STATEMENT ON MONETARY POLICY

International economic conditions are continuing to support growth in Australia. The world economy is now in its fourth successive year of above-average growth, and most observers expect this to continue in the year ahead. While there have been signs of some moderation in the United States recently, this is currently being offset by stronger growth in other parts of the world. The Japanese economy is experiencing its best period of sustained expansion for some time. In China, recent indications are that the pace of growth has picked up this year from an already high rate. The performance of the smaller east Asian economies has remained solid, benefiting from the strength in China and in global electronics demand. There has also been a gradual improvement in conditions in the euro area.

The strength of the global economy over recent years has been accompanied by sustained upward pressure on commodity prices. One important element of this has been the increase in crude oil prices during this period. Although events in the Middle East have recently contributed to the pressure on oil prices, their upward trend over the past few years has been mainly a consequence of strong global demand. The increases in commodity prices have been broadly based. Prices of Australia's base metals exports have increased by 40 per cent since the start of the year, following on from strong increases in each of the previous two years. In addition, contracts finalised in recent months for Australia's bulk commodity exports have provided for further rises in iron ore prices, while coal prices have fallen only modestly after their near-doubling last year. Overall, Australia's terms of trade are estimated to have increased by 6 per cent over the year to the June quarter, and by a cumulative 34 per cent since 2002.

These global trends have also been associated with upward pressure on consumer price inflation in the major countries. Headline inflation around the world has been pushed up by higher fuel costs, but there have also been signs of more widespread price pressures, with some upward drift in core inflation rates. In the United States, the core CPI inflation rate has picked up by around half a percentage point since the start of the year. In Japan, consumer prices have begun to rise, and there have been increases in inflation rates in a number of other Asian economies.

Against this background, it is not surprising that interest rates in the major economies have been increasing. Long-term bond yields have risen noticeably since the start of the year. Central banks in the major economies have been in the process of normalising their interest rates after a period when they had been unusually low. The United States is the furthest advanced in this, but the European Central Bank has also been gradually raising its policy rate since late last year and the Bank of Japan has recently started to increase its interest rate after a lengthy period when it had been held at zero. In Australia, short-term market interest rates increased over recent months in response to stronger economic data, such that by late July the prospect of an increase in the cash rate at the August Board meeting was fully reflected in market yields.

The Australian economy has continued to grow at a good pace recently, with GDP expanding by around 3 per cent over the year to the March quarter. The expansion has been driven by domestic spending, with business investment the fastest growing component. Growth in investment spending has been broadly based, though the strongest part has been the mining industry, where investment has roughly doubled over the past year. Combined with moderate increases in spending by other domestic sectors, the rapid growth in business investment has meant that total domestic spending has been expanding at an above-trend pace.

More recent information on domestic activity and finance suggests that conditions may have strengthened further over recent months. Employment posted strong gains in the June quarter, and business surveys have continued to report above-average trading conditions for the economy overall. Retail sales, though moderating recently, appear to be on a firmer trend than last year. While rising fuel costs may be having a dampening effect on discretionary spending, the tax cuts that came into effect in July, coupled with growing employment, will boost household incomes and should add to spending in the second half of the year.

Evidence of strong domestic conditions can also be seen in the increasing demand for finance. The growth of household credit picked up to an annualised pace of almost 15 per cent over the six months to June, compared with a rate of 11 per cent at the end of last year. Monthly data for credit and loan approvals suggest that the demand for finance by households was strengthening further in May and June. Business credit has also continued to expand at a fast pace, reflecting favourable business conditions and rapid expansion in investment spending. Over the past six months, business credit grew at an annualised rate of 18 per cent. It is clear from these trends that both households and businesses have found it attractive to borrow at recently prevailing interest rates.

One of the factors stimulating credit growth has been the compression of margins by lenders. This has had the effect of limiting the rise in interest rates paid by borrowers over the past couple of years. While the cash rate is now modestly above its average for the low-inflation period since 1993, compression of lending margins over recent years means that interest rates paid by both housing and business borrowers are still a little below average, and will remain so even after allowing for the expected pass-through of the August policy change.

The increased household demand for finance has been accompanied by signs of firmer conditions in the established housing market. House prices nationally have been rising gradually since late last year, and preliminary indications are that they also rose in the June quarter. However, the national average has been pushed up by large increases in Perth, where prices rose by more than 30 per cent over the past year. Prices have been broadly flat in Sydney over the year, while rising in the other capitals. These differences have in part been a reflection of the broader regional disparities in demand and output, with the resource-rich states of Western Australia and Queensland growing more strongly than the south-eastern states.

As has been the case for some time, the strength of the economy over the past year has reflected contrasting contributions from domestic spending and exports. Despite the strong conditions prevailing internationally, Australia's export performance has been disappointing. While it is true that export revenues have been growing strongly, and thus have added to the growth of national income, this revenue growth has been largely accounted for by higher prices, with volumes increasing only modestly. Nevertheless, while the expected pick-up in export volumes has been slow to materialise, prospects for growth in resource-based exports should be assisted by the substantial investment underway in that sector.

The national economy is now at a stage of the economic cycle where spare capacity is rather limited. Capacity utilisation levels reported by businesses in the June quarter were close to their highest levels in more than a decade. Labour market conditions are tight, with the unemployment rate at its lowest point since the 1970s, while job vacancies are at a record level. Business surveys and liaison reports continue to indicate that labour scarcity is a significant concern, with many businesses reporting that this is a bigger constraint on their activities than traditional concerns about the adequacy of demand. These indications of tight capacity are not surprising in an economy in its fifteenth year of continued expansion. Looking ahead, it appears likely that growth of the economy in the next year or two will on average be somewhat higher than it was over the year to the March quarter. This outlook implies that capacity is likely to remain tight over the period ahead.

The combination of rising world commodity prices, strong domestic demand and tight capacity has contributed to increased inflationary pressure in Australia. Raw materials costs have picked up as a result of broad-based increases in global commodity prices, and there has been a general pick-up in output prices at all stages of production. Wages growth, although more stable recently, has been somewhat higher than its average of the past few years, particularly in the private sector. There has also been an increase in underlying consumer price inflation. Over the year to the June quarter, underlying inflation is estimated to have picked up to a rate of just under 3 per cent, continuing the upward drift that had started to become apparent in the previous quarter. These developments indicate that underlying inflationary pressures have been a little stronger than was expected at the time of the May *Statement*.

Although the increase in the June quarter headline CPI was much larger than estimates of the underlying rate, reflecting fuel price increases and a sharp rise in the price of bananas in the wake of Cyclone Larry, it is important to abstract from temporary influences in assessing the medium-term outlook. Overall, the Bank's assessment following receipt of the June quarter prices data was that underlying inflation would remain somewhat higher than had previously been forecast. This assessment was based on the gradual increase in underlying inflation this year, and the wider background of above-average global growth and strong domestic demand. Taking into account the expected effect of the August policy decision, the Bank's current forecast is that underlying inflation over the next two years will be around 3 per cent. In the short term, headline CPI inflation can be expected to remain significantly higher than that, but will decline to the underlying rate when temporary factors drop out of the calculation.

In summary, the situation reviewed by the Board at its recent monthly meetings was one in which evidence of stronger domestic conditions and inflation pressures was accumulating. The global economy was maintaining its strong pace of growth, while inflation in a number of countries was rising. In Australia, national accounts data indicated a pick-up in the pace of growth in demand and output in the early part of the year, while more recent data pointed to further strength, with business surveys reporting good conditions in the June quarter and employment posting large gains. In addition it was apparent that the household sector's demand for finance had been increasing through the first half of the year. Data on producer and consumer prices for the June quarter indicated that these domestic and international developments had been accompanied by stronger inflationary pressures.

As a result of these considerations, the Board judged at its August meeting that a further increase in the cash rate was warranted in order to contain inflationary pressures in the medium term. The Board will continue to monitor developments and make such policy adjustments as may be required to promote sustainable expansion of the economy consistent with low inflation.

International Economic Developments

Global economy

The world economy has continued to grow strongly during 2006. US economic growth remains solid, although it moderated somewhat recently; the rapid growth in the Chinese economy shows no signs of slowing; and Japan's economic expansion is looking increasingly robust. Growth has also continued at a firm rate in the rest of east Asia, and the economic recovery in the euro area is progressing, albeit at a moderate pace. Following the favourable economic outcomes during the first half of 2006, the Consensus forecast for world growth in 2006 was revised up again over the past three months and now stands at 5 per cent, well above the trend rate of growth (Table 1). World growth is also expected to remain firm in 2007. The overall growth outlook for Australia's major trading partners in 2006 and 2007 is similar to that for the world as a whole.

The strong growth performance has underpinned continuing high prices for energy and other commodities. Oil prices have recently traded around US$75 per barrel, up slightly from their level around the time of the last *Statement*, with recent strength largely reflecting events in the Middle East (Graph 1). Prices have increased from around US$60 per barrel at the start of the year, to be triple the oil price level prevailing as recently as 2002, but most of this rise reflects ongoing strong global demand and low spare capacity in global supply. Looking ahead, although the International Energy Agency revised down its forecast for growth in world oil demand for 2006 and increased its forecast for oil production for 2007, long-term futures prices remain

Table 1: World GDP
Year-average percentage change(a)

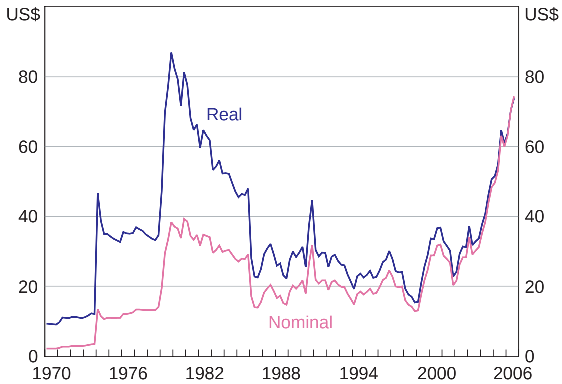
	2004	2005	2006	2007
			Consensus forecasts (July 2006)	
United States	3.9	3.2	3.5	2.8
Euro area	1.8	1.4	2.2	1.8
Japan	2.3	2.6	3.0	2.2
China	10.1	9.9	9.7	8.8
Other east Asia(b)	5.9	4.8	5.2	4.8
India	7.3	8.2	7.6	7.2
Latin America	5.8	4.3	4.7	4.1
Emerging Europe	6.1	5.2	5.8	5.5
World	**5.3**	**4.7**	**5.0**	**4.6**
Australia's trading partners(c)	4.9	4.4	4.6	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 1

Nominal and Real Oil Prices*

West Texas Intermediate, quarterly



* September quarter is an estimate. Real series reflects June 2006 prices, deflated by the US GDP deflator.
Sources: Bloomberg; RBA; Thomson Financial

at high levels, suggesting that market participants expect prices to stay around current levels for an extended period.

In response to the strong economic growth and high oil and other commodity prices, CPI inflation has increased in most regions. 'Core' inflation has also increased in some countries, leading to concerns that the higher energy prices may be feeding through to second-round price effects. These developments have prompted central banks around the world to tighten monetary policy. Nonetheless, inflation has generally been more contained than past experience might suggest, due in large part to solid productivity growth and continued well-anchored inflation expectations.

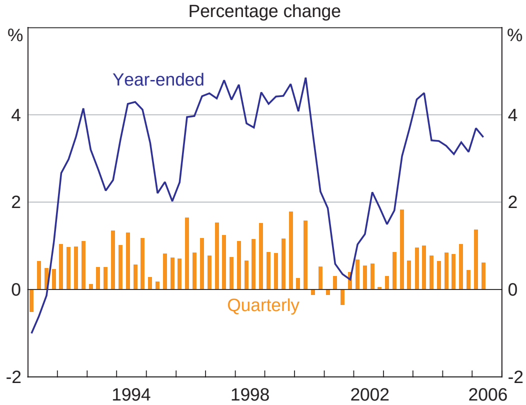
United States

After several years of above-trend growth, surplus capacity in the US economy appears to have been substantially removed. Real GDP growth slowed to 0.6 per cent in the June quarter and 3.5 per cent over the year, as demand has started to respond to the increases in interest rates over the past couple of years, the recent slowing in the housing market, and high energy prices (Graph 2).

Graph 2

United States – GDP

Percentage change



Source: Thomson Financial

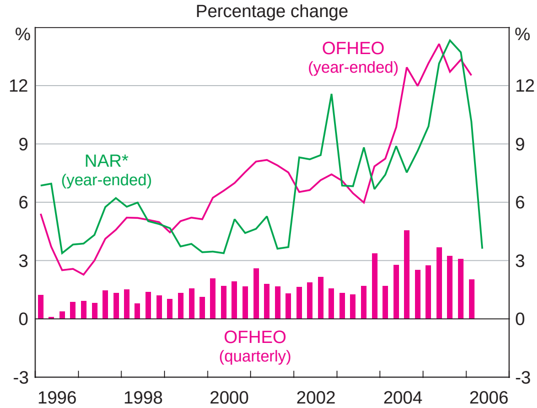
Consumption increased by 0.6 per cent in the June quarter, below the average quarterly growth rate of 0.9 per cent in recent years, to be 3.0 per cent higher over the year. This slowing may partly reflect an easing in the pace of house price growth that, through strong household wealth effects, had boosted consumption growth over the past couple of years. The rise in gasoline prices since the start of the year is also reported to have reduced consumer spending on other items. Nonetheless, the strength in the labour market has helped to support household spending. Although non-farm payrolls growth slowed to 0.2 per cent over the June quarter, the unemployment rate continued to fall, to be at a five-year low of 4.6 per cent in June.

After several years of strong performance, conditions in the US housing market have eased. The 30-year fixed mortgage rate has continued to drift higher, averaging 6.8 per cent in July compared with 5.7 per cent a year earlier, which has dampened home sales. As a consequence, the stock of unsold new and existing houses has increased to around six months of current monthly sales from around four months over much of the past decade. Residential investment fell by 1.6 per cent in the June quarter, following small falls in the previous two quarters. Leading indicators such as housing starts and permits to build have fallen noticeably since the start of the year, while builders' confidence is at the lowest level since the early 1990s. House price growth has eased. Growth in the Office of Federal Housing Enterprise Oversight (OFHEO) repeat sales index of house prices slowed to 2.0 per cent in the March quarter, the lowest quarterly rate for two years, and the National Association of Realtors' (NAR) existing home sales series suggests an even sharper slowing (Graph 3).

Graph 3

United States – House Prices

Percentage change



* Median price of existing home sales
Source: Thomson Financial

Growth in business investment moderated in the June quarter, to be 0.7 per cent for the quarter, and growth in core capital goods orders also slowed. Nonetheless, the outlook for business investment remains favourable: capacity utilisation is high, profits continue to grow strongly and business sentiment remains at a healthy level.

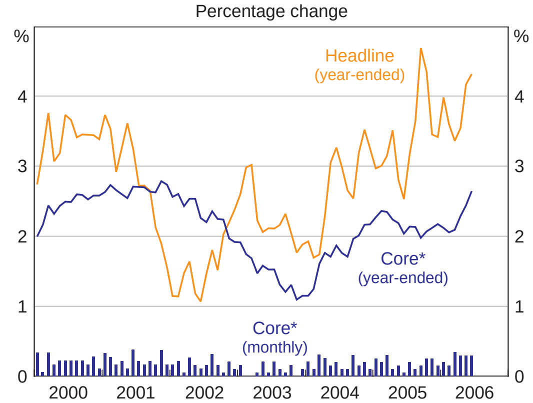
Net exports contributed 0.1 percentage points to growth in the June quarter, as the volume of exports increased while imports were flat. In nominal terms, the trade deficit in the June quarter was steady at 5.9 per cent of GDP.

Energy price increases pushed headline inflation up to 4.3 per cent over the year to June, and core inflation picked up to 2.6 per cent, its fastest pace in over four years (Graph 4). Some indicators suggest that inflation expectations have increased, although productivity growth has remained firm. The

Graph 4

United States – Consumer Prices

Percentage change



* Excluding food and energy
Source: Thomson Financial

Federal Reserve has continued to tighten monetary policy, raising the federal funds rate by a further 25 basis points to 5.25 per cent at the June meeting of the Federal Open Market Committee.

Asia-Pacific

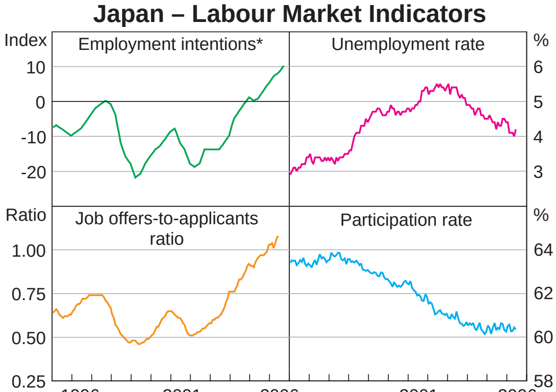
Japan

The economic expansion in Japan has continued, with growth broadly based across domestic private demand and the export sector. Real GDP increased by 0.8 per cent in the March quarter, to be 3.5 per cent higher over the year. In the June quarter, year-ended growth in industrial production remained solid at around 4 per cent and the ongoing global ITC recovery continued to underpin strong merchandise export growth of 15 per cent over the year. A more confident business sector has remained an important feature of the recovery, reflecting solid balance sheets and profitability, as well as strong domestic and external demand conditions. Investment increased by 3.1 per cent in the March quarter, with year-ended growth at 7.4 per cent. The investment outlook remains favourable: machinery orders continue to trend upwards, and capacity utilisation rates for both the manufacturing and non-manufacturing sectors are at high levels. Investment intentions in the June quarter Tankan survey were revised up significantly, with business conditions reported at their highest level since the early 1990s.

Conditions in the household sector have continued to strengthen. Consumption increased by 2.4 per cent over the year to the March quarter, and consumer sentiment remains well above its long-run average, helped by a further improvement of the labour market (Graph 5). The unemployment rate is around an eight-year low, the participation rate has stabilised following a protracted decline, and the job offers-to-applicants ratio has been above one since late 2005. Positive sentiment about future employment conditions suggests a favourable outlook.

Graph 5

Japan – Labour Market Indicators



* Tankan survey, deviation from long-run average
Sources: Bank of Japan; Thomson Financial

Consumer prices have continued to record modest annual increases in recent months, providing further evidence that the deflation period has ended. As a consequence, after an extended period when interest rates were held at zero per cent, the Bank of Japan increased the short-term interest rate to 0.25 per cent at its July meeting. This is a further step toward policy normalisation that began with the termination of the quantitative easing policy in March, although the Bank noted in its recent statement that rates are likely to remain low for some time.

China

Rapid growth in the Chinese economy continues to support growth elsewhere in Asia, Australia and around the world. Real GDP is estimated to have increased by more than 11 per cent over the year to the June quarter, its fastest pace in over a decade. Growth was again concentrated in business-sector activity and net exports. Fixed asset investment increased by 34 per cent over the year to June and industrial production increased by 20 per cent. Retail sales are also growing at around their strongest pace in more than a year. Growth in exports, at 22 per cent over the year to June, continued to run somewhat ahead of the growth in imports. The monthly trade surplus in the first half of 2006 averaged US$12.5 billion, nearly 50 per cent larger than the monthly average during the first half of 2005.

The strong growth in the Chinese economy has been accompanied by stimulatory financial conditions, with recent rates of money and credit growth around two-year highs. In response, the People's Bank of China increased lending rates in April and has raised the required reserve ratio by 1 percentage point (to 8.5 per cent), and in the past few months the government introduced tax measures designed to cool the housing sector. While producer price inflation has picked up, the official measure of consumer price inflation has remained low, at 1.5 per cent over the year to June.

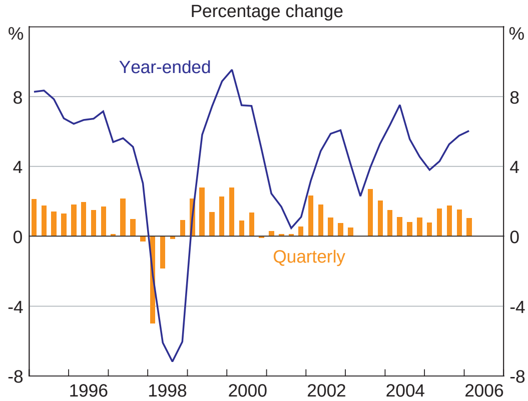
Other Asia-Pacific

In the rest of east Asia, solid growth is being supported by healthy domestic demand, global demand for ITC goods and strong demand from China. Real GDP in the region increased by 1.0 per cent in the March quarter, to be 6.0 per cent higher in year-ended terms (Graph 6). Most countries have experienced favourable outcomes, but a decline in confidence in response to a rise in consumer credit card defaults has led to weaker growth in Taiwan, and growth has slowed in Indonesia in response to high interest rates and a fall in government consumption.

Graph 6

East Asia* – GDP

Percentage change



* Excluding China and Japan

Source: CEIC

The generally solid growth performance of the region has reflected firm domestic and external demand. On the domestic side, low real interest rates and good labour market conditions underpinned private consumption growth in most countries in the March quarter. In addition, business investment rebounded in the quarter after the surprising weakness seen in 2005. More timely indicators suggest that this strength in domestic demand continued into the June quarter. On the external side, merchandise exports grew by more than 15 per cent over the year to May, and the continued improvement in ITC demand indicators suggests that external demand will remain strong in coming months.

Inflation has drifted higher across the region over the past couple of years in line with oil prices, especially in the countries that have reduced oil subsidies. Central banks across the region have raised rates, with Korea, Thailand and Taiwan recently tightening policy further, although real interest rates have mostly remained low. In contrast, interest rates in Indonesia were lowered by 50 basis points over the past three months in response to slower economic growth and an easing of the inflationary pressures evident in the second half of 2005.

The Indian economy expanded particularly strongly in the March quarter, taking year-ended growth to 9.3 per cent, its fastest pace for over two years. Construction and services remained the strongest performing sectors. Growth in industrial production has also strengthened, to be 10 per cent over the year to May. Wholesale price inflation picked up to close to 5 per cent over the year to June from 3½ per cent in August 2005. In response, the Bank of India has raised its policy rate by 50 basis points since the last *Statement*.

In New Zealand, economic growth rebounded to 0.7 per cent in the March quarter, after outcomes close to zero in the second half of 2005, and GDP was 2.0 per cent higher over the year. However, more recent indicators suggest domestic demand remains relatively subdued, and consumer and business confidence measures have been weak. Nevertheless, the labour market remained tight in the March quarter, with employment increasing by 2.6 per cent over the year and labour costs continuing to rise strongly. Year-ended consumer price inflation increased to 4.0 per cent in the June quarter, and the Reserve Bank of New Zealand has noted that it remains concerned about inflationary pressures.

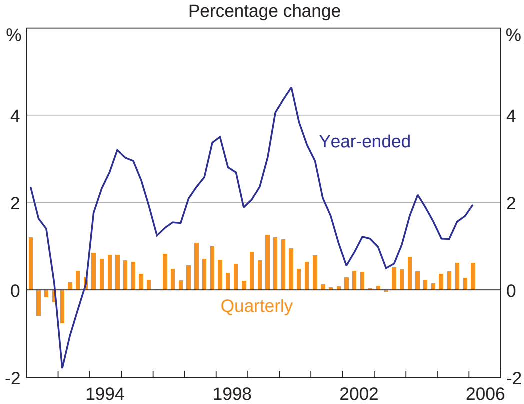
Europe

The recovery in the euro area is progressing. Following a weak December quarter, growth was 0.6 per cent in the March quarter and 2.0 per cent over the year (Graph 7). Growth in Germany and Italy improved in the March quarter after flat December quarter outcomes, while French growth remained solid and the Spanish economy continued to expand strongly.

Graph 7

Euro Area – GDP

Percentage change



Source: Thomson Financial

Consumption increased by 0.6 per cent in the March quarter and was broadly based across the region. While the increase in German consumption only unwound the fall in the December quarter, recent indicators suggest that consumer spending in Germany may improve further, after stagnating for the past five years or so. Consumer confidence is above its long-run average level, employment has increased and unemployment is trending downwards. While recent strength in consumption may partly reflect the staging of the FIFA World Cup in Germany, developments have generally been positive across the euro area as a whole.

Business conditions remain buoyant, with euro area business confidence and the manufacturing PMI advancing steadily over the past year, to be well above their long-run averages. Much of the positive sentiment in the business sector has stemmed from strong external demand; merchandise exports increased by 12 per cent over the year to May and foreign manufacturing orders increased strongly. Industrial production in the euro area continues to expand, increasing by almost 5 per cent over the year to May, and profits increased further in the March quarter.

The European Central Bank (ECB) has continued to tighten policy, with the repo rate rising by 25 basis points to 2.75 per cent in June, the third increase since December 2005. Nevertheless, the ECB views monetary policy as remaining accommodative and expects that, on the basis of their current assumptions, some further tightening will be required. Headline inflation is above the ECB's 2 per cent reference rate, at 2.5 per cent in July, although core inflation has been lower at around 1½ per cent.

Economic growth in the UK continued to recover in the June quarter, and was 2.6 per cent over the year. Growth has been led by the consumer sector; consumer sentiment remains above its long-run average and house price growth continues to recover, although the unemployment rate increased to 5.4 per cent in May from a low of 4.7 per cent during 2005. Headline inflation picked up to 2.5 per cent over the year to June, but underlying inflation remained low, at 1.2 per cent over the same period. In recent months, the Bank of England held its policy rate unchanged at 4.5 per cent.

International and Foreign Exchange Markets

International financial markets

The relatively calm conditions which characterised global financial markets over the past few years have been punctuated by several bouts of volatility in recent months. The volatility was initially triggered by growing concerns about inflation and the prospect of further increases in policy interest rates in the major economies. This contributed to a further unwinding of the carry trades discussed in the previous *Statement*. Together with a general reappraisal of the appetite for risk, this resulted in declines in more risky assets including a number of commodities, emerging equity markets and exchange rates in emerging markets such as Turkey, Indonesia and South Africa. The price declines were generally most pronounced in those markets which had previously experienced the largest rises and, in most cases, prices only fell back to the levels prevailing earlier in the year. More recently, the conflict in the Middle East, rising oil prices and the political tensions surrounding North Korea have contributed to further volatility in financial markets.

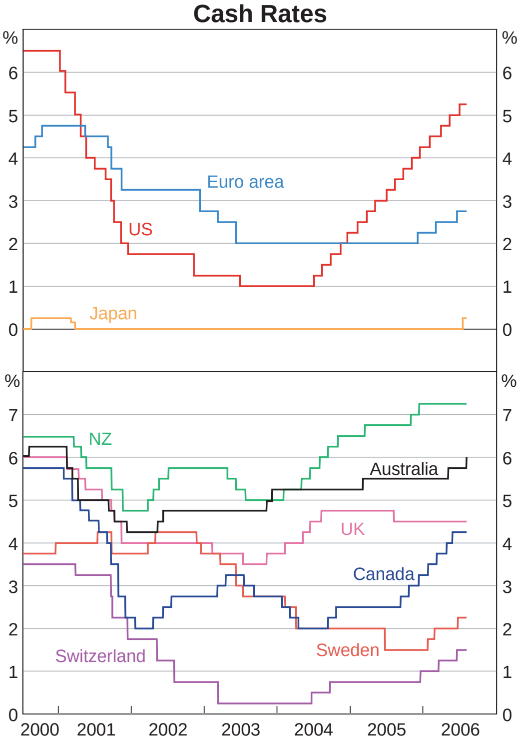
Official interest rates

The three major central banks are now all in the process of unwinding the sizeable monetary stimulus that has been in place in recent years, although they are at different stages of this process (Graph 8).

The Bank of Japan (BoJ) increased official rates for the first time since 2000, raising the overnight rate by 25 basis points from zero per cent at its July meeting. The impact of this on global financial markets had mainly been felt several months earlier when it became clear that the BoJ was close to the start of its tightening cycle. This had been a major cause of the reduction in yen carry trades in May. Having been widely anticipated, the announcement itself had little impact on financial markets. The market currently expects the BoJ will raise

Graph 8

Cash Rates



Source: central banks

the policy rate by a further 25 basis points towards the end of this year (Table 2). The European Central Bank is more advanced in the process, having begun to increase rates in late 2005, and tightening further at its March and June meetings. With the economic recovery in Europe continuing and with inflation still above 2 per cent, the market currently expects further rate increases later this year.

Table 2: Changes in Monetary Policy

	Current level Per cent	Most recent change	Market expectations for next 6 months
United States	5.25	↑ Jun 06	No change
Euro area	2.75	↑ Jun 06	↑ 50 bps
Japan	0.25	↑ Jul 06	↑ 25 bps
United Kingdom	4.50	↓ Aug 05	↑ 25 bps
Canada	4.25	↑ May 06	No change
New Zealand	7.25	↑ Dec 05	No change

Sources: central banks; Bloomberg; Reuters

The US Federal Reserve is most advanced in the tightening process. In late June it raised the federal funds rate by 25 basis points for the 17th consecutive meeting since June 2004. In total, US rates have risen by 425 basis points to 5¼ per cent. The Fed has indicated that further rate rises are dependent on the evolution of the economic outlook and that its central scenario is for growth to stabilise around potential and the inflation outlook to remain benign, albeit with upside risks. Consequently, the market has significantly increased its assessment of the probability that the Fed will pause at its next meeting. The Bank of Canada paused in its tightening process in July after having tightened at each meeting since mid 2005. The market currently expects that rates will remain unchanged at 4¼ per cent for the rest of the year.

Policy rates continue to be raised from low levels in Switzerland, Sweden and Norway, with the central banks increasing policy rates by 25 basis points since the last *Statement*, to 1½ per cent, 2¼ per cent, and 2¾ per cent respectively. The market is currently expecting the Bank of England to increase rates by 25 basis points later this year.

Given the very strong growth outcomes in China, the monetary authorities have taken further steps to tighten policy settings. In an attempt to dampen rapid credit growth of 15 per cent per annum the interest rate banks charge on loans was raised in May, and the amount banks are required to hold in reserves was increased twice in recent weeks. Additional administrative measures were also introduced to contain activity in the housing sector. The success of policy measures to date has been limited as monetary growth of 18½ per cent continues to outpace the official target of 16 per cent for this year, in part due to the difficulties in sterilising intervention in the foreign exchange market.

Elsewhere in Asia, policy rates continued to be raised with central banks in Korea, India, Thailand and Taiwan all increasing rates since the last *Statement*. The level of rates still remains relatively low in real terms. In some countries, large depreciations in their exchange rates have contributed to central banks, including those in South Africa, Turkey and Iceland, raising policy rates significantly. In contrast, Indonesia and Brazil have lowered rates as inflation pressures in those countries have eased.

Bond yields

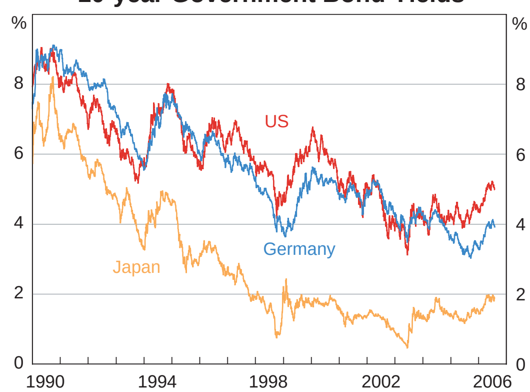
Government bond yields have risen noticeably in the major markets over the past year to be the highest they have been for several years (Graph 9). Strong global economic activity, heightened concerns about inflation and expectations of further interest rate tightening by the major central banks have been the major factors pushing up yields. Yields have come off their highs in recent weeks as market participants moved out of riskier assets into government bonds in the wake of recent political instability.

Yields on US 10-year government bonds are currently trading at around 5 per cent, having reached their highest level in this cycle of 5¼ per cent in late June. Similarly in Germany, 10-year government bond yields are back trading around 4 per cent, having risen to 4¼ per cent in recent months. In Japan, long-term yields are just under 2 per cent. The increase in yields at shorter maturities was particularly marked due to the prospect of an increase in interest rates by the Bank of Japan (Graph 10).

Spreads on emerging-market and corporate debt rose during the period as a number of global events caused market participants to move

Graph 9

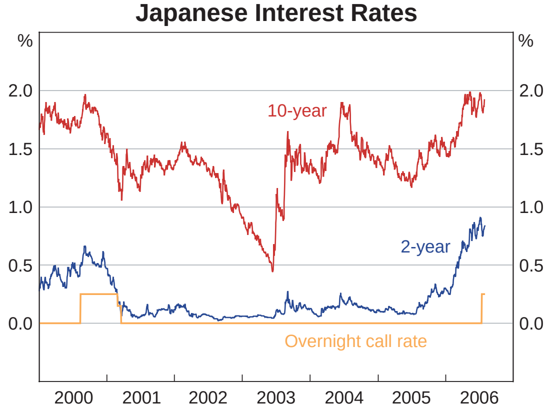
10-year Government Bond Yields



Source: Bloomberg

Graph 10

Japanese Interest Rates

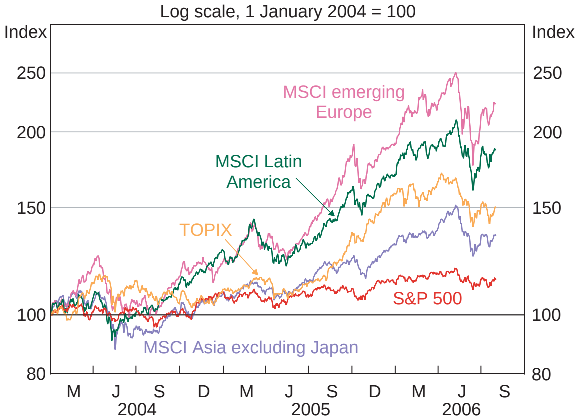


Source: Bloomberg

Graph 11

Share Price Indices

Log scale, 1 January 2004 = 100



Source: Bloomberg

Table 3: Changes in Major Country Share Prices

Per cent

	Since 2000 peak	2006 to date	Since previous *Statement*
United States			
– Dow Jones	–5	4	–2
– S&P 500	–17	2	–3
– NASDAQ	–59	–6	–11
Euro area			
– STOXX	–27	4	–5
United Kingdom			
– FTSE	–15	5	–2
Japan			
– TOPIX	–11	–5	–10
Canada			
– TSE 300	5	6	–2

Source: Bloomberg

away from more risky assets. The increase in spreads was largest for US corporate and emerging European debt. However, despite the rise, spreads remain at low levels by the standards of the past decade.

Equity markets

After having risen quite strongly during the first part of the year, global equity markets have experienced pronounced volatility since the last *Statement* as investors appeared to have reappraised their appetite for risk (Graph 11, Table 3). Losses have tended to be most severe in emerging markets where the preceding gains were strongest. In particular, equity prices fell substantially in a number of Latin American and emerging European countries, although these declines unwound only part of the gains in these markets earlier in the year. While equity markets staged a brief recovery in late June, heightened political instability since then has led to renewed volatility. The Israeli-Lebanese conflict, bombings in India, and concern over North Korea's missile testing all contributed to the move away from risky assets.

Exchange rates

The US dollar appreciated against several currencies over the past three months but remained little changed on a trade-weighted basis (Table 4). The dollar appreciated against the yen, despite the decision by the Bank of Japan to raise its official interest rate (Graph 12). This possibly reflected a judgment by market participants that Japanese interest rates would continue to be well below US rates for a long time.

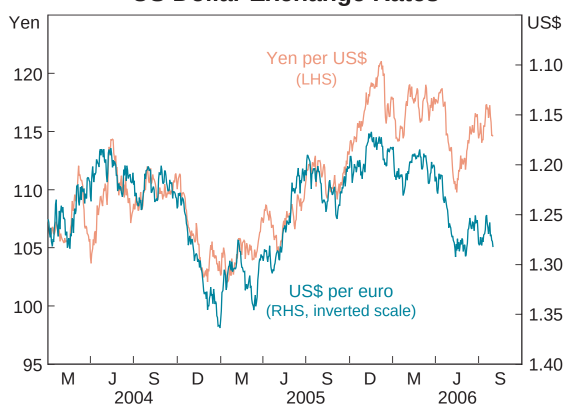
The Chinese renminbi has continued to appreciate against the US dollar, although in recent months the pace of appreciation has been slow. Since the initial revaluation in July 2005, the renminbi has only appreciated by a further 1½ per cent against the US dollar. A number of other emerging-market currencies have experienced noticeable depreciations since the last *Statement* due to volatility in commodity prices, the unwinding of carry trades, equity market weakness and general paring back of speculative positioning. The declines were most evident in the Turkish lira, Indonesian rupiah, Brazilian real and South African rand. These currencies now appear to have stabilised, with the Brazilian real and Indonesian rupiah still stronger against the US dollar than at the beginning of the year.

Table 4: Change in US Dollar against Other Currencies
Per cent

	2006 to date	Since previous *Statement*
Sweden	–10	–2
United Kingdom	–8	–1
Thailand	–8	0
Euro area	–8	–1
Indonesia	–7	4
Switzerland	–7	0
Brazil	–6	7
South Korea	–5	2
Singapore	–5	0
Australia	–4	1
Philippines	–3	0
Malaysia	–3	2
Canada	–3	2
Japan	–3	2
China	–1	0
Taiwan	0	4
India	3	4
Mexico	4	1
South Africa	10	15
New Zealand	10	3
Majors TWI	**–5**	**1**
Broad TWI	**–3**	**1**

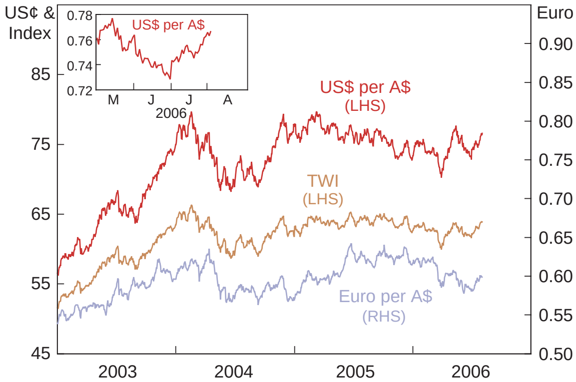
Source: RBA

Graph 12
US Dollar Exchange Rates



Source: Bloomberg

Graph 13
Australian Dollar



Sources: RBA; Reuters

Table 5: Australian Dollar against Selected TWI Currencies
Per cent

	2006 to date	Since previous *Statement*
New Zealand	16	3
South Africa	15	15
Taiwan	5	4
US	5	0
China	3	–1
PNG	3	–1
Japan	2	1
Canada	2	3
Philippines	1	0
South Korea	–1	2
Singapore	–1	0
Switzerland	–2	–1
Euro area	–3	–1
Indonesia	–3	4
UK	–4	–2
Sweden	–5	–3
TWI	**2**	**1**

Source: RBA

Australian dollar

The Australian dollar is little changed in net terms since the last *Statement*, both against the US dollar and on a trade-weighted basis (Graph 13, Table 5). Over the period it has moved in a range between US73 and US77 cents. It peaked in the first half of May, subsequently depreciated through to the end of June as commodity prices experienced a sharp correction, before rising again recently. Currently the exchange rate is trading at a little over US76 cents, and 64 against the trade-weighted index. These levels are similar to the average of the past couple of years. The relative stability of the currency over the past few years is the result of two opposing forces. The continuing strong rise in the terms of trade has been supportive of the currency but the narrowing of the interest differential with the US has had the opposite effect.

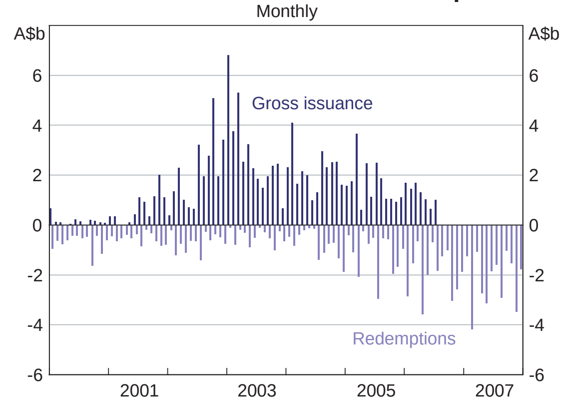
The impact of narrowing interest differentials can be seen in the declining level of Australian dollar Eurobond issuance after the surge in 2003 and 2004. Recent levels of issuance have fallen short of maturities (Graph 14). Redemptions scheduled over the remainder of the year are also relatively large compared to issuance levels in 2006 to date.

One gauge of investor sentiment towards the Australian dollar is the net speculative positioning in Australian dollar futures on the Chicago Mercantile Exchange. These positions have generally been net long recently, though somewhat smaller than was the case in 2005 (Graph 15).

With the exchange rate at levels only a little above average, the Bank has not been adding to net reserve holdings since the last *Statement*. Its market purchases of foreign exchange have been only sufficient to cover sales to the Government. After taking acccount of earnings, net reserves are a little higher since May, at just over A$30 billion. The Bank's holdings of foreign exchange under swap agreements, which are largely determined by liquidity management operations, have increased to A$40 billion.

Graph 14

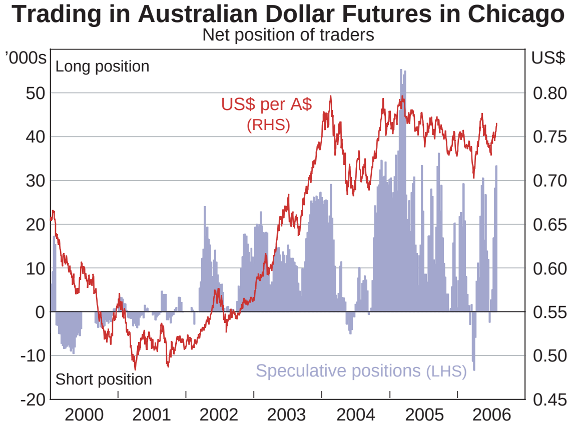
A$ Eurobond Issuance and Redemptions



Sources: RBA; Westpac

Graph 15

Trading in Australian Dollar Futures in Chicago



Sources: Commodity Futures Trading Commission; RBA

Domestic Economic Conditions

The pace of economic expansion in Australia appears to have picked up over the first half of 2006. Ongoing positive business conditions have in recent months been joined by renewed strength in recorded employment growth and some pick-up in household spending growth. Reports of capacity constraints and labour market tightness continue to feature in both survey data and feedback from liaison with firms.

The March quarter national accounts reported that growth in the Australian economy returned to a rate closer to long-run trends, after a period of somewhat slower growth (Table 6). Growth was also more balanced between domestic and external demand than had been the case for some time, with net exports not subtracting from GDP growth in the quarter. Business investment has been particularly strong in the resource-intensive states of Western Australia and Queensland, where activity continued to run faster than in the rest of the country. In addition, household consumption growth picked up in the quarter, to be more in line with the overall rate of economic expansion.

More recent data suggest that the economy has continued to grow at a firm pace. Available information on household consumption points to a solid increase in the June quarter, while forward indicators of housing activity suggest the downturn in dwelling construction is nearing its end. The established housing market has also shown signs of firmer conditions in recent months, with nationwide house prices rising in the June quarter. Business investment is expected to continue to grow, although a noticeable slowing from its earlier rapid pace of expansion seems likely. Looking through the considerable monthly volatility, a recovery in exports growth appears to be in train, supported by continued strong growth in the world economy and a large amount of new capacity that is starting to come on line in the resources sector.

Table 6: Demand and Output
Percentage change

	December qtr 2005	March qtr 2006	Year to March qtr 2005	Year to March qtr 2006
Domestic final demand	1.6	0.8	3.4	5.0
Change in inventories[(a)]	0.0	0.0	–0.2	–0.3
GNE[(b)]	1.3	0.8	3.5	4.0
Net exports[(a)]	–0.6	0.0	–1.7	–1.1
GDP	0.7	0.9	2.0	3.1
Memo item:				
Real GDP adjusted for changes in terms of trade	1.3	0.7	3.4	5.1

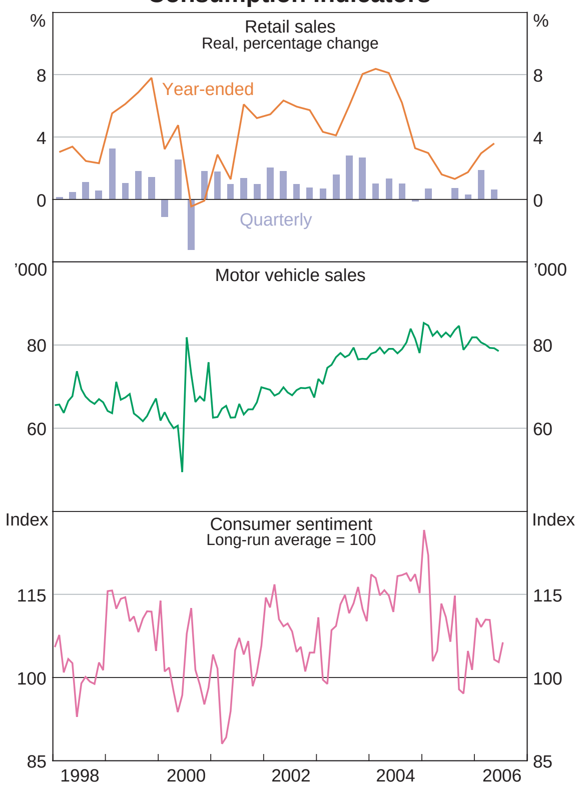
(a) Contributions to GDP growth
(b) Includes the statistical discrepancy
Source: ABS

Household sector

Household demand strengthened in the first half of the year, following a period of moderate growth in consumption spending and a corresponding increase in the household saving ratio in 2005. In the March quarter, household consumption rose by 0.9 per cent, to be 2.9 per cent higher over the year. Spending growth was broad-based across both goods and services, and outpaced household income growth in the quarter.

More recently, the volume of retail sales increased further, rising by 0.6 per cent in the June quarter and 3.6 per cent over the year (Graph 16). Across the mainland states, year-ended retail sales growth was still fastest in Western Australia and Queensland. Motor vehicle sales to households fell slightly in the June quarter and have been broadly unchanged over the past two years, following a period of strong growth before that. Consumer sentiment, as measured by the Westpac-Melbourne Institute index, rose in July and remains above average levels, after having eased in recent months in line with higher petrol prices and the increase in the cash rate in early May.

Graph 16
Consumption Indicators



Sources: ABS; FCAI; Melbourne Institute and Westpac

Even during the earlier period of more moderate consumption growth, household credit expanded at a solid pace, and it increased by around 13 per cent over the year to June. As a result, the debt-servicing ratio has been rising steadily, to stand a little below 11 per cent in the March quarter (Graph 17). Continued strength in the labour market, and the recent tax cuts and other fiscal measures announced in the Australian Government Budget, are expected to support growth in household income and consumption in the second half of this year. Despite the expected growth in disposable income, the household debt-servicing ratio is likely to rise further in the period ahead, since household debt has been growing at an even faster pace than income. Together with the recent increases in interest rates, this is likely to boost households' interest payments.

Housing

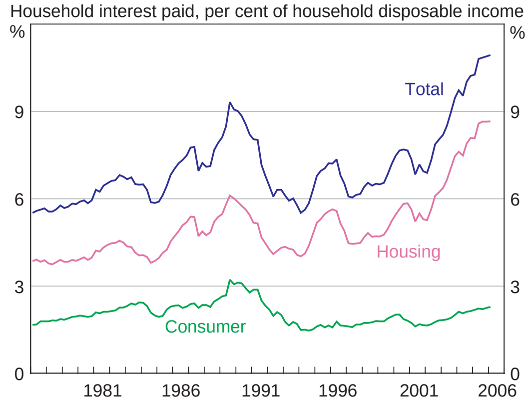
Construction

The downturn in housing construction activity since early 2004 continued into the early part of 2006. Dwelling investment fell by 2.5 per cent in the March quarter, with declines in both new dwellings and alterations & additions. The weakness in the quarter was concentrated in New South Wales and Victoria. However, there was a sharp rise in the number of dwellings commenced in the March quarter, reportedly as work began on a number of large medium-density projects in New South Wales that had been approved some time ago but then kept on hold by the developers. In addition, other forward indicators, such as local government building approvals, have risen a little over the past six months or so, suggesting that the current downturn may be nearing its end (Graph 18).

Graph 17

Debt-servicing Ratio*

Household interest paid, per cent of household disposable income

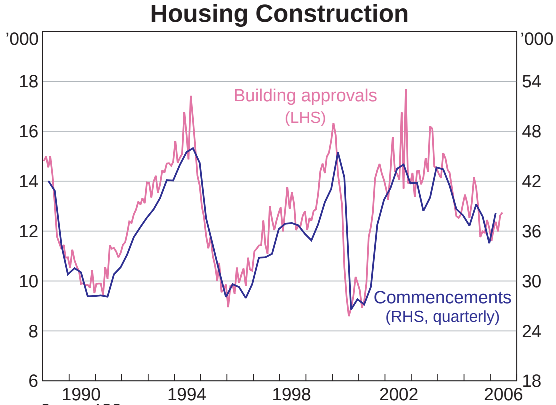


* Household sector excludes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments. Includes imputed financial intermediation service charge.

Sources: ABS; RBA

Graph 18

Housing Construction



Source: ABS

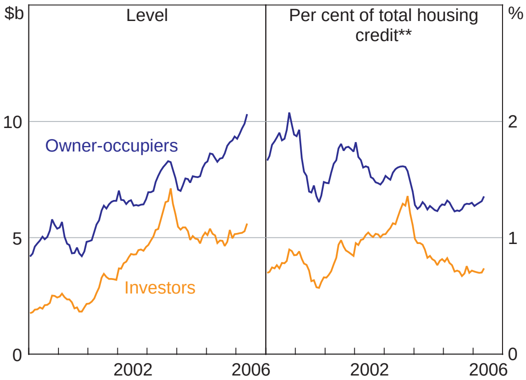
Feedback from liaison with builders has also pointed towards a modest recovery in demand for new housing since the start of the year; contracts to build are above their trough, which is expected to flow through to higher commencements in the second half of the year. The current downturn has been mild compared with previous dwelling investment cycles; investment has fallen by around 9 per cent nationwide from its peak in early 2004. The bulk of this occurred in New South Wales, where dwelling investment has fallen by 23 per cent and the process of recovery appears likely to be fairly slow.

Financing and prices

Housing finance has continued to strengthen in recent months, with the value of housing loan approvals increasing by 5.5 per cent over the three months to May (Graph 19). The growth in loan approvals since the trough in 2004 has been almost entirely attributable to owner-occupiers. As a result, the shares of investors and owner-occupiers in total approvals have now returned to levels last seen in early 2002; investors have recently accounted for around 35 per

Graph 19

Housing Loan Approvals*

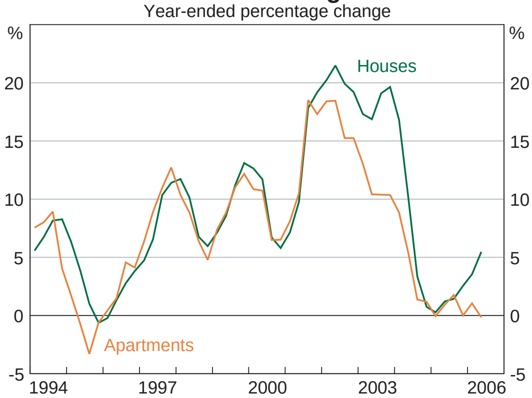


* Excludes approvals for new construction by investors
** Includes securitised loans
Sources: ABS; RBA

Graph 20

Australian Dwelling Prices

Year-ended percentage change



Sources: APM; RBA

cent of approvals, compared with a peak of 45 per cent in late 2003. In line with their lower share of loan approvals, investors have accounted for less of the growth in the stock of housing credit than previously. Overall housing credit grew at an annualised rate of around 15 per cent over the six months to June, up from 11½ per cent over the previous six months.

Conditions in the established housing market picked up further over the first half of the year. The APM mix-adjusted measure of nationwide house prices rose by around 2 per cent in the June quarter, to be 5½ per cent higher over the year (Graph 20). House prices were estimated to have risen in all state capitals in the quarter except Melbourne, with the strongest growth continuing to be in Perth and Darwin; prices rose in Sydney in the quarter but were broadly flat over the year (Table 7). Apartment prices were also broadly flat over the year, partly because the relatively higher concentration of apartments located in Sydney and Melbourne has weighed on the nationwide measure relative to that for houses. Auction markets appear to have been little affected by the increase in interest rates in May, with clearance rates in Sydney and Melbourne broadly unchanged over recent months, at around their highest levels for two years.

Residential rental markets have continued to tighten, in line with a gradual absorption of earlier excess supply in the apartment market; this is likely to result in some recovery in rental yields towards more normal levels. Data from state real estate institutes suggest that rental vacancy rates have fallen steadily over the past couple of years. Consistent with this, tenancy authorities confirm that apartment rents are now increasing, even in inner-city areas, where oversupply had been most evident. Apartment rents rose by more than 5 per cent over the year to the June quarter in all capital cities.

Table 7: House Prices
Percentage change

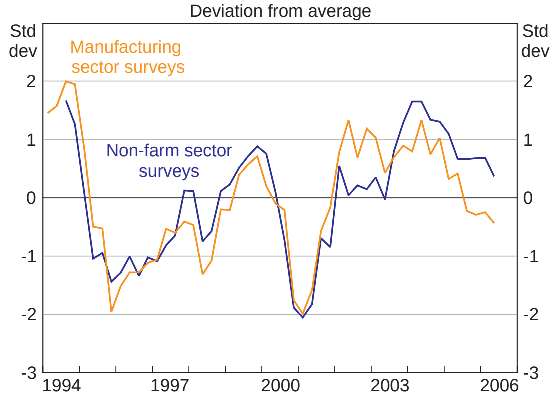
	APM		REIA		Residex		ABS
	Jun qtr 2006	Year to Jun qtr	Jun qtr 2006[a]	Year to Jun qtr	Jun qtr 2006[b]	Year to Jun qtr	Year to Mar qtr
Sydney	1.2	–0.9	..	..	2.8	1.8	–3.1
Melbourne	–0.8	2.5	3.2	4.2	1.7	8.3	3.8
Brisbane	1.4	4.4	..	..	1.1	4.8	2.8
Adelaide	2.7	5.9	2.3	4.2	..	..	5.3
Perth	10.1	36.6	..	..	8.2	28.3	28.8
Canberra	1.3	3.4	..	..	0.0	4.5	1.4
Hobart	1.0	8.0	..	..	..	..	9.9
Darwin	6.9	20.5	..	..	1.2	17.4	17.4
Australia	**2.0**	**5.6**	**..**	**..**	**3.1**[c]	**9.0**[c]	**3.6**

(a) Seasonally adjusted by the RBA
(b) Three-month-ended
(c) Excludes Adelaide and Hobart
Sources: ABS; APM; REIA; state REIs; RBA; Residex

Business sector

Overall business conditions remained positive during the first half of 2006, but this was more evident in the services sector than the goods sector, particularly manufacturing, where production fell in the March quarter. Business surveys for the June quarter were broadly consistent with a continuation of this pattern (Graph 21). The NAB survey indicated that non-farm business conditions remained well above average levels, and capacity utilisation high (Graph 22). Positive business conditions were also reported in the ACCI Survey of Investor Confidence and the St. George-ACCI survey in the June quarter, while the Sensis survey reported softer conditions for small and medium-sized firms. The major surveys continue to indicate more moderate conditions in the manufacturing sector. This has had the greatest effect on the manufacturing-intensive states of Victoria and South Australia where trading conditions are generally reported to be weaker than elsewhere.

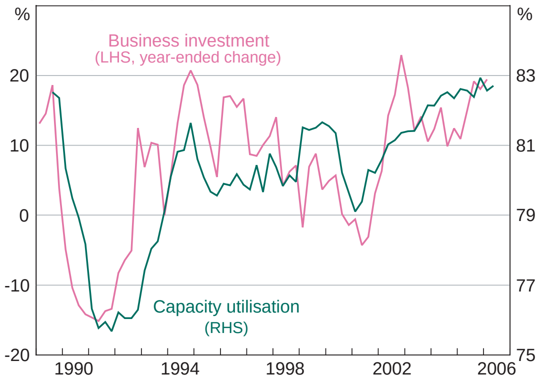
Graph 21
Actual Business Conditions*
Deviation from average



* 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

Consistent with the business surveys, the Bank's liaison continues to suggest that capacity utilisation remains unusually high across a range of industries. However, constraints are said to have eased in the residential construction industry and in parts of manufacturing where demand has been subdued.

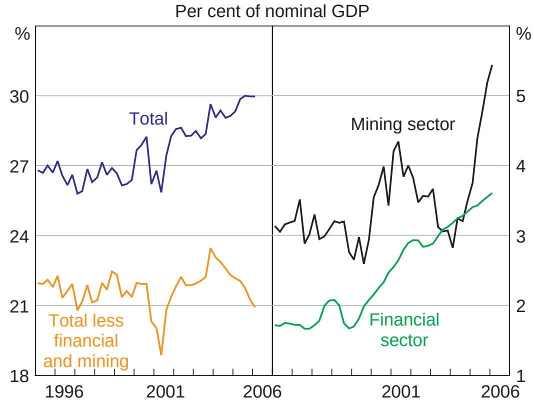
Graph 22
Capacity Constraints and Investment



Sources: ABS; NAB

Graph 23
Profits*

Per cent of nominal GDP



* Combined profits of both the incorporated and unincorporated sectors
Sources: ABS; RBA

The outlook for rural production is less favourable than it was a few months ago. The latest ABARE forecasts suggest that the 2006/07 winter crop will fall by 11 per cent from last year's record crop, with a 9 per cent decrease in wheat production. Private-sector forecasters and state government departments are factoring in even lower production, owing to further deterioration in growing conditions since ABARE's forecasts were released, particularly in Western Australia, the largest wheat-growing region. Continued dry conditions in New South Wales have also reduced forecast crop levels; more than 90 per cent of the state is now drought-declared.

Total private-sector profits rose by 9.6 per cent over the year to the March quarter, with the profit share hovering at a record-high 30 per cent of GDP (Graph 23). Profits growth continues to be driven by the mining and finance sectors; excluding these two sectors, profits fell in each of the three quarters up to March, to be slightly below their decade average as a share of GDP. It appears that businesses' margins are being squeezed by rising material and labour costs. Nevertheless, forward indicators such as the NAB survey's actual and expected profitability series continue to point to reasonable optimism about near-term prospects for overall profits.

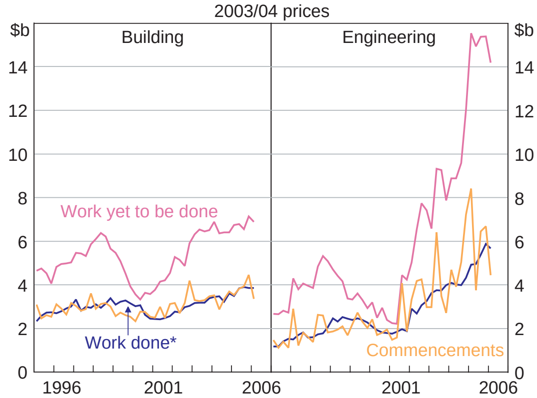
Business investment increased further in the March quarter, after a period of exceptionally fast growth in 2005, to be 19 per cent higher over the year. This strength was seen in both machinery & equipment and non-residential building investment, and was quite broad-based across industries. Business investment continued to be the major contributor to the very strong growth of demand in Queensland and Western Australia, with investment in these states increasing by more than 30 per cent over the year.

High levels of capacity utilisation and corporate profitability continue to provide a favourable backdrop for investment. The March quarter capital expenditure (Capex) survey's early reading of firms' investment plans for 2006/07 suggests modest growth in spending on machinery & equipment, from the current high levels. However, these long-range expectations are very preliminary and have historically been subject to large changes. Forward-looking indicators of non-residential construction suggest that activity will remain strong over coming quarters, with the pipeline of work yet to be done still at high levels despite a fall in the March quarter (Graph 24). However, ongoing labour and equipment shortages have reportedly been causing delays in some resource projects, and the viability of some planned projects has been reduced by rising construction costs. Together with the additional call on resources from public infrastructure projects, this could hamper further expansion in non-residential construction activity.

Graph 24

Non-residential Construction Indicators

2003/04 prices



* Seasonally adjusted

Sources: ABS; RBA

Government budgets

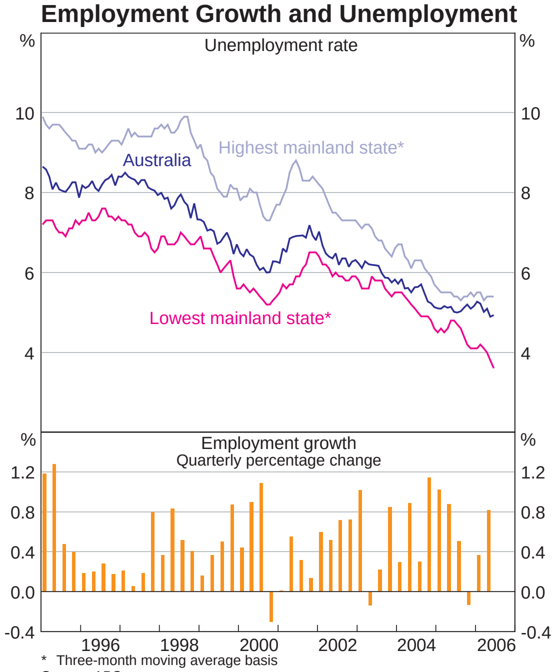
The Australian Government Budget for 2006/07, delivered in May, showed a substantial increase in the expected underlying surplus for 2005/06 in both cash and accrual terms. This largely resulted from significant upward revisions to the revenue estimates, particularly for individual employee and company taxation. While revenue growth is expected to remain strong in 2006/07, the budget surplus is projected to be lower than in the previous year, as a further round of personal income tax cuts and various other fiscal measures take effect (Table 8). The State Budgets for 2006/07, announced over May and June, are expected to move slightly into deficit in aggregate, reflecting expectations of slower growth in revenue and an increase in spending on capital projects and health. In addition to developments in the general government sector, state government trading enterprises are also expected to increase their investment spending significantly in the current year. However, it remains to be seen if the planned higher investment by the various levels of government can be fully implemented in an environment of capacity constraints and strong investment spending by the private sector.

Table 8: Fiscal Balance – General Government Sector[a]
Estimates, $ billion

	2005/06	2006/07
States		
NSW	–0.6	–2.5
Victoria	–1.2	–0.6
Queensland[b]	0.7	–1.8
WA	1.4	0.5
SA[c]	0.0	–0.2
Tasmania	0.1	–0.1
ACT	–0.1	–0.2
NT	–0.1	–0.1
Total states	**0.1**	**–4.9**
– Per cent of GDP	0.0	–0.5
Federal government	**16.5**	**10.9**
– Per cent of GDP	1.7	1.1
Total:		
States and federal	**16.6**	**6.0**
– Per cent of GDP	1.7	0.6

(a) ABS Government Finance Statistics basis
(b) Adjusted for differing funding arrangements for future superannuation liabilities
(c) As at 2005/06 South Australian Budget Mid-Year Review
Sources: Australian Treasury; RBA; state Treasuries

Graph 25
Employment Growth and Unemployment



* Three-month moving average basis
Source: ABS

Labour market

Employment growth was strong in the first half of 2006, following some weakness in the second half of 2005. Employment increased by 0.8 per cent in the June quarter and by 1.8 per cent over the year, with the growth broadly based across both the full-time and part-time components (Graph 25). The strength in the labour market has encouraged new entrants into the labour force, with the participation rate reaching a record level of 64.8 per cent in June. The unemployment rate recorded a 30-year low of 4.9 per cent in May and June, after remaining in the 5 to 5¼ per cent range for an extended period.

Labour market conditions remain favourable across all the states, although employment growth has been particularly strong in Western Australia and Queensland, reflecting the strength in mining and construction employment. Despite some divergence lately, there is by historical standards relatively little dispersion in unemployment rates across the mainland states, except for Western Australia, where it has been below the national rate for some time (Table 9).

Over the year to the June quarter, employment growth was strongest in the mining and electricity, gas & water industries, with the household services, business services and construction sectors also experiencing particularly strong growth. The largest decline was in the accommodation, cafes & restaurants industry, and employment also

Table 9: Labour Market by State

Per cent

	Employment growth		Unemployment rate	
	June qtr 2006	Year-ended June qtr 2006	June qtr 2005	June qtr 2006
NSW	0.4	0.9	5.1	5.4
Victoria	0.9	1.4	5.4	5.1
Queensland	1.1	2.1	5.0	4.7
WA	0.3	2.5	4.8	3.6
SA	0.3	0.8	5.0	5.1
Tasmania	0.4	3.0	6.1	6.5
Australia	0.8	1.6	5.1	5.0

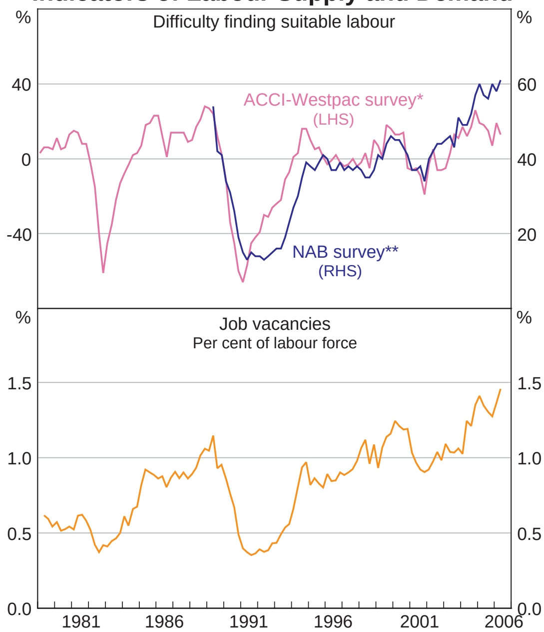
Source: ABS

contracted in the rural sector. These outcomes were broadly in line with recent sectoral trends in output. Employment growth has been strongest amongst the more-skilled occupations, consistent with reports of high demand for skilled workers.

Survey-based indicators and vacancy data mostly suggest that demand for labour is still strong and that the labour market will remain tight. The ABS measure of job vacancies increased in the June quarter, to show a nationwide vacancy rate of 1.5 per cent, the highest level in over thirty years (Graph 26). Private-sector measures of vacancies also show robust annual growth in job vacancies. In contrast, the ACCI-Westpac measure of manufacturing firms' hiring intentions fell in the June quarter.

Graph 26

Indicators of Labour Supply and Demand



* Net balance of manufacturing 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: ABS; ACCI and Westpac; NAB

Continued strength in labour demand has led to ongoing labour shortages. Business surveys report that firms are experiencing difficulty finding suitable labour, and employers note that this remains a key factor constraining their output. Feedback from the Bank's liaison program indicates that labour shortages are broad-based across industries and skill levels. However, shortages are most pronounced for skilled workers in the non-residential construction and resources sectors, and in much of the business services sector.

Foreign Trade and Capital Flows

Commodity prices and the terms of trade

After strong rises in the terms of trade through 2004 and 2005, there was a further modest increase in the first half of 2006. The rise of over 30 per cent in recent years has lifted the terms of trade to around their highest level in 50 years (Graph 27). This increase mainly reflects sharp rises in the prices of Australia's major commodity exports, which have taken the RBA's index of commodity prices to around its highest level since the series began in 1982 (Graph 28). During the most recent three months, commodity prices were volatile, particularly for gold and base metals, with a sharp increase until mid May, a decline through to mid June, and a subsequent recovery. Overall, the index increased by 1.3 per cent over the three months to July and is up around 7 per cent since the end of 2005 (Table 10).

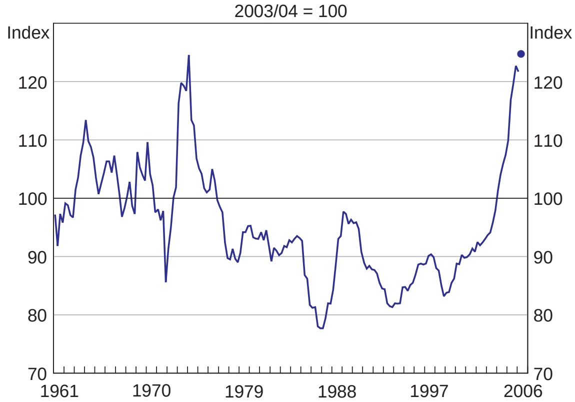
The increase in the commodity price index during 2006 has largely reflected a 40 per cent increase in base metals prices. Nickel and copper prices rose especially strongly over the past three months, with the nickel price boosted by a pick-up in global stainless steel demand and the copper price supported by low global inventories. Speculative activity and higher portfolio allocations to commodities have also supported base metals prices and contributed to the recent high level of price volatility.

Benchmark contract prices for coking coal and iron ore for the 2006/07 year (beginning April) have now been settled, but steaming coal contract prices are still being negotiated. Iron ore contract prices were settled at a 19 per cent premium over the 2005/06 prices (which were 72 per cent higher than prices in the previous year), underpinned

Graph 27

Terms of Trade

2003/04 = 100

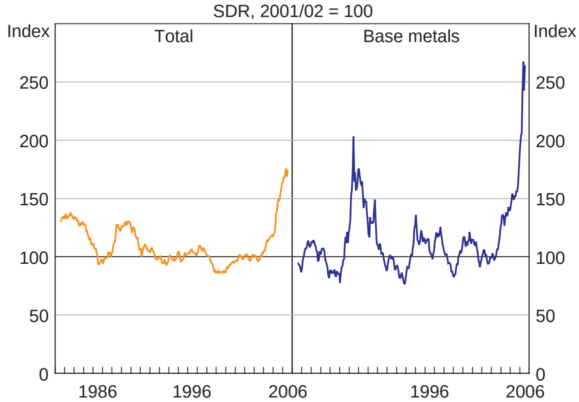


Sources: ABS; RBA

Graph 28

RBA Index of Commodity Prices

SDR, 2001/02 = 100



Source: RBA

Table 10: Commodity Prices
Percentage change; SDR

	Three months to July 2006	Year to July 2006
RBA Index	1.3	17.0
Rural	0.1	12.7
– Wheat	4.3	30.8
– Beef & veal	1.2	2.1
– Wool	3.3	0.3
Base metals	11.2	74.9
– Aluminium	–5.9	38.3
– Copper	18.7	110.2
– Nickel	42.8	76.3
Other resources	–2.1	3.9
– Coking coal[a]	–7.2	12.9
– Steaming coal[a]	–2.1	1.0
– Iron ore[a]	–8.5	–2.9
– Gold	1.6	46.6
Memo item:		
Oil in US$[b]	6.9	26.7

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

by expectations of strong growth in Chinese steel production. In contrast, coking coal contract prices fell by around 18 per cent, due to expectations that recent high prices are bringing forward a significant global supply response. These are yet to be reflected in the commodity price index, but assuming an eventual modest fall in steaming coal contract prices, the new contracts should leave the overall commodity price index broadly unchanged. (For further details on these commodities, see 'Box C: Commodity Contract Prices and Trade', May 2006 *Statement on Monetary Policy*.)

Rural commodity prices were flat over the past three months, as higher prices for wheat and wool were offset by lower sugar and cotton prices. The price of wheat increased as weather conditions continue to weigh on the outlook for the 2006/07 world crop. The price of sugar fell, on expectations of an increase in global production in the coming year.

Given the outlook for the various commodities, Australia's terms of trade are expected to remain at around their current historically high level over the coming year. Looking further ahead, an increase in the global supply of resource commodities is expected to put some downward pressure on commodity prices which, when combined with moderate growth in import prices, is likely to result in an easing in the terms of trade. Nonetheless, commodity prices are likely to remain at significantly higher levels than the averages seen over the past decade or so.

International trade

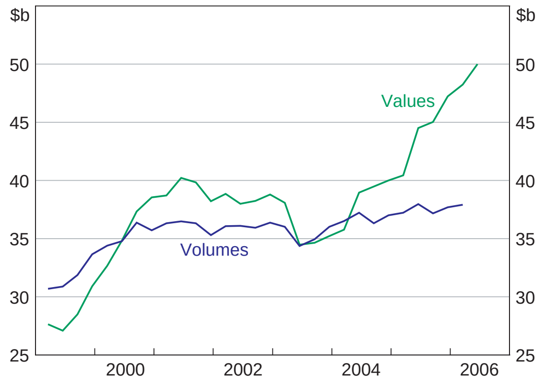
Recent trade data have been volatile, with the monthly deficit fluctuating between $0.4 billion in February and $2.3 billion in May (the most recent monthly data available). This volatility was mainly caused by temporary export supply disruptions and the timing of several large import items.

The value of exports increased by 14 per cent in the three months to May compared with the same period a year earlier. This mostly reflected the impact of higher commodity prices. The growth of export volumes was subdued, due to capacity constraints and temporary supply disruptions, including the severe cyclone season in Western Australia that impeded shipments of iron ore, oil and gas early in the year (Graph 29). Nonetheless, some recovery in export volumes appears to be underway.

The value of resource exports declined by 2 per cent in the three months to May compared with the previous three months, but is up by 21 per cent compared with the same period last year, primarily reflecting the large increases in resource commodity prices. Looking ahead, the record number of projects either recently completed or in the final stages of construction is expected to underpin a solid expansion in resource export volumes in the second half of this year. For example, the Darwin LNG compression plant that started operations in February will eventually increase LNG shipments by almost 25 per cent, projects in the Pilbara will likely boost the volume of iron ore exports in late 2006, and the first exports from the Enfield oil project are expected in August. High metals prices have also improved the feasibility of smaller mining projects, particularly for gold, while coal exports are benefiting from recent efforts to ease transport constraints throughout the supply chain. However, some projects may be delayed due to ongoing shortages of labour and essential mining equipment, such as tyres for trucks.

Graph 29

Exports*



* RBA estimate for June quarter 2006
Sources: ABS; RBA

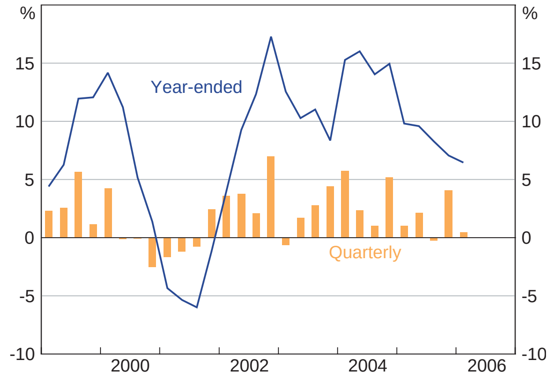
Rural export earnings have increased solidly in 2006 so far, after falling by around 3 per cent over 2005; the trade data show a 7 per cent increase in the three months to May compared with the same period last year. Although shipments of meat and wool declined, cereal exports increased sharply and are expected to remain strong in the next few months.

Manufactured goods export earnings increased by around 2 per cent in the three months to May compared with the same period last year. Manufactured exports are expected to continue to grow at only a moderate rate due to intense competition from developing countries and the relocation of some operations offshore. However, prospects remain better for those manufacturers exposed to the resources sector. Services exports are also being constrained by international competition, although they have grown solidly so far this year, partly reflecting a pick-up in education exports. International demand for travel services appears to have been largely unaffected by Cyclone Larry, which hit northern Queensland in late March.

The value of imports increased by around 13 per cent over the year to the three months to May, partly reflecting the large increase in world oil prices. The volume of total imports grew by 6 per cent over the year to the March quarter, a pace much slower than the 10–15 per cent rates recorded over the previous three years, in line with the slower growth of consumer spending (Graph 30). Volume growth over the year was driven by a 25 per cent increase in capital imports, due to the strength in machinery & equipment investment, while imports of consumption and intermediate goods increased only slightly. Recent data indicate the value of imports increased strongly in April and May but fell in June; both prices and volumes are expected to have increased solidly in the June quarter.

Graph 30

Import Volumes

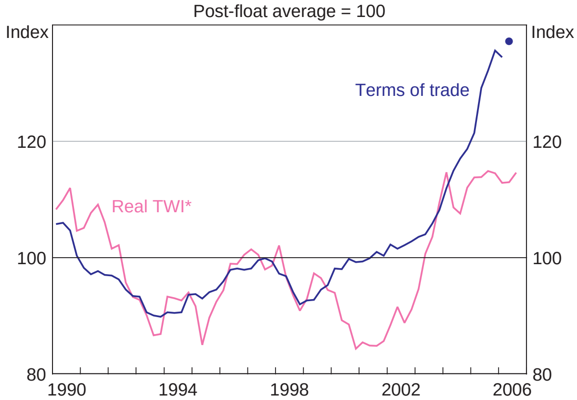


Source: ABS

Graph 31

Real Exchange Rate and Terms of Trade

Post-float average = 100



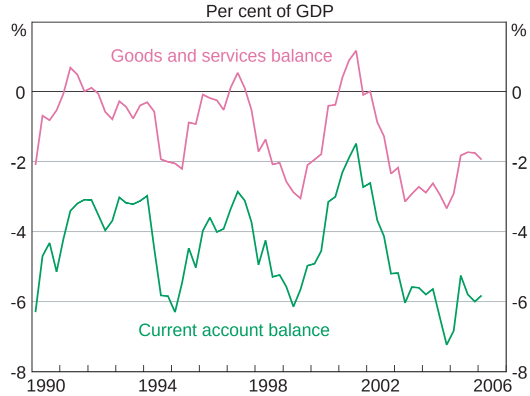
* September quarter 2006 observation assumes that the nominal bilateral exchange rates on 1 August are maintained for the remainder of the quarter, and uses the latest core inflation rates.

Sources: ABS; RBA

Graph 32

Balance of Payments*

Per cent of GDP



* Excludes RBA gold transactions

Sources: ABS; RBA

In real trade-weighted terms, the Australian dollar is about 14 per cent above its post-float average, and has been broadly flat for more than a year (Graph 31). Accordingly, while the relatively high level of the exchange rate continues to restrict activity in some trade-exposed sectors, particularly manufacturing, this effect is likely to have been more than offset by the stimulus to the overall economy from the stronger terms of trade.

Current account

The current account deficit narrowed to 5.8 per cent of GDP in the March quarter, compared with 6.0 per cent in the December quarter (Graph 32). With the trade deficit widening slightly to 1.9 per cent of GDP, the overall narrowing of the current account deficit was driven by a decline in the volatile net income deficit (NID) to 3.8 per cent of GDP (Graph 33). This mostly reflected lower net payments on equity in the March quarter. Nonetheless, the level of the NID remains high, due to increases in interest payments on Australia's foreign debt and dividend payments on equity investments in Australia over recent years. The strength in the latter mainly reflects the strong increase in the profitability of mining companies.

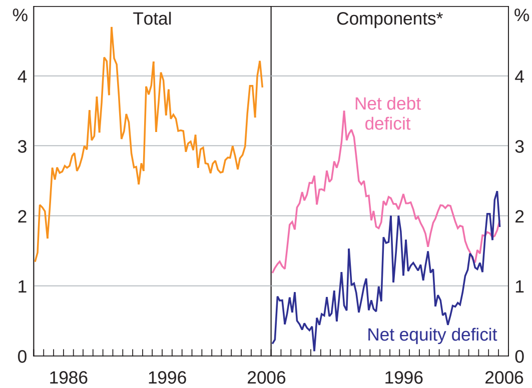
Capital account

The strength in spending, especially business investment, relative to income in recent years has been accompanied by strong demand from foreigners for claims on Australian assets. Consequently, the stock of net foreign liabilities has increased, and reached 60.5 per cent of GDP in the March quarter. At a component level, the increase in the stock of net foreign liabilities in recent years has reflected a run-up in debt liabilities, with the level of net equity liabilities broadly tracking sideways. Indeed, almost the entire net capital inflow to Australia since 2000 has been for the purchase of debt securities, particularly asset-backed securities and bonds issued by financial companies, which have largely funded lending for housing (Graph 34). Gross foreign equity investment in Australia has remained buoyant, but this has been more than offset by substantial equity investment offshore. The available evidence for the June quarter suggests that debt inflows have remained strong, particularly borrowing by financial intermediaries (see the chapter on 'Domestic Financial Markets and Conditions' for more details).

Graph 33

Net Income Deficit

Per cent of GDP

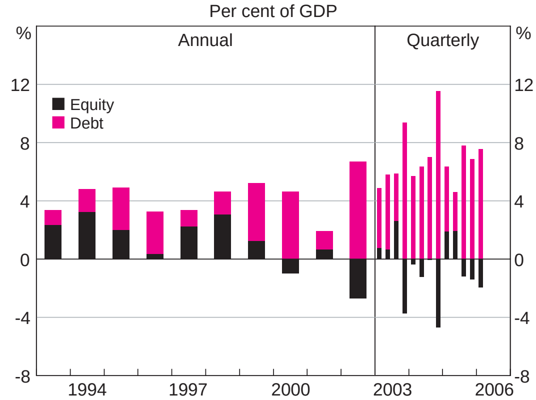


* Excluding net compensation of employees
Sources: ABS; RBA

Graph 34

Net Capital Inflow

Per cent of GDP



Sources: ABS; RBA

Domestic Financial Markets and Conditions

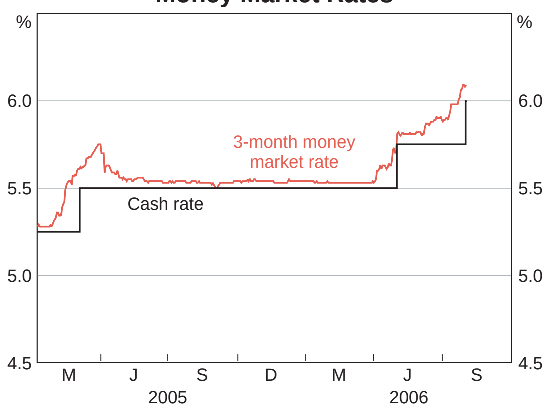
Interest rates and equity prices

Money and bond yields

At the time of the last *Statement* – released a few days after the cash rate target was increased to 5.75 per cent in early May – short-term yields were trading broadly in line with the cash rate. In mid June, however, market yields began to rise in response to continuing signs of strength in the domestic economy and increased concerns about inflationary pressures (Graph 35). By late July, the level of short-term yields was consistent with the market having fully priced in a tightening in August. In the event, when the Bank did tighten in August, yields were unchanged.

Graph 35

Money Market Rates

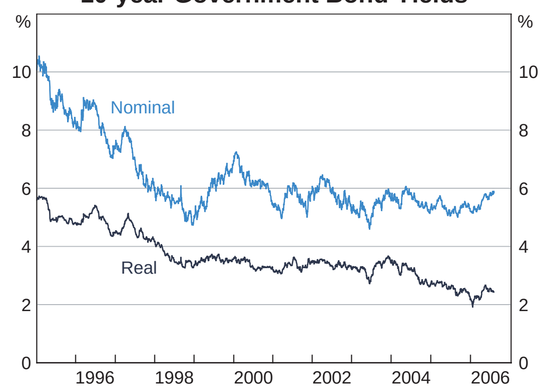


Source: Tullet Prebon (Australia) Pty Ltd

Yields on long-term bonds in Australia have been rising since mid 2005. In recent weeks yields on 10-year bonds have been trading around 5.8 per cent, whereas in mid 2005 they were only a little over 5 per cent (Graph 36). During this period, there has been little net change in real yields on indexed bonds. Accordingly, the rise in nominal yields has been mainly a reflection of rising inflationary expectations.

Graph 36

10-year Government Bond Yields



Source: RBA

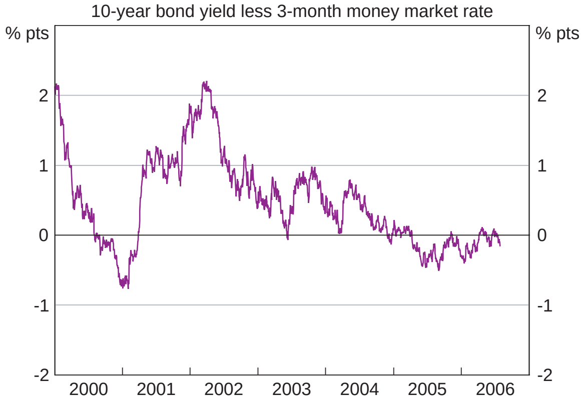
The rise in long-term yields in Australia has been part of a general worldwide trend. In fact, yields in the US have risen more than in Australia, resulting in the spread between yields in the two countries narrowing from about 1 percentage point a year ago to about 85 points now.

Even though long-term yields have risen since 2005, for much of the past year they have remained

Graph 37

Yield Spread

10-year bond yield less 3-month money market rate

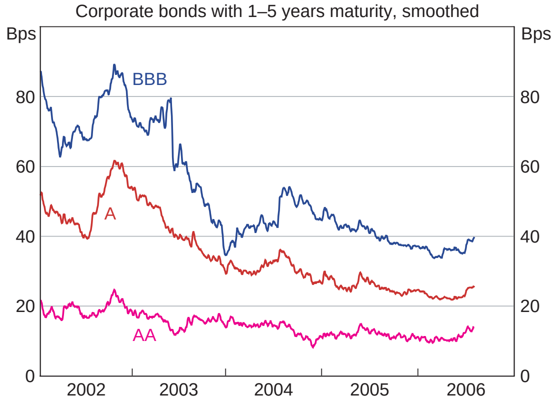


Source: RBA

Graph 38

Corporate Bond Spread to Swap

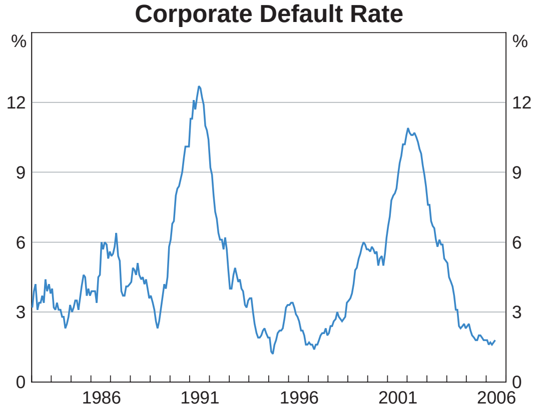
Corporate bonds with 1–5 years maturity, smoothed



Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 39

Moody's Global Speculative Grade Corporate Default Rate



Source: Moody's

below the level of short-term rates – i.e. the yield curve has been inverted (Graph 37). Traditionally, an inverted yield curve has been regarded as indicative of expectations of a slowing in the economy and falling short-term rates. In recent years, however, interpreting the slope of the yield curve has become problematic because it has been affected by factors other than the state of the economy, such as the relative scarcity of government bonds and the low level of overseas bond yields. While the yield curve does typically flatten or invert with the onset of an economic slowdown, it can also do so at other times. Over the past 15 years of uninterrupted economic growth, for example, the yield curve has been flat or inverted on a number of occasions.

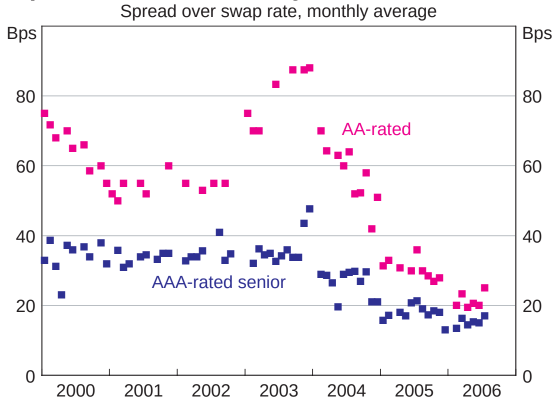
In the corporate bond market there has been a small pick-up in credit spreads but they remain low (Graph 38). In part, this reflects the very low rates of corporate bond default being experienced in Australia and globally: in the first half of 2006 less than 2 per cent of global speculative grade issuers defaulted. This is around the lowest default rate seen in the past 20 years (Graph 39).

Also contributing to low spreads is the continued strong demand from domestic and non-resident investors for higher-yielding assets. Within the Australian corporate bond market, this has been particularly noticeable in the market for residential mortgage-backed securities (RMBS). Spreads at issuance for AA-rated RMBS tranches have, on average, declined by around 10 basis points from their 2005 levels and are around 35 basis points lower than two years ago. Spreads on AAA-rated tranches are around 10 basis points lower than in 2004 (Graph 40).

Graph 40

Spreads on Domestically Issued Prime RMBS

Spread over swap rate, monthly average



Source: RBA

Intermediaries' interest rates

Following the 25 basis point increase in the target cash rate in early May, most lenders increased the indicator rates on their variable-rate housing loans by a similar amount (Table 11). In most cases, these increases were passed on to existing borrowers within a week of the policy announcement, similar to the experience of recent monetary policy changes. At the time of writing, intermediaries were yet to raise lending rates in response to the August monetary policy tightening.

Table 11: Intermediaries' Indicator Lending Rates

Per cent

	Current level (1 August)	Change since end April
Variable rates – household		
Housing:		
– Major banks' standard variable	7.55	+0.25
– Major banks' basic variable	7.00	+0.25
– Mortgage managers' standard variable	7.15	+0.25
– Mortgage managers' basic variable	6.55	+0.25
Other household:		
– Home equity	7.70	+0.25
– Margin loans	8.50	+0.20
– Standard credit cards	17.00	+0.25
– Low-rate/no-frills credit cards	11.00	–0.10
Variable rates – small business		
Residential security:		
– Overdraft	8.45	+0.25
– Term loan	7.80	+0.25
Other security:		
– Overdraft	9.35	+0.25
– Term loan	8.40	+0.25
Variable rates – large business		
– Overdraft	9.35	+0.25
Fixed rates (3 years)		
– Housing	7.20	+0.35
– Small business	8.10	+0.45
– Swap rate	6.40	+0.30

Source: RBA

While lenders in recent years have pegged their housing loan indicator rates to the cash rate, a declining proportion of loans has been extended at the indicator rate. Around 95 per cent of home loan borrowers now receive a discount on the indicator rate. The discounts are also becoming larger; the major banks' average advertised discount for a $250 000 variable-rate housing loan taken as part of a package is 60 basis points, almost 20 basis points more than the actual discount new borrowers received two years ago. Actual discounts currently received are likely to be higher, as some borrowers are able to negotiate larger-than-advertised discounts.

This discounting of home loans is part of a continuing trend towards increased competition in the home loan market that has been going on for over a decade. In 1996, the average home loan borrower was paying 2.5 percentage points more than the cash rate; now the margin is 1.2 percentage points. As a result, while the cash rate is now 50 basis points above its average since 1993, even full pass-through of the August tightening would see actual rates paid on housing loans around 30 basis points lower than their average (Table 12).

Table 12: Housing Loan Interest Rates
Per cent

	Average January 1993 to July 2006	July 2006	August 2006
Cash rate	5.50	5.75	6.00
Standard variable indicator rate	7.75	7.55	7.80[a]
Actual rate paid by new borrowers	7.50	6.95	7.20[a]

(a) Assuming full pass-through of the August tightening
Source: RBA

Most institutions also increased the rates on their personal loans and standard credit cards by 25 basis points following the May monetary policy tightening. However, competition remains intense in the low-rate (no-frills) segment of the credit card market, with some lenders actually lowering their rates following the tightening and more products being launched in the past few months.

Rates on fixed-rate housing loans have also increased since the time of the last *Statement*, in response to increases in the cost of funding fixed-rate loans. The major banks' average 3-year fixed housing rate has increased by 35 basis points since early May, to 7.20 per cent. This is probably a little above the average rate recently paid on new variable-rate housing loans, given the discounts that are available on those loans. Demand for fixed-rate housing loans has strengthened in recent months. Around 15 per cent of new owner-occupier housing loans were taken out at fixed rates in the three months to May (the latest figures available) compared with a longer-run average of 11 per cent.

Regarding business loans, intermediaries also increased their indicator rates on variable-rate business loans by 25 basis points after the May tightening. However, the weighted-average rate actually paid on variable-rate business loans – incorporating risk margins charged by banks – has also tended to rise less than the cash rate in recent years, consistent with competitive pressures in the business loan market. Fixed rates on small business loans have also increased since the last *Statement,* by around 45 basis points, to their highest level since 2000.

With regard to deposit accounts, relatively few institutions have increased their rates since the May tightening. Where they have increased deposit rates, it has typically been on their online savings accounts, the most competitive segment of the deposit market over the past few years.

Equity prices

Australian share prices continued to rise strongly in the first few months of 2006, with the ASX 200 reaching a record high in mid May. Since then, share prices have been volatile, and generally declining. They are currently around 7 per cent below their May peaks (Graph 41). Despite these falls, the index is still 5 per cent higher than at the start of 2006, whereas overseas markets have risen by around 2 per cent.

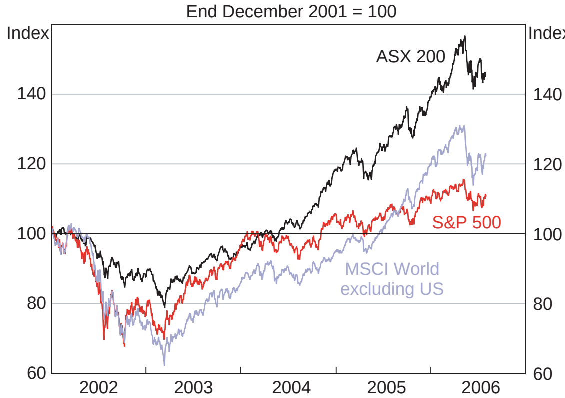
Daily movements in the share market were unusually large in May and June: the average absolute daily percentage change in the ASX 200 was 1.1 per cent in June, the largest since September 2001 (Graph 42). There was some moderation in volatility in July, though it remained above its historical average. The increase in volatility in recent months followed an unusually stable period in financial markets since early 2003.

For much of 2006 to date, volatility and weakness in prices largely reflected international developments, including some nervousness about the risk of rising global inflation and a number of geo-political events; domestic news was generally favourable. Consistent with this, analysts' earnings forecasts for domestically-listed companies have continued to be revised higher, including in the period since the previous *Statement*. Analysts are currently expecting growth in earnings per share (EPS) in 2005/06 of around 17 per cent, with a similar rate of growth expected for 2006/07. For both years, expected EPS growth

Graph 41

Australian and World Share Price Indices

End December 2001 = 100

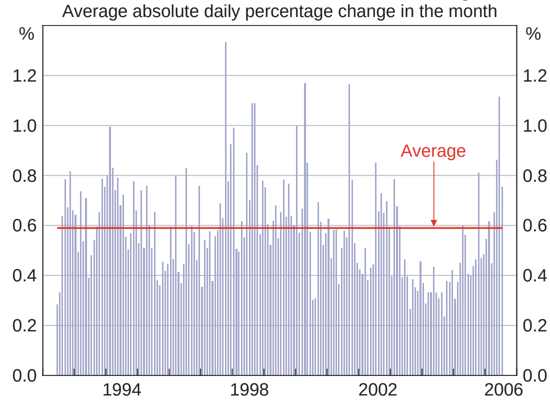


Source: Thomson Financial

Graph 42

Australian Share Market Volatility

Average absolute daily percentage change in the month

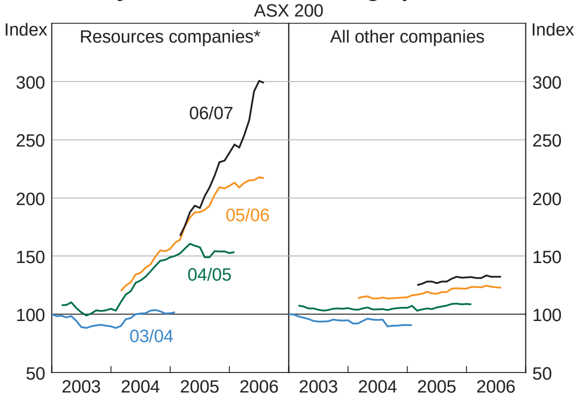


Sources: Bloomberg; RBA

Graph 43

Analysts' Forecast Earnings per Share

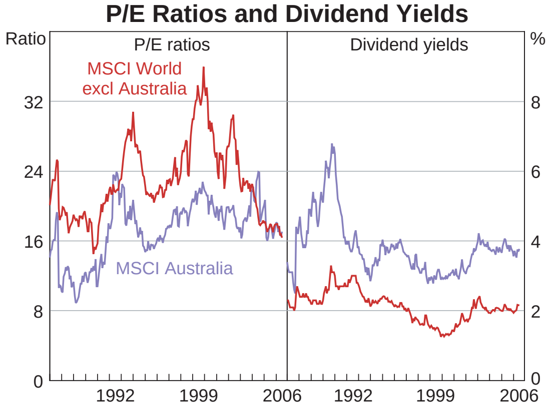
ASX 200



* Comprises all companies in the energy and materials sectors
Sources: RBA; Thomson Financial

Graph 44

P/E Ratios and Dividend Yields

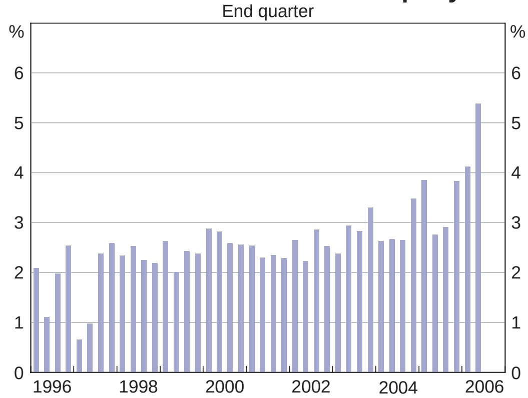


Sources: RBA; Thomson Financial

Graph 45

Returns on Australian Unlisted Property Trusts

End quarter



Source: Mercer Investment Consulting

for resources companies is around 40 to 45 per cent, with that for other companies in the ASX 200 around 8 per cent (Graph 43).

Measures of share market valuation have changed little in recent months: the price-to-earnings (P/E) ratio for the ASX 200 index is about 17, above its post-1975 average but below the average for the second half of the 1990s. The dividend yield is 3.8 per cent, slightly below its long-term average (Graph 44).

Prices of commercial property in Australia have also risen strongly over the past year (Graph 45).

Financing activity

Intermediated financing

After picking up noticeably in the first quarter of 2006, credit growth continued at a fast pace in the June quarter. As a result, total credit grew at an annual rate of almost 16 per cent over the six months to June (Graph 46 and Table 13). Growth was again strongest in the business component, but household credit growth was also solid at an annual rate of around 14¾ per cent, mainly driven by ongoing strength in borrowing for housing, particularly at fixed interest rates. (For further discussion, see the chapter on 'Domestic Economic Conditions'.)

Over half the growth in personal credit over the six months to June was due to very strong growth in margin lending for the purchase of shares and managed funds. Margin debt rose by 15 per cent in the June quarter, and by nearly 40 per cent

Table 13: Financial Aggregates
Percentage change

	Average monthly growth		
	December qtr 2005	March qtr 2006	June qtr 2006
Total credit	1.1	1.3	1.2
Household	1.0	1.1	1.1
– Housing	1.1	1.2	1.2
– Personal	0.4	0.8	1.0
Business	1.2	1.4	1.2
Broad money	0.3	1.1	0.7

Source: RBA

over the year, driven mainly by an increase in the average loan size (Graph 47). Demand for margin loans that incorporate capital protection was particularly strong in the June quarter, likely associated with the pick-up in share market volatility.

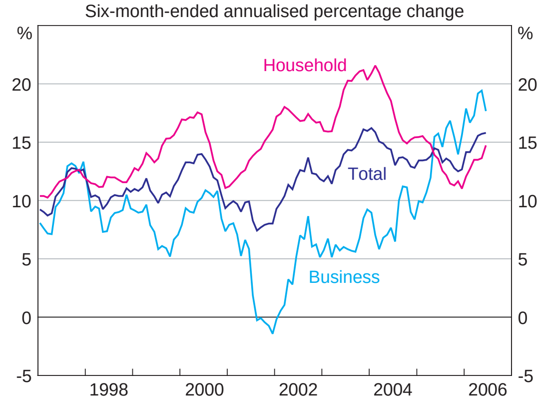
The average gearing ratio of borrowers with margin loans increased by 4 percentage points, to 42 per cent during the quarter, and the proportion of credit limits being used rose by a similar amount, to 49 per cent. These ratios remain low by historical standards. The sharp rise in share market volatility resulted in the frequency of margin calls almost doubling from the previous quarter, but it too remained low by historical standards.

Business credit continues to grow very rapidly and has recently run at around the fastest rates seen since the late 1980s. This has been driven by growth in borrowing by corporations, with more moderate increases in borrowing by unincorporated businesses, which are mainly small businesses and farms.

Graph 46

Credit Growth*

Six-month-ended annualised percentage change

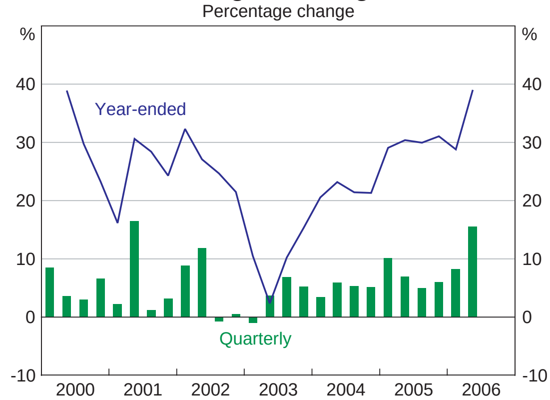


* Includes securitised loans
Source: RBA

Graph 47

Margin Lending

Percentage change



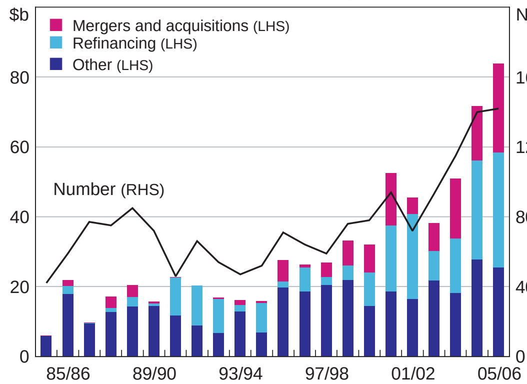
Source: RBA

A broader, though less timely, measure of business credit includes direct lending by foreign financial intermediaries to Australian businesses – so-called cross-border lending. This measure has been growing at a faster pace than domestic business credit due to a sharp pick-up in cross-border lending since mid 2004. Year-ended growth in this broader measure of business credit has recently been around 3 percentage points faster than growth in domestic business credit.

Contributing to growth in business credit in the past few years and, in part, the strength of cross-border lending, has been increased activity in the syndicated lending market. A record $84 billion of syndicated loans were approved in 2005/06, 17 per cent higher than in the previous year (Graph 48). Almost all the growth in syndicated lending was due to an increase in the average loan size, reflecting an increase in the number of 'jumbo' deals, defined as loans in excess of A$1 billion each. Though refinancing remained the primary use for syndicated loans in 2005/06, accounting for almost 40 per cent by value, the pick-up in lending activity from the previous year was mostly due to mergers and acquisitions. Acquisition-related deals accounted for 30 per cent of syndicated loans in 2005/06, up from 22 per cent in the previous year.

Graph 48

Syndicated Loan Approvals



Sources: RBA; Thomson Financial

Non-intermediated financing

Bond raisings by Australian non-government entities was again very strong in the June quarter, with $42 billion of new bonds issued (Table 14). Roughly equal amounts were issued in the domestic and offshore markets. Within the domestic market, a record $15 billion of asset-backed securities (ABS) was issued in the quarter. As discussed earlier, investor demand for these securities remains very strong. With issuance strongly outpacing maturities over the first half of the year, outstandings of non-government bonds in the domestic market rose by 20 per cent – the most rapid pace of six month-ended growth in almost seven years.

Equity raisings also picked up in the June quarter, for both financial and non-financial companies. As a result, total capital raisings (i.e. debt plus equity) were around $50 billion in the June quarter, compared with a quarterly average of around $30 billion in 2005.

Table 14: Non-government Bond Issuance by Sector

$ billion

Sector	2003	2004	2005	2006 March quarter	2006 June quarter
Bond issues by Australian entities					
Onshore					
Financial institutions	9.9	14.3	20.9	4.5	5.9
Non-financial corporations	5.6	8.0	9.3	1.9	2.4
Asset-backed	20.7	25.0	32.2	7.9	14.8
Total	***36.1***	***47.3***	***62.4***	***14.3***	***23.1***
Offshore					
Financial institutions	51.5	64.9	52.2	25.4	12.2
Non-financial corporations	14.7	13.6	16.5	0.6	1.7
Asset-backed	24.3	29.8	25.6	6.2	5.3
Total	***90.5***	***108.2***	***94.4***	***32.2***	***19.2***
Total	**126.6**	**155.5**	**156.8**	**46.4**	**42.4**
A$ bond issues by non-resident entities					
Onshore	7.1	21.3	26.2	15.9	4.2
Offshore	24.8	21.5	12.0	3.7	2.6
Total	**31.9**	**42.9**	**38.2**	**19.6**	**6.7**

Source: RBA

Inflation Trends and Prospects

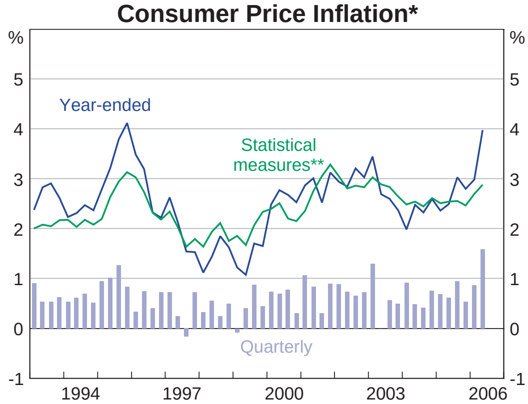
Recent developments in inflation

Based on a range of measures, the Bank's assessment is that underlying consumer inflation edged up to around 0.9 per cent in the June quarter and to a little below 3 per cent over the year to the June quarter. Most measures of underlying inflation were higher than they were six months ago. There has been a similar pick-up in underlying inflation in most industrial countries, reflecting the gradual erosion of spare capacity in the world economy.

The increase in the headline Consumer Price Index (CPI) was larger, at 1.6 per cent in the June quarter and 4.0 per cent over the year (Graph 49, Table 15). The index was substantially boosted by sharp increases in both petrol prices (due to higher world oil prices) and fruit prices (due especially to the effect of Cyclone Larry on banana prices); each of these added around ½ percentage point to inflation in the quarter. The rise in banana prices will be temporary and should be fully reversed by mid 2007. In addition

Graph 49

Consumer Price Inflation*



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

** Average of the seasonally-adjusted trimmed mean and weighted median

Sources: ABS; RBA

Table 15: Measures of Consumer Prices

Percentage change

	Quarterly		Year-ended	
	March quarter 2006	June quarter 2006	March quarter 2006	June quarter 2006
CPI	0.9	1.6	3.0	4.0
– Tradables	0.8	2.7	2.8	4.8
– Tradables (ex food and petrol)	0.4	0.1	0.3	0.2
Non-tradables	0.9	0.8	3.1	3.4
Underlying measures				
Weighted median	0.7	0.9	2.8	3.0
Trimmed mean	0.8	0.9	2.6	2.8
CPI ex volatile items[(a)]	0.8	0.6	2.2	2.4

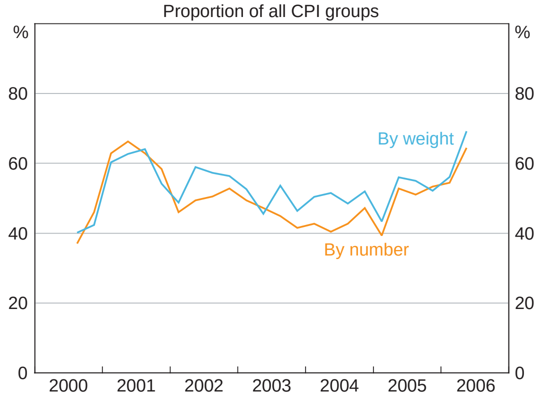
(a) Volatile items are fruit, vegetables and petrol

Sources: ABS; RBA

Graph 50

CPI Items Rising Faster than 2.5 Per Cent*

Proportion of all CPI groups



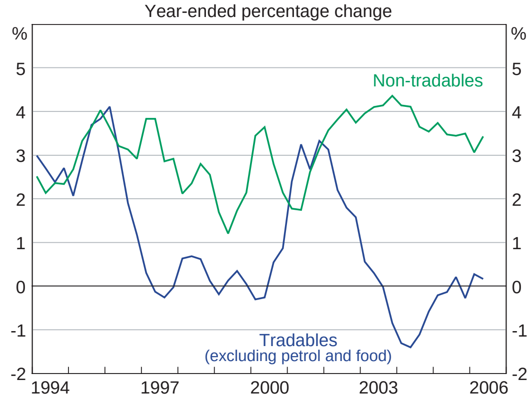
* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent

Sources: ABS; RBA

Graph 51

Tradables and Non-tradables Prices*

Year-ended percentage change



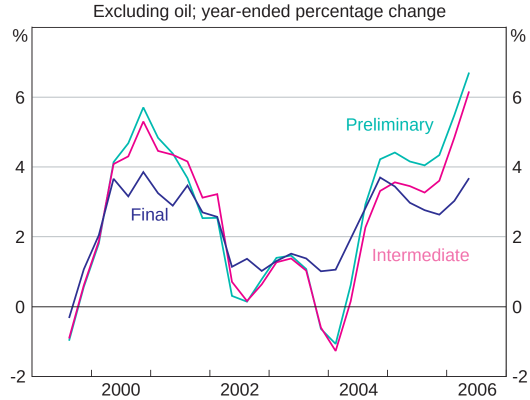
* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 52

Prices by Stage of Production

Excluding oil; year-ended percentage change



Sources: ABS; RBA

to the increases in petrol and fruit prices in the June quarter, there were significant increases for hospital & medical services, and a number of clothing & footwear categories. At the other end of the distribution, prices fell for audio, visual & computing equipment, domestic travel costs, and motor vehicles. More generally, a larger than usual proportion of items – nearly 70 per cent – grew at an annual rate of above 2.5 per cent (Graph 50).

Non-tradables inflation picked up a little, to be 3.4 per cent over the year to the June quarter, after trending down over the previous two years as house-building costs moderated (Graph 51). Tradables prices rose by 4.8 per cent over the year to the June quarter, but this was concentrated in petrol and food prices; the increase was 0.2 per cent excluding these items. With the exchange rate having been relatively steady for more than two years, the prices of tradables are no longer being affected by the significant exchange rate appreciation of 2002–2003. Instead, the low level of tradables inflation appears to reflect longer-term global factors, including the increasing importance of low-cost goods from China and other emerging markets in Australia's imports.

Producer price data for the June quarter were consistent with continuing upstream inflation pressures (Graph 52, Table 16). Prices at the final stage of production rose by 1.6 per cent in the quarter, compared with an increase of

0.7 per cent in the March quarter, to be 4.5 per cent higher over the year. The pick-up was seen in both the domestically produced and imported components, even after excluding the contribution of higher oil prices. Quarterly price growth was also higher at the preliminary and intermediate stages of production, largely reflecting increases in oil and base metal prices. Liaison has particularly highlighted cost pressures from rising prices of fuel and oil derivatives, such as plastics and packaging, and an increasing share of firms is reporting an intention to pass on these cost increases in an effort to recover margins.

Table 16: Output Prices at Different Stages of Production
Percentage change

	June quarter 2006	Year to June quarter 2006
Preliminary	**3.1**	**9.4**
– Domestically produced	2.7	8.7
– Imported	4.9	13.8
– Excluding oil	2.2	6.7
Intermediate	**2.8**	**8.0**
– Domestically produced	2.6	7.5
– Imported	3.8	10.8
– Excluding oil	2.1	6.2
Final[(a)]	**1.6**	**4.5**
– Domestically produced	1.8	4.9
– Imported	0.7	2.3
– Excluding oil	1.0	3.7

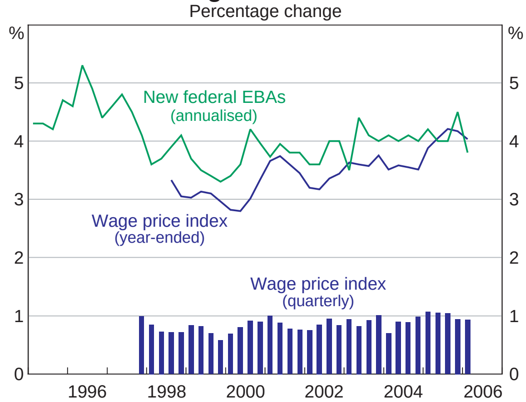
(a) Excluding exports
Sources: ABS; RBA

Labour costs

Data for the March quarter suggest that growth in wages remains firm. The wage price index (WPI) rose by 0.9 per cent in the quarter, and by 4.0 per cent over the year, a rate that is somewhat higher than its average over the past few years (Graph 53). Wage increases for new federal enterprise bargaining agreements (EBAs) have been volatile as a result of compositional changes, but the average figure for currently active agreements is also higher than its average in recent years. Both data sources point to some divergence between outcomes in the public and private sectors. According to the WPI, wage growth has eased somewhat in the public sector after a period when measured growth had been fairly high, while growth for the private sector has remained somewhat above average levels, at 4.0 per cent in the year to the March quarter. Overall, the evidence from these data is that wage growth has increased over the past few years, though it has been more stable recently.

Graph 53

Wage Indicators
Percentage change



Sources: ABS; DEWR

Business surveys and the Bank's liaison program continue to suggest that labour shortages are leading firms to use a range of non-wage incentives to attract and retain staff. These include bonus payments, more frequent promotion rates and more attractive work arrangements. One sign of this in the official data is that when bonuses are included, the WPI increased by 1.2 per cent in the March quarter. Total labour cost pressures therefore appear to be stronger than is recorded in those official wage measures which do not capture these forms of compensation. This is especially apparent in resource-related and non-residential construction industries, particularly in Western Australia, but solid labour cost growth is evident in most industries.

Inflation expectations

Business surveys are providing a mixed picture about inflation expectations. The June quarter ACCI-Westpac survey of manufacturing firms and Dun & Bradstreet survey both suggested that the net balance of respondents expecting to raise prices in the near term was below the average level over the inflation-targeting period. However, the AIG survey of manufacturing indicated that businesses were facing increased input cost pressures, with an above-average proportion of firms reporting actual and expected increases in their selling prices.

Market economists surveyed by the Bank following the release of the June quarter CPI increased their forecasts of CPI inflation over the year to the December quarter 2006, with the median expectation rising by 0.7 percentage points to 3.6 per cent (Table 17). This almost entirely reflects a stronger rise in inflation in the June quarter than they had earlier anticipated. The median forecast of the market economists for headline inflation over the year to December 2007 remained at 2.6 per cent. Union officials' inflation expectations are a percentage point higher than six months ago.

The Melbourne Institute survey indicates that the median expectation for consumer price inflation over the coming year was 4.1 per cent in July, which is above the average over the inflation-targeting period. The implied medium-term inflation expectations of financial market participants, as measured by the difference between nominal and indexed bond yields, has continued to drift higher over recent months, to be just under 3½ per cent in early August. However, this measure probably overstates market inflation expectations: yields on indexed securities may have been held down by some specific factors that are unrelated to expectations about inflation. In particular, institutional demand has increased in the face of unchanged tight supply.

Table 17: Median Inflation Expectations
Per cent

	Year to December 2006			Year to December 2007	
	February 2006	May 2006	August 2006	May 2006	August 2006
Market economists[a]	2.8	2.9	3.6	2.6	2.6
Union officials[b]	3.0	3.3	4.2	3.2	4.1

(a) RBA survey
(b) Workplace Research Centre

Inflation outlook

Although headline inflation rose sharply in the June quarter, much of this increase resulted from large increases in the prices of particular items, notably petrol and fruit. Looking through this volatility, measures of underlying inflation picked up, confirming the upward shift in underlying inflation that was apparent in the March quarter data. The pick-up appears to reflect a number of factors, including higher input cost pressures, ongoing solid growth in total labour costs, and the strengthening in consumer demand that was apparent in the March quarter national accounts and seems to have been maintained in the June quarter.

These factors are likely to continue to result in firm outcomes for underlying inflation for some time. The Bank's forecasts assume that oil prices and the exchange rate remain around current levels through the forecast period to the June quarter 2008, and that global growth remains above trend but slows in line with the path implied by Consensus forecasts. The terms of trade are expected to remain close to recent highs in the near term, before falling by around 10 per cent by the end of the forecast period. The forecasts envisage that GDP growth over the next year or so will be around 3½ per cent, somewhat higher than previously expected, largely reflecting the strengthening that has been apparent in a range of recent data. Growth is then expected to moderate slightly, a result of both some easing in the impetus from the terms of trade and some dampening impact from the two recent increases in the cash rate.

While underlying inflation has been increasing recently, the central forecast is that it will remain broadly stable over the forecast period, at around 3 per cent, with a number of factors helping to contain inflationary pressures. On the external side, the forecast assumes no further increases in the world prices of oil and other commodities. On the domestic side, the two recent interest rate increases should help to contain demand and inflation pressures. Although the labour market is likely to remain tight, wages growth is expected to remain stable. The annual rate of CPI inflation is likely to remain around 4 per cent in the short term, but should then decline as the effect of recent increases in petrol prices passes. Indeed, the unwinding of the recent pick-up in fruit prices is likely to result in CPI inflation being below underlying inflation in early 2007.

The risks to the inflation forecast appear evenly balanced. On the external side, there is the possibility of a larger than expected slowing in the global economy. On the other hand, there are upside risks associated with the domestic economy operating close to capacity. Most importantly, the current high level of headline inflation may lead to some pick-up in inflation expectations. However, with the two recent increases in the cash rate, monetary policy has been adjusted in response to these risks, and the flow of data over the next few months will give a clearer indication of the extent to which inflationary pressures are likely to remain contained.