2. International and Foreign Exchange Markets

Current and expected policies of the major central banks continue to be an important driver of developments in global financial markets. Financial markets had been volatile, both in the lead-up to and, in particular, in the period just after the United Kingdom's referendum on 23 June where a majority voted to exit the European Union (EU). The outcome surprised financial markets, resulting in large moves in bond yields, equity prices (especially those of banks) and exchange rates. The UK pound depreciated sharply following the referendum and reached a 31-year low against the US dollar. Despite considerable price movements, financial markets generally functioned in an orderly manner. Sovereign bond yields have subsequently fallen further and reached the lowest level on record in many countries. The Japanese yen has experienced sizeable swings in recent months and reached its highest level against the US dollar in several years.

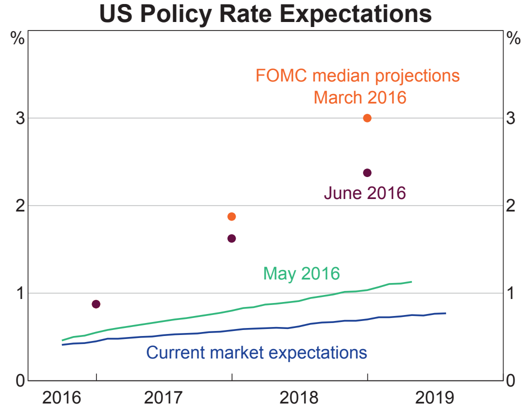
Central Bank Policy

The US Federal Open Market Committee (FOMC) left the target range for the federal funds rate at 0.25–0.50 per cent at both its June and July meetings. At the July meeting, the FOMC noted that household spending and the labour market had strengthened and the near-term risks to the outlook had diminished. Market-implied expectations for the next increase in the federal funds rate have been scaled back since May, with the next policy tightening currently not priced in until late 2017 (Graph 2.1).

The European Central Bank (ECB) has left policy unchanged since it announced additional stimulus measures at its March meeting. It commenced the second round of targeted longer-term refinancing operations (TLTRO II) as well as its purchases of corporate bonds in June. At the first TLTRO II allotment in late June, euro area banks obtained close to €400 billion in four-year term funding, which represents about a quarter of the amount they were eligible to draw from the facility. These banks used most of this funding to repay existing ECB long-term loans (that had less favourable interest rates), such that the net increase in term funding to banks was only €30 billion.

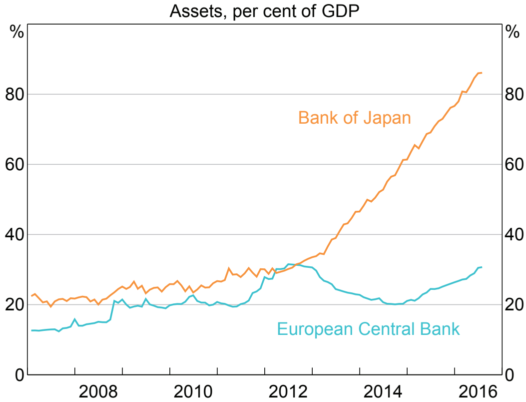
The ECB balance sheet now exceeds its previous peak in 2012. The ECB's outright purchases of public and private sector debt securities account for most of the €1.3 trillion increase in the ECB's balance sheet since mid 2014, which now stands

Graph 2.1
US Policy Rate Expectations



Sources: Bloomberg; Board of Governors of the Federal Reserve System; RBA at €3.3 trillion (or about 30 per cent of GDP; Graph 2.2). The UK vote to exit the EU raised expectations for further ECB stimulus, with markets now pricing in an additional reduction in the deposit rate over the coming year.

Graph 2.2
Central Bank Balance Sheets
Assets, per cent of GDP



Sources: Bank of Japan; European Central Bank; Thomson Reuters

The Bank of England (BoE) left its policy rate unchanged at 0.5 per cent at its July meeting but signalled that it expects to ease monetary policy at its August meeting. At the time of writing, markets had priced in a 25 basis point reduction of the policy rate at the BoE's meeting on 4 August with some expectations of a resumption of asset purchases.

Following the introduction of a negative interest rate on certain deposits in late January, the Bank of Japan (BoJ) has left monetary policy largely unchanged. At its July meeting, it increased the pace of annual purchases of exchange-traded funds from ¥3.3 trillion to ¥6 trillion, but maintained the overall pace of its balance sheet expansion at around ¥80 trillion annually. The BoJ announced that it will conduct a comprehensive assessment of its current policy measures, which will be deliberated at its next policy meeting in September.

The People's Bank of China (PBC) has held benchmark interest rates steady so far this year and left system-wide reserve requirement ratios unchanged since a 50 basis point reduction in February. Interbank interest rates have remained broadly stable over recent months, with the PBC actively managing liquidity conditions through open market operations and the use of its lending facilities.

A number of other central banks have eased policy in recent months (Table 2.1). The Bank of Korea lowered its policy rate by 25 basis points to 1.25 per cent, noting that while it expects a modest recovery in economic activity, the risks to growth have increased. Malaysia's central bank lowered its policy rate by 25 basis points to 3 per cent due to concerns that slower growth in major trading partners could weigh on growth. Bank Indonesia also reduced its policy rate by 25 basis points in

Table 2.1: Monetary Policy

	Policy rate Per cent		Most recent change
Euro area[a]	–0.40	↓	Mar 16
Japan[a]	–0.10	↓	Jan 16
United States[b]	0.375	↑	Dec 15
Australia	1.50	↓	Aug 16
Brazil	14.25	↑	Jul 15
Canada	0.50	↓	Jul 15
Chile	3.50	↑	Dec 15
India	6.50	↓	Apr 16
Indonesia	5.25	↓	Jun 16
Israel	0.10	↓	Feb 15
Malaysia	3.00	↓	Jul 16
Mexico	4.25	↑	Jun 16
New Zealand	2.25	↓	Mar 16
Norway	0.50	↓	Mar 16
Russia	10.50	↓	Jun 16
South Africa	7.00	↑	Mar 16
South Korea	1.25	↓	Jun 16
Sweden	–0.50	↓	Feb 16
Switzerland[b]	–0.75	↓	Jan 15
Thailand	1.50	↓	Apr 15
Turkey	7.50	↓	Feb 15
United Kingdom	0.50	↓	Mar 09

(a) Marginal rate paid on deposits at the central bank
(b) Midpoint of target range
Sources: Central banks; RBA; Thomson Reuters

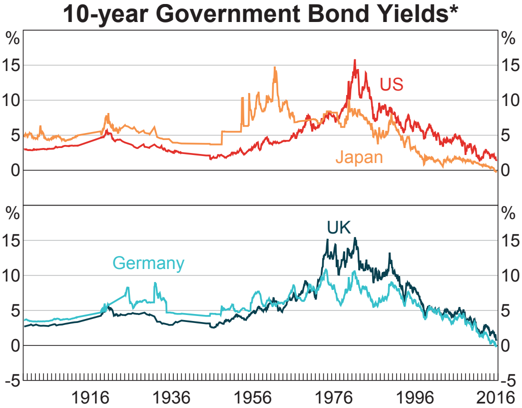
an effort to boost economic growth and domestic credit, while Russia's central bank lowered its policy rate by 50 basis points in response to easing concerns about high inflation and a further decline in inflation expectations. Following the attempted coup in Turkey, the central bank announced a number of measures to ensure the functioning of financial markets, including providing banks with unlimited liquidity. Mexico's central bank raised its policy rate by 50 basis points to 4.25 per cent, to counter the effects of the recent depreciation of the peso on inflation and inflation expectations.

Sovereign Debt Markets

Yields on major market sovereign bonds have been volatile in recent months. Major market sovereign bond yields fell sharply immediately following the UK referendum, with yields on 10-year UK, US and German government bonds declining by around 25–35 basis points intraday. Sovereign bond yields in major markets continued to decline over the following days to reach historical lows, including for Australia (Graph 2.3). Yields on UK sovereign bonds declined despite a ratings downgrade (by two ratings agencies) following the referendum.

Bond yields have at least partly reversed these falls over the past month, following generally stronger-than-expected US economic data and some reduction in UK political uncertainty, with

Graph 2.3
10-year Government Bond Yields*

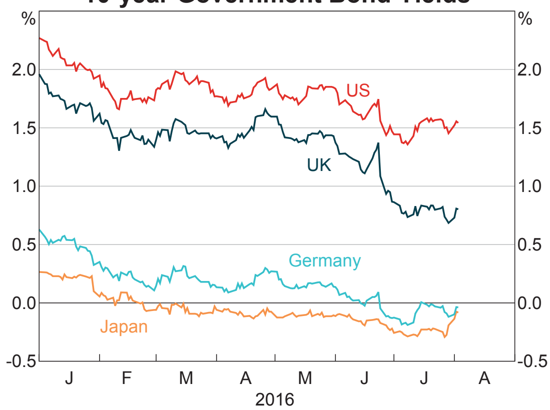


* Data interpolated during World War I and World War II; German data also interpolated between 1921 and 1924

Sources: Bloomberg; Global Financial Data; RBA

the appointment of a new prime minister and the announcement that the UK government would not trigger the start of the formal process to exit the EU this year (Graph 2.4).

Graph 2.4
10-year Government Bond Yields



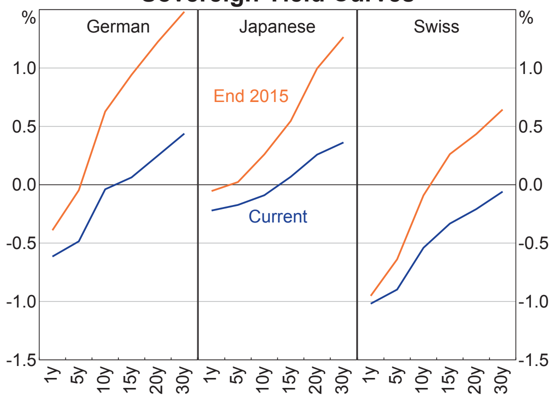
Source: Bloomberg

Japanese government bond yields have been particularly volatile over the past few months. Yields declined, in part owing to expectations of additional fiscal and monetary stimulus, but then rose significantly after the BoJ left its policy largely unchanged at its July meeting. Overall, since the previous *Statement* Japanese government bond yields have increased a little.

Looking through the volatility in recent months, most major market sovereign bond yields have declined markedly since the start of the year – with 10-year US, German and Japanese sovereign bond yields around 35–75 basis points lower. There has also been a material flattening of yield curves since the beginning of the year. German and Japanese government bonds with tenors up to 10 years are currently trading at negative yields, while Swiss government bonds trade at negative yields up to 30 years maturity (Graph 2.5).

Yields on 10-year bonds issued by governments in the euro area periphery have generally declined since the start of the year. Spreads of these bonds over German Bunds have generally narrowed slightly since early May, as the initial widening

Graph 2.5
Sovereign Yield Curves

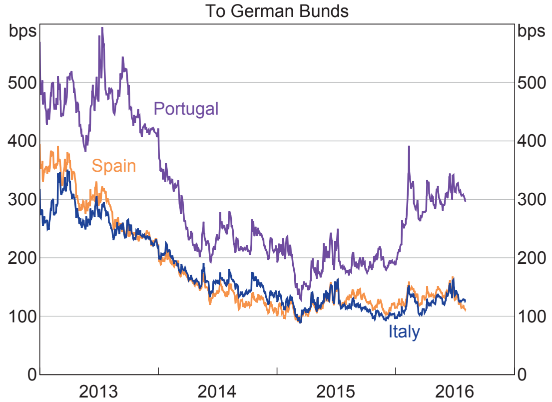


Source: Bloomberg

of spreads directly after the UK referendum was subsequently more than unwound (Graph 2.6). Since the start of the year, spreads on 10-year Italian sovereign bonds have widened amid investor concerns about the broader risks arising from non-performing loans of Italian banks and the upcoming Italian constitutional referendum in October.

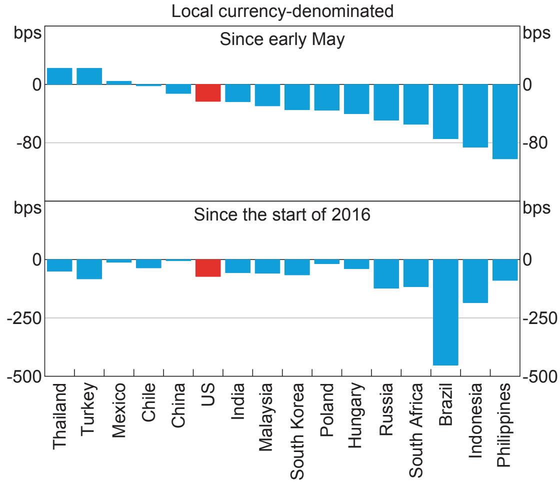
Yields on emerging market sovereign bonds denominated in local currency have generally declined in recent months, alongside falls in US Treasury yields (Graph 2.7). Local currency-denominated sovereign bond yields of a number of commodity exporters declined by up to 85 basis points, as commodity prices rose. The

Graph 2.6
Euro Area 10-year Government Bond Spreads
To German Bunds



Source: Bloomberg

Graph 2.7
Change in 10-year Government Bond Yields
Local currency-denominated



Sources: Bloomberg; Thomson Reuters

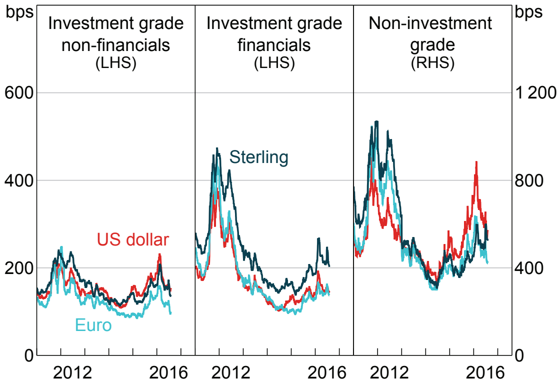
suspension of Brazilian President Rousseff's powers and duties and the appointment of an interim president as well as a recovery in commodity prices have contributed to a very large fall in 10-year Brazilian government bond yields since the start of the year. In contrast, yields on 10-year Turkish government bonds rose following the attempted military coup in mid July and have increased since early May.

Credit Markets

Yields on both investment grade and non-investment grade corporate bonds in US and euro area markets have fallen in recent months, as spreads have narrowed in combination with declines in sovereign yields. Spreads on non-investment grade bonds in the United States narrowed by as much as 100 basis points, before widening following a decline in oil prices (Graph 2.8). The fall in US investment grade bond spreads was relatively muted. Similar to other financial markets, conditions in corporate bond markets were volatile around the time of the UK referendum.

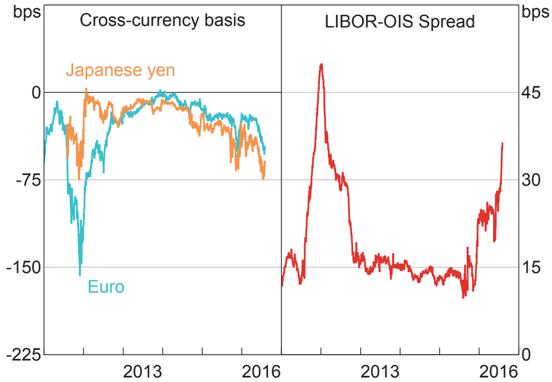
Moves in sterling markets were particularly pronounced following the referendum and in some

Graph 2.8
Corporate Bond Spreads
To equivalent government bonds



Sources: Bank of America Merrill Lynch; Bloomberg; RBA

Graph 2.9
US Dollar Funding Costs
3-month maturity



Source: Bloomberg

cases have been only partially unwound. Spreads on sterling non-investment grade bonds, which are primarily issued by UK corporations, rose by around 110 basis points after the referendum and have subsequently reversed only two-thirds of that. Spreads on bonds issued by financial corporations in the sterling market also rose by more than those in non-sterling markets; spreads on these bonds have since returned to around their pre-referendum levels, but these bonds have underperformed other sterling investment grade bonds. Spreads on short-term bank funding in the sterling unsecured market widened significantly after the UK referendum result, reaching their highest levels since 2012. These spreads remain elevated, but banks' borrowing costs have fallen in absolute terms due to a lower expected path of UK policy rates.

The cost of borrowing US dollars in exchange for yen and euros in short-term foreign exchange swap markets has increased; in late July, the cost of borrowing in exchange for yen reached its highest level in almost five years (Graph 2.9). This reflects an increase in demand from Japanese investors to reallocate to (hedged) US dollar-denominated assets where bond yields are higher.

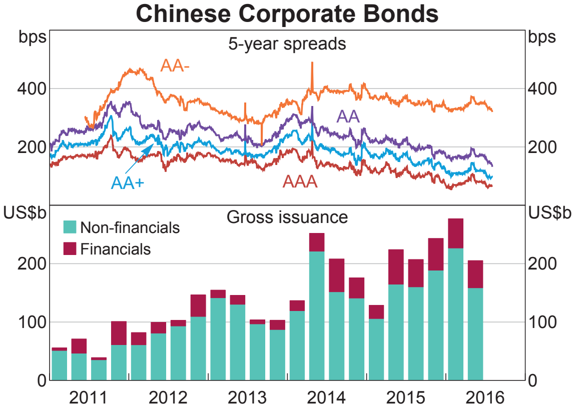
Spreads on short-term bank funding in US dollar markets have risen to their highest levels since 2012. Some part of this reflects the fact that the increased cost of borrowing US dollars in short-term foreign exchange swap markets has led to Japanese banks raising more funds in US short-term funding markets. The upcoming implementation of reforms to US money market funds (MMFs) in October is also reducing the number of such funds that lend to banks. Partly as a result of these reforms, prime MMFs' (that is, those MMFs that lend to banks) assets under management have fallen by over US$400 billion over the past year, as some prime funds switched their classification to government-only (which invest only in US government securities) and investors have begun to reallocate away from prime funds. Moreover, remaining prime funds have lowered the weighted-average maturity of their assets to increase their liquidity buffers ahead of the implementation date in October.

Bond issuance from US and euro area firms fell back to low levels in June and July amid uncertainty and volatility around the time of the UK referendum, after strong issuance from US firms in May. Issuance from firms incorporated in the euro area had previously increased following the ECB's announcement in March that its asset purchase program would be extended to include bonds issued by non-bank investment grade corporations. The ECB commenced purchases of these bonds in early June and currently holds a total of €13.2 billion.

Gross bond issuance by Chinese corporations slowed in the June quarter, following record high issuance in the March quarter (Graph 2.10). As a result, net corporate bond issuance in the June quarter was weak. Issuance of short-term corporate debt securities also declined in the quarter, and was less than the value of maturities during the period. The weaker corporate bond issuance coincided with a period of heightened investor caution towards the corporate bond market and an increase in the number of cancellations of planned bond issues, after a number of missed bond payments by some corporations over March and April. The increase in missed bond payments also contributed to an increase in local currency-denominated corporate bond spreads. Since May, these increases have been reversed, with spreads on highly rated bonds returning to around historical lows. Cancellations of bond issues have returned to normal levels, following a decline in the number of missed bond payments and the payment of bond obligations by some corporations that were expected to default (including a central government-owned enterprise). Local government bond issuance remained strong in the June quarter, supported by the ongoing local government debt swap program.

Since May, the first four issues of asset-backed securities with non-performing loans as underlying assets were sold as part of a pilot program involving the six largest Chinese banks. The program attempts to improve the quality of assets on banks' balance sheets in response to an increase in the proportion of non-performing loans.

Graph 2.10
Chinese Corporate Bonds



Sources: Bloomberg; CEIC Data; Dealogic; RBA

Spreads on US dollar-denominated bonds issued by other emerging market corporations mostly continued to narrow, consistent with developments in non-investment grade bonds in the United States. The narrowing in spreads was particularly pronounced for Brazilian corporations, consistent with falls in Brazilian sovereign yields. In contrast, spreads on bonds issued by Turkish corporates have widened sharply following the attempted coup. New issuance remains subdued, with cumulative gross issuance by emerging market corporations in the year to date continuing at its slowest pace since 2009.

Equities

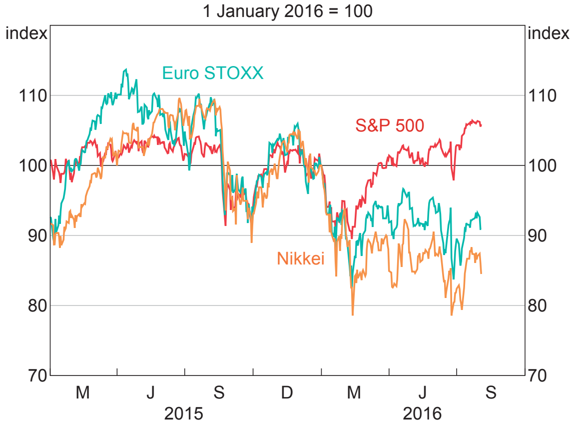
Global equity prices fell following the UK referendum but have since retraced most of these falls and, in some cases, exceed their pre-referendum levels (Table 2.2). The share price falls were particularly pronounced in Japan and the euro area (especially in the periphery countries) (Graph 2.11). While an appreciation of the Japanese yen (see Foreign Exchange) had contributed to

Table 2.2 Changes in International Share Prices
Per cent

	Over 2015	2016 to date
United States – S&P 500	–1	6
Euro area – STOXX	8	–9
United Kingdom – FTSE	–5	6
Japan – Nikkei	9	–16
Canada – TSE 300	–11	12
Australia – ASX 200	–2	3
China – MSCI All China	2	–12
MSCI indices		
– Emerging Asia	–8	3
– Latin America	–11	20
– Emerging Europe	–4	2
– World	**–1**	**1**

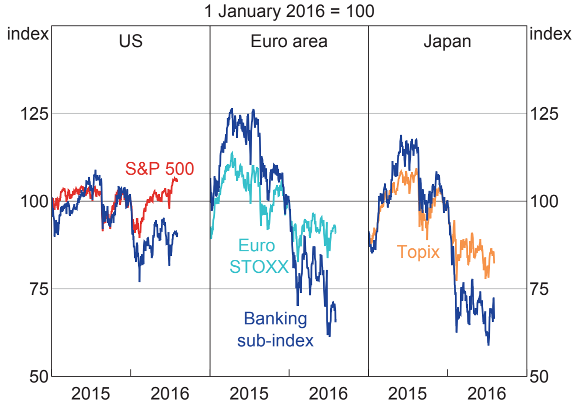
Source: Bloomberg

Graph 2.11
Major Share Price Indices



Source: Bloomberg

Graph 2.12
Major Market Bank Share Prices



Source: Bloomberg

the fall in Japanese stock prices, expectations of increased fiscal stimulus have since provided some support. In the United Kingdom, share prices of domestically focused firms fell significantly following the referendum and remain slightly below their pre-referendum levels. In contrast, share prices of more internationally focused UK firms fell by less than many other major markets immediately following the referendum and have since increased significantly, as the depreciation of the UK pound was seen as supporting these firms' earnings (see Foreign Exchange).

The US S&P 500 index has significantly outperformed the MSCI World index so far this year and has reached a record high. The UK referendum outcome had a less pronounced effect on US share prices, which were supported by expectations of a delay in policy tightening by the Federal Reserve, stronger-than-expected US payrolls data and better-than-expected corporate earnings.

Share prices of banks in the major markets fell following the UK referendum result (by around 10 per cent) and have underperformed the broader indices to be significantly lower over the year so far (Graph 2.12). A number of factors have contributed to the weakness in bank share prices: a general decline in bank earnings expectations, predominantly attributed to concerns about growing pressure on net interest margins resulting from lower risk-free rates and a flatter yield curve; ongoing concerns about Italian banks' non-performing loans; and the upcoming Italian constitutional referendum in October.

Reported net income of European banks has declined compared with the same period in 2015, but was generally above consensus expectations. Net interest income tended to be lower, while higher revenues from trading provided some support for the income of a number of banks. Headline profits of the major US banks declined in the June quarter compared with the same period last year, largely as a consequence of idiosyncratic factors (such as restructuring costs), most of which are not likely to be recurring. US banks benefited from a decline in expenses (largely a result of cost-cutting efforts), lower loan loss provisions and an increase in fixed income trading revenues amid higher client activity. However, net interest margins declined in the quarter.

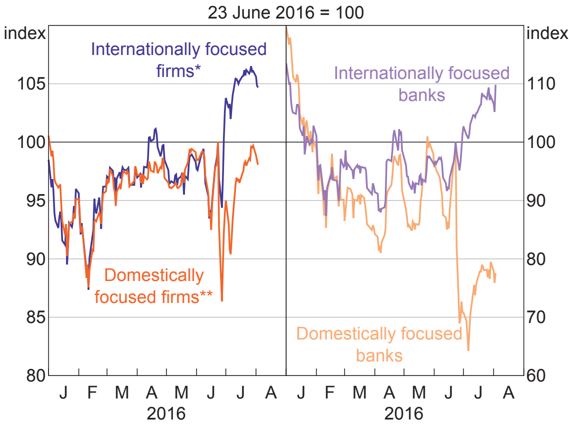
The stress tests by the European Banking Authority published in late July highlighted the progress of 51 of the largest European banks (covering around 70 per cent of banking assets in the European Union) in strengthening their capital. Only a small number of banks had their projected capital ratio fall below their respective regulatory minimums in the 'adverse' stress test scenario, although the sample was smaller than at the previous stress test in 2014.

Share prices of UK banks also fell immediately following the referendum, though there has been a large variance in outcomes (similar to the wide spectrum of outcomes for UK companies discussed above). The share prices of large UK banks with a more domestic focus (such as Lloyds and Royal Bank of Scotland) have fallen by around 25 per cent, reflecting concerns that weaker macroeconomic fundamentals could expose these banks to a decline in revenues and deteriorating asset quality (including in relation to the commercial property market). The BoE reduced the countercyclical capital buffer (which was scheduled to become effective from March 2017) from 0.5 per cent to 0 per cent in an effort to ease financial conditions for UK banks. In contrast to their domestically focused counterparts, share prices of more internationally focused UK banks have risen significantly (Graph 2.13).

Share prices of asset managers and insurance firms in the United Kingdom also fell immediately after the referendum. Six UK commercial property funds, representing a large proportion of the property fund market, have suspended redemptions temporarily due to exceptional liquidity pressures. Redemption requests had risen after the UK referendum as investors became concerned about a fall in UK commercial property prices. Other commercial property funds continued to allow redemptions but had significantly lowered the unit prices at which investor holdings could be redeemed.

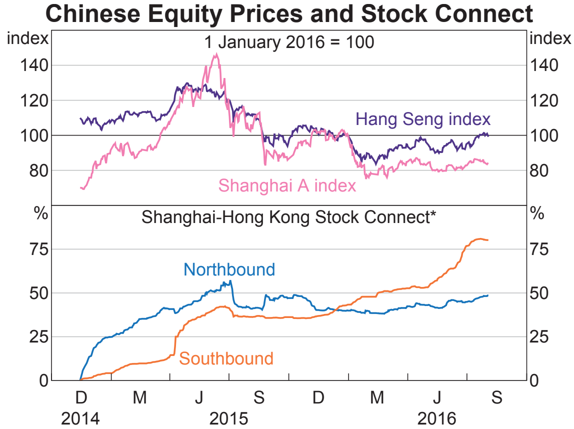
Share prices in emerging market economies have generally outperformed advanced economy equity prices since the beginning of the year, although performance has been mixed in recent months. Chinese equity prices, while still significantly lower than at the start of the year, have been little changed in recent months (Graph 2.14). Investments in Hong Kong-listed (and Hong Kong dollar-denominated) shares via the Stock Connect program have increased by around 50 per cent since early May (equivalent to an increase in the aggregate quota usage by 25 percentage points), alongside a decline in the renminbi's exchange rate against the US dollar. Equity prices in the Philippines rose by around 10 per cent following the presidential election in the beginning of May. Brazilian equity prices performed strongly alongside capital inflows and improved sentiment under the government led by the interim president. In contrast, Turkish equity prices fell sharply following the attempted military coup and announcement of a three-month state of emergency, reversing most of their gains since the start of the year.

Graph 2.13
UK Share Prices



* FTSE 100
** FTSE 250
Sources: Bloomberg; RBA

Graph 2.14
Chinese Equity Prices and Stock Connect

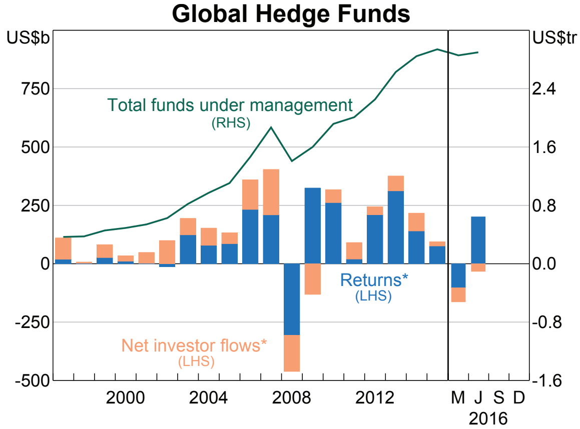


* Aggregate balance used as a share of total aggregate quota. Calculated on a 'net buy' basis after adjustments
Source: Bloomberg

Hedge Funds

Global hedge funds recorded an asset-weighted return on investment of 1.1 per cent over the June quarter. The return underperformed a balanced portfolio of global bonds and equities. The strongest performance came from funds that invest in emerging markets, particularly Latin America. Fixed income relative value funds also experienced strong gains amid declining interest rates (and rising bond prices) in the United States, Europe and Japan. Investors have made net withdrawals from hedge funds for the third consecutive quarter, but positive investment returns saw funds under management increase by over US$40 billion over the June quarter to US$2.9 trillion (Graph 2.15).

Graph 2.15
Global Hedge Funds

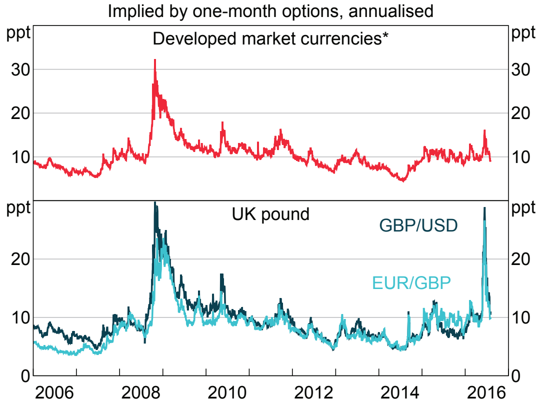


* Annualised for 2016 data
Sources: Hedge Fund Research, Inc.; RBA

Foreign Exchange

Foreign exchange markets have been primarily influenced by the UK referendum and evolving expectations about monetary policy in the major economies. Heightened uncertainty in the lead-up to the referendum contributed to a sharp increase in forward-looking measures of volatility in the main developed market currency pairs, particularly for the UK pound (Graph 2.16). Immediately following the referendum, the UK pound depreciated sharply, while the US dollar and yen appreciated markedly. Volatility eased in the days following the referendum and is currently around its long-run average.

Graph 2.16
Volatility
Implied by one-month options, annualised

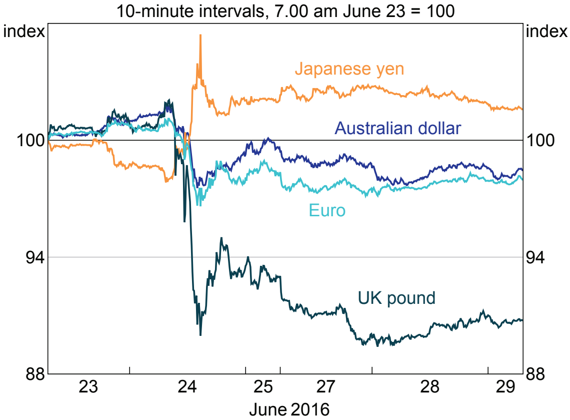


* EUR/USD, USD/JPY, GBP/USD, AUD/USD, USD/CAD, USD/CHF, EUR/JPY, EUR/GBP, EUR/CHF; weighted by share of foreign exchange turnover
Source: Bloomberg

Prior to the referendum, the UK pound moved within a relatively wide range alongside changes in the expected probability of the United Kingdom voting to exit the EU. The UK pound reached a high of US$1.50 per pound shortly after UK polls closed as markets expected a 'Remain' vote, but then depreciated by over 10 per cent to reach a low of US$1.32 per pound as it became likely that the referendum outcome would be a 'Leave' vote (Graph 2.17). Throughout this period, transaction volumes in foreign exchange markets were higher than usual and markets generally functioned well. The UK pound recovered slightly to US$1.37 by the close of the trading session on 24 June to finish the day 8 per cent lower; this was the largest daily move in the GBP/USD currency pair since the currency floated in 1971. Overall, the UK pound has depreciated by around 10 per cent against the US dollar from its level immediately prior to the referendum and is around its lowest level since 1985 (Graph 2.18). On the day of the referendum outcome, heightened risk aversion contributed to appreciation pressures on the Japanese yen, US dollar and Swiss franc. The euro also depreciated markedly against

Graph 2.17
Selected Currencies against the US Dollar*

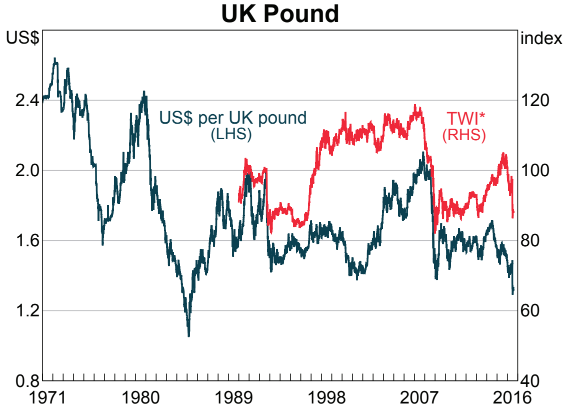
10-minute intervals, 7.00 am June 23 = 100



* Australian Eastern Standard Time (AEST)

Sources: EBS; Thomson Reuters

Graph 2.18
UK Pound



* 1990–2016 average = 100

Source: Bloomberg

the US dollar on the day of the referendum outcome, but recovered to settle around 2½ per cent lower over the day. Over the year to date, the euro has appreciated by around 2 per cent against the US dollar and on a trade-weighted (TWI) basis.

Since early May, the US dollar has appreciated by 3 per cent on a trade-weighted basis, despite market participants pushing back their expectations for the timing of the next policy rate increase by the FOMC (Table 2.3; Graph 2.19). The appreciation has been most pronounced against the currencies of European countries,

Table 2.3: Changes in the US Dollar against Selected Currencies

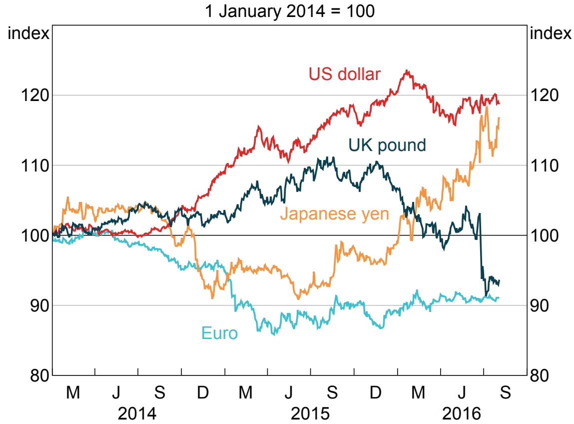
Per cent

	Over 2015	2016 to date
UK pound sterling	6	11
Mexican peso	17	10
Chinese renminbi	5	2
Swedish krona	8	1
Indian rupee	5	1
Philippine peso	5	0
European euro	11	−3
Thai baht	10	−3
Swiss franc	1	−3
New Taiwan dollar	4	−3
Australian dollar	12	−4
New Zealand dollar	14	−5
Indonesian rupiah	11	−5
South Korean won	8	−5
Singapore dollar	7	−5
Canadian dollar	19	−6
Malaysian ringgit	22	−6
Russian rouble	24	−8
Japanese yen	0	−16
Brazilian real	50	−18
TWI	**10**	**−1**

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

Graph 2.19
Nominal Trade-weighted Indices

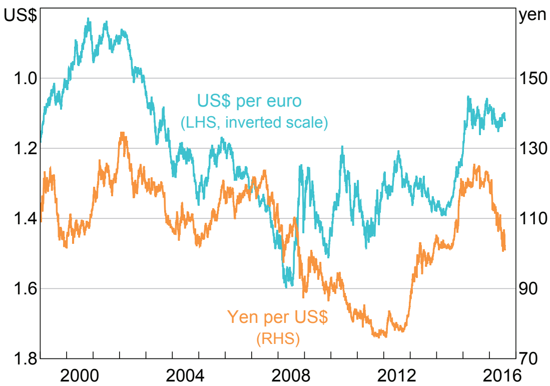
1 January 2014 = 100



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System particularly the United Kingdom. Notwithstanding the recent appreciation, the US dollar remains around 4 per cent below its peak in late January on a trade-weighted basis.

The Japanese yen has traded in a wide range against the US dollar amid speculation of further macroeconomic policy stimulus in Japan (Graph 2.20). The Japanese yen experienced bouts of appreciation alongside the BoJ's decision to leave monetary policy largely unchanged at its June and July meetings and increased risk aversion associated with uncertainty around the UK referendum, but also depreciated significantly ahead of the BoJ's July meeting. Overall, the yen has appreciated by around 6 per cent against the US dollar and around 8 per cent in trade-weighted terms since the previous *Statement*. It reached its highest level against the US dollar in three years.

Graph 2.20
US Dollar

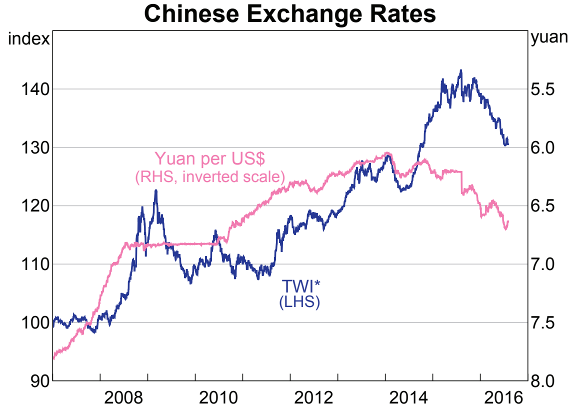


Source: Bloomberg

In the month leading up to the UK referendum, the Swiss franc appreciated by 3 per cent against the US dollar and by 2 per cent against the euro, reflecting safe-haven flows. Since the referendum, the Swiss franc has been little changed against the US dollar and the euro. The Swiss National Bank (SNB) intervened in the foreign exchange market following the UK referendum to mitigate appreciation pressure on the franc. Over the month of June, SNB's foreign currency reserves rose by 6.7 billion francs to 608.8 billion francs (equivalent to 95 per cent of GDP).

The Chinese renminbi (RMB) has continued to depreciate against a broad range of currencies, to be 6 per cent lower on a trade-weighted basis since the start of the year and 9 per cent lower since its early August 2015 peak (Graph 2.21). Against the US dollar, the RMB has depreciated by 2 per cent over the year to date and reached its lowest level since 2010. The RMB continues to trade in the offshore market at a discount to the onshore market; however, the level of the discount has remained small relative to that seen in December 2015.

Graph 2.21
Chinese Exchange Rates

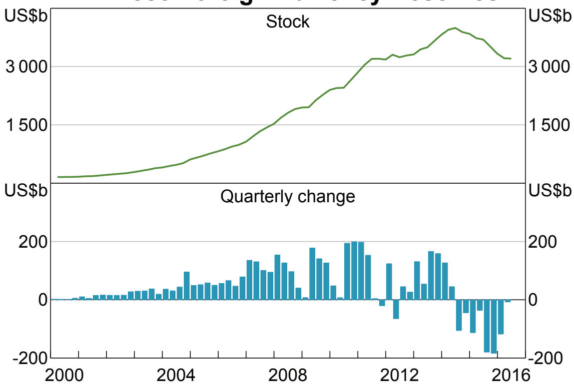


* Indexed to 2007 average = 100
Sources: BIS; Bloomberg; RBA

The PBC's foreign currency reserves decreased by only US$7 billion in the June quarter, which is likely to have reflected valuation effects (Graph 2.22). Overall, the value of reserves has been broadly stable since February, at around US$3.2 trillion (29 per cent of GDP). This suggests that net capital outflows have declined, following the large capital outflows in the year to the March quarter 2016.

In mid June, the Chinese authorities granted the United States a RMB250 billion quota under the RMB Qualified Foreign Institutional Investor scheme and committed to establish two RMB clearing banks in the United States. A commitment to establishing a clearing bank in Russia was also announced. The

Graph 2.22
Chinese Foreign Currency Reserves

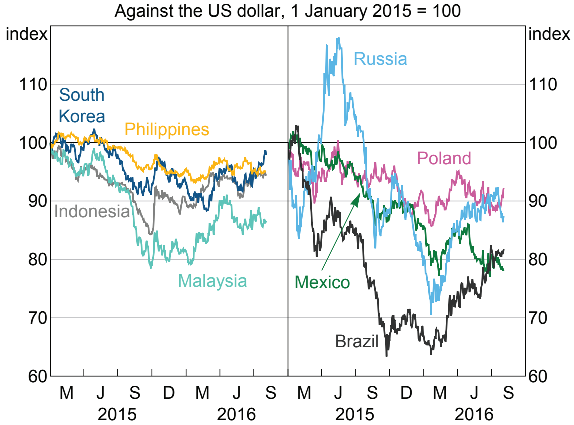


Source: CEIC Data

PBC also allowed the Korean won and the South African rand to trade directly with the RMB in the onshore foreign exchange market. There are now 14 currencies that trade directly with the RMB in the onshore market.

Over the past few months, most other Asian currencies have been little changed against the US dollar, while most other emerging market currencies have depreciated against the US dollar (Graph 2.23). In the lead-up to the UK referendum, most emerging market currencies appreciated against the US dollar but depreciated following the outcome – particularly the currencies of emerging European economies. Over the past few months,

Graph 2.23
Asian and Emerging Market Currencies
Against the US dollar, 1 January 2015 = 100



Source: Bloomberg

volatility in emerging market currencies has remained above its average level since 2010.

The Brazilian real has continued to appreciate against the US dollar over recent months alongside domestic political developments and increases in commodity prices, to be around 28 per cent above its trough in late January. In July, Brazil's central bank recommenced auctioning reverse foreign exchange swaps, which helped to curb appreciation pressure on the currency from late March through to mid May this year. In contrast, the Mexican peso has depreciated by 9 per cent since its peak in late April. Over recent months, the peso has depreciated by more than most other emerging market currencies; according to market participants, this is partly due to the peso being traded as a general proxy for risk in emerging market economies. Given the depreciation of the peso and concerns about its effect on inflation and inflation expectations, the Bank of Mexico increased its policy rate by 50 basis points at its June meeting.

The gross foreign currency reserves of most emerging market economies have been little changed or have increased slightly since the end of March (Table 2.4). The increase in Argentina's gross foreign currency reserves since the end of March has largely reflected the proceeds of bond sales.

Australian Dollar

The Australian dollar has appreciated a little against the US dollar and on a trade-weighted basis since the previous *Statement*, and appreciated by 11 per cent against the UK pound (Table 2.5; Graph 2.24). Throughout this period, the Australian dollar has been affected by changes in expectations for monetary policy in Australia and the United States, as well as the uncertainty surrounding the UK referendum. The Australian dollar was volatile on the day of the UK referendum outcome and bid-ask spreads in the AUD/USD currency pair increased for a time (see 'Box C: Australian Financial Markets and the UK Referendum'). The Australian dollar is

Table 2.4: Gross Foreign Currency Reserves[(a)]

	Percentage change since:		Level
	End June 2015	End March 2016	US$ equivalent (billions)
China	–13	0	3 205
Saudi Arabia	–15	–3	560
Taiwan[(b)]	3	0	434
South Korea	–2	0	360
Brazil	–1	3	357
Hong Kong	7	1	351
India	2	1	338
Russia	5	0	318
Singapore	–2	1	246
Mexico	–8	–1	169
Thailand	12	2	169
Indonesia	1	2	103
Turkey	1	6	100
Malaysia	–8	0	89
Argentina	–8	10	26

(a) Data to end June for China, Hong Kong, Indonesia, Mexico, Saudi Arabia, Singapore, South Korea, Taiwan and Thailand; to 15 July for Malaysia; to 22 July for India, Russia and Turkey; to end July for Argentina and Brazil.
(b) Foreign exchange reserves (includes foreign currency and other reserve assets).
Sources: Bloomberg; CEIC Data; central banks; IMF; RBA

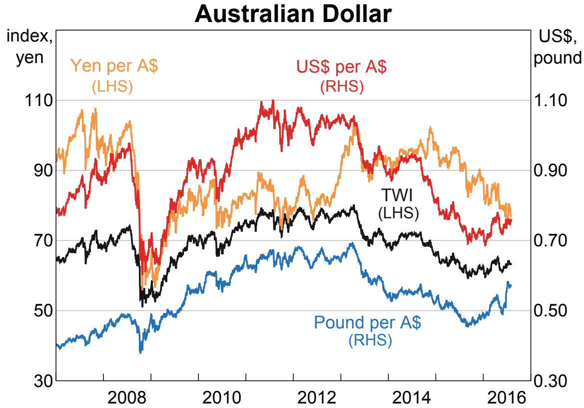
Table 2.5: Changes in the Australian Dollar against Selected Currencies

Per cent

	Over 2015	2016 to date
UK pound sterling	–6	15
Chinese renminbi	–7	6
Indian rupee	–7	5
US dollar	–11	4
European euro	–1	1
Thai baht	–2	1
Swiss franc	–10	1
New Zealand dollar	2	–1
Indonesian rupiah	–1	–1
South Korean won	–4	–1
Singapore dollar	–5	–1
Canadian dollar	6	–2
Malaysian ringgit	9	–2
South African rand	19	–6
Japanese yen	–11	–12
TWI	**–6**	**1**

Sources: Bloomberg; RBA

Graph 2.24
Australian Dollar



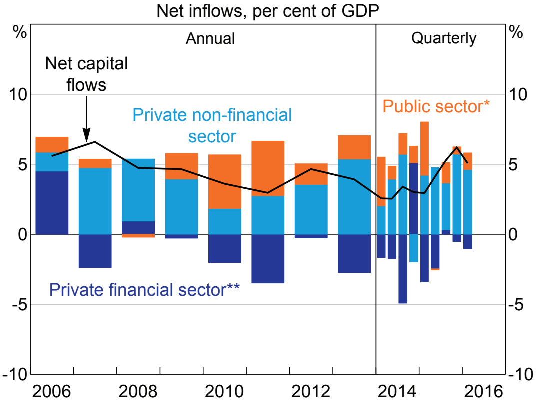
Sources: Bloomberg; RBA

currently around 10 per cent higher against the US dollar and 8 per cent higher on a TWI basis than the low it reached in September 2015. However, the Australian dollar is still around 20 per cent lower against the US dollar and around 12 per cent lower on a TWI basis than its peak in mid 2014.

Capital Flows

Net capital inflows to the Australian economy were equivalent to 5.1 per cent of GDP in the March quarter, around ½ percentage point higher than the average of net capital inflows over the past 10 years (Graph 2.25). Net capital inflows in the quarter largely reflected flows to the private non-financial sector, most of which were directed to the mining sector, while there were net outflows from the financial sector. There were modest net inflows to the general government and state and local government sectors in the March quarter. Notwithstanding this, the foreign ownership share of Australian Government Securities fell by 3 percentage points to 60 per cent as net issuance was larger than foreign purchases, while the foreign ownership share of state government debt increased slightly.

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



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

Australia's net foreign liability position increased to a little over 60 per cent of GDP at the end of the March quarter, in part because of exchange rate valuation effects. The net income deficit, which largely comprises payments made on Australia's net foreign liabilities, widened to 3.1 per cent of GDP in the March quarter, primarily reflecting operating losses on Australia's foreign direct equity assets.