International and Foreign Exchange Markets

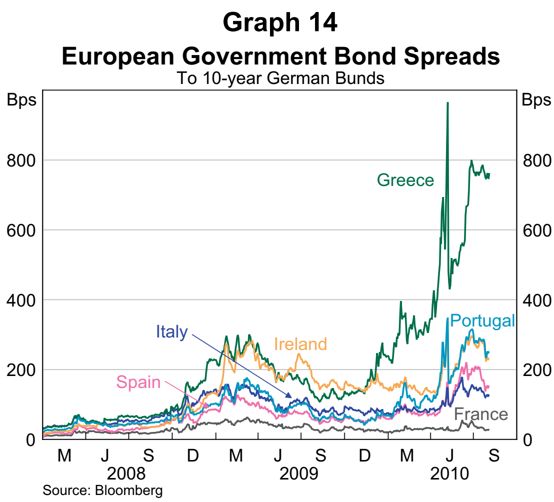
Developments in European sovereign debt markets have been the main influence on financial markets in recent months. Concerns about fiscal sustainability in peripheral euro area countries intensified in early May as markets focussed on the Greek Government's large near-term funding requirement. The announcement by euro area countries and the IMF that they would provide €110 billion in financial assistance to Greece (of which €20 billion has since been allocated) failed to calm markets.

In the following week, the European Union (EU) announced a stabilisation mechanism that would provide support of up to €500 billion to euro area governments if needed. Of this amount, €440 billion would be provided via a special purpose vehicle – the European Financial Stability Facility (EFSF) – that would issue bonds guaranteed by participating EU countries. This facility became operational towards end July and may be extended beyond its three-year lifespan. The IMF would provide additional financial assistance should the stabilisation mechanism be utilised.

In addition to these stabilisation measures, at the same time the European Central Bank (ECB):

- announced that it would purchase euro area government bonds in order to improve the functioning of these markets;
- announced that it would provide further unlimited fixed-rate funds at three- and six-month maturities to support market liquidity; and
- together with the Bank of Canada, Bank of England, Bank of Japan and the Swiss National Bank, re-established temporary US dollar swap lines with the US Federal Reserve to help address emerging strains in US dollar short-term funding markets. Use of these swap facilities has been low, partly reflecting that the US dollars are provided above the market rate payable by most financial institutions.

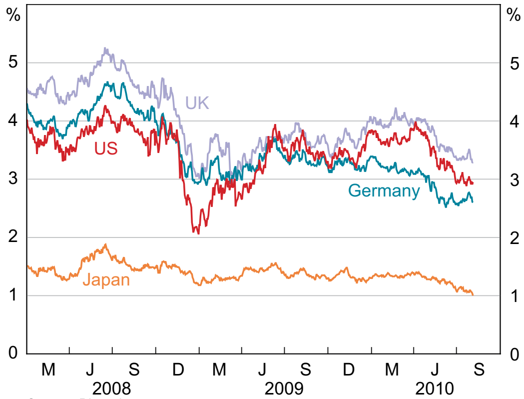
Financial market conditions stabilised somewhat following the announcement of the EFSF and the various central bank initiatives. Spreads between yields on peripheral euro area sovereign bonds and German Bunds narrowed, although the market for some of these bonds has been highly illiquid and pricing is indicative only (Graph 14).



However, tensions in financial markets persisted, exacerbated at times by sovereign ratings downgrades. Following earlier downgrades by other rating agencies, over the past three months Moody's downgraded Greece's credit rating to sub-investment grade, Portugal's credit rating to the equivalent of A+ from AA, and Ireland's credit rating by one notch to the equivalent of AA; Fitch also downgraded Spain's credit rating to AA+ from AAA.

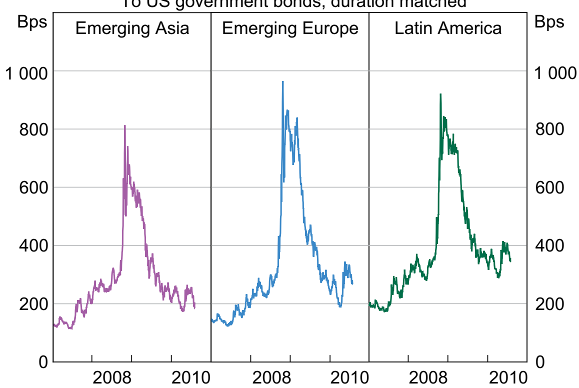
In response to the continuing concerns over fiscal sustainability, a number of government austerity measures were announced, including in Spain, Portugal and Italy (see Chapter on 'International Economic Developments'). Although these announcements generally supported market sentiment, they also raised concerns about the implications for economic growth.

Graph 15
10-year Government Bond Yields



Source: Bloomberg

Graph 16
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched



Source: Thomson Reuters

In late July, the European authorities released the results of stress tests of 91 European banks, representing 65 per cent of EU banking sector assets, to adverse macroeconomic and financial market conditions and sovereign risks. The results of these stress tests suggest that most large European banks are sufficiently capitalised relative to a benchmark of a Tier 1 capital ratio of 6 per cent. Seven banks (one German, one Greek and five Spanish) did not pass the tests, with a combined capital shortfall of €3.5 billion under the stress scenario. Aggregate losses across all banks under the stress scenario were estimated to be €566 billion, most of which reflected loan-loss provisions.

Sovereign Debt Markets

Longer-term government bond yields in the major advanced economies have fallen to low levels, reflecting safe-haven demand as risk aversion and concerns about the outlook for global growth have increased (Graph 15). Yields on German 10-year bonds fell to their lowest level since at least the 1920s and 10-year US Treasury yields fell below 3 per cent for the first time since April 2009. Shorter-term government bond yields remain around their historically low levels, reflecting expectations that policy rates will remain low for some time. In the United States, the 2-year bond yield declined to its lowest rate in over 70 years.

Spreads of emerging market US dollar-denominated debt have narrowed slightly from those prevailing prior to the announcement of the EFSF but remain above the lows in April (Graph 16). The absolute levels of emerging market yields are around the lowest since at least the early 1990s. Fitch raised Argentina's local- and foreign-currency credit ratings to B with a stable outlook, citing the country's restructuring of over 90 per cent of its defaulted debt and solid economic performance in recent years.

Central Bank Policy

Financial markets have pushed back the expected timing of initial monetary policy tightening in the euro area, Japan, the United Kingdom and the United States: no change in policy interest rates is expected until at least some time in 2011. However, a number of other central banks have started to increase policy rates, including those in Brazil, Canada, India, Malaysia, New Zealand, South Korea and Sweden (Table 3). The first five of these have raised rates on more than one occasion. In contrast, several central banks in Europe, including the Czech Republic and Russia, have continued to ease monetary policy.

The ECB's balance sheet continued to expand until the maturity of a large one-year liquidity providing operation on 1 July. Of the €442 billion in one-year loans that matured, €132 billion was rolled into three-month fixed-rate loans. With the decline in liquidity, money market rates in the euro area have risen by around 25 basis points (Graph 17).

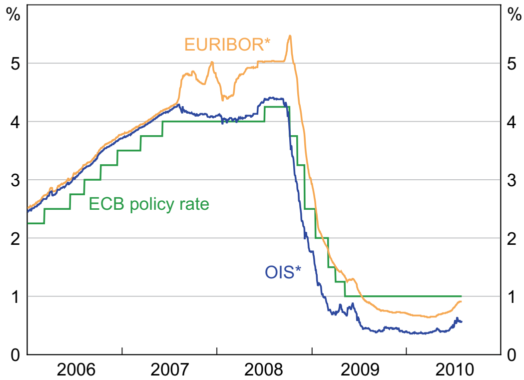
As noted above, the ECB began purchasing euro area sovereign bonds in May. The purchases have been generally modest and have declined steadily to be very small amounts in recent weeks. The ECB also completed its purchases of €60 billion of covered bonds at the end of June. These bond purchases have not offset the fall in liquidity provided by the ECB and, as a result, the ECB's balance sheet has started to contract (Graph 18). In contrast, the balance sheets of the Fed and Bank of England have been relatively stable since early 2010.

Table 3: Policy Rates

	Current level Per cent		Most recent change	Cumulative increase Basis points
Euro area	1.00	↓	May 09	–
Japan	0.10	↓	Dec 08	–
United States	0.125	↓	Dec 08	–
Brazil	10.75	↑	Jul 10	200
Canada	0.75	↑	Jul 10	50
China	5.31	↓	Dec 08	–
India	5.75	↑	Jul 10	100
Indonesia	6.50	↓	Aug 09	–
Israel	1.75	↑	Aug 10	125
Malaysia	2.75	↑	Jul 10	75
Mexico	4.50	↓	Jul 09	–
New Zealand	3.00	↑	Jul 10	50
Norway	2.00	↑	May 10	75
Russia	7.75	↓	Jun 10	–
South Africa	6.50	↓	Mar 10	–
South Korea	2.25	↑	Jul 10	25
Sweden	0.50	↑	Jul 10	25
Switzerland	0.25	↓	Mar 09	–
Taiwan	1.38	↑	Jun 10	13
Thailand	1.50	↑	Jul 10	25
Turkey	7.00	↓	Nov 09	–
United Kingdom	0.50	↓	Mar 09	–

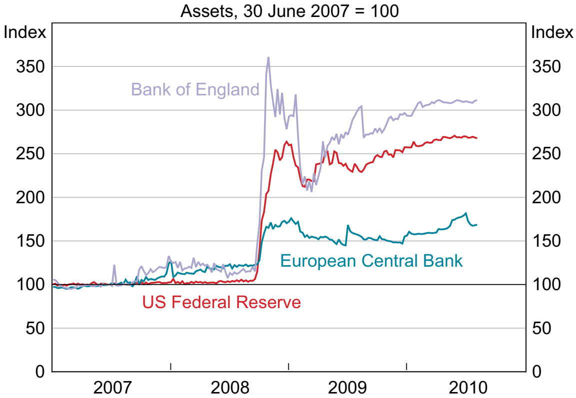
Sources: central banks

Graph 17
Euro Area Interest Rates



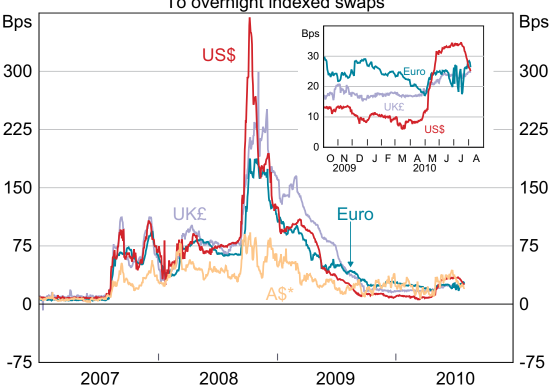
* 3-month annualised
Sources: Bloomberg; European Central Bank

Graph 18
Central Bank Balance Sheets
Assets, 30 June 2007 = 100



Source: Thomson Reuters

Graph 19
3-month LIBOR Spreads
To overnight indexed swaps



* Bank bills to overnight indexed swaps
Sources: Bloomberg; Thomson Reuters; Tullett Prebon (Australia) Pty Ltd

In the United States, the Fed has tested its Term Deposit Facility, which allows financial institutions to deposit funds at the Fed for up to 84 days at competitively-determined interest rates. This facility, and large-scale reverse repo operations, will allow the Fed to reduce the substantial reserves held by depository institutions when required.

The Bank of Japan announced a new loan facility for financial institutions to fund loans to industries with potential for growth. The facility will start around the end of August and disbursements could continue until mid 2012. Under the facility a maximum of ¥3 trillion (US$35 billion) in loans will be offered.

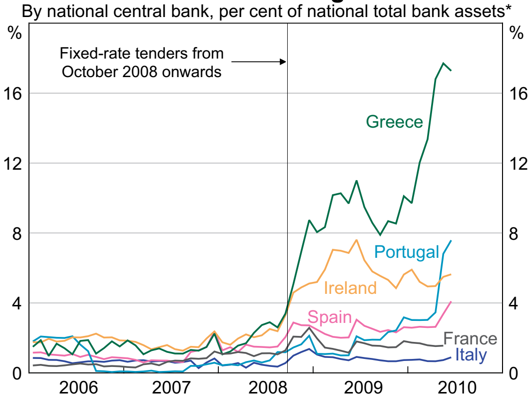
Credit Markets

In money markets, spreads between LIBOR and the expected cash rate (a measure of perceived bank risk) widened as European sovereign debt and banking sector concerns escalated in early May (Graph 19). This was most pronounced for US dollar LIBOR spreads as the relative cost of US dollar funds increased for European banks, although these spreads are well below those prevailing during the height of the financial crisis.

There are indications of tiering in the interbank market in Europe, with some banks having to pay a sizeable premium to obtain funding. Reflecting this, borrowing from the ECB by banks in several peripheral euro area economies has risen (Graph 20). Relative to the size of banks' balance sheets, this increase in borrowing has been most pronounced for Greek and Portuguese banks, while Spanish banks have relied a little more on ECB lending than in the past.

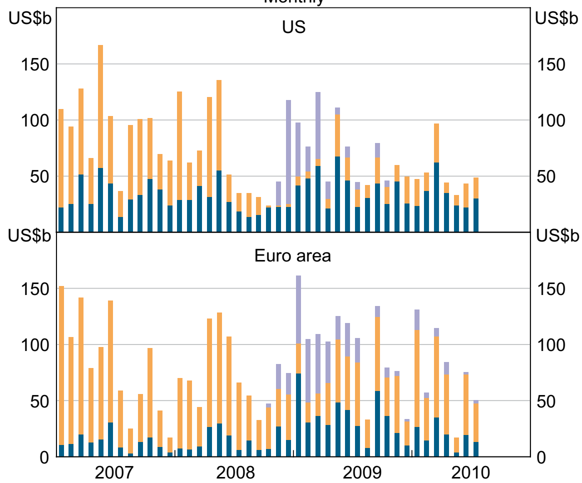
Spreads on bonds issued by US and euro area corporates also widened in response to heightened sovereign debt concerns but have since narrowed slightly. In part reflecting the deterioration in credit market conditions, corporate bond issuance in both regions has been low in recent months (Graph 21). Much of the issuance by financial institutions in Europe has been in the form of covered

Graph 20
ECB Lending
By national central bank, per cent of national total bank assets*



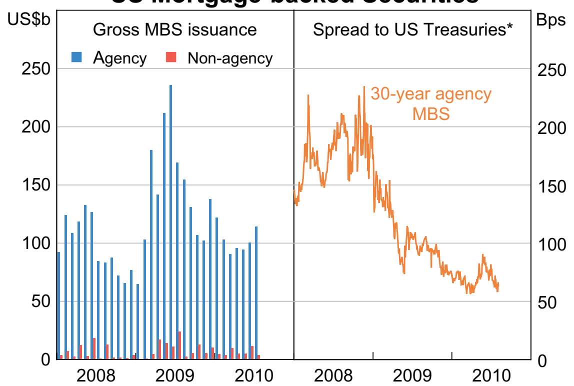
* Monetary financial institutions used as a proxy for total bank assets
Sources: central banks

Graph 21
Corporate Bond Issuance
Monthly



Sources: RBA; Thomson Reuters

Graph 22
US Mortgage-backed Securities



* Spread to 10-year US Treasury yields to approximate the duration of 30-year MBS
Sources: Bloomberg; agency monthly summary reports

bonds. Several EU countries recently extended the expiry date for their government guarantees on bank-issued bonds from end June to end December 2010 but increased the cost of the guarantees. Government-guaranteed issuance, however, has been minimal.

Issuance of agency mortgage-backed securities (MBS) in the United States has increased a little in recent months despite the completion of the Fed's purchase program in March (Graph 22). Nearly all of the issuance continues to be by the agencies, with minimal non-agency issuance. Agency debt and MBS spreads to US Treasuries remain at relatively low levels.

Government Financial Policy

In the United States, financial reform legislation was signed into law in July. Key points in the Act include:

- banking entities will be prohibited from proprietary trading (the 'Volcker rule'). Banks can, however, invest up to 3 per cent of Tier 1 capital in hedge funds and private equity if they are involved in organising or offering the funds. Non-bank financial corporations that conduct proprietary trading will be subject to additional capital requirements;
- banks will be required to spin-off to affiliates derivatives trading operations other than hedging activities using foreign exchange swaps, interest rate swaps, credit default swap contracts and gold/silver derivatives. Most derivatives will be required to be traded on exchanges and cleared through central counterparties;

- issuers of MBS will be required to retain at least 5 per cent of the credit risk, unless the underlying loans meet certain criteria for being low risk;
- an orderly liquidation procedure will be created that will allow regulators to liquidate financial firms that pose a risk to financial stability. No taxpayer funds are to be put at risk in this process and the Federal Reserve is prohibited from bailing out individual institutions in default or in danger or default;
- leverage restrictions and increased capital requirements will be imposed to prevent firms becoming 'too big to fail';
- a Financial Stability Oversight Council will be set up to identify and respond to emerging risks throughout the financial system; and
- a Consumer Financial Protection Bureau will be set up within the Federal Reserve to regulate the offering and provision of consumer financial products and services under federal laws.

The Act also makes rating agencies liable for the quality of their rating decisions if the ratings are included in the registration documents associated with securities issues. As a result, the three major rating agencies have refused permission for their ratings to be included in the registration documents for new debt issues. In response, the Securities and Exchange Commission (SEC) has suspended until January 2011 the requirement that publicly issued asset-backed bonds include ratings in the associated documentation.

The costs of implementing the Act will be recouped by ending the Troubled Asset Relief Program (TARP) earlier than planned and by increasing the fees that banks pay to the Federal Deposit Insurance Corporation for insuring deposits. The US Treasury revised lower its projection of the lifetime cost of the TARP to around US$105 billion in net present value terms from an estimate of US$117 billion made earlier in the year. These costs mainly derive from losses from assisting insurer AIG and the automakers as well as housing-related assistance. The US Treasury expects to earn a profit on the assistance to banks using TARP funds. Repayments of funds provided under the TARP have reached US$201 billion; US$185 billion of funds remain outstanding. The US Treasury has also received US$23 billion in revenue (e.g. dividends) associated with TARP funding.

The UK Government announced that it will introduce a levy on the balance sheets of banks and building societies with relevant liabilities of £20 billion or more in January 2011. The levy will initially be 0.04 per cent and increase to 0.07 per cent in 2012, except for funding with a maturity of more than one year, which will incur half the standard rate. The proceeds from the levy will go to consolidated revenue rather than be used to establish a rescue fund. The French and German Governments as well as the EU Council and European Commission are in the process of drafting proposals for bank levies.

The UK Government also announced significant changes to financial regulation infrastructure. Under the proposal, the Financial Services Authority (FSA) will cease to exist in its current form. A new Prudential Regulatory Authority will be established as a subsidiary of the Bank of England with sole responsibility for the day-to-day prudential supervision of financial institutions. A new Financial Policy Committee, to be chaired by the Governor of the Bank of England, will assess macroeconomic and financial risks to financial stability. The remaining functions of the FSA, which include monitoring the conduct of both retail and wholesale financial services firms, will be performed by a new Consumer Protection and Markets Authority. An independent commission on banking is also looking at how to reduce systemic risk in the banking sector, mitigate moral hazard, and promote competition in both retail and investment banking.

In a similar effort to improve oversight, the European Commission proposed creating a new single supervisor of credit rating agencies in the European Union. Moreover, the Commission aims to make the derivatives market safer and more efficient by enhancing reporting and clearing requirements for over-the-counter derivatives.

Germany introduced a ban on naked short-sales of euro area government bonds, credit default swaps based on such bonds, and shares. In addition, the German regulator has been given authority to ban euro currency derivatives for up to one year if required.

The Irish Government's 'bad bank', the National Asset Management Agency (NAMA), has purchased loans at around 50 per cent of their nominal book value of €20.5 billion from a number of Irish banks. NAMA expects to return a profit of €1 billion in net present value terms but there is considerable uncertainty around this estimate.

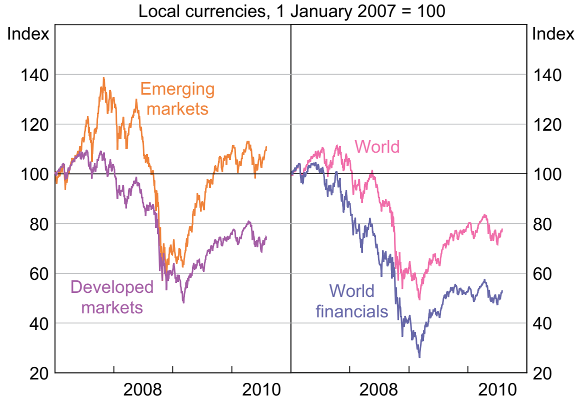
Equities

Global equity markets declined by 15 per cent from their recent peak in mid April as European tensions increased, and by early July had fallen to around the level of September 2009 (Graph 23). Most major equity markets have since retraced some of these falls but remain well below their mid-April highs (Table 4).

Equity markets have recently been supported by US corporate earnings results, with around 80 per cent of earnings reports for the June quarter better than expected. The US forward price-to-earnings ratio has fallen to be well below average (Graph 24).

Most large US banks' earnings beat analysts' expectations due to lower loan-loss provisions but revealed relatively subdued revenue growth. Goldman Sachs' earnings were affected by its agreement to pay US$550 million to settle the SEC charge that Goldman Sachs had made materially misleading statements and omissions in connection with a collateralised debt obligation (CDO) issued in 2007. This penalty is the largest assessed by the SEC against a financial firm but is less than the estimated US$1 billion investors lost on the CDO. US$250 million of the penalty will be returned to the CDO investors and US$300 million will be paid to the US Treasury.

Graph 23
MSCI Global Share Price Indices
Local currencies, 1 January 2007 = 100



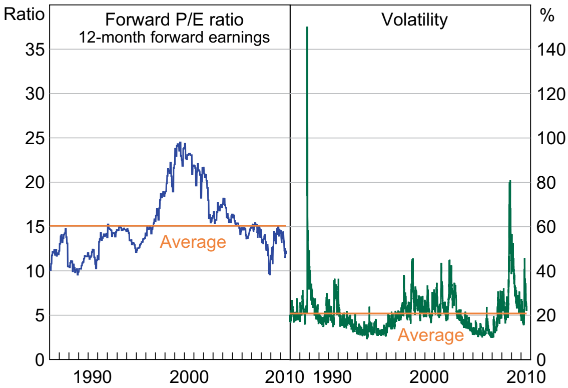
Source: Bloomberg

Table 4: Changes in International Share Prices
Per cent

	Since 08/09 trough	April peak to current
United States		
– Dow Jones	63	–5
– S&P 500	67	–7
– NASDAQ	82	–9
Euro area		
– STOXX	59	–6
United Kingdom		
– FTSE	53	–8
Japan		
– Nikkei	35	–16
Canada		
– TSE 300	57	–4
China		
– China A	54	–17
Australia		
– ASX 200	44	–9
MSCI indices		
– Emerging Asia	101	–1
– Latin America	101	–4
– Emerging Europe	107	–7
– World	**58**	**–7**

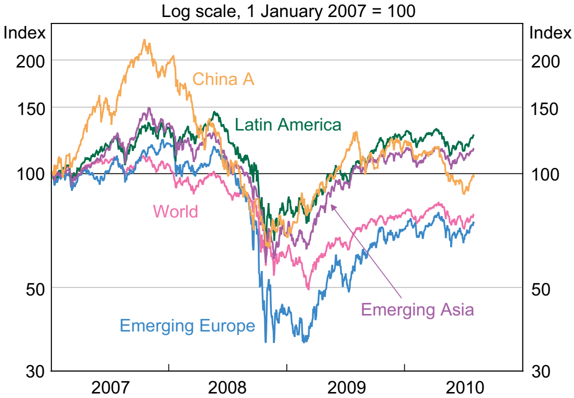
Source: Bloomberg

Graph 24
S&P 500



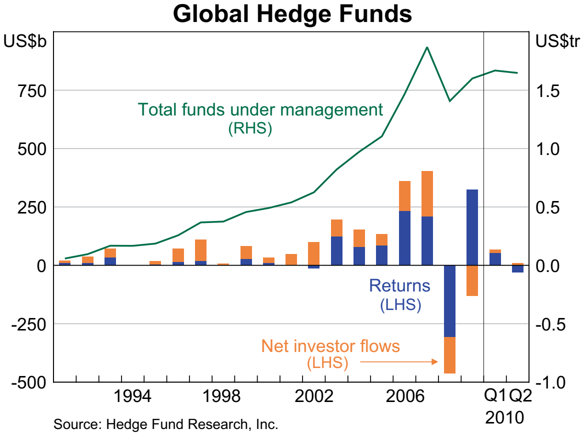
Sources: Bloomberg; Thomson Reuters

Graph 25
MSCI Share Price Indices
Log scale, 1 January 2007 = 100



Source: Bloomberg

Graph 26
Global Hedge Funds



Source: Hedge Fund Research, Inc.

Volatility in US equity prices has been above average since early May. In response to the unusually large price movements in US equity markets on 6 May, the SEC commenced a six-month pilot program in June that requires each US national exchange to pause trading in any S&P 500 stock that experiences a price change of more than 10 per cent in a five minute period. In addition, the national exchanges have proposed rules to clarify processes for cancelling erroneous trades.

Japanese equity market prices have underperformed other major advanced equity markets, in part reflecting the effect of the appreciation of the yen on Japanese export earnings. European equity markets have slightly outperformed other major equity markets since early May, with European banks' share prices increasing particularly sharply.

Equity price movements in most emerging economies have broadly reflected those in major advanced economies in recent months (Graph 25). An exception is Chinese equity prices which reached a 15-month low in July and have fallen by around 17 per cent since mid April. This has reflected concerns over the pace of policy tightening in China and the related uncertainty regarding China's economic outlook.

Hedge Funds

The decline in equity markets was reflected in an average 3 per cent loss for the global hedge fund industry in the June quarter 2010 (Graph 26). The fall followed five quarters of positive returns. A small injection of investor capital partly offset the loss so that funds under management declined by just 1 per cent. Despite funds largely recovering losses incurred during the financial crisis, funds under management in the industry remain around 15 per cent below their peak prior to the crisis owing to the large redemptions in 2008 and 2009.

Foreign Exchange

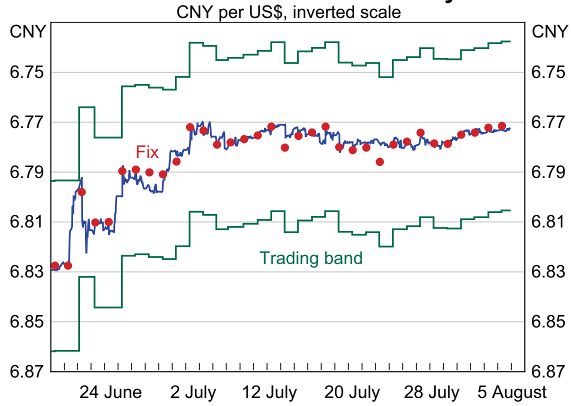
In mid June the People's Bank of China (PBC) announced that it would increase the flexibility of the renminbi exchange rate, signalling an end to the peg with the US dollar that had been in place since July 2008. Daily moves in the exchange rate will continue to be limited to a 0.5 per cent band around the fix set by the central bank each day. There was a number of relatively large daily moves in the renminbi in the two weeks following the announcement – with the renminbi appreciating against the US dollar by around 1 per cent – but since then it has traded in a tight range (Graph 27).

The PBC's statement emphasised the official view that the renminbi is close to its equilibrium value and that there is no basis for a large scale appreciation. In trade-weighted terms, the Chinese exchange rate has appreciated modestly since the start of 2010, but remains below its peak in March 2009 (Graph 28).

In trade-weighted terms the US dollar and the euro have depreciated slightly since the previous *Statement*, although there have been sizeable swings over the period (Graph 29). The US dollar is 5 per cent above its lows in late 2009, while the euro is around 10 per cent lower than its peak of around the same time.

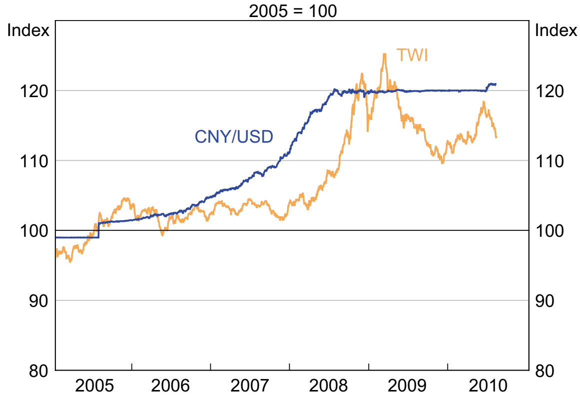
Concerns over the fiscal position of a number of euro area countries saw the euro depreciate against the US dollar in May (Graph 30; Table 5). However, the euro has appreciated against the US dollar since its low point in early June, reflecting relatively strong economic data, in contrast with the somewhat weaker-than-expected US data, and moderating concerns regarding the European fiscal situation following the positive outcome from the bank stress tests. The Japanese yen has also appreciated against the US dollar to be close to its record highs.

Graph 27
Chinese Renminbi – Intraday
CNY per US$, inverted scale



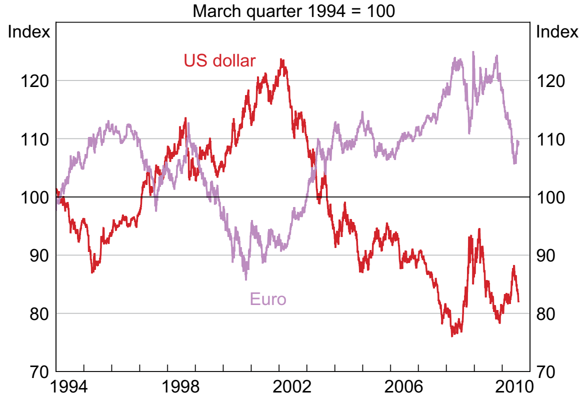
Source: Bloomberg

Graph 28
Chinese Renminbi
2005 = 100



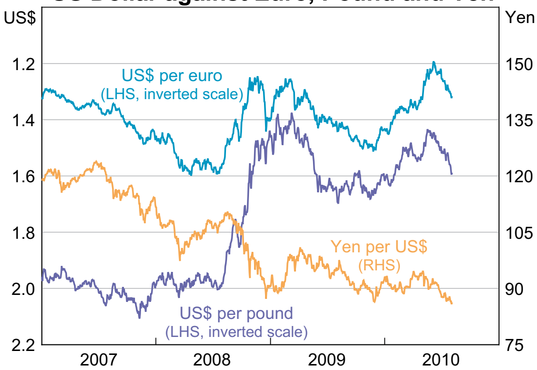
Source: Bloomberg

Graph 29
US Dollar TWI and Euro TWI
March quarter 1994 = 100



Sources: Board of Governors of the Federal Reserve System; European Central Bank

Graph 30
US Dollar against Euro, Pound and Yen



Source: Bloomberg

Table 5: US Dollar against Other Currencies
Percentage change

	Past year	Since previous *Statement*
European euro	9	0
UK pound sterling	7	–4
Swedish krona	0	–2
Swiss franc	–1	–3
Chinese renminbi	–1	–1
New Taiwan dollar	–3	–1
Brazilian real	–4	0
Indian rupee	–4	3
South Korean won	–4	5
Mexican peso	–5	1
Canadian dollar	–5	1
Philippine peso	–5	1
Thai baht	–5	–1
Singapore dollar	–6	–2
South African rand	–7	–2
Australian dollar	–8	1
New Zealand dollar	–8	–2
Indonesian rupiah	–9	–1
Malaysian ringgit	–9	–1
Japanese yen	–9	–8
Majors TWI	**0**	**–2**
Broad TWI	**–1**	**–1**

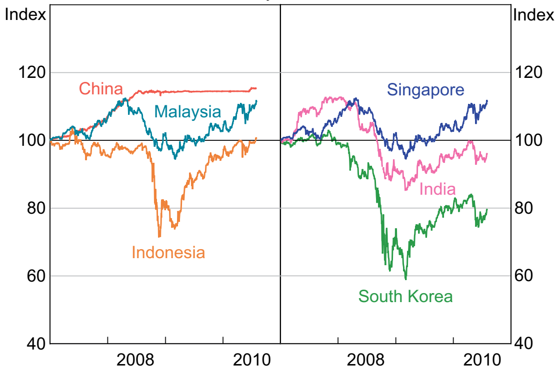
Sources: Bloomberg; Board of Governors of the Federal Reserve System

The Swiss franc appreciated against the US dollar and reached a record high of nearly 76 euro cents on 30 June. The Swiss National Bank intervened heavily in the market, rapidly accumulating foreign exchange reserves until mid June, when it indicated in a statement that the receding risk of deflation would allow it to moderate its intervention activity. The franc has since depreciated slightly against the euro.

Emerging Asian currencies have been mixed against the US dollar, despite the strength of the recovery in the region, due to lingering concerns about sovereign debt in some euro area countries and evidence that China's growth may be slowing (Graph 31). The South Korean won and the Indian rupee have depreciated significantly in recent months, by 5 per cent and 3 per cent respectively, while most other currencies have appreciated modestly.

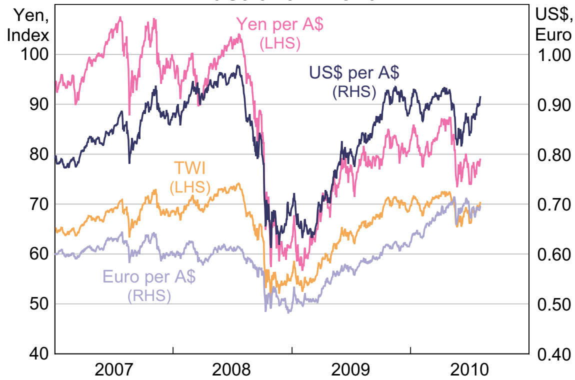
South Korea introduced capital controls in June, citing a need to reduce the volatility in their capital flows. The Bank of Korea announced that it was placing new limits on banks' currency forward positions and reinforcing restrictions on foreign-currency lending for domestic operations. Indonesia also introduced measures designed to reduce the short-term volatility of their capital flows. Bank Indonesia introduced longer maturity central bank bills, restrictions on the resale of bills within a month of purchase, and reduced the interest rate on deposits at the central bank. These measures apply to both foreign and domestic investors, but are designed primarily to slow potentially volatile short-term capital inflows. Both announcements were perceived by the market as relatively benign, with the negative effect on the respective currencies relatively muted.

Graph 31
Selected Asian Currencies against US Dollar
1 January 2007 = 100



Source: Bloomberg

Graph 32
Australian Dollar



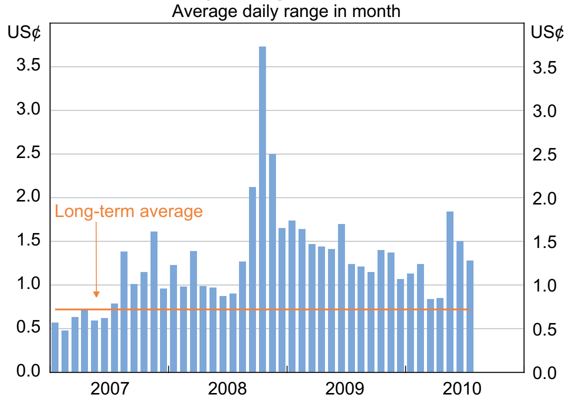
Sources: RBA; Thomson Reuters; WM/Reuters

Australian Dollar

The Australian dollar depreciated sharply from early May as risk appetite fell in response to concerns about the fiscal situation in some European economies and lower commodity prices, reaching a low of 81 US cents in early June (Graph 32). As concerns about the European situation have moderated and domestic data releases have signalled that the Australian economy is performing relatively well, the currency has reversed most of the decline (Table 6). On a trade-weighted basis, the Australian dollar remains around 35 per cent above its trough in February 2009.

After rising in May to its highest level since the most intense period of the financial crisis, volatility in the Australian dollar has declined, but remains high relative to its long-term average (Graph 33).

Graph 33
Intraday Range in AUD/USD
Average daily range in month



Source: Bloomberg

Table 6: Australian Dollar against Selected TWI Currencies
Percentage change

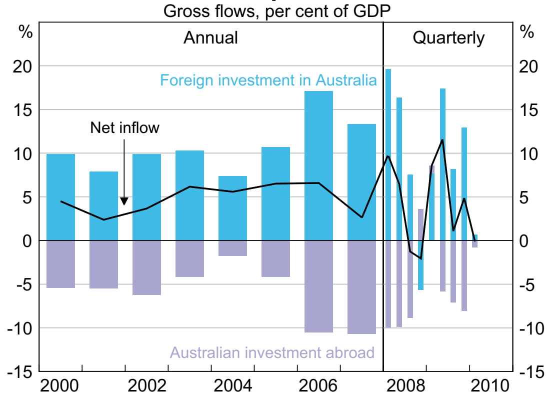
	Past year	Since previous *Statement*	Deviation from post-float average
European euro	19	0	5
UK pound sterling	17	–5	29
US dollar	9	–1	26
Swiss franc	8	–4	–9
Chinese renminbi	8	–2	33
Indian rupee	6	2	58
South Korean won	4	4	55
Canadian dollar	4	0	0
Thai baht	3	–1	24
Singapore dollar	3	–2	–1
South African rand	0	–3	49
New Zealand dollar	0	–3	1
Japanese yen	–1	–9	–16
Malaysian ringgit	–1	–2	30
Indonesian rupiah	–1	–2	119
TWI	**6**	**–3**	**19**

Sources: Bloomberg; RBA; Thomson Reuters; WM/Reuters

Capital Flows

Net private capital inflow was relatively modest in the March quarter as strong issuance of long-term debt by Australian banks was offset by a decline in their short-term foreign liabilities, a trend evident over the past year (Graph 34). Some of the decline in private inflows was accommodated by stronger inflows into government debt, in line with the pick-up in issuance of Commonwealth government debt. ✠

Graph 34
Private Capital Flows
Gross flows, per cent of GDP



Sources: ABS; RBA