Statement on Monetary Policy

FEBRUARY 2014

Contents

	Overview	1
1.	International Economic Developments	5
	Box A: Japan's Consumption Tax Increase	12
2.	International and Foreign Exchange Markets	15
3.	Domestic Economic Conditions	29
	Box B: The Housing Market	38
4.	Domestic Financial Markets	41
5.	Price and Wage Developments	51
	Box C: Recent Developments in Retail Prices and Margins	56
6.	Economic Outlook	59

The material in this *Statement on Monetary Policy* was finalised on 6 February 2014. The next *Statement* is due for release on 9 May 2014.

The *Statement on Monetary Policy* is published quarterly in February, May, August and November each year. All the *Statements* are available at www.rba.gov.au when released. Expected release dates are advised ahead of time on the website. For copyright and disclaimer notices relating to data in the *Statement*, see the Bank's website.

Some graphs in this publication were generated using Mathematica.

Statement on Monetary Policy Enquiries

Information Department
Tel: +61 2 9551 9830
Fax: +61 2 9551 8033
Email: rbainfo@rba.gov.au

ISSN 1448–5133 (Print)
ISSN 1448–5141 (Online)

Overview

In the second half of 2013, growth in Australia's major trading partners looks to have continued at close to the average pace of the past decade. Economic growth in China remained a little above the government's target of 7.5 per cent for 2013, supported by consumption and investment. In Japan, economic conditions showed further improvement towards the end of last year, consistent with expansionary fiscal and monetary policy and the associated depreciation of the yen. In the rest of east Asia, growth over recent quarters appears to have been close to its average of the past decade and was broad based across consumption, investment and exports. There are signs that economic growth in India has improved somewhat, and inflation has eased a little but remains high. The recovery in the US economy strengthened through the second half of 2013, driven by private demand, and the labour market continued to improve. The recent agreement on the budget implies a smaller contraction in public demand than was scheduled to occur. In the euro area, there are tentative signs of a gradual recovery. Inflation in the major economies remains low, although it has increased in Japan.

With the global economy evolving broadly as expected since the November *Statement,* the Bank's forecast for growth in Australia's major trading partners is little changed. Year-average trading partner growth in 2014 is expected to be a bit faster than in 2013, at around 4½ per cent, driven by a recovery in the advanced economies. It is expected to return to its decade average of around 4 per cent in 2015.

Overall, commodity prices are lower in the past three months than in the preceding period, with spot prices for iron ore and coking coal having declined over the past couple of months. While global demand for commodities is expected to continue to expand, commodity prices, and hence Australia's terms of trade, are likely to decline gradually over coming years on the back of strong growth in global production of bulk commodities. This follows a number of years of high investment in the resources sector in Australia and elsewhere.

Financial markets have been focused on two factors in recent months: the policy actions of the major central banks and developments in emerging markets. The US Federal Reserve started the process of reducing its asset purchases and also indicated that it is likely to keep the policy rate at its current low level for a considerable period. Meanwhile, the European Central Bank stated that it will take further action to address the risk of deflation, if needed, and the Bank of Japan stands ready to increase the extent of its stimulus, but so far it has not suggested that this will be needed to meet its inflation goal. The response of most bond markets to these developments was fairly muted, with yields largely unchanged. Moreover, borrowing costs of countries in the periphery of the euro area declined to their lowest level in some time. Corporate bond spreads in the United States and the euro area continued to narrow. In contrast, financial conditions in some emerging markets have become more unsettled of late. In these cases, bond and equity prices have fallen and exchange rates have depreciated noticeably. This recent weakness follows from a general lessening of the appetite for risk compounded by country-specific problems.

The Australian dollar has depreciated by around 5 per cent since the November *Statement* in response to economic developments both at home and abroad. This unwound the appreciation over the preceding few months, leaving the currency around 12 per cent lower than it was at the time of the May *Statement*. If sustained, lower levels of the exchange rate will assist in achieving balanced growth in the economy.

The economy looks to have expanded at a below-trend pace over the second half of 2013, although a range of indicators suggest that conditions have been more positive of late. Below-trend growth has occurred against the background of declining mining investment, subdued growth of non-mining business investment, ongoing fiscal restraint and the high level of the exchange rate that had prevailed. It is too early to have seen the effects of the most recent movements in the Australian dollar on economic activity, but the effects of the lower currency would be expected to begin to appear in the traded sector over the year ahead.

Consumption growth was a little below average over the year to the September quarter, consistent with little growth in employment and slow growth of wages. However, indicators of consumption have been more positive of late. Growth of retail sales picked up over the latter months of last year and the Bank's liaison points to further growth around the turn of the year. Measures of consumer sentiment remain a little above average, notwithstanding a small decline. The run-up in housing and equity prices over the past year or so would typically be associated with consumption growing a bit faster than incomes, so the household saving rate may decline a little in coming quarters.

While dwelling investment made only a minor contribution to growth in the economy over the year to the September quarter, a strong increase in approvals for residential building points to a pick-up in investment in the coming year. Low lending rates and the continued strength in the established housing market are providing support to new dwelling activity. Nationally, housing prices have increased by around 10 per cent over the past year, with recent increases broad based across capital cities. Demand for established housing has been strong by both investors (particularly in New South Wales) and repeat-buyers, with the value of loan approvals to these buyers increasing strongly over 2013. Accordingly, growth of housing credit, while still low by historical standards, is gradually picking up, and more so for investors.

Mining investment appears to have declined over the past year and is expected to fall further over the next few years. This has been, and will continue to be, associated with lower capital imports and rising exports as more resource projects reach completion. Indeed, exports have grown strongly of late, largely reflecting higher resource exports. Exports of services and manufactured goods have been little changed over the past year, although the depreciation of the exchange rate should provide support for these exports over time.

Non-mining business investment remains subdued. While this is consistent with measures of business conditions and confidence having been below average over the past year, in the past few months these measures have improved noticeably. Some measures of business conditions have increased to be a little above average. However, at this point, surveys of investment intentions for non-mining investment remain subdued and liaison suggests that firms want to see a substantive improvement in demand conditions before committing to hiring new workers or increasing investment significantly.

The labour market has remained weak, a result of growth in economic activity having remained below trend. There has been little employment growth over the past year, the unemployment rate has edged higher and the participation rate has declined noticeably. Much of the weakness in employment has been accounted for by business services, which in part reflects the effects of the shift from the investment to the production phase of the resources boom. Forward-looking indicators of labour demand, such as vacancies and job advertisements, have shown tentative signs of stabilising over recent months, but remain at low levels consistent with only slow growth of employment in the months ahead.

Weakness in the labour market has seen growth of wages slow further. Various measures of wage growth are now around the lowest they have been over the past decade or longer. Wage growth is likely to remain moderate for some time given the weak labour market, with fiscal restraint also weighing on public sector wage growth.

Consumer price inflation was higher than expected in the December quarter, for both tradable and non-tradable items, and picked up in the second half of 2013. In the quarter, much of the pick-up was attributable to tradables prices, which have increased in recent quarters after declining markedly since 2010. However, non-tradables inflation (abstracting from increases in administered prices) also increased in the quarter. The various measures of underlying inflation suggest that the quarterly pace picked up to between ¾ and 1 per cent in the December quarter, and in year-ended terms underlying inflation is now a touch above 2½ per cent.

There are several possible explanations for the higher-than-expected inflation outcome. For tradable items, it could be that higher import prices, following the depreciation of the exchange rate, have been passed through to final consumer prices a little faster than in the past. For non-tradable items, it could be that slower growth of labour costs is taking longer than usual to pass through to final prices. More generally, margins in both the traded and non-traded sectors may have increased. Such a rise in margins appears to be at odds with the below-trend growth of consumption, at least over the year to the September quarter. However, more recently there have been tentative signs of improved trading conditions for the retail sector, housing construction and domestic travel and leisure. If the higher-than-expected inflation did result from a strengthening in demand, this would suggest that there is less spare capacity in the economy than previously thought. Alternatively, it could be that there is less spare capacity because the productive potential of the economy has been growing more slowly than previously thought given subdued non-mining investment. It is equally possible that the quarterly outturn reflects a degree of random noise in the data. It is not possible to distinguish clearly between the different explanations because of the inability to directly observe pass-through, margins, costs or noise. Some combination of these may be at work.

The outlook for the domestic economy is a little stronger over 2014 than at the time of the November *Statement*. The revision reflects, in part, the effect of the lower exchange rate, which is expected to provide some boost to activity in the traded sector. As foreshadowed by the improvement in a number of indicators of activity over recent months, GDP growth is likely to strengthen a little in 2014 though to a pace that is still only trend at best. Growth is then expected to pick up to an above-trend pace by mid 2016. The outlook for the next year or so reflects the substantial fall in mining investment and planned fiscal restraint. At the same time, low interest rates are stimulating prices and turnover in the established housing market as well as dwelling construction. Over time, these conditions can be expected to lead to higher consumption growth and provide support for non-mining investment. Also, resource exports are expected to continue to make a significant contribution to output growth for some time as resource investment projects reach completion.

With growth of economic activity expected to remain below trend for a few more quarters at least, it is likely that employment growth will be only moderate over the coming year and the unemployment rate will continue to edge higher. From around early 2015, stronger economic growth should underpin an increase in labour demand, with growth in employment increasing and the unemployment rate declining gradually.

The inflation forecasts have been revised higher in the short term, reflecting the effect of the depreciation of the exchange rate since November and the higher-than-expected December quarter CPI outcome, offset somewhat by the impact of the softer outlook for wages growth. Underlying inflation is expected to be close to 3 per cent over the year to June 2014. Given the slow growth of wages and limited domestic cost pressures more generally, underlying inflation is then expected to decline to be closer to 2½ per cent. Headline inflation is expected to peak a bit higher than underlying inflation, reflecting movements in some volatile items. As these effects drop out of the year-ended rate, headline inflation is also forecast to decline. Over the forecast period, inflation is expected to be consistent with the 2 to 3 per cent target.

Overall, the risks surrounding the forecasts for the global economy appear to be broadly balanced for most countries. However, in the United States more positive economic conditions and recent progress in addressing budget funding issues suggest that the risks there are now somewhat to the upside. In the euro area, the risks are still to the downside, reflecting the ongoing need for resolution of its banking and fiscal problems. Financial market volatility and capital outflows affecting some emerging market economies remain an important concern. If these problems were to deepen and become more widespread, they could impinge upon the global outlook.

For the domestic economy, there are both downside and upside risks for economic activity and inflation. The magnitude and timing of the decline in mining investment over the forecast period remains an important source of uncertainty, as does the anticipated pick-up in non-mining investment. For the household sector, the weak growth of labour income could weigh on spending, although rising asset prices and higher turnover of housing could work to boost consumption by more than expected.

There are a number of plausible explanations for the higher-than-expected inflation data in the December quarter, and so the implications of that for activity and inflation are unclear at this stage. In particular, there is uncertainty about the speed and extent of pass-through of the lower exchange rate, which is working to increase inflation, and the weaker growth of wages, which is working in the other direction.

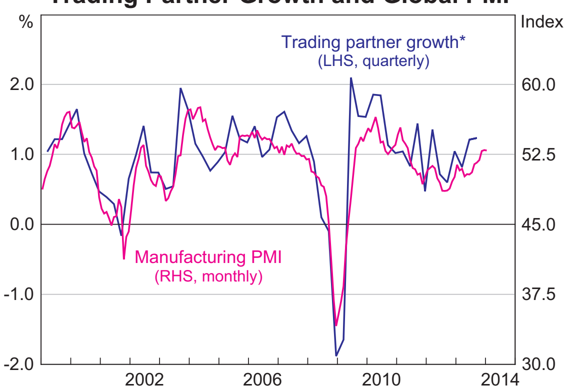
After reducing the cash rate by 25 basis points in August, the Board kept the cash rate at 2.50 per cent. This has left interest rates for household and business borrowing at historically low levels. Over the past few months, there have been further signs that very stimulatory monetary policy is working to support economic activity. This is clearly evident in the housing market and indications are that dwelling investment will pick up in the coming quarters. There have also been some recent signs of a modest improvement in consumer spending and a recent pick-up in business sentiment. These developments, and the depreciation of the exchange rate over recent months, suggest that there are reasonable prospects for activity outside the resources sector to pick up over time. Nevertheless, it is likely that the unemployment rate will continue to edge higher for a few quarters, and turn down only after growth rises to an above-trend pace. The recent further depreciation of the exchange rate will also add to inflation for a period. But domestic cost pressures remain contained and, over the forecast period, inflation is expected to remain consistent with the target.

At the December and February meetings, the Board judged that, given the substantial degree of policy stimulus that had been imparted and evidence of its effects, it was prudent to hold the cash rate steady. At present, market pricing suggests no change to the cash rate is expected for about a year.

The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the inflation target over time. Based on the outlook for inflation and activity as it currently stands, the Board's view is that a period of stability in the policy rate is likely.

1. International Economic Developments

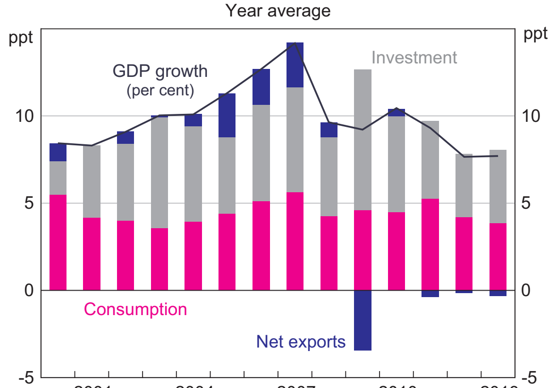
Growth in Australia's major trading partners in the September quarter remained close to its average of the past decade. Global PMIs and the available GDP data are consistent with these conditions continuing into the December quarter (Graph 1.1). Conditions have improved in the advanced economies and have been little changed in China, while Australia's other trading partners in Asia have generally been growing at around their decade-average pace.



* Aggregated using total export weights
Sources: CEIC Data; IMF; Markit Economics; RBA; Thomson Reuters

Asia-Pacific

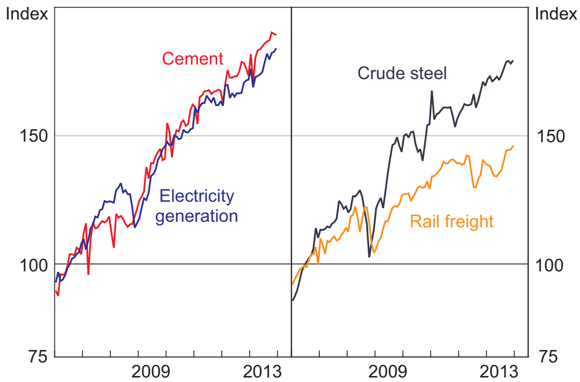
In China, economic growth has now been relatively stable for a year and a half, following an earlier slowing in the pace of growth. In the December quarter, GDP increased by 1.8 per cent, to be 7.7 per cent higher in 2013 (Graph 1.2). Real household consumption has grown strongly, consistent with the growth of household disposable income, and growth of fixed asset investment has been stable despite some decline in the rate of growth of infrastructure investment. A range of indicators suggest that industrial activity moderated a little towards the end of 2013 (Graph 1.3). Growth in electricity generation and rail freight volumes slowed in November and December, while modest growth in the output of construction-related products, such as crude steel and cement, partly offset stronger outcomes for other manufactured items.



Source: CEIC Data

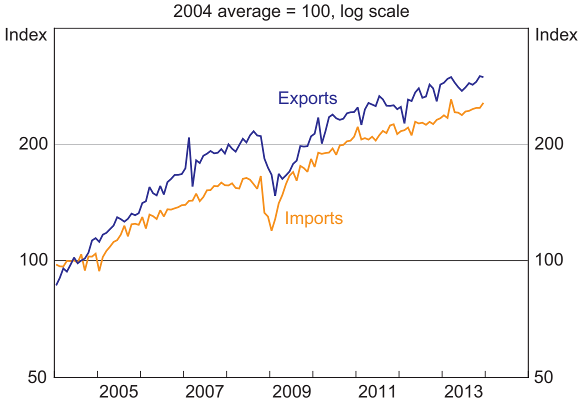
Exports rose strongly in the December quarter, with the pick-up broad based across destinations (Graph 1.4). This is consistent with the stronger growth in advanced economies. In recent months, exports to Hong Kong have continued to grow more rapidly than implied by Hong Kong's imports data. In December, Chinese authorities tightened controls on trade documents to counteract false invoicing of exports being used to circumvent controls on capital flows. Both non-resource imports and resource imports (including coal and iron ore) grew at a moderate pace in the December quarter.

Graph 1.3
China – Selected Activity Indicators
2006 average = 100, log scale



Sources: CEIC Data; RBA

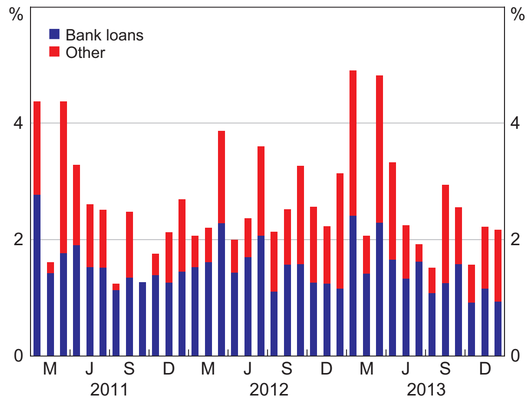
Graph 1.4
China – Merchandise Trade Volumes*
2004 average = 100, log scale



* Seasonally adjusted by the RBA
Sources: CEIC Data; RBA

Liquidity conditions in Chinese money markets tightened markedly on a number of occasions in recent months, following a period of relative calm since the earlier tightening in June (see the 'International and Foreign Exchange Markets' chapter). Total social financing flows have moderated from the rapid pace seen in early 2013, consistent with authorities' efforts to reduce the scale of bank and non-bank financing (Graph 1.5). However, financing activity is still being substantially driven by non-bank sources, which has been a particular concern of the authorities over the past year. Somewhat related to this, there have been concerns about local governments' liabilities and their ability to service

Graph 1.5
China – Total Social Financing
Monthly flows, per cent of annual GDP

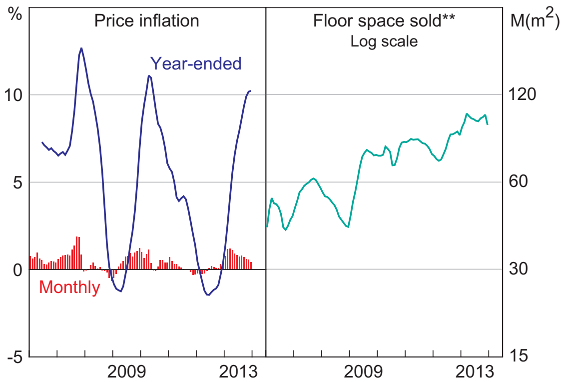


Sources: CEIC Data; RBA

them. In response, an audit of government debt was conducted, which estimated that local government borrowing had increased to around 33 per cent of GDP as at mid 2013, higher than reported by the previous audit at the end of 2010. The composition of local government debt had changed noticeably and, as with non-government debt, was increasingly being sourced from outside of bond markets and the formal banking sector. Reflecting concerns about the risks involved in the type of financing used by local governments, reforms announced late last year would eventually enable more local governments to issue debt directly rather than needing to obtain funding via less transparent means.

The property market appears to be responding to the tightening of controls on property transactions and borrowing imposed through 2013. In particular, price growth has slowed a little in recent months (Graph 1.6). In the large eastern cities, the authorities have introduced city-specific controls and increased the supply of land available for development; these policies are expected to remain in place through 2014. Consistent with the slowing in property price inflation, property sales fell in the December quarter. Real estate investment grew at a strong pace in the quarter, reflecting strong growth in non-residential building and more moderate growth in residential building investment.

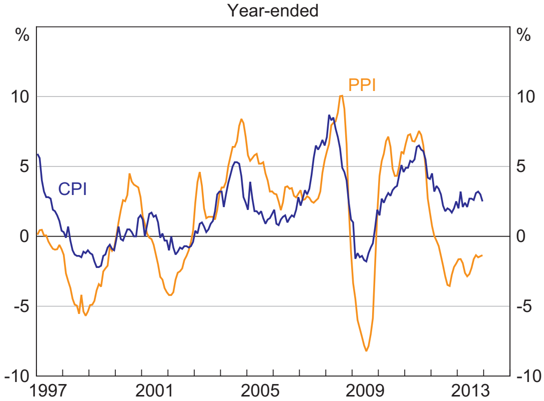
Graph 1.6
China – Residential Property Market*



* RBA estimates
** Three-month moving average
Sources: CEIC Data; RBA

Inflationary pressures in the Chinese economy remain contained (Graph 1.7). Year-average inflation for 2013, at 2.6 per cent, was well below the authorities' target of 3.5 per cent. Non-food price inflation remained subdued, and there was little evidence of upstream price pressures, with producer prices continuing to decline. Food price inflation has stopped rising, consistent with improved supply conditions after weather-related disruptions to vegetable crops earlier last year.

Graph 1.7
China – Inflation
Year-ended

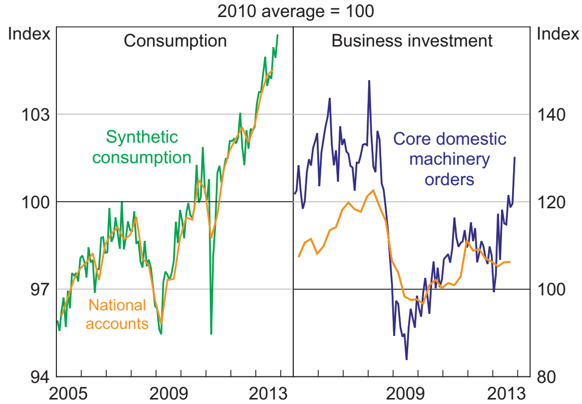


Source: CEIC Data

In Japan, the implementation of more expansionary monetary and fiscal policies, as well as the associated depreciation of the yen, saw economic growth pick up to be well above the average of the past decade. Private consumption, residential investment, public demand and exports grew strongly over the first three quarters of 2013.

A range of indicators suggest that the above-average pace of growth was sustained in the December quarter, with PMIs and exports rising further and industrial production growing strongly. Timely indicators suggest that consumption also continued to grow in the quarter and investment picked up (Graph 1.8). Consumption is likely to have been supported, at least in part, by consumers bringing forward some spending ahead of the scheduled increase in the consumption tax in April (see 'Box A: Japan's Consumption Tax Increase').

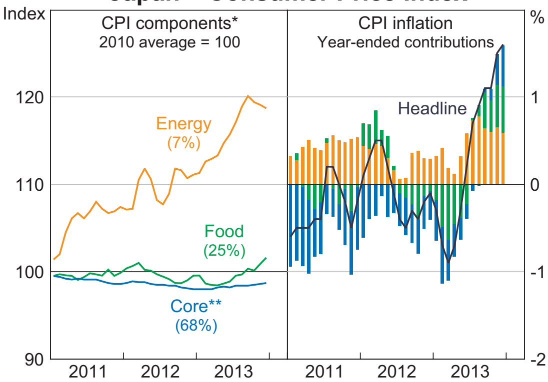
Graph 1.8
Japan – Consumption and Investment
2010 average = 100



Sources: CEIC Data; RBA; Thomson Reuters

Consumer price inflation picked up markedly over 2013 and is now close to the Bank of Japan's 2 per cent inflation target (Graph 1.9). The pick-up in inflation has largely flowed from increases in import prices, particularly for energy, stemming from the depreciation of the yen. More recently, energy prices appear to have stabilised. While inflation expectations have increased somewhat, to date there does not appear to have been a significant increase in wages. The increase in core inflation (which excludes food and fuel) appears to mostly reflect the effect of rising prices for imports and rising administered prices.

Graph 1.9
Japan – Consumer Price Index

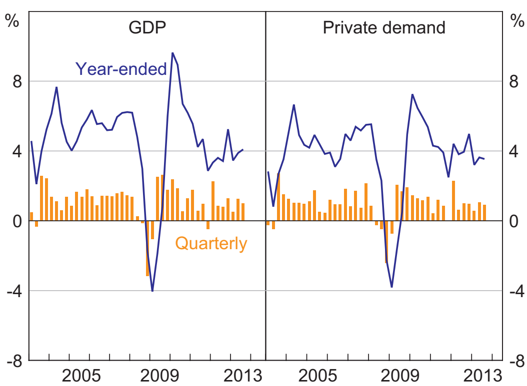


* Share of total CPI in 2010 indicated in parentheses
** Excludes energy and food (less alcoholic beverages)
Sources: CEIC Data; RBA; Thomson Reuters

In the rest of east Asia, growth in the September quarter was close to its average of the past decade (Graph 1.10). Recent growth has been broad based across private consumption, investment and exports.

The available data suggest that growth continued at around its average pace in the December quarter. PMIs and industrial production picked up in the quarter while retail sales data suggest moderate growth of consumption across the region. Growth of export volumes in the December quarter was above the pace seen in recent quarters.

Graph 1.10
East Asia* – GDP and Demand Growth

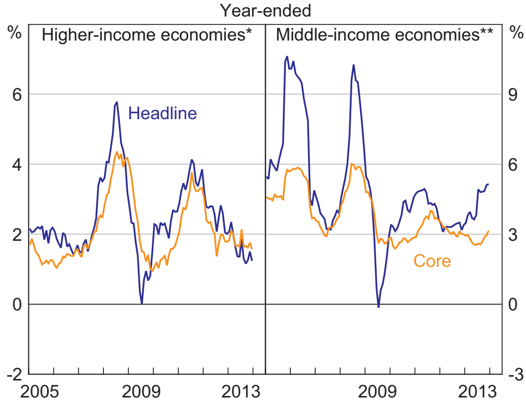


* Excluding China and Japan
Sources: CEIC Data; IMF; RBA

Meanwhile, inflation has been subdued in most economies in the region, although it has increased in some of the middle-income economies (Graph 1.11). In Malaysia, monthly headline inflation has remained elevated following reductions in fuel subsidies in September. The Malaysian Government allowed the national power distributor to increase electricity prices from January. In Thailand, inflation has been moderate alongside below-average growth in 2013, and recent political unrest may further weaken growth in 2014.

Graph 1.11
East Asia – Consumer Price Inflation

Year-ended

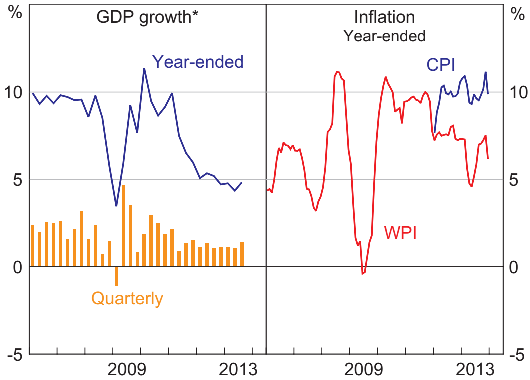


* Hong Kong, Singapore, South Korea and Taiwan
** Indonesia, Malaysia, Philippines and Thailand
Sources: CEIC Data; IMF; RBA; Thomson Reuters

Depreciations of a number of currencies in the region since the middle of 2013 have also put some upward pressure on import prices, which is expected to flow through to consumer prices.

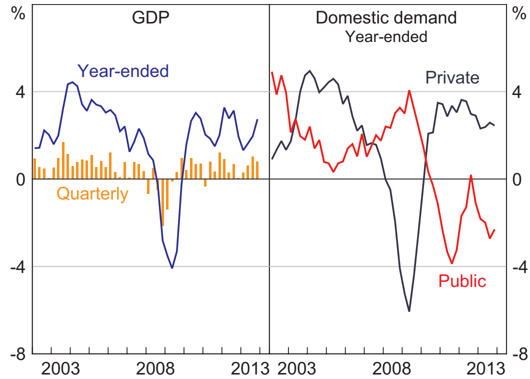
In India, recent data on activity show tentative signs of improved conditions, with GDP at factor cost growing by 4.8 per cent over the year to September 2013 (Graph 1.12). While consumption and investment rose in the quarter, both continued to grow at relatively modest rates. Net exports made a significant contribution to growth, partly reflecting the effect of depreciation of the rupee earlier in the year. Growth was also supported by agricultural output following good monsoon rainfall, although the large harvest in October and November will mostly be reflected in the December quarter output

Graph 1.12
India – GDP Growth and Inflation



* Measured at factor cost
Sources: CEIC Data; RBA

Graph 1.13
United States – Economic Growth



Source: Thomson Reuters

data. Inflation in India has shown some signs of moderating, aided by an easing of food prices following the improved harvest. The Reserve Bank of India recently published a review of its monetary policy framework, which recommended the eventual adoption of a target range for consumer price inflation centred on 4 per cent.

In New Zealand, the pace of economic growth picked up in the September quarter, to be 3.5 per cent higher over the year. Growth was driven by strong domestic demand, especially for residential investment. Housing prices increased by around 9 per cent over 2013, with the fastest pace recorded in Auckland. Consumer price inflation remains moderate; headline inflation is around 1½ per cent in year-ended terms.

United States

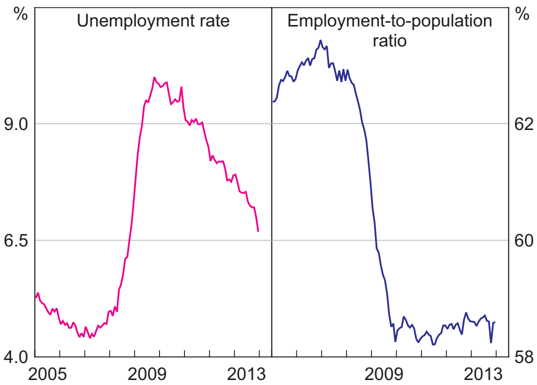
The pace of economic growth in the United States increased a little over the second half of 2013, with the economy expanding at an annualised rate of 3½ per cent (Graph 1.13). The recovery continues to be driven by private demand, with a noticeable increase in consumption, while declining public demand continues to weigh on growth. The recent political agreement to avoid further automatic federal government spending cuts in 2014 and 2015 implies that public demand will contract a little less than might otherwise have been the case.

More timely indicators are consistent with moderate growth of the US economy in recent months. Consumer sentiment has picked up in recent months and is now almost back to the levels seen just prior to the government shutdown in October last year. The manufacturing PMI and ISM index declined in January, although some of this weakness is likely to reflect adverse weather conditions. Capital goods orders ticked down in December, following strong growth in the preceding month.

Housing market conditions remain generally favourable. Housing prices have continued to rise at an annualised rate of around 10 per cent, builder confidence remains high and forward-looking indicators of residential building have picked up after a weak patch in the September quarter. Sales of new and existing homes have been below their recent peaks.

Conditions in the labour market have continued to improve over recent months. Even though non-farm payrolls employment increased only modestly in December, this followed a considerable increase in November. Over the two months, monthly payrolls growth was close to the average in the preceding six months. The unemployment rate declined by 0.9 percentage points over the second half of 2013, bringing it close to the Federal Open Market Committee's stated threshold of 6½ per cent for considering raising the federal funds rate (see the 'International and Foreign Exchange Markets' chapter; Graph 1.14). Nevertheless, the ratio of employment to

Graph 1.14
United States – Labour Market



Source: Thomson Reuters

population has remained around its lowest level in 30 years as the participation rate has declined. This is in large part because of the ageing of the population, but it is also likely to reflect some discouraged workers leaving the labour force.

Both core and headline measures of inflation are around 1 per cent in year-ended terms. In both December and January, the US Federal Reserve reduced its monthly asset purchases by US$10 billion to US$65 billion.

Europe

The gradual recovery of economic activity in the euro area continued in the September quarter, with GDP expanding modestly. Consumption and investment rose for the second consecutive quarter and imports continued to grow strongly. Germany again recorded comparatively strong growth, although GDP also increased in a number of other countries, including the Netherlands and Spain.

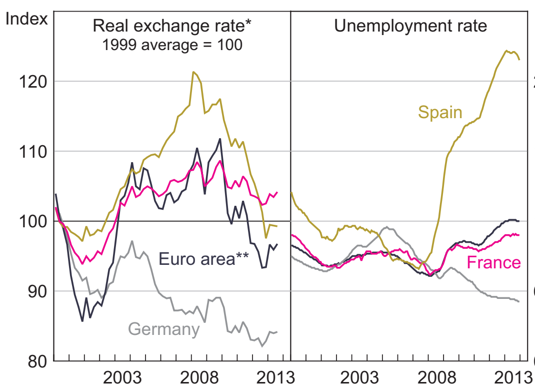
Activity also looks to have increased in the December quarter. Industrial production picked up noticeably in November, to be above the levels of the September quarter. More generally, the PMIs have been well above their levels of early 2013, and measures of both consumer and industrial confidence continued to improve to be slightly above long-run average levels.

These better economic conditions follow a period of gradually improving competitiveness in some crisis economies, reflecting a decline in unit labour costs relative to their major trading partners (Graph 1.15). Notably, Portugal and Spain saw strong growth of exports over 2013.

The unemployment rate appears to have stabilised over the second half of 2013, although it remains very high in many euro area economies. At the same time, credit growth has been particularly weak. Inflation remains very low in the euro area, with both headline and core inflation less than 1 per cent in year-ended terms, well below the European Central Bank's target of 2 per cent.

In the United Kingdom, the pace of economic growth picked up in 2013, with the economy expanding by 2.8 per cent over the year to the December quarter. Inflation has eased and has returned to the Bank of England's target of 2 per cent.

Graph 1.15
Euro Area – Economic Indicators



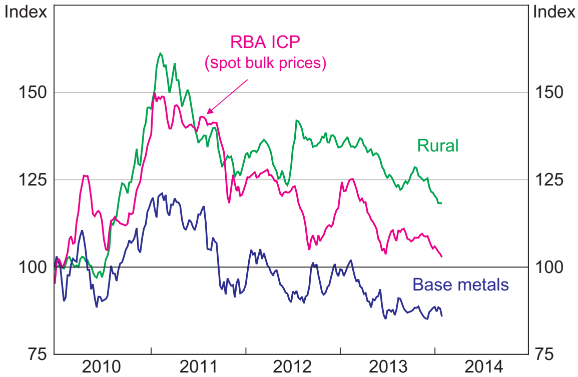
* Trade-weighted; deflated by unit labour costs
** Excluding intra-regional trade
Sources: European Central Bank; Thomson Reuters

Commodity Prices

Commodity prices have declined in the past few months (Graph 1.16; Table 1.1). The spot price for iron ore is a little lower, on average, since the November *Statement*. This reflects a decline in the iron ore price over the past month as growth in Chinese steel production has moderated. The spot price for hard coking coal continues to ease, which is likely

Graph 1.16
Commodity Prices*

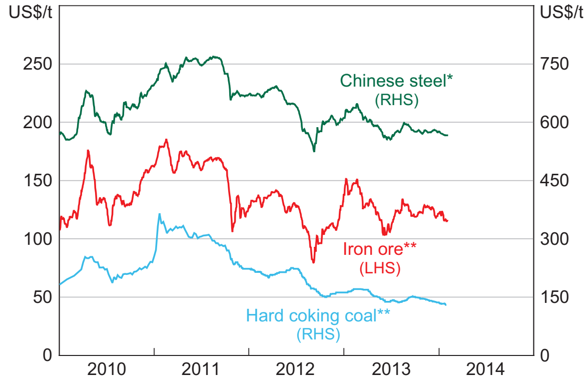
SDR, January 2010 average = 100, weekly



* RBA Index of Commodity Prices (ICP) sub-indices
Source: RBA

Graph 1.17
Steel, Iron Ore and Coking Coal Prices

Spot prices



* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; Citigroup; IHS Energy Publishing; Macquarie Bank; RBA

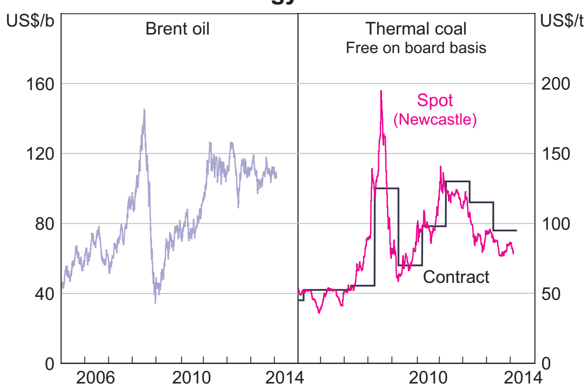
Table 1.1: Commodity Prices Growth[(a)]

SDR, 3-month-average prices, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	–2	–7
– Iron ore	–2	–4
– Coking coal	–7	–15
– Thermal coal	4	–9
Rural	–3	–11
Base metals	–2	–11
Gold	–8	–27
Brent oil[(b)]	–2	–2
RBA ICP	–1	–6
– using spot prices for bulk commodities	–2	–9

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodities prices are spot prices
(b) In US dollars
Sources: Bloomberg; IHS Energy Publishing; RBA

Graph 1.18
Energy Prices



Sources: Bloomberg; BREE; RBA; Thomson Reuters

to reflect increasing supply on the seaborne market (Graph 1.17). Base metal prices have edged a little lower since the November *Statement*. Gold prices declined over 2013, in anticipation of the US Federal Reserve's scaling back its asset purchase program.

Developments in energy prices have been mixed over the past few months (Graph 1.18). Crude oil prices have been little changed since the November *Statement*, while global spot prices for thermal coal have strengthened after declining over much of 2013. However, spot prices for thermal coal remain at low levels and considerably below the Japanese Financial Year contract price.

Prices of rural commodities overall have declined a little in recent months, despite some variation across individual commodities. Wheat prices have declined in conjunction with upward revisions to estimates of global crop production, but prices remain elevated relative to inflation-adjusted averages of recent decades.

Box A

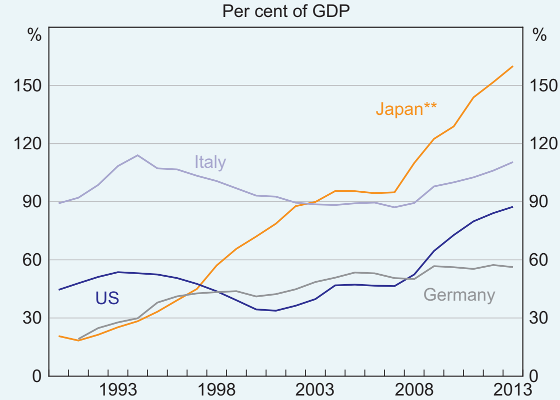
Japan's Consumption Tax Increase

Japan first introduced a consumption tax in 1989. The rate was initially set at 3 per cent, and was raised to 5 per cent in 1997. Following an improvement in economic conditions in 2013, the Japanese Government has decided to proceed with a further increase in the consumption tax rate to 8 per cent in April this year. The tax rate is legislated to increase a further 2 percentage points in October 2015, to 10 per cent. These increases will have important implications for the profile of consumption and economic activity around the time of implementation.

Following the collapse of property prices in the early 1990s and the subsequent recession, Japan's economy entered a period of slow growth in output and a general decline in prices. These developments, combined with an ageing population, contributed to a sustained weakening of the fiscal position and a substantial build-up in Japan's net public debt, which increased from 21 per cent of GDP in 1990 to 160 per cent in 2013, the highest of any advanced economy (Graph A1).

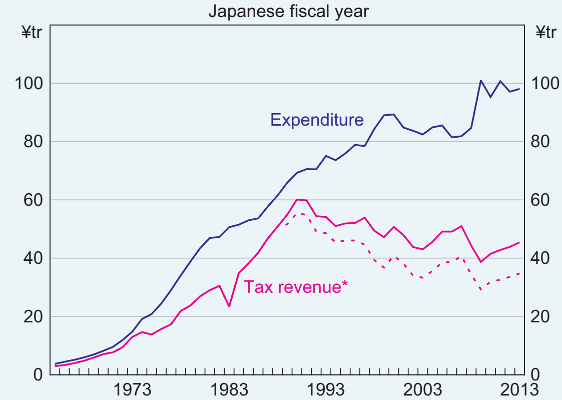
Between 1990 and 2013, tax revenues decreased by around 25 per cent in nominal terms (and by around 40 per cent excluding consumption tax revenue), while public expenditure rose by around 40 per cent (Graph A2). About two-thirds of the increase in public expenditure over that period was accounted for by higher social security payments owing to the ageing of the population. From 1990 to 2013, the share of Japan's population aged 65 years and over increased from 12 per cent to 25 per cent. This share is expected to increase to 32 per cent by 2030. The increases in the consumption tax rate in 2014 and 2015 form an important part of the government's plans for fiscal consolidation.

Graph A1
General Government Net Debt*
Per cent of GDP



* Data for 2012 and 2013 for countries other than Japan are IMF projections
** Adjusted to exclude the government's net equity assets
Sources: IMF; Ministry of Finance Japan; RBA; Thomson Reuters

Graph A2
Government Revenue and Expenditure
Japanese fiscal year



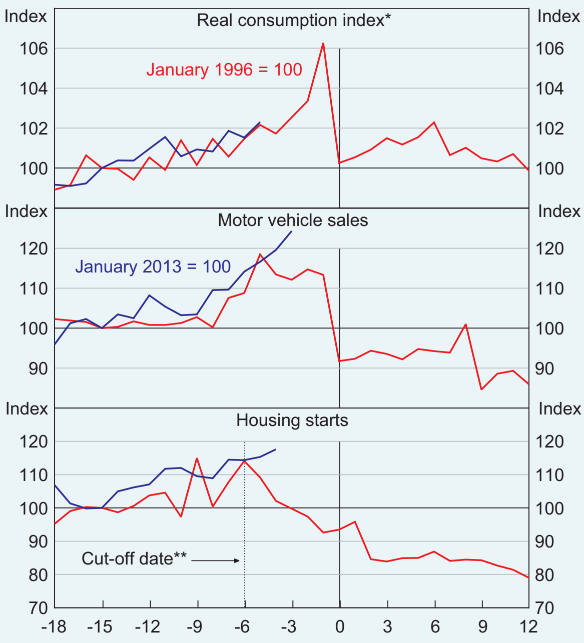
* Tax revenue excluding consumption tax revenue is indicated by the dotted line
Sources: Ministry of Finance Japan; RBA

Expected Effect on Activity and Prices

In the lead-up to the consumption tax increase in April 1997, private consumption grew strongly as consumers brought forward purchases to avoid the impending increase in the tax rate. Consumption then contracted after the tax was increased (Graph A3). This pattern was most evident for durable goods, for which there is more discretion in the timing of purchases. For example, motor vehicle sales increased by around 10 per cent in the six months leading up to the tax increase and fell by almost 20 per cent in the following month. Residential investment was also affected by the tax increase (contracts signed before 1 October 1996 were not subject to the higher tax rate). While consumption and residential investment growth remained subdued for several years following the tax increase, this period coincided with the Asian financial crisis and the expiration of a temporary income tax rebate, making it difficult to isolate the adverse effects of the consumption tax increase on economic activity.

A similar shifting of expenditure is expected to occur in the first half of 2014. Consumption is likely to grow strongly in the first quarter of 2014 – as consumers bring some spending forward in anticipation of the tax increase – but then contract in the June quarter. Timely indicators provide some early evidence of this, with motor vehicle sales having grown strongly in recent months. The expected effect of the tax increase on residential investment is more uncertain. As in 1997, contracts entered into before 1 October 2013 (when the tax increase was confirmed) are subject to the current 5 per cent tax rate, regardless of when the transfer of assets takes place. Given that the possibility of the tax increase was well publicised, it is not surprising that sales of off-the-plan apartments rose sharply over the September quarter and then fell. However, whether this will affect the timing of construction activity is unclear given the potential for builders to smooth their construction activity over time. Housing starts – a leading indicator of residential investment – have held up through to December, suggesting that residential building activity is not likely to fall in the very near term.

Graph A3
Japan – Effects of the Consumption Tax Increase



* The Cabinet Office's monthly measure of real private consumption
** Contracts signed before October are subject to the lower tax rate
Sources: RBA; Thomson Reuters

In anticipation of the contractionary effect of the tax increase on economic activity, the Japanese Government announced that it will implement a temporary ¥5.5 trillion fiscal stimulus package in 2014 (equivalent to around 1.1 per cent of GDP). The package includes tax breaks for capital expenditure, public works projects (including facilities for the 2020 Tokyo Olympics), measures to accelerate the reconstruction of earthquake-affected areas and direct transfers to low-income earners.

The increase in the consumption tax rate is also expected to temporarily increase inflation. According to the Bank of Japan, around two-thirds of the items by weight in Japan's CPI are directly affected by the consumption tax, implying that the increase in the tax rate will raise the level of the CPI by around 2 per cent in April (assuming the tax increase is passed through to prices one for one). Excluding food and energy, consumer prices are expected to increase by around 1.6 per cent as a result of the tax increase.

2. International and Foreign Exchange Markets

Global financial markets were relatively calm over the latter part of 2013, notwithstanding a decision by the US Federal Reserve to commence the process of reducing its monthly asset purchases in December. In part this relative calm owed to active assurance by the Federal Reserve, the European Central Bank (ECB) and the Bank of Japan (BoJ) that policy will remain very accommodative for an extended period. These assurances were accompanied by a reduction in the ECB's main policy rate in November and the BoJ's ongoing commitment to continue increasing its balance sheet over 2014.

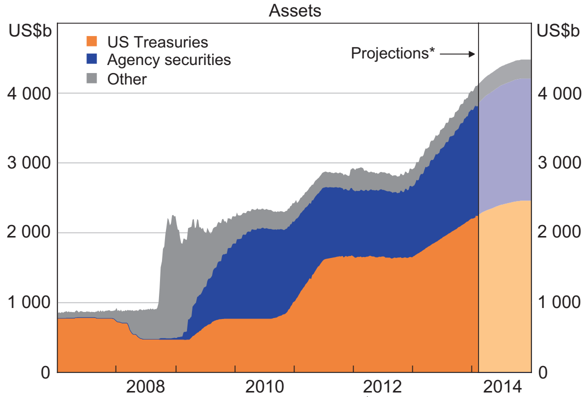
Since the start of 2014, however, global share prices have fallen sharply. In the major markets bond yields have also fallen although yields have increased noticeably in emerging markets, as certain country-specific factors and renewed concern about the risks associated with the Fed reducing its asset purchases dampened risk sentiment. While the US dollar has been broadly stable on a trade-weighted basis since the start of the year, it has continued to appreciate against a number of emerging market and commodity currencies. The Australian dollar has depreciated further in recent months.

Central Bank Policy

The US Federal Reserve commenced the process of scaling back its asset purchase program following its December meeting, reducing its monthly purchases of US Treasuries and agency mortgage-backed securities (MBS) by US$5 billion each. The Fed subsequently scaled back its asset purchases by a further US$10 billion at its late January meeting, to US$35 billion of Treasuries and US$30 billion of agency MBS per month. These reductions occurred in light of the improvement in the outlook for the labour market, with concerns that the marginal benefit of additional purchases may be declining and that a further expansion in holdings could raise financial stability risks also contributing. The accompanying statements signalled that the Fed anticipates it will continue to scale back its purchases in similar 'measured steps' over 2014, conditional on economic data broadly conforming to expectations. Market commentators have interpreted this as meaning a US$10 billion reduction at each upcoming meeting, which would see the Federal Reserve cease all asset purchases later this year. If this expectation is realised, the Fed's holdings of assets will rise by a further US$450 billion over 2014, having increased by US$1.1 trillion over 2013 (Graph 2.1).

In an effort to assure markets that monetary policy will remain highly accommodative for a considerable

Graph 2.1
US Federal Reserve Balance Sheet
Assets

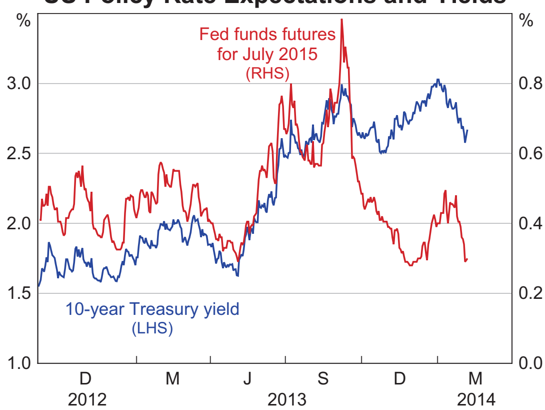


* Projections assume purchases decline by US$10 billion per meeting, evenly split between Treasuries and agency MBS, and finish in October 2014

Sources: Board of Governors of the Federal Reserve System; RBA time, the announcement of the reduction in asset purchases in December was accompanied by a statement that the Fed expects to leave the federal funds rate unchanged until 'well past the time' that the unemployment rate falls below 6½ per cent, especially if inflation continues to be below its 2 per cent target. Consistent with this, the median expectations of the members of the Federal Open Markets Committee (FOMC) for the level of the federal funds rate in 2015 and 2016 were revised down by 25 basis points and now imply 50 basis points of tightening in 2015, followed by 100 basis points in 2016.

This changing emphasis by the Fed over the second half of 2013 saw expectations for future short-term interest rates decouple from longer-term bond yields from late September (Graph 2.2). However, since mid January, both the implied path of the federal funds rate and long-term bond yields have fallen noticeably in response to some weaker US economic data and an increase in risk aversion. Current market pricing indicates the first increase in the fed funds rate is expected in late 2015.

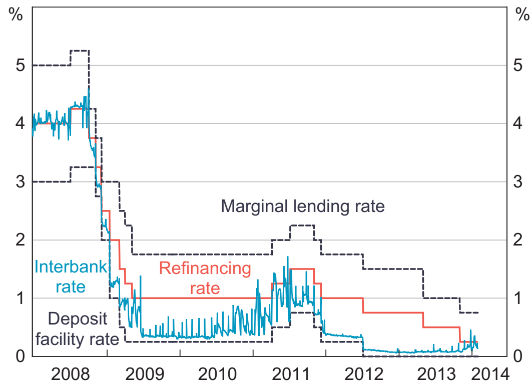
Graph 2.2
US Policy Rate Expectations and Yields



Sources: Bloomberg; RBA

The ECB reduced its policy rate by a further 25 basis points to 0.25 per cent at its November meeting, in response to below-target inflation (Graph 2.3). The ECB also lowered the rate at which it lends funds overnight by 25 basis points, but left the rate of interest on deposits at the ECB unchanged at 0 per cent. The ECB concurrently announced an extension of its commitment to fully provide for any liquidity needs of the Eurosystem – at terms of 3 months or less – to at least July 2015, a year later than previously advised. This is aimed at ensuring that ample liquidity is available when the 3-year long-term refinancing operations (LTROs) mature in early 2015. More recently, the ECB 'strongly emphasised' its commitment to maintain accommodative policy for an extended period following its January meeting, and clarified that it would be prepared to ease monetary policy further in response to an unwarranted tightening of financial conditions or a softening of the medium-term outlook for inflation. In line with this, markets are not pricing in any rise in euro area interest rates for almost three years.

Graph 2.3
ECB Interest Rate Corridor

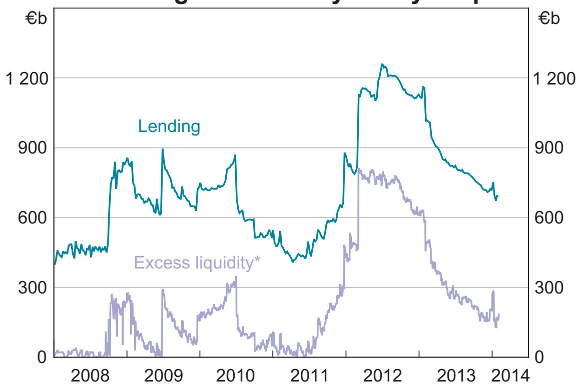


Source: Thomson Reuters

The ECB's balance sheet has continued to contract over recent months, with lending for monetary policy purposes declining by around €100 billion since September and by more than €550 billion since its peak in mid 2012 (Graph 2.4). The recent decline has been driven by prepayments of 3-year loans extended under the ECB's LTRO in late 2011 and early 2012, with almost half of the initial €1 trillion disbursement now repaid. Spanish banks continue to account for the largest share of this prepayment, having repaid around 40 per cent of their estimated initial €300 billion loan, though Spanish and Italian banks still account for almost three-quarters of outstanding borrowing. The resulting decline in

Graph 2.4

ECB Lending for Monetary Policy Purposes

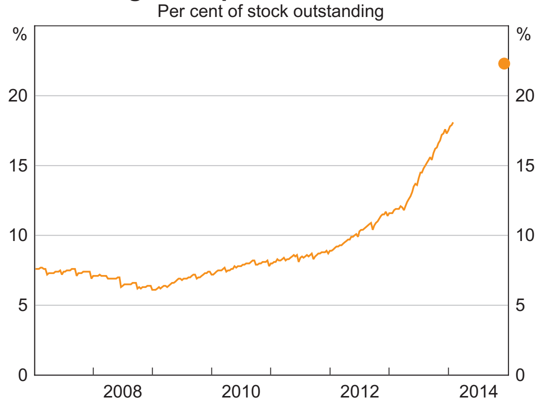


* Deposits at ECB in excess of reserve requirements
Sources: European Central Bank; RBA

Graph 2.5

BoJ Holdings of Japanese Government Bonds*

Per cent of stock outstanding



* Dot based on projection from BoJ
Sources: Bank of Japan; RBA

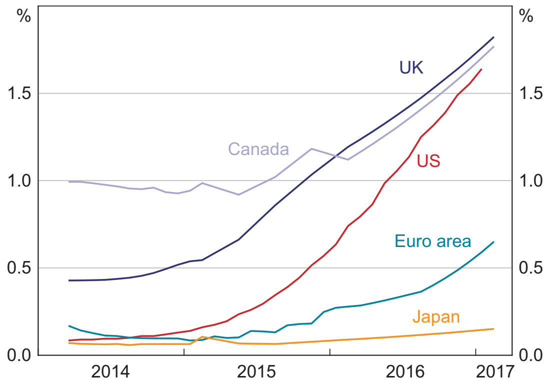
excess liquidity has contributed to a rise in interbank rates, with a marked spike over year-end and again in January (Graph 2.3).

The BoJ continues to provide monetary stimulus, with its balance sheet expanding rapidly. Total asset holdings rose by ¥60 trillion between the announcement of its Quantitative and Qualitative Monetary Easing program in April 2013 and the end of the year, and are scheduled to increase by a further ¥70 trillion over 2014. The majority of this rise in asset holdings reflects purchases of Japanese government bonds (JGBs), with the BoJ increasing its share of total JGBs outstanding by 6 percentage points since April, to 18 per cent (Graph 2.5). Governor Kuroda continues to assert that the BoJ is likely to meet its target of raising inflation to 2 per cent on a sustainable basis by 2015. However, market commentators generally expect additional stimulus to be injected this year.

Market expectations for the timing of the first rise in UK policy interest rates were brought forward over the second half of 2013, and currently are for an increase in 2015 (Graph 2.6). This revision to expectations has been in response to improving economic data, particularly the fall in the unemployment rate to just above the 7 per cent threshold contained in the Bank of England's forward interest rate guidance (which will be reconsidered in February). In contrast, markets do not expect a rise in interest rates in Canada until 2016, consistent with statements by the Bank of Canada that downside risks to inflation have increased.

Graph 2.6

Market Implied Interest Rate Expectations



Sources: Bloomberg; RBA

Liquidity in Chinese money markets has continued to tighten over recent months, with the overnight Shanghai Interbank Offered Rate (SHIBOR) averaging around 50 basis points higher in the December quarter than in the September quarter, and more than 100 basis points higher than in the year to June 2013 (Graph 2.7). The People's Bank of China has on occasions injected liquidity quite quickly to alleviate tensions, while at other times allowing liquidity to remain tight for some time, leading to higher and at times volatile interbank rates.

Central banks in emerging markets whose exchange rates have depreciated over recent months have continued to tighten policy at recent meetings (Table 2.1). The central bank of Turkey raised its main policy rate by 550 basis points at an unscheduled meeting in late January (although the effective increase was around half this because of a change in operating procedure), in an attempt to contain the impact of the depreciation of the lira on inflation and macroeconomic stability. The central bank of Brazil tightened policy further in both November and January, in response to higher inflation, with 50 basis point increases on both occasions bringing the cumulative rise in its interest rate since April to 325 basis points. The Reserve Bank of India also raised its policy rate by a further 25 basis points in January to contain upside risks to its inflation projections, while the Reserve Bank of South Africa increased its policy rate by 50 basis points in response to an upgrade of its inflation forecasts, stemming largely from the depreciation of the rand. Bank Indonesia raised policy rates by 25 basis points in November, citing a desire to contain inflation and reduce the current account deficit, and has now raised interest rates by 175 basis

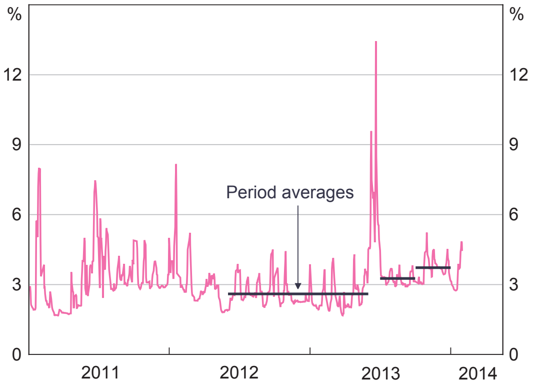
Table 2.1: Monetary Policy

	Policy rate Per cent		Most recent change	Cumulative change in current phase[(a)] Basis points
Euro area	0.25	↓	Nov 13	–125
Japan[(b)]	na		na	
United States	0.125	↓	Dec 08	–512.5
Australia	2.50	↓	Aug 13	–225
Brazil	10.50	↑	Jan 14	325
Canada	1.00	↑	Sep 10	75
Chile	4.50	↓	Nov 13	–75
China	6.00	↓	Jul 12	–56
India	8.00	↑	Jan 14	75
Indonesia	7.50	↑	Nov 13	175
Israel	1.00	↓	Sep 13	–225
Malaysia	3.00	↑	May 11	100
Mexico	3.50	↓	Oct 13	–475
New Zealand	2.50	↓	Mar 11	–50
Norway	1.50	↓	Mar 12	–75
Russia	5.50	↑	Sep 12	25
South Africa	5.50	↑	Jan 14	50
South Korea	2.50	↓	May 13	–75
Sweden	0.75	↓	Dec 13	–125
Switzerland	0.00	↓	Aug 11	–275
Taiwan	1.875	↑	Jun 11	62.5
Thailand	2.25	↓	Nov 13	–125
Turkey	10.00	↑	Jan 14	550
United Kingdom	0.50	↓	Mar 09	–525

	Current monthly asset purchases	Most recent change	Assets on balance sheet Per cent of GDP
United States	$65 billion	Jan 14	24.2
Japan	¥6 trillion	Apr 13	48.4
United Kingdom	0	Jul 12	24.5

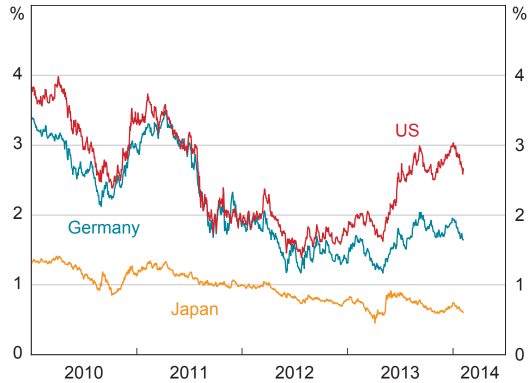
(a) Current rate relative to most recent trough or peak
(b) Since April 2013, the Bank of Japan's main operating target has been the money base
Sources: RBA; Thomson Reuters; central banks

Graph 2.7
Overnight SHIBOR



Source: CEIC Data

Graph 2.8
10-year Government Bond Yields



Source: Bloomberg

points since June. However, it held rates constant in January, stating that the current rate is consistent with reducing inflation and the current account deficit to 'more sound' levels.

In contrast, the Swedish Riksbank reduced rates by 25 basis points in December, in response to low inflation, while the central banks of Chile and Thailand both cut rates by 25 basis points in November to counter softening economic activity. The reduction in interest rates in Thailand was also intended to guard against the possible impact on the economy of widespread political protests in that country.

Sovereign Debt Markets

Yields on 10-year US Treasuries rose by 30 basis points over December, in response to strengthening economic data, to return to 3 per cent around year-end. This brought the rise in yields over 2013 to 130 basis points as it became clear that the Federal Reserve would reduce the scale of its asset purchase program. However, US yields have since fallen by almost 40 basis points as some economic data disappointed and concerns about the outlook for developing economies resurfaced (Graph 2.8).

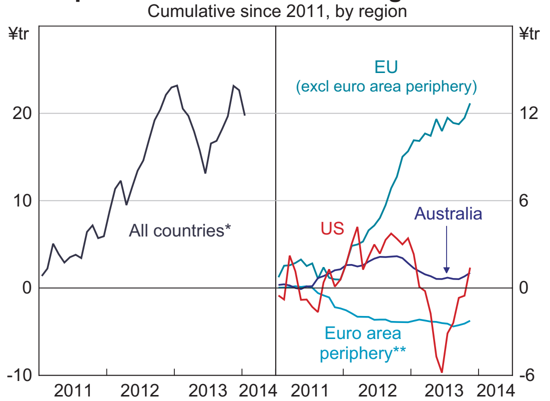
Yields on 10-year German Bunds likewise rose by 20 basis points over December, to be 60 basis points higher over 2013, before falling by 30 basis points since the start of 2014. The subdued outlook for euro area inflation and the associated difference in expectations for future Fed and ECB policy rates have continued to restrain yields on Bunds, relative to those on US Treasuries.

The US Congress negotiated a two-year budget deal that unwinds part of the expenditure cuts scheduled for 2014 and 2015. The deal averted the prospect of a mid-January shutdown of essential government services. No deal has yet been struck to raise the debt ceiling, which is currently suspended until 7 February, though the US Treasury's funding capacity can be extended by a few weeks due to the use of various 'extraordinary' measures.

Yields on 10-year JGBs also increased over December, in contrast to the trend decline in yields over the second half of 2013, but have declined since the start of 2014. However, these moves have been less pronounced than for Treasuries and Bunds. Purchases by the BoJ continue to put downward pressure on JGB yields, with such purchases worth 1½ times net issuance in 2013 and expected to again exceed net issuance in 2014.

Japanese residents have increased their holdings of foreign bonds by almost ¥7 trillion since June, reversing the net selling of foreign bonds observed in the first half of 2013 (Graph 2.9). Country breakdowns of these net purchases, available to November, show that transactions in US Treasuries account for most of this fall and rise in foreign bond holdings. Nonetheless, Japanese residents have continued to increase their

Graph 2.9
Japanese Purchases of Foreign Bonds
Cumulative since 2011, by region



* Calculated using monthly data to November 2013 and weekly data thereafter

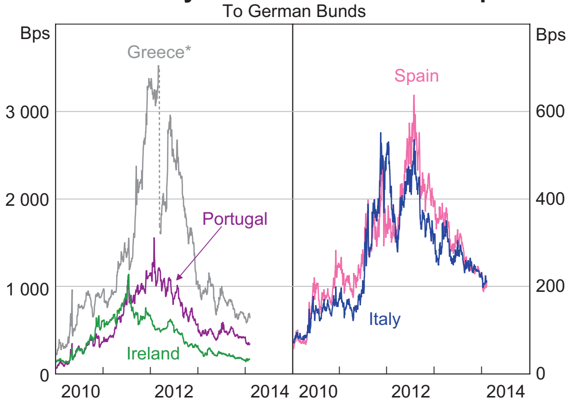
** Greece, Ireland, Italy, Portugal and Spain

Sources: Japanese Ministry of Finance; RBA

holdings of European bonds including, in the three months to November, those issued by governments of periphery countries.

The improvement in sentiment towards the euro area periphery accelerated towards the end of 2013. Spreads between yields on Spanish, Irish and Portuguese government bonds and those on German Bunds all narrowed by 150–175 basis points over 2013, while spreads on Italian and Greek bonds narrowed by 100 and 400 basis points (Graph 2.10). The significant narrowing of spreads has reflected an improvement in these countries' competitiveness and reduced current account deficits. As a result,

Graph 2.10
Euro Area 10-year Government Bond Spreads
To German Bunds



* Data from 12 March 2012 are yields on Greek bonds post first private sector debt swap

Source: Bloomberg

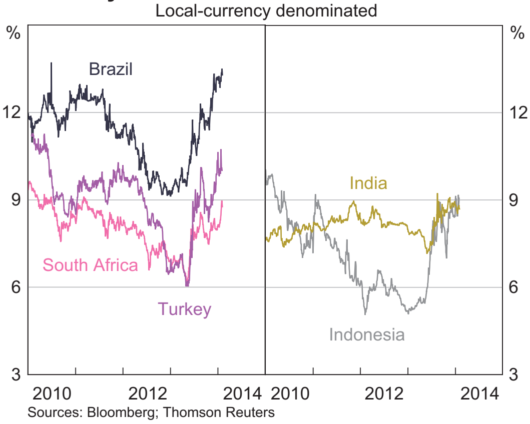
Spanish and Italian bond spreads have fallen to levels last seen prior to concerns about contagion from other periphery economies first surfacing, while Irish, Portuguese and Greek bond spreads are around their lowest level since their need for financial assistance first became apparent. These spreads have been unaffected by the recent deterioration in global risk sentiment.

This improvement in sentiment towards the euro area periphery allowed Spain, Ireland and Portugal to raise considerable funds from bond markets in January. Ireland's issue was its first since exiting its assistance program at the end of last year (Portugal expects to exit its assistance program midyear). All three issues were heavily oversubscribed and bought by a broad range of investors, with foreigners accounting for more than two-thirds of demand. Spanish bank Bankia also managed to issue its first bond since being recapitalised by authorities in early 2012.

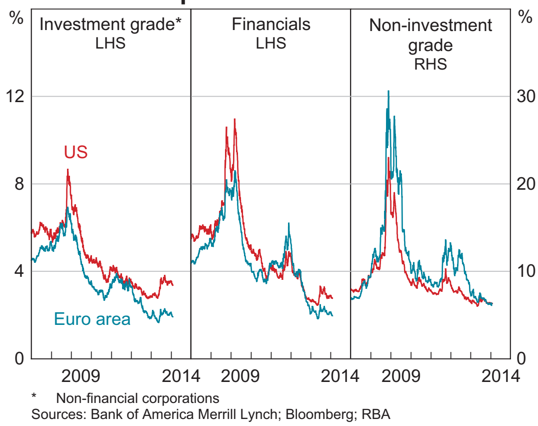
European Union finance ministers agreed in December on a draft regulation for recapitalising failing banks, known as the Single Resolution Mechanism (SRM). Under the agreement, creditors of a failing bank will be required to absorb initial losses, to a minimum of 8 per cent of total liabilities, before the bank is eligible for official assistance. Any official assistance will first be sought from resolution funds to be established via levies on banks. Additional euro-wide public support may become available but, at this stage, not for at least 10 years.

Yields on bonds issued by emerging market sovereigns continued to drift up towards the end of 2013, before moving notably higher over January as concerns about the vulnerability of several developing economies increased (Graph 2.11). Yields on Turkish bonds have risen most sharply over recent months, in response to political tensions and a view that Turkey is especially vulnerable to a change in US monetary policy due to its large external financing needs and foreign currency exposure. Yields on South African and Brazilian bonds have also increased notably, alongside concerns about their current account deficits and a tightening of monetary policy, while yields on Indonesian, Russian and Hungarian bonds

Graph 2.11
10-year Government Bond Yields
Local-currency denominated



Graph 2.12
Corporate Bond Yields



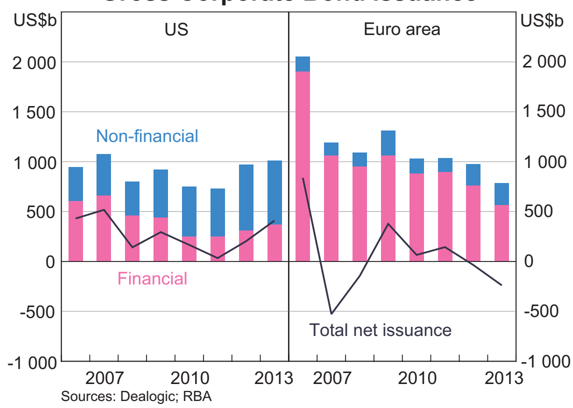
are significantly higher as well. Foreign capital outflows from emerging bond markets slowed significantly around year-end, following a period of heavy outflows in the second half of last year, but increased again in late January. While the withdrawal of capital has been broad based across countries, a significant share reflected outflows from funds invested in Brazil, India, Indonesia, South Africa and Turkey.

Credit Markets

Spreads on bonds issued by US and euro area corporations continued to narrow in late 2013, but have increased in recent weeks. Spreads on non-investment grade bonds have moved most notably, falling by around 130 basis points for US borrowers over 2013 and by 240 basis points for euro area corporations, before rising by 50–60 basis points since mid January. Nonetheless, the cost of borrowing for these issuers remains around historical lows, given that the recent widening in spreads has been largely offset by a fall in sovereign bond yields (Graph 2.12). In contrast, spreads on investment grade bonds issued by US and euro area corporations narrowed only modestly over 2013, and are a little higher so far this year.

Gross bond issuance by US corporations in 2013 slightly exceeded that in 2012 (Graph 2.13). The increase in net issuance, however, was more pronounced; net issuance rose to its highest level

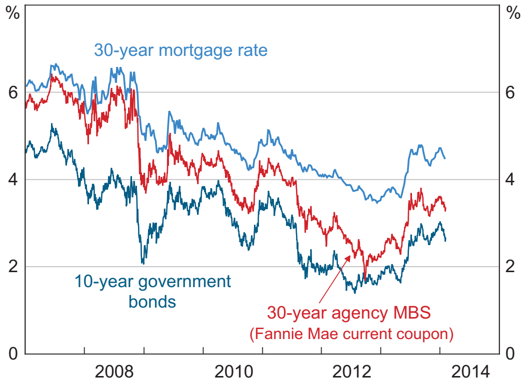
Graph 2.13
Gross Corporate Bond Issuance



since 2007, with financials increasing their stock of outstanding bonds for the first time since 2009. In contrast, euro area gross corporate bond issuance contracted further, and the stock of outstanding bonds declined, with these developments being driven largely by Spanish and Italian banks. Gross and net issuance by emerging market corporations slowed over the second half of 2013, to be slightly lower than in 2012.

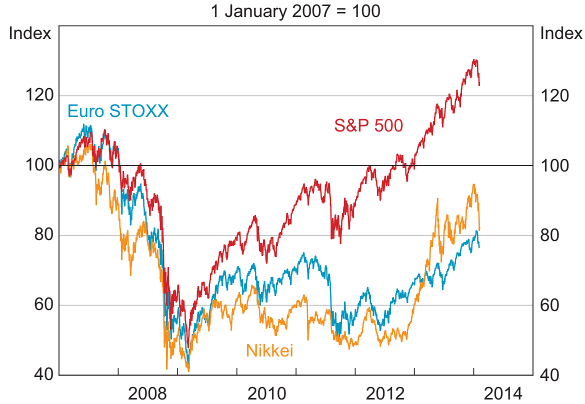
Yields on agency MBS have fluctuated alongside moves in US Treasuries, with a 20 basis point rise over December more than unwound since the start of the year (Graph 2.14). There was very little observable change in yields in response to the Federal Reserve's decision to reduce its purchases of MBS. Since the

Graph 2.14
US Mortgage Interest Rates



Sources: Bloomberg; Thomson Reuters

Graph 2.15
Share Price Indices
1 January 2007 = 100



Source: Bloomberg

start of 2013, mortgage interest rates have increased alongside the rise in MBS yields, to be around 100 basis points higher.

Equities

Global share prices increased by 23 per cent over 2013 (Graph 2.15; Table 2.2). Japanese equities rose particularly strongly, increasing by 57 per cent over 2013, while US shares rose by 30 per cent. In contrast, emerging market share prices tended to decline over the second half of 2013. More recently, global share prices have fallen significantly in response to some weaker global economic data, along with renewed concerns about the outlook for emerging markets. These falls have been relatively broad based, though most pronounced for Japan and several emerging markets.

US and euro area banking shares have significantly outperformed the broader market over the past year, with their prices up 40 and 25 per cent, respectively, over 2013. The outperformance of US bank share prices has been in part attributable to a 30 per cent increase in profits at the six largest banks over 2013, underpinned by reduced provisions for loan losses, to just over US$70 billion. US bank earnings were also generally better than expected in the December quarter, as increased earnings from equity raisings and reduced provisions for legal expenses more than offset ongoing weakness in mortgage origination and bond trading. A few European banks have released fourth quarter profit results. These tended to be mixed, with reduced income from bond trading weighing heavily on some but strength in equity trading supporting others.

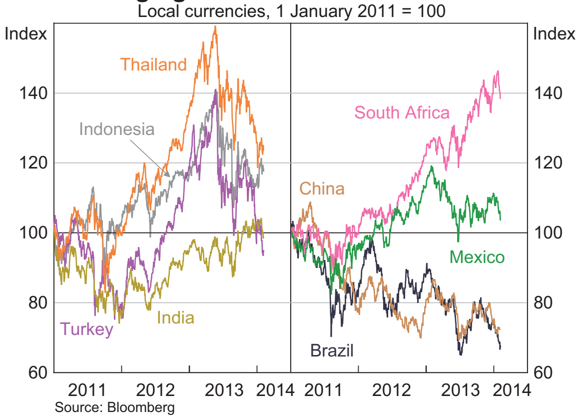
Table 2.2: Changes in International Share Prices
Per cent

	Over 2013	Since end 2013
United States		
– S&P 500	30	–5
Euro area		
– STOXX	20	–4
United Kingdom		
– FTSE	14	–4
Japan		
– Nikkei	57	–13
Canada		
– TSE 300	10	–1
Australia		
– ASX 200	15	–5
China		
– China A	–7	–4
MSCI indices		
– Emerging Asia	3	–6
– Latin America	–7	–8
– Emerging Europe	–2	–5
– World	**23**	**–5**

Source: Bloomberg

Share prices in emerging markets increased a little following the Fed's decision in December to reduce its purchases, owing to its statement that the federal funds rate would likely be unchanged until well after the unemployment rate falls below 6½ per cent. However, emerging market share prices fell noticeably over January, as some weak global data and various idiosyncratic risks were compounded by renewed concerns about these countries' vulnerabilities to a tapering of asset purchases by the US Federal Reserve (Graph 2.16). Countries that have large external financing needs have again been most affected, though political instability in Turkey and Thailand contributed to weak outcomes in those countries and Brazilian stocks fell further in response to tighter monetary policy and some concerns about the outlook for China. Foreign capital has continued to flow out of emerging stock markets in recent months, though at a slower pace than mid last year. The Indian market has been a notable exception, with capital inflow contributing to its outperformance over recent months.

Graph 2.16
Emerging Market Share Price Indices
Local currencies, 1 January 2011 = 100

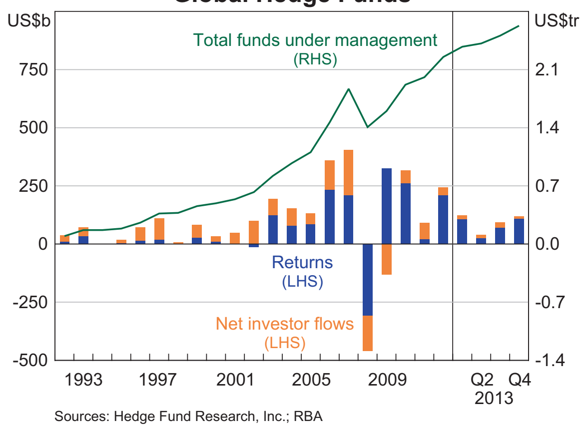


Chinese share prices have been especially weak over recent months, and are now 30 per cent lower than at the start of 2011. The decline in Chinese equities over the second half of 2013 partly reflected ongoing uncertainty about the outlook for monetary policy in light of tightening liquidity conditions. More recently, the resumption of initial public offering activity, after a freeze since October 2012, has weighed on the market.

Hedge Funds

Global hedge funds recorded an average return on investments of 9 per cent over 2013 (Graph 2.17). This was less than the total return from a balanced portfolio of global bonds and equities (including dividends) over the year, extending the period of underperformance to three years. Funds under management increased over the December quarter to US$2.6 trillion. This was largely as a result of positive returns; net investor inflows remained modest.

Graph 2.17
Global Hedge Funds

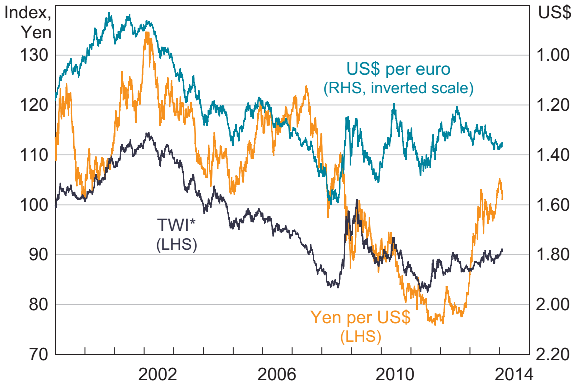


Foreign Exchange

While foreign exchange markets have continued to be influenced by changes in market participants' expectations about the outlook for US monetary policy, the increased focus on country-specific vulnerabilities has led to relatively pronounced depreciations for some emerging market currencies.

The US dollar has appreciated by 4 per cent on a trade-weighted basis since the beginning of 2013, but remains 6 per cent below its average over the past 15 years (Graph 2.18). The modest appreciation of the US dollar over the past year masks some divergent movements against individual currencies. Over the past year, the US dollar has appreciated markedly against the Japanese yen as well as against a number of emerging market and commodity currencies, but has been little changed or depreciated against

Graph 2.18
US Dollar



* Indexed to average since January 1999 = 100
Sources: Bloomberg; Board of Governors of the Federal Reserve System; RBA

the currencies of some of its major trading partners, including the euro and Chinese renminbi (RMB) (Table 2.3).

The Japanese yen has depreciated by a further 2–3 per cent on a trade-weighted basis and against the US dollar since the end of October. The yen has now depreciated by around 20 per cent in nominal trade-weighted terms since November 2012, and is around 5 per cent below its average over the past 15 years. However, in real effective terms, the yen is currently around 20 per cent below its average of the past 15 years, due to price deflation in Japan throughout much of this period (Graph 2.19). After having appreciated modestly over much of 2013, the euro has been little changed in trade-weighted terms since the end of October and remains slightly higher than its average of the past 15 years.

The RMB has appreciated slightly against the US dollar since the end of October, remaining in the upper part of its ±1 per cent trading band (Graph 2.20). Over 2013, the RMB appreciated by around 3 per cent against the US dollar and by 8 per cent on a nominal effective basis, with the latter primarily reflecting the RMB's significant appreciation against the Japanese yen.

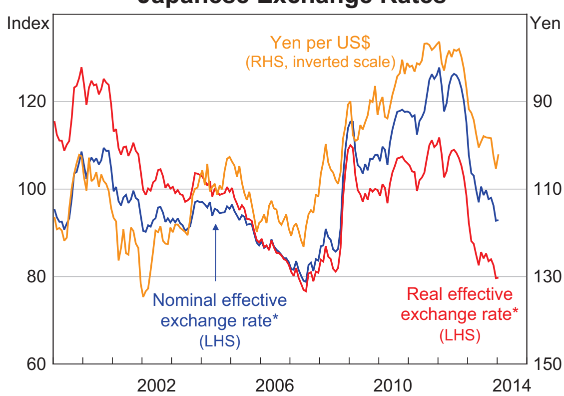
The stock of Chinese foreign currency reserves increased by US$157 billion (around 4 per cent) over the December quarter, to be US$508 billion

Table 2.3: Changes in the US Dollar against Selected Currencies
Per cent

	Over 2013	Since end 2013
South African rand	24	6
Canadian dollar	7	4
South Korean won	–1	3
Philippine peso	8	2
New Taiwan dollar	3	2
Mexican peso	1	2
Brazilian real	15	2
European euro	–4	2
UK pound sterling	–2	2
Swedish krona	–1	1
Swiss franc	–3	1
Malaysian ringgit	7	1
Indian rupee	13	1
Singapore dollar	3	0
Thai baht	7	0
Indonesian rupiah	26	0
Chinese renminbi	–3	0
Australian dollar	17	0
New Zealand dollar	1	0
Japanese yen	21	–4
TWI	**3**	**1**

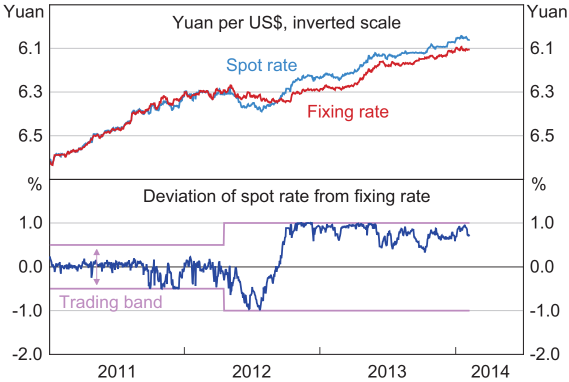
Sources: Bloomberg; Board of Governors of the Federal Reserve System

Graph 2.19
Japanese Exchange Rates



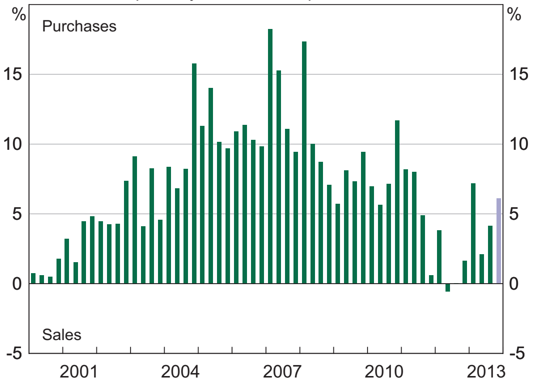
* Indexed to average since January 1999 = 100
Sources: BIS; Bloomberg; RBA

Graph 2.20
Chinese Renminbi



Sources: Bloomberg; China Foreign Exchange Trade System; RBA

Graph 2.21
Chinese Foreign Currency Reserves*
Net quarterly transactions, per cent of GDP



* RBA estimate for the December quarter 2013

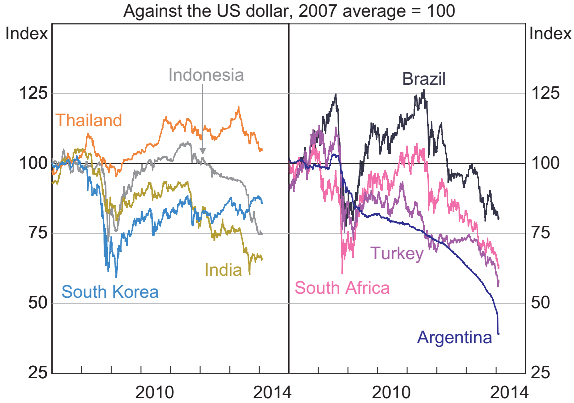
Sources: Bloomberg; CEIC Data; RBA

(15 per cent) higher over the year. Consistent with reports of capital inflows, the increase in Chinese reserves over the December quarter is likely to have largely reflected net purchases of foreign currency, although modest positive valuation effects are also likely to have contributed (Graph 2.21). While most other Asian and emerging market countries' foreign currency reserves increased over September and October, a number of countries have since recorded declines (see below).

After having appreciated modestly over September and October, most other emerging market currencies have since depreciated against the US dollar and remain well below their end-April levels (Graph 2.22). However, despite the renewed depreciation pressure, emerging market currency volatility generally remains below the elevated levels reached in mid 2013.

The currencies of countries that are perceived to have relatively weak domestic economic outlooks, unstable domestic political environments and/or external vulnerabilities have typically continued to experience the most pronounced depreciations. In particular, the Turkish lira has depreciated by a further 11 per cent against the US dollar since the end of October, prompting the central bank to increase interest rates at an emergency meeting in late January. The Turkish lira has depreciated by around 20 per cent against the US dollar since the end of April 2013. The Brazilian real, Indonesian rupiah, South African rand and Thai baht have also depreciated further over recent months to be 10–20 per cent lower since the end of April. In addition, although the Argentine peso had been depreciating since mid 2008, the pace of depreciation picked up noticeably in January as market participants focused on the central bank's increasingly limited capacity to continue to support the currency through foreign exchange market intervention. In contrast, the Indian rupee has been little changed against the US dollar since the end of October, though it remains 14 per cent below its end-April level.

Graph 2.22
Emerging Market Currencies
Against the US dollar, 2007 average = 100



Source: Bloomberg

The authorities in some of these countries have continued to enact policy measures or intervene in foreign exchange markets in an effort to counter the pace of depreciation, improve market functioning and/or curb volatility (although one exception is India, where recent stability in the rupee has allowed authorities to end a key policy measure which was used to supply US dollars to state-owned oil companies). The gross foreign currency reserves of a number of Asian and other emerging market countries have declined since the end of October, with most remaining below their end-April levels (Table 2.4).

Australian Dollar

The Australian dollar has depreciated by a further 5 per cent on a trade-weighted basis and against the US dollar since the end of October, more than reversing the appreciation recorded over the previous three months (Table 2.5; Graph 2.23). The Australian dollar has now depreciated by 14 per cent on a trade-weighted basis since its peak in early April 2013, though it remains 9 per cent higher than its average

Table 2.5: Changes in the Australian Dollar against Selected Currencies
Per cent

	Over 2013	Since end 2013
South African rand	6	6
Canadian dollar	–8	4
South Korean won	–15	3
European euro	–18	1
UK pound sterling	–16	1
Swiss franc	–16	1
Malaysian ringgit	–8	1
Indian rupee	–3	1
Singapore dollar	–11	0
Thai baht	–8	0
Indonesian rupiah	8	0
Chinese renminbi	–17	0
US dollar	–14	0
New Zealand dollar	–13	0
Japanese yen	4	–4
TWI	**–11**	**0**

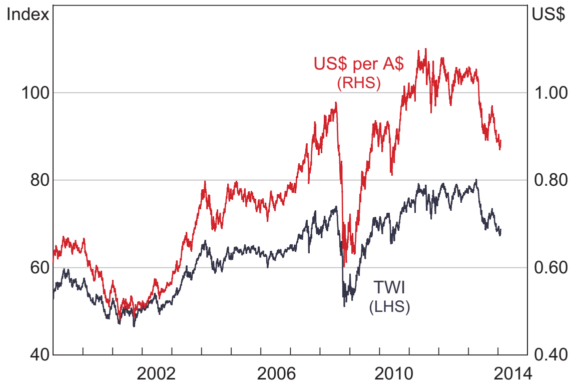
Sources: Bloomberg; Thomson Reuters; WM/Reuters

Table 2.4: Gross Foreign Currency Reserves
As at end December 2013

	Percentage change since:		Level
	End April	End October	US$ equivalent (billions)
China	8	2	3 821
Russia[a]	–4	–4	439
Brazil[b]	–5	–1	351
South Korea[b]	6	2	338
India	2	5	268
Thailand	–6	–3	158
Malaysia	–4	–2	122
Turkey[a]	–10	–9	101
Indonesia	–7	3	93
South Africa	1	1	42
Argentina[b]	–34	–20	22

(a) As at 24 January
(b) As at end January
Sources: Bloomberg; CEIC Data; IMF; RBA

Graph 2.23
Australian Dollar

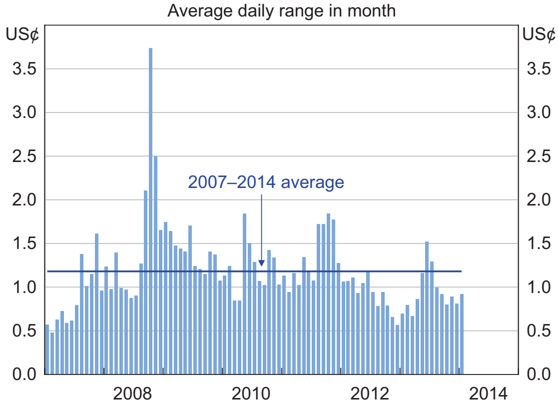


Sources: Bloomberg; RBA; WM/Reuters

over the past 15 years and 15 per cent higher than its 15-year average in real terms. The Australian dollar continues to be influenced by changes in market participants' expectations about the outlook for domestic and US monetary policy.

Consistent with developments in other currency markets, intraday volatility in the Australian dollar has remained subdued relative to the elevated levels recorded in mid 2013 (Graph 2.24).

Graph 2.24
Intraday Range in AUD/USD
Average daily range in month

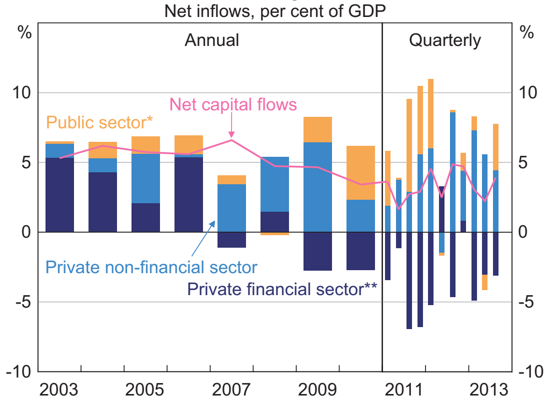


Sources: Bloomberg; RBA

Capital Flows

Net capital inflows to the Australian economy were directed to both the private non-financial and public sectors in the September quarter, a pattern that has been broadly evident since 2009 (Graph 2.25). The mining sector again received a sizeable share of the net inflows to the private non-financial sector, continuing a trend that has been evident since 2011. There was also a relatively large net inflow to the public sector; however, the increase was roughly proportional to net issuance of Commonwealth Government securities (CGS) in the quarter, leaving the foreign ownership share of CGS broadly unchanged at 68 per cent. The net inflows to the private non-financial and public sectors more than offset continued net outflows from the private financial sector in the September quarter. The net outflows from the private financial sector primarily reflected an increase in foreign investment by the non-bank financial sector (including superannuation funds and other types of investment funds) with the Australian banking sector receiving modest net inflows in the quarter.

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

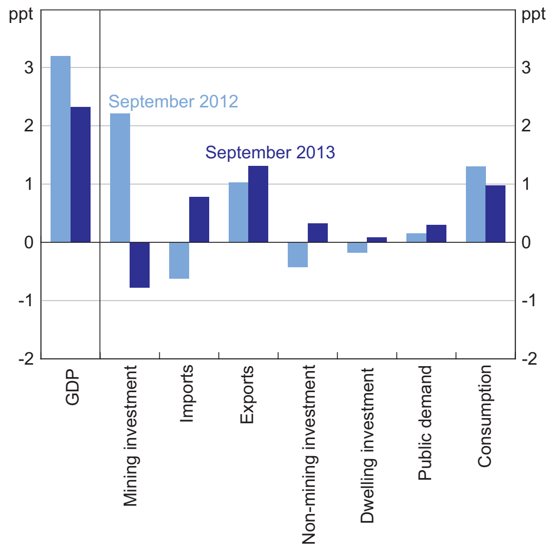


* Excludes official reserves and other RBA flows
** Adjusted for the US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

3. Domestic Economic Conditions

The Australian economy expanded at a below-trend pace over the year to the September quarter, although recent indicators point to some improvement toward the end of 2013 (Graph 3.1; Table 3.1). After growing very strongly over recent years, mining investment appears to have fallen by around 10 per cent from its peak a year ago. At the same time, investment by non-mining firms remained weak in an environment of relatively subdued demand and profit growth. Ongoing fiscal restraint resulted in only a slight increase in public demand. Growth of household consumption has been below average, consistent with little growth in employment over the past year and a marked slowing in wages growth. The level of dwelling investment has increased moderately, and a significant upswing looks to be in prospect, consistent with the recent strength in the established housing market. The depreciation of the exchange rate since the middle

Graph 3.1
GDP Growth
Year-ended contribution



Sources: ABS; RBA

Table 3.1: Demand and Output Growth
Per cent

	September quarter 2013	Year to September quarter 2013
GDP	0.6	2.3
Domestic final demand	0.4	0.9
– Private demand	0.5	0.8
– Public demand	0.0	1.3
Change in inventories[(a)]	–0.5	–0.9
Gross national expenditure	–0.1	0.1
Exports	0.3	6.1
Imports	–3.3	–3.7
Nominal GDP	0.6	3.6
Real gross domestic income	–0.1	1.5

(a) Contribution to GDP growth
Source: ABS

of 2013 can be expected to start providing some support to domestic production. Exports have grown, although this has predominantly been among resource exports, reflecting mining projects continuing to move into the production phase.

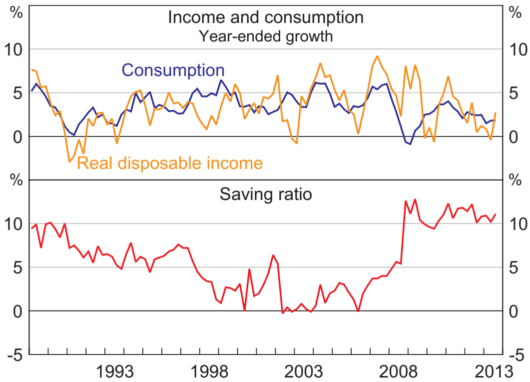
Economic indicators and liaison suggest that growth in the December quarter was moderate, although they generally point to some improvement in activity in recent months. Consumer spending on retail items picked up in the December quarter and surveys suggest that consumer sentiment has been a little above average levels, despite further weakness in the labour market. Housing turnover and prices have continued to increase and forward-looking indicators of dwelling investment have risen strongly. Trade data suggest that exports grew at a strong rate in the December quarter. Survey-based measures of current business conditions have improved over recent months, with some measures jumping sharply to above-average levels. However, surveyed business conditions had been below average for some time, and consistent with this, non-mining investment appears to have remained subdued. Firms' surveyed capital expenditure intentions indicate little growth in investment in 2013/14 as a whole. Liaison information continues to suggest that mining investment is in the process of a pronounced downswing.

Household Sector

Real household disposable income increased by 2¾ per cent over the year to the September quarter. Growth in labour income has been subdued, consistent with the weakness in the labour market. In contrast, a decline in interest payments has provided some support to measures of disposable income growth, as average mortgage rates have decreased in recent quarters.

Growth of household consumption was below average over the year to the September quarter, broadly in line with growth in income and notwithstanding a strong rise in household wealth. Consequently, the saving ratio has been little changed at a bit above 10 per cent (Graph 3.2). Over the past year, below-average consumption growth has largely reflected subdued growth in spending on discretionary items such as meals out and recreational activities. Spending on non-discretionary items such as food, health care and some financial services has grown at around the average pace of the past decade.

Graph 3.2
Household Income and Consumption*

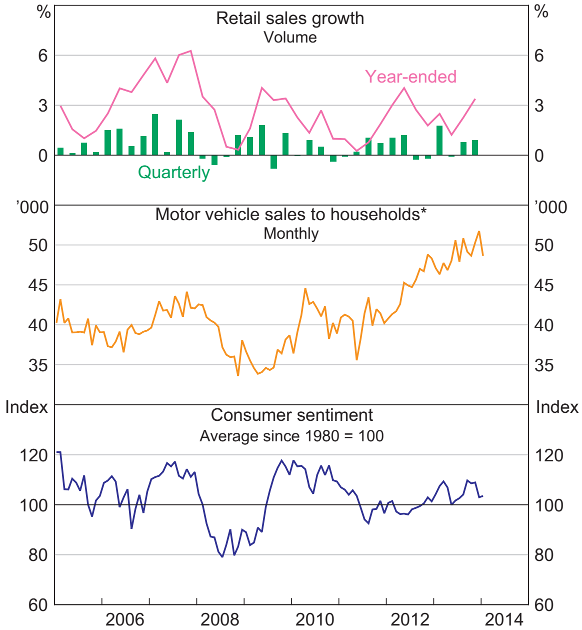


* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

Sources: ABS; RBA

More recent data suggest that growth of household consumption increased a little in the December quarter. Retail sales volumes increased by 0.9 per cent in the quarter, with prices rising by 1.1 per cent (Graph 3.3). Sales increased particularly strongly at cafés, restaurants & takeaway stores and apparel retailers. Consistent with this, liaison with retailers suggested that the Christmas trading period overall was reasonably good, including for home improvement retailers as the buoyant housing market is reportedly supporting stronger sales. Motor vehicle sales continued to grow in the December quarter, although sales declined in January and growth over the past year has slowed from the rapid pace seen over 2012 when the high level of the exchange rate contributed to particularly attractive offers for purchases of motor vehicles. Survey measures of consumer sentiment are a little above average levels, despite having declined in recent months, and consumers' concerns about future conditions in the labour market remain somewhat elevated.

Graph 3.3
Consumption Indicators



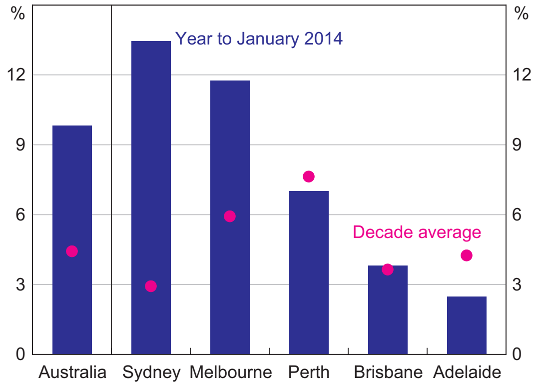
* Seasonally adjusted by the RBA
Sources: ABS; FCAI/VFACTS; Melbourne Institute and Westpac; RBA; Roy Morgan Research

Household wealth has continued to increase strongly in recent quarters and is estimated to be 10 per cent higher over the year to December 2013. This increase has been driven by higher equity and housing prices, as well as continued saving by households.

Nationwide housing prices increased by around 4 per cent over the December quarter and by a little under 10 per cent over the year to January (Graph 3.4). Housing price growth has broadened over recent months, with sizeable price increases in all state capitals in the December quarter. Sydney continues to be the strongest market, with prices rising by around 13 per cent over the past year. Nationwide, housing price inflation has been above the average of the past decade, a period during which prices grew marginally slower than household incomes. For more details on recent developments in housing prices, see 'Box B: The Housing Market'.

Conditions in the rental market remain relatively tight, although a bit less so than was the case some years ago. The nationwide rental vacancy rate declined a little in the September quarter, to around 2 per cent,

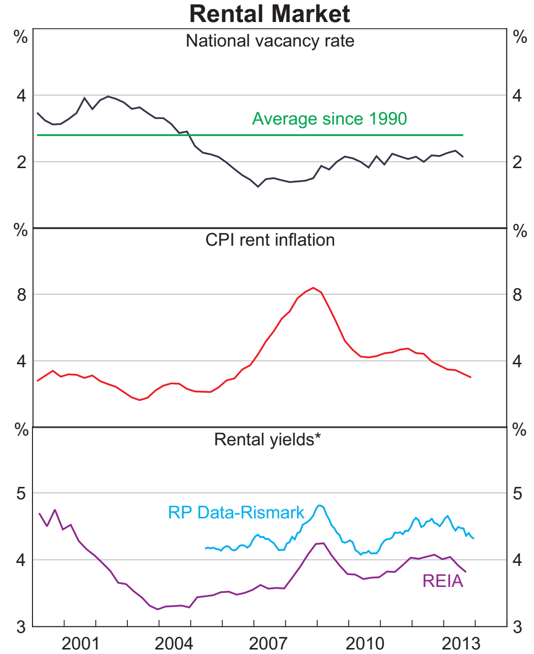
Graph 3.4
Housing Price Growth



Sources: RBA; RP Data-Rismark

which is below the long-run average but above the very low levels reached around 2007 (Graph 3.5). Rent inflation has slowed to around 3 per cent annually, the slowest pace since the mid 2000s, although it is still above the rate of CPI inflation. With growth in rents slowing and housing prices increasing strongly, rental yields have fallen in recent quarters to be around the average of the past decade.

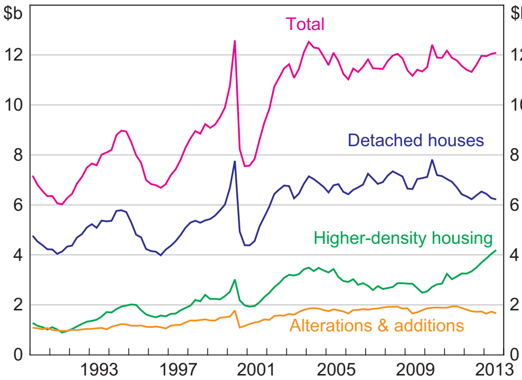
Graph 3.5
Rental Market



* REIA series uses an unmatched sample of rents and prices; RP Data-Rismark series uses a matched sample
Sources: ABS; RBA; REIA; RP Data-Rismark

Dwelling investment was little changed in the September quarter, to be 1¾ per cent higher over the year. While work done on new dwellings continued to pick up, driven by the building of higher-density housing, there has been ongoing weakness in measured activity on large alterations & additions (Graph 3.6). The estimated activity on small alterations & additions, which is included in the national accounts, has also been weak.

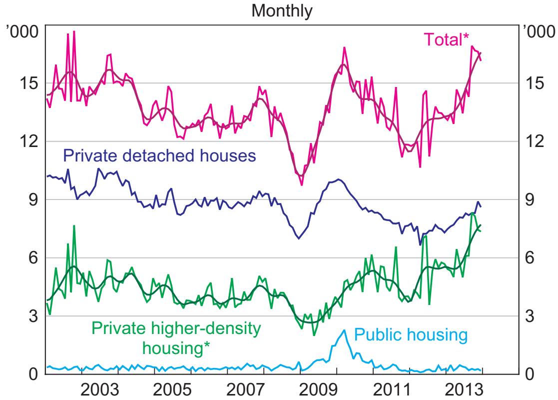
Graph 3.6
Private Residential Building Work Done
Chain volumes*, quarterly



* 2011/12 prices
Source: ABS

However, forward-looking indicators point to relatively strong growth of dwelling investment in coming quarters. The number of building approvals for new private dwellings rose by 7½ per cent in the December quarter, with higher-density and detached house approvals both rising strongly (Graph 3.7). Consistent with the steep increase in sales of new land in 2013, detached house approvals have continued to rise, buoyed by strong growth in New South Wales and a recent pick-up in Victoria, while approvals in Western Australia have moderated recently after an earlier upswing. Higher-density approvals increased very strongly over the second half of 2013, concentrated in the large eastern states. This was a significant increase, even by the standards of this volatile series. Liaison contacts have noted the increasing presence of overseas developers for high-rise developments in inner-city areas, particularly in Melbourne, Sydney and Brisbane. In part this may be a consequence of changes to foreign investment laws in 2009 that increased the share of new developments that foreign buyers were allowed to purchase. Builders also report an increase in confidence more generally, with more enquiries from prospective new home buyers.

Graph 3.7
Residential Building Approvals
Monthly



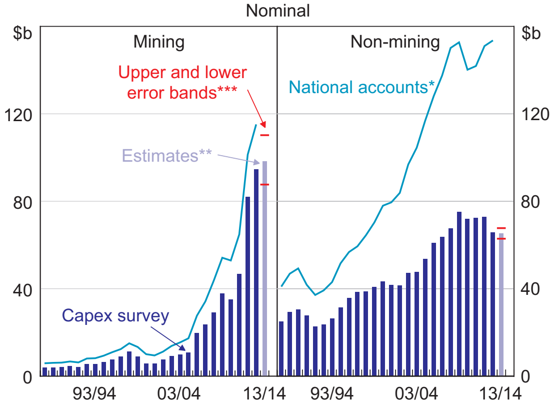
* Smoothed lines are ABS trend measures
Source: ABS

In aggregate, building approvals are expected to remain at a high level over the period ahead, underpinning strong growth in new dwelling construction. This reflects a continued recovery in the established housing market, low lending rates and government support to first home buyers that has increasingly been directed towards purchases of newly built rather than existing dwellings. Indeed, first home owner grants for new dwellings have already risen by around 60 per cent from their recent trough in 2011. Higher house prices and the associated increase in housing turnover are also expected to support a pick-up in renovation activity in the period ahead given that many renovations occur in preparation to sell a property or after one is purchased.

Business Sector

Business investment has declined from its peak in late 2012, but remains very high as a share of output both historically and in comparison with other advanced economies. The run-up in business investment in recent years reflected very strong growth in mining investment. Over the next few years, however, mining investment is expected to fall, with Bank liaison suggesting that it is likely that the peak in the investment phase of the resources boom has passed. This is consistent with other information, such as the lack of new commitments to mining projects and the low level of expenditure on development and planning work. In contrast, the most recent ABS capital expenditure (Capex) survey of mining investment intentions, which tends to be a relatively imprecise guide to realised spending, points to further growth in 2013/14 (Graph 3.8). Nevertheless, estimates of spending by mining firms in 2013/14 derived from this survey have been revised lower over the past year.

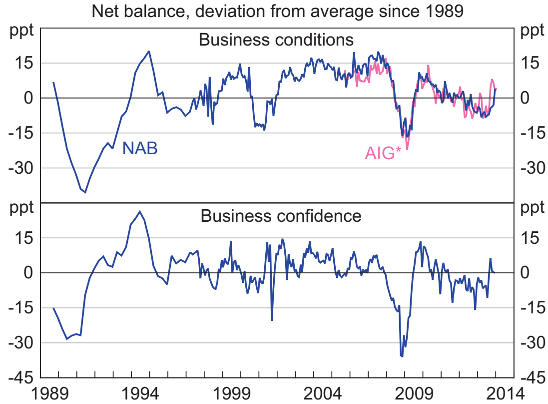
Graph 3.8
Measures of Private Business Investment
Nominal



* Adjusted for second-hand asset transfers between the private and other sectors, excluding cultivated and biological resources
** Estimates are firms' expected capital expenditure in 2013/14, adjusted for the past average difference between expected and realised spending
*** Error bands are based on the root mean square error of each adjusted estimate compared with the final outcome for investment in each year
Sources: ABS; RBA

In recent months, the Capex survey indicates that there has been a slight improvement in non-mining investment expectations (compared with earlier surveys for 2013/14), although firms continue to report that they have some spare capacity, which is likely to weigh on capital spending plans. Survey measures of business conditions jumped in the December quarter to be above their long-run averages. Business confidence is around its long-run average for most surveys (Graph 3.9).

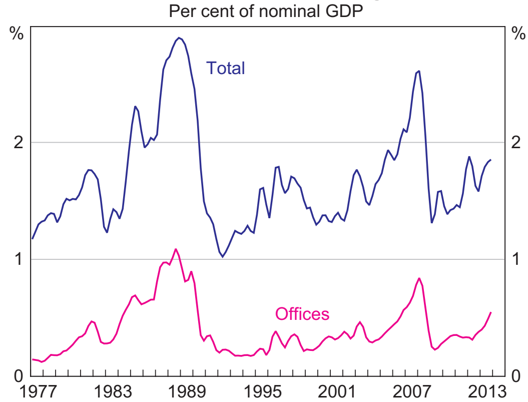
Graph 3.9
Business Sentiment
Net balance, deviation from average since 1989



* Weighted average of AIG's Performance of Construction, Performance of Services and Performance of Manufacturing indices, scaled to have the same mean and standard deviation as the NAB Business Conditions Index
Sources: AIG; NAB; RBA

Confidence within the construction sector has improved in recent months, consistent with strong growth in residential approvals. The pick-up in approvals for non-residential buildings over the past year has been much less pronounced than for residential buildings, even though there is a large stock of work yet to be done on some large-scale healthcare projects (Graph 3.10). Approvals for office buildings have trended higher, even though the vacancy rate for national capital city CBD offices remains well above its decade average.

Graph 3.10
Private Non-residential Building Approvals*
Per cent of nominal GDP

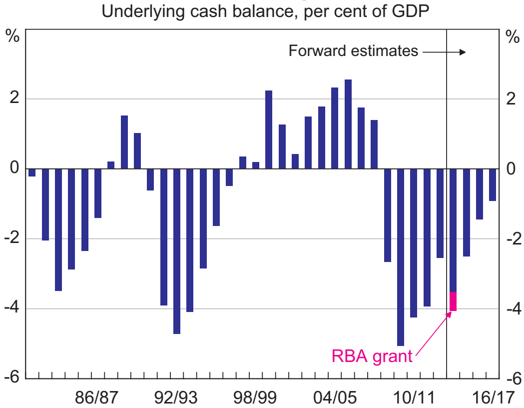


* 7-period Henderson trends
Sources: ABS; RBA

Government Sector

The Australian Government's Mid-Year Economic and Fiscal Outlook, together with the recent state budget updates, suggest a larger consolidated state and federal budget deficit in 2013/14 and for the next few years. Abstracting from the planned $8.8 billion grant by the Australian Government to the Reserve Bank, the majority of the widening in the deficit reflects a downward reassessment of prospects for growth of the economy, with future receipts revised lower and future payments revised higher (Graph 3.11). Nonetheless, the budget projections continue to imply a pronounced fiscal consolidation over coming years.

Graph 3.11
Consolidated Budget Balance*
Underlying cash balance, per cent of GDP



* Combined Australian Government and state budget balances
Sources: Australian Treasury; state treasuries

Farm Sector

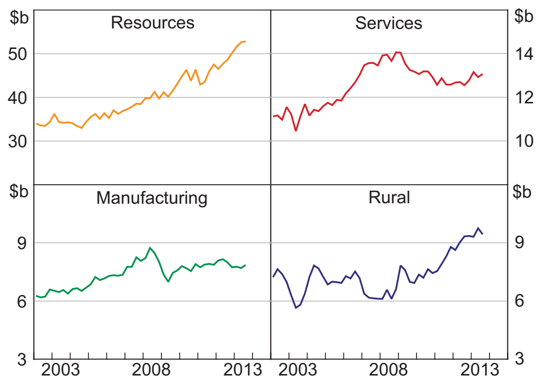
Around 60 per cent of Queensland is currently drought declared. The dry conditions there and in northern New South Wales have created unfavourable conditions for the planting of summer crops and led to an increase in cattle slaughtering (Graph 3.12). Despite this, farm production is forecast to increase 3 per cent in 2013/14 by the Australian Bureau of Agricultural and Resource Economics and Sciences. This improvement largely reflects an increase in production of the 2013 winter crop in other parts of the country.

Prices received by farmers overall are expected to increase in 2013/14, as the depreciation of the exchange rate and higher world prices for dairy products, wool and lamb, are expected to more than offset lower world prices for most grains.

External Sector

Exports rose modestly in the September quarter, as increases in resource, services and manufactured exports more than offset a decline in rural exports (Graph 3.13). The growth in resource exports was driven by stronger exports of iron ore, with coal exports falling slightly. Imports were 3.3 per cent lower in the quarter, with capital goods, intermediate goods and services imports all declining, while imports of consumption goods were unchanged.

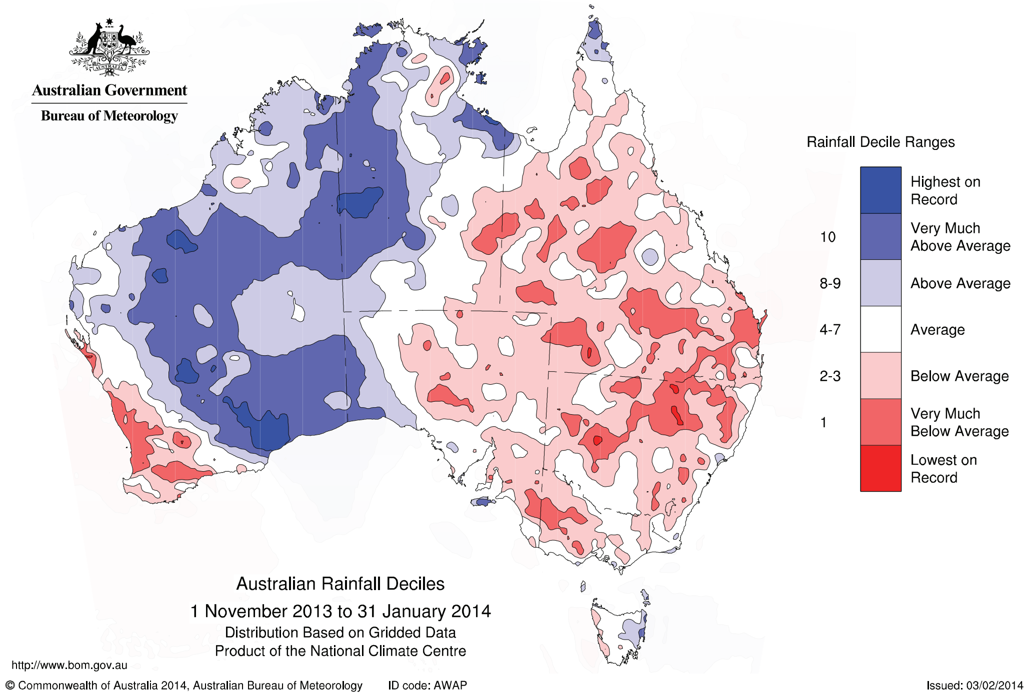
Graph 3.13
Export Volumes*
Quarterly



* 2011/12 prices
Sources: ABS; RBA

More timely trade data suggest that iron ore volumes increased further in the December quarter, which accords with ongoing expansions to capacity. Coal exports appear to have rebounded in the quarter. Resource exports are expected to continue growing strongly over the next few years as further projects reach completion. Exports of services are estimated to have been subdued in the December quarter, although the recent depreciation in the exchange rate should, in time, provide some support for exports. Import volumes appear to have been unchanged over the December quarter.

Graph 3.12
Australian Rainfall
1 November 2013 to 31 January 2014



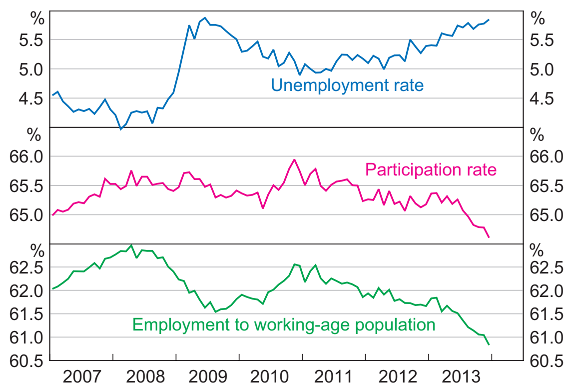
Source: Bureau of Meteorology

Labour Market

Labour market conditions have remained weak in recent months. The unemployment rate has continued to trend upwards, while the participation rate has declined noticeably since the middle of last year (Graph 3.14). There has been little growth in employment over the past year, and the ratio of employment to the working-age population declined to its lowest level since 2005. Total hours worked have also turned down in recent months, in contrast to the stronger growth observed up to mid 2013 (Graph 3.15). Measures of underemployment, which include employed workers wanting to work more hours, remain around their highest levels in the past decade.

The recent decline in the participation rate continues a trend seen since late 2010, and it is likely to reflect a mixture of structural and cyclical factors.[1] A little over half of the decline in the participation rate over this period can be attributed to the ageing

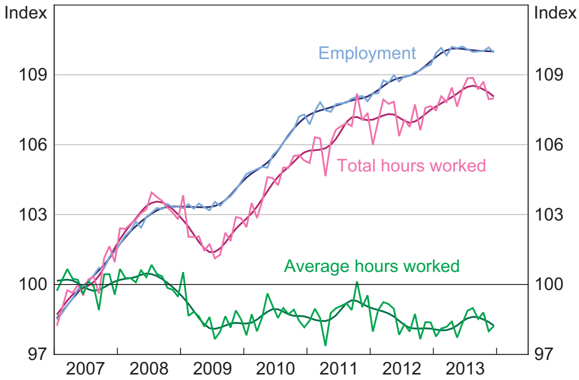
Graph 3.14
Labour Market



Sources: ABS; RBA

1 See RBA (2013), 'Box C: The Labour Force Participation Rate', *Statement on Monetary Policy*, February, pp 40–42.

Graph 3.15
Employment and Hours Worked*
2007 average = 100

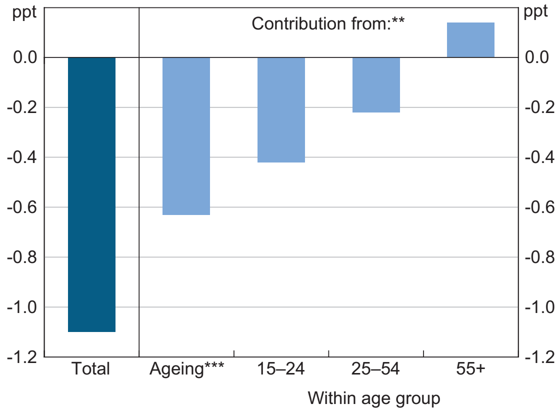


* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

of the population, since older persons tend to have a lower rate of labour force participation than younger working-age persons (Graph 3.16). The negative effect of ageing on the participation rate has picked up in recent years, as the oldest members of the relatively large baby boomer cohort have passed the traditional retirement age of 65 years. The remainder of the decline in the participation rate since late 2010 has reflected changes in participation rates within age groups. In particular, the rise in the participation rate of those aged 55 years and over has tapered off, in contrast to its relatively strong trend increase over the preceding decade. Also, the participation rate of 15 to 24 year olds and males aged 25 to 54 years has declined. Historically, a weak labour market has often been associated with a decline in participation rates within age groups, as discouraged jobseekers drop out of the labour force rather than continue to look for work, and so the decline in participation rates within age groups may reflect the weak state of the labour market. However, structural factors associated with policy changes or preference shifts may have also played a role.

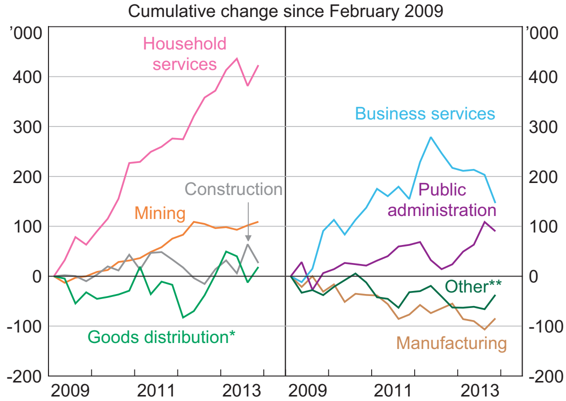
The recent softness in aggregate employment outcomes has largely reflected declines in employment in the business services sector, where employment is now substantially below its 2012 peak (Graph 3.17). Employment declines in the sector have been largely attributable to the professional, scientific & technical and media & telecommunications industries, with Bank liaison indicating that business services firms that are exposed to the mining sector have been particularly affected. In contrast, overall employment in financial services has remained relatively stable since mid 2011. Mining employment has also been little changed over the past year and a half after earlier strong growth. These developments are consistent with the transition toward the less labour-intensive production phase of the resources

Graph 3.16
Change in Participation Rate*
December quarter 2010 to December quarter 2013



* Seasonally adjusted by RBA
** Contributions do not add to total due to interaction effect
*** Contribution from the change in population age structure
Sources: ABS; RBA

Graph 3.17
Employment by Industry
Cumulative change since February 2009



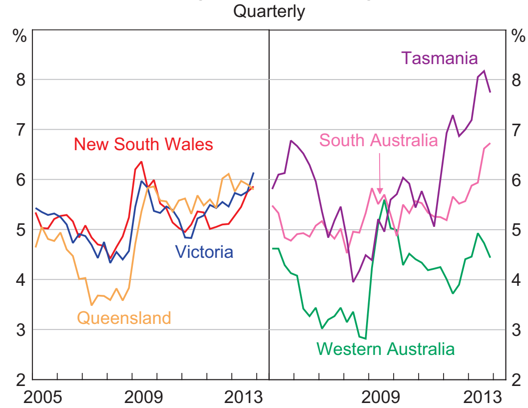
* Retail trade, wholesale trade, and transport, postal & warehousing
** Agriculture and utilities
Source: ABS

boom, as well as a continued focus by mining-related businesses on containing costs. Over recent years there has been a pronounced increase in household services sector employment (which includes the health, education and hospitality industries), driven mainly by the health industry. More recently, growth in household services employment looks to have slowed. Construction employment appears to have trended a little higher over the past year or so, consistent with the pick-up in activity in the housing market.

Labour market conditions have remained weak in most states. After relatively strong growth over the first half of 2013, employment has declined in New South Wales and Victoria over the past six months, while participation rates in both states have also fallen. Labour market conditions have also remained subdued in South Australia and Tasmania. In contrast, employment has continued to rise in Queensland and Western Australia over recent months, while the unemployment rates in these states have declined modestly (Graph 3.18).

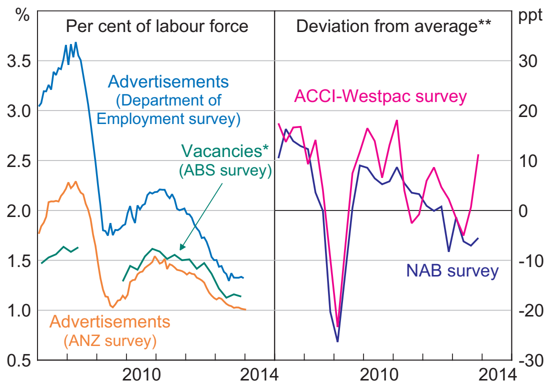
Most forward-looking indicators of labour demand have shown tentative signs of stabilising in recent months, following declines to relatively low levels (Graph 3.19). Measures of job advertisements and job vacancies were little changed over the second half of 2013. Reports from the Bank's liaison suggest that businesses' employment intentions have improved over recent months but remain weak compared with their history.

Graph 3.18
Unemployment Rates by State



Source: ABS

Graph 3.19
Labour Market Indicators



* This survey was suspended between May 2008 and November 2009

** Net balance of surveyed employment intentions for the following quarter; deviation from average since 1989

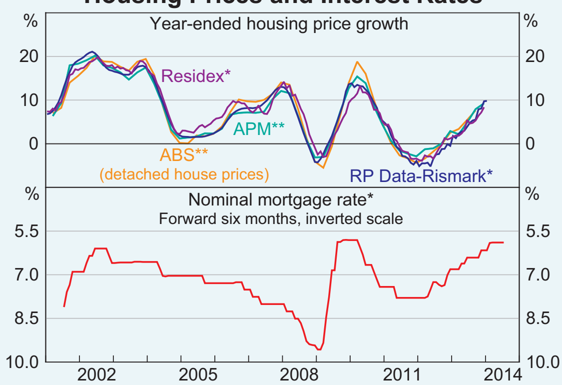
Sources: ABS; ACCI; ANZ; Department of Employment; NAB; RBA; Westpac

Box B

The Housing Market

Housing prices are sensitive to interest rates and are an important channel of the transmission of monetary policy. More broadly, developments in the housing market have an important bearing on economic activity and financial system stability.[1] Following earlier reductions in interest rates, housing prices have been rising quite strongly, though growth has been well below the rates seen in the early 2000s (Graph B1). Housing price inflation over 2013 was around 10 per cent, with the rate of increase slightly stronger in the second half of the year than in the first half.

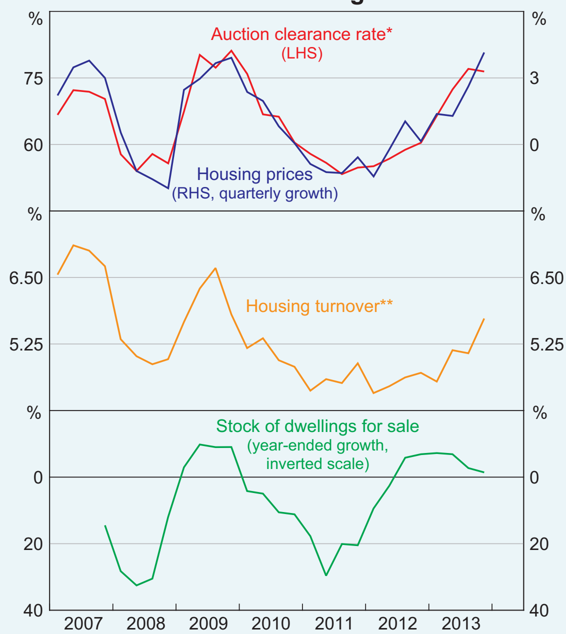
Graph B1
Housing Prices and Interest Rates



* Monthly
** Quarterly
Sources: ABS; APM; RBA; Residex; RP Data-Rismark

The strengthening in the housing market is evident in a range of other indicators. In particular, dwelling turnover (or sales) has been picking up since the middle of 2013 and auction clearance rates remain at very high levels (Graph B2). The total number of dwellings for sale (listings) has also declined, which tends to occur when the market is strong, as sales typically pick up

Graph B2
Established Housing Market



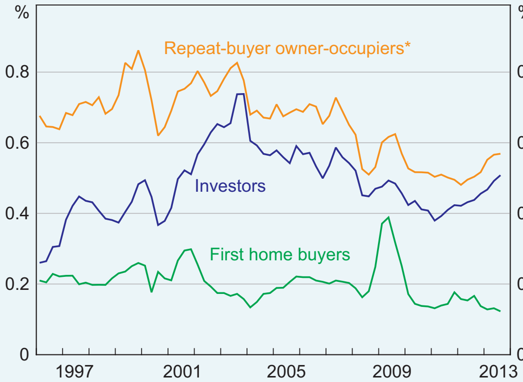
* Average of Melbourne and Sydney
** Share of dwelling stock; annualised; RBA estimate for December 2013
Sources: APM; RBA; REIV; RP Data-Rismark

more strongly than new listings. The extent of seller discounting (relative to the original listing price) and the average time taken to sell a property also vary inversely with the housing cycle and have fallen considerably, to be close to their lowest levels in nearly a decade.

The increase in turnover over the past year or so has been driven by investors and repeat-buyer owner-occupiers, with the value of loan approvals to these types of buyers increasing by around 35 per cent and 25 per cent, respectively, over the year to November (Graph B3). Growth of investor loan approvals in New South Wales has been particularly

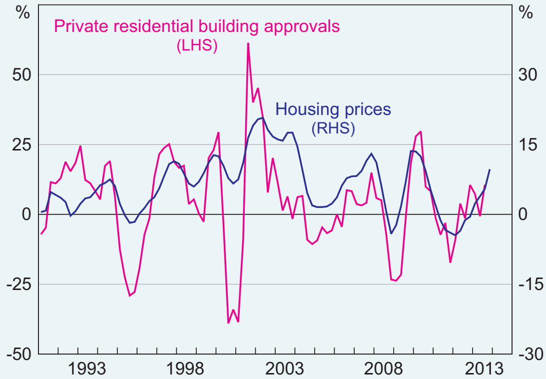
1 See, for example, RBA (2013), *Financial Stability Review*, September, pp 2 and 49.

Graph B3
Value of Housing Loan Approvals
Ratio to value of the dwelling stock, quarterly



* Net of refinancing
Sources: ABS; RBA

Graph B4
Housing Prices and Building Approvals
Year-ended growth



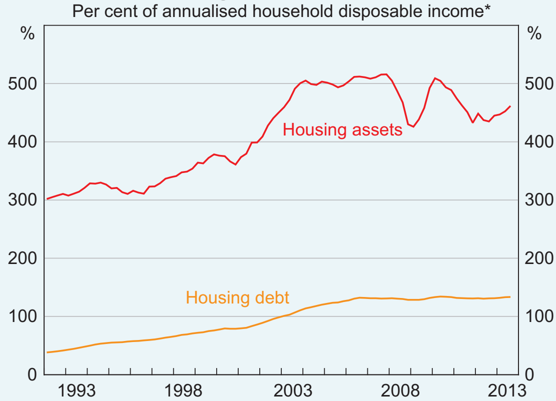
Sources: ABS; APM; RP Data-Rismark

strong at nearly 55 per cent over the year to November. In contrast, first home buyer demand for housing has been subdued, reflecting especially weak demand for established housing. The changes in state government incentives for first home buyers away from *established* dwellings and toward *new* dwellings has shifted their purchases accordingly.

The rise in housing prices over the past year or so is broadly consistent with the historical relationship between interest rates and housing prices (see Graph B1). The reduction in interest rates has eased some financing constraints, reduced the user cost of housing and increased the attractiveness of investing in riskier, higher-yielding assets, resulting in stronger demand for residential property. Indeed, this effect of lower interest rates on housing prices is an important channel through which expansionary monetary policy supports economic activity. Increases in housing demand and prices boost dwelling construction as well as renovation activity (Graph B4). Higher housing prices and turnover also stimulate consumer spending by easing some home owners' borrowing constraints and raising home owners' perceptions of wealth. The demand for some real estate, legal and financial services also moves in tandem with housing transactions.

The upswing in housing asset values to date has not been fuelled by a rapid expansion in borrowing. Growth in housing credit is gradually picking up but remains relatively moderate and the ratio of households' housing debt to income has been little changed at around 130 per cent (Graph B5). While the value of loan approvals has been rising strongly, this follows a period of weak growth and, as a share of the stock of housing credit, new loan approvals remain relatively low. Loan approvals tend to move closely with the value of dwelling turnover, which

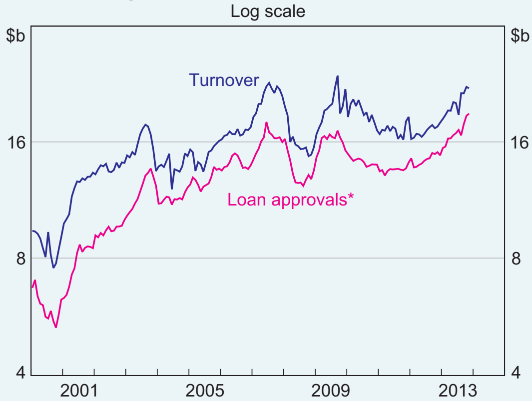
Graph B5
Housing Assets and Debt
Per cent of annualised household disposable income*



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

has picked up owing to both higher prices and turnover volumes. Nonetheless, to date, the rate of dwelling turnover has been a little below average (Graph B6 and Graph B2; see the 'Domestic Financial Markets' chapter for further details on developments in housing finance). ✠

Graph B6
Housing Turnover and Loan Approvals



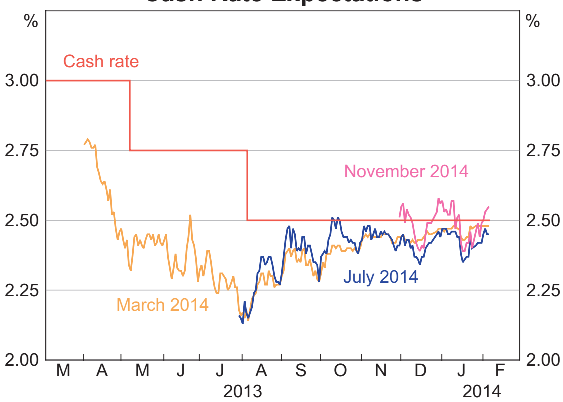
* Excludes loans for refinancing, construction and alterations & additions by owner-occupiers, and construction loans by investors
Sources: ABS; RBA; RP Data-Rismark

4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank has maintained the cash rate target at 2.50 per cent since the previous *Statement*. Yields on money market instruments imply an expectation that there is little chance of an easing in monetary policy in 2014 (Graph 4.1).

Graph 4.1
Cash Rate Expectations



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Rates on bank bills and certificates of deposit have been stable over the past few months, and remain close to historically low levels of around 2.60 per cent. Spreads between bank bill and OIS rates have risen by around 5 basis points, reflecting a modest increase in issuance activity, but remain narrow.

Yields on long-term Commonwealth Government securities (CGS) have moved in a wide range during the past few months, but in net terms are around 20 basis points lower than at the time of the previous *Statement* (Graph 4.2). Yields on 10-year CGS reached a 20-month high of 4.38 per cent in January in response to stronger-than-expected economic data in the United States, before declining to around 4 per cent.

The spread between 10-year CGS and US Treasuries is little changed since the previous *Statement*. (Graph 4.3).

Graph 4.2
Australian Government Bond Yields

Source: RBA

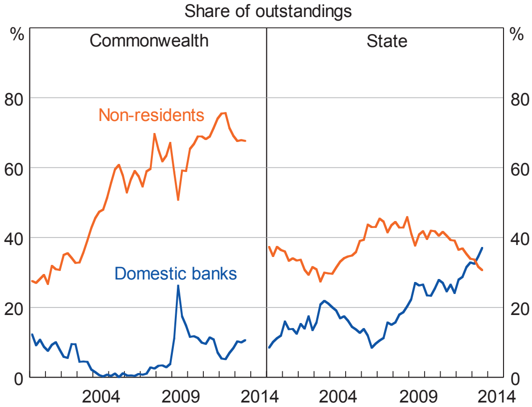
Graph 4.3
Australia/US 10-year Bond Differential

Source: RBA

The Australian Office of Financial Management (AOFM) announced a revised CGS issuance program for the 2013/14 financial year in response to the Mid-Year Economic and Fiscal Outlook (MYEFO). Net issuance is projected to be $52 billion over the year, an increase of $15 billion from the Pre-Election Economic and Fiscal Outlook (PEFO). The total amount of CGS on issue is expected to reach $310 billion by the end of the financial year.

The share of CGS held by non-residents remained broadly unchanged in the September quarter at around 68 per cent (Graph 4.4). Non-residents' holdings of state government bonds declined further to 31 per cent, while the share held by Australian banks increased further as they continued to increase their liquid asset holdings ahead of implementation of the Australian Prudential Regulation Authority's (APRA's) Basel III liquidity reforms in 2015. The share of non-government bonds held by non-residents was broadly unchanged in the September quarter.

Graph 4.4
Ownership of Australian Government Debt
Share of outstandings



Sources: ABS; RBA

State government bonds (semis) outstanding have increased slightly since the previous *Statement*, with a total of $2.5 billion in new lines issued via fixed- and floating-rate bonds. The states raised a total of $15.3 billion of term funding in the first half of the 2013/14 financial year, which is around 60 per cent of their aggregate funding target for the financial year (Table 4.1). Planned term borrowing by the states for the current financial year is significantly lower than their bond issuance in the 2012/13 financial year. In December, Queensland, Victoria and Western Australia revised down their planned issuance for this financial year by a total of $3.2 billion, mainly reflecting lower-than-anticipated government expenditure. Spreads between 5-year CGS and semis declined by as much as 10 basis points, reaching their lowest levels since mid 2011 (Graph 4.5).

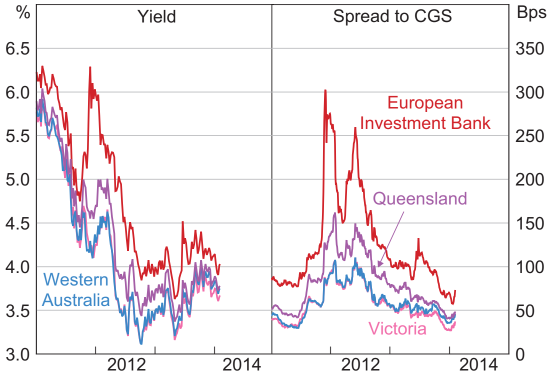
Domestic bond issuance by non-resident entities ('Kangaroos') was around $30 billion in 2013, similar to the amount raised in the previous year. Around $7 billion has been raised since the previous *Statement*, mostly by supranational and financial entities. Secondary market spreads for Kangaroo bonds have declined slightly and remain around

Table 4.1: Term Borrowing by State Authorities

Issuer	2012/13 Issuance $ billion	2013/14 Issuance as at end December 2013 $ billion	2013/14 Indicative target $ billion
New South Wales	6.9	2.8	5.3
Queensland	13.7	3.0	6.1
South Australia	~4	~2	~3
Tasmania	1.0	0	0.4
Victoria	7.2	3.5	6.1
Western Australia	8.6	~4	6.1
Total	**41**	**15**	**27**

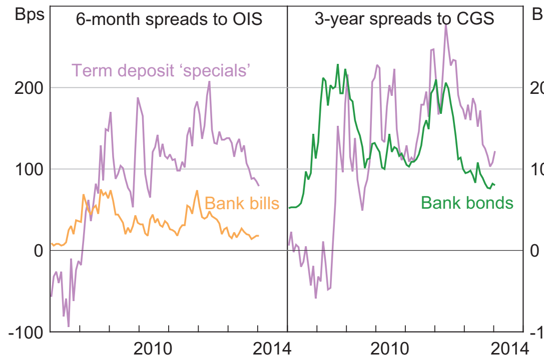
~ Indicates an approximation
Sources: state borrowing authorities

Graph 4.5
5-year Semi-government Debt



Sources: RBA; Yieldbroker

Graph 4.6
Major Banks' Pricing of Term Deposits



Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

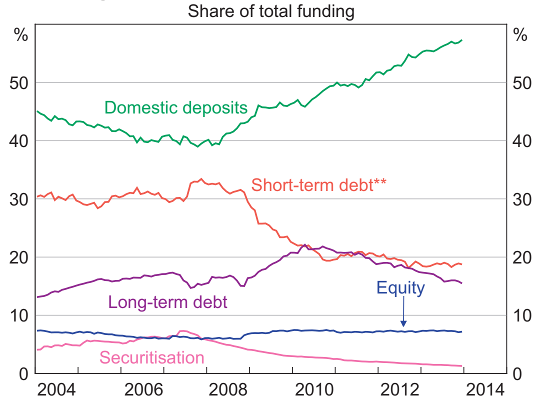
their lowest levels since late 2007. Australian dollar cross-currency basis swap spreads have been broadly unchanged against the US dollar but have narrowed against the euro and the yen, reducing the attractiveness of issuance in Australian dollars for euro- and yen-based issuers.

Financial Intermediaries

Since the previous *Statement*, bank funding costs have declined a little relative to the cash rate. As conditions in wholesale funding markets have improved, interest rates on some term deposit 'specials' have been reduced, leading to a further narrowing in spreads relative to comparable term wholesale market rates (Graph 4.6). With average interest rates on at-call deposits little changed, term deposits have become less attractive to savers than at-call deposits, which has resulted in a continued inflow of household savings into at-call deposit accounts. The aggregate share of funding from domestic deposits has remained broadly stable over this period (Graph 4.7).

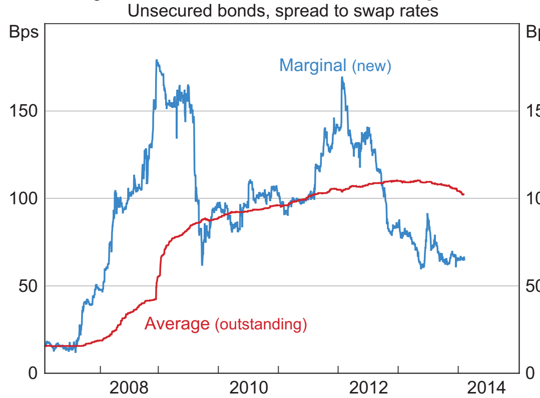
Over the past three months, the cost of banks' new issuance of unsecured long-term wholesale debt has been little changed, and remains at around its lowest level since mid 2009 (Graph 4.8). The outstanding cost of wholesale debt has started to decline over the past few months as some of the debt issued in 2008 and 2009 at high spreads has matured. This has had a limited effect on banks' overall funding

Graph 4.7
Funding Composition of Banks in Australia*
Share of total funding



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.8
Major Banks' Domestic Bond Spreads
Unsecured bonds, spread to swap rates



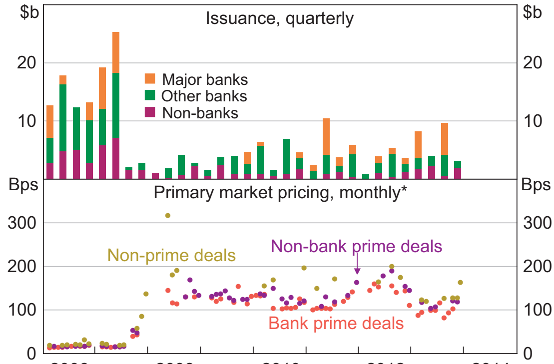
Sources: Bloomberg; RBA; UBS AG, Australia Branch costs to date as long-term wholesale debt currently represents only 15 per cent of banks' total funding.

Relative to CGS, spreads on the major banks' bonds have remained broadly unchanged since the previous *Statement*. Spreads over CGS on the unsecured bonds of the major banks are near their lowest level since the onset of the global financial crisis, while spreads on covered bonds are at their lowest since the banks started issuing these securities.

Around $29 billion of bonds have been issued by Australian banks since the previous *Statement* (Graph 4.9). Over 85 per cent of these bonds were issued offshore, including $9 billion of covered bonds. US dollar issuance comprised half of the total, with the remainder split equally between the Australian dollar, euro and yen. Notwithstanding the pick-up in gross issuance late in the year, net bank bond issuance in 2013 was lower than in 2012 reflecting a combination of subdued asset growth and the ongoing shift towards deposit funding by the Australian banks. The stock of outstanding government guaranteed bonds has declined to around $30 billion reflecting maturities and buybacks.

Issuance in the Australian securitisation market of $32 billion in 2013 was the highest it has been since the start of the global financial crisis (Graph 4.10). Most of the issuance was in the form of residential mortgage-backed securities (RMBS), although issuance of other asset-backed securities was also robust, including the first issuance of commercial mortgage-backed securities since 2010. Around $2.5 billion of these securities have been issued since the previous *Statement*, with most of that in the domestic market. RMBS issuance spreads have remained broadly unchanged since March 2013.

Graph 4.10
Australian RMBS



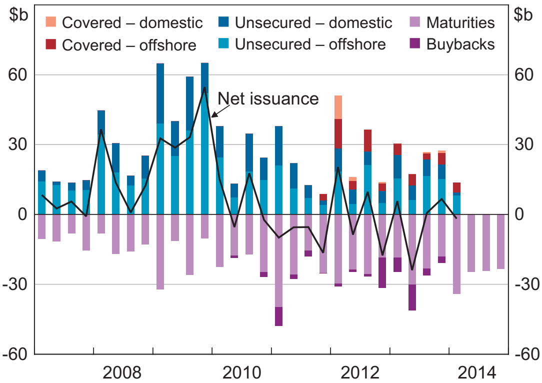
* Face-value weighted monthly average of the primary market spread to bank bill rate

Source: RBA

Financial Aggregates

Total credit grew modestly in the December quarter, increasing at an annualised rate of around 4¾ per cent (Graph 4.11; Table 4.2). This is still below growth in broad money, which increased at an annualised rate of 7 per cent over the quarter. The growth in broad money mainly reflected continued inflows into saving and transaction deposit accounts.

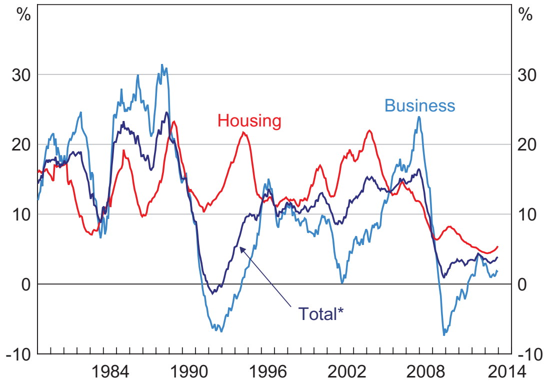
Graph 4.9
Banks' Bond Issuance and Maturities
A$ equivalent



* Latest quarter gross issuance and net issuance are quarter to date

Source: RBA

Graph 4.11
Credit Growth
Year-ended



* Includes housing, personal and business credit

Sources: APRA; RBA

Table 4.2: Financial Aggregates
Percentage change(a)

	Three-month ended		Year-ended
	Sep 2013	Dec 2013	Dec 2013
Total credit	0.9	1.2	3.9
– Owner-occupier housing	1.1	1.4	4.6
– Investor housing	1.7	2.2	7.1
– Personal	0.4	0.1	0.9
– Business	0.4	0.5	1.7
Broad money	1.1	1.7	5.8

(a) Growth rates are break adjusted and seasonally adjusted
Sources: APRA; RBA

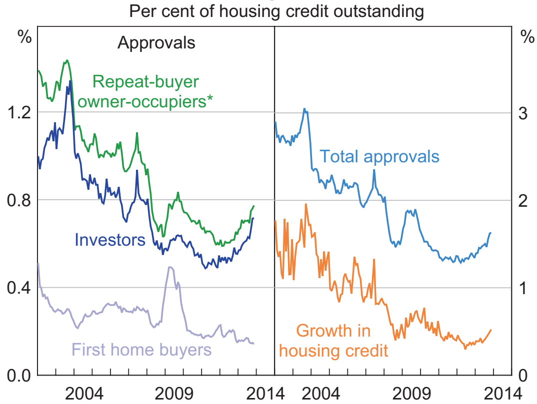
Household Financing

Growth in housing credit edged higher over the December quarter, consistent with the pick-up in prices and activity in the housing market over the past year (Graph 4.12). The value of housing loan approvals is around 5 per cent higher than its previous peak in June 2007. The increase in both the value and number of loan approvals has been underpinned by loans to investors and repeat-buyer owner-occupiers. Loan approvals for purchases of dwellings in New South Wales by investors continue to be particularly strong. With the value of first home buyer loan approvals at historically low levels, the small share of first home buyer approvals is likely to have held down housing credit growth. This reflects the fact that approvals to first home buyers typically translate into larger increases in housing credit than loans to investors and repeat-buyer owner-occupiers. In addition, households continue to maintain a high pace of mortgage prepayments.

The average interest rate on outstanding housing loans continued to fall as borrowers refinanced at lower rates (Graph 4.13). The average interest rate on housing loans is now around 30 basis points below its previous trough in September 2009.

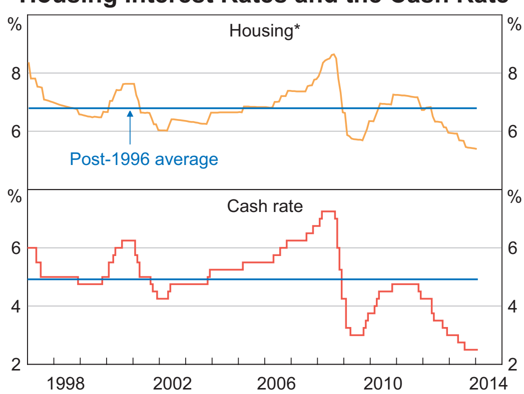
Lenders' standard variable rates have remained largely unchanged since the last reduction in the cash rate target in August, although some lenders have altered their advertised package discount rates amid ongoing mortgage competition (Table 4.3).

Graph 4.12
Housing Loans



* Net of refinancing
Sources: ABS; RBA

Graph 4.13
Housing Interest Rates and the Cash Rate



* On outstanding loans
Sources: ABS; APRA; Perpetual; RBA

Table 4.3: Intermediaries' Fixed and Variable Lending Rates

	Level at 31 January 2014	Change since October 2013	Change since end October 2011
	Per cent	Basis points	Basis points
Housing loans			
– Standard variable rate[a]	5.93	0	–186
– Package variable rate[b]	5.10	2	–195
– Fixed rate[c]	5.29	5	–123
Personal loans			
– Standard variable rate	11.58	2	–96
Small business (variable rates)			
Residentially secured, advertised			
– Term loans	7.10	0	–190
– Overdraft	7.97	0	–188
Average rate[d]	6.80	0	–183
Large business			
Average rate[d] (variable rate and bill funding)	4.67	1	–236

(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package variable rates on new, $250 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) Rates on outstanding business lending (includes discount)
Sources: ABS; APRA; RBA

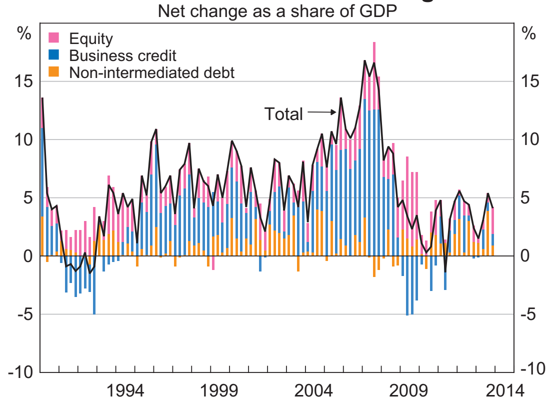
Many lenders continued to advertise special offers to new customers, including fee waivers and additional discounts on rates for a limited time.

The value of outstanding personal credit increased slightly over the December quarter. The stock of fixed-term loans continued to increase, supported by ongoing strength in credit extended by car finance companies. Notwithstanding the rise in equity prices over the second half of 2013, preliminary data from the RBA's December quarter margin lending survey suggest that the value of margin loans outstanding remains less than one-third of its pre-crisis peak.

Business Financing

External business funding has risen by the equivalent of around 4 per cent of GDP in the December quarter. The main contribution was from equity raisings (Graph 4.14).

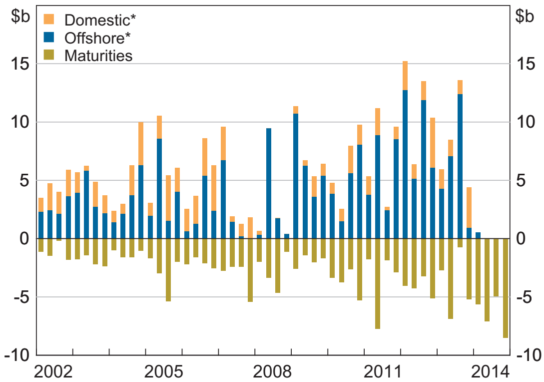
Graph 4.14
Business External Funding
Net change as a share of GDP



Sources: ABS; APRA; ASX; RBA

Corporate bond issuance totalled $2 billion since the previous *Statement* (Graph 4.15). Issuance was mostly confined to the domestic market with around half at the 5-year tenor. Issuance in 2013 was slightly below the record issuance volume in 2012, mostly due to

Graph 4.15
Australian Corporates' Bond Issuance
A$ equivalent



* Latest quarter issuance to date
Source: RBA

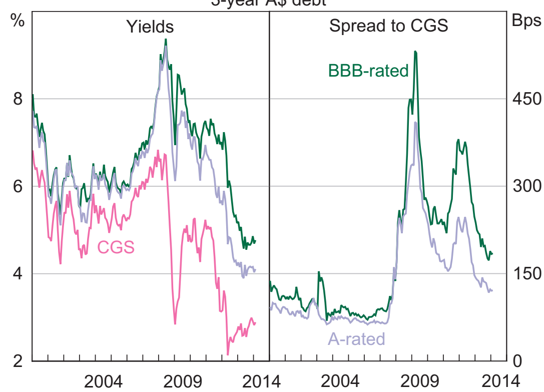
reduced activity by the large diversified miners. Corporate bond issuance by other companies was very strong in mid 2013, with significant issuance in the domestic market and at longer-than-usual tenors for the lower-rated issuers.

Secondary market spreads for Australian dollar corporate bonds over CGS have increased since the previous *Statement* for BBB-rated entities, and have remained unchanged for A-rated entities. Spreads remain near their lowest levels since the onset of the global financial crisis (Graph 4.16).

The value of outstanding business credit rose modestly over the December quarter, reflecting an increase in lending to both private trading corporations and unincorporated businesses. Much of the growth in business credit over the past year was driven by lending by Asian banks operating in Australia which have increased their share of total business credit from around 4 per cent in December 2008, to almost 7½ per cent in December 2013 (Graph 4.17). However, the overall rate of growth in business credit remains low, consistent with subdued investment intentions despite some surveys indicating improved business conditions.

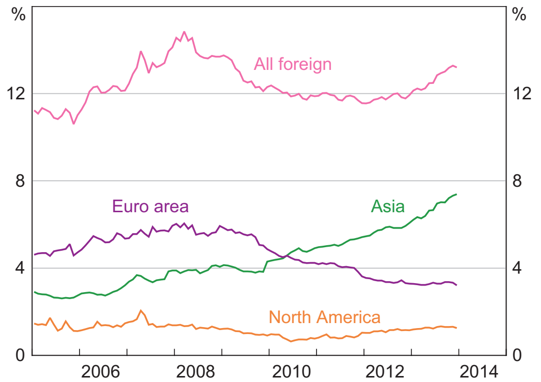
Since the previous *Statement*, the cost of intermediated business borrowing for both small and large businesses has continued to decline (Graph 4.18). Rates on small and large business loans outstanding remain well below their post-1996 averages.

Graph 4.16
Australian Corporates' Bond Pricing
3-year A$ debt



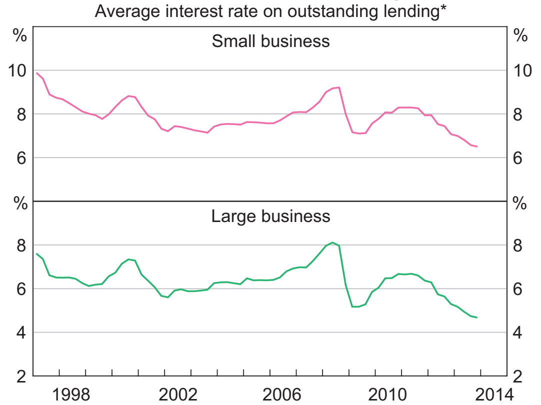
Sources: RBA; UBS AG, Australia Branch

Graph 4.17
Business Credit*
Share of total business credit provided by foreign banks



* Non-seasonally adjusted, non-break adjusted; includes securitisation
Sources: APRA; RBA

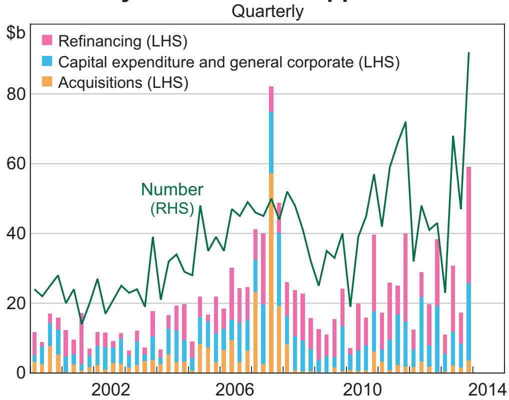
Graph 4.18
Australian Business Lending Rates
Average interest rate on outstanding lending*



* RBA estimate for December quarter 2013
Sources: APRA; RBA

Activity in the Australian syndicated lending market picked up over the December quarter (Graph 4.19). Loan approvals for refinancing, capital and general corporate expenditure increased strongly even after accounting for seasonality. Acquisition-related financing increased a little in the quarter but remains at a low level.

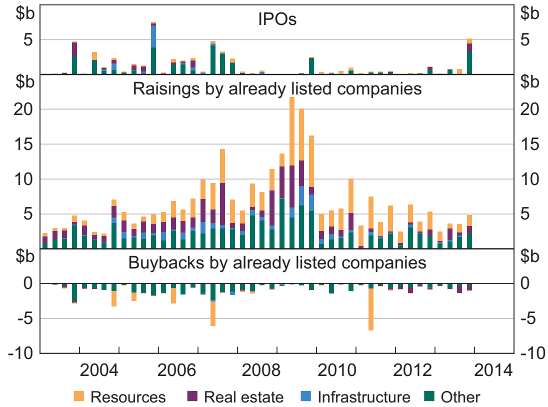
Graph 4.19
Syndicated Loan Approvals
Quarterly



Sources: RBA; Thomson Reuters

Equity raisings by non-financial corporations (but including real estate companies) rose sharply in the December quarter to $9 billion (Graph 4.20). The increase was mainly driven by $5 billion in initial public offerings (IPOs), which was the highest level of quarterly IPO activity since 2005 and a number of these transactions involved private equity interests. The pick-up in activity is expected to continue into 2014, reflecting a build-up of supply in recent years. Several large deals accounted for most of the IPO activity, including a $1 billion deal by a New Zealand based renewable energy developer – the largest IPO since November 2009 – as well as listings of around $650 million each from two other companies. Real estate companies raised a further $1 billion across four IPOs. Equity raisings by already listed companies also increased in the December quarter, with issuance totalling $5 billion and driven by private placements across a number of sectors. There were $1 billion in share buybacks during the quarter, mainly by real estate companies. With the pick-up in

Graph 4.20
Listed Corporates' Equity Raisings*



* Excludes financial corporations other than real estate; excludes privatisations and hybrid conversions
Sources: ASX; RBA

issuance late in the year – especially IPOs – total net equity raisings in 2013 were the highest since 2010.

In contrast, merger and acquisition (M&A) activity has remained subdued with around $9 billion in deals announced by listed companies since the previous *Statement*. The level of M&A activity in 2013 was the lowest in over a decade, with only $30 billion in deals announced.

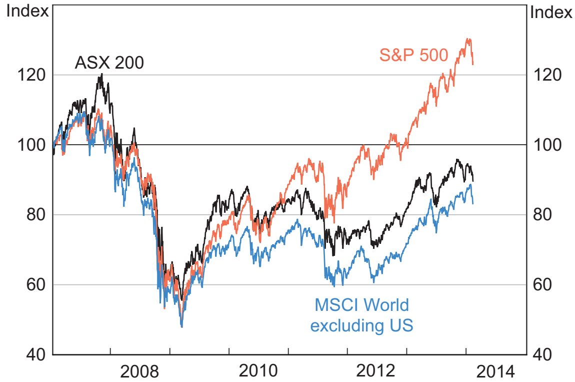
Equity Markets

Australian equity prices have declined by 6½ per cent since the previous *Statement*, broadly following overseas market developments (Graph 4.21). Over 2013, Australian equity prices rose by 15 per cent, underperforming global equity markets, particularly Japan and the United States.

Resource sector share prices have declined by 6½ per cent since the previous *Statement* (Graph 4.22). The share prices of major diversified mining companies have generally tracked movements in the price of iron ore.

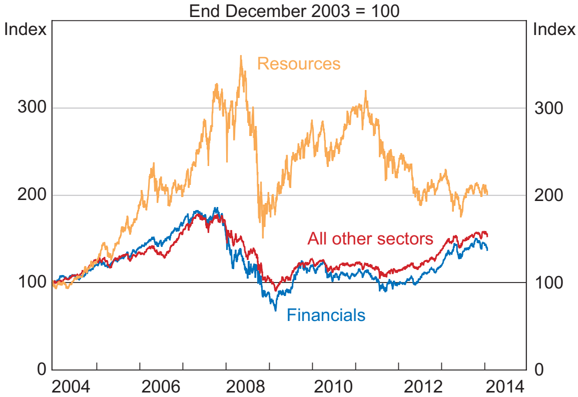
Financial sector share prices have declined by 9 per cent since the previous *Statement*, with the dividend payments by three of the major banks adding to the general equity market trend. Prices in the insurance subsector have declined by 16½ per cent, following

Graph 4.21
Share Price Indices
End December 2006 = 100



Sources: Bloomberg; MSCI; Thomson Reuters

Graph 4.22
Australian Share Price Indices
End December 2003 = 100



Sources: Bloomberg; RBA

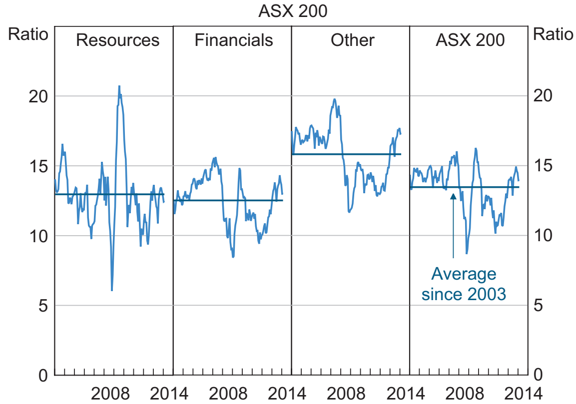
QBE's announcement of an expected $275 million loss for this financial year related to weakness in its North American business, including asset writedowns and higher–than-expected insurance claims.

Share prices in other sectors have declined by 3 per cent since the previous *Statement*, although defensive stocks, in particular the healthcare and telecommunications sectors, have outperformed. In contrast, industrial companies' share prices have declined by 5 per cent since the previous *Statement*.

In line with international markets, the option-implied volatility of Australian equities has increased since the previous *Statement*. Trading activity has remained subdued.

Equity analysts' consensus earnings forecasts have increased for the resources sector by around 7 per cent since the previous *Statement*. This is largely due to the translation impact on the sector's US dollar generated earnings following the depreciation of the Australian dollar, rather than an upward revision of expected underlying performance. Earnings expectations for the other sectors have been broadly unchanged over this period. Valuations of Australian equities, as measured by forward price-earnings (PE) ratios, have declined since the previous *Statement* but remain close to or above their decade averages across all of the broad sectors (Graph 4.23). The PE ratio of the resources sector declined alongside lower share prices and an increase in expected Australian dollar earnings in the sector, while PE ratios for financials and other companies followed developments in these sectors' share prices. ✠

Graph 4.23
Australian Forward Price-earnings Ratios
ASX 200



Sources: RBA; Thomson Reuters

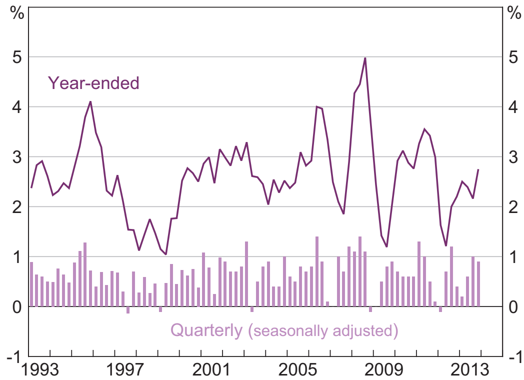
5. Price and Wage Developments

Recent Developments in Inflation

Consumer price inflation was stronger than expected in the December quarter, and it has picked up somewhat in the past six months. The consumer price index (CPI) rose by 0.9 per cent on a seasonally adjusted basis, following a similar increase in the September quarter, to be 2.7 per cent higher over the year (Graph 5.1; Table 5.1).

Taken together, price movements for volatile items and tobacco had only a small effect on headline inflation in the quarter. Food price inflation (excluding fruit and vegetables) remained relatively low at 0.5 per cent in the December quarter. This was despite the modest pick-up in inflation in the

Graph 5.1
Consumer Price Inflation*



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

Table 5.1: Measures of Consumer Price Inflation
Per cent

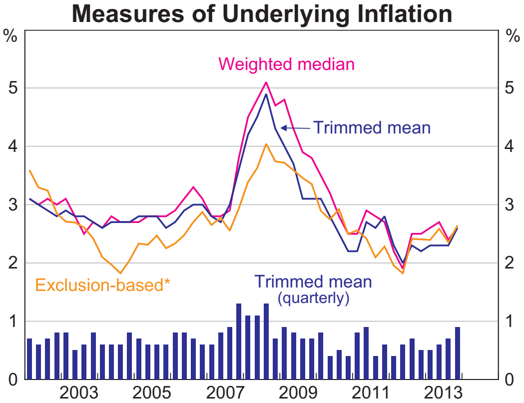
	Quarterly(a)		Year-ended(b)	
	December quarter 2013	September quarter 2013	December quarter 2013	September quarter 2013
Consumer Price Index	0.8	1.2	2.7	2.2
Seasonally adjusted CPI	0.9	1.0	–	–
– Tradables	0.7	1.1	1.0	–0.1
– Tradables (excl volatile items and tobacco)(c)	0.5	0.3	–0.1	–1.1
– Non-tradables	0.9	0.9	3.7	3.6
Selected underlying measures				
Trimmed mean	0.9	0.7	2.6	2.3
Weighted median	0.9	0.6	2.6	2.4
CPI excl volatile items(c)	0.8	0.8	2.6	2.4
CPI excl volatile items and tobacco(c)	0.8	0.7	2.4	2.2

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS
(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median
(c) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

prices of meals out and takeaway, and is consistent with reports from the Bank's liaison that supermarket competition continues to constrain increases in many food prices. Tobacco inflation picked up, largely reflecting a 12.5 per cent increase in tobacco excise, which came into effect in December. Vegetable prices rose by 6.5 per cent, reflecting adverse growing conditions in some areas, while fruit prices overall were little changed. Fuel prices declined by 1 per cent in the quarter.

The various measures of underlying inflation were also higher than expected, at between ¾ and 1 per cent in the December quarter. In year-ended terms, underlying inflation was a touch above 2½ per cent, a little higher than has been observed in recent quarters (Graph 5.2).

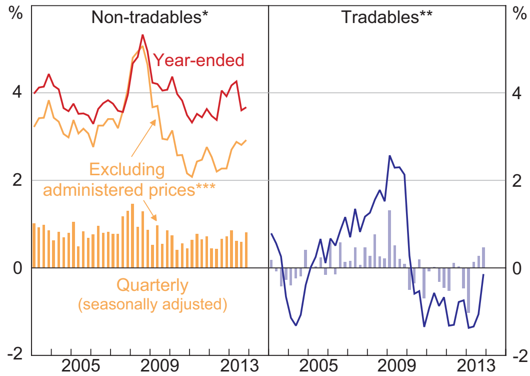
Graph 5.2
Measures of Underlying Inflation



* Excludes fruit, vegetables, automotive fuel (and deposit & loan facilities to June 2011)
Sources: ABS; RBA

The increase in underlying inflation largely reflected a rise in tradables prices. This followed a substantial decline in tradables prices from 2010 until early 2013 (Graph 5.3). In the December quarter, tradables prices (excluding volatile items and tobacco) rose by 0.5 per cent. While the prices of tradable items, by definition, are relatively sensitive to movements in the exchange rate, the recent increases in tradables prices were greater than might have been expected given the magnitude of the depreciation of the exchange rate over the past year. In part, this reflects changes in consumer durables prices, which increased in the

Graph 5.3
Non-tradables and Tradables Inflation



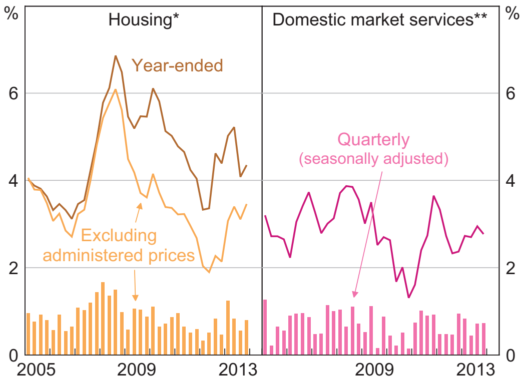
* Excluding deposit & loan facilities to June 2011
** Excluding volatile items (fruit, vegetables and automotive fuel) and tobacco
*** Administered prices include the prices of utilities, education, health services, some motor vehicle services, property rates & charges, pharmaceutical products, child care, urban transport fares and postal services
Sources: ABS; RBA

December quarter for the first time since 2010, driven by large price increases for household appliances and clothing accessories. In contrast, during the past two to three years durable items had experienced a persistent decline in prices, despite the relative stability of the exchange rate over that period. Falling durables prices over this period contributed to relatively muted inflation in retail prices overall and, in turn, the modest outcomes in aggregate inflation (see 'Box C: Recent Developments in Retail Prices and Margins').

The quarterly rate of non-tradables inflation was unchanged in the December quarter, with year-ended inflation picking up slightly to 3.7 per cent. However, abstracting from the effects of administered prices (which had boosted non-tradables inflation in the previous quarter) non-tradables inflation picked up a little in the December quarter. Non-tradables prices tend to be less affected by movements in the exchange rate, and relatively more influenced by domestic labour costs. So it is somewhat surprising that non-tradables price inflation has not eased given that growth in labour costs has been weak in recent quarters.

Over the past year, non-tradables inflation has been buoyed by an increase in the pace of housing inflation (Graph 5.4). This has been partly attributable

Graph 5.4
Non-tradables Inflation



* Includes prices for rents, dwelling repair & maintenance, new dwelling purchases and administered items (utilities and property rates & charges)

** Excludes deposit & loan facilities to June 2011 and housing services

Sources: ABS; RBA

to a strong rise in new dwelling costs, consistent with recent signs of a recovery in housing construction. Overall, market services inflation was unchanged in the December quarter, but remains somewhat stronger than expected given the recent weak growth in wages and unit labour costs. Inflation in domestic travel prices, despite easing in the December quarter, remained relatively strong, consistent with liaison reports that the lower exchange rate is encouraging substitution away from international travel, which might have allowed domestic travel providers to increase their margins. Also, there was higher inflation in the prices of household services and meals out & takeaway.

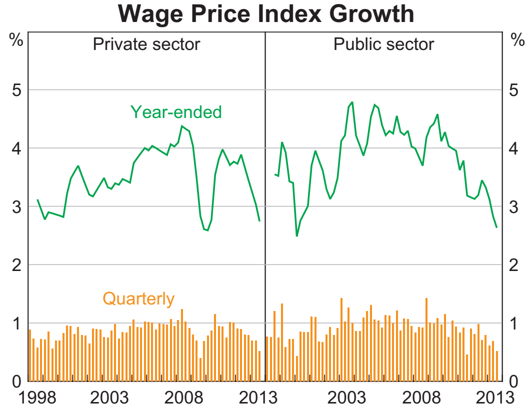
Both tradables and non-tradables inflation were somewhat higher than expected in the quarter. It could be that there was a higher-than-usual degree of noise in the data, which can occasionally occur owing to the difficulties of measurement or the timing of price changes. Alternatively, the higher-than-expected inflation recorded in the quarter might reflect a number of other factors. For tradables prices, it could be that the 'second stage' of exchange rate pass-through – from import prices (across the docks) to the prices facing consumers – has been more rapid than has been the case historically. For non-tradables prices, it could be that slower growth of labour costs is taking longer to pass through to final prices than usual. More generally, margins in both the traded and non-traded sectors may have increased. Such a rise appears to be at odds with the below-trend growth of consumption at least over the year to the September quarter, although more recently there have been tentative signs of improved trading conditions for retail trade, housing construction and domestic travel & leisure.

It is hard to distinguish among the different explanations because second-stage pass-through, margins, costs or noise in the data cannot be directly observed, and it may be that some combination of these factors is at work.

Costs

Wage growth slowed further in the September quarter. The wage price index increased by 2.7 per cent in year-ended terms, which is around 1 percentage point below its average of the past decade. The pronounced slowing in wage growth over the past year reflects the effect of spare capacity in the labour market, combined with relatively low consumer and union inflation expectations and continuing pressures on firms and public sector employers to contain costs. Private sector wage growth slowed in both quarterly and year-ended terms, with reports from liaison suggesting that labour is readily available and the rate of employee resignations is low (Graph 5.5). The annual award

Graph 5.5
Wage Price Index Growth

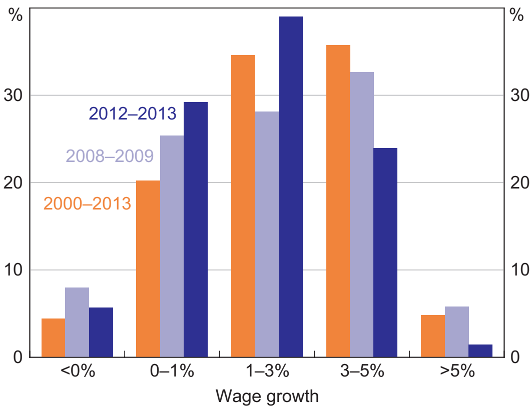


Source: ABS

wage increase, which came into effect in July and was a little less than the increase awarded in 2012, also contributed to the slowing in wage growth. In an environment of ongoing fiscal restraint, wage growth in the public sector eased to its slowest pace in year-ended terms since 2000. Bank liaison and surveys of firms' wage expectations indicate that wage pressures are likely to remain low over the next year.

Slower wage growth has been accompanied by a fall in the proportion of employees receiving relatively large wage increases. Survey data on the distribution of wage growth outcomes suggest that the slowing in wage growth has been more widespread across firms than was the case during the period of slower wage growth in 2008 and 2009 (Graph 5.6). At that time, a higher proportion of firms continued to offer wage increases of 3 per cent or more. In contrast, in the recent episode, wage growth of between 1 and 3 per cent has been more common.

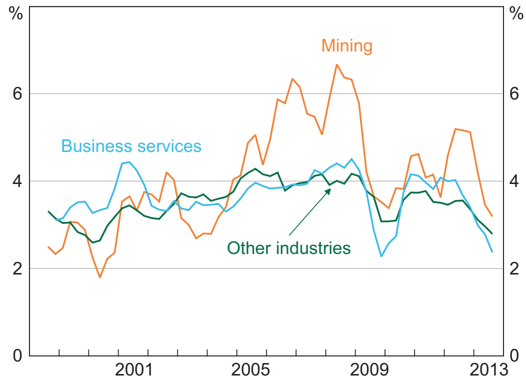
Graph 5.6
Distribution of Wage Growth Outcomes
Per cent of firms



Sources: NAB; RBA

The slowing in wage growth has been broad based across industries, but it has been somewhat more pronounced in mining and business services, reflecting the more noticeable slowing in demand for labour from these industries (Graph 5.7). Wage growth has also slowed across all states over the past year, with year-ended wage growth in New South Wales the slowest in the 15-year history of the wage price index. Consistent with the decline in demand for labour in the mining and mining-related industries, private sector wage growth in Western Australia and Queensland has also slowed sharply.

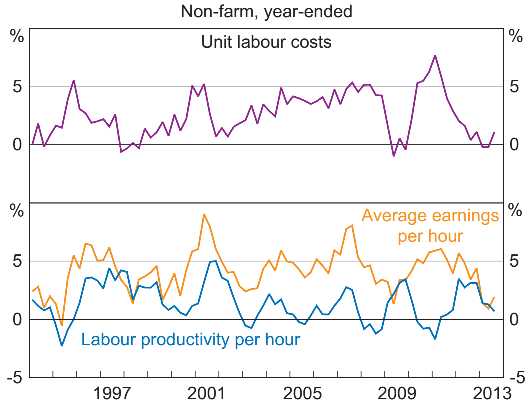
Graph 5.7
Wage Growth by Industry
Year-ended



Sources: ABS; RBA

The national accounts measure of average earnings rose only modestly in the September quarter, after being little changed in the first half of 2013. Measured growth in labour productivity has slowed from its relatively fast pace in 2012. With average earnings growing only slightly faster than labour productivity, year-ended growth in unit labour costs is estimated to have remained low (Graph 5.8).

Graph 5.8
Unit Labour Costs Growth
Non-farm, year-ended



Sources: ABS; RBA

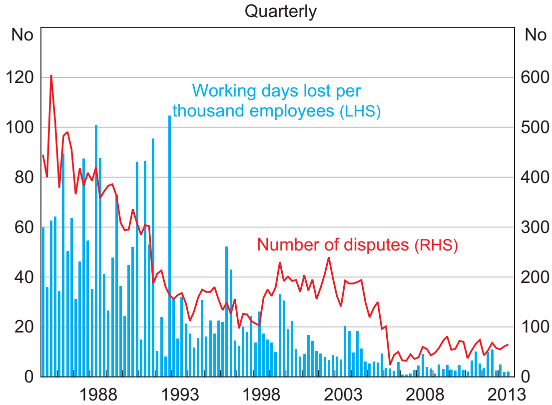
Producer price data suggest that domestic inflation pressures at the producer level were subdued across all stages of production over the year to the December quarter. Producer prices for imported goods declined slightly in the quarter after rising sharply in the previous quarter as a result of the depreciation of the exchange rate.

The number of working days lost per employee as a result of industrial disputes was little changed in the September quarter, remaining well below its decade average (Graph 5.9). There were slight increases in the number of industrial disputes and the average number of employees involved per dispute, but these were offset by a decline in the average duration of disputes.

Inflation Expectations

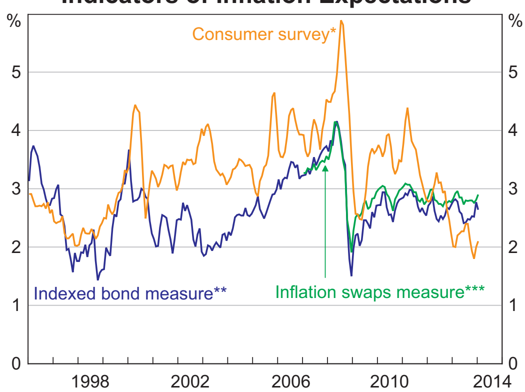
Measures of inflation expectations remain consistent with the inflation target, and are generally around or a little below their long-term averages (Graph 5.10; Table 5.2). Since the November *Statement*, market economists have revised down their expectations for inflation over 2014 slightly, while expectations for 2015 have remained steady. Union officials' forecasts for inflation over 2014 have increased somewhat. Financial market measures of inflation expectations have ticked up over the quarter to be around their average levels. The Melbourne Institute measure of consumers' inflation expectations for the year ahead has also increased modestly but remains low relative to its history.

Graph 5.9
Industrial Disputes
Quarterly



Source: ABS

Graph 5.10
Indicators of Inflation Expectations



* Three-month moving average of the trimmed mean expectation of inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
*** Expectation of average annual inflation over the next 10 years
Sources: Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA

Table 5.2: Median Inflation Expectations
Per cent

	Year to December 2014			Year to December 2015	
	August 2013	November 2013	February 2014	November 2013	February 2014
Market economists	2.6	2.6	2.5	2.6	2.6
Union officials	2.6	2.5	2.8	–	2.8

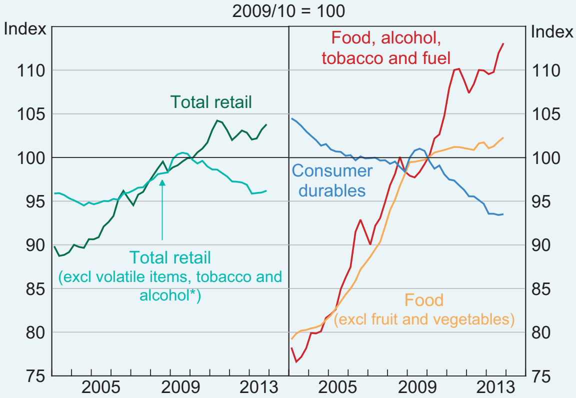
Sources: RBA; Workplace Research Centre

Box C

Recent Developments in Retail Prices and Margins

Retail goods are an important component of the Consumer Price Index (CPI), accounting for around 40 per cent of the CPI basket. These goods include consumer durable items, food, alcohol & tobacco and fuel. Overall, the prices of retail goods have been little changed over recent years, reflecting declines in the prices of consumer durables and relatively modest increases in most food prices (Graph C1). This stability in overall retail prices has been quite unusual and has made a significant contribution to the moderate CPI inflation outcomes observed during this period.

Graph C1
Retail Prices
2009/10 = 100



* Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

To understand the drivers of retail prices, it is useful to split them into several components (Figure C1):

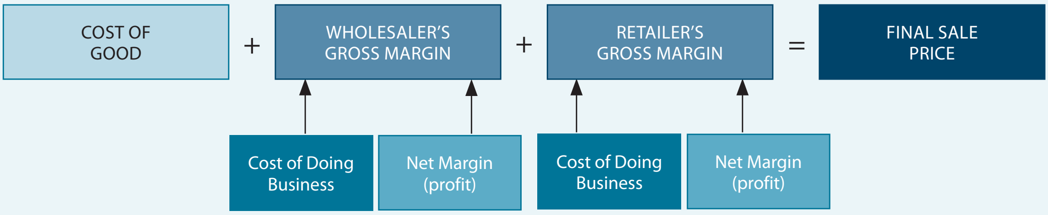
- Cost of goods sold: this includes all costs associated with purchasing stock, such as the price paid to the producer of the good, as well as tariffs and the cost of transport (to the wholesaler). Information from liaison and input-output table analysis suggests that, on average, these costs account for around half of the final sale price of a good.[1]
- Wholesalers' gross margins: the difference between the price of the good sold by the wholesaler (typically to retailers) and the cost of the good sold. This covers the wholesaler's cost of doing business – labour costs, rent, freight, and inventory holding costs – as well as a profit or 'net' margin.
- Retailers' gross margins: the difference between the final sales price and the sum of the cost of the good sold and the wholesaler's gross margin. Retailers' gross margins cover their own costs of doing business, with the remainder earned as profit. Estimates suggest that, on average, retailers' gross margins account for around one-third of the final sale price of a good.

A significant influence on the cost of goods sold component of final retail prices is the exchange rate. Around three-quarters of retail goods in the CPI basket – mainly durable items, fuel and tradable food items – are either imported or exposed to international competition. Accordingly, the appreciation of the exchange rate from 2009 to 2011 helps to explain why there was little inflation in final retail prices over the past few years. However, the persistence and extent of the decline in the prices of durable goods in particular over this period has been greater than that implied by historical relationships between retail prices and the exchange rate or import prices.[2] So the appreciation of the exchange rate up to 2011 does not appear to account in full for the low rate of retail price inflation over recent years.

1 See D'Arcy P, D Norman and S Shan (2012), 'Costs and Margins in the Retail Supply Chain', RBA *Bulletin*, June, pp 13–22.

2 For more details, see RBA (2013), 'Box B: The Recent Deflation in Consumer Durables Prices', *Statement on Monetary Policy*, May pp 57–59, and Chung E, M Kohler and C Lewis (2011), 'The Exchange Rate and Consumer Prices', RBA *Bulletin*, September, pp 9–16.

Figure C1
The Supply Chain for Retail Goods



Source: Adapted from Figure 1 in D'Arcy P, D Norman and S Shan (2012), 'Costs and Margins in the Retail Supply Chain', RBA *Bulletin*, June, p 15

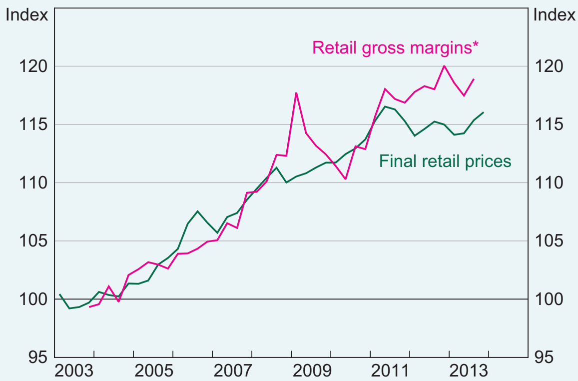
It does not appear that the low rate of retail price inflation has been due to a decline in retailers' gross margins. Recently released data from the ABS provide a new measure of changes in retailers' gross margins. The Experimental Producer Price Index for the Output of the Retail Trade Industry (RTPI) is constructed using data (starting in 2003) on retailers' total sales and cost of goods sold (as faced by the retailer, thereby including wholesaler gross margins). This series, available up to the September quarter 2013, can be used to measure the change over time in the dollar value of retailers' gross margins on a fixed quantity of retail goods.[3] According to the RTPI, over most of the 2000s, gross margins increased roughly in line with inflation in final retail prices (Graph C2). Over the past six years or so, retail gross margins appear to have increased slightly more than final retail prices, although in recent years (during which final retail prices have been little changed), retail gross margins have been relatively stable or increased only slightly.

Further evidence regarding retail margins can be drawn from data provided in retailers' annual reports. These data, which are based on a sample of 21 firms accounting for around 40 per cent of retail sales, do not align perfectly with the RTPI data. Nevertheless,

3 The RTPI is a chain-weighted index, with the weights (which reflect the retail trade margin shares of each product group) updated annually. Data are collected by the Australian Bureau of Statistics for those products that make the highest contribution to total retail margins, and where data collection is feasible. These products account for around two-thirds of total retail trade margins.

Graph C2
Retail Margins and Final Prices

2003/04 = 100



* Seasonally adjusted by the RBA
Sources: ABS; RBA

they have a similar trend and suggest that the retail 'gross margin share' (i.e. the proportion of final sale prices accounted for by gross margins) may have increased somewhat over the past six years (Graph C3).

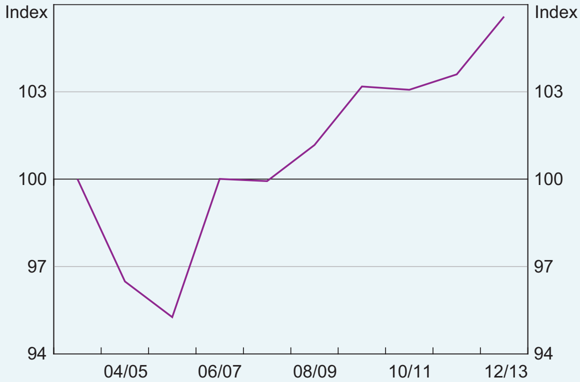
While changes in retailers' gross margins do not appear to explain the weak growth in overall retail prices over recent years, it may be that there has been downward pressure on gross margins further up the supply chain. Liaison suggests that many domestic retailers have tried to reduce the prices paid to wholesalers in recent years, by sourcing from cheaper suppliers, negotiating lower prices with existing suppliers, or purchasing stock in larger volumes. Other retailers say that they have attempted to reduce their reliance on wholesalers by importing directly from producers. These efforts may indeed have contributed to some compression of gross margins at the wholesale level, although it is difficult to find data that would allow confirmation of this hypothesis.

While the recent pick-up in inflation in some retail prices may reflect some noise in the data, it is likely to incorporate some pass-through of the recent exchange rate depreciation. It may also suggest that any downward pressure on margins further up the supply chain has lessened somewhat in recent quarters, or that retail margins might have risen in the December quarter.

Graph C3

Retail Gross Margin Share*

Sample of listed retailers, 2003/04 = 100



* Calculated as the sum of gross margins across a sample of 21 listed retailers, divided by the sum of their sales revenues

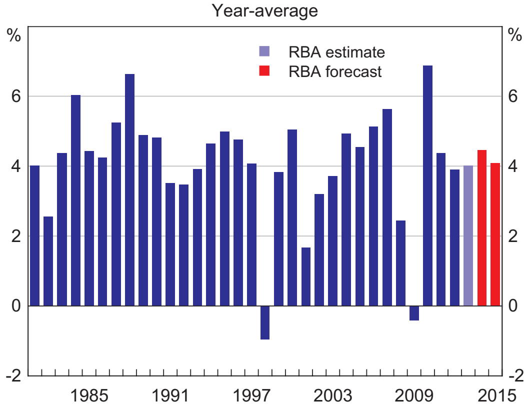
Sources: Morningstar; RBA; annual reports and company data

6. Economic Outlook

The International Economy

The Bank's forecast for overall growth of Australia's major trading partners is little changed from those in the November *Statement*. Year-average trading partner growth in 2014 is expected to be a little higher than in 2013 at around 4½ per cent, with a recovery in the advanced economies, before returning to its decade average of around 4 per cent in 2015 (Graph 6.1). This forecast is similar to those of most other forecasters.

Graph 6.1
Australia's Trading Partner Growth*
Year-average

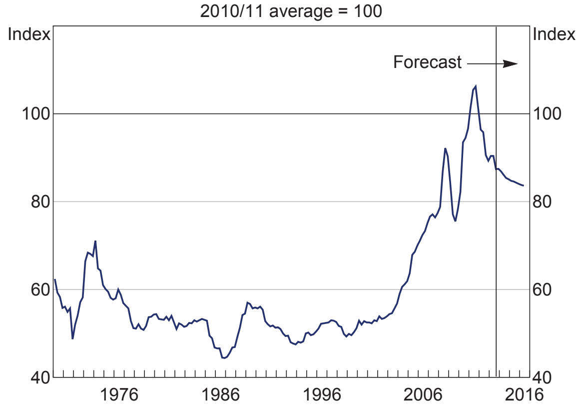


* Aggregated using Australia's export shares
Sources: ABS; CEIC Data; RBA; Thomson Reuters

Growth in the US economy in 2014 is expected to be a little stronger than earlier anticipated – reflecting stronger domestic demand – supported by stimulatory monetary policy and an easing in the extent of fiscal tightening. Chinese growth in 2014 is expected to be around 7½ per cent, similar to growth in 2013. A slight easing of growth in domestic demand, in part reflecting the government's efforts to moderate the growth of financing, is expected to be largely offset by a modest improvement in export demand from China's major trading partners. In Japan, growth in 2014 is expected to be similar to the pace seen over the past year or so, but stronger earlier in the year ahead of the rise in the consumption tax in April and lower thereafter, with only a partial offset from a temporary fiscal stimulus. In the rest of east Asia, the economic outlook is little changed, with growth expected to remain at around its decade average. In the euro area, economic conditions improved a little over the second half of 2013, and the economic recovery is expected to continue at a gradual pace.

The terms of trade are estimated to have been little changed for several quarters, and are 18 per cent lower than their late 2011 peak (Graph 6.2). They are expected to decline further in coming years as an increase in the supply of global bulk commodities, including from Australia, weighs on prices. This would still leave the terms of trade about 50 per cent higher than the long-run average up to the mid 2000s.

Graph 6.2
Terms of Trade
2010/11 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, as usual a number of technical assumptions have been employed. The exchange rate is assumed to remain at its current level over the forecast period (TWI at 69 and A$ at US$0.89, which is around 5 per cent lower than was assumed in the November *Statement*). The forecasts are based on the price for Brent oil remaining at US$104 per barrel, in line with the assumption in November. The cash rate is assumed to be unchanged over the forecast period at 2.5 per cent, which implies that borrowing rates remain at very low levels. The working-age population is assumed to grow by 1.8 per cent each year, drawing on forecasts by the Department of Immigration and Border Protection and in line with the November *Statement*.

The starting point for the forecasts of the Australian economy is below-trend growth over the year to the September quarter 2013, against the background of declining mining investment, subdued growth of consumer spending and non-mining business investment, and ongoing fiscal restraint. The available indicators suggest that growth was moderate in the December quarter. Until recently, survey measures of current business conditions have been below average, consistent with subdued non-mining business investment and the weak state of the labour market.

A number of indicators, however, suggest a gradual increase in growth over time. The depreciation of the exchange rate should provide some additional impetus to activity in the traded sectors of the economy. Survey measures of business conditions moved to above-average levels late in 2013. Retail sales and the Bank's liaison point to a pick-up in household consumption growth in the December quarter and measures of consumer sentiment remain a little above average levels, despite easing somewhat from a few months ago. Leading indicators suggest that dwelling investment is likely to have increased in the quarter and will grow further over the coming months. Strengthening conditions in the housing market more generally are evident in further increases in housing turnover and prices. Trade data imply strong growth of exports in the December quarter, boosted in part by new resource projects coming on line.

Overall, growth is thought likely to strengthen a little in 2014, though to a pace that is still a little below trend. It is then expected to pick up further to an above-trend pace by 2015/16 (Table 6.1). This outlook is a little stronger than it was at the time of the November *Statement*, primarily owing to the lower exchange rate, which is expected to boost exports and restrain imports (to the benefit of domestic production). The outlook for the various components of domestic demand is little changed.

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	Dec 2013	June 2014	Dec 2014	June 2015	Dec 2015	June 2016
GDP growth	2½	2¾	2¼–3¼	2½–3½	3–4	3–4½
Non-farm GDP growth	2½	2¾	2¼–3¼	2½–3½	3–4	3–4½
CPI inflation[(b)]	2.7	3¼	2¼–3¼	2¼–3¼	2–3	2–3
Underlying inflation[(b)]	2½	3	2¼–3¼	2¼–3¼	2–3	2–3
	Year-average					
	2013	2013/14	2014	2014/15	2015	2015/16
GDP growth	2¼	2½	2¼–3¼	2¼–3¼	2½–3½	3–4

(a) Technical assumptions include A$ at US$0.89, TWI at 69 and Brent crude oil price at US$104 per barrel
(b) Based on current legislation for the price of carbon
Sources: ABS; RBA

This outlook over the year ahead continues to be affected by the substantial fall in mining investment and planned fiscal restraint. At the same time, low interest rates are stimulating prices and turnover in the established housing market, as well as construction of new dwellings. In addition to boosting activity directly, it is likely that these trends will, in time, be associated with stronger growth in some areas of household consumption. This pick-up in domestic demand, coupled with improved economic conditions overseas, is expected to flow through to stronger non-mining business investment and employment, and therefore higher GDP growth. Over 2015/16, GDP growth is also expected to be boosted by a significant increase in liquefied natural gas (LNG) exports as a number of large plants currently being constructed commence production.

The outlook for household consumption is little changed from that outlined in the November *Statement*. Growth of consumption is expected to be below average through 2014, before gradually rising to around average by the end of the forecast period. This pick-up in growth is assisted by a gradual increase in employment and wage growth. Consumption spending is expected to grow a little faster than incomes, however, given rising wealth. This implies a modest decline in the household saving ratio toward the lower end of the range seen over recent years.

Dwelling investment is expected to grow quite strongly over the forecast period. Building approvals have increased sharply in recent months and other forward-looking indicators, such as loan approvals and first home owner grants for new construction, remain at relatively high levels. Conditions remain supportive of dwelling investment, with very low interest rates, rental yields around the average of the past decade and government incentives for first home buyers that promote the purchase of new dwellings. Stronger conditions in the established housing market, including a rise in housing turnover, are also expected to support renovation activity, which to date has been quite subdued.

With governments at both the federal and state levels planning to undertake fiscal consolidation over the next few years, the outlook for growth in public demand remains very weak relative to its historical average. Consistent with budget projections, the contribution to GDP growth from public demand over the forecast period is expected to be around half of its long-term average.

Surveys of firms' investment intentions continue to suggest that non-mining investment is likely to remain subdued over the next year. Further out, non-mining business investment is expected to recover, given the low level of interest rates, an improved competitive position, limited growth of the non-mining capital stock in recent years, and a pick-up in other parts of the economy, such as the housing sector.

At the time of the November *Statement*, the outlook for mining investment was marked down, particularly for 2014/15, following a reappraisal of the likelihood of new large projects going ahead. There has been little change to the profile since then, with mining investment expected to decline rapidly over the next few years as the investment projects now underway move into the production phase and with few new projects expected to commence. While Bank liaison suggests that the peak in mining investment has passed, the expectations component of the ABS capital expenditure survey, which tends to be a relatively imprecise guide to firms' realised spending, continues to point to some growth in mining investment in 2013/14.

Export volumes are expected to make a significant contribution to GDP growth in the forecast period. As mining projects move into the production phase, bulk commodity export volumes are forecast to continue growing strongly. Iron ore exports are expected to increase significantly in 2014, while LNG exports are likely to pick up even more noticeably from 2016 onwards as the new LNG production facilities commence production. The recent depreciation of the exchange rate should, in time, provide some support to exports of manufactured goods and services, which have been subdued in recent years.

Labour market conditions have remained weak in recent months. There has been little growth in employment, which has risen by only ½ per cent over the past year. The unemployment rate has continued to move higher and the participation rate has declined noticeably. Total hours worked have declined in recent months, reversing some of the steady growth seen earlier in 2013 (and bringing growth in total hours over the past year back into line with that of employment). Various factors have weighed on growth in labour demand: below-trend growth in output, particularly among sectors of the economy that are more labour intensive; a continued focus among firms on reducing costs and improving productivity; and a degree of uncertainty causing a general reluctance to employ new workers (consistent with subdued non-mining business investment intentions). These factors are likely to continue to weigh on employment growth in the near term, and the unemployment rate is expected to remain on an upward trend for several quarters. This outlook for the unemployment rate over the next year or so is little changed from the previous *Statement*. In 2015, the expected improvement in the non-resource sector should underpin an improvement in labour demand, with growth in employment increasing gradually and the unemployment rate declining.

The increase in spare capacity in the labour market over the past year or so has been accompanied by a decline in various measures of wage growth to historically low levels. Reflecting elevated concerns of households over job security, relatively low inflation expectations and pressures for firms to contain labour costs, the forecast profile for wages has been revised a little lower over coming quarters. In the public sector, fiscal restraint is expected to contribute to very slow growth in wages, as reflected in recent enterprise bargaining agreement outcomes. Private sector wage growth is expected to pick up somewhat from the middle of 2015 as the labour market recovers. However, it will take some time for spare capacity in the labour market to be absorbed and so wage growth is expected to remain below its decade average.

Inflation

The inflation forecasts have been revised higher in the short term, reflecting a combination of the lower exchange rate and the higher-than-expected December quarter CPI outcome, which have more than offset the effect of the softer outlook for wage growth.

The various measures of underlying inflation suggest that the quarterly pace picked up to between ¾ and 1 per cent in the quarter – around ¼ percentage point higher than the assessment of underlying inflation a quarter ago. In year-ended terms, the pace of underlying inflation increased to be a touch above 2½ per cent.

Underlying inflation is expected to reach 3 per cent over the year to June 2014, about ½ percentage point higher than forecast in November. This upward revision reflects the higher-than-expected inflation reported for the December quarter – which is assumed to persist somewhat into early this year – as well as the effect of the further depreciation of the exchange rate since November. Given the slow growth of wages and the limited extent of domestic cost pressures more generally, year-ended underlying inflation is expected to ease back later this year. Headline inflation is forecast to reach 3¼ per cent over the year to June 2014. In addition to the same factors influencing underlying inflation, the upward revision to headline inflation reflects the increase in the price of tobacco in December. As this and the large rise in fuel prices in the September quarter drop out of the year-ended rate, headline inflation is expected to fall back. Over the forecast horizon, inflation is forecast to be consistent with the target.

The depreciation of the exchange rate since April 2013 is expected to exert mild upward pressure on inflation for several years, reflecting the drawn out pass-through that has occurred historically. The depreciation has seen a rise in import prices, which firms are expected to pass through gradually to final retail prices. In turn, this should encourage consumers to shift some of their spending toward domestically produced goods and services, and may allow domestic producers to lift prices and margins. Altogether, the lower exchange rate is expected to add around ½ percentage point to underlying inflation over each of 2014 and 2015. However, it could be that the 'second stage' of exchange rate pass-through – from import prices (across the docks) to the prices facing consumers – may have been more rapid than has been the case historically.

Working in the other direction, the subdued outlook for the labour market is expected to exert downward pressure on wages and so inflation. Growth in labour costs is expected to remain moderate, while labour productivity is expected to continue to grow. While it is difficult to ascertain the extent to which slower wage growth has been passed on to final prices, the relatively high December quarter inflation outcome suggests that, so far, there has been less pass-through of the slowing in wages to final prices than had been anticipated.

The CPI will also be affected by changes in the price for carbon. As in the previous *Statement*, the forecasts incorporate a path for the carbon price that is based on current legislation. On this basis, a floating carbon price will be introduced on 1 July 2015, which on present indications would be expected to see the carbon price fall to be similar to that of European permits. Consistent with the previous forecasts, and estimates in the 2013/14 Australian Government budget, this change would subtract a bit less than ½ percentage point from CPI inflation in 2015 and around half that much from underlying inflation.

The government has stated that it intends to repeal the carbon price on 1 July 2014. Based on modelling by Treasury, the introduction of the carbon price was expected to add 0.7 per cent to the CPI and its removal may well result in a reduction in the CPI of a similar magnitude. Under this outcome, the forecast for CPI inflation would be lower by around 0.7 percentage points over the year to June 2015 at around 2 per cent (with inflation in the subsequent period being higher than the current forecasts because the price of carbon would not be declining at that time). Underlying inflation would respond by less than this, with the forecasts a little more than ¼ percentage point lower over the year to June 2015, at around 2¼ per cent.

The government has also stated its intention to increase tobacco excise in a sequence of steps over a period of four years. The first of these increases was implemented in December, which contributed to inflation in the December quarter and will do so again in the March quarter. Further increases in the excise have not yet been legislated and therefore are not incorporated in the forecasts. If they came to pass, they would be expected to add around ¼ percentage point per year to the forecasts for headline inflation over the next few years. Underlying inflation would not be affected.

Risks

For most economies, the uncertainty surrounding the forecasts continues to appear broadly balanced; there have been some welcome developments on some of the risks to the global outlook identified in the previous *Statement* while other risks have emerged. In the United States, the risks now seem somewhat to the upside. There has been a positive resolution to the political discord regarding budget funding, which had earlier created significant uncertainty around fiscal policy (although as yet there is not an agreement on the debt ceiling). In addition, the Federal Reserve's scaling back of its asset purchases, and the provision of some guidance on the possible future path of its asset purchases, has reduced uncertainty about the course of monetary policy. The economic recovery is gathering pace and the strong financial position of firms means that business investment, and domestic demand more broadly, could recover even faster than expected. In the euro area, while the economy has shown some modest improvement of late, the risks remain to the downside, reflecting the ongoing need for resolution of banking and fiscal problems.

In Japan, there is a risk that the increase in the consumption tax will have a negative impact on economic activity. The increase in the consumption tax rate in the late 1990s was one factor contributing to the slowdown at that time, although this time around the Japanese Government has put in place a temporary fiscal stimulus to offset the initial contraction in spending.

In China, the near-term outlook will depend on the balance that can be achieved between structural reforms, including the need to place financing on a more sustainable footing, and the authorities' apparent resolve to maintain relatively strong rates of growth. Further efforts to reduce the scale of financing activity to more sustainable levels could result in increased financial market volatility and a sharper short-term slowdown in growth. In a similar vein, the reform agenda announced by the authorities in November (encompassing reforms to the financial sector, central-local fiscal relations, rural land markets, state-owned enterprises and the pricing of utilities) could raise the long-term productive capacity of the economy at the expense of some near-term growth. If these efforts were to stall, however, growth could be stronger in the near term at the risk of weaker growth in future years.

A number of emerging market economies have experienced an increase in financial market volatility recently. This has followed a general lessening of the appetite for risk compounded by country-specific problems. If, however, such pressures were to deepen or become more widespread, it could have a significant effect on emerging market growth and weigh on the outlook for the global economy more broadly.

On the domestic front, at this stage the implications for activity and prices of the higher-than-expected inflation data for the December quarter are unclear.

It could be that there was a higher than usual degree of noise in the data, which can occasionally occur owing to the difficulties of measurement or the timing of price changes. This would imply that the higher-than-expected inflation recorded in the quarter will not persist.

Alternatively, the stronger inflation outcome raises the possibility that there is less spare capacity in the economy than previously thought, which would suggest that the outlook for inflation would be somewhat higher than previously anticipated. This could be because there has been some strengthening of demand in recent months that enabled firms to increase prices. But, while some measures of trading conditions and profitability have improved, the behaviour of share prices for listed retailers and information from liaison do not yet point to a broad-based increase in demand and evidence on changes in profit margins over the recent period is mixed.

There could also be less spare capacity in the economy if supply is increasing more slowly than previously thought. However, this is hard to reconcile with the weak state of the labour market.

Another possibility is that the December quarter CPI outcome reflected, in part, faster pass-through of the exchange rate depreciation than in the past. Such faster pass-through could persist for several quarters, adding to inflation in the near term, or it could prove temporary.

A range of other risks appear much as they were a few months ago. There are few signs of an imminent turnaround in non-mining investment intentions, but in time the very stimulatory financial conditions could see non-mining investment pick up at a pace more in line with past sharp upturns than the gradual improvement embodied in the forecasts.

While it is widely accepted that mining investment will decline from its very high level over coming years, there is considerable uncertainty about the timing and magnitude of the decline. The most recent ABS survey of mining investment expectations suggests that there may yet be some more strength in mining investment in the near term. While this provides some short-term upside risk, public information from mining companies and the Bank's liaison suggests that mining investment is likely to decline sharply over the next few years. Indeed, the lack of new commitments for large-scale projects suggests that there is limited upside risk further out in the forecast profile, although there is still some uncertainty surrounding the prospects for some large investments. Similarly, there are risks surrounding the boost to growth of economic activity from LNG exports in 2015/16 given that there is little historical precedent of such projects to guide this forecast.

The willingness of households to increase their consumption spending slightly faster than the relatively soft pace of income growth represents a key risk to the outlook. If, instead, the saving rate remains steady or even increases, this would imply slower consumption growth than assumed in the forecasts. Alternatively, the saving rate could decline more sharply than the moderate reduction implied in the forecasts, particularly in light of the recent and prospective strength in housing market conditions. If stronger consumption and housing market conditions were to be accompanied by a substantial increase in leverage, it could raise longer-run concerns from the perspective of macroeconomic and financial stability. While the growth of aggregate housing credit has remained moderate to date, it has been increasing of late, more so in some segments of the market.

The fiscal consolidation foreshadowed by state and federal governments implies the weakest period of growth in public demand for at least 50 years. With below-trend growth in the economy, it is possible that governments will not restrain spending growth to the extent assumed. Alternatively, budget deficits at the federal level are projected to be noticeably larger over the forecast period than expected at the time of the November *Statement*, which could lead to greater spending restraint.

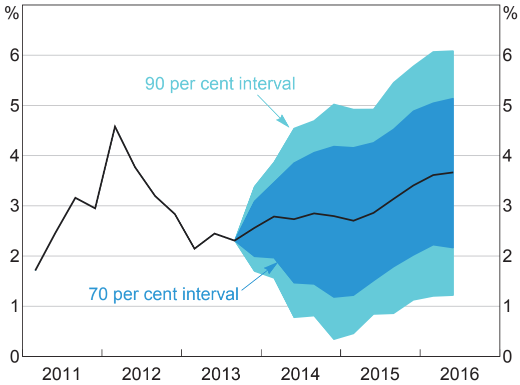
The path of the exchange rate is a significant uncertainty for the forecasts, as always. The exchange rate has depreciated by a further 5 per cent since the November *Statement*, contrasting with the usual assumption used then that the exchange rate would remain unchanged. Just as the appreciation of the exchange rate that accompanied the resources boom shifted demand towards external sources, thereby relieving pressure on domestic capacity, a depreciation helps to rebalance demand by stimulating traded parts of the domestic economy. With the terms of trade expected to decline, the exchange rate could decline further, over time. But with numerous forces affecting the exchange rate – the anticipated gradual decline in resource prices, the sharp decline in resource investment and associated capital inflow, the increase in income payments to foreign owners accruing from strong growth in resource exports and the conduct of monetary policy in major countries – the exchange rate path is highly uncertain.

Softer-than-expected growth in activity would see the labour market weaken more than anticipated, placing additional downward pressure on wages and inflation. Wage growth has slowed more than expected over the past year, and an environment of lower wage growth may prove more entrenched than expected. However, with the depreciation of the exchange rate expected to exert some upward influence on inflation over the next few years, domestic costs need to remain contained for inflation to remain consistent with the target. With employees having sustained a period of slow growth in real incomes, stronger-than-expected growth in activity and an associated recovery in the labour market – which saw employees seek to regain spending power – could result in more upward pressure on nominal wage growth, and so inflation, than forecast.

These identified, and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented. One way of demonstrating the uncertainty surrounding the GDP and inflation forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4).[1]

1 This is based on Bank research; see Tulip P and S Wallace (2012), 'Estimates of Uncertainty around the RBA's Forecasts', RBA Research Discussion Paper No 2012-07 and RBA (2013), 'Box E: Forecast Confidence Intervals', *Statement on Monetary Policy*, February, p 68, for further details.

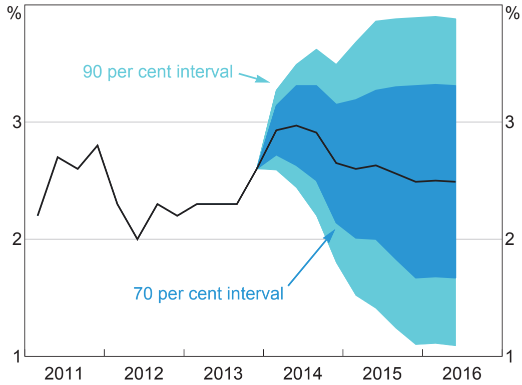
Graph 6.3
GDP Growth Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA