2. International and Foreign Exchange Markets

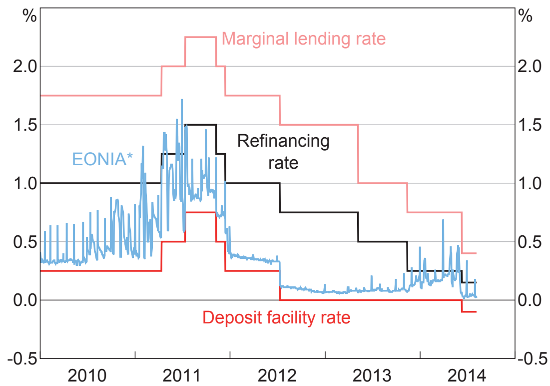
Conditions in global financial markets have remained very accommodative over recent months, with global bond yields declining further, equity prices rising, most exchange rates relatively stable and volatility in a range of asset markets near historical lows (see 'Box C: Low Volatility in Financial Markets'). Foreign capital has also continued to flow to emerging markets, boosting asset prices in these economies. These outcomes have been supported in part by ongoing accommodative monetary policy settings, particularly in the major economies, notwithstanding expectations that the US Federal Reserve and central banks in some other advanced economies will raise rates over the coming year.

Central Bank Policy

The European Central Bank (ECB) announced a package of monetary easing measures at its early June meeting. These measures were motivated by concerns about the possibility of a prolonged period of low inflation and persistent financial fragmentation within the euro area. The package consists of three main components: a reduction in policy rates; targeted term funding for banks to support lending to the non-financial private sector (excluding housing); and a commitment to continue providing unlimited liquidity to banks for the next few years. The ECB also repeated its commitment to engage in broad-based asset purchases if these measures fail to lift inflation.

The reduction in policy rates included a 10 basis point reduction in both the main policy rate (to 0.15 per cent) and the rate paid on deposits held at the ECB, taking the latter below zero to –0.10 per cent (Graph 2.1). The negative deposit rate applies to banks' holdings of reserves (in excess of requirements), which increased as a result of the ECB's additional decision to cease sterilising its earlier purchases of sovereign bonds under the Securities Market Program. Around 90 per cent of these excess reserves are held by banks in core countries. The ECB has noted that the cost of holding these deposits could encourage such banks to lend to those in the periphery via the interbank market.

Graph 2.1
ECB Interest Rate Corridor



* Euro overnight index average

Sources: Bloomberg; Thomson Reuters

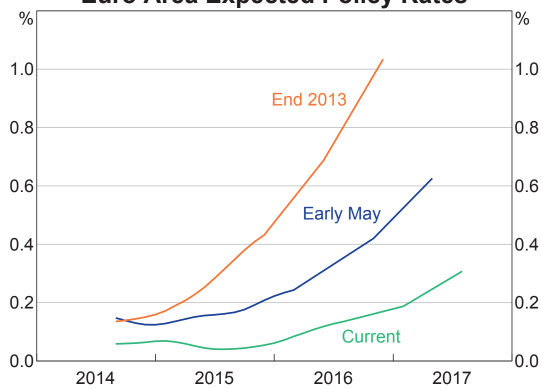
In a further attempt to improve the transmission of monetary policy across the euro area, the ECB also announced a program of 'targeted' long-term refinancing operations (TLTROs) that will provide banks with low-cost term funding. Under the first two operations, in September and December 2014, banks will be able to borrow up to 7 per cent of their outstanding lending to the non-financial private sector (excluding housing) as at 30 April 2014, amounting to almost €400 billion. In the subsequent six operations, conducted each quarter from March 2015 to June 2016, banks will be able to borrow up to three times the difference between their outstanding stock of eligible loans as at the date of the operation and an institution-specific benchmark (which is set equal to the value of their loans outstanding as at 30 April 2014 for institutions whose lending has been expanding and somewhat lower than this for those whose loan book has been contracting). The amounts available under these operations will therefore depend on developments in credit outstanding, though the ECB has suggested that a further €600 billion is likely to be available to banks. All loans extended under these operations will mature in September 2018, but banks that fail to expand eligible lending beyond their benchmark level by mid 2016 will be required to repay their borrowings two years earlier. The rate of interest on the TLTROs will be fixed at 10 basis points above the policy rate at the time of the allotment (currently implying a borrowing rate of 0.25 per cent).

In a commitment to assure money markets that liquidity will remain abundant for a considerable time, the ECB also extended its provision of liquidity under fixed-rate full allotment effectively until at least March 2017 (previously mid 2015). Under this facility, banks can borrow for a three month term at the prevailing policy rate (currently 0.15 per cent).

Interbank rates fell by almost 20 basis points in response to this package of measures, and have since generally traded at between 3 and 5 basis points (Graph 2.1). The expected path of interest rates has also flattened significantly since early May when the ECB first flagged its intentions to ease policy (Graph 2.2). With interbank rates again consistently trading below the rate at which banks can borrow short-term funds from the ECB, banks' use of the ECB as a funding source has declined rapidly since the end of May (Graph 2.3). As a result, outstanding lending by the ECB for monetary policy purposes is currently only a little higher than pre-crisis levels.

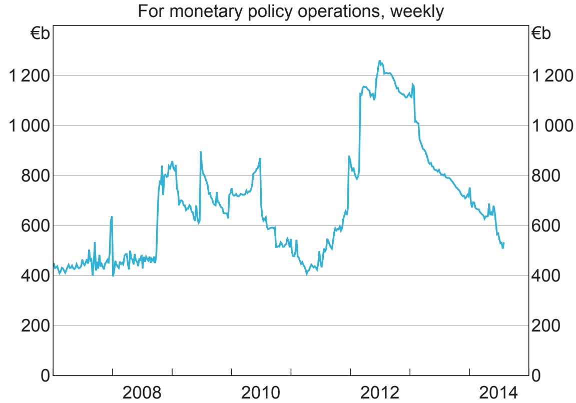
The Federal Reserve continued to reduce its asset purchases following its June and July meetings. The Fed has made it clear that it intends to reduce

Graph 2.2
Euro Area Expected Policy Rates



Sources: Bloomberg; RBA

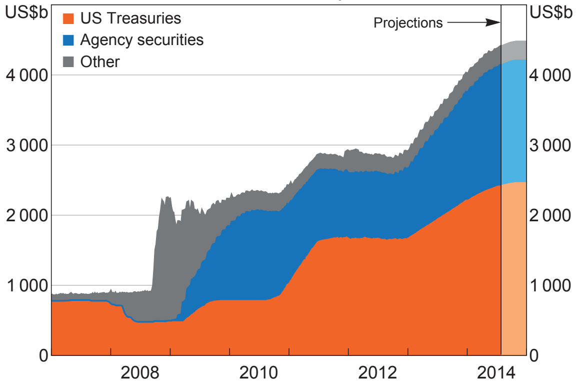
Graph 2.3
ECB Lending
For monetary policy operations, weekly



Source: European Central Bank

purchases by a further US$10 billion following its September meeting and then cease purchases after its meeting in October, assuming the economy evolves broadly in line with expectations. This would see the Fed's balance sheet peak at almost US$4.5 trillion (Graph 2.4). The focus of the Federal Open Markets Committee's (FOMC) deliberations now centres on when to begin raising interest rates and how to normalise policy. FOMC members generally continue to expect the first rise to occur around the middle of next year, and be followed by around 200 basis points of additional tightening by the end of 2016, though the Fed continues to state that it expects rates to remain below longer-run norms for some time. This outlook for rates remains somewhat higher than that expected by markets (Graph 2.5).

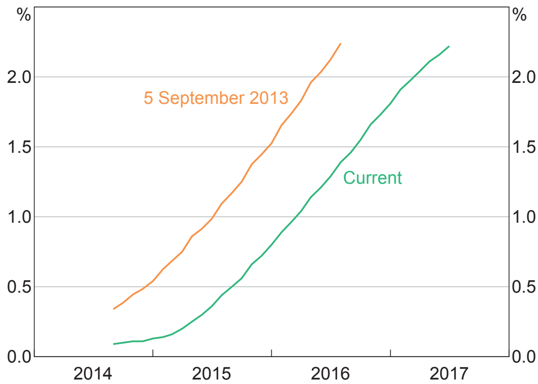
Graph 2.4
Federal Reserve Balance Sheet*
Assets, weekly



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

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

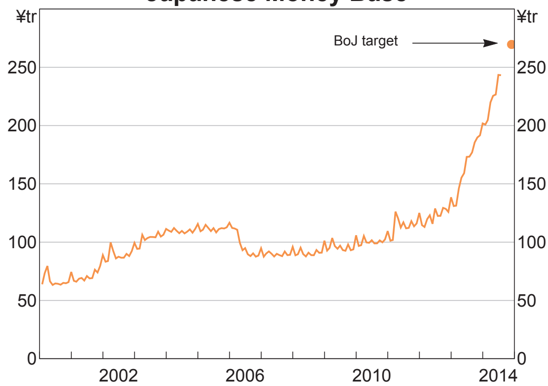
Graph 2.5
US Federal Funds Futures



Source: Bloomberg

The Bank of Japan (BoJ) continues to expand its balance sheet rapidly, in line with the policy announced in April last year. Over the first seven months of 2014, this has seen the Japanese money base rise by over ¥40 trillion (compared with a full year target of ¥70 trillion; Graph 2.6). The BoJ assesses economic activity to be evolving in line with its expectations following the sales tax rise in April, and continues to forecast that inflation will reach its 2 per cent target in 2015.

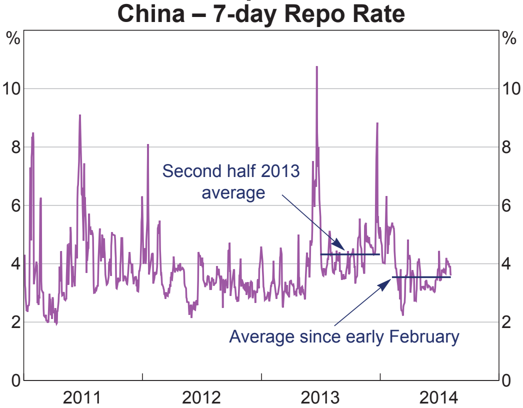
Graph 2.6
Japanese Money Base



Source: Bank of Japan

In China, short-term money market rates have continued to average well below the levels prevailing over the second half of last year. On average, the 7-day repo rate has been 80 basis points lower over the past six months than over the second half of 2013 (Graph 2.7). The Chinese authorities undertook a number of measures in recent months that effectively eased monetary conditions for certain segments of the economy – including lowering the reserve requirement ratios of certain banks and making technical adjustments to the calculation of banks' loan-to-deposit ratios, which are capped at 75 per cent. However, the impact of these on monetary conditions is assessed to be small, and the People's Bank of China (PBC) has emphasised that these measures do not signal a material change in its policy stance.

Graph 2.7
China – 7-day Repo Rate



Source: CEIC Data

The Reserve Bank of New Zealand (RBNZ) raised its policy rate by a further 25 basis points in each of June and July, in response to strong economic growth and expectations of an increase in inflation (Table 2.1). In the United Kingdom, expectations for when the Bank of England (BoE) will first raise its rate have moved forward noticeably over recent months, following remarks by Governor Carney that rates could rise sooner than the markets had been expecting, and are now consistent with an increase to 0.75 per cent early next year. In contrast, the Swedish central bank cut its rate by 50 basis points to 0.25 per cent in July in response to persistently low inflation, while the central bank of Israel also cut its rate in response to a decline in the inflation outlook.

A number of central banks in developing economies have changed interest rates over recent months. The central banks of both Mexico and Chile lowered rates in response to weaker-than-expected economic activity. The central bank of Turkey also reversed

Table 2.1: Monetary Policy

	Policy rate Per cent		Most recent change	Cumulative change in current phase[(a)] Basis points
Euro area	0.15	↓	Jun 14	–135
Japan[(b)]	na		na	
United States	0.125	↓	Dec 08	–512.5
Australia	2.50	↓	Aug 13	–225
Brazil	11.00	↑	Apr 14	375
Canada	1.00	↑	Sep 10	75
Chile	3.75	↓	Jul 14	–150
China[(b)]	na		na	
India	8.00	↑	Jan 14	75
Indonesia	7.50	↑	Nov 13	175
Israel	0.50	↓	Jul 14	–275
Malaysia	3.25	↑	Jul 14	125
Mexico	3.00	↓	Jun 14	–525
New Zealand	3.50	↑	Jul 14	100
Norway	1.50	↓	Mar 12	–75
Russia	8.00	↑	Jul 14	250
South Africa	5.75	↑	Jul 14	75
South Korea	2.50	↓	May 13	–75
Sweden	0.25	↓	Jul 14	–175
Switzerland	0.00	↓	Aug 11	–275
Taiwan	1.875	↑	Jun 11	62.5
Thailand	2.00	↓	Mar 14	–150
Turkey	8.25	↓	Jul 14	–175
United Kingdom	0.50	↓	Mar 09	–525
	Current monthly asset purchases		**Most recent change**	**Assets on balance sheet** Per cent of GDP
United States	$25 billion		Jul 14	25.5
Japan	¥6 trillion		Apr 13	55.2

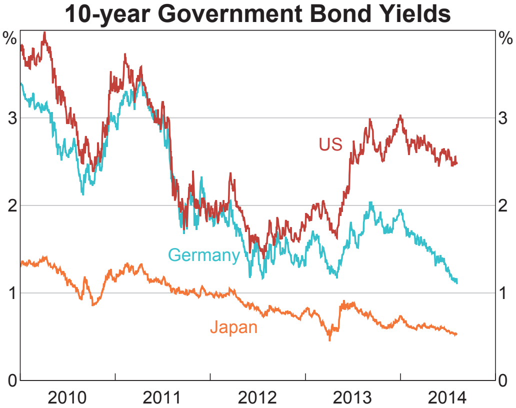
(a) Current rate relative to most recent trough or peak
(b) Since April 2013, the Bank of Japan's main operating target has been the money base; China does not have an official policy rate
Sources: Central Banks; RBA; Thomson Reuters

175 of the 550 basis point tightening in January over recent months, citing a disinflationary outlook as depreciation pressure on the lira has abated and a narrowing in the current account deficit. In contrast, the South African Reserve Bank increased its rate by a further 25 basis points in July due to heightened inflation risk, notwithstanding a downgrade to its outlook for economic activity. The central bank of Malaysia also raised its rate in July, the first rise in three years, due to strong growth prospects and above-average inflation. The Russian and Ukrainian central banks increased rates by a further 50 and 300 basis points, respectively, in July, following similar-sized moves in April, in an attempt to support their currencies and thereby contain inflation.

Sovereign Debt Markets

Yields on 10-year US Treasury bonds have moved within a narrow range of 2.45 to 2.65 per cent in recent months, having fallen somewhat over May (Graph 2.8). Consistent with this, volatility remains around historic lows (see 'Box C: Low Volatility in Financial Markets' for further details). Yields on US Treasuries are now 55 basis points lower than at the start of the year, with yields on inflation-linked bonds falling by an equal amount. Part of this decline appears to reflect a reassessment by market participants of the longer-run level for the federal funds rate.

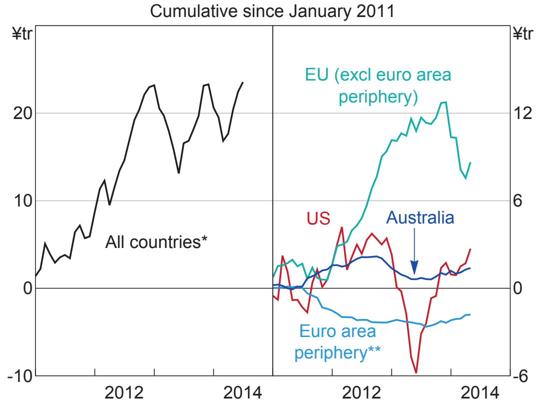
Graph 2.8
10-year Government Bond Yields



Source: Bloomberg

Yields on 10-year German Bunds have fallen by 80 basis points since the start of the year to reach their lowest level on record at 1.10 per cent. As in the United States, the decline can be largely explained by a reduction in expected real yields. Yields on Japanese government bonds (JGBs) have also continued to decline as a result of ongoing purchases by the BoJ. Yields on such securities are now at their lowest level on record, outside of two brief periods in 2003 and April last year. The decline in JGB yields has occurred despite residents increasing their holdings of foreign bonds since March, unwinding the selling that occurred in the first quarter of 2014 (Graph 2.9). Much of the recent purchases by Japanese residents have been of US, French, euro area periphery and Australian bonds, while residents have been large sellers of German bonds this year.

Graph 2.9
Japanese Purchases of Foreign Bonds
Cumulative since January 2011



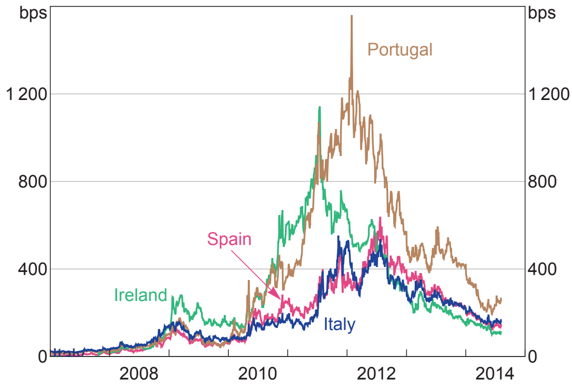
* Calculated using monthly data to May 2014 and weekly data thereafter
** Greece, Ireland, Italy, Portugal and Spain
Sources: Japanese Ministry of Finance; RBA

Spreads between yields on bonds issued by euro area periphery governments and Bunds narrowed moderately after the ECB's June meeting, in response to expectations that the imminent TLTRO funds would be used, at least partially, to purchase such bonds. As a result, by mid June spreads on Italian and Spanish bonds had unwound all but 50 basis points of their rise following the onset of the euro area debt crisis in 2010, while spreads on Irish bonds had fully reversed their increase (Graph 2.10). Yields on

Graph 2.10

Euro Area 10-year Government Bond Spreads

To German Bunds

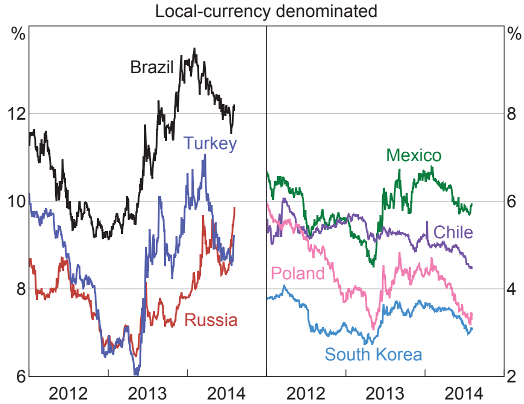


Source: Bloomberg

Graph 2.11

10-year Government Bond Yields

Local-currency denominated



Sources: Bloomberg; Thomson Reuters

10-year bonds issued by Italy, Spain and Ireland are now at their lowest levels in many decades. However, spreads on Portuguese and Greek government bonds widened in July as concerns about the health of periphery banking sectors (and hence the need for financial support from sovereigns) resurfaced following difficulties at Portugal's largest bank, Banco Espírito Santo (BES). In the event, Portuguese authorities announced a €4.9 billion resolution plan for BES following revelations of capital losses associated with exposures to its parent company. The resolution involves splitting BES into a 'good bank' and a 'bad bank'. The 'good bank' will be recapitalised with an injection of money from the country's industry-funded bank resolution scheme and includes all deposits and senior bondholders. The 'bad bank' will include shareholders and junior bondholders, and will be wound down.

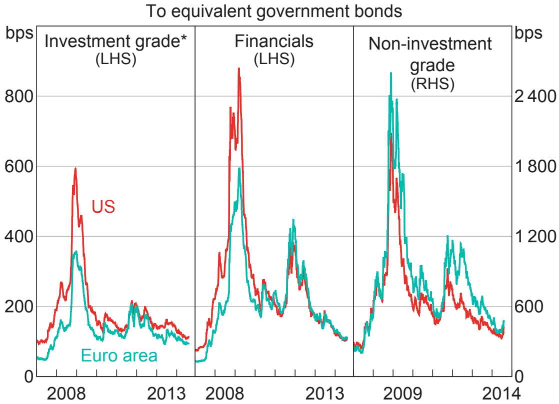
Yields on bonds issued by emerging market sovereigns have generally continued to fall over recent months, alongside a resumption of foreign capital inflows since February and a slowing growth outlook in many economies (Graph 2.11). Yields on Russian government bonds, however, have risen sharply over the past month following the shooting down of the Malaysian passenger airline over Ukraine and the subsequent tightening of sanctions against Russia.

Yields on Argentine government bonds have been highly volatile since mid June, reflecting the dispute between its government and 'holdout' creditors who refused to accept a restructuring of the bonds on which Argentina defaulted in 2001. In June, the Supreme Court of the United States affirmed the New York District Court ruling that Argentina is legally prohibited from paying interest to holders of restructured bonds without simultaneously meeting its obligations to these holdout creditors, which the government has refused to do. As a result, holders of restructured Argentine bonds did not receive payments due at the end of June, pending a resolution of this dispute, and the country defaulted on its obligations 30 days later. The outcome of this case may have implications for future debt restructuring arrangements by other sovereigns.

Credit Markets

Borrowing costs for US and euro area corporations remain very favourable. Spreads between investment grade corporate bonds in these regions and equivalent government bonds have remained around their lowest levels since 2007, and with yields on government bonds declining, absolute borrowing costs have continued to fall (Graph 2.12). Spreads on non-investment grade bonds also remain very low, though have increased moderately over the past month.

Graph 2.12
Corporate Bond Spreads
To equivalent government bonds

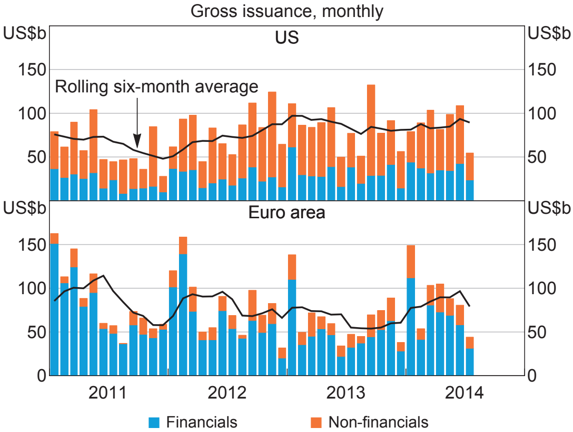


* Non-financial corporations

Sources: Bank of America Merrill Lynch; Bloomberg; RBA

Bond issuance by euro area corporations has picked up in 2014 (Graph 2.13). This has been driven by increased issuance from financials in both core and periphery countries, and occurred alongside reduced recourse to ECB lending. Issuance by US corporations has remained around the strong pace recorded last year. The average credit rating of new issuance in advanced economies has continued to decline; almost 30 per cent of bonds issued so far this year have been either non-investment grade or unrated, compared with just over 20 per cent in 2013.

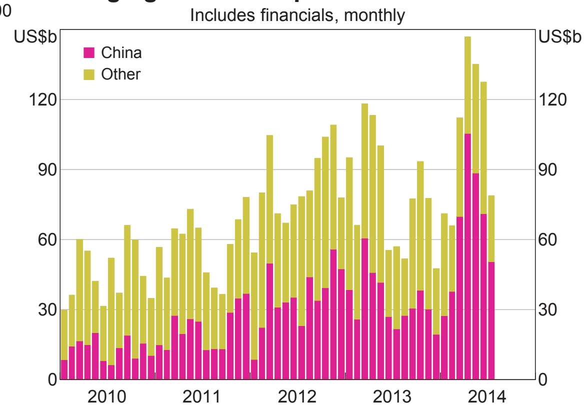
Graph 2.13
Corporate Bond Issuance
Gross issuance, monthly



Sources: Dealogic; RBA

Bond issuance by corporations in emerging markets has increased considerably since late February (Graph 2.14). Much of this has been driven by a sharp increase in issuance by Chinese corporations. However, issuance by corporations in other countries, particularly from emerging Europe, has also increased.

Graph 2.14
Emerging Market Corporate Bond Issuance
Includes financials, monthly



Sources: Dealogic; RBA

The US Securities Exchange Commission has finalised rules to address money market funds' susceptibility to heavy redemptions in times of financial stress. Institutional prime money market funds will be required to sell and redeem shares at the current market-based value of the securities underlying their portfolios (i.e. adopt a floating net asset value), instead of transacting at a fixed price. Such funds will also be required to temporarily suspend or impose a liquidity fee on investor redemptions if a fund's weekly liquid assets fall below set thresholds relative to total assets, unless their board of directors determines that doing so would not be in the fund's best interests. In addition, government funds will have to hold 99.5 per cent of their assets in US Treasuries, compared with only 80 per cent currently, which will increase demand for Treasury bills. Funds have two years to comply with these new regulations.

Equities

Global share prices continued to grow over recent months, to be moderately above the levels prevailing at the start of the year, notwithstanding falls over the past two weeks (Table 2.2). These gains have occurred alongside a further reduction in volatility (see 'Box C: Low Volatility in Financial Markets'), and despite a number of geopolitical and financial shocks (including escalating tensions in Ukraine and Gaza). Growth in advanced economies share prices has been underpinned by modest gains in the United States and strong increases in Japan, though the latter only unwinds part of the sharp fall recorded over January (Graph 2.15). In contrast, European share prices fell quite sharply over the past two weeks due to that economy's greater exposure to Russia and renewed concerns about the European banking sector.

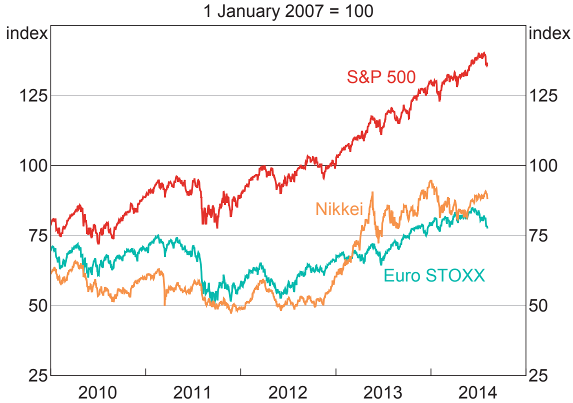
Table 2.2: Changes in International Share Prices
Per cent

	Over 2013	Year to date
United States – S&P 500	30	4
Euro area – STOXX	20	–2
United Kingdom – FTSE	14	–2
Japan – Nikkei	57	–7
Canada – TSE 300	10	12
Australia – ASX 200	15	3
China – A shares	–7	5
MSCI indices		
– Emerging Asia	3	7
– Latin America	–7	6
– Emerging Europe	–2	–6
– World	**23**	**2**

Source: Bloomberg

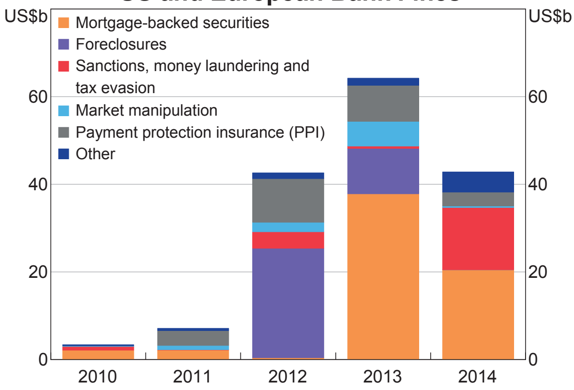
Bank share prices have been relatively volatile over recent months, particularly in Europe as concerns about the stability of the Portuguese banking sector emerged. US bank share prices have largely tracked their broader index over recent months, as second quarter profit results for the six largest US banks (abstracting from litigation expenses) increased strongly from that reported last quarter, to be slightly higher than a year earlier. This strong result reflected increased fees from investment banking activities and reduced loan-loss provision charges, which offset reduced income from fixed income and commodity trading activities as volatility in markets abated. In contrast, European banking shares have underperformed their broader index. Second quarter profit results for 12 of the larger European banks (abstracting from litigation expenses) were well below that reported last quarter, though only slightly lower than a year earlier. As in the United States, a decline in trading income weighed on profits. Litigation expenses continued to weigh on both US and European bank profit results in the quarter. US and European banks have agreed with regulators globally to fines totalling almost US$25 billion since the start of the June quarter, taking the total paid out this year to almost US$40 billion (Graph 2.16). The majority of the fines this year have continued to relate to the mis-selling of mortgage-backed securities and collateralised debt obligations prior to the financial crisis, though penalties for facilitating the evasion of either sanctions or tax have also figured prominently.

Graph 2.15
Major Share Price Indices
1 January 2007 = 100



Source: Bloomberg

Graph 2.16
US and European Bank Fines*

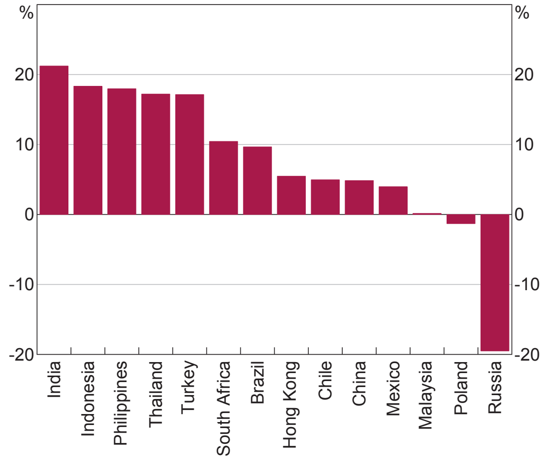


* Imposed by US and European regulators; includes borrower relief

Sources: Company reports; European Commission; Financial Conduct Authority; Financial Times; London School of Economics; RBA; Swiss Financial Market Supervisory Authority

Graph 2.17
Change in Emerging Market Equity Price Indices

Since end 2013



Source: Bloomberg

Merger and acquisition (M&A) activity has increased significantly in 2014, buoyed by rising business confidence and cheap financing conditions. The value of global M&A activity announced in 2014 has totalled more than US$2.3 trillion in the year to date, the strongest level since 2007 and only slightly lower than the value announced throughout 2013. A sizeable portion of this activity has been in pharmaceuticals, finance and media, with much of it occurring across borders.

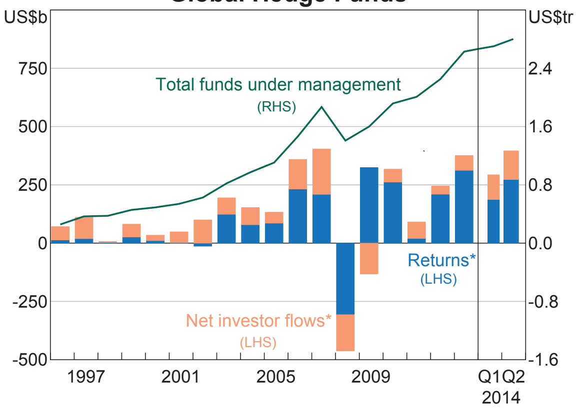
Share prices in emerging markets have continued to rise strongly since early February, outpacing the gains recorded in advanced economies for the first time in three years. Price indices have increased by at least 10 per cent since the start of the year across a large number of emerging markets, despite the sharp falls observed in January (Graph 2.17). Share prices in India, Indonesia, the Philippines, Thailand and Turkey have all risen by around 20 per cent since the start of the year, with markets in India and Indonesia buoyed by changes in government. These gains have occurred alongside a return of foreign capital to emerging equity markets since mid February, particularly in India and Indonesia. Chinese and Hong Kong share prices have also increased particularly strongly over the past month, following large falls earlier in the year, driven by better-than-expected Chinese data and increased confidence in its economy.

In contrast, share prices in eastern Europe have either been little changed or declined this year. Russian stocks have been especially weak, with the re-escalation of tensions surrounding eastern Ukraine in mid July driving stocks back down towards the lows observed immediately after the annexation of Crimea. Other markets in the region, such as Poland and Hungary, have also been affected by these tensions.

Hedge Funds

Global hedge funds recorded an average return on investment of 9.1 per cent over the year to the June quarter, significantly underperforming the total return from a balanced portfolio of global bonds and equities over the past year. This continues a three-year period of underperformance, though this has occurred alongside a significant reduction in the volatility of hedge fund returns. This underperformance has been especially pronounced for macro funds, which trade in response to movements in economic variables; such funds have posted virtually no return over this period. Hedge funds continue to receive new inflows which, combined with positive investment returns, saw funds under management rise by almost US$100 billion over the June quarter to US$2.8 trillion (Graph 2.18).

Graph 2.18
Global Hedge Funds



* Annualised for 2014:Q1 and 2014:Q2
Sources: Hedge Fund Research, Inc.; RBA

Foreign Exchange

Conditions in foreign exchange markets have remained subdued in recent months. Volatility in the main developed market currency pairs has declined further to reach new lows, while movements in most currencies against the US dollar have been relatively small since May (see 'Box C: Low Volatility in Financial Markets'). This follows a period between late January and early May, when most emerging market and other 'growth-sensitive' currencies had appreciated against the US dollar.

The US dollar has depreciated by around 1 per cent on a trade-weighted basis since its recent peak in early February (Table 2.3; Graph 2.19). This is notwithstanding market participants' expectations that the US Federal Reserve will soon end its asset purchase program and is moving closer to raising its key policy rate.

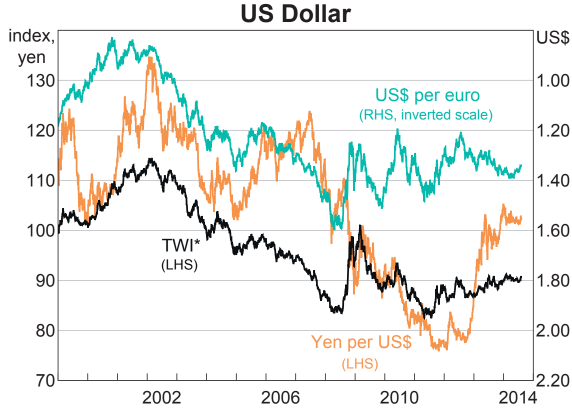
The euro has depreciated by around 3 per cent on a trade-weighted basis and against the US dollar since early May, when ECB President Draghi first signalled that further monetary easing measures would likely be implemented. The subsequent decision to deliver additional stimulus in June partly reflected the ECB's concerns about the strength of the euro in the context of low inflation and weak economic

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

	Since end April 2013	Since end January 2014
Swedish krona	6	5
Chinese renminbi	0	2
European euro	–2	1
Swiss franc	–2	0
Japanese yen	5	0
New Taiwan dollar	2	–1
Canadian dollar	8	–2
Singapore dollar	1	–2
Mexican peso	9	–2
Thai baht	10	–2
UK pound sterling	–8	–2
Indian rupee	14	–3
Philippine peso	6	–4
Indonesian rupiah	21	–4
Malaysian ringgit	5	–4
New Zealand dollar	1	–5
South Korean won	–6	–5
South African rand	19	–5
Brazilian real	14	–6
Australian dollar	11	–6
TWI	**4**	**0**

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

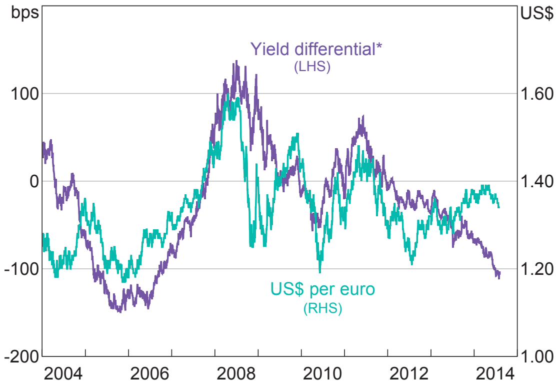
Graph 2.19
US Dollar



* 1 January 1999 = 100
Sources: Bloomberg; Board of Governors of the Federal Reserve System; RBA

activity. Notwithstanding the recent depreciation, and the growing divergence in the outlook for euro area and US monetary policy, the euro remains 11 per cent higher against the US dollar since mid 2012 (Graph 2.20). On a trade-weighted basis, the euro is currently around 2 per cent above its average since the introduction of the single currency in 1999.

Graph 2.20
EUR/USD and Yield Differential



* Average of 2-year, 5-year and 10-year spreads between German and US government bond yields

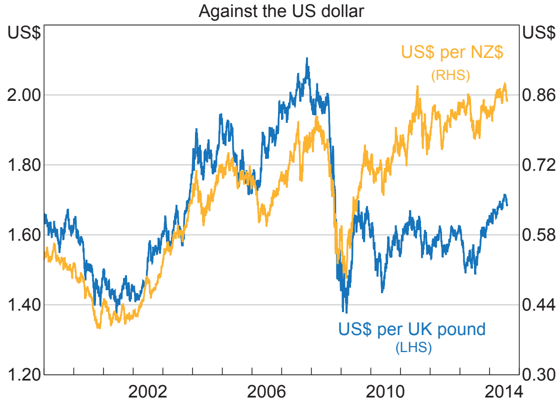
Source: Bloomberg

The Japanese yen has been little changed over recent months, but remains around 3–4 per cent higher against the US dollar and on a trade-weighted basis over 2014 to date. In real effective terms, the yen is around 18 per cent below its average over the past 15 years.

The UK pound and New Zealand dollar have appreciated by 2–3 per cent against the US dollar over 2014 to date to be 10–13 per cent above their mid 2013 lows (Graph 2.21). In both cases, the appreciation reflects a change in market participants' views about the outlook for monetary policy, with expectations of the timing of the BoE's first interest rate increase being brought forward and the RBNZ increasing its policy rate by 100 basis points since March. The BoE has stated that the recent appreciation of the UK pound is a 'headwind' facing the economy, while the RBNZ has noted that the currency is 'overvalued' and 'unjustified and unsustainable' and that 'there is the potential for a significant fall'. The RBNZ has also suggested that if the New Zealand dollar remains high in the face of

Graph 2.21
New Zealand Dollar and UK Pound

Against the US dollar

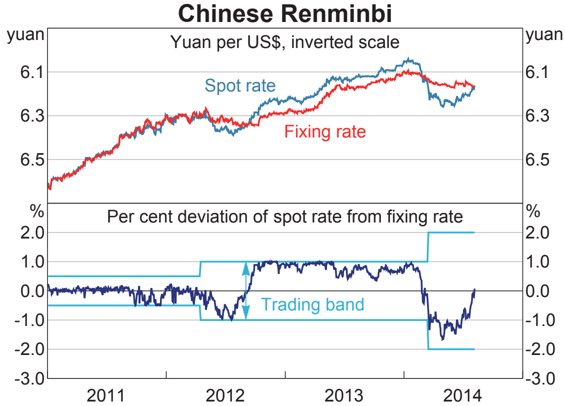


Source: Bloomberg

worsening fundamentals, it would become 'more opportune' to intervene in foreign currency markets.

The Chinese renminbi (RMB) has appreciated by around 1 per cent against the US dollar since early May but remains around 2 per cent below its mid January peak (Graph 2.22). The recent appreciation has seen the RMB return to the centre of its +/–2 per cent daily trading band around the PBC's daily fixing rate for the first time since March.

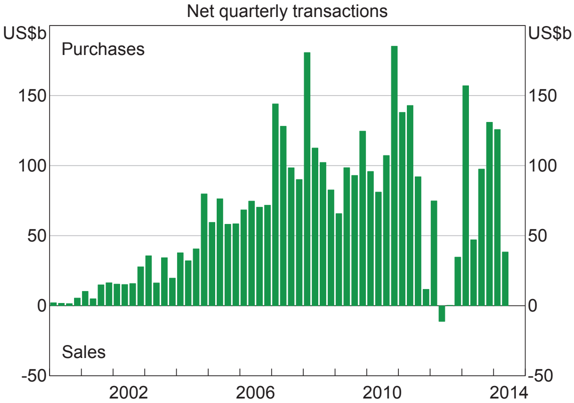
Graph 2.22
Chinese Renminbi



Sources: Bloomberg; China Foreign Exchange Trade System

The stock of Chinese foreign currency reserves increased by US$45 billion (around 1 per cent) over the June quarter, largely reflecting net purchases of foreign currency by the PBC (Graph 2.23). The pace of reserve accumulation was noticeably slower than

Graph 2.23
Chinese Foreign Currency Reserves
Net quarterly transactions



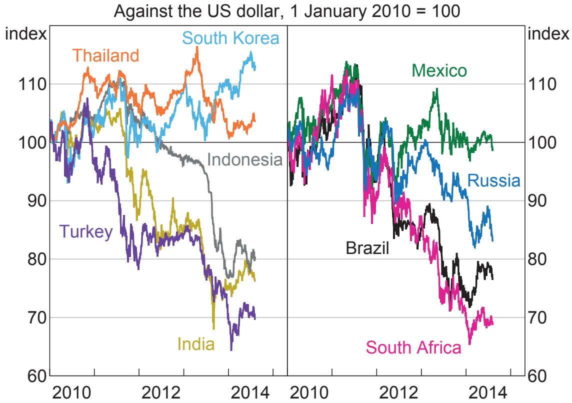
Sources: Bloomberg; CEIC Data

that seen over the previous three quarters, but is consistent with capital outflows from China and, more generally, reduced appreciation pressure on the RMB in the June quarter.

The Chinese authorities have continued to take steps towards internationalising the RMB. In June and July, the PBC designated official RMB clearing banks in London, Frankfurt and Seoul. These clearing banks will have more direct access to onshore RMB liquidity, including approval to transact in China's onshore foreign exchange market. The PBC also signed Memorandums of Understanding with the central banks of France and Luxembourg to establish RMB clearing banks in these jurisdictions in the future. In addition, 'direct trading' between the UK pound and the RMB – that is, trading between these currencies without the use of the US dollar as an intermediate currency – commenced in Mainland China's interbank market. In July, the PBC signed a bilateral local currency swap agreement with the Swiss National Bank (SNB) of up to RMB150 billion (or the equivalent of US$24 billion) and reopened a bilateral local currency swap line with Argentina of up to RMB70 billion (or the equivalent of US$11 billion). Chinese authorities have also allocated a RMB80 billion investment quota to both Germany and South Korea under the RMB Qualified Foreign Institutional Investors (RQFII) scheme, and have granted the SNB a RMB15 billion quota to invest in the Chinese interbank bond market.

After having appreciated noticeably between late January and early May, most other Asian and Latin American currencies have since been little changed or depreciated slightly against the US dollar. While most of these currencies remain above their lows in early 2014, they are well below their end April 2013 levels (Graph 2.24).

Graph 2.24
Asian and Emerging Market Currencies
Against the US dollar, 1 January 2010 = 100



Source: Bloomberg

Emerging European currencies have generally depreciated by more than other emerging market currencies since early May, amid heightened market concerns about geopolitical developments in Russia and Ukraine. The Russian rouble has depreciated by around 7 per cent since its peak in June, while the Ukrainian hryvnia has depreciated by around 4 per cent over the same period.

Most Asian and emerging market central banks' gross foreign currency reserves have continued to increase modestly since the end of March (Table 2.4). This is consistent with reports that authorities in some of these economies have been intervening in foreign exchange markets to curb appreciation pressure on their currencies and/or have been continuing to rebuild their reserves following declines in the latter part of 2013.

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

	Percentage change since:			Level
	End April 2013	End December 2013	End March 2014	US$ equivalent (billions)
China	13	4	1	3 993
Taiwan[(b)]	5	2	1	424
Russia	–9	–8	–3	416
Brazil	0	5	4	367
South Korea	12	7	4	358
Hong Kong	4	2	1	308
India	12	10	6	294
Thailand	–6	0	0	159
Malaysia	–6	–2	2	120
Turkey	–2	1	6	110
Indonesia	1	9	5	101
South Africa	–3	–3	–2	41

(a) Data to end June for China, Hong Kong, Indonesia, South Africa and Thailand; to 14 July for Malaysia; to 25 July for India, Russia and Turkey; to end July for Brazil, South Korea and Taiwan
(b) Foreign exchange reserves (includes foreign currency and other reserve assets)
Sources: Bloomberg; CEIC Data; Central Banks; IMF; RBA

Australian Dollar

The Australian dollar has been little changed against the US dollar and on a trade-weighted basis since the previous *Statement*, notwithstanding further declines in key commodity prices (Table 2.5; Graph 2.25). Interest rate differentials between Australia and a number of other advanced economies have also narrowed somewhat over this period. The Australian dollar is still 7 per cent higher than its low in late January, but around 11 per cent below its recent peak in April 2013. By longer-term standards, the Australian dollar remains 16 per cent above its post-float average in nominal trade-weighted terms and around 30 per cent above its post-float average in real trade-weighted terms.

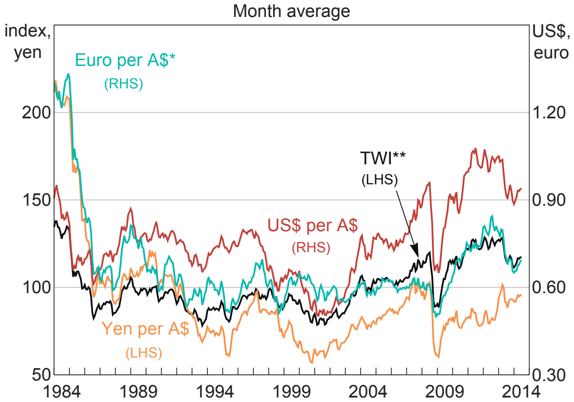
Volatility in the Australian dollar has been little changed over recent months, with the average intraday trading range for the AUD/USD exchange rate remaining around multi-year lows (Graph 2.26).

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

	Since April 2013 peak in TWI[(a)]	Since January 2014 trough in TWI[(b)]
European euro	–13	10
Chinese renminbi	–12	10
Swiss franc	–14	9
US dollar	–11	8
Japanese yen	–9	7
Canadian dollar	–5	6
Thai baht	–2	6
UK pound sterling	–19	5
Singapore dollar	–11	5
Indian rupee	0	5
New Zealand dollar	–10	4
South African rand	7	4
Indonesian rupiah	8	4
South Korean won	–19	3
Malaysian ringgit	–6	3
TWI	**–11**	**7**

(a) 11 April 2013
(b) 25 January 2014
Sources: Bloomberg; RBA

Graph 2.25
Australian Dollar
Month average

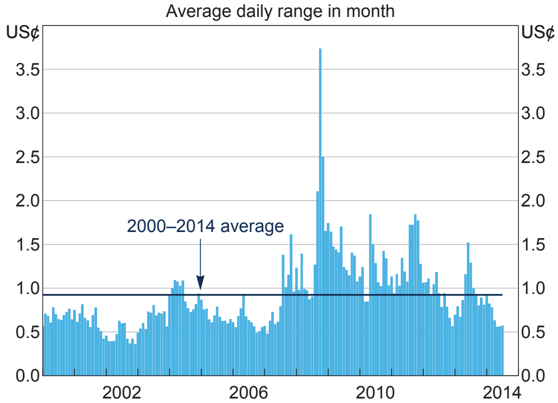


* Deutsche Mark spliced to euro before 1999

** Post-float average = 100

Sources: Bloomberg; RBA; Thomson Reuters

Graph 2.26
Intraday Range in AUD/USD
Average daily range in month

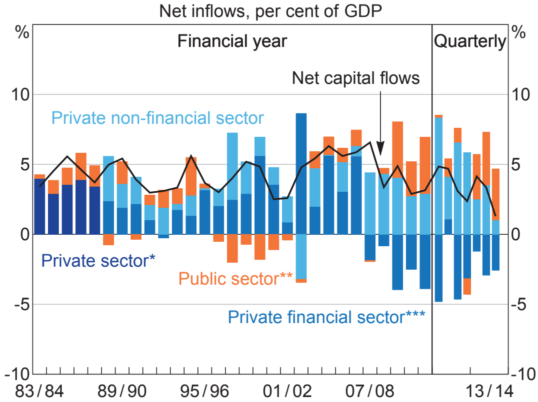


Sources: Bloomberg; RBA

Capital Flows

Net capital inflows to the Australian economy declined to 1.3 per cent of GDP in the March quarter, the lowest share of GDP since quarterly data commenced in 1988. The net inflow was directed primarily to the public sector, although there was also a net inflow to the private non-financial sector. In contrast, there was a continued net outflow from the private financial sector in the quarter (Graph 2.27).

Graph 2.27
Australian Capital Flows
Net inflows, per cent of GDP



* The split of private sector flows into private financial sector and private non-financial sector flows is only available from 1988/89

** Excludes official reserves and other RBA flows

*** Adjusted for the US dollar swap facility in 2008 and 2009

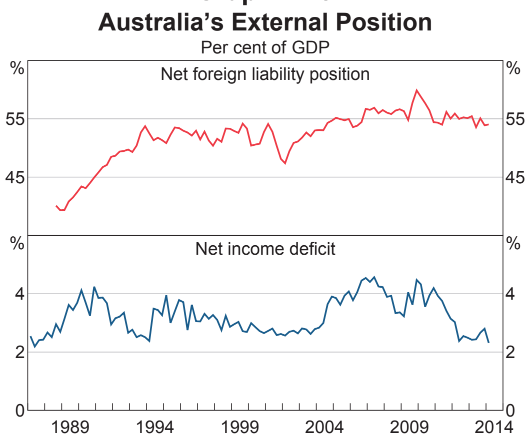
Sources: ABS; RBA

The net inflow to the public sector in the March quarter largely reflected foreign purchases of Commonwealth Government securities (CGS), although there was also a net inflow to the state and local government sector. Net foreign purchases of CGS were again roughly proportional to net issuance in the quarter, leaving the foreign ownership share of CGS little changed at 67 per cent. The foreign ownership share of state government securities was also little changed at 31 per cent.

Net inflows to the private non-financial sector moderated in the March quarter, reflecting reduced net inflows to both the mining and non-mining sectors. In gross terms, the Australian non-mining sector received a larger share of foreign investment in Australia than the mining sector for the first time since 2010. The net outflow from the private financial sector reflected continued net outflows from 'other financial institutions' (which include superannuation and other types of investment funds).

Consistent with the reduction in net capital inflows, Australia's current account deficit also narrowed in the March quarter. This in turn partly reflected a narrowing in the net income deficit to 2.3 per cent of GDP – its lowest share of GDP since 1987 (Graph 2.28). With Australia's net foreign liability position little changed over the quarter, the narrowing in the net income deficit was due to an increase in the yield received on Australia's overseas equity assets and a reduction in the yield paid to non-residents on Australia's equity liabilities. ✠

Graph 2.28



Source: ABS