

# Financial Markets and the Economy in the March Quarter

Financial markets were quite unsettled in December and January. This in part reflected volatility in international markets but appeared to owe more to domestic factors, especially perceptions in some quarters that changes in political leadership and foreshadowed expansionary fiscal measures could reverse the earlier anti-inflationary thrust of macroeconomic policy.

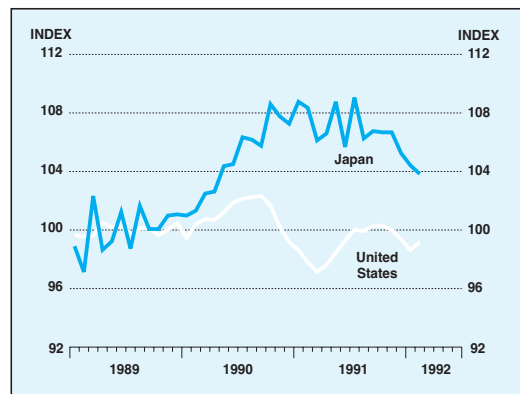
During January yields on 10-year bonds rose by around a percentage point and, in the foreign exchange market, substantial intervention by the Bank was needed to maintain reasonably orderly conditions. The markets steadied in February and March as uncertainties about the direction of policy were resolved and the Government reaffirmed its commitment to low inflation. By the end of the quarter, both the bond and foreign exchange markets had reversed part of their earlier movements.

The economic indicators released during the March quarter continued to show a mixed picture but, overall, suggested that a gradual recovery in economic activity was now underway. Housing and consumption figures have been stronger, and labour market conditions appear to have stabilised. At the same time, the prospects for continued low inflation seem good: price and wage pressures are subdued and survey-based measures of expected inflation point to a continuation of these conditions.

## The World Economy

After appearing to stall in the latter part of last year, renewed signs of recovery in the US economy have appeared during the March quarter. Retail sales picked up in January and February, and housing starts rose sharply. Industrial production showed a small increase in February, having fallen for several months (Graph 1). Despite these positive signs, the level of employment in the United States has barely changed since its trough in mid 1991, and consumer confidence, although rising in March, remains at a low level. Inflation

INDUSTRIAL PRODUCTION  
Index 1989 = 100



GRAPH 1

continued to slow, falling to 3.8 per cent in the year to February (excluding the volatile food and energy components).

Monetary policy in the US was held steady in the March quarter. Long-term bond yields, however, rose sharply on the back of stronger signs of economic recovery, with market participants apparently concerned that this could boost inflation; continued heavy issues of bonds by the US authorities and nervousness about the US Presidential election later this year are also cited as reasons.

The Japanese economy appears to have slowed more sharply than was generally expected. Industrial production fell in January and February, to a level 4 per cent lower than a year earlier (Graph 1). The rapid accumulation of inventories since the middle of 1991 suggests there will be further pressure on firms to reduce production over the months ahead. Declines in job vacancies and overtime indicated some easing in the demand for labour, and the demand for credit continued to decelerate rapidly. Inflation also fell, to around 2 per cent in the year to February.

After the easing in late December, monetary policy in Japan was held steady through the March quarter, until a further cut of 0.75 percentage points was made in the official discount rate on 1 April. Short-term security yields had already declined in anticipation of a cut in interest rates, although bond yields remained steady. On the previous day, the Government had announced a package of fiscal measures to boost economic activity; this package includes proposals to concentrate the public works spending planned for the new financial year in the first half of the year.

Reflecting the worsening outlook for the Japanese economy, the Japanese stockmarket fell sharply during the quarter. On 6 April, the Nikkei index closed at 18435, 20 per cent lower than at the end of 1991, and the lowest level since November 1986.

In western Germany, the economy has also slowed recently. Labour market conditions have started to ease after being very tight

through 1991, although this has not yet produced any clear reduction in inflationary and wage pressures – some unions continue to make large wage demands, of around 10 per cent. Inflation has risen to about 4<sup>1</sup>/<sub>2</sub> per cent over the year to March. The Bundesbank raised one of its key interest rates late in March, amid signs of continuing strong inflationary pressures.

With economic prospects in the major countries undergoing major reassessments, exchange rates were volatile over the quarter. In particular, the US dollar strengthened sharply against both the mark and the yen (up 6-8 per cent over the quarter); these reversed the falls that had occurred over the December quarter. The unsettled conditions attracted some central bank intervention, with Bank of Japan entering the market on a number of occasions to support the yen.

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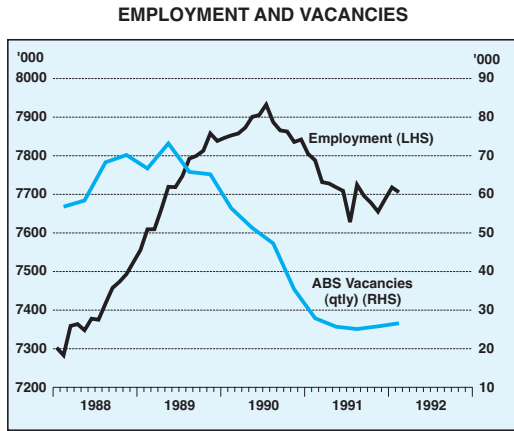
## **The Domestic Economy**

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The December quarter national accounts showed a slight pick-up in the economy. The Statistician's preferred measure of production, GDP(A) (the average of the income, expenditure and production measures of GDP), rose by 0.1 per cent in the September quarter and 0.3 per cent in the December quarter. The accounts suggested that consumption and dwelling investment were beginning to recover towards the end of last year, but that business investment was still very weak. Stocks made a positive contribution to growth in the December quarter, indicating that increases in demand were flowing through to increases in production.

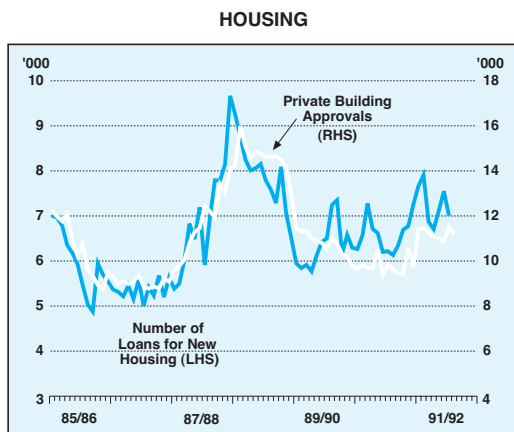
March quarter data have been mixed but encouraging overall. Employment was little changed in February after increasing in both December and January, and other labour market indicators strengthened. Average overtime hours increased in the quarter by 6 per cent, the first increase since mid 1989.

The ABS measure of job vacancies rose by 3 per cent, following a similar increase in the previous quarter, although the ANZ measure of job advertisements remained flat (Graph 2).



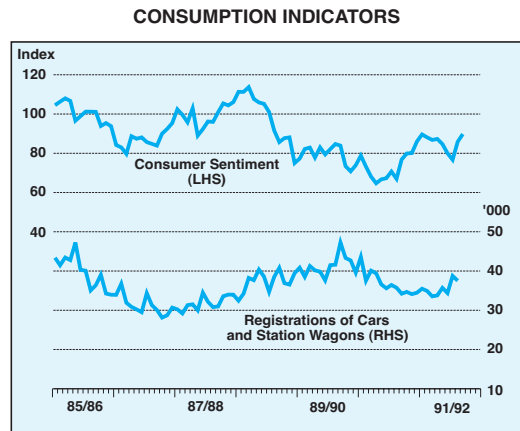
GRAPH 2

Indicators for the housing sector have been trending upwards since mid 1991. In the three months to February, building approvals were 16 per cent higher than the trough level in the March quarter of 1991. Home lending figures showed a similar trend, although the month-to-month patterns have been different; in the latest three months, the number of loans for new housing was also 16 per cent above the trough (Graph 3).



GRAPH 3

Consumer spending appeared stronger in early 1992 although some of these indicators are especially volatile and difficult to interpret. The value of retail trade rose sharply in January, more than offsetting falls in the previous two months. Motor vehicle registrations showed a small fall in February, but were still 5 per cent higher than in November 1991. The consumer sentiment index rose strongly in February and March, returning to its level of mid 1991 (Graph 4).



GRAPH 4

The latest CAI/Westpac survey of the manufacturing sector, conducted in the three weeks to 13 March 1992, indicated that activity remains weak in that sector. Both output and new orders were significantly lower than expected at the time of the previous survey in December. Manufacturers' expectations for the general business situation over the next six months improved slightly but remain well below the levels recorded at the time of the recovery in activity in 1983/84.

The Government's Economic Statement, released on 26 February, announced a number of initiatives designed to assist employment and stimulate growth. The largest components of the package were on the spending side, and included increased spending on transport infrastructure and a once-off payment through the family

allowance system designed to provide an immediate boost to consumer spending. The projected costs of the revenue measures – which included changes to depreciation schedules, some concessions to small business and a reduction in wholesale tax on most passenger vehicles – were relatively small over the next two years but more substantial further out.

Overall, the initiatives are estimated to add \$0.5 billion to the Commonwealth budget deficit in 1991/92 and \$1.8 billion (about half a per cent of GDP) in 1992/93. The deficit was projected to rise from \$6.8 billion in 1991/92 to \$8 billion in 1992/93.

Inflation remains low. In the year to the December quarter, consumer prices (as measured by the Consumer Price Index) rose by 1.5 per cent, the lowest annual increase since 1964 (Graph 5). This outcome was assisted by some special factors such as declining mortgage interest charges and oil prices, but other price measures confirm the downward trend. The private consumption deflator (which is unaffected by movements in mortgage interest rates, but includes favourable oil price effects) rose by 2.0 per cent in the year to the December quarter. The underlying rate of inflation is estimated to have been of the order of 3 per cent in the year to the December quarter. In January the monthly price indicators for the building and manufacturing

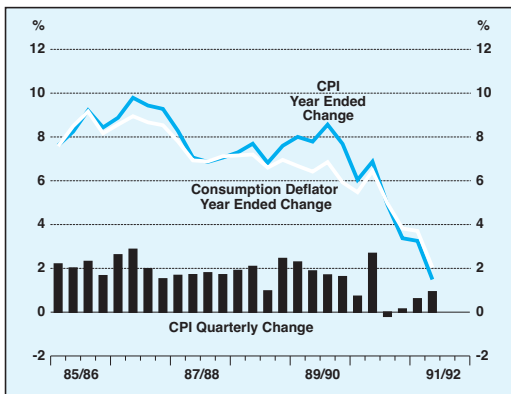
sectors were showing annual increases close to zero.

Survey-based measures of inflationary expectations also remain low. The Melbourne Institute's March quarter survey indicated that consumers expected the inflation rate for the year ahead to be only slightly up on the record low levels recorded in the previous two quarters. The CAI/Westpac survey of manufacturers again indicated that a large majority (83 per cent) of respondents do not expect to raise selling prices in the quarter ahead.

Wages growth moderated during 1991. The increase in ordinary-time earnings for the year to November 1991 was 4.2 per cent, a little more than half the rate for the previous year. Much of the increase occurred in the final quarter of the year, and reflected mainly the delayed flow-through of the April 1991 national wage case increase. Wage increases under enterprise bargaining have not been widespread to this time but most such agreements appear to provide for at least offsetting productivity increases.

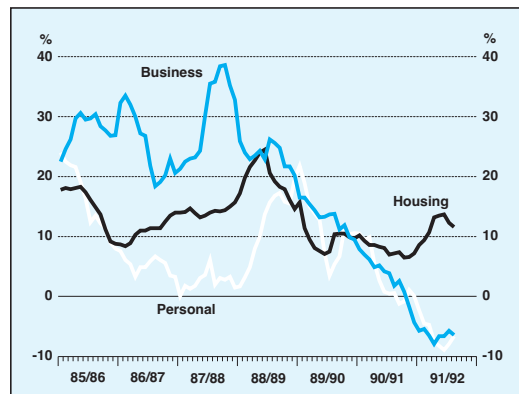
Credit and other broad financial aggregates continue to show little or no growth. Total credit provided to the private sector by financial intermediaries was little changed in January and February but a little below its level a year earlier. While business and personal credit remained weak, housing credit continued to grow strongly (Graph 6).

CONSUMER PRICES



GRAPH 5

CREDIT BY SECTOR  
6-Month-Ended Seasonally Adjusted Annualised Rate



GRAPH 6

Direct funding from domestic markets through equities and issues of fixed-interest securities continued to grow in the March quarter. Over January and February, equity listings on the Australian Stock Exchange totalled \$2.2 billion. These funds were ear-marked mainly for corporate restructuring or refinancing of earlier debt issues, rather than for expanding productive capacity. Overall, domestic private finance (intermediaries' credit plus raisings of equity and fixed-interest securities by the private non-finance sector) rose modestly over the 12 months to February.

After several relatively high figures late in 1991, Australia's current account deficit declined markedly in December, January and February. The deficit averaged \$731 million in those months after averaging around \$1.1 billion over the five months to November. This improvement is explained partly by a fall in exogenous imports from the unusually high levels recorded in October and November. In the first eight months of 1991/92, the current account deficit was \$8.1 billion, about \$4 billion less than in the same period a year earlier.

Commodity prices improved a little during the March quarter after falling during the second half of 1991. The March quarter rises were broadly based, with the main

contributions coming from wool, wheat and aluminium. In SDR terms, the RBA index of commodity prices was 2.3 per cent higher in March than at the end of 1991 (Graph 7).

## Financial Markets

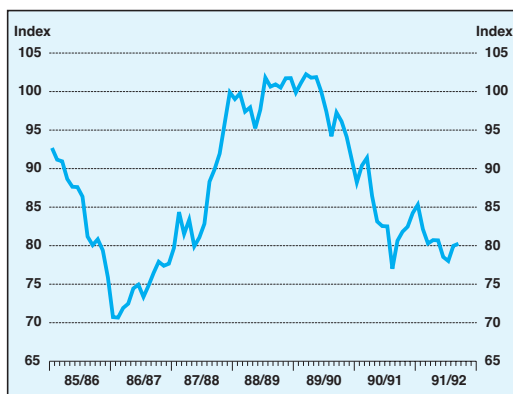
As explained in the January *Bulletin*, the Bank reduced cash rates by 1 percentage point on 8 January, against a background of subdued domestic demand conditions and an improved outlook for inflation. A reduction of at least this order had been widely anticipated in financial markets at the time and it had little impact on short-term security yields.

Most financial intermediaries announced cuts in their lending and deposit rates soon after the policy easing (a couple had moved their rates in anticipation of it). Reductions in deposit rates were generally less than 1 percentage point, with most in the order of 0.75 of a percentage point. Lending rates were generally cut by a full percentage point. For the major banks, business benchmark rates are currently in the range 11.25 to 11.75 per cent; the standard variable housing loan rate is 11 per cent but many lenders are offering lower rates over an initial period of new loans.

The financial markets became unsettled soon after the interest rate cut but this seemed to be more a reaction to political developments and nervousness about what these might mean for the settings of economic policies. In particular, there were concerns that the new leadership might over-stimulate the economy and that it was predisposed for a lower exchange rate. These concerns manifested themselves in a fall in the exchange rate and a rise in bond yields; they also combined to dispel some lingering expectations of possible further reductions in cash rates and short-term security yields (Graph 8).

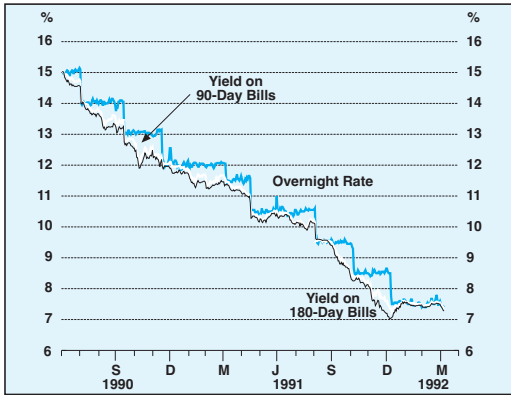
The uncertainty in financial markets was not helped by some reckless predictions about the

**RBA COMMODITY PRICE INDEX**  
ALL ITEMS - SDRs



**GRAPH 7**

**SHORT-TERM INTEREST RATES**  
DAILY



**GRAPH 8**

exchange rate emanating from overseas investment houses and accompanied by advice to clients to liquidate Australian dollar investments. The Bank was an active participant in the market at this time, seeking to provide a degree of orderliness. The Bank did not wish to see unfounded speculation about future policy changes and extreme predictions about the exchange rate create havoc in the exchange rate market, with all that that implied for confidence about inflation and the economy more generally. From the second week of January, the Bank was a heavy buyer of Australian dollars and long-term bonds. Purchases of Australian dollars (sales of foreign currency) for the month totalled \$4.2 billion.

At its low point in late January, the exchange rate reached 73.6 US cents, down 8.1 per cent from its recent peak in late September; against the yen, it reached 91.2, down from 107.2 in September. In trade-weighted terms the exchange rate reached a low of 54.8, down almost 10 per cent on its September peak.

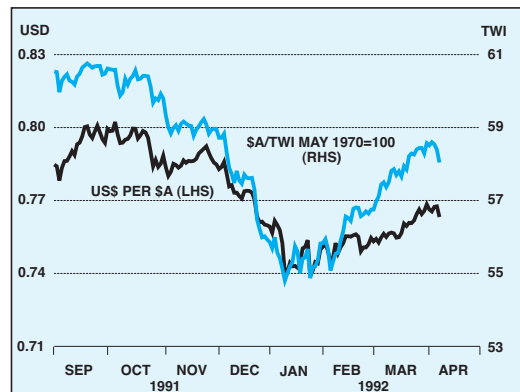
In the bond market, long-term yields in early January were at their lowest level since 1979. They moved up by a full percentage point, to about 10.3 per cent, over following weeks as the market reacted to speculation that an excessive easing in fiscal policy and substantial currency depreciation could boost inflation. The Bank bought a substantial volume of bonds in January, to some extent the counterpart of its heavy sales of foreign

exchange, i.e. holdings of bonds in the Bank's portfolio increased while its holdings of foreign exchange declined.

By early February, markets were more composed and the Bank stepped back from the foreign exchange market, although it continued to buy bonds. The markets settled further after the Government's Economic Statement was delivered, and the exchange rate began to pick up. By early March, sentiment in the foreign exchange market had turned more bullish; the nervousness about direction of policy had gone and the focus shifted back onto Australia's low rate of inflation, high real interest rates and emerging signs of a recovery in economic activity. Overseas investment advisors, who had earlier turned against Australian dollar investments, began advising their clients to increase their holdings.

Late in the month the Bank intervened in the market and sold modest amounts of Australian dollars to test the strength of the upward pressures on the \$A. That caused the market to pause, although the underlying bullish sentiment remained. The exchange rate ended the quarter at 76.8 US cents, about half way between September's peak and January's trough. On the trade-weighted index, the exchange rate ended the quarter at 58.6, compared with a September peak of 60.8 and a January trough of 54.8 (Graph 9). Turnover in the foreign exchange market was

**AUSTRALIAN DOLLAR**  
DAILY



**GRAPH 9**

up a little in the March quarter, reflecting the more volatile conditions.

The bond market also strengthened in March as confidence gradually returned, although at times the market was adversely affected by overseas developments, including rises in US bond yields and strains in the Japanese markets. Yields on 10-year bonds at the end of March were about 9.8 per cent, unwinding about half the rise that occurred over January and early February (Graph 10).



GRAPH 10