STATEMENT ON MONETARY POLICY

The Australian economy is continuing to benefit from favourable international conditions. The global expansion is proceeding at a strong pace and is broadly based across the world's main economic regions. Growth in the United States economy is now showing further strength after a temporary dip late last year. In Japan the indications are that the recovery is gathering momentum, and there are encouraging signs that the economy has emerged from the debt-deflation spiral of the past decade or more. In China and other parts of Asia the already rapid pace of growth appears to have picked up further recently. Overall, the world economy is likely to expand at a faster-than-average pace in 2006 for the fourth successive year, and most observers expect this to continue in 2007.

The strong global expansion in recent years has been accompanied by sustained upward pressure on a range of international commodity prices. An important aspect of this has been the rise in world oil prices. Concerns about possible supply disruptions have at times contributed to these oil price fluctuations, but for the most part the upward trend has been a consequence of strong global demand. As a result, expectations of world growth have generally remained strong throughout the period when oil prices have been rising.

More generally, the strength of the world economy over recent years has underpinned substantial increases in a wide range of other commodity prices in the resources sector. As a major resources exporter, Australia is one of the countries that most benefits from these developments. Over the past three years, Australia's terms of trade have increased by more than 30 per cent, and this has had a significant expansionary effect on domestic incomes and spending. Recent indications are that the upward pressure on world commodity prices has continued. Prices of the base metals included in Australia's commodity price index have increased by an average of more than 50 per cent over the past year, building on the already large increases that had occurred over previous years. At the same time, indications from the current contract negotiations for Australia's coal and iron ore exports are that prices of these bulk commodities in aggregate will remain close to record highs.

Against the background of the strong global economic expansion, interest rates in the major economies have been increasing. Most of the major central banks are now in the process of normalising their official interest rates from the unusually low levels that they reached earlier in the decade. In addition, long-term market rates have been rising recently in response to the continuing strong economic news. In Australia, market interest rates have also been increasing, in response to a combination of strong global economic trends and firmer domestic data. Market interest rates moved upwards across the yield curve in Australia during the recent period such that, by the time of the May Board meeting, the market was fully pricing in a rise in the cash rate in the coming months, with a 50 per cent probability that it would occur at the May meeting itself. Also noteworthy has been the buoyancy of the Australian share market. Australian share

prices have increased by 11 per cent since the start of the year, outperforming the main share markets overseas.

The Australian economy has been operating for some time with rather limited spare capacity. During the course of a sustained expansion, now in its fifteenth year, Australia's unemployment rate has been substantially reduced, and unused productive capacity re-employed. The unemployment rate has been broadly steady over the past year at an average of just over 5 per cent, its lowest since the 1970s. Business surveys and liaison reports continue to indicate that labour market conditions are tight and that the economy as a whole is operating at a high level of capacity utilisation. Businesses have been reporting that lack of suitable labour was a bigger constraint on their activities than more traditional concerns about the adequacy of demand or sales.

Growth of the Australian economy over the past couple of years has been influenced by a combination of factors including strong commodity prices, which are contributing to a favourable climate for business investment, and a process of balance-sheet adjustment taking place within the household sector, which has been constraining consumption. As a result, the economy has undergone a marked shift in the composition of growth, with the overall growth in demand now being mainly driven by business investment rather than household spending. Since the middle of 2002, business investment has increased at an average annual rate of 14 per cent. Investment in the resources sector has been the fastest growing component, but the growth has been broadly based across industries. Although some easing from these unusually high growth rates can be expected, prospects for expansion in business investment remain favourable. Strong profitability and rising share prices are indicative of good business conditions, confidence in most sectors is high, and the recent further increases in a range of commodity prices will provide continued stimulus to the resources sector.

The boom in business investment has been accompanied by a slowing in household spending, which helped to contain the overall growth in domestic demand. Consumption growth peaked around the end of 2003 and has since slowed to a little below trend, mainly reflecting a period of balance-sheet adjustment in which households have shown a reduced appetite for additional debt. Nevertheless there are some signs that consumer spending may be starting to pick up. Notwithstanding higher petrol prices, retail sales have been stronger over the past three months and consumer sentiment has been above average. Employment has picked up recently, which should support household incomes.

Australia's export performance over recent years has been disappointing, considering the favourable international conditions. While export earnings have increased substantially, this has to date been mainly a result of higher prices rather than growth in volumes. Nevertheless, there are some early signs that volume growth in resource exports is beginning to pick up, flowing from the substantial investment undertaken in that sector in recent years.

The net effect of these factors is that domestic demand has continued to grow at a solid pace over the past couple of years, though down from the unsustainably high rates seen earlier in the decade. GDP growth has been below trend recently but appears likely to pick up, given the continued growth in domestic spending, the stimulus from Australia's rising terms of trade, and the likelihood of a recovery in export volumes. Overall, the Bank's assessment is that demand

and output growth over the next year or two are likely to converge to a pace broadly in line with the growth of the economy's productive capacity. This outlook implies that the economy will continue operating at a relatively high level of capacity utilisation, although strong business investment will undoubtedly contribute to capacity expansion over time.

Recent trends in credit growth indicate that households and businesses have continued to find it attractive to borrow at prevailing interest rates. After touching a low point in the September quarter, the growth of household credit has picked up over the two most recent quarters. Business credit growth has continued to trend upwards. A factor that is likely to have contributed to the overall strength of credit growth has been the continuing compression of lending margins by financial intermediaries over recent years, reflecting competition among lenders. As a consequence, although the cash rate has been close to its historical average, interest rates paid by borrowers have remained below average.

The combination of strong global conditions, tight capacity and solid demand growth in the domestic economy has added to inflationary pressures. Wages growth, though not accelerating further recently, is higher than it was a year ago. Producer price indices continued to rise quickly in the March quarter, reflecting the general strength in international commodity prices. Consumer price inflation has to date been well contained but in the March quarter was higher than expected, with the CPI rising by 0.9 per cent in the quarter and by 3.0 per cent over the year. The latest quarterly figure was boosted by seasonal factors (health and education costs) while petrol price increases contributed significantly to the annual figure. Abstracting from the influence of extreme movements in individual prices, underlying CPI inflation is estimated to have risen to around 2¾ per cent, a rate it had not been expected to reach until the second half of the year.

The Bank's assessment of the outlook as presented in the February *Statement* was that underlying inflation would increase only modestly and would most likely level out at a rate of 2¾ per cent. This forecast reflected the upward pressure on inflation stemming from the pick-up in labour and materials costs, while recognising that global disinflationary forces would help to contain prices in the tradables sector. In reviewing the outlook to incorporate the March quarter inflation data and other domestic and international news, the Bank's assessment was that, other things equal, the medium-term inflation risks were increasing. However, taking into account the expected dampening effect of the May policy tightening, the forecast for underlying inflation is broadly unchanged at 2¾ per cent. In the short term, headline CPI inflation can be expected to be noticeably higher than that figure, as recent increases in fuel prices are recorded in the index in the next quarter.

In summary, the economic situation reviewed by the Board has for some time been one in which international conditions have been favourable to growth in Australia, the economy has been operating with limited spare capacity, and underlying inflation has been forecast to increase gradually. In these circumstances, the Board had taken the view that the next move in interest rates was more likely to be up than down, and this was signalled in the Bank's policy statements.

The Board's judgment at its May meeting was that the flow of recent information strengthened the case for an increase in the cash rate. International data continued to suggest

strong prospects for the global economy, with forecasts having recently been revised upwards. Domestic indicators were consistent with a solid outlook for demand and activity, while credit growth was strengthening and local equity markets had been buoyant. While underlying inflation had generally been quite stable over the previous couple of years, there were a number of signs that the prevailing conditions were starting to add to inflationary pressures.

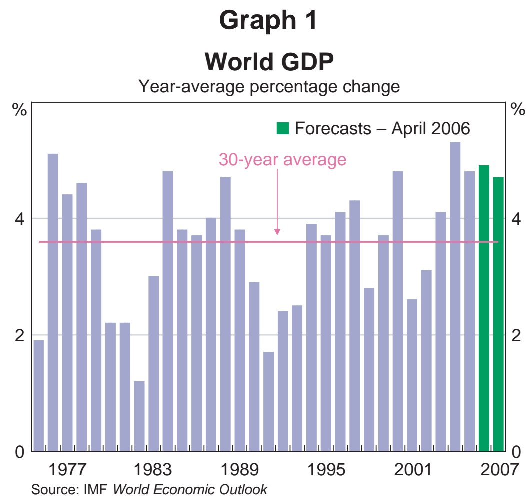
Taking account of this information, the Board's assessment was that inflationary risks had increased sufficiently to warrant an increase in the cash rate. The Board will continue to monitor developments and make such adjustments as required to promote sustainable growth of the economy with low inflation. ✠

International Economic Developments

Global economy

World economic growth remained strong in early 2006. The US economy has resumed a solid pace of growth following the weak December quarter outcome. The economic recovery in Japan, Australia's largest export destination, is also gaining strength. Rapid growth continues in China, now Australia's second most important export destination, while growth in the rest of east Asia remains solid, supported by the upswing in the global ITC sector. Strong growth is continuing in other emerging markets, and conditions remain supportive of recovery in the euro area. Reflecting this favourable situation, the IMF's latest forecasts, from the April 2006 *World Economic Outlook* (WEO), are for world growth to maintain its well-above-average pace in 2006 and 2007 (Graph 1, Table 1). Growth in 2006 is forecast to be among the strongest rates in the past 30 years. Weighting countries according to

Graph 1



Source: IMF *World Economic Outlook*

Table 1: World GDP

Year-average percentage change[(a)]

	2004	2005	2006	2007
			IMF forecasts (April 2006)	
United States	4.2	3.5	3.4	3.3
Euro area	1.8	1.4	2.0	1.9
Japan	2.3	2.7	2.8	2.1
China	10.1	9.9	9.5	9.0
Other east Asia[(b)]	5.9	4.8	5.2	4.9
India	7.4	8.0	7.3	7.0
Latin America	5.8	4.3	4.3	3.6
Emerging Europe	6.1	5.2	5.6	5.4
World	**5.3**	**4.8**	**4.9**	**4.7**
Australia's trading partners[(c)]	4.9	4.4	4.4	4.2

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Weighted using market exchange rates
(c) Weighted using merchandise export shares

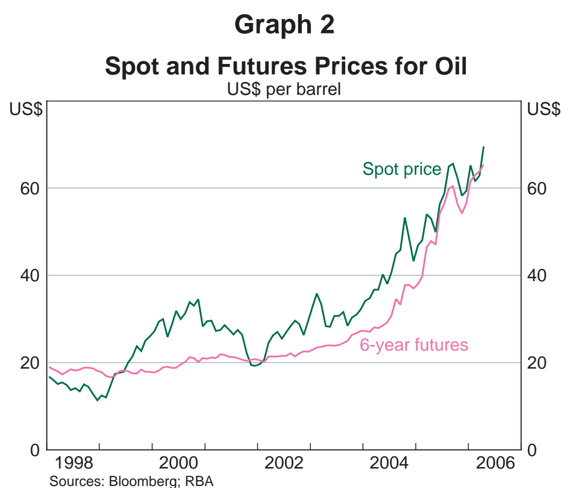
Sources: CEIC; IMF; RBA; Thomson Financial

their importance for Australian exports, growth in Australia's trading partners is also expected to remain strong.

Despite continued solid growth in the world economy and high commodity prices, inflation thus far has generally remained contained. Nevertheless, as the global economy's spare capacity progressively diminishes, energy prices stay high and inflationary risks mount, central banks around the world have been tightening monetary policy. Persistently high oil prices have also contributed to the widening global current account positions, as oil-producing countries have been saving much of their extra revenue.

Graph 2

Spot and Futures Prices for Oil



Oil prices have risen in 2006, and in early May traded at around US$74 per barrel, which is above the previous peaks seen in September 2005 following the damage from Hurricane Katrina in the Gulf of Mexico (Graph 2). Recent increases have been attributed to concerns about potential disruptions to supply from the Middle East and Nigeria. Iran is the world's fourth-largest oil producer, so disruptions there could significantly reduce global supply; around one-quarter of the world's oil trade passes through the Straits of Hormuz between Iran and Oman. Long-term futures prices have also touched record highs and suggest that market participants expect prices to stay high for an extended period.

Resource commodity prices more generally have also risen substantially in recent months, particularly for metals. Although supply disruptions have played a role for some of these commodities from time to time, the longer-term price increases mainly reflect strong global demand, both for portfolio holdings and industrial use (see the chapter on 'Foreign Trade and Capital Flows' for further details).

Although actual or expected disruptions to oil supply can explain much of the short-term movements in oil prices, as with other resource commodities, the longer-term upward trend in prices is still substantially the result of the strong growth in world demand over recent years. Nevertheless, higher oil prices would be expected to result in some reduction in global growth relative to what might have been possible had the supply of oil been more responsive. IMF estimates suggest that a 10 per cent increase in oil prices would tend to reduce global growth by around 0.10–0.15 percentage points, although the effect would be expected to differ across countries and regions.[1] In particular, the recent strength in the price of oil and other commodities is expansionary for a net energy and resource exporter such as Australia.

1 *This estimate is broadly in line with the May 2004 estimates from the IEA, IMF and OECD that an increase in oil prices from US$25 to US$35 per barrel (a 40 per cent increase) would reduce global GDP by around 0.5 per cent.*

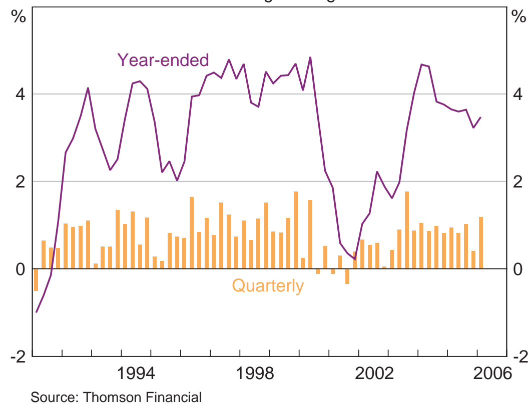
United States

The US economy entered 2006 with solid momentum, having grown at an above-trend pace over the previous two years. In the March quarter, domestic demand growth rebounded strongly from the temporary weakness of the previous quarter, with real GDP expanding by 1.2 per cent in the quarter, to be 3.5 per cent higher over the year (Graph 3). Net exports subtracted slightly from growth in the March quarter, and in nominal terms the trade deficit remained at 6.2 per cent of GDP. Thus the US current account deficit is likely to have stayed close to its previous record of 7.0 per cent of GDP in the March quarter.

Graph 3

United States – GDP

Percentage change



Source: Thomson Financial

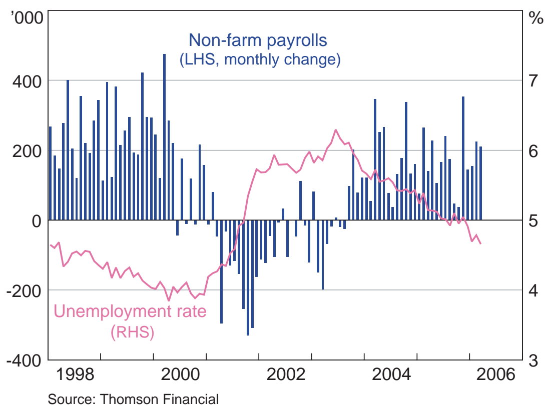
Consumption grew by 1.3 per cent in the March quarter, partly reflecting a recovery in auto sales from their sharp fall in the December quarter. Consumption growth continues to be supported by firming labour market conditions, and consumer sentiment is at above-average levels. However, the fillip from rapidly rising house prices may fade in the period ahead, as growth in house prices is likely to slow. In recent months, the 30-year fixed mortgage rate has drifted higher and demand for housing appears to have passed its peak; home sales are well down from recent highs.

Business investment also picked up in the March quarter, following a surprisingly soft December quarter outcome, to be 9 per cent higher over the year. Core capital goods orders rose in the March quarter. The outlook for investment is favourable: financing conditions are accommodative; corporate profits are at a historically high share of GDP; and business sentiment remains above long-run average levels. Capacity utilisation in the industrial sector is at a 5½-year high.

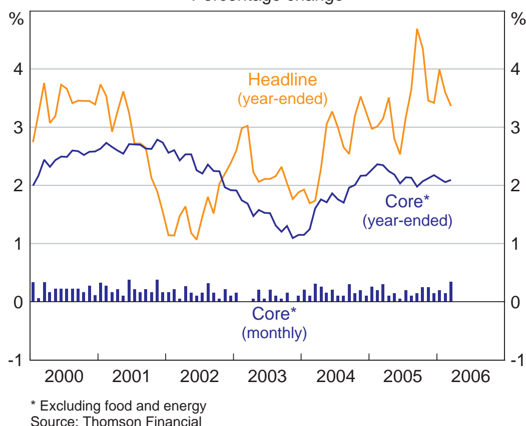
Reflecting the healthy state of the business sector, the labour market remains buoyant. Non-farm payrolls increased by nearly 600 000 in the first three months of 2006, to be 1.6 per cent higher over the year to March (Graph 4). Along with this strong growth in employment, the unemployment rate fell to a five-year low of 4.7 per cent in March,

Graph 4

United States – Labour Market



Source: Thomson Financial



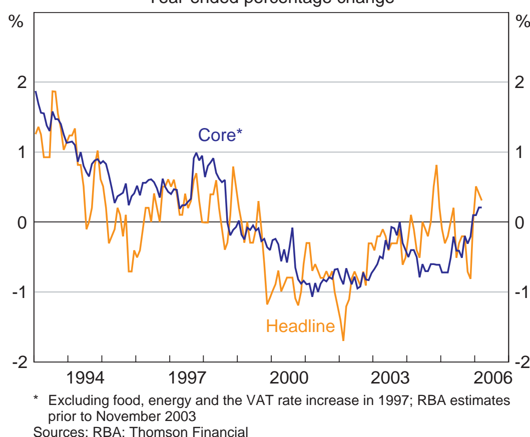
and average hourly earnings growth has picked up. Weekly initial jobless claims and surveyed employment intentions all point to a continuation of these trends.

Energy price fluctuations have resulted in relatively high and volatile headline producer and consumer price inflation in the past couple of years (Graph 5). In underlying terms, however, inflation has remained moderate, with core CPI inflation around 2 per cent in March. Strong productivity growth has tended to offset the effect of rising wages on unit labour costs. Nonetheless, with the economy operating at a high level of capacity utilisation and ongoing strength in energy and other commodity prices, the Federal Reserve has continued to tighten monetary policy. At its March meeting, the Federal Open Market Committee raised the fed funds rate by a further 25 basis points to 4.75 per cent. The policy statement continued to highlight upside risks to inflation and signalled that some further policy firming may be required.

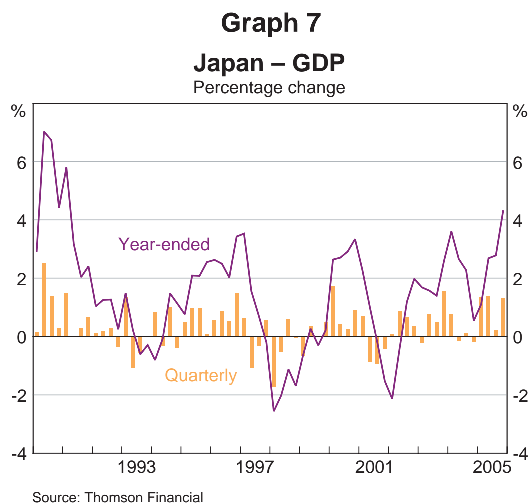
Asia-Pacific

Japan

The Japanese economic recovery has continued to build, with the rise in consumer prices seen in recent months suggesting that the economy is emerging from its extended period of deflation (Graph 6). In this context, following its March meeting, the Bank of Japan (BoJ) announced the end of the quantitative easing policy and returned to using the short-term interest rate as the operating target for monetary policy. (For more details see the 'International and Foreign Exchange Markets' chapter in this *Statement*.) The BoJ stated that it will set policy so as to ensure medium to longer-term price stability, consistent with inflation in the approximate range of 0 to 2 per cent, although it said that this should not be interpreted as an inflation target.



The change in policy framework is expected to have little immediate effect on economic activity, with the short-term interest rate remaining at zero for the time being.



Real GDP increased by 4.3 per cent over 2005, the highest year-ended rate of growth in almost 15 years (Graph 7). The economy has been expanding for more than three years, with growth now broadly based across domestic and external demand. Conditions are conducive to an enduring expansion, with the corporate sector in good shape and the benefits flowing through to the labour market (for further details see 'Box A: Recovery in Japan').

Business investment increased by 7.7 per cent over 2005. In the March quarter, industrial production increased, to be around 3 per cent higher over the year; merchandise exports were 18 per cent higher over the year, boosted by the global ITC recovery. Forward-looking indicators of investment are suggestive of continued growth. Machinery orders remained on an upward trend in early 2006, and investment intentions were again revised upwards in the March quarter Tankan survey. Employment indicators, such as surveyed hiring intentions and job vacancies as measured by the offers-to-applicants ratio, are also consistent with a positive outlook. Buoyed by the strong labour market, conditions in the household sector have continued to improve; consumption grew by 3.5 per cent over the year to the December quarter, the fastest pace of growth in almost nine years, and consumer sentiment is high.

China

China's rapid economic expansion is providing a substantial impetus to growth in the east Asian region and elsewhere. Real GDP grew by 10.2 per cent over the year to the March quarter. The recently released Five-Year Plan forecasts somewhat slower annual average growth of 7.5 per cent for 2006 to 2010, and introduces measures to promote sustainable growth, such as improved environmental protection and energy-efficiency targets. The People's Bank of China raised benchmark lending rates in late April.

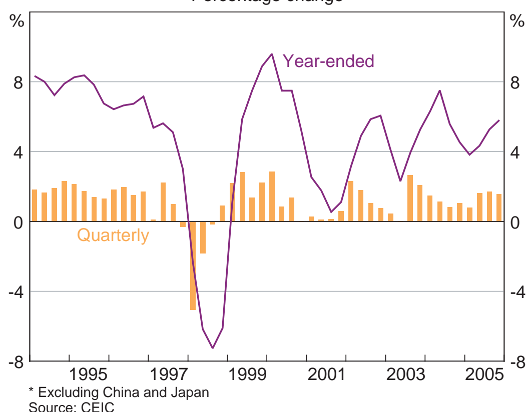
The revisions to the national accounts following the 2005 census involved a large increase in the services sector's share of GDP (from 32 per cent to 41 per cent in 2004), but only relatively minor changes to the expenditure component shares of GDP. The estimated investment share of GDP therefore remains very high by international standards, and recent growth in investment is still outpacing that of consumption. Year-ended growth in urban fixed-asset investment picked up to 33 per cent in March, while retail sales grew by 13½ per cent over the same period. Annual growth in exports has picked up in recent months to around 28 per cent, compared with 21 per

cent for imports; the monthly merchandise trade surplus was above US$10 billion in early 2006, compared with a monthly average of US$8.4 billion in 2005.

Inflation remains subdued in China, despite strong economic growth, high commodity prices and several years of annual wage growth of around 15 per cent. In fact, inflation has been trending down, reaching 0.8 per cent for consumer prices and 2.5 per cent for producer prices over the year to March. Strong productivity growth, as workers move from the rural sector to the industrial sector, has apparently offset higher input costs.

Other Asia-Pacific

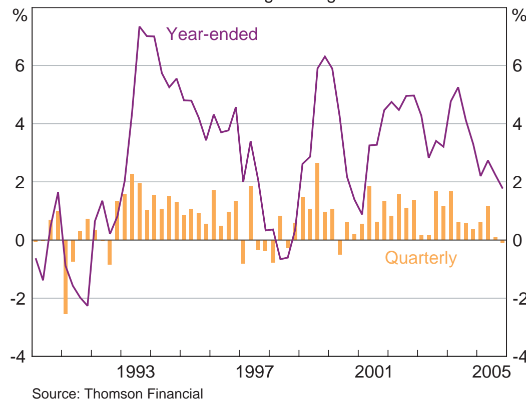
Growth in the rest of east Asia remains solid, supported by strengthening demand for ITC goods and continued rapid growth in China. Real GDP increased by 1.6 per cent in the December quarter and by 5.8 per cent over the year (Graph 8). The more ITC-exposed economies expanded most rapidly, while growth was slowest in Indonesia and Thailand. Other important drivers of growth were the continued expansion of the biomedical sector in Singapore, and the Hong Kong services sector, which has been benefiting from ties with the rest of China.



This overall strength has continued into 2006, with year-ended growth in industrial production and merchandise exports for the region of 11 per cent and 16 per cent in February. Indicators of demand for ITC products remain favourable, suggesting the sector should continue to support growth. Domestic demand also remains solid across most of the region, driven by positive labour market conditions, recent gains in asset prices and low real interest rates. The recovery in domestic demand continued in the March quarter in Korea, the largest economy in the region and the fourth-most important destination for Australia's exports. GDP in Korea grew by 1.3 per cent in the quarter, to be 6.1 per cent higher over the year. Business investment has been surprisingly weak for the region as a whole, particularly given increasing capacity utilisation, but this is partly attributable to political uncertainty in some countries. Monetary policy has been tightened towards more neutral settings across the region over the past year in response to demand and inflation pressures. Inflation has trended up a little in most countries in the region, but remained low overall in early 2006.

Domestic demand remains the main driver of the rapid growth in India. GDP grew by 1.5 per cent in the December quarter, to be 7.7 per cent higher over the year, with particular strength in the construction and services industries. Growth in industrial production has also been rapid, at 8.8 per cent over the year to February. Wholesale price inflation has moderated in recent months, to be 4 per cent over the year to March.

Economic growth has slowed in New Zealand. Real GDP expanded by 1.8 per cent over the year to the December quarter but was flat over the second half of 2005 (Graph 9). Consumption and investment growth both eased in late 2005, and preliminary indicators suggest domestic demand has slowed further in 2006. The softening in the economy has been felt in the labour market, with year-ended employment growth slowing to 1.6 per cent over 2005, down from 4.4 per cent a year earlier. Unemployment nonetheless remained at a multi-decade low of 3.6 per cent in the December quarter. Rapid house price growth has boosted consumption in recent years, but this effect is likely to wane. Year-ended median house price growth eased to 7.7 per cent in March, down from highs above 17 per cent during 2005 and the lowest rate in almost three years. Consumer price inflation moderated in the December and March quarters, but it remained above the RBNZ's 1 to 3 per cent target band, at 3.3 per cent over the year to the March quarter.



Europe

Growth in the euro area eased in the December quarter, but conditions remain supportive of recovery. GDP increased by 0.3 per cent in the quarter and by 1.8 per cent over the year (Table 2). A flat outcome in Germany, the region's largest economy, reflected weak consumption. Growth was also weak in France and Italy, but remained strong in Spain and the Netherlands. Despite the December quarter weakness, euro area growth is expected to pick up in 2006, with the region displaying buoyant business sentiment and improved consumer confidence (Graph 10). In addition, corporate profitability has increased further and investment growth remains relatively strong.

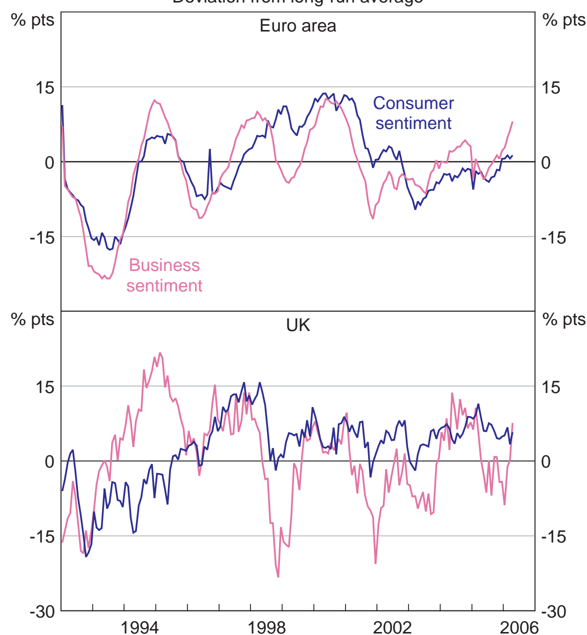
Conditions in the business sector continue to improve, with high levels of confidence supported by an improvement in exports. Given continued strength in external demand, merchandise exports have picked up further, increasing by 13 per cent over the year to February. Industrial production has also picked up, increasing by 3.2 per cent over the year to February; the pick-up has been driven largely by Germany, but has become more broad-based in recent months. Credit growth has also increased significantly in recent years. Survey data continue to suggest a positive outlook in the business sector, with most measures of sentiment increasing further in 2006. The German Ifo business climate index has been particularly strong, suggesting renewed optimism in the German economy.

In contrast, conditions in the household sector remain lacklustre, with year-ended growth in retail sales easing to 1.1 per cent in February. Nonetheless, most observers expect consumption to strengthen eventually, given the gradual improvement in the labour market; at 8.2 per cent

Table 2: Europe GDP
Percentage change

	September quarter 2005	December quarter 2005	Year to December quarter 2005
Euro area	0.7	0.3	1.8
– Germany	0.6	0.0	1.6
– France	0.7	0.4	1.5
– Italy	0.3	0.0	0.5
– Spain	0.9	0.9	3.5
– Netherlands	0.8	0.8	2.1
United Kingdom	0.5	0.6	1.8

Source: Thomson Financial



Source: Thomson Financial

in February, the unemployment rate has fallen ¾ percentage point over the past year and a half. As measured by the European Commission, consumer confidence has been just above its long-run average since December.

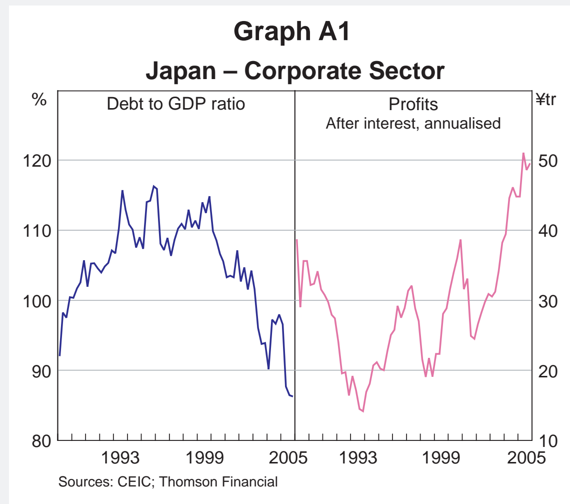
Headline consumer price inflation stood at 2.4 per cent in April, while underlying inflation remained relatively stable at 1.3 per cent in March. The ECB tightened policy again in March, with a second 25 basis point increase in its benchmark rate, bringing it to 2.5 per cent; the announcement expressed confidence in the region's recovery in output growth and concern over the upside risks to price stability.

After slowing in 2004, consumption growth in the UK has recovered since mid 2005, supported by above-average consumer sentiment and a pick-up in house prices, which increased by around 6 per cent over the year to March. GDP increased by 0.6 per cent in the March quarter and by 2.2 per cent over the year. Businesses are benefiting from strong profitability and increased external demand. Measures of business sentiment are above long-run averages and growth in the value of exports exceeded 14 per cent over the year to February, although manufacturing production remains weak. Headline consumer price inflation has eased, to be 1.8 per cent in March, and is likely to remain contained in 2006 despite scheduled increases in utilities prices.

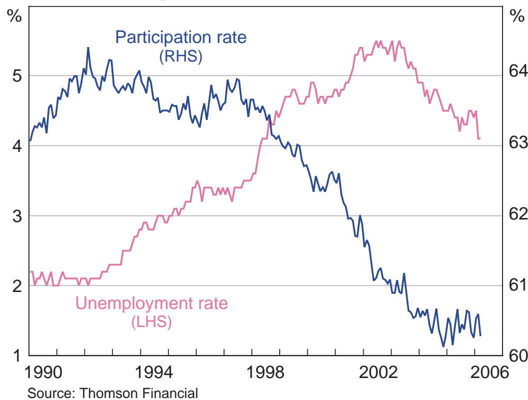
Box A: Recovery in Japan

Japan's economic expansion is now in its fourth year and is increasingly showing signs of durability. Unlike in the short-lived public-demand-driven episodes of the 1990s, growth is now broadly based across domestic private demand and exports, and thus more likely to be sustained. A feature of the current recovery has been the improvement of conditions in the corporate sector, which has now flowed through to households via labour market recovery. A further positive sign is that the deflation of the past decade also appears to have abated.

Structural adjustment by businesses has allowed them to reduce their excess debt, labour and capacity from the bubble years. Previously fragile corporate balance sheets have markedly improved, as strong profitability has permitted lower debt levels. Corporate profits after interest payments increased by almost 11 per cent in 2005 (Graph A1). The ratio of corporate debt to GDP has declined to 86 per cent, its lowest level in almost 20 years, and debt to equity ratios are at low levels by Japanese standards, though they are still higher than in most other countries. Balance-sheet repair has also been evident in the banking sector. Official estimates show that non-performing loans have fallen from a peak of 8.4 per cent of bank lending in 2001, to 3.5 per cent in September 2005, as bad loans have been written off and, more recently, lending has begun to expand. In February, loans outstanding were higher than a year earlier, for the first time in over nine years. Within the total, lending to individuals has been increasing solidly since early 2005, while the pace of decline in lending to firms has moderated.



Central to the corporate restructuring process has been the active shedding of labour by firms. Over the 10 years to 2002, the unemployment rate had increased from 2 per cent to 5.5 per cent – the highest rate in more than 50 years. Full-time employment declined over the same period, as firms replaced full-time employees with part-time and casual employees, shifting away from the traditional Japanese system of lifetime employment. More recently, however, labour market conditions have begun to recover. The unemployment rate has fallen to its lowest level in over seven years and the participation rate has stabilised after a protracted period of decline (Graph A2). Total employment has been rising steadily since late 2003, and full-time employment has risen since the start of 2005. Surveys are now indicating that firms have insufficient labour to



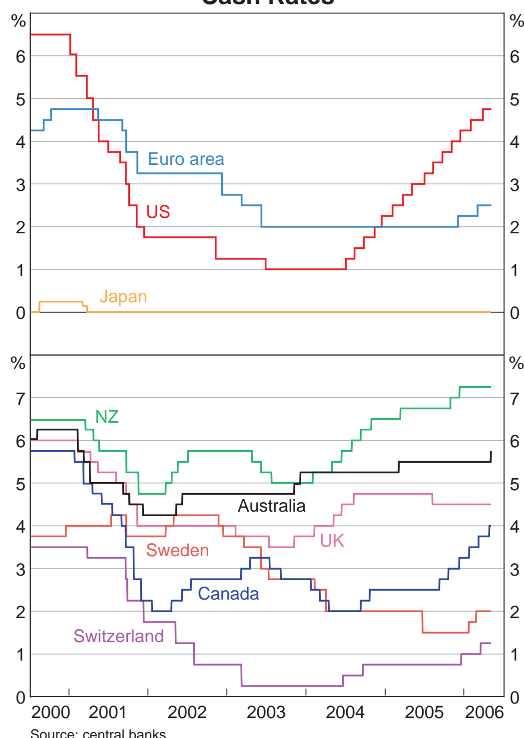
meet demand. The improving labour market is encouraging consumer spending. Year-average consumption growth was 2.2 per cent in 2005, compared with an average of 1.1 per cent over the preceding 10 years.

Japan is also showing some early signs of emerging from deflation. Year-ended CPI inflation was running at around ½ per cent in the first three months of 2006, both in headline and underlying terms. Asset prices have also been rising. The health of the corporate sector has been reflected in strong growth of share prices; the Topix index has risen by more than 50 per cent over the past year and is now around 15-year highs. There are also tentative signs of a turnaround in property prices. Over 2005, Tokyo property prices increased for the first time in 15 years, and the year-ended pace of decline in nationwide property prices continued to moderate. The developments in both consumer and asset prices have contributed to an improvement in balance sheets, which should assist prospects for a sustainable recovery. Given these signs of self-sustaining growth, the Bank of Japan has begun the transition to more normal policy settings, after an extended period of very expansionary monetary policy.

International and Foreign Exchange Markets

Overseas markets

Official interest rates



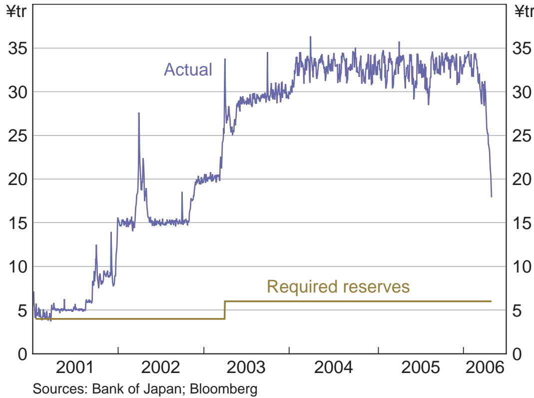
For some time, the major central banks around the world have engaged in a process of normalising interest rates after the very low levels reached in 2003 (Graph 11). The exception to this had been the Bank of Japan (BoJ) which until recently had been combating deflation. With the Japanese economy continuing to improve and prices starting to rise, however, the BoJ too has now started the process of normalising policy. The BoJ has begun to withdraw the vast amounts of excess liquidity it had provided banks under its policy of 'quantitative easing'. This has not yet resulted in any rise in official interest rates, which remain at zero. The reduction in the provision of liquidity to more normal levels consistent with required reserve holdings is expected to take a number of months (Graph 12). While largely technical in nature, many observers expect it to be followed soon after by a rise in policy rates.

The US Federal Reserve, which started tightening in mid 2004 and has since raised rates to 4¾ per cent, has recently indicated that the process of normalisation may be nearing an end. Markets expect the Fed to increase its policy rate by a further 25 basis points, to 5 per cent, at its next meeting in early May (Table 3).

The European Central Bank (ECB) is less advanced in this process, having only begun to increase rates late last year. Following the two 25 basis point increases over the past six months, current market expectations are for two further increases of 25 basis points over the next six months, which would lift rates to 3 per cent. Elsewhere in Europe, policy rates also continue to be normalised in Norway, Denmark, Sweden and Switzerland.

Graph 12

Current Balances at the Bank of Japan



Sources: Bank of Japan; Bloomberg

The Bank of Canada continued on the gradual tightening path which it commenced in 2004, raising rates twice since the last *Statement*, from 3½ to 4 per cent. Markets expect some further tightening over the next six months. In contrast, the markets expect the Bank of England and the Reserve Bank of New Zealand to leave rates unchanged at 4½ and 7¼ per cent respectively over the next six months.

In non-Japan Asia, policy rates also continue to be raised from historically low levels, with the central banks of China, Korea, Malaysia, Thailand and Taiwan each increasing rates since the last *Statement*. Nonetheless, real interest rates in Asia remain unusually low. In other emerging markets robust economic growth and concerns about inflation saw central banks in Chile and Israel increasing rates. However, rates were lowered in Brazil, Mexico, Poland and Turkey as inflationary pressures continued to ease.

Table 3: Changes in Monetary Policy

	Current level Per cent	Most recent change	Expectations for next 6 months
United States	4.75	Mar 06	↑ 50 bps
Euro area	2.50	Mar 06	↑ 50 bps
Japan	0.00	Mar 01	↑ 10–25 bps
United Kingdom	4.50	Aug 05	no change
Canada	4.00	Apr 06	↑ 25 bps
New Zealand	7.25	Dec 05	no change

Sources: central banks; Bloomberg; Reuters

Bond yields

After a prolonged period of below-average volatility, government bond yields have risen in all the major markets and are now noticeably above the ranges in which they had traded in 2005 (Graph 13). The main catalyst for this reassessment appears to be ongoing strength in the global economy and the prospect of simultaneous policy tightening in the major economies, with much of the increase being in real yields rather than in inflation expectations.

Yields on US 10-year government bonds, which had been in the range of 4 to 4½ per cent for much of the past 2 years, are currently trading above 5 per cent – the highest level since 2002. However, the yield curve has remained essentially flat over recent months, with long-term bond yields rising broadly in line with the increase in policy interest rates. In Japan, long-term

yields have been on an upward trend since the middle of last year, with the 10-year yield rising from around 1¼ per cent to be currently trading around 2 per cent – the highest since 1999 (Graph 14). The monetary policy announcement in March saw only a relatively modest increase in long yields but yields at shorter maturities rose more rapidly. In Germany long yields are now trading around 4 per cent, having been almost 3 per cent late last year.

As yet, the increases in policy interest rates and government bond yields have not had any effect on spreads on emerging-market and corporate debt, which remain at low levels by the standards of the past decade (Graph 15).

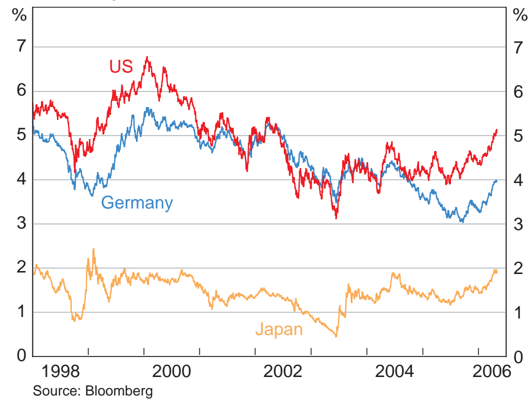
Equity markets

Global equity markets have continued to post steady gains since the last *Statement*, with the positive economic outlook being partially countered by the rise in global interest rates and oil prices (Table 4).

In the US, the S&P 500 has risen by 4 per cent since the last *Statement*, although it remains 14 per cent below its 2000 peak. Japanese equities have been particularly volatile over recent months, but on average have increased by similar amounts to US share prices since the last *Statement*. In April, the TOPIX reached a 15-year high, but remains 40 per cent below the 1989 peak. Equity markets reacted favourably to the BoJ's announcement that it was ending quantitative easing,

Graph 13

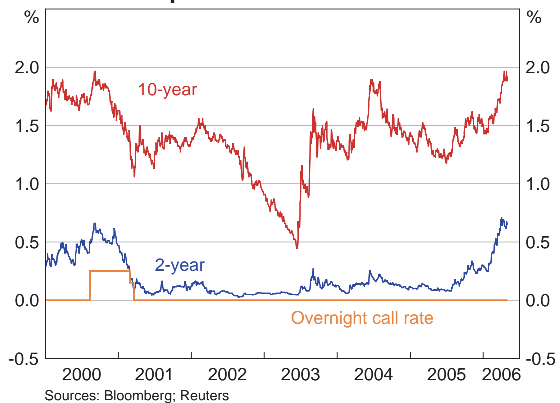
10-year Government Bond Yields



Source: Bloomberg

Graph 14

Japanese Interest Rates

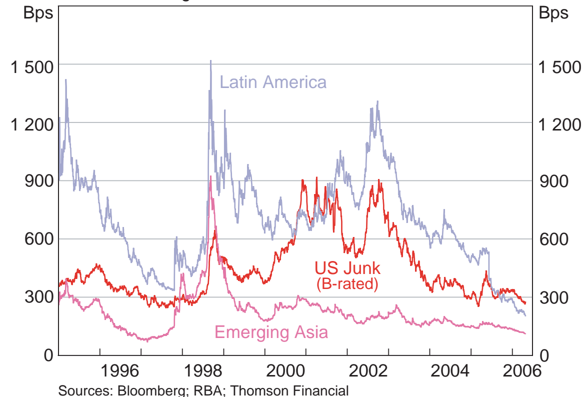


Sources: Bloomberg; Reuters

Graph 15

Market Spreads

To US government bonds, duration matched



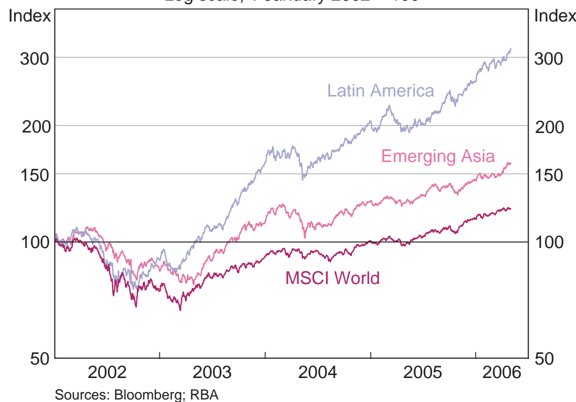
Sources: Bloomberg; RBA; Thomson Financial

Table 4: Changes in Major Country Share Prices

Per cent

	Since 2000 peak	Since 2003 trough	2005	Since previous *Statement*
United States				
– Dow Jones	–3	52	–1	5
– S&P 500	–14	64	3	4
– NASDAQ	–54	82	1	2
Euro area				
– STOXX	–22	120	23	5
United Kingdom				
– FTSE	–12	85	17	5
Japan				
– TOPIX	–1	125	44	3
Canada				
– TSE 300	8	97	22	5
Australia				
– ASX 200	56	95	18	8

Source: Bloomberg



interpreting it as validation of recent positive economic developments. European equity markets have performed particularly well since the trough of 2003, and this trend has continued throughout 2006.

The emerging markets of Asia and Latin America have on average recorded strong share price gains recently, in the order of 10 per cent each (Graph 16). Regulatory changes saw China's foreign-currency-denominated B shares, which are available to both foreign and domestic investors, rise strongly. Indonesian share prices also rose faster than average as the policy measures taken by the Indonesian Government after the sharp fall in the exchange rate last year have restored market confidence.

Exchange rates

The policy interest rate changes announced by major central banks in recent months have not had much impact on exchange rates between the major currencies. However, recently the US dollar has depreciated against the major currencies to be at the bottom of the range it has traded over the past year or so (Graph 17, Table 5).

The impact of recent monetary policy changes in the major economies has been felt mainly by a number of other currencies. Two of the biggest changes have been in the New Zealand dollar and the Icelandic krona. The background to this is that over the past 2–3 years, very low short-term interest rates in a number of countries such as Japan and Switzerland had seen investors borrow money in these countries to buy assets in countries where interest rates were higher. A disproportionate amount of this money had gone to New Zealand and Iceland, due to their particularly high interest rates.

This so-called 'carry trade' sought to benefit from the interest rate differential between the two currencies, though it faced the risk of foreign exchange losses if the currency in which the funds were borrowed were to appreciate. As such, the Japanese monetary announcement triggered a sharp reversal of these flows because investors feared that the yen might appreciate, resulting in currency losses which could easily more than offset the return from the interest differential. While a range of currencies, including the Australian dollar (see below), were affected by this, the most heavily affected were the New Zealand dollar and Icelandic krona. Both had appreciated sharply previously, and the subsequent exodus of capital saw these currencies fall by about 15 per cent in a matter of a few weeks (Graph 18). In the case of the New Zealand dollar at least, this simply restored a more normal level to the currency and has generally been seen as a welcome development by the authorities.

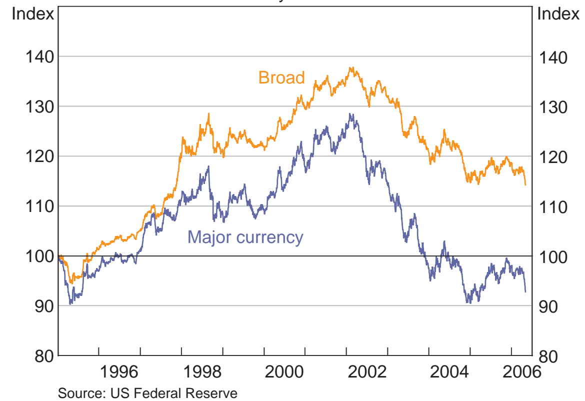
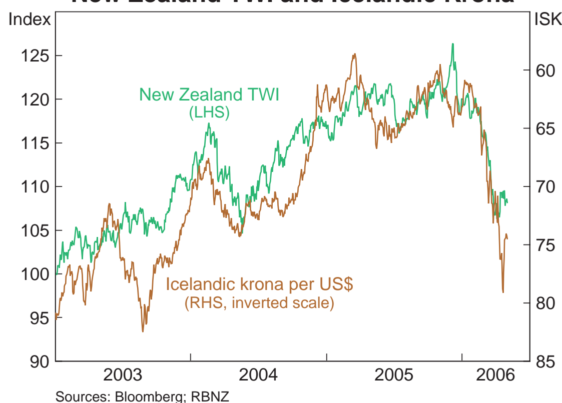
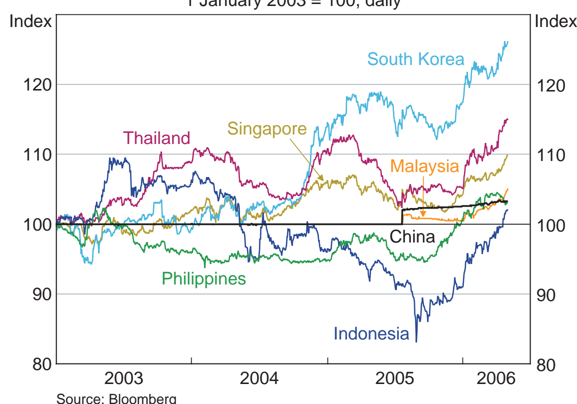


Table 5: Change in US Dollar against Other Currencies

	Since USD peak Jan 2002	2005	Since last *Statement*
South Africa	–48	12	–1
New Zealand	–34	5	6
Australia	–33	6	–3
Euro area	–32	14	–5
Sweden	–31	19	–4
Canada	–31	–3	–3
South Korea	–29	–2	–3
Switzerland	–28	15	–5
United Kingdom	–23	11	–5
Indonesia	–16	6	–5
Thailand	–15	5	–5
Japan	–15	15	–5
Brazil	–15	–12	–5
Singapore	–14	2	–3
Taiwan	–9	3	–2
India	–7	4	1
Malaysia	–5	–1	–3
China	–3	–2	0
Philippines	1	–6	0
Mexico	20	–5	5
Majors TWI	–28	8	–5
Broad TWI	–17	3	–3

Source: RBA





Asian exchange rates generally have risen modestly against the US dollar recently, continuing a trend that has been evident since late 2005 (Graph 19). This reflects favourable economic conditions in Asia and reduced intervention by the authorities to slow the pace of appreciation (with the exception of China).

The pace of appreciation of the Chinese exchange rate picked up on average in the past three months, with the renminbi rising by half a per cent against the US dollar over the period, although in recent weeks the currency has depreciated slightly. The cumulative appreciation since the July 2005 revaluation now amounts to 1¼ per cent. Foreign exchange intervention by the authorities has remained heavy, with US$21 billion added to reserves in March, bringing the cumulative increase in 2006 to date to US$56 billion. As a result China's official reserves now surpass Japan's. Pricing in the non-deliverable forward market suggests that markets expect the renminbi to be around 4 per cent higher in twelve months' time, which is in line with the average expectation since last year's revaluation.

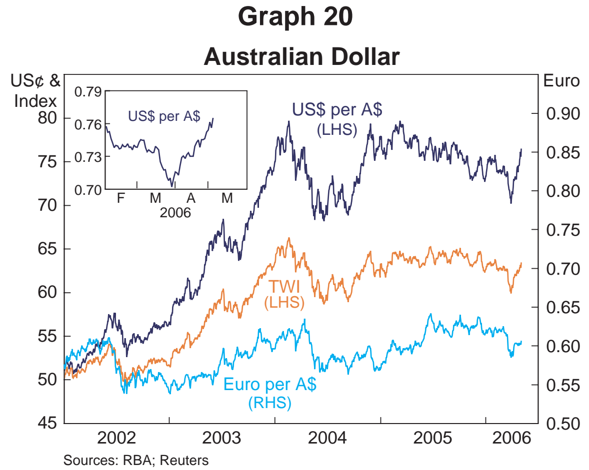
Latin American currencies have also generally appreciated modestly against the US dollar since the last *Statement*, supported by generally favourable economic conditions in the region and ongoing strength in commodity prices. The main exception had been the Mexican peso, which has depreciated by around 5 per cent in part reflecting a declining interest differential with the US.

Australian dollar

Since the last *Statement* the Australian dollar has experienced two broad movements: a relatively sharp decline in late March, followed by a similarly sharp rise in April (Graph 20). The move lower in March was part of the global unwinding of carry trades (see above) and saw the Australian dollar fall to its lowest levels since September 2004, both in trade-weighted terms and against the US dollar. While sizeable, the move was much smaller than that experienced by the New Zealand dollar at that time, resulting in a sizeable appreciation against the latter currency (Graph 21). The subsequent appreciation in April was underpinned by a sequence of stronger-than-expected domestic economic data releases and resurgence in global commodity markets, with the appreciation particularly marked against the US dollar given that currency's recent decline.

Graph 20

Australian Dollar

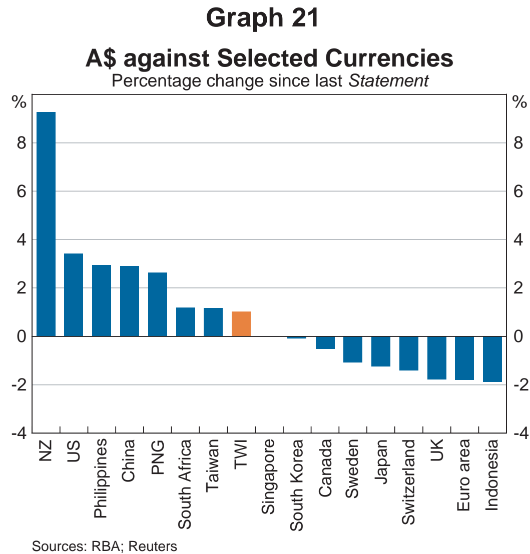


Sources: RBA; Reuters

Graph 21

A$ against Selected Currencies

Percentage change since last *Statement*



Sources: RBA; Reuters

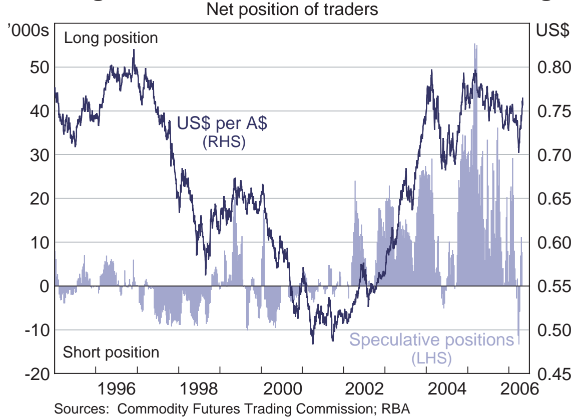
Speculative positions in Australian dollar futures on the Chicago Mercantile Exchange provide an indication of investor sentiment towards the Australian dollar. The net long positions that had been held through most of 2005 and early 2006 were unwound over February and March, with positioning moving to record net short levels in late March (Graph 22). However, sentiment swung back in April, with small net long positions held by speculators. The relatively large movements in the Australian dollar over March and April caused volatility measures of the currency to rise to their highest level in over a year (Graph 23).

Australian dollar Eurobond issuance has remained at relatively modest levels in recent months. With increased levels of redemptions, net issuance has become negative, which may have weighed on the Australian dollar recently. Redemptions scheduled for coming months also generally exceed recent issuance levels.

Graph 22

Trading in Australian Dollar Futures in Chicago

Net position of traders

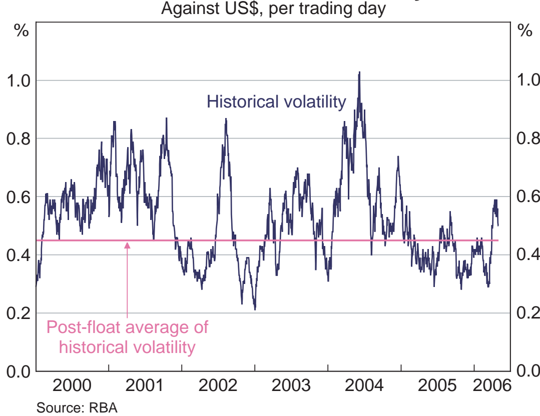


Sources: Commodity Futures Trading Commission; RBA

Graph 23

Australian Dollar Volatility

Against US$, per trading day

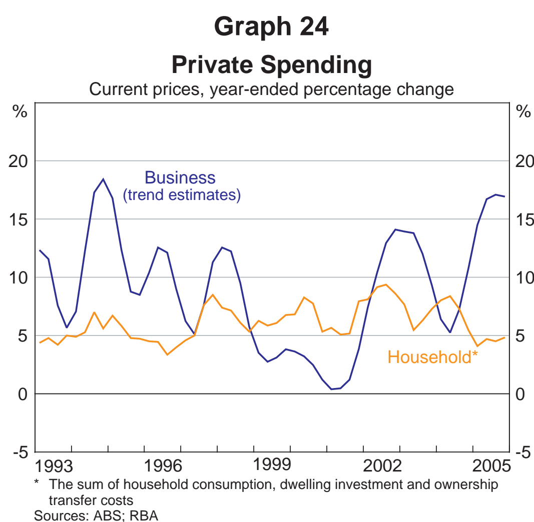


Source: RBA

With foreign exchange reserves at a relatively comfortable level and the Australian dollar only a little above its longer-run averages, over recent months the Bank only purchased sufficient foreign exchange to cover sales to the Government. Net reserves therefore have not changed much apart from valuation effects, and currently stand at $29¼ billion. The Bank's holdings of foreign exchange under swap agreements have increased over recent months to $35 billion, as the Bank has made substantial use of these instruments to help manage domestic liquidity conditions.

Domestic Economic Conditions

GDP growth in the Australian economy is estimated to have been 2.7 per cent over 2005 (Table 6). While this was somewhat below trend, there were broad-based increases in the prices of resource commodities over the year, which were reflected in a 13 per cent increase in the terms of trade. As a result, Australia's income grew strongly, with real GDP adjusted for the terms of trade rising by 5.2 per cent over the year. Growth in demand continued to run ahead of that in production. Domestic spending was characterised by strong growth in business investment, and relatively subdued growth in household spending, following the levelling out of house prices (Graph 24). Growth in household consumption was relatively moderate and there was a fall in dwelling investment. Growth in the resource-intensive states of Western Australia and Queensland continued to outpace that in the rest of the country (see 'Box B: Regional Economic Performance').



* The sum of household consumption, dwelling investment and ownership transfer costs

Sources: ABS; RBA

More timely data suggest reasonably buoyant conditions in the early months of 2006. The available indicators of household consumption picked up in the first months of the year, and businesses have continued to report

Table 6: Demand and Output

Percentage change

	March qtr 2005	June qtr 2005	September qtr 2005	December qtr 2005	Year to Dec qtr 2005
Domestic final demand	0.2	2.1	0.6	1.4	4.4
Change in inventories[(a)]	0.7	–0.2	–0.1	–0.3	0.1
GNE[(b)]	0.8	1.3	0.6	0.9	3.6
Net exports[(a)]	–0.1	–0.1	–0.4	–0.5	–1.1
GDP	0.7	1.3	0.3	0.5	2.7
Memo item:					
Real GDP adjusted for changes in terms of trade	1.1	2.5	0.6	0.9	5.2

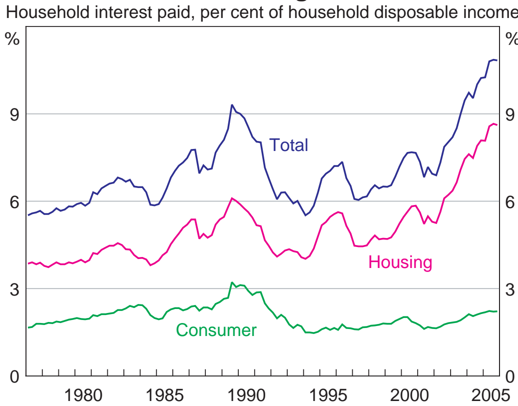
(a) Contributions to GDP growth

(b) Includes the statistical discrepancy

Source: ABS

Graph 25

Debt-servicing Ratio*

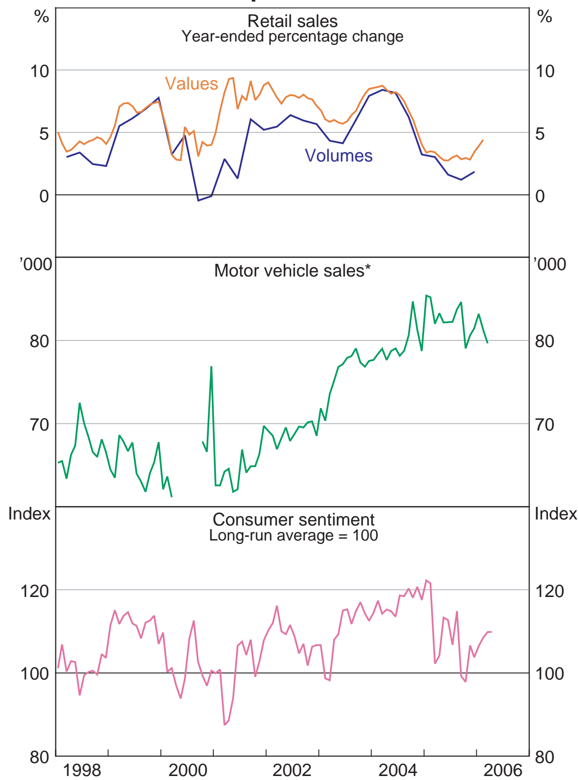


* Household sector excludes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments. Includes imputed financial intermediation service charge.

Sources: ABS; RBA

Graph 26

Consumption Indicators



* Break indicates period affected by introduction of the GST

Sources: ABS; Melbourne Institute and Westpac

healthy conditions, with profitability and capacity utilisation at high levels. Looking ahead, domestic demand is expected to grow at a solid pace, although somewhat slower than the rate recorded last year. Growth in household consumption and a gradual turnaround in dwelling investment should offset some easing in the recent rapid growth in business investment. A recovery in exports growth is also anticipated, supported in part by new productive capacity in the resources sector.

Household sector

For much of 2005, households were more cautious in their spending than in preceding years. Household consumption increased by 0.7 per cent in the December quarter 2005 and by 2.9 per cent over the year, somewhat below the growth in real household incomes and well down from the higher rates seen during the period of rapid house price increases. The somewhat more cautious attitude on the part of households was reflected in a slowing in the growth of household debt. The debt-servicing ratio was broadly flat in the December quarter, at 10.8 per cent (Graph 25).

More recently, there were signs of a strengthening in spending in early 2006, with retail sales up by 1.6 per cent in the three months to February and 4.6 per cent higher over the year (Graph 26). Motor vehicle sales increased by 1.2 per cent in the March quarter compared with

the December quarter. Consumer sentiment, as measured by the Westpac-Melbourne Institute survey, has also risen in recent months and is currently above its long-run average level.

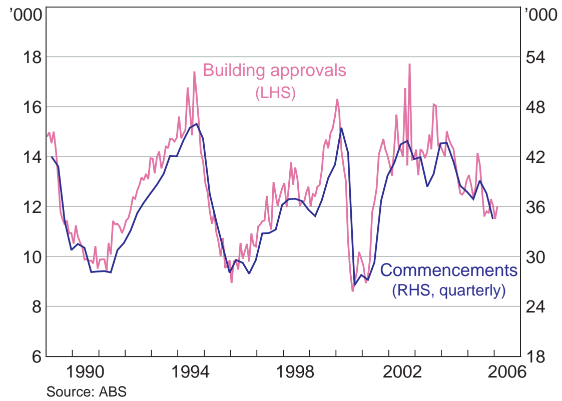
Housing

Construction

Housing construction activity has continued to decline. Dwelling investment fell by 2.7 per cent in the December quarter, bringing the fall since the peak in early 2004 to 7 per cent. The decline reflected a fall in investment in new dwellings; expenditure on alterations and additions was broadly flat in the quarter. Available indicators of housing activity point to further falls in the first half of 2006. The number of dwelling commencements fell by 8 per cent in the December quarter, mostly due to a sharp decline in medium-density dwellings, while the number of private residential dwelling approvals was down 0.8 per cent for the three months to February compared with the previous three months (Graph 27).

Graph 27

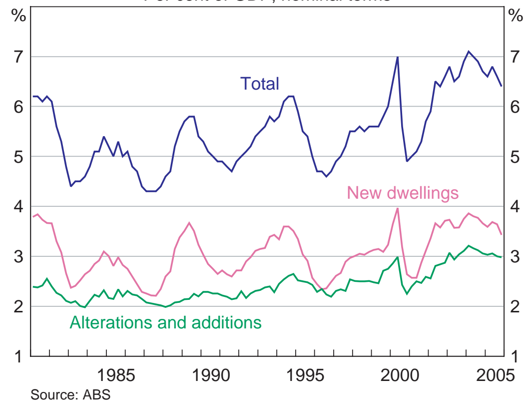
Housing Construction



Graph 28

Dwelling Investment

Per cent of GDP, nominal terms

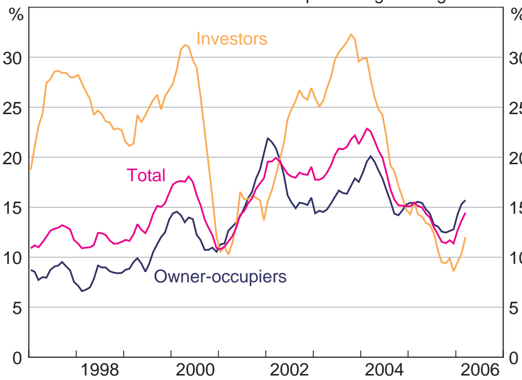


Nonetheless, the data continue to suggest that the current downturn has been comparatively mild by historical standards and dwelling investment as a share of GDP has remained high (Graph 28). This reflects both the increase in the relative price of housing construction over recent years and shifts towards larger and higher-quality dwellings, with a one-quarter increase in the average size of new houses and a rise in the importance of expenditure on alterations and additions to existing dwellings over the past decade.

Graph 29

Housing Credit Growth*

Six-month-ended annualised percentage change



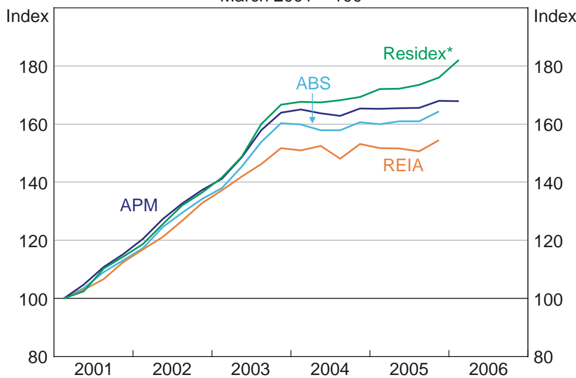
* Growth rates for investors and owner-occupiers are estimated from bank data prior to April 2003 and from on-balance sheet loans of all financial intermediaries thereafter; includes securitised loans.

Source: RBA

Graph 30

Australian House Prices

March 2001 = 100



* Excludes Adelaide

Sources: ABS; APM; RBA; REIA; Residex

Financing and prices

Housing finance has shown a modest pick-up in recent months. The value of housing loan approvals increased by 2.9 per cent in the three months to February to reach $14.6 billion, with growth in both the owner-occupier and investor components. Housing credit grew at an annualised rate of 14.5 per cent over the six months to March, up from 11.5 per cent over the six months to September (Graph 29). This reflected a pick-up in the owner-occupier component, although the slowdown in investor credit growth also appears to have abated.

Conditions in the established housing market have firmed modestly (Graph 30, Table 7). The APM composition-adjusted measure of nationwide house prices was flat in the March quarter and increased by 1.7 per cent over the year. The various measures suggest house prices have generally stabilised in most capital cities, but continue to increase strongly in Perth. Recent auction clearance rates in Sydney and Melbourne have been around their highest levels of the past two years, although they remain well below the peaks seen earlier in the decade. Residential rental markets have also been tightening, with rents rising and the nationwide vacancy rate around its lowest level since the late 1980s. REIA data suggest nationwide rents increased by 6.8 per cent over the year to the December quarter, while the ABS series indicated growth of 2.8 per cent over the year to the March quarter.

Business sector

Most business surveys indicate that overall conditions in the first quarter of 2006 were at or above long-run average levels, but below the high levels recorded in 2004 (Graph 31). The NAB survey of the non-farm sector reported that business conditions improved in the March

Table 7: House Prices
Percentage change

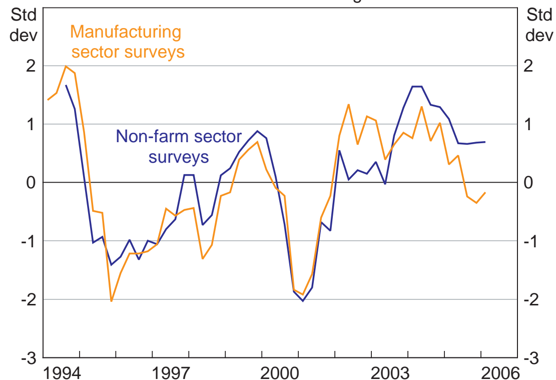
	APM		REI		Residex		ABS
	Mar qtr 2006	Year to Mar qtr	Mar qtr 2006	Year to Mar qtr	Mar qtr 2006[(a)]	Year to March	Year to Dec qtr 2005
Sydney	–1.1	–3.8	..	..	–2.2	–3.5	–3.9
Melbourne	–1.1	0.9	–3.1	4.2	5.9	5.5	2.9
Brisbane	–1.1	0.5	..	..	1.7	4.9	3.5
Adelaide	1.7	3.4	–0.1	2.7	..	..	3.4
Perth	5.4	24.8	..	..	10.1	24.4	22.5
Canberra	–0.6	1.4	..	..	5.0	7.5	0.8
Australia	–0.1	1.7	..	..	3.4[(b)]	5.8[(b)]	2.3

(a) Three-month-ended
(b) Excludes Adelaide, Hobart and Darwin
Sources: ABS; APM; state REIs; RBA; Residex

quarter, and that capacity utilisation remained around a historically high level (Graph 32). Generally positive business conditions were reported in most other surveys, such as the Sensis and St. George-ACCI surveys. Liaison indicates that activity in the services sector has been especially strong, particularly in industries supplying services to businesses.

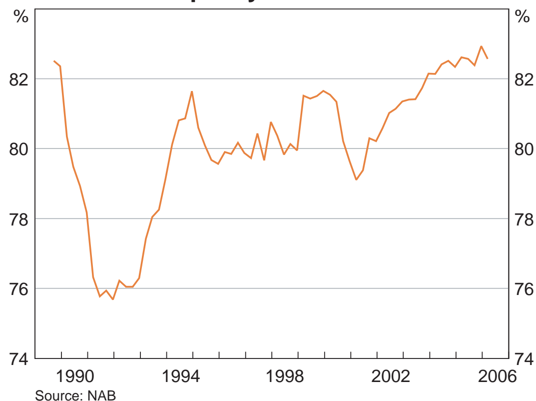
Conditions in the manufacturing sector continue to be weaker than in the rest of the economy. The AIG's quarterly manufacturing survey indicates that activity strengthened a little in the March quarter, but remains below long-run average levels, while the ACCI-Westpac survey shows business conditions in the manufacturing sector were around long-run average levels. Liaison suggests that reduced export competitiveness and intense import competition are inhibiting output growth for some trade-exposed manufacturers, while those geared

Graph 31
Actual Business Conditions*
Deviation from average



* Weighted average of data from various business surveys, with weights determined by the principal component method
Sources: ACCI; ACIL Tasman; AIG; NAB; Sensis; St. George Bank; Westpac

Graph 32
Capacity Utilisation

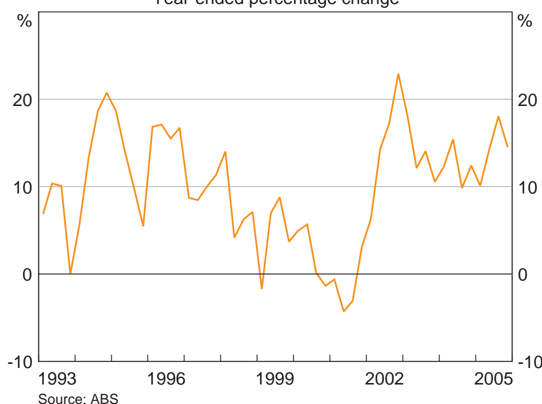


Source: NAB

towards local markets have been affected by the slowing of the housing cycle and more modest pace of household spending.

The overall outlook for farm output remains positive. The summer crop harvest is likely to have increased sharply from last year, particularly for cereals, and favourable weather conditions are enabling livestock producers to rebuild herds. Cyclone Larry, which struck north Queensland in mid March, is expected to have reduced national sugar cane production by around 10 per cent and banana production by around 90 per cent, as well as affecting some other crops. However, these crops are a relatively small share of Australia's overall farm output.

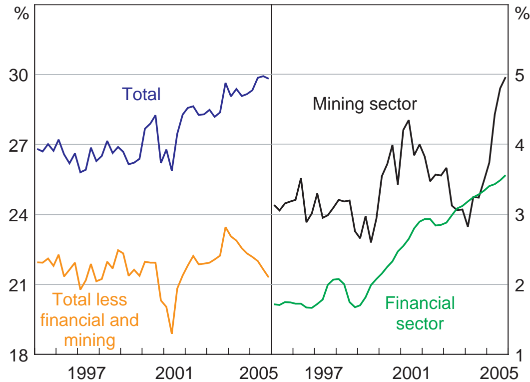
Business investment has been strong for several years, buoyed by the high level of capacity utilisation and a favourable funding environment due to high profitability and relatively low borrowing interest rates. Business investment increased by 14.5 per cent over 2005 and by 4.3 per cent in the December quarter, driven by strong growth in machinery & equipment investment and engineering construction (Graph 33). Growth in capital spending over 2005 was particularly rapid for resource-related industries, although strong increases were also recorded across a range of other industries.



The outlook for business investment is favourable, given the good prospects for growth in the domestic and world economies. Although the December quarter capital expenditure (Capex) survey suggested a relatively subdued outlook for the period ahead, recent experience has been that the profile presented in the Capex survey has been significantly upgraded as the year has progressed. Accordingly, machinery & equipment investment growth is likely to be solid, but possibly slower than the pace recorded in 2005. The latest Rabobank survey suggests that investment intentions for farm equipment (which are not covered in the Capex survey) remain strong, at close to their pre-drought levels. Forward-looking indicators of non-residential construction also suggest a high level of activity over coming quarters, following the upswing over the past year. Non-residential building commencements increased in the December quarter, and the amount of work approved continues to run well above the current level of work done. Engineering construction activity has been supported by the large amount of resource-related work underway, particularly in Western Australia.

Business profitability has been strong, with total private-sector profits – measured by corporate gross operating surplus plus gross mixed income – increasing by 10 per cent over 2005. The profit share has increased to around 30 per cent of GDP, its highest level for more

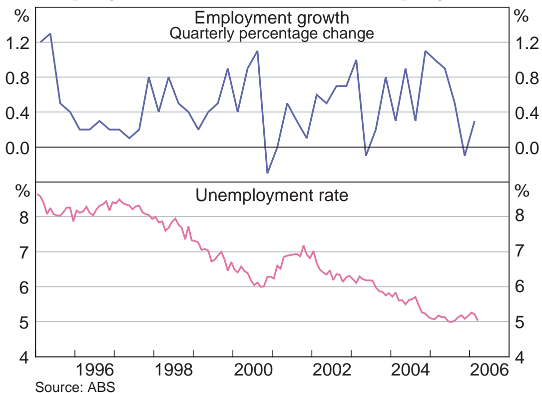
than 30 years (Graph 34). In the corporate sector, both financial and non-financial enterprises posted strong earnings growth over 2005. Aggregate corporate profit growth was driven by the mining industry, reflecting the strength in commodity prices. Profit growth in the non-mining non-financial corporate sector was less strong. Profits of unincorporated enterprises – which comprise a little less than one-third of total private-sector profits – have also been relatively weak.



Labour market

Employment growth resumed in early 2006, following a pause in the second half of 2005. Employment increased by 0.3 per cent over the three months to March and by 1.6 per cent over the year. More generally, labour market conditions remain strong; the participation rate has been at a high level of 64.4 per cent for the past six months, and the unemployment rate has stayed within the 5 to 5¼ per cent range for the past year and a half (Graph 35).

Over the year to the March quarter, employment growth was mainly concentrated in the construction and services sectors, with growth in the property and business services sector particularly strong. Employment growth in the wholesale, retail and manufacturing industries was weaker. Labour market conditions are favourable across all states, and unemployment rates are generally close to the national average (Table 8).



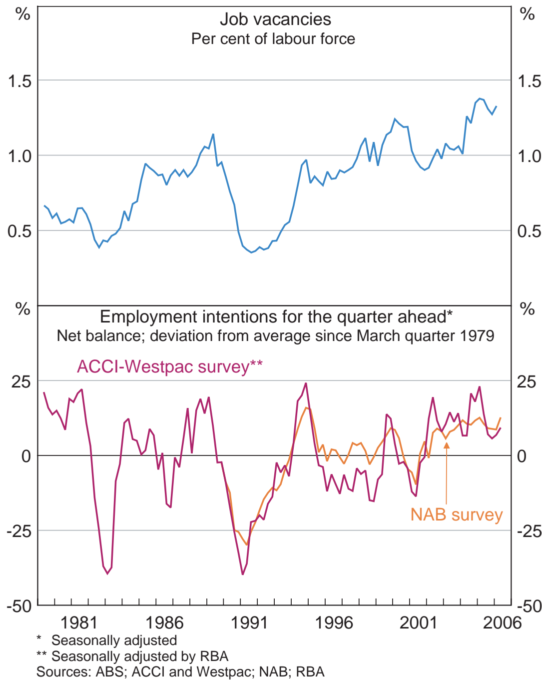
Survey-based indicators and vacancy data suggest that labour market demand has strengthened recently and that labour supply remains relatively tight. The ABS measure of job vacancies shows a nationwide vacancy rate of 1.3 per cent, around its highest level for over 25 years (Graph 36). In addition, the ACCI-Westpac survey of manufacturers and the NAB survey suggest that hiring intentions increased in the March quarter, and remain well above long-term average levels.

Table 8: Labour Market by State

Per cent

	Employment growth		Unemployment rate	
	March qtr 2006	Year-ended March qtr 2006	March qtr 2005	March qtr 2006
NSW	0.2	1.2	5.3	5.3
Victoria	0.4	1.3	5.5	5.3
Queensland	0.4	1.7	4.6	5.3
WA	0.8	3.7	4.8	4.1
SA	0.2	1.3	5.4	5.2
Tasmania	0.1	2.9	5.7	6.5
Australia	0.3	1.6	5.1	5.2

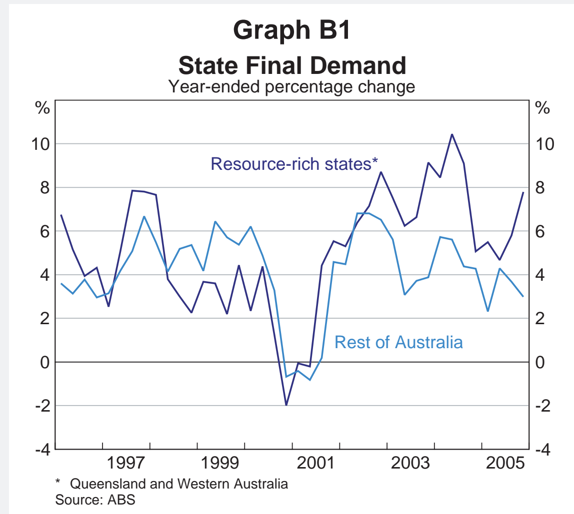
Source: ABS



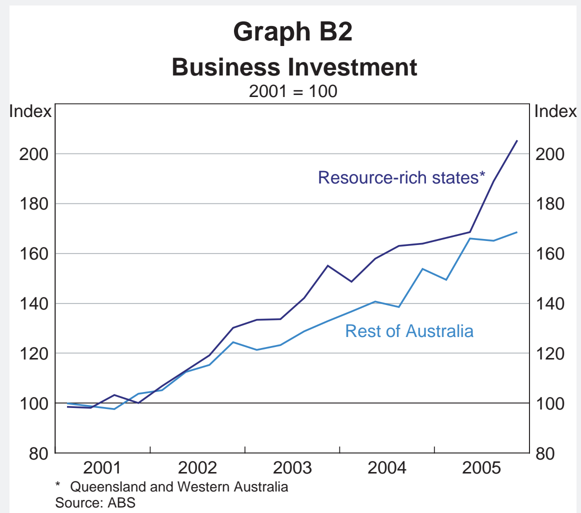
However, these surveys also show an increase in the proportion of firms having difficulty finding suitable labour, and employers note that this difficulty remains a key factor constraining their output. Liaison indicates that, while labour shortages are broad-based across industries and skill levels, these shortages are most pronounced among skilled workers in the non-residential construction and resources sectors, and in much of the business services sector.

Box B: Regional Economic Performance

Over the past few years, economic activity has been strongest in the resource-rich states of Western Australia and Queensland, while in other states it has eased noticeably (Graph B1). Two main factors have contributed to this disparity. First, resource-rich states have most directly benefited from the sharp increase in world commodity prices in recent years. Second, the earlier run-up in house prices resulted in reduced housing affordability in the larger states; in the case of New South Wales, this has contributed to an outflow of migrants that has slowed the pace of economic output in that state.



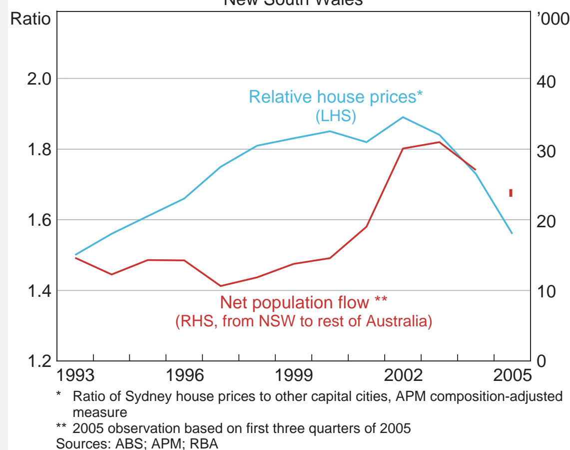
All the states have benefited from the recent commodity price increases through multiplier effects across the whole economy, dividend distributions from resource companies to domestic shareholders, and other channels.[1] However, the stimulus to activity has been strongest in the resource-rich states of Western Australia and Queensland where mining accounts for a larger share of output. Activity in the more manufacturing-oriented states such as Victoria and South Australia has been more subdued, in part because the large increases in commodity prices have been associated with a period where the exchange rate has been above its post-float average.



During the past year, the faster growth in the resource-rich states has owed largely to strength in business investment (Graph B2), reflecting strong growth in mining-related

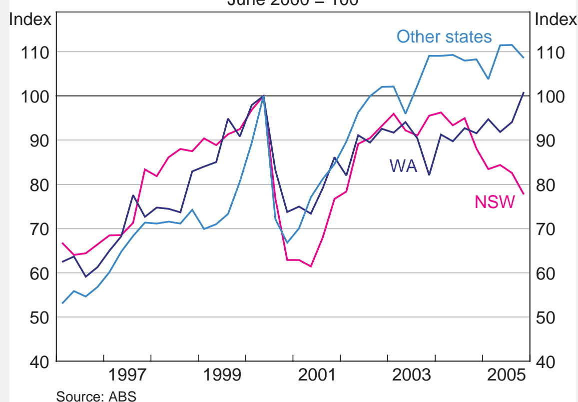
1 *See 'Commodity Prices and the Terms of Trade', Reserve Bank of Australia* Bulletin, *April 2005, pp 1–7 for a more detailed discussion of the channels through which an increase in the terms of trade stimulates activity.*

Graph B3
House Prices and Migration
New South Wales



* Ratio of Sydney house prices to other capital cities, APM composition-adjusted measure
** 2005 observation based on first three quarters of 2005
Sources: ABS; APM; RBA

Graph B4
Dwelling Investment
June 2000 = 100



Source: ABS

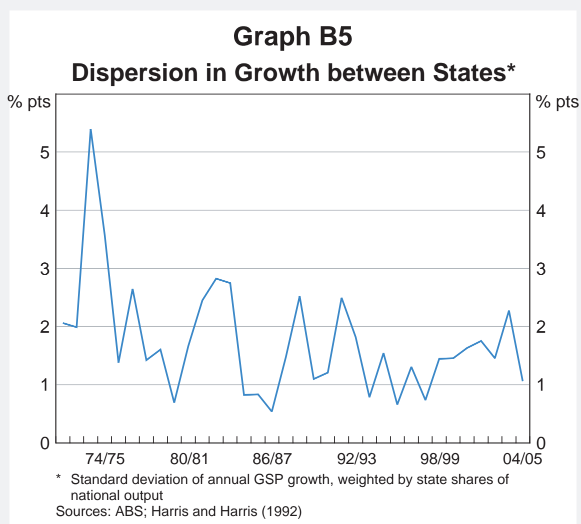
engineering construction. In addition, domestic demand in the resource-rich states has been boosted by buoyant consumption growth, which has been weaker in other states.

Differing trends in house prices and in dwelling investment have also accentuated the recent divergences across states. During the house price boom, prices grew most in Sydney, with prices at one point almost 90 per cent higher than the average level in other capitals. This contributed to population outflows to regions where housing was relatively more affordable and economic activity was stronger (Graph B3). The resulting slowdown in population growth in New South Wales reduced growth in consumption and contributed to a fall in dwelling investment in that state. In contrast, dwelling investment has continued to expand in Western Australia and has been broadly stable in the rest of the country (Graph B4). However, the population outflow from New South Wales now appears to have slowed, possibly reflecting the fact that house price relativities between Sydney and the other capitals have moved back towards pre-boom levels.

Consistent with these developments, Western Australia and Queensland have experienced strong growth in employment, while employment in the largest states has expanded more modestly. The sustained strength in employment growth in the resource-rich states has seen their unemployment rates fall substantially. However, in part reflecting the equilibrating role of migration between states, there has been broad similarity in movements in unemployment rates in all the states over the course of the current economic expansion.

Finally, despite the differences in the economic circumstances faced by the states, the extent of the recent divergences in the growth performance of states is not unusually large. Much

larger divergences – as measured by dispersion in the growth rate of annual gross state product (GSP) – have occurred in earlier periods, as states entered and exited national recessions at different times, and during the terms of trade shocks of the 1970s (Graph B5).[2] ☧



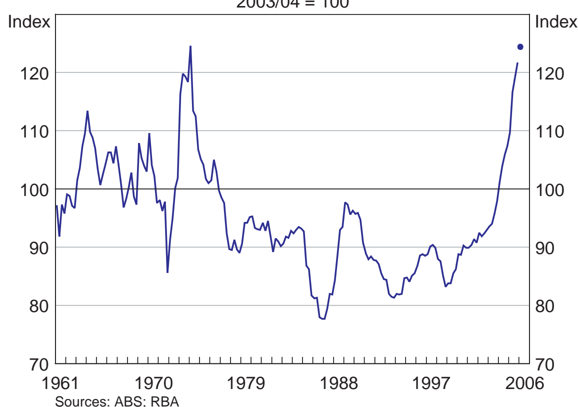
* Standard deviation of annual GSP growth, weighted by state shares of national output
Sources: ABS; Harris and Harris (1992)

2 *Data for the 1980s are from Harris CP and D Harris (1992), 'Interstate differences in economic growth rates in Australia, 1953–54 to 1990–91',* Economic Analysis and Policy, *22(2), pp 129–148.*

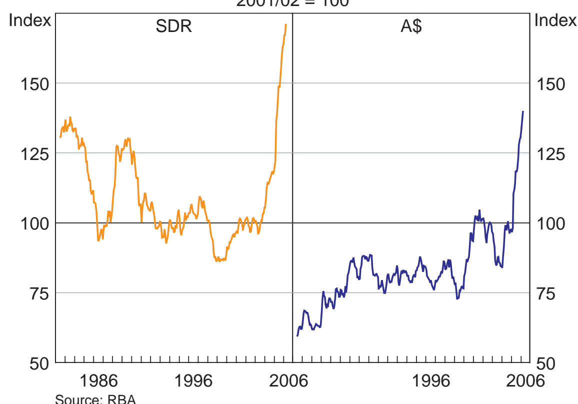
Foreign Trade and Capital Flows

Commodity prices and the terms of trade

Australia's terms of trade rose sharply over 2005, and they are likely to have increased by a further 2 per cent in the March quarter (Graph 37). They have increased by more than 30 per cent over the past three years, and are probably now just above the peak in the early 1970s, to reach their highest level since the wool boom of the early 1950s. This dramatic upswing has been mostly driven by substantial rises in the prices of Australia's commodity exports, supported by strong growth in the global economy. The RBA index of commodity prices (ICP) increased by 6 per cent over the three months to April, and by 26 per cent over the year, to be at its highest level since 1982, when the series commenced (Graph 38 and Table 9).



Although there has been broad-based strength in commodity markets, the most recent increase in the ICP has been mainly driven by the exceptional strength in base metals prices. The base metals index increased by 22 per cent over the three months to April. The recent rise partly reflected higher global portfolio allocations to commodities and speculative demand, particularly in the case of the 15 per cent run-up in the month of April. However, fundamental factors such as robust global demand, supply disruptions and low inventory levels are also supporting prices, particularly for copper and zinc.



Contract prices for coal and iron ore for the 2006/07 year (beginning April) had not been settled at the time this *Statement* was being finalised in early May. However, based on forecasts

Table 9: Commodity Prices
Percentage change; SDR

	Three months to April 2006	Year to April 2006
RBA Index	5.8	26.5
Rural	3.5	16.1
– Wheat	10.9	29.1
– Beef & veal	–2.9	0.0
– Wool	6.7	–1.5
Base metals	21.5	56.2
– Aluminium	9.8	44.2
– Copper	34.6	96.4
– Nickel	23.0	16.2
Other resources	1.8	21.8
– Coking coal[a]	–4.7	95.0
– Steaming coal[a]	–4.8	6.6
– Iron ore[a]	–4.1	66.2
– Gold	10.9	48.3
Memo item		
Oil in US$[b]	6.6	31.3

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

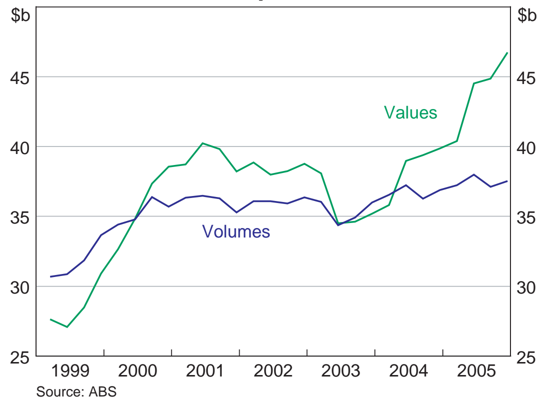
of price settlements, the new contract prices should be broadly neutral in aggregate for the ICP. (For further details, see 'Box C: Commodity Contract Prices and Trade'.) Rural commodity prices rose by 3 per cent over the past three months, reflecting higher prices for sugar, wheat and wool. The price of sugar has been supported by high oil prices and an expected supply shortfall in 2006, which has been exacerbated by crop damage in Queensland from Cyclone Larry. Sugar prices are related to those for oil because of sugar's role in ethanol production, a substitute for petrol.

The terms of trade are likely to remain strong over the coming year. In the June quarter, expected increases in iron ore contract prices, as well as the sharp increases in metals and fuel prices through April, are likely to more than offset falls in contract prices for coal. Further ahead, expansion in global supply capacity for resources will probably, over time, tend to put downward pressure on their prices. Together with moderate growth in import prices, this is likely to result in some cyclical weakening in the terms of trade in due course. However, for at least the next year or so, the terms of trade are expected to remain at exceptionally high levels.

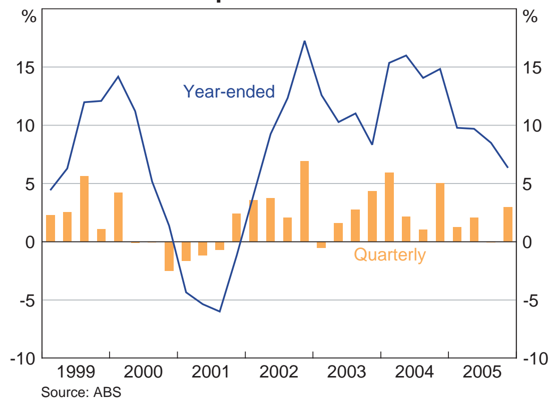
International trade

The subdued growth in Australia's export volumes over 2005 has in part been a signal of tight supply capacity. As a consequence, the 17 per cent increase in export earnings over the year was almost entirely due to rapid growth in resource export prices, which lifted resource export earnings by 40 per cent (Graph 39). Growth in resource export volumes was relatively sluggish, partly because of a number of episodes of disruption to coal, oil and LNG exports. Similarly, resource export volumes look to have fallen in the March quarter, due to precautionary shutdowns and some delays to resource export operations due to cyclones in Western Australia. These disruptions added to the recent volatility of monthly trade data and highlight the sensitivity of mining production when the industry has little spare capacity. Nonetheless, strong world demand and expansions in production capacity make for a positive growth outlook for resource export volumes over the remainder of 2006. In particular, shipments of LNG from the new Darwin compression plant commenced in February, and additional LNG shipments from the North-West Shelf are due to have commenced in the June quarter.

Earnings from manufactured exports increased by around 8 per cent over 2005, mostly reflecting solid growth in volumes in the middle of the year. More recently, export volumes appeared to have been relatively soft in early 2006. Strong global demand for raw materials has benefited resource-related manufactured exports, but reduced competitiveness with imports has encouraged some firms in the automotive sector to shift manufacturing operations offshore. Rural export earnings fell by around 3 per cent over 2005, as higher prices only partly offset broad-based falls in export volumes. The overall outlook for rural exports in 2006 is nonetheless positive, given above-average global prices, the large winter crop harvest in late 2005, and early indications of a large increase in summer crop production in 2006. The value of services exports increased solidly in January and February, to be 5 per cent higher over the year. The staging of the Commonwealth Games will have provided a boost in the March quarter. However, as noted in previous *Statements*, services exports are being dampened by declining average visitor expenditure and the increasing competition from foreign airlines.



The demand for imports slowed noticeably over 2005, in line with the more restrained pace of domestic spending (Graph 40). However, import volumes appear to have risen solidly in the March quarter, to be around 8 per cent higher over the year. Trends across the components of imports have been broadly consistent with the recent pattern of domestic spending; the value of capital goods imports increased by around 20 per cent over the year to March, in line with the favourable conditions for machinery & equipment investment. Fuels & lubricants imports have surged since the beginning of 2006, partly because some of the LNG production in the Timor Sea is being treated as an import before being re-exported.



Some categories of imports have been boosted, and some types of exports reduced, by the elevated level of the exchange rate in recent years. Compared to the level of the terms of trade, however, the exchange rate is much lower than earlier relationships would have suggested

(Graph 41). This implies that, notwithstanding effects on areas of manufacturing, the exchange rate is not providing much of an offset to the stimulatory effects of the terms of trade on the economy as a whole.

Current account

The net income deficit (NID) widened to 4.2 per cent of GDP in the December quarter 2005, the highest level in over a decade (Graph 42). While there has been a rise in interest payments on debt owed abroad, the bulk of the recent movement reflects strong profitability of enterprises operating in Australia, mainly in the resources sector. Since the resources sector has a relatively high degree of foreign ownership, some of these higher profits accrue to foreign investors, and are thus recorded in the balance of payments statistics. With business investment rising strongly over the past couple of years, but corporate and government saving also increasing, the national saving–investment gap appears to have changed little. The total current account deficit remains around 6 per cent of GDP (Graph 43).

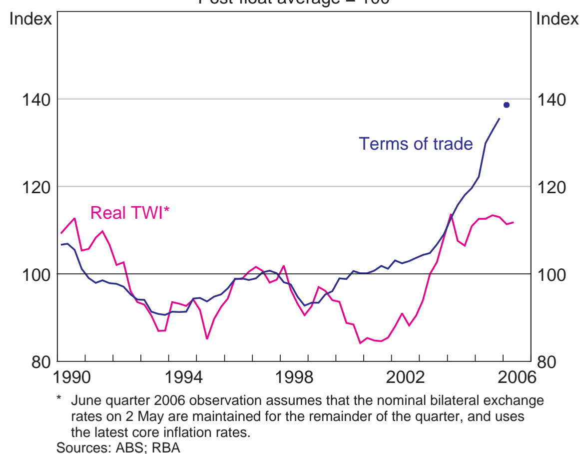
Capital account

Strong demand from foreign investors for Australian assets has driven continued strong gross capital inflows in recent quarters. Given the net inflow of capital of around 6 per cent of GDP during the past year, Australian net foreign liabilities in nominal terms have risen as a ratio to GDP. Relative to the value of Australia's private-sector wealth, however, net foreign liabilities are

Graph 41

Real Exchange Rate and Terms of Trade

Post-float average = 100

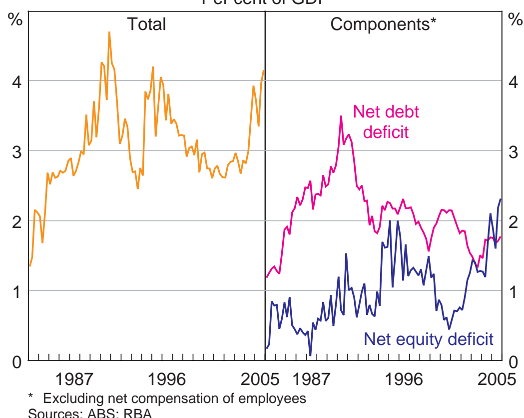


* June quarter 2006 observation assumes that the nominal bilateral exchange rates on 2 May are maintained for the remainder of the quarter, and uses the latest core inflation rates.
Sources: ABS; RBA

Graph 42

Net Income Deficit

Per cent of GDP

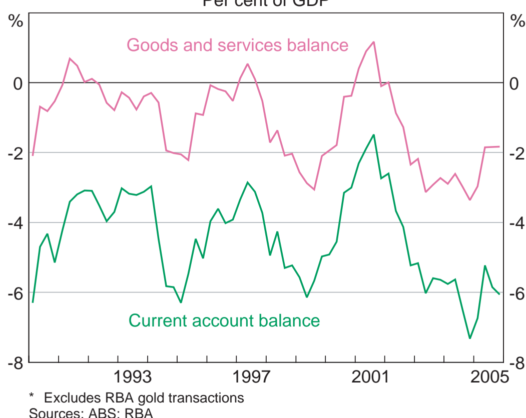


* Excluding net compensation of employees
Sources: ABS; RBA

Graph 43

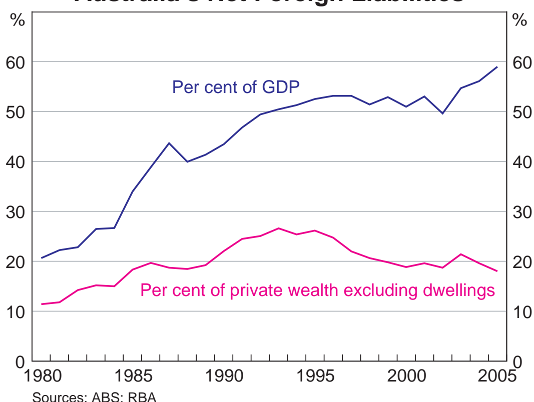
Balance of Payments*

Per cent of GDP



* Excludes RBA gold transactions
Sources: ABS; RBA

little changed since the late 1990s, at slightly below 20 per cent. This ratio has been broadly stable in recent years at a lower level than in the first half of the 1990s (Graph 44).

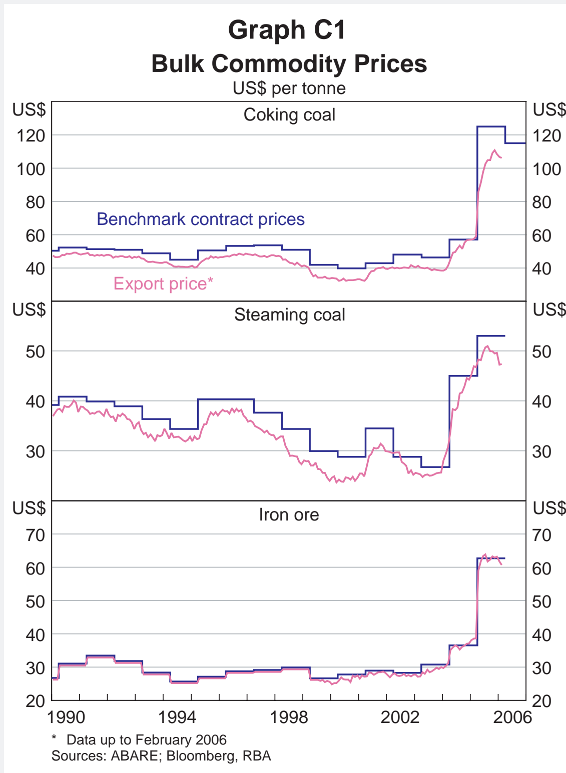


Within the total net capital inflow, gross foreign equity investment into Australia has been strong for some time, and was underpinned in the December quarter by foreign interest in share floats by several Australian companies. However, this was largely outweighed by substantial direct equity investment offshore by Australian entities, which resulted in almost the entire net capital flow into Australia over 2005 being accounted for by the debt component. Available data for the March quarter are suggestive of debt inflows having been increasingly concentrated in borrowings by financial intermediaries, especially via offshore bond issues, where these highly rated borrowers have been able to raise funds at attractive rates (see the chapter on 'Domestic Financial Markets and Conditions' for more details). In contrast, offshore bond issuance by non-financial businesses was much lower than the average of recent years, both in gross terms and adjusting for maturities.

Box C: Commodity Contract Prices and Trade

Australia's terms of trade have risen by more than 30 per cent over the past three years, boosting national income by about 5½ per cent. The rise has been driven by a surge in commodity export prices, especially for coal and iron ore, which together account for around 15 per cent of the value of total exports. With demand from the global steel industry much stronger than expected, export prices for coking coal and iron ore have more than doubled in recent years. Similarly, growing electricity demand in China and India has underpinned strong rises in steaming coal export prices.

In the past, Japan was the major destination for Australia's coal and iron ore exports. Japan accounted for roughly half of Australia's steaming coal exports and about 40 per cent of coking coal and iron ore exports in 2004/05. More recently, however, China has also become an important market, as its rapid industrialisation has led to very strong demand for raw materials. In particular, China now accounts for almost half of Australia's iron ore exports.



Export prices for Australia's bulk commodities are generally set by annual contract (for the Japanese financial year (JFY), 1 April to March 31), rather than on the spot market (Graph C1). At the time that this *Statement* was being finalised, contracts for coking coal had been settled, but contracts for iron ore and steaming coal were still being negotiated. Overall, coking coal contract prices fell by about 18 per cent, after rising by around 110 per cent in the previous contract year. Prices for hard coking coals fell by between 8 per cent and 16 per cent. However, prices of lower-quality pulverised coal injection and semi-soft coking coals declined by roughly 35 per cent. The larger decline for lower-quality coals reflects stronger actual and predicted increases in their global supply, as well as switching from lower-quality coking

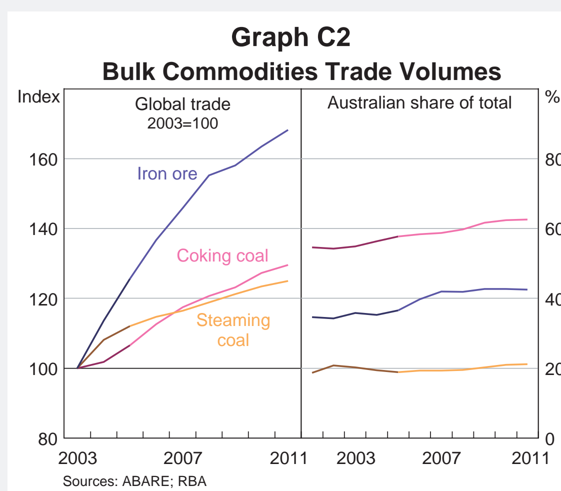
coal to cheaper steaming coal or more efficient hard coking coals. Steaming coal contract prices are also expected to fall, albeit more modestly, in JFY2006, after roughly doubling over the previous two years; producers and consumers expect faster growth in global supply capacity than in demand in the coming year.

In contrast, iron ore contract prices are expected to rise by at least 10 per cent in JFY2006, following a 72 per cent rise last year. The envisaged increase reflects expectations of further strong growth in steel production and limited new supply. Although coking coal and iron ore are both primarily inputs into steel production, their prices are likely to move in opposite directions in JFY2006. This divergence can be partly explained by the fact that China is a large and growing net importer of iron ore, while it is only a small net importer of coking coal.

Overall, the expected decline in coal contract prices in JFY2006 will be broadly offset by the rise in iron ore contract prices, with little overall effect on the RBA Index of Commodity Prices (ICP). This compares with the 22 percentage point contribution to the ICP's growth from the rise in these contract prices last year. Therefore, bulk commodity export prices are likely to remain high in 2006, supporting the terms of trade at an historically strong level.

Australian incomes have been substantially boosted by these developments, but almost all of the gain has come from higher export prices rather than from increased volumes. The volume of coal exports has been broadly unchanged over the past three years. Growth has been limited by capacity constraints in the mining sector, some transport infrastructure bottlenecks, and the long lead times required for large mining projects to come on line. Export volumes of iron ore have shown more growth, possibly because this sector's vertically integrated supply chain may have allowed faster expansion of capacity.

Australia's experience with supply constraints has been broadly replicated in other exporting countries.[1] However, most forecasters expect global supply capacity to increase more quickly in coming years, leading to moderate declines in prices. Nevertheless, according to projections by the Australian Bureau of Agricultural and Resource Economics (ABARE), Australia's coal and iron ore exports are expected to expand faster than total world trade in bulk commodities (Graph C2). Much of this anticipated increase in Australian export volumes stems



1 *The other main global exporters are Canada, Russia and the United States for coking coal; China, Indonesia, Russia and South Africa for steaming coal; and Brazil, Canada and India for iron ore.*

from expansions in mine and port capacity that are already under construction or in advanced stages of planning. Australia also has advantages in responding to increases in Chinese demand for iron ore, given the competitiveness of Australia's relatively cheap high-quality iron ore and its favourable location. ✠

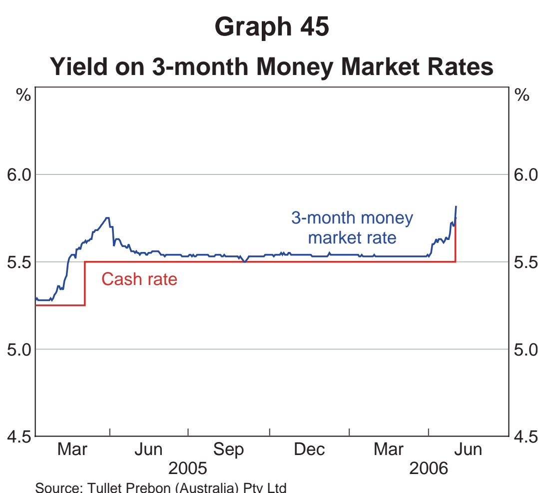
Domestic Financial Markets and Conditions

Interest rates and equity prices

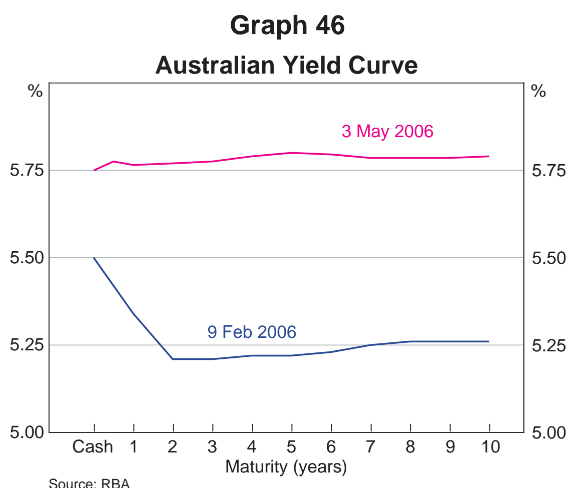
Money and bond yields

Short-term interest rates were fairly steady for most of the period since the last *Statement*, at a level consistent with a cash rate of 5.5 per cent. During April, however, they rose noticeably in response to a number of stronger domestic data releases, strengthening prospects for the world economy and rising commodity prices. By late April, the market had fully priced in a 25 basis points tightening within several months, with a greater than 50 per cent chance of it occurring in early May (Graph 45). In the event, when the Bank did tighten in May, yields rose only a little further.

Graph 45



Graph 46

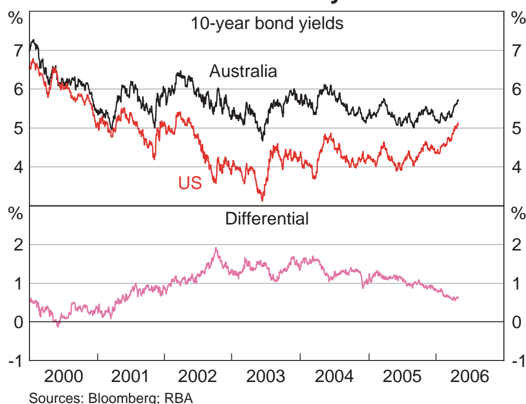


Bond yields have also risen since the time of the last *Statement*, with 10-year government bonds now yielding around 5.80 per cent, an increase of 50 basis points over the period. The rise in bond yields has exceeded the rise in money market rates and the yield curve has moved from being inverted to being flat (Graph 46).

Despite having risen in recent months, yields on long-term bonds are not much higher than in early 2005. In contrast, US bond yields have risen by around 85 basis points since early 2005 (Graph 47). The bigger rise in US yields reflects the fact that monetary policy tightening in the US has turned out to be greater than expected by markets a year ago. As a result of the smaller increase in yields on Australian securities, the spread between Australian

Graph 47

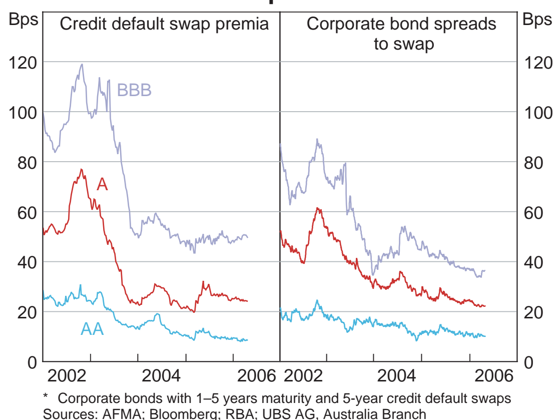
Australian and US 10-year Bonds



Sources: Bloomberg; RBA

Graph 48

Indicators of Corporate Credit Risk*



* Corporate bonds with 1–5 years maturity and 5-year credit default swaps

Sources: AFMA; Bloomberg; RBA; UBS AG, Australia Branch

and US 10-year bond yields narrowed considerably, to around 55 basis points in late March/early April, its lowest level in five years. It is now around 65–70 basis points.

Yields on inflation-indexed bonds have also risen in recent months, with yields on 10-year indexed bonds currently 65 basis points above their lows recorded in January. The increase has been broadly in line with the increase in nominal bond yields over the same period, with implied inflation expectations remaining a little over 3 per cent. As discussed in the last *Statement*, institutional factors have boosted global, particularly European, demand for indexed bonds relative to conventional bonds, thereby holding down their yields and pushing up implied inflation expectations.

Spreads on corporate bonds – an indicator of financial market participants' perceptions of credit risk – are little changed since the time of the last *Statement* and remain low compared with recent years (Graph 48). Premia on credit default swaps, which are financial derivatives that provide insurance against losses from default on corporate bonds and loans, are also at low levels. The low credit spreads reflect a combination of generally good prospects for Australian companies – strong profit growth, low default rates and a favourable economic environment – and strong demand for corporate bonds from Australian and non-resident investors.

Intermediaries' interest rates

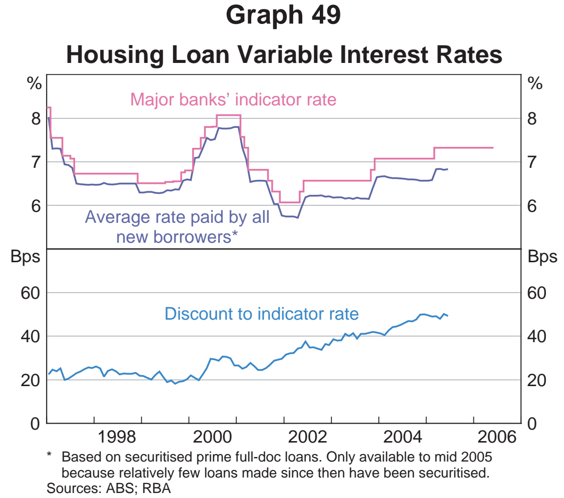
Most intermediaries' variable housing loan indicator rates have not changed since the time of the last *Statement*, with intermediaries yet to respond at the time of writing to the May monetary policy tightening. During the past three months, a few smaller lenders had reduced their indicator rates by around 10–20 basis points, but this was usually only for their honeymoon and basic variable-rate products. As has been the case for some time, most of the recent competition on housing loan interest rates has been reflected in increases in the size and availability of discounts being offered on indicator rates, rather than in changes in the indicator rates themselves.

A number of lenders in recent months have lowered the thresholds at which their housing loan interest rate discounts apply. Most now advertise a 70 basis point discount for loans between $250 000 and $500 000 whereas a year ago a 50 basis point discount was the norm for loans of this size. Also, it has become more common for borrowers, particularly those taking out bigger loans, to negotiate larger discounts than those that are advertised.

Reflecting the trend towards discounting, the effective rate that borrowers pay on new housing loans has been falling relative to housing loan indicator rates for some time. In mid 2005, the latest period for which we have reliable data, the average rate paid on new variable-rate housing loans was around 6.8 per cent, or ½ percentage point below the major banks' average standard variable indicator rate (Graph 49). This average discount has increased by around 30 basis points since early 2000, with the available evidence suggesting it has increased further over the past year.

Graph 49

Housing Loan Variable Interest Rates

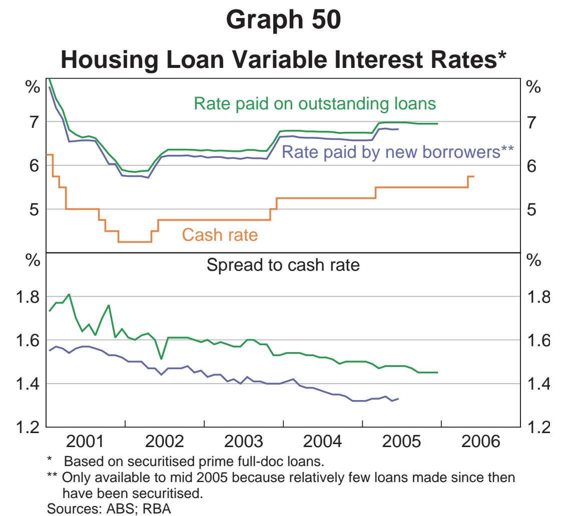


* Based on securitised prime full-doc loans. Only available to mid 2005 because relatively few loans made since then have been securitised.
Sources: ABS; RBA

Borrowers who receive a discount to the prevailing indicator rate are usually entitled to that discount for the life of the loan. In the event that bigger discounts subsequently become available, existing borrowers can obtain these by refinancing their loans. The fact that the average interest rate being paid on all outstanding housing loans is only a little above the average rate being paid on new loans (and that the refinancing share of loan approvals has risen in recent years) suggests housing loan borrowers have become keener 'shoppers' and are taking advantage of higher discounts (Graph 50). In part, this behaviour has been encouraged by the rise of mortgage brokers who are now estimated to arrange around one-third of housing loans.

Graph 50

Housing Loan Variable Interest Rates*



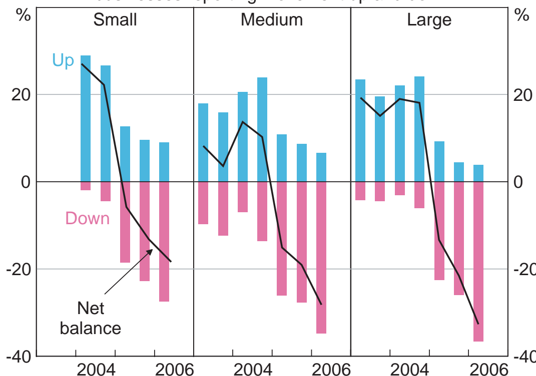
* Based on securitised prime full-doc loans.
** Only available to mid 2005 because relatively few loans made since then have been securitised.
Sources: ABS; RBA

With respect to fixed-rate housing loans, interest rates were relatively steady between late 2005 and mid April at which time they were raised in response to the pick-up in bond yields. Nonetheless, the major banks' average 3-year fixed rate, currently 6.85 per cent, is still broadly in line with the average of the past two years and the rate paid on standard variable-rate

Graph 51

Business Borrowing Spreads*

Spread above lenders' reference rates; share of businesses reporting movement up and down



* 'Small' and 'medium' refer to samples of businesses with annual turnover of \$5–\$20 million and \$20–\$340 million respectively; 'large' is a near census of the largest 500 companies by annual turnover.

Source: JPMorgan and East & Partners

loans (after discounting). Demand for fixed-rate housing loans was relatively strong over the three months to February, the latest period for which we have data.

The competitive pressures in the housing loan market are also evident in the business loan market. The spread between the weighted-average variable rate paid by businesses and the cash rate continued to fall in the December quarter of 2005 and has declined by over 1¼ percentage points since early 2000. This narrowing of business loan spreads reflects the moderation in lending to households and the emergence of a number of regional and foreign-owned banks competing more aggressively for a share of the business lending market. Surveys conducted by JPMorgan and East & Partners indicate that loan discounting is occurring across all customer segments, from small to large businesses (Graph 51). As in the housing finance market, refinancing activity in the business loan market has been encouraged by the growing use of loan brokers.

Equity prices

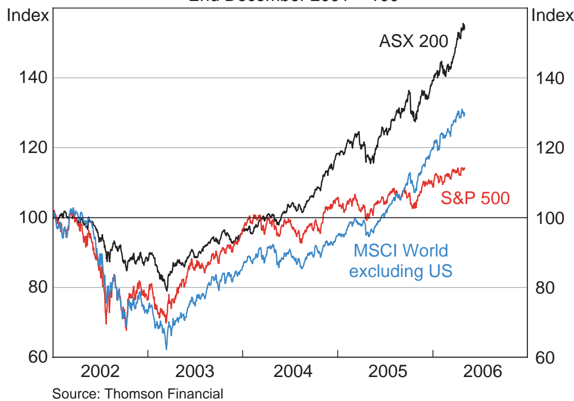
Australian share prices have increased by 11 per cent so far in 2006, reaching new record highs (Graph 52). While the rise was particularly pronounced for resource companies, reflecting further large increases in commodity prices, all sectors apart from telecommunications recorded increases. The domestic share market has continued to outperform most major overseas equity markets.

Since its trough in March 2003, the Australian share market has recorded 12 consecutive quarters of positive returns, with prices almost doubling over the period. The last long rally in the share market (over 11 quarters from December 1984 to September 1987) ended with a 40 per cent fall in the December quarter of 1987 but that rally was considerably more speculative than the current one.

Graph 52

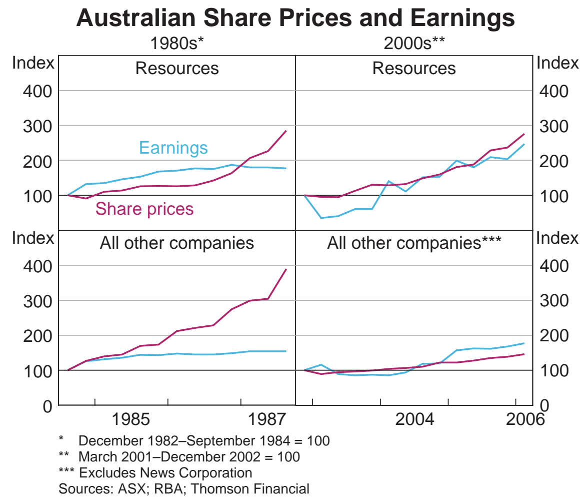
Australian and World Share Price Indices

End December 2001 = 100



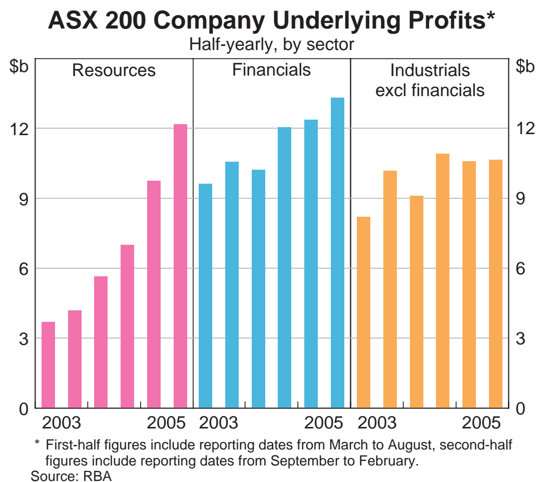
Source: Thomson Financial

One indication of this can be gained by comparing movements in share prices and company profits for each period. Graph 53 does this for resource and other companies. The Australian share market was relatively flat in 2001 and 2002, with its rise since then mostly concentrated in the resources sector. But the rise of 175 per cent in this sector has been well supported by higher profits, with share prices running a little ahead of profits only recently. Other companies' share prices have risen by around 45 per cent, on average, with their profits rising by more. Consequently, the price/earnings (P/E) ratio for the market as a whole remains broadly in line with the March 2003 level and its post-1980 average. Moreover, the current dividend yield is only slightly below average.

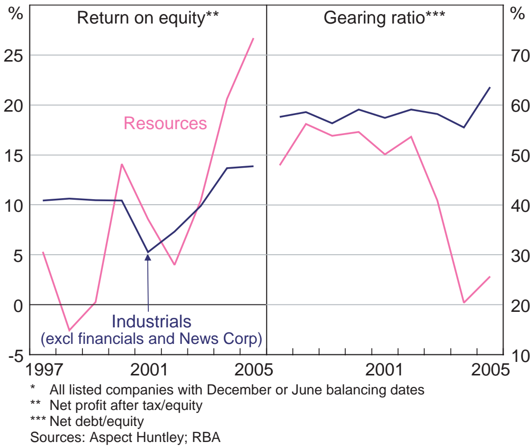


In sharp contrast, the 1984–1987 rally saw the share prices of resources and other companies increase by almost 200 and 300 per cent, respectively, with neither of these gains supported by similar increases in earnings. Consequently the P/E ratio doubled to around 20 over the period, and dividend yields fell to very low levels. The 1984–1987 rally was also characterised by a surge in equity market turnover and sharp increases in corporate debt levels, neither of which has been evident during the current rally.

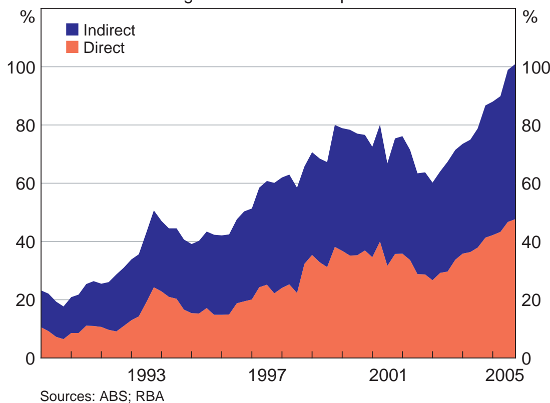
The latest corporate profit reporting season was another strong one. Underlying profits (which exclude significant items such as write-downs and gains and losses from asset revaluations or asset sales) for the half year to December 2005 amounted to $35 billion, 24 per cent higher than in the corresponding period of the previous year. Resource companies reported the strongest growth, with their aggregate underlying profits rising by 65 per cent, boosted by higher prices for base metals, bulk commodities and oil (Graph 54).



Graph 55



Graph 56



The profit results were consistent with analysts' earnings expectations.

The strong growth in resource companies' profits since 2002 has seen their return on equity rise from 5 per cent to 25 per cent (Graph 55). Other non-financial companies have also increased their returns on equity, albeit more moderately.[1] Resource companies' strong profitability has contributed to a substantial decrease in their gearing levels: the debt-to-equity ratio has fallen to 25 per cent, from 55 per cent in 2002. This is despite some increase in these companies' debt levels over the past year, consistent with the increasing amounts of investment they have undertaken. In contrast, other non-financial companies' debt-to-equity ratios have remained fairly constant at around 60 per cent, reflecting similar increases in debt and equity levels.

The strong rise in share prices and increased investment in shares by households have resulted in a large increase in the value of household share holdings. These holdings are now equivalent to about 100 per cent of annual household gross disposable income, up from 20 per cent fifteen years ago (Graph 56). Around half of these shares are held directly and the remainder indirectly through superannuation funds, life insurance and other managed investments.[2]

This rise in the value of share holdings has underpinned a rapid accumulation of financial wealth by Australian households, even though the household saving rate, as conventionally measured, is very low. This apparent contradiction is examined in Box D. In essence, the conventional measure of household saving calculated from the national accounts systematically understates the extent of household saving in countries such as Australia where households tend

1 *News Corp made a very large loss of $11 billion in 2002 and has been excluded from these calculations.*

2 *Direct share ownership by Australian households is high by international standards: according to a survey by the Australian Stock Exchange, just under half of Australia's adult population own shares directly, similar to the US and Canada but more than double the proportion in Europe.*

to invest mainly in shares, since the return on shares that comes in the form of capital gain is not captured in such measures.

Financing activity

Intermediated financing

Total credit growth has picked up in recent months, with the six-month-ended annualised rate increasing to 15.2 per cent in March, the highest rate since early 2004 (Table 10 and Graph 57). While total credit growth continues to be underpinned by rapid growth in business credit, household credit also recently appears to be showing signs of strengthening. Growth in both the housing and personal components of household credit has picked up since the troughs of late last year, leaving the six-month-ended annualised growth rate of household credit at 13.8 per cent. This has coincided with a modest strengthening of conditions in the housing market and the aforementioned ongoing competition in lending markets that is placing downward pressure on interest rate margins.

Table 10: Financial Aggregates
Percentage change

	Average monthly growth		
	September quarter 2005	December quarter 2005	March quarter 2006
Total credit	0.9	1.1	1.3
Household	0.8	1.0	1.2
– Housing	0.7	1.0	1.2
– Personal	0.8	0.4	1.0
Business	1.0	1.2	1.5
Broad money	0.5	0.1	0.6

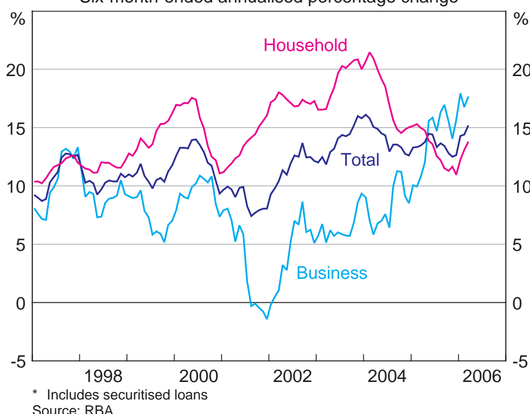
Source: RBA

Growth in business credit continues to gather pace, reaching a six-month-ended annualised growth rate of 17.7 per cent in March, to remain around the highest rate recorded since the late 1980s. Data on banks' business lending by size of facility indicate that the pick-up in the growth of total business credit over the past few years has mainly been due to stronger growth in 'large' loan facilities, defined as those over $2 million each. Consistent with this, data from the annual and interim reports of listed (non-

Graph 57

Credit Growth*

Six-month-ended annualised percentage change



* Includes securitised loans
Source: RBA

financial) companies suggest that intermediated borrowing in 2005 by the top 350 companies was relatively strong.

Non-intermediated financing

Australian non-government entities issued a near record $46 billion of bonds in the March quarter of 2006 (Table 11). Of this, financial institutions issued $30 billion, roughly double their post-2001 quarterly average (Graph 58). Most of these bonds were issued in offshore markets, with strong investor demand and low cross-currency basis swap spreads allowing the major banks to issue large volumes in foreign currency and swap into Australian dollars at attractive interest rates. Asset-backed vehicles' bond issuance was also a little above average in the March quarter, but was fairly evenly divided between domestic and offshore markets. Non-financial corporates' bond issuance was weak.

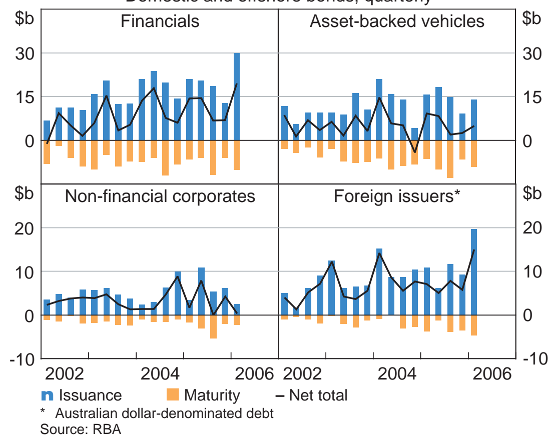


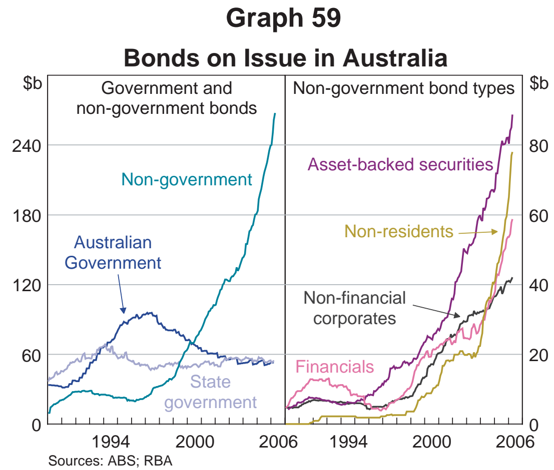
Table 11: Non-government Bond Issuance by Sector
$ billion

Sector	2003	2004	2005	March quarter 2006
Bond issues by Australian entities				
Onshore				
Financial institutions	9.9	14.3	20.9	4.5
Non-financial corporates	5.6	8.0	9.3	1.9
Asset-backed	20.7	25.0	32.2	7.9
Total	***36.1***	***47.3***	***62.4***	***14.3***
Offshore				
Financial institutions	51.5	64.9	52.0	25.4
Non-financial corporates	14.7	13.6	16.5	0.6
Asset-backed	24.3	29.8	25.6	6.2
Total	***90.5***	***108.2***	***94.2***	***32.2***
Total	**126.6**	**155.5**	**156.6**	**46.4**
A$ bond issues by non-resident entities				
Onshore	7.1	21.3	26.2	15.9
Offshore	24.8	21.5	11.9	3.7
Total	**31.9**	**42.9**	**38.1**	**19.6**

Source: RBA

In addition to the large issues by Australian entities, non-residents issued a record $20 billion of Australian-dollar denominated bonds in the March quarter, with heavy demand from Australian and non-resident investors allowing European and US financial institutions to issue large quantities of debt at low spreads. While this took place in a number of markets, issuance in the domestic market was particularly strong. Foreign quasi-government entities also made substantial issues in the domestic market.

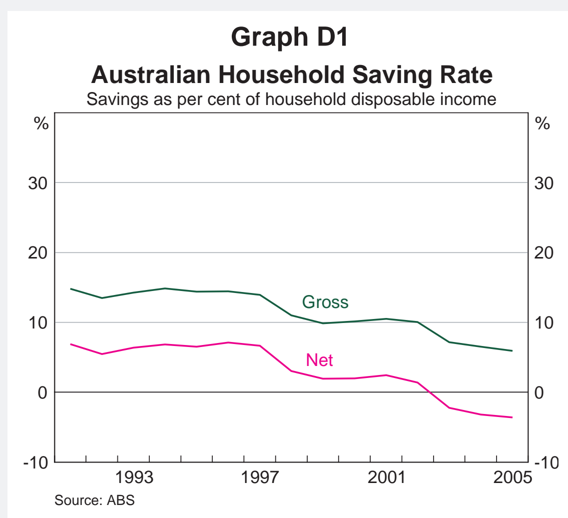
With gross issuance far in excess of maturities, total outstandings of non-government bonds in the domestic market have continued to grow strongly. At the end of March, outstandings stood at $261 billion, compared with just over $50 billion each of Commonwealth and State government bonds (Graph 59). Non-residents accounted for two-thirds of the increase in non-government bonds in the past quarter, with the rapid growth in their outstandings over the past couple of years indicative of the strength of demand for high-quality Australian dollar securities.



Australian companies' net equity raisings amounted to only $4 billion in the March quarter. The weakness was partly seasonal and follows exceptionally strong raisings in the December quarter of 2005. In addition, and as noted above, financial institutions (who raised only half their usual amount) were very active in debt markets while non-financial companies have generated high levels of internal funds.

Box D: Capital Gains and Measures of Household Saving

The most frequently-cited measure of household saving is the net saving rate, which is measured as a residual by subtracting consumption and depreciation from household disposable income. On this measure, the saving rate of Australian households has been declining, and in recent years has been negative (Graph D1). This is lower than in many other developed countries, though not dissimilar to developments in the US. Adding back the amount deducted for depreciation (most of which is on housing) lifts the saving rate, though the position of Australia and the US remains below average. These conventional measures of saving are calculated from the household income account in the national accounts and do not include in income (and therefore saving) that part of the return on investments that comes in the form of capital gains. In the case of equity investments, for example, only the return that is in the form of dividends is included as income even though historically this has accounted for only about one-third of the overall return on equities.[1]



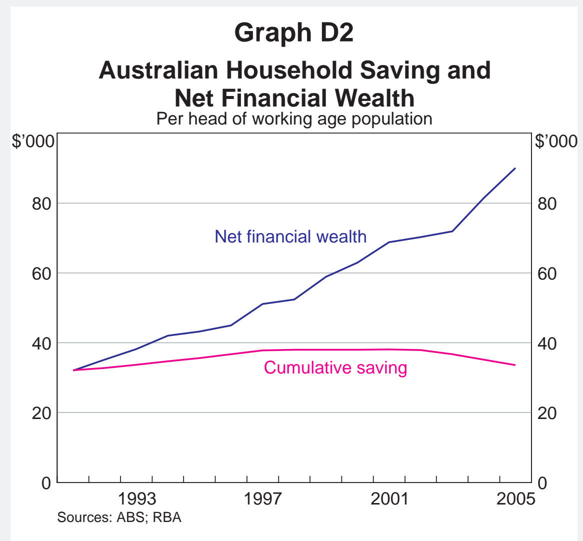
In countries such as Australia where the composition of household investments has shifted from bank deposits and fixed income to equity holdings, this measure of saving has increasingly understated the true extent of household saving. In such countries a more meaningful measure of household saving is the change in household net financial wealth, defined as household financial assets (bank deposits, bonds, equities and unit trusts) less non-housing debt. This measure, which can be directly measured using financial data, focuses only on financial wealth and abstracts from wealth in the form of dwellings and the household debt used to fund that investment in dwellings. To the extent that households borrow against dwellings to buy financial assets (i.e. engage in housing equity withdrawal) the measure of financial wealth used here would be overstated, but on average over the 1990s the impact of this has not been very significant.

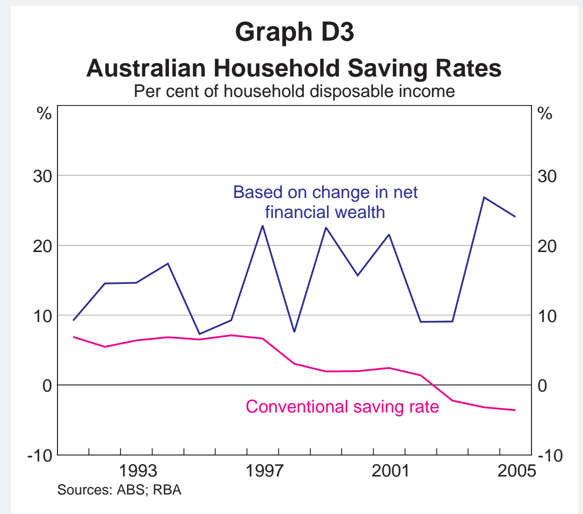
Graph D2 shows net financial wealth of Australian households, per head of working-age population. It has risen from $32 000 in 1991 to $90 000 in 2005. Also shown on the graph is

1 *See ABS Australian System of National Accounts, 2002–03, Cat No 5204.0, 'New analytical measures of income, saving and wealth', for more detail of the shortcomings of this saving measure.*

the increase in wealth that would be implied by the cumulation of (net) saving as measured in the national accounts. This latter series shows a much smaller increase, with the bulk of the gap between the two lines due to the compounding of capital gains on equities which, as noted, are not captured in the conventional saving rate.

Graph D3 shows a broader measure of the saving rate calculated from household net financial wealth – i.e. as the annual change in net financial wealth expressed as a proportion of household disposable income. This broader measure is more volatile than conventional measures because of year-to-year changes in equity valuations, but it is also significantly higher on average and does not exhibit the same downward trend. This measure, which is more relevant to a country where households maintain a large proportion of their wealth in equities, presents a more realistic picture of Australian household saving behaviour than conventional measures.





It is also interesting to note that on this broader measure of the household saving rate, Australia is not out of line with international experience. Countries which have relatively high household saving rates as conventionally measured (e.g. countries in Europe) tend also to be those where household investments are mainly in bank deposits and fixed income, whereas in countries with low household saving on conventional measures (of which the US and Australia are examples) households hold a greater proportion of their investments in equities. Once the capital gains in these are included in saving measures, the international dispersion in saving rates is reduced (Table D1).

Table D1: Comparison of Household Saving Rates

Annual average 1994–2004, per cent

	Conventional saving rate	Change in net financial assets as percentage of household disposable income
Australia	2.9	18.5
Canada	5.1	13.5
France[(a)]	12.0	15.3
Germany	10.2	11.1
Italy	13.2	19.1
Japan[(a)]	9.7	10.9
United Kingdom	6.8[(b)]	19.1
United States	3.1	23.6

(a) Average 1994–2003

(b) Gross saving rather than net saving

Sources: ABS; Bundesbank; OECD; RBA; US Federal Reserve

Inflation Trends and Prospects

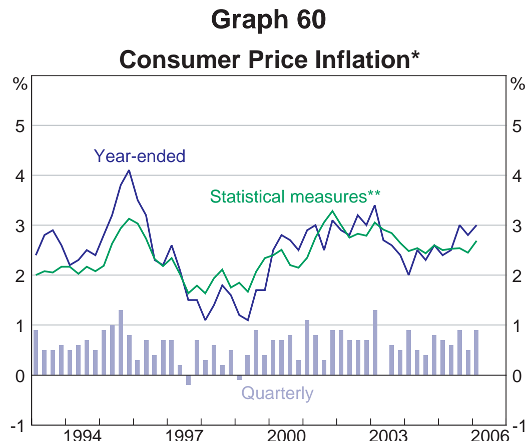
Recent developments in inflation

The Consumer Price Index (CPI) rose by 0.9 per cent in the March quarter, to be 3.0 per cent higher over the year (Graph 60, Table 12). Although petrol prices had little direct impact on the quarterly inflation outcome, they did boost the annual rate of inflation, following their increases of around 20 per cent over the last year. As is usual, there was some variation across the different indicators of underlying inflation. The Bank's assessment is that underlying inflation was around ¾ per cent in the quarter and around 2¾ per cent over the year to the March quarter.

The relatively large CPI increase in the March quarter partly reflected seasonal price resetting for education and health, as well as increases in

Graph 60

Consumer Price Inflation*



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

** Average of the seasonally-adjusted trimmed mean and weighted median

Sources: ABS; RBA

Table 12: Measures of Consumer Prices

Percentage change

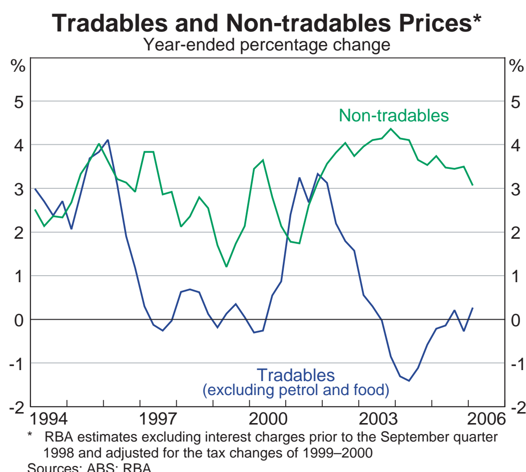
	Quarterly		Year-ended	
	December quarter 2005	March quarter 2006	December quarter 2005	March quarter 2006
CPI	0.5	0.9	2.8	3.0
– Tradables	0.0	0.8	2.0	2.8
– Tradables (ex food and petrol)	–0.5	0.4	–0.3	0.3
Non-tradables	0.8	0.9	3.5	3.1
Underlying measures				
Weighted median[a]	0.7	0.7	2.6	2.8
Trimmed mean[a]	0.5	0.8	2.3	2.6
CPI ex volatile items[b]	0.4	0.8	2.3	2.2

(a) Based on the distribution of seasonally adjusted quarterly price changes.

(b) Volatile items are fruit, vegetables and petrol.

Sources: ABS; RBA

prices for vegetables and motor vehicles. These increases were offset somewhat by falls in the prices of clothing & footwear, furniture & furnishings, and deposit & loan facilities.[1] Over the year, fuel prices, house purchase costs, and food items made the largest contributions to inflation. Price declines were most significant in audio, visual & computing equipment, telecommunication charges, and clothing & footwear. There was some evidence of indirect effects from higher oil prices on a range of items affected by higher fuel and transport costs. There was no effect on prices of fruit and vegetables from Cyclone Larry in the March quarter, but the June quarter outcome is likely to be boosted by this factor.



The prices of tradables rose by 2.8 per cent over the year to the March quarter, boosted by rises in petrol prices; abstracting from petrol and food prices, the annual increase was just 0.3 per cent, partly reflecting the ongoing disinflationary effect from China and other low-cost producers (Graph 61). Non-tradables prices grew by 3.1 per cent over the year. This rate has fallen significantly from the levels seen a few years ago, partly reflecting a slowing in the growth of prices of new homes.

Table 13: Output Prices at Different Stages of Production
Percentage change

	March quarter 2006	Year to March quarter 2006
Preliminary	**1.6**	**8.6**
– Domestically produced	1.5	7.5
– Imported	2.7	16.3
– Excluding oil	1.4	5.6
Intermediate	**1.5**	**6.9**
– Domestically produced	1.4	6.3
– Imported	2.8	11.5
– Excluding oil	1.3	4.9
Final[(a)]	**0.8**	**3.8**
– Domestically produced	0.7	4.1
– Imported	0.8	2.0
– Excluding oil	0.7	3.1

(a) Excluding exports
Sources: ABS; RBA

Producer price data suggest firm upstream inflationary pressures in the March quarter. This was especially the case at the preliminary and intermediate production stages where price increases were mainly due to rises in oil and metal prices (Table 13). The pace of quarterly growth in prices at the final stage of production

1 *The CPI expenditure class for deposit and loan facilities measures the fees and margins paid by households on their loans, deposits and credit cards.*

remained unchanged at 0.8 per cent (Graph 62).

Labour costs

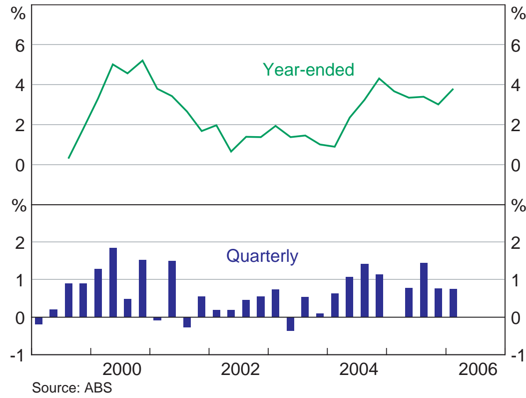
Wage indicators for the December quarter showed continued firm growth in labour costs. The wage price index grew by 0.9 per cent in the quarter, and by 4.2 per cent over the year (Graph 63). The average annualised wage increase for federal enterprise agreements certified in the December quarter increased to 4.5 per cent, the highest level in eight years. This strength was partly due to a bunching of large wage increases in the education sector: when reweighted according to the composition of the labour force, the average increase was closer to earlier levels, at around 4.2 per cent. Other measures of the wage bill and average earnings are volatile, but reinforce the view that wage growth has remained somewhat above its average rate over the inflation targeting period. Additionally, according to the December quarter national accounts data, unit labour costs (total labour costs per unit of output) are estimated to have been growing at a year-ended rate of around 4 per cent for the past couple of years.

More recently, business surveys and the Bank's liaison with businesses point to continued tight labour market conditions and shortages of skilled labour. The NAB survey suggests that labour scarcity remains a greater constraint on activity than the more traditional concerns about lack of demand (Graph 64). Firms

Graph 62

Final Producer Prices

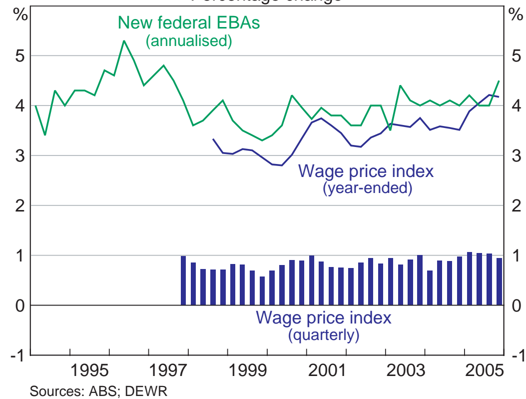
Percentage change



Graph 63

Wage Indicators

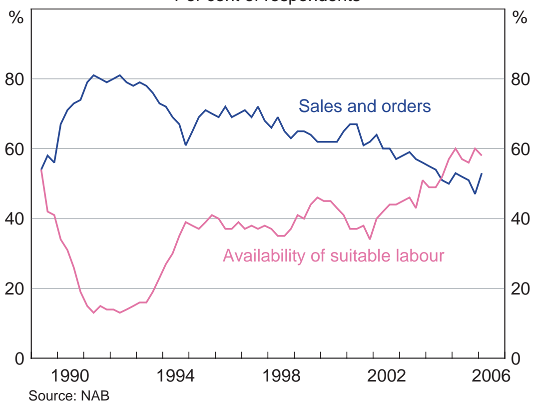
Percentage change



Graph 64

Factors Constraining Output

Per cent of respondents



across a wide range of private-sector industries are using non-wage forms of remuneration that are not fully captured in the standard wage measures, such as bonus payments and more flexible working arrangements, to attract and retain employees. Wage and non-wage cost pressures are most pronounced in industries facing strong labour demand and acute skill shortages, such as mining and non-residential construction, although solid labour costs growth is evident in most industries.

Inflation expectations

Business surveys indicate that expectations of future price growth remain broadly contained. In the ACCI-Westpac survey, the net balance of manufacturing firms expecting to raise their prices in the next three months increased in the March quarter, to be slightly above its average level over the past decade. A similar result was reported in the most recent Dun & Bradstreet survey. However, the NAB quarterly business survey measure of expected inflation in final product prices has been broadly steady in recent quarters.

Forecasts of market economists surveyed by the Bank following the release of the March quarter CPI indicate that headline CPI inflation is expected to remain close to current levels in the near term. The median expectation for inflation over the year to December 2006 is 2.9 per cent, little changed from last quarter. Thereafter, inflation is expected to fall back, to be 2.6 per cent in the year to December 2007 (Table 14). Union officials expect inflation to be 3.3 per cent for the year to December quarter 2006 and to remain at around this level over 2007.

Table 14: Median Inflation Expectations
Per cent

	Year to December 2006			Year to December 2007	
	November 2005	February 2006	May 2006	February 2006	May 2006
Market economists[a]	2.6	2.8	2.9	2.6	2.6
Union officials[b]	3.5	3.0	3.3	3.0	3.2

(a) RBA survey
(b) Workplace Research Centre

The implied medium-term inflationary expectations of financial market participants have traditionally been calculated as the difference between nominal and indexed bond yields. This measure has continued to edge higher since the February *Statement*, to be around 3.2 per cent in early May. However, this rise in part reflects developments in the indexed bond market that are unrelated to inflation expectations. In particular, the limited supply of indexed securities and increasing institutional demand for these securities has pushed down their yields relative to those on conventional bonds.

Inflation outlook

Headline CPI inflation rose to 3.0 per cent in the year to the March quarter, and underlying inflation is estimated to have increased to around 2¾ per cent after an extended period when it

was close to 2½ per cent. This increase provides evidence that the modest pick-up in underlying inflation that has been forecast for some time is now starting to occur.

The factors affecting the inflation forecast are broadly as discussed in previous *Statements*. With a tight labour market, an economy close to full capacity and rising commodity prices, there are a number of forces contributing to domestic inflation. At the same time, the prices of imported manufactured goods are holding down inflation. Furthermore, domestic wage outcomes have remained more contained than would have been expected in the past, given the tight labour market. And profit margins in a broad range of sectors appear quite healthy, providing some scope for businesses to absorb cost pressures without the need to raise prices.

The inflation forecast presented in the February *Statement* envisaged that underlying inflation would remain in the 2½–3 per cent range over the forecast period to end 2007, with a central forecast that underlying inflation would rise to 2¾ per cent in the second half of 2006 and stay around this level in 2007. The March quarter outcome, which was higher than expected, together with the recent run-up in commodity prices and other domestic and international data, suggested that the risks to the earlier forecast had shifted to the upside. However, taking into account the expected impact of the May policy tightening, the forecast for underlying inflation through 2007 is broadly unchanged.

The Bank's revised forecasts are based on the assumption that oil prices and the trade-weighted index of the exchange rate remain broadly around current levels, at US$70 per barrel and 63, respectively. GDP growth is forecast to accelerate to an annual rate of 3–3½ per cent over the forecast period to the end of 2007, helped by stronger export growth. The unemployment rate is forecast to stay around its recent low level, and wage growth is likely to remain firm, but is not expected to accelerate further. Underlying inflation should remain in the 2½–3 per cent range. Headline CPI inflation is likely to be above 3 per cent in the near term, affected by higher petrol prices, but also reflecting some effect from Cyclone Larry on fruit and vegetable prices. In due course, CPI inflation would be expected to decline gradually, back to 2½–3 per cent. However, for the realisation of this forecast, it will be important that inflation expectations remain anchored through a period when higher petrol prices are likely to substantially boost headline CPI inflation. ✠