Statement on Monetary Policy

FEBRUARY 2011

Contents

The material in this *Statement on Monetary Policy* was finalised on 3 February 2011. The next *Statement* is due for release on 6 May 2011.

The *Statement on Monetary Policy* is published quarterly in February, May, August and November each year. All the *Statements* are available on the Reserve Bank's website when released. Expected release dates are advised ahead of time on the website. For copyright and disclaimer notices relating to data in the *Statement* see the Bank's website.

Statement on Monetary Policy Enquiries

Information Department
Tel: (612) 9551 9830
Facsimile: (612) 9551 8033
E-mail: rbainfo@rba.gov.au

ISSN 1448–5133 (Print)
ISSN 1448–5141 (Online)

Overview

The global economy grew at an above-trend pace in 2010 and a continuation of strong growth is expected over the next couple of years, albeit with some moderation in the pace. There are, however, large differences in the amount of spare capacity across economies. In many advanced economies, output remains around, or below, pre-crisis levels and unemployment rates are still very high. In contrast, most emerging market economies have experienced very strong recoveries and spare capacity is limited.

In Asia, growth looks to have picked up again recently, after softening in the middle of 2010. The Chinese economy is growing strongly and this is benefiting other economies in the region, with international trade and industrial production recording significant increases in the final months of 2010. Across the region, inflation rates have picked up, with food prices in particular rising strongly. In response, policy interest rates have been increased in most countries, although real interest rates generally remain quite low. Authorities have also taken measures to slow credit growth and short-term capital inflows, which are putting upward pressure on exchange rates.

In the United States, the near-term outlook has improved, with household consumption stronger than earlier expected and indicators of investment showing a gradual improvement. The euro area as a whole continues to experience a modest recovery, although conditions vary significantly across countries.

The improvement in the global economy, together with some weather-related disruptions to supply, has led to generalised strength in global commodity prices over recent months. The spot price of iron ore is around its record high and there have been substantial increases in food prices and the prices of a range of base metals. The price of oil has also risen, although it remains substantially below its mid-2008 peak. This increase in commodity prices is adding to global inflationary pressures and, in the case of Australia, is leading to a further increase in the terms of trade from their already elevated level.

Despite global growth having generally surprised on the upside over the past 18 months, one ongoing downside risk is that the sovereign debt problems in some euro area economies escalate again, triggering another round of very high risk aversion. More generally, the need for continuing repair of both private- and public-sector balance sheets in a number of advanced economies means that the winding back of spare capacity in those countries is likely to be protracted. In Asia, a continuation of strong growth is expected in the short term, although rising inflation pressures have increased the risk of a significant slowdown over a somewhat longer horizon.

In financial markets, sentiment has generally improved over recent months. Globally, equity markets and bond yields have risen, although the latter remain low overall. Bond market issuance has also picked up further, including in Australia, where the issuance of residential mortgage-backed securities has increased. The Australian dollar, in real terms, remains at around its highest level in the post-float era, reflecting the high level of commodity prices and the interest differential between Australia and the rest of the world.

The main exception to this general improvement in sentiment is in Europe, where concerns about the sustainability of public finances in a number of countries have increased. While the primary focus recently has been on Ireland and Portugal, the borrowing costs of Spain and Belgium have also risen significantly over recent months. Given the considerable task of improving the state of public finances in a number of European countries, it is likely that concerns about sovereign creditworthiness will remain elevated for some time.

The Bank's medium-term outlook for the Australian economy remains broadly unchanged from that in the November *Statement*, although the floods in eastern Australia will have a temporary effect on GDP outcomes over coming quarters. Cyclone Yasi is also likely to have an effect although, at the time of writing, an assessment of the magnitude was not yet possible. These recent extreme weather events have damaged parts of the capital stock in the affected regions and disrupted production, with the biggest effect on GDP likely to arise from swings in coal production.

While the full extent of the disruption and damage is not yet known, the Bank's preliminary estimate (made prior to an assessment of the impact of Cyclone Yasi) is that the level of output in 2010/11 as a whole will be around ½ per cent lower than would otherwise have been the case, with most of the negative effect in the December and March quarters. The pace of the recovery will vary by industry and region but the overall level of GDP in the June quarter is likely to be back close to the level it would have been in the absence of the floods. This assessment assumes that there are no substantial economic effects of further extreme weather events. Following the June quarter, rebuilding efforts are expected to add modestly to aggregate demand, with the exact size of the boost depending on the extent of the damage, the speed of rebuilding and the extent to which other private and public spending is deferred.

Over recent months there have been further indications that the forecast pick-up in private investment is occurring, with the announcement of a number of large resource-sector projects. Broader measures of business conditions and overall capacity utilisation remain around average, although conditions differ significantly across industries. While the resources sector and some service industries are expanding strongly, parts of the manufacturing, education, retail and tourism sectors are experiencing difficult trading conditions. Business credit remains weak, with much of the expansion of the resources sector being financed through internal funds. Commercial property construction also remains at low levels.

The household sector has continued to exhibit considerable caution in its spending and borrowing behaviour. With growth in income over recent years significantly outstripping growth in consumption, the household saving ratio has increased substantially. Nominal retail sales remain weak and retailers report that consumers continue to be very value-conscious. Housing credit growth is also subdued compared with the standards of previous years, although it is only a little below the pace of growth in household income. Nationwide measures of housing prices have been broadly flat since mid 2010. Overall, many households appear to be taking a more cautious approach to their finances than was the case in earlier years. With business investment expected to grow strongly, this more cautious approach, if it is maintained, would reduce the pressures on capacity that are likely to arise over the period ahead.

The labour market continues to be strong, with employment increasing by nearly 200 000 persons over the second half of 2010, the participation rate increasing, and the unemployment rate ending the year at 5 per cent. Employment growth has been particularly strong not only in the mining industry, but also in a number of service industries. Forward-looking indicators of the labour market – including job vacancies, job advertisements and business surveys – all suggest continued solid employment growth over coming months, though most likely at a slower pace. Businesses are reporting that the labour market has tightened, although most are not experiencing significant difficulties in hiring employees. The labour market appears tightest for some mining-related and skilled occupations.

Wage growth increased over 2010, consistent with the strengthening in labour market conditions. This pick-up reflects stronger wage growth in the private sector, following low outcomes in 2009, and continued solid growth of public-sector wages. Overall, however, labour costs appear to have grown at around their average pace over 2010. Looking ahead, a gradual increase in wage growth is expected as the labour market tightens further.

Consumer price inflation has continued to moderate from its peak of just over 4½ per cent in September 2008. In underlying terms, inflation was a little under ½ per cent in the December quarter and around 2¼ per cent over the year. In headline terms, the CPI increased by 0.4 per cent in the December quarter, to be 2.7 per cent higher over the year. Most of the difference between the year-ended rates of underlying and headline inflation is due to the increase in tobacco excise in 2010, which is estimated to have increased the CPI by nearly 0.4 per cent.

These recent inflation outcomes were lower than expected. While food prices recorded a large increase in the December quarter – following a period of low outcomes – there were sizeable price declines for a wide range of consumer goods. These price declines largely reflect the pass-through of both the exchange rate appreciation and the tariff cuts in early 2010, which appears to have been a little faster than suggested by earlier experience, most likely reflecting weak consumer demand. Growth in rents and the prices of utilities slowed in the December quarter, although the latter reflects the timing of utility tariff adjustments.

The Bank's central forecast for the economy over the next few years is largely unchanged from the November *Statement*. However, as noted above, the recent floods will have a material effect on the near-term profile of GDP, with growth in the December and March quarters notably lower than would otherwise have been the case, followed by a strong recovery in the June quarter as coal production picks up and the rebuilding effort gets under way. Over the four quarters to December 2011, GDP is expected to increase by 4¼ per cent. This is higher than was expected at the time of the November *Statement*, but this revision reflects the lower starting point as a result of the flooding in December 2010. Beyond 2011, GDP is forecast to grow by 3¾–4 per cent.

This medium-term outlook continues to reflect the expected strong growth in mining investment and high commodity prices, which have been providing a substantial boost to incomes in Australia. With GDP growth expected to be above trend over much of the forecast horizon, pressures on capacity are likely to emerge in parts of the economy as the structural adjustment to the large change in relative prices takes place. The substantial increase in the price of Australia's exports has meant that the real exchange rate is higher than it would otherwise have been, and this is contributing to differences in growth prospects across industries.

The near-term forecast for year-ended underlying inflation has been revised down a little since November, reflecting the base effects of the recent outcome. While the exchange rate appreciation and soft retail spending are expected to continue to place downward pressure on the prices of many consumer durables, the floods have temporarily boosted the prices of some commodities. In terms of headline inflation, the floods are expected to add around ¼ percentage point to CPI inflation in the March quarter – mainly through higher fruit and vegetable prices – with much of this being reversed in the following quarter. Some additional effects can also be expected from Cyclone Yasi, but at the time of writing not enough information was available to quantify these.

The medium-term outlook for inflation is broadly unchanged. In underlying terms, inflation is expected to be around 2½ per cent later in 2011, before picking up gradually to 3 per cent by late 2012. In the next few quarters, year-ended CPI inflation is likely to remain above underlying inflation, largely due to the effects of the earlier increase in tobacco excise and significant increases in the prices of utilities.

In addition to the international factors discussed earlier, one uncertainty surrounding these forecasts is the economic impact of the recent severe weather events, and the possibility of further such events. The outlook for consumption and the timing of the pick-up in resource sector investment are two other important influences on the outlook. The household saving ratio is forecast to remain broadly unchanged over the forecast period, after having increased significantly since the mid 2000s. There are, however, plausible scenarios in which the saving ratio increases further, and others in which it declines. On investment, while confidence in the broad outlook has increased, the exact timing and scale of projects remain difficult to forecast. Given the size of the large projects, changes in timing can have a material effect on the quarterly profile of aggregate demand and GDP.

Over late 2009 and 2010, the Board gradually removed the monetary stimulus that was put in place during the global downturn. In late 2010, it concluded that given the medium-term outlook for the economy and inflation, it was prudent to make a further modest adjustment to monetary policy. As a result of this move, and the subsequent adjustments by lenders, most loan rates are now a little above their average levels of the past decade or so.

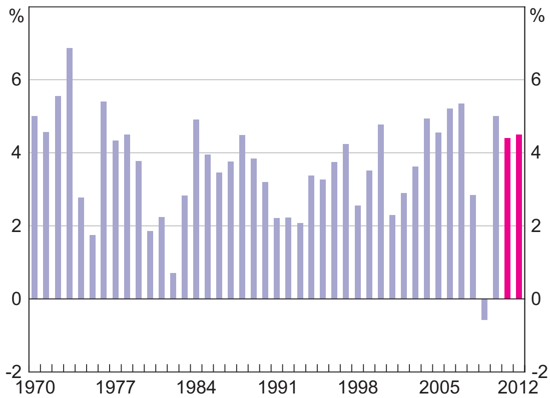
In setting monetary policy over the period ahead, the Board will, as on past occasions when natural disasters have occurred, look through the estimated short-term effects on output and prices. The focus of monetary policy will remain on the medium-term prospects for economic activity and inflation. At its recent meeting, the Board judged that in view of the general macroeconomic outlook, the current setting of monetary policy remained appropriate.

1. International Economic Developments

The world economy continues to recover, although the extent of the recovery varies significantly across regions. In 2010, global output is estimated to have increased by around 5 per cent in year-average terms, and the IMF forecasts a continuation of above-trend growth in both 2011 and 2012 (Graph 1.1; Table 1.1). World industrial production expanded robustly over October and November, and the global manufacturing and services PMIs both rose firmly over recent months to levels consistent with solid output growth.

While the world economy as a whole has grown strongly over the past year, most developed countries continue to operate with extensive spare capacity and high unemployment rates, with some unlikely to return to their pre-crisis levels of quarterly

Graph 1.1
World GDP Growth*
Year-average



* Weighted by GDP at PPP exchange rates
Source: IMF

Table 1.1: World GDP Growth
Year-average, per cent[(a)]

	2009	2010	2011	2012
		Estimate	IMF forecasts[(b)]	
United States	–2.6	2.8	3.0	2.7
Euro area	–4.1	1.8	1.5	1.7
Japan	–6.3	4.3	1.6	1.8
China	9.2	10.3	9.6	9.5
Other east Asia[(c)]	0.0	7.6	5.0	4.9
India	5.8	9.7	8.4	8.0
World	**–0.6**	**5.0**	**4.4**	**4.5**
Australia's trading partners[(d)]	–0.3	6.7	5.1	5.3

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Forecasts from the January *World Economic Outlook Update*
(c) Weighted using GDP at market exchange rates
(d) Weighted using merchandise export shares
Sources: CEIC; IMF; RBA; Thomson Reuters

output until 2013 or even later (Graph 1.2). In many of these economies, ongoing balance-sheet repair by households and corporates, tightened credit standards and (in some economies) continuing financial sector fragility have meant that growth has not rebounded as quickly as has typically occurred in earlier recoveries. In addition, many of the advanced economies face the challenge of putting their public finances on a sounder footing.

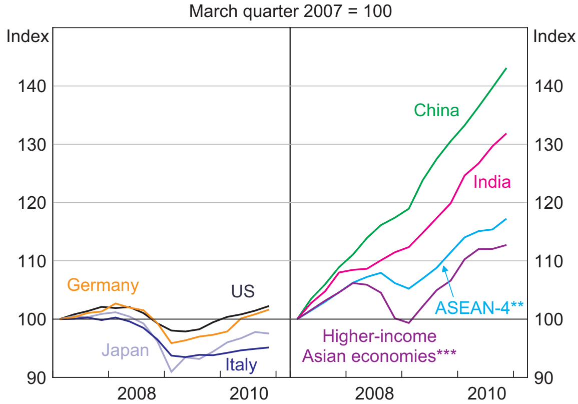
In contrast, the recovery from the global downturn has been strong in many emerging market economies. In Asia, output is now well above pre-crisis levels, and the attention of policy-makers has in many cases turned to controlling consumer and asset price inflation and credit growth, rather than stimulating activity. Strong growth in industrial production in these economies is putting upward pressure on global commodity prices.

The Chinese economy has grown particularly strongly, with GDP estimated to have expanded by around 2½ per cent in the December quarter to be around 10 per cent higher over the year (Graph 1.3). Retail sales increased at a robust pace in the quarter and passenger vehicle sales rose very strongly in advance of the increase in sales tax on some cars and the expiry of the car scrappage scheme at the end of 2010.

Urban fixed asset investment moderated in the December quarter, as a fall in real estate investment more than offset strong investment growth in the manufacturing sector and moderate growth in infrastructure investment. The decline in real estate investment reflects, to some extent, the effects of government measures to cool the property market earlier in 2010, which have also resulted in more modest increases in property prices than were recorded at the start of 2010. More recently, property taxes were introduced in Shanghai and Chongqing as part of a pilot program to curb speculation in the property market. At the same time, however, ongoing efforts to increase the supply of low-income housing form an important part of government policy towards the property market and will support construction investment over the coming year.

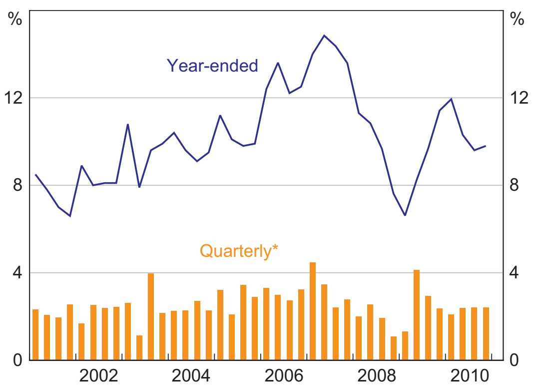
Consistent with strength in domestic and external demand, industrial production has continued to expand at a firm pace in recent months. Growth has been broad-based, although the production of machinery and transport equipment has been particularly strong, having been boosted by a surge in automobile manufacturing. The production of crude steel recovered strongly towards the end of 2010, after having fallen earlier in the year (Graph 1.4; see also the article 'China's Steel

Graph 1.2
World Output*
March quarter 2007 = 100



* Includes some RBA estimates for December quarter 2010
** Indonesia, Malaysia, the Philippines and Thailand; PPP-weighted
*** Hong Kong, Singapore, South Korea and Taiwan; PPP-weighted
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 1.3
China – GDP Growth



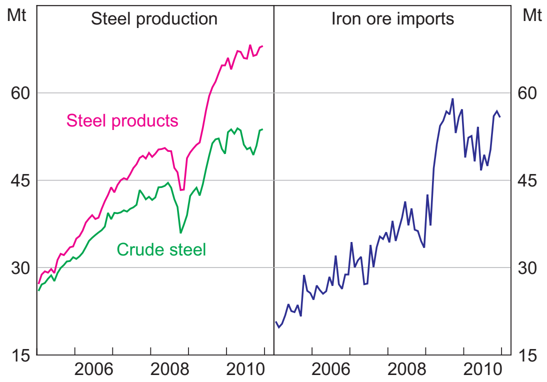
* RBA estimates
Sources: CEIC; RBA

Industry' in the December 2010 *Bulletin*). Imports of iron ore, which had increased prior to the recovery in crude steel production, have remained high in recent months. More generally, China's merchandise imports continue to grow at a robust pace, consistent with strong domestic demand and signs of a recovery in intra-Asian trade (following some softness around mid 2010). Exports rebounded strongly in the December quarter, with increases in shipments to all of China's major trading partners.

Inflation rose noticeably in the last few months of 2010, reaching 4.6 per cent over the year to December (Graph 1.5). As has been the case in a number of previous episodes, the recent pick-up in inflation has been primarily due to rises in food prices, although there is evidence that broader inflation expectations are rising as well. Until recently, food price increases had been fairly broad-based, with the prices of pork and rice rising noticeably, along with the prices of fresh vegetables (although these fell significantly in December; Graph 1.6). While price increases for some food items appear to be mostly due to an especially bad run of weather in China's food-producing regions, strong growth in demand as per capita incomes rise has also had an effect over a longer horizon. Non-food inflation has also picked up recently, with non-food prices rising strongly over the three months to December.

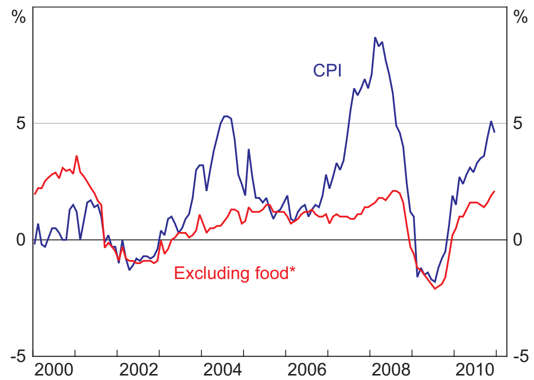
In response to rising food price inflation, the Chinese Government announced an anti-inflation plan in late November that included measures to combat activities related to hoarding and speculation. The government also announced additional support for low-income households to help them cope with the higher cost of living. In addition to these administrative measures, the People's Bank of China (PBC) raised deposit and lending rates in late December, the second increase in the current tightening phase. The 1-year benchmark deposit and lending rates were increased by 25 basis points, while deposit rates for other maturities were increased by between 30 and 35 basis points. The PBC has also raised

Graph 1.4
China – Steel Production and Iron Ore Imports



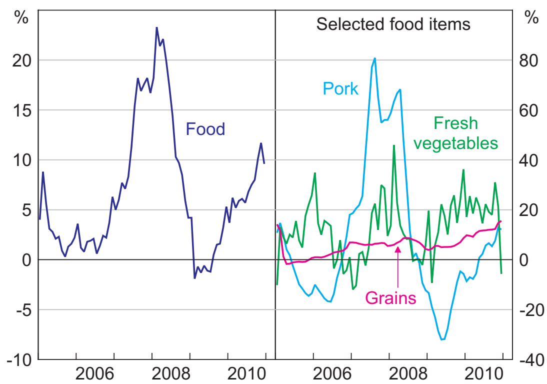
Sources: CEIC; RBA

Graph 1.5
China – Consumer Price Inflation
Year-ended



* RBA estimates
Sources: CEIC; RBA

Graph 1.6
China – Consumer Price Inflation
Year-ended

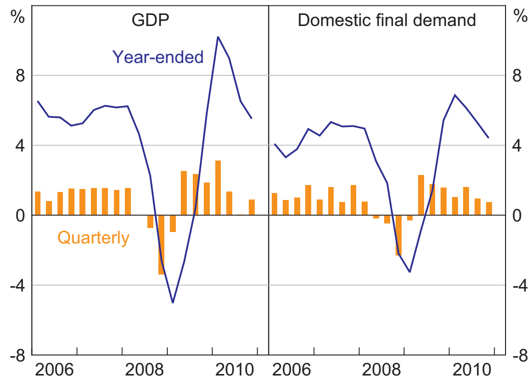


Source: CEIC

reserve requirements by a cumulative 200 basis points since the previous *Statement*, with the reserve requirement ratio for large banks now exceeding its previous peak in mid 2008. Notwithstanding these moves, the stance of policy remains accommodative; real lending rates are close to zero and real deposit rates are negative, while growth in the money supply (M2) remains strong at around 20 per cent over the year to December.

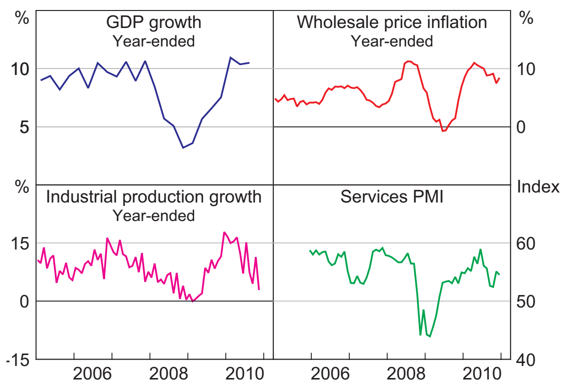
Elsewhere in east Asia (excluding Japan), aggregate domestic final demand continued to expand in the September quarter, and retail sales data for the higher-income Asian economies point to further growth in household consumption in the December quarter (Graph 1.7). Exports have also picked up strongly across the region, after a brief period of weakness around the middle of last year. As a result, firm output growth appears to have resumed in the December quarter following a temporary pause in the September quarter driven by the inventory cycle, some slowing in external demand growth, and disruptions to agricultural production in a number of countries. However, December quarter GDP growth was subdued in Korea, with activity increasing by only 0.5 per cent, held down by a decline in investment.

Graph 1.7
East Asia* – GDP and Demand Growth



* Excludes China and Japan; RBA estimates for December quarter 2010
Sources: CEIC; IMF; RBA

Graph 1.8
India – Economic Indicators



Sources: CEIC; JPMorgan Chase & Co. and Markit; RBA

With aggregate domestic final demand growth remaining firm for the seventh consecutive quarter, inflationary pressures have continued to build in the region. Aggregate year-ended consumer price inflation rose to 3½ per cent in December, although this primarily reflects a surge in food prices, with year-ended non-food inflation increasing only modestly. Central banks in most countries in the region have responded by tightening policy since the last *Statement*, although the stance of policy generally remains accommodative.

The Indian economy has also continued to expand at a robust pace (Graph 1.8). Growth has been underpinned by broad-based strength in domestic demand, with output in each of the agriculture, manufacturing and services sectors growing rapidly over the year to the September quarter. More timely data indicate some moderation in the pace of expansion in the December quarter, with growth in industrial production easing towards the end of 2010 and the services PMI suggesting a more modest pace of expansion in that sector. Conditions in the agricultural sector, however, remain supportive of growth due to the favourable summer monsoon.

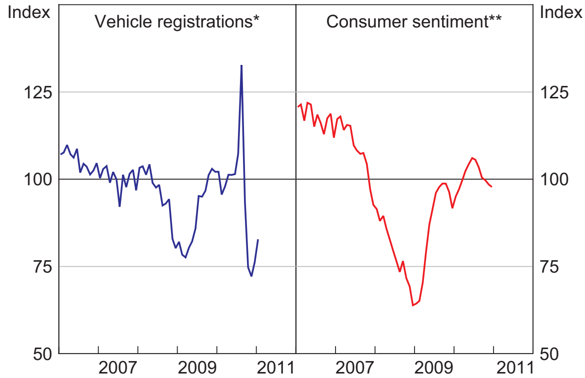
Inflation in India has also been high over the past year, with the wholesale price index rising by 8½ per cent over the year to December. Although the year-ended rate eased over the latter half of 2010, prices rose again strongly in the month of December (up by 2 per cent), reflecting increases in primary food prices. The spike in prices for fresh food such as onions, garlic and tomatoes, which has continued into January, has been attributed to recent unusually heavy rain in some major food producing regions. In response to the renewed inflationary pressures, the Reserve Bank of India increased its policy rates by 25 basis points at its January meeting.

In Japan, output appears to have increased only moderately over the second half of 2010. Growth was strong in the September quarter, led by private consumption (which increased by over 1 per cent), but this robust outcome was driven by a temporary policy-induced boost to demand, including a sharp pick-up in vehicle sales ahead of the expiration of government incentives in early September. New vehicle registrations have since plunged and consumer confidence has weakened over recent months, although it remains close to its long-run average (Graph 1.9). Export volumes and industrial production picked up solidly in the final months of 2010, although this followed a period of noticeable declines in both.

In the United States, output growth picked up to a solid 0.8 per cent in the December quarter, following sub-trend growth over the preceding six months (Graph 1.10). Consumption was stronger than earlier expected, rising by over 1 per cent in the December quarter, its fastest pace of expansion since early 2006. The household saving ratio fell modestly in the quarter and has now been around 5–6 per cent since late 2008 after rising by around 3 percentage points over the prior year. This saving ratio is proving sufficient to allow households to undertake some balance sheet repair by gradually paying down debt. Mortgage debt has been falling since mid 2008, to be nearly 5 per cent below its peak, while credit card debt (including the effect of write-offs) has declined every month for more than two years, to be nearly 20 per cent below its peak in August 2008.

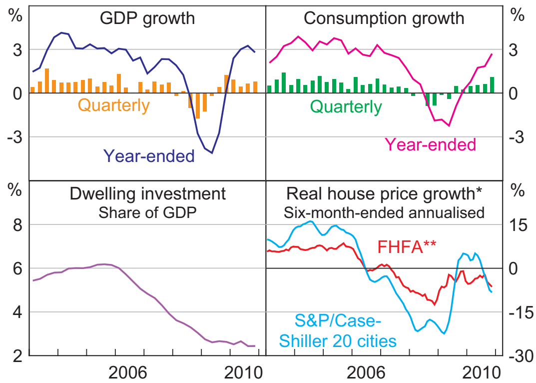
Conditions in the US housing market remain weak. Dwelling investment is around its lowest level as a share of GDP in the post-War period, despite increasing modestly in the December quarter. In addition, after broadly holding steady for more than a year, house prices have fallen again recently, following the cessation of government support measures for buyers around mid 2010. Sales of new homes continue to be depressed, and the stock of vacant dwellings remains elevated.

Graph 1.9
Japan – Consumption Indicators



* 2007 average = 100
** Average since January 1992 = 100
Sources: CEIC; Thomson Reuters

Graph 1.10
United States – Activity and Housing Indicators

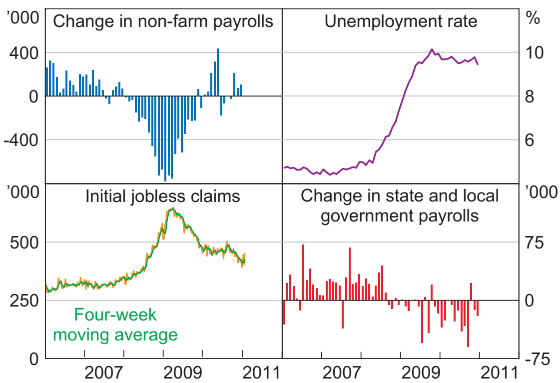


* Deflated by core CPI
** Federal Housing Finance Agency
Sources: Standard & Poor's; Thomson Reuters

Business sector conditions, in contrast, continue to be more positive. Both the manufacturing and non-manufacturing ISM surveys picked up further over recent months, to stand at levels consistent with firm growth in output. Industrial production expanded by 1 per cent over the three months to December, although the level of production remains well below its peak in the latter part of 2007, and equipment investment rose by 1.4 per cent in the quarter. While non-residential construction remained weak in the December quarter, leading indicators suggest that the outlook has improved in recent months.

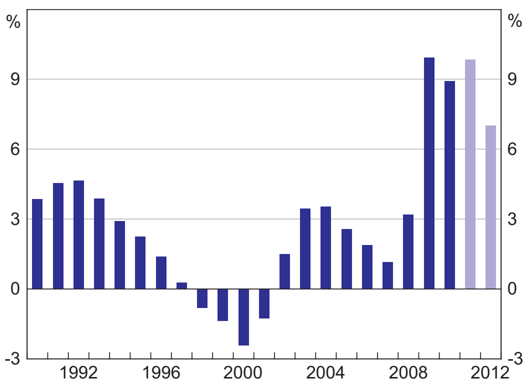
Labour market conditions have also picked up somewhat, although they remain subdued. The US economy added around 400 000 non-farm payrolls jobs in the December quarter, and weekly initial jobless claims have shifted lower over the past few months after remaining broadly unchanged at an elevated level through much of 2010 (Graph 1.11). Nevertheless, the unemployment rate remains well above 9 per cent – with nearly half of those unemployed having been jobless for more than six months – and there remain over 7 million fewer payrolls jobs than at the pre-crisis peak in late 2007. More rapid private sector jobs growth will be necessary to reduce these figures significantly,

Graph 1.11
United States – Labour Market Indicators



Sources: Bureau of Labor Statistics; Thomson Reuters

Graph 1.12
United States – Federal Budget Deficit*
Per cent of GDP



* Data are for fiscal years which end on 30 September
Source: Congressional Budget Office

particularly given the ongoing budgetary pressure on state and local governments, which saw them shed around 250 000 jobs over the course of 2010.

In addition to the gradual underlying recovery under way in the labour market, jobs growth should receive a further boost from recently enacted additional stimulus measures. Late last year, the US Administration and Congress agreed to extend a range of tax cuts, which had been scheduled to expire at the end of 2010, for a further two years and also enacted a number of further discretionary measures including a temporary payroll tax cut. These additional measures are estimated to amount to around US$350 billion over 2011 and 2012, or 2½ per cent of annual GDP. In 2011, the United States appears likely to record its third consecutive federal deficit of around 9 per cent of GDP or more, with the Congressional Budget Office also expecting the deficit to remain very large in 2012 (Graph 1.12).

In the euro area, a gradual recovery remains under way, with particular strength in the manufacturing sector recently. Industrial production increased solidly in October and November, and the European Commission's industrial sentiment indicator remained at an elevated level in January.

However, the level of aggregate output remains low and is not expected to regain its pre-crisis peak until late 2012. Moreover, solid aggregate growth over 2010 masks large divergences in performance across countries within the region. Recovery is proceeding most briskly in Germany, which is benefiting from the significant improvement in competitiveness achieved over the decade prior to the crisis (through wage restraint and productivity growth), as well as the absence of the sorts of household balance sheet problems besetting some other countries in Europe. German GDP expanded by 3 per cent over the six months to September, and the unemployment rate is already well below its pre-crisis level, after barely rising during the crisis. Output growth has generally been more subdued but still solid in some neighbouring euro area economies, such as France and the Netherlands, since mid 2009.

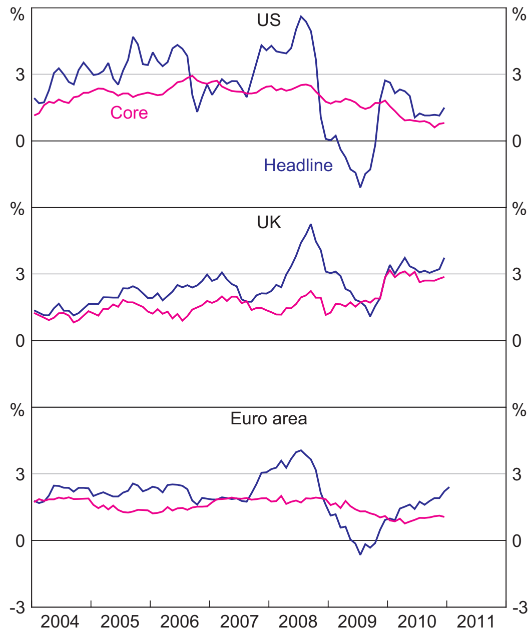
By comparison, recovery from the downturn thus far remains modest in Italy, and output barely expanded in Spain over the year to the September quarter. Activity also continues to contract sharply in Greece in the face of severe austerity measures and a prolonged decline in international competitiveness prior to the global downturn. All of these countries, as well as Portugal, Ireland and even Belgium, face market concerns about the creditworthiness of their governments. Such concerns initially arose in relation to Greece, prompting the emergency bailout package announced in May 2010. In late 2010, Ireland became the focus of sovereign debt concerns, following the news that the Irish government would need to provide further very large capital injections to the Irish banking system. This was the culmination of a series of major shocks to Ireland's economy and domestic banks, and triggered the implementation of a second emergency bailout package within the euro area.

Core inflation generally remains subdued across the advanced economies, although deflation fears have eased in the United States and policy-makers in Europe have noted some signs of emerging price pressures (Graph 1.13). These have been most evident in the United Kingdom, where year-ended core inflation is around 3 per cent, having drifted up since mid 2009 despite GDP remaining well below its pre-crisis level. Headline inflation is higher and likely to remain elevated in the near term due to the 2½ percentage point increase in the VAT rate at the start of January. In the euro area, headline inflation has also been pushed up recently by energy price pressures and increases in a range of tax rates and administered prices.

Commodity Prices

Commodity prices have risen sharply over recent months, reflecting strong demand from Asia and a range of weather-related disruptions to supply.

Graph 1.13
Advanced Economies – Consumer Price Inflation
Year-ended



Sources: Eurostat; Thomson Reuters

In particular, bulk commodity prices have been supported by strong growth in emerging economies, with Asian industrial production expanding at a solid pace over 2010 to a level that is well above the peak reached prior to the global recession (Graph 1.14).

The RBA's Index of Commodity Prices has increased by 12 per cent in SDR terms since the previous *Statement* and is now around 12 per cent above its previous peak in September 2008 (Table 1.2). The strength in commodity prices has boosted the terms of trade to a historically high level and is supporting nominal incomes, as discussed further in the 'Economic Outlook' chapter.

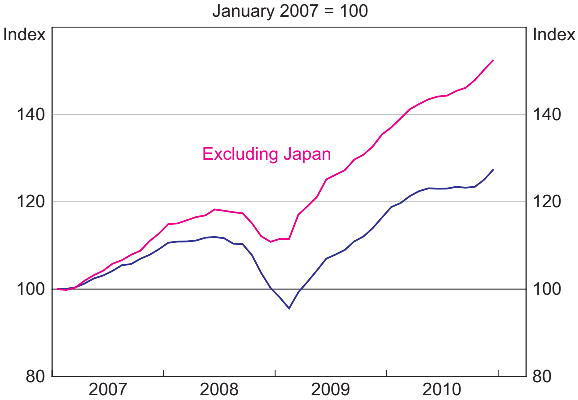
The average export prices of Australia's major bulk commodities (coal and iron ore) are estimated to have increased by around 7–14 per cent in recent months in SDR terms. Spot prices, which typically affect the contract prices that producers receive with a lag, have risen more significantly. In late

Table 1.2: Commodity Price Growth
Per cent, SDR terms

	Since end October 2010	Since end January 2010
RBA index	12	54
– Excluding coal and iron ore	11	31
Bulk commodities	12	82
– Coking coal[(a)]	7	64
– Iron ore[(a)]	14	116
– Thermal coal[(a)]	13	35
Rural	21	51
– Wheat	21	81
– Cotton	42	165
– Sugar	5	26
Base metals	13	31
– Copper	22	47
Gold	–2	23
Oil[(b)]	14	30

(a) RBA estimates for recent months
(b) Average of WTI and Tapis crude oil prices
Sources: Bloomberg; RBA

Graph 1.14
East Asia – Industrial Production
January 2007 = 100



Sources: CEIC; RBA; Thomson Reuters; United Nations

January, the spot price for iron ore was around 30 per cent above the estimated March quarter contract price level, while the spot price for hard coking coal was around 50 per cent above its contract price (Graph 1.15). The strength in the prices of iron ore and coking coal has reflected growth in Chinese steel production as well as significant disruptions to supply. In particular, recent heavy flooding in Queensland's coal producing regions has constrained mine output and hampered transportation to the ports.

The spot price for thermal coal has risen strongly over recent months, supported by strong demand from Northern Hemisphere countries facing unusually cold weather and the disruptions to coal supply in Australia and other key export countries. The Australian thermal coal spot price was around 30 per cent above the current Japanese financial year contract price in early February, suggesting the next contract price will be significantly higher than its current level.

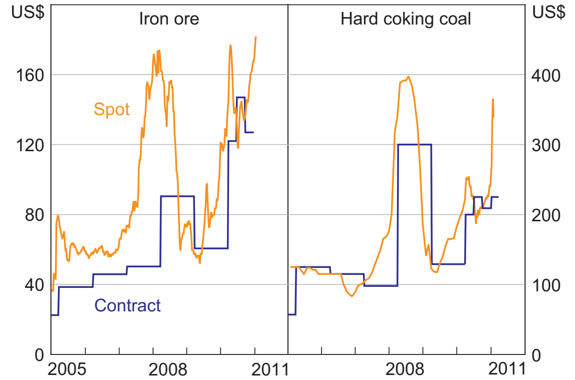
Global food prices have risen further in recent months; the IMF Food Price Index is estimated to have increased by around 34 per cent over the past year to be higher than its previous peak in mid 2008. The recent rise in food prices has been attributed mainly to a range of supply disruptions, with unfavourable weather conditions in a number of key agricultural producing countries weighing on production, particularly for crops such as wheat, corn, sugar and soybeans (Graph 1.16). These supply disruptions have coincided with a period of ongoing strong demand for food commodities. Rising living standards in emerging and developing economies are leading to an increase in demand for higher protein sources of food, which – through demands on land usage and demand for feed grains – is flowing through into broad-based pressure on the prices of food commodities. For example, much of the growth in global grain consumption in recent years has come from Brazil, Russia, India, Indonesia and China. China's domestic grain stocks are at low levels; as a result, grain import volumes increased by around 30 per cent over the year to the December quarter. Reflecting the run-up in global prices, the RBA index of rural prices has increased by 21 per cent since the November *Statement*, to be well above its previous peak in early 2008 (Graph 1.17). Recent price increases have also been partly due to heavy rain in Australia's eastern states, which has damaged wheat and sugar crops and disrupted the supply and distribution of beef.

Exchange-traded mineral commodity prices have also risen since the November *Statement*. The RBA index of base metals prices has risen by around 13 per cent over this period, in part reflecting the ongoing increase in demand for base metals as global industrial production has recovered. Copper prices have risen particularly sharply, as supply has been disrupted in key exporting countries, while demand remains solid. Crude oil prices have also risen over recent months, reflecting unusually cold weather in the Northern Hemisphere and supply disruptions. ✠

Graph 1.15

Bulk Commodity Prices

US$ per tonne, free on board basis

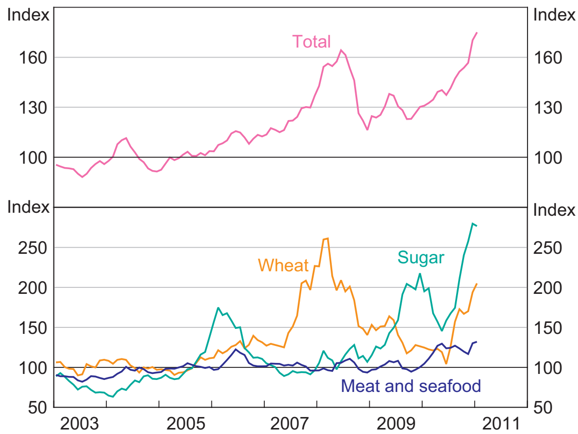


Sources: ABARES; Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA

Graph 1.16

Global Food Commodity Prices*

2005 average = 100, SDR terms



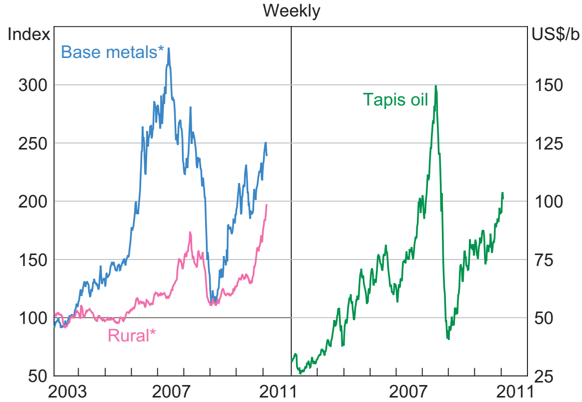
* RBA estimates for January 2011

Sources: IMF; RBA

Graph 1.17

Commodity Prices

Weekly



* 2003 average = 100; SDR terms

Sources: Bloomberg; RBA

2. International and Foreign Exchange Markets

Central Bank Policy

While financial markets continue to expect the US federal funds rate target to remain unchanged through 2011, expectations of initial monetary policy tightening in the euro area and United Kingdom have been brought forward to around mid 2011, in part due to a less benign outlook for inflation. The People's Bank of China has tightened policy further by increasing its lending and deposit policy rates and raising banks' reserve requirement ratios several times, while banks will also be required to bring off-balance sheet lending onto their balance sheets by around the end of the year. Policy rates were also increased in Brazil, India, Israel, South Korea, Sweden, Taiwan and Thailand but were lowered in South Africa (Table 2.1).

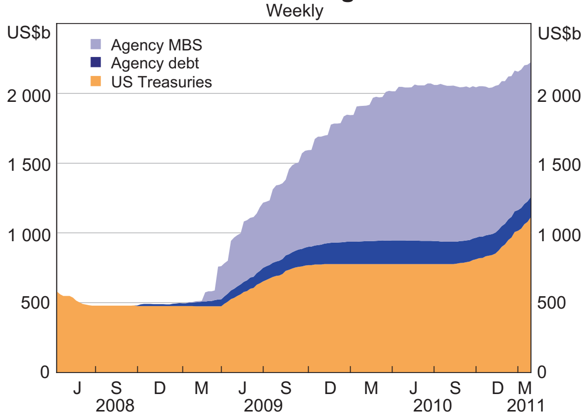
Table 2.1: Policy Rates

	Current level Per cent		Most recent change	Cumulative increase Basis points
Euro area	1.00	↓	May 09	–
Japan	0.05	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Brazil	11.25	↑	Jan 11	250
Canada	1.00	↑	Sep 10	75
China	5.81	↑	Dec 10	50
India	6.50	↑	Jan 11	175
Indonesia	6.50	↓	Aug 09	–
Israel	2.25	↑	Jan 11	175
Malaysia	2.75	↑	Jul 10	75
Mexico	4.50	↓	Jul 09	–
New Zealand	3.00	↑	Jul 10	50
Norway	2.00	↑	May 10	75
Russia	7.75	↓	Jun 10	–
South Africa	5.50	↓	Nov 10	–
South Korea	2.75	↑	Jan 11	75
Sweden	1.25	↑	Dec 10	100
Switzerland	0.25	↓	Mar 09	–
Taiwan	1.625	↑	Dec 10	37.5
Thailand	2.25	↑	Jan 11	100
United Kingdom	0.50	↓	Mar 09	–

Source: central banks

The US Federal Reserve's balance sheet has expanded further following the commencement of its second round of large-scale asset purchases in November. The Fed has purchased around US$200 billion of the US$600 billion purchases of US Treasuries planned by mid 2011 (Graph 2.1). The Fed extended the expiration of its US dollar swap lines with several central banks to 1 August 2011. This was a precautionary move; use of the swap lines has been minimal since their re-establishment in May 2010.

Graph 2.1
Federal Reserve Holdings of Securities
Weekly



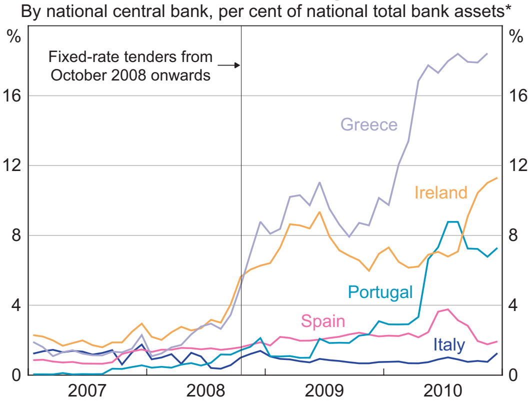
Source: Board of Governors of the Federal Reserve System

The European Central Bank's (ECB) balance sheet has increased marginally in recent months but remains below its peak in June 2010. While the ECB purchased further amounts of sovereign debt during recent bouts of market volatility, liquidity provided through its monetary policy operations fell to the lowest level since September 2008. Lending to Irish banks accounts for around one-quarter of aggregate ECB liquidity outstanding (Graph 2.2). While lending to Irish banks fell marginally in December, this was more than offset by an increase in support provided by the Irish central bank.

Sovereign Debt Markets

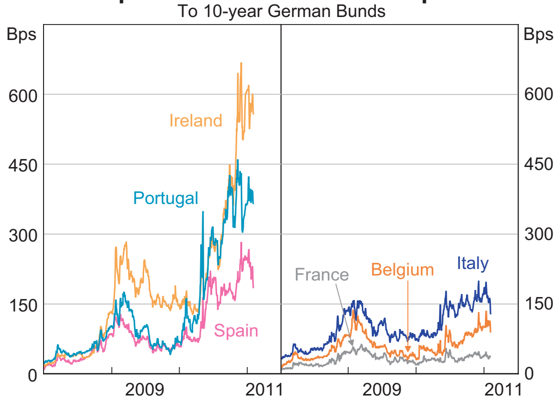
Spreads between yields on most peripheral euro area sovereign bonds and German Bunds reached historic highs in November, with concerns primarily focused on the Irish Government's ability to support the banking sector (Graph 2.3). Spreads narrowed briefly following the announcement of an €85 billion financial assistance package for Ireland, jointly funded by the European Union and IMF. Spreads again widened, however, as financial markets turned their attention to the sustainability of government

Graph 2.2
ECB Lending
By national central bank, per cent of national total bank assets*



* Banks proxied by credit institutions for all countries except Portugal which uses the broader category of monetary financial institutions
Source: central banks

Graph 2.3
European Government Bond Spreads
To 10-year German Bunds



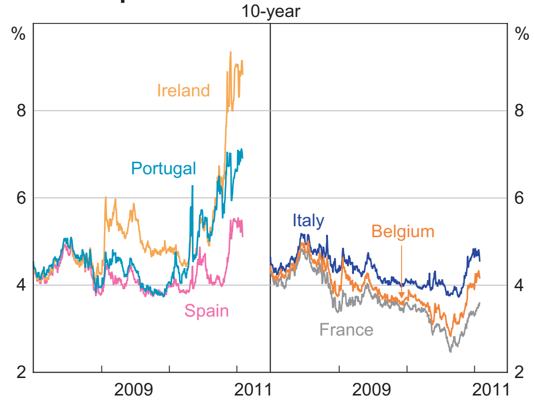
Source: Bloomberg

finances in Portugal, as well as Spain and Belgium (which has had a caretaker government since mid 2010). The Portuguese Government expects to issue debt of around €20 billion (11 per cent of GDP) in 2011, while the Spanish Government expects to issue debt of more than €90 billion (9 per cent of GDP). These amounts are only a little lower than issuance in 2010. Peripheral euro area spreads declined in January as the ECB increased its purchases of sovereign bonds, government bond auctions in Portugal were well received and there was discussion of an expansion of the euro area support facility. However, actual borrowing costs – the level of yields – in the euro area periphery remain elevated (Graph 2.4).

At the same time, longer-term bond yields in the major economies have risen, partly reflecting data showing stronger economic conditions (Graph 2.5). Both 'real' yields and compensation for expected inflation have increased. 10-year government bond yields in the major advanced economies rose to their highest levels since mid 2010. Shorter-term bond yields have also increased after falling to historic lows in 2010. S&P lowered Japan's sovereign credit rating to AA- in late January, citing fiscal concerns, but this had little impact on yields.

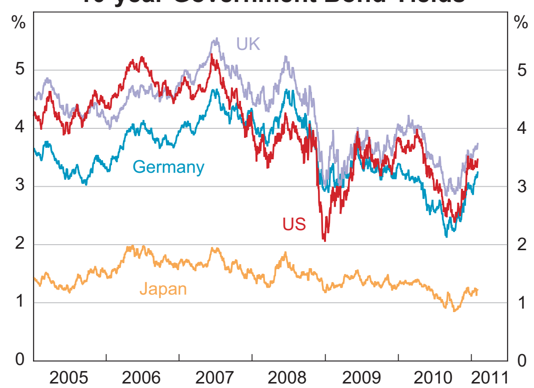
The concerns about the euro area periphery have, to date, not spread to other regions: spreads of emerging market US dollar-denominated sovereign debt have been broadly stable over the past few months after narrowing since mid 2010 (Graph 2.6). In December, S&P raised China's sovereign credit rating to AA-, citing China's large foreign asset position, low levels of public debt and structural reforms during the crisis. Moody's upgraded Indonesia's sovereign rating to the equivalent of BB+.

Graph 2.4
European Government Bond Yields
10-year



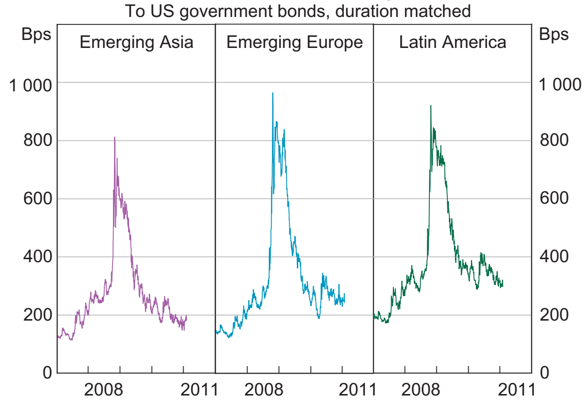
Source: Bloomberg

Graph 2.5
10-year Government Bond Yields



Source: Bloomberg

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



Source: Thomson Reuters

Government Financial Policy

The US Treasury sold its remaining stake in Citigroup, realising a profit of US$12 billion on its US$45 billion investment. AIG and the US Treasury also took further steps towards unwinding AIG's government obligations, using proceeds from asset sales and TARP funds to repay its loans from the New York Fed. Following this repayment, the US Treasury converted some of its preferred shares to common equity and now owns 92 per cent of AIG.

In Europe, the European Council endorsed the creation of a permanent crisis mechanism to safeguard the financial stability of the euro area. In mid 2013, the European Stability Mechanism (ESM) will replace the European Financial Stability Facility initiated in May 2010 following the support package for Greece. The ESM will be able to provide financial assistance to euro area governments under strict conditionality. Claims of private creditors on these governments will be subordinated to those of the ESM and IMF. In the event that a member state which has received ESM support is subsequently considered insolvent, the government will be required to negotiate a restructuring plan with private-sector creditors to restore debt sustainability. In addition, all new euro area government bonds issued from mid 2013 will include collective action clauses to enable a majority of private creditors to vote for a legally binding change to a sovereign's terms of payment – an extension of the maturity, interest rate cut and/or 'haircut' – in the event that the sovereign is unable to pay its obligations.

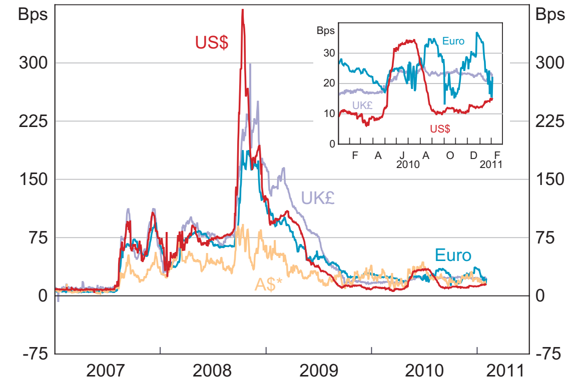
The European Commission launched a public consultation paper on a possible European Union framework for crisis management. Alongside more traditional resolution tools, such as creating a 'bridge bank' or effecting a 'good bank/bad bank' split, the consultation paper discusses a 'last resort' proposal for converting to equity, or writing down debt, to the extent needed to ensure a financial institution's viability. This would be achieved either by allowing authorities to determine bond holders' losses or requiring banks to issue a certain amount of 'bail-in' debt that could be written off or converted into equity on a specified trigger. The European Commission's proposal has the potential to impose losses on a broader range of debt holders than recently announced Basel Committee on Banking Supervision (BCBS) proposals that apply to subordinated debt but not senior debt.

Following its announcement in September concerning proposed changes to capital requirements under Basel III, the BCBS has advised national authorities of alternative treatments for banks' liquidity coverage ratio (LCR) in jurisdictions where the supply of liquid assets (primarily government debt) is insufficient to meet the total demand of resident banks. One such treatment is to allow banks to establish contractual committed liquidity facilities provided by their central bank, subject to an appropriate fee, with such facilities counting towards the LCR requirement. This approach will be taken in Australia (see the 'Domestic Financial Markets' chapter for further discussion).

In addition, the BCBS provided further guidelines on banks' required countercyclical capital buffers. The guidelines envisage national authorities raising minimum capital requirements by as much as 2.5 percentage points during periods of 'excessive' aggregate credit growth, as determined by the national authorities. For internationally active banks, the additional capital requirement will be a weighted average of the buffers deployed across all the jurisdictions to which they have credit exposures.

The Irish Government passed the *Credit Institutions (Stabilisation) Act* in December which gives the government broad powers to force subordinated bondholders to share the cost of rescuing a bank. Following the approval of the Act, the Irish Government announced that the National Pensions Reserve Fund would provide a further €3.7 billion in capital support to Allied Irish. The Irish Government's 'bad bank', the National Asset Management Agency, reported that it had met its objective of acquiring problem loans with a nominal value of around €71 billion (45 per cent of GDP) from Irish banks. On average, these loans were acquired at a 58 per cent discount to the nominal value.

Graph 2.7
3-month LIBOR Spreads
To overnight indexed swaps



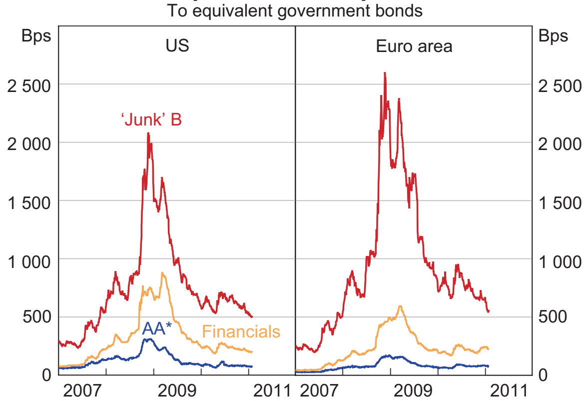
* Bank bills to overnight indexed swaps
Sources: Bloomberg; Thomson Reuters; Tullett Prebon (Australia) Pty Ltd

Credit Markets

Conditions in credit markets have been mixed in recent months. In the euro area, spreads between money market rates and expected policy rates have been volatile (Graph 2.7). Money market spreads in other major economies, however, have been relatively stable.

Corporate debt market conditions have also been mixed. In the United States, spreads between yields on corporate bonds (both financial and non-financial) and US Treasuries have declined in recent months to be around the levels prior to the Greek crisis in May 2010 (Graph 2.8). In contrast, spreads on euro area financial institution bonds increased to their highest levels since mid 2010. In both markets, spreads on higher-yield 'junk' bonds have fallen to their lowest levels since around end 2007.

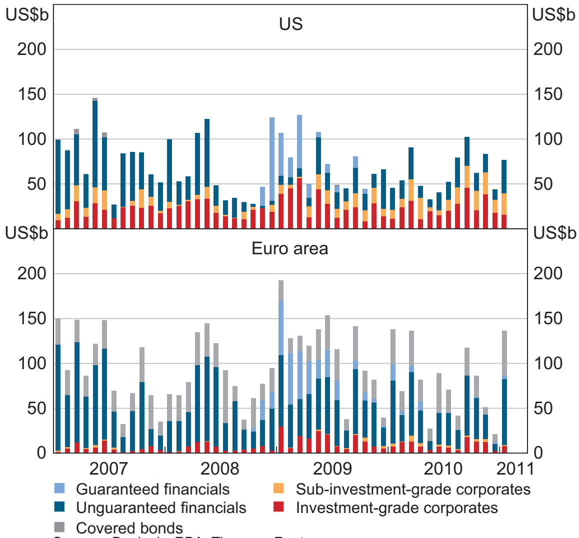
Graph 2.8
Corporate Bond Spreads
To equivalent government bonds



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

Corporate bond issuance in the United States has remained strong and in the euro area rose significantly in January following limited issuance in December (Graph 2.9). Portuguese, Irish and Spanish banks face relatively large debt maturities in the first half of 2011. More generally, there is a sizeable amount of debt issued by financial institutions globally to be refinanced in the first half of the year. While investors will obviously need to re-invest the maturing funds, there may be more discrimination than previously between weaker and stronger financial institutions.

Graph 2.9
Corporate Bond Issuance
Monthly



Sources: Dealogic; RBA; Thomson Reuters

Table 2.2: Changes in International Share Prices
Per cent

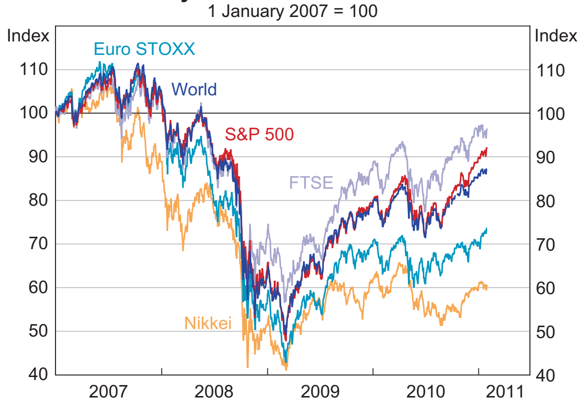
	Over 2010	Since previous *Statement*
United States		
– Dow Jones	11	7
– S&P 500	13	9
– NASDAQ	17	8
Euro area		
– STOXX	0	6
United Kingdom		
– FTSE	9	4
Japan		
– Nikkei	–3	14
Canada		
– TSE 300	14	8
Australia		
– ASX 200	–3	2
China		
– China A	–14	–8
MSCI Indices		
– Emerging Asia	12	0
– Latin America	7	–4
– Emerging Europe	16	7
– World	**8**	**6**

Source: Bloomberg

Equities

Over 2010, there was quite a divergence in equity market performance (Graph 2.10, Table 2.2). While equity prices in the United States and United Kingdom recorded solid increases, equity prices fell in Japan, largely reflecting the appreciation of the yen, although Japanese markets have outperformed those in other major advanced economies markedly in recent months. Despite a recent recovery, European equity prices and particularly those of euro area banks have underperformed most other major equity market prices. Chinese equity prices fell by nearly 15 per cent over 2010, with much of the fall in recent months reflecting ongoing concerns about Chinese policy tightening.

Graph 2.10
Major Share Price Indices
1 January 2007 = 100

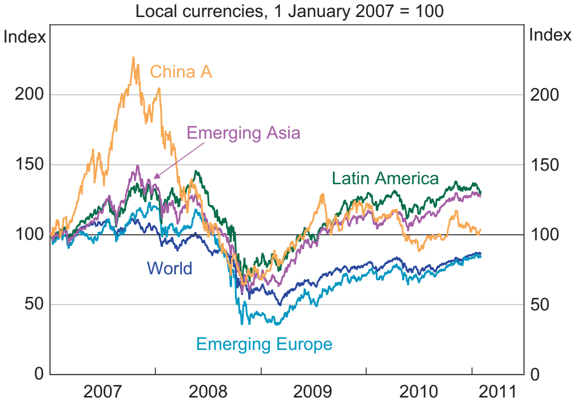


Source: Bloomberg

In recent months, global equity prices have increased to their highest level since September 2008. Prices have been supported, particularly in the United States, by increased investor risk appetite, reflecting the improving economic outlook, the Fed's large-scale asset purchases and generally better-than-expected corporate earnings reports. However, US bank earnings for the December quarter were mixed: some earnings results were below analyst expectations but underlying profits generally rose in the quarter. Loan-loss provisions continued to decline on an improved outlook for credit quality. Some banks increased reserves, however, for any litigation and restitution of funds resulting from mortgage buy-backs. Generally, revenue was adversely affected by banks' trading activities, particularly in fixed income.

Emerging market equity prices generally outperformed those in developed markets over 2010, although they have been mixed in recent months (Graph 2.11). Concerns about policy tightening in China have also contributed to the recent underperformance of some other emerging Asian equity markets. Latin American equity prices have also underperformed recently over concerns about the impact that inflation and currency appreciation may have on the region's economic recovery.

Graph 2.11
MSCI Share Price Indices
Local currencies, 1 January 2007 = 100

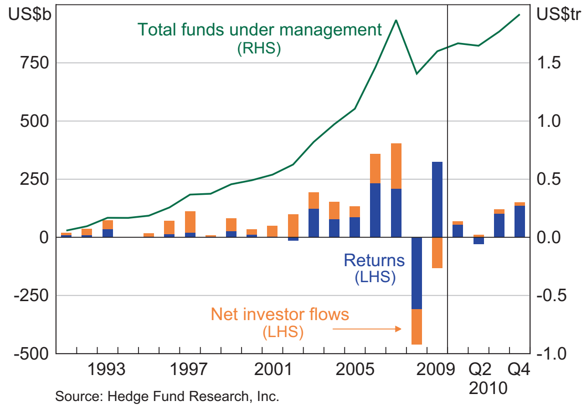


Source: Bloomberg

Hedge Funds

Hedge funds underperformed equity markets over the second half of 2010. However, over 2010 as a whole, the average return on hedge funds was 10 per cent, broadly in line with equity market returns over the year. Most of the increase in funds under management over 2010 has been driven by

Graph 2.12
Global Hedge Funds



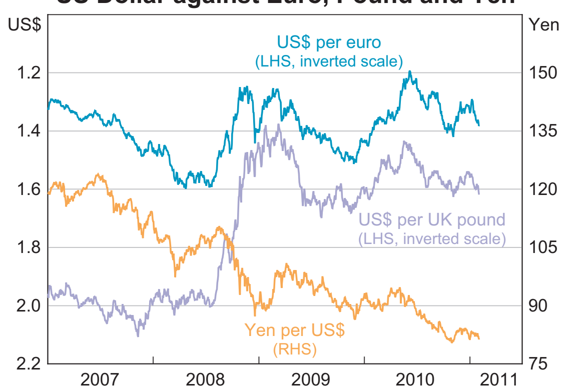
Source: Hedge Fund Research, Inc.

returns, although investors have also increased their exposure to hedge funds, making small positive capital contributions over the past four quarters (Graph 2.12). Funds under management have now reached US$1.9 trillion, regaining the previous high in mid 2008.

Foreign Exchange

Concerns about European sovereign debt have continued to dominate developments in major foreign exchange markets, albeit with some improvement in investor sentiment towards the euro in recent weeks (Table 2.3). From around mid 2010 to early November, the US dollar depreciated against the other major currencies including the euro (Graph 2.13). However, news of the Irish

Graph 2.13
US Dollar against Euro, Pound and Yen



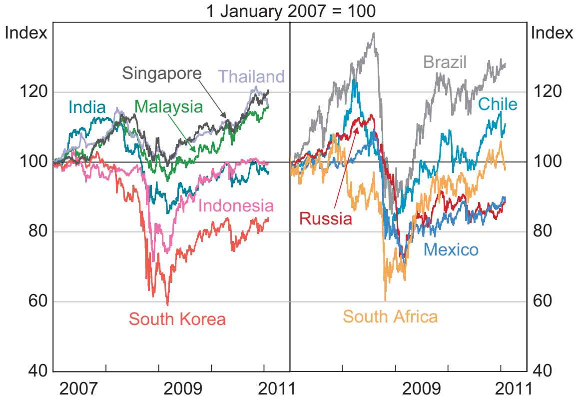
Source: Bloomberg

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

	Past year	Since previous *Statement*
European euro	1	2
Indian rupee	–1	3
UK pound sterling	–1	–1
Chinese renminbi	–4	–1
Indonesian rupiah	–4	1
South African rand	–4	4
South Korean won	–4	–1
Philippine peso	–5	4
Mexican peso	–7	–2
Canadian dollar	–7	–2
Thai baht	–7	4
New Zealand dollar	–8	0
Brazilian real	–9	–2
New Taiwan dollar	–9	–5
Singapore dollar	–10	–1
Japanese yen	–10	1
Swiss franc	–11	–3
Malaysian ringgit	–11	–1
Swedish krona	–11	–2
Australian dollar	–12	0
Majors TWI	**–4**	**0**
Broad TWI	**–5**	**–1**

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

Graph 2.14
Selected Currencies against the US Dollar
1 January 2007 = 100



Source: Bloomberg

support package and concerns over the fiscal positions of other peripheral euro area economies weighed on the euro from early November to early January. During this period, the euro depreciated by 8 per cent against the US dollar. Investor sentiment towards the euro improved during January following the well-received debt auctions by Portugal, and also Italy and Spain. Safe-haven buying of the Swiss franc saw it reach a record high against the euro in December.

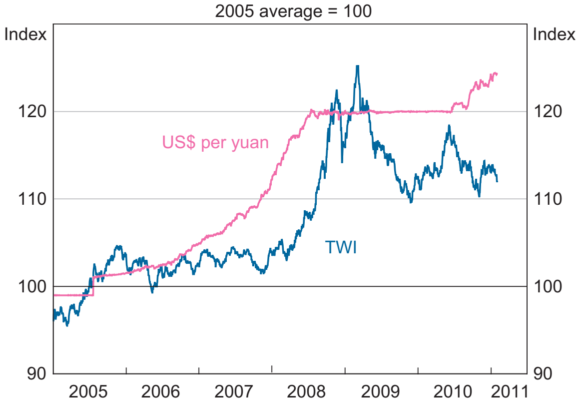
The currencies of many emerging economies of Asia and South America have continued to face strong appreciation pressures, with a number of currencies reaching highs against the US dollar, as investors continued to seek out higher-yielding assets. Among the Asian currencies, the Malaysian ringgit, New Taiwan dollar and Thai baht all reached 13-year highs, and the Singapore dollar reached a record high (Graph 2.14). Elsewhere, the Brazilian real, the Chilean peso and South African rand recorded their highest levels against the US dollar for at least two years. The Canadian dollar also approached record high levels against the US dollar in early January, supported by rising commodity prices and speculation of faster economic recovery in the United States.

In an effort to curb capital inflows, a number of Asian countries have introduced additional measures in recent months. South Korean authorities re-imposed a 14 per cent withholding tax on foreign investors' earnings from government bonds and have announced plans to impose a 'Macro-prudential Stability Levy' on non-deposit foreign currency liabilities of financial institutions. Taiwanese authorities now limit foreigners to hold no more than 30 per cent of their investment in Taiwan in government bonds and in Indonesia the central bank introduced measures designed to limit rupiah deposits held by foreigners.

In Latin America, authorities in Brazil and Chile intervened in foreign exchange markets in an effort to reduce appreciation pressure on their currencies. The Central Bank of Chile announced that it would buy US$12 billion of foreign exchange over 2011. The Chilean peso has depreciated by around 3 per cent since its peak in early January. In January, the Central Bank of Brazil acted in the futures market to reduce pressure on its exchange rate, having introduced a reserve requirement on short US dollar positions earlier in the month. At the same time, however, Brazil has eased some of its capital controls as it seeks foreign capital to finance the infrastructure required to host the 2014 World Cup and 2016 Olympics.

The Chinese renminbi has appreciated by around 4 per cent against the US dollar since mid June when the People's Bank of China announced that it would increase the flexibility of the exchange rate (Graph 2.15). However, over this period the renminbi has depreciated by around 3 per cent in trade-weighted terms. The premium in the non-deliverable forward market indicates an expected further appreciation of around 2 per cent against the US dollar over the next 12 months. Over recent months, China has introduced a number of additional measures as part of the incremental easing of restrictions on the convertibility of the renminbi and its use by foreigners: exporters are able to keep foreign exchange income offshore without converting it back into renminbi; and, under a pilot scheme announced by the People's Bank of China, mainland enterprises can conduct direct overseas investment using renminbi. At the same time, domestic banks are now required to maintain a minimum foreign exchange position set at the level held on 8 November 2010.

Graph 2.15
Chinese Renminbi
2005 average = 100

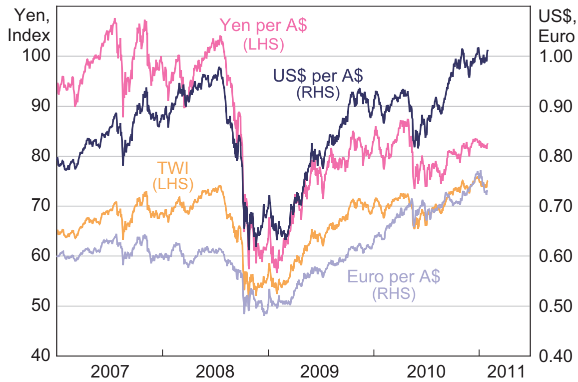


Sources: BIS; Bloomberg; RBA

Australian Dollar

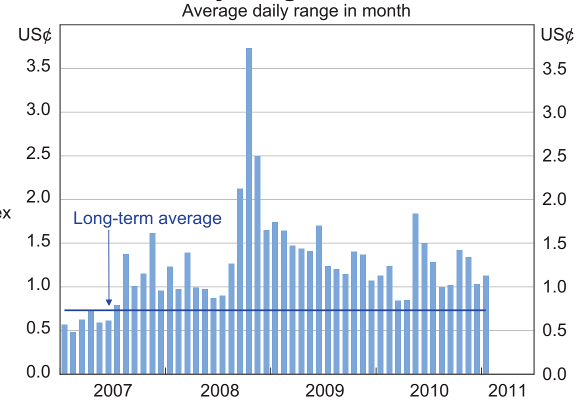
The Australian dollar remains close to its post-float highs (Graph 2.16, Table 2.4). It recorded a new post-float high against the US dollar in thin trading on the last trading day of 2010. Developments in the Australian dollar over recent months have been strongly influenced by offshore events, particularly news related to European sovereign debt. Uncertainty in the foreign exchange market continues to be reflected in above-average intraday volatility of the currency (Graph 2.17).

Graph 2.16
Australian Dollar



Sources: RBA; Thomson Reuters; WM/Reuters

Graph 2.17
Intraday Range in AUD/USD
Average daily range in month



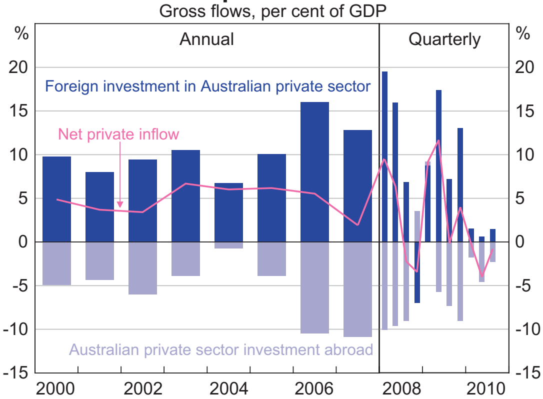
Source: Bloomberg

Table 2.4: Australian Dollar against Selected TWI Currencies
Per cent

	Change over past year	Change since previous *Statement*	Deviation from post-float average
European euro	15	3	10
US dollar	14	0	38
Indian rupee	13	3	69
UK pound sterling	12	0	38
Indonesian rupiah	11	1	136
Chinese renminbi	10	–1	41
South Korean won	9	0	60
South African rand	9	5	59
Thai baht	7	4	31
Canadian dollar	6	–2	7
New Zealand dollar	3	0	5
Singapore dollar	3	–1	3
Japanese yen	2	1	–12
Malaysian ringgit	2	–1	36
Swiss franc	1	–3	–11
TWI	**9**	**0**	**26**

Sources: Bloomberg; Thomson Reuters; W/M Reuters

Graph 2.18
Capital Flows
Gross flows, per cent of GDP



Sources: ABS; RBA

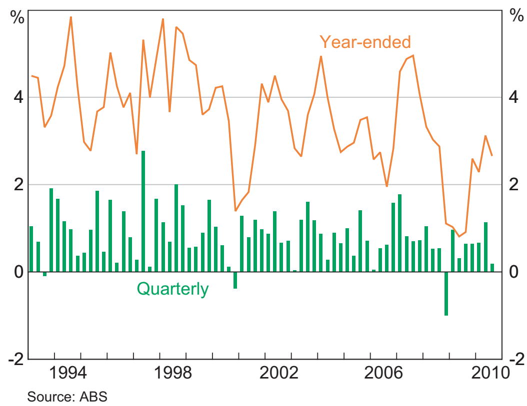
Capital Flows

Over the first three quarters of 2010, the domestic banking sector issued less debt abroad than that maturing, largely accounting for net outflows from the private sector as a whole (Graph 2.18). This is in contrast to the strong issuance over 2009. There were larger inflows into government debt, with net foreign investment in government securities equivalent to around 4 per cent of GDP over the first three quarters of 2010.

3. Domestic Economic Conditions

Activity in the Australian economy grew at a solid pace over the second half of 2010. Strong demand for Australian commodities is underpinning growth in national income and a high level of business investment, while growth in household consumption remains relatively subdued. The latest available data for real GDP show growth of 2.7 per cent over the year to September, with nominal income up by nearly 10 per cent over the year due to the increase in the terms of trade (Graph 3.1, Table 3.1). Employment growth continues to be strong and business conditions – as measured by surveys – remain generally positive.

Graph 3.1
GDP Growth



Heavy rainfall and the associated widespread floods across eastern Australia in December and January will have a noticeable effect on output in the December, March and June quarters. In particular, coal production has declined significantly over recent months, and economic activity has been disrupted in the flood-affected areas. It is expected that coal production will recover over coming months and the rebuilding of flood-damaged property and infrastructure will provide a mild boost to demand from the middle of 2011. The effects will be most

Table 3.1: Demand and Output Growth
Per cent

	September quarter 2010	Year to September quarter 2010
Domestic final demand	0.6	4.4
– Private demand	0.6	3.0
– Public demand	0.9	8.9
Change in inventories[(a)]	–0.2	–0.1
GNE	0.4	4.3
Net exports[(a)]	–0.4	–1.8
GDP	0.2	2.7
Nominal GDP	1.2	9.6

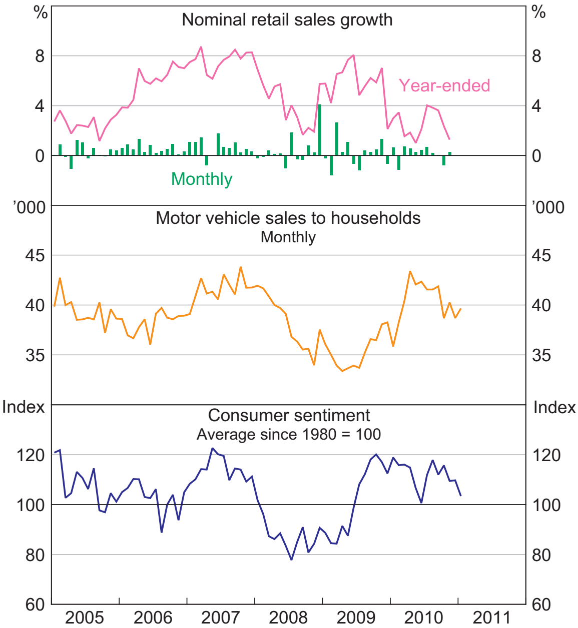
(a) Contribution to GDP growth
Source: ABS

evident in Queensland, where the severest flooding has occurred (see 'Box A: The Impact of the Recent Floods on the Australian Economy').

Household Sector

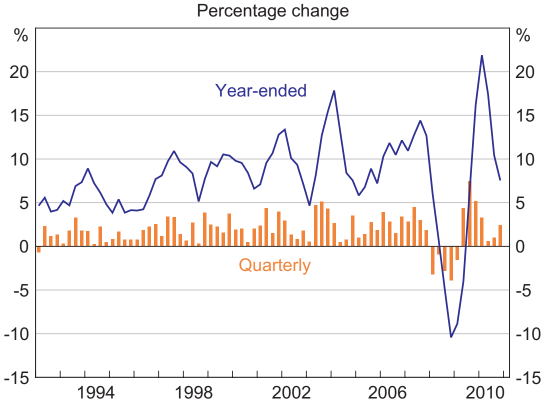
Indicators of household consumption suggest that households remained cautious in their spending behaviour in the December quarter. Data to November showed only modest growth in retail sales, while motor vehicle sales to households have also softened recently, after a boost in early 2010 due to the replacement of hail-damaged cars (Graph 3.2). Liaison with retailers suggests sales improved for some firms in December and January, but there are few signs that consumers are becoming less cautious. Retailers note that households continue to display a reduced willingness to buy products that are not on sale and have been trading down to less premium brands. While growth in most components of household consumption has been modest, there has been strong growth in online purchases of goods, although this type of spending is still relatively small in comparison to total consumption. For further discussion, see 'Box B: Online Spending by Households'.

Graph 3.2
Consumption Indicators



Sources: ABS; FCAI/VFACTS; Melbourne Institute and Westpac; RBA

Graph 3.3
Household Net Worth*
Percentage change



* RBA estimate for December quarter 2010
Sources: ABS; APM; RBA

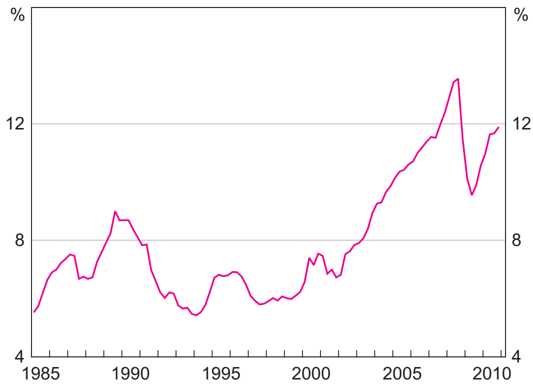
This restraint in household spending is occurring despite around-average levels of consumer sentiment and solid growth in household income. Recent revisions to income and consumption have led to a significant upward revision to the household saving ratio, which is now at levels last seen in the late 1980s. A more detailed discussion of the household saving ratio is provided in 'Box C: The Increase in the Household Saving Ratio'. Other indicators of savings have also shown an increase, although generally not to the same extent as the saving ratio; for example, housing equity injection is estimated at around 4 per cent of household disposable income, which is around levels recorded over the second half of the 1990s but below the 6 per cent recorded in the late 1980s.

Household net worth is estimated to have increased by around 2½ per cent in the December quarter and 7½ per cent over the year, with growth in the December quarter driven by a moderate increase in equity prices (Graph 3.3). Net worth remains around six times annual household disposable income. Household interest payments are estimated to have increased slightly to 12 per cent of disposable income in the December quarter, reflecting the increase in mortgage rates (Graph 3.4). Household debt has continued to grow at a much slower rate than in earlier years, and the household debt to income ratio has fallen modestly recently.

Housing prices have been largely unchanged over the past few months, with data from private-sector providers showing nationwide prices broadly flat in the December quarter. By city, prices have increased modestly in Sydney and Melbourne, while prices have continued to fall in Perth and Brisbane (Graph 3.5, Table 3.2). Overall, prices were around 5 per cent higher over the year. Auction clearance rates, which are a timely indicator of housing market conditions, are currently a little above long-run average levels in Sydney and a little below average levels in Melbourne.

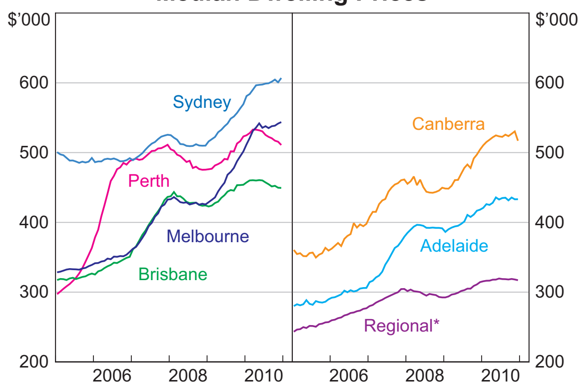
Indicators of house building have softened over the past year, as the effects from higher grants for first-home buyers have been unwinding and borrowing rates have increased. However, building approvals for apartments have increased significantly, led by growth in Victoria (Graph 3.6). Public residential approvals have fallen as the impetus from the Social and Defence Housing Initiative has faded. If maintained, the flow of monthly approvals in late 2010 implies around 160 000 commencements a year, which is around average levels seen over the past two decades, at a time when population growth remains above

Graph 3.4
Household Interest Payments*
Per cent of household disposable income



* Excludes unincorporated enterprises; income is before the deduction of interest payments; RBA estimate for December quarter 2010
Sources: ABS; RBA

Graph 3.5
Median Dwelling Prices



* Excluding apartments; measured as areas outside of capital cities in New South Wales, Queensland, South Australia, Victoria and Western Australia
Sources: RBA; RP Data-Rismark

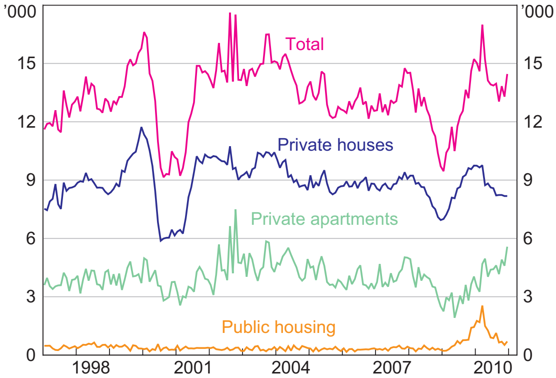
Table 3.2 National Housing Price Growth
Per cent

	3 months to September 2010	3 months to December 2010	Year to December 2010
Capital cities			
ABS[(a) (b)]	–0.3	0.7	5.8
APM	0.9	–0.4	4.7
RP Data-Rismark	–0.1	0.4	4.7
Regional areas			
APM[(b)]	–0.4	0.2	1.2
RP Data-Rismark[(a)]	–0.4	–0.4	0.8

(a) Detached houses only
(b) Quarter-on-quarter growth rate
Sources: ABS; APM; RBA; RP Data-Rismark

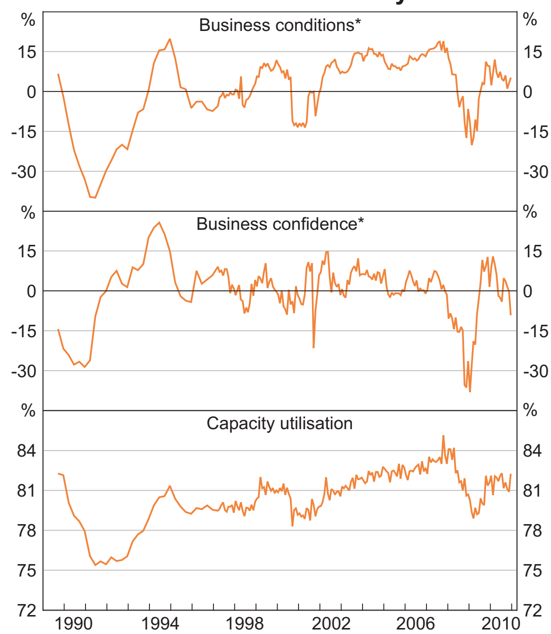
average. Partly reflecting softness in homebuilding in recent years, rental vacancy rates are tight in a number of cities, with the national vacancy rate estimated to have fallen to a little below 2 per cent in the September quarter.

Graph 3.6
Residential Building Approvals
Monthly



Source: ABS

Graph 3.7
NAB Business Survey



* Net balance; deviation from average since 1989
Sources: NAB; RBA

Business Sector

Measures of business conditions are around average levels, although down somewhat from early 2010 (Graph 3.7). Expectations of future conditions vary significantly across industries, with confidence highest in the resources sector. In contrast, both survey data and liaison suggest that the strong Australian dollar is weighing on the manufacturing and tourism industries, while subdued consumer spending is weighing on retailing (Graph 3.8). Surveys suggest that overall capacity utilisation is around average levels.

Mining sector investment is at a historically high level and is expected to increase significantly in coming years (Graph 3.9). There is a large stock of work in the pipeline, with work on the $43 billion Gorgon LNG project and a range of other projects, including in the iron ore sector, now underway. In addition, plans for a number of large resource projects have advanced significantly in the past few months. Notably, two large coal-seam methane projects in Queensland have recently received final investment approval; the $15 billion Curtis Queensland LNG project at the end of October and the $16 billion Gladstone LNG project in mid January. While the recent floods are likely to cause some delays to coal mining construction activity in the near term, the high level of commodity prices and robust outlook for growth in China and other trading partners in Asia are contributing to a strong medium-term outlook for investment in the mining sector.

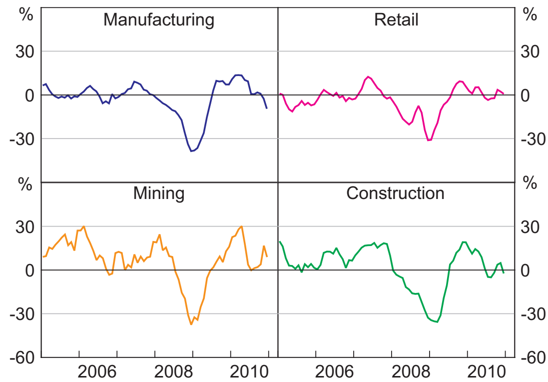
Outside the mining sector, liaison suggests that firms remain cautious in their investment decisions. The tourism industry has experienced a marked decline in domestic visitor travel as short-term overseas departures have risen steadily in response to the lower relative cost of holidays abroad (Graph 3.10). While the number of short-term overseas arrivals into Australia has remained broadly steady, average real expenditure by overseas visitors has declined. In the manufacturing industry, the high Australian dollar is weighing on import-competing and export-oriented businesses, while manufacturers focused on the domestic market (particularly those servicing the mining sector) report that they have experienced solid demand.

Non-residential construction activity remains relatively subdued. Excluding public spending on education facilities, the value of private non-residential building approvals remains below the peak levels seen in 2007, although it has risen somewhat from the low levels seen in 2009 and early 2010. The Bank's liaison program continues to report that some developers are experiencing difficulty in gaining access to finance for new projects and private demand for non-residential construction projects remains weak overall. However, there are reports that demand is beginning to recover in some areas, and office markets in some capital cities are likely to tighten over the next few years, due to strong tenant demand and modest planned additions to the existing stock.

Company profits remained broadly unchanged at a high level in the September quarter. Over the year to September 2010 profits increased by 20 per cent, to around 19 per cent of GDP, only slightly below the peak reached in September 2008. The recent growth in profits has been driven by the mining sector, which saw profits rise by over 60 per cent over the year (Graph 3.11). The strong profit figures have translated to robust internal funding, which coupled with solid equity raisings has partly offset declining business credit.

Graph 3.8

Business Confidence – Selected Industries*

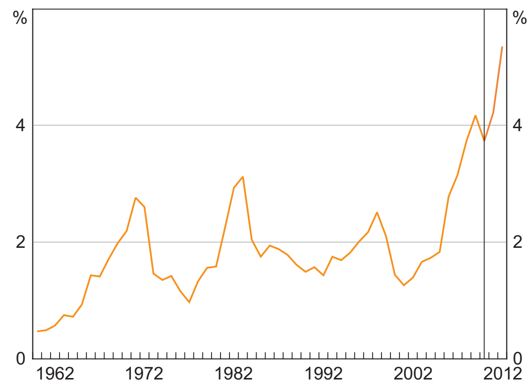


* Net balance; deviation from average since 1989; three-month moving average
Sources: NAB; RBA

Graph 3.9

Mining Investment*

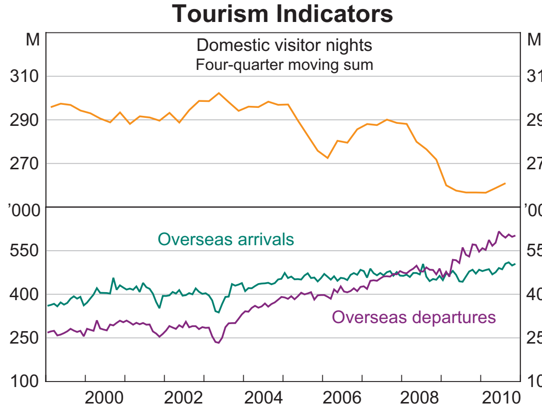
Share of nominal GDP



* Financial year; RBA forecasts for 2010/11 and 2011/12
Sources: ABS; RBA

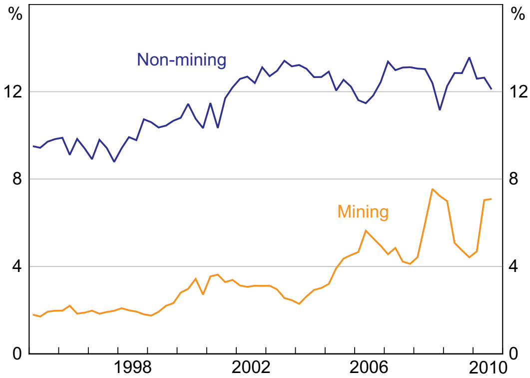
Graph 3.10

Tourism Indicators



Sources: ABS; Tourism Research Australia

Graph 3.11
Private Non-financial Corporation Profits*
Share of nominal GDP



* Gross operating profits; inventory valuation adjusted
Sources: ABS; RBA

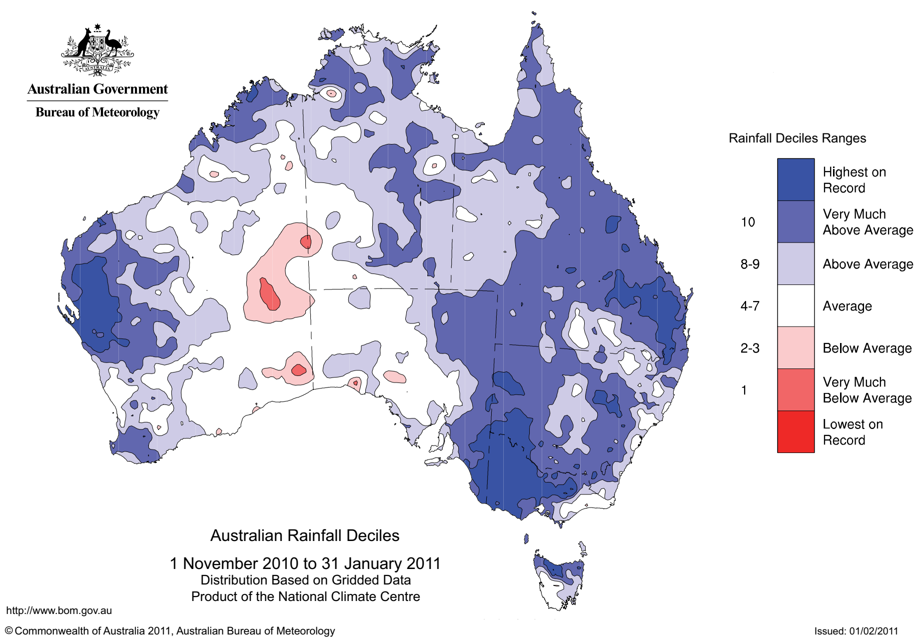
Government Spending

The expected rebalancing of growth from public to private demand has started, with the effect of the earlier fiscal stimulus likely to unwind over the next few quarters. Public demand was broadly unchanged over the middle quarters of 2010, after contributing significantly to GDP growth in 2009 and early 2010. The expected decline in public investment, as stimulus-related projects draw to completion, is likely to be partly offset by an increase in government expenditure associated with replacing and repairing flood-damaged infrastructure.

Farm Sector

The outlook for the farm sector has been affected by the heavy rainfall in the eastern states in recent months. A La Niña weather pattern is well established, as indicated by the Southern Oscillation Index which is at extremely high levels. Consistent with this, there has been record or well above-average rainfall in most parts of eastern and northern Australia in recent months (Graph 3.12). This weather pattern has brought widespread flooding to central and southern Queensland, New South Wales and Victoria which has resulted in heavy damage to crops.

Graph 3.12
Australian Rainfall
1 November 2010 to 31 January 2011



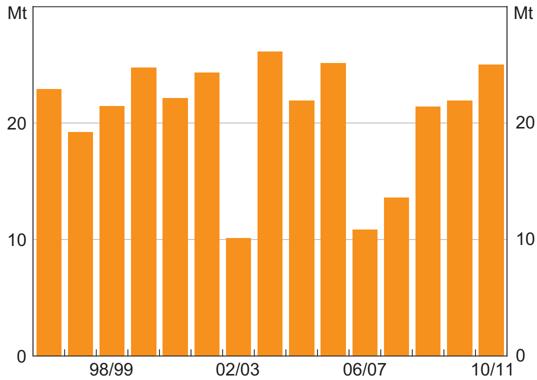
Crop growing conditions had been favourable up until the end of November, but heavy rain and flooding in December caused delays in the harvest of wheat and other winter crops. In contrast, damage to crops from plague locusts appears to be smaller than expected as a result of the combination of spraying of insecticides and wet and cool weather. The national wheat crop is estimated at close to 25 million tonnes, up from 22 million tonnes in 2009, although up to 50 per cent of this year's crop has been downgraded from milling to feed wheat (Graph 3.13). In Queensland, protracted wet conditions have prevented the harvesting of some cane and reduced the sugar content of the harvest. Fruit and vegetable production in Queensland and Victoria will also be significantly affected in coming months. Meat production has been constrained by difficulties in delivering livestock to market, as well as by farmers reducing sales of livestock in response to improved pasture which allows them to rebuild herds.

Inflows into the Murray-Darling basin in December were the highest December reading in 130 years of records, and total inflows in 2010 were the highest in a calendar year since 1996. In aggregate, non-metropolitan dams in Victoria and New South Wales are at about 80 per cent of capacity, while most dams in Queensland are full.

External Sector

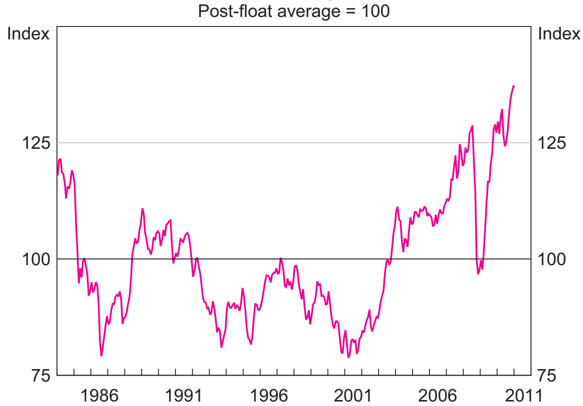
Export revenues have been boosted by a significant increase in commodity prices, contributing to trade surpluses over the past year. Higher commodity prices have taken the terms of trade to record levels and a further increase is likely in the near term as weather-related supply constraints and strong demand increase the price of Australian exports. Although the terms of trade are expected to ease over the medium term as additional supply comes online, they are expected to remain at high levels. The increase in the terms of trade, as well as the large interest rate differential between Australia and most other advanced economies, has been associated with an appreciation of the exchange rate. In real terms the exchange rate is at a multi-decade high and around 37 per cent above its post-float average (Graph 3.14).

Graph 3.13
Wheat Production*



* RBA estimate for 2010/11
Sources: ABARES; RBA

Graph 3.14
Real Exchange Rate
Post-float average = 100



Sources: ABS; RBA; Thomson Reuters

Table 3.3: Components of Exports

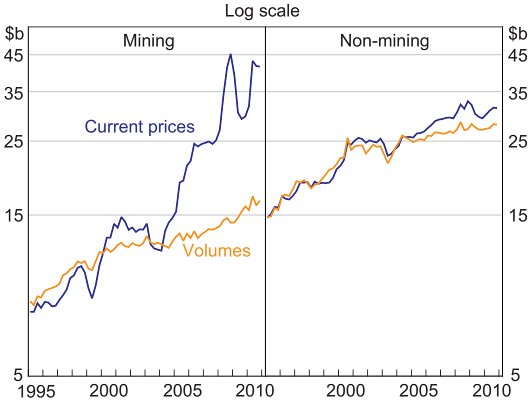
Per cent; current prices

	Share of total exports 2010	Growth over year to December 2010
Resources	56	44
– Iron ore[(a)]	17	105
– Coal[(a)]	15	35
Rural	10	19
Services	19	1
Manufacturing	11	2
Total	100	25

(a) RBA estimates
Sources: ABS; RBA

Export values grew strongly through 2010, with particularly strong growth in the value of iron ore exports (Table 3.3). Coal exports, which accounted for 15 per cent of the value of exports of goods and services in 2010, also grew strongly but heavy rain in Queensland in late 2010 severely disrupted coal production at the end of the year. As discussed in Box A, flooding forced the temporary closure of a number of Queensland mines and rail lines in December and January. While inventories were used to continue shipments in December, it is likely coal export volumes will decline sharply in the March quarter. Assuming no significant damage to infrastructure or further adverse weather, coal production and exports are expected to recover in the June and September quarters. In contrast, the volume of iron ore exports increased by around 10 per cent over 2010 as capacity has continued to expand. Looking ahead, significant expansions to mines and infrastructure capacity are expected to provide a substantial boost to exports in coming years, particularly in iron ore, coal and LNG (Graph 3.15).

Graph 3.15
Exports*
Log scale



* Volumes data referenced to 2003/04 prices; RBA estimates for December quarter 2010
Sources: ABS; RBA

Rural export revenues also increased strongly over the year, reflecting higher global prices and strong growth in cereal exports. Rural export volumes are estimated to have been roughly flat in the December quarter, following very strong growth in the September quarter driven by higher wheat exports. Services exports are estimated to have declined in the December quarter, partly reflecting the high Australian dollar which is depressing tourist arrivals and boosting overseas departures.

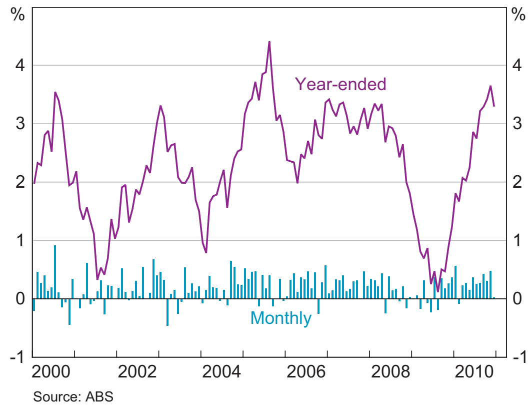
After rebounding sharply in 2009/10, growth in import volumes slowed in the second half of 2010. Imports are expected to grow at an above-average pace going forward, reflecting the relatively high exchange rate and expected growth in domestic demand, with particular strength in imports of equipment for the mining sector.

Labour Market

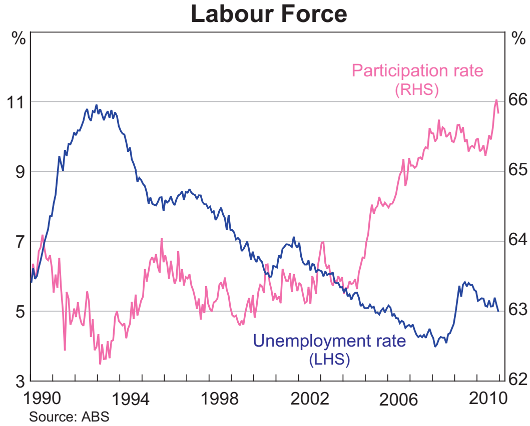
Labour market conditions have remained positive in recent months. Employment has continued to grow strongly, increasing by 1.0 per cent in the December quarter, to be 3.3 per cent higher over 2010 (Graph 3.16). This compares with average annual growth of 2.4 per cent over the past decade. The unemployment rate declined to 5 per cent in December, to be ¾ percentage point below its peak in mid 2009 and around the levels recorded between mid 2005 and early 2006 (Graph 3.17). By state, the lowest unemployment rates were recorded in Western Australia and New South Wales, while the highest were recorded in Queensland and South Australia.

The modest decline in the unemployment rate over late 2010 occurred alongside a large increase in the labour force. The participation rate reached 66 per cent in November – the highest level recorded since the labour force survey began in 1960 – before declining modestly in December. All age groups recorded an increase in participation over the second half of 2010. The participation rate has been trending upwards since the 1980s, particularly for females and older workers. The trend increase in female participation has been associated with a range of factors, including increased educational attainment, lower fertility rates (until recently), improved access to childcare, more flexible work arrangements, an increase in part-time employment opportunities and the expansion of the services sector. The increase in the participation rate of older workers is consistent with improved employment opportunities, reduced retirement rates and the rise in longevity.

Graph 3.16
Employment Growth
Per cent

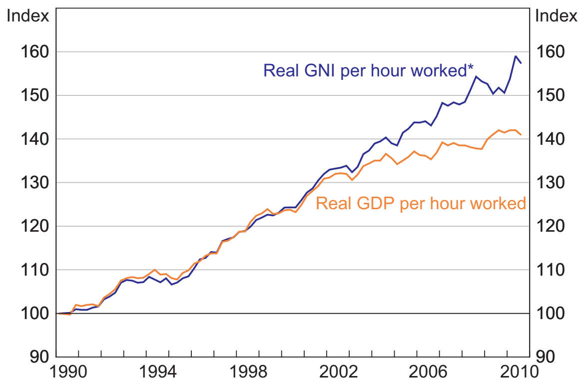


Graph 3.17
Labour Force



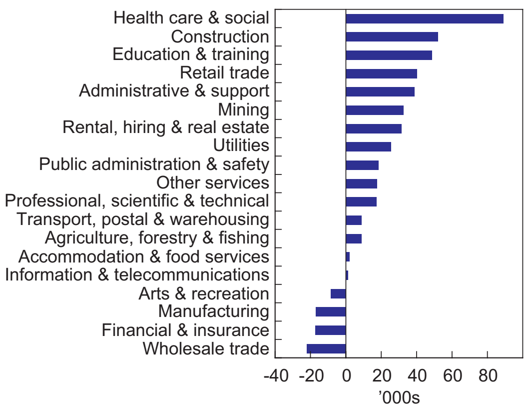
The effect of the recent rise in the participation rate on labour force growth appears to have been partially offset by a moderation in working-age population growth. Available data suggest that population growth continued to ease over 2010, following rapid growth over 2008 and early 2009. However, this easing was not reflected in the labour force survey until the December quarter – when the ABS adjusted the method for population benchmarking – suggesting that employment growth may have been somewhat overstated earlier in 2010.

Graph 3.18
Productivity and Income
March 1990 = 100



* Real GDP adjusted for the purchasing power of changes in the terms of trade and income accruing to foreigners
Source: ABS

Graph 3.19
Employment Growth by Industry
Year to November 2010, trend



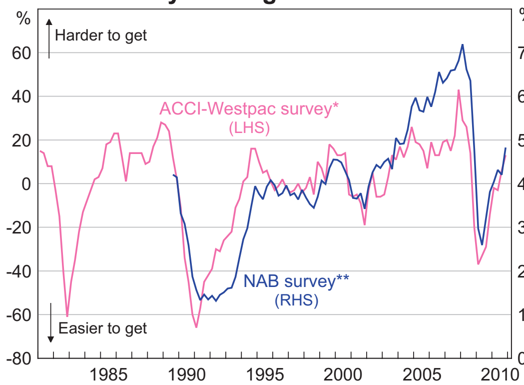
Source: ABS

Measurement issues aside, growth in employment over 2010 still appears to have been strong relative to that in output, with labour productivity (output per hour worked) estimated to have declined. One possibility that would be consistent with strong growth in the number of people employed and subdued growth in average hours worked per employee (although compositional changes in the labour force are also relevant) is that firms may be hiring workers in anticipation of future demand and labour shortages, based on their experience prior to the recent downturn when skills shortages were widespread and vacant positions were difficult to fill. While there is some anecdotal evidence of firms hiring pre-emptively, this appears at best a partial explanation for the divergence in output and employment growth. More generally, productivity growth has been relatively weak in Australia over the 2000s, although real incomes per hour worked have risen strongly due to the large increase in the terms of trade (Graph 3.18).

The strength in employment growth has been fairly broad-based. Employment expanded in the majority of industries over 2010, with the largest contributions coming from the health care, construction and education industries (Graph 3.19). Particularly rapid growth was recorded in the utilities, mining and rental, hiring & real estate services industries (17 to 20 per cent in trend terms), although these industries are a relatively small share of total employment. By state, employment growth over 2010 was at or above its decade average in all states except South Australia, with New South Wales recording the strongest growth.

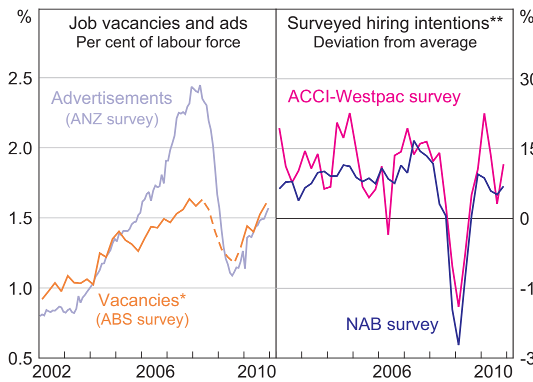
Business surveys and the Bank's liaison suggest that the labour market has tightened, although firms are generally not currently encountering significant difficulty in hiring suitable labour, except in mining-related industries and for some skilled occupations (Graph 3.20). Looking ahead, indicators of labour demand point to solid employment growth in the near term and some further tightening in labour market conditions. The ABS measure of job vacancies recorded a large increase over the three months to November, to be nearly 30 per cent higher over the year, and vacancies as a proportion of the labour force are now at relatively high levels (Graph 3.21). The ANZ measure of job advertisements also increased significantly over 2010. Business survey measures of hiring intentions remain at above average levels.

Graph 3.20
Difficulty Finding Suitable Labour



* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI-Westpac; NAB

Graph 3.21
Labour Market Indicators



* Dashed line represents estimates for August 2008 to August 2009
** Net balance of expectations for the following quarter
Sources: ABS; ACCI-Westpac; ANZ; NAB; RBA

Box A

The Impact of the Recent Floods on the Australian Economy

The eastern states of Australia experienced very high rainfall in the second half of 2010 and early 2011 due to the development of a La Niña weather pattern and then Cyclone Tasha in December. Subsequent flooding affected Queensland (including Brisbane) in particular, although there were also floods in parts of Victoria and New South Wales. While information is still incomplete – and there could be further weather-induced disruptions in coming months – this box sets out initial estimates of the effects of these events on GDP and inflation. The analysis does not include any effects from Cyclone Yasi in north Queensland, as little information was available at the time this document was finalised.

In terms of the economy, natural disasters such as floods are a negative supply shock as production is disrupted and public infrastructure, homes, cars and business assets are damaged. In terms of demand, spending is initially delayed but then increases as the disruptions ease and the repair and replacement of damaged assets gets under way. While production and consumption spending generally bounce back fairly quickly, the repair and rebuilding of damaged public and private assets is often spread over a number of years. This reflects the time it takes both to plan new building projects and to reassess risks in terms of the location and resilience of homes and other fixed structures to future similar events. The price effects associated with floods are most pronounced in the short term, with a temporary increase in prices due to loss of crops and transport disruptions.

Impact on GDP in the Near Term

The largest impacts of the rains on the path of GDP are likely to be in the December, March and June quarters, primarily due to the disruption to coal production. Starting in early December, the rain and flooding significantly affected the Bowen Basin coalfields, Queensland's primary coal producing region that supplies over half of Australia's coal exports. During December and January, around 25 per cent of mines in the basin became inoperable and a further 60 per cent were operating under restrictions. As a result, many mining companies declared *force majeure*, which releases them from liability when they are unable to meet contracts due to circumstances beyond their control. The flood impact on mines varied depending on their location and flood mitigation methods (e.g. levees in place and whether the mines are underground or open cut) and whether supporting rail lines were flooded. Production has since recommenced in many mines and most rail systems are now running, though there are still some ongoing limitations.

There is a wide range of estimates as to the magnitude of the coal production that has been lost.[1] If the total loss of production, relative to the level of coal production in the pre-flood period, was around 25 million tonnes spread over the December and March quarters, this would represent a loss of around 15 per cent of Australian six-monthly coal production. Assuming no significant additional disruption from further rain, industry reports suggest coal production will be back close to its pre-flood forecast level in the June quarter, a pace of recovery that would be consistent with previous floods in early 2008 and 2010. Companies report that they will not be able to make up lost production as mines and ports have been operating at close to full capacity.

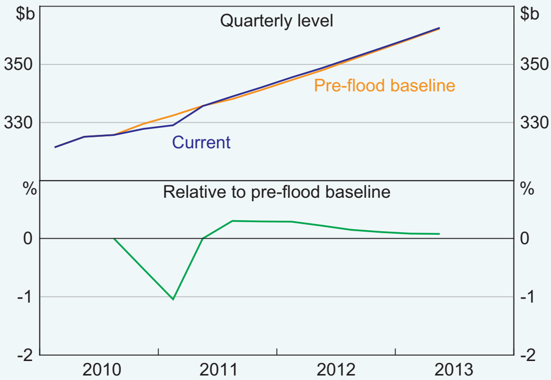
1 ABARES and the Queensland Government have estimated a loss of 15 million tonnes in exports, while the Queensland Resources Council has estimated a production loss of 31 to 54 million tonnes over the three quarters to June 2011.

The floods also affected agricultural areas across the eastern states. For some commodities, the primary effect has been on the quality rather than the quantity of production. An exception is fruit and vegetables, where a significant share of the Queensland crop in particular has been lost. While there could be further reductions in output of some fruits and vegetables during 2011/12, yields for some other crops will benefit from an improvement in soil moisture.

The rainfall and flooding also caused some delay in other private output as well as expenditure. While there are few indicators available yet, consumption in Queensland and Victoria is likely to have been reduced somewhat due to the cutback on non-essential expenditure in early January and the loss of retail trading days. Thereafter, however, consumption spending will be boosted by the replacement of flood-damaged household goods, although there has been some loss of wealth and income. In terms of business investment, only a limited number of projects appear to have suffered flood inundation; while some investment was delayed in December and January, the consequent reduction in GDP will be largely offset in future months by spending to replace damaged assets.

Putting all these aspects together, the Bank's preliminary estimate – made prior to an assessment of the impact of Cyclone Yasi – is that GDP growth in each of the December and March quarters could be around ½ percentage point lower than what it otherwise would have been, with the biggest impact arising from the disruption to coal production in Queensland (Graph A1). However, assuming no further significant weather disruptions, the recovery in coal production, bounce-back in delayed private spending and commencement of replacement and repair spending are estimated to bring the level of June quarter GDP back close to its pre-flood forecast.

Graph A1
GDP



Sources: ABS; RBA

This profile implies a reduction in the level of GDP in 2010/11 as a whole of close to ½ per cent compared with the outlook immediately prior.

Impact on GDP in the Medium Term

Beyond the June quarter, the size of the effects on the quarterly GDP profile will depend on the magnitude of the damage to private and public assets, the time horizon over which these assets are rebuilt and repaired, and the extent to which planned spending on unrelated projects is postponed. While the full extent of damage has yet to be determined, the rebuilding program will mostly be focused on repairs and rebuilding of houses and contents, farm and other business assets, and public infrastructure.

Initial estimates suggest around 35–40 000 residential properties may have been affected by the floods across the eastern states (mainly in Queensland), which includes damages to houses as well as yards, fencing and other structures. Some homes will need to be completely replaced; assuming an average cost of around $250 000 per dwelling, every 1 000 homes rebuilt will cost around $¼ billion. The balance of the homes damaged will require repairs (though not all of this activity will be included in

GDP).[2] The rebuilding and repair of dwellings is likely to take some time, reflecting both financing issues (some early reports suggest around half of the homes affected were insured for flooding) and possible new building restrictions in flood-vulnerable areas. Overall, the rebuilding program is likely to provide a modest boost to dwelling investment and GDP from the second half of 2011.

The full extent of the damage to public buildings and infrastructure from the floods is still being determined. The Queensland Government estimates damage to local government roads, water supplies and waste facilities, buildings and airports alone at around $2 billion. Based on this and other initial reports from the state and federal governments, the total damage to public infrastructure across the eastern states is currently estimated at around $6–7 billion. The overall boost to GDP from this reconstruction expenditure will depend on the period over which the rebuilding effort is spread and the degree to which the spending on repairs and rebuilding is offset by lower spending on other planned public projects.[3] Experience from other natural disasters suggests that, after an initial boost to spending on essential repairs, the planning and building of infrastructure projects will likely be spread over several years.

2 Based on the standard national accounts framework, household repairs are not included in final household consumption. The national accounts treat dwellings as an investment by households that returns a rental service over the life of this investment (like a machine does for a company). Hence, repairs to this investment detract from the 'profit' provided by dwellings and are counted as intermediate rather than final household consumption. On the income side of the accounts, higher spending on repairs will be reflected in higher compensation of employees, but the 'gross operating surplus of dwellings' will fall by the amount of the repairs. However, in terms of resource usage and the level of activity in the economy more broadly, labour is required to undertake these repairs (in order to provide the same level of housing rental services as before the flood), which implies there is less spare labour (and other inputs) that can be used for other purposes.

3 The replacement of public capital is recorded in public investment in the national accounts. Unlike for dwellings, repairs to public capital are recorded in GDP, under final public consumption (since public assets are not treated as delivering a flow of services to the economy thereafter).

Taking all these factors into account, net additional spending – primarily on public infrastructure and dwellings, although also including the rebuilding of farm and other business assets – could be around $8 billion, spread over around two years from mid 2011. With not all of this spending included in GDP and part of it spent on imports, the overall effect could be to boost the level of quarterly GDP during the rebuilding period by up to ¼ percentage point (Graph A1).

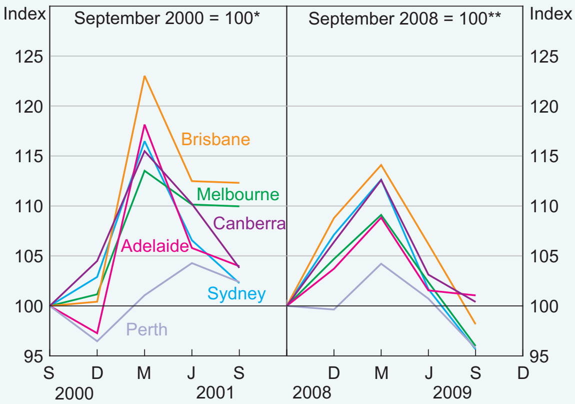
Impact on the Consumer Price Index

The floods will temporarily boost some food prices, primarily due to the loss of fruit and vegetable crops. In regards to fruit and vegetable prices, two previous episodes of severe rainfall – in the eastern states from October 2000 to March 2001 and in Queensland in early 2009 – showed a sharp and immediate pick-up in these prices in most states (Graph A2). If nationwide fruit and vegetable prices were to rise by an average of 5-10 per cent in the March quarter as a result of the floods in the eastern states then, given the weight of fruit and vegetables in the overall CPI of 2½ per cent, this would increase March quarter headline inflation by up to ¼ percentage point.[4] As the effects unwind – with alternative sources of supply (including imports) becoming available – fruit and vegetable prices are likely to fall in the June quarter. Some inflationary pressure may persist for fruits or vegetables that have longer growing periods (such as pineapples) or where there have been delays in replanting due to water-logged soil. There has not been a significant loss of livestock from the floods though difficulties transporting livestock may have increased prices for a short period.

In regard to other commodities, while Queensland produces virtually all of Australia's sugar and Victoria

4 In the case of Cyclone Larry in 2006, there were larger and more prolonged effects on banana prices because bananas cannot be imported for quarantine reasons. Early reports indicate Cyclone Yasi has also damaged the banana crop.

Graph A2
Consumer Prices – Fruit and Vegetables



* Floods in NSW and Queensland from October 2000 to March 2001
** Floods in Queensland in January and February 2009
Source: ABS

is an important producer of wheat (although much of Victoria's wheat crop had already been harvested before the floods), flood-related effects on inflation from these commodities are unlikely to be significant.

Overall, price increases related to the floods could contribute around ¼ percentage point to headline inflation in the March quarter, although much of this is likely to be reversed fairly quickly. The effect on underlying inflation would be lower.

Looking further ahead, the demand for housing, including for out-of-area construction workers, could place upward pressure on rents, especially in Brisbane. However, vacancy rates ahead of the floods were comparatively high in Queensland (reportedly around 3½ to 4½ per cent in Brisbane, and 5 per cent on the Gold Coast). Increased demand for construction materials may lift inflation in house purchase costs somewhat. Finally, repairs and rebuilding will also increase demand for construction-related labour, with potential flow-on effects to other industries in Queensland or construction costs in other states if workers come from interstate. The increased demand for labour may lead to some increase in wage pressures, although this will be tempered by the unemployment rate in Queensland (6.0 per cent in December), which is above the national average, and the current soft conditions in Queensland's construction sector.

Impact on the Financial Sector

Early indications are that the recent floods in Queensland and elsewhere will generate insurance claims that are high by the standards of previous Australian natural disasters, but Australia's general insurance industry is well placed to cope with a large increase in claims expenses. As at end January, the insurance industry had received 38 460 claims in Queensland totalling $1.5 billion (excluding industrial and mining sector claims) and 4 780 claims in Victoria totalling $69 million.[5] While some insurers are more exposed to the flood-affected regions than others, most are well diversified geographically, particularly the larger insurers. Furthermore, insurers are well capitalised, with the industry as a whole holding around double the regulatory minimum amount of capital. In addition, they generally have in place re-insurance arrangements, often with insurers located in other countries. The impact of the floods on the banking sector is also likely to be limited. The most heavily affected regions account for a relatively small share of most banks' customer bases, and although some smaller institutions based in Queensland are more exposed, their loan losses are still expected to be quite low.

5 In approximate current dollar terms, the 2009 Victorian bushfires generated private insurance claims totalling around $1 billion, the 1974 Brisbane floods around $2½ billion, and Cyclone Tracy in 1974 over $4 billion.

Box B

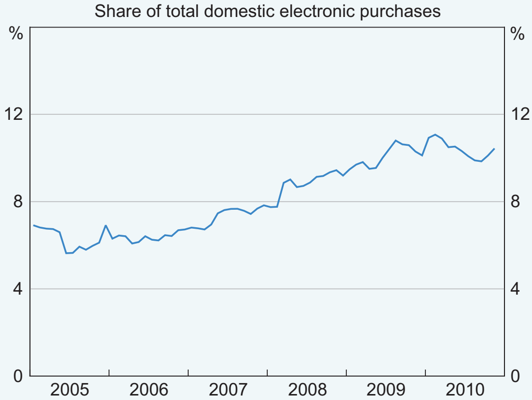
Online Spending by Households

The ongoing growth in online shopping has led to an increased focus on the size and growth of the online market in Australia. There are, however, no official data on the total value of online purchases, although a range of industry estimates suggest that these purchases are equivalent to around 3 per cent of household consumption.[1, 2] Industry reports and the Bank's liaison also suggest that online purchases have grown strongly over recent years.

One source of information on the size and growth of the online market is the data collected by the Reserve Bank in carrying out its responsibility for monitoring developments in Australia's payments system. On a monthly basis, the Bank collects data from financial institutions on the value of spending on debit and credit cards, with the data split into spending on these cards at domestic merchants and overseas merchants. For spending at domestic merchants, the data are further split into spending that is undertaken online (i.e. where the payment card is not physically present) and traditional spending where the payment card is present or details are provided over the phone or by mail.[3]

While there are some structural breaks in the data due to changes in reporting over time, the data on domestic spending show rapid growth in online purchases over recent years. Since 2005, the value of online spending on debit and credit cards has grown at an average annual rate of more than 15 per cent, although over the past year there has been little change in this type of spending. In contrast, traditional card spending has increased at a slower average rate of around 9 per cent since 2005. It is important to note that despite the stronger growth in online spending, online payments account for only around 10 per cent of total domestic payments on credit and debit cards (Graph B1).

Graph B1
Domestic Internet Purchases*
Share of total domestic electronic purchases



* Domestic purchases on personal and business cards issued in Australia; excludes cash withdrawals and advances
Source: RBA

The data on payments made on Australian cards at overseas merchants include payments made when Australians travel overseas, as well as payments made by Australians for online purchases from overseas merchants.[4] In total, the value of international electronic purchases has grown at an

1 See Access Economics, 'Household E-Commerce Activity and Trends in Australia', November 2010, for more details of these industry estimates.

2 The ABS Survey of Retail Trade includes most internet purchases from local online retailers, although it does not distinguish these purchases from spending at bricks-and-mortar retailers. Internet purchases from overseas are not included in ABS retail trade data, and only internet sales valued at more than $1 000 are included in ABS imports and consumption data in the national accounts.

3 These data are provided by financial institutions that process transactions for merchants.

4 These data are provided by financial institutions that issue cards to cardholders.

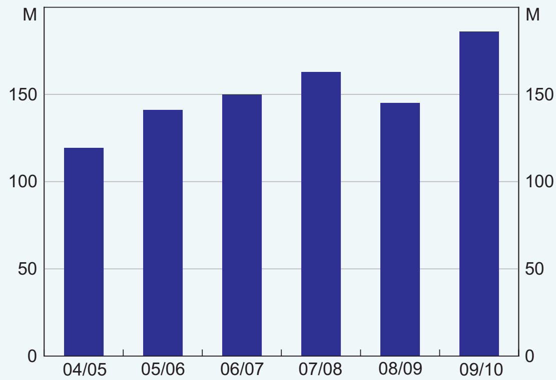
average rate of 15½ per cent since 2005, which is faster than the growth in electronic domestic purchases of 10 per cent (Graph B2).

It is likely that much of this growth in international purchases reflects the significant increase in the number of Australians travelling overseas. In 2010, Australians made around 6¼ million trips overseas, excluding business-related trips. This has increased by 55 per cent since 2005, with this growth in travel leading to increased spending overseas. In addition, the appreciation of the exchange rate has made foreign goods and services cheaper. While this has reduced the value of a given quantity of foreign goods and services in Australian dollar terms, it is also likely to have led households to increase the quantity of purchases abroad. Although it is not possible to specifically identify online offshore purchases, the data suggest that the share of this type of purchase in total spending remains relatively low. In aggregate, total spending at foreign merchants – including spending by Australians travelling abroad – is less than 4 per cent of total payments.

Another source of information that points to growth in online purchases from overseas is the number of inbound postal items delivered through the Australia Post network. Since 2005, the total number of items delivered has increased at an average annual rate of around 10 per cent, in contrast to an average annual decline of 1 per cent in the total number of domestic and outbound postage flows (Graph B3). There has also been a steady increase over a number of years in the number of Google searches for 'Amazon' and 'eBay US', with the number of such searches increasing significantly in the second half of 2010 as the Australian dollar appreciated against the US dollar (Graph B4).

Graph B3

Inbound Postal Items*

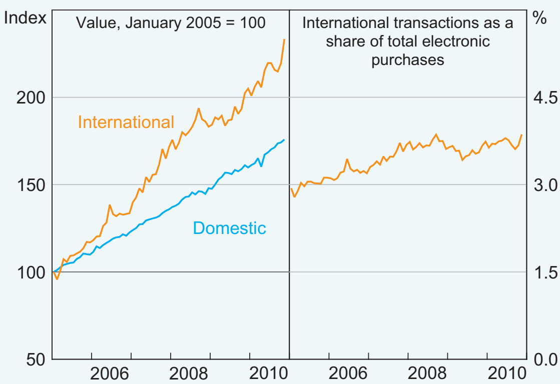


* Items posted overseas for delivery in Australia through the Australia Post network

Source: Australia Post

Graph B2

Electronic Purchases*



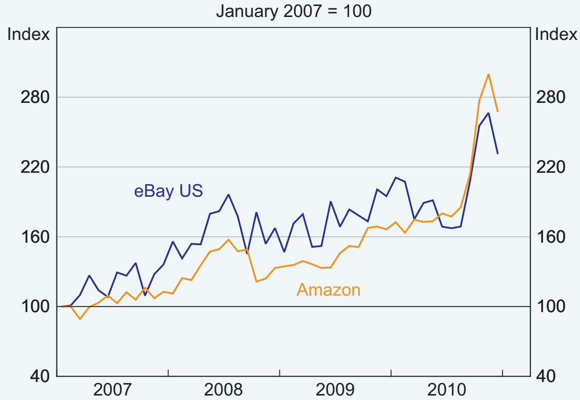
* Purchases on personal cards issued in Australia; excludes purchases on charge cards and cash withdrawals and advances

Source: RBA

Graph B4

Google Searches for International Websites*

January 2007 = 100



* Searches relative to total number of shopping-related Google searches within Australia

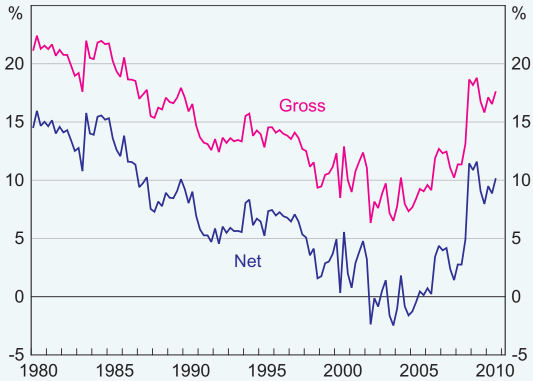
Sources: Google; RBA

Box C

The Increase in the Household Saving Ratio

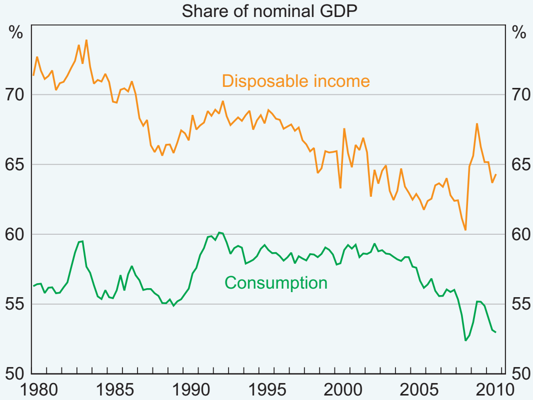
The household saving ratio is estimated to have increased sharply in recent years. After falling for over two decades to a low point of around minus 2 per cent, household saving (net of depreciation) has increased since the mid 2000s (Graph C1). It is now estimated at 10 per cent of household disposable income, which – abstracting from the period in late 2008 and early 2009 that was affected by the government stimulus payments – is the highest saving ratio in over 20 years. While estimates of saving are prone to significant revision – since they are measured as the difference between household income and consumption, two very large aggregates that are subject to measurement errors – and there are also several definitional issues as to what should constitute saving, this is nonetheless a significant turnaround in the saving ratio.[1]

Graph C1
Household Saving Ratio
Per cent of household disposable income



Source: ABS

Graph C2
Household Sector Income Account
Share of nominal GDP



Source: ABS

The decline in the measured saving ratio during the 1980s and 1990s occurred against the background of financial deregulation, falls in nominal interest rates, a significant increase in the ratio of household debt to income and a rise in household wealth (including capital gains on housing assets). Although there was a fall in the share of national income that accrued to the household sector, these other factors contributed to stronger growth in consumption spending during this period. In contrast, the increase in household saving since the mid 2000s has reflected a period of strong increases in household income and a more modest pace of household spending (Graph C2).

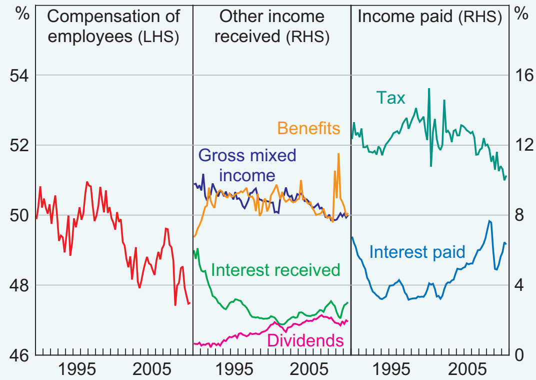
1 Recent revisions to historical saving ratio estimates have been especially large, in the order of 5–7 percentage points. There are several conceptual issues concerning the measurement of the household saving ratio, and different approaches can produce very different trends: see ABS, Australian System of National Accounts, 2002–03, Cat No 5204.0, 'New Analytical Measures of Income, Saving and Wealth', for a detailed discussion of the household saving measure. For an alternative approach to measuring the saving ratio, see 'Box D: Capital Gains and Measures of Household Saving', *Statement on Monetary Policy*, May 2006.

Since 2004, nominal household disposable income has grown strongly, at an annual average rate of 7.3 per cent. This is slightly faster than the growth in nominal GDP over that period, which was boosted by the rise in the terms of trade. The growth in income has mostly reflected strong growth in after-tax wage and salary compensation, due to a buoyant labour market and income tax cuts (Graph C3).

Despite the solid rises in income over a number of years, the growth in nominal household consumption has remained quite modest, at an annual average of 5.4 per cent since 2004. Until mid 2008, this occurred in the context of rising interest rates as monetary policy was tightened. In the past two years, consumption has grown at an annual nominal rate of just 3.8 per cent. With household incomes growing strongly and the pace of consumption growth remaining quite low since 2004, the household saving rate has increased markedly.

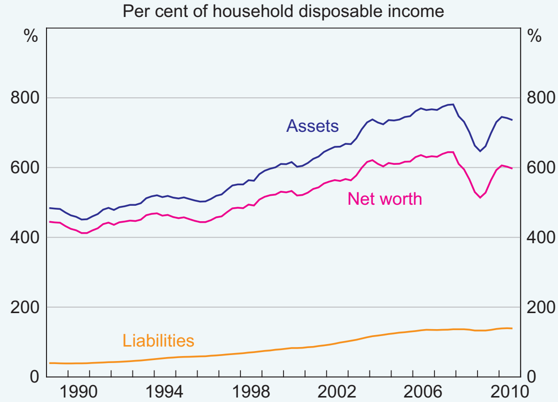
The moderation in consumption spending and corresponding rise in the saving ratio appear to reflect a change in households' attitudes towards debt and financial vulnerability, after a long period when lower interest rates and financial deregulation saw a significant rise in household indebtedness. Initial signs of a change were apparent around the middle of the decade, when there was a cooling of the earlier housing boom. There appears to also have been a more significant change in attitudes and behaviour following the onset of the global financial crisis and the sharp fall in equity markets and wealth, as well as the slowing in the domestic economy in late 2008 and general increase in uncertainty (Graph C4). This change in behaviour is apparent in other indicators, including the increase in housing equity injection since the middle of the decade and surveys that show an increased share of households that believe bank deposits or paying down debt are the 'wisest place for saving.' The modest rate of increase in household indebtedness suggests that household behaviour remains cautious. However, there are a few factors – including the recovery in household net worth over the past 18 months and the improvement in the labour market – that would suggest that growth in household consumption is unlikely to remain as low as over the past couple of years. ✢

Graph C3
Household Disposable Income
Share of nominal GDP



Source: ABS

Graph C4
Household Net Worth
Per cent of household disposable income



Sources: ABS; APM; RBA

4. Domestic Financial Markets

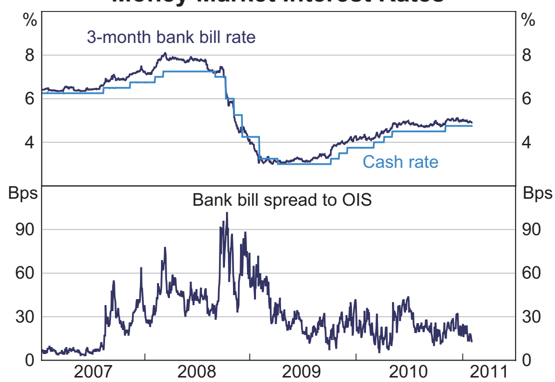
Money Markets and Bond Yields

The Reserve Bank Board has maintained its target for the overnight cash rate at 4.75 per cent since November (Graph 4.1). At the time of the November *Statement,* market yields pointed to expectations of a further increase in the cash rate in the first half of 2011, but over the past three months those expectations have been scaled back, in part reflecting the lower inflation data and concerns about the drag on economic activity from the floods.

To maintain the cash rate at the Board's target, the Bank has kept exchange settlement (ES) balances around $1¼ billion, although higher balances were temporarily accommodated over year-end. Rates on 3-month bank bills have remained relatively steady at just below 5 per cent and the spread to overnight indexed swaps (OIS) is close to its lowest level over the past three years.

Reflecting global developments, long-term bond yields have risen since November (Graph 4.2). However, the rise has been less than in the major offshore markets, which has seen the spread between CGS and US government bond yields narrow significantly from its recent peak late last year. Spreads between other highly rated domestic securities and CGS – including state-government and supranational paper – have generally remained steady, with the exception of spreads on European-based issuers which have widened.

Graph 4.1
Money Market Interest Rates



Sources: AFMA; RBA; Tullett Prebon (Australia) Pty Ltd

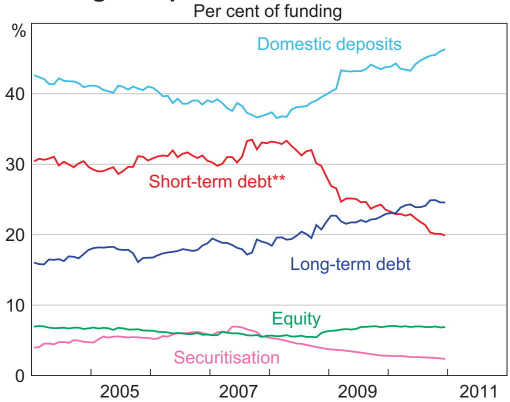
Graph 4.2
Australian Government Bond Yields

Source: RBA

Financial Intermediaries

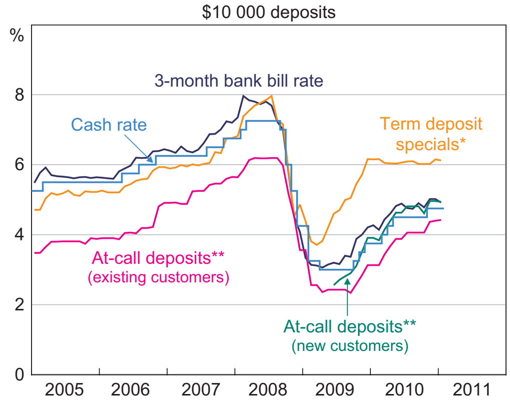
The trends in bank financing evident over the past couple of years have continued (Graph 4.3). The share of funding accounted for by short-term debt has fallen to close to 20 per cent, well down from its share prior to the onset of the global financial crisis. This decline has been offset by a marked increase in deposits and an increase in the share of funding from long-term debt, both of which are relatively more expensive sources of funding. These changes in funding reflect both regulatory and market pressures.

Graph 4.3
Funding Composition of Banks in Australia*
Per cent of funding



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.4
Deposit Rates
$10 000 deposits



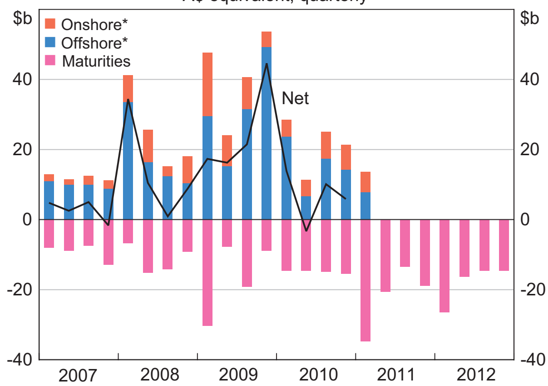
* Average of 1–12, 24-, 36- and 60-month terms at the major banks
** Average of online, bonus and cash management accounts at the major banks
Source: RBA

The announcement of new global standards for liquidity by the Basel Committee in December, that will come into effect in 2015, is one factor that has contributed to this. Banking institutions will need to have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. Increasing the share of funding from longer-term debt can reduce the size of the liquidity portfolio that needs to be held under that scenario. The Basel standard prescribes that high-quality liquid assets will take the form of government securities, which in Australia's case are limited. As a consequence, APRA and the Bank have announced that the Bank will offer a committed secured liquidity facility, sufficient in size to cover any shortfall between a banking institution's holdings of high-quality liquid assets and the liquidity requirement. In return for this committed facility, the Bank will charge a market-based fee.

Banks have continued to compete for deposits in recent months. The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) has increased by around 35 basis points since the previous *Statement*, more than the increase in the cash rate (Graph 4.4). The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has also risen a little to around 6.12 per cent. This rate is almost 2½ percentage points higher than it was in early 2009, a considerably larger increase than the cash rate over this period. Over the past year, rates on term deposit 'specials' have remained approximately 100 basis points above equivalent duration market rates (bank bill and swap rates). On average, the smaller Australian-owned banks' 'special' term deposit rates are at similar levels to those offered by the major banks.

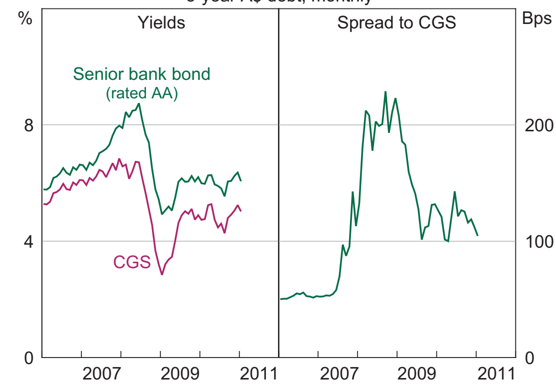
Australian banks continue to take opportunities to lengthen the maturity of their funding. Around $35 billion of bonds has been issued in domestic and international wholesale markets since the November *Statement* (Graph 4.5). While around two-

Graph 4.5
Major Banks' Bond Issuance
A$ equivalent, quarterly



* Latest quarter issuance to date
Source: RBA

Graph 4.6
Major Banks' Bond Pricing
3-year A$ debt, monthly



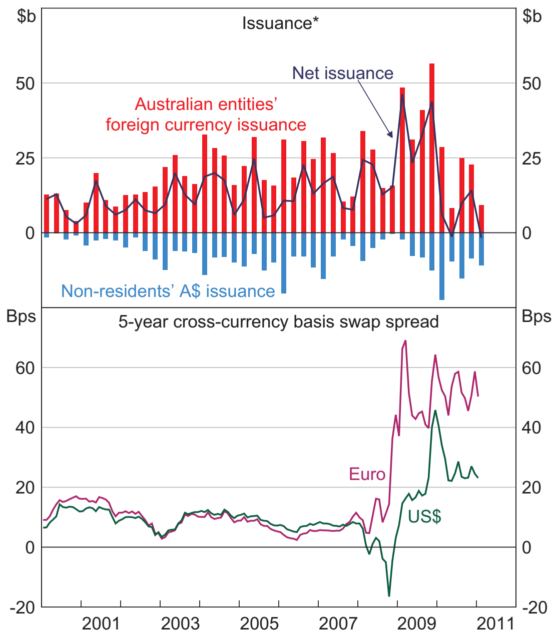
Sources: RBA; UBS AG, Australia Branch

thirds of recent issuance has been offshore, local issuance has included a record $2½ billion deal by a major bank. The cost of recent issuance has remained broadly stable since the previous *Statement* (Graph 4.6).

A number of banks, including three of the major banks, have repurchased around $6 billion of their government-guaranteed debt on issue. Repurchases have been concentrated in debt with a relatively short residual maturity of around one year, as the guarantee fee on this debt exceeds the current market spread on equivalent unguaranteed funding.

Cross-currency basis swap spreads – which represent the hedging cost of Australian issuers swapping foreign currency funding into Australian dollars – have been relatively stable over recent months at above their pre-crisis levels (Graph 4.7). Combined with strong demand for Australian dollar assets, including from Australian banks looking to purchase high-grade liquid assets, these favourable spreads continue to attract foreign issuers into the local market. Issuance by offshore entities in Australian dollars (the kangaroo bond market) totalled over $7 billion in January alone, around twice the average monthly issuance in 2010.

Graph 4.7
Bond Issuance and the Cross-currency Basis Swap Spread

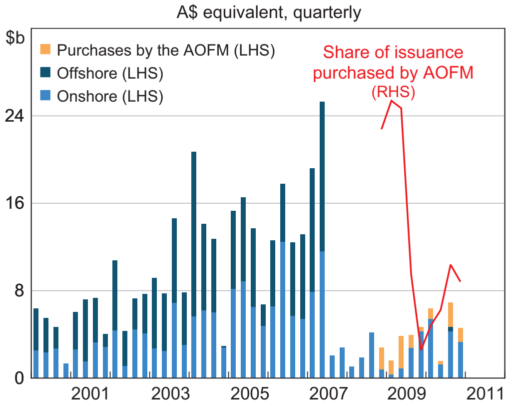


* Latest quarter issuance to date
Sources: Bloomberg; RBA

Graph 4.8

Australian RMBS Issuance

A$ equivalent, quarterly



Source: RBA

There have been a number of positive developments in the domestic securitisation market in recent months. Several deals, including the first involving non-conforming mortgages since early 2008, have priced without AOFM support (Graph 4.8). Some deals have also included 'bullet' structures, which aim to appeal to a broader base of investors. Pricing for both primary issuance and in secondary markets has been little changed over recent months.

Household Financing

Most bank and non-bank lenders raised their variable housing loan rates by more than the increase in the cash rate in November (Table 4.1). Interest rates on new full-doc variable-rate housing loans have increased by an average of 39 basis points, and are a little more than 200 basis points above their lows in 2009. Around the time of the November interest rate announcements, two lenders also announced the removal of early termination fees on new and existing mortgages.

Table 4.1: Intermediaries' Lending Rates[(a)]

Per cent

	Level at 2 February 2011	Change since: End October 2010	Change since: End April 2009
Cash rate	4.75	0.25	1.75
Swap rate, 3-year	5.47	0.18	1.55
Housing loans			
Prime full-doc	7.22	0.39	2.03
Prime full-doc, 3-year fixed rate	7.42	–0.01	1.55
Prime low-doc	7.88	0.40	2.08
Personal loans	12.88	0.28	1.93
Small business			
Term loans			
– Residentially secured	8.99	0.41	1.91
– Residentially secured, 3-year fixed rate	8.53	0.05	1.64
– Other security	9.70	0.36	1.81
Overdraft			
– Residentially secured	9.86	0.41	1.96
– Other security	10.67	0.36	1.86
Average actual rate	8.92	0.41	1.81
Large business			
Average actual rate (variable and bill funding)	6.98	0.20	1.95

(a) Variable interest rates unless otherwise indicated
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

The major banks' interest rates on new fixed-rate housing loans have been little changed in recent months. Relative to corresponding swap rates, a common pricing benchmark, these rates have declined further from their peaks in mid 2010. As the spread between fixed and variables rates has narrowed, the share of housing loans approved at fixed rates has picked up, although it remains below its longer-run average.

Overall, the average interest rate on all outstanding housing loans (fixed and variable) is estimated to be around 45 basis points above its post-1996 average, having risen by around 155 basis points since its trough in 2009 (Graph 4.9).

The total value of housing loan approvals has increased a little in recent months, largely as a result of demand from owner-occupiers (excluding first-home buyers) (Graph 4.10). The increase in approvals has been most significant for credit unions and building societies, and to a lesser extent for wholesale lenders and smaller banks. The major banks have continued to experience a decline in their market share, which is now under three-quarters, around 11 percentage points below its early 2009 peak (Graph 4.11).

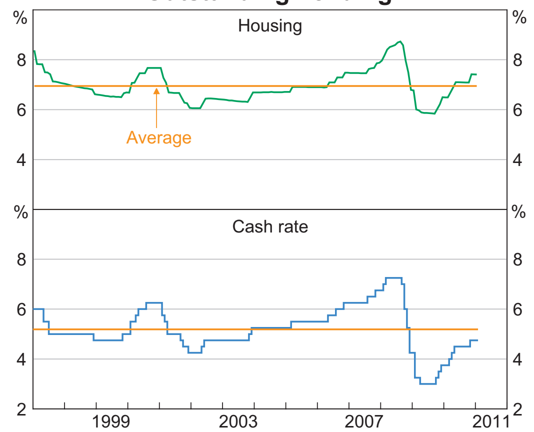
Over the December quarter, the growth of housing credit averaged 0.5 per cent per month, little changed from the pace of the previous six months. Owner-occupier credit and investor credit have grown at broadly similar rates over the past year (Graph 4.12).

Financial institutions' rates on variable personal loans have increased by an average of 28 basis points since the end of October. Average variable rates on unsecured personal loans, credit cards and margin loans have increased by 25 basis points, while rates on home equity loans have increased by around 40 basis points.

Personal credit, which is a small component of household credit, rose at a monthly average rate of 0.1 per cent over the December quarter. The modest growth in recent months was largely due to increased credit card lending. The value of

Graph 4.9

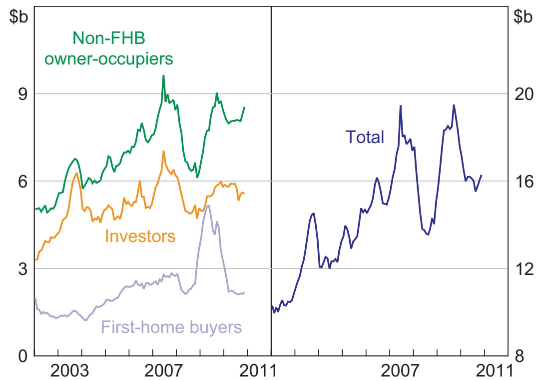
Average Interest Rates on Outstanding Lending



Sources: ABS; APRA; Perpetual; RBA

Graph 4.10

Value of Housing Loan Approvals*



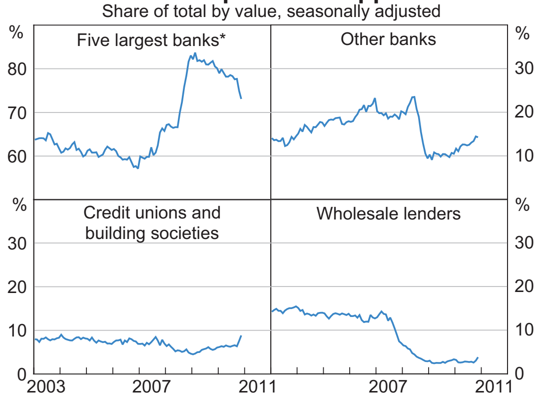
* Excludes owner-occupier refinancing, alterations and additions, investor approvals for new construction and by 'other' investors

Sources: ABS; RBA

Graph 4.11

Owner-occupier Loan Approvals

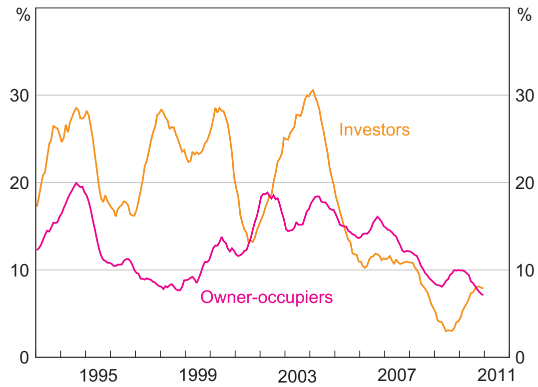
Share of total by value, seasonally adjusted



* Includes Bankwest from December 2008

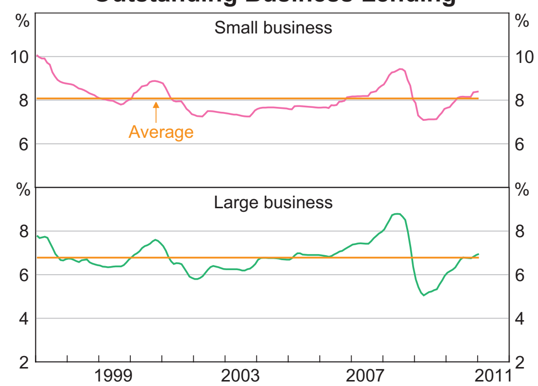
Sources: ABS; APRA; RBA

Graph 4.12
Housing Credit Growth
Year-ended



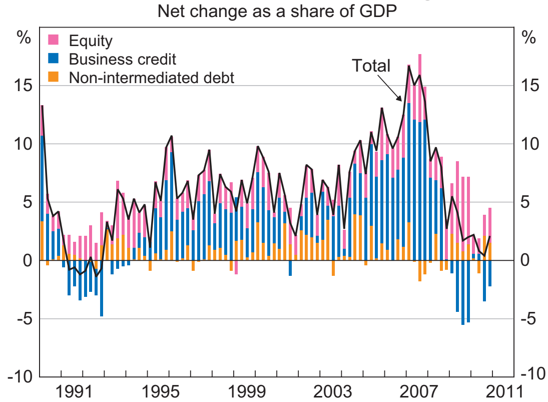
Source: RBA

Graph 4.13
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

Graph 4.14
Business External Funding
Net change as a share of GDP



Sources: ABS; ASX; Austraclear Limited; RBA

outstanding margin lending continued to decline over the quarter despite favourable conditions in equity markets. As such, an increase in the value of collateral backing margin loans has meant that gearing remains at low levels.

Business Financing

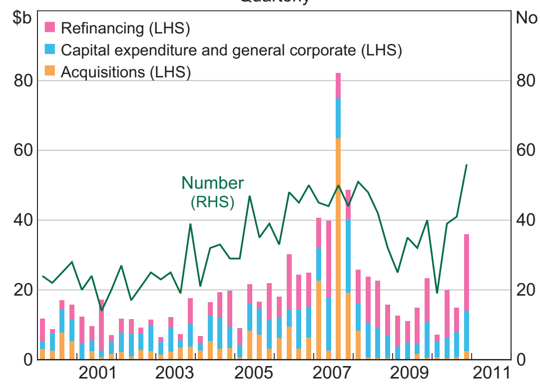
In November, the major banks increased their indicator rates on residentially-secured small business loans by an average of 41 basis points, to 8.99 per cent, in line with the increase in their variable housing rates. Indicator rates on 1–5 year fixed-rate facilities have also generally increased by around 5 to 15 basis points, slightly less than corresponding swap rates. At 8.40 per cent, the average rate on outstanding small business loans is about 30 basis points above its post-1996 average (Graph 4.13).

The average interest rate on banks' variable-rate lending to large business is estimated to have increased by about 20 basis points since the end of October, to 6.98 per cent. These loans are repriced at regular intervals from money market benchmark rates (such as the 3-month bank bill yield), which have increased in recent months. The risk margins that banks charge above these benchmark rates for new customers have tended to decline somewhat over 2010, after rising substantially over the previous couple of years.

Net external business funding picked up slightly as a share of GDP in the December quarter, with a decline in business credit more than offset by robust corporate debt issuance and solid equity raisings, particularly by resource companies (Graph 4.14). Debt issuance by Australian corporates reached $10 billion in the December quarter, with around $6 billion of that placed in the US market by large resource companies seeking funding for new projects. Bond spreads for Australian corporates have tightened slightly, with resource firms in particular benefiting from strong demand for Australian debt. Resource companies also accounted for much of the pick-up in equity raisings in the quarter. Most of the equity raisings have been by smaller resource companies, as the larger resource firms have sufficient equity financing through retained profits and, in some cases, have announced that they will be returning surplus capital to shareholders via share buybacks.

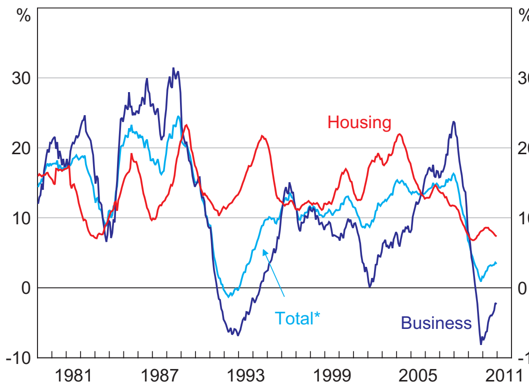
The decline in business credit has been driven by falls in lending to corporates, while lending to unincorporated enterprises has been broadly stable. Although commercial loan approvals have been steady over the year, syndicated loan approvals picked up strongly in the December quarter, with 56 deals worth around $35 billion (Graph 4.15). This is the largest quarter of approvals since 2007. Refinancing of existing facilities accounted for most of the increase, although lending for the purpose of funding acquisitions, capital expenditure and general corporate purposes also rose. A broader trend in syndicated lending in the past couple of years has been the sizeable increase in the market share of Asian banks, albeit from a relatively low base.

Graph 4.15
Syndicated Loan Approvals
Quarterly



Sources: RBA; Thomson Reuters

Graph 4.16
Credit Growth
Year-ended



* Includes housing, personal and business credit
Source: RBA

Aggregate Credit

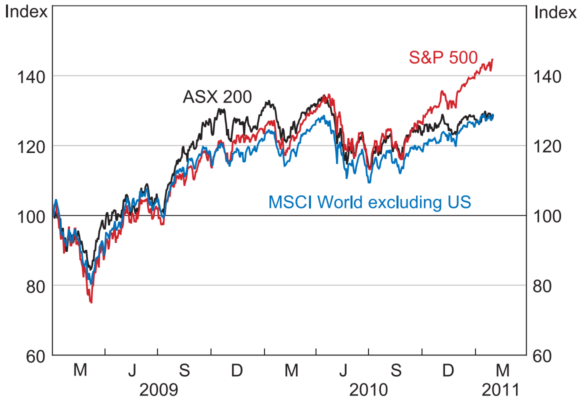
Total outstanding credit grew at an annualised rate of around 2½ per cent over the December quarter, reflecting moderate growth in household credit and a decline in lending to businesses (Graph 4.16, Table 4.2). Growth in broad money remained solid over 2010, partly reflecting a preference to hold assets in deposits. Reflecting the increase in deposits, the growth of broad money has outpaced credit since the latter half of 2007.

Table 4.2: Financial Aggregates
Percentage change

	Monthly average		Year to December 2010
	September quarter 2010	December quarter 2010	
Total credit	0.1	0.2	3.4
– Owner-occupier housing	0.5	0.6	7.1
– Investor housing	0.7	0.5	7.9
– Personal	0.0	0.1	1.2
– Business	–0.6	–0.4	–2.3
Broad money	0.5	0.8	8.1

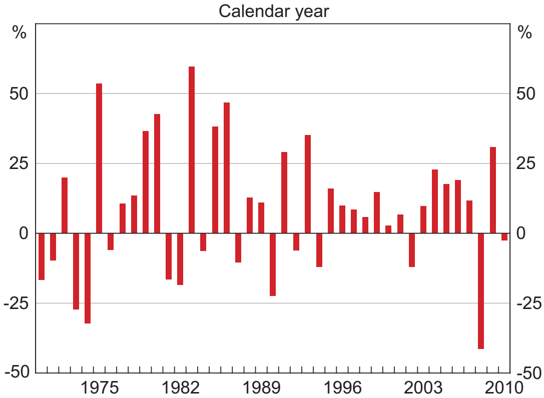
Source: RBA

Graph 4.17
Share Price Indices
End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

Graph 4.18
Australian Equity Market Annual Returns
Calendar year



Sources: RBA; Thomson Reuters

Equity Markets

Despite the solid improvement in global equity markets over recent months, the Australian equity market is only slightly higher since the previous *Statement* (Graph 4.17). In net terms, it is little changed since late 2009 having fallen slightly over 2010 following the strong recovery in 2009 (Graph 4.18). At the sectoral level, the continued rally in resource firms' share prices has led the market higher, partly offset by a decline in the share price of financials (Table 4.3). Forward P/E ratios remain below historical averages with valuations continuing to be supported by analysts' forecasts for solid profit growth over the next two years.

The Queensland floods and Cyclone Yasi have led to some volatility in the share prices of insurance firms but the net effect has been relatively muted with insurers indicating that weather-related claims will be capped by reinsurance. A number of mining firms have indicated that production has been hampered by the adverse weather conditions.

There was a relatively high level of merger and acquisition activity in the second half of 2010, with a number of large announced deals – including the ASX/SGX merger and AXA Asia Pacific takeover – still subject to regulatory or shareholder approval. Currently just over $50 billion of M&A deals remain pending.

Table 4.3: Sectoral Movements in the ASX 200
Per cent

	Change since:		
	November *Statement*	Trough (March 2009)	Peak (November 2007)
Resources	5.2	64	–9
Financials	–0.6	62	–41
Other	0.6	34	–32
ASX 200	**1.6**	**52**	**–30**

Source: ASX

5. Price and Wage Developments

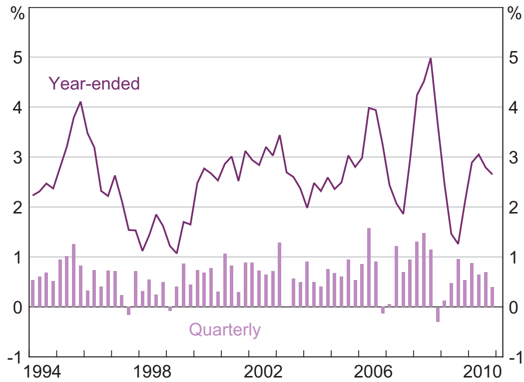
Recent Developments in Inflation

Consumer price inflation has declined significantly over the past couple of years. This has reflected the relatively subdued growth in demand, especially from households, since the slowing in the economy in late 2008 and the associated easing in capacity pressures and wage growth. More recently, the appreciation of the exchange rate has also exerted downward pressure on inflation.

The consumer price index (CPI) increased by 0.4 per cent in the December quarter, to be 2.7 per cent higher over the year (Graph 5.1, Table 5.1). The quarterly outcome was lower than had been expected at the time of the November

Graph 5.1

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 5.1: Measures of Consumer Price Inflation

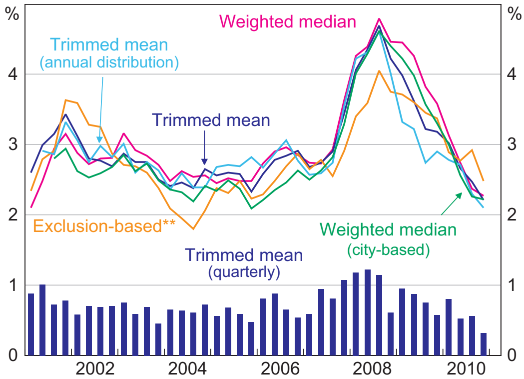
Per cent

	Quarterly		Year-ended	
	September quarter 2010	December quarter 2010	September quarter 2010	December quarter 2010
CPI	0.7	0.4	2.8	2.7
– Tradables	0.2	0.3	1.4	1.6
– Tradables (excl food, fuel and tobacco)	0.4	–1.2	–1.0	–2.0
– Non-tradables (excl deposit & loan facilities)	1.2	0.6	3.8	3.5
Selected underlying measures				
Trimmed mean	0.6	0.3	2.5	2.2
Weighted median	0.5	0.5	2.4	2.3
CPI excl volatile items[(a)] and deposit & loan facilities	1.1	0.1	2.9	2.5

(a) Volatile items are fruit, vegetables and automotive fuel

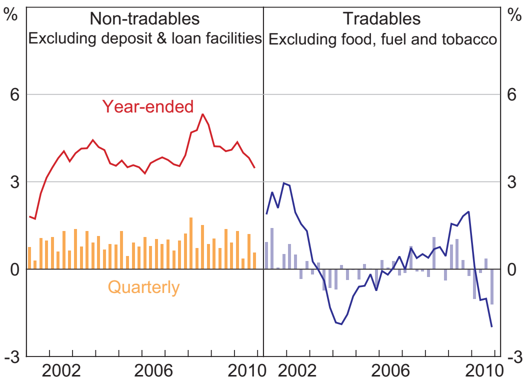
Sources: ABS; RBA

Graph 5.2
Consumer Price Inflation*



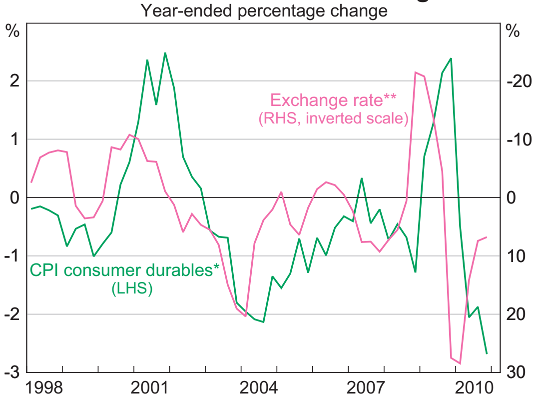
* Adjusted for the tax changes of 1999–2000
** Excludes fruit, vegetables, automotive fuel and deposit & loan facilities
Sources: ABS; RBA

Graph 5.3
Consumer Price Inflation*



* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

Graph 5.4
Consumer Prices and the Exchange Rate
Year-ended percentage change



* Retail items (excluding food and alcohol) and motor vehicles and parts; adjusted for the tax changes of 1999–2000
** Import-weighted index
Sources: ABS; RBA

Statement. This reflected larger-than-expected price declines for a range of tradable consumer items and lower outcomes for deposit & loan facilities prices and rents than had been anticipated. In contrast, the price of fruit & vegetables rose sharply, and there was an increase in the price of automotive fuel. The recent floods are expected to have an impact on CPI inflation in coming quarters (see 'Box A: The Impact of the Recent Floods on the Australian Economy').

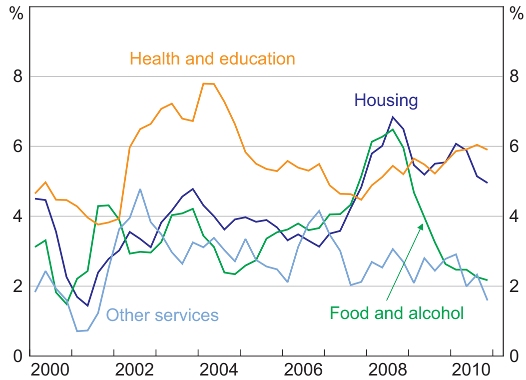
Based on a range of measures, underlying inflation is estimated to have declined to around 2¼ per cent over the year to December (Graph 5.2). This is significantly below the recent peak of a little over 4½ per cent in September 2008. Most of the difference between the year-ended rates of headline and underlying inflation in the December quarter was due to the large increase in tobacco excise in 2010, which is estimated to have increased CPI inflation by nearly 0.4 percentage points. In the quarter, underlying inflation is estimated to have been a little less than ½ per cent.

The prices of a wide range of tradable consumer items declined over 2010, including clothing (–6 per cent), major household appliances (–4 per cent), audio, visual & computing equipment (–18 per cent) and motor vehicles (–1½ per cent). In aggregate, tradables prices (excluding food, fuel and tobacco) fell by more than 1 per cent in the December quarter and by 2 per cent over 2010; this was the largest year-ended decline in the three decades for which the series is available (Graph 5.3). This decline reflects the ongoing effects of the exchange rate appreciation since early 2009 (Graph 5.4), the tariff cuts for imported motor vehicles, textiles, clothing and footwear implemented in early 2010, and the subdued growth in household spending. Looking ahead, the appreciation of the exchange rate is likely to exert additional downward pressure on tradables prices in coming quarters.

Non-tradables inflation (excluding deposit & loan facilities) eased to 0.6 per cent in the December quarter and 3.5 per cent over the year. This is the slowest year-ended pace since September 2007, and almost 2 percentage points below the peak in late 2008. The rates of increase in rents, house purchase costs and the price of non-tradable food have declined over the past couple of years (Graph 5.5). Domestic holiday prices declined over 2010, as the domestic tourism industry was affected by the exchange rate appreciation and bad weather later in the year. However, further substantial moderation in non-tradables inflation seems unlikely in the near term. Conditions in the rental market are relatively tight, and the cost of building materials has increased, although liaison continues to point to some underlying weakness in the house construction industry. Inflation remains relatively high for a number of services. Health services and education prices rose by around 6 per cent over 2010, and utilities prices increased by 11½ per cent. More generally, labour market conditions have tightened since mid 2009 and wage growth picked up over 2010.

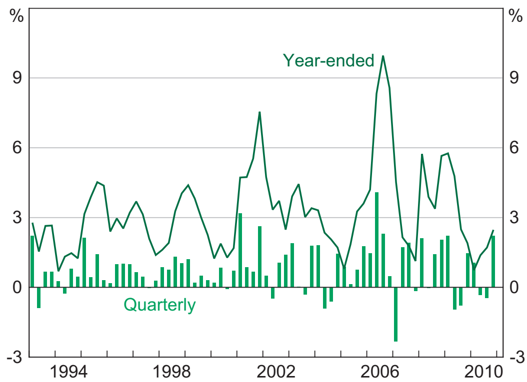
Food prices rose by 2.2 per cent in the December quarter, following subdued inflation since early 2009, to be 2½ per cent higher over the year (Graph 5.6). Fruit & vegetable prices increased by 13 per cent in the quarter – contributing 0.3 percentage points to CPI inflation – which was the largest increase since mid 2006, when banana prices temporarily spiked following Cyclone Larry. Seasonal strength in fruit & vegetable prices in the quarter was exacerbated by heavy rainfall in several states which damaged crops and reduced supply. Abstracting from fruit & vegetables, food price inflation picked up to 0.5 per cent in the quarter, although the year-ended rate remained low relative to history at 1.6 per cent. Looking ahead, the recent wet weather (including the Queensland and Victorian floods), Cyclone Yasi and elevated commodity prices will place upward pressure on food prices, particularly for fruit & vegetables, although this will be partly offset to the extent that alternative sources of supply become available (see Box A).

Graph 5.5
Non-tradables Inflation by Category*
Year-ended



* Adjusted for the tax changes of 1999–2000; excluding deposit & loan facilities
Sources: ABS; RBA

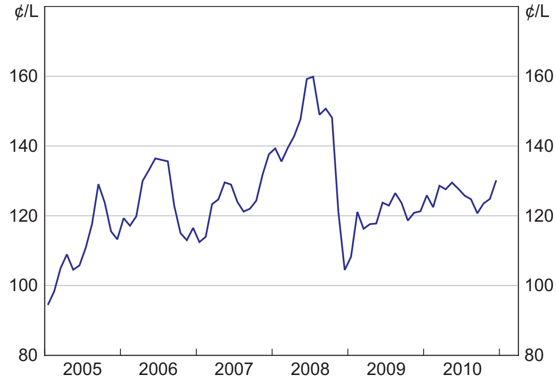
Graph 5.6
Food Price Inflation*



* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

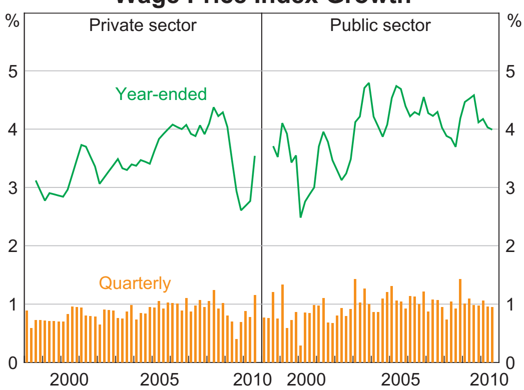
Automotive fuel prices have risen since late 2008, following the sharp decline over the previous year. As noted in the 'International Economic Developments' chapter, global oil prices have continued to rise in recent months. The price increase has been significant for Tapis oil, the relevant benchmark for Australian petrol prices, which has risen by more than 15 per cent since October 2010. The impact on petrol prices of rising oil prices has more than outweighed the effects of the exchange rate appreciation (Graph 5.7).

Graph 5.7
Retail Petrol Prices
Cents per litre, monthly



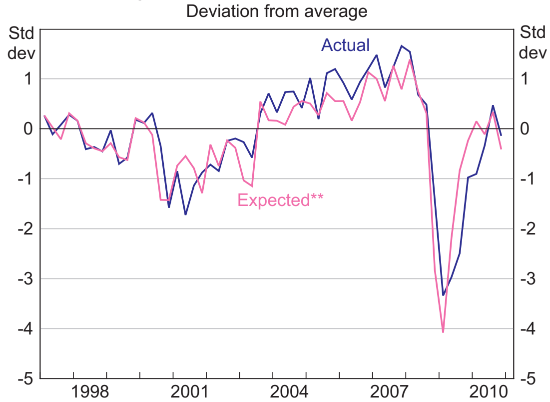
Sources: FUELtrac; RBA

Graph 5.8
Wage Price Index Growth



Source: ABS

Graph 5.9
Surveys of Business Labour Costs*
Deviation from average



* Weighted average of data from various business surveys since 1994, with weights calculated by the RBA using the principal component method

** Expectation for following quarter

Sources: CBA-ACCI; NAB; RBA; Sensis

Costs

Labour cost growth picked up during 2010, broadly in line with the Bank's expectations, following low outcomes in the private sector over 2009. This pick-up is consistent with the strengthening in labour market conditions, and a further gradual increase in wage growth is expected as the labour market continues to tighten.

The wage price index (WPI) rose by 1.1 per cent in the September quarter, after rising by 0.8 per cent in the previous quarter. The quarterly outcome partly reflected the effects of the relatively large minimum wage increase in 2010 – which came into effect in July, and followed the minimum wage freeze in 2009 – as well as the broader pick-up in wage growth due to the strengthening in labour market conditions. Over the year to September, the WPI increased by 3.5 per cent, which is slightly below the average since 1997. Private-sector wage growth picked up to 3.5 per cent over the year to September, following subdued growth over 2009 (Graph 5.8). In contrast, public sector wages have grown at a consistently solid pace in recent years, and were 4.0 per cent higher over the year to September. Wage growth has been highest in the utilities and education industries, while Queensland and Western Australia recorded the fastest pace of wage growth across the states over the year to September.

Business surveys and the Bank's liaison suggest that labour cost growth has remained around its average pace (Graph 5.9). Firms are generally not experiencing significant difficulty finding suitable labour at present, although the labour market has tightened and labour shortages have been reported in mining-related industries and for some skilled occupations.

Estimated labour productivity growth has been relatively low for several years. The combination of weak productivity growth and the pick-up in wage growth implies that growth in labour costs per unit of output was relatively high in 2010, following low growth over 2009.

Producer prices rose by around 3–4 per cent at the different stages of production over 2010, after falling over 2009 (Graph 5.10). In the December quarter, however, producer prices were broadly flat at all stages of production, with rising domestic prices offset by falling import prices. Imported producer prices fell by around 3–4 per cent in the quarter at each stage of production, with the exchange rate appreciation more than offsetting upward pressure stemming from rising commodity prices.

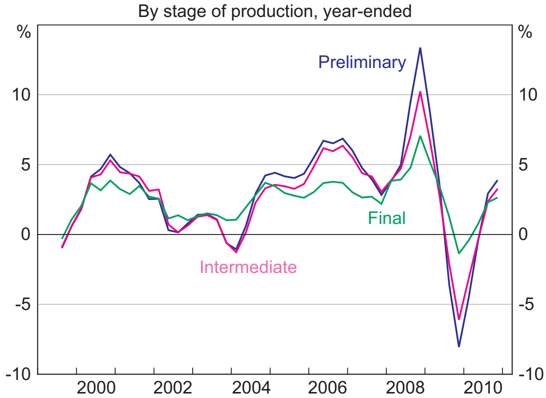
Inflation Expectations

There was a sharp increase in consumer inflation expectations in the Melbourne Institute's January survey, which may reflect expectations of large increases in fruit and vegetable prices following the floods (Graph 5.11). Medium-term inflation expectations derived from financial markets have risen more modestly over recent months, with the indexed bond measure around its average over the inflation-targeting period. Union officials have raised their near-term inflation expectations slightly, but their medium-term expectations are unchanged (Table 5.2). Market economists surveyed by the Bank are forecasting headline inflation to remain at, or a little above, the top of the medium-term target over the next couple of years, before declining to around 2¾ per cent. In contrast, business survey measures of expected selling prices in the near term remain below average levels. ✣

Graph 5.10

Producer Price Inflation*

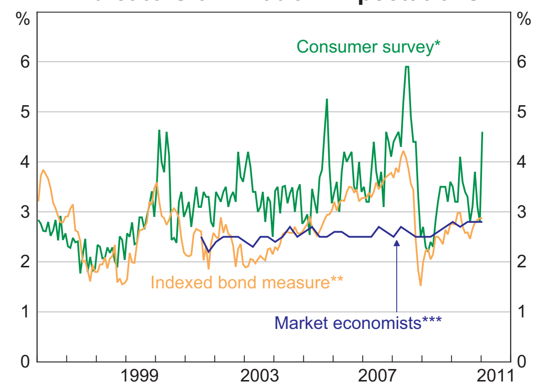
By stage of production, year-ended



* Excluding oil
Sources: ABS; RBA

Graph 5.11

Indicators of Inflation Expectations



* Median expectation of average annual inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
*** Median expectation of annual inflation 2 years ahead
Sources: Melbourne Institute of Applied Economic and Social Research; RBA

Table 5.2: Median Inflation Expectations

Per cent

	Year to December 2011			Year to December 2012	
	August 2010	November 2010	February 2011	November 2010	February 2011
Market economists[a]	3.0	3.2	3.3	2.8	3.1
Union officials[b]	3.2	3.0	3.2	na	3.2

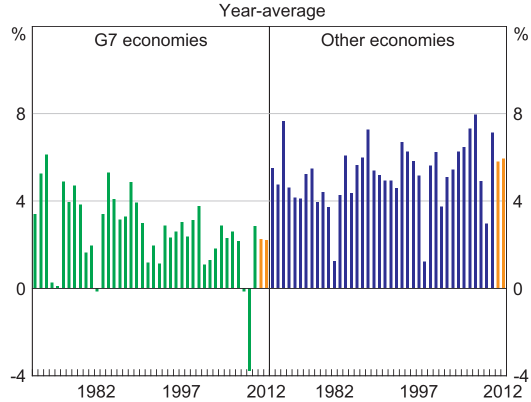
(a) RBA survey
(b) Workplace Research Centre

6. Economic Outlook

The International Economy

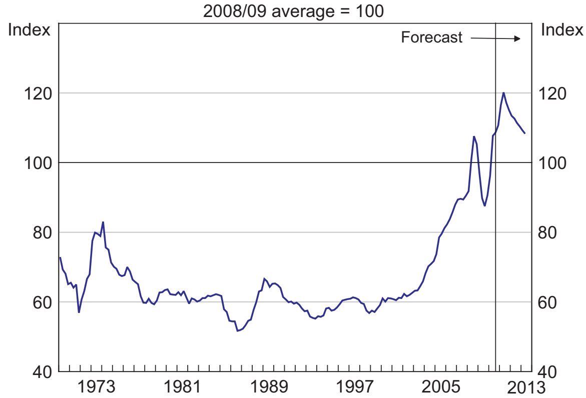
The outlook for the global economy is a little stronger than at the time of the November *Statement*, with world output expected to expand at a slightly above-trend annual pace of 4¼ per cent in both of the next two years. In the central scenario, growth is projected to remain strong in China and India, and to be firm elsewhere in Asia (excluding Japan) over the forecast period (Graph 6.1). Recovery is forecast to continue at a moderate pace in the United States and in the euro area as a whole, while growth in Japan is expected to be slower than in 2010. Considerable excess capacity is likely to remain in most of the advanced economies, in contrast to most emerging economies. The main uncertainties around the central scenario arise from the sovereign debt problems in Europe and the rate at which the current accommodative policy stance in much of Asia is tightened.

Graph 6.1
Global GDP Growth*
Year-average



* Australia's major trading partners, weighted using output shares at market exchange rates
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 6.2
Terms of Trade
2008/09 average = 100



Sources: ABS; RBA

Commodity prices have increased since the November *Statement*, reflecting continued solid demand from Asia as well as weather-related disruptions to supply. Spot prices for coking and thermal coal have increased sharply, amid significant disruption to production as a result of flooding in Queensland. Unusually cold weather in the Northern Hemisphere has also contributed to the increase in prices. Iron ore spot prices have also moved higher, on strong demand from China and tight global supply. In addition, food prices globally have increased significantly in recent months. This generalised increase in commodity prices has led to a further upward revision to the near-term outlook for Australia's terms of trade (Graph 6.2). Most commodity prices are forecast to remain at a higher level over the next couple of years than expected at the time of the November *Statement*, although the forecasts still envisage a gradual decline in bulk commodity prices over the medium term as more supply comes on line.

Domestic Activity

While the recent floods in eastern Australia are expected to have a material effect on the near-term quarterly profile of economic activity, the medium-term outlook for the economy is broadly unchanged from the time of the November *Statement*, with strong growth in mining investment and higher commodity prices boosting national income and demand. The risks around the forecasts are discussed below.

The central forecasts were finalised before an assessment of the damage from Cyclone Yasi in north Queensland was possible. They are based on the technical assumption that the exchange rate remains at its current level – which is little changed since the November *Statement* – and that the cash rate moves broadly in line with market pricing. As noted in previous *Statements*, the latter assumption does not represent a commitment by the Board to any particular path for policy. The WTI oil price assumption is US$96 per barrel, which is 10 per cent higher than at the time of the November *Statement*. The Tapis oil price assumption – which is more relevant for Australian fuel prices – is 14 per cent higher at US$103, and assumes that the current large spread to the WTI oil price narrows somewhat over the forecast period.

The central forecasts are summarised in Table 6.1 and the impact of the floods on GDP and inflation are discussed further in 'Box A: The Impact of the Recent Floods on the Australian Economy'. Growth in the December quarter and for 2010 as a whole is likely to have been weaker than was expected in November, with retail spending in late 2010 relatively subdued and heavy rain in central Queensland leading to a fall in coal production in December. The forecast for the March quarter has also been revised down, reflecting the impact of the floods on the coal industry and reduced spending by households and businesses amid the disruption of the floods in south-eastern Queensland and in Victoria. However, growth in the June quarter is forecast to be boosted as coal production recovers and as households and firms in flood-affected areas begin to replace damaged household items and machinery and equipment. There will also be a boost to activity from the rebuilding of flood-damaged dwellings as well as the public spending on repairing and rebuilding of public infrastructure, although this is likely to occur gradually over a couple of years. Overall, by the June quarter the level of GDP is expected to be back close to where it would have been in the absence of the floods and, over the remainder of the forecast period, to be slightly above where it would have been.

GDP is expected to grow by around 4¼ per cent over 2011, boosted by the recovery in coal production from the effect of the floods. Growth is expected to remain at an above-average pace of around 3¾–4 per cent over the rest of the forecast period. In year-average terms, GDP is forecast to grow by 2¾ per cent in 2010/11, 4¼ per cent in 2011/12 and 4 per cent in 2012/13. There is likely to be considerable variation across industries, with growth expected to be strongest in the mining industry, and some related service industries also experiencing

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent, over year to quarter shown

	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013
GDP growth	3.1	2¾	3¼	4¼	3¾	4	4
Non-farm GDP growth	3.2	2½	3¼	4¼	3¾	4	4
CPI inflation	3.1	2.7	2½	3	2¾	3	3
Underlying inflation	2¾	2¼	2¼	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$1.00, TWI at 74, WTI crude oil price at US$96 per barrel and Tapis crude oil price at US$103 per barrel
Sources: ABS; RBA

strong conditions. In contrast, the high level of the Australian dollar will weigh on a number of other industries.

For some time, the Bank has been expecting very strong growth in resources sector investment. The information received over recent months has provided greater confidence in this forecast, with announced plans to date at least as strong as had been expected. A number of large LNG and iron ore projects are now under way; the $43 billion Gorgon LNG project is under construction, while two large coal-seam methane projects in Queensland (together worth around $31 billion) have recently received final investment approval. Overall, the profile for mining investment projects has been revised slightly higher since the November *Statement*. Outside of the mining sector, however, liaison and survey measures suggest that firms remain cautious in their investment decisions.

Household spending and borrowing have remained subdued, with the household saving ratio now estimated to have risen back to around its level in the mid 1980s. There have been few signs of households becoming less cautious recently, with retailers continuing to report that sales have been quite soft. However, the central forecast does not envision that the saving ratio will continue to rise; growth in household consumption over the forecast period is expected to be around its trend rate, supported by solid growth in income. Dwelling investment is expected to gradually pick up, underpinned by solid population growth.

After some near-term volatility in coal exports as a result of the floods, resource exports are expected to grow solidly over the forecast period as significant new capacity comes on line. Growth in non-resource exports is expected to be modest, reflecting the high real exchange rate and policy changes in the education export sector. Import growth is expected to be strong, reflecting firm growth in domestic demand, particularly mining investment, which has a significant imported component.

The medium-term outlook for the labour market is little changed since November, although year-ended employment growth has been revised up modestly in the near term reflecting the stronger-than-expected outcome seen in the December quarter and some additional employment related to the recovery from the floods. Employment is expected to grow at an above-average pace over the forecast period, consistent with the forecast for GDP. While growth in the labour force is also expected to remain above average over the forecast period, labour market conditions are expected to tighten gradually, with the unemployment rate declining from its current rate of 5 per cent to 4½ per cent by mid 2013. The forecasts imply that growth in labour productivity will pick up over the forecast period, but remain below average.

Inflation

The medium-term outlook for inflation is largely unchanged, although the near-term forecast for year-ended underlying inflation has been revised down since the November *Statement*, following the lower-than-expected December quarter outcome.

Underlying inflation eased to around 2¼ per cent over the year to the December quarter – which was a little lower than had been expected at the time of the November *Statement* – and has now declined by around 2¼ percentage points since its peak in September 2008. Much of this overall decline has been due to the easing in domestic demand and capacity pressures in late 2008 and 2009 and the subsequent slowing in wage growth. More recently, the appreciation of the exchange rate and ongoing soft consumer spending have continued to exert downward pressure on inflation. While the exchange rate appreciation is expected to continue to have some effect in coming quarters, the forecast strengthening in private demand and the tightening labour market are expected to lead to a pick-up in year-ended inflation later this year. The floods are expected to have a noticeable effect on fruit and vegetable prices in coming quarters (as discussed in Box A), although the forecasts have been prepared on the assumption that this does not flow through to a sustained pick-up in inflation expectations.

Overall, year-ended underlying inflation is forecast to remain in the bottom half of the target range in the first half of 2011, before picking up gradually to 3 per cent by late 2012. Inflation is expected to be strongest for non-tradable items, with significant contributions from rent, utilities and other housing costs, while tradables inflation is expected to remain moderate for the next year or so, reflecting the ongoing effects of the exchange rate appreciation on imported consumer goods prices.

Headline CPI inflation was 2.7 per cent over the year to the December quarter. Year-ended CPI inflation is expected to remain above underlying inflation in the near term, at around 2½–2¾ per cent, largely reflecting the tobacco excise increase in 2010 and high inflation in utilities, fruit and vegetable prices. These forecasts do not incorporate any effects from Cyclone Yasi in north Queensland. Based on previous experience, an increase in fruit and vegetable prices can be expected, particularly for bananas. However, at the time of writing not enough information was available to form a quantitative assessment of the likely effects.

Risks

As always, there are risks around the central forecasts.

For the international economy, one ongoing downside risk is the possibility of further escalation in the sovereign debt problems of some euro area economies. If this were to be accompanied by a generalised retreat from cross-border risk-taking, it could have a significant contractionary effect on the global economy.

A further set of risks concerns the accommodative settings of policies in much of Asia and some other parts of the emerging world. Economic growth in many of these economies is strong, property market conditions have been buoyant in some countries, and inflation pressures are building. A continuation of strong growth would see further strong increases in commodity prices and income gains for Australia. The experience of 2007 and early 2008 suggests that – notwithstanding the insulating role of a floating exchange rate – the combination of rising global inflationary pressures, large increases in commodity prices and a domestic economy close to full employment could lead to domestic inflation rising more quickly than envisaged in the central scenario. On the other hand, if overheating in these economies prompted a significant tightening of policies, there could be a sharper-than-anticipated slowing in growth in these economies, with flow-on effects to commodity markets. This would be contractionary for Australia and would result in some easing in the outlook for the resources sector.

The impact of extreme weather events on the macroeconomy is an important source of short-term uncertainty for the forecasts, as the full extent of damage to public infrastructure and private property is yet to be determined. On the downside, there is the risk that damage to infrastructure is larger than currently estimated with coal production taking longer to recover than in the central forecast. In addition, given the La Niña weather pattern, there is the possibility of further extreme weather events over the next few months. There is, however, also the possibility that the process of rebuilding and repair draws in more resources than is currently assumed, with more broad-based pressure on price and wage inflation than in the central forecast.

As noted in previous *Statements*, the resources sector is an important element of the outlook for the economy. The recent announcements that some large projects have obtained final investment approval provide greater confidence in the pick-up in resources investment that the Bank has been expecting for some time. Nevertheless, there is still uncertainty surrounding other projects that are in earlier stages of planning and could be delayed. On a broader perspective, as resources investment and exports grow in relative importance, developments in the resources sector will have a greater impact on the domestic economy, whether from supply-side factors or from swings in global demand.

A final uncertainty relates to the behaviour of Australian households. Household spending in recent years has been subdued compared with income growth, resulting in a significant increase in the household saving ratio. It is possible that this trend will continue, reflecting an ongoing change in households' attitudes to spending and debt as well as the current mildly restrictive monetary policy settings. On the other hand, there is a possibility that household spending, at some point, could pick up by more than is assumed in the forecasts, with households being prepared to spend more of their growing incomes after a period of balance-sheet consolidation. This would result in stronger pressures on domestic resource utilisation and an increased risk of higher inflation outcomes.