term at the pace seen since 2002/03 without exerting additional pressure on the already tight labour market. These pressures would increase if non-residential construction growth does not moderate as anticipated, or the recovery in residential construction is stronger than expected.

Domestic Financial Markets and Conditions

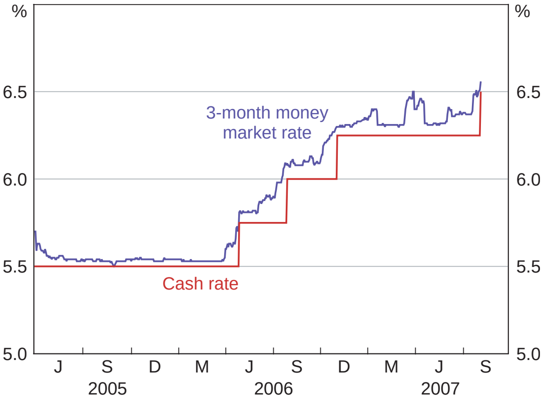
Interest rates and equity prices

Money and bond yields

Since the cash rate was last increased in November 2006, markets had assigned some probability to the need for a further increase. These expectations increased in the first half of June, prompted by the release of several indicators pointing to continued strength in the domestic economy and growing confidence that global activity would remain buoyant (Graph 50). Market expectations were scaled back somewhat over the next month or so, but shifted upward again in late July following the June quarter CPI release. By late July, the market had almost fully priced in a 25 basis point rise in the cash rate at the August board meeting. The turbulence in global credit and equity markets around that time had little effect on these expectations. In the event, the announcement of an increase in the cash rate to 6.5 per cent had little impact on financial markets.

Graph 50

Money Market Rates



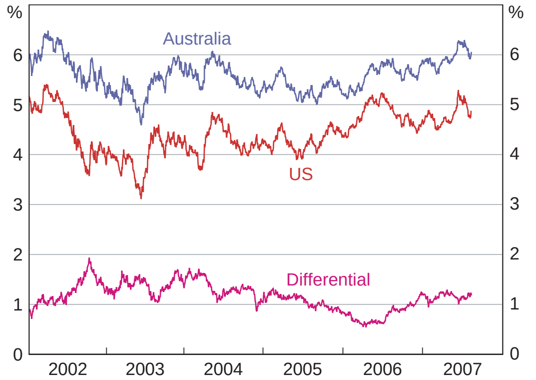
Source: Tullet Prebon (Australia) Pty Ltd

There have been quite sizeable movements in long-term interest rates since the last *Statement*, primarily reflecting global long-term yields (Graph 51). Yields on 10-year Commonwealth Government securities (CGS) rose by almost 50 basis points in May and early June to reach a five-year high of 6.3 per cent in line with a similar rise in US yields. This rise in yields was substantially reversed over the second half of July reflecting the large fall in global yields as financial markets became increasingly concerned about credit quality. By early August, yields on domestic 10-year government bonds were around 6.1 per cent, some 25 basis points higher than in early May and around 25 basis points below their mid-June peak.

Despite broadly tracking US markets, movements in CGS yields have been a little less volatile than in the US. Domestic yields did not rise by as much when US yields rose in May and early June and have not fallen by as much since then. As a result, the spread between Australian and US 10-year bonds has fluctuated between 100 basis points and 125 basis points since the last

Graph 51

Australian and US 10-year Bonds

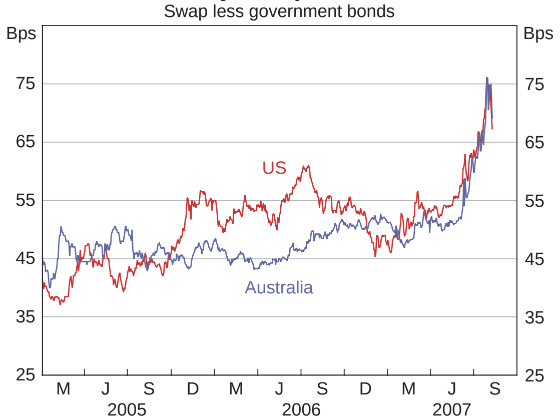


Source: RBA

Graph 52

10-year Spreads

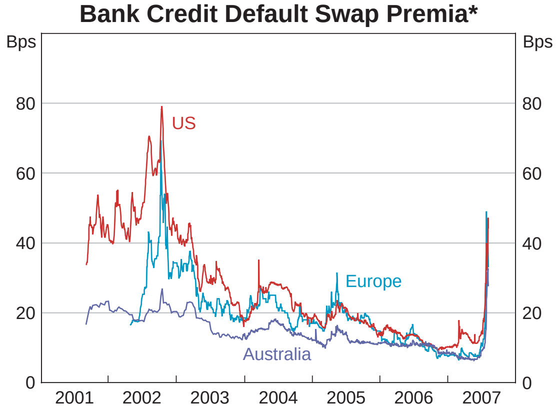
Swap less government bonds



Sources: Bloomberg; RBA

Graph 53

Bank Credit Default Swap Premia*



* 5-year credit default swap premia on senior bank debt

Sources: AFMA; Bloomberg; JP Morgan

Statement. It is currently around 120 basis points, similar to its level at the time of the last *Statement*.

The fall in CGS yields was not matched by movements in other long-term yields, such as swap yields. The spread between yields on 10-year swaps and CGS widened significantly in July – it is now around 70 basis points, having been steady at around 50 basis points over the past few years (Graph 52). This is the widest spread over the past decade. A widening of this spread is normally associated with periods of heightened financial uncertainty, when investor demand for the security of risk-free assets increases. As with CGS yields, the widening in swap spreads tracked that in the US.

Yields on state government securities (semis) have moved with the swap rate rather than with CGS yields. The semis' spread to CGS yields has also widened by around 20 basis points. With most states' credit ratings at AAA, however, credit risk considerations do not appear to be a factor.

The heightened uncertainty has also been reflected in increased premia on credit default swaps (CDS) – financial derivatives that provide insurance against defaults on bonds – for local banks' debt, though the rises have been much less than for similar instruments issued on US and European banks (Graph 53).

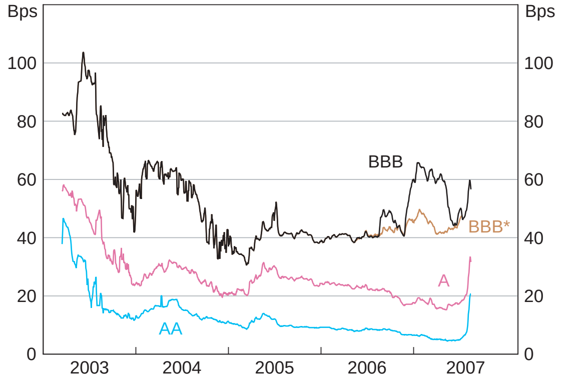
Premia on corporate CDS have also shown a noticeable uptick in view of the increased volatility in global equity and credit markets in July, rising to levels last seen in mid 2004 (Graph 54). The latest rise has occurred across the corporate sector, in contrast to the increase earlier in the year when it was largely confined to a subset of companies that were takeover targets in leveraged buyout deals.

Despite the pick-up in corporate bonds spreads, default rates remain low, both in Australia and overseas. There has not been a (rated) corporate bond default in Australia for three years. S&P downgraded the ratings of a few Australian companies in the June quarter, including the takeover target, Rinker, which was downgraded to that of its acquirer, Cemex, but overall, the ratings experience for Australian companies over the past year has been positive. The global speculative-grade default rate is close to its historical low at 1.5 per cent in July (Graph 55). While Moody's expects the default rate to pick up a little over the next couple of years, it is forecast to remain at relatively low levels.

Rising concerns about the fragility of the US housing market have had a relatively modest impact upon the domestic residential mortgage-backed securities (RMBS) market. Spreads on RMBS at the time of issuance have remained close to historically low levels (Graph 56).

Graph 54

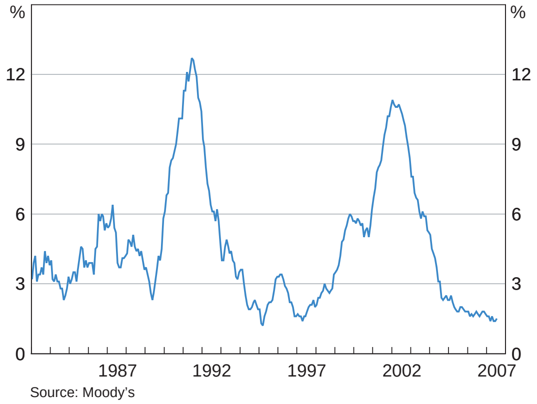
Credit Default Swap Premia



* Excluding announced takeover targets
Sources: Bloomberg; RBA

Graph 55

Moody's Global Speculative Default Rate

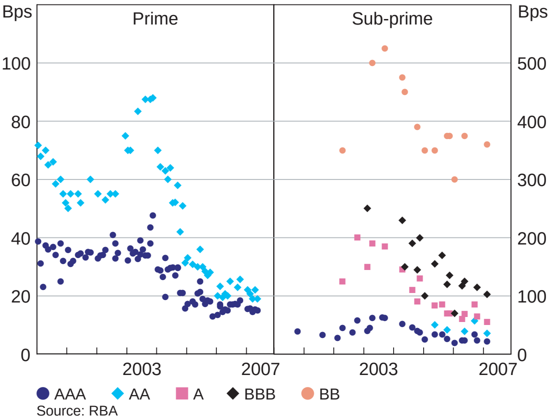


Source: Moody's

Graph 56

RMBS Pricing at Issuance

Spread to bank bill rate



Source: RBA

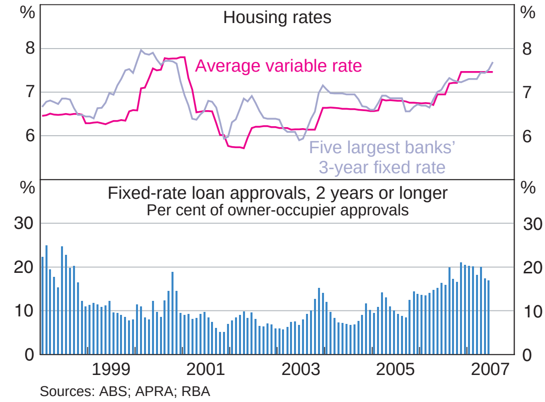
Several recent issues have been oversubscribed, though in early August one institution decided to temporarily delay bringing an issue to market. The low level of RMBS spreads continues to be supported by the fact that investors in these securities have suffered no loss of principal, with any losses on the underlying loans after the sale of the property being covered by lenders' mortgage insurance and the profits of securitisation vehicles.

Intermediaries' interest rates

Most financial intermediaries' variable housing loan indicator rates have not changed since the time of the last *Statement*. At the time of writing, intermediaries were yet to raise lending rates in response to the August monetary policy tightening. After taking into account discounts, which are now received by almost all borrowers, the average variable housing rate paid by new borrowers is currently 7.45 per cent (Graph 57).

Graph 57

Housing Rates and Loan Type

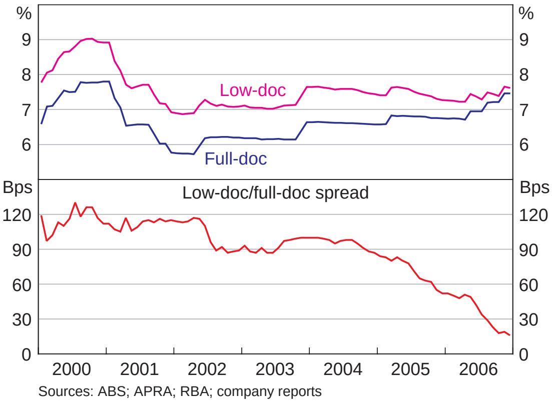


Sources: ABS; APRA; RBA

Graph 58

Housing Loan Variable Interest Rates

Average actual rates paid on new prime loans



Sources: ABS; APRA; RBA; company reports

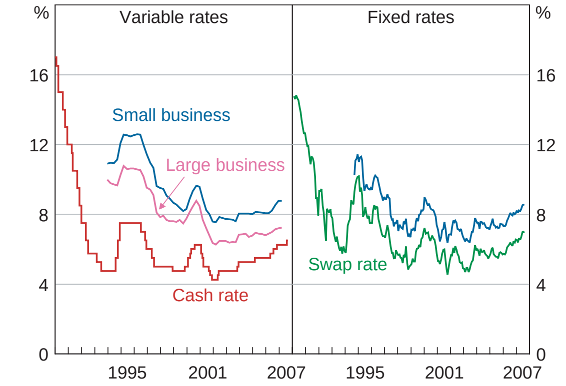
Strong competition has caused interest margins on prime low-doc loans to decline sharply over the past two years. Relative to prime full-doc loans, the interest premium on prime low-doc loans was 15 basis points in December 2006, down from 100 basis points in 2003. Increased competition from the five largest banks in the low-doc loan market, combined with small realised losses on low-doc loans over recent years, have driven the fall in the interest premium (Graph 58).

The five largest banks' average 3-year fixed rate on housing loans is currently 7.70 per cent, 25 basis points higher than at the time of the last *Statement*. A 45 basis point increase in the 3-year swap rate, which approximates the cost of funding these loans, has underpinned the rise.

Interest rates on variable-rate business loans were little changed in the March quarter (the latest period for which data are available) (Graph 59). The average 3-year fixed rate on small business loans has risen by 35 basis points to 8.55 per cent since the last *Statement*, broadly in line with the rise in the 3-year swap rate.

Graph 59

Business Interest Rates



Sources: APRA; RBA

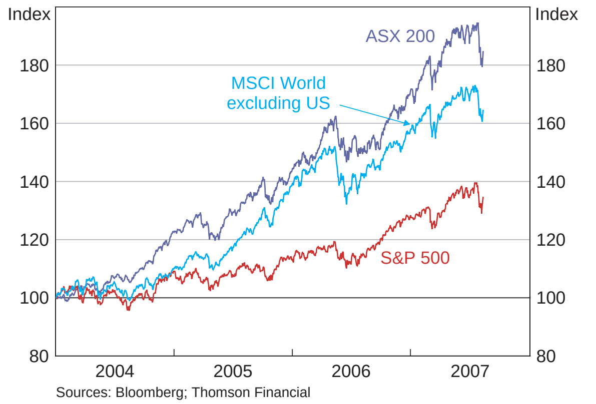
Equity markets

Having risen to a record high during July, the ASX 200 has fallen by 5 per cent over the past two weeks (Graph 60). The local market's fall followed declines in the US and other major markets reflecting the developments in global credit markets. Notwithstanding the recent decline, the Australian share market has tended to outperform the major share markets; over the year so far, the ASX 200 is up 8 per cent, compared with around 5 per cent for other major markets (Table 12). This follows four consecutive years of very strong returns in the local market, averaging about 17 per cent per year. The resources sector continues to underpin the local market, having risen by 26 per cent since the start of the year, similar to the average annual increase over the previous four years. The decline in the share prices of retail banks has been similar to the overall market, though the prices of diversified financial companies – whose activities cover investment banking – have fallen by around 15 per cent over recent weeks.

Graph 60

Australian and World Share Price Indices

End December 2003 = 100



Sources: Bloomberg; Thomson Financial

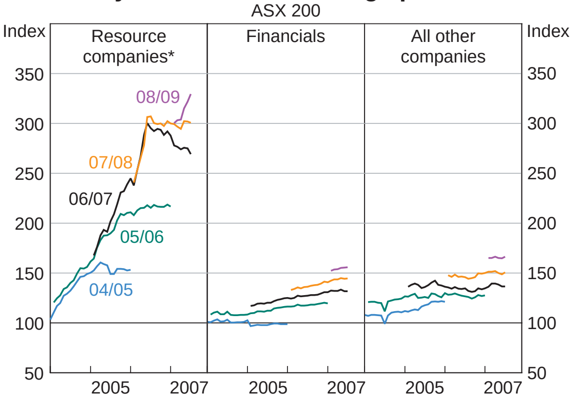
Table 12: Share Market Performance
Per cent

	Dec 2002–Dec 2006 Average annual change	Financial year 2006/07	Calendar year to date
ASX 200	17.2	23.7	7.6
S&P 500	12.7	18.4	5.6
MSCI ex US	16.8	20.3	4.2

Sources: Bloomberg; RBA; Thomson Financial

Graph 61

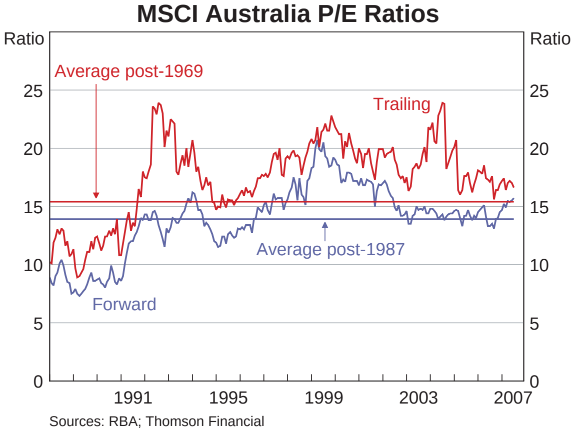
Analysts' Forecast Earnings per Share



* Energy and materials sectors
Sources: RBA; Thomson Financial

Graph 62

MSCI Australia P/E Ratios



Sources: RBA; Thomson Financial

While analysts have revised upward their forecasts for resource companies' earnings for the next couple of years, they continue to expect growth to slow – from 24 per cent growth in 2006/07 to 11 per cent in 2007/08 and 8 per cent the following year (Graph 61). This still leaves the level of earnings per share at an historically high level. Earnings for financial and other companies are expected to increase by between 7 and 10 per cent per annum over the next few years.

The P/E ratio – the ratio of share prices to earnings per share – on both a trailing basis (which uses actual earnings over the past year) and a forward basis (which uses expected earnings over the next year) continues to be a few points above its long run average (Graph 62).

Merger and acquisition (M&A) activity has been buoyant (Graph 63). In 2006, completed M&A deals totalled around $100 billion, representing about 8 per cent of local share market capitalisation. Currently, there are around $90 billion of deals pending. Many of these deals have relatively low gearing as the offers are predominantly made up of shares of the acquiring company and hence may not be significantly affected by the stresses evident in the global credit markets. In contrast, highly-leveraged deals associated with private equity and which rely on the smooth functioning of the leveraged loan market are more likely to be put on hold.

Financing activity

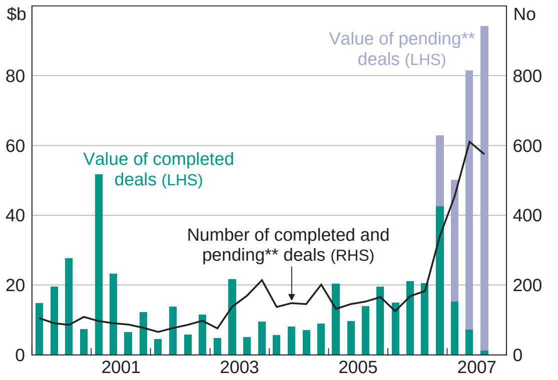
Credit growth has picked up over the first half of 2007 from the rates seen in the latter part of 2006 (Graph 64 and Table 13). Total credit grew at an average monthly rate of around 1.2 per cent over the five months to May, before increasing sharply to 1.8 per cent in June. Growth in June, however, appears to have been boosted by households borrowing to fund superannuation contributions ahead of the rule changes at the end of the month. The increase in the rate of credit growth during 2007 has been broad-based across the business and household sectors.

Household financing

After slowing over the latter part of 2006, housing credit growth has picked up this year to an average monthly rate of 1 per cent over the five months to May and 1.5 per cent in June. The pick-up over the first five months of 2007 largely reflected increased new lending for housing rather than slower repayment of existing debt (Graph 65). However, credit growth in June appears to have been boosted by borrowing to fund superannuation contributions.

Graph 63

Mergers and Acquisitions by Listed Australian Entities*

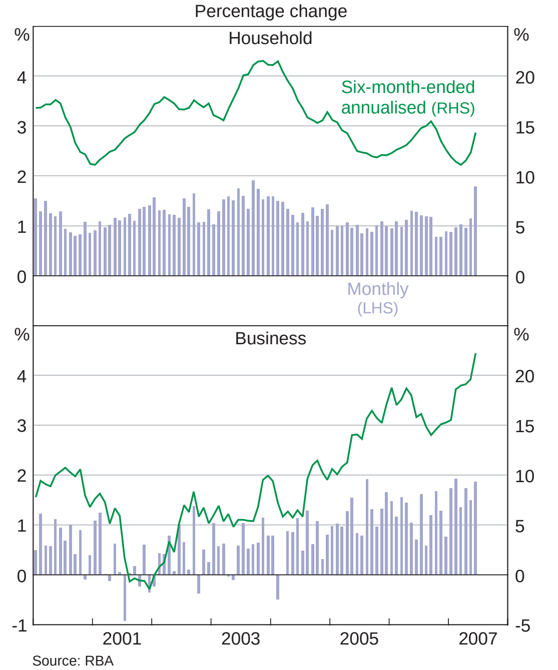


* Excludes real estate transactions; data to 9 August 2007
** Transactions announced since October 2006 but not completed
Sources: RBA; Thomson Financial

Graph 64

Credit Growth

Percentage change



Source: RBA

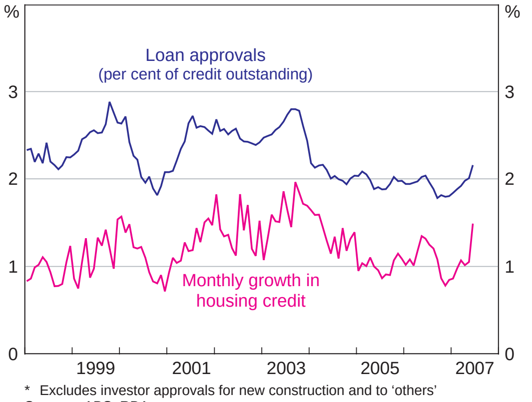
Table 13: Financial Aggregates
Average monthly growth, percentage change

	September quarter 2006	December quarter 2006	March quarter 2007	June quarter 2007
Total credit	1.2	1.0	1.2	1.4
Household	1.2	0.8	1.0	1.3
– Housing	1.2	0.8	1.0	1.2
Owner-occupier housing	1.4	1.0	1.0	1.2
Investor housing	0.8	0.5	0.9	1.3
– Personal	1.2	0.7	0.9	2.0
Business	1.1	1.2	1.7	1.7
Broad money	1.1	0.8	1.2	1.3

Source: RBA

Graph 65

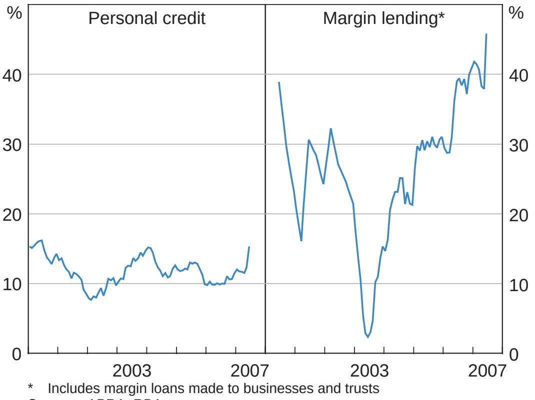
Housing Loan Approvals* and Credit Growth



* Excludes investor approvals for new construction and to 'others'
Sources: ABS; RBA

Graph 66

Personal Credit Growth
Year-ended percentage change



* Includes margin loans made to businesses and trusts
Sources: APRA; RBA

While the large increase in personal credit growth in June partly reflected households borrowing to invest in superannuation, growth has tended to be stronger over recent months (Graph 66). Within personal credit, margin lending for the purchase of shares and managed funds has grown very strongly, with large increases in both the number of loans and the average loan size.[1] There were few margin calls in the June quarter, as the equity market was fairly stable, and borrowers' average gearing levels were low by historical standards. No data are available for July to assess the effect of the recent falls in equity markets. While several margin lenders allowed holdings in Basis Capital funds to be used as collateral, the number of affected clients appears to be very small (see chapter on 'International and Foreign Exchange Markets').

Reflecting the pick-up in credit growth, net non-intermediated capital raisings by financials and asset-backed vehicles have been

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

strong, totalling $46 billion in the June quarter (Graph 67). Net bond raisings by asset-backed vehicles reached a record high, with robust issuance both onshore and offshore. While net bond issuance by financial institutions was subdued, this was offset by strong short-term raisings.

Business financing

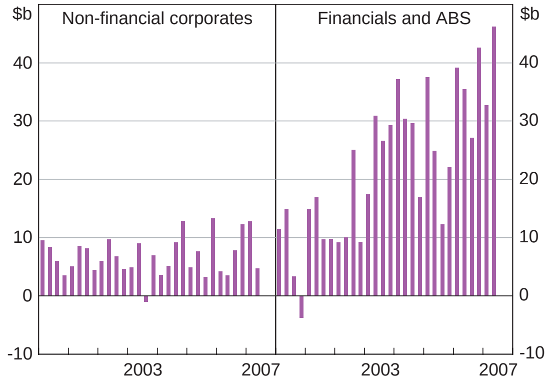
Total business debt increased at an annualised rate of 20 per cent over the six months to June; this was the fastest growth since the late 1980s (Graph 68). Within the total, business credit grew by 22 per cent; lending to corporations (which comprises 60 per cent of total business credit) has grown particularly rapidly, although lending to unincorporated entities has also risen. Companies in the infrastructure, industrial and finance & insurance sectors have recorded the strongest growth in borrowings.

In contrast, growth in corporates' non-intermediated debt, which includes bonds and short-term paper, grew more slowly at around 12 per cent over the same period. Despite the robust growth in total debt, business' balance sheets appear to be in good shape. Debt remains at moderate levels as a share of both equity and profits, and the interest-servicing burden is low (see 'Box D: Recent Developments in Corporate Gearing in Australia').

Graph 67

Net Non-intermediated Capital Raisings*

Quarterly

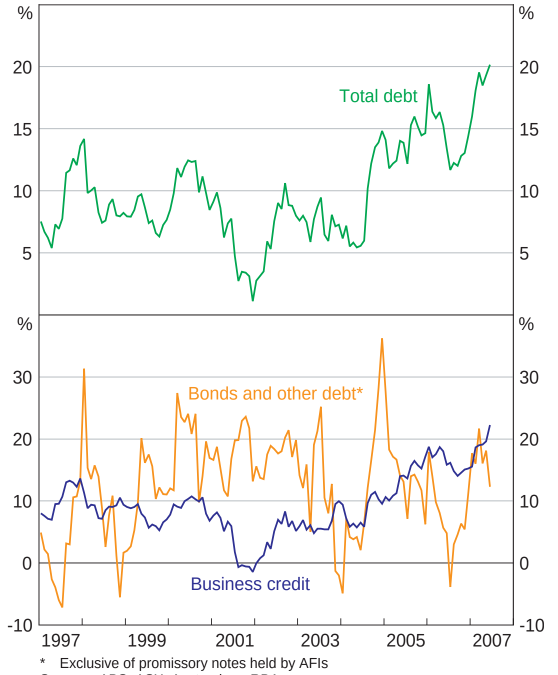


* Equity, hybrids, bonds, and short-term debt
Sources: APRA; ASX; Austraclear; RBA

Graph 68

Business Funding

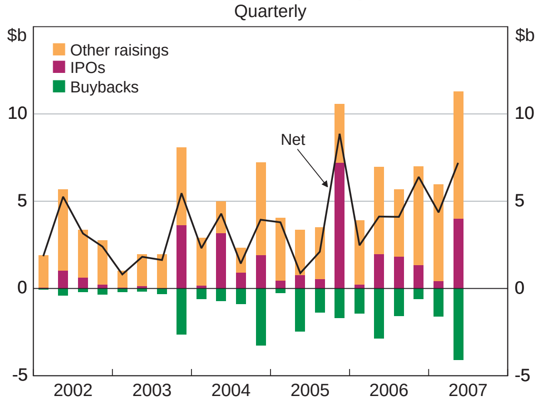
Six-month-ended annualised percentage change



* Exclusive of promissory notes held by AFIs
Sources: ABS; ASX; Austraclear; RBA

Graph 69

Non-financial Corporates' Equity Raisings



Sources: ASX; RBA

Businesses have also raised significant quantities of equity. Net external equity raisings were around $7 billion – IPO activity and seasoned equity raisings picked up in the quarter though buybacks also increased (Graph 69).

Box D: Recent Developments in Corporate Gearing in Australia

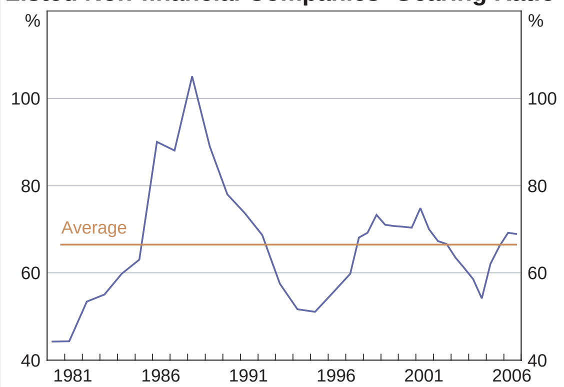
The gearing ratio – the ratio of the book value of debt to equity – of listed non-financial companies has risen by 15 percentage points in the two years to December 2006 to stand at 69 per cent (Graph D1). This is close to its post-1980 average of 67 per cent, but well below its level in the late 1980s when it exceeded 100 per cent. It suggests that corporate balance sheets remain in a sound condition on average.

The aggregate movement, however, masks quite a range of behaviour by individual firms. All of the recent increase in leverage is due to non-resource companies (Graph D2). Their gearing has increased by 25 percentage points since December 2004, to 88 per cent, reflecting faster growth in debt than equity. In contrast, the gearing ratio of resource companies – at 35 per cent in December 2006 – was broadly the same as two years ago, and almost 40 percentage points below its level earlier in the decade. For resource companies, strong profitability and a fall in their dividend payout ratio has meant they can finance investment out of current cash flows. As a consequence, the value of their outstanding debt has fallen over the past five years and is around the same level as in the late 1990s.

Within the non-resource sector, much of the rise in debt and gearing was accounted for by a small number of companies. These were mostly utility companies, many of whom were newly listed over this period, and industrial companies which have been active in acquiring other

Graph D1

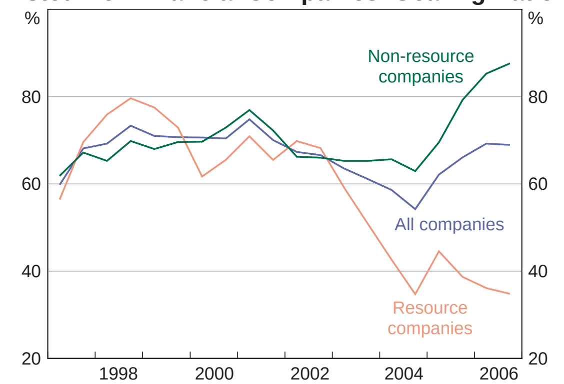
Listed Non-financial Companies' Gearing Ratio*



* Gross debt/shareholders' equity, excludes foreign companies
Sources: ABS; Aspect Huntley; RBA; Statex

Graph D2

Listed Non-financial Companies' Gearing Ratio*



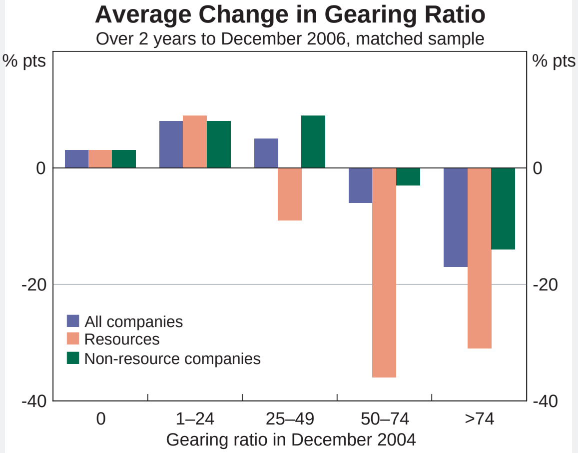
* Gross debt/shareholders' equity, excludes foreign companies
Sources: Aspect Huntley; RBA

companies and assets. Of the $70 billion increase in debt holdings of listed companies over the two years to December 2006, 10 companies raised over $40 billion of this.

More generally, about one-third of the 15 percentage point increase in aggregate gearing owes to delistings of less-leveraged companies and new listings of more highly leveraged companies. At end 2006, the gearing ratio of companies that listed on the ASX in the preceding two years averaged 120 per cent, almost double the gearing ratio of companies that were listed for the 2004 to 2006 period, while the gearing ratio of companies that delisted was around 40 per cent.

The remaining 10 percentage point increase in aggregate gearing primarily reflected an increase in leverage of companies that initially had low gearing ratios (of up to 25 per cent) (Graph D3). The gearing ratios of more highly leveraged companies (>50 per cent) actually fell, with particularly sharp declines recorded by resource companies. In terms of company size, smaller listed companies (market capitalisation of up to $5 billion) have tended to increase their gearing over the past two years, with average gearing ratios rising by about 6 percentage points over this period. This has been partly offset by a moderate fall in leverage of large companies (market capitalisation above $5 billion).

Graph D3



Sources: Aspect Huntley; RBA

Finally, while the book value of equity provides one basis for assessing corporate gearing, the market value of equity can also be used, as it incorporates expectations about future profits which can be used to service corporate debt. While the book-value gearing ratio of all non-financial companies has increased in recent years, it has remained broadly unchanged when measured on a market-value basis. This is because strong increases in share prices have largely offset rising debt levels. On this measure, gearing has remained at around 25 per cent, though it can move sharply given the underlying volatility of equity markets.

Inflation Trends and Prospects

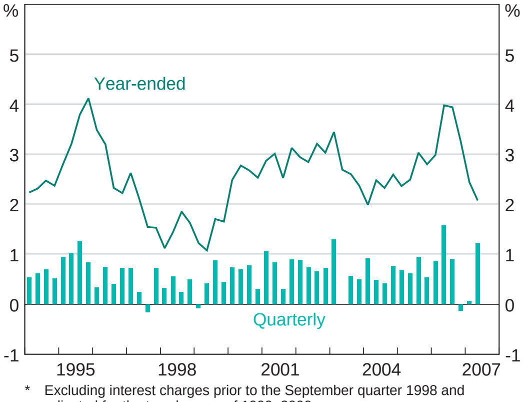
Recent developments in inflation

The consumer price index (CPI) rose by 1.2 per cent in the June quarter, and by 2.1 per cent over the year (Graph 70, Table 14). The largest contributions came from increases in petrol and fruit & vegetables prices, which together contributed around 0.5 percentage points to the quarterly inflation rate. However, the strength of price increases in the quarter was broad-based, with around 60 per cent of items in the CPI basket rising by more than 2.5 per cent when measured on an annualised basis (Graph 71).

Tradables prices increased sharply in the quarter; abstracting from petrol and food prices, they grew by 0.8 per cent in the quarter and by 1.0 per cent over the year, the fastest pace since 2002 (Graph 72). While the import-weighted exchange rate appreciated by 4½ per cent in the June quarter, which could be expected to reduce tradables prices over time, it is unlikely to have had a significant effect on the CPI data to date; the pass-through of exchange rate movements into final prices in recent

Graph 70

Consumer Price Inflation*



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

Sources: ABS; RBA

Table 14: Measures of Consumer Prices

Percentage change

	Quarterly		Year-ended	
	March quarter 2007	June quarter 2007	March quarter 2007	June quarter 2007
CPI	0.1	1.2	2.4	2.1
– Tradables	–1.0	2.0	1.0	0.3
– Tradables (ex food and petrol)	0.0	0.8	0.4	1.0
– Non-tradables	0.9	0.7	3.5	3.4
Underlying measures				
Weighted median	0.6	0.9	2.8	2.8
Trimmed mean	0.5	0.9	2.7	2.7
CPI ex volatile items[(a)]	0.6	0.7	2.5	2.6

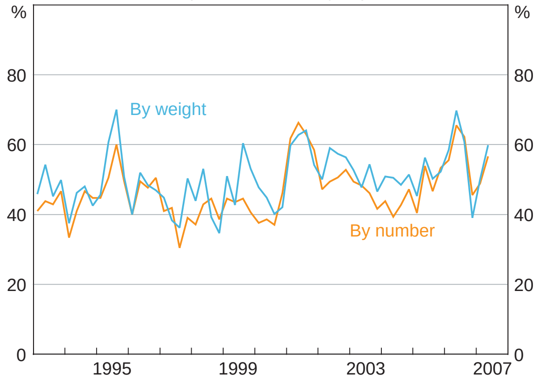
(a) Volatile items are fruit, vegetables and petrol

Sources: ABS; RBA

Graph 71

CPI Items Rising Faster Than 2.5 Per Cent*

Proportion of all CPI groups



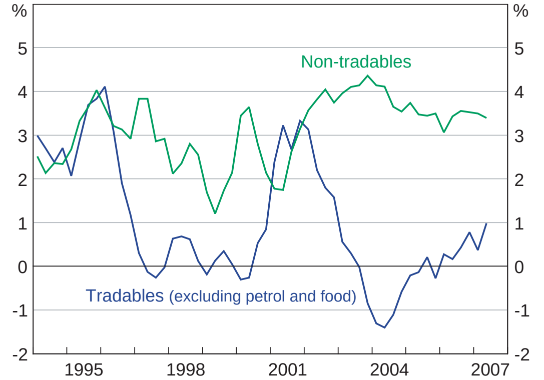
* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent

Sources: ABS; RBA

Graph 72

Tradables and Non-tradables Prices*

Year-ended percentage change

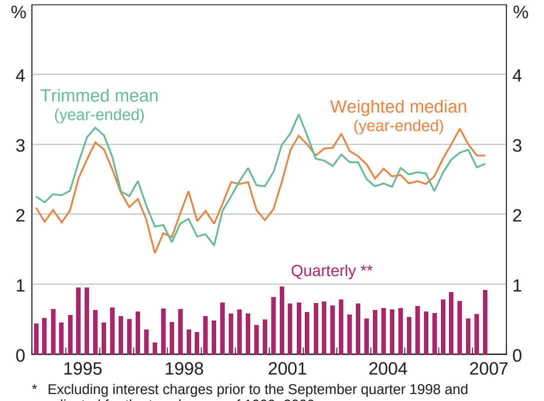


* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 73

Statistical Measures of Inflation*



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

** Average of the trimmed mean and weighted median

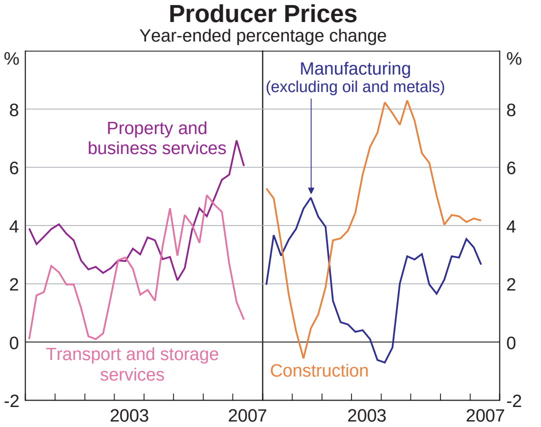
Sources: ABS; RBA

years has tended to be prolonged and relatively moderate. Non-tradables inflation decreased slightly in the June quarter, to 0.7 per cent, but this reflected seasonal influences. In year-ended terms, non-tradables inflation was little changed, at 3.4 per cent, driven by price increases in services such as education, health and especially housing. The strength in housing costs is reflected in both house purchase costs and rents; rents increased by 1.6 per cent in the quarter, which is the largest rise since the September quarter 1989.

The broad-based nature of inflationary pressures in the quarter was also reflected in measures of underlying inflation. Based on a range of measures, the pace of underlying inflation is estimated at around 0.9 per cent – around the levels seen in the first half of 2006 – with the annual rate around 2¾ per cent (Graph 73). This follows two quarters when measured underlying inflation was surprisingly low, at 0.5 to 0.6 per cent in the December and March quarters, and appeared a little at odds with the observed strength in the real economy and the labour market.

Final-stage producer prices increased by 1.0 per cent in the June quarter and by 2.3 per cent over the year. The June quarter results mainly reflected higher non-residential construction prices and housing construction costs, which are closely related to house purchase costs in the CPI. In year-ended terms, the increase in the prices of property & business services was also high (Graph 74). More generally, liaison contacts note that they are experiencing persistent and strong cost pressures due to high commodity prices and upward pressure on foodstuffs affected by the drought. Wholesale electricity prices have also increased sharply in recent quarters, although retail electricity prices have remained more contained.

Graph 74

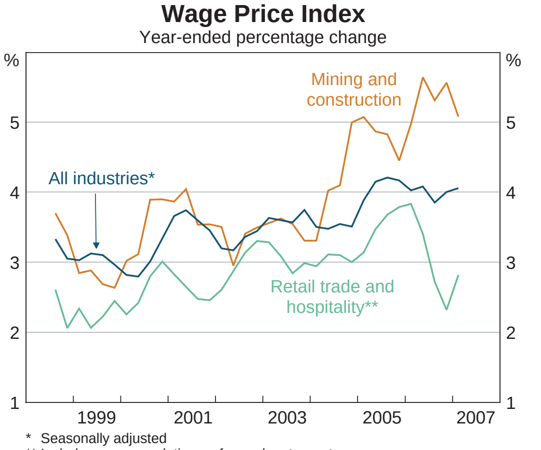


Sources: ABS; RBA

Labour costs

Recent data suggest that wages growth remained firm in the March quarter. The wage price index (WPI) increased by 1.0 per cent in the March quarter, to be 4.1 per cent higher over the year, around the same year-ended pace that has prevailed during the past 18 months. In recent years, wages in industries experiencing the most severe shortages of skilled labour, such as mining and construction, have increased more rapidly than the average, while industries such as accommodation, cafes & restaurants and retail trade have recorded more subdued wages growth (Graph 75).

Graph 75



* Seasonally adjusted
** Includes accommodation, cafes and restaurants
Sources: ABS; RBA

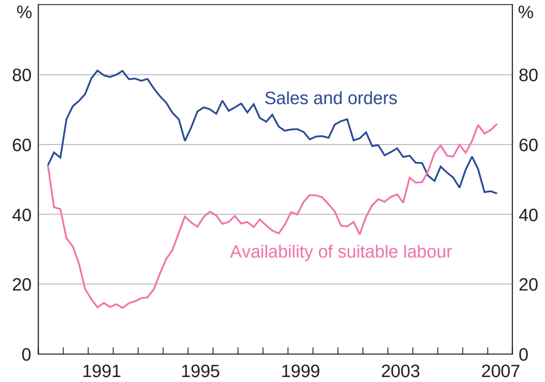
Other wage indicators also suggest the recent pace of wages growth, while high, has not been accelerating. The average annualised increase for new federal enterprise bargaining agreements (adjusted for industry composition) certified in the March quarter was 3.7 per cent, slightly lower than the increase in the December quarter. Increases under all currently active agreements have remained little changed at around 4 per cent. More broadly, average earnings from the national accounts – which includes both wage and non-wage labour costs – rose by 1.2 per cent in the March quarter, to be 4.7 per cent higher over the year. This is within the range experienced over recent years, though towards the higher end of this range. With the pick-up in measured labour productivity over the year to the March quarter, the annual increase in unit labour costs over this period was more moderate than in the preceding year.

Looking ahead, the Australian Fair Pay Commission's second minimum wage ruling, handed down in July, will become effective from October 2007. This decision granted a 2.4 per cent increase in annualised terms in the Federal minimum wage, which is somewhat lower than the increase awarded in previous decisions, although the Commission reports that this decision directly affects only around 12 per cent of all employees. More broadly, the pace of average wages growth is likely to reflect conditions in the labour market, which have remained tight. The number of job vacancies, as measured by the ABS, is at a high level, with service sectors such as retail trade, property & business services and accommodation, cafes & restaurants making strong contributions to year-ended growth. According to the NAB survey, finding suitable labour is cited as a greater constraint to increasing output for businesses than lack of demand, as has been the case for several years (Graph 76).

Graph 76

Factors Constraining Output

Per cent of respondents



Source: NAB

Inflation expectations

The various measures of inflation expectations have remained somewhat elevated. According to the Melbourne Institute survey of households, the median expectation for CPI inflation over the year ahead fell to 3.5 per cent in July, although expectations remain above their average over the inflation targeting period, of 3.0 per cent. Market economists surveyed by the Bank following the release of the June quarter CPI have increased their inflation forecasts, with the median expectation for headline inflation over the year to the June quarter 2008 at 2.7 per cent (Table 15). Inflation expectations of union officials have remained unchanged, at 3.0 per cent. In addition, the proportion of businesses increasing their prices in the June quarter or expecting to increase their prices in the near term remains above its long-run average according to business surveys.

Table 15: Median Inflation Expectations

Per cent

	Year to June 2008			Year to June 2009
	February 2007	May 2007	August 2007	August 2007
Market economists[(a)]	2.5	2.5	2.7	2.7
Union officials[(b)]	3.5	3.0	3.0	3.0

(a) RBA survey
(b) Workplace Research Centre

Inflation outlook

Assessing the current level of underlying inflation is a key input into the Bank's inflation forecasts. There is inevitably some uncertainty around any such estimate, but taking either the information for the first half of 2007 or for the year to the June quarter, underlying inflation appears to be running in the upper part of the target range, at an annual rate of around 2¾ per cent.

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). This represents a modest appreciation (around 3 per cent) in the exchange rate since the May *Statement* and an upward revision for oil prices. Global growth is assumed to remain strong over 2007 and 2008, in line with IMF forecasts, which have been raised since the time of the last *Statement*. The terms of trade are assumed to decline modestly from their current high level, but the magnitude of the expected decline is smaller than at the time of the last *Statement*, reflecting upgrades to forecasts for coal and iron ore contract prices.

The outlook for growth in activity has been revised up modestly in the near term, the net effect of stronger-than-expected domestic and external conditions, an appreciated exchange rate and a higher level of interest rates. Domestic demand is expected to grow at a little above trend, while exports are expected to pick up, reflecting the increase in resource export capacity and the expected improvement in the rural sector. Non-farm GDP is expected to expand at an annual rate of around 3½ per cent over the years to June 2008 and June 2009. Overall GDP growth is expected to pick up to 4¼ per cent over the year to June 2008, before easing to 3½ per cent over the following year. The unemployment rate is forecast to remain fairly close to the current low level.

The inflation forecast has been revised up relative to the forecast contained in the last *Statement*. The central forecast is for year-ended underlying inflation – which was around 2¾ per cent over the year to the June quarter – to rise to around 3 per cent over the year to June 2008 (Table16). Headline CPI inflation has been held down over the past year by the unwinding of the increase in banana prices that occurred in mid 2006, but is expected to rise over the next year towards the forecast rate for underlying inflation. For the year to June 2009, the central forecast is for both underlying and headline inflation to remain near the top of the target range.

Table 16: 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	2.1	2½	3	2½–3	2½–3
Underlying inflation	2.9	3.0	2.8	3	3	2½–3	2½–3

(a) Actual data to June 2007. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.86, TWI at 69, cash rate at 6.5 per cent, and WTI crude oil price at US$73 per barrel and Tapis crude oil price at US$75 per barrel.

Sources: ABS; RBA

The upward revision to the forecast takes into account the stronger-than-expected inflation outcome for the June quarter, the upward revision to the activity forecast (which implies continuing pressure on resource utilisation in the economy), and the expected effect of the recent adjustment to monetary policy. The ongoing tightness of the labour market is expected to result in a moderate pick-up in wages growth from current levels, while sustained high levels of capacity utilisation raise the likelihood of a strengthening in inflationary pressures from current levels. The appreciation of the exchange rate – the import-weighted exchange rate is now around 7 per cent above the average level in late 2006 – will mitigate the rise in overall inflation to some extent, but consistent with the experience from earlier movements of the exchange rate, the effect on inflation is likely to be modest and fairly drawn out.

These forecasts are subject to risks in both directions. The main upside risk is that pressures on resource utilisation could feed through more strongly into inflation. Most measures suggest that the labour market is as tight as it has been for a generation and that capacity utilisation is stretched. The growth rates of domestic demand and activity are expected to remain strong, as are labour market conditions. These factors could result in more upward pressure on wages growth and inflation than has been incorporated in the forecasts. On the downside, the main risk at present appears to be that of a further slowdown in the US economy. If that were to eventuate, it would reduce global growth and hence would help to dampen inflation around the world, including in Australia.