Statement on Monetary Policy

The recovery in the global economy is continuing, although conditions clearly differ across regions. Growth remains solid in most of Asia, although below the rapid pace seen earlier this year. Strong growth is also continuing in parts of Latin America. In contrast, in many of the advanced economies, consumption remains subdued and the earlier boost to activity from the dynamics of the inventory cycle is waning, as are the effects of the earlier fiscal expansions.

In China and in most of east Asia, growth looks to have returned to a sustainable pace and concerns about the possibility of a larger-than-expected slowing have lessened recently. Growth also remains strong in India. In many countries in the region, the authorities have begun the process of tightening policy, although real interest rates remain low. In several countries, housing markets have been strong over the past year, which has prompted a tightening of prudential requirements and other measures to cool these markets. Inflation in the region has also increased, although this largely reflects a rise in food prices. In a number of countries, policy-makers remain concerned about the possibility of a pick-up in short-term capital inflow given the likelihood that interest rates in the advanced economies will remain low for an extended period.

The Bank's central forecast for the world economy continues to be for around trend growth over the next couple of years. In the period immediately ahead, the risks in some of the advanced economies look tilted to the downside as they grapple with necessary adjustments in household and public-sector balance sheets and, in some cases, continuing difficulties in the financial system. Inflation in a number of these countries continues to move lower and unemployment rates remain high. In the United States, this has prompted the Federal Reserve to announce a further significant expansion of its balance sheet. In Asia, the risks to growth look more balanced, particularly given that financial conditions in many countries in the region remain very accommodative.

Compared with the middle of this year, risk aversion in global markets has declined somewhat, although sentiment remains fragile, with concerns about the situation in a number of smaller European countries remaining elevated. The general improvement in conditions has been partly due to the anticipation of the Federal Reserve's decision to expand its balance sheet, which has contributed to longer-term government bond yields falling to around historical lows. In turn, low government bond yields have contributed to an increase in demand for other assets. Over recent months, equity prices have recovered to be only a little below their mid-April peaks, and conditions in money markets have improved further. Credit spreads have also generally narrowed since the August *Statement,* with corporate borrowing costs in capital markets at historic lows. As a result, bond issuance has picked up, although growth in bank lending remains weak in many countries.

In currency markets, the prospect and then the announcement of further quantitative easing in the United States has seen the US dollar depreciate against most currencies. In response, some countries have intervened in their foreign exchange markets or tightened capital controls in an effort to slow the appreciation of their currencies and restrain short-term capital inflows. In trade-weighted terms, the Australian dollar has appreciated by around 6 per cent since the August *Statement* to a post-float high.

Conditions in the domestic economy continue to evolve broadly in line with the Bank's central scenario and are consistent with recent growth being at around trend pace. There is evidence that private demand is strengthening, offsetting the scaling back in public investment as stimulus projects are completed.

The economy is continuing to benefit from the high level of commodity prices, with nominal income growing very strongly over the past year. The prices of many commodities have increased further recently and Australia's terms of trade are estimated to have reached around the highest level since at least Federation. While the terms of trade are expected to decline over the medium term, the recent strength in both resources and agricultural prices has led to an upward revision to the Bank's forecasts for the terms of trade over the next couple of years.

The high level of commodity prices continues to underpin a positive outlook for aggregate investment. Survey-based measures of business conditions and confidence remain at or above average levels, indicators of investment intentions in the resources sector are very strong, and the pipeline of work to be done is large. Notwithstanding this, determining the exact timing of the pick-up in investment remains difficult, especially given the uncertainty around the timing of some very large projects. One area of business investment that has yet to show signs of recovery is non-residential construction, with building activity remaining low relative to the likely medium-term growth in demand for commercial buildings. For some developers, access to finance remains a significant constraint, although, more broadly, financial conditions for businesses have eased somewhat from the tight conditions that applied in late 2008 and early 2009. Business credit outstanding has, however, declined over recent months, after having been largely unchanged over the first half of the year. This partly reflects a lower need for intermediated funding, with strong profit growth leading to a significant increase in businesses' internal funding, and some firms accessing global capital markets rather than borrowing from banks in Australia.

Consumer confidence has been at high levels over recent months, with consumer surveys reporting that it is a good time to buy major household items. Despite this, the Bank's liaison continues to suggest that consumers are cautious in their spending. The appetite for new debt also remains more subdued than in the past, with both housing and credit card debt currently growing at historically low rates. This has been associated with a welcome cooling in the housing market, with dwelling prices declining slightly over recent months, after increasing solidly over the year to the March quarter.

The labour market has been strong over the past year, with the unemployment rate declining to just over 5 per cent, down by around ¾ percentage point from its peak in mid 2009. The forward-looking indicators point to a continuation of solid employment growth, although below the pace seen over the recent past. Despite a high level of vacancies and the relatively low unemployment rate, firms in most industries are not reporting unusual difficulties in hiring suitable labour. The main exceptions are in some mining-related occupations, where the labour market is quite tight.

Measures of wage growth have risen in 2010, after the subdued outcomes in 2009. Despite this pick-up, wage growth in the private sector was slightly below average over the first half of 2010, while in the public sector, wages have continued to grow at a slightly above-average pace. Looking forward, a further increase in wage growth is expected over time, as the labour market tightens further.

While the overall economy is currently growing at around its trend rate, conditions differ across sectors. A number of industries are benefiting directly from the expansion of the resources sector and others are benefiting indirectly from the increase in national income arising from higher commodity prices. The accompanying appreciation of the exchange rate is, however, dampening prospects in other sectors. In the tourism industry, for example, there has been a sharp increase in the number of Australians travelling abroad rather than taking holidays domestically and overseas visitor arrivals have been soft. These differences across industries and regions are not unexpected in an economy that is being affected by large changes in relative prices.

Over the past two years, inflation has moderated significantly. In underlying terms, inflation has returned to the middle of the 2–3 per cent medium-term target band, after having been above the target in recent years as a result of the build-up in pressure associated with the strong domestic economy prior to the global downturn. In the September quarter, the CPI increased by 0.7 per cent, to be 2.8 per cent higher over the year. This outcome was slightly lower than expected, partly reflecting movements in the prices of some volatile items. One factor that has, however, boosted the CPI over the past couple of quarters has been the increase in the tobacco excise earlier in the year. Utilities price inflation has also been high, although in year-ended terms it is likely to have peaked.

The Bank's central forecast for the economy is broadly unchanged from six months ago. GDP is expected to expand by 3½ per cent over 2010 and then by 3¾–4 per cent over both 2011 and 2012. This forecast continues to be driven by the effects of the income boost flowing from the very high level of the terms of the trade and the expected substantial increase in business investment, particularly in the resources sector. While public demand is forecast to contract over the coming year as stimulus-related projects are completed, this is expected to be offset by a pick-up in private demand. This central scenario for the economy continues to assume that more of the boost to national income from the terms of trade is saved than was the case in the earlier phase of the boom a few years ago.

The near-term forecast for year-ended inflation has been lowered, partly reflecting the recent appreciation of the exchange rate. However, the medium-term outlook for inflation is largely unchanged. In underlying terms, inflation is expected to remain around 2½ per cent until mid next year, before gradually rising to 3 per cent by the end of 2012. Over this period, the economy is likely to start pushing up against supply-side constraints, given the relatively limited amount of spare capacity that currently exists. Year-ended headline inflation is forecast to remain above underlying inflation in the near term, largely due to the effect of the increase in the tobacco excise.

As usual, these forecasts are subject to a range of uncertainties. One is the scale and timing of the expected pick-up in private investment. A number of the proposed projects are very large and a change to their timing could affect the profile for investment over the next few years. Another factor that will influence how the economy evolves is the degree to which the recent change to households' attitudes to debt and spending persists. A further factor is the exchange rate. To date, the appreciation appears broadly consistent with increases in commodity prices and interest rate differentials, and the exchange rate is playing a stabilising role for the economy as a whole. However, in the current international environment it is possible that the exchange rate appreciates further for reasons unrelated to these factors. If this were to occur, both growth and inflation would likely be lower than in the central scenario. There are also the continuing uncertainties emanating from the global economy discussed above.

From June to October, the Board kept the cash rate steady at 4.5 per cent, after having moved over the previous eight months to withdraw the considerable monetary stimulus that was put in place when the outlook seemed much weaker. Over this recent period, interest rates to most borrowers have been close to their average over the past decade. With growth around trend and underlying inflation around the middle of the target band, this has provided the Board some time to observe the early effects of the previous policy changes and to monitor the evolving balance of risks to both the domestic and global economies.

For a few months now, the Board has had the view that if economic outcomes in Australia turned out broadly as expected, then it was likely that higher interest rates would be required at some point to ensure that inflation remains consistent with the target over the medium term. The economy is experiencing a large expansionary shock from the high terms of trade at a time when there are relatively modest amounts of spare capacity, with the result that the medium-term inflation risks have been to the upside. Over the past couple of months, economic developments appear to have been broadly in line with the Bank's central scenario, and the downside risks in Asia look to have lessened a little. As a result, at its November meeting the Board concluded that it was prudent to make an early and modest adjustment to monetary policy, increasing the cash rate to 4.75 per cent. The Board will continue to monitor domestic and global developments carefully and set monetary policy to ensure that inflation remains consistent with the 2–3 per cent medium-term target.