STATEMENT ON MONETARY POLICY

Global economic conditions are continuing to provide a favourable environment for the Australian economy. The expansion underway over the past few years was initially led by the United States and China, but it has become more broadly based over time. Conditions in Japan have improved markedly over the past year, and there has been good growth elsewhere in east Asia and in other emerging economic regions. There have also been some signs of improvement recently in the euro area. Growth in world GDP is estimated to have been well above average in 2005, and most observers expect this to continue in 2006. The most recent economic indicators have tended to strengthen these expectations.

Against this background central banks in the major economies, with the exception of Japan, have begun normalising official interest rates from the unusually low levels they reached in the early part of the decade. The United States is now quite advanced in this process, with the Fed funds rate back to a level generally regarded as close to normal. Central banks in other major countries are at a much earlier stage, however, and world policy rates on average remain well below normal. Long-term interest rates are also relatively low, having remained broadly steady in the face of rising official rates. The combination of strong economic growth, low inflation and low interest rates has contributed to buoyant conditions in world financial markets. Spreads on emerging market and corporate debt have narrowed, and global equity prices have increased solidly in each of the past three years.

An important consequence of the strong global expansion has been an increase in commodity prices, most noticeably the rise in world oil prices over recent years. While supply disruptions have undoubtedly contributed to oil price fluctuations during this period, the increase appears to have been mainly a result of the upswing in global demand. Hence observers have generally maintained strong expectations of global growth throughout the period when oil prices have been rising. The main effect of the higher oil prices to date has been to raise headline measures of consumer price inflation, though in underlying terms inflation in most countries remains contained.

For a resource exporter such as Australia, the more significant aspect of global commodity trends has been the broad-based nature of the price increases seen over recent years, with sharp rises in the prices of coal, iron ore and a wide range of other minerals. This has contributed to a substantial lift in Australia's terms of trade, which have increased by around 30 per cent over the past three years, their largest cumulative increase since the 1970s.

The increase in the terms of trade is one of a number of important factors influencing growth of the Australian economy at present. In combination with strong corporate balance sheets, favourable financial conditions and high capacity utilisation, the rise in the terms of trade has contributed to a highly stimulatory environment for the business sector. Business investment is now undergoing a major upswing, having expanded by 18 per cent over the past year and at an average annual rate of 14 per cent over the past three years. While this growth has been led by the resources sector, it has been quite broadly based across a range of industries. The general strength of the business sector has also been evident in the growth of corporate profits and in the performance of the share market. Share prices in the Australian market have outperformed those overseas in recent years and, unlike most other major markets, have surpassed their 2000 peak.

In contrast to the business sector, households have moderated the growth of their spending in the past year or two. Previously, households had been expanding their borrowing and spending at rates that could not be sustained, but they now appear to have entered a period of financial adjustment. They are still increasing their levels of debt, but are doing so at a slower pace than they were a couple of years ago. Another moderating influence on the growth of household spending has been the mild downturn in the housing construction cycle. At the same time, moderate spending growth continues to be supported by growth in employment and real wages, and by rising household wealth stemming from the buoyant equity market.

Australia's export performance over recent years has been disappointing, despite the generally favourable international conditions. While export earnings have picked up strongly, this has been mainly driven by rising prices, with only very limited increases to date in volumes. At the same time, imports have continued to grow at quite a fast pace, though moderating recently. Hence Australia's current account deficit has remained relatively high, at around 6 per cent of GDP in recent quarters. With substantial investment in the resources sector and in related infrastructure projects currently underway, it is likely that export volume growth will pick up, though the expected improvement has been slow to eventuate.

The net effect of these various influences on the Australian economy is that growth of domestic spending has remained quite solid over the past couple of years, though it has eased from the unusually rapid rates seen previously. Growth of the economy overall has been a little below average recently, at an annual rate of around 3 per cent over the two latest quarters for which GDP data are available. Given the continued strength of the business sector and the prospect of some improvement in export volumes, growth is likely to continue at a similar or higher pace in the period ahead.

Notwithstanding the inevitable short-term fluctuations in growth, the Australian economy over recent years has been more stable than most, and is now in its fifteenth year of expansion. In the course of the expansion to date, the economy has substantially re-employed unused resources of both labour and capital. The unemployment rate has declined from a peak of around 11 per cent in 1993 to a current level of just over 5 per cent, which is around its lowest since the 1970s. For the past year or so, many businesses have been in the unusual position of reporting that scarcity of labour was a bigger constraint on their activities than more traditional concerns about the adequacy of demand or sales. Surveys also report that businesses are operating at cyclically high levels of capacity utilisation, though parts of the manufacturing sector are an exception to this. While strong business investment will contribute to the growth of productive capacity in due course, the current outlook suggests the economy will continue to operate with much smaller margins of spare capacity for the time being than was the case earlier in the expansion.

Consumer prices increased by 0.5 per cent in the December quarter, and by 2.8 per cent over the past year. The annual figure was boosted by rising fuel prices, and underlying inflation measures have remained broadly stable at around 2½ per cent. At the current stage of the expansion there are a number of factors that could be expected to put upward pressure on inflation in the period ahead. Aggregate wages growth has picked up over the past year, reflecting the tight conditions in the labour market, though these may have eased a little recently. Rising world commodity prices have resulted in some large increases in businesses' raw materials costs. More generally, with the economy operating at a high level of capacity utilisation, any acceleration in demand would more readily put pressure on the economy's productive capacity than at earlier stages of the expansion. The main factor likely to be working in an offsetting direction for the inflation outlook is the continued global disinflationary pressure on prices of manufactures and some services in the tradables sector.

The relative strength of these influences is of course difficult to gauge. One risk is that the tightness of the labour market gives rise to significant further wage and price pressures, but it is also possible that global disinflationary forces will prove stronger and more persistent than expected. On balance, underlying inflation is expected to increase modestly to 2¾ per cent by the end of this year. Given the current level of oil prices, this would mean that headline CPI inflation remains close to 3 per cent in the short term.

The Australian cash rate has been unchanged since March last year, at a level that is in line with its average over the low-inflation period. Interest rates of financial intermediaries remain a little below average, however, reflecting the compression of lending margins relative to the cash rate over recent years. Strong growth in credit suggests that businesses and households are finding it attractive to borrow at prevailing interest rates. In the household sector, while the demand for credit has cooled considerably since around the end of 2003, credit growth seems to have flattened out at an annual rate of around 12 per cent. Businesses have until relatively recently been much more conservative than households in their borrowing behaviour. However, in the past two or three years, this has been changing as businesses have begun to take advantage of their strong balance sheet positions and the favourable climate for investment. Business credit has strengthened quite markedly during this period, so that it is now growing at an annual rate of 16 per cent, well above that for the household sector.

In summary, the economic situation reviewed by the Board at its recent meetings was one where the broad international forces influencing the Australian economy, namely the global expansion and rising commodity prices, have remained favourable for growth. Domestically, these trends are contributing to a strong upswing in business investment, though at the same time there has been a moderation of growth in household spending. The Board's assessment overall is that demand and output can be expected to grow at a pace broadly in line with the economy's productive potential over the period ahead. Given the prevailing levels of capacity utilisation and labour market tightness, this outlook is consistent with a modest increase in underlying inflation.

In these circumstances, the Board decided at its February meeting to hold the cash rate unchanged. However the Board recognises that policy would need to respond in the event that demand or inflation pressures prove stronger than currently expected. The Board will continue to monitor developments and make policy adjustments as required to promote sustainable economic growth with low inflation.

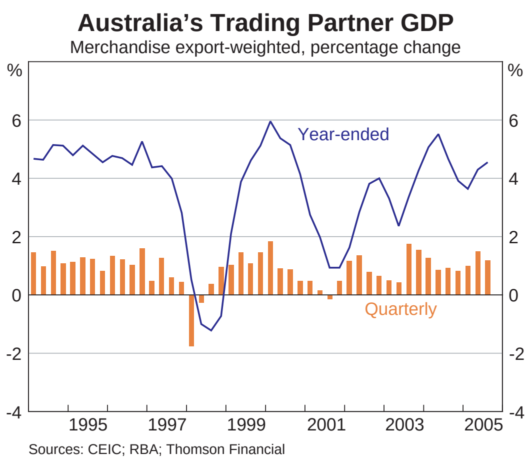
International Economic Developments

Introduction

The world economy expanded at a solid pace in 2005, as strong growth in the US and China continued. Economic growth firmed in Japan, and activity in the rest of east Asia also picked up, as demand in the global ITC sector began to recover. In addition, after a disappointing performance in recent years, growth in the euro area appears to be strengthening. In line with these developments, the trend towards higher official interest rates has continued, with both the Federal Reserve and European Central Bank (ECB) increasing policy rates in the period since the previous *Statement*.

Most economic indicators point to ongoing healthy growth in the world economy, which is now in its fifth year of expansion (Graph 1). Consensus forecasts have been revised up over recent months, with world GDP growth now expected to be at an above-average 4½ per cent in 2006 (Table 1). While health experts suggest that the risk of a bird-flu pandemic has increased, most economic forecasts are not incorporating any impact at this stage.

Graph 1



The price of oil remains high, reflecting the interaction of strong global demand and limited spare capacity, as well as concerns over possible shocks to supply. After a brief peak at over US$70 per barrel in September 2005 following the damage to production and refinery infrastructure from hurricanes Katrina and Rita, oil prices eased to below US$60 per barrel in November and December as capacity was gradually restored in the Gulf of Mexico. However, prices have since edged upwards, mostly on concerns about possible disruptions to oil supplies due to heightened tension in the Middle East. Oil traded at around US$65 per barrel in early February. The strength of the world economy has also led to an increase in the prices of other commodities (see discussion in the chapter on 'Balance of Payments').

The large increase in oil prices over the past two years has boosted headline inflation in the major economies. Nonetheless, despite these pressures and the reduction in economic slack, measures of core inflation have remained contained in most regions (Graph 2).

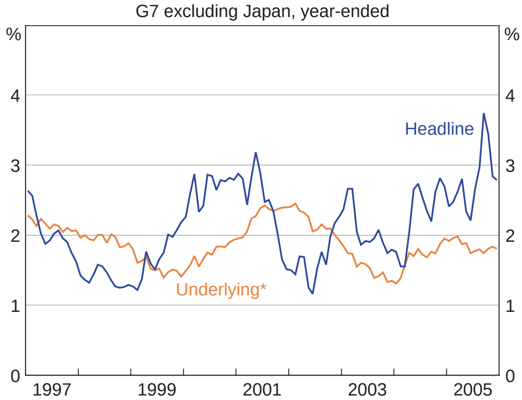
Table 1: World GDP Growth
Year-average, per cent[(a)]

	2004	2005 Estimate	2006 Consensus forecasts (January 2006)
United States	4.2	3.5	3.4
Euro area	1.8	1.4	1.9
Japan	2.3	2.5	2.2
China	10.1	9.9	8.7
Other east Asia[(b)]	5.8	4.7	4.8
India	7.2	7.6	7.1
Latin America	5.7	4.3	4.1
Emerging Europe	7.4	5.5	5.5
World	**5.1**	**4.5**	**4.5**
Australia's trading partners[(c)]	4.9	4.3	4.1

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

Graph 2

Global CPI Inflation
G7 excluding Japan, year-ended



* Underlying inflation is based on national definitions. All exclude petrol; various other items are also excluded.
Sources: RBA; Thomson Financial

United States

The US economy posted above-trend growth in 2005, with real GDP expanding by 3.5 per cent. The quarterly growth rate dipped to 0.3 per cent in the December quarter (Graph 3). However, recent indicators suggest that the earlier hurricanes and spike in retail petrol prices had little lasting impact on the US economy, and stronger growth is expected to resume in the first half of 2006.

Consumption increased by 0.3 per cent in the December quarter and by 3.0 per cent over the year. The weakness in the quarter was due largely to lower auto sales, which declined by 12 per cent following the ending of various discounting schemes. In contrast, ex-auto spending has been firm and the outlook for consumption remains favourable. Petrol prices have fallen back to pre-hurricane levels, the labour market continues to strengthen, and consumer sentiment has improved. Nonetheless, looking forward, it seems likely that there will be a reduction in the stimulus to consumption that has come from the strong growth in house prices in recent years (for further details see 'Box A: Developments in the US Housing Market').

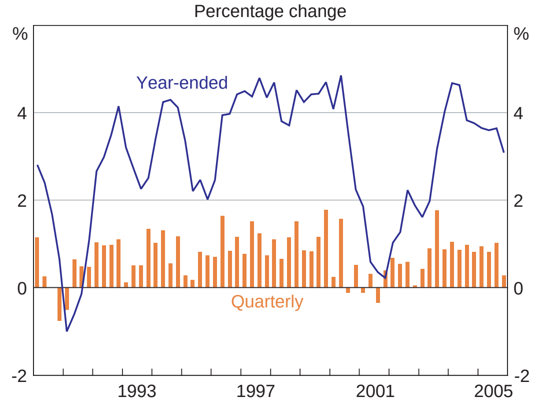
Labour market conditions have strengthened in recent months, as the effects of the hurricanes have dissipated. After increasing by only 85 000 in the two months to October, payrolls employment increased by 690 000 in the three months to January. At 4.7 per cent, the unemployment rate is at a 4½-year low, and average earnings growth is picking up. Forward indicators suggest continued strong employment growth. Initial jobless claims have fallen to below their pre-hurricanes level, and the employment indices from the ISM surveys are above average (Graph 4).

Business investment increased by 6.4 per cent over the year to the December quarter. Although business investment has been growing strongly for the past two years, it is still relatively low as a share of GDP, and financing conditions and healthy profitability remain supportive of further growth. Business sentiment measures are also well above average levels and capital goods orders rose significantly in the December quarter, auguring well for future growth in equipment investment.

Graph 3

United States – GDP

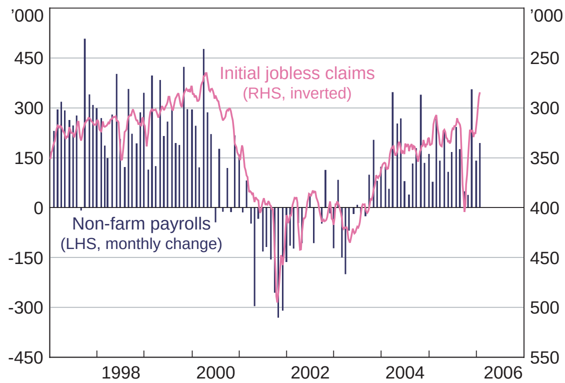
Percentage change



Source: Thomson Financial

Graph 4

United States – Labour Market



Sources: Bloomberg; Thomson Financial

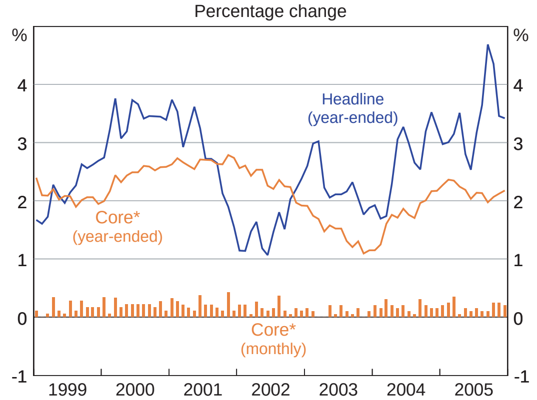
Having narrowed slightly to 6.2 per cent of GDP in the September quarter, the US current account deficit is likely to have widened again in the December quarter. Net exports subtracted 0.3 percentage points from real GDP growth in the quarter, and the trade deficit increased to 6.2 per cent of GDP, from 5.8 per cent in the September quarter.

After peaking at 4.7 per cent in September, year-ended headline CPI inflation declined to 3.4 per cent in December, as retail petrol prices fell back following the hurricanes (Graph 5). However, underlying inflation has remained around 2 per cent since mid 2005 according to the core measures of the CPI and chain price index for personal consumption expenditure, and unit labour cost growth was just 1.0 per cent over 2005. At 4.5 per cent, the policy rate now stands closer to neutral levels, although the Federal Reserve's January policy statement signalled that some further tightening may still be needed.

Graph 5

United States – Consumer Prices

Percentage change



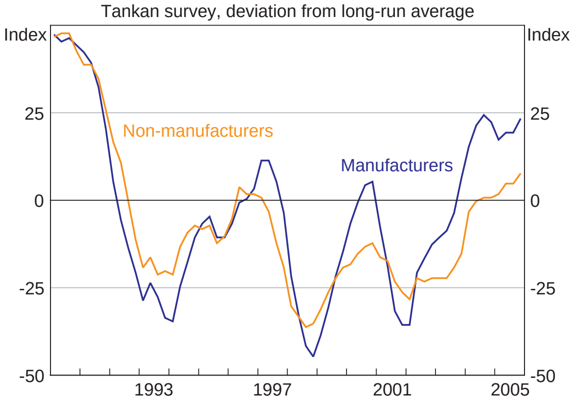
* Excluding food and energy

Source: Thomson Financial

Graph 6

Japan – Business Sentiment

Tankan survey, deviation from long-run average



Source: Bank of Japan

Asia-Pacific

Japan

The recovery has continued in the Japanese economy, which is Australia's largest export destination. Year-ended growth in GDP was 2.8 per cent in the September quarter, and has been positive for more than three years. The current upswing has been led by the business sector, which is benefiting from improved balance sheets and stronger domestic and external demand conditions. Investment grew by 8.2 per cent over the year to the September quarter. More timely data show strength in the December quarter in industrial production and machinery orders, and capacity utilisation rates are high in the manufacturing and non-manufacturing sectors. Merchandise export volumes increased by 10 per cent over the year to December, boosted by the global ITC recovery. In addition, business conditions reported in the December quarter Tankan survey were at their highest level in over 10 years, and investment intentions were again revised upwards (Graph 6).

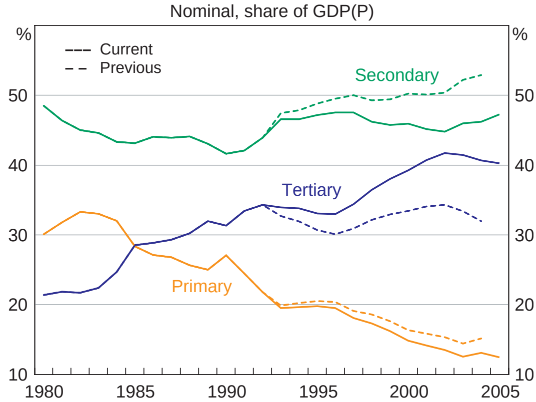
Conditions in the household sector have also improved. Consumption grew by 2 per cent over the year to the September quarter and consumer sentiment is at a high level. Employment growth was a solid 0.5 per cent over 2005, with full-time employment increasing by 1.1 per cent. Forward-looking indicators of employment point to continued hiring by firms; the job offers-to-applicants ratio has increased to its highest level in 13 years, and surveys indicate positive sentiment from both employers and employees.

There is now increasing evidence that the Japanese economy may be emerging from the deflationary environment that has existed for most of the past decade. The strength of the corporate sector has been reflected in strong growth in share prices, including an increase of more than 40 per cent over 2005. The rate of decline in consumer prices has eased, with the official core measure marginally higher over the year to December. In recent months the Bank of Japan has stated that its quantitative easing policy could be terminated in fiscal year 2006, as core inflation is expected to remain positive.

China

China's real GDP grew by almost 10 per cent in 2005, in line with the growth reported for the previous two years. Following the recent national economic census, there have been significant upward revisions to Chinese national accounts data back to 1993. As a result of improved coverage, the tertiary (or services) sector is now estimated to have accounted for 41 per cent of GDP in 2004, compared with 32 per cent prior to the revisions (Graph 7). The level of nominal GDP in 2004 was revised up by 17 per cent; according to the recent data, China is now the world's fourth-largest economy (at market exchange rates), behind the US, Japan and Germany, and remains the second-largest when measured at purchasing power parity exchange rates. In real terms, the average growth rate since 1992 has been revised up from 9.4 per cent to 9.9 per cent.

Graph 7
China – GDP by Industry
Nominal, share of GDP(P)



Source: CEIC

The revisions also suggest that the composition of spending is more balanced than it previously appeared, with the investment share of GDP likely to be revised down once full data are released. Nevertheless, the economy remains heavily reliant on investment spending; the investment share of GDP will still be high by international standards, and urban fixed asset investment increased by around 24 per cent over the year to December. By contrast, consumption continues to be constrained by high rates of precautionary saving, and retail sales grew by 12½ per cent through 2005.

The merchandise trade surplus increased from US$32 billion in 2004 to US$102 billion in 2005 (4½ per cent of GDP), although it narrowed somewhat in the December quarter. Annual growth of both imports and exports has been running at around 20 per cent in recent months.

Despite the strong growth in the economy, inflation remains low, with consumer prices rising by 1.6 per cent over the year to December. At the producer level, inflationary pressure has continued to abate; producer prices rose by 3 per cent over 2005, compared with 7 per cent over 2004.

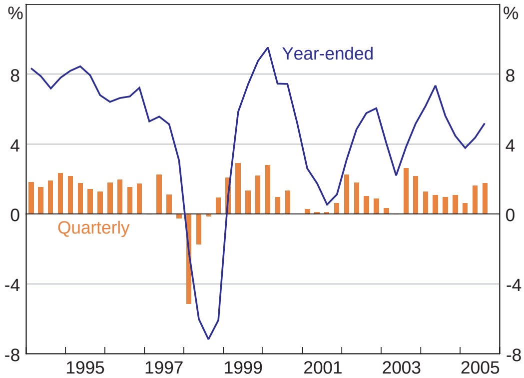
Other Asia-Pacific

In the rest of east Asia, GDP growth rates have recovered following the slowdown recorded during 2004 and early 2005. GDP increased by 1.8 per cent in the September quarter and by 5.2 per cent over the year (Graph 8). The more ITC-exposed economies in the region are

Graph 8

East Asia* – GDP

Percentage change



* Excluding China and Japan
Source: CEIC

benefiting most from the global ITC recovery, while growth in Hong Kong has also benefited from links with the rest of China. The economic recovery continued in Korea and in Thailand, where agricultural output improved following the end of a drought. Growth was slower in Indonesia and the Philippines. In the December quarter, GDP grew strongly in Korea, the Philippines and Singapore.

Conditions in the business sector remained strong throughout the second half of 2005, as the global ITC recovery took hold. Growth in industrial production in the region has picked up, to be 11 per cent over the year to November. World semiconductor sales increased by 9 per cent over the year to the December quarter, with sales from the non-Japan Asia region continuing to outperform sales from the rest of the world. On the consumption side, retail sales in the region have been supported by improving labour markets, low real interest rates and rising asset prices. In Korea, consumption has improved, with wholesale & retail sales increasing by 5 per cent over the year to December and household credit rising steadily. Increasing confidence in the Korean economy contributed to the 50 per cent increase in Korean share prices over 2005 and to the appreciation in the Korean won exchange rate, which in January reached its highest level in eight years. Demand and inflation pressures have prompted increases in official interest rates across the region.

Strong growth in India has also contributed to the world expansion. GDP grew by 1.8 per cent in the September quarter, to be 7.9 per cent higher over the year, well above India's 30-year average growth rate of 5½ per cent. Domestic demand continues to be the main driver of growth, with activity concentrated in the services and manufacturing industries. Growth in industrial production has been solid, at 7.1 per cent over the year to November, despite some volatility during the year due to coal shortages and flooding. Wholesale price inflation picked up to 4½ per cent by the end of 2005, in part reflecting pass-through from higher global oil prices. At its January meeting, the Reserve Bank of India raised interest rates by 25 basis points to 5.5 per cent, citing favourable growth prospects and upside risks to inflation.

In New Zealand, economic growth has slowed but inflation concerns remain, with consumer prices rising by 0.7 per cent in the December quarter and by 3.2 per cent over the year. Wage growth has been strong, and house price growth has remained rapid, at 13.5 per cent over the year to December. The Reserve Bank of New Zealand increased the official cash rate in both October and December, bringing it to 7.25 per cent, citing concerns about a lack of spare capacity in the economy and associated inflation pressures.

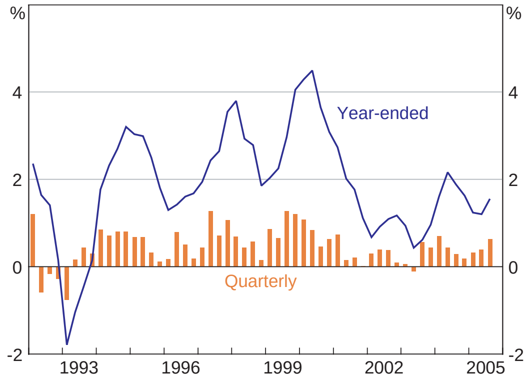
Europe

The euro area's prospects brightened in the second half of 2005. Quarterly growth outcomes have gradually strengthened through the year, with GDP growing by 0.6 per cent in the September quarter and year-ended growth picking up to 1.6 per cent (Graph 9). Activity in the September quarter was more broadly based than previously, with both domestic demand and net exports adding to growth. Net exports contributed 0.3 percentage points to growth in the quarter, as exports and imports grew strongly. Across the region, GDP growth picked up in Germany and France and remained healthy in Spain, while growth in Italy slowed to 0.1 per cent over the year.

Graph 9

Euro Area – GDP

Percentage change



Source: Thomson Financial

Stronger external demand and a weaker euro have supported a revival in production and export growth. Led by Germany, industrial production in the euro area grew by 2.5 per cent over the year to November, and export growth picked up, to be 11 per cent over the year to November. The euro area manufacturing PMI has increased, signalling further gains in production, and measures of business sentiment have also improved (Graph 10).

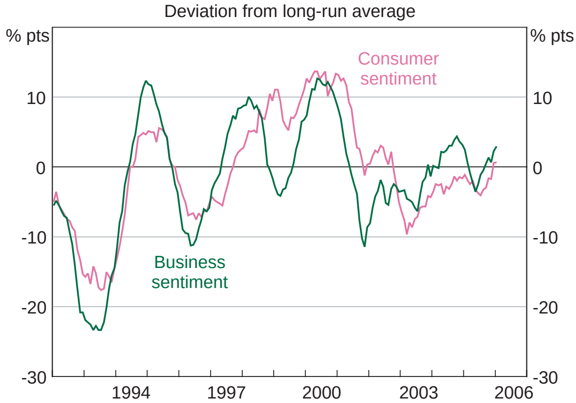
Despite the improvement in the business sector, household consumption has remained subdued. Euro-wide retail sales growth was just 0.7 per cent over the year to December, weighed down by weak wage growth. Nonetheless, the euro area unemployment rate has fallen to 8.4 per cent, from a peak of 8.9 per cent in late 2004, and consumer sentiment has increased to around long-run average levels for the first time in more than three years.

Year-ended headline consumer price inflation was 2.4 per cent in January, compared with its recent peak of 2.6 per cent in September, and underlying inflation has continued to hover around 1¼ per cent. The ECB raised its policy rate to 2.25 per cent at its December meeting, noting that the increased pace of activity could begin to put pressure on inflation and expressing concern about the rapid rate of money supply growth.

Graph 10

Euro Area – Sentiment Indicators

Deviation from long-run average

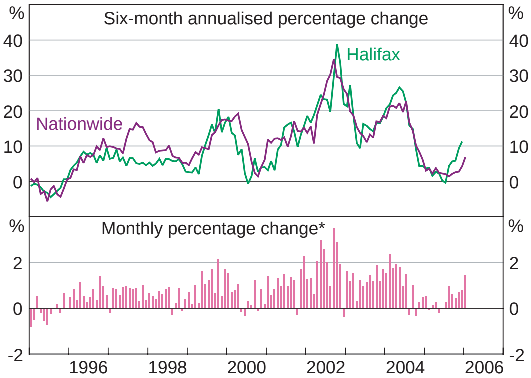


Source: Thomson Financial

Growth in the UK remains relatively subdued, but appears to have stabilised following the slowing that began in mid 2004. GDP grew by 0.6 per cent in the December quarter and by 1.7 per cent over the year. Strong profitability and increased external demand have supported activity in the business sector, although industrial production has been weighed down by declining oil production and a weak manufacturing sector. There have been signs of stronger conditions in the housing market. House price growth picked up in the second half of 2005 according to the Nationwide and Halifax measures, and housing loan approvals have accelerated (Graph 11). These developments have been associated with a modest recovery in retail sales, which increased by 4 per cent over the year to December. However, inflation pressures remain subdued, with average earnings growth slowing to 3.4 per cent over the year to November and underlying inflation running at 1.2 per cent over the year to December.

Graph 11

United Kingdom – House Prices



* Average of Halifax and Nationwide measures; last month is Nationwide only

Source: Thomson Financial

Box A: Developments in the US Housing Market

Like a number of other industrialised countries, the United States has experienced buoyant conditions in the housing market in recent years. Housing construction, sales and real price growth have all reached record levels. The house-building sector has made a large contribution to overall economic activity and employment, and the wealth effects of strong house price gains have supported consumption growth. However, the rapid growth in prices has raised concerns that housing may have become overvalued and that a slowing in the market would remove an important recent driver of economic growth. This box outlines some recent developments in the US housing sector.

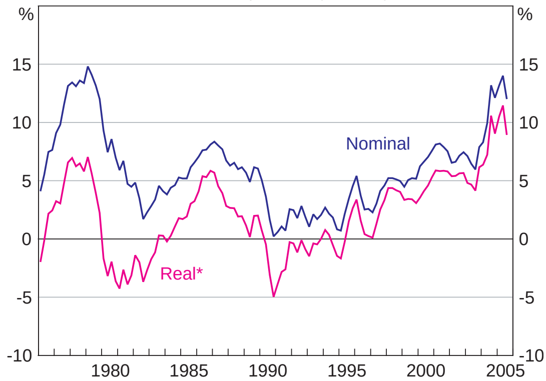
US house prices have increased especially strongly over the past two years, with growth averaging around 13 per cent per annum according to the Office of Federal Housing Enterprise Oversight (OFHEO) house price index (Graph A1). In real terms, house price growth has been stronger than at any other time in the 30 years for which the OFHEO index is available, although the cumulative increase in prices since the late 1990s is not as large as the increases seen in Australia and the UK (Graph A2). The resultant rise in housing wealth is likely to have boosted US consumption growth in the last couple of years, with housing equity withdrawal increasing substantially and the saving rate declining.

The rapid house price appreciation has been accompanied by strong building activity. Annualised housing starts have averaged about 2 million

Graph A1

United States – OFHEO House Price Index

Year-ended percentage change

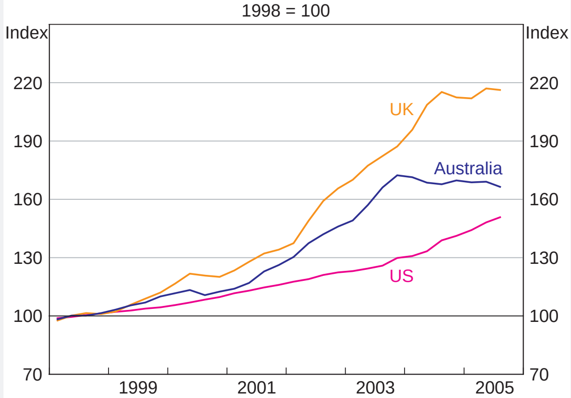


* Deflated by the consumption implicit price deflator
Source: Thomson Financial

Graph A2

Real House Prices*

1998 = 100



* Deflated by the consumption implicit price deflator
Source: Thomson Financial

since late 2003, or about 1.6 per cent of the overall housing stock, well above the average of 1.3 per cent over the second half of the 1990s. Residential investment now stands at 6.2 per cent of GDP, the highest share for 50 years, up from 4.6 per cent at the start of the decade. Strong housing activity has also led to a boom in housing-related employment. Residential building employment increased by 26 per cent over the five years to January 2006, while overall employment increased by only 1½ per cent during this period.

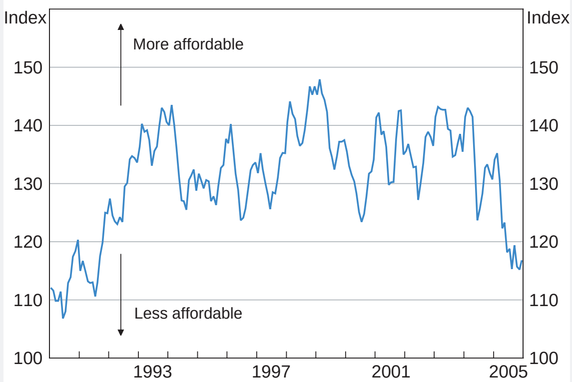
Conditions in the housing market have varied across the US. To some extent, the regional divergences in price growth have reflected divergences in underlying demand for housing due to different rates of population growth. For example, average annual price growth of more than 20 per cent over the past two years in California, Florida, Arizona and Nevada has been associated with strong population growth in these areas. More generally, the South and West have accounted for a disproportionate share of building activity in recent years, reflecting the relative shift in the population away from the Northeast and Midwest and the comparative availability of land. However, house price growth has also been rapid in a number of areas in the Northeast – such as New Jersey, New York and the District of Columbia – in which population growth has lagged behind the US average.

Although higher house prices and levels of borrowing have caused an increase in the US household debt-servicing ratio in recent years, it remains at the lower end of the range of the ratios in other English-speaking countries. Low mortgage rates have been an important factor. The nominal 30-year fixed mortgage rate, which applies to the bulk of US mortgages, is around the same level now as when the Federal Reserve began its tightening cycle in mid 2004. Furthermore, the development of new mortgage products, such as adjustable-rate and interest-only mortgages, has increased the capacity of households to borrow, as such mortgages typically entail smaller initial repayments than fixed-rate mortgages. In recent times, adjustable-rate mortgages have accounted for around one-third of new mortgages, although they remain a small share of the overall stock of mortgages.

Strong house price appreciation has led to a reduction in housing affordability over the past couple of years (Graph A3). However, with mortgage rates remaining at relatively low levels, the median family income has nonetheless remained sufficient to qualify for a mortgage for a median-price home (based on standardised loan qualification criteria), and the home ownership rate has increased from 65 per cent to 69 per cent over the past decade.

Graph A3

United States – Housing Affordability Index*



* A value of 100 indicates that a family with the median income has exactly enough income to qualify for a mortgage for a median-priced home, assuming a 20 per cent deposit and loan repayments equal to 25 per cent of the median family monthly income.

Sources: Thomson Financial; US National Association of Realtors

The strong pace of activity and house price inflation in the US has raised questions about their sustainability. However, the rate of new dwelling construction over recent years, while high, appears to have been broadly in line with estimates of underlying demand. Furthermore, the rise in the ratio of housing turnover to the housing stock can be partly explained by population movements, although increased investor activity and 'flipping', whereby investors buy properties with the intention of selling quickly to make capital gains, have also been important factors. With regard to prices, while it is difficult to be definitive, the house price-to-income ratio has increased to unprecedented levels in some areas (especially in parts of California) and former Federal Reserve Chairman Alan Greenspan referred to 'signs of froth in some local markets where home prices seem to have risen to unsustainable levels'.[1] Hence, it may not be surprising that there is some evidence house price growth in the US started to slow in late 2005, which most commentators expect will lead to a moderation in the pace of consumption growth.

1 *Greenspan A (2005), 'Testimony', Joint Economic Committee, United States Congress, 9 June.*

International and Foreign Exchange Markets

Overseas markets

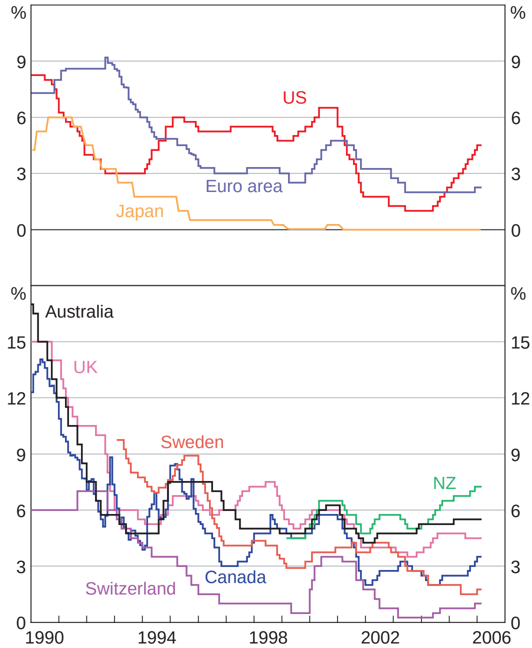
Official interest rates

All major central banks around the world, with the exception of the Bank of Japan, have now begun the process of normalising interest rates from the unusually low levels reached earlier this decade (Graph 12). In the US, the Federal Reserve has raised the federal funds rate from its record low level of only 1 per cent in 2003 to a more normal level of 4½ per cent in a sequence of 14 consecutive tightenings of 25 basis points (Graph 13). Real policy rates are now more in line with historical averages, following several years of negative real rates. Current market expectations are that, with interest rates now at more normal levels, the Fed will soon pause in the current tightening cycle to assess whether incoming data about the economic cycle and inflation warrant a tighter stance in monetary policy settings (Table 2).

European central banks have lagged behind the US in restoring normal interest rates, reflecting the fact that economic conditions in Europe have, until recently, been relatively subdued. The European Central Bank (ECB) made its first policy tightening in December 2005, raising rates by 0.25 per cent to

Graph 12

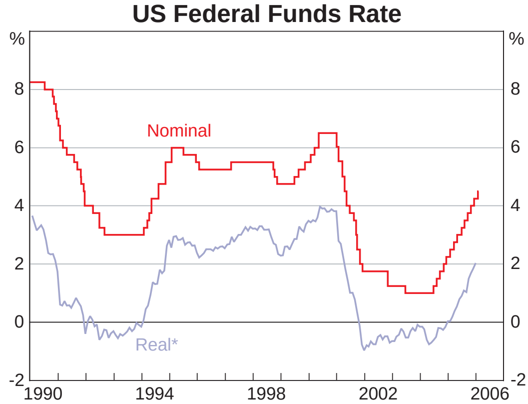
Cash Rates



Source: central banks

Graph 13

US Federal Funds Rate



* Real Fed Funds target calculated using core CPI updated to December 2005

Sources: RBA; US Federal Reserve

Table 2: Changes in Monetary Policy

	Current level Per cent	Most recent change	Expectations for next 6 months
United States	4.50	↑ Jan 06	↑ 50 bps
Euro area	2.25	↑ Dec 05	↑ 50 bps
Japan	0.00	↓ Mar 01	no change
United Kingdom	4.50	↓ Aug 05	no change
Canada	3.50	↑ Jan 06	↑ 50 bps

Sources: central banks; Bloomberg; Reuters

2.25 per cent. Markets currently have two additional rate rises to 2.75 per cent priced in over the next six months. Elsewhere in Europe, rates have also recently been raised from historic lows in Denmark, Sweden and Switzerland.

The Bank of England had not reduced its policy rate as much as some other developed economies earlier in the decade, and had a relatively brief tightening cycle from late 2003 until mid 2004 during which the policy rate was raised by 125 basis points. It has since lowered its policy rate by 25 basis points to 4½ per cent in August 2005, reflecting a slowdown in the economy. The Reserve Bank of New Zealand (RBNZ) continued its monetary tightening in 2005, raising the official cash rate by ¾ percentage point over the year, to 7.25 per cent, bringing the cumulative tightening to 225 basis points since early 2004. Following recent signs of a slowdown in the economy, the market expects that the RBNZ's tightening cycle is at an end. The Bank of Canada also has continued on its gradual tightening path that commenced in 2004, raising its policy rate at its December 2005 and January 2006 meetings to the current level of 3.50 per cent. The accompanying statement indicated further modest rate increases would probably be necessary.

Policy interest rates in Japan have been at zero for more than five years now. Monetary policy in Japan has been exceptionally easy to help offset some of the deep-rooted structural problems in the economy that came to the fore during the economic downturn that began in the early 1990s. Part of the Bank of Japan's monetary policy has been to provide an unusually large amount of liquidity to banks and the recent policy debate has revolved around when this policy will end, given that the financial system is now in better health and that economic recovery has taken hold. Markets expect that this will occur in the next few months, but that the subsequent, and more important, step in the normalisation process – beginning to raise official interest rates – will not occur in 2006.

Markets are quite anxious about any tightening by the Bank of Japan because a lot of speculative activity, mainly borrowing short-term funds in low-interest countries to invest in higher-yielding assets, has been funded by zero cost money from Japan. Hedge funds have been particularly active in this so-called 'carry' trade and it is possible that they may respond to the start of tightening by the Bank of Japan by quickly liquidating holdings of bonds and equities that have been funded in this way.

In the rest of Asia, policy rates are also being gradually raised from historically low levels in most countries. The largest increases have been in Indonesia, where there has been a cumulative tightening of 425 basis points, to 12¾ per cent since July 2005. In contrast, in several other emerging-market economies, such as Brazil, Mexico and Turkey, rates have been lowered in recent months as inflation pressures have eased and, in the case of the first two, the domestic economy has slowed in response to earlier monetary policy tightening.

Bond yields

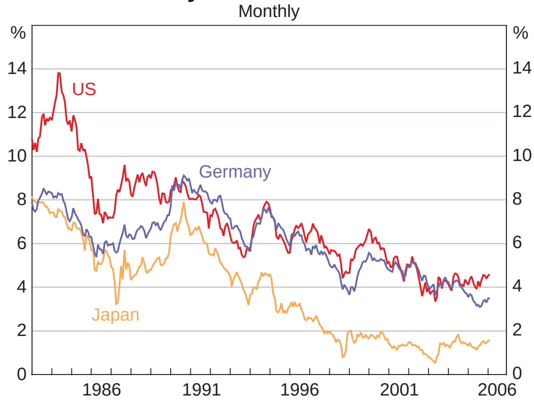
Yields on the major economies' long-term government debt have declined significantly over the past decade and remain at unusually low levels by historical standards despite recent rises in short rates (Graph 14). While the low level of yields is in part due to a step down into a low-inflation environment over the past decade or so, this alone does not explain the decline in real yields that has also been evident in recent years.

In the US, yields on government bonds have fluctuated broadly within a narrow range of 4 to 4½ per cent over the past two years. As the current tightening cycle has progressed, the spread between long-term yields and short rates has continually narrowed, so that the US yield curve is now effectively flat (Graph 15). The recent stability of longer-term yields stands in contrast to past episodes of monetary tightening, during which long-term yields have tended to rise by at least as much as short rates in the early stages of the cycle.

Graph 14

10-year Bond Yields

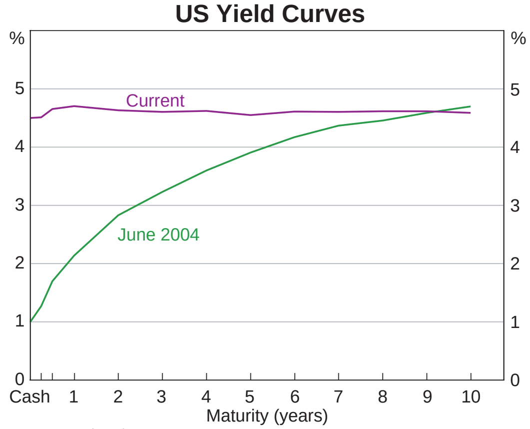
Monthly



Source: Thomson Financial

Graph 15

US Yield Curves



Source: Bloomberg

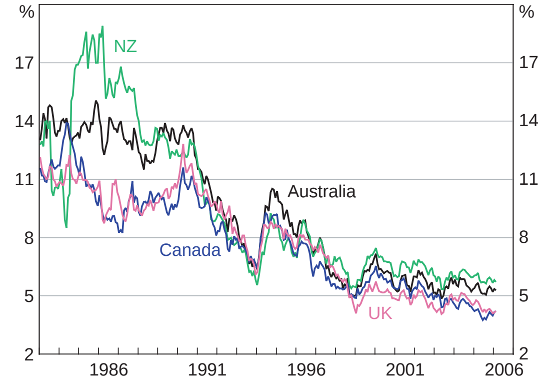
German yields reached a post-War low of 3 per cent in late 2005, a move also reflected elsewhere in the euro area. Against a background of relatively steady US yields, this caused the bond spread between the two countries to widen to around 125 basis points, the largest it has been since the late 1990s. The widening in the spread with US yields reflected the less favourable economic outlook in Europe through much of 2005.

Japanese government bond yields remain at very low levels, generally trading a relatively tight range of just ±50 basis points around 1½ per cent since 1998. Over the second half of 2005, an improvement in the country's economic outlook and the related sharp rise in Japanese

Graph 16

Selected OECD 10-year Bond Yields

Monthly

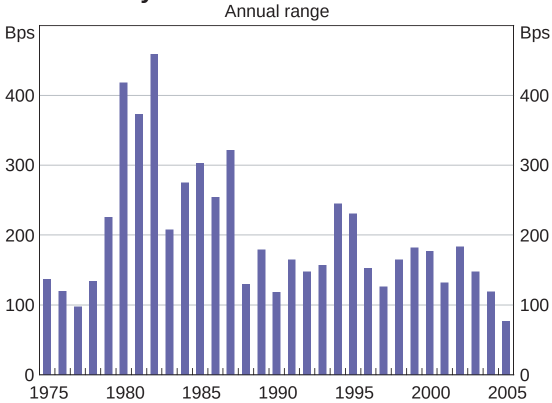


Sources: Bloomberg; RBA

Graph 17

US 10-year Government Bond Yields

Annual range

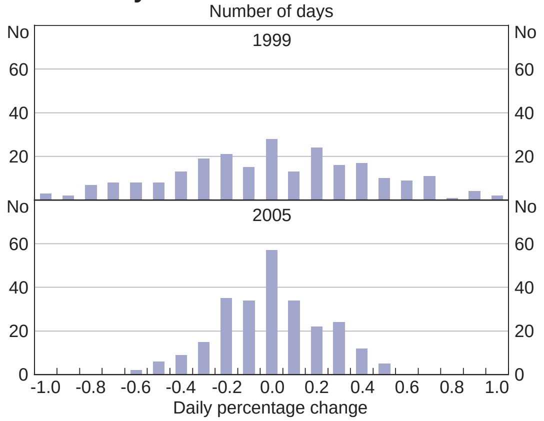


Source: Global Financial Data

Graph 18

US 10-year Government Bond Prices

Number of days



Sources: Global Financial Data; RBA calculations

equities gave rise to a small increase in yields on government debt.

The downward trend evident in yields in the major three markets has also occurred in other developed countries (Graph 16), as well as a number of countries in east Asia, where long-term yields on local currency bonds are even trading below those in the US.

The low level of global bond yields is not fully explained by well-anchored inflation expectations or improved central bank credibility. It appears that an excess of global saving over investment (in an ex ante sense) has also been an important contributory factor. Additionally, in some countries, most notably the United Kingdom, changes to the rules governing the way that pension funds account for their liabilities have led to a surge in demand for very long-dated bonds. The demand for inflation-protected long bonds has been particularly strong, pushing real yields to an all time low of just half of one percentage point.

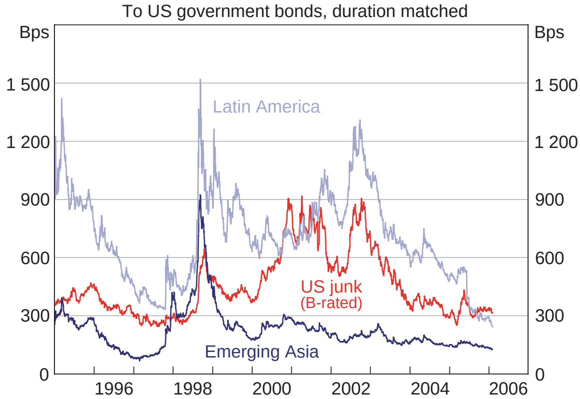
Not only are global bond yields low, but volatility in yields has been at its lowest in several decades. Over the calendar year 2005, yields on US government bonds moved in a range of only 77 basis points, the narrowest in the past three decades (Graph 17). Similarly, day-to-day fluctuations have been much smaller than in previous years (Graph 18).

The low level of yields on government bonds has prompted a 'search for yield' in recent years, creating demand for more risky assets. Consequently, risk premia on corporate and emerging-market bonds have declined sharply to relatively low levels (Graph 19).

Graph 19

Market Spreads

To US government bonds, duration matched



Sources: Bloomberg; JPMorgan; RBA; Thomson Financial

Equities

Global share markets generally posted solid gains for the third consecutive year in 2005 (Table 3). Although volatility in equity markets was also less than usual in 2005, it has not been at the record lows seen in bond markets.

The US market rose less than most last year despite strong corporate earnings, possibly because of rising official interest rates (Graph 20). Although the US price-to-earnings (P/E) ratio declined further in 2005, it remains above long-term average levels suggesting that the effects of the bubble have not yet been totally removed from the market. The current level of share prices remains 17 per cent below the peak six years ago.

Equity markets in Europe performed strongly throughout 2005, with the Euro STOXX rising by 23 per cent. Aggressive cost cutting and restructuring has helped European firms record stronger earnings growth than in the United States, despite relatively lacklustre overall economic performance.

Table 3: Changes in Major Country Share Prices

Per cent

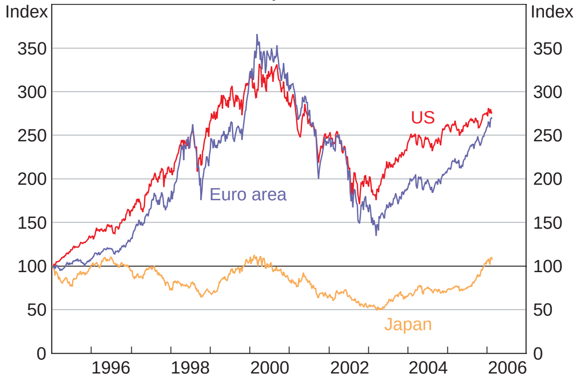
	Since 2000 peak	Since 2003 trough	2005	Since previous *Statement*
United States				
– Dow Jones	–7	44	–1	4
– S&P 500	–17	58	3	4
– NASDAQ	–55	78	1	6
Euro area				
– STOXX	–26	107	23	12
United Kingdom				
– FTSE	–17	74	17	7
Japan				
– TOPIX	–5	117	44	13
Canada				
– TSE 300	3	88	22	11
Australia				
– ASX 200	43	79	18	8

Source: Bloomberg

Graph 20

Share Price Indices

2 January 1995 = 100

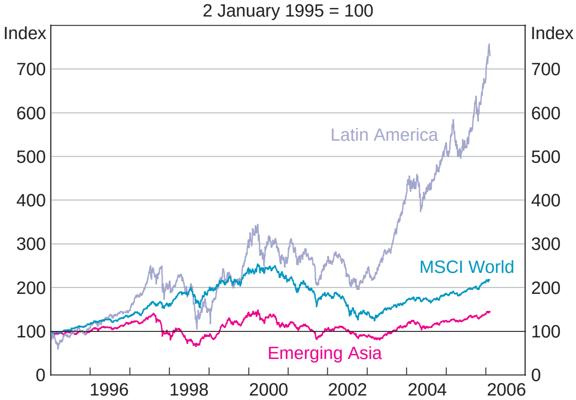


Source: Bloomberg

Graph 21

Share Price Indices

2 January 1995 = 100



Sources: Bloomberg; RBA

After a relatively slow start to 2005, Japanese share prices significantly outperformed other major equity markets in the second half of the year on optimism about the strength of the Japanese economy. Over the year as a whole they were up 44 per cent. However, Japanese share prices are still 40 per cent below their peak in 1989.

Share prices in emerging Asia also rose in 2005 to their highest levels since August 2000 (Graph 21). The strongest gains of more than 50 per cent were in the Korean stock market reflecting a recovery in domestic demand and improved corporate profitability. Notably, the strong foreign inflows into Korean equities observed over recent years slowed sharply in 2005, implying that gains were largely domestically driven. One area of weakness was China's foreign currency-denominated B-shares, which are available to both foreign and domestic investors. They fell by 18 per cent in 2005 on uncertainty regarding the government's disposal of its shares in state-owned enterprises and on disappointing corporate earnings. Nevertheless, in a sharp turn-around since then, these shares are up by around 50 per cent over 2006 to date, following news that companies may be permitted to convert the foreign currency-denominated shares into local currency-denominated shares.

Latin American share prices also continued to build on a sharp rally that has been in place since 2003. Share prices in Latin America have more than trebled since that time, buoyed by a more stable economic and political outlook for the region, coupled with rising commodity prices.

Exchange rates

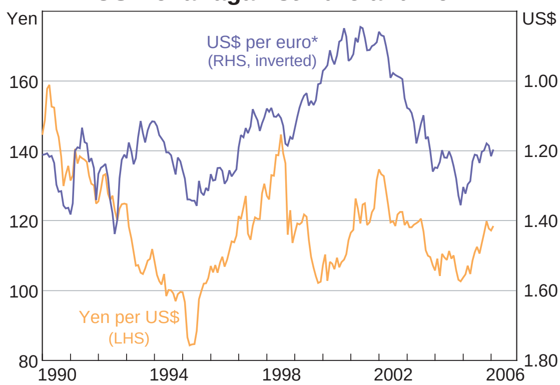
The notable development in global currency markets in 2005 was that, contrary to widespread predictions, the US dollar rose rather than fell against the major currencies (Graph 22, Table 4). The US dollar had fallen over the previous three years, unwinding a good part of the rise that took place in the second half of the 1990s and in the early part of this decade. But with the

US economy performing better than most last year and interest rates in the US again at levels well above those in Europe and Japan, the US dollar again found favour among investors. The US dollar's level relative to other major currencies is currently around long-run average levels.

Many commentators believe that the US dollar should fall sharply further because of that country's current account deficit, but such views may be underestimating the importance of the other half of the balance of payments – namely the capital account. In a world of globalised capital markets, capital flows seeking to take advantage of actual and perceived differences in rates of return across countries can be more powerful than trade positions for currency markets.

Graph 22

US Dollar against Euro and Yen



* US$ per ECU until 31 December 1998
Sources: Bloomberg; Eurostat

Market forces seem to be working to push up Asian currencies against the US dollar, but these have been resisted strongly by central banks in the region. Many countries have engaged in very large-scale foreign exchange intervention to limit any tendency for their currencies to appreciate (Graph 23). Over the past three years, Asian countries (including Japan) have undertaken US$1 250 billion of intervention, a figure unprecedented in history and very large relative to the size of these countries' economies. As a result, Asian currencies have on average appreciated only a little against the US dollar over recent years, and current exchange rates for the most part remain well below pre-crisis levels (Graph 24). The Japanese and most other Asian central banks scaled back sharply their rate of reserves accumulation in 2005 but the People's Bank of China has maintained its level of activity. It

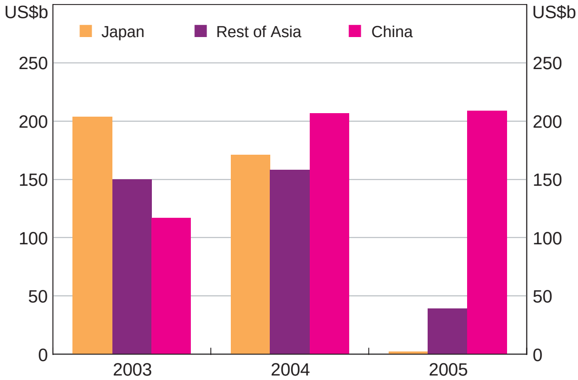
Table 4: Change in US Dollar against Other Currencies

Per cent

	Since USD peak Jan 2002	2005	Since last *Statement*
South Africa	–46	12	–8
New Zealand	–37	5	1
Australia	–30	6	–1
Canada	–28	–3	–3
Euro area	–28	14	–1
Sweden	–28	19	–5
South Korea	–26	–2	–7
Switzerland	–24	15	–1
UK	–19	11	0
Japan	–11	15	1
Singapore	–11	2	–4
Indonesia	–11	6	–8
Thailand	–10	5	–3
Brazil	–10	–12	–1
India	–8	4	–4
Taiwan	–7	3	–4
China	–3	–2	0
Malaysia	–2	–1	–1
Philippines	1	–6	–5
Mexico	15	–5	–2
Majors TWI	**–24**	**8**	**–1**
Broad TWI	**–15**	**3**	**–2**

Source: RBA

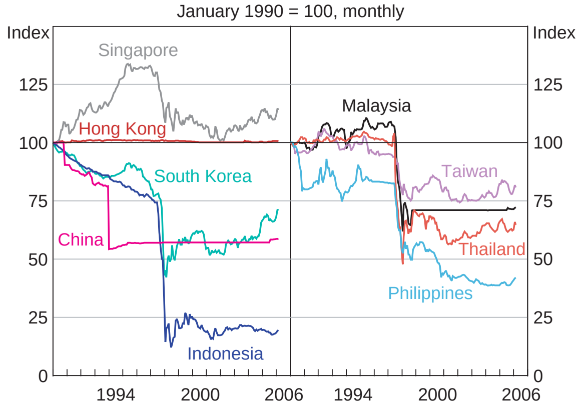
Graph 23
Foreign Reserves Accumulation



Sources: CEIC; RBA calculations

Graph 24
Asian Currencies against US Dollar

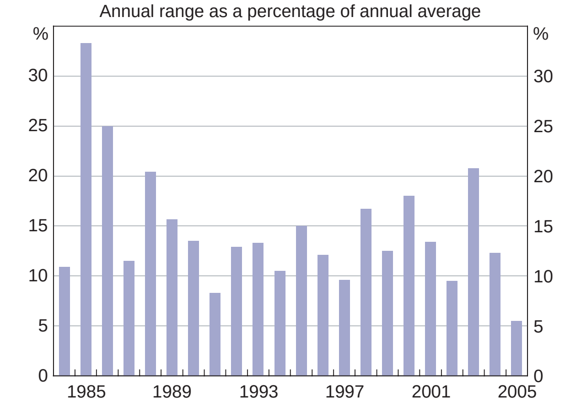
January 1990 = 100, monthly



Sources: Bloomberg; Thomson Financial

Graph 25
TWI Volatility

Annual range as a percentage of annual average



Source: RBA

is not surprising, therefore, that there remains intense interest in global financial markets in Chinese exchange rate arrangements.

Since the revaluation of the Chinese renminbi in the middle of last year, there has been negligible change in the currency against the US dollar. Pricing in the non-deliverable forward market indicates that markets expect the renminbi to be around 4½ per cent higher against the US dollar in 12 months.

Latin American currencies generally appreciated against the US dollar in 2005, with the Brazilian real rising by 15 per cent reflecting the ongoing improvement in economic prospects there.

Australian dollar

The Australian dollar traded in a narrow range over 2005; on a trade-weighted basis, its range was the lowest recorded in the post-float era (Graph 25). While the domestic currency depreciated modestly against the US dollar and many Asian currencies from the beginning of 2005, gains against European currencies, the Japanese yen and the British pound were broadly offsetting (Table 5). In recent months the Australian dollar has traded in a relatively narrow range around US75 cents, a little above its post-float average of US71 cents. In trade-weighted terms, it is around 63, compared with a post-float average of 58.1 (Graph 26). Box B discusses movements in the Australian dollar over a longer horizon.

The relative stability of the currency in 2005 seemed to be the outcome of two offsetting forces. Strong commodity prices – particularly coal, iron ore and base metals – and the resulting rise in the terms of trade have been a positive influence. On the other hand, the narrowing of interest differentials relative to some overseas countries has reduced demand for the Australian dollar. Most notably, the short-term interest differential with the United States has narrowed from 300 basis points at the start of 2005 to 100 basis points currently. In addition, there appears to have been some diversion to New Zealand of international money previously flowing to Australia as the cash rate in New Zealand was raised to 7.25 per cent. This was most evident in uridashi issuance, with A$-denominated issuance declining sharply and NZ$-denominated issuance rising markedly.

Investor sentiment towards the Australian dollar remains positive as evidenced by the continuing net long speculative positions in Australian dollar futures on the Chicago Mercantile Exchange (Graph 27). However, the size of these positions declined noticeably over the course of 2005.

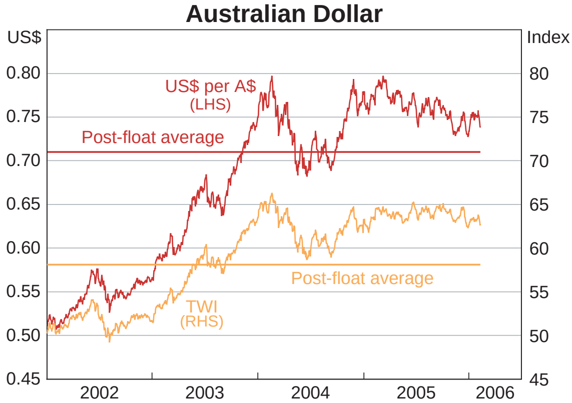
Table 5: Australian Dollar against Selected TWI Currencies
Percentage change

	Since April 2001 trough	2005	Since last *Statement*
Philippines	59	–11	–5
US	53	–6	1
Taiwan	50	–3	–3
China	49	–8	0
PNG	44	–7	1
Japan	44	7	1
Singapore	38	–4	–3
Indonesia	36	–1	–7
UK	25	5	1
South Africa	16	6	–7
Switzerland	15	9	0
Sweden	14	13	–4
Euro	13	8	0
Canada	11	–9	–2
South Korea	10	–8	–7
New Zealand	–9	–1	2
TWI	**34**	**–1**	**–1**

Source: RBA

Graph 26

Australian Dollar



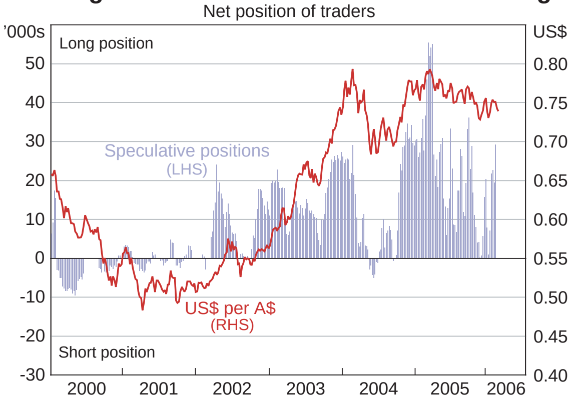
Sources: RBA; Reuters

Over recent years, the Reserve Bank has been buying foreign exchange to replenish reserves sold during intervention to support the exchange rate between 1997 and 2001. It bought about $7½ billion of foreign exchange in each of 2003 and 2004, but over the past year net purchases were scaled back to around half that amount. This reflected the slightly softer exchange rate and the reduced imperative to add further to reserves given the relatively comfortable level of existing holdings. Net reserves are currently around $28½ billion.

Graph 27

Trading in Australian Dollar Futures in Chicago

Net position of traders

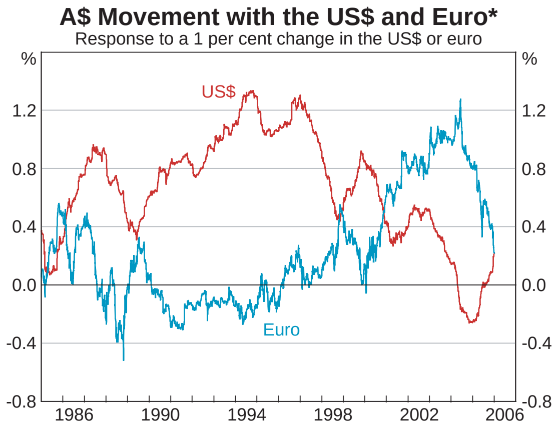


Sources: Commodity Futures Trading Commission; RBA

In addition to this, the Bank also holds about $30 billion of foreign exchange under swap arrangements undertaken for domestic liquidity operations.

Box B: The Relationship of the Australian Dollar with the US Dollar and the Euro

Graph B1



* Prior to 1999, changes in the deutschemark are used in place of changes in the euro

Sources: RBA calculations; Reuters

Up until the mid to late 1990s, movements in the Australian dollar tended to track those in the US dollar (Graph B1) and it was often referred to as one of the 'dollar bloc' currencies.[1] However, over the past nine years the strength of this correlation has declined markedly, with a stronger correlation observed between the Australian dollar and the euro in recent years, particularly from late 2000 until mid 2004.

One possible explanation for the earlier positive correlation between the Australian dollar and the US dollar was the synchronicity of the Australian and US business cycles over that period.[2] The subsequent decline in the correlation occurred during the US dollar bubble of the late 1990s/early 2000s when the US dollar rose strongly against all other currencies, including the Australian dollar, as investors were attracted to US assets, most notably equities. The correlation of a number of other currencies, such as the euro, New Zealand and Canadian dollars and the British pound, with the US dollar also declined noticeably during this period.

Over the same period the correlation of the Australian dollar with the euro rose markedly. This was somewhat surprising given the divergent economic conditions and interest rate cycles experienced by the two economies during this period. The most plausible explanation was that this was the by-product of the US dollar bubble, which saw all currencies affected first by the flow of capital to the US and then by the subsequent reversal. This argument is supported by the observation that, with the stabilisation of the US dollar over the past year, the strength of the relationship between the Australian dollar and the euro has fallen significantly.

The correlations of the Australian dollar with the US dollar and the euro are now similar, and both relatively low. This is more in keeping with the relatively de-synchronised movement of the Australian economy at present, and especially the fact that it is benefiting more than most from the sharp rise in commodity prices. ✠

1 *The lines on the graph show the coefficients from a multivariate rolling regression of the daily percentage change in the Australian dollar on a constant and changes in the US dollar, euro and yen. Window length is 260 days; all variables are priced in terms of Swiss francs. The higher the value, the closer the two currencies move together. As the graph shows, since late 2000, the coefficient on the euro has exceeded that on the US dollar.*

2 *See C Kent and D Norman (2005),* The changing nature of the business cycle *(available at <http://www.rba.gov.au/PublicationsAndResearch/Conferences/2005/index.html>).*

Domestic Economic Conditions

Growth in the Australian economy remained moderate in 2005 when compared with the rates recorded a few years ago. GDP is estimated to have increased by 2.6 per cent over the year to the September quarter, with annualised growth of around 3 per cent in the middle two quarters of 2005 (Table 6). Recent quarterly GDP data have indicated a profile of strong growth in business investment, moderate growth in household consumption, modest falls in dwelling investment and a subtraction from GDP growth by net exports, as growth in spending has continued to run ahead of production.

Table 6: Demand and Output
Percentage change

	December qtr 2004	March qtr 2005	June qtr 2005	September qtr 2005	Year to Sep qtr 2005
Domestic final demand	1.4	0.2	2.0	0.2	3.8
Change in inventories[a]	–0.2	0.7	–0.2	–0.2	0.1
GNE	1.3	0.8	1.8	0.0	3.9
Net exports[a]	–0.7	–0.2	–0.1	–0.3	–1.3
GDP	0.4	0.7	1.3	0.2	2.6
Memo item:					
Real GDP adjusted for changes in terms of trade	0.7	1.2	2.5	0.4	4.8

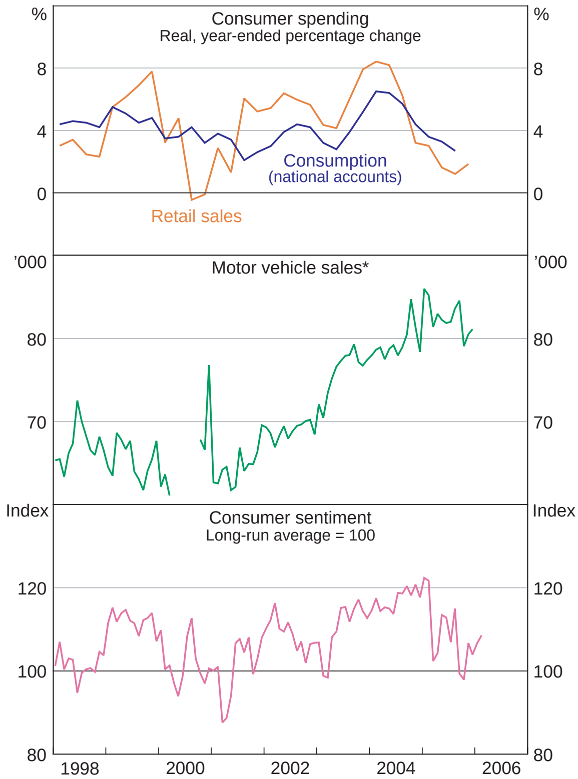
(a) Contributions to GDP growth
Source: ABS

The outlook for growth remains favourable. The income gains from the strong terms of trade are providing ongoing support to domestic spending, particularly in the regions most exposed to the resources sector. Conditions in the business sector are generally positive, with profitability and capacity utilisation both at high levels. Growth in household consumption is likely to remain relatively modest, as households continue to consolidate their financial positions. Indicators of housing activity continue to suggest that the current downturn in construction activity is proving to be mild by historical standards. Moderation of the growth in domestic demand should result in an easing in imports growth which, when combined with an expected recovery in export volumes, should reduce the drag on growth from net exports. Conditions in the rural sector have improved noticeably, with better weather in the second half of 2005 likely to boost crop and livestock production.

Household sector

Growth in household consumption slowed during 2005, with real spending increasing by 2.7 per cent over the year to the September quarter, a marked deceleration from an annual growth rate of around 6½ per cent at the start of 2004 (Graph 28). Growth in the September quarter was quite modest, at 0.6 per cent, despite a sizeable boost to household incomes from tax cuts and

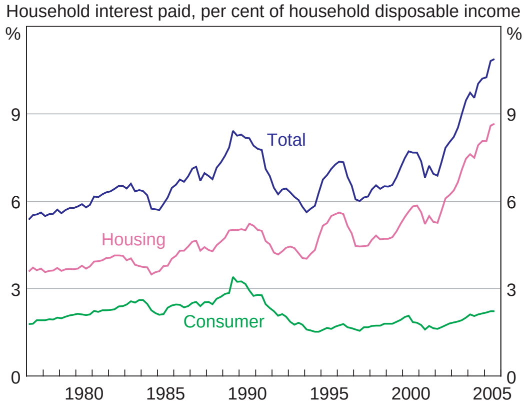
Graph 28
Consumption Indicators



* Break indicates period affected by introduction of the GST
Sources: ABS; Melbourne Institute and Westpac

Graph 29
Debt-servicing Ratio*

Household interest paid, per cent of household disposable income



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

other measures in the May Budget. Partial indicators of consumption suggest that growth remained relatively subdued in the December quarter: the volume of retail sales increased only slightly in the December quarter and motor vehicle sales fell by 3.8 per cent. Although consumer sentiment, as recorded by the Melbourne Institute survey, has fallen from the levels seen in 2004 and early 2005, it remains above long-run average levels. The recent improvements suggest that the effect of higher petrol prices on sentiment has been fairly transitory.

Moderate consumption growth, combined with strong growth in disposable income, led to a further rise in the household saving rate in the September quarter, bringing the estimated total increase since the end of 2004 to 2¼ percentage points. Although the saving rate as measured is still negative, the fact that consumption is now growing more slowly than income suggests that households are taking a more cautious approach to their finances. This would be consistent with the further easing in growth in household debt in the September quarter. Nevertheless, the debt-servicing ratio increased marginally in the quarter, to 10.9 per cent (Graph 29). Following revisions to the data, the debt-servicing burden is now well above previous peaks. Although there is still little sign of household financial distress in the loan arrears data, the rising interest burden may be one reason for the moderation in consumption growth.

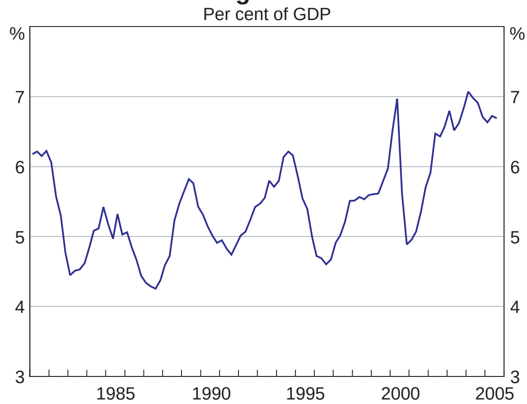
Housing

Construction

The housing construction downturn continued in 2005, with dwelling investment falling modestly in the September quarter, but still remaining fairly high as a percentage of GDP (Graph 30). Dwelling investment has fallen by around 4 per cent from its early 2004 peak, with the decline fairly evenly spread between the two main components, construction of new dwellings and alterations & additions. The recent weakness was driven largely by developments in New South Wales; dwelling investment remains high in most other states.

Graph 30

Dwelling Investment



Source: ABS

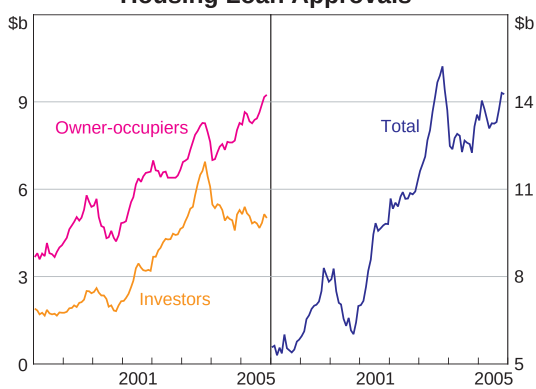
Forward-looking indicators remain consistent with the current downturn in dwelling construction activity being mild by the standards of previous cycles. Building approvals were broadly flat in the December quarter, following a sharp fall in the September quarter. The large amount of work remaining in the pipeline will help to support dwelling construction activity in the near term. Looking further ahead, builders responding to the latest Master Builders Association construction survey are becoming more optimistic about prospects for demand over the next six months.

Financing and prices

The value of housing loan approvals increased by around 6 per cent in the three months to November, and by 11.5 per cent over the year, to be around its highest level since the end of 2003. Recent growth has mostly been driven by an increase in loan approvals to owner-occupiers, although loan approvals to investors have retraced some of their previous falls (Graph 31). The value of loan approvals for investors increased by around 4½ per cent in the three months to November, but is still

Graph 31

Housing Loan Approvals*



* Excluding approvals for new construction by investors
Source: ABS

around 25 per cent below its peak in late 2003. In most states, incentives offered by state governments combined with recent increases in housing affordability have attracted re-entry of first-home buyers, and their share of total loan approvals has increased accordingly.

Following a period of rapid growth in previous years, average nationwide house prices have been relatively stable on most measures since the end of 2003. In the December quarter, both the APM composition-adjusted measure of nationwide house prices and the repeat-sales data from Residex rose by around 1 per cent. The APM measure suggested a similar increase over the year to the December quarter, while the Residex repeat-sales data suggested a somewhat stronger outcome over this period (Table 7). Average price changes in the major capitals over 2005 were all relatively small, with the exception of Perth which again recorded strong growth. Prices appear to have fallen in Sydney for the second year. The price falls that have occurred in Sydney, together with stable or increasing prices in other capitals, have brought price relativities between Sydney and the other capitals back to the pre-boom levels of the early to mid 1990s (Graph 32).

Table 7: House Prices
Year-ended percentage change

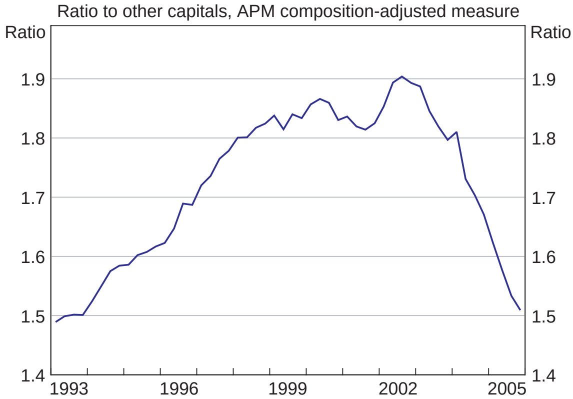
	APM		REIA		Residex		ABS	
	Dec qtr 2004	Dec qtr 2005	Dec qtr 2004	Dec qtr 2005	Dec qtr 2004	Dec qtr 2005	Dec qtr 2004	Sep qtr 2005[(a)]
Sydney	–3.3	–5.1	0.0	–3.5[(a)]	–3.5	–1.0	–4.7	–5.2
Melbourne	0.6	2.0	–4.3	1.4	4.5	4.2	0.4	–1.3
Brisbane	4.4	2.6	4.7	–0.6[(a)]	4.9	3.5	3.4	1.5
Adelaide	7.1	2.1	10.7	0.0	–	–	6.9	2.3
Perth	12.1	18.7	11.3	12.0[(a)]	14.2	15.3	13.2	12.5
Canberra	–0.9	2.3	0.0	5.1	–1.7	5.2	–1.4	0.8
Australia	**0.9**	**0.8**	**0.9**	**–1.2**[(a)]	**3.1**[(b)]	**4.2**[(b)]	**0.2**	**–0.7**

(a) Three quarters to September quarter 2005
(b) Excludes Adelaide, Hobart and Darwin
Sources: ABS; APM; RBA; REIA and state REIs; Residex

Graph 32

Sydney House Prices

Ratio to other capitals, APM composition-adjusted measure



Source: APM

With ongoing growth in household incomes but little change in nationwide average prices over the past two years, there has been some reduction in house price-income ratios from the extremely high levels of late 2003. There is likewise some evidence of unwinding of previous overvaluations in price-rent ratios, with data from the CPI and the REIA both recording increases in rents over the same period. REIA data also show that the nationwide vacancy rate fell to 2.5 per cent in the September quarter from 3.3 per cent a year earlier, with vacancy rates lowest in Adelaide, Canberra and Perth.

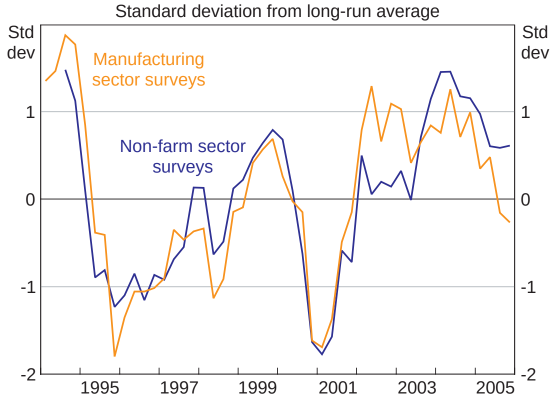
Business sector

Business conditions generally continue to be favourable, as evidenced by strong growth in profits and investment. Most business surveys indicate that conditions in late 2005 were at or above long-run average levels, although somewhat below the very high levels recorded in 2004 (Graph 33). The NAB survey reported that business conditions remained healthy in the December quarter at well above long-run average levels, and that capacity utilisation reached a new historical peak (Graph 34). The ACIL Tasman/ACCI Survey of Investor Confidence also reported buoyant business conditions and high levels of investment intentions. The November Sensis survey similarly suggested that actual business conditions of small and medium-sized firms improved, to be back around long-run average levels. Consistent with business surveys, capacity constraints continue to be reported in liaison with firms in most industries. However, they appear to have eased in the residential construction industry, in line with the maturation of the housing cycle, and in parts of manufacturing where trading conditions have been difficult.

Graph 33

Actual Business Conditions*

Standard deviation from long-run average

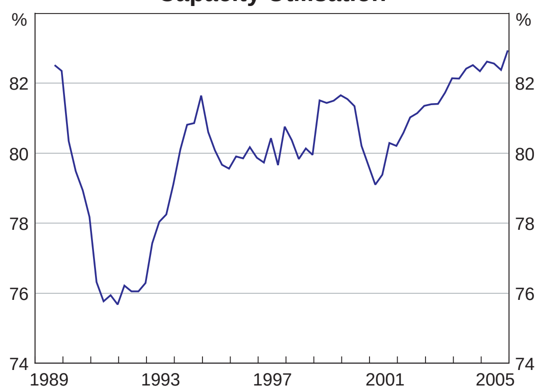


* Weighted average of data from various business surveys, with weights determined by the principal component method

Sources: ACCI; ACIL Tasman; AIG; NAB; Sensis; St. George Bank; Westpac

Graph 34

Capacity Utilisation



Source: NAB

Throughout 2005, the business surveys and liaison reports indicated that conditions remained less positive in the manufacturing sector than for the rest of the economy, due to increasing competition from China and other emerging economies, as well as the housing construction downturn. In the December quarter, the ACCI-Westpac survey reported that actual business conditions in the manufacturing sector improved marginally and remained a little above their long-run average level. However, the AIG's Survey of Manufacturing and its Performance of

Manufacturing Index (PMI) both suggested that activity in this sector weakened further in the December quarter, although the PMI has recovered somewhat in the past two months.

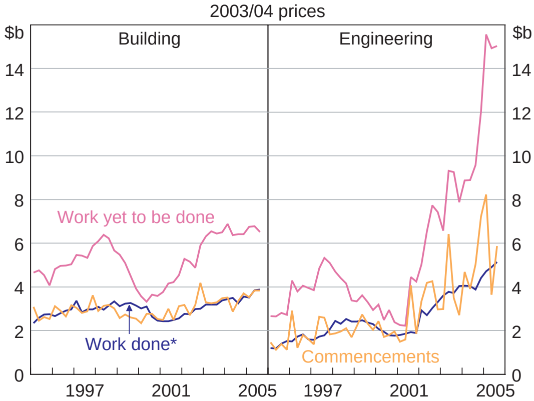
Prospects for farm output are looking more favourable, following a pronounced improvement in seasonal conditions over the second half of 2005. Mild spring temperatures and timely rainfall resulted in a national winter grains harvest well in excess of the average crop over the previous five years. Greater availability of irrigation water will also support higher yields for most summer crops, particularly rice and sorghum. The outlook is similarly positive for livestock producers, with farmers taking advantage of the more favourable weather conditions to rebuild herds depleted by record slaughter rates earlier in the year.

Buoyed by high capacity utilisation and favourable funding conditions, real business investment continues to expand at a strong pace, increasing by 2.5 per cent in the September quarter and by 18 per cent over the year. All major components of investment recorded rapid rates of growth, with machinery & equipment and non-residential building investment both expanding by close to 20 per cent over the year, while engineering construction increased by around 30 per cent; spending on intangible fixed assets such as software recorded growth of around 10 per cent. Capital spending growth also continues to be relatively broad-based across industries (for more details, see 'Box C: Recent Trends in Business Investment').

Graph 35

Non-residential Construction Indicators

2003/04 prices



* Seasonally adjusted; other data are unadjusted

Source: ABS

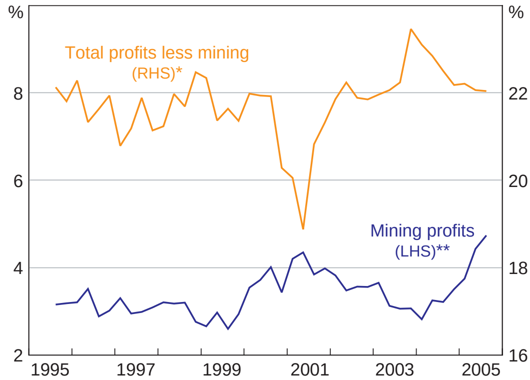
The outlook for business investment remains bright, with solid profitability and a positive external financing environment ensuring that firms have ample access to funds for expanding capacity. Forward-looking indicators of non-residential construction suggest continued growth from the current high level of activity over coming quarters, following its sharp upswing over the past year (Graph 35). Engineering construction activity is expected to be supported by the large amount of resource-related and road construction work underway, including the recently commenced $1.5 billion Enfield oil project in Western Australia. The prospect of further growth in non-residential building has also improved in recent months, with the volume of work approved running above the current high level of construction work done. In addition, investment intentions in the latest capital expenditure (Capex) survey suggest a healthy rise in real machinery & equipment investment in 2005/06, driven by increased spending in the manufacturing, finance & insurance and transport & storage industries. Similarly, the latest Rabobank survey suggests that investment intentions for farm equipment (which are not covered in the Capex survey) remain elevated and are close to their pre-drought levels.

Corporate profitability maintained its momentum through 2005, with the gross operating surplus of private non-financial corporations increasing by 2.6 per cent in the September quarter, to be 18 per cent higher over the year. Although profit growth continues to be driven by the mining sector, non-mining profits have also grown solidly in the past two quarters and are at reasonably healthy levels by historical standards (Graph 36). While growth in mining profits is expected to ease, and faster wage growth is likely to place upward pressure on costs, forward indicators such as the NAB survey's actual and expected profitability series suggest that profitability should remain solid in the near term.

Graph 36

Profits

Per cent of nominal GDP



* Combined profits of the incorporated (excluding mining and financial) and unincorporated sectors
** Adjusted for inventory movements
Sources: ABS; RBA

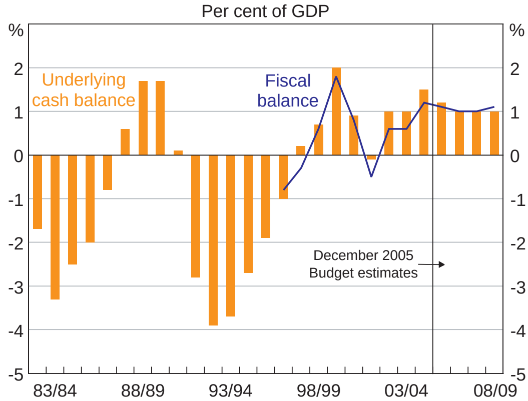
Australian Government Budget

The Mid-Year Economic and Fiscal Outlook (MYEFO) for 2005/06, released in December, showed an increase in the forecast budget surplus from that expected in the May Budget (Graph 37). This upward revision mainly reflects an increase in estimated income taxation revenue, resulting from greater than expected increases in corporate profits and employment, and a larger dividend from Telstra. These effects significantly outweighed the estimated increase in spending flowing from new policy measures announced since the Budget.

Graph 37

Australian Government Budget Balance

Per cent of GDP



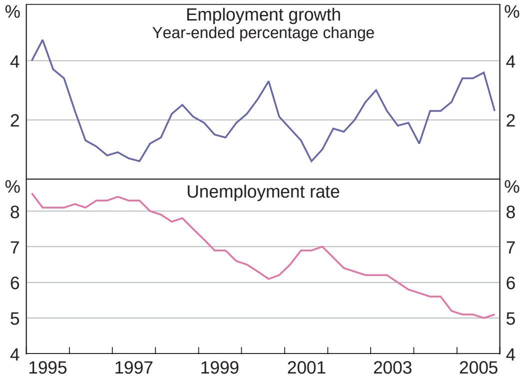
Source: Australian Treasury

Labour market

Most labour market indicators point to some cooling in recent months. However, this appears to be mostly a return towards normal conditions following the extremely strong conditions registered around a year ago (Graph 38). Total employment grew by 1.6 per cent over the year to January, with part-time employment increasing by 0.6 per cent and full-time employment by 2.0 per cent. Total employment is estimated to have grown by a modest 0.3 per cent over the three months to January. This represents a significant slowing from the peak annual rate of total employment growth of around 4 per cent seen in mid 2005. However, the strength at that time was a little puzzling given the more subdued growth of output, so some slowing in measured

Graph 38

Employment Growth and Unemployment



Source: ABS

employment growth is not surprising. The participation rate remained high at 64.4 per cent in January, while the unemployment rate has stopped falling, and has remained around 5–5¼ per cent for some time.

Labour market outcomes have been broadly consistent with the pattern of output performance across industries and states (Table 8). Over the year to the December quarter, employment growth was strongest – at around 30 per cent – in the mining industry, while the largest fall was in wholesale trade. More generally, employment growth was strong in both the business and household services sectors, while employment fell in the rural and government sectors. Reflecting the strength in mining employment, annual employment growth was particularly strong in Western Australia, highlighting the effects of the stimulus to activity stemming from the strong terms of trade.

Looking ahead, surveys point to further growth in employment. The ABS measure of job vacancies fell in the December quarter for the third consecutive quarter, but it remains at high levels following extremely strong growth in 2004. The ACCI-Westpac and NAB surveys also suggest some modest easing in firms' hiring intentions, although they are still above their

Table 8: Labour Market by State
Per cent

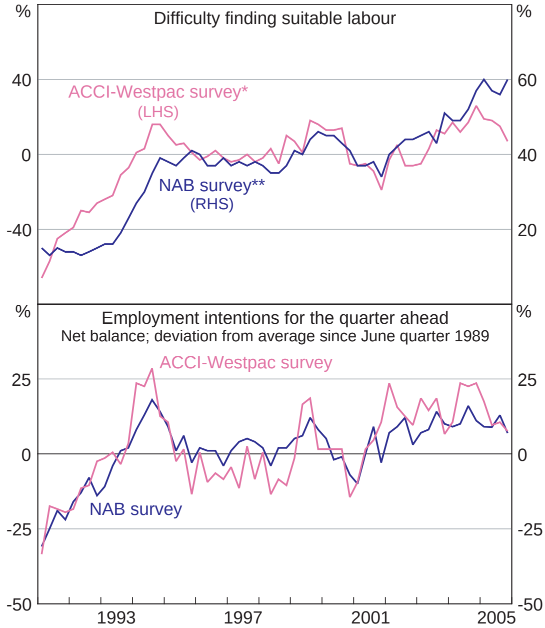
	Employment growth		Unemployment rate	
	Three months to January 2006	Year-ended January 2006	January 2005	January 2006
NSW	0.4	1.1	5.1	5.7
Victoria	–0.4	0.7	5.5	5.4
Queensland	–0.1	1.8	4.8	5.3
WA	0.9	4.4	4.7	4.0
SA	0.4	1.8	5.7	5.0
Tasmania	2.1	4.8	5.6	6.7
Australia	**0.3**	**1.6**	**5.1**	**5.3**

Source: ABS

long-run averages (Graph 39). The Bank's liaison program indicates the existence of ongoing broad-based labour shortages, which are most pronounced among skilled workers in the non-residential construction and resources sectors, and in much of the business services sector. Both business surveys and liaison indicate that firms continue to face difficulty attracting suitable labour.

Graph 39

Indicators of Labour Supply and Demand



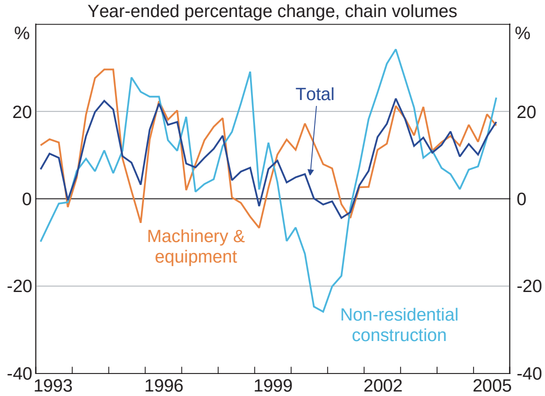
* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI and Westpac; NAB

Box C: Recent Trends in Business Investment

Graph C1

Business Fixed Investment

Year-ended percentage change, chain volumes



Source: ABS

Graph C2

Investment by Industry – 3 Years to 2004/05*

Annual average per cent growth, chain volumes

* Includes transfers of second-hand assets between the business and other sectors
Sources: ABS; RBA

Business investment has made a strong contribution to growth in aggregate demand over the past three years. In real terms, spending has expanded at an average annual rate of around 14 per cent, well above the average rate recorded over the previous decade (Graph C1). Investment has responded to the combination of strong growth in world and domestic demand, high levels of capacity utilisation and favourable funding conditions. The declining price of imported capital goods, in part reflecting the appreciation of the currency in 2002 and 2003, has also been an incentive to invest.

The strength in investment growth has been most pronounced in investment in computing and electrical equipment. There has also been a recent sharp upswing in construction investment. But, consistent with the generally favourable macroeconomic environment, strong investment growth has been broadly based across most industries, with even those industries below the average recording healthy growth rates (Graph C2).[1] Buoyant external demand for resource commodities has provided additional support for

1 *These data are constructed using nominal private-sector spending together with price deflators calculated for total investment, since deflators for private investment are not available by industry. This approach implicitly assumes that within each industry, private firms spend the same proportion on various types of investment goods, and at the same prices, as the public-sector firms in the same industry.*

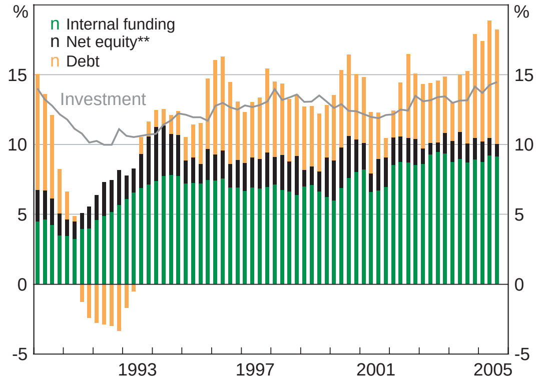
investment spending by the mining industry, as well as by resource-related firms in other industries. Perhaps surprisingly, investment in the manufacturing sector has been very strong, though this mostly reflects the resource-related areas of metals, petroleum, coal and chemical products, with investment growth relatively muted elsewhere.

The recent strength in overall investment has also been facilitated by favourable conditions for both internal and external funding. Corporate profitability has been high, although the resulting pick-up in retained earnings has been outstripped by the expansion in investment spending. Consequently, firms' demand for external funds has also increased, with the larger and generally more cyclical debt component picking up by more than net equity raisings (Graph C3). The strength in debt financing in recent quarters has been encouraged by relatively low corporate bond yields and interest rates on business loans. ✠

Graph C3

Investment and Funding*

Share of nominal GDP



* Funding measures – three-quarter moving average
** Issued equity less equity buybacks
Sources: ABS; ASX; RBA

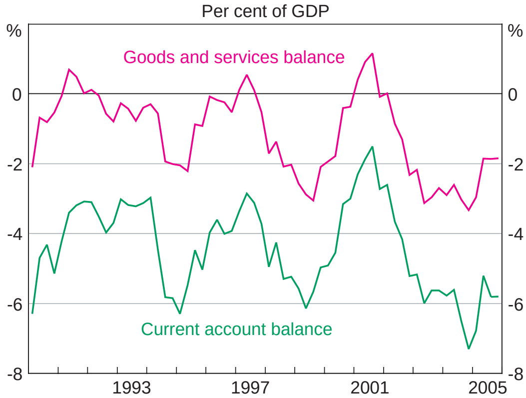
Balance of Payments

Australia's trade deficit narrowed in 2005 reflecting the run-up in commodity prices, most notably the significant increases in contract prices for coal and iron ore that helped push the level of the terms of trade to a 30-year high. However, the trade deficit (at around 2 per cent of GDP) and current account deficit (at around 6 per cent of GDP) both remain large by historical standards (Graph 40). While export prices have increased sharply, growth in the volume of Australia's exports has remained lacklustre, with average annual growth over the past five years of only around 1½ per cent. Import volumes have continued to expand more rapidly, although growth moderated during 2005 in line with the easing in the pace of domestic spending.

Graph 40

Balance of Payments*

Per cent of GDP



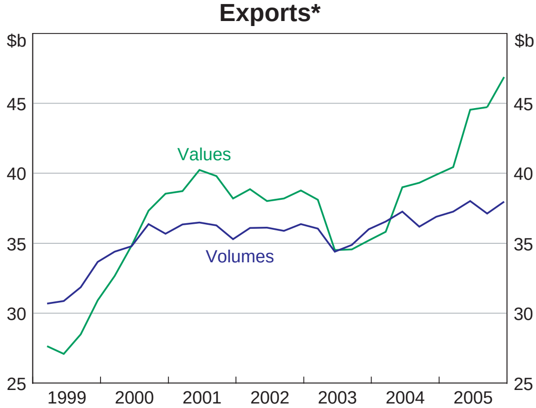
* Excludes RBA gold transactions; RBA estimates for December quarter 2005
Sources: ABS; RBA

Exports

Export earnings increased by around 18 per cent over the year to the December quarter of 2005, mostly reflecting higher export prices (Graph 41). The strongest growth came from resources, where export values increased by over 40 per cent, driven by sharply higher prices for iron ore, coal and base metals. Resource export volumes are estimated to have risen by around 7 per cent over the year, reflecting growth in many components (notably iron ore, alumina and aluminium), although coal exports were somewhat restrained by temporary disruptions in the second half of 2005. Further increases in resource exports appear likely, with several new mining projects due to come on-line in the first half of 2006 (particularly for coal) and transport infrastructure constraints easing somewhat,

Graph 41

Exports*



* RBA estimates for December quarter 2005
Sources: ABS; RBA

although there are likely to be declines in production from some existing operations, especially for gold and oil.

Earnings from manufactured goods exports increased by around 8 per cent over 2005, with volumes estimated to have grown more strongly than overall exports, albeit at a rate well below that seen during the 1990s. Nonetheless, recent business surveys report a pessimistic outlook for manufactured exports, and the Bank's liaison with Australian manufacturers reports that producers are finding it difficult to compete with developing economies in Asia.

In contrast to the other goods categories, rural export earnings declined over 2005, falling by about 3 per cent due largely to a fall in cereals export volumes. However, the outlook for cereals exports is positive given the above-average crop harvested in late 2005 and the improved prospects for the summer crop following the widespread rainfalls in the second half of the year. Wool exports have continued to trend lower, in part reflecting farmers substituting towards meat production to take advantage of high prices, particularly for lamb. The outlook for livestock-based exports is mixed, although the reimposition of bans on US beef sales into Japan should support demand for Australian beef. Overall, although rural export volumes appear to have fallen in the second half of 2005, the Australian Bureau of Agricultural and Resource Economics (ABARE) forecasts a modest rise in total rural exports in 2005/06.

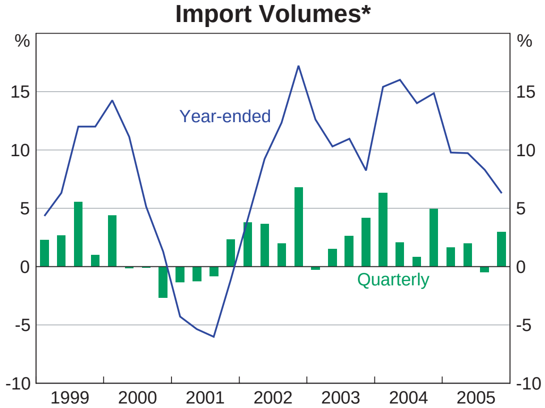
Services export earnings increased by around 1 per cent over 2005, while volumes have continued to track sideways at around their 2001 levels. Growth in travel and transportation services exports, which account for over two-thirds of total services exports, has been subdued despite a sizeable increase in short-term visitor arrivals over recent years. This reflects a decline in average visitor expenditure, in part resulting from changes in the mix of visitors to Australia.

Imports

Growth in import volumes eased in 2005, due to the more moderate expansion in domestic spending and the waning of the adverse effect on competitiveness from the appreciation of the exchange rate seen over 2002 and 2003. The annual pace of import growth is estimated to have slowed to around 6 per cent over the year to the December quarter, down from the particularly rapid 15 per cent rate recorded over 2004 (Graph 42). All categories of imports have shown signs of easing, although growth in capital imports remains relatively strong, consistent with the strength in business investment.

Graph 42

Import Volumes*



* RBA estimates for December quarter 2005
Sources: ABS; RBA

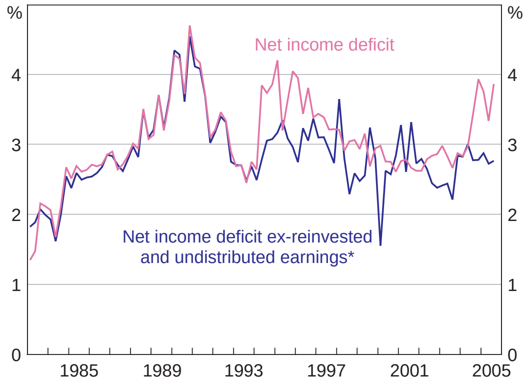
Net income

After narrowing over the first two quarters of 2005, the net income deficit (NID) increased sharply in the September quarter to $9 billion or 3.9 per cent of GDP (Graph 43). This largely reflected an increase in equity returns on foreign direct investment in Australia, in line with the strong profit growth in the resource sector. As has been the case for the past year, a significant proportion of these equity earnings were reinvested within the Australian-based companies and did not result in actual payment outflows. Excluding such reinvested earnings, the NID has been broadly unchanged for the past two years, at just below 3 per cent of GDP.

Graph 43

Net Income Deficit

Per cent of GDP



* Excluded earnings component seasonally adjusted by RBA
Sources: ABS; RBA

Commodity prices and the terms of trade

The prices of Australia's commodity exports have continued to move higher, buoyed by the ongoing upswing in the global economy. The RBA index of commodity prices (ICP) increased by 5.9 per cent over the three months to January, and has risen by almost 40 per cent over the past year (Table 9). The ICP is now at its highest level in nominal terms since 1982, the first year for which the index is available (Graph 44). The lift in prices over the past three months has been broadly based across commodity groups, with the pick-up in base metals prices particularly marked. In Australian dollar terms, the ICP rose by 6.6 per cent over the three months to January, and was up by 34 per cent over the year.

Table 9: Commodity Prices

Percentage change; SDR

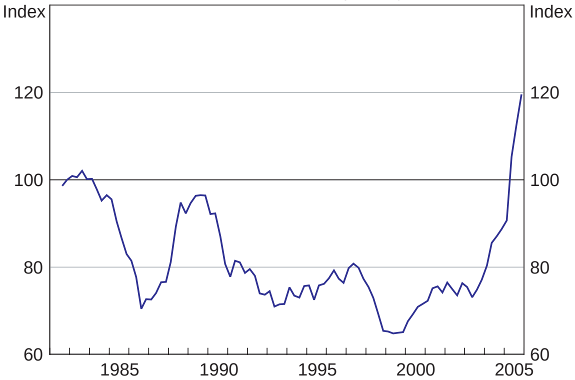
	Three months to January 2006	Year to January 2006
RBA Index	5.9	38.6
Rural	*4.2*	*10.7*
– Wheat	–1.5	10.6
– Beef & veal	3.0	–2.1
– Wool	–1.5	–8.0
Base metals	*22.1*	*37.2*
– Aluminium	23.0	36.3
– Copper	16.7	57.5
– Nickel	17.4	5.7
Other resources	*2.3*	*52.4*
– Coking coal[(a)]	5.5	104.0
– Steaming coal[(a)]	2.4	21.4
– Iron ore[(a)]	0.0	76.3
– Gold	17.1	36.9
Memo item:		
Oil in US$[(b)]	4.6	39.1

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

Graph 44

RBA Index of Commodity Prices

SDR, 1982/83 = 100, quarterly



Source: RBA

The base metals sub-index surged by 22 per cent over the past three months, reflecting sizeable price gains across all base metals, to reach its highest level since 1988. Base metals prices have doubled since mid 2003, boosted by strong demand from China and other emerging economies, supply disruptions and resulting low inventory levels. Growth in zinc prices was particularly strong over the three months to January, at more than 40 per cent. The price of copper rose further to reach a new record high (in nominal terms), partly reflecting a series of supply disruptions. The price of gold has also risen, reflecting both speculative activity and increased portfolio allocations to commodities, in addition to weak growth in global production.

Rural commodity prices rose by 4.3 per cent over the past three months, buoyed by higher prices for beef & veal and sugar. The price of beef has been supported by a pick-up in Japanese demand towards the end of last year, while good rainfall in Australia in the second half of 2005 has prompted herd rebuilding and restrained supply. The price of sugar has continued to rise strongly as sugar cane is increasingly devoted to ethanol production, while the EU's decision to curtail sugar subsidies has also boosted prices.

Looking ahead, contract price negotiations for coal and iron ore exports in 2006/07 have commenced. Early contract price settlements suggest that average coal contract prices will ease somewhat relative to 2005/06 prices, in line with softer spot prices for most types of coal. However, with the global market for iron ore tight, it appears likely that there will be further increases in iron ore contract prices following the 70 per cent jump seen in early 2005.

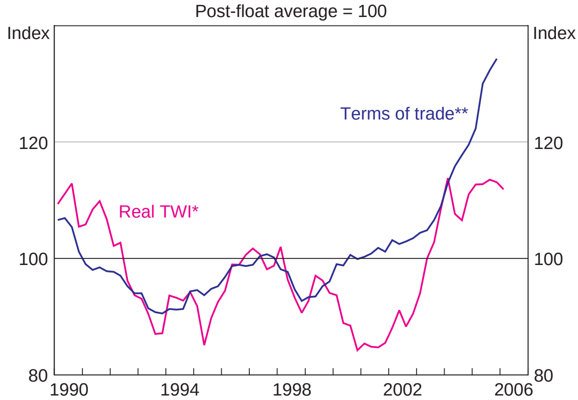
Broad-based rises in commodity prices, coupled with relatively modest growth in import prices, are estimated to have boosted the terms of trade in the December quarter, following a 1.8 per cent increase in the September quarter. The annual increase is estimated at around 12 per cent, taking the overall terms of trade to a level last seen in the commodity boom of 1974.

Real exchange rate

In real trade-weighted terms, the Australian dollar has been broadly steady over the past year, although it is still 12 per cent above its post-float average (Graph 45). At this level, the exchange rate is restraining activity in some trade-exposed sectors, particularly in the manufacturing sector. However, for the economy as a whole, the benefits from the increased terms of trade are likely to have more than offset the adverse effects of the high exchange rate.

Graph 45

Real Exchange Rate and Terms of Trade



* March quarter 2006 observation assumes that the nominal bilateral exchange rates on 8 February are maintained for the remainder of the quarter, and uses the latest core inflation rates.
** RBA estimate for December quarter 2005
Sources: ABS; RBA

Domestic Financial Markets and Conditions

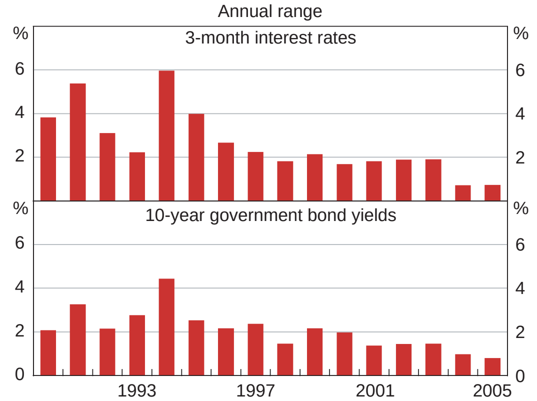
Interest rates and equity prices

Money and bond yields

Domestic interest rates have moved in a narrow range over the past 12 months or so. This reflects the relatively stable conditions that have characterised global interest rate markets during this period and, since early to mid 2005, market expectations that the Bank was unlikely to change the target cash rate in the near term. The range of movement in interest rates in 2005, at less than 1 percentage point for both short-term and long-term rates, was well below the averages for the past 15 years (Graph 46).

Graph 46

Australian Interest Rates

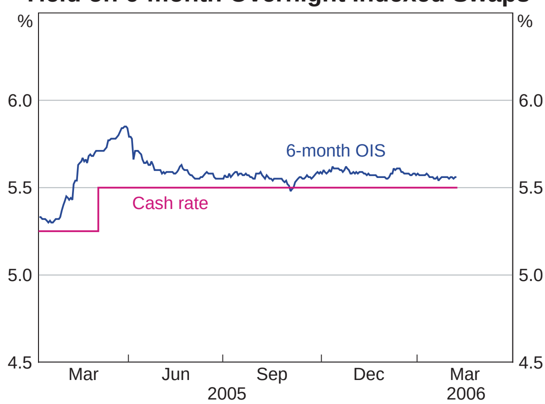


Sources: Bloomberg; RBA

Since the monetary tightening in March 2005, the cash rate has been held steady at 5.5 per cent, a level in line with the average rate over the past decade. Short-term market yields rose a little further following the tightening in March as investors looked for successive policy moves (Graph 47). But once these expectations were not realised, yields settled into a relatively narrow range, typically just above the cash rate target, suggesting that the market has seen little chance of a further rate rise. The only significant departure from this pattern came in August when there was a temporary dip in line with the sharp fall in US short-term yields associated with the Gulf of Mexico hurricanes.

Graph 47

Yield on 6-month Overnight Indexed Swaps



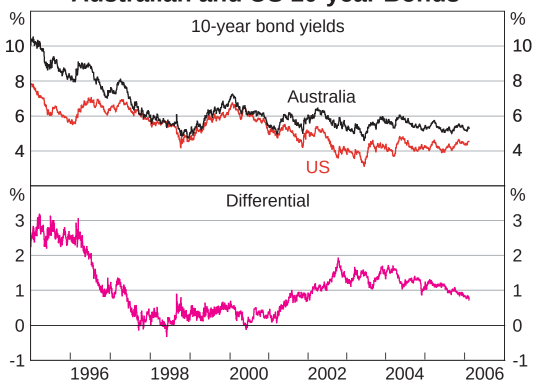
Source: Tullet Prebon (Australia) Pty Ltd

As noted above, the fluctuation in long-term interest rates over the past year or so has also been relatively small by historical standards. Bond yields rose in early 2005 and again in the second half of the year, on fears of a re-emergence of global inflation, but each of these proved transitory. Ten-year bond yields touched a high of 5.8 per cent in March 2005 and a low of 5.0 per cent in September but, at 5.3 per cent, are just a little lower than at the beginning of 2005.

For some years now, daily movements in Australian bond yields have been highly correlated with movements in US yields. That said, the small net fall in local bond yields over the past year or so has occurred against a background of a small net rise in US yields. In part, this reflected market expectations of some moderation in domestic growth. More importantly, however, it reflected the ongoing search for yield, with demand for higher-yielding Australian assets from overseas investors an important factor, especially during recent months. As a result, the spread between Australian and US 10-year yields has narrowed to around 75 basis points, its lowest level for four years (Graph 48).

Graph 48

Australian and US 10-year Bonds



Source: RBA

With short-term yields having risen in early 2005, and long-term yields tending to move lower from around that time, the domestic yield curve has been inverted for most of the subsequent period. Yields on all Commonwealth government securities are currently below the cash rate, with those on 10-year bonds some 20 basis points lower. An inverted yield curve normally arises when monetary policy is thought to be close to the end of a tightening cycle, as it implies future short-term interest rates are expected to be lower than current rates. But the excess of global savings in search for returns has pushed bond yields to exceptionally low levels around the world. As a result, it is difficult to infer market expectations for the stance of monetary policy from the current shape of the yield curve.

It should also be noted that the domestic yield curve, as measured by the spread between the cash rate and 10-year bond yields, has been negative on several occasions since the early 1990s without there having been a significant slowdown in the economy.

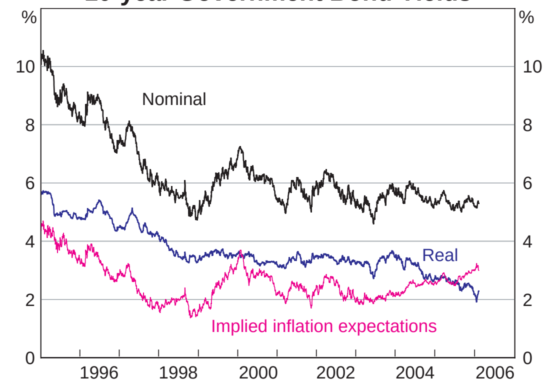
One development of particular note over the past year or so has been the fall in yields on inflation-indexed bonds. Yields on 10-year indexed bonds fell by 85 basis points from the beginning of 2005 to mid January 2006. This took them below 2 per cent, by far the lowest level since their introduction in the mid 80s and, as a result, the spread between 10-year nominal and real yields widened to 3.2 per cent, compared with around 2.7 per cent in the first half of 2005 (Graph 49). While this spread is usually seen as a measure of expected inflation, its recent increase is at odds with other measures of inflation expectations and reflected special factors, unrelated to inflationary pressures. As noted in the earlier chapter on international markets, regulatory changes abroad have encouraged life insurers and superannuation funds to acquire long-dated bonds as an asset class that better matches their liabilities. Other investors, such as hedge funds, are said to have recognised that this process is likely to continue for some time and have added to demand. These developments, against a background of a small, tightly-held domestic supply of indexed bonds, have seen their prices rise (yields fall) significantly. As a consequence, and despite having fallen a little in February, the current spread between yields on nominal and indexed government bonds overstates the market's expectations of inflation.

Spreads on corporate bonds – an indicator of financial market participants' perceptions of default risk – have generally drifted lower since mid 2004 and are now very low by historical standards. Similarly, premia on credit default swaps (which are financial derivatives that provide 'insurance' against defaults on corporate bonds) are at low levels (Graph 50).

Underpinning the market's sanguine view on corporate credit risk are the generally good prospects for these borrowers; globally in 2005, only around 2 per cent of issuers that were rated as sub-investment grade defaulted on their borrowings, well below average but around the same as in other periods of good economic performance over the past 20 years (Graph 51). Also putting downward pressure on corporate bond spreads has been the strong global investor demand for higher-yielding assets.

Graph 49

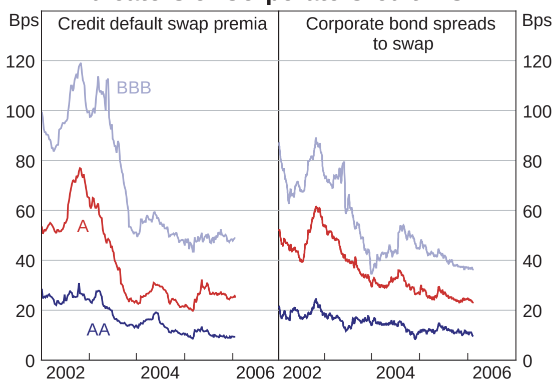
10-year Government Bond Yields



Source: RBA

Graph 50

Indicators of Corporate Credit Risk*

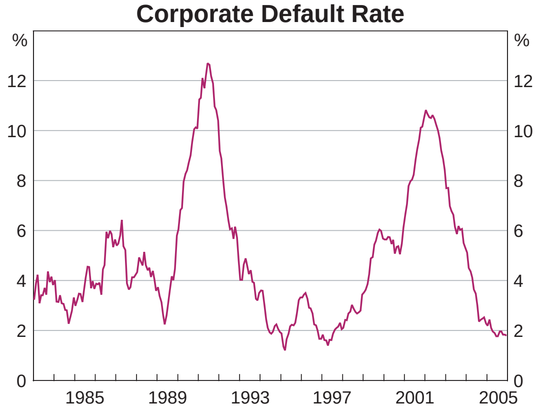


* Corporate bonds with 1–5 years maturity and 5-year credit default swaps

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

Graph 51

Moody's Global Speculative Grade Corporate Default Rate



Source: Moody's Monthly Default Report

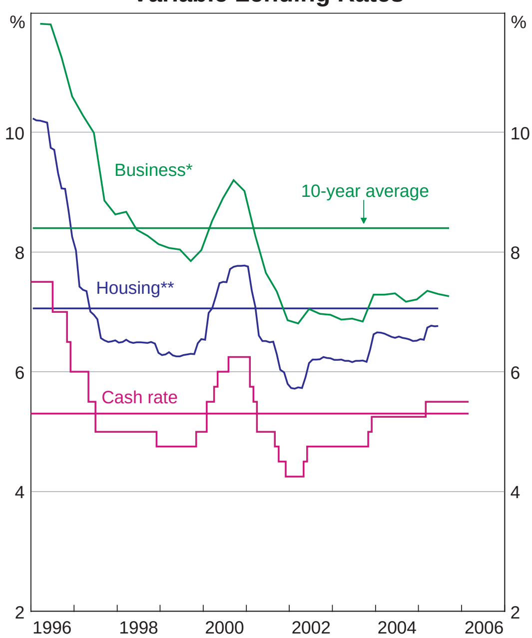
Intermediaries' interest rates

Most intermediaries' indicator rates on variable-rate housing loans have been unchanged since the cash rate target was last increased in March 2005. There have, however, been some small reductions in the indicator rates offered on variable-rate loans, mostly by non-bank mortgage originators, as demand for housing loans has remained well below earlier peaks.

Most of the recent competition in the housing loan market has manifested itself in increases in the size and availability of 'discounts' offered on indicator rates, rather than changes in indicator rates themselves. Over 90 per cent of borrowers taking out variable-rate housing loans in the first half of 2005 were charged an interest rate below the major banks' average standard variable indicator rate. Moreover, the average size of this discount has risen from around 40 basis points in early 2004 to 55 basis points in mid 2005, the latest period for which we have reliable data. While this increase in the average discount may partly reflect borrowers choosing cheaper loan products, it also reflects lenders easing the requirements for borrowers to access discounts and increasing the size of the discounts they offer.

Graph 52

Variable Lending Rates



* Weighted-average rate on banks' outstanding variable-rate business loans
** Weighted-average rate on new variable-rate housing loans; based on securitised loans
Sources: ABS; APRA; RBA

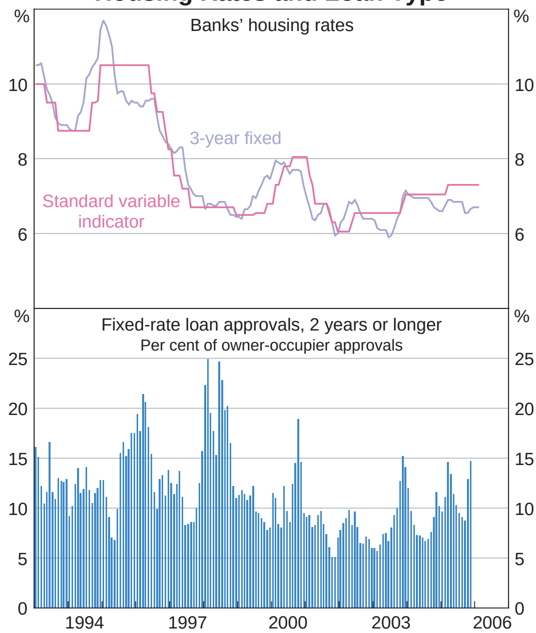
Reflecting the trend towards discounting, the average rate that borrowers paid on new variable-rate housing loans in mid 2005 was around 30 basis points below its decade average in both real and nominal terms (Graph 52).

Competition has also been evident in other parts of the household lending market, particularly credit cards. In the past few years there has been a proliferation of so-called 'no-frills' credit cards which have relatively low interest rates and annual membership fees, but generally no loyalty rewards programs. Interest rates on 'no-frills' cards range from 9 to 13 per cent compared with rates of 17 per cent or higher on most standard rewards-based cards. Competition has also seen some lenders offer significantly discounted introductory interest rates on balances transferred from other credit cards and on new purchases, in some cases as low as zero per cent for six months. These discounts represent considerable – but not indefinite – savings for cardholders with outstanding debts.

With the moderation in lending to households over the past couple of years, banks have also been competing more for business loans. While indicator rates on variable-rate business loans have mostly been unchanged since last March, the overall rate being paid on these loans after incorporating risk margins and discounts has declined by 10–15 basis points. In both real and nominal terms, the overall business loan rate has been below its decade average for several years (Graph 52). The recent decrease in spreads on business loans is consistent with other signs of competitive pressure in the business loan market, including fee discounting and indications that banks have eased their loan approval standards, particularly for larger loans.

Graph 53

Housing Rates and Loan Type



Sources: ABS; RBA

With respect to fixed-rate loans, the major banks' average 3-year fixed rate on housing loans (the most popular term for fixed-rate loans) is currently 6.70 per cent (Graph 53). This is around its level at the beginning of 2005 and close to the average rate that new borrowers would pay on these banks' variable-rate housing loans, given the tendency for the latter to be discounted.

Overall, demand for fixed-rate housing loans remains fairly low in Australia, with only around 10 per cent of new owner-occupier loans taken out at fixed rates on average, though this share does tend to cycle (Graph 53). Demand was relatively strong ahead of the monetary policy tightening in early March 2005, then moderated over the middle half of the year before picking up again, to around 15 per cent in November, the latest month for which we have data. The recent strengthening in demand is likely to reflect the reductions in interest rates on these loans that occurred around September, which have since been partially reversed.

Small business fixed rates, which tend to follow movements in wholesale market rates more closely than do fixed housing rates, are also little changed in net terms since early 2005. For small business loans, the share of outstanding loans at fixed rates has been largely unchanged for the past few years, at around 30 per cent.

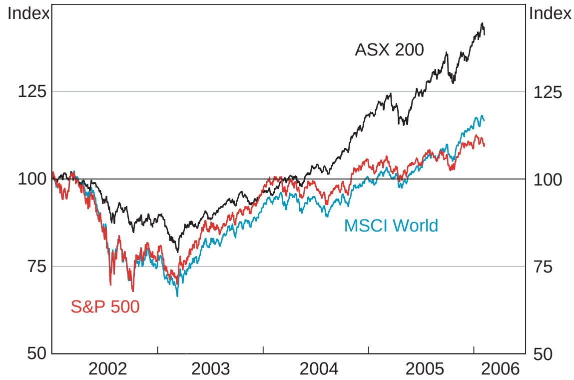
Equity prices

The ASX 200 rose by 18 per cent over the course of 2005, following increases of 23 per cent in 2004 and 10 per cent in 2003. This cumulative increase is the biggest rise over a three-year period for 12 years. Since the previous *Statement*, the share market has risen 8 per cent, continuing to reach record high levels (Graph 54).

Graph 54

Share Price Indices

End December 2001 = 100

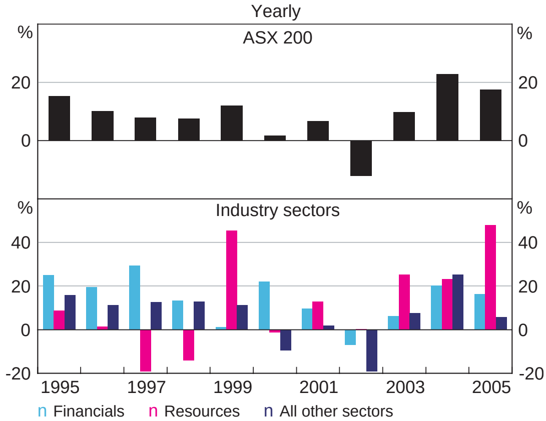


Sources: Bloomberg; Thomson Financial

Graph 55

Australian Equity Returns

Yearly

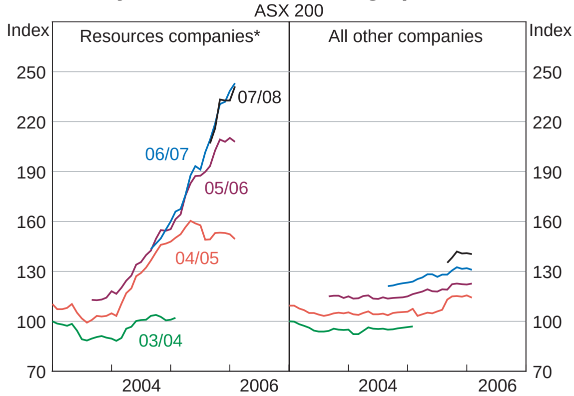


Sources: RBA; Thomson Financial

Graph 56

Analysts' Forecast Earnings per Share

ASX 200



* Comprises all companies in the energy and materials sectors

Sources: RBA; Thomson Financial

An important factor contributing to the high returns of the past few years has been the large increases in resources companies' share prices, which increased by around 50 per cent in 2005 after increasing by over 20 per cent in each of the previous two years (Graph 55). Share prices in most other sectors also increased noticeably in 2005, with the exception of consumer discretionary and telecommunications companies.

Underpinning the strength in resources companies' share prices over the past few years has been continuous upward revisions of the forecast earnings for these companies (Graph 56). Expected earnings per share for companies in the energy and materials sectors for the 2005/06 financial year have now been revised upwards by around 85 per cent from analysts' initial estimates made in the latter part of 2003. Earnings estimates for subsequent years have also been strongly revised upwards, with these companies' earnings per share in 2006/07 now expected to be around 70 per cent higher than initially forecast. In contrast, there has been little revision to analysts' estimates of other companies' earnings: the expected earnings growth in each financial year has been fairly steady at around 7 per cent.

There has been little change in aggregate measures of the valuation of the Australian market: while the price/earnings (P/E) ratio based on actual earnings has risen since the previous *Statement*, it currently stands at 18, which is only a little above its 50-year average. Australian dividend yields have fallen slightly, to 3.6 per cent, which is a little above the historical average (Graph 57). These measures indicate that the rise in share prices has been underpinned by the rise in profits. While, as always, future profits cannot be predicted with certainty, the outlook for the domestic and global economic environment appears to be very favourable for corporations.

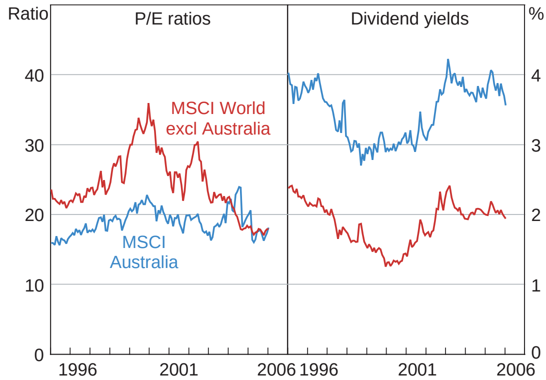
Financing activity

Intermediated financing

Total credit growth over the course of 2005 was 13½ per cent, around the same as growth in the previous year (Graph 58). The 12-month ended growth rate for household credit fell from around 17 per cent at the end of 2004 to 12 per cent in December – below its average of the past 10 years. The slowdown was particularly marked for investor housing credit growth. Growth in owner-occupier housing credit and personal credit both finished the year somewhat below their averages for the past 10 years. However, these slowing trends looked to be levelling out by the December quarter (Table 10). One issue here is that lenders have become more aggressive in marketing loans with increased discounting of interest rates and lowering of credit standards.

Graph 57

P/E Ratios and Dividend Yields

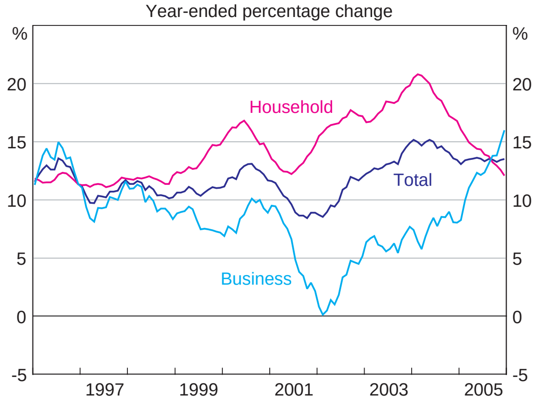


Sources: RBA; Thomson Financial

Graph 58

Credit Growth*

Year-ended percentage change



* Includes securitised loans
Source: RBA

One component of personal credit that continued to record strong growth throughout 2005 is margin lending for the purchase of shares and managed funds. Outstanding margin debt, which accounts for around 16 per cent of personal credit, rose by more than 30 per cent over the course of 2005 (Graph 59). Two-thirds of this growth was due to growth in the average loan size, with the remainder due to an increase in the number of borrowers. Despite the strong growth in margin debt, indicators of the riskiness of borrowers' margin loan positions, such as average gearing levels and the percentage of credit limits being used, are fairly conservative by historical standards.

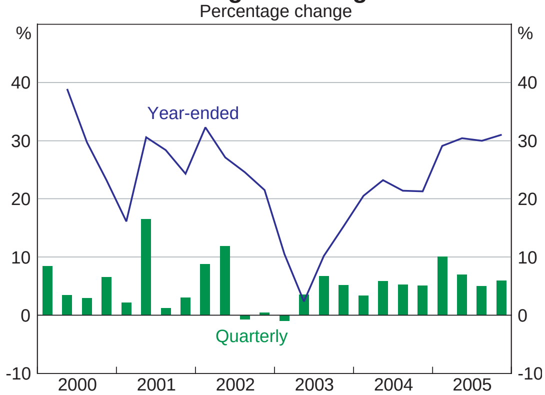
Table 10: Financial Aggregates
Percentage change

	Average monthly growth		
	September quarter 2005	December quarter 2005	Year-ended December 2005
Total credit	0.9	1.1	13.5
Household	0.8	0.9	12.1
– Housing	0.7	0.9	12.3
– Personal	0.8	0.7	10.7
Business	1.0	1.3	16.0
Broad money	0.5	0.5	9.1

Source: RBA

Graph 59

Margin Lending
Percentage change



Source: RBA

Business credit growth picked up strongly in 2005, with 12-month ended growth rising from around 8 per cent at the end of 2004 to stand at 16 per cent in December. Strong business credit growth was supported by strong investment spending, as well as a competitive lending market and interest rates remaining below their historical average.

Data on banks' business lending by size of facility suggests that growth in borrowing by large businesses has tended to outpace that of small businesses for the past couple of years. This is consistent with the strength seen in the syndicated loan market: in 2005, a record $70 billion of syndicated loans were approved, 14 per cent higher than in the previous year, even though the average loan size fell slightly, to $520 million.

Non-intermediated financing

Total issuance of bonds by Australian non-government entities amounted to $157 billion in 2005, the same as in the year before (Table 11). Increased issuance in the domestic market was offset by reduced issuance offshore. The domestic bond market was further boosted by issuance by non-resident entities, including quasi-government entities who have been taking advantage of the decline in issuance by the Commonwealth Government in recent years to satisfy demand for high-quality fixed-interest bonds. On the other hand, offshore Australian dollar issuance by non-resident entities fell during the year, in part because of a switch in Japanese retail demand away from Australian dollar denominated debt to higher-yielding New Zealand dollar debt.

A pick-up in maturities meant net bond issuance by Australian non-government entities was a little weaker than in the previous year. Nonetheless, total outstandings of non-government

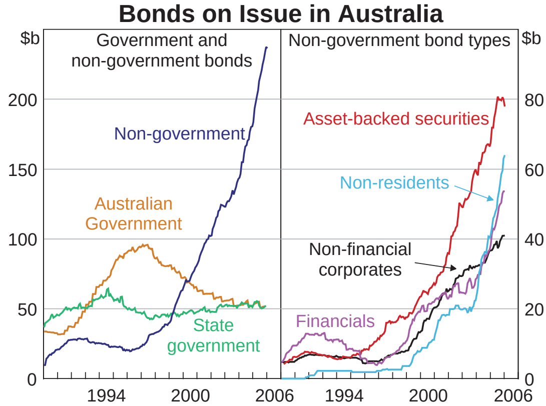
Table 11: Non-government Bond Issuance by Sector $ billion					
Sector	2002	2003	2004	2005	
					of which December quarter
Bond issues by Australian entities					
Onshore					
Financial institutions	7.4	9.9	14.3	20.9	4.1
Non-financial corporates	7.6	5.6	8.0	9.2	2.0
Asset-backed	19.5	20.6	25.0	32.2	5.4
Total	*34.5*	*36.1*	*47.3*	*62.4*	*11.5*
Offshore					
Financial institutions	32.2	51.0	64.7	52.0	8.7
Non-financial corporates	10.5	15.2	13.8	16.5	4.2
Asset-backed	16.6	24.3	29.8	25.6	3.7
Total	*59.4*	*90.5*	*108.2*	*94.2*	*16.6*
Total	93.9	126.6	155.5	156.6	28.0
A$ bond issues by non-resident entities					
Onshore	3.1	7.1	21.3	26.2	7.8
Offshore	18.7	24.8	21.5	11.9	1.5
Total	21.8	31.9	42.9	38.1	9.3

Source: RBA

bonds in the domestic market again grew strongly, to stand at $237 billion at year end, compared with just over $50 billion each of Commonwealth and State government bonds (Graph 60). Non-government bonds presently account for 70 per cent of domestic bond outstandings, compared with only 13 per cent a decade ago.

Graph 60

Bonds on Issue in Australia

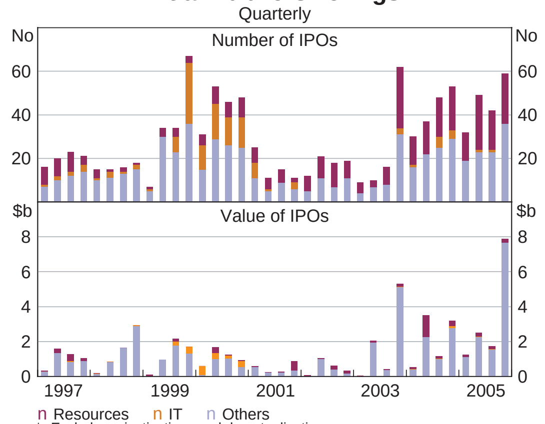


Sources: ABS; RBA

Net issuance of equity by Australian-listed companies amounted to $23 billion in 2005, up slightly from 2004. (This compares with net bond issuance by Australian entities – here and abroad – of triple this amount.) IPO activity was well above average in 2005, especially in the December quarter, when there were several very large raisings (Graph 61). IPO activity in general has been supported by buoyant equity markets, though other equity raisings were weak and buybacks were stronger than usual.

Graph 61

Initial Public Offerings*

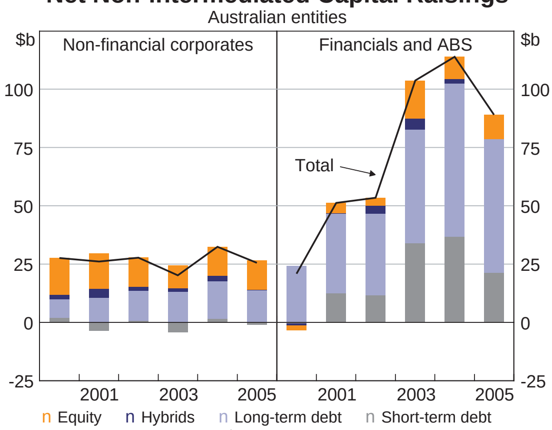


* Excludes privatisations and demutualisations

Sources: ASX; RBA

Graph 62

Net Non-intermediated Capital Raisings



Sources: APRA; ASX; Austraclear; RBA

The strength in commodity prices and the resources sector over the past few years has seen strong IPO activity for companies in this sector. By number, around 40 per cent of new listings since the December quarter of 2003 have been resources companies. By value, however, these companies' raisings have been very small in comparison to overall raisings, with individual resources companies' raisings averaging only $15 million.

While net bond and equity raisings in 2005 were much the same as in 2004, short-term debt raisings fell. As a result, total non-intermediated capital raisings by the Australian non-government sector fell in 2005. For non-financial companies, total net capital raisings were only a little weaker than in 2004, at around $25 billion (Graph 62). This small reduction in net capital raisings by non-financial corporates reflected a pick-up in intermediated funding (with banks more willing to lend to businesses as demand for housing loans moderated) and high levels of profitability. As noted in the chapter on 'Domestic Economic Conditions', these firms continue to have ample ability to fund investment without heavy reliance on capital markets.

Inflation Trends and Prospects

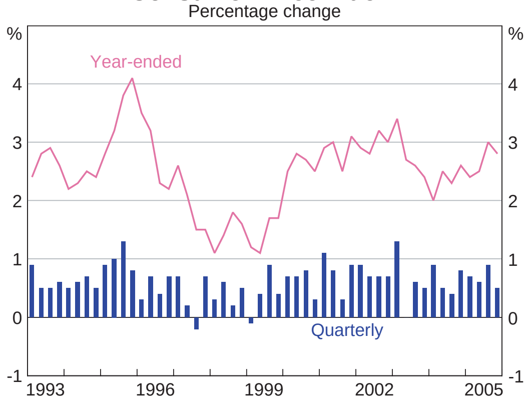
Recent developments in inflation

The Consumer Price Index (CPI) rose by 0.5 per cent in the December quarter, to be 2.8 per cent higher over the year (Graph 63, Table 12). The annual rate has recently been boosted by petrol prices, which were up by around 15 per cent over the year. Based on a range of measures, including statistical measures which downweight (but do not exclude) the impact of large rises and falls in particular items, the Bank's assessment is that underlying inflation was around 2½ per cent over the year to the December quarter.

Graph 63

Consumer Price Index*

Percentage change



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

Sources: ABS; RBA

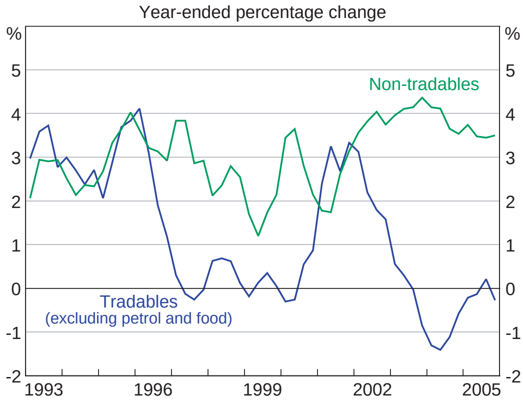
Table 12: Measures of Consumer Prices

Percentage change

	Quarterly		Year-ended	
	September quarter 2005	December quarter 2005	September quarter 2005	December quarter 2005
CPI	0.9	0.5	3.0	2.8
– Tradables	1.2	0.0	2.6	2.0
– Tradables (ex food and petrol)	0.1	–0.5	0.2	–0.3
– Non-tradables	0.8	0.8	3.4	3.5
Underlying measures				
Weighted median[(a)]	0.6	0.7	2.5	2.6
Trimmed mean[(a)]	0.6	0.5	2.6	2.3
CPI ex volatiles[(b)]	0.6	0.4	2.4	2.3

(a) Based on the distribution of seasonally adjusted quarterly price changes.
(b) Volatile items are fruit, vegetables and petrol.
Sources: ABS; RBA

Graph 64
Tradables and Non-tradables Prices*



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

Sources: ABS; RBA

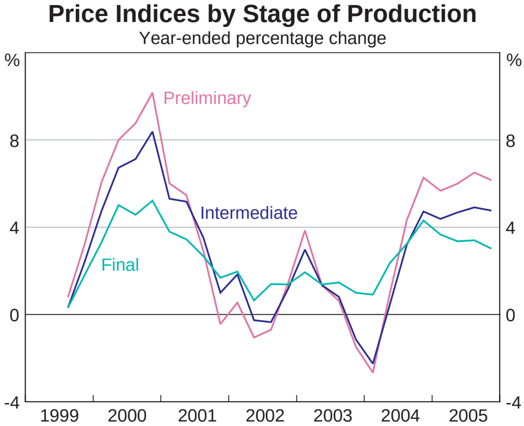
Increases in the prices of food and deposit & loan facilities made the most significant contributions to CPI inflation in the December quarter, while falls in the prices of audio, visual & computing equipment, pharmaceuticals and motor vehicles partly offset these rises. In contrast to previous quarterly outcomes, there was little direct effect from petrol prices in the December quarter.

Inflation continues to be driven by the non-tradables component of the CPI (Graph 64). Non-tradables prices rose by 0.8 per cent in the quarter and, in year-ended terms, inflation in non-tradables prices remained around 3½ per cent.

Producer prices

Producer price data suggest that upstream inflation pressures remained firm and fairly widespread over the year to the December quarter (Graph 65, Table 13). Although rates of price growth at all stages of production were lower than those recorded in the September quarter, they were still relatively strong.

Graph 65
Price Indices by Stage of Production



Source: ABS

By industry, building construction costs continued to make the largest contribution to the quarterly rise in prices at the final stage of production, followed by various food and agricultural products. Strong raw materials prices, reflecting healthy world demand, made the largest contribution to growth at the preliminary and intermediate stages of production. Property and business services also contributed significantly to producer prices at these stages. As with the CPI, oil prices have boosted the annual rate of producer price inflation, although there was little effect from oil prices in the December quarter.

Labour costs

Recent data show that wages are continuing to grow at a rate above the average of recent years, which is consistent with other indications of tight labour market conditions and shortages of suitable labour. However, the recent information does not suggest any acceleration from the rate of wages growth recorded in the first half of 2005. The wage price index (WPI) grew by 1.0 per cent in the September quarter, broadly similar to the pace seen in the two previous quarters, to be 4.2 per cent higher over the year (Graph 66). The average annualised wage increase (AAWI) for federal enterprise agreements certified in the September quarter rose to 4.1 per cent from 4.0 per cent in the June quarter. Measures of average earnings are much more volatile, but on balance these also suggest that wage pressures remain strong (see 'Box D: Measures of Labour Costs' for discussion of these measures and their interpretation).

More recently, the NAB survey suggests that growth in actual labour costs in the December quarter was broadly similar to its September quarter pace. While liaison indicates that wage pressures are most pronounced in industries facing strong demand, such as non-residential construction and mining, they are becoming more broadly based. Employees in a growing number of occupations have been granted wage rises to maintain relativities, for example, to match increases granted to similar workers in other states.

Although there has been some easing in the ABS measure of vacancies, labour market conditions remain relatively tight. According to the NAB survey, firms reported that the difficulty in finding suitable labour increased in the December quarter, to be close to its recent peak. The survey reports that labour scarcity has for the past year been a greater constraint on business

Table 13: Output Prices at Different Stages of Production

Percentage change

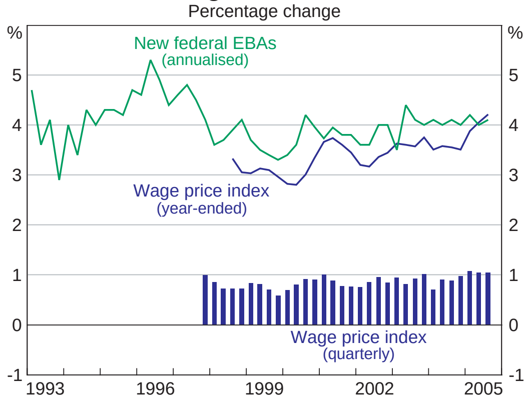
	December quarter 2005	Year to December quarter 2005
Preliminary	**1.1**	**6.2**
– Domestically produced	1.1	5.5
– Imported	1.4	10.3
– Excluding oil	1.1	4.3
Intermediate	**1.0**	**4.8**
– Domestically produced	1.0	4.5
– Imported	1.1	6.0
– Excluding oil	1.0	3.6
Final[(a)]	**0.8**	**3.0**
– Domestically produced	0.9	3.8
– Imported	0.1	–1.1
– Excluding oil	0.9	2.6

(a) Excluding exports

Source: ABS

Graph 66
Wage Indicators

Percentage change

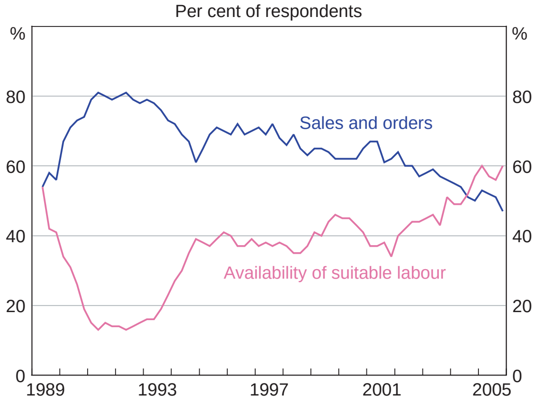


Sources: ABS; DEWR

Graph 67

Factors Constraining Output

Per cent of respondents



Source: NAB

activity than the more traditional concerns about lack of demand (Graph 67). The Bank's liaison program has indicated that firms are using a variety of strategies to attract and retain employees, many of which add to labour costs. These include increased frequency of salary reviews and promotion, as well as enhanced non-wage remuneration (such as bonus payments and leave provisions) that is not recorded in some of the standard wage measures.

Inflation expectations

Business surveys suggest that both near-term inflationary pressures and expectations of future price growth remain contained. According to the ACCI-Westpac survey, the net balance of manufacturing firms expecting to raise their prices picked up a little in the December quarter. The Dun & Bradstreet survey reported a similar small rise, with the net balance marginally above its long-run average. The NAB survey measure of expected inflation in final product prices has been broadly steady in recent quarters.

Forecasts of market economists, surveyed by the Bank following the release of the December quarter CPI, show that they expect headline inflation to remain around recent levels through 2006, before declining modestly in 2007. The median expectation for inflation over the year to December 2006 was slightly higher than the previous survey, at 2.8 per cent, while the median expectation for the year to December 2007 was for a decline to 2.6 per cent (Table 14). Union officials expect inflation to be 3.0 per cent for the year to December quarter 2006 and to remain at this level over 2007.

Table 14: Median Inflation Expectations

Per cent

	Year to December 2006			Year to December 2007
	August 2005	November 2005	February 2006	February 2006
Market economists[(a)]	2.6	2.6	2.8	2.6
Union officials[(b)]	3.0	3.5	3.0	3.0

(a) RBA survey
(b) ACIRRT survey

The median inflation expectation of consumers, as reported in the Melbourne Institute survey, was 5.0 per cent in February. While this is slightly below its peak in the second half of 2005, it is somewhat above its long-run average. The implied medium-term inflation expectations of financial market participants, which are calculated as the difference between nominal and indexed bond yields, have also edged higher since the previous *Statement*, to around 3 per cent in early February. However, it appears that this in part reflects tight supply, as well as increasing demand for indexed bonds that is unrelated to expectations about inflation (see the chapter on 'Domestic Financial Markets and Conditions').

Inflation outlook

Based on the December quarter CPI data, underlying inflation appears to have remained fairly constant through 2005, as opposed to earlier expectations that it would gradually increase. It appears that the combination of the slowing in domestic demand and greater pricing discipline from international competition have so far reduced or offset the pass-through of higher unit labour costs into CPI inflation. Furthermore, although the rise in oil prices has resulted in price increases and surcharges for some specific goods and services, it has not so far fed through into more generalised inflation. This recent experience has been mirrored in some other countries. Despite the pick-up in prices of oil and other commodities, core inflation rates have remained well-behaved in most industrial countries.

It remains to be seen if the benign recent outcomes will continue or whether the impact of cost pressures on inflation has merely been delayed. For the moment, the Bank continues to expect underlying inflation to pick up modestly over the coming year, though not by as much as was earlier forecast. The forecast for inflation is based on the assumption that oil prices remain around recent levels of US$65 per barrel. It envisages GDP growth of 3 per cent or a little more over the forecast period and a slowing in the growth of domestic expenditure towards that of production. Underlying inflation is expected to remain in the 2½–3 per cent range over the forecast period, with our central forecast being that underlying inflation will increase to 2¾ per cent in the second half of 2006 and remain around this level through 2007. Headline CPI inflation is expected to remain at around 3 per cent for the next few quarters, and then to converge with underlying inflation from around the end of 2006.

The forecast pick-up in underlying inflation largely reflects our forecast for the profile of growth in wages and unit labour costs. Survey data and liaison continue to indicate firm labour demand and pervasive shortages of skilled labour. Accordingly, the current strength in wage growth is expected to persist for some time and is forecast to feed through into consumer prices to a greater extent than has been seen recently. However, the central forecast incorporates an expectation that any additional pressures from labour costs on consumer price inflation will be quite modest, based largely on indications that profit margins remain healthy, which should permit firms to continue to absorb some additional labour cost pressures during the forecast period. But if demand were to be stronger than envisaged, it is likely that there would be less margin compression and stronger inflation than in the central forecast.

Increases in the prices of administered items such as health, education and utilities are likely to continue to contribute significantly to domestic inflation. By contrast, the forecasts do not include any significant indirect effects from higher fuel prices, nor any additional increases in world oil prices. As discussed in the previous *Statement*, the effects of oil prices on inflation do not appear to be as pronounced as they were in the past. In addition, any effects from oil prices are being offset by another international factor, namely the higher degree of international competition, most notably from China and other emerging economies. The integration of low-cost producers into the world economy seems to have a long way to run, and this is likely to continue to help contain domestic inflation.

Box D: Measures of Labour Costs

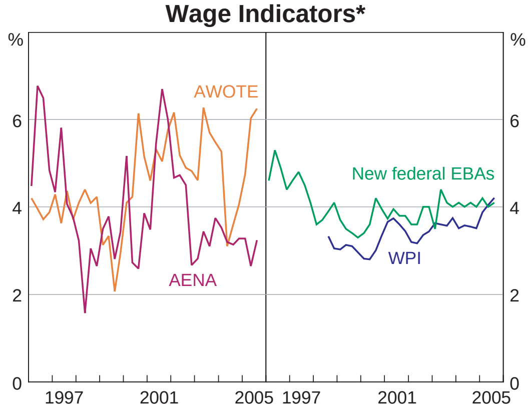
Information about labour costs is important for assessing inflation trends and prospects. In Australia, there are a number of alternative measures that help to summarise economy-wide developments in labour costs. Four that are commonly cited are average weekly ordinary-time earnings (AWOTE), average earnings from the national accounts (AENA), the wage price index (WPI), and wage increases in enterprise bargaining agreements (EBAs). Each measure captures a slightly different aspect of labour costs and so can give a different signal about wage growth at any given time (Graph D1). This box discusses these measures of labour costs and the indications they are currently giving about inflationary pressures.

Both AWOTE and AENA are measures of the average wage bill. That is, they are designed to measure the average *level* of labour costs per employee. AWOTE measures the ordinary-time average weekly earnings of non-farm wage and salary earners who work full time. AENA, which is based on a different survey, also includes part-time workers, along with non-wage costs (such as bonuses, superannuation, workers' compensation and redundancy payments) and irregular wage payments. However, both of these measures can be affected by changes in the composition of labour that firms use. Importantly, these measures are also sensitive to changes in the sample of respondent firms and sometimes give volatile and divergent pictures of growth in labour costs.

In contrast, the WPI and EBAs provide measures of *changes* in wage rates. The WPI is designed to measure changes in the cost of employing a constant quantity and quality of labour. The hourly wage rate for a given job is compared with the wage rate for that same job in the previous quarter, with an attempt made to exclude wage changes resulting from changes in the nature of work performed, hours worked and the characteristics of the job occupant (such as age or experience). The WPI is then constructed as the average change in the adjusted wage rates for a fixed basket of jobs. By design, it is not affected by compositional change and so is unaffected by many of the sampling issues that cloud interpretation of growth in other measures. But being narrower in scope, the WPI may exclude wage movements stemming from a range of cyclical influences, such as increased rates of promotion in a tight labour market. Furthermore, on average, it would be expected to grow more slowly than a wage bill measure, given that there is a longer-term increase in the share of higher-skilled occupations.

Graph D1

Wage Indicators*



* New federal EBAs are average annualised wage increase; others are year-ended percentage change

Sources: ABS; DEWR

Changes in wage rates can also be identified for that group of employees whose wages are governed by EBAs. Most often cited is the average annualised wage increase in all new certified federal agreements. It is calculated over the life of an agreement, and excludes bonuses and most non-wage payments. Although the population of new agreements is entirely different each quarter, the limited variation in outcomes of enterprise agreements within industries reduces the effects of compositional change. Consequently, the EBA series is less volatile than wage bill measures.

The various measures of labour costs each serve different purposes. When assessing inflationary pressures from labour costs, the most relevant concept is unit labour costs (ULCs) – that is, total labour costs (or the wage bill) per unit of output produced.[1] In principle, the wage bill component of ULCs is most fully captured by AENA because it has the broadest coverage of labour costs and its construction is consistent with the output measure used. However, in practice, the volatility of AENA, together with volatility in data for productivity, results in fairly noisy estimates of changes in ULCs. Accordingly, an assessment of inflationary pressures still requires consideration of the full range of wage measures, paying attention to their conceptual differences. On one hand, the WPI and EBAs are subject to less volatility than measures of the wage bill, and are likely to be more helpful in gauging short-term wage movements. On the other hand, the wage bill measures include elements of labour costs that are important for gauging inflationary pressures over longer horizons.

The short-term volatility in the wage bill measures is particularly evident in the data for the year to the September quarter. One simple way of reducing this volatility is to look at the average of growth in the two wage bill measures. Table D1 summarises the range of wage indicators over the year and compares them with their trend growth rates since the September quarter 1997 (the period for which the WPI is available). The composite wage bill measure would suggest that wage inflation was running above its longer-term trend rate (4.8 per cent versus 4.2 per cent). Growth in the WPI was also running above its longer-term trend rate by a broadly similar margin, while growth in EBAs was only slightly above its average. On balance, therefore, the various wage measures are running somewhat above their average rates for the past eight years, which would suggest that labour cost pressures may be adding to inflation.

Table D1: Growth in Labour Costs

Per cent

	Average annualised September qtrs 1997–2005	Year to September qtr 2005
WPI	3.5	4.2
EBAs	3.9	4.1
AWOTE	4.7	6.3
AENA[(a)]	3.6	3.2
Average of wage bill measures	*4.2*	*4.8*

(a) Measured in per hour terms

Sources: ABS; RBA

1 *Or, equivalently, growth in the average wage bill minus growth in labour productivity.*