STATEMENT ON MONETARY POLICY

12 FEBRUARY 2007

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Australia's economic performance during 2006 continued to be marked by strong growth in incomes and employment. Capacity utilisation remained high and there was a pick-up in underlying inflationary pressures in the first half of the year. These developments took place against the backdrop of above-average global growth and high commodity prices.

Recent indications are that the world economy is continuing to grow strongly. The US economy has remained robust, and concerns that a downturn in the housing sector would significantly dampen activity have not so far been borne out. Information on other parts of the world remains consistent with expectations of strong aggregate growth. The Chinese economy has continued to expand at a double-digit rate, with recent policy measures having had some success in encouraging a shift from investment to consumer spending. In Japan, despite more moderate growth recently, improving conditions in the business sector and the labour market point to good prospects for further expansion. Growth in the rest of east Asia has remained firm, and in the euro area the indications are that a moderate pace of expansion is continuing. Overall, most observers expect world growth in 2007 to be a little below last year's pace, but still above trend.

A number of countries have experienced upward pressure on underlying inflation over the past couple of years. Although at this stage global inflation remains relatively low, the strong pace of growth in demand has been putting increased pressure on productive capacity in many countries. Against this background, central banks around the world continued to wind back the accommodative stance of monetary policy that characterised the early part of this decade. Most have now returned interest rates to levels that are close to normal, though an important exception to this has been Japan, where official rates are still very low.

Despite the increases in interest rates, 2006 was a buoyant year in global financial markets. Debt and equity markets were strong and market volatility generally was low. Share markets recorded their fourth year in a row of strong returns. Government bond yields have remained low, as have credit spreads. Given the run of strong market performances in recent years, it is not surprising that there are signs of increased appetite for risk. This is most visible in the marked increase in merger and acquisition activity, particularly leveraged buyouts, in many economies. Domestic markets have largely reflected these international trends. The share market rose by about 20 per cent last year which, as in other markets, was the fourth strong rise in a row. This was, however, broadly in line with the increase in profits, resulting in little change in the price-earnings ratio. Bond yields rose a little, but have remained low relative both to historical standards and to the current level of short-term rates. The Australian dollar rose by 4 per cent in trade-weighted terms through 2006 but this was partly reversed during January.

The Australian economy has continued to benefit from strong global commodity prices. Australia's terms of trade have increased by more than 30 per cent over the past three years, and they are now estimated to be at their highest level since the early 1950s. This has been an important source of growth in incomes and spending.

Domestic demand has continued to grow at a firm pace over the past year, though it has moderated from the unsustainable rates seen earlier in the decade. Business investment has, until recently, been the fastest growing component of domestic spending, increasing at an average annual rate of 14 per cent over the three years to mid 2006. The increases in investment were led by the resources sector but were nonetheless quite broadly based, with above-average rates of growth being reported in most industries during this period. While it now appears that growth in investment is moderating, the level of investment remains high and hence continues to add strongly to the nation's capital stock. This cumulative lift in the level of investment has been an important part of the economy's response in recent years to the combination of strong domestic demand, high commodity prices and tight capacity.

Consumer spending has generally shown moderate growth over the past couple of years, though there were signs that it strengthened in the December quarter. Spending continues to be underpinned by growth in household disposable incomes, which in turn have been boosted by rising employment and real wages. Of the other components of domestic demand, spending on housing construction has contributed only modestly to growth recently, while public-sector demand has grown at an above-average rate over the past year. Overall growth in domestic demand is likely to be at or a little below trend in the period ahead.

Increases in interest rates over the recent period have encouraged some moderation in households' demand for finance, with the level of mortgage interest rates now a little above its average of the past decade. The value of housing loan approvals has declined since the middle of last year, and household credit growth has eased back to a rate of around 1 per cent a month. Demand for finance in the business sector has also moderated somewhat, though business credit growth remains well above its average of recent years.

As has been the case for some time, the growth in Australia's aggregate output in the recent period has been below that of domestic demand. A significant part of the growth in demand has been met by imports, while there has been only a moderate pick-up in exports. Growth of the non-farm economy over the year to the September quarter was thus a little below trend, at 2.6 per cent. In the short term, growth in overall GDP will continue to be affected by the drought. Farm output is expected to fall by around 20 per cent in the current financial year, which would directly reduce GDP growth by around half a percentage point, with some additional indirect effects flowing on to other parts of the economy.

Notwithstanding the estimated below-average growth in aggregate output, strong labour market conditions have persisted into the new year. Employment posted large increases in recent months, to be around 3 per cent higher over the past year. Job vacancies have increased further and the unemployment rate is around a 30-year low. Strong demand for labour is also confirmed by a range of business surveys and liaison reports. Although regional differences exist, the strength of the labour market has been widespread around the country, with most states over the past year recording strong employment growth and declining unemployment rates.

Over the past couple of years, high aggregate capacity utilisation has been associated with a pick-up in wage and price pressures. Underlying consumer price inflation picked up from around 2½ to around 3 per cent, while growth in the wage price index also picked up by around ½ percentage point. A range of indicators such as the unemployment rate and business survey results continue to suggest that capacity usage is relatively high. But the recent period of more moderate growth in demand and output, coupled with capacity expansions as a result of strong investment, should be helping to alleviate these pressures somewhat. Aggregate wages growth has stopped increasing recently, though it remains higher than average. In addition, data on producer and consumer prices for the December quarter give some support to the view that inflation pressures may have been contained after picking up noticeably in the first half of last year.

Abstracting from fluctuations in oil prices, producer price indices continued to show strong increases at the preliminary and intermediate stages of production, reflecting the strength of a range of raw materials costs. However, these measures of upstream inflation are no longer accelerating, and recent declines in oil prices, if sustained, will help to contain the growth in input costs overall. The consumer price index declined slightly in the December quarter, having been affected by a sharp fall in petrol prices and by the partial unwinding of the earlier spike in banana prices. Given these influences, a low CPI outcome in the quarter had been widely expected, and does not of itself constitute evidence of any broad-based easing in inflation pressures. Nonetheless, measures which abstract from volatile price movements suggest that underlying inflation moderated. Consumer prices in underlying terms are estimated to have increased by ½ per cent in the December quarter and by 3 per cent over the past year. While the annual figure is still relatively high, underlying inflation in the second half of 2006 was below that in the first half.

Through 2006, monetary policy responded to evidence of rising inflation pressures with a series of increases in the cash rate. At its most recent meetings the Board has considered whether this sequence of measures would be sufficient to contain inflation pressures in the medium term, or whether some additional tightening might be required. As set out in the previous *Statement*, the situation following the November meeting was that underlying inflation had increased to around 3 per cent but was tentatively forecast to decline somewhat in the period ahead. In the Board's judgment, the new information available for the February meeting, and in particular the December quarter CPI figures, suggested grounds for a little more confidence in this forecast.

With the economy still operating at a high overall level of capacity utilisation, it remains possible that the upward pressure on inflation that was evident for much of last year could re-emerge. Nonetheless, given the currently available information, the Board judged that the most likely prospect was that underlying inflation in the medium term would be a little below its recent rate, and in these circumstances decided to hold the cash rate unchanged at its February meeting. The Board will continue to monitor incoming data and adjust monetary policy as required to ensure that inflation remains satisfactorily contained.

International Economic Developments

Global economy

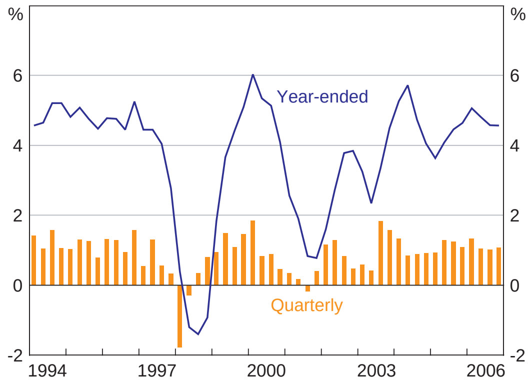
The world economy continued to expand at a strong pace in 2006, led by rapid growth in China and other emerging economies (Graph 1). The United States grew at a robust pace in 2006 despite the slowdown in the housing sector. While conditions in Japan remain supportive of its expansion, growth there has softened in recent quarters. The upswing in the euro area continued and economic activity in the east Asian region remains healthy.

Consensus forecasts are for above-trend global growth of 4.7 per cent in 2007, down from 5.4 per cent in 2006, reflecting moderation in growth in most of the major regions (Graph 2). A key risk to the global economy has been that the US economy might slow more sharply than expected if prolonged weakness in the housing sector spreads to the rest of the economy. However, to date the US economy has proved resilient. In addition, the rise of China and other emerging economies, and the expansions underway in Japan and Europe, are likely to support global growth in the event of a slowing in the United States.

Graph 1

Australia's Trading Partner GDP

Merchandise export weighted, percentage change

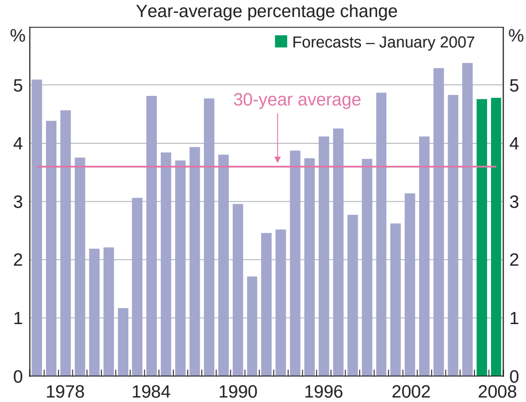


Sources: ABS; CEIC; RBA; Thomson Financial

Graph 2

World GDP

Year-average percentage change



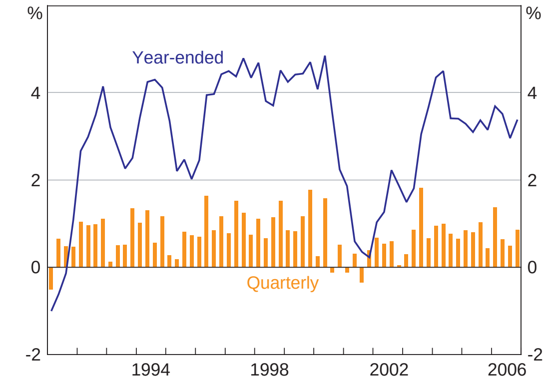
Sources: Consensus Economics; IMF; RBA

Headline inflation eased significantly in most industrialised countries towards the end of 2006 reflecting lower oil prices. However, core inflation has picked up over the past year in a number of countries. With many economies operating much closer to capacity after several years of expansion, central banks remain concerned about upside risks to inflation.

Graph 3

United States – GDP

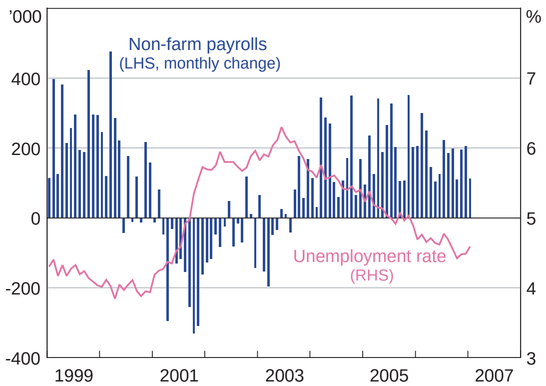
Percentage change



Source: Thomson Financial

Graph 4

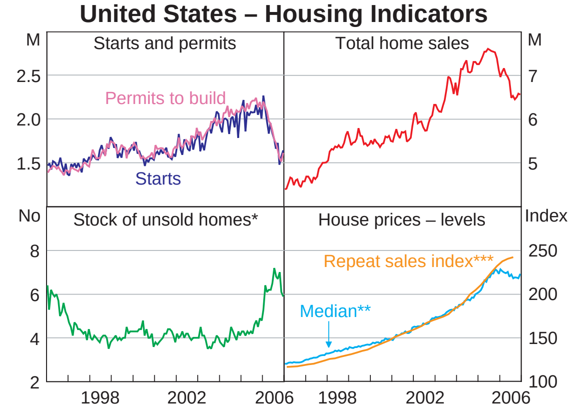
United States – Labour Market



Source: Thomson Financial

Graph 5

United States – Housing Indicators



* Months’ supply of houses for sale

** Monthly

*** Quarterly

Sources: Bloomberg; Thomson Financial

United States

The US economy continued to expand at a healthy pace over 2006. Real GDP increased by 0.9 per cent in the December quarter, defying earlier expectations of only soft growth, to be 3.4 per cent higher over the year (Graph 3). Strong consumption and exports drove growth in the quarter. The downturn in housing construction continued and there were cutbacks in production in the auto sector in part because consumers are switching to more fuel-efficient foreign-made vehicles. However, other parts of the economy proved resilient.

Consumption grew by a strong 1.1 per cent in the December quarter. Although slowing house price growth is likely to be weighing on consumption, buoyant financial markets and the decline in petrol prices are likely to be providing some offset. Tight labour markets also continue to bolster household spending. Payrolls employment growth remained firm at 1.6 per cent over the year to January, and at 4.6 per cent the unemployment rate was close to recent lows (Graph 4). Measures of consumer sentiment are positive.

The US housing market cooled over 2006 after a strong upswing during the preceding four years (Graph 5). Residential investment contracted by 5.2 per cent in the December quarter, to be 12½ per cent lower over the year: the largest year-ended fall since 1991. The stock of unsold new houses is high, and further falls in residential investment are expected in the first half of 2007. House price growth has continued to slow. The Office of Federal Housing Enterprise Oversight (OFHEO) repeat sales measure of house price growth eased to 6.0 per cent in year-ended terms in the September quarter and some other price series have recorded falls. However, some indicators of housing demand have been more positive: mortgage applications have increased in line with lower 30-year mortgage rates, home buyers' sentiment has also improved markedly, and home sales have levelled out after falling sharply until mid 2006.

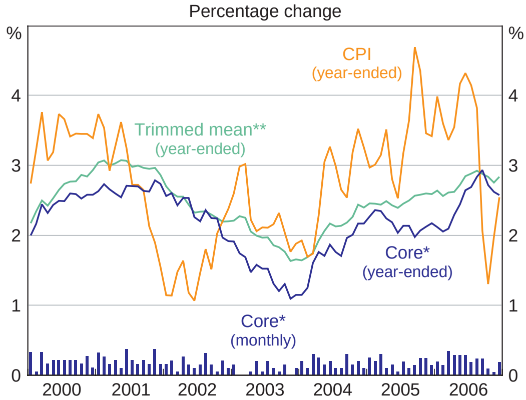
Conditions in the business sector remain generally positive despite weakness in some sectors. Manufacturing production was weak in the December quarter reflecting softness in construction-related sectors and falling motor vehicle production. Outside of these sectors, production is stronger and business confidence is generally positive. Although there was a pause in growth in business investment in the December quarter, financing conditions remain supportive of solid investment growth as corporate balance sheets are strong and the cost of capital is low.

CPI inflation has fallen significantly since the middle of 2006, largely reflecting lower oil prices (Graph 6). Core inflation has also been more subdued in recent months, although the year-ended rate, 2.6 per cent in December, remains high relative to recent years. The Federal Reserve expects inflation to continue to ease as a result of lower energy prices and moderating domestic demand growth, although upside risks remain, especially from the tight labour market.

Graph 6

United States – Consumer Prices

Percentage change



* Excluding food and energy
** 15 per cent trim (from each end of the distribution of monthly price changes); calculated by RBA
Sources: Bureau of Labor Statistics; RBA; Thomson Financial

Asia-Pacific

Japan

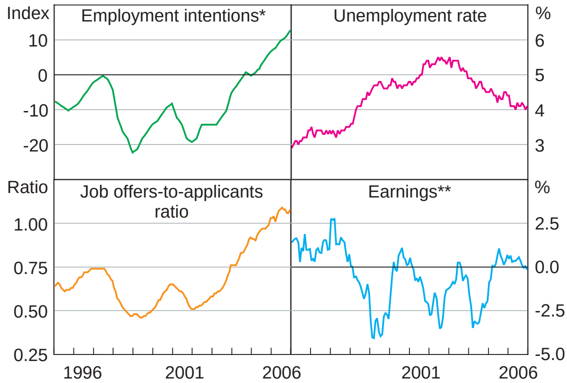
Growth in Japan slowed over 2006, and recent revisions have reduced the reported year-ended GDP growth rate by about 1 percentage point, to 1.7 per cent over the year to the September quarter. This followed growth of 2.9 per cent over 2005. However, conditions remain supportive of continued growth.

Business investment increased by 7.7 per cent over the year to the September quarter and more timely indicators are consistent with continued investment growth. Corporate balance sheets are healthy, and firms are positive about their own financial positions and the financing environment. Production and exports have continued to expand, and according to the December quarter Tankan survey, capacity is stretched in many sectors of the economy and firms have continued to revise up their near-term investment intentions.

After increasing over 2005, consumption growth appears to have slowed in 2006. To some extent this probably reflects a slowing in growth in household earnings, which were broadly

Graph 7

Japan – Labour Market Indicators



* Tankan survey, deviation from long-run average

** Year-ended growth, smoothed

Sources: Bank of Japan; Thomson Financial

flat over 2006 (Graph 7). However, continuing favourable conditions in the labour market suggest that the weakness in earnings and consumption is unlikely to persist. The unemployment rate was 4.1 per cent in December, close to an 8-year low, and job offers exceeded applicants. Surveys suggest both employers and employees continue to be positive about future labour market conditions.

Growth in consumer prices has been modest, with the CPI increasing by 0.3 per cent over 2006. Core inflation, as measured by the CPI excluding food and energy prices, remained negative, though the pace of decline in prices has slowed slightly to 0.3 per cent. Upstream prices continue to rise more quickly, with corporate goods prices rising by 2.5 per cent over the year to December.

China

Chinese GDP increased by 10.4 per cent over 2006, the fourth year of growth around 10 per cent. While consumer spending is expanding at a strong pace, growth has been concentrated in the business sector as rapid investment drives the development of the economy and the expansion of manufacturing capacity, and thereby exports. However, there were signs of a slowing in growth in fixed-asset investment in the second half of 2006 following various policy initiatives aimed at restraining some forms of investment. Most recently, this involved 50 basis point increases by the People's Bank of China in its reserve requirement ratio in both November and January, the third and fourth such increases since June 2006. Nevertheless, growth in credit has eased only a little from the high rates reached in mid 2006 and financial conditions are very buoyant.

External demand continues to support growth, though export growth slowed slightly in recent months to be 24 per cent over the year to December. Year-ended growth in imports remained lower, at 14 per cent in December, and so the trade surplus widened further in the December quarter to US$54 billion, compared with US$23 billion a year earlier.

Growth in upstream prices has continued to run ahead of consumer prices, but strong productivity growth appears to be keeping inflation in check. Over the year to December, producer prices increased by 3 per cent, while year-ended growth in urban incomes was around 15 per cent, indicative of continued rapid wages growth. Growth in Chinese export prices also appears to have picked up moderately; the growth of the prices of goods re-exported through Hong Kong increased over 2006, to be 2 per cent over the year to November. Consumer price inflation picked up somewhat to 2.8 per cent over the year to December, though this appears to largely have reflected growth in food prices.

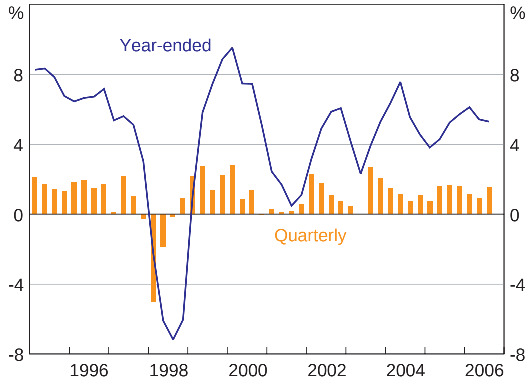
Other Asia-Pacific

GDP growth in the rest of east Asia continued at a healthy pace in 2006. GDP in the region increased by 5.3 per cent over the year to the September quarter (Graph 8). Growth in Korea, the largest economy in this group, was slower at 4 per cent over the year to December in response to policy tightening during the year. There were some indications that growth in the ITC sector moderated in mid 2006, leading to a slight easing in industrial production and export growth from their earlier rapid rates, though growth in goods exports from the region remained solid at 13 per cent over the year to November. Favourable labour market conditions also continue to support consumption throughout much of the region. However, inflation is contained; year-ended inflation for the region as a whole slowed to 2.7 per cent over 2006.

Graph 8

East Asia* – GDP

Percentage change



* Excluding China and Japan
Source: CEIC

The Indian economy continues to grow rapidly, with real GDP increasing by 9.2 per cent over the year to the September quarter. Industrial production increased strongly in November, to be 15 per cent higher over the year. Domestic demand remains the major driver of growth, and credit and asset prices are growing strongly. Furthermore, after four years of growth averaging around 8 per cent, infrastructure bottlenecks are intensifying. Wholesale price inflation remained high at 5.6 per cent over 2006, although recent monthly inflation outcomes have been subdued.

In New Zealand, GDP growth in the September quarter was again soft at 0.3 per cent in the quarter and 1.3 per cent over the year. Domestic demand growth weakened during 2006 in response to higher interest rates. However, consumer sentiment increased strongly in the December quarter – to be back above long-run average levels – buoyed by lower petrol prices, renewed strength in the housing market and continuing favourable labour market conditions. Year-ended consumer price inflation eased to 2.6 per cent in the December quarter, reflecting lower petrol prices, after peaking at 4.0 per cent in mid 2006.

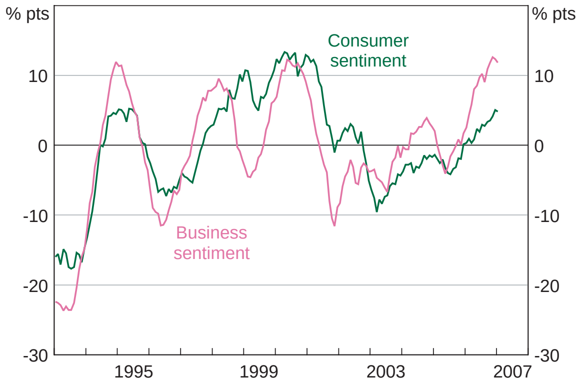
Europe

The expansion in the euro area economy has continued, though growth moderated in the second half of 2006 after strong growth in the first half of the year. GDP increased by 0.5 per cent in the September quarter, to be 2.8 per cent higher over the year. External demand has provided a considerable impetus to growth, with exports increasing by 12 per cent over the year to November. However, domestic demand also picked up in 2006 driven by investment, which increased by 4.6 per cent over the year to the September quarter. In Germany, investment is being

Graph 9

Euro Area – Sentiment Indicators

Deviation from long-run average



Source: European Commission

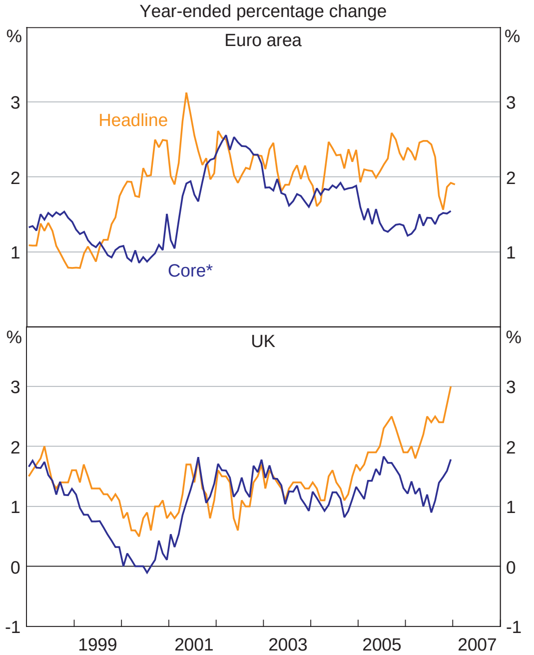
boosted by increasing construction activity, which had been in decline for a decade. For the euro area, business confidence remains well above long-run average levels, and over the year to November industrial production increased by 2.5 per cent and industrial orders for manufactured goods rose by 6.2 per cent (Graph 9).

While there are some signs of improvement in the household sector as well, consumption growth has remained subdued. Labour market conditions are strengthening and the euro area unemployment rate has fallen steadily to 7.5 per cent in December from a peak of 8.9 per cent in mid 2004. In addition, consumer sentiment has increased to be around its highest level since mid 2001. However, year-ended growth in consumption was still moderate at 1.8 per cent in the September quarter, and retail sales growth was subdued in the December quarter. This was despite some apparent pull-forward of expenditure ahead of the increase in the VAT in Germany at the start of 2007.

Graph 10

Europe – Consumer Prices

Year-ended percentage change



* Excluding food, energy, alcohol and tobacco

Source: Thomson Financial

Headline inflation in the euro area has eased in line with oil prices to be just below the European Central Bank's (ECB) reference rate of 2 per cent, after an extended period around 2½ per cent (Graph 10). While core inflation, which excludes the effect of petrol prices, remained lower at 1½ per cent over 2006, upstream price pressures persist. Year-ended growth in core producer prices was 3.4 per cent over 2006. The ECB raised its policy rate by 25 basis points in December to 3.5 per cent and noted that the stance of policy remains stimulatory.

Growth in the United Kingdom has remained firm. GDP rose by 3.0 per cent over 2006, driven by the ongoing investment upswing and solid growth in household spending, which was supported by rising house prices. Headline inflation picked up to be 3.0 per cent over 2006, above the Bank of England's target of 2 per cent. The Bank of England raised its policy rate by 25 basis points to 5.25 per cent in January, noting that limited spare capacity in the economy appears to be placing upward pressure on inflation, with the risks to inflation judged to have moved further to the upside.

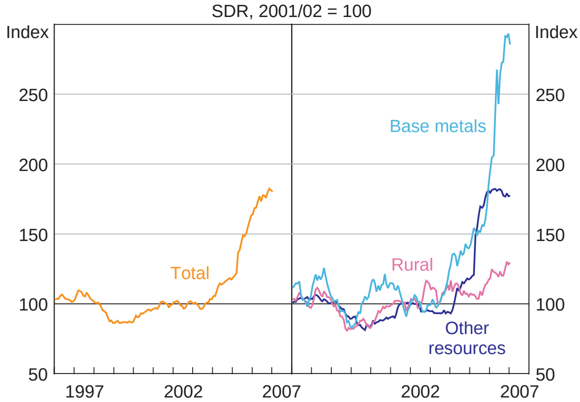
Commodity prices and Australia's terms of trade

Strong global economic growth and demand for commodities, in particular from China, have driven a substantial upswing in the prices of Australia's resource exports over the past three years. With expansions in supply beginning to come on line for some commodities, and possibly some slowing in the growth of demand, in recent months increases in prices of commodities have been much more moderate. The RBA's index of commodity prices (ICP) was broadly flat (in SDR terms) over the three months to January after rising by 16 per cent over the prior twelve months (Graph 11, Table 1). The base metals price index, which had roughly trebled since 2003, fell by 2 per cent over the most recent three months. The small change in this index disguised large offsetting movements in the prices of different metals. The price of copper fell by 25 per cent over the three months to January. The fall followed a very substantial run-up in the price and no doubt reflected a combination of news about fundamentals – in recent months the growth in production outpaced the growth in demand – and reversal of earlier speculative sentiment. In contrast, the prices of most other base metals

Graph 11

RBA Index of Commodity Prices

SDR, 2001/02 = 100



Source: RBA

Table 1: Commodity Prices

Percentage change; SDR

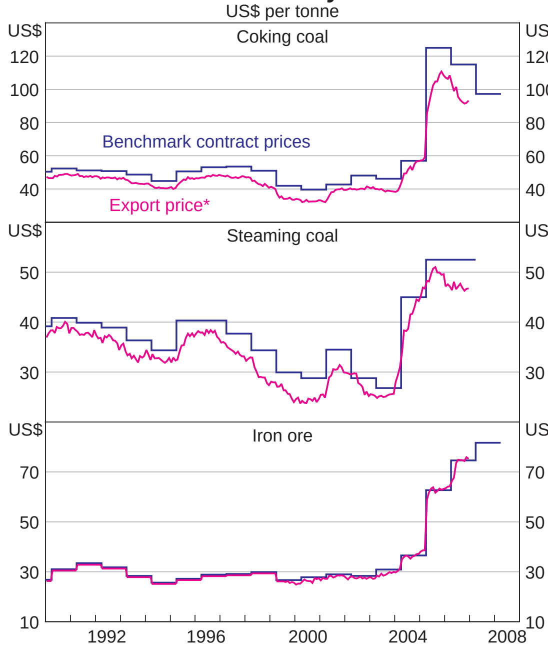
	Three months to January 2007	Year to January 2007
RBA index	0.3	9.9
Rural	3.3	9.6
– Wheat	–4.0	16.3
– Beef & veal	–1.2	4.1
– Wool	26.6	41.5
– Sugar	–2.8	–33.3
Base metals	–2.2	46.0
– Aluminium	3.9	13.8
– Copper	–24.9	16.7
– Nickel	11.1	143.0
– Zinc	–2.0	76.7
Other resources	0.4	–1.1
– Coking coal[a]	–0.9	–18.6
– Steaming coal[a]	–2.1	–10.6
– Iron ore[a]	–1.0	13.0
– Gold	6.0	11.0
Memo item		
Oil in US$[b]	–6.9	–16.0

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

Graph 12

Bulk Commodity Prices

US$ per tonne



* Data up to December 2006
Sources: ABARE; Bloomberg; RBA

continued to increase. In addition, oil prices (not in the ICP) have fallen by around 7 per cent since the last *Statement* and are around 25 per cent lower than their peaks in July. The decline in oil prices appeared to reflect a combination of increasing supply from non-OPEC countries, some softening in growth of demand, and some easing in speculative pressures.

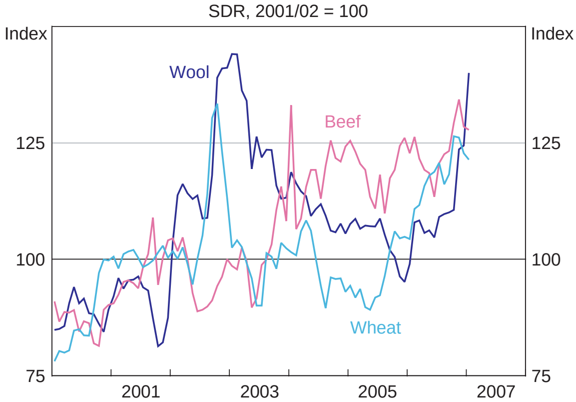
Benchmark contract prices for coking coal and iron ore for 2007/08 have already been settled, though steaming coal contract prices are still being negotiated (Graph 12). Iron ore prices were settled at a 9½ per cent premium over 2006/07, underpinned by expectations of continued strong demand from Chinese steel producers. In contrast, key coking coal prices will fall by 15–20 per cent, as large increases in global supply are expected over the next year or so, much of it coming from Australia. However, this would leave the price around 110 per cent higher than the 2003/04 contract price. The combined impact of the new bulk commodity contracts should leave the ICP marginally lower.

Rural commodity prices rose by 3½ per cent over the three months to January (Graph 13). Wool prices have risen by around 25 per cent over the past few months reflecting concerns about the effect of the drought on Australian wool production, which accounts for around a quarter of global production and roughly two-thirds of global exports. Wheat and beef prices have fallen in recent months though they remain at relatively high levels.

Graph 13

Rural Prices

SDR, 2001/02 = 100



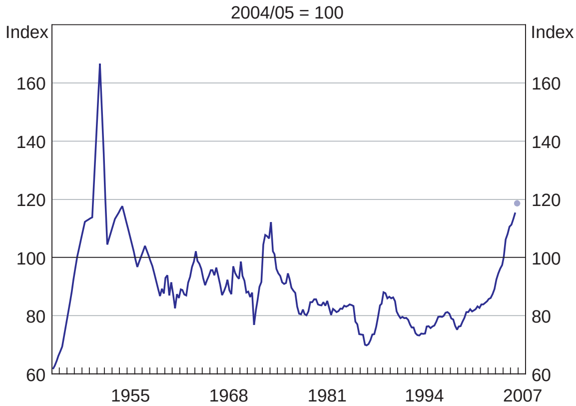
Sources: AWB Limited; Australian Wool Exchange; Meat & Livestock Australia Limited

Commodity prices are generally expected to moderate in 2007, but to remain at historically high levels. Analysts' forecasts and futures market pricing both suggest that base metals prices are expected to fall as new mine production comes on stream following the large run-up in prices in recent years. In addition, developments in the coal and iron ore markets suggest that significant additional price growth is unlikely for those commodities.

Australia's terms of trade continued to rise solidly through 2006 (Graph 14). Export prices rose by around 7 per cent, mostly due to the strength of commodity prices. Import prices were broadly unchanged over the year. The increase in the terms of trade over the three years to the December quarter was around 33 per cent, taking them to the highest level since the 1950s wool boom.

Graph 14

Terms of Trade*



* RBA estimate for December quarter 2006

Sources: ABS; RBA

International and Foreign Exchange Markets

International financial markets

Global financial markets were relatively buoyant over the past year, reflecting the strong performance of the global economy. Five features have characterised global market developments over the year:

- Moderate monetary tightening by virtually all central banks. By the end of the year, the majority of central banks had official interest rates at or near normal levels. Japanese interest rates, however, remain close to zero, and this is continuing to provide an ongoing source of cheap money for global markets.
- A search for yield. This has kept bond yields low and credit spreads tight. Demand for investments funded out of Japan (the carry trade) was one factor contributing to this. Unprecedented increases in the official reserves of Asian and oil-producing countries most likely was another.
- Strong share markets. The strong state of the world economy and company profits accounted for most of this, but leveraged merger and acquisition (M&A) activity may also have contributed.
- Low market volatility. Even a run of political events in some emerging markets, which in earlier times would have caused a great deal of instability, passed with little impact.
- Widespread expansion in debt financing. This no doubt was related to the low cost of debt relative to the expected return on assets. Most developed economies experienced strong growth in credit and a marked increase in leveraged buyout activity last year.

Official interest rates

All the major central banks increased policy rates in 2006 (Table 2, Graph 15). In the English-speaking countries, rates are either at neutral levels, or even somewhat on the restrictive side. In the case of the US, the Fed has kept interest rates steady at 5¼ per cent since June as it waits to see the impact of the seventeen policy tightenings over the previous couple of years. For much of the second half of 2006 markets priced in the possibility that the Fed would be easing in 2007 in order to offset the consequences of the housing downturn. The most recent expectation, however, is that rates will not change for at least the next six months.

European countries still have interest rates a little lower than what is commonly regarded as normal. The ECB, for instance, has interest rates at 3½ per cent. As such, with European economies remaining strong, some further policy tightening is expected there over the next few months.

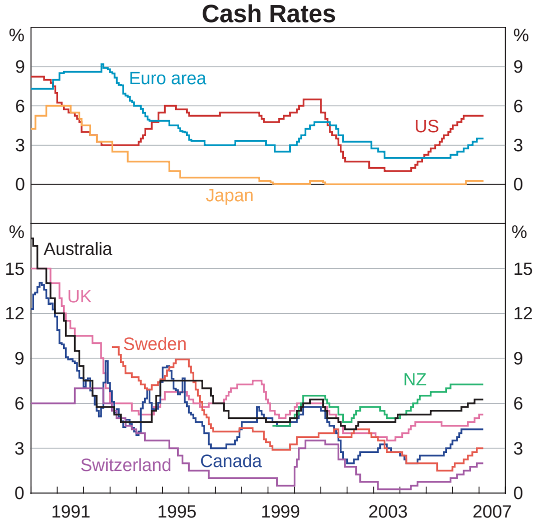
Table 2: Changes in Monetary Policy

	Current level Per cent	Most recent change	Change since end 2005	Expectations for next 6 months
United States	5.25	↑ Jun 06	↑ 100 bps	No change
Euro area	3.50	↑ Dec 06	↑ 125 bps	↑ 50 bps
Japan	0.25	↑ Jul 06	↑ 25 bps	↑ 25 bps
United Kingdom	5.25	↑ Jan 07	↑ 75 bps	↑ 50 bps
Canada	4.25	↑ May 06	↑ 100 bps	No change
New Zealand	7.25	↑ Dec 05	No change	↑ 50 bps

Sources: central banks; Bloomberg; Reuters

Graph 15

Cash Rates



Source: central banks

In Japan, rates remain very low. The Bank of Japan (BoJ) has only just begun its monetary tightening, lifting interest rates to 0.25 per cent in July after five years of following a zero interest rate policy. Amid mixed signals on the strength of the domestic economy and inflation, the BoJ has left rates unchanged at this low level since then. Markets currently expect rates to be raised by another 25 basis points some time in the first half of 2007.

Thus far in 2007, only one developed country has changed official interest rates: the Bank of England tightened by 25 basis points in January, lifting rates to 5¼ per cent, in response to a rise in inflation to 3 per cent, the upper end of the range set for the Bank of England.

Among the emerging markets, the most notable policy moves have been in China. The People's Bank of China (PBoC) tightened monetary conditions several times in 2006 to try to curtail the growth in money and credit. The PBoC has used a number of policy instruments. Benchmark interest rates that banks can pay and charge have been increased, as have the required reserves ratios for banks. These measures have produced some modest slowing in monetary and credit growth but asset prices have continued to rise rapidly.

Elsewhere in Asia, most countries have gradually raised rates from historically low levels earlier in the decade, but the overall level of interest rates remains relatively low. Recently Indonesia and Thailand have reduced policy rates after tightening earlier in 2006. Bank Indonesia has reduced its policy rate by 350 basis points since June 2006, to 9¼ per cent, as inflation pressures there have eased. The Bank of Thailand cut rates by 25 basis points to 4¾ per cent in

January 2007. Elsewhere in emerging-market economies, policy rates were generally increased over 2006, with the notable exception being Brazil, where rates have been cut by 675 basis points in this easing cycle, reflecting a sizeable decline in inflation there.

Bond yields

Yields on the major economies' long-term government debt traded in a historically narrow range in 2006 (Graph 16). Most countries experienced a modest net rise in yields over the year, mostly in the first half when the market was most concerned about inflation (Graph 17). Overall, the level of bond yields remains relatively low, with yield curves negatively sloped in the English-speaking economies and most of Asia.

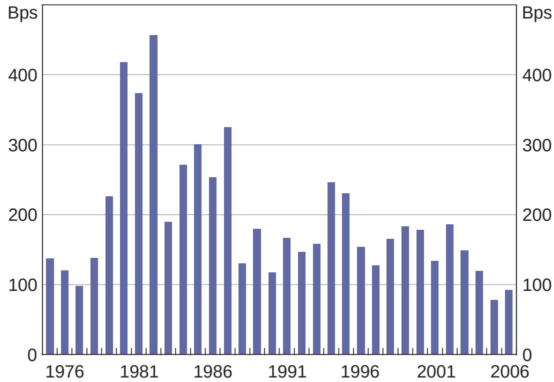
In the US, yields on government bonds rose noticeably over the first half of 2006, in line with the Fed's removal of monetary accommodation and growing concerns about inflation. By the second half of the year, however, the market's focus had shifted to the downturn in the US housing market and yields fell again. In recent months, these concerns too have faded and yields have risen again, though not to the levels of mid year.

At 4¾ per cent, US 10-year bond yields are about 50 points below the fed funds rate (Graph 18). This degree of inversion would normally signal expectations of monetary easing but, as noted earlier, such expectations

Graph 16

US 10-year Government Bond Yields

Annual range

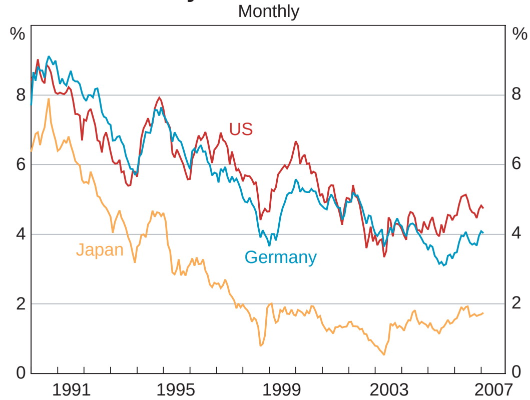


Source: Global Financial Data

Graph 17

10-year Bond Yields

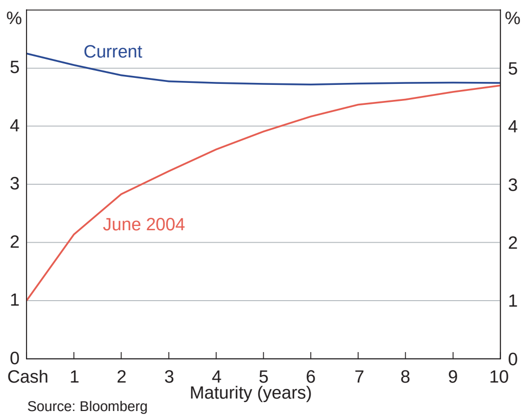
Monthly



Source: Thomson Financial

Graph 18

US Yield Curves



Source: Bloomberg

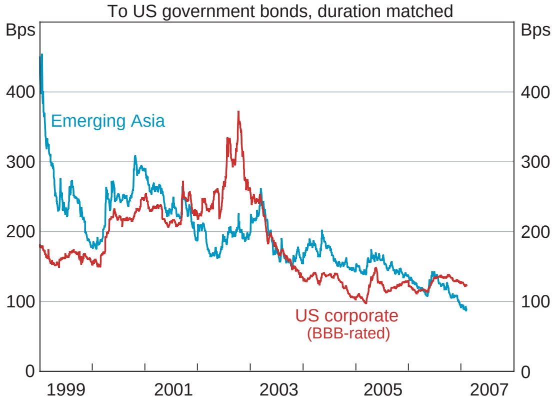
no longer exist in the US. Rather, it appears that longer-term yields have been held down by strong demand for such securities.

German yields also rose in 2006 and are just over 4 per cent, up from a post-war low of 3 per cent in late 2005. The net rise over the year was more than that in the US. Japanese government bond yields increased slightly in 2006, fluctuating within a narrow range between 1½ and 2 per cent.

Graph 19

Market Spreads

To US government bonds, duration matched



Sources: Bloomberg; JP Morgan; Thomson Financial; RBA

Spreads on corporate and emerging-market bonds remained low after declining sharply over recent years (Graph 19). Emerging-market debt was sold over May and June 2006, as risk aversion temporarily increased, but spreads on such debt soon returned to earlier lows. They have remained there since. There was little movement in emerging-market spreads in response to events, such as the coup in Thailand and increased concerns about nationalisation of major industries in parts of Latin America, which in the past have resulted in a large widening. Thai spreads rose modestly following the coup and the introduction of capital controls, but have since declined again.

Heightened speculation of a significant slowdown in the US economy in the second half of 2006 saw spreads on low-rated corporate debt in the US rise somewhat in anticipation that an economic slowdown would cause an increase in corporate defaults. However, these spreads too have since narrowed following the publication of data indicating only a modest slowing in US growth.

Equities

Global equity markets were strong in 2006 (Table 3). There was only a brief interruption to their rise mid year when there was a general increase in risk aversion in all global markets. Share markets ended 2006 with a weighted average increase of 14 per cent, the fourth consecutive year of strong gains. The rise was supported by continued robust global growth, strong earnings and an environment of low volatility. The share of profit in national income in many countries is close to historical highs. The relatively cheap cost of debt and low gearing ratios of a number of companies, particularly in the US and euro area, resulted in a large amount of takeover activity in 2006, further boosting equity prices. Global M&A activity has returned to levels last seen during the 1990s share market bubble (Graph 20). A number of equity markets approached, and in some cases exceeded, their peaks reached in 2000, including the Dow Jones in the US and the Canadian and Hong Kong equity market indices. Despite the rally in equity markets,

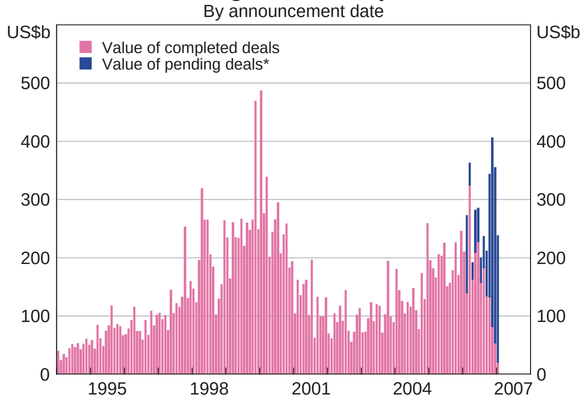
Table 3: Equity Markets
Percentage change

	Since 2000 peak	Since 2003 trough	2006	Since previous *Statement*
United States				
– Dow Jones	8	68	16	5
– S&P 500	–5	81	14	5
– NASDAQ	–51	96	10	5
Euro area				
– STOXX	–12	149	20	7
United Kingdom				
– FTSE	–8	94	11	2
Japan				
– TOPIX	–2	124	2	9
Canada				
– TSE 300	15	111	15	6
Australia				
– ASX 200	75	118	19	9
MSCI Emerging Asia	28	162	24	9
MSCI Latin America	191	282	34	13
MSCI World	1	106	14	6

Source: Bloomberg

global price-to-earnings (P/E) ratios, measured on historical earnings, remain around long-run averages (Graph 21).

Graph 20
Global Mergers and Acquisitions
By announcement date



* Transactions announced in 2006 but not completed
Source: Thomson Financial

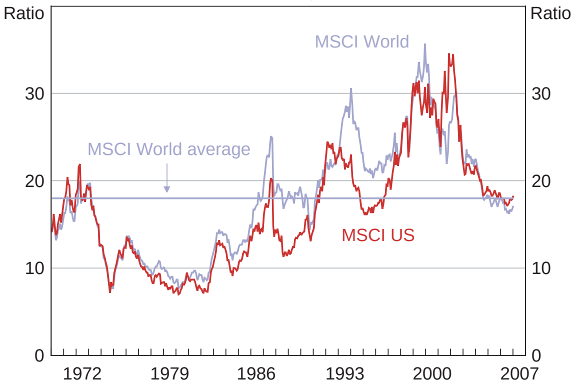
The one notable exception to the strength in global share markets was in Japan, where equities rose only marginally in 2006, albeit after having outperformed other markets in 2005.

Equity markets in emerging economies have benefited from a general climate of low market volatility, improved economic conditions, and high commodity prices. They have risen strongly since 2003, the rise interrupted only briefly by a sharp fall in May and June as risk aversion by investors increased for a short time. In emerging Asia, the Indian and Indonesian equity markets have led the rally, growing by more than 300 per cent since the start of 2003. The primary exception has been in Thailand, where in early January the equity market fell to its lowest level since August 2004 following the introduction of capital controls late in 2006.

Graph 21

P/E Ratios

Monthly



Source: Thomson Financial

In recent months the rapid rise of share prices in China has been causing concern for the authorities. Local currency share prices on the Shanghai exchange have risen 50 per cent in the past three months and 135 per cent over the past year.

Shares in Latin America have increased by nearly 300 per cent since their 2003 trough, with equity markets in the smaller Latin American economies recording the strongest growth. Despite Venezuelan equities recording large falls on several days last month following the announcement of plans to nationalise companies in a number of key industries, Venezuelan equities remain 120 per cent higher than their levels at the start of 2006, and over 450 per cent higher than at the start of 2003.

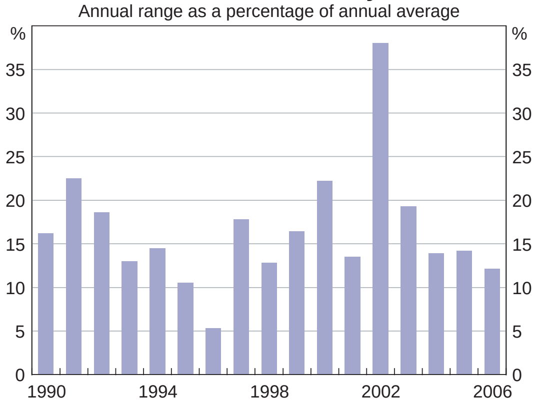
Exchange rates

Volatility in the major exchange rates has continued to remain at low levels over the past year (Graph 22). The main trend has been for the US dollar to depreciate against most major currencies, with the exception of the yen (Table 4). The US dollar fell most sharply against the euro and other European currencies. This in part reflected the differing economic and policy cycles in the two regions, summed up by the fact that US monetary policy has been held steady since June while European interest rates have continued to rise. Overall, the US TWI fell by 5 per cent last year, to a level which is about 25 per cent below the 2002 peak (Graph 23).

Graph 22

Euro/US$ Volatility

Annual range as a percentage of annual average



Source: RBA

The US dollar was affected at various times during the year by talk that holders of official reserve assets were diversifying away from US dollars. A number of countries either announced diversification plans or were rumoured to be considering such moves. At the aggregate level, however, there is little evidence of a shift away from US dollars in global reserves holdings; the proportion of

US dollars in official reserves remains around two-thirds.

The Japanese yen was the only major currency that did not rise against the US dollar. Despite the Bank of Japan's decision to end the zero interest rate policy in July, the level of interest rates in Japan remains very low. This appears to have encouraged increased 'carry trade' activity, where funds are borrowed at low interest rates in Japan and converted to other currencies for investment at higher rates elsewhere. In addition, there have been large capital outflows from Japan due to Japanese investors diversifying their financial portfolios. On a real trade-weighted basis, the Japanese exchange rate has depreciated to its lowest level in around two decades, and is 45 per cent below its peak in the mid 1990s (Graph 24).

The pace of appreciation in the Chinese renminbi against the US dollar accelerated somewhat during 2006, though the total appreciation over the year was only 3 per cent. The PBoC undertook over $US200 billion of intervention last year to stem what would have otherwise been a larger rise in the exchange rate. With the US dollar depreciating by more than 3 per cent against many other currencies, the renminbi depreciated in trade-weighted terms. Pricing in the non-deliverable forward market indicates that the markets expect the renminbi to appreciate by a further 5½ per cent against the US dollar this year.

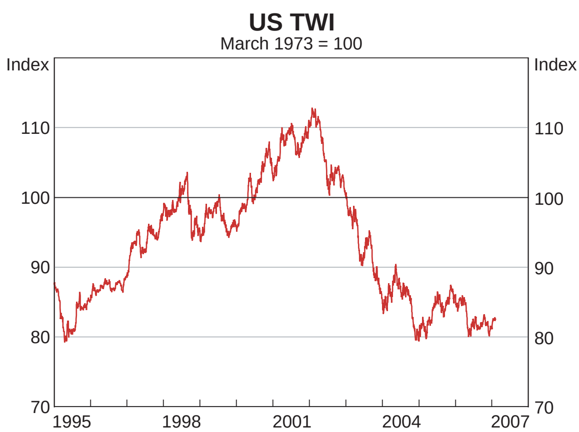
Table 4: Change in US Dollar against Other Currencies

Per cent

	2006	Since previous *Statement*
Sweden	–14	–1
Thailand	–14	–6
United Kingdom	–12	–3
Euro area	–10	–1
Brazil	–9	–2
Indonesia	–9	–1
South Korea	–8	0
Philippines	–8	–3
Singapore	–8	–2
Australia	–7	–1
Switzerland	–7	0
Malaysia	–7	–4
China	–3	–2
New Zealand	–3	–3
India	–2	–1
Taiwan	–1	0
Canada	0	5
Japan	1	2
Mexico	2	0
South Africa	11	–1
Majors TWI	**–5**	**1**
Broad TWI	**–4**	**0**

Source: RBA

Graph 23

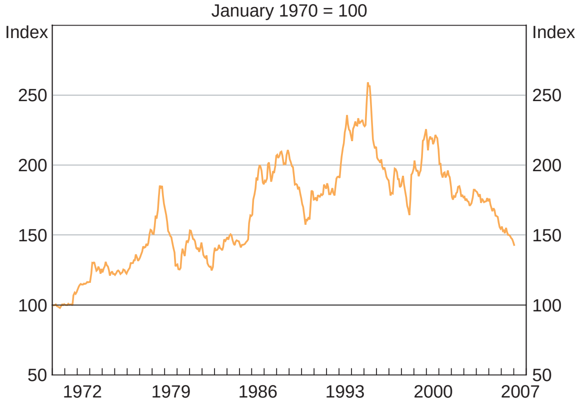


Source: Board of Governors of the Federal Reserve System

Graph 24

Japanese Real Trade-weighted Exchange Rate

January 1970 = 100

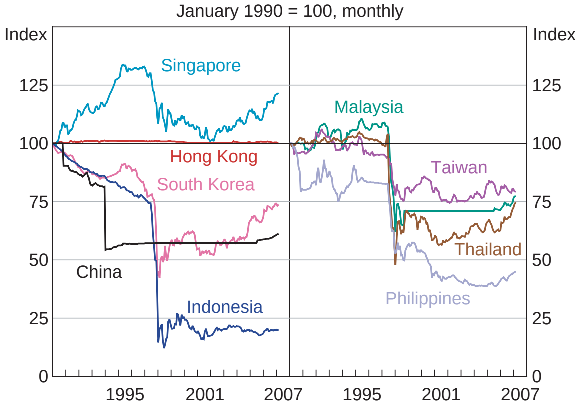


Source: BIS

Graph 25

Asian Currencies against US Dollar

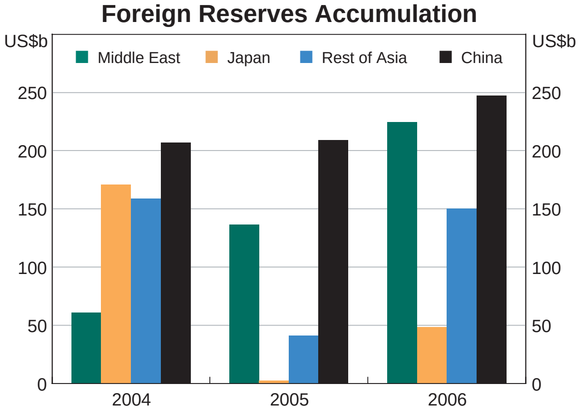
January 1990 = 100, monthly



Sources: Bloomberg; Thomson Financial

Graph 26

Foreign Reserves Accumulation



Sources: CEIC; IMF; RBA

Emerging Asian currencies continued to appreciate against the US dollar during 2006, although they remain significantly below their levels at the time of the financial crisis of 1997/98 (Graph 25). As in the case of China, the pace of appreciation in Asian currencies was tempered by large-scale foreign exchange intervention. East Asian central banks resumed their build-up of reserves after scaling back activity in the previous year (Graph 26).

Reflecting concerns about the appreciation of the baht, which at that point had risen by 14 per cent against the US dollar since the beginning of 2006, the Bank of Thailand in December announced controls on short-term capital inflows. The controls primarily involved penalties on non-trade related capital flows that were reversed in less than 12 months. Foreign direct and portfolio equity investment were exempt from this measure. This resulted in a short-lived depreciation in the baht, but the largest effect appeared to be on the Thai stock market (see above). In January, the Thai authorities reduced controls on capital outflow by residents to try to further alleviate the upward pressure on the baht. Similar measures to encourage capital outflows were also introduced in Korea where residents obtained a tax holiday for three years on foreign portfolio investment.

Australian dollar

The Australian dollar appreciated by about 4 per cent on a trade-weighted basis in 2006 (Table 5). The rise was more pronounced against the US dollar and even more so against the yen. The Australian dollar's exchange rate against the yen in January 2007 reached its highest level since the onset of the Asian crisis in mid 1997 (Graph 27). The release of the December quarter CPI, which resulted in a downward adjustment to interest rate expectations, saw the Australian dollar fall from its peaks of early January. The currency is currently trading at US77¾ cents and 64 on a trade-weighted basis, around the levels at the time of the previous *Statement*.

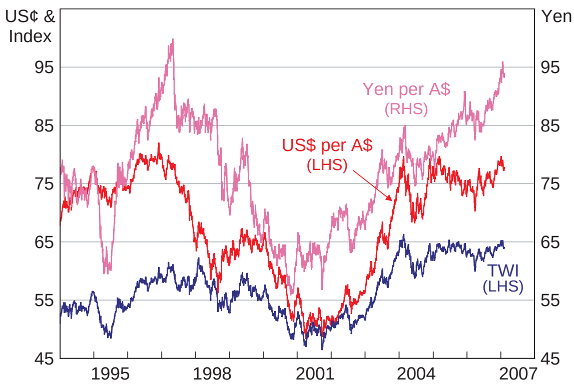
Table 5: Australian Dollar against Selected TWI Currencies
Percentage change

	2006	Since previous *Statement*
South Africa	19	–1
Japan	9	4
US	8	2
Canada	8	6
Taiwan	7	2
PNG	6	2
New Zealand	5	–2
China	4	0
Switzerland	1	1
Philippines	0	–2
South Korea	0	1
Singapore	–1	0
Indonesia	–1	1
Euro area	–3	0
UK	–5	–2
Sweden	–7	–1
TWI	**4**	**1**

Source: RBA

Graph 27

Australian Dollar



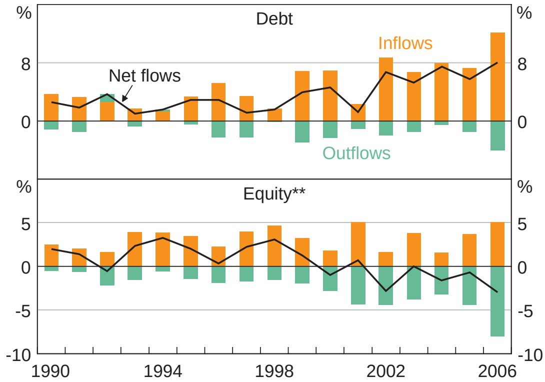
Sources: RBA; Reuters

Over the past year, the demand for the currency has been supported by the rising terms of trade, reflecting continued strength in commodity prices, particularly base metals, iron ore and gold. In addition, in recent months the Australian dollar has been boosted by an increased appetite for carry trades. Australian dollar investments, along with the New Zealand dollar and British pound, have been an important destination of much of these flows, particularly from Japan. As investors have become more convinced that the Bank of Japan will not raise interest rates significantly in the foreseeable future, they have increased their appetite for carry trades. Moreover, as noted above, there appears to be a structural shift by Japanese household investors to increase their holdings of higher yielding offshore assets. By international standards Japanese investors have traditionally held very conservative financial portfolios skewed towards domestic assets, but this now seems to be changing.

Graph 28

Capital Flows*

Per cent of GDP



* Data for 2006 are for the year to the September quarter

** Data for 2005 exclude the June quarter due to large capital flows resulting from a corporate restructure

Sources: ABS; RBA

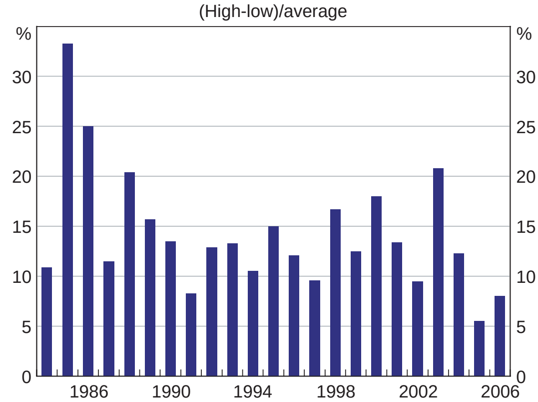
The attractiveness of yields in Australia has been reflected in the large net inflows into bank and money market instruments which have accounted for the largest share of total capital inflow in Australia (Graph 28). A sizeable component of these inflows also reflected Australian banks sourcing funds in offshore markets, taking advantage of strong demand for such investments in these markets. There has been a trend of modest net outflow of equity capital in recent years, with large investments offshore both directly by Australian companies and through portfolio flows of Australian funds managers. These have more than offset inflows of equity capital from abroad, even though these too have been substantial. Australian superannuation funds continue to allocate about one-quarter of their funds under management to overseas equities.

Notwithstanding the appreciation over the year, the trading range for the trade-weighted index of the Australian dollar in 2006 remained narrow by historical standards (Graph 29). The range was only slightly wider than that recorded in 2005 which was the lowest in the floating exchange rate period. While volatility of the currency has picked up in recent months, it still remains below its post-float average (Graph 30).

Graph 29

Annual Range in Trade-weighted Index

(High-low)/average



Source: RBA

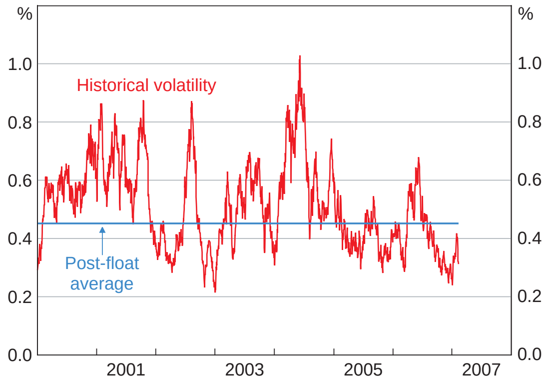
Measures of investor sentiment towards the Australian dollar appear positive with speculators continuing to hold net long positions in Australian dollar futures on the Chicago Mercantile Exchange.

Since 2002, the Reserve Bank has been buying foreign exchange reserves to replenish sales that it had made during intervention operations to support the Australian dollar between 1997 and 2001. After significant purchases were made in both 2003 and 2004, net purchases were scaled back over both 2005 and 2006, given reserves had reached relatively comfortable levels and the exchange rate had settled into a steadier range. Over 2006, net purchases of foreign exchange totalled around $360 million. The Bank stepped up its purchases somewhat in January 2007 when the exchange rate of the Australian dollar rose to around its highest level since 2004. Net reserves are currently around $31½ billion.

Graph 30

Australian Dollar Volatility

Against US$, per trading day



Source: RBA

Domestic Economic Conditions

Most of the data released since the last *Statement* suggest the non-farm economy has expanded at a moderate pace, although the effect of the drought on the farm sector has weighed on growth of the economy as a whole. Employment grew by 0.8 per cent over the three months to January and by 3.0 per cent over the year. Business surveys suggest that trading conditions remained buoyant in the December quarter, and that capacity utilisation remained around the highest levels on record. The latest national accounts, which are for the September quarter of 2006, indicate that non-farm GDP increased by 0.6 per cent in the quarter and by 2.6 per cent over the year, supported by the run-up in resource-related investment and growth in export activity in response to the large increase in commodity prices in recent years (Table 6). In contrast, conditions in the farm sector were weak due to the drought; farm GDP was estimated to have fallen by 10 per cent in the quarter. The continuing pattern of subdued growth in GDP and strong growth in employment has implied that measured productivity growth has remained weak. In general, the divergence between GDP data and a number of other indicators discussed in the November *Statement* has continued.

While farm GDP could fall by around 20 per cent in 2006/07, directly subtracting around one-half of a percentage point from GDP growth, conditions in the rest of the economy are expected to remain solid. Moderate growth in household consumption should continue, and housing construction activity is expected to gradually strengthen, supported by firm underlying housing demand. Business investment is projected to remain high as a share of GDP, but it is likely to grow at a significantly slower pace than that seen in recent years. In addition, with continuing strong world growth and the completion of several large resource sector investment projects in 2006 and 2007, exports should increase over the coming period, although in the near term higher resource exports will be offset by a decline in the volume of rural exports.

Table 6: Demand and Output
Percentage change

	June qtr 2006	September qtr 2006	Year to September qtr 2006
Domestic final demand	1.2	0.1	3.4
Change in inventories[(a)]	–0.7	–0.1	–0.8
GNE[(b)]	0.7	–0.1	2.5
Net exports[(a)]	–0.2	0.4	–0.5
GDP	0.5	0.3	2.2
Non-farm GDP	0.7	0.6	2.6
Farm GDP	–5.1	–10.0	–11.4
Memo item:			
Real GDP adjusted for changes in the terms of trade	0.9	0.7	3.6

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

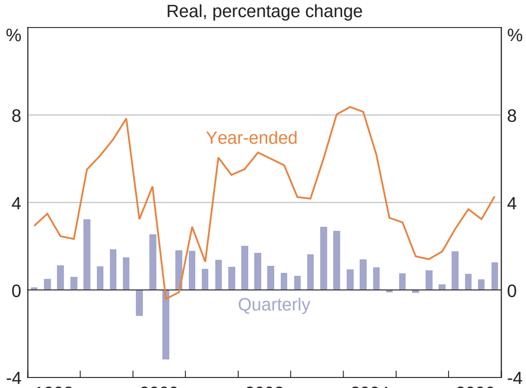
Household sector

Growth in household spending picked up modestly during 2006, but remained below the pace of a few years ago. Household consumption increased by 2.8 per cent over the year to the September quarter, and more timely data indicate that real retail sales increased strongly in the December quarter, to be around 4 per cent higher over the year (Graph 31). Liaison with retailers indicates that spending growth has been broad-based across classes of expenditure, with signs of recovery in some areas of discretionary spending. Retailers generally attribute the strengthening in sales to strong employment outcomes and the fall in petrol prices. Motor vehicle sales also picked up moderately in the second half of 2006 after a period of weakness. Measures of consumer sentiment are above long-run average levels, although lower than the peaks recorded several years ago.

Graph 31

Retail sales

Real, percentage change

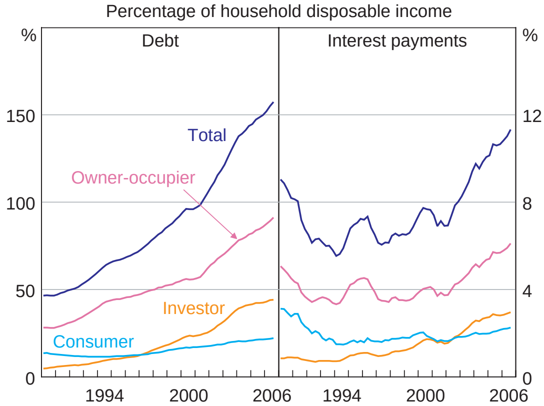


Source: ABS

Graph 32

Household Debt and Interest Payments*

Percentage of household disposable income



* Household sector excludes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.

Sources: ABS; RBA

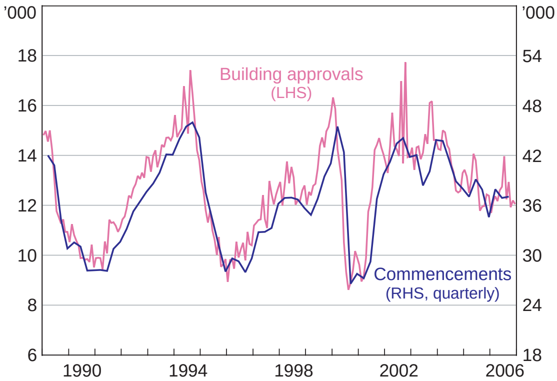
The recent pick-up in household spending may indicate some slowing in the process of household financial consolidation. For an extended period from the mid 1990s to 2003 – roughly coinciding with the housing boom – growth in spending ran ahead of growth in household income. In contrast, for most of the period since early 2004, growth in consumption has been below that of household income and hence the net household saving ratio has increased, although it is still slightly negative. This has also coincided with a period when growth in household debt has been running below the high levels seen in the late stages of the housing boom. Nonetheless, the debt-to-income ratio has continued to increase, along with the household interest payments ratio, which rose to 11.3 per cent in the September quarter reflecting in part the recent increases in interest rates (Graph 32). Still, as spelled out in the September 2006 *Financial Stability Review*, household balance sheets appear healthy, with household net worth rising steadily in recent years due to growth in the value of both housing and financial assets.

Housing

The various indicators of housing construction show a strengthening in activity occurred through the first three quarters of 2006 (Graph 33). Dwelling commencements in the September quarter were 7 per cent higher than in late 2005, while dwelling investment was 2 per cent higher over the same period. The pick-up reflected increased building of houses and growth in alterations & additions; construction of apartments continued to fall. There is only limited information available for the December quarter, but data for building approvals and sales of new homes suggest some slowing in activity, following the increases in interest rates during 2006.

Graph 33

Housing Construction



Source: ABS

Average nationwide house prices rose through 2006 – the APM mix-adjusted measure suggests growth of around 1 per cent in the December quarter and 6 per cent over the year – although there were significant differences across states. Prices were broadly flat in Sydney over 2006 and rose modestly in most other capitals. The exceptions were Perth and Darwin which saw very strong price growth, although recent data suggest that the pace of growth in Perth – where prices rose by around 80 per cent over the past three years compared with growth of only about 3 per cent in the rest of the country – may have slowed significantly late in the year (Table 7, Graph 34). Nationwide apartment prices were flat over the year to the December quarter, with soft conditions in the larger markets of Sydney and Melbourne offset by growth in the other capitals, particularly Perth.

Table 7: House Prices

Percentage change

	APM		REIA		Residex	
	Dec qtr 2006	Year to Dec qtr	Dec qtr 2006[a]	Year to Dec qtr	Dec qtr 2006	Year to Dec qtr
Sydney	1	1	..	..	1	1
Melbourne	1	3	1	5	1	4
Brisbane	1	5	..	..	2	7
Adelaide	3	8	–1	4	2	7
Perth	1	31	3	37	2	27
Canberra	3	5	3	8	–2	3
Hobart	–1	7	–3	5	4	8
Darwin	5	17	–4	13	0	21
Australia	**1**	**6**	**..**	**..**	**1**	**8**

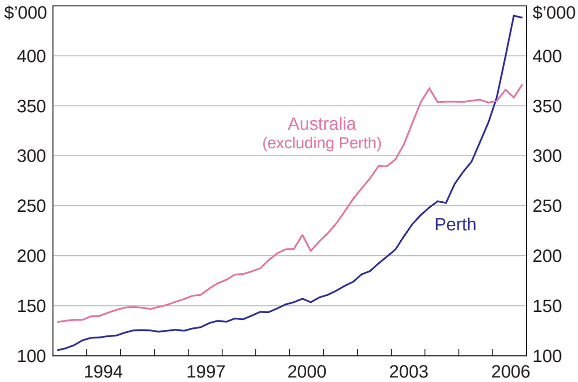
(a) Seasonally adjusted by the RBA

Sources: APM; REIA; state REIs; RBA; Residex

Graph 34

Australian House Prices

Quarterly median levels, seasonally adjusted

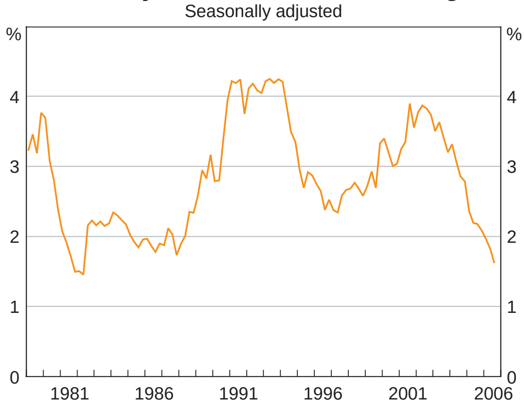


Sources: APM; RBA

Graph 35

Vacancy Rates for Rental Dwellings

Seasonally adjusted



Sources: RBA; REIA

Table 8: Rental Vacancy Rates

Per cent, seasonally adjusted

	1979–2005 Average	2006[(a)]
Sydney	2.4	1.9
Melbourne	2.8	1.7
Brisbane	3.6	1.9
Adelaide	2.9	1.6
Perth	3.7	1.8
Canberra	2.9	1.8
Australia	**2.9**	**1.8**

(a) Estimate based on data for the first three quarters

Sources: RBA; state REIs

Looking over a longer horizon, average capital city house prices have grown by around 175 per cent since the mid 1990s; prices outside the capital cities have risen by a broadly similar magnitude. This has taken the ratio of house prices to household incomes to a level which is well above its historical average. This increase has been sharply at odds with developments in rents; the ABS measure for average nationwide rents increased by around 35 per cent over the same period and data from the state Real Estate Institutes suggest overall rents increased by around 60 per cent. The result has been an approximate doubling in price-rent ratios or a halving in rental yields (see also 'Box B: Recent Developments in Housing Prices', *Statement on Monetary Policy*, August 2005). With rents unusually low compared with the cost of buying a house, it might be expected that households' demand to live in rental properties would be strong. At the same time, it would not be surprising if investors' willingness to supply additional rental property might be subdued in the face of the combination of low rental yields and limited prospect of capital appreciation given the current high level of prices.

The result has been that conditions in residential rental markets have tightened, with the national vacancy rate now around its lowest level since the early 1980s (Graph 35). According to the state Real Estate Institutes, vacancy rates in all capitals are well below their long-run average levels (Table 8). The low vacancy rates are contributing to growth in rents and should boost dwelling construction over the medium term. Over the year to the December quarter, the CPI measure of nationwide rents increased by 3.7 per cent, its fastest pace of growth since 1991. However, information on new rental contracts suggests significantly larger rent increases, which are yet to pass through into the broader ABS measure for the total rental stock.

Business sector

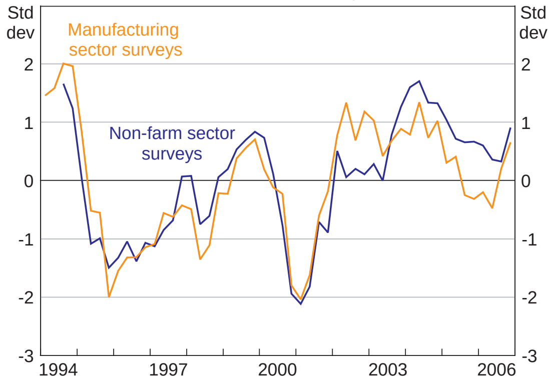
Business conditions in the non-farm sector are favourable. Private-sector surveys suggest that aggregate conditions remained above long-run average levels in the December quarter, although below the peaks recorded in 2004 (Graph 36). The ACCI-Westpac and AIG surveys suggest that business conditions in the manufacturing sector have picked up over the past quarter or two, to be above average levels, and the most recent Sensis survey indicates that conditions for small & medium-sized firms have improved. The NAB survey reported that capacity utilisation has remained around its highest level on record (Graph 37).

Business profits continued to expand in 2006, although growth eased from the rates seen in 2005 (Graph 38). Profits increased by around 6 per cent over the year to the September quarter and – at 30 per cent of GDP – the profit share was around record levels. The divergence between mining and non-mining profit growth has narrowed recently. Rising material and labour

Graph 36

Actual Business Conditions*

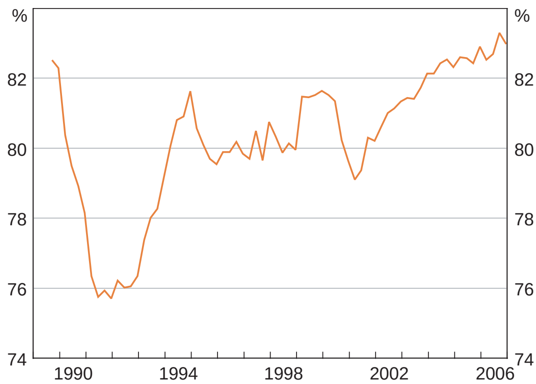
Deviation from average



* Weighted average of data from various business surveys, with weights calculated by the RBA using the principal component method
Sources: ACCI; AIG; NAB; SAI Global; Sensis; St. George Bank; Westpac

Graph 37

Capacity Utilisation

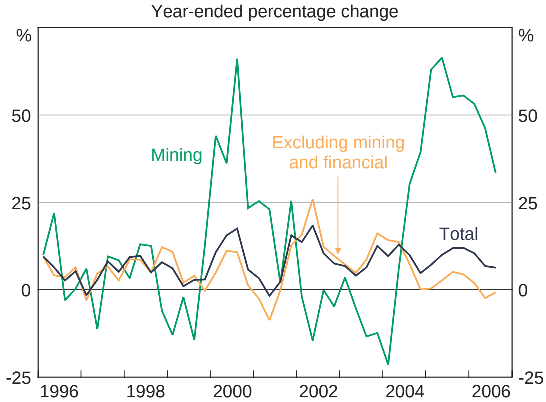


Source: NAB

Graph 38

Profits*

Year-ended percentage change



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

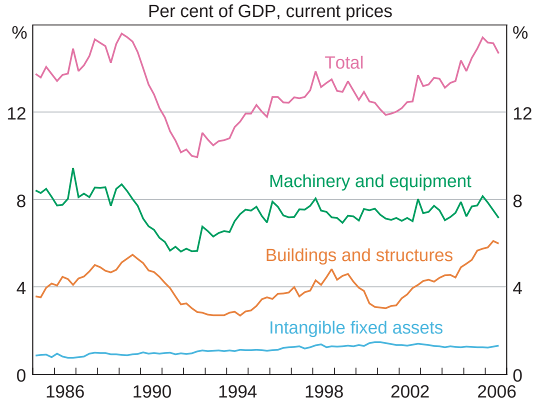
costs, combined with slower growth in commodity prices, are resulting in a slowing in mining profit growth from the exceptional rates recorded in recent years. Business surveys generally indicate that firms' profit expectations remain close to or above long-run average levels, and equity analysts expect reasonable growth in earnings of non-resource companies in the 2006/07 reporting year (for details see the 'Domestic Financial Markets and Conditions' chapter).

Reflecting these favourable conditions, business investment has been strong. Although the pace of growth in investment moderated during 2006, declining to 4 per cent over the year to the September quarter compared with average annual growth of more than 15 per cent over the four years to end 2005, the level of investment is high (Graph 39). Even without further growth, this is boosting the size of the capital stock. The ABS estimates that the business sector's net capital stock grew by 6 per cent in 2005/06, compared with average annual growth of 4 per cent over the past 25 years. This should help, in time, to alleviate some of the capacity constraints reported in recent years.

Graph 39

Investment*

Per cent of GDP, current prices



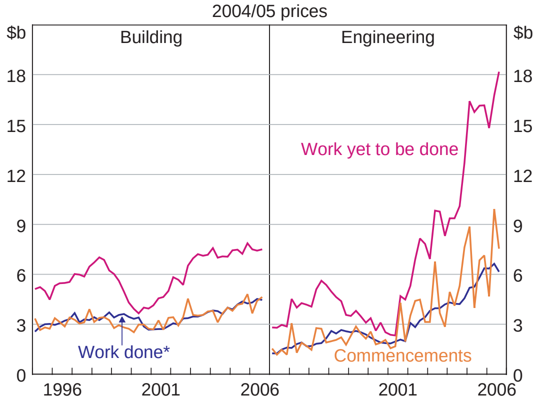
* Business investment adjusted for transfers between the private and other sectors

Source: ABS

Graph 40

Non-residential Construction Indicators

2004/05 prices



* Seasonally adjusted

Sources: ABS; RBA

Looking ahead, the capital expenditure (Capex) survey's fourth reading of firms' spending plans for 2006/07 suggests moderate growth in spending on machinery & equipment. In addition, forward-looking indicators suggest that non-residential construction activity will remain at a high level over coming quarters. The pipeline of engineering work yet to be done increased in the June and September quarters as commencements of new projects ran ahead of construction activity (Graph 40). However, labour and equipment shortages have slowed progress on some projects, and rising construction costs have reportedly prompted some new projects to be delayed.

Farm sector

Conditions in the rural sector remain very weak. The 2006 wheat crop is estimated by the Australian Bureau of Agricultural and Resource Economics (ABARE) at 9.7 million tonnes, less than half the average of the past five years, reflecting the exceptionally dry conditions in mid and late 2006. Forecasts by ABARE suggest that farm GDP will fall by around 20 per cent in 2006/07 (for details on the impact of the drought, see the November 2006 *Statement on Monetary Policy*). While January rains in some agricultural regions and recent movements in the Southern Oscillation Index have provided tentative signs of a prospective improvement in climatic conditions, significant follow-up rains will be necessary to improve the overall outlook for 2007/08. Furthermore, while during previous droughts the decline in output has usually been followed by a sharp recovery in production once seasonal conditions return to normal, in the current episode low levels of stored water and soil moisture may slow the pace of the eventual recovery, especially for irrigated crops.

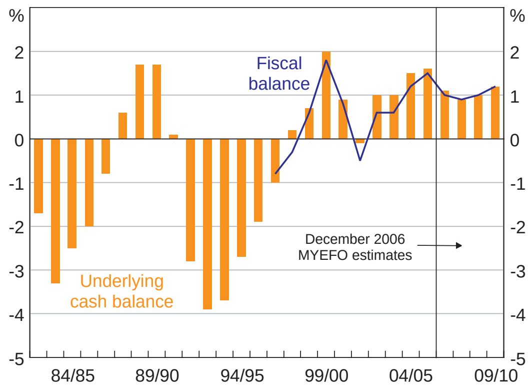
Australian Government Budget

The Mid-Year Economic and Fiscal Outlook (MYEFO) for 2006/07, released in December, showed a small increase in the expected Australian Government cash surplus compared with that projected in the May Budget, to $11.8 billion or 1.1 per cent of GDP (Graph 41). The upward revision largely reflected reduced expenditures; expected taxation revenues are broadly unchanged from the Budget estimates. Estimates of the aggregate budget deficit of the states in 2006/07 have been revised slightly higher in the states' mid-year reviews, reflecting in large part a forecast increase in capital expenditure in the year (Graph 42). Given the already-high level of investment activity occurring in the economy, it may prove difficult to implement all these plans in the short term.

Graph 41

Australian Government Budget Balance

Per cent of GDP

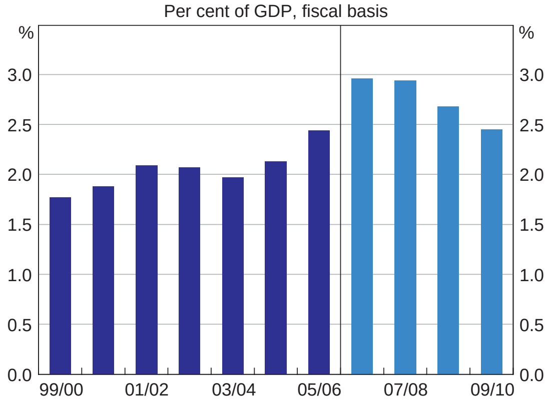


Source: Australian Treasury

Graph 42

State Capital Expenditure*

Per cent of GDP, fiscal basis

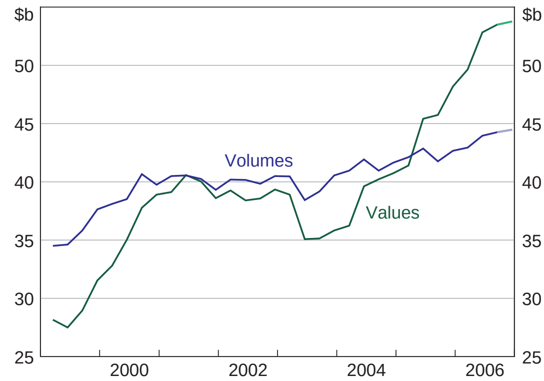


* Total state non-financial public sector. Data from 2005/06 sourced from state budget papers; ABS data prior to this.

Sources: ABS; RBA; state Treasury Departments

Graph 43

Exports*



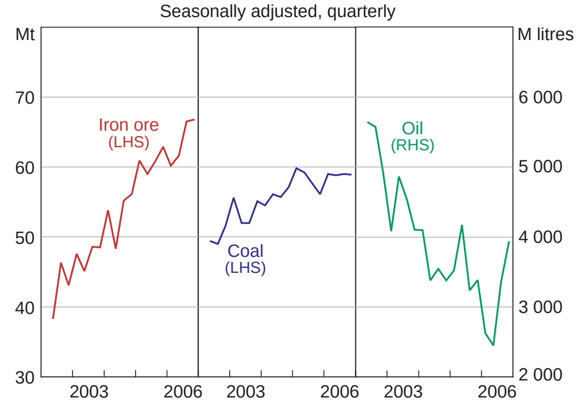
* RBA estimate for December quarter 2006

Sources: ABS; RBA

Graph 44

Resource Export Volumes

Seasonally adjusted, quarterly

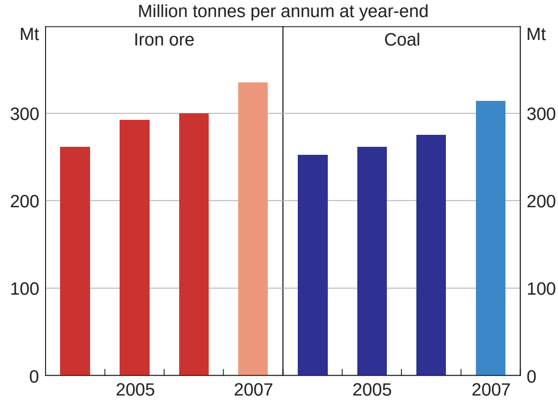


Sources: ABS; RBA

Graph 45

Resource Export Transport Capacity

Million tonnes per annum at year-end



Sources: port and rail authorities

External sector

Export values expanded strongly in 2006, reflecting further growth in prices and a modest lift in volumes (Graph 43). The value of resource exports grew by around 15 per cent over the year, mostly attributable to higher prices. There have been strong increases in volumes of LNG and iron ore exports, and a pick-up in oil exports after a long period of decline (Graph 44). This has reflected new projects coming on line, including the Darwin LNG compression plant and the Enfield oil project on the North West Shelf. For iron ore, there have been expansions in mine capacity in the Pilbara, and a significant increase in port and rail capacity (Graph 45). However, increases in exports of these commodities have been partly offset by falls in some non-ferrous metals and ores, and broadly flat coal exports. Although there has been a moderate increase in transport capacity for coal over the past two years, exports have been hindered by disruptions in production and reliability issues in the transport chain. Looking ahead, growth in the volume of overall resource exports is expected to pick up solidly over the coming year, supported by the completion of a number of additional projects and a further easing in infrastructure bottlenecks, especially in the case of coal.

Rural export volumes are estimated to have increased by around 3 per cent over 2006, reflecting strong demand for Australian beef from Japan and

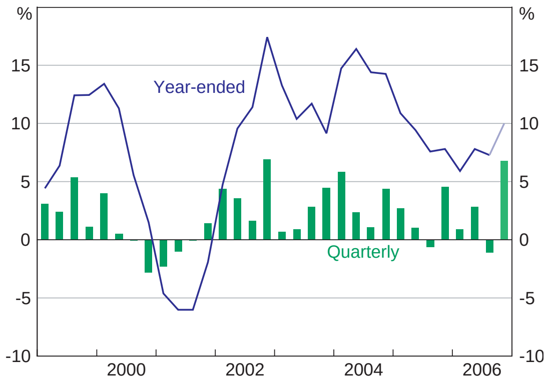
Korea and the large 2005 cereals crop. Looking ahead, the drought is expected to reduce exports of cereals, wool, canola, dairy and cotton, although wheat inventories remaining from the 2005 crop should help to moderate the size of the decline in wheat exports.

The volume of manufactured exports is estimated to have increased by around 4 per cent over 2006. With surveys suggesting that sentiment among manufacturers has picked up and global demand expected to remain strong, growth in manufactured exports should continue into 2007. Service exports volumes also appear to have increased solidly over 2006, including a boost in the December quarter due to the influx of visitors for the Ashes cricket series.

The volume of imports rebounded sharply in the December quarter after falling in the September quarter, to be around 10 per cent higher over the year (Graph 46). Although year-ended growth has eased from the high rates recorded in 2004, the current pace of growth is consistent with continued solid growth in domestic demand. The growth in the December quarter was broad-based, with strength in imports of consumption, capital and intermediate goods.

Graph 46

Import Volumes*

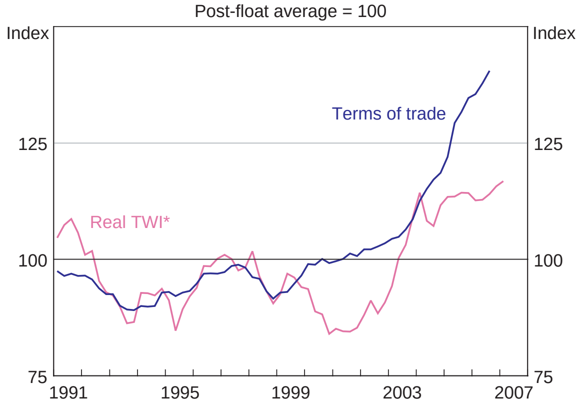


* RBA estimate for December quarter 2006
Sources: ABS; RBA

Graph 47

Real Exchange Rate and Terms of Trade

Post-float average = 100



* March quarter 2007 observation assumes that the nominal bilateral exchange rates on 7 February are maintained for the remainder of the quarter, and uses the latest core inflation rates.
Sources: ABS; RBA

The growth in import volumes is likely to partly reflect the upward drift in the real exchange rate which, at 17 per cent above its post-float average, is around its highest level for 20 years (Graph 47). While the elevated level of the real exchange rate is having a dampening effect on some non-resource sectors of the economy, at an economy-wide level it is likely that this is being offset by the boost to national income generated from the high level of the terms of trade, which are around 40 per cent above their post-float average.

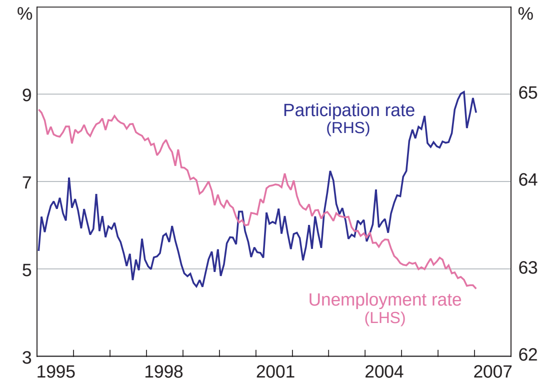
The latest current account data are for the September quarter, when the deficit narrowed to 4.8 per cent of GDP as a sizeable decline in the trade deficit more than offset an increase in the net income deficit (NID). The NID has widened in recent years reflecting larger net payments on equity due to strong profits of Australian firms, particularly in the mining industry, and the rise in interest payments from increases in world interest rates and the stock of foreign debt. While monthly exports and imports data indicate that the trade deficit widened in the December quarter, it remains well below the levels recorded a year or two ago. Assuming the NID stayed close to its September quarter level of 4.3 per cent of GDP, the December quarter current account deficit is estimated to have been around 5¾ per cent of GDP.

Labour market

The number of employed persons increased by 3 per cent over the year to January, with growth strong in both full- and part-time employment. The increase in employment during the past year was accompanied by a fall in the unemployment rate to a 30-year low of 4.5 per cent (Graph 48). The participation rate is also around the highest level on record, boosted in recent years by the large increase in participation by older workers (for further discussion, see the November 2006 *Statement on Monetary Policy*).

Graph 48

Labour Market Indicators



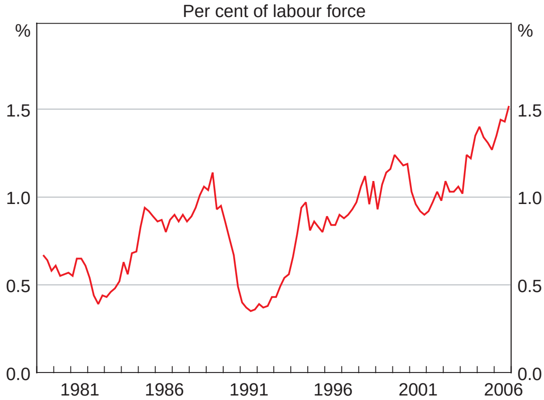
Source: ABS

Employment growth has been broad-based, with the goods and services sectors both making strong contributions to year-ended growth. While mining employment has gained much attention, over the past year employment growth was also high in construction, finance & insurance, and wholesale trade.

Graph 49

Vacancy Rate

Per cent of labour force



Source: ABS

Vacancies data suggest that demand for labour remains high, both nationally and across the states. The ABS measure of job vacancies increased by 5.9 per cent in the three months to November and, at 1.5 per cent, the nationwide vacancy rate is at its highest level since the 1970s (Graph 49). Businesses continue to report difficulties recruiting suitable staff, especially in the business services, mining and non-residential construction sectors.

Regional economic developments

A noteworthy feature of the domestic economy in recent years has been divergences in state performance. These divergences have been most pronounced in measures of spending, especially dwelling and business investment. This is unsurprising given the historically large rise in commodity prices, which has attracted both capital and labour to the resource-rich states. However, measures of spending provide an incomplete picture of state activity since they exclude flows associated with interstate and international trade, which are very significant in magnitude. State trade flows are captured by estimates of gross state product. While these data are only available annually and are published with a considerable lag, they suggest that measures that take into account trade flows between the resource-intensive and other states considerably reduce the magnitude of the divergent outcomes observed in final demand over recent years.

Employment growth has been firm across the states, and recently there has been some convergence in outcomes, with annual employment growth in New South Wales increasing and that in Western Australia slowing as employers have found it harder to find suitable labour (Table 9). There has also been a broad-based reduction in unemployment rates in recent years. Similarly, the composite measure of business conditions in the NAB survey – which reflects firms' responses on trading conditions, profitability and employment – shows that conditions in the non-farm economy remain above average in all the mainland states.

Table 9: Labour Market by State
Three-month-ended basis, per cent

	Employment growth		Unemployment rate	
	Three years to January 2007, annualised	Year to January 2007	January 2004	January 2007
NSW	1.6	2.1	5.5	5.0
Victoria	2.4	2.4	5.5	4.9
Queensland	4.4	5.4	6.2	4.1
WA	3.6	2.2	5.9	3.1
SA	1.9	2.0	6.7	5.5
Tasmania	2.2	–0.8	7.0	5.9
Australia	**2.6**	**2.8**	**5.8**	**4.6**

Source: ABS

Domestic Financial Markets and Conditions

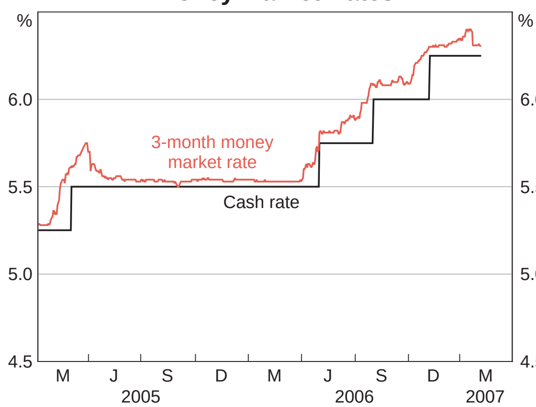
Interest rates and equity prices

Money and bond yields

Short-term market rates rose by ¾ of a percentage point in 2006, in line with the three monetary tightenings. They rose further in early 2007, on the back of strong data for Australia and elsewhere, and by mid January the market had almost fully priced in a further 25 basis point rise in the cash rate by the middle of 2007 (Graph 50). These expectations were scaled back significantly, however, following the CPI release in late January. Market pricing at present embodies little prospect of a tightening in monetary policy in 2007.

Graph 50

Money Market Rates



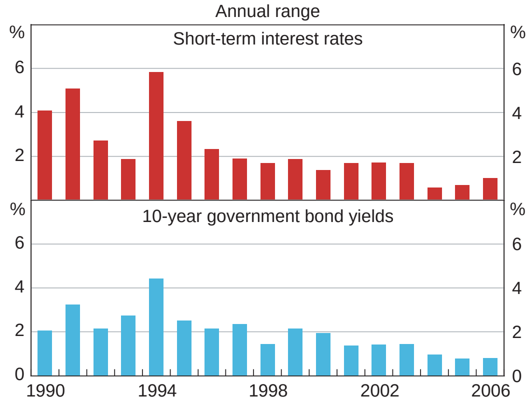
Source: Tullet Prebon (Australia) Pty Ltd

Yields on Australian long-term government bonds again moved in a narrow range in 2006, reflecting a continuation of the relatively stable conditions that have characterised global bond markets in recent times. Volatility in yields was less than half the average over the second half of the 1990s (Graph 51). Yields on 10-year government bonds recorded a net increase of 70 basis points over the year. Most of this rise took place in the first half of the year; there has been little net change in yields since August, when they reached 5.9 per cent.

Graph 51

Australian Interest Rates

Annual range

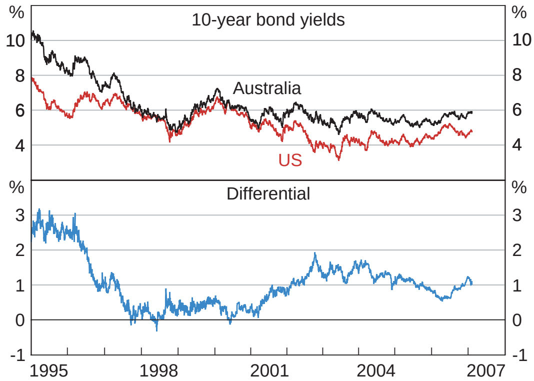


Sources: Bloomberg; RBA

While domestic bond yields have generally followed movements in US yields over the past year, their rise over the first few months of 2006 was not as pronounced as that in US yields. This reflected the fact that US monetary policy, at that time, was tightened by a larger degree than had been expected (and by more than in Australia). In contrast, for the rest of the year domestic bond yields held up relative to US yields, reflecting concerns about rising inflation pressures in Australia and the prospect that the US may have reached the end of this phase of monetary tightening. As a result of these developments, the spread between Australian and US 10-year bond yields narrowed from around 80 basis points at the beginning of the year to around 50 basis points mid year but has since widened to around 100 basis points (Graph 52).

Graph 52

Australian and US 10-year Bonds



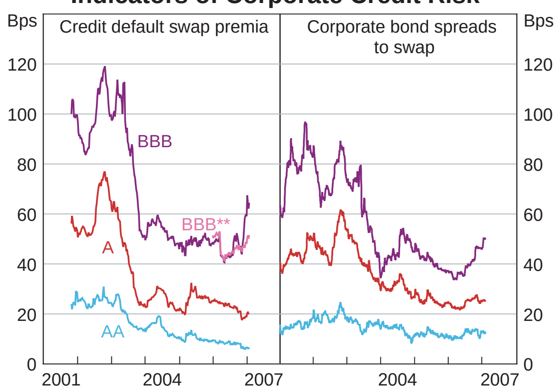
Sources: Bloomberg; RBA

Yields on inflation-indexed bonds have moved broadly in line with yields on nominal bonds over the past year with implied inflation expectations, at a little over 3 per cent, showing little net change over the period. As discussed in the past, institutional factors have boosted demand for inflation-indexed bonds relative to nominal bonds. As a consequence, yields on inflation-indexed bonds have been a little lower than they may have otherwise been, making it difficult to use them to draw conclusions about inflation expectations.

The relative movements in short and long-term yields saw the Australian yield curve become a little more inverted over the course of the past year. The yield curve has been inverted for most of the past two years. As mentioned in previous *Statements*, an inverted yield curve has on occasions signalled expectations of a period of slower economic growth and hence an easing in monetary policy, but this has not characterised market expectations over the past few years. Other factors affecting global markets, in particular strong demand for investments from a variety of sources, have tended to hold long-term yields lower.

Graph 53

Indicators of Corporate Credit Risk*



* Corporate bonds with 1–5 years maturity and 5-year credit default swaps
** Excluding takeover targets
Sources: AFMA; Bloomberg; RBA; UBS AG, Australia Branch

Spreads on corporate bonds, which are an indicator of perceived default risk, generally remained low in 2006 (Graph 53). However, spreads on bonds issued by companies that became the actual (or anticipated) targets for takeover, particularly via leveraged buyouts (LBOs), widened noticeably. This was because of the likelihood that many of these deals would result in an increase in the debt-servicing burdens of these companies and, accordingly, in their default risk. For low-rated debt, the premia on credit default swaps – which are financial derivatives that provide insurance against defaults on corporate debt – have also risen recently, mostly due to the increase in LBO activity.

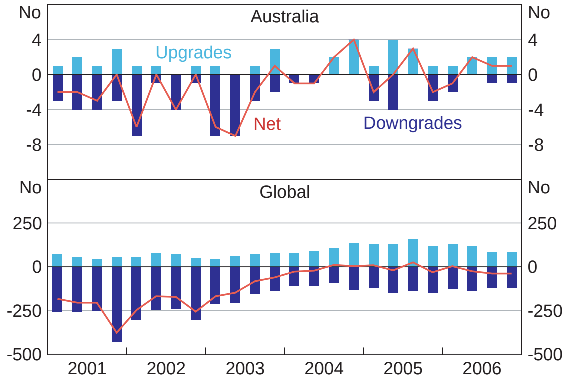
Despite some widening in spreads, Standard and Poor's announced more upgrades than downgrades to Australian corporate credit ratings in 2006. This is a favourable situation, both relative to history and relative to the global bond market in 2006, where more downgrades than upgrades occurred (Graph 54).

The relatively low level of corporate bond spreads is partly due to low default rates in Australia and the rest of the world. Notwithstanding the modest increase in net downgrades to global ratings, the global default rate remains around its lowest level seen in the past 20 years, with less than 2 per cent of global speculative grade issuers defaulting in 2006 (Graph 55). There have been very few corporate bond defaults in Australia in recent years.

Ongoing strong demand for relatively high-yielding bonds from both Australian and non-resident investors has also helped keep spreads quite low. This has been particularly evident in lower spreads on domestically issued residential mortgage-backed securities (RMBS). Although spreads on RMBS increased slightly during 2006, they remain well below the levels seen earlier in the decade (Graph 56). At the end of 2006, the AAA-rated tranches of these securities were issued at around 20 basis points above bank

Graph 54

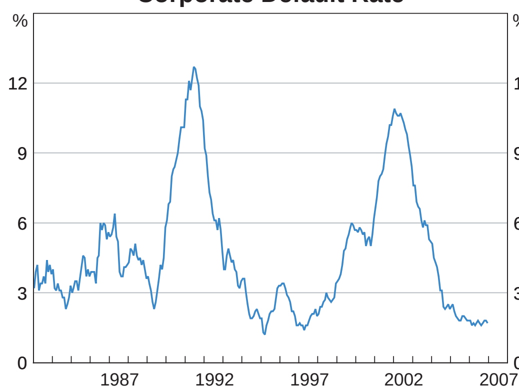
Corporate Ratings Actions



Source: Standard & Poor's

Graph 55

Moody's Global Speculative Grade Corporate Default Rate

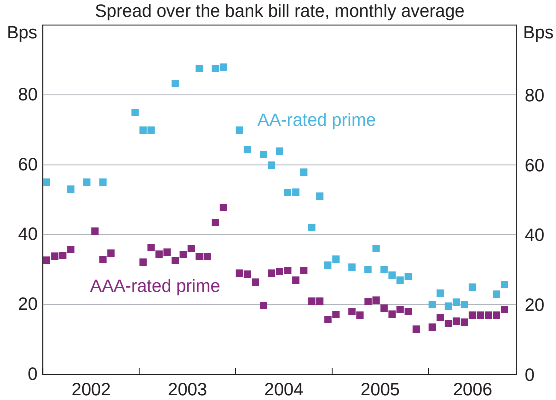


Source: Moody's

Graph 56

Spreads on Issues of Mortgage-backed Securities

Spread over the bank bill rate, monthly average



Source: RBA

bill rates, compared with around 35 basis points in mid 2002. Spreads on lower rated RMBS have fallen more sharply.

The low level of RMBS spreads is supported by relatively small losses on the underlying loan pools of these securities compared to historical standards. Importantly, investors in these securities have suffered no loss of principal, with any losses on the underlying loans covered by lenders' mortgage insurance and the profits of securitisation vehicles.

Intermediaries' interest rates

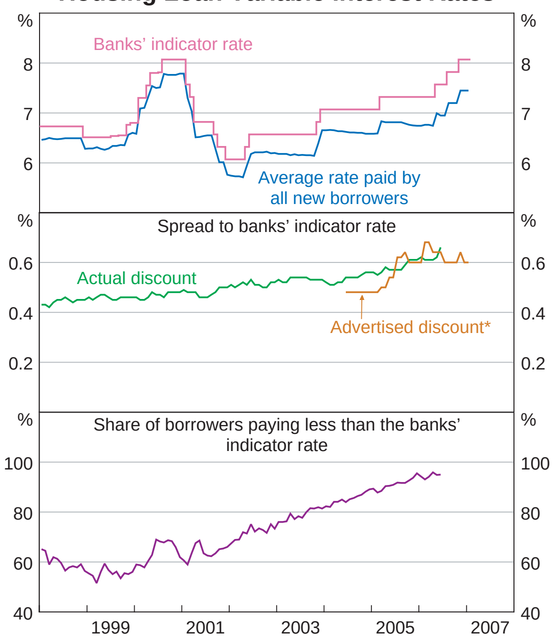
Financial intermediaries increased their variable housing loan indicator rates by a cumulative 75 basis points in 2006, with each of the three cash rate increases reflected in indicator rates within a week or so of their announcements.

One of the features of housing interest rates over recent years has been lenders' tendency to discount, relative to the indicator rate, the actual rate that borrowers pay. The available evidence suggests that the average size of discounts offered to borrowers may be starting to stabilise at around 60 basis points, and that almost all new borrowers receive a discount (Graph 57). While discounting has limited the rise in interest rates on new loans over recent years, actual housing rates are around 80 basis points above their decade average (Table 10). In addition, because the current tightening cycle has been relatively long and a large proportion of the loans outstanding have been taken out in recent years, a relatively high proportion of current borrowers are paying a higher rate than when they took out their loan.

Interest rates on fixed-rate loans did not rise as much as those on variable-rate loans in 2006. The

Graph 57

Housing Loan Variable Interest Rates



* Average advertised discount by the five largest banks for a $250 000 loan
Sources: ABS; RBA

Table 10: Interest Rates
Per cent, February 2007

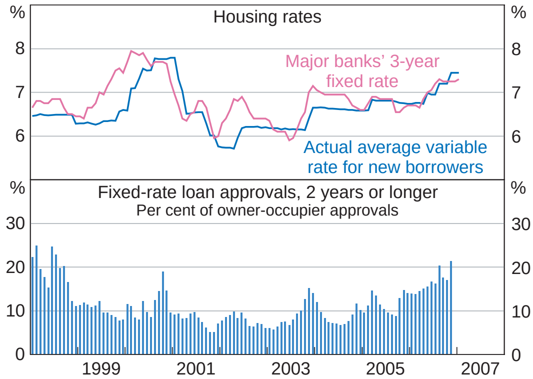
	Cash rate	Actual rate on new housing loans[a]	Actual business rate[a]
Level	6.25	7.45	7.80
Deviation from decade average	1.05	0.80	0.00

(a) RBA estimates
Sources: APRA; RBA

major banks' average 3-year fixed rate on housing loans is currently 7.3 per cent, up 60 basis points over the year, and 15 basis points below the average actual variable rate (Graph 58). The share of new housing loans at fixed rates grew steadily through 2006. In November (the latest month for which data are available) fixed-rate loans accounted for 21 per cent of owner-occupier loan approvals, their highest share since 1998. This appears to reflect both increased demand, with borrowers concerned by the prospect of further rises in interest rates, and increased competition between banks to supply such loans. The latter is evidenced by the fact that banks increased the interest rate on new fixed-rate loans in 2006 by only a little more than half the increase in their cost of funding such loans.

Graph 58

Housing Rates and Loan Type



Sources: ABS; RBA

Banks have been willing to cut their margins on housing loans over recent years because of the extremely low losses from default on residential mortgages. In 2006, losses on fully documented, prime housing loans, expressed as a percentage of loans outstanding, averaged 0.01 per cent, or 1 basis point, less than a third of their level in 2000. Losses on sub-prime loans have risen to around 20 basis points in 2006, but these losses appear to have been adequately covered – at least to date – by the 290 basis point average interest spread on these loans (Table 11). Arrears on housing loans have risen over the past year but remain at reasonably low levels by historical standards.

On personal loans and standard credit cards, most lenders increased interest rates shortly after each of the monetary policy tightenings in 2006. But competitive pressures were clearly evident in the low-rate credit card market, with most providers passing on only part of the tightenings, often with a significant lag. Since the end of 2005, the average interest rate on low-rate credit cards has risen by only 25 basis points, to 11.45 per cent.

Table 11: Interest Margins and Losses on Housing Loans

Basis points

	2000	2002	2004	2006
Prime, full-documentation loans				
Interest margin[(a)]	155	145	135	125
Losses[(b)]	3	2	1	1
Sub-prime loans				
Interest margin[(a)]	na	425	390	290
Losses	na	na	5	19

(a) Spread between the interest rate on new variable-rate housing loans and the cash rate

(b) For loans held on the balance sheets of the four major banks

Sources: banks' annual reports; ABS; RBA; Standard and Poor's

Intermediaries increased their indicator rates on variable-rate business loans by the full 25 basis points following each of the tightenings in 2006. But, consistent with previous years, competitive pressures in the business loan market have meant that the weighted-average interest rate actually paid on variable-rate business loans – incorporating risk margins – has risen by a smaller amount. Business variable rates remain around their decade average (Table 10).

In contrast to lending rates, the pass-through of the 2006 cash rate increases to rates on deposit accounts was quite mixed. Interest rates on online savings accounts, the most competitive part of the deposit market, rose by an average of 50 basis points, to 5.9 per cent. Average interest rates on cash management accounts and bonus saver accounts rose by more than the cash rate during 2006 but this was largely due to a couple of financial institutions increasing their interest rates significantly to make their products more competitive with online savings accounts. Rates on other such deposit accounts were little changed while rates on transaction accounts remained close to zero.

Equity markets

The ASX 200 rose by 19 per cent over the course of 2006. This represents the fourth consecutive year of positive returns and the third consecutive year in which the Australian index outperformed overseas share markets (Graph 59). So far in 2007, the share market has risen by 4 per cent, reaching new record highs. The ASX 200 is currently around 115 per cent higher than the trough in March 2003.

Graph 59

Australian and World Share Price Indices

End December 2001 = 100

Sources: Bloomberg; Thomson Financial

Unlike in 2005, when resource companies' share prices increased by nearly 50 per cent, the rise in the ASX 200 in 2006 was quite broadly based. Resource companies' share prices increased by 15 per cent last year, which was below the 20 per cent increase in the share prices of non-resource companies.

The general strength in equities in 2006 was underpinned by strong profit results for ASX 200 companies. In terms of profits in the future, there were sharp upward revisions during the first half of 2006 to expectations for resource companies' earnings per share (EPS), followed by some modest downward revisions in the second half of the year. Despite these (modest) downgrades, analysts currently expect resource companies' EPS to increase by 32 per cent in 2006/07 and by a further 4 per cent in 2007/08 (Graph 60). For non-resource companies, analysts currently expect EPS growth of 8 per cent in 2006/07 and 9 per cent in 2007/08. For all ASX 200 companies, EPS are forecast to increase by 14 per cent in 2006/07 and around 7 per cent in 2007/08.

In recent months, part of the strength in the share market has been due to merger and acquisition (M&A) activity. Although the value of deals finalised in 2006 was similar to

2005, deals pending lifted the level of activity to roughly double that seen in 2005 (Graph 61). The value of M&A activity in 2006 was equivalent to about 10 per cent of the capitalisation of the Australian share market.

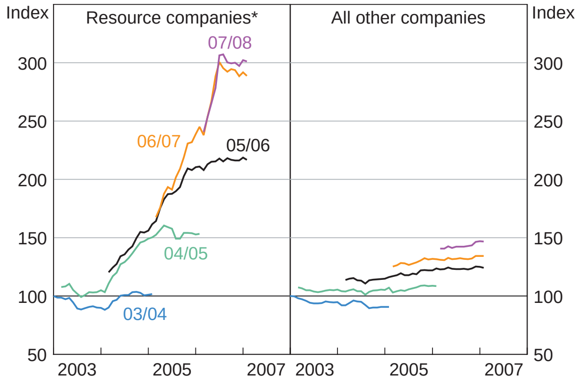
The value (including both the debt and equity funding) of domestic LBOs that have been completed or have been recommended by the company's board rose sharply in 2006 to $27 billion, compared with an annual average of $1½ billion over the previous five years. The December quarter alone saw completed or pending LBOs amount to $19 billion (Graph 62). LBO activity is likely to remain strong in 2007, with private equity firms reported to be preparing bids for several large listed companies. The surge in LBO activity in Australia, as well as abroad, has been largely driven by the low cost of debt relative to returns on equity (Graph 63). Strong inflows into private equity funds, largely from superannuation funds, and a favourable economic outlook have also contributed to the increase in LBO activity.

An LBO typically results in a significant increase in the bought-out company's debt-to-equity ratio, making it more vulnerable to rising interest rates or a deterioration in economic conditions. To date, the impact on the broader economy has likely been limited, as only a very small proportion of the Australian corporate sector has been acquired through LBOs. But if the current surge in LBO activity continues for

Graph 60

Analysts' Forecast Earnings per Share

ASX 200

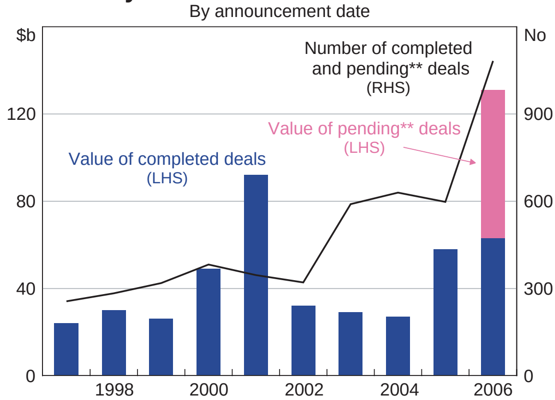


* Energy and materials sectors
Sources: RBA; Thomson Financial

Graph 61

Mergers and Acquisitions by Listed Australian Entities*

By announcement date

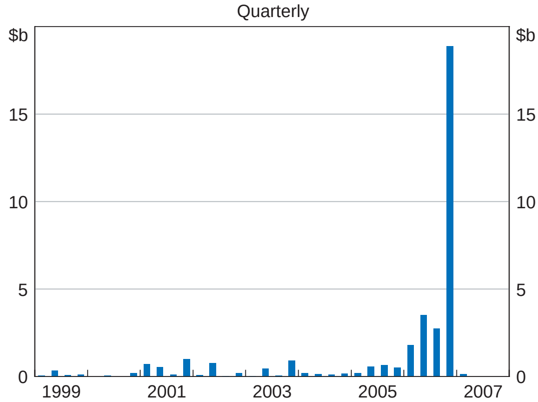


* Excludes real estate transactions
** Transactions announced in 2006 but not completed
Source: Thomson Financial

Graph 62

LBO Activity in Australia

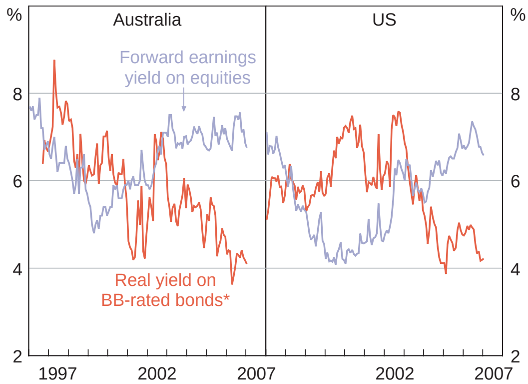
Quarterly



Sources: *Australian Venture Capital Journal*; RBA; Thomson Financial

Graph 63

Return on Equity and Cost of Debt

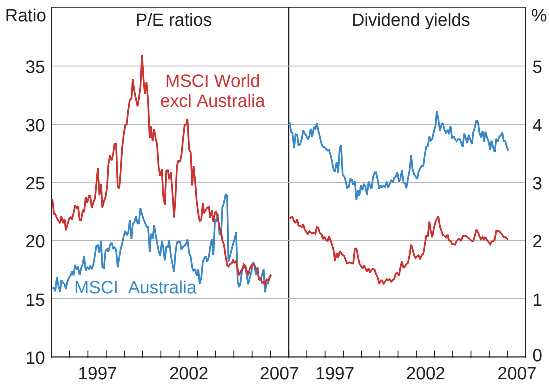


* Estimate for Australia

Sources: Merrill Lynch; RBA; Thomson Financial; UBS AG, Australia Branch

Graph 64

P/E Ratios and Dividend Yields



Sources: RBA; Thomson Financial

some time, the increase in corporate leverage could become a longer-term risk to macroeconomic stability.

A third, but relatively minor, factor supporting share prices has been strong debt-financed demand for Australian equities from retail investors. (See section below on intermediated financing.)

Despite the strong rise in share prices, aggregate measures of share market valuation improved slightly over the course of 2006. The ratio of share prices to actual earnings per share – the P/E ratio – fell from 18 to 17, with the gain in share prices being more than matched by the rise in profits. At its current level, the Australian P/E ratio is only slightly above its long-run average and in line with P/E ratios for world equity markets. The dividend yield on Australian shares remained broadly unchanged over the course of 2006 and currently stands at 3.6 per cent, which is around its historical average (Graph 64).

Financing activity

Intermediated financing

Total credit expanded by nearly 15 per cent over 2006, well above the growth rate of nominal GDP and somewhat above the average rate of growth in recent years (Graph 65). Growth in business credit was stronger than for household credit, which slowed a little later in the year (Table 12).

Growth in business credit was particularly strong early in 2006. It slowed through the year, but nonetheless remained rapid. Data on banks' business lending by size of facility suggest that much of the strength in business credit has been driven by large loans (those greater than $2 million). Part of the growth in large loans has come from syndicated lending, which increased by about 15 per cent in 2006.

Following a pick-up around the middle of 2006, demand for housing credit appears to have eased in recent months, consistent with the three cash rate increases during last year having had some dampening effect. The slowing in housing credit growth has been broadly matched by

Table 12: Financial Aggregates
Average monthly growth, percentage change

	March quarter 2006	June quarter 2006	September quarter 2006	December quarter 2006
Total credit	1.2	1.2	1.2	1.1
Household	1.0	1.3	1.2	1.0
– Owner-occupier housing	1.2	1.3	1.4	1.1
– Investor housing	0.8	1.3	0.8	0.7
– Personal	0.8	1.0	1.2	0.9
Business	1.4	1.1	1.1	1.2
Broad money	1.0	0.9	1.0	0.8

Source: RBA

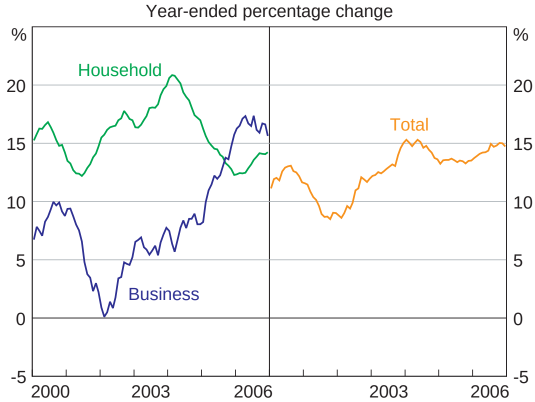
a decline in approvals of new loans, which fell by 6 per cent over the three months to November (Graph 66). This suggests the slowing in housing credit growth is largely attributable to the extension of fewer new loans rather than faster repayment of existing loans. The moderation in demand for housing credit occurred in both the owner-occupied and investor components.

Growth in personal credit, which is quite volatile from month to month, has been slightly weaker than growth in housing credit, increasing by 13 per cent in 2006. Within personal credit, growth in margin lending for the purchase of shares and managed funds increased by 41 per cent to $28 billion (Graph 67). The strong growth in margin loans outstanding over the year was driven by large increases in both the number of loans and their average size. Indicators of the riskiness of borrowers' margin loan positions, such as the average gearing level and the proportion of available credit limits used, picked up slightly in 2006 but remain low by historical standards.

Graph 65

Credit Growth*

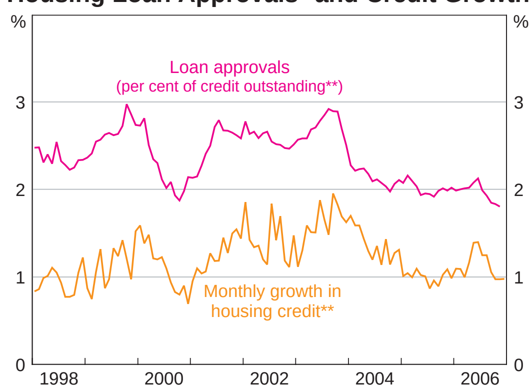
Year-ended percentage change



* Includes securitised loans
Source: RBA

Graph 66

Housing Loan Approvals* and Credit Growth

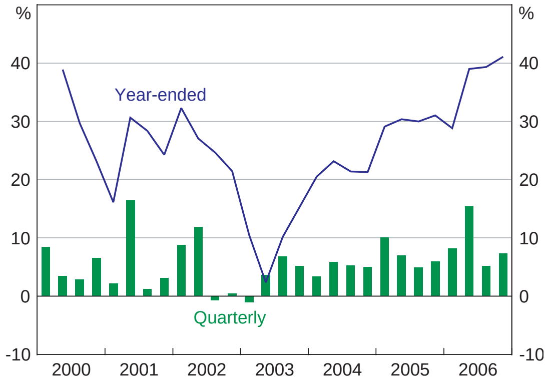


* Excluding approvals for new construction by investors
** Includes securitised loans
Sources: ABS; RBA

Graph 67

Margin Lending

Percentage change



Source: RBA

Non-intermediated financing

Net issuance of bonds by Australian non-government entities amounted to $92 billion in 2006, 17 per cent more than in 2005 (Table 13). This was driven by a pick-up in both onshore and offshore issuance; the increase in onshore bond raisings was largely due to asset-backed vehicles, while the rise in offshore issuance reflected raisings by financial institutions. Strong investor demand and favourable conditions in currency swap markets made it attractive for the major banks to issue large volumes offshore in foreign currency and swap into Australian dollars. In total, offshore net issuance accounted for around half of raisings by Australian non-government entities in 2006.

Non-residents were also active in issuing A$ bonds in the domestic bond market in 2006, raising a net $27 billion. The strong growth in the value of non-residents' bond issues suggests that the Australian market continues to be an internationally competitive source of debt finance.

Table 13: Non-government Net Bond Issuance by Sector

$ billion

Sector	2003	2004	2005	2006	*of which* December quarter
Bond issues by Australian entities					
Onshore					
Financial institutions	3.8	8.8	16.6	15.7	2.7
Non-financial corporates	2.8	4.4	3.9	7.2	2.5
Asset-backed	10.7	6.7	15.5	23.4	2.9
Total	***17.3***	***19.8***	***36.0***	***46.3***	***8.1***
Offshore					
Financial institutions	26.2	36.5	26.1	33.2	6.1
Non-financial corporates	9.7	11.6	9.4	5.6	1.2
Asset-backed	8.8	14.6	6.4	6.4	1.4
Total	***44.6***	***62.7***	***41.9***	***45.2***	***8.7***
Total	**61.9**	**82.5**	**78.0**	**91.5**	**16.9**
A$ bond issues by non-resident entities					
Onshore	2.6	18.0	22.9	27.2	3.4
Offshore	23.1	18.1	5.4	–2.7	–2.7
Total	**25.7**	**36.1**	**28.2**	**24.5**	**0.7**

Source: RBA

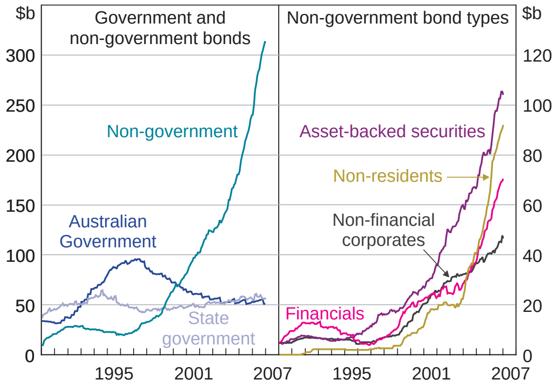
Total outstandings of non-government bonds in the domestic market rose strongly in 2006, to exceed $300 billion (Graph 68). This greatly exceeds the amount of Commonwealth and State government bonds outstanding, of around $50 billion each. Non-residents and asset-backed vehicles each accounted for a large part of the increase in outstanding non-government bonds.

Capital raisings other than bonds were also generally strong in 2006. Net equity raisings exceeded $30 billion, with most of this accounted for by companies already listed; IPO activity fell from the very high levels recorded in 2005.

Reflecting these developments, total net capital raisings – debt, hybrids and equity – for the Australian non-government sector in 2006 were 36 per cent higher than in 2005. However, this was entirely due to strong raisings by financials and asset-backed vehicles; net capital raisings by non-financial corporates were broadly unchanged in 2006 (Graph 69). This latter group relied more on intermediated funding and high levels of profitability to fund investments.

Graph 68

Bonds on Issue in Australia

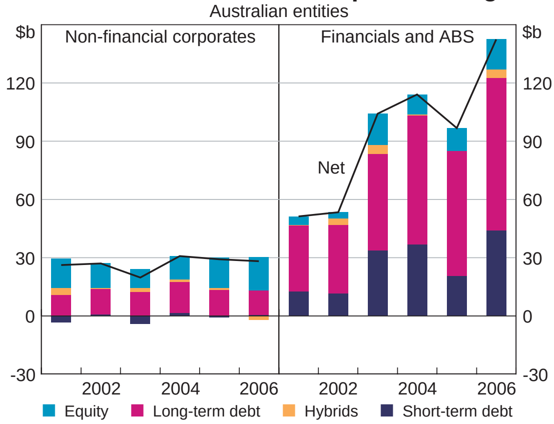


Sources: ABS; RBA

Graph 69

Net Non-intermediated Capital Raisings

Australian entities



Sources: APRA; ASX; Austraclear; RBA

Inflation Trends and Prospects

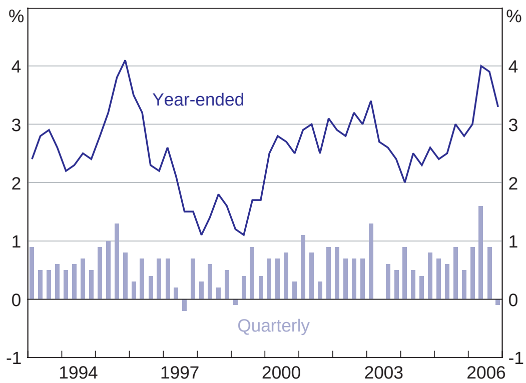
Recent developments in inflation

The consumer price index (CPI) fell by 0.1 per cent in the December quarter, and increased by 3.3 per cent over the year (Graph 70, Table 14). The fall in the headline CPI largely reflected falls in petrol prices (due to lower world oil prices) and the partial unwinding of the mid-2006 increase in banana prices. Significant increases in prices were seen only in a few categories, such as domestic travel & accommodation, vegetables and rents. Abstracting from large price changes in individual components, a range of measures suggest that the pace of underlying inflation slowed to around ½ per cent in the December quarter, with underlying inflation remaining around 3 per cent over the year to the December quarter (Graph 71).

Excluding the effects of food and petrol, tradables inflation remains relatively low, at 0.8 per cent over the year to the December quarter. This reflects falls in the prices of a range of manufactured goods such as clothing & footwear; household

Graph 70

Consumer Price Inflation*



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

Sources: ABS; RBA

Table 14: Measures of Consumer Prices

Percentage change

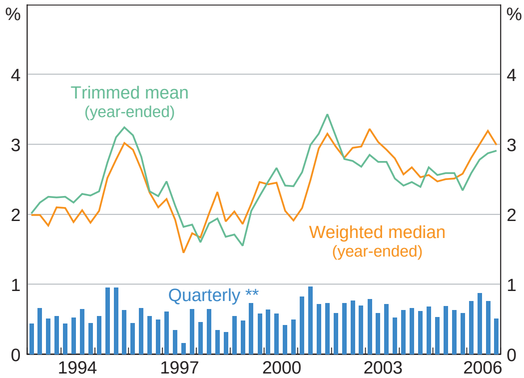
	Quarterly		Year-ended	
	September quarter 2006	December quarter 2006	September quarter 2006	December quarter 2006
CPI	0.9	–0.1	3.9	3.3
– Tradables	0.8	–1.4	4.4	2.9
– Tradables (ex food and petrol)	0.4	–0.1	0.4	0.8
Non-tradables	1.0	0.8	3.6	3.5
Underlying measures				
Weighted median	0.8	0.5	3.2	3.0
Trimmed mean	0.7	0.5	2.9	2.9
CPI ex volatile items[(a)]	0.8	0.5	2.6	2.7

(a) Volatile items are fruit, vegetables and petrol

Sources: ABS; RBA

Graph 71

Statistical Measures of Inflation*



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

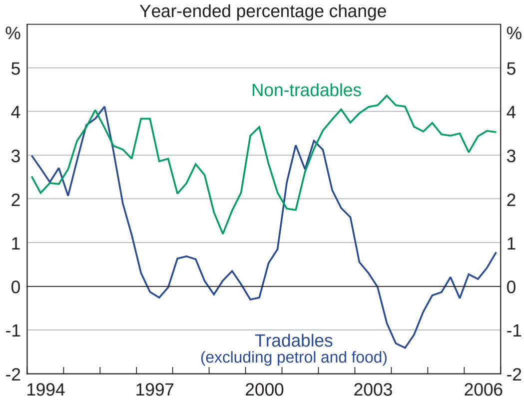
** Average of the trimmed mean and weighted median

Sources: ABS; RBA

Graph 72

Tradables and Non-tradables Prices*

Year-ended percentage change



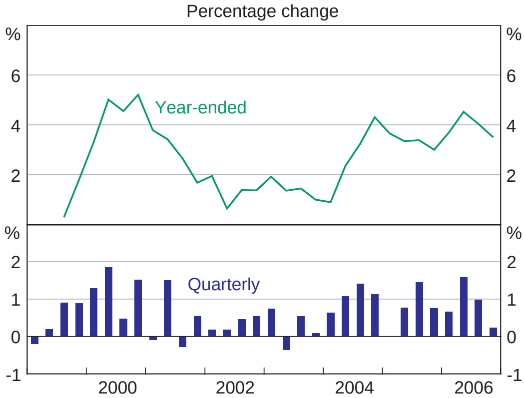
* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 73

Final Producer Prices

Percentage change



Source: ABS

appliances; and audio, visual & computing equipment. Nonetheless, tradables inflation has picked up over the past two to three years as the effects of the earlier exchange rate appreciation have faded. Non-tradables inflation has remained relatively high, at 3½ per cent over the year to the December quarter, reflecting significant increases in the prices of a range of services, including rents, childcare, health services and education (Graph 72).

Producer price data for the December quarter suggest that upstream inflation pressures persist, but are not increasing (Graph 73). While final-stage prices increased by a moderate 0.2 per cent in the December quarter and by 3.5 per cent over the year, when oil products are excluded they increased by 0.8 per cent in the quarter and by 3.7 per cent over the year. Manufacturing input and output prices (excluding oil) rose strongly, while lower oil prices contributed to a fall in transport prices, with road, rail and air transport prices all decreasing.

Labour costs

Recent wage data have been somewhat more difficult than usual to interpret, reflecting the delay in the granting of award wage rises last year associated with the introduction of the Australian Fair Pay Commission (AFPC) and the consequent disruption to the earlier seasonal pattern to wage increases. The changed timing of the AFPC decision relative to previous

Australian Industrial Relations Commission decisions will continue to affect indicators of wages growth over the coming year.

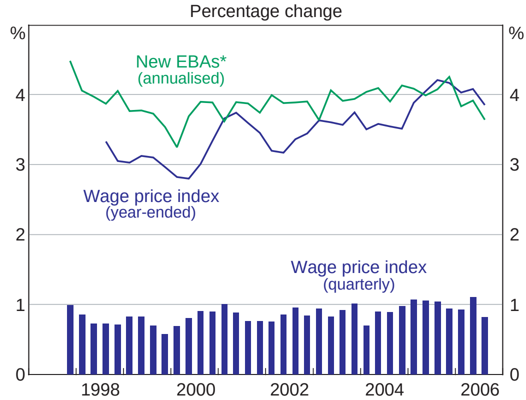
The wage price index (WPI) grew by 0.8 per cent in the September quarter, and by 3.8 per cent over the year (Graph 74). After accounting for the impact of the timing of the AFPC decision, it appears that the underlying annual rate of wage inflation remained around 4 per cent. Adjusted for industry composition, the average annualised wage increase for federal enterprise bargaining agreements (EBAs) certified in the September quarter fell somewhat to 3.6 per cent. Overall, these and other wages data from the national accounts and average weekly earnings survey continue to indicate that wages growth has remained reasonably stable in the face of sustained strength in the labour market. Nevertheless, the WPI, which is the most reliable indicator, suggests that wages growth is at the upper end of the range that has been observed in the period since the late 1990s.

Business surveys and the Bank's liaison program with firms both indicate that labour market conditions remain tight with firms experiencing shortages of skilled labour. According to the NAB survey in the December quarter, firms report that labour scarcity continues to constrain their activity to a larger extent than lack of demand (Graph 75).

Graph 74

Wage Indicators

Percentage change



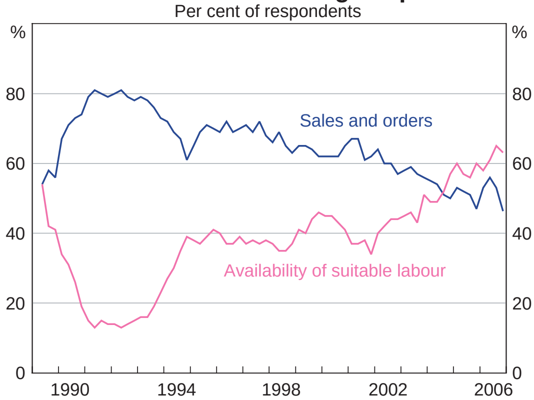
* Re-weighted to reflect wage price index weights

Sources: ABS; DEWR; RBA

Graph 75

Factors Constraining Output

Per cent of respondents



Source: NAB

Inflation expectations

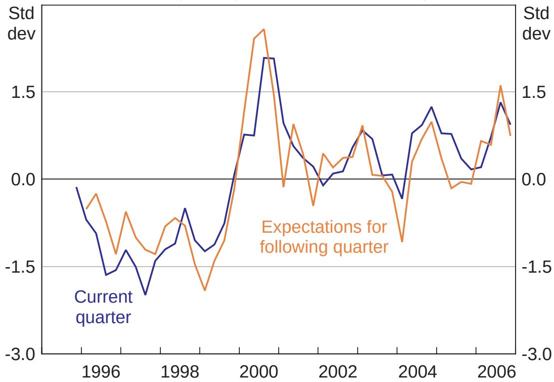
The proportion of businesses increasing their prices in the December quarter or expecting to increase their prices in the near term is somewhat above the long-run average according to business surveys. However, on balance the pick-up in pricing pressures apparent in the surveys in late 2005 and early 2006 seems not to have continued (Graph 76).

Market economists, surveyed by the Bank following the release of the December quarter CPI, have reduced their forecasts of CPI inflation slightly. The median expectation for headline inflation over the year to the December quarter 2007 was 2.5 per cent, down from 2.7 per cent

Graph 76

Selling Prices*

Quarterly change, deviation from average



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

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

in November (Table 15). Over the year to December 2008, the median inflation expectation was also 2.5 per cent. Union officials have reduced their median inflation expectation over the year to the December quarter 2007, by ½ percentage point.

According to the Melbourne Institute survey of households, the median expectation for consumer price inflation over the coming year was 3.5 per cent in January. Although this is slightly higher than the average over the inflation-targeting period, it has fallen from the peaks reached in mid 2006, in line with the easing in fuel prices. The implied medium-term inflation expectations of financial market participants, as measured by the difference between nominal and indexed bond yields, was a little over 3 per cent in early February. Given the institutional factors noted in previous *Statements*, this figure may overstate actual inflation expectations.

Table 15: Median Inflation Expectations

Per cent

	Year to December 2007			Year to December 2008
	August 2006	November 2006	February 2007	February 2007
Market economists[(a)]	2.6	2.7	2.5	2.5
Union officials[(b)]	4.1	3.9	3.5	3.5

(a) RBA survey

(b) Workplace Research Centre

Inflation outlook

Most measures suggest underlying inflation was around ½ per cent in the December quarter. While this may understate the strength of ongoing underlying inflationary pressures, taking the September and December quarters together, it does appear underlying inflation was running at a lower rate in the second half of 2006 than the annualised rate of around 3¼ per cent seen in the first half of the year.

The Bank's forecasts assume that oil prices and the exchange rate remain around current levels through to the end of the forecast period (December quarter 2008), and that global growth evolves in line with Consensus forecasts. The forecasts envisage non-farm GDP growth of around 3¼ per cent over 2007 and 2008, with total GDP growth likely to be a little higher if climatic conditions result in a recovery in rural sector output. These outcomes would be somewhat higher than recent growth outcomes, with the improvement reflecting higher exports of commodities following the substantial investment in new capacity, and a gradual pick-up in the house-building sector. Growth in consumer demand is expected to remain moderate and investment is likely to grow a good deal more slowly than the rapid rates seen in recent years. Overall, growth is forecast to be more balanced than in recent years, with more growth from exports and less from domestic demand.

The central forecast is for year-ended underlying inflation – currently around 3 per cent – to fall to 2¾ per cent in 2007 and 2008 (Table 16). With the recent falls in oil prices and the unwinding of the banana price increases, headline CPI inflation is expected to fall below 2 per cent in mid 2007 before rising to be about the same as underlying inflation later in the forecast period. These forecasts represent a modest downward revision to the inflation forecasts contained in the previous *Statement*, reflecting both the evidence that underlying inflationary pressures in the second half of 2006 were somewhat weaker than in the first half, and the likelihood that recent falls in world oil prices will result in some dampening effect on cost pressures and inflation expectations. But many of the factors that have pushed up underlying inflation over the past few years persist. Ongoing labour market tightness is likely to keep wage growth at above-average levels. In addition, upstream price pressures appear to remain reasonably strong, and capacity utilisation in the economy has been high and is only expected to ease modestly. Hence the reduction in inflation is likely to be only modest, and outcomes are forecast to be in the upper half of the target band over the next few years. Overall, risks to the forecasts appear to be broadly balanced.

Table 16: RBA Inflation Forecasts[(a)]
Percentage change over year to quarter shown

	Dec 2005	June 2006	Dec 2006	June 2007	Dec 2007	June 2008	Dec 2008
Consumer price index	2.8	4.0	3.3	1¾	2¼	2½ – 3	2½ – 3
Underlying inflation	2.5	2.9	3.0	2¾	2¾	2½ – 3	2½ – 3

(a) Actual data to December 2006. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.78, TWI at 64, cash rate at 6.25 per cent, and WTI crude oil price at US$60 per barrel.

Sources: ABS; RBA