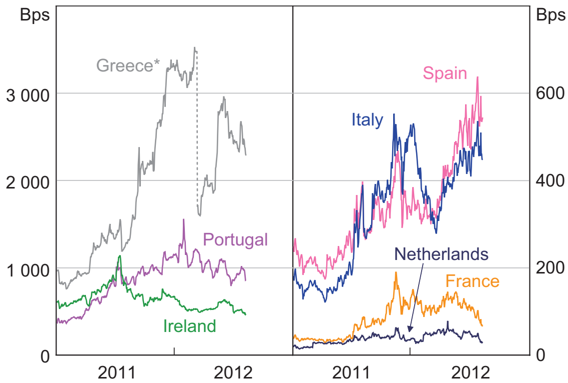
2. International and Foreign Exchange Markets

Sovereign Debt Markets

Global market sentiment has been buffeted by concerns about the state of euro area public finances and the stability of the banking system in the euro area as well as the health of the global economy. The resolution of political uncertainties in Greece, the announcement of a financing package for Spanish banks and a number of broad policy initiatives in the euro area provided some support to markets around the middle of the year but did not have a lasting impact. The deterioration in confidence was most evident in a sharp widening of spreads, particularly at the short end, between yields on some euro area 'periphery' government bonds and German bunds (Graph 2.1). Recent statements by European Central Bank (ECB) President Draghi that the ECB would do 'whatever it takes to preserve the euro' and was considering purchasing short-term sovereign debt saw some of this widening retrace.

Developments in Spain have weighed heavily on market sentiment over recent months. The Spanish Government has been granted official assistance from the euro area to recapitalise its troubled banking sector. Spain's request for assistance followed the announcement of a significant capital shortfall at a large savings bank. The assistance package provides for up to €100 billion in financial support over 18 months, with the amounts required by individual banks to be determined by independent stress tests conducted by a consultant over coming months. A first tranche of €30 billion has been made available as a contingency in case of a need for immediate funding. Further funds will not be disbursed until the European Commission (EC) has assessed banks' recapitalisation plans in October, following the stress tests.

Graph 2.1
Euro Area Government 10-year Bond Spreads
To German Bunds



* Data from 12 March 2012 are yields on Greek bonds post private sector debt swap
Source: Bloomberg

Unlike the assistance packages for Greece, Ireland and Portugal, conditionality under the Spanish package focuses primarily on recapitalising and reforming the financial sector, rather than requiring the Spanish Government to implement additional fiscal and structural reforms. Nonetheless, the current reform agenda will be monitored regularly as part of the agreement and, relatedly, the EC has given Spain an extra year (to 2014) to meet the deficit target of 3 per cent of GDP. The government has committed to achieving a fiscal deficit of 6.3 per cent of GDP in 2012 (previously expected to be 5.3 per cent) and has announced €102 billion in additional budgetary measures over 2½ years to meet the targets. Another difference to the packages for other euro area members is that the International Monetary Fund (IMF) will not contribute funds; Spain's package will be financed solely by the European Financial Stability Facility (EFSF) and then by the permanent European Stability Mechanism (ESM) once it becomes operational. Activation of the ESM had been scheduled for 1 July but has been delayed by a constitutional challenge in Germany, which is expected to be resolved in mid September.

The initial announcement of the package provided some support to confidence but this was quickly reversed as investors focused on the implications for Spanish central government finances – funding to banks will be channelled through Spain's bank restructuring agency and will therefore increase the central government's indebtedness. Yields on long-term Spanish government bonds reached a new euro era high of over 7½ per cent in July and shorter-term bond yields increased sharply (Graph 2.2). Concerns about the state of Spanish regional governments' finances and a deteriorating outlook for the Spanish economy also contributed to the rise in yields. Spanish bond yields have fallen from their recent highs following Draghi's comments, with shorter-term yields falling particularly sharply.

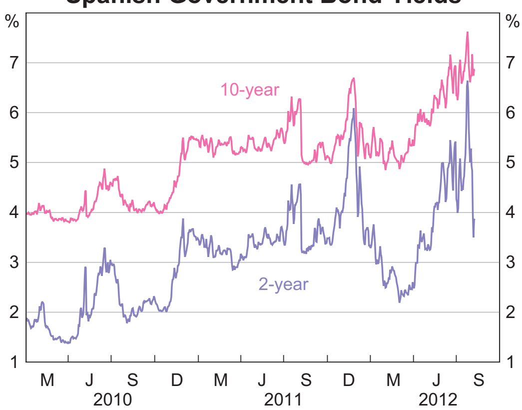
The Spanish central government had €600 billion of outstanding debt securities at the end of May 2012, with nearly 40 per cent of this held by Spanish banks (Table 2.1). A further 30 per cent of debt securities are held by foreign investors who, in aggregate, have significantly reduced their holdings of Spanish, as well as Italian, sovereign debt over the past year or so (Graph 2.3). In addition to funding the budget deficit for the remainder of the year, Spain needs to fund €22 billion in maturing bonds by the end of 2012 – equivalent to around 2 per cent of GDP.

Table 2.1: Spanish Central Government Debt Securities[a]
As at May 2012

	€ billions	Share of total Per cent
Securities	600	
Held by:		
Spanish banks	233	39
Government/Bank of Spain	65	11
Other domestic	116	19
Foreign holders[b]	186	31
– Foreign banks[c]	57	10

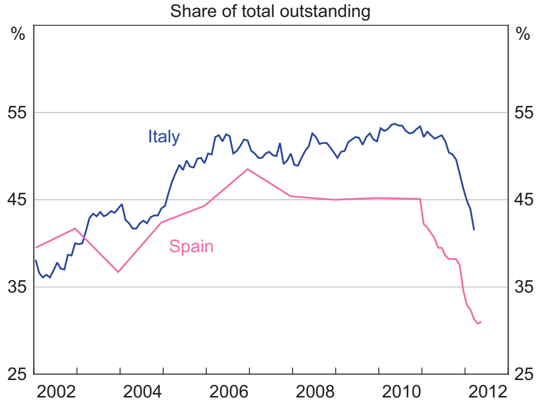
(a) Does not include unconsolidated autonomous regional debt of €145 billion and local government debt of €37 billion
(b) Includes ECB holdings
(c) As at March 2012
Sources: Bank of Spain; BIS; RBA; Spanish Treasury

Graph 2.2
Spanish Government Bond Yields



Source: Bloomberg

Graph 2.3
Foreign Holdings of Central Government Debt Securities
Share of total outstanding



Sources: Bank of Italy; RBA; Spanish Treasury

The situation in Greece has also contributed to the uncertainty in sovereign debt markets. Greek parliamentary elections in early May were inconclusive and speculation mounted that Greece may exit the euro area if a second election in June did not produce a government supportive of the EU/IMF assistance package and associated reforms. In the event, Greek voters elected a government that has stated its intention to continue with the reforms that are a condition for ongoing official financial support. Further disbursements of funding under the Greek assistance package are dependent on reviews of the program by 'the troika' of official agencies, and markets are concerned about how far off track the program may have become as a result of the recent political turmoil. The privatisation program is reportedly several months behind schedule. The next troika report is expected by September. In the meantime, a €3 billion bond held by the ECB is due to mature in August, and the Greek Government will reportedly issue short-term paper to facilitate that payment.

At a summit in late June, European leaders outlined further strategies for dealing with the debt crisis and strengthening the euro area over a longer horizon. Investors initially responded favourably to the broad policy announcements, but optimism quickly faded due to a lack of detail and uncertainty about the timelines for implementing the measures. The main proposals were:

- To establish a single European bank supervisory mechanism, involving the ECB. The EC is due to present proposals in September and euro area leaders are expected to consider these by the end of 2012.
- Once this mechanism is established, the ESM could possibly be given the authority to recapitalise banks directly, rather than channelling funds through the sovereign. This would avoid an ESM-funded bank recapitalisation increasing the sovereign's debt.
- A €120 billion growth package, primarily consisting of increasing the European Investment Bank's lending capacity and reallocating unused Structural Funds.

Following these announcements, Irish sovereign yields fell sharply on speculation that once a pan-European supervisor is established, sovereign debt previously used to fund bank recapitalisations could be retrospectively shifted to the ESM. Estimates suggest this could significantly reduce Ireland's debt-to-GDP ratio. The troika completed the seventh review of the Irish assistance package, noting that all fiscal targets are being met despite challenging macroeconomic conditions. In July, Ireland successfully returned to bond markets for the first time since late 2010, issuing 5- and 8-year bonds. Yields on long-term Irish sovereign debt have fallen to be at comparable levels to those in Spain and Italy.

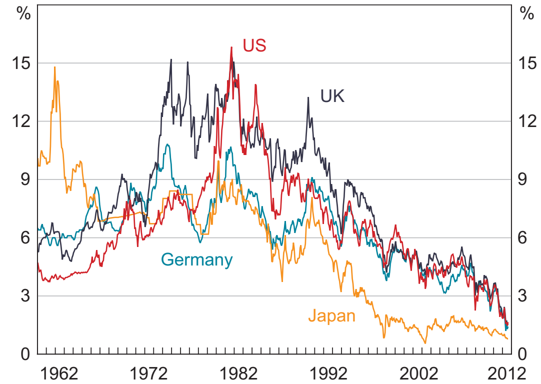
The troika completed their fourth review of Portugal, noting that the program is on track overall but risks remain. Portugal has indicated that it intends to issue medium-term bonds of 1–5 years duration to specific creditors by September 2013 (coinciding with the timing of a €9.7 billion bond maturity).

In June, Cyprus asked for EU/IMF assistance to recapitalise its banking sector and finance its budget deficit, becoming the fifth euro area member to request official financial assistance. Cyprus is also seeking to supplement this assistance with Russian aid; Russia lent Cyprus €2.5 billion in December 2011.

Government bond yields in the major advanced economies fell to new historical lows in July (Graph 2.4). Yields on 10-year German, US and UK government bonds are all around 1½ per cent as investors have sought assets perceived to be low risk. Yields on shorter-term government debt have fallen sharply in recent months across a range of markets and have turned negative in a number of cases (Graph 2.5). German 2-year yields fell below zero for the first time in July after the ECB cut its deposit facility rate to zero (see 'Central Bank Policy'), and short-term Swiss and Danish paper are also trading at negative yields. The Swiss yield curve is currently negative to a maturity of four years.

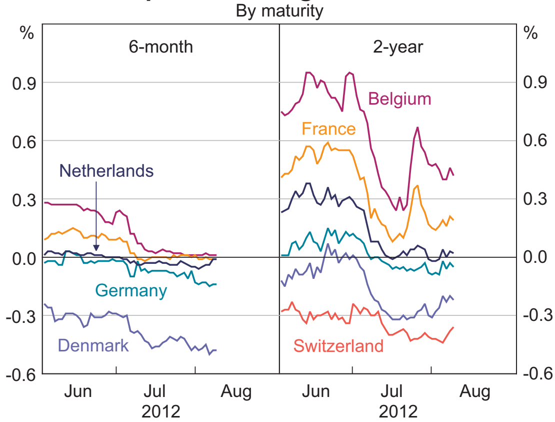
Spreads on US dollar-denominated debt issued by emerging market sovereigns are narrower than they were late last year (Graph 2.6).

Graph 2.4
10-year Government Bond Yields



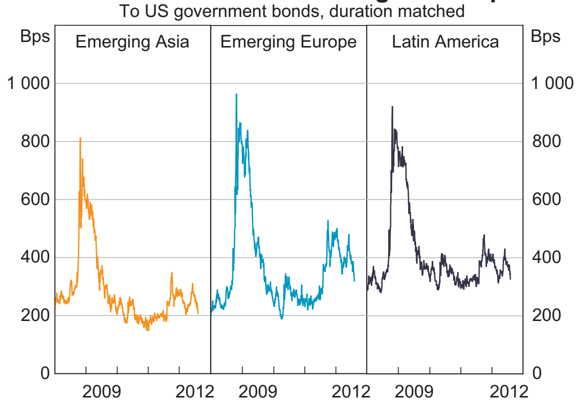
Sources: Bloomberg; Global Financial Data

Graph 2.5
European Sovereign Debt Yields
By maturity



Source: Bloomberg

Graph 2.6
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched



Source: Thomson Reuters

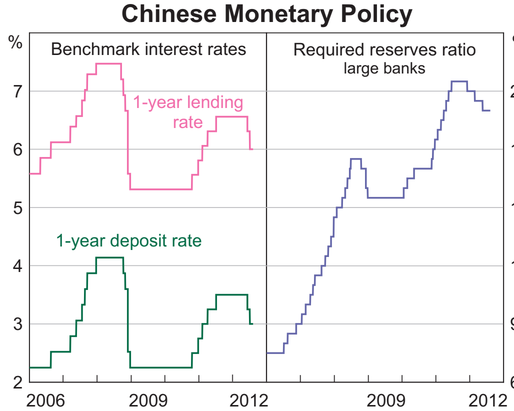
Central Bank Policy

A number of central banks have eased policy in recent months (Table 2.2). The ECB cut its main refinancing rate by 25 basis points to 0.75 per cent. The ECB also reduced its deposit facility interest rate to zero, which had a significant effect on euro area money markets (see below). Following the ECB's decision, the National Bank of Denmark reduced its lending rate by 25 basis points, to 0.2 per cent, and cut its deposit rate to –0.2 per cent.

The People's Bank of China (PBC) cut its benchmark 1-year lending rate in June and July by a total of 56 basis points and reduced a range of the other benchmark deposit and lending rates by a similar amount (Graph 2.7). The 1-year benchmark lending rate is currently 6.0 per cent, and the 1-year benchmark deposit rate is 3.0 per cent. The PBC also increased the flexibility that financial institutions have to set lending rates; banks may now offer loans at 0.7 times the benchmark rate, compared with 0.9 times the benchmark at the beginning of June. In addition, the reserve requirement ratio was reduced in May, to 20 per cent for large banks, which was the third reduction since December 2011.

Elsewhere, the Central Bank of Brazil twice cut its policy rate by 50 basis points, bringing the cumulative reduction to 450 basis points since August last year. The South African Reserve Bank cut

Graph 2.7
Chinese Monetary Policy



Source: People's Bank of China

Table 2.2: Policy Rates

	Current level Per cent		Most recent change	Change from 2011 peak Basis points
Euro area	0.75	↓	Jul 12	–75
Japan	0.05	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Australia	3.50	↓	Jun 12	–125
Brazil	8.00	↓	Jul 12	–450
Canada	1.00	↑	Sep 10	–
China	6.00	↓	Jul 12	–56
India	8.00	↓	Apr 12	–50
Indonesia	5.75	↓	Feb 12	–100
Israel	2.25	↓	Jun 12	–100
Malaysia	3.00	↑	May 11	–
Mexico	4.50	↓	Jul 09	–
New Zealand	2.50	↓	Mar 11	–50
Norway	1.50	↓	Mar 12	–75
Russia	8.00	↓	Dec 11	–25
South Africa	5.00	↓	Jul 12	–50
South Korea	3.00	↓	Jul 12	–25
Sweden	1.50	↓	Feb 12	–50
Switzerland	0.00	↓	Aug 11	–25
Taiwan	1.875	↑	Jun 11	–
Thailand	3.00	↓	Jan 12	–50
United Kingdom	0.50	↓	Mar 09	–

Source: central banks

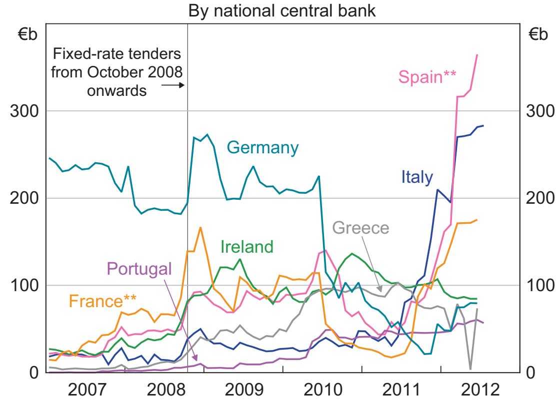
its policy rate target by 50 basis points, to 5 per cent, while the Bank of Korea lowered its policy rate by 25 basis points, to 3 per cent.

Central banks have also taken a number of other policy actions in recent months. The Bank of England increased the size of its Asset Purchase Facility by £50 billion, to £375 billion, with purchases expected to be completed by November. At the completion of the program, it is estimated that the Bank of England will hold around one-quarter of outstanding gilts. The Bank of Japan adjusted the composition of its Asset Purchase Program, increasing planned asset purchases by ¥5 trillion (to ¥45 trillion) while reducing the size of its fixed-rate liquidity program commensurately.

In total, ECB lending to banks for monetary policy purposes stood at around €1.2 trillion in July. Lending to banks has increased by around €80 billion since the second round of 3-year loans was provided in late February, with a significant share of this due to lending via the Bank of Spain and the Bank of Italy (Graph 2.8).

The ECB has made a number of changes to its range of eligible collateral. It will accept a wider range of asset-backed securities for monetary policy operations, including lower-rated residential mortgage-backed securities and securities backed by loans to small and medium-sized enterprises. However, Greek sovereign debt instruments will no longer be accepted. This decision reflects the expiry of €35 billion in

Graph 2.8
ECB Lending to Banks*
By national central bank



* Lending provided through monetary policy operations only
** Month-average; France is month-end prior to September 2010
Sources: RBA; central banks

guarantees provided by the EFSF at the time of the Greek debt swap earlier in the year, which had allowed banks to continue to use Greek government securities as collateral. Banks without alternative collateral (likely to be primarily Greek banks) will be able to access emergency liquidity assistance from their national central banks. The ECB noted that it would review its decision following the conclusion of the current troika review of Greece. The ECB also announced that it will not accept any additional self-issued, government-guaranteed securities from banks as collateral (though it will consider requests to accept such securities in 'exceptional cases').

As noted above, at its August meeting the ECB announced that it may undertake additional purchases of sovereign debt but would only do so if governments adhere to their fiscal and structural commitments and after governments request that the EFSF/ESM buy their debt. The ECB also suggested that it was considering other non-standard policy measures, with the details of any such measures to be designed over the coming weeks.

In the United States, the Federal Reserve announced a US$267 billion extension of its Maturity Extension Program (MEP), increasing the size of the program to US$667 billion. The MEP was due to conclude at the end of June but will now continue through to the end of the year.

Government Financial Policy

In the United Kingdom, the Bank of England and HM Treasury announced the introduction of the Funding for Lending Scheme. Participating banks and building societies will be able to borrow UK Treasury bills from the Bank of England (in return for eligible collateral) worth up to 5 per cent of their stock of existing lending to the real economy via the scheme, plus any net expansion of lending that occurs between June 2012 and December 2013. The borrowings from the Bank of England will have a maximum term of four years, and the fee will be between 25 and 150 basis points, depending on whether banks expand, maintain or reduce their lending over the 18-month period.

The Fed announced that its loans to two investment vehicles – Maiden Lane I and Maiden Lane III – have been fully repaid. Maiden Lane I contained mortgage assets acquired as part of the wind-up of Bear Stearns, while Maiden Lane III contained CDOs that AIG had sold insurance on to investment banks. Furthermore, AIG has been repaid in full for the US$5 billion equity (plus accrued interest) it contributed to Maiden Lane III. Net proceeds from asset sales also provided residual profits to the New York Fed, which will continue to receive two-thirds of any residual profits generated by asset sales.

In Canada, the government announced measures to tighten lending practices for mortgages eligible for government-backed insurance. To be eligible, mortgages with a loan-to-valuation ratio of greater than 80 per cent must have a maximum amortisation period of 25 years (down from 30), a gross debt-servicing ratio of no more than 39 per cent, be for a house bought for less than C$1 million and may not be refinanced at a loan-to-valuation ratio of above 80 per cent (previously 85 per cent).

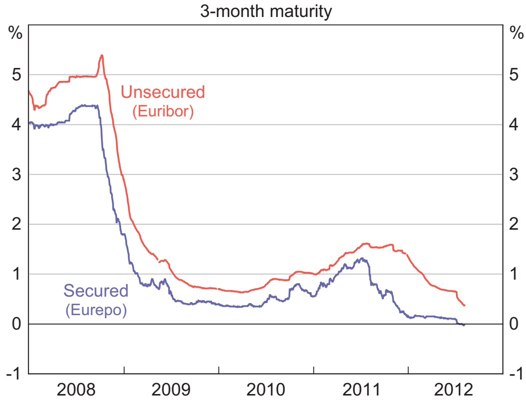
Credit Markets

The cut in ECB policy rates has had a significant effect on euro area money markets. The deposit facility rate has become the key reference rate for euro area money markets in recent years. Until the recent cut, the ECB's deposit facility could be used by a bank to earn a return on reserves held at the ECB in excess of regulatory requirements. Unsecured rates stepped lower following the ECB decision (with 3-month rates having now fallen by a total of around 100 basis points since the injection of liquidity from the ECB's 3-year loan operations) (Graph 2.9). Secured rates have also fallen, though some of these were already close to zero prior to the ECB's decision; interest rates on short-term secured lending using high-quality collateral are currently slightly negative. Activity in some euro area interbank markets has reportedly fallen to low levels as interest rates have approached zero or become negative, and several euro-denominated money market funds have announced their closure to new investments, citing an inability to invest additional funds profitably.

Corporate bond spreads in the euro area and the United States remain narrower than they were late last year, although spreads in the euro area are slightly wider than their recent lows reached in March 2012 (Graph 2.10). Euro area financials' bond spreads fell after the Euro Summit in June.

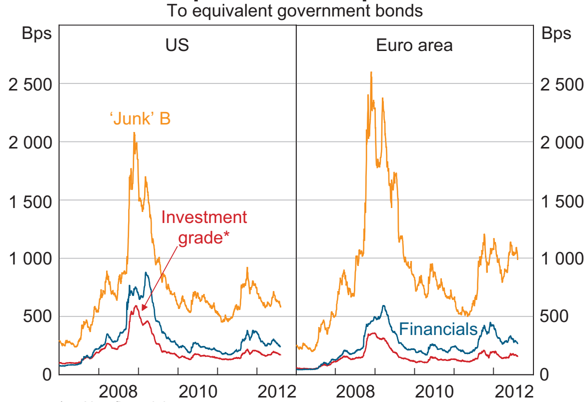
Corporate bond issuance in the euro area has been relatively subdued in recent months, after strong issuance in the first quarter as conditions improved following the ECB's 3-year lending operations (Graph 2.11). Although covered bond issuance picked up in June, a large proportion was accounted for by Spanish banks' self-issuance. These bonds have been used to generate additional collateral for use at ECB monetary policy operations. Issuance in the United States has remained firm, with non-financial companies in particular continuing to raise funds in bond markets.

Graph 2.9
Euro Interbank Interest Rates
3-month maturity



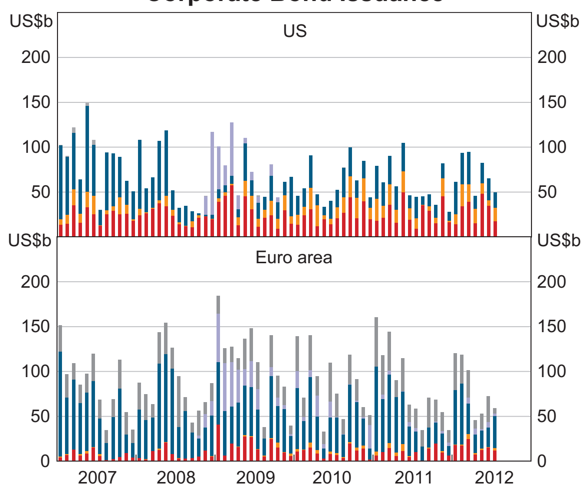
Sources: Bloomberg; Thomson Reuters

Graph 2.10
Corporate Bond Spreads
To equivalent government bonds



* Non-financial corporates
Sources: Bank of America Merrill Lynch; Bloomberg; RBA

Graph 2.11
Corporate Bond Issuance



Sources: Bloomberg; Dealogic; RBA; Thomson Reuters

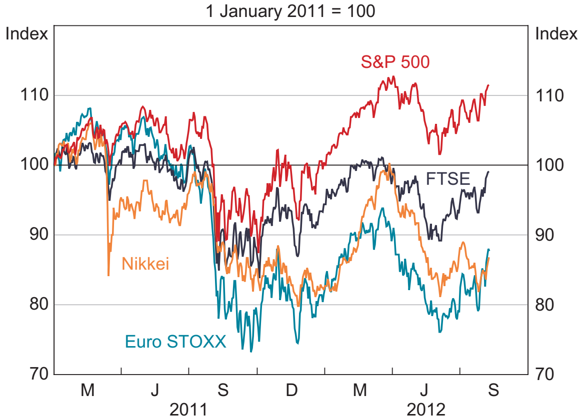
Equities

Global equity prices have risen by around 8 per cent over the year to date, with gains in the early part of 2012 partly unwound as renewed concerns about European banks and sovereign debt as well as mixed economic data dampened sentiment (Graph 2.12, Table 2.3). While sentiment has recently been bolstered by expectations of policy action by the ECB, global equity prices remain below their 2012 peaks recorded around March.

Despite a recent rally, euro area equity prices have underperformed most major markets over recent months, as the June summit and announcement of measures to support the Spanish banking sector failed to have a lasting effect on confidence. Outside of Europe, the Japanese equity market has fallen notably, partly reflecting the appreciation of the yen.

Chinese equity prices have also been particularly weak of late, having fallen by 10 per cent since mid March, to be around 2 per cent lower over the year. Concerns about economic growth appear to have been only partly alleviated by recent policy actions. The weakness in Chinese equities has contributed to the underperformance of emerging equity markets as a whole relative to their developed counterparts in recent months.

Graph 2.12
Share Price Indices
1 January 2011 = 100



Source: Bloomberg

Table 2.3: Changes in International Share Prices
Per cent

	Since end 2011	Since mid March 2012
United States		
– Dow Jones	8	0
– S&P 500	11	0
– NASDAQ	16	–1
Euro area		
– STOXX	7	–6
United Kingdom		
– FTSE	5	–2
Japan		
– Nikkei	5	–12
Canada		
– TSE 300	–1	–6
Australia		
– ASX 200	6	1
China		
– China A	–2	–10
MSCI indices		
– Emerging Asia	6	–6
– Latin America	5	–5
– Emerging Europe	7	–8
– World	**8**	**–3**

Source: Bloomberg

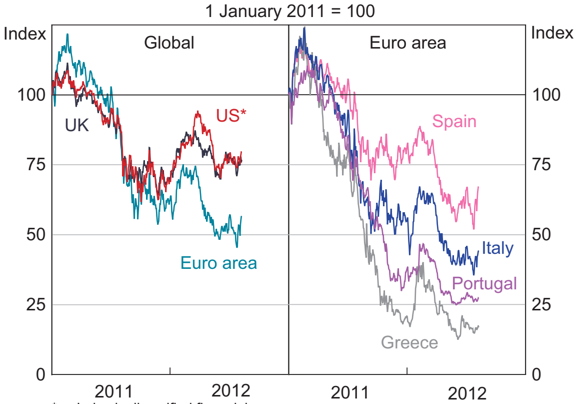
Banking sector shares have been influenced by a number of sector-specific factors over recent months and have generally underperformed the broader market in most of the major economies (Graph 2.13). Euro area bank share prices have fallen by 25 per cent since February despite rallying recently on expectations of ECB policy action. Weaker-than-expected earnings results reported by several large European banks have weighed on the sector.

In the United States, financials have underperformed in recent months despite most large US banks reporting stronger-than-expected earnings for the June quarter as an improvement in credit quality

Graph 2.13

Bank Share Price Indices

1 January 2011 = 100

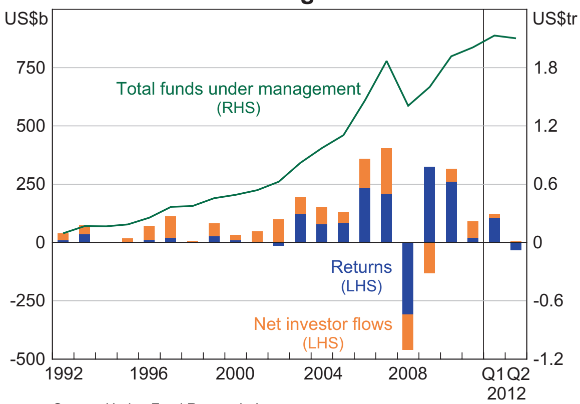


* Index is diversified financials

Source: Bloomberg

Graph 2.14

Global Hedge Funds



Source: Hedge Fund Research, Inc.

led to a decline in provisions. US banking shares have been affected by JPMorgan's disclosure of a large trading loss on a synthetic credit portfolio managed within its Chief Investment Office. In the United Kingdom, Barclays' share price fell sharply on news that the firm would pay a £290 million settlement for their role in manipulating the LIBOR (see 'Box D: Interbank Reference Rates'). The ongoing investigation of other banks for similar misconduct is weighing on the sector more broadly.

Hedge Funds

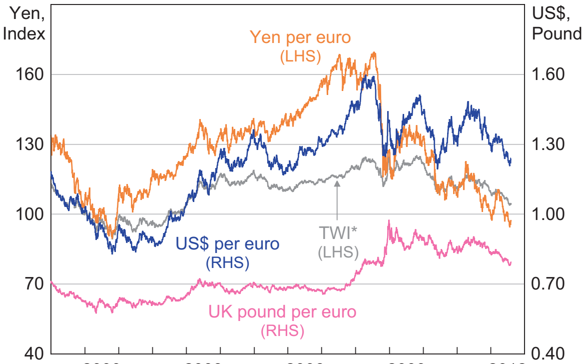
Global hedge funds recorded an average loss on investments of 4 per cent over the year to June, which was slightly larger than the loss recorded by global equity markets on a total return basis (that is, including dividends) over the same period (Graph 2.14). Nevertheless, monthly returns from investment in hedge funds have continued to be less volatile than equity market returns. Valuation effects associated with recent losses largely explain the small decline in funds under management, to US$2.1 trillion, with hedge funds receiving only a modest injection of new capital in the June quarter.

Foreign Exchange

European developments have also continued to be the dominant influence on foreign exchange markets. This was particularly evident in May, when heightened uncertainty in the lead up to the second election in Greece and increasing concerns about Spain saw European, emerging market and commodity currencies all depreciate sharply against the US dollar. The euro faced renewed downward pressure in July as returns on some risk-free euro-denominated assets fell to zero; however, in contrast to May, other risk-sensitive currencies generally appreciated against the US dollar (Graph 2.15). This broad-based weakness in the euro resulted in it reaching a 10-year low on a trade-weighted basis and a 12-year low against the yen. The euro received some support in late July and early August from the prospect of further policy measures from the ECB, but nevertheless has depreciated by around 6 per cent against the US dollar since its late April peak.

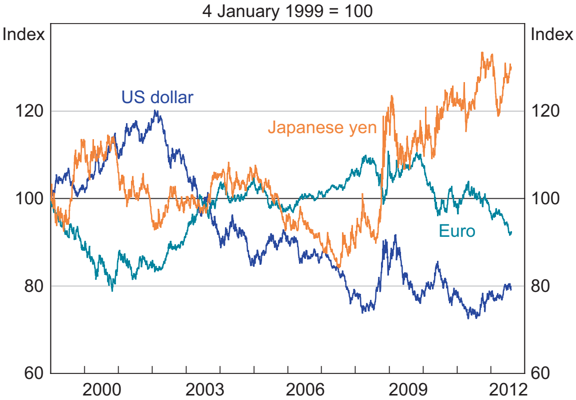
The US dollar and Japanese yen, on the other hand, have been supported by safe haven and repatriation flows in recent months, particularly from around the time of the first (inconclusive) Greek election, with both currencies appreciating on a trade-weighted basis since early May (Graph 2.16, Table 2.4). Overall,

Graph 2.15
Euro against Selected Currencies



* Indexed to 3 January 2000 = 100
Source: Bloomberg

Graph 2.16
Major Currencies' Nominal TWI
4 January 1999 = 100



Source: Bloomberg

Table 2.4: Changes in the US Dollar against Selected Currencies
Per cent

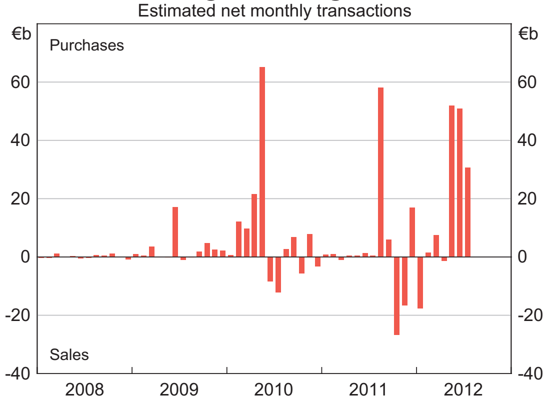
	Over 2011	Since end 2011
Brazilian real	12	9
European euro	3	5
Indonesian rupiah	1	4
Indian rupee	19	4
Swiss franc	0	4
Japanese yen	–5	2
Chinese renminbi	–5	1
South African rand	22	0
Thai baht	5	0
UK pound sterling	0	–1
New Taiwan dollar	4	–1
Malaysian ringgit	3	–2
Canadian dollar	2	–3
South Korean won	3	–3
Swedish krona	3	–3
Australian dollar	0	–3
Singapore dollar	1	–4
New Zealand dollar	0	–5
Philippine peso	1	–5
Mexican peso	13	–6
Majors TWI	**0**	**1**
Broad TWI	**2**	**0**

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

the US dollar has appreciated by 1 per cent on a trade-weighted basis since the start of the year and remains at a relatively low level by historical standards. While slightly lower against the US dollar, the yen has appreciated against the euro since the start of the year. As a result, the trade-weighted yen exchange rate is currently only slightly below its 2011 peak – a multi-decade high – which was when the Japanese authorities last intervened in the foreign exchange market to depreciate the currency. The Japanese authorities have recently reiterated their willingness to intervene to curtail further appreciation if required. While high in nominal terms, the trade-weighted yen exchange rate is only slightly above its long-run average in real terms.

More generally, there has been strong demand for highly rated debt from a broad range of countries in 2012 to date as sovereign and private investors have sought alternatives to holding euro area assets. Within Europe, strong demand for Swiss assets is evident in the negative yields on Swiss short-term government debt and in recent increases in the Swiss National Bank's (SNB) foreign exchange holdings, which suggest that sizeable purchases of foreign exchange have been required to defend the Swiss franc ceiling against the euro (Table 2.5, Graph 2.17). Once exchange rate valuation effects are taken into account, the SNB is estimated to have purchased around €130 billion over the three

Graph 2.17
Swiss Foreign Exchange Reserves*
Estimated net monthly transactions



* Transactions estimated based on changes in gross reserves and the SNB's documented currency composition
Sources: Bloomberg; RBA; Swiss National Bank

months to July to defend the Swiss franc ceiling against the euro. The reserves data published by the SNB indicate that a significant amount of the euros purchased have since been exchanged for other currencies, particularly the US dollar, but also the Australian dollar.

In contrast to the trend seen since mid 2010, the Chinese renminbi (RMB) has depreciated against the US dollar since early May, by around 1½ per cent, consistent with a somewhat weaker economic outlook for China. The RMB has recently traded around its lowest level against the US dollar in eight months (Graph 2.18). However, the RMB has appreciated modestly in trade-weighted terms since early May, largely reflecting the recent broad-based appreciation of the US dollar.

The depreciation of the RMB against the US dollar coincided with a rare decline in the stock of China's foreign exchange reserves over the June quarter (Graph 2.19). Official data indicate that the PBC undertook net sales of foreign exchange during the quarter, consistent with capital outflow. In line with ongoing downward pressure on the exchange rate, the RMB has generally traded towards the bottom of its daily trading band against the US dollar since around mid May.

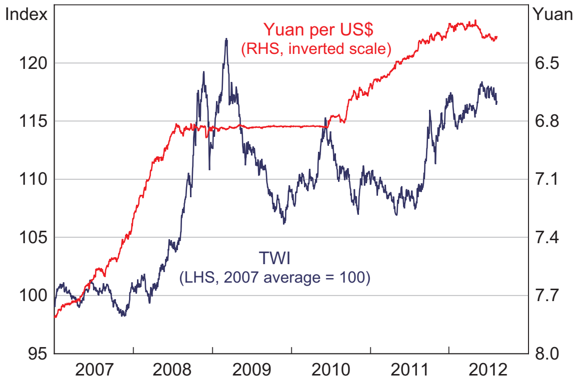
Further gradual steps have been taken towards internationalising the RMB. These include: plans to establish the 'Pearl River Delta Financial Reform and Innovation Zone' to test measures aimed at liberalising the capital account in specified regions of three cities; some relaxation of rules related to investing in onshore markets through the Qualified Foreign Institutional Investor scheme; the announcement of further bilateral local currency swap agreements with Brazil and Ukraine; and the

Table 2.5: Foreign Currency Reserves
As at end July 2012

	Three-month-ended change		Level
	US$ equivalent (billions)	Per cent	US$ equivalent (billions)
China[(a), (b)]	–65	–2	3 240
Japan	–14	–1	1 197
Russia	–19	–4	440
Switzerland	155	59	416
Taiwan	–4	–1	391
Brazil	3	1	367
South Korea	–3	–1	306
India	–4	–2	256
Thailand[(b)]	–4	–2	164

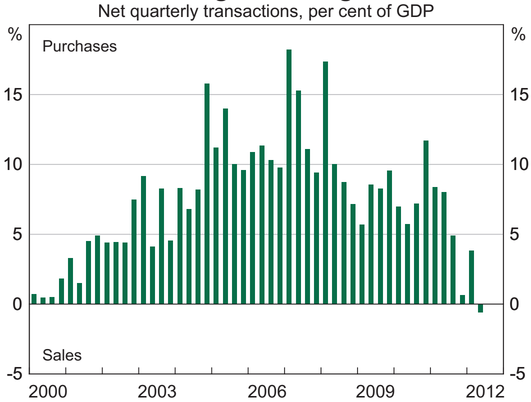
(a) Foreign exchange reserves (includes foreign currency and other reserve assets)
(b) End June
Sources: Bloomberg; CEIC; IMF; RBA

Graph 2.18
Chinese Renminbi



Sources: BIS; Bloomberg; RBA

Graph 2.19
Chinese Foreign Exchange Reserves
Net quarterly transactions, per cent of GDP



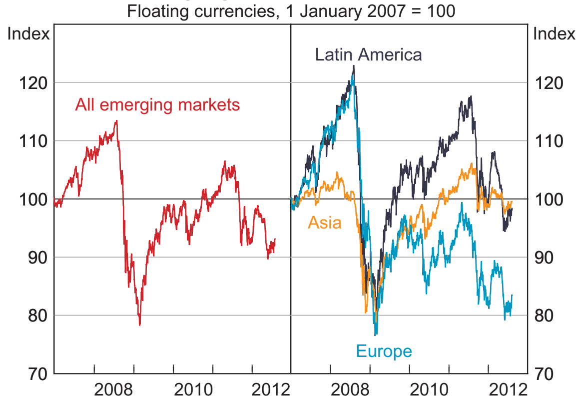
Sources: Bloomberg; CEIC

commencement of direct trading between the RMB and the Japanese yen in the Shanghai and Tokyo interbank markets. In offshore markets, the Hong Kong Monetary Authority (HKMA) launched an RMB liquidity facility, designed to ease potential short-term RMB liquidity pressures in Hong Kong's offshore market, and a Chinese bank is expected to be authorised as an RMB 'offshore clearing bank' in Singapore.

Australia and Hong Kong also commenced an ongoing RMB Trade and Investment Dialogue that will be facilitated by the RBA, the Australian Treasury, and the HKMA and will involve the private sector. The Dialogue aims to broaden RMB trade settlement and support the development of new RMB-denominated financing and investment products.

Most other emerging market currencies depreciated markedly against the US dollar between late February and mid June, although these falls have been slightly retraced since (Graph 2.20). Reports that some central banks intervened in the foreign exchange market to support their currencies – particularly during May – are consistent with declines in foreign currency reserves (in US dollar terms) for most emerging market economies over the June quarter, although valuation effects related to the depreciation of the euro also contributed (Table 2.5).

Graph 2.20
Emerging Market Currencies*
Floating currencies, 1 January 2007 = 100



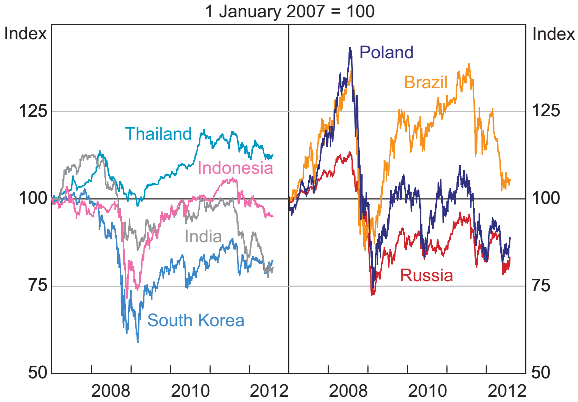
* Against the US dollar; weighted by GDP at PPP exchange rates
Sources: Bloomberg; IMF; RBA

The depreciations since February have generally been less pronounced for emerging Asian currencies. A key exception is the Indian rupee, which has depreciated by 12 per cent since early February, although the exchange rate appears to have recently stabilised (Graph 2.21). The rupee's rapid depreciation prompted the Indian authorities to introduce a range of policy measures designed to encourage foreign investment – including, for example, lowering the capital gains tax on long-term private equity investments – and to limit capital outflows.

Graph 2.21

Selected Currencies against the US Dollar

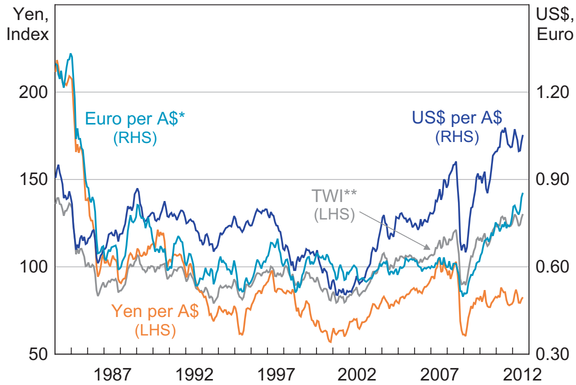
1 January 2007 = 100



Source: Bloomberg

Graph 2.22

Australian Dollar



* Deutsche Mark spliced on to euro prior to 4 January 1999

** Indexed to post-float average = 100

Sources: Bloomberg; RBA; Thomson Reuters; WM/Reuters

In Latin America, the Brazilian real is currently 16 per cent below its peak in late February, though it has appreciated modestly since late May. The currencies of emerging European economies have also generally experienced relatively pronounced depreciations against the US dollar since late February, reflecting ongoing concerns about their exposures to the euro area.

Australian Dollar

The Australian dollar remains at a high level by historical standards, with the nominal trade-weighted index almost at the multi-decade high recorded in early March, despite a deterioration in the global economic outlook and a decline in the terms of trade (Graph 2.22). The Australian dollar appreciated to a new record high (since the launch of the euro in 1999) of just above 86 euro cents in early August.

The Australian dollar has appreciated by 4 per cent against the US dollar since the beginning of the year, but has traded in a relatively wide range (Table 2.6). After depreciating to just under 96 US cents in early June in the lead up to the second Greek election, the Australian dollar has subsequently appreciated by around 10 per cent against the US dollar and in trade-weighted terms. Ongoing strong foreign demand for Commonwealth Government securities (CGS) is likely to have been a supporting factor.

Table 2.6: Changes in the Australian Dollar against Selected TWI Currencies

Per cent

	Over 2011	Since end 2011
European euro	3	9
Indonesian rupiah	1	8
Indian rupee	18	8
Swiss franc	0	7
Japanese yen	–6	6
Chinese renminbi	–5	5
South African rand	22	4
US dollar	0	4
Thai baht	5	3
UK pound sterling	0	3
Malaysian ringgit	3	2
Canadian dollar	2	1
South Korean won	3	1
Singapore dollar	1	0
New Zealand dollar	0	–1
TWI	**0**	**4**

Sources: Bloomberg; Thomson Reuters; WM/Reuters

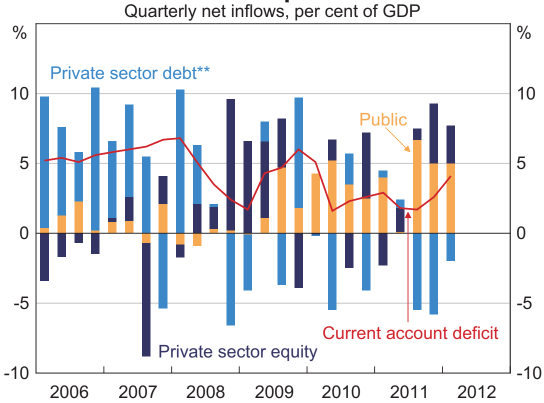
Capital Flows

Net capital inflows in the March quarter were directed largely towards the public sector, consistent with the trend over the past few years (Graph 2.23). This reflects ongoing strong foreign demand for CGS, with the Australian Office of Financial Management reporting that 76.5 per cent of the stock of CGS on issue was held by non-residents at end March, up from around 60 per cent in late 2009. There was also a small net capital inflow to the private sector in the March quarter, which included ongoing foreign investment in Australian corporates – including in the mining sector – and an offsetting net outflow of debt from the Australian banking sector, due to both increased foreign lending and maturing portfolio debt.

Graph 2.23

Australian Capital Flows*

Quarterly net inflows, per cent of GDP



* Excludes official and other RBA flows

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

Sources: ABS; RBA