

# Statement on Monetary Policy

FEBRUARY 2012

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*Reserve Bank*

The material in this *Statement on Monetary Policy* was finalised on 9 February 2012. The next *Statement* is due for release on 4 May 2012.

The *Statement on Monetary Policy* is published quarterly in February, May, August and November each year. All the *Statements* are available at [www.rba.gov.au](http://www.rba.gov.au) 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  
Email: [rbainfo@rba.gov.au](mailto:rbainfo@rba.gov.au)

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

# Overview

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The global outlook remains clouded by the sovereign debt problems in Europe. Notwithstanding this, there has been a general improvement in sentiment over the past month or so following further measures by the European Central Bank and European governments. Equity and commodity prices have picked up after earlier falls, and bond yields in a number of European countries have declined. Nonetheless, further measures by European policymakers will be required over the months ahead for public finances in a number of countries to be placed on a sustainable path.

Largely reflecting developments in Europe, official forecasts for global growth have been revised lower, with growth in the world economy now expected to be below trend in 2012, but nothing like as weak as 2008–09. As has been the case over recent years, a significant share of overall growth is expected to come from the emerging market economies, particularly those in Asia. In contrast, in many of the advanced economies a broadly synchronised fiscal consolidation is taking place at a time when both households and financial institutions are also deleveraging, which is likely to be contractionary for growth. As a result, limited progress is expected over the next couple of years in reducing unemployment in these countries.

In Europe, the economy appears to be in recession. In contrast, the US economy has improved over recent months after a soft patch in mid 2011, with the unemployment rate declining and tentative signs of improvement in housing activity. In east Asia, growth has slowed, partly reflecting weaker export

demand as well as the earlier policy tightening. Growth in China has moderated, as was intended by the Chinese authorities, and is now running at a more sustainable pace. Inflation in China has also moderated, and the authorities are continuing with measures to contain property prices, which is having a dampening effect on the real estate industry.

While spreads on bonds issued by a number of European governments remain elevated, they are noticeably lower than they were in late 2011. In the major bond markets, yields remain near their historic lows and, in Australia, yields on 10-year government bonds recently fell to 50-year lows, with significant purchases by non-residents, including sovereign asset managers. The Australian dollar has appreciated against major currencies over the past couple of months and is currently not far below the multi-year peaks reached last year, even though commodity prices have declined since then.

Bank debt markets globally were particularly dislocated in the latter part of 2011, with minimal issuance, partly reflecting concerns about the European banking system. Over the past month, conditions have improved, with issuance picking up markedly, but spreads on bank debt are significantly higher than they were in the middle of last year. Indeed, some large corporates are now able to raise funds in the capital markets more cheaply than banks with a higher credit rating. These global developments have had an effect in Australia, where there has been a step-up in the banks' overall cost of funding relative to the cash rate.

The recent improvement in sentiment is reflected in commodity prices, which have risen over the past couple of months after falling over the second half of last year. The price of iron ore has picked up, reflecting ongoing strength in Chinese demand, although global steel production has softened. Energy commodity prices have remained at high levels, partly due to geopolitical factors. Australia's terms of trade reached a record high in the September quarter, and are estimated to have declined somewhat in the December quarter.

The Australian economy continues to record moderate growth, with GDP estimated to have increased by around 2¾ per cent over 2011, which is a little below average, partially reflecting the extreme weather events early in the year. Conditions continue to vary significantly across industries, with the economy undergoing considerable structural change in response to high commodity prices and the accompanying high exchange rate. Real incomes in Australia have received a significant boost over recent years as a result of the rise in the terms of trade, but the effects are being felt unevenly across the economy.

Overall measures of business conditions and confidence are at, or slightly below, average levels, after recovering from their falls around August. Business credit has also increased slightly over the second half of 2011 after falling over the previous year. Credit conditions, however, remain quite tight for the commercial property industry.

In the resources sector, investment is expanding at a rapid pace. As a result, it is likely that over the next year the level of business investment in the economy will reach its highest level, relative to GDP, in at least half a century. Since the previous *Statement*, another large liquefied natural gas (LNG) project has received final investment approval, bringing the total value of LNG projects approved or under construction to around \$180 billion.

In contrast, conditions in a number of other sectors remain subdued, with the high exchange rate, soft

consumer demand for goods, the scaling back of public investment and weak building construction all weighing on activity. The recovery in coal production from the Queensland floods has also taken longer than initially expected, with Queensland coal exports yet to return to pre-flood levels.

Retail spending remains subdued, although demand for services has been growing relatively strongly. Over the past year, household consumption has increased broadly in line with incomes, with the household saving ratio steady at around 10 per cent. The ratio of household debt to income has declined modestly over the past couple of years, with household debt increasing at an annual rate of 5 per cent, slightly below the growth in aggregate household income.

The housing market remains soft, with turnover rates around the lowest they have been over the past two decades. Nationwide measures of prices recorded modest declines over 2011, although there were signs of stabilisation in some markets at the end of the year. Building construction activity remains subdued, in part due to the earlier pull-forward of demand from the boost to first home buyer grants, slower population growth, tight access to credit for developers and lowered expectations of capital gains.

The unemployment rate has been steady at 5¼ per cent over recent months, after increasing slightly around mid year. Measured employment growth has slowed noticeably, following the strong growth in 2010. Employment has declined in a number of industries, including manufacturing, retail and real estate, but has increased strongly in others, particularly in mining. At the aggregate level, additional demand for labour appears to have been met largely through existing employees working longer hours, rather than an increase in hiring. The forward-looking indicators point to moderate growth in employment over the period ahead, although the Bank's liaison suggests that some firms are looking for greater certainty about the economic environment before hiring additional workers.

Growth in private sector wages is running at around its medium-term average pace, while public sector wage growth has slowed over the past year. Outside of industries exposed to the mining boom, there is little evidence of upward pressure on wage inflation, with the moderation in labour market conditions over the past year reducing the likelihood of an acceleration in wages.

The recent inflation data were broadly in line with expectations, with the various measures showing underlying inflation of around ½ per cent in the December quarter. On a year-ended basis, underlying inflation is running at around 2½ per cent, the midpoint of the medium-term target range, with the outcomes over the second half of the year lower than in the first half.

On a seasonally adjusted basis, the headline CPI rose by 0.2 per cent in the quarter, to be 3.1 per cent higher over the year. The outcome was again affected by the price of bananas, which subtracted around 0.3 percentage points from inflation in the quarter as supply recovered from disruptions caused by Cyclone Yasi. The price of tradables (excluding food, fuel and tobacco) fell by ½ per cent in the quarter, with noticeable falls in the prices of cars and major household appliances. Outside of these items, however, most other tradable items recorded smaller price declines than in the recent past, partly reflecting higher world prices.

In contrast, the prices of non-tradables continue to increase at a fairly firm pace, rising by 0.9 per cent in the quarter and by 3¾ per cent over the year. There were slightly above-average increases in the prices of a range of non-tradables, including rents, communication, restaurant & takeaway meals and childcare. While non-tradables inflation has slowed significantly since 2008, some further moderation is likely to be required for overall inflation to be consistent with the midpoint of the target range once the effect of the appreciation of the exchange rate on tradables prices fades.

The Bank's central forecast for the aggregate economy remains for around trend GDP growth over 2012 and 2013. Demand is expected to continue to increase more quickly than output, with a significant share of the growth in investment met through imports. Employment growth is expected to remain fairly subdued in the near term, with a further small increase in the unemployment rate forecast over 2012, before the unemployment rate declines again over the later part of the forecast period.

The very strong growth in investment in the resources sector remains a key element in the forecasts. This investment is expected to have positive spin-offs to a number of other sectors, although the high exchange rate, fiscal consolidation and subdued consumer spending on goods mean that overall growth outside the resources sector is expected to remain below trend.

The major uncertainty regarding these forecasts stems from developments in Europe, where there is still some possibility of an intensification of the sovereign debt problems. While the likelihood of such an outcome seems to have lessened a little recently, if it did occur, Europe would be likely to experience a severe recession with spillover effects to the rest of the world through trade, financial and confidence linkages. Australia is better placed than many other countries to deal with this downside risk, given the scope to adjust macroeconomic policy, the flexible exchange rate and the strong banking system. Nevertheless, if this downside risk did eventuate, growth in Australia would be weaker than in the Bank's central scenario.

In terms of domestic factors, it remains difficult to judge the net impact on the economy of, on the one hand, a once-in-a-century investment boom in the resources sector and, on the other, a high real exchange rate. With the exchange rate having been at a high level for some time, a number of businesses are reassessing their business models and medium-term prospects. Other businesses are benefiting from the boom in the resources sector and from

the lift in national income from the high terms of trade. Given the historically unusual nature of these events, there is, inevitably, considerable uncertainty about how these factors will ultimately play out, with plausible upside and downside scenarios for domestic growth.

The broad outlook for inflation is little changed from the forecasts published in the November *Statement*. In underlying terms (excluding the introduction of the price on carbon) inflation is forecast to remain around the midpoint of the target range for most of the next couple of years, before increasing late in the forecast horizon as the disinflationary effects from the exchange rate appreciation diminish. In headline terms, inflation is expected to fall below underlying inflation in the near term as the earlier spike in fruit prices continues to unwind. Then, from the September quarter 2012, inflation will be boosted by the introduction of the carbon price, which is expected to add 0.7 percentage point to headline inflation and around  $\frac{1}{4}$  percentage point to underlying inflation over the following year. This outlook for inflation incorporates a modest slowing in domestic cost pressures. It also assumes that the

introduction of the price on carbon does not lead to second-round effects on prices through higher margins or wage claims.

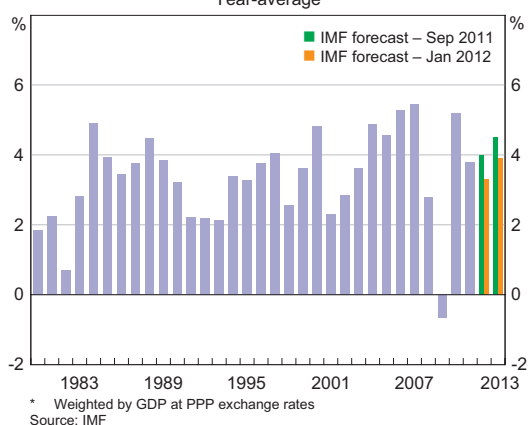
With the inflation outlook having improved late last year, the Board lowered the cash rate by a cumulative 50 basis points at its November and December meetings, after having maintained a mildly restrictive stance of monetary policy through most of 2011. These reductions in official interest rates were largely passed through to borrowers, so that most lending rates in the economy are now close to their medium-term averages. At its February meeting, the Board judged that it was appropriate, for the moment, to hold the cash rate steady at 4.25 per cent, given that the central forecast was for close to trend growth in GDP and inflation being close to target. The current inflation outlook would, however, provide scope for easier monetary policy should demand conditions weaken materially. Over the months ahead, the Board will continue to monitor information on economic and financial conditions and adjust the cash rate as necessary to foster sustainable growth and low inflation. ✦

# 1. International Economic Developments

Sovereign debt problems in a number of advanced economies continue to be a major factor influencing developments in the global economy. The economic data in Europe have deteriorated significantly since mid 2011 and a feedback loop between sovereign debt problems and deteriorating economic conditions has developed in some countries. The European authorities, however, have made some progress in their efforts to craft a credible solution to the problems and, alongside the falls in sovereign bond spreads discussed in the chapter on 'International and Foreign Exchange Markets', there have been tentative signs of improvement in survey data over the past two months. The problems in Europe are having spillover effects to the rest of the world through trade, financial channels and an increase in broader economic uncertainty. Growth in Asia has slowed, although the region continues to expand at a faster pace than many other parts of the world. In the United States, economic indicators have picked up in recent months following a soft patch in mid 2011, although the fiscal position there also poses medium-term challenges.

In line with these developments, the International Monetary Fund's (IMF) January World Economic Outlook Update made downward revisions to the forecasts in the September 2011 Outlook (Graph 1.1, Table 1.1). Global growth is now forecast to be below trend at 3.3 per cent in 2012 and 3.9 per cent in 2013, with forecast growth in Australia's major trading partners around one percentage point higher in each year, reflecting Australia's strong trading links with Asia. A further intensification of sovereign debt problems in Europe is still seen as the biggest risk to global growth.

**Graph 1.1**  
**World GDP Growth\***  
Year-average



With the pace of growth of the world economy slowing over 2011, global inflationary pressures have lessened. Headline rates of inflation have fallen as oil and food price inflation has eased; rates of core inflation have generally moderated, consistent with the significant spare capacity in much of the advanced world.

## Asia

In east Asia, growth has slowed reflecting weaker export demand from the North Atlantic economies and the earlier policy tightening, as well as some temporary supply factors. Merchandise exports from east Asia (excluding Japan) fell in the December quarter, with particular weakness in the value of exports to Europe and of electronics (Graph 1.2). Natural disasters (most recently the floods in Thailand) are also affecting production and feeding through regional supply chains. Exports to the United

**Table 1.1: World GDP Growth**  
Year-average, per cent

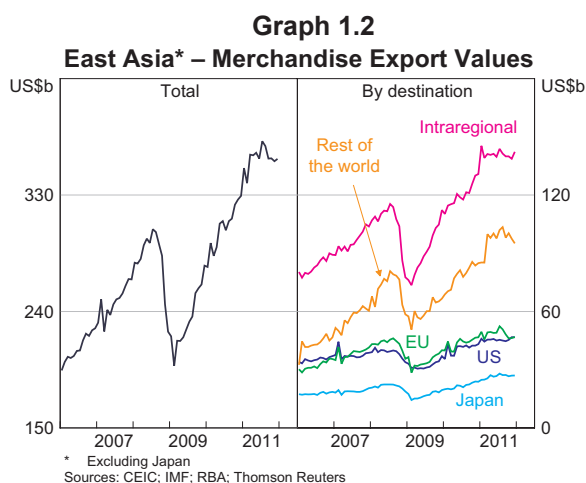
	2010	2011	2012	2013
		Estimate	IMF forecasts	
United States	3.0	1.7	1.8	2.2
Euro area	1.9	1.6	-0.5	0.8
Japan	4.4	-0.9	1.7	1.6
China	10.4	9.2	8.2	8.8
Other east Asia <sup>(a)</sup>	7.7	4.5	4.1	4.7
India	9.9	7.4	7.0	7.3
<b>World<sup>(b)</sup></b>	<b>5.2</b>	<b>3.8</b>	<b>3.3</b>	<b>3.9</b>
Australia's trading partners <sup>(c)</sup>	6.9	4.4	4.4	4.9

(a) Based on the IMF forecasts for the newly industrialised Asian economies and the ASEAN-5 categories

(b) Weighted using GDP at PPP exchange rates

(c) Weighted using merchandise export shares

Sources: IMF; RBA



States have been stronger, however, in line with recent signs of improvement in the US economy.

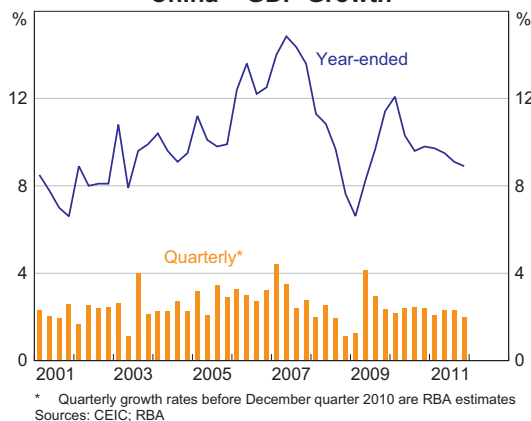
There are also signs that domestic demand in Asia has softened a little. Greater uncertainty about growth prospects is likely to have been a dampening influence. The policy-induced tightening in credit conditions that occurred in early to mid 2011, particularly in China, is also likely to have weighed on domestic demand growth. Reflecting these factors, sentiment has softened, credit growth has eased across the region and aggregate output growth has slowed.

The Chinese economy continues to record strong growth, although the pace of expansion has slowed, with GDP growing by 2 per cent in the December quarter to be 8.9 per cent higher over the year (Graph 1.3). In part, the moderation in Chinese growth is due to domestic economic policies, including the continuing unwinding of the late 2008 fiscal stimulus, tighter monetary policy and measures to contain the property market. Weaker global demand has also weighed on growth. Similar to other economies in the region, growth in the value of Chinese exports slowed in the second half of 2011. In contrast, imports have grown solidly in recent months, with imports of crude oil, coal and copper expanding at a robust pace and imports of iron ore remaining high (Graph 1.4).

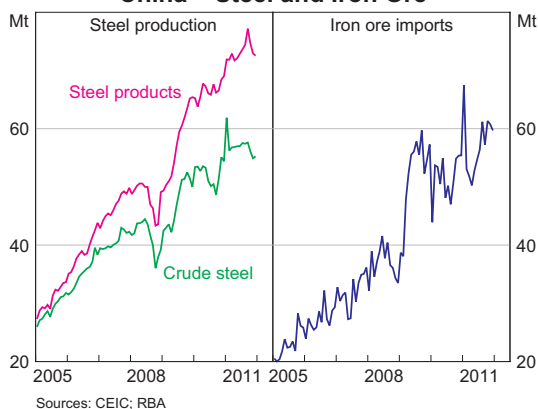
Growth in domestic demand remains firm, although below the pace of 2010. Retail sales have continued to expand at a solid pace and passenger vehicle sales have increased further to be just below the policy-affected peak level of late 2010. Manufacturing investment has continued to grow, notwithstanding weaker external demand, and industrial production growth has remained firm, albeit below the pace recorded earlier in 2011. Although power generation and automobile production have been growing strongly over recent months, other components of



**Graph 1.3**  
**China – GDP Growth**



**Graph 1.4**  
**China – Steel and Iron Ore**



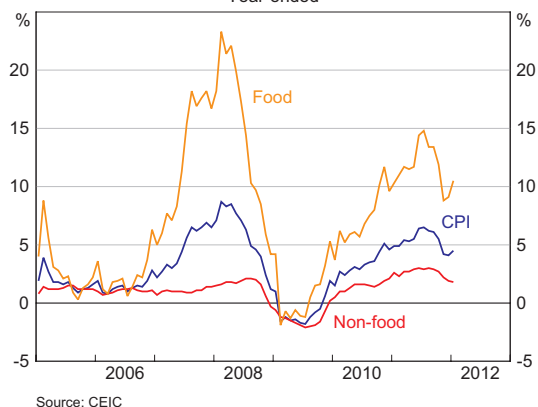
industrial production have been softer, particularly those more closely related to the construction sector. Output of crude steel, steel products and cement all fell towards the end of 2011, reflecting both the slowing in infrastructure investment due to the withdrawal of fiscal stimulus and softer growth in real estate investment. The gradual extension of property controls to more cities over time and the restricted availability of credit to property developers have had the desired effect of slowing activity in the property market (for more details, see 'Box A: China's Residential Property Market').

Inflationary pressures eased significantly towards the end of 2011, reflecting falls in agricultural prices and lower commodity prices. Consumer prices increased

by 4.5 per cent over the year to January after having peaked at 6.5 per cent in July (Graph 1.5). This disinflation largely reflects lower food price inflation, though year-ended non-food inflation has also eased, to be below 2 per cent after having reached 3 per cent in mid 2011. Housing has been the main driver of lower non-food inflation, reflecting lower growth in rents for public housing. Year-ended inflation is expected to moderate further in coming months as lower commodity prices, including for cotton and grains, feed through into retail prices of products such as clothing and alcohol.

Monetary policy settings have remained mostly unchanged since the November *Statement*, although the People's Bank of China (PBC) has lowered banks' reserve requirements by 50 basis points as the pace of foreign exchange reserve accumulation has slowed. While credit growth moderated to around 16 per cent over 2011, the monthly pace of credit growth increased towards the end of the year. This possibly reflects a switch in how financing was being provided following regulations introduced in September requiring banks to hold reserves against margin deposits used to secure bank acceptances, which is likely to have caused banks to shift some lending activity back onto their balance sheets. There was also a slowing in a broader measure of financing, with the flow of total social financing in 2011 below the target set by the PBC earlier in the year.

**Graph 1.5**  
**China – Consumer Price Inflation**  
Year-ended

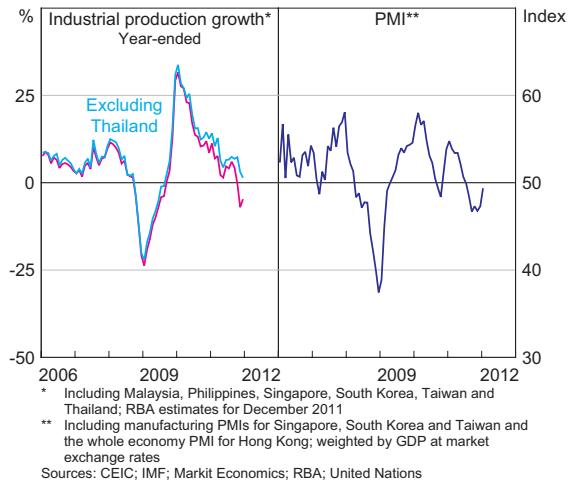


Consistent with the falls in exports, industrial production in east Asia (excluding China and Japan) has been weak. Excluding Thailand, where manufacturing production halved over October and November due to severe flooding and is yet to fully recover, industrial production was broadly flat over the year to December with growth in electronics production softening (Graph 1.6). Uncertainty about the global outlook also appears to have dampened domestic demand. Retail sales fell by ½ per cent in the December quarter and consumer confidence declined, though it remains at above-average levels (Graph 1.7). Indicators of investment have also weakened. Nonetheless, credit growth remains relatively firm and the PMI surveys of manufacturing activity picked up noticeably in January.

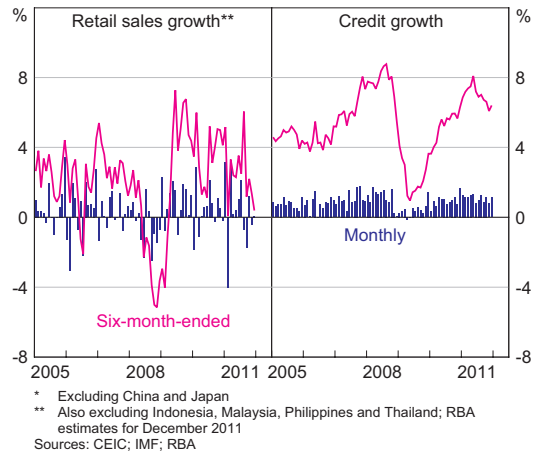
Labour market indicators were mixed in the December quarter. Average hours worked in South Korea and Taiwan declined and wage growth in the higher-income economies slowed sharply. Unemployment rates, however, declined a little further. Price pressures have started to ease and a number of monetary authorities in the region have loosened policy. The region has ample scope to pursue more stimulatory macroeconomic policies if required, with low government debt ratios and the ability to cut nominal interest rates following policy tightening over the first half of 2011.

Indicators of activity in Japan softened in the December quarter. Export volumes fell by more than 7 per cent over October and November (partly due to the Thai floods disrupting supply chains) and recovered only slightly in December. Machinery orders and indicators of production also fell in the quarter, as did household expenditure (Graph 1.8). In contrast, activity in the services sector appears to have improved modestly in the quarter. The rebuilding of earthquake-damaged houses and infrastructure is now expected to begin in the March quarter, which will boost growth in 2012; land clearing has been completed and in November the Diet passed a third supplementary budget to finance the rebuild.

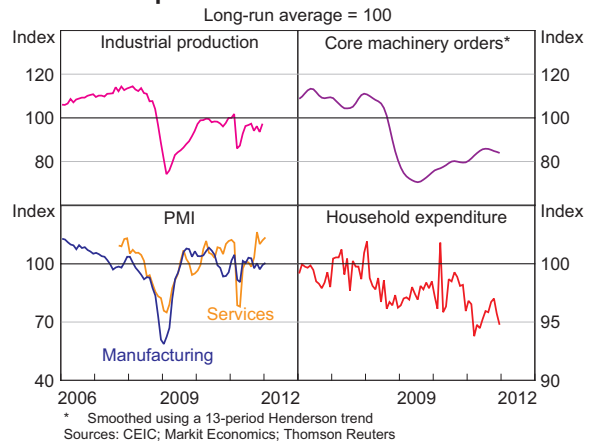
**Graph 1.6**  
**East Asia – Production and PMI**



**Graph 1.7**  
**East Asia\* – Domestic Indicators**



**Graph 1.8**  
**Japan – Economic Indicators**



In India, GDP grew by 7 per cent, down from the rates of around 10 per cent that were recorded during 2010. The slowing in growth follows a significant tightening in monetary policy, and recent data suggest that growth eased further in the December quarter (Graph 1.9). Growth in industrial production remains subdued; in the final months of 2011, average manufacturing output remained around 5 per cent below its peak in early 2011. In addition to the effect of monetary policy, industrial production has also been affected by problems at a number of coal mines, which have lowered mining output and disrupted the supply from thermal power stations. The value of merchandise exports fell in the December quarter, reflecting weaker external demand and lower commodity prices, particularly for iron ore. In contrast, conditions in India's services sector appear to have improved, with the services PMI rising to its highest level in six months in January.

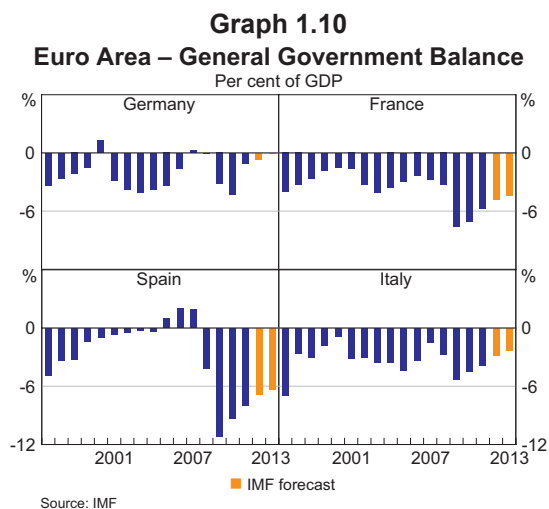
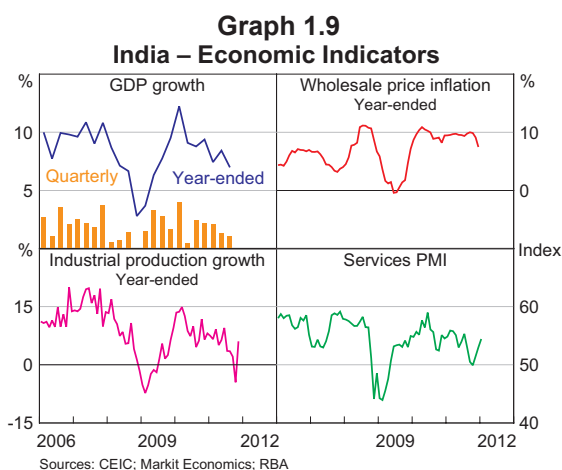
Despite some moderation, inflation in India remains high. The wholesale price index rose by 7½ per cent over the year to December. While inflation in prices of food and other primary products has eased in recent months, this has been partly offset by a pick-up in inflation for fuel and power; non-food manufacturing inflation has remained elevated. After increasing its policy rate by a cumulative 375 basis points starting in early 2010, the Reserve Bank of India has left rates on hold at its past three policy reviews, although it has recently reduced the

cash reserve ratio by 50 basis points in order to ease liquidity conditions.

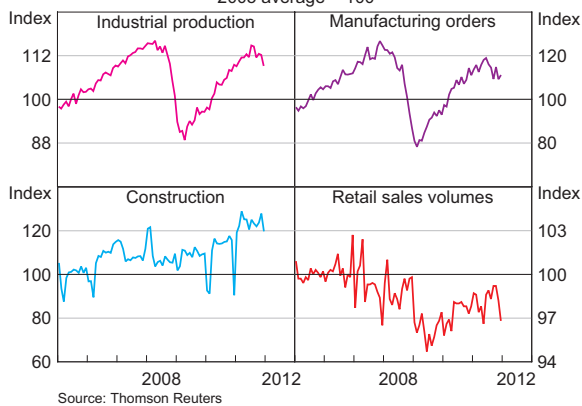
## Europe

Conditions in the euro area have deteriorated since mid 2011. Over this period, fiscal consolidation measures have slowed growth and sentiment has been dampened by concerns about the sustainability of sovereign debt positions (Graph 1.10). Business and consumer sentiment are well below their July levels, notwithstanding some improvement over the past two months in some countries.

Reflecting these developments, activity indicators for the euro area were weak in the December quarter, including in Germany which had led the modest expansion seen in the euro area over the previous two years. In Germany, industrial production has fallen by almost 5 per cent from its peak in July and retail sales volumes have fallen by 2½ per cent since September (Graph 1.11). Forward-looking indicators of equipment investment and exports, the two strongest sectors in the German recovery, have also declined. In contrast, construction activity in Germany has generally remained firm in recent months, the unemployment rate has continued to fall and the most recent readings of business and consumer confidence have strengthened somewhat.

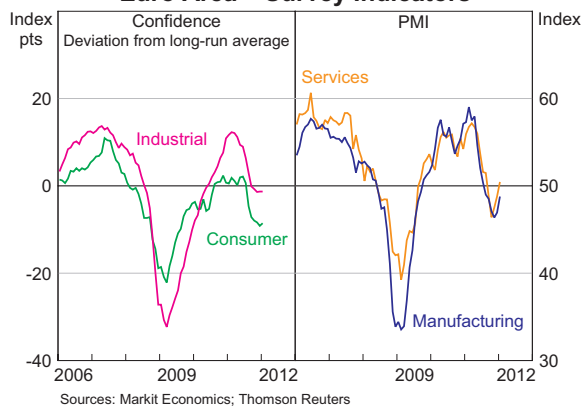


**Graph 1.11**  
**Germany – Activity Indicators**  
2005 average = 100



Outside of Germany and the northern economies, conditions remain fragile. The Greek economy continues to contract sharply, while activity is weak in Italy and Spain; further fiscal consolidation is expected to weigh on growth in these economies in the next couple of years (see 'Box B: Fiscal Consolidation and Economic Growth in the Advanced Economies' for more details). Unemployment in the euro area as a whole has risen in recent months to a rate of 10.4 per cent, the stock of outstanding credit has fallen recently, while consumer and business confidence remain at low levels, notwithstanding some improvement in the manufacturing and services PMIs in recent months (Graph 1.12).

**Graph 1.12**  
**Euro Area – Survey Indicators**



## United States

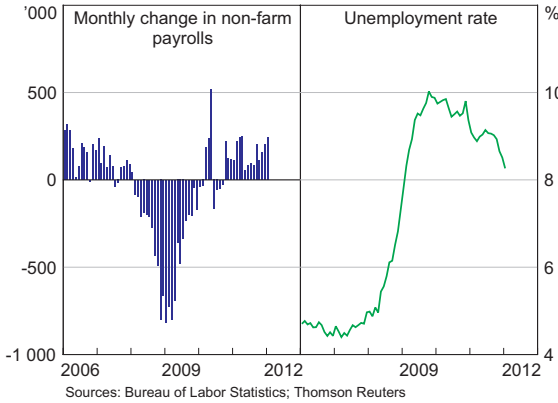
In contrast to the deterioration in economic conditions seen in a number of other parts of the world, economic activity in the United States has continued to improve, following a soft patch in mid 2011. The labour market has picked up, consumption growth has been solid, and house sales and housing starts have increased a little in recent months. However, the stock of unsold homes is still high and some measures of house prices have continued to fall in recent months. Further, the boost to spending from lower saving in the second half of 2011 is unlikely to be sustained, with household balance sheets still weak and many household mortgages still in negative equity. As in many other advanced economies, the ratio of government debt to GDP is high and fiscal consolidation is likely to weigh on growth in the medium term.

After softening in the middle of the year, the labour market picked up towards the end of 2011. Non-farm payrolls employment increased by an average of around 200 000 per month in the three months to January, up from an average of 78 000 in the three months to July 2011, and the unemployment rate fell to 8.3 per cent in January after having been broadly steady at around 9 per cent for much of 2011 (Graph 1.13). Other timely indicators, such as initial jobless claims, have also continued to improve.

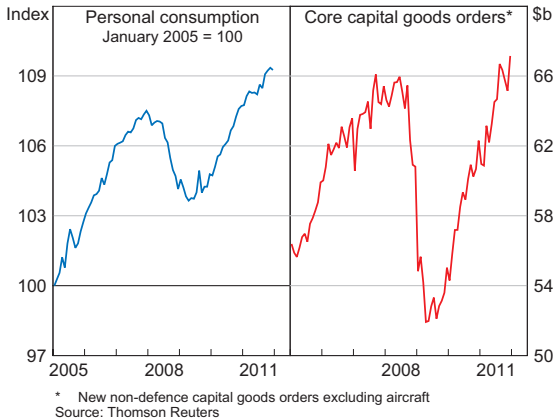
In line with the labour market improvement, consumer spending growth strengthened in the second half of 2011 (Graph 1.14). This pick-up in consumption partly reflects the recovery in purchases of motor vehicles following supply problems stemming from the Japanese earthquake, but purchases of other goods have also increased. Household consumption grew by ½ per cent in the December quarter and the continued improvement in the labour market and a recovery in consumer confidence from low levels should support consumer spending in the period ahead.

Business equipment investment continued to grow in the December quarter, although there

**Graph 1.13**  
**United States – Labour Market**



**Graph 1.14**  
**United States – Economic Indicators**



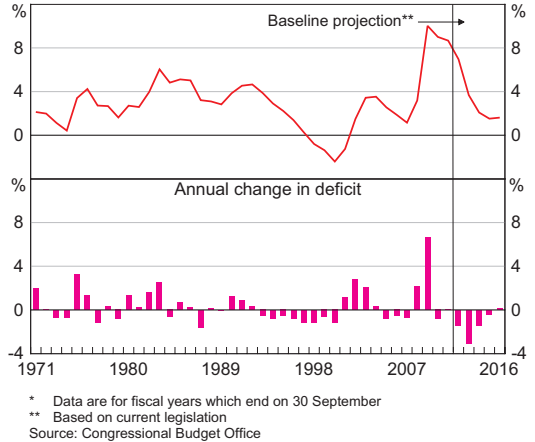
\* New non-defence capital goods orders excluding aircraft  
Source: Thomson Reuters

has been some slowing. Manufacturing activity, however, looks to have remained firm, with industrial production continuing to trend higher and the manufacturing ISM picking up from its recent lows. Growth in business credit (outside of commercial real estate) has also picked up.

Inflationary pressures in the United States eased markedly in late 2011, largely reflecting falls in global commodity prices and the reversal of some temporary factors that were boosting prices earlier in the year. Headline measures of consumer prices were broadly flat over the three months to December and the monthly pace of core inflation has moderated since mid 2011.

The Joint Select Committee on Deficit Reduction did not reach any agreement about cuts to spending or increases in taxes, while Congress has not passed key components of President Obama’s proposed American Jobs Act. As a result, on current legislation a large fiscal contraction is scheduled to occur in 2013. The Congressional Budget Office estimates that this contraction could be around 3 per cent of GDP in fiscal year 2013, although there is some uncertainty about how much of this contraction will ultimately occur (Graph 1.15).

**Graph 1.15**  
**United States – Federal Budget Deficit\***  
Per cent of nominal GDP



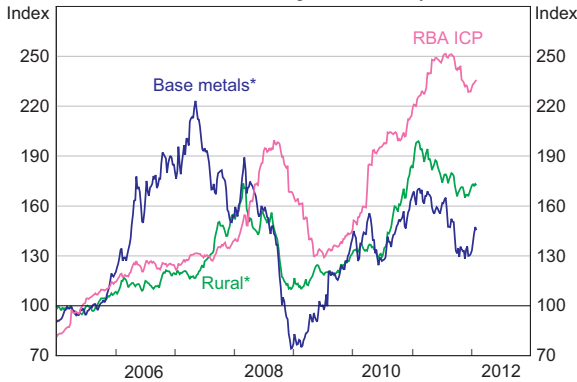
\* Data are for fiscal years which end on 30 September  
\*\* Based on current legislation  
Source: Congressional Budget Office

## Commodity Prices

Global commodity prices have remained at relatively high levels over the past three months, despite ongoing sovereign debt problems in Europe and some slowing in economic growth in China (Graph 1.16 and Table 1.2). While spot prices for coking coal and some rural commodities have edged lower since early November, spot prices for base metals and iron ore have increased, and oil prices have also risen. The terms of trade are estimated to have fallen in the December quarter reflecting the earlier weakening in iron ore prices, but the forecast profile has been revised up slightly.

**Graph 1.16  
Commodity Prices**

SDR, 2005 average = 100, weekly



\* RBA Index of Commodity Prices (ICP) sub-indices  
Source: RBA

The iron ore spot price has retraced almost half of the sharp fall recorded over September and October, rising by around 30 per cent from the low recorded in late October to be around US\$136 per tonne (free on board basis; Graph 1.17). Global steel production has declined over recent months, though Chinese iron ore demand has remained strong, with mills and traders reportedly rebuilding inventories. While global iron ore production capacity expanded in the second half of 2011, an increase in duty on iron ore exports from India – the world’s third-largest iron ore exporter – and some weather-related disruptions in Brazil have restrained supply more recently. Coking coal spot prices have edged lower over the past three months, and are now around the levels seen prior to the significant flood-related disruptions to Queensland coal production early in 2011. Contract prices for hard coking coal look to have moved sharply lower in the March quarter, in line with the earlier falls in the spot price.

Quarterly contracts emerged almost two years ago as a dominant price-setting mechanism for Australian iron ore and coking coal exports, largely replacing annual benchmark prices. More recently, price-setting mechanisms have continued to shift towards shorter-term index-based approaches. In the case of iron ore, this evolution appears to have been accelerated by the sharp decline in spot prices

**Table 1.2: Commodity Price Growth<sup>(a)</sup>**  
SDR, per cent

	Change since previous Statement	Change over the past year
Bulk commodities <sup>(b)</sup>		
– Iron ore	24	–24
– Coking coal	–11	–35
– Thermal coal	3	–3
Rural	1	–12
– Beef	2	2
– Cotton	–4	–49
– Wheat	0	–23
– Wool	5	4
Base metals	10	–14
– Aluminium	9	–11
– Copper	11	–14
– Lead	11	–16
– Nickel	18	–24
– Zinc	12	–14
Gold	1	28
Oil <sup>(c)</sup>	6	20
– US\$ terms	4	19
RBA ICP	1	5

(a) RBA Index of Commodity Prices (ICP) components except oil and bulk commodities; latest available

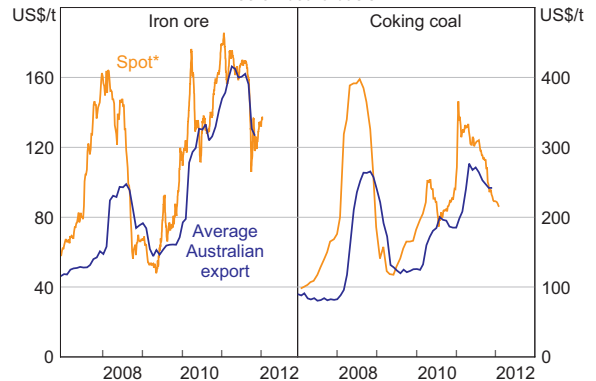
(b) Spot prices

(c) Average of WTI and Tapis crude oil prices

Sources: Bloomberg; RBA

**Graph 1.17  
Bulk Commodity Prices**

Free on board basis



\* Iron ore fines and premium hard coking coal

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

in October, as customers shifted from backward-looking (and therefore higher) quarterly contract prices to arrangements based on more timely (and therefore lower) monthly or quarterly averages of spot price indices. Looking ahead, company announcements suggest that over half of Australian iron ore exports will be sold on either spot or monthly contract price terms, while one major producer has indicated that it expects to sell almost two-thirds of its coking coal on such terms in 2012.

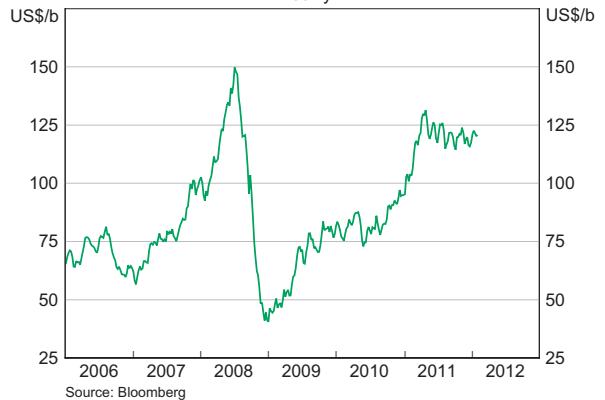
The prices of energy-related commodities have tended to rise over recent months. Thermal coal spot prices have increased since the November *Statement*, but they remain around 9 per cent below the 2011/12 Japanese fiscal year contract price of US\$130 per tonne. Global crude oil prices have risen over recent months, despite a weakening in the outlook for global economic activity (Graph 1.18). Geopolitical factors are affecting global oil markets, with the EU imposing an embargo on Iranian oil exports from mid 2012, and US sanctions also weighing on Iranian oil trade. Oil production also continues to be disrupted in Syria, Libya and South Sudan due to political tensions.

Base metals prices have strengthened over the past three months, after falling through much of 2011 in response to softer growth in global industrial production and weaker prospects for demand (Graph 1.19). Market reports suggest that the prices of aluminium, and some other base metals, are close to marginal costs of production, and there has been some mothballing of global aluminium production capacity. The gold price has risen by 1 per cent since November to around US\$1 730 per troy ounce, but it remains well below the peak reached in early September.

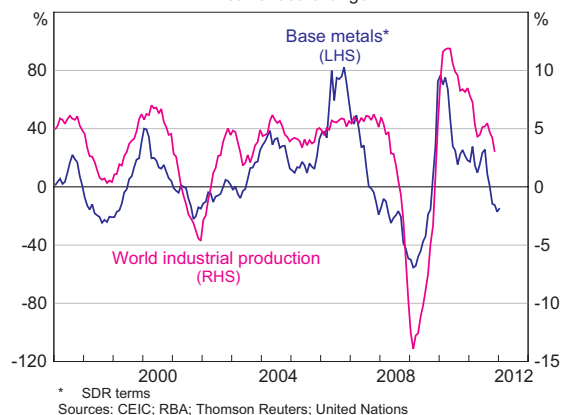
Global food prices tended to ease further in the latter stages of 2011, contributing to the moderation in global consumer price inflation. The prices of rural commodities most important to Australia's exports have been mixed over the past three months, after falling significantly over the first half of 2011. Strong global production of wheat, cotton and sugar has

led to price declines for these commodities over the past year, although prices remain at relatively high levels. Global beef prices have also remained at high levels, in line with rising production costs and growing demand in emerging economies.

**Graph 1.18**  
**Tapis Crude Oil Price**  
Weekly



**Graph 1.19**  
**Base Metals Prices and Industrial Production**  
Year-ended change



Box A

# China's Residential Property Market

Over the past year, conditions in China's residential property market have eased significantly. Transaction volumes have been lower than in previous years, and property prices have fallen modestly in a number of first- and second-tier cities (Graph A1). In part, these developments reflect policy measures that were introduced in 2010 to contain the property market, and they are currently contributing to the moderation of growth in the overall Chinese economy.

very rapid expansion in housing mortgage credit, with the result that turnover and property prices increased significantly during 2009 and early 2010. While official indices of nationwide property prices recorded a peak rate of growth of around 13 per cent over the year to April 2010, other data suggested that property prices were increasing at a much faster rate.

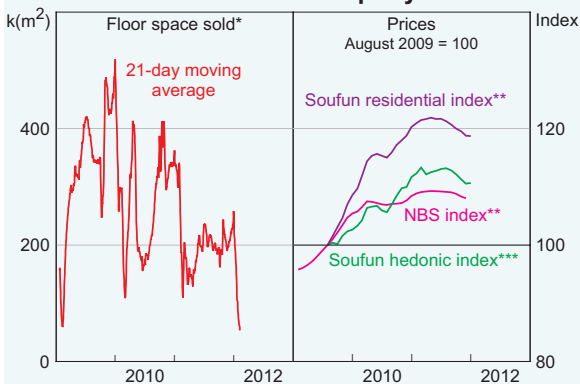
The increases in property prices raised concerns in many quarters about housing affordability, prompting the central government to introduce policies to curb speculative activity in residential property. Starting in early 2010, the central government unwound many of its earlier stimulatory policies and banned new mortgages for those who already owned multiple properties; this latter measure was coupled with stricter enforcement by banks to ensure loans were used for their intended purpose. At the urging of the central government, local governments in around 50 cities also introduced limits on the number of properties people could purchase based on their existing holdings; in some cities, purchases by non-residents were banned altogether. The authorities also announced that apartments designated as affordable would no longer be able to be sublet, left empty, or sold by individuals on the secondary property market.

At the onset of the global financial crisis, the Chinese Government implemented a number of policies to stimulate activity in the residential property market. In particular, it reduced down payment requirements on the purchase of properties, lowered minimum interest rates for mortgages, and reduced the minimum holding period for a property to qualify for an exemption from capital gains tax. These measures were accompanied by a

These measures were accompanied by policies aimed at boosting the supply of affordable housing. The authorities granted favourable access to credit and expanded the range of subsidies to those developers engaged in the construction of low-income housing, including providing free land. In 2011, development began on more than 10 million affordable apartments, and construction of an additional 7 million is expected to begin in 2012. The

**Graph A1**

**China – Residential Property Market**



\* Aggregate floor space sold for Beijing, Chengdu, Chongqing, Guangzhou, Hangzhou, Nanjing, Shanghai, Shenzhen, Tianjin and Wuhan  
 \*\* Based on average property prices per square metre  
 \*\*\* Prices adjusted for location and other housing characteristics  
 Sources: CEIC; China Index Academy; National Bureau of Statistics; RBA



government also instituted audits of developers' land holdings to ensure land was not left idle; the government has reserved the right to confiscate land that is left unused for too long.

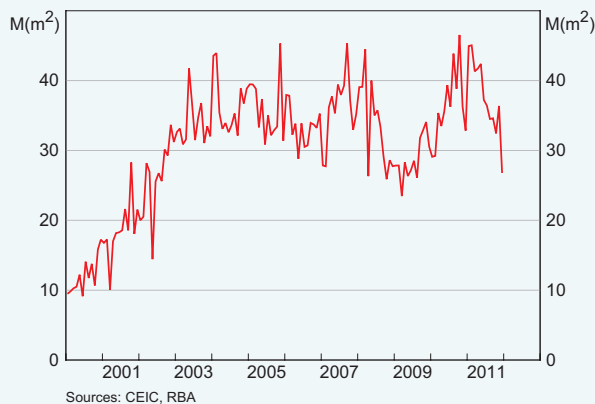
The effects of these measures have become apparent over the past year. Attitudes towards buying property have changed considerably; the Urban Depositor Survey by the People's Bank of China reported that between the December quarters of 2010 and 2011, the share of respondents expressing a preference to invest in real estate had fallen significantly, and the share of respondents expecting to purchase an apartment within three months of the survey dropped to levels not seen since 2008. Confidence of developers has also been affected by lower sales revenue and expectations of lower property prices; the Business Climate Index for real estate has decreased towards global financial crisis levels, reflecting the tighter financial conditions many property developers have been experiencing (Graph A2). Many developers have been scaling down their construction plans and reducing their purchases of land (Graph A3).

As developers revise their construction plans for the coming year, slowing residential construction activity will have direct and indirect effects on GDP growth. Dwelling investment has become an important source of demand in China, with its share of GDP having increased from about 5½ per cent in 2004 to approximately 9 per cent in 2011. Although the rate of growth in dwelling investment was strong in 2011 as a whole, residential building activity slowed noticeably in the second half of 2011, which contributed to the moderation in economic growth over the same period. The slowing in housing investment is also likely to have an indirect effect on growth as local governments rein in spending in response to weaker revenues – roughly 20 per cent of taxes collected by local governments are related to land, and land sales

**Graph A2**  
**China – Real Estate Business Climate Index**



**Graph A3**  
**China – Land Area Purchased**



generate an amount equivalent to around 35 per cent of local governments' current expenditure.

The easing in conditions in the residential property market also has implications for the financial sector. Overall, the stock of loans to the real estate sector (including commercial real estate) is roughly 20 per cent of outstanding loans (although this ratio is around 30 per cent for the five largest banks). Nearly two-thirds of these loans are residential mortgages, although most analysts consider that the risks this lending poses are limited; mortgages

typically have relatively low loan-to-valuation ratios, with down payments around 40 per cent of the value of a property on average.<sup>1</sup> The main risks from the property market emanate from loans to property developers and, to a lesser extent, loans to local government financing vehicles. While loans to property developers are roughly 7 per cent of total loans outstanding (with a maximum loan-to-valuation ratio of 75 per cent), financial institutions also have exposure to property developers through bond and equity holdings. Slowing land-related revenues could also create financial strains for local governments, although should this occur, it is likely that assistance from the central government would be forthcoming.

The central government's plans to expand the supply of affordable housing will provide some support to construction activity over the year ahead and, so far, there has been very little evidence that infrastructure projects are being shelved by local governments because of revenue shortfalls. Official statements suggest that the main goal of the residential property controls has been to improve housing affordability and to reduce the likelihood that developments in the property sector lead to overheating in the broader economy. Should the property market turn out to be weaker than expected, central and local governments are likely to relax some of these controls in order to support activity in the sector, and economic activity more broadly.

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<sup>1</sup> A 2007 PBC survey in the 20 biggest cities suggested that the average down payment was 37½ per cent, although some reports have suggested somewhat higher ratios.

## Box B

# Fiscal Consolidation and Economic Growth in the Advanced Economies

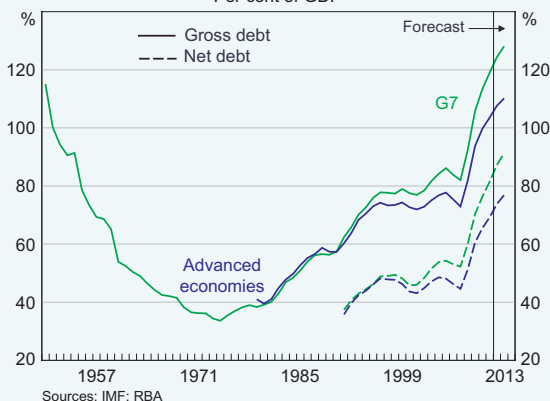
Over the next few years, governments in most advanced economies are planning to undertake substantial fiscal consolidation to help put public finances on a sounder footing. This box outlines fiscal positions and consolidation plans in the euro area, Japan, the United Kingdom, the United States and Canada and discusses the implications of these plans for economic growth both within these economies and for the world as a whole. The focus is on the challenges of the next few years, rather than the significant longer-term issues resulting from the ageing population in the advanced world over coming decades.

## Current Fiscal Positions and Consolidation Plans

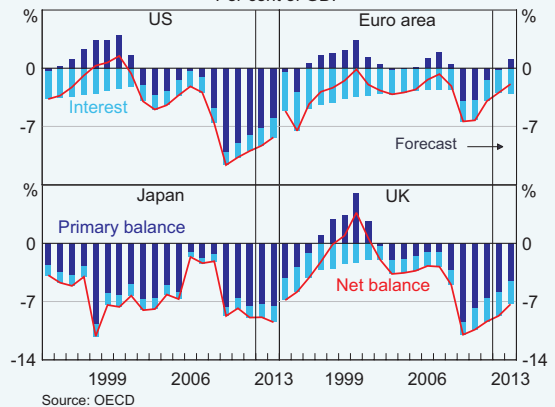
Over the three decades leading up to the 2008–09 global slowdown, governments in most major advanced economies spent more than they collected in revenues. This was reflected in a marked increase in the ratio of debt to GDP in many countries (Graph B1).

The fiscal positions of most advanced economies then deteriorated substantially during the global downturn in 2008 and 2009, reflecting declines in the level of GDP, the budgetary impact of the automatic stabilisers, fiscal stimulus measures and government support for banking systems. Spain had a particularly large change in its fiscal position (moving from a budget surplus of 2 per cent of GDP in 2007 to a deficit of 11 per cent in 2009), while the budget deficit in the United States increased by 10 percentage points of GDP and in the United Kingdom by around 8 percentage points of GDP (Graph B2). The budget deterioration in the other large euro area economies was smaller, at around 4 percentage points of GDP. Although budget deficits have generally narrowed since 2009, they remain large in many economies and debt-to-GDP ratios have continued to increase (Graph B3).

**Graph B1**  
Government Debt  
Per cent of GDP



**Graph B2**  
General Government Balance  
Per cent of GDP



**Graph B3**  
**General Government Net Debt**  
Per cent of GDP

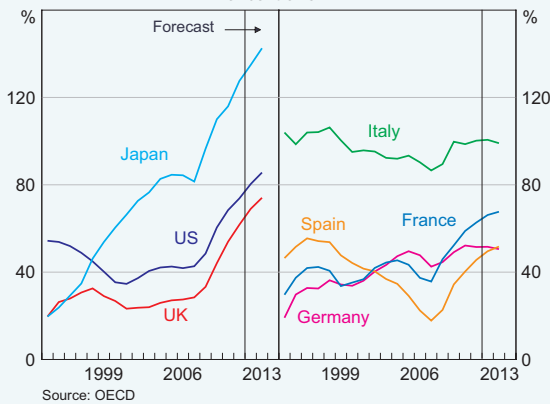


Table B1 provides estimates of the size of the fiscal consolidation expected to occur in the major advanced economies in 2012 and 2013. These figures are largely based on published International Monetary Fund (IMF) estimates and contain some

judgement on the likelihood that legislated and announced fiscal plans will be implemented. Most notably, in the case of the United States current federal legislation implies a fiscal consolidation in the next couple of years equivalent to 5 percentage points of GDP; the IMF assumes that 3 percentage points of fiscal consolidation will actually occur, across all levels of government.

Changes in overall government budget balances can arise from discretionary policy actions, 'automatic' fiscal responses to the economic cycle, and changes in interest payments. The change from discretionary actions (which are reflected in forecast changes in the cyclically adjusted primary balance) provides a widely used measure of fiscal consolidation. On this basis, the size of the fiscal consolidation over the next two years is estimated at around 2½ to 4 per cent of GDP in the United States, the United Kingdom, Italy and Spain. Estimates of fiscal consolidation in Germany, France and Canada are about half this size, while the consolidation in Japan is expected to

**Table B1: Projections for Fiscal Consolidation**

	Net debt		Budget balance		Change in budget balance 2011 to 2013	
	Per cent of GDP					
	2011	2011	2013	Total	Cyclically adjusted primary balance <sup>(a)</sup>	
Euro area	61	-4.3	-2.9	1.4	2.3	
– Germany	51	-1.1	-0.1	1.0	1.3	
– France	63	-5.7	-4.4	1.3	1.5	
– Italy	100	-3.9	-2.3	1.6	3.9	
– Spain	46	-8.0	-6.3	1.7	3.4	
United States	74	-9.5	-6.4	3.1	2.6	
<i>Federal law<sup>(b)</sup></i>	62	-8.7	-3.7	5.0	5.1	
Japan	128	-10.1	-8.8	1.3	0.5	
United Kingdom	62	-8.6	-6.5	2.1	2.8	
Canada	34	-4.9	-3.6	1.3	1.2	

(a) The budget balance excluding cyclical influences (automatic stabilisers), interest payments and one-off items; per cent of potential GDP

(b) Federal Government budget positions only; data are for fiscal year

Sources: Congressional Budget Office; IMF; OECD; RBA

be small, with government expenditure to remain elevated by repairs to buildings and infrastructure due to the March 2011 earthquake and tsunami. In aggregate, across all advanced economies, the fiscal consolidation is expected to be roughly equal in each of 2012 and 2013, with a larger euro area consolidation in 2012 broadly offset by a fiscal expansion in Japan.

While these fiscal consolidations are large, there are earlier cases of similar actions for many of these economies. However, what is particularly unusual about the current episode is the degree of synchronisation of the consolidations, with all of the eight largest advanced economies (the G7 economies plus Spain) reducing their cyclically adjusted primary deficits between 2010 and 2013. Data limitations make it difficult to be definitive, but in aggregate this appears to be the largest fiscal consolidation in at least 30 years, and possibly the largest since World War II. In addition, these fiscal consolidations are occurring when the degree of excess capacity in these economies (as measured by their aggregate output gap) is large.

The programs of fiscal consolidation generally consist of both revenue- and expenditure-side measures, though there is marked variation in the balance of these measures across countries. In the United Kingdom and Spain, consolidation is expected to occur mostly through reduced expenditures, whereas in Italy increases in revenues are expected to be more important. Increasing interest payments (relative to GDP) are expected to make the deficit reduction process more difficult in most of these economies, while the effect of the economic cycle is expected to differ across countries. Economic conditions are projected to contribute to an improvement in the fiscal position of many English-speaking countries (through a narrowing of the cyclical primary deficit), while the projections are for deteriorations in Europe

and elsewhere. This in part explains why the change in the cyclically adjusted primary balance is much larger than the change in the overall deficit for Italy and Spain.

## The Implications of Fiscal Consolidation for Growth

The empirical evidence on whether fiscal consolidation reduces output growth in the short term is mixed. Researchers have pointed to a few cases – such as Denmark (1982–86), Ireland (1987–90), Finland (1992–98) and Sweden (1993–98) – where fiscal consolidations have been associated with strong growth. In addition, there are also some cross-country studies of many episodes of large reductions in deficits that suggest fiscal adjustments are frequently associated with stronger-than-average GDP growth.<sup>1</sup>

Critics of the ‘expansionary consolidations’ view, however, have pointed to some specific factors applying in the case studies that are most often cited. These cases were all small economies, and the episodes were typically ones where the country benefited from a large depreciation and solid economic growth in their major trading partners. In addition, a recent comprehensive cross-country study by the IMF presents evidence that consolidations are usually associated with below-average growth.<sup>2</sup> In particular, the IMF study shows that consolidations equivalent to 1 per cent of GDP are associated with cumulative GDP growth being 0.6 percentage points below average after two years.

One caveat regarding this recent empirical work is that it does not control well for the initial (generally unfavourable) conditions for growth facing countries

1 See, for example, Alesina A and S Ardagna (1998), ‘Tales of Fiscal Adjustments’, *Economic Policy*, 13(27), pp 478–545.

2 Guajardo J, D Leigh and A Pescatori (2011), ‘Expansionary Austerity: New International Evidence’, IMF Working Paper WP/11/158.

that underwent large fiscal consolidations. Hence the existing empirical work needs to be interpreted with caution when considering whether fiscal consolidations are followed by less adverse growth outcomes than would have happened in the absence of the consolidation. The answer to this question most likely depends on the specific circumstances of each case.

In the current conjuncture, there are a number of elements that increase the probability that the large fiscal consolidations now in prospect could be significantly contractionary, at least in the short term, for activity in those economies. In particular, with most of the affected countries at, or near, the zero lower bound for policy interest rates, there is limited scope for the impact of fiscal consolidation to be offset by further conventional monetary stimulus. This is particularly the case for individual economies within the euro area, given the constraint of a single monetary policy for the region. There is also limited

scope for currency depreciation to offset the effects of the planned fiscal consolidation on overall activity. Countries in the euro area by definition cannot depreciate in nominal terms against each other, and, given the combined size of all the advanced economies where medium-term consolidation is required, there is fairly limited scope for depreciations to boost growth.

If the currently planned fiscal consolidation does prove to be significantly contractionary for the affected economies, this will imply renewed pressure on government revenues and fiscal positions in these economies, a concern recently noted by the IMF and others. This suggests that fiscal consolidation in these countries will have to be carefully managed and highlights the desirability of policy measures to improve confidence, increase medium-term growth prospects and bring down bond yields, so as to offset the contractionary effects of the consolidation that is being undertaken. ✎

# 2. International and Foreign Exchange Markets

## Sovereign Debt Markets

Market sentiment deteriorated in early November due to a perceived lack of progress by European officials in dealing with the debt crisis. Political instability in several euro area countries also contributed to the uncertainty, with new governments being formed in Greece and Italy.

Financial market conditions have improved in the new year. In addition to generally better-than-expected US economic data, sentiment was bolstered by large-scale lending to banks by the European Central Bank (ECB) (see section on 'Central Bank Policy'). This has improved liquidity in the European banking system and reduced the near-term risk of bank failures. Investor sentiment, however, remains vulnerable to developments in the European sovereign debt crisis.

Over the past few months, European policymakers have announced several initiatives to deal with the crisis. These included a 'fiscal compact', agreed to by all European Union (EU) countries except the United Kingdom and the Czech Republic, which will see enforceable fiscal rules and penalties written into a new treaty. The new treaty will be signed in March and will come into force once it has been ratified by 12 euro area countries.

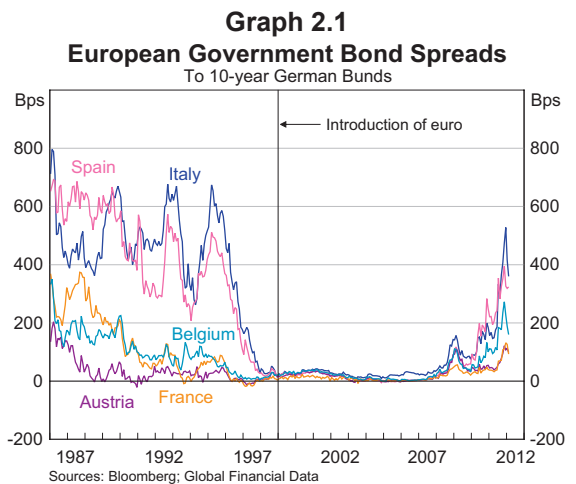
EU governments also pledged a number of measures related to financial bail-out resources:

- euro area nations pledged €150 billion to increase the IMF's resources;
- the permanent European Stability Mechanism (ESM) will be operational from July 2012, one

year ahead of schedule, and its combined lending capacity with the existing European Financial Stability Facility (EFSF) of €500 billion will be reassessed in March this year;

- governments will accelerate payments of capital into the ESM;
- changes to the ESM will be able to be made by a qualified majority of countries, rather than by unanimity;
- leveraging of the current EFSF will be implemented rapidly; and
- private sector involvement in bail-outs, like that for Greece, will not be mandatory in future assistance packages for other countries.

Spreads on sovereign bonds issued by a broad range of euro area countries widened sharply in November, with those for Austria, Belgium, France, Italy and Spain reaching new euro-era highs (Graph 2.1). Reflecting the improvement in sentiment since then, euro area government bond yields have fallen from



their recent peaks (Graph 2.2). Perceptions of the risk of a near-term euro area break-up and/or banking crisis have receded.

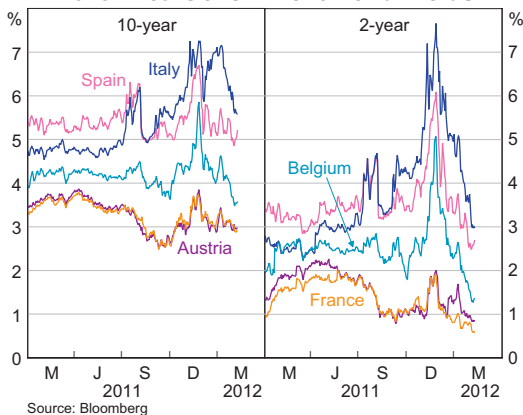
The deterioration in the outlook for euro area economies prompted Standard & Poor's (S&P) and Fitch to place the ratings of many euro area sovereigns on negative credit watch in December. S&P subsequently downgraded the credit ratings of nine euro area sovereigns in January: Italy, Spain, Portugal and Cyprus by two notches; and Austria, France, Malta, Slovenia and the Slovak Republic by one notch. As a result, France and Austria lost their AAA ratings although this had little market impact. S&P also downgraded the EFSF's rating to AA+ (although it is still rated AAA by Fitch and Moody's). Fitch downgraded five euro area sovereigns in late January but reaffirmed France's AAA credit rating.

The agreement on the restructuring of private sector holdings of Greek sovereign debt appears to be reaching a conclusion with a loss in net present value terms of approximately 70 per cent in prospect. The latest EU/IMF disbursements to Greece under the initial assistance package were approved in December despite substantial slippage by Greece in meeting its targets under the program: €73 billion of the €110 billion first assistance package has now been disbursed. Greece is fully funded until 20 March when a €14.4 billion bond matures. The EU

and IMF have also approved the latest disbursements to Ireland and Portugal. Nonetheless, yields on Portuguese government debt increased to euro area highs in recent weeks due to concerns about the possibility of a similar outcome to Greece.

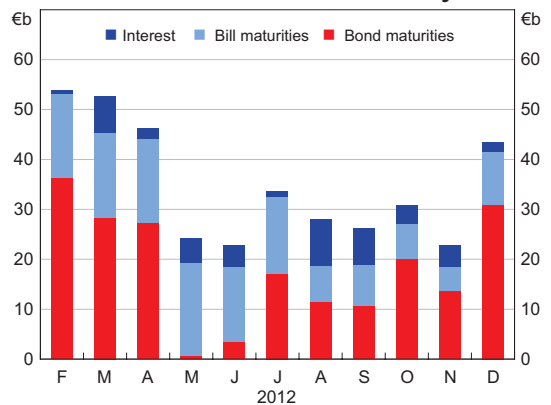
Yields on longer-term Italian government bonds remain relatively high despite falling after the new technocrat government passed a number of fiscal reforms. Investors remain nervous about the large volume of Italian government debt maturing this year (equivalent to around 20 per cent of GDP), particularly over the next few months (Graph 2.3). Yields on Spanish government bonds are well below their November peak, in part due to the government announcing additional budgetary measures and pledging to legislate fiscal rules to enforce budget discipline on both central and regional governments. The fall in yields was despite Spain's 2011 budget deficit being equivalent to at least 8 per cent of GDP compared with the 6 per cent government target. Spain has completed around one-quarter of its anticipated 2012 bond issuance. Belgium's sovereign finances have come under scrutiny in recent months, in part because of its substantial banking sector support. Belgium formed a new government in early December, having had a caretaker government since June 2010.

**Graph 2.2**  
**Euro Area Government Bond Yields**



**Graph 2.3**

**Italian Central Government Debt Payments**



Source: Bloomberg



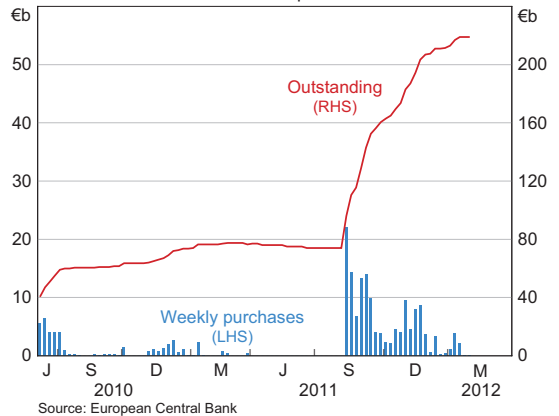
The improvement in investor sentiment has seen the ECB purchase only a small amount of sovereign debt under the Securities Markets Program in recent weeks (Graph 2.4).

Government bond yields in the major advanced economies have remained at low levels due to strong demand for debt issued by the US Government and those sovereigns perceived to have solid AAA ratings. Yields on 10-year US, UK and German government bonds remained around or below 2 per cent, with UK yields falling to a historical low (Graph 2.5). Secondary market yields on very short-term German government securities have been negative in recent months, resulting in the format of German government debt auctions being changed, allowing investors to effectively bid at negative yields. In addition, yields in short-term secured funding markets fell to very low levels, reflecting the dearth of available high-quality government securities to be used as collateral to raise funding.

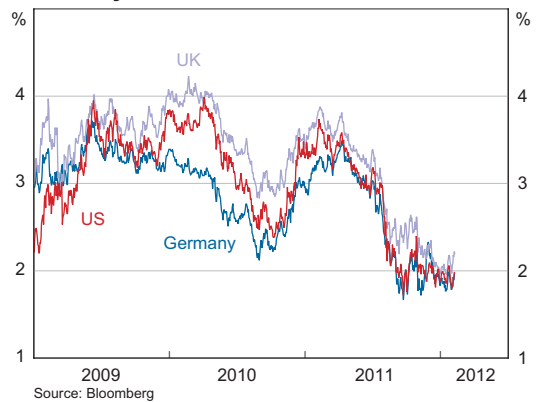
In the United States, the Joint Select Committee on Deficit Reduction (the 'Super Committee'), formed after the debt-ceiling impasse in August, failed to reach an agreement on reducing the US budget deficit. Unless a new agreement is reached, automatic budget cuts of US\$1.2 trillion will be implemented from 2013. These developments have not had any noticeable impact on US government bond yields.

Spreads on US dollar-denominated debt issued by emerging market sovereigns widened sharply from August last year as global risk appetite waned (Graph 2.6). Spreads on emerging European sovereign debt widened particularly sharply due to fears that the euro area debt crisis could spill over to the region, including through banking channels. The rise in Hungarian yields has been particularly stark. In contrast, yields on Indonesian government bonds declined after Moody's upgraded Indonesia's credit rating to investment grade, citing a more favourable assessment of the country's economic strength.

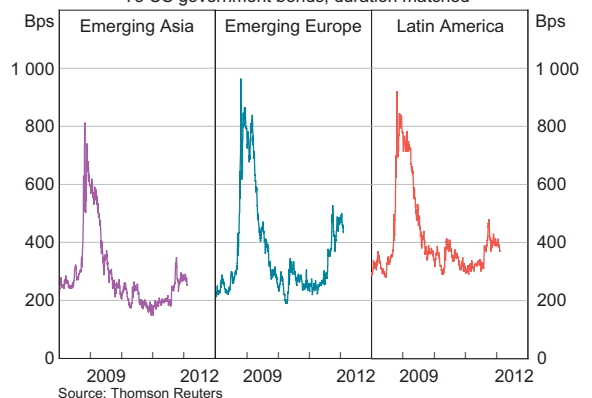
**Graph 2.4**  
**ECB Securities Markets Program**  
Euro area bond purchases



**Graph 2.5**  
**10-year Government Bond Yields**



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



## Central Bank Policy

A number of central banks have eased monetary policy in recent months as the outlook for global growth has weakened (Table 2.1). Among these, the ECB lowered its policy rate target by a cumulative 50 basis points. In addition, the People's Bank of China and Reserve Bank of India lowered banks' reserve requirement ratios by 50 basis points; these were the first decreases by these banks in around three years.

The ECB has significantly increased its lending to banks and its purchases of sovereign debt since the European sovereign debt crisis escalated in mid 2011.

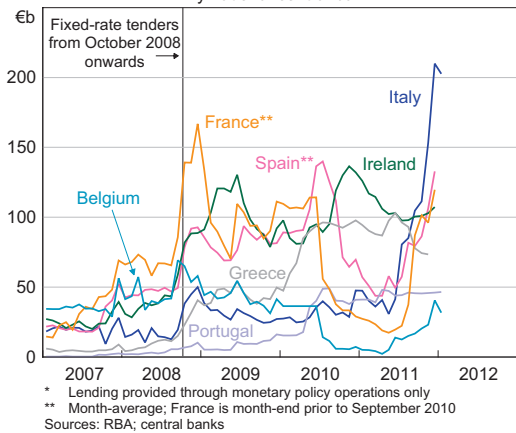
Since June, the ECB's balance sheet has expanded by around one-third to €2.7 trillion. The ECB provided €489 billion of 3-year loans to banks at its policy rate in December, of which around €190 billion was new lending (the difference was loans maturing or rolled into 3-year loans). Lending through the Bank of Italy increased particularly sharply over December, with significant increases also recorded by the national central banks of Belgium, France, Germany and Spain (Graph 2.7). The ECB's actions have allowed banks to secure long-term financing at a time when market-based funding has become increasingly difficult to obtain. The ECB will provide additional 3-year loans at the end of February.

**Table 2.1: Policy Rates**

	Current level Per cent		Most recent change	Change from 2011 peak Basis points
Euro area	1.00	↓	Dec 11	-50
Japan	0.05	↓	Oct 10	-
United States	0.125	↓	Dec 08	-
Brazil	10.50	↓	Jan 12	-200
Canada	1.00	↑	Sep 10	-
China	6.56	↑	Jul 11	-
India	8.50	↑	Oct 11	-
Indonesia	6.00	↓	Nov 11	-75
Israel	2.50	↓	Jan 12	-75
Malaysia	3.00	↑	May 11	-
Mexico	4.50	↓	Jul 09	-
New Zealand	2.50	↓	Mar 11	-50
Norway	1.75	↓	Dec 11	-50
Russia	8.00	↓	Dec 11	-25
South Africa	5.50	↓	Nov 10	-
South Korea	3.25	↑	Jun 11	-
Sweden	1.75	↓	Dec 11	-25
Switzerland	0.00	↓	Aug 11	-25
Taiwan	1.875	↑	Jun 11	-
Thailand	3.00	↓	Jan 12	-50
United Kingdom	0.50	↓	Mar 09	-

Source: central banks

**Graph 2.7**  
**ECB Lending to Banks\***  
 By national central bank

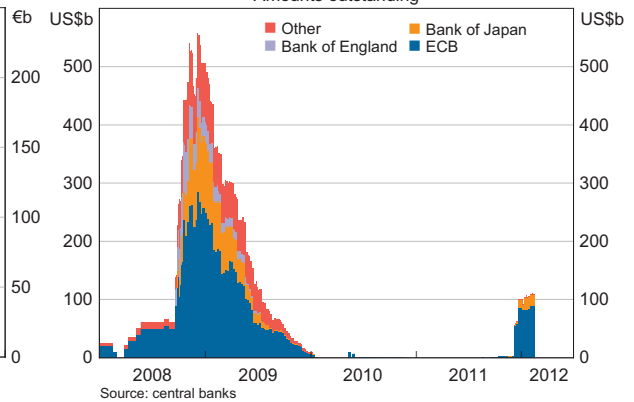


The ECB also announced a broadening of the range of eligible collateral for its market operations to further support banks' access to liquidity. The ECB has lowered the rating threshold for certain asset-backed securities and, as a temporary measure, will allow national central banks to accept certain bank loans as collateral. The ECB also reduced banks' required reserves ratio from 2 per cent to 1 per cent, freeing up additional liquidity.

In response to the increased cost of obtaining US dollar funding for non-US banks, in early December the major central banks announced a decrease in the cost of accessing US dollars under the swap facilities with the Federal Reserve. The margin over the US dollar overnight indexed swap rate fell from 100 basis points to 50 basis points. Subsequently, recourse to the facilities increased sharply to around US\$110 billion but remains relatively modest compared with peak usage at the height of the financial crisis (Graph 2.8). To some extent this reflects European banks having scaled back their US dollar assets and related funding needs over the past few years.

The US Federal Reserve has purchased around US\$175 billion of longer-term US Treasuries as part of a US\$400 billion program to extend the average maturity of its bond holdings, due to be completed

**Graph 2.8**  
**Central Bank US Dollar Swap Facilities**  
 Amounts outstanding



by end June. The Fed currently holds around 30 per cent of outstanding longer-term US Treasuries and this share is expected to rise to around 40 per cent at the completion of the program. The Fed also resumed sales of mortgage-backed securities that its investment vehicle, Maiden Lane II, had acquired in December 2008 as part of AIG's bail out.

The Fed stated after its policy meeting in late January that the federal funds rate target was now likely to remain at exceptionally low levels at least until late 2014. As part of a number of changes to its policy communications, the Fed announced a long-run goal of 2 per cent for inflation (based on the personal consumption expenditure price index) and has commenced quarterly publication (without identification) of each meeting participant's expectations of the policy rate for the next few years and in the longer run.

The Bank of England (BoE) has completed the expansion of its Asset Purchase Facility. The BoE has purchased £75 billion of gilts since October 2011, bringing total asset purchases under the facility to £275 billion.

## Financial Policy and Regulation

The European Banking Authority (EBA) released its EU bank recapitalisation plan in early December. The EBA requires banks to have core Tier 1 capital ratios

of 9 per cent by 30 June. After allowing for any losses on holdings of sovereign debt, the 65 participating banks would require about €115 billion in additional capital to meet their required capital ratios. Many banks, however, are expected to meet at least part of their capital ratio targets by shrinking their balance sheets via asset sales and/or restricting lending, particularly outside of the EU. Indeed, a number of banks have recently sold, or announced plans to sell, significant banking operations outside of their home country.

The Obama Administration announced changes to the Home Affordable Modification Program (HAMP) to expand eligibility for mortgage refinancing, including to the owners of rental properties. Incentives for eligible participants (which will now include Fannie Mae and Freddie Mac) to modify loans will also be increased, including a boost in incentive payments from 18 per cent to 63 per cent of principal reduction. Furthermore, HAMP will be extended to December 2013.

In the United Kingdom, the government accepted the vast majority of the recommendations of the ‘Vickers Report’ by the Independent Commission on Banking. Recommendations included increasing capital requirements and the ‘ring-fencing’ of commercial banking activities from wholesale banking groups. Subsequently, the Royal Bank of Scotland (RBS) announced details of its plans to reduce and restructure its wholesale operations. A notable concession will apply, however, to HSBC and Standard Chartered, which will have to meet the higher capital requirements only for assets in the United Kingdom rather than globally.

The UK Government also announced its sale of Northern Rock. Virgin Money is acquiring the bank’s retail and wholesale deposit businesses, along with its performing mortgage book, for at least £900 million. The government had nationalised the bank for £1.4 billion in 2008 and retains the bank’s distressed assets in a ‘bad bank’ to wind down over time. This bad bank has been profitable and paid back around £2.1 billion of its £22.8 billion government loan by

June 2011. The UK Treasury still holds majority stakes in RBS and Lloyds.

French President Sarkozy unveiled plans to introduce a financial transactions tax in France starting in August, irrespective of the outcome of the current EU initiative to introduce such a tax. It is expected to generate around €1 billion a year and will reportedly apply to certain credit default swap and equity transactions. However, unlike the EU’s proposal, bond purchases will be exempt.

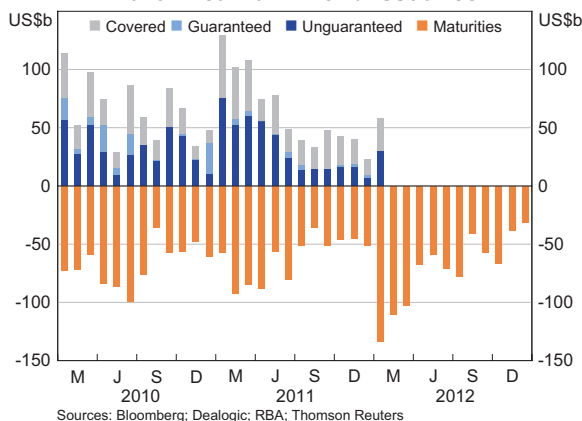
## Credit Markets

Conditions in credit markets have improved in recent months but remain strained for European banks. The relative cost of short-term unsecured borrowing in euros has fallen modestly since late December as market sentiment and liquidity have improved following the ECB’s large 3-year lending operation (see section on ‘Central Bank Policy’; Graph 2.9). Euro area bank bond issuance moderated in the second half of 2011, and was very low in December, as yields rose sharply and markets closed to some borrowers (Graph 2.10). While covered bond issuance remained relatively solid, unsecured issuance declined to low levels. Issuance increased in January with the improvement in sentiment but also reflecting the need to refinance sizeable bond maturities in the early months of this

**Graph 2.9**  
Euro Unsecured Interbank Borrowing Spread  
To overnight indexed swaps, 3-month maturity



**Graph 2.10**  
**Euro Area Bank Bond Issuance**

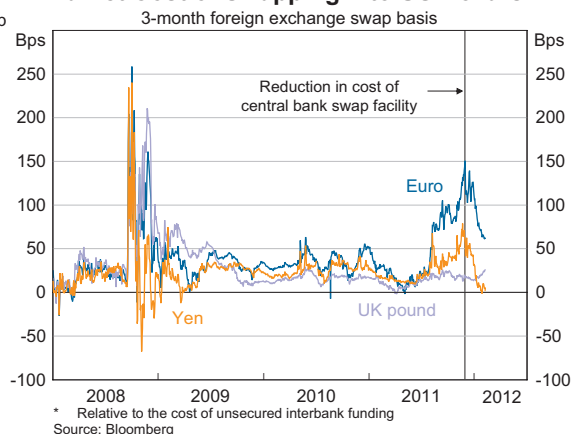


year. Looking ahead, declining economic activity in Europe, balance sheet contraction by euro area banks, and access to 3-year ECB funding is likely to reduce euro area banks' debt funding needs.

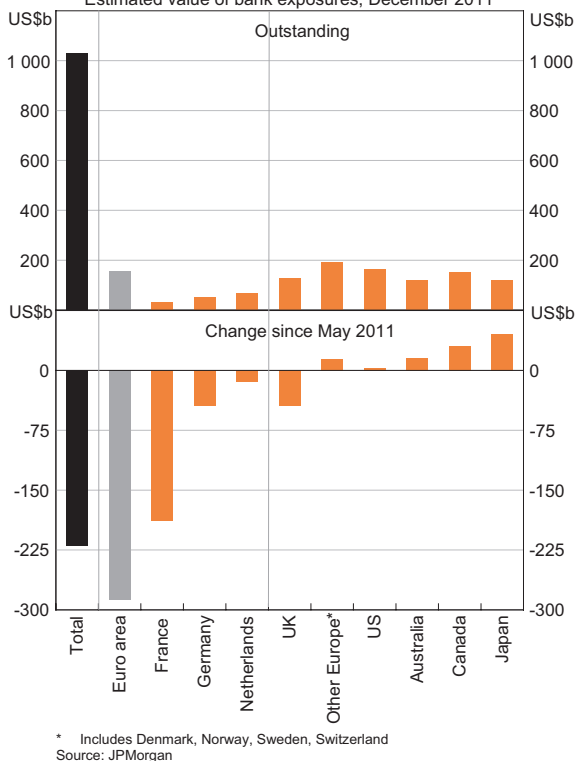
The cost of swapping euros (and yen) into US dollars in the foreign exchange market also declined after the US Federal Reserve reduced the cost to banks of borrowing US dollars via its swap facilities with other central banks (see section on 'Central Bank Policy'; Graph 2.11). Some European banks have continued to scale back their need for US dollars by selling US dollar assets or reducing US dollar lending. The latter includes the provision of trade and commodity finance, which is typically denominated in US dollars. At the same time, US money market funds have continued to reduce their exposures to euro area, particularly French, banks (Graph 2.12).

US banks' bond issuance picked up in January after being relatively subdued over the previous six months. Yields on financial and non-financial bonds in the United States and the euro area have generally fallen in net terms over the past few months (Graph 2.13). Issuance by US non-financial corporates has remained solid but in 2011 was lower than in the previous year (Graph 2.14). In part, this has reflected their strong internal funding growth and significant holdings of cash and other liquid assets.

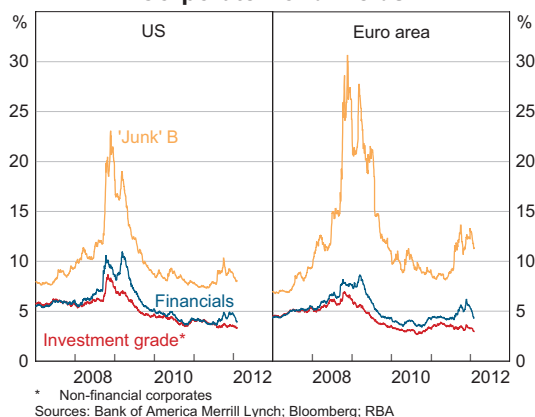
**Graph 2.11**  
**Market Cost of Swapping into US Dollars\***



**Graph 2.12**  
**US Prime Money Market Fund Assets**  
Estimated value of bank exposures, December 2011



**Graph 2.13**  
**Corporate Bond Yields**

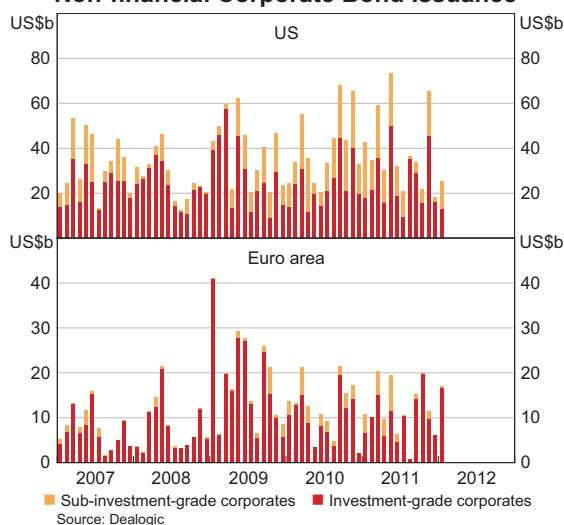


the deteriorating global growth outlook on the domestic economy.

Equity price indices generally increased over January 2012, supported by the better recent US economic data and the modest improvement in the European debt situation. This occurred despite relatively disappointing US corporate earnings reports for the December quarter. Share price volatility implied by options declined to below long-run averages.

Banking sector share prices significantly underperformed over 2011, particularly in Europe where the market value of some large banks more

**Graph 2.14**  
**Non-financial Corporate Bond Issuance**



## Equities

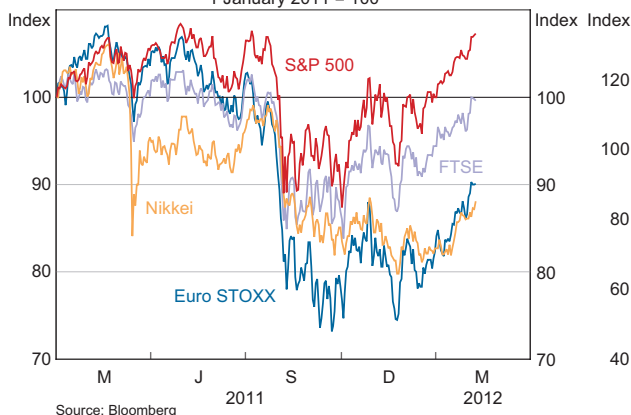
Global equity prices fell by 9 per cent over 2011 and double-digit declines were common across countries. The US equity market was a notable exception, reflecting relatively strong corporate earnings and better-than-expected economic data (Table 2.2, Graph 2.15). Euro area equity prices fell by 18 per cent with financial share prices particularly weak (see below). Chinese equity prices fell by 22 per cent over the year, partly reflecting concerns about the effect of policy tightening and

**Table 2.2: Changes in International Share Prices**  
Per cent

	Over 2011	Since previous Statement
United States		
– Dow Jones	6	7
– S&P 500	0	7
– NASDAQ	–2	8
Euro area		
– STOXX	–18	7
United Kingdom		
– FTSE	–6	6
Japan		
– Nikkei	–17	4
Canada		
– TSE 300	–11	0
Australia		
– ASX 200	–15	3
China		
– China A	–22	–6
MSCI indices		
– Emerging Asia	–16	7
– Latin America	–13	8
– Emerging Europe	–19	5
<b>– World</b>	<b>–9</b>	<b>7</b>

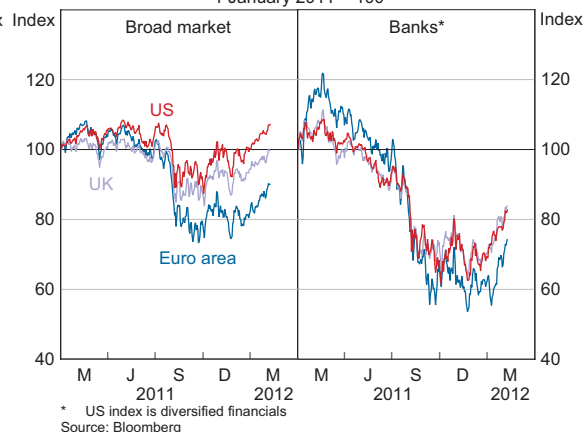
Source: Bloomberg

**Graph 2.15**  
**Major Share Price Indices**  
1 January 2011 = 100



Source: Bloomberg

**Graph 2.16**  
**Share Price Indices**  
1 January 2011 = 100



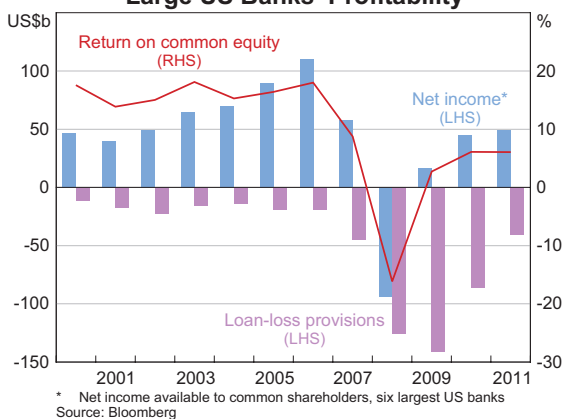
\* US index is diversified financials  
Source: Bloomberg

than halved (Graph 2.16). The European debt crisis and concerns surrounding euro area banks' need to raise capital to meet regulatory requirements has weighed on their share prices. Moreover, several European and US banks' ratings were downgraded or placed on review for downgrade, including a number of large banks following S&P's shift to new bank rating criteria. Recently, however, banks' share prices have increased in line with the improvement in investor sentiment.

Large US bank earnings for the December quarter were mixed, with weak trading and investment banking revenues weighing on earnings. For 2011 as a whole, aggregate profit for the six largest US banks was about US\$50 billion, marginally higher than in 2010 (Graph 2.17). Profits were boosted by a US\$45 billion fall in loan-loss provisions. Return on common equity remained at less than half pre-crisis rates.

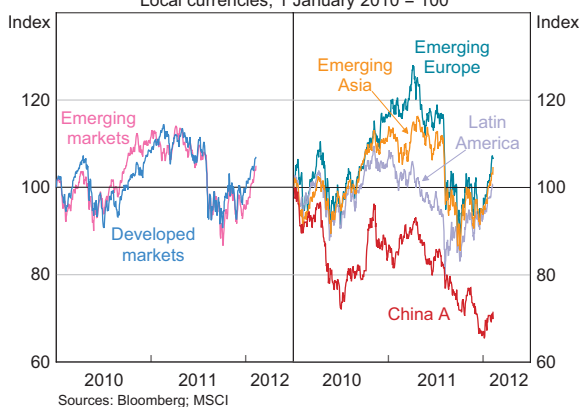
Emerging market equity prices in aggregate underperformed those in developed markets over 2011, reaching their lowest point since mid 2009 (Graph 2.18). In recent months, share prices in most of emerging Asia have risen strongly but Chinese share prices continued to underperform due to concerns about slower growth. In Latin America, equity prices rose particularly sharply in Brazil, in part supported by monetary policy easing.

**Graph 2.17**  
**Large US Banks' Profitability**



\* Net income available to common shareholders, six largest US banks  
Source: Bloomberg

**Graph 2.18**  
**Share Price Indices**  
Local currencies, 1 January 2010 = 100

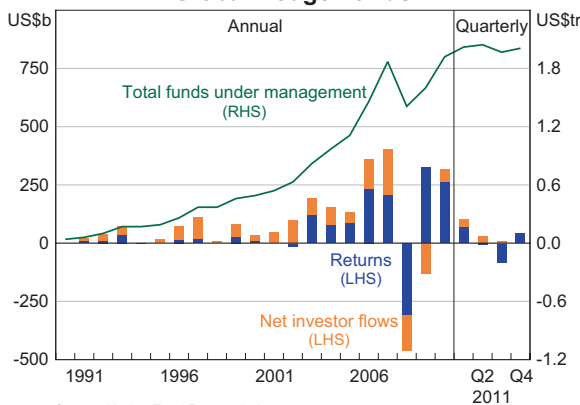


Sources: Bloomberg, MSCI

## Hedge Funds

Global hedge funds recorded an average loss on investments of 5 per cent over the year to December (Graph 2.19). While hedge funds significantly underperformed equities over the December quarter, they provided similar total returns (including dividends) for the year as a whole. Funds under management edged up to US\$2.0 trillion, with positive quarterly returns more than offsetting a very small withdrawal of investor contributions, the first net quarterly withdrawal of capital since the December quarter 2009.

**Graph 2.19**  
**Global Hedge Funds**



## Foreign Exchange

The European sovereign debt crisis has continued to drive developments in foreign exchange markets in recent months, although the reduction in news flow saw volatility in foreign exchange markets ease somewhat.

The euro has depreciated against most currencies since late October, having previously been relatively resilient to concerns about the prospects for a near-term resolution to the European debt crisis. This depreciation has generally been more pronounced against non-European currencies, as other European currencies have typically been affected by concerns about possible spillovers from the euro area. Since mid 2011, the euro has depreciated by between 10 and 20 per cent against the US dollar and the

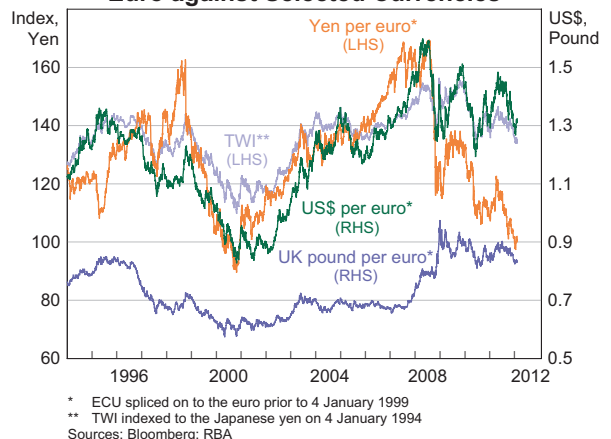
Japanese yen, but by 4–8 per cent against the main Scandinavian currencies and the UK pound (Graph 2.20). In contrast, since early September, the Swiss franc has moved little against the euro as it continues to operate under a ceiling imposed by the Swiss National Bank against the euro. Overall, the euro has depreciated by 8 per cent on a trade-weighted basis since mid last year, to be around its long-run average.

As the euro continued to shift lower in December and early January, previously close correlations between developments in the euro and other assets weakened markedly. In particular, the MSCI World and Euro STOXX equity indices have both risen strongly over the past three months, despite the euro's broad-based depreciation.

The US dollar has appreciated particularly strongly against the euro, but has depreciated against most other currencies since late October (Table 2.3, Graph 2.21). Over the past year, the US dollar is unchanged on a trade-weighted basis and remains well below its long-run average.

The Japanese yen has depreciated modestly against the US dollar from its recent highs reached in late October/early November, following the Japanese authorities intervening in the foreign exchange market by buying up to US\$120 billion to weaken the yen. Overall, the yen is unchanged against the

**Graph 2.20**  
**Euro against Selected Currencies**





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

	Over past year	Since previous Statement
European euro	4	4
Swiss franc	-5	4
UK pound sterling	2	1
Swedish krona	3	1
Indian rupee	8	0
Thai baht	0	0
Indonesian rupiah	0	0
Chinese renminbi	-4	-1
Brazilian real	4	-1
Canadian dollar	0	-1
South Korean won	0	-1
Japanese yen	-6	-1
Singapore dollar	-2	-1
Philippine peso	-3	-2
New Taiwan dollar	2	-2
Australian dollar	-6	-4
South African rand	5	-4
Malaysian ringgit	-1	-4
Mexican peso	5	-5
New Zealand dollar	-7	-5
<b>Majors TWI</b>	<b>0</b>	<b>1</b>
<b>Broad TWI</b>	<b>0</b>	<b>-1</b>

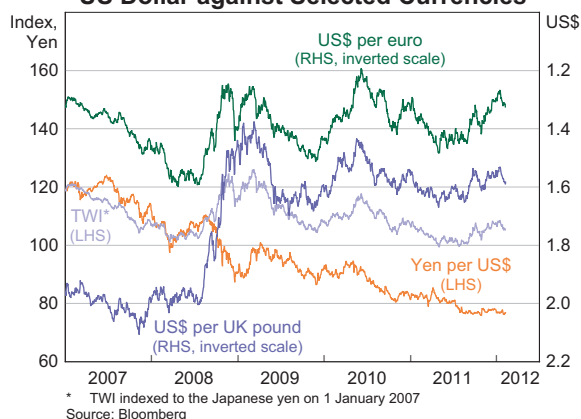
Sources: Bloomberg; Board of Governors of the Federal Reserve System

US dollar over the past six months, and has generally traded in a very narrow range of 76–78 yen per US dollar throughout much of this period. However, the yen has appreciated by 6 per cent against the euro since late October, reaching an 11-year high in January. Reflecting this, Japan’s nominal trade-weighted index has returned to historically high levels, though it remains only slightly above its long-run average in real terms (Graph 2.22).

The Chinese renminbi appears to have come under some downward pressure in the last two months

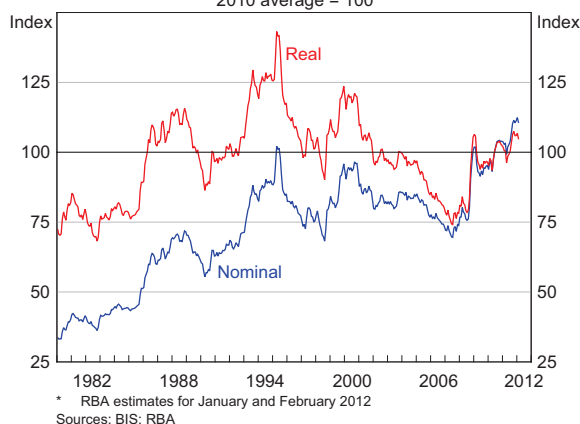
**Graph 2.21**

**US Dollar against Selected Currencies**



**Graph 2.22**

**Japanese Effective Exchange Rates\***  
2010 average = 100



of 2011, reflecting weaker global risk sentiment and some concerns about the outlook for the Chinese economy. This was seen in the renminbi trading close to the bottom of the official trading band throughout December. Also consistent with this, the Chinese authorities reported declines in their foreign exchange reserve holdings in November and December, resulting in the first quarterly decline in China’s reserves since the June quarter 1998 (Table 2.4). Although valuation effects will have contributed to this fall, it seems likely that the Chinese authorities sold foreign exchange to support the renminbi during the quarter. Nevertheless, the authorities have appreciated the currency, albeit

**Table 2.4: Foreign Currency Reserves**  
As at end December 2011

	Three-month-ended change		Level US\$ equivalent (billions)
	US\$ equivalent (billions)	Per cent	
China <sup>(a)</sup>	-21	-1	3 181
Japan	98	9	1 221
Russia	-16	-4	435
Taiwan	-4	-1	386
Brazil	2	1	343
South Korea	1	1	298
India	-13	-5	263
Thailand	-5	-3	165
Indonesia	-4	-4	103
Turkey	-9	-11	77
Chile	4	11	40

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

only slightly, against the US dollar since the previous *Statement*, taking the cumulative appreciation over 2011 to around 4½ per cent (Graph 2.23).

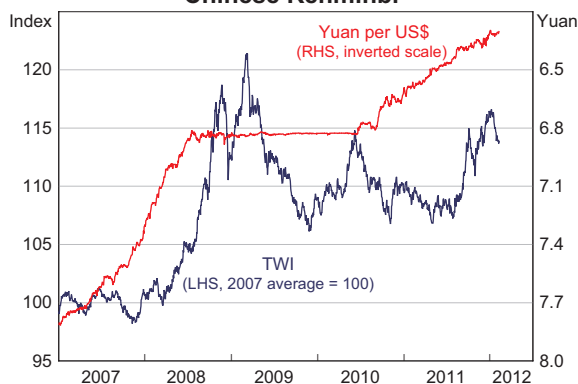
The apparent downward pressure on the renminbi in late 2011 was also reflected in the offshore (floating) renminbi exchange rate, which traded at a small discount to the onshore rate throughout this period, and in the non-deliverable forward market, which had been pricing in a small expected depreciation of the onshore renminbi exchange rate over the

next year. However, in line with generally improved risk appetite, the offshore rate is now trading at a small premium to the onshore rate, and the non-deliverable forward market is again pricing in a small expected appreciation of the renminbi over the next year.

After depreciating further in the last few months of 2011, other emerging market currencies have appreciated in 2012 to date (Graph 2.24). Emerging European currencies remain relatively weak, reflecting ongoing concerns about spillover effects from the euro area debt crisis. The Turkish lira reached its lowest level against the US dollar in late December since it floated in 2001, prompting the Central Bank of Turkey to intervene to support the currency, with the lira since appreciating by around 10 per cent from this low. Consistent with this reported intervention, Turkey's foreign currency reserves fell over the quarter (Table 2.4).

Emerging Asian currencies have also appreciated since the start of the year, retracing the depreciations seen in late 2011 (Graph 2.25). The Indian rupee depreciated particularly sharply in the latter part of 2011, in response to the deteriorating growth

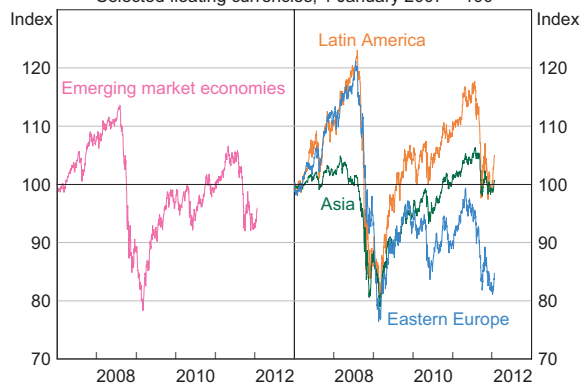
**Graph 2.23**  
**Chinese Renminbi\***



\* Onshore exchange rates  
Sources: BIS; Bloomberg; RBA

**Graph 2.24**  
**Emerging Market Currencies\***

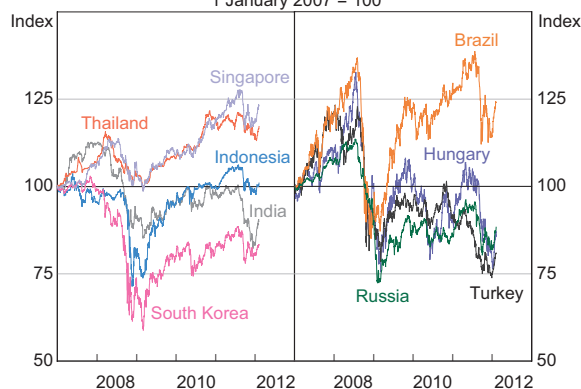
Selected floating currencies, 1 January 2007 = 100



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

**Graph 2.25**  
**Selected Currencies against the US Dollar**

1 January 2007 = 100



Source: Bloomberg

outlook for the Indian economy and concerns about India's reliance on external funding. The rupee troughed in mid December and has since recovered around one-half of its decline, supported by the more general improvement in risk sentiment outside of Europe and sales of foreign exchange by the Indian authorities in order to support the rupee.

## Australian Dollar

The Australian dollar has traded in a wide range over recent months, but has appreciated significantly since mid December (Table 2.5). In particular, the Australian dollar has appreciated strongly against

the euro, reaching its highest level in early February since the inception of the euro in 1999 and, based on historical movements in the Deutsche mark prior to the euro's introduction, its highest level against a representative European currency since early 1989 (Graph 2.26). This contrasts with much of 2011, when movements in the Australian dollar tended to be closely correlated with developments in the euro. The Australian dollar also reached its highest level since February 1985 against the British pound.

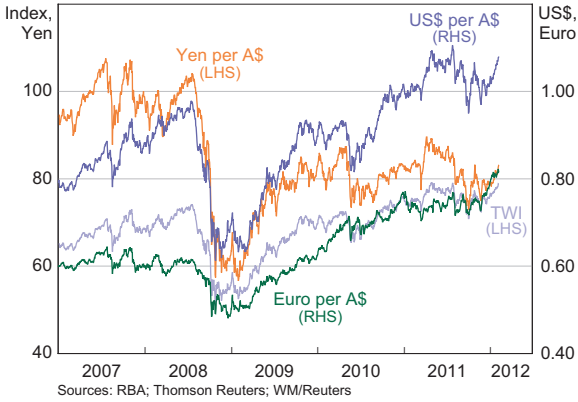
In trade-weighted terms, the Australian dollar is around its highest level since mid last year, notwithstanding a decline in the terms of trade, and has appreciated by around 5 per cent over the past year (Table 2.5). In line with developments in other currencies, intraday volatility in the Australian dollar has eased to levels seen in early 2011.

**Table 2.5: Changes in the Australian Dollar against Selected TWI Currencies**  
Per cent

	Over past year	Since previous Statement
European euro	9	8
Swiss franc	1	8
UK pound sterling	8	5
Indian rupee	16	4
Thai baht	6	4
US dollar	6	4
Indonesian rupiah	6	3
Chinese renminbi	2	3
Canadian dollar	6	3
South Korean won	7	2
Japanese yen	-1	2
Singapore dollar	4	2
Malaysian ringgit	6	-1
South African rand	12	-1
New Zealand dollar	-1	-1
<b>TWI</b>	<b>5</b>	<b>3</b>

Sources: Bloomberg; Thomson Reuters; WWM/Reuters

**Graph 2.26**  
**Australian Dollar**

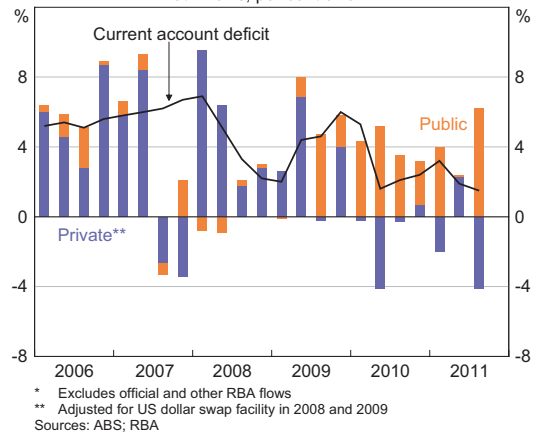


### Capital Flows

Consistent with the trend of the past two years, net capital inflows in the September quarter 2011 were directed towards the public sector, reflecting strong foreign purchases of government securities. In contrast, there was a large net outflow of capital from the private sector, predominantly reflecting financial derivative outflows (including margin or final payments made on derivative positions

that had acquired a negative market value for the Australian holder) and a reduction in Australian banks' overseas borrowing (Graph 2.27). These net debt outflows from the Australian banking sector were partly offset by net equity inflows to Australian private non-financial corporations, reflecting continued strong foreign investment in the Australian mining sector and the repatriation of overseas equity investments by Australian firms. ↘

**Graph 2.27**  
**Australian Capital Flows\***  
Net inflows, per cent of GDP



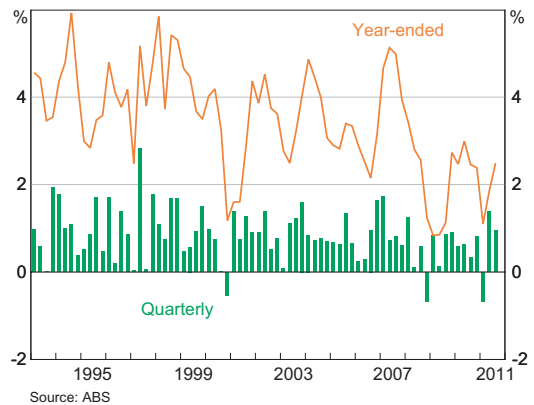
### 3. Domestic Economic Conditions

Output growth in the Australian economy is estimated to have been a little above trend over the second half of 2011, largely reflecting very strong growth in mining investment and the ongoing recovery in mining production from the extreme weather events earlier in the year (Graph 3.1, Table 3.1). National income was also boosted by higher commodity prices, with the terms of trade reaching their highest level on record in the September quarter. The outlook for mining investment remains very strong, with further announcements of new projects over recent months. In contrast, conditions are more subdued in some other industries, as the high level of the exchange rate, tight credit conditions for some sectors, the decline in public investment and changes in household spending behaviour continue to weigh on activity in the manufacturing, building construction and retail industries. More broadly, measures of consumer and business sentiment are around or a little below long-run average levels, in part reflecting concerns about developments overseas. The unemployment rate has been around 5¼ per cent in recent months, after increasing in mid 2011.

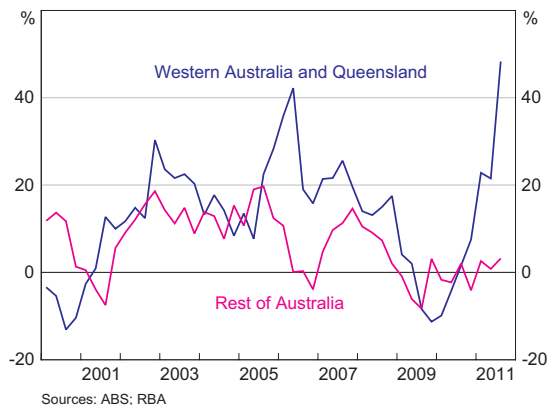
The variation in conditions across industries is also seen in regional outcomes. In resource-rich Western Australia and Queensland, demand is being driven by very strong growth in mining investment (Graph 3.2). Consistent with firm labour market outcomes, consumer spending has also been

strong in Western Australia. In contrast, in the rest of Australia domestic demand has increased only modestly in recent quarters.

**Graph 3.1  
GDP Growth**



**Graph 3.2  
Business Investment Growth by State**  
Year-ended



**Table 3.1: Demand and Output Growth**  
Per cent

	September quarter 2011	Year to September quarter 2011
Domestic final demand	2.1	4.6
– Private demand	3.6	6.7
– Public demand	–2.8	–1.9
Change in inventories <sup>(a)</sup>	–0.8	0.2
GNE	1.2	4.7
Net exports <sup>(a)</sup>	–0.6	–2.7
GDP	1.0	2.5
Nominal GDP	1.6	6.1

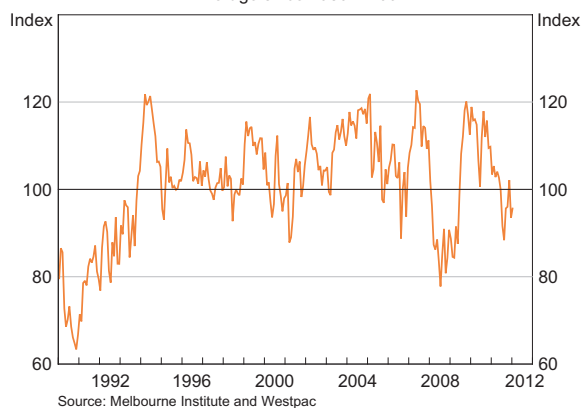
(a) Contribution to GDP growth  
Source: ABS

## Household Sector

Over the year to the September quarter, consumer spending grew at an around trend pace and broadly in line with growth in disposable incomes. More recently, the available indicators suggest the pace of consumer spending has moderated, with growth in retail sales volumes and motor vehicle sales slowing in the December quarter. While consumer confidence has recovered somewhat following the sharp decline in mid 2011, it remains below its long-run average (Graph 3.3). Sentiment is likely being affected by developments overseas, falls in asset prices and the softening in labour market conditions over 2011. Indeed, the proportion of household survey respondents recalling overseas news and news related to economic conditions rose sharply in December.

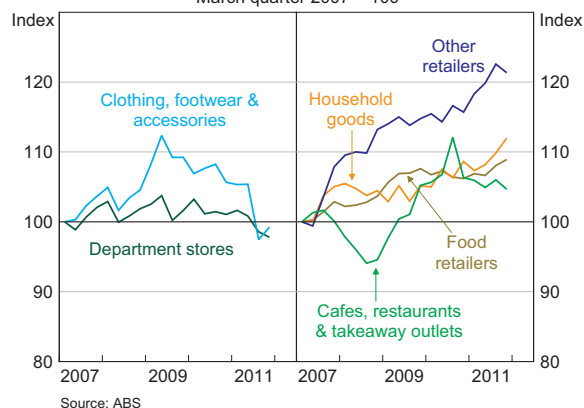
Consumer spending on goods has generally been quite weak over the past year, particularly spending in department stores and on clothing, footwear & accessories (Graph 3.4). While there are no official data on the total value of online purchases, there is some evidence that online purchases of goods have grown strongly over the past year. The value of international electronic purchases – which includes payments made by Australians travelling overseas as well as online purchases from overseas merchants – increased by 6 per cent over the year to November,

**Graph 3.3**  
**Consumer Sentiment**  
Average since 1980 = 100



Source: Melbourne Institute and Westpac

**Graph 3.4**  
**Retail Sales Volumes**  
March quarter 2007 = 100



Source: ABS

although online purchases remain a small share of total retail purchases.<sup>1</sup> Growth in spending on services has been stronger than that on goods, with services consumption up around 4 per cent over the year to the September quarter.

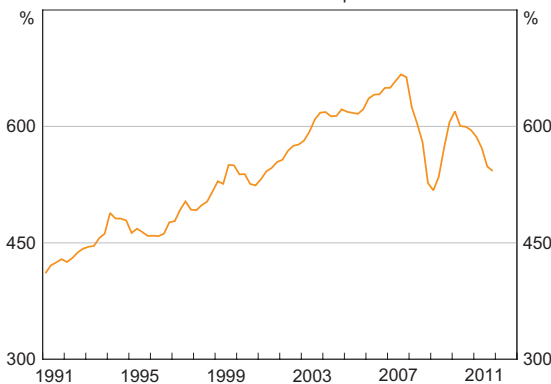
Household wealth is estimated to have grown slightly in the December quarter, but was around 2½ per cent lower over the year, with a 3½ per cent fall in average dwelling prices more than offsetting a small rise in the value of financial asset holdings over the year. The ratio of net wealth to household disposable income was just under 5½, after having been over 6½ in late 2007 (Graph 3.5).

In contrast to wealth, incomes have been growing strongly. Real household disposable income increased by 2.1 per cent in the September quarter to be 4½ per cent higher over the year, with nominal incomes almost 7 per cent higher over the year (Graph 3.6). Households have continued to devote a significant portion of their income to rebuilding assets and paying down debt – the household saving ratio has been around 10 per cent over the

past three years and well above levels recorded in the 1990s and early 2000s. With income growing a little faster than debt, the household debt-to-income ratio has declined somewhat, although it remains high by historical standards (Graph 3.7).

Australian capital city dwelling prices declined a little through most of 2011, although there were some tentative signs of stabilisation towards the end of the year. Prices were around 3½ per cent lower over the year and fell by around ½ per cent in the December quarter (Graph 3.8, Table 3.2). Brisbane, Perth and

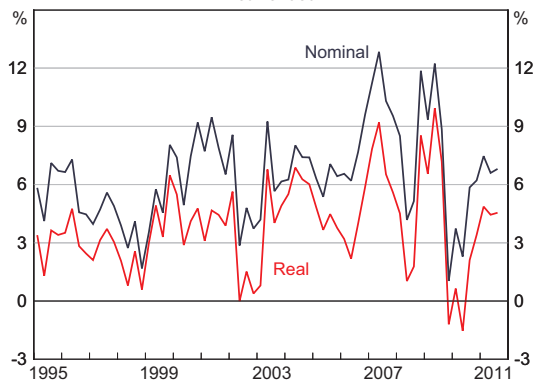
**Graph 3.5**  
**Household Net Worth**  
Per cent of annual household disposable income\*



\* Household sector includes unincorporated enterprises; disposable income is after tax and before the deduction of interest payments; RBA estimate for December quarter 2011  
Sources: ABS; RBA; RP Data-Rismark

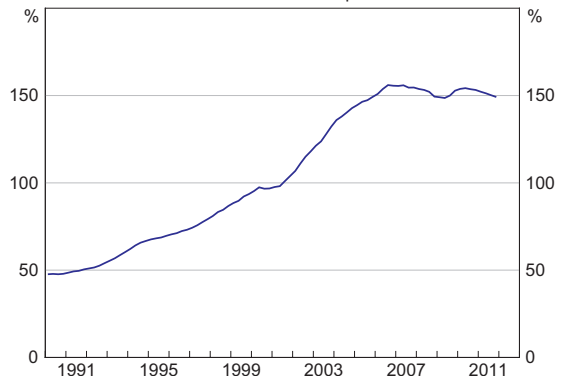
<sup>1</sup> Internet purchases from local retailers are included in ABS data. Internet purchases from overseas are not included in ABS retail trade data, and only internet sales valued at more than \$1 000 are included in ABS imports and consumption data in the national accounts. See 'Box B: Online Spending by Households', *Statement on Monetary Policy*, February 2011.

**Graph 3.6**  
**Household Disposable Income Growth\***  
Year-ended



\* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002  
Source: ABS

**Graph 3.7**  
**Household Debt**  
Per cent of annual household disposable income\*



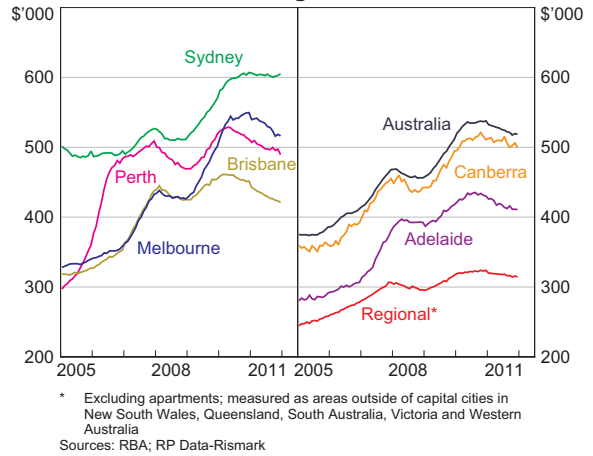
\* Household sector excludes unincorporated enterprises; disposable income is after tax and before the deduction of interest payments; RBA estimate for December quarter 2011  
Sources: ABS; RBA

Melbourne were the weakest markets, down by around 4 to 6 per cent over the year; prices in Sydney were broadly unchanged over the year. The values of properties in more expensive suburbs have tended to fall by more than those in less expensive suburbs over the past year, although they also rose by more in earlier years, while house prices have tended to fall more than apartment prices.

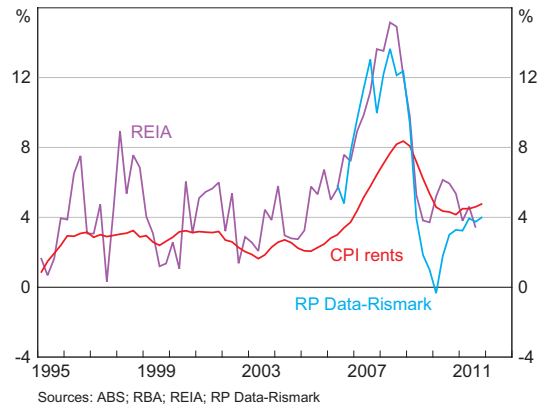
The various measures suggest that average nationwide rents have increased by around 4 to 5 per cent over the past year, implying a rise in rental yields, in contrast to the fall in yields that has occurred over much of the past 15 years (Graph 3.9). Rental vacancy rates, at around 2.2 per cent nationwide (based on the REIA survey data), are low by historical standards. The vacancy rate is estimated to be lowest in Sydney.

Residential building activity was very soft in 2011, with new home building remaining at low levels, and little growth in spending on alterations and additions. The weakness has partly reflected the earlier pull-forward of demand from the boost to grants to first home buyers in 2009, as well as lower expectations about capital gains from housing. As a result, growth in the dwelling stock has been soft in most of Australia; Victoria is the exception, reflecting significant apartment building over the past year (Graph 3.10). While private residential building approvals remain around 14 per cent below their decade average, some

**Graph 3.8  
Dwelling Prices**



**Graph 3.9  
Growth in Rents**  
Year-ended



**Table 3.2: National Housing Price Growth**  
Per cent

	3 months to September 2011	3 months to December 2011	Year to December 2011
<b>Capital cities</b>			
ABS <sup>(a),(b)</sup>	-1.9	-1.0	-4.8
APM <sup>(b)</sup>	-1.5	-0.2	-2.8
RP Data-Rismark	-0.8	-0.5	-3.6
<b>Regional areas</b>			
APM <sup>(b)</sup>	-1.5	-0.5	-2.2
RP Data-Rismark <sup>(a)</sup>	-0.5	-0.5	-2.9

(a) Detached houses only

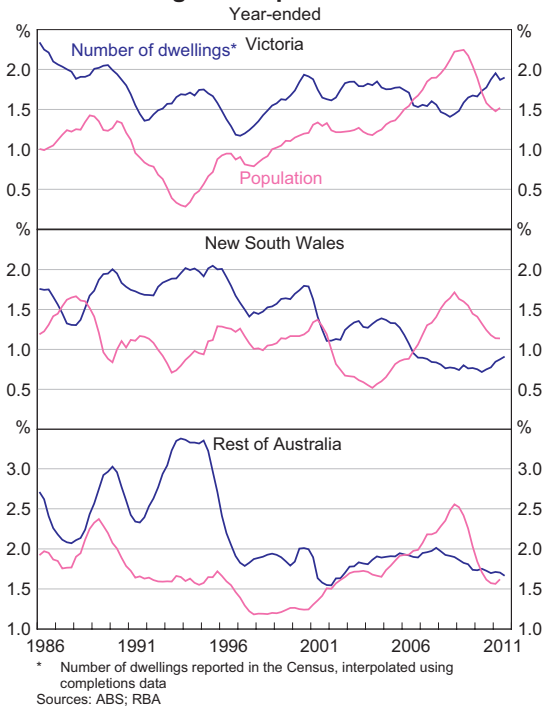
(b) Quarter-on-quarter growth rate

Sources: ABS; APM; RBA; RP Data-Rismark



other timely indicators of home building activity have increased modestly in recent months, albeit from a low level (Graph 3.11). The HIA-AIG Performance of Construction Index new orders series for houses has risen since October and first home buyer grants for new dwellings increased modestly in the second half of 2011.

**Graph 3.10**  
**Dwelling and Population Growth**



**Graph 3.11**  
**Indicators of Dwelling Investment**

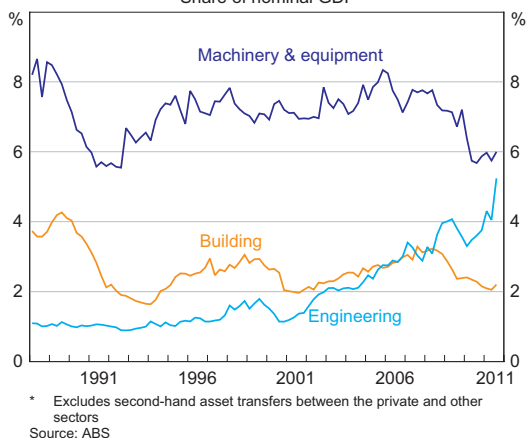


## Business Sector

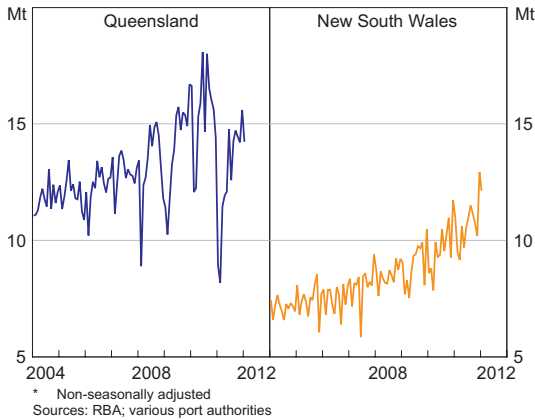
Business investment rose very strongly in the September quarter, mainly reflecting engineering work on large mining projects (Graph 3.12). Over the year to the September quarter, mining investment is estimated to have increased by more than 50 per cent. The sharp upswing in mining investment continues to drive very strong growth in capital imports, which rose by around 40 per cent over 2011 (for further details on the impact of mining investment on Australia's imports, see 'Box C: Imports and Investment').

Mining production and exports also grew strongly over the second half of 2011, owing in part to a recovery in coal production in Queensland after flooding earlier in that year. Coal exports from Queensland have risen significantly since early 2011, but remain below pre-flood levels as some mines are still inundated (Graph 3.13). While recently there has been significant rainfall in Queensland's coal-producing regions, mining companies have not yet reported material disruptions to coal production, although the situation is still developing. Heavy rainfall in New South Wales over recent months has caused some loss of production. Iron ore exports have risen rapidly since mid 2011, by around 15 per cent, underpinned by capacity expansions and

**Graph 3.12**  
**Business Investment Components\***  
Share of nominal GDP



**Graph 3.13**  
**Coal Shipments\***  
Monthly



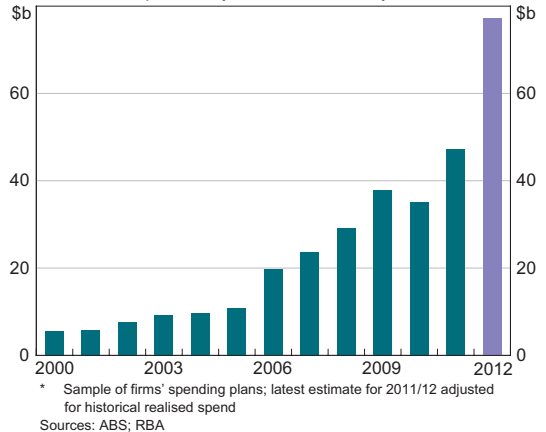
efficiency improvements by some of the major producers.

The outlook for mining investment remains very positive, with the ABS capital expenditure survey of firms' spending plans pointing to a large rise in mining sector investment in 2011/12 (Graph 3.14). Consistent with this, there have been further announcements of large-scale projects in recent months, including the approval of the US\$34 billion Ichthys liquefied natural gas (LNG) project, which will transport gas by pipeline from the Browse Basin off the coast of Western Australia to Darwin. The huge amount of investment in LNG production facilities that is currently under way will drive a subsequent surge in LNG exports; the Pluto project is expected to begin production around March this year, with other large projects expected to come online from late 2014. The outlook for iron ore and coal exports also remains strong. Investment in mine, rail and port infrastructure projects is expected to result in a significant increase in coal production in coming years. Large expansions in iron ore capacity are also in the pipeline.

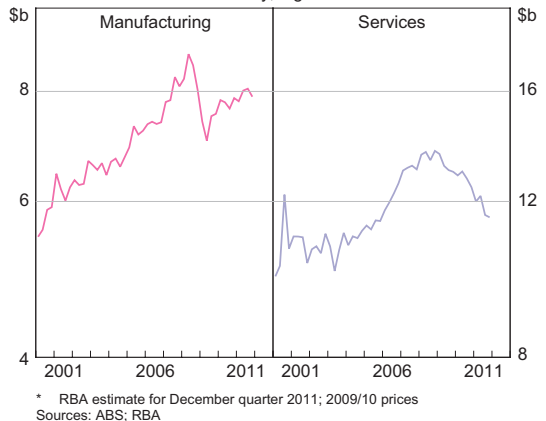
In contrast, conditions remain subdued in some other areas of the economy. The ABS capital expenditure survey points to little growth in non-mining sector investment over the remainder of 2011/12. The high level of the Australian dollar continues to

restrain activity in trade-exposed industries such as manufacturing, tourism and education. Services exports have fallen by around 15 per cent since their peak in 2008 and have continued to trend lower (Graph 3.15). Education exports, especially to India, have fallen particularly sharply, due to both the high exchange rate, which has made education in Australia more expensive, and the tightening of access to student visas. Manufacturing exports also remain well below their peak recorded prior to the global financial crisis, with exports of road vehicles and beverages (including wine) particularly weak. Firms in some of these sectors are facing some

**Graph 3.14**  
**Mining Capital Expenditure\***  
Capex survey, nominal, financial years



**Graph 3.15**  
**Non-commodity Export Volumes\***  
Quarterly, log scale



difficult adjustments as they respond to the higher exchange rate.

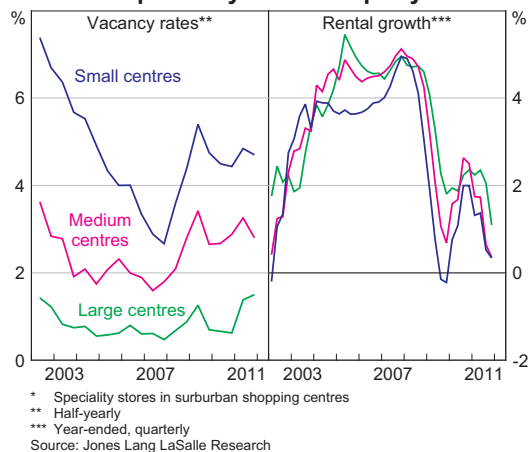
Measures of conditions within the construction sector are well below average, reflecting weak demand for residential and non-residential building as well as tight credit conditions. The value of private sector non-residential building approvals remains at well below average levels (Graph 3.16).

In the property market, the national CBD office vacancy rate ticked down in the December quarter, to 7.2 per cent, a little below its decade average. Vacancy rates fell in the quarter in Brisbane, Canberra, Melbourne and Perth, with the vacancy rate in Perth now at 2½ per cent, down from 7½ per cent a year ago. Nationwide office capital values are estimated to have risen by 6 per cent over the year to the December quarter, with values in Perth and Sydney showing the strongest growth. In contrast, retail property vacancy rates rose over 2011 in line with the subdued trading conditions faced by retailers (Graph 3.17). This deterioration in the retail market has seen rental growth slow.

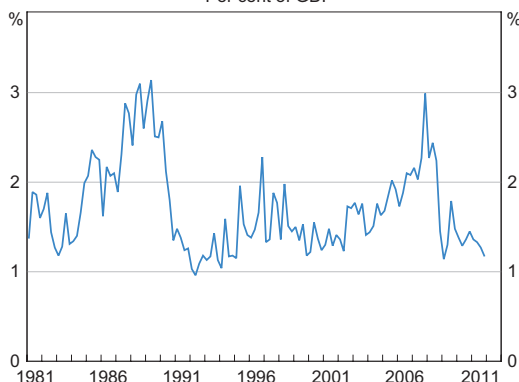
Overall, company profits grew by 5½ per cent in the September quarter to be 11½ per cent higher over the year. Non-mining profits grew by 7 per cent in the quarter to be equivalent to 12½ per cent of GDP, in line with the decade average. Robust profit

growth has seen internal funding generated by businesses rise to its highest level as a share of GDP in over 20 years (Graph 3.18). Internal funding now accounts for around 70 per cent of total business funding, compared with around 35 per cent in the mid 2000s when businesses were much more reliant on externally sourced funding, and in particular debt funding. This increased reliance on internally generated funds reflects both a reduced appetite for debt among corporates and, for some sectors, more restricted access to debt.

**Graph 3.17**  
**Capital City Retail Property\***

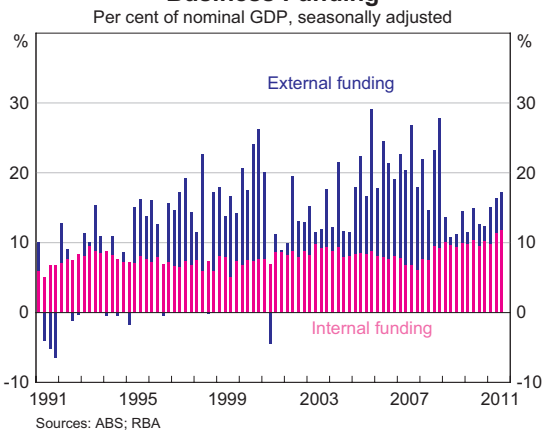


**Graph 3.16**  
**Private Non-residential Building Approvals\***  
Per cent of GDP



\* RBA estimate for December quarter 2011 GDP  
 Sources: ABS; RBA

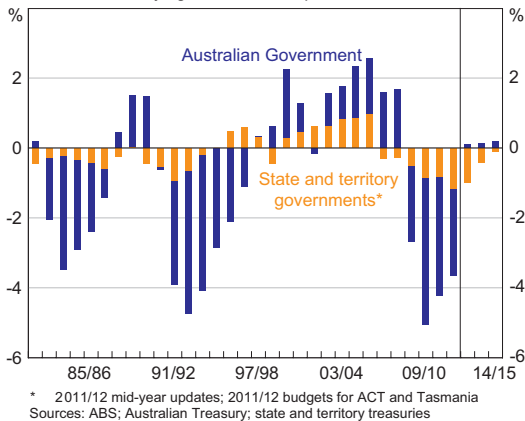
**Graph 3.18**  
**Business Funding**



## Government Spending

Public demand contracted over 2011 as spending associated with the earlier fiscal stimulus was completed. In the November Mid-year Economic and Fiscal Outlook, the Australian Government budget position was forecast to move from a deficit of 2.5 per cent of GDP in 2011/12 to a small surplus in 2012/13 (Graph 3.19). The consolidated budget position for the states is expected to be a deficit of 1.1 per cent of GDP in 2011/12, with a narrowing of the deficit forecast over coming years. The forecast combined state and federal deficit for 2011/12 was revised upwards, reflecting weaker-than-expected growth and falls in asset prices weighing on tax receipts, and new government payments to households and businesses announced as part of the Government's Clean Energy Future package.

**Graph 3.19**  
**General Government Budget Balance**  
 Underlying cash balance, per cent of GDP

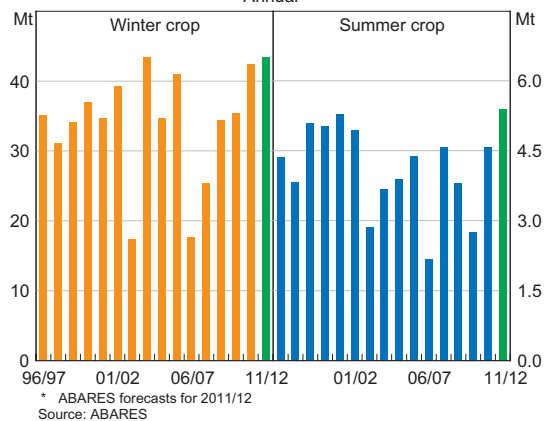


## Farm Sector

Conditions in the farm sector mostly remain favourable. Rural exports increased strongly over 2011, with large winter and summer crops resulting in a significant increase in exports of grain and cotton. With relatively high prices for rural commodities, real farm income has also been at high levels. Looking ahead, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects the recently harvested winter crop and current

summer crop to both surpass previous records, ensuring rural exports remain high (Graph 3.20). The recently harvested wheat crop is estimated to be a little over 28 million tonnes, underpinned by a doubling in wheat production in Western Australia following last season's drought-affected crop. Spring rainfall across most wheat-growing regions in the eastern states improved yields, but heavy rain in both Western Australia and parts of the eastern states late in 2011 caused some crop damage and quality downgrades. Cotton production is also expected to reach record levels, driven by relatively high prices and the increased availability of irrigation water, although recent rain has caused some crop damage. ABARES' forecast of gross farm production, which includes both crops and livestock, has been revised up to growth of 4 per cent in 2011/12, following a rise of just under 7 per cent in 2010/11.

**Graph 3.20**  
**Australian Crop Production**  
 Annual\*



## External Sector

Australia's trade surplus reached a 40-year high as a ratio to GDP in the September quarter, reflecting large increases in bulk commodity contract prices. More recently, a decline in iron ore and coal prices has resulted in a smaller trade surplus as well as a fall in the terms of trade from their record level (Graph 3.21). Solid growth in export volumes has been outstripped by more rapid growth in import

volumes, reflecting the appreciation of the Australian dollar and the sharp upswing in mining investment (for further details on Australia's imports, see 'Box C: Imports and Investment'). In line with these developments, the current account deficit, which had narrowed significantly over the past few years, is likely to have widened towards the end of 2011.

While Australia's aggregate trade balance remains close to record highs, this masks diverging trends in goods and services trade (Graph 3.22). While the balance on goods trade has shifted to surplus recently, in part reflecting the very high level of

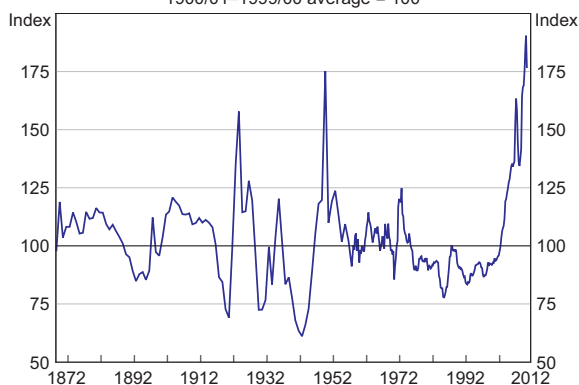
commodity prices, a sizeable deficit in services trade has emerged. The latter trend has been driven largely by the increase in Australia's exchange rate over recent years, coupled with strong growth in Australian incomes. Overseas travel is now more affordable for Australians, leading to a strong increase in tourism-related services imports. In contrast, services exports have fallen over recent years.

## Labour Market

The unemployment rate has remained around 5¼ per cent in recent months, although employment growth has been soft and the participation rate is estimated to have fallen in December (Graph 3.23). Growth in total employment remains patchy, with mixed employment outcomes across industries and little net employment growth over 2011. Some of the weakness in employment likely reflects the effect of earlier pre-emptive hiring that supported above-trend employment growth in 2010. Recent business liaison has indicated that some firms have become more cautious about hiring new workers in the absence of clear indications of a pick-up in demand. Growth in total hours worked has been stronger than employment growth over the year, suggesting firms have been meeting additional labour needs via increases in average hours rather than hiring additional workers (Graph 3.24).

**Graph 3.21**  
**Terms of Trade\***

1900/01–1999/00 average = 100

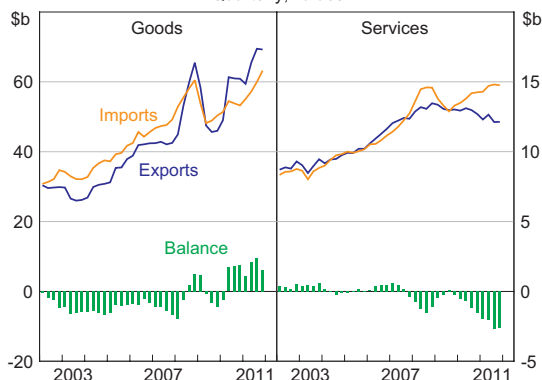


\* Annual data to 1958/59, quarterly data thereafter with dates referring to December quarter; RBA estimate for December quarter 2011  
Sources: ABS; RBA

**Graph 3.22**

**Goods and Services Trade Balances\***

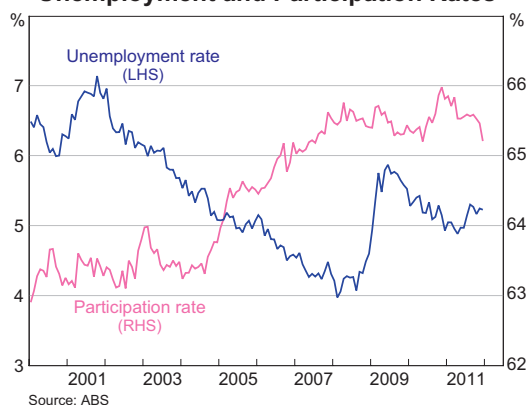
Quarterly, values



\* RBA estimates for December quarter 2011  
Sources: ABS; RBA

**Graph 3.23**

**Unemployment and Participation Rates**



Source: ABS

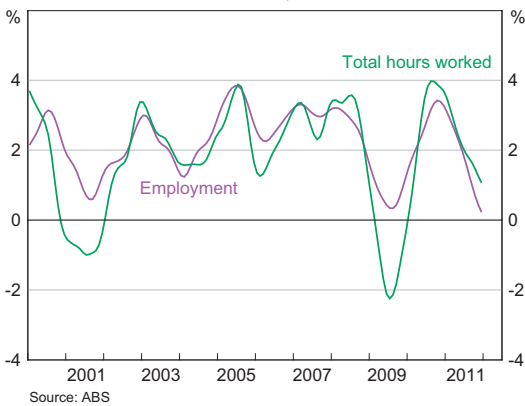
The slowdown in the pace of employment growth is evident across most industries, with a number of industries experiencing a decline over the year to November (the latest available data). In part this reflects structural adjustment to the resources boom and the accompanying high exchange rate. Employment has been particularly weak in the manufacturing and agriculture, forestry & fishing industries (Graph 3.25). Other industries recording declines in employment include construction and retail trade. Although there are no official industry employment data for December, the weakness in part-time employment in the monthly data suggests

that retailers did not hire as many additional staff in the peak pre-Christmas period as normal. In contrast, employment growth in other industries such as health care & social assistance and financial & insurance services has been relatively solid, and employment in public administration & safety also increased strongly. Despite its small size, rapid growth in mining industry employment again made a sizeable contribution to aggregate employment growth over the year.

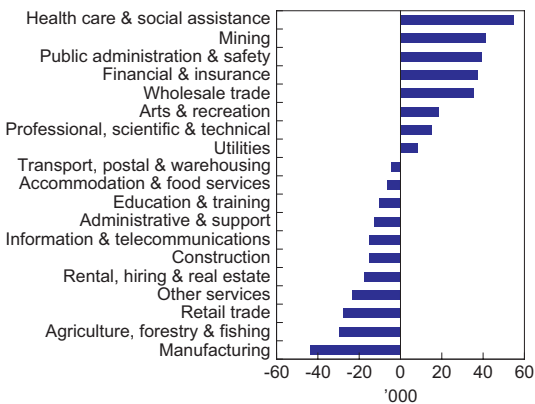
Forward-looking indicators of labour demand point to modest employment growth in coming months. Both the ABS measure of job vacancies and ANZ's job advertisements series fell in the December quarter, although advertisements picked up in January and the vacancy rate remains at a high level (Graph 3.26). The decline in vacancies is consistent with reports from liaison of continued caution by firms in their hiring intentions and the below-average intentions reported by manufacturing firms in the ACCI-Westpac survey. The Bank's liaison with firms suggests that the share of firms expecting to increase employment declined over 2011 and the share expecting to decrease employment rose. A number of large employers in the finance and manufacturing industries have also recently announced job losses associated with business restructures.

The relatively high level of vacancies and low unemployment rate indicate that despite the moderation in labour demand over the past year, labour market conditions remain reasonably tight. Nationally, the ratio of vacancies per unemployed worker is around 0.3, which is well above the long-run average. The level of vacancies is particularly high in Western Australia where the vacancy rate has continued to rise over the past year, in part owing to the very rapid pace of growth in vacancies in the mining industry. The vacancy rate has also been rising in Queensland, which has relatively high exposure to mining activity; in contrast, vacancies have been declining in other states over the past year (Graph 3.27).

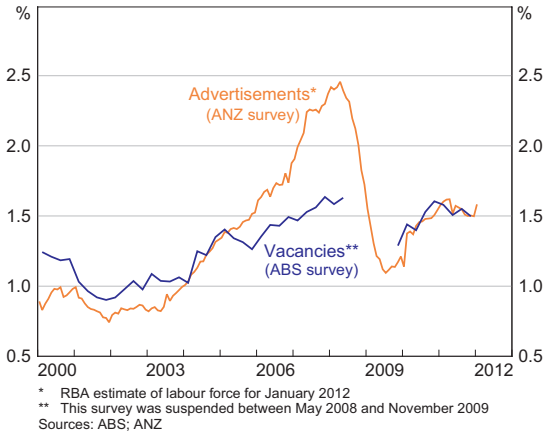
**Graph 3.24**  
**Growth in Labour Input**  
Year-ended, trend



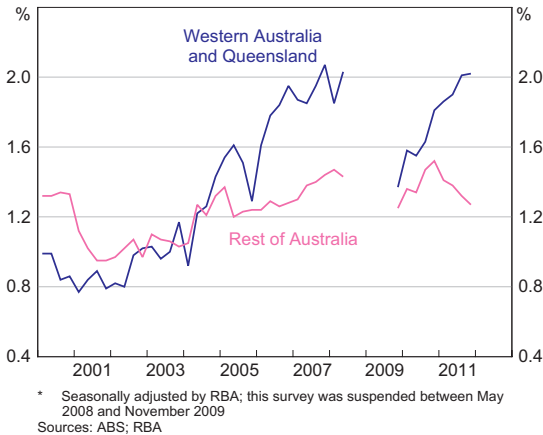
**Graph 3.25**  
**Employment Growth**  
Year to November 2011



**Graph 3.26**  
**Job Vacancies and Advertisements**  
 Per cent of labour force

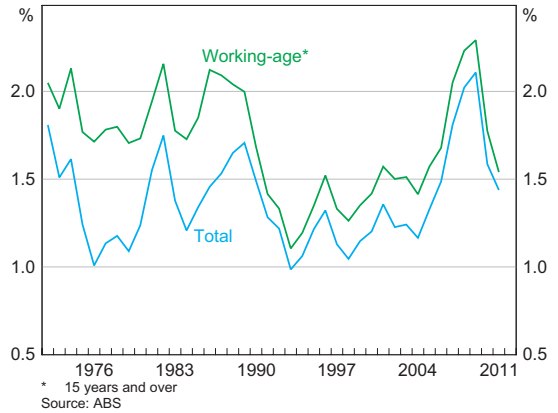


**Graph 3.27**  
**Job Vacancies\***  
 Per cent of labour force



Growth in the labour supply eased over 2011 in line with slower growth in the working-age population and the recent fall in the participation rate (Graph 3.28). The latest ABS population estimates for the year to June 2011 confirm that the rate of population growth has slowed significantly in recent years as a result of a decline in net immigration and a slight slowing in natural increase.

**Graph 3.28**  
**Population Growth**  
 Year to June



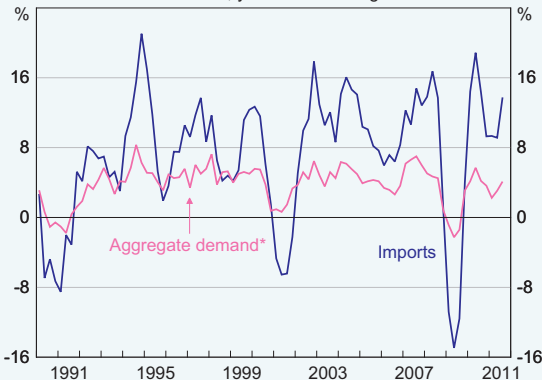
## Box C

# Imports and Investment

Import volumes have grown very strongly over recent years (Graph C1). While this partly reflects a recovery in demand following the global financial crisis, an unusually large proportion of the recent increase in demand has been met with higher imports, rather than domestically produced goods, with this trend particularly pronounced for investment goods. Accordingly, the average import intensity of demand has risen sharply in real terms. At the same time, the value of imports as a proportion of nominal GDP has actually declined, because import prices have fallen sharply over recent years (Graph C2). Indeed, overall import prices in Australian dollar terms are now lower than they were more than 20 years ago (Graph C3).

There are a number of factors driving these trends. First, Australia's trade openness has been trending higher for several decades, in line with the rise in world trade as a share of global GDP. This trend reflects lower trade barriers, falls in transport costs, and the growth of low-cost manufacturing in

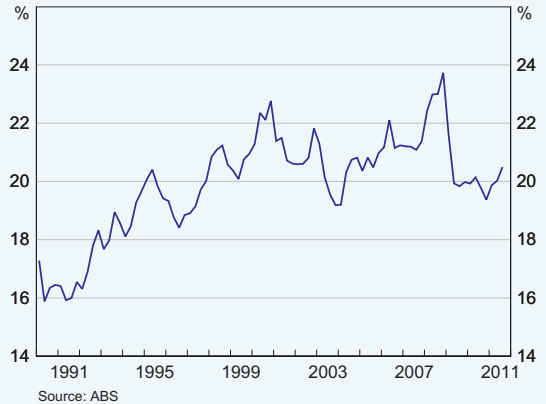
**Graph C1**  
Imports and Aggregate Demand  
Volumes, year-ended change



\* Gross national expenditure plus exports  
Sources: ABS; RBA

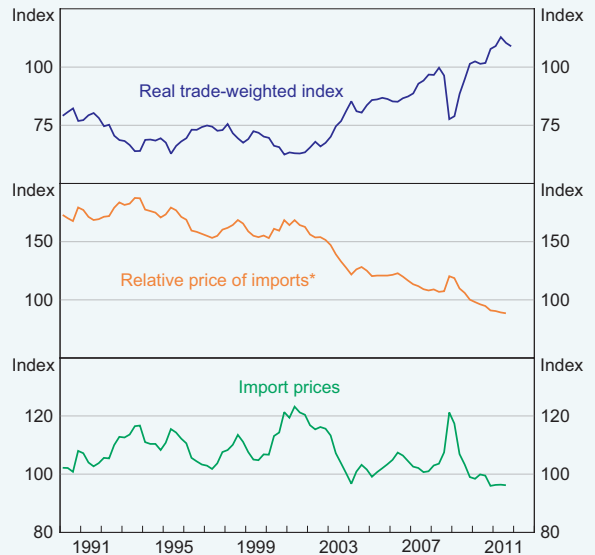
**Graph C2**  
Import Intensity

Imports as a per cent of nominal GDP



Source: ABS

**Graph C3**  
Import Prices and the Exchange Rate  
2009/10 = 100



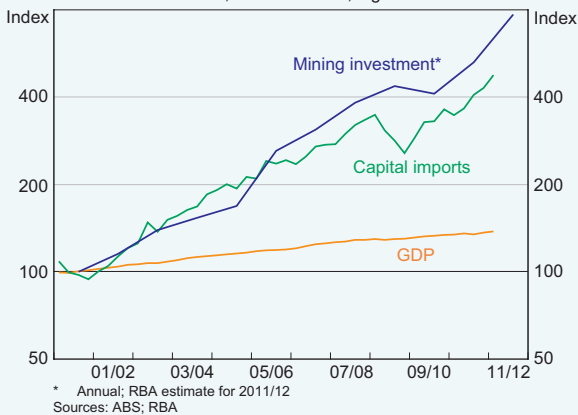
\* Imports implicit price deflator divided by GDP implicit price deflator  
Sources: ABS; RBA



emerging economies. As a result, import volumes have tended to grow more quickly than aggregate demand for an extended period (Graph C1). While this long-run trend has continued, it has recently been amplified by several other factors. The most obvious of these is the sharp appreciation of the exchange rate over recent years, which has lowered the Australian dollar price of imports (Graph C3). In particular, firms and households switch towards imports as they become cheaper relative to similar goods and services produced domestically, while the increase in real purchasing power as a result of lower import prices boosts domestic demand more generally.

Another key driver of the recent strength in import demand is the current boom in mining investment. Mining investment is significantly more import intensive than other forms of spending, and has therefore contributed to a sharp rise in imports (particularly of capital goods) as it has surged as a share of GDP (Graph C4). Liquefied natural gas (LNG) projects, which have accounted for a very large share of recent project commencements, are particularly import intensive.

**Graph C4**  
**Mining Investment and Capital Imports**  
 Volumes, 2000/01 = 100, log scale



The import intensity of current mining investment projects is also higher than in earlier years. One aspect of this is a global tendency for greater use of off-site ‘modular’ construction processes as opposed to the traditional on-site ‘stick-build’ processes. Developers of LNG and magnetite iron ore projects are increasingly modularising their processing plants, making it easier for them to be built offshore and then installed in Australia. In addition, a range of inputs to mining projects that have historically been sourced locally are now often being imported. This includes, for example, rail wagons and track, chemicals, container housing for construction workers, and engineering services. This change in large part reflects the same factors boosting import penetration in the economy more generally – namely, the trend rise in import intensity and the more recent significant decline in the relative price of foreign goods and services as a result of the appreciation of the exchange rate. In addition, the sheer scale of current mining investment projects has meant that local industry does not always have the capacity to service the large contracts being tendered by project managers. Further, the infancy of the LNG industry in Australia has meant that local firms are sometimes at a competitive disadvantage, due to a perception that they lack the same experience as foreign suppliers.

With the ongoing boom in mining investment – particularly in import-intensive LNG projects – and the high level of the Australian dollar, strong growth in demand for imports looks set to persist for the next few years. While the high exchange rate will involve difficult adjustment for some domestic import-competing industries, other industries are benefiting from lower-cost imported capital and intermediate goods, which should help boost productivity over time. More generally, the increased use of foreign sources of supply is an important mechanism for reducing pressures on overall capacity and inflation in Australia when demand is growing rapidly. ✎



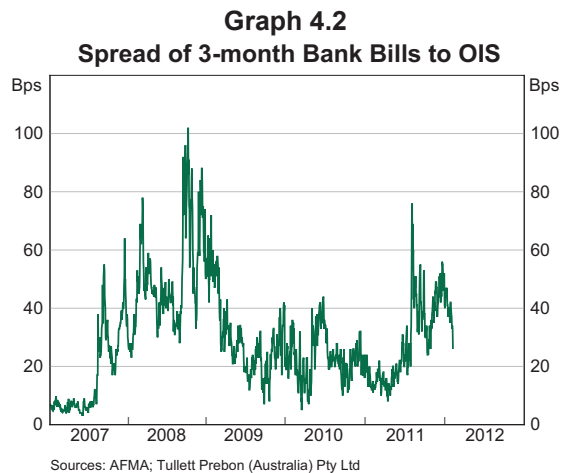
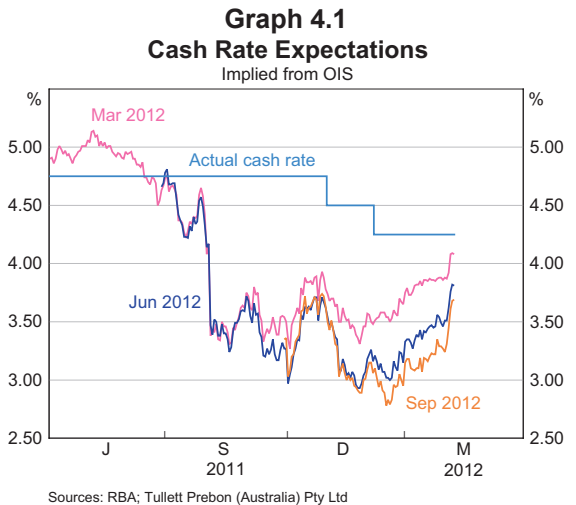
# 4. Domestic Financial Markets

## Money Markets and Bond Yields

The Reserve Bank lowered the target for the overnight cash rate to 4.25 per cent at its December 2011 meeting (Graph 4.1). Market expectations are for further easing in the target rate through 2012, although the extent of expected easing has lessened considerably since December. Overnight index swap (OIS) rates now indicate an expectation that the Reserve Bank will reduce the cash rate to around 3¾ per cent later in the year.

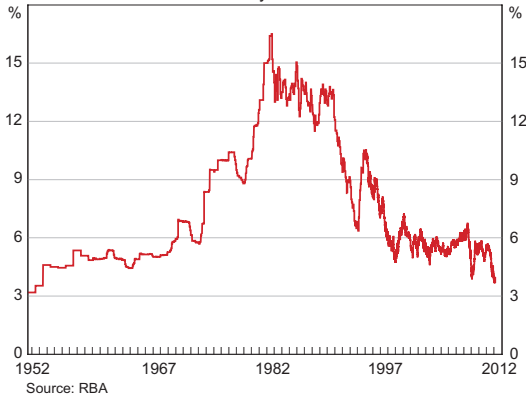
The domestic interbank money market has continued to function smoothly. The level of exchange settlement balances has generally been maintained at around \$1¼ billion, except over year-end when, as usual, the pool was temporarily raised to accommodate additional demand. The spread between the 3-month bank bill swap rate and OIS peaked at the end of December at a little below 60 basis points in response to higher issuance of short-term unsecured paper by domestic banks (Graph 4.2). The spread has subsequently fallen to around 25 basis points currently.

Strong demand, particularly from offshore investors, for relatively safe assets in the uncertain global climate has been apparent in the demand for Australian Government bonds over the past couple of months. (As at the end of September, non-residents were estimated to be holding around 75 per cent of Commonwealth Government securities (CGS) on issue.) The yield on 10-year CGS fell to 3.67 per cent in mid January, its lowest level in 50 years (Graph 4.3). Around the same time, the spread between the yields on 10-year CGS and 10-year US Treasury bonds



narrowed to its lowest level in 2 years. The yields on 10-year CGS have subsequently risen to around 4 per cent.

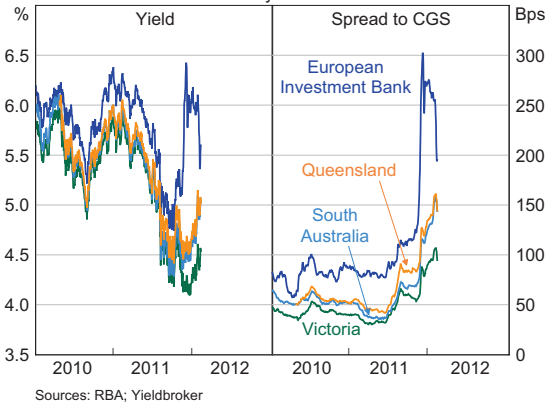
**Graph 4.3**  
**Australian Government Bond Yield**  
10-year



The strong investor preference for CGS and a deterioration in liquidity in the state government securities market, primarily as a result of heightened risk aversion related to events in Europe, led to a widening of the spread between yields on these securities (Graph 4.4). At their peak, 5-year spreads had widened by around 70 basis points from where they were at the end of October for South Australia and Queensland, and by around 50 basis points for New South Wales and Victoria. In recent weeks, spreads have narrowed and issuance has picked up considerably. Yields on longer-term state government debt have increased since the previous *Statement* as the increase in spreads has more than offset the fall in yields on CGS, but they remain low by historical standards.

Spreads between yields on Australian dollar-denominated securities issued by foreign institutions (Kangaroo bonds) and CGS increased sharply after a number of European sovereigns and agencies were placed on negative ratings watch, and liquidity in the market deteriorated markedly. Five-year spreads on securities issued by the AAA rated European Investment Bank (EIB), the largest Kangaroo issuer, widened by as much as 180 basis points from their level three months ago. The widening in spreads on European sovereign agency issuers, such as those from Norway, Sweden and Germany, was smaller. Non-European supranational issuers, such as the World Bank, also experienced some widening in

**Graph 4.4**  
**State Government and Supranational Debt**  
5-year

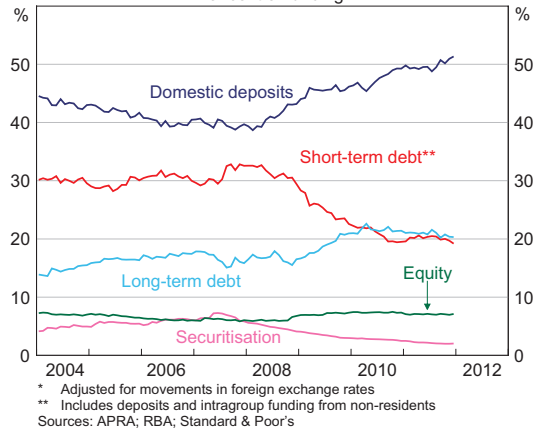


spreads. In the event, not all European names were downgraded. EIB retained its AAA rating but remains on review for a possible downgrade. A small number of Kangaroo bonds became ineligible for sale to the Reserve Bank under repurchase agreement following S&P's downgrade of some sovereigns. Trading conditions have improved a little since mid January, with five primary issues including two from A rated Korean institutions placing their inaugural Kangaroo bonds.

## Financial Intermediaries

The composition of bank funding has continued to shift towards deposit liabilities, reflecting solid

**Graph 4.5**  
**Funding Composition of Banks in Australia\***  
Per cent of funding



growth in household term deposits. The deposit share of bank funding is now at its highest level since 1998, at just under 52 per cent (Graph 4.5).

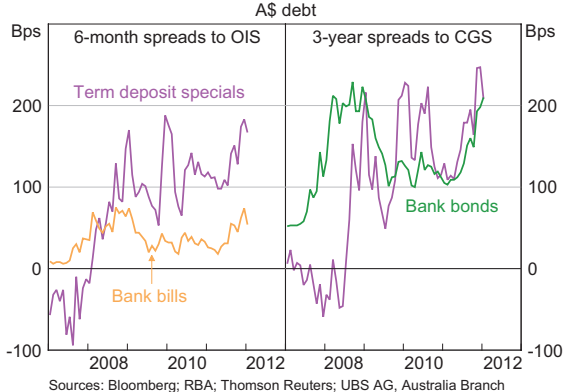
Bank funding costs have increased relative to the cash rate over the past six months. In particular, there have been increases in the spreads on term deposits due to competition for deposit funding, an increase in the spreads on wholesale funding due to an increase in the compensation required by investors globally for bank credit risk (see chapter on 'International and Foreign Exchange Markets') and an increase in the cost of foreign exchange hedging. These developments are summarised below and a more detailed discussion of developments in bank funding costs will be provided in the March Reserve Bank *Bulletin*.

Banks have continued to compete actively for deposits in recent months. The average rate on major banks' term deposit 'specials' has fallen by less than the cash rate, and the spread paid on term deposits has generally been above spreads on equivalent wholesale funding instruments (Graph 4.6). The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) has fallen by around 50 basis points over the past quarter, in line with movements in the cash rate.

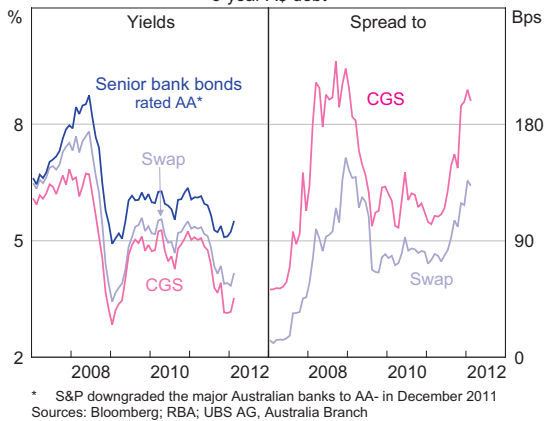
Yields on the major banks' senior unsecured bonds have increased a little since the previous *Statement*, but are around 80 basis points below their average for the first half of 2011 (Graph 4.7). Spreads on the major banks' unsecured bonds widened sharply around year end, reflecting the broad-based increase in the compensation required by investors globally for bank credit risk. More recently, however, banks have begun to issue unsecured bonds for terms of up to 5 years at somewhat narrower spreads.

The cost of offshore debt issuance has also increased because there has been a significant increase in the cost of hedging (Graph 4.8). This increased cost reflects both a pick-up in offshore issuance by Australian banks and weak Kangaroo bond issuance, which has typically been one of the predominant

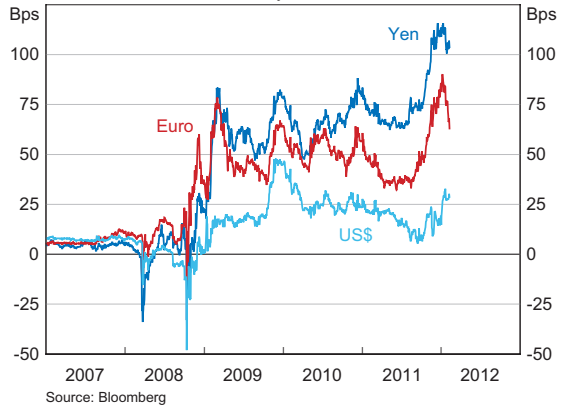
**Graph 4.6**  
**Major Banks' Pricing of Term Deposits and Bonds**  
A\$ debt



**Graph 4.7**  
**Major Banks' Bond Pricing**  
3-year A\$ debt



**Graph 4.8**  
**Cross-currency Basis Swap Spreads**  
5-year



sources of flows swapping Australian dollars into foreign currency.

Australian banks have issued around \$28 billion worth of bank bonds since the previous *Statement*, compared with issuance of \$6½ billion in the prior three months (Graph 4.9). Some of the pick-up in issuance can be explained by the major banks' refinancing relatively large bond maturities in January, two-thirds of which are government guaranteed bonds. During 2011, banks' outstanding bond funding declined somewhat, partly reflecting the reduced need for this funding given the strength in deposit growth relative to credit growth.

The composition of recent Australian bank bond issuance reflects the global trend towards issuing secured bonds as a way of mitigating the perceived increase in bank credit risk. Since the most recent *Statement*, there has been around \$9½ billion of unsecured issuance by the major banks.

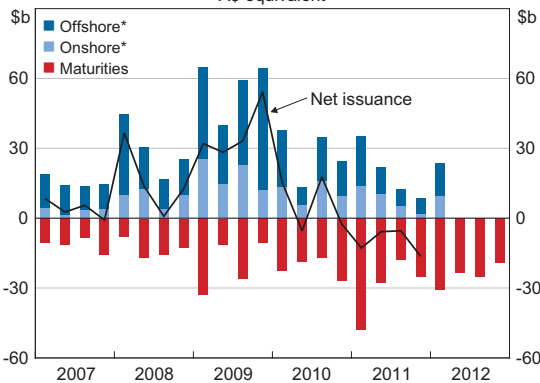
In contrast, the major banks have issued \$17 billion in AAA rated covered bonds since they were issued for the first time in November 2011. The initial issues were completed by the major banks in the US dollar market at spreads of around 230 basis points to CGS, reflecting both the broad-based increase in spreads on bank debt and the higher costs of exchange rate hedging. In January, there were two large domestic covered bonds issued with spreads of around

250 basis points over CGS; these spreads have subsequently narrowed by around 30 basis points. Covered bonds have allowed the banks to achieve good issuance volumes and at longer tenors than is normally the case with unsecured debt, particularly in the current environment (see 'Box D: Covered Bond Issuance by Australian Banks' for more details).

Since the November *Statement*, there have been four residential mortgage-backed securities (RMBS) transactions totalling \$2.4 billion (Graph 4.10). The main AAA tranches of these deals were at the 3-year tenor. Private investors took up most of the issuance, with the Australian Office of Financial Management (AOFM) only purchasing around one-quarter. Issuance spreads have continued to rise, consistent with developments in other bank debt markets. There has been no RMBS issuance so far in 2012.

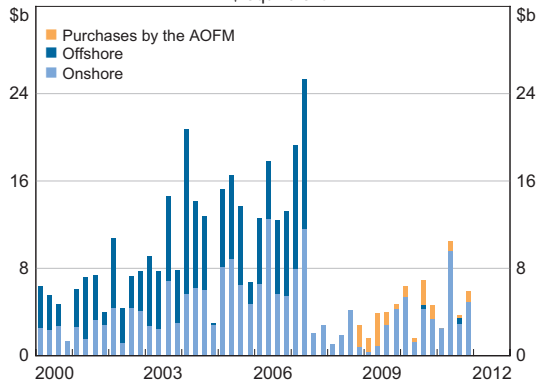
In December, S&P downgraded the credit ratings of the four major Australian banks by one notch from AA to AA-, following the global application of its revised ratings methodology for banking industries. The revision brought S&P's credit ratings for most of the major Australian banks to one notch below those of Moody's and Fitch. There was little market reaction to S&P's announcement. The major Australian banks now form four of only 20 global banks rated within the AA band or higher. As part of the same exercise, the Bank of Queensland's rating was lowered by

**Graph 4.9**  
**Banks' Bond Issuance**  
A\$ equivalent



\* Latest quarter issuance to date  
Source: RBA

**Graph 4.10**  
**Australian RMBS Issuance\***  
A\$ equivalent



\* Latest quarter issuance to date  
Source: RBA

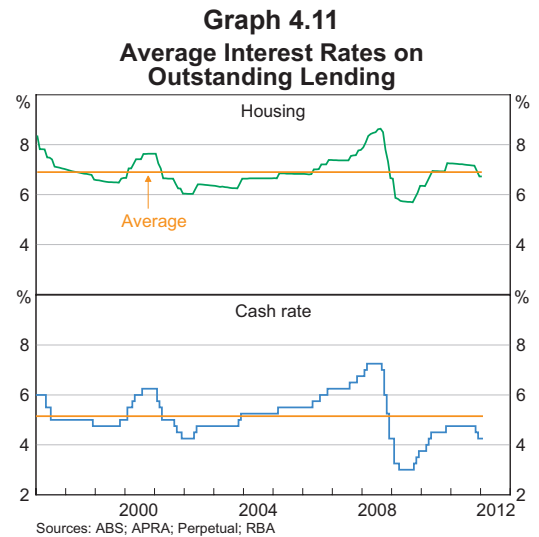
one notch from BBB+ to BBB, Macquarie Bank retained its A rating (although Macquarie Group was downgraded by two notches from A- to BBB), Suncorp-Metway's A+ rating was affirmed, while Bendigo and Adelaide Bank's rating was raised by one notch to A-. More recently, Fitch has announced that it has placed the Australian major banks on negative ratings watch.

## Household Financing

Most bank and non-bank lenders lowered their variable housing loan indicator rates in line with the reductions in the cash rate at the November and December Board meetings (Table 4.1). Taking into account the cessation of some additional discount offers introduced in mid 2011, average interest rates on new full-doc, variable-rate housing loans have decreased by slightly less than the cash rate since the end of October.

Rates on new fixed-rate mortgages have also fallen since the end of October. Fixed rates are now, on

average, about 25 basis points lower than variable rates, and the share of housing loans approved at fixed rates has increased to be just above its long-run average. Overall, the average rate on outstanding housing loans (fixed and variable) has fallen by 44 basis points since the end of October, to be 17 basis points below its post-1996 average (Graph 4.11).



**Table 4.1: Intermediaries' Variable Lending Rates**  
Per cent

	Level at end January 2012	Change since:	
		End October 2011	End November 2010
<b>Housing loans<sup>(a)</sup></b>	6.59	-0.44	-0.56
<b>Personal loans</b>	12.97	-0.24	0.17
<b>Small business</b>			
Residentially secured			
– Term loans	8.52	-0.48	-0.48
– Overdraft	9.38	-0.48	-0.48
Average rate <sup>(b)</sup>	8.25	-0.48	-0.56
<b>Large business</b>			
Average actual rate <sup>(b)</sup> (variable-rate and bill funding)	6.70	-0.26	-0.21

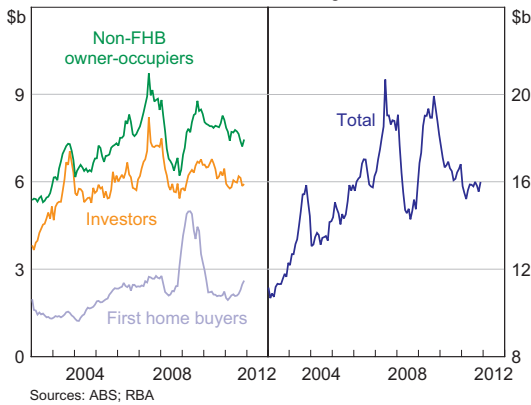
(a) Average of the major banks' discounted package rates on \$250 000 full-doc loans

(b) Rates on outstanding, as opposed to new, business lending

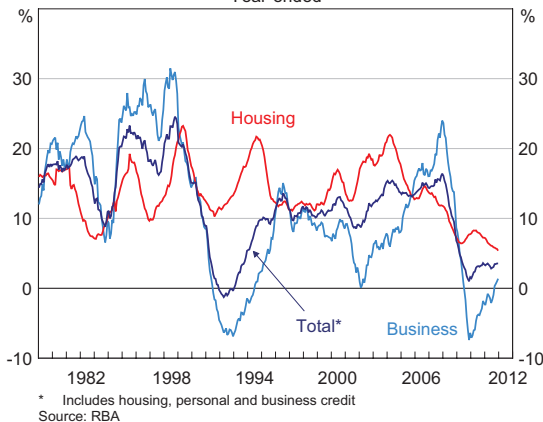
Sources: ABS; APRA; RBA

The total value of housing loan approvals was broadly unchanged over the three months to November; a fall in approvals to investors and repeat buyers offset a rise in approvals to first home buyers (Graph 4.12). The expiry of some first home buyer stamp duty exemptions in New South Wales at the end of 2011 is likely to have brought forward some housing loan approvals that would have otherwise occurred in 2012. Growth in housing credit has remained around an annual pace of 5–6 per cent and, given the level of loan approvals, is likely to remain around that pace in the period ahead (Graph 4.13).

**Graph 4.12**  
**Value of Housing Loan Approvals**  
 Net of refinancing



**Graph 4.13**  
**Credit Growth**  
 Year-ended



Personal credit continued to contract in the December quarter. The fall was largely the result of a decline in margin lending. The high frequency of margin calls, due to volatility in global equity markets, and heightened investor risk aversion are likely to have weighed on margin lending activity.

## Business Financing

Corporate bond spreads have continued to widen over recent months. For example, average secondary market yields on BBB rated corporate bonds have risen by around 30 basis points relative to CGS yields since the previous *Statement*, with the level of yields rising by around 15 basis points over this period (Graph 4.14). Notwithstanding this increase in spreads, funding conditions in wholesale markets for some corporates have been more favourable than for financial institutions, despite having a lower credit rating. For example, Coca-Cola Amatil (rated A-) raised 5-year bond funding at a spread that was 120 basis points tighter to the bank bill swap rate than Westpac's 5-year AAA rated covered bond.

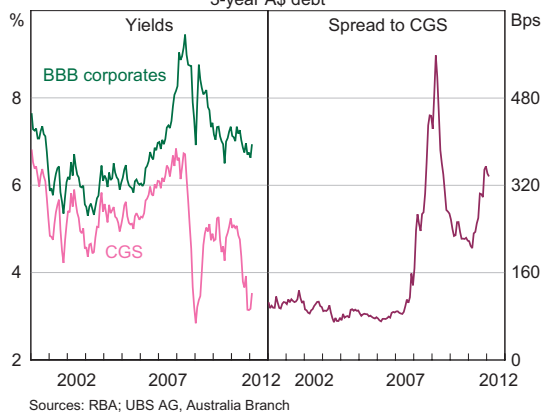
Corporate bond issuance has been relatively strong over the past few months; deals worth around \$7 billion have been completed (Graph 4.15). The bulk of this issuance was in November in offshore markets, and many were done at tenors of around 10 years or longer, which is difficult to achieve in the domestic market.

Intermediated business credit grew at a monthly average rate of around 0.2 per cent in the December quarter. Most of this growth was accounted for by an increase in lending to private trading corporations, rather than to small businesses. Business lending extended by euro area bank branches and subsidiaries fell over the quarter, following more modest declines since the beginning of 2009. Lending by European entities is currently less than 4 per cent of business credit.

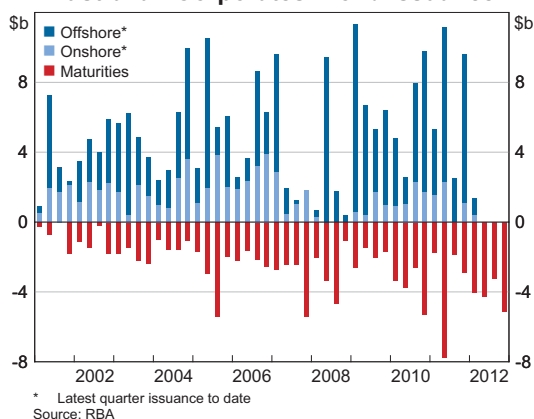
The value of syndicated loan approvals, around two-thirds of which are included in domestic business credit, increased over the December



**Graph 4.14**  
**Australian Corporates' Bond Pricing**  
 3-year A\$ debt



**Graph 4.15**  
**Australian Corporates' Bond Issuance**



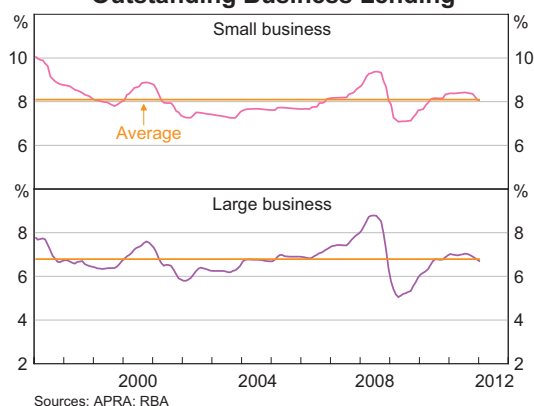
quarter, although the rise was driven by a pick-up in refinancing approvals. As with business credit more generally, the outstanding value of syndicated lending extended by euro area banks has declined over the second half of 2011, and has been offset by an increase in the role played by Asia-based institutions. Euro area banks accounted for a little over 10 per cent of Australian syndicated loan approvals in 2011, compared with an average of 20 per cent over the two preceding years.

The cost of new intermediated business borrowing has declined over the past three months, commensurate with the fall in benchmark rates.

Indicator rates on new variable-rate small business loans have fallen by 48 basis points, while indicator rates on new fixed-rate loans have declined by 21 basis points. As such, the average rates on banks' outstanding lending to small and large businesses have fallen to be around their post-1996 averages (Graph 4.16).

Net business external funding picked up in the December quarter. This was largely due to an increase in non-intermediated debt; equity raisings and business credit growth were more modest. Net equity issuance in 2011 was at its lowest level in nearly a decade, reflecting the already low level of corporate gearing. There were also some large buybacks, particularly by resource companies.

**Graph 4.16**  
**Average Interest Rates on Outstanding Business Lending**



## Aggregate Credit

Total outstanding credit grew at an annualised rate of 3.5 per cent over the December quarter, with modest growth in household credit and little growth in business credit (Table 4.2). Growth in broad money continues to outpace credit growth, reflecting a preference by households and businesses to hold their assets in deposits, particularly given the uncertainty surrounding equity markets.

**Table 4.2: Financial Aggregates**  
Percentage change

	Average monthly growth		
	September quarter 2011	December quarter 2011	Year to December 2011
Total credit	0.4	0.3	3.5
– Owner-occupier housing	0.5	0.4	5.7
– Investor housing	0.4	0.3	4.8
– Personal	–0.4	–0.1	–1.0
– Business	0.3	0.2	1.3
Broad money	0.9	0.5	7.4

Source: RBA

## Equity Markets

Conditions have been more settled in equity markets in the past couple of months, with volatility returning to average levels, following relatively high volatility at times during the second half of 2011. International developments, particularly regarding European sovereign debt, continue to be a focus of the market.

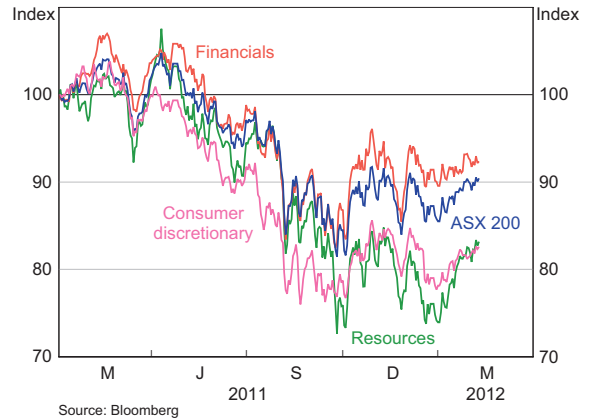
The ASX 200 has increased by 3 per cent since the previous *Statement*, underperforming global equity markets (Graph 4.17). Consumer discretionary stocks have underperformed the ASX 200, weighed down by a large fall in some retailers stocks following some downward revisions to profit forecasts. Share prices of Australian financials underperformed slightly, with the insurance sector showing a fall of 4 per cent; QBE announced that earnings would be 50 per cent lower than in 2010 due to record catastrophe claims and weak investment returns. Bank share prices have moved broadly in line with the overall market over the past year and have outperformed bank share price indices in Europe, the United Kingdom and the United States (Graph 4.18).

Merger and acquisition activity has been modest, with \$13 billion in deals announced since the previous *Statement*, mostly in December. The larger deals that have been announced involve companies in the resource sector. Around \$20 billion in deals are still pending.

**Graph 4.17**

### Australian Share Prices

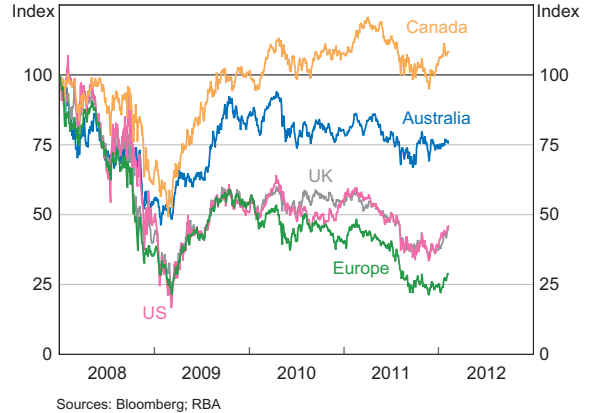
End December 2010 = 100



**Graph 4.18**

### Commercial Banks' Share Prices

End December 2007 = 100



## Box D

# Covered Bond Issuance by Australian Banks

Covered bonds are on-balance sheet asset-backed securities issued by financial institutions. Investors in covered bonds have a preferential claim on a pool of assets (called the cover pool) in the event that the issuing institution fails to make the scheduled payments on the covered bond. If the cover pool is insufficient to meet the issuer's obligations to investors, they have an unsecured claim on the issuer for any residual amount.<sup>1</sup>

Covered bonds typically have a higher credit rating than that of the issuer because the cover pools are usually comprised of high-quality assets such as prime mortgages, covered bond holders rank above unsecured creditors, and extra collateral is held in the cover pool.

There is a well-developed global market for covered bonds, particularly in Europe. In Australia, however, authorised deposit-taking institutions (ADIs) have only recently been permitted to issue these bonds, following the passing of legislation – the *Banking Amendment (Covered Bonds) Act 2011* – in October 2011. Under the new legislation, there is a cap on covered bond issuance by ADIs to limit the subordination of depositors to covered bond

investors. An ADI must limit the value of its cover pools to a maximum of 8 per cent of its assets in Australia. Given that Australian ADIs have set their cover pools at close to 120 per cent of the value of covered bonds – with some variation of this 'over-collateralisation' across banks – this implies that covered bonds could provide up to around 6¾ per cent of total on-balance sheet funding for Australian assets. This is equivalent to about \$140 billion for the major banks, based on the current level of their assets in Australia. The covered bond programs of the four major banks have all received a AAA credit rating, which is higher than the issuer credit ratings of these banks of AA or AA- (depending on the rating agency).

The major Australian banks have issued \$17 billion in covered bonds since October (Table D1). While terms have ranged from 3 years to 18 years, most issuance has been at the 5-year and 10-year tenors. This is longer than that typically available for senior unsecured bonds, which usually have a 3- or 5-year tenor. The ability to achieve longer-term funding reflects the high credit quality of covered bonds, as well as an expanded investor base. Over one-third of the issuance has been in the domestic

**Table D1: Covered Bond Programs of the Major Banks**

Issuer	Program size (A\$ billion)	Issuance to date (A\$ billion)	Tenor (years)	Currency
ANZ	20	3.5	3, 5, 7, 10, 11	CHF, EUR, NOK, USD
CBA	30	6.4	5, 10, 15, 18	AUD, EUR, GBP, NOK, USD
NAB	20	2.8	3, 5, 10, 15	EUR, GBP, NOK
WBC	20	4.5	5, 10	AUD, NOK, USD
<b>Total</b>	<b>90</b>	<b>17.3</b>		

Source: RBA

<sup>1</sup> Under the *Banking Amendment (Covered Bonds) Act 2011*, any residual claim of covered bond investors on an issuer ranks below claims of most depositors and the government.

market in Australian dollars, comprised of two large bond issues (Graph D1). The vast majority of these two issues was taken up by local investors, such as pension funds and other asset managers. The remainder of the issuance has been across five foreign currencies, primarily in euro for which the covered bond market is quite well developed. The wide range of currencies, in part, reflects the desire of the major banks to establish themselves as issuers in these markets. Some of the issues in the less-traded currencies have been placed privately.

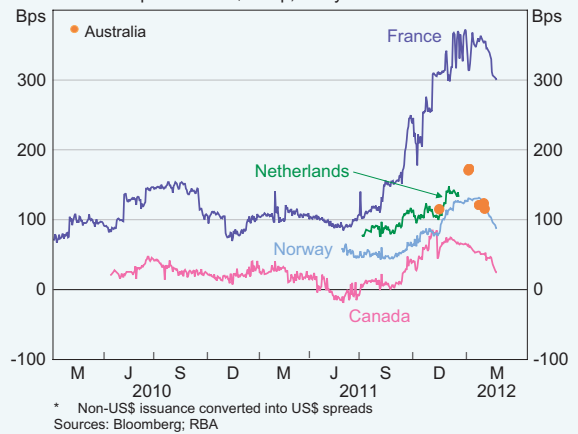
The Australian major banks' issuance has been at broadly similar spreads to many of their foreign peers (Graph D2). Covered bonds issued by some European banks, such as those in France, have been trading at much higher spreads, highlighting investor concerns about those banking systems. Canadian banks' covered bonds have tended to trade at lower spreads, in part because the cover pools for these bonds typically include residential mortgages that are insured by the Canadian Government. Notwithstanding these differences, issuance costs have been high, with spreads on a number of the major bank 10-year covered bond issues in excess of 230 basis points over the bank bill swap rate. However, secondary market yields suggest that these spreads have narrowed noticeably since they were issued.

A comparison of 5-year covered bonds issued by the major Australian banks since the start of the year shows that after accounting for the cost of hedging back into Australian dollars, the overall cost has been relatively similar across issues in Australian dollars, US dollars and Swiss francs (Graph D3). However, issuance costs in euro-denominated covered bonds have been higher. This largely reflects the relatively high cost of hedging these issues back into Australian dollars. At the same time, Australian banks have indicated a desire to establish themselves in the euro covered bond market, given it is the deepest and most developed globally. ↕

**Graph D2**

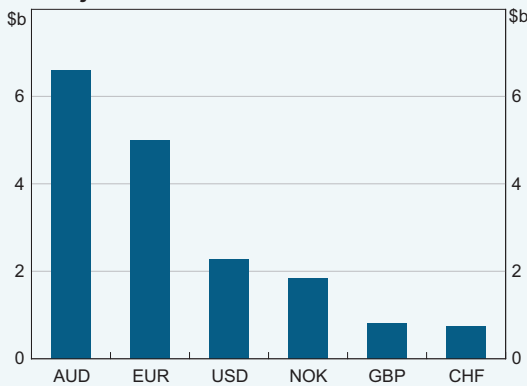
**Covered Bond Pricing\***

Spread to US\$ swap, 4-6 year AAA rated



**Graph D1**

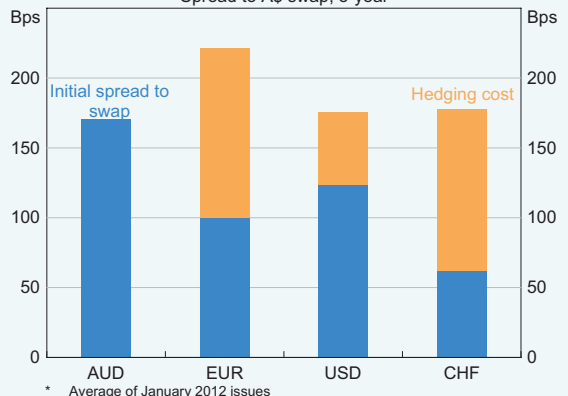
**Major Banks' Covered Bond Issuance**



**Graph D3**

**Covered Bond Primary Market Pricing\***

Spread to A\$ swap, 5-year

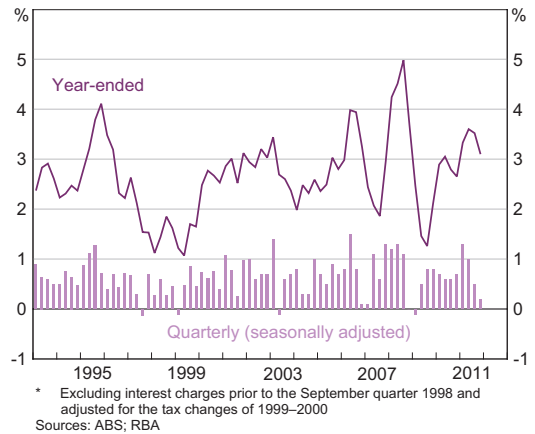


# 5. Price and Wage Developments

## Recent Developments in Inflation

Consumer price inflation eased in the second half of 2011 following strong outcomes in the earlier part of the year. The seasonally adjusted consumer price index (CPI) rose by 0.2 per cent in the December quarter and the year-ended inflation rate fell to 3.1 per cent (Table 5.1 and Graph 5.1). Fruit and vegetable prices fell sharply in the quarter following large rises associated with supply disruptions in early 2011. CPI inflation is expected to moderate further in year-ended terms in the March quarter as fruit prices continue to fall.

**Graph 5.1**  
**Consumer Price Inflation\***



**Table 5.1: Measures of Consumer Price Inflation**  
Per cent

	Quarterly		Year-ended	
	September quarter 2011	December quarter 2011	September quarter 2011	December quarter 2011
Consumer Price Index	0.6	0.0	3.5	3.1
Seasonally adjusted CPI <sup>(a)</sup>	0.5	0.2	3.5	3.1
– Tradables <sup>(b)</sup>	0.0	–0.9	3.3	1.8
– Tradables (excl food, fuel and tobacco) <sup>(b)</sup>	–0.2	–0.6	–1.4	–1.1
– Non-tradables (excl deposit & loan facilities) <sup>(b)</sup>	0.8	0.9	3.5	3.7
<i>Selected underlying measures</i>				
Trimmed mean	0.4	0.6	2.4	2.6
Weighted median	0.4	0.5	2.7	2.6
CPI excl volatile items <sup>(b),(c)</sup>	0.5	0.5	2.3	2.5

(a) Year-ended changes are based on non-seasonally adjusted data

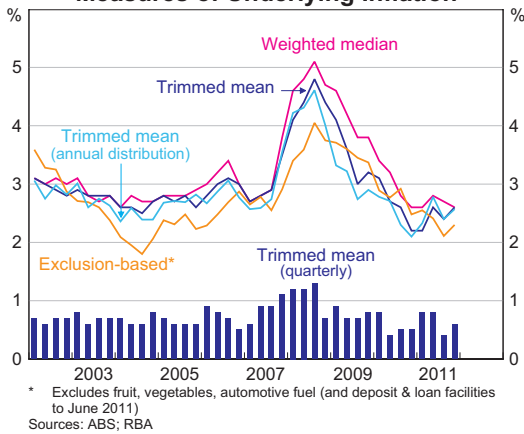
(b) Quarterly data are calculated by the RBA, based on seasonal factors for components from the ABS; year-ended changes are based on non-seasonally adjusted data

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

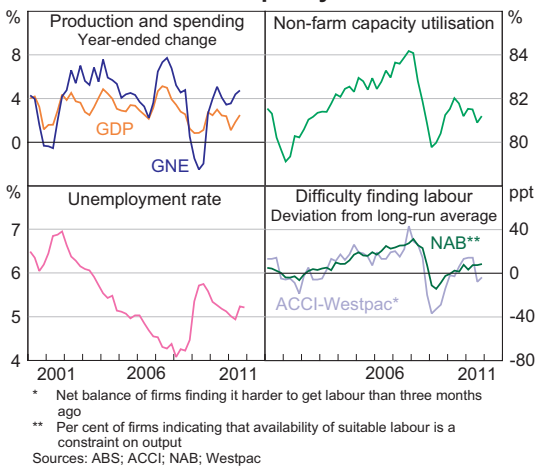
Sources: ABS; RBA

The various measures suggest underlying inflation was around ½ per cent in the December quarter and around 2½ per cent over the year (Graph 5.2); measures of underlying inflation were revised up slightly for the September quarter, reflecting concurrent seasonal adjustment. The latest data indicate that the pace of underlying inflation moderated in the second half of 2011 compared with the solid outcomes in the first half of the year. More broadly, the data suggest that inflation outcomes over the past couple of years have been consistent with the medium-term target, and below the levels seen in 2007 and 2008 when most indicators suggested that capacity in the economy was stretched (Graph 5.3).

**Graph 5.2  
Measures of Underlying Inflation**



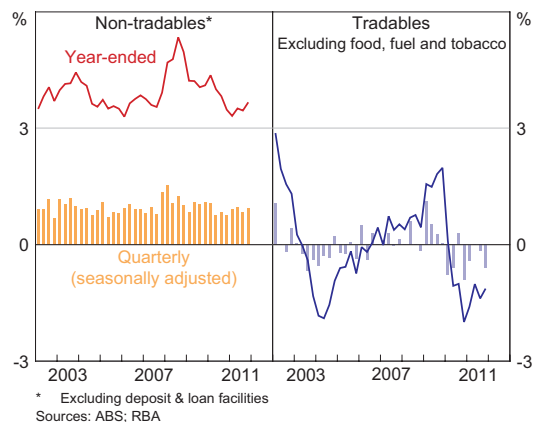
**Graph 5.3  
Indicators of Capacity Pressures**



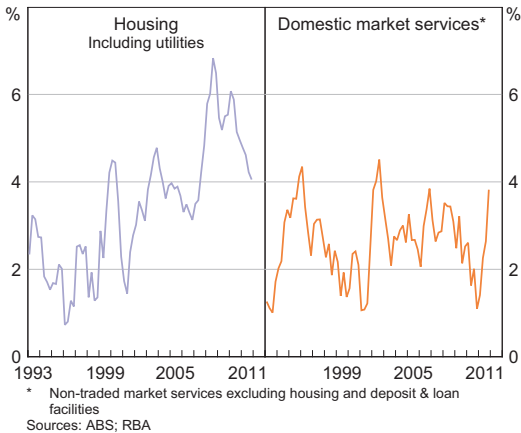
Inflation in non-tradables prices, which includes housing and a large range of domestic services prices, and accounts for around 60 per cent of the CPI basket, picked up slightly in the December quarter. In seasonally adjusted terms, non-tradables prices rose by 0.9 per cent to be 3.7 per cent higher over the year – around ¼ percentage point higher than the trough in non-tradables inflation in early 2011 (Graph 5.4). Housing costs made a sizable contribution to inflation in the December quarter, although there are divergent inflationary pressures within the group. Inflation in rents remained firm in the quarter. In contrast, inflation in the prices of new dwellings remained low and in year-ended terms was around its lowest level in over a decade, reflecting soft demand conditions in the residential construction industry. Inflation in the prices of several administered services, including hospital & medical and childcare, as well as a range of market services, such as domestic travel, telecommunication, insurance and restaurant meals, was relatively strong in the quarter. The pace of year-ended inflation in market services has returned to around the average of the years prior to the slowdown in inflation in 2008 (Graph 5.5).

Declines in the prices of tradable items continued to hold down overall consumer price inflation. In seasonally adjusted terms, tradables prices (excluding food, fuel and tobacco) fell by 0.6 per cent in the quarter and by 1.1 per cent over the year.

**Graph 5.4  
Consumer Price Inflation**



**Graph 5.5**  
**Non-tradables Inflation**

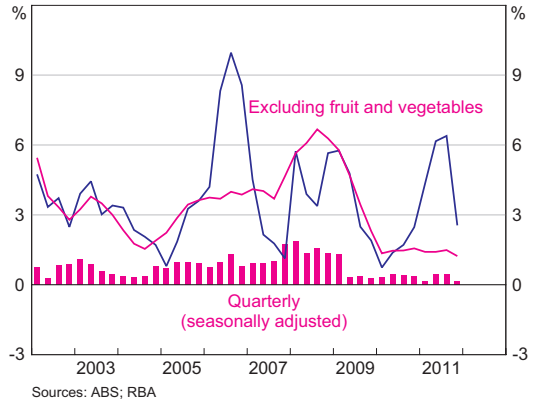


The fall in the quarter was driven by lower prices for overseas travel, audio visual & computing equipment and motor vehicles. The decline in motor vehicle retail prices reflected a small fall in import prices and some additional discounting by distributors. Outside of these items, however, tradables prices were broadly flat in the quarter and over the year, in contrast to the sizable falls which occurred in 2010 associated with the earlier large appreciation in the Australian dollar.

As expected, food prices fell sharply in the December quarter, primarily due to the unwinding of the effects of Cyclone Yasi on banana supplies and prices (Graph 5.6). The ABS indicated that banana prices fell by nearly 50 per cent in the quarter, which is estimated to have subtracted around 0.3 percentage points from headline CPI inflation. Inflation in food prices, excluding fruit and vegetables, moderated further in the quarter to 1¼ per cent in year-ended terms, the slowest pace since 1994. The prices of milk, bread and several meat categories fell over the year. The underlying softness in food price inflation in part reflects ongoing competition among retailers which is limiting price rises in the grocery supply chain.

Automotive fuel prices rose by over 5 per cent in seasonally adjusted terms in the December quarter. Over the year, fuel prices rose by 12½ per cent with the strong rise in global oil prices outweighing the effects of the exchange rate appreciation.

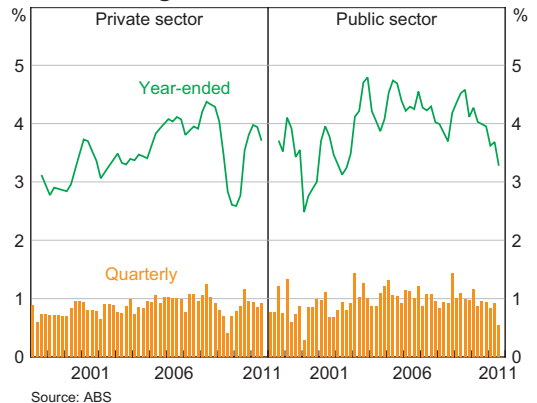
**Graph 5.6**  
**Food Price Inflation**



## Costs

Although growth in wage costs remains firm, the moderation in labour market conditions over the past year has lessened the likelihood of a pick-up in wage inflation. The wage price index (WPI) rose by 0.7 per cent in the September quarter, after rising by 0.9 per cent in the previous quarter. Private sector wage growth remained firm, with growth of 0.9 per cent in the quarter (Graph 5.7). Although the WPI data indicate there is currently relatively little dispersion in the growth of wage rates across states and industries, the national accounts measures indicate that total labour income is rising strongly in Western Australia, consistent with rapid growth

**Graph 5.7**  
**Wage Price Index Growth**



in high-wage employment in the resources sector in that state. The annual award wage increase came into effect at the beginning of July, increasing award wages by 3.4 per cent.

Public sector wage growth was unusually soft in the September quarter, owing to delays in finalising new enterprise agreements in a number of states and Commonwealth agencies. It is likely there will be some catch-up in public sector wages as outstanding agreements are finalised over the December and March quarters.

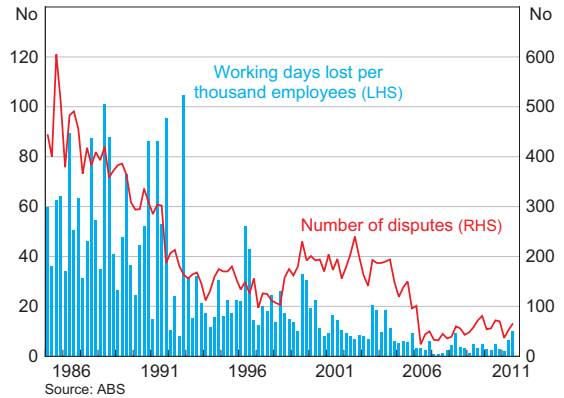
Overall, the official data suggest that wage growth is currently running around the average rate seen since 1997, having moderated slightly over the past year. Consistent with this, business surveys and the Bank's liaison suggest that wage pressures have remained firm, although there is little evidence of upward pressure on wage inflation.

Data from the national accounts indicate that unit labour costs – the average cost of labour per unit of output – grew at a rapid pace in early 2011 owing to weak labour productivity growth. However, unit labour costs growth moderated in the September quarter in line with a pick-up in labour productivity, which reflected strong growth in GDP and softer employment growth; a continuation of these trends is expected to see the national accounts measure of unit labour costs moderate further in coming quarters.

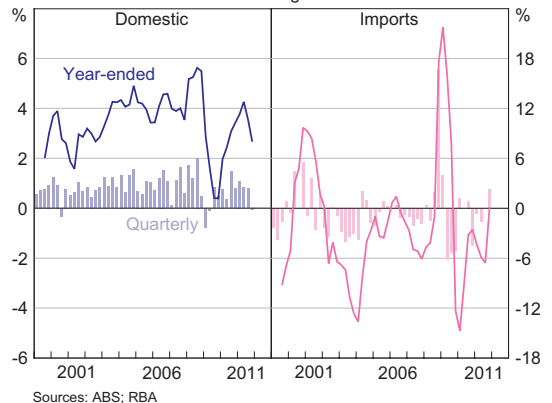
ABS data on working time lost in industrial disputes – which capture stop-work meetings, strikes and employer lockouts – indicate an increase in industrial action in the June and September quarters, partly reflecting a large public sector dispute (Graph 5.8). Nevertheless, the number of disputes and level of working days lost remains low relative to history.

The December quarter producer price data also point to an easing in upstream price pressures in the second half of 2011. Final stage producer prices rose modestly in the quarter to be 2.9 per cent higher over the year. Although part of this easing was due to the large fall in banana prices in the quarter, abstracting from this, domestic price pressures appear to have slowed across all stages of production (Graph 5.9). In contrast, with the effects of the 2009 and 2010 exchange rate appreciation largely passed, and a modest depreciation having occurred in the second half of 2011, import prices picked up across all stages of production in the December quarter.

**Graph 5.8**  
**Industrial Disputes**  
Quarterly



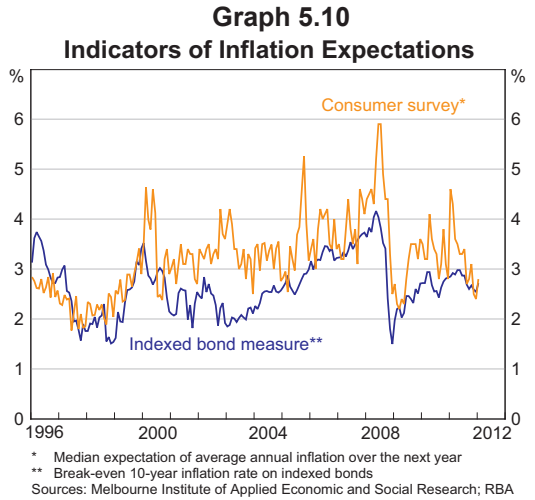
**Graph 5.9**  
**Final Stage Producer Price Inflation**  
Excluding oil





## Inflation Expectations

Most measures of inflation expectations are a little lower since the time of the November *Statement* and remain consistent with the medium-term target (Graph 5.10). The Melbourne Institute’s measure of consumer inflation expectations has decreased slightly, to be a little below its average over the inflation-targeting period. Financial market measures of medium- to long-term inflation expectations are little changed, with the indexed bond measure remaining around its inflation-targeting average. Market economists have revised down their forecasts for inflation in 2012 over the past three months, while expectations for inflation over 2013 were unchanged (Table 5.2). Union officials have also revised down their expectations throughout the forecast horizon. Consistent with near-term inflation expectations, survey measures suggest that business expectations for near-term selling price inflation remain below average. ↗



**Table 5.2: Median Inflation Expectations<sup>(a)</sup>**  
Per cent

	Year to December 2012			Year to December 2013	
	August 2011	November 2011	February 2012	November 2011	February 2012
Market economists	3.0	2.9	2.5	2.7	2.7
Union officials	3.1	3.4	3.0	3.4	3.0

(a) Excluding carbon price effect  
Sources: RBA; Workplace Research Centre



# 6. Economic Outlook

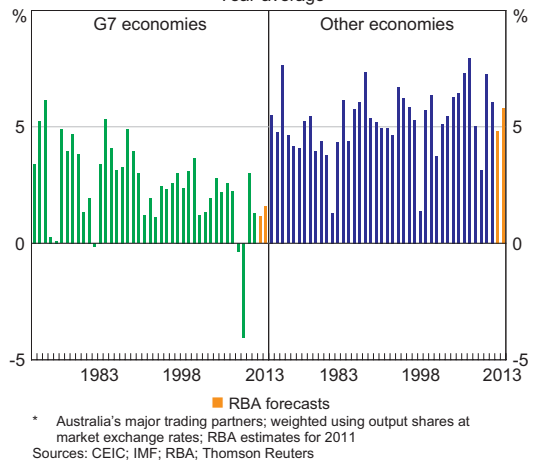
## The International Economy

The global outlook has weakened since mid 2011, with the euro area economy appearing to have slipped into recession. The euro area authorities have made progress in developing a comprehensive response to the sovereign debt and banking sector problems, although further measures will be required. In contrast, the recovery in the United States is continuing after a soft patch in mid 2011, although there is still considerable spare capacity in the labour market and broader economy. Growth in emerging economies is likely to be a little softer than earlier expected, reflecting both trade and financial linkages with Europe and the broader effects on domestic demand of the global economic uncertainty.

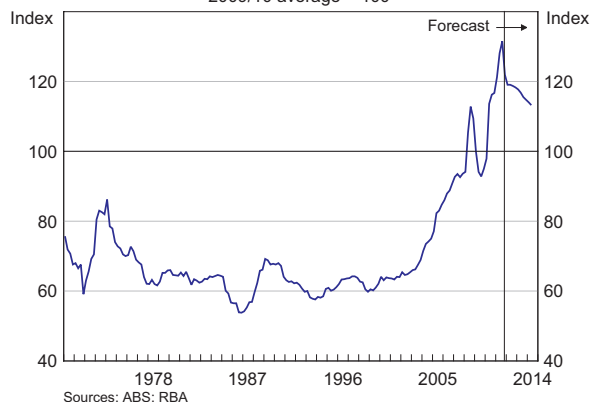
In line with these developments, the International Monetary Fund's (IMF) January forecasts were for global growth to slow to a below-trend pace of 3.3 per cent in 2012 before strengthening to 3.9 per cent in 2013, with growth in Australia's major trading partners (weighted by export shares) around a percentage point higher than that in each year. The Bank's central scenario is broadly similar (Graph 6.1). The projected recovery in 2013 largely reflects the expectation of some easing in sovereign debt concerns in Europe and an anticipated policy response to the slower growth in Asia. Nevertheless, it is likely to take some years for the worst-affected economies in Europe to restore their competitiveness and ensure more sustainable debt profiles, and there is still a risk of a disorderly outcome, as discussed below.

The terms of trade are estimated to have fallen slightly from their record level in the September quarter, but remain high (Graph 6.2). With global

**Graph 6.1**  
**Global GDP Growth\***  
Year-average



**Graph 6.2**  
**Terms of Trade**  
2009/10 average = 100



commodity prices mostly a little higher than in early November, consistent with the improvement in global sentiment over the past month or so, the Bank's forecast path for the terms of trade has been revised up slightly. However, the terms of trade are still expected to decline gradually over the forecast period, reflecting slower growth in global demand for commodities and increased global supply capacity for bulk commodities.

## Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed. The exchange rate is assumed to remain at its current level over the forecast horizon (A\$ at US\$1.07, TWI at 78), which is a little higher than assumed in the November *Statement*. The price of Tapis oil – which is the most relevant for Australian fuel prices – is assumed to remain at US\$125 per barrel over the forecast period, US\$9 higher than in November. The cash rate is assumed to be unchanged over the forecast period. Finally, the forecasts assume that growth in the working-age population will pick up slightly over the forecast period to 1.6 per cent in 2013 and 2014, based on the most recent data for population growth and forecasts from the Department of Immigration and Citizenship.

GDP growth over 2011 is estimated to have been around 2¾ per cent, with conditions quite uneven across industries and regions in the economy. As was expected, work is accelerating on the large pipeline of liquefied natural gas (LNG) projects, which is boosting imports of capital goods. In Queensland, the recovery in coal production from the floods has taken longer than initially expected, with Queensland coal exports still below pre-flood levels. Consumer spending has grown at around the same pace as household income over the past year, with stronger spending on services and on overseas trips offsetting slower growth in spending on goods, particularly at department stores. At the same time, the high exchange rate, the completion of some

fiscal stimulus programs and uncertainty about the global economic outlook have weighed on growth in some sectors. Consistent with this divergence in conditions, the strong growth in mining activity and associated stronger labour market outcomes in Western Australia are flowing through to stronger consumer spending, with some early signs that this is also occurring in Queensland. Growth in demand in other states has been weaker.

The domestic economy is expected to grow at an around-trend pace in 2012 and 2013 (Table 6.1). The forecast profile is broadly similar to the outlook at the time of the November *Statement*, but is weaker than forecast in mid 2011 reflecting the weaker outlook for global economic growth, with the uncertainty about the European situation expected to weigh on household and business spending decisions. The pipeline of mining investment projects and solid growth in resources exports are expected to continue to support growth, with activity more subdued in sectors of the economy benefiting less from the mining boom or being adversely affected by the high exchange rate.

Growth in mining sector investment is being underpinned by the \$180 billion of LNG projects approved or under construction, including the recently approved US\$34 billion Ichthys LNG project, which will transport gas by pipeline from the Browse Basin off the coast of Western Australia to Darwin. The investment in LNG production facilities will subsequently drive a surge in LNG exports; the commissioning of the Pluto project is expected to boost exports starting around March this year, with other projects expected to come online from late 2014. The outlook for iron ore and coal exports also remains strong. Based on mining, rail and port infrastructure projects currently under way or in planning, significant growth in coal export capacity is expected over the next three years. Large expansions in iron ore capacity are also in the pipeline.

Growth outside the mining sector is expected to remain below trend over the forecast period.

**Table 6.1: Output Growth and Inflation Forecasts<sup>(a)</sup>**  
Per cent

	Year-ended					
	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013	June 2014
GDP growth	2¾	3½	3–3½	3–3½	3–4	3–4
CPI inflation	3.1	1¾	3	3¼	2½	2½–3
Underlying inflation	2½	2¼	2¾	2¾	2½	2½–3
CPI inflation (excl carbon price)	3.1	1¾	2½	2½	2½	2½–3
Underlying inflation (excl carbon price)	2½	2¼	2½	2½	2½	2½–3
	Year-average					
	2011	2011/12	2012	2012/13	2013	2013/14
GDP growth	2	3¼	3½	3–3½	3–3½	3–4

(a) Technical assumptions include A\$ at US\$1.07, TWI at 78, Tapis crude oil price at US\$125 per barrel  
Sources: ABS; RBA

Non-mining investment is forecast to remain subdued over the next year, consistent with the near-term outlook in business surveys, but is expected to pick up gradually further out. In the building industry, conditions remain weak in both the office- and home-building sectors. The high level of the exchange rate is also weighing on trade-exposed sectors including manufacturing, tourism and education. Further, sizeable fiscal consolidation plans have been announced for 2012/13, with public demand as a share of GDP likely to return to its average over the 2000s.

Growth in household spending is expected to remain moderate in the near term, as softer labour market outcomes, concerns about developments abroad, and declines in net wealth weigh on spending. Consumption growth is then expected to pick up gradually in line with income growth, with the household saving ratio expected to remain around its current level over the forecast period.

Employment growth is expected to remain fairly subdued in the first half of this year. With firms expressing caution about hiring, growth in labour demand is likely to be met partly through increased hours for existing employees, and the unemployment

rate is expected to increase modestly. Employment growth is expected to begin to strengthen later in the year in line with solid GDP growth and as firms' current caution subsides somewhat. The unemployment rate is expected to decline modestly over the later part of the forecast period, broadly in line with forecasts in the November *Statement*.

Given the outlook for the labour market, the wage price index is expected to continue to increase at around its current rate. With some improvement in productivity expected, growth in unit labour costs over the forecast period is expected to be below the elevated rate seen over 2005–08.

## Inflation

The outlook for inflation is little changed from the forecasts published in the November *Statement*.

The latest CPI data indicate underlying inflation was around 2½ per cent over 2011, with quarterly inflation outcomes lower in the second half of the year than in the first half. The forecasts incorporate small downward revisions to expected inflation in the near term, which imply year-ended underlying inflation dipping to around 2¼ per cent in June

2012 as the large quarterly increases from the first half of 2011 drop out of the annual numbers. Looking ahead, domestically generated inflation pressures are expected to ease slightly in line with lower growth in unit labour costs and the easing in capacity pressures that has occurred. However, the disinflationary impetus from lower import prices evident over the past few years is expected to wane, and tradable prices are expected to begin making a modest positive contribution to inflation over the forecast period. Overall, underlying inflation (excluding the effect of the carbon price) is forecast to remain within the target range over the next few years, with the year-ended underlying rate declining slightly in the near term before drifting gradually higher to be in the upper half of the target range by 2014.

A number of one-off factors are expected to affect the profile for headline CPI inflation over the first half of the forecast period. The continued unwind of the spike in fruit prices will see headline inflation fall below underlying inflation in the near term. Then, from the September quarter 2012, the headline numbers will be boosted by the introduction of a price on carbon, which is expected to add 0.7 percentage points to headline inflation over the following year; the effect on underlying inflation is expected to be around  $\frac{1}{4}$  percentage point.

## Risks

The central outlook for the global economy assumes a continuation of the uncertainty surrounding the sovereign debt problems in Europe. However, as in previous forecasts, it also assumes that a disorderly outcome is avoided. This remains the major downside risk for the global economy. If this risk did eventuate it would lead to a severe recession in Europe, which would spill over to the rest of the world through trade, financial and confidence linkages. However, there have been some positive developments over the past six weeks or so, including the agreements made at the Euro Summits in early December and late January as well as the

European Central Bank's extension of three-year funding to banks, which appear to have reduced this risk somewhat.

Risks are more balanced in the case of the US economy. Based on current legislation, a large fiscal consolidation is scheduled to occur in 2013, which would be significantly contractionary for the US economy. The Bank's central forecast assumes, consistent with recent forecasts from the IMF and the OECD, that some compromise is reached and that only part of the currently legislated consolidation occurs. The possibility of a larger consolidation remains a downside risk. On the upside, however, the recovery in the United States economy could strengthen more than in the central forecast, with a self-sustaining cycle of an improving labour market and increases in consumption and investment, particularly given that business balance sheets are generally in good shape.

Risks to the outlook for China and other economies in Asia appear to be skewed slightly to the downside. Growth has slowed in these economies, reflecting both domestic policy settings and trade, financial and confidence linkages to Europe. These economies do, however, have ample scope to ease monetary and fiscal policies in response to emerging economic weakness, which should support growth.

As noted in the November *Statement*, the possibility of a sharp slowing in Europe and contagion to the rest of our trading partners remains the key downside risk to the Australian economy. In this scenario, business and consumer confidence would likely decline, while a slowing in global demand for commodities would see prices fall more sharply than in the central forecast and some of the planned expansions to mining production may be postponed or scaled back. In this environment, there would be scope to boost domestic demand via policy stimulus and it is possible – as in late 2008 – that the exchange rate would depreciate, which would be stimulatory for some sectors. Overall, however, growth would be weaker than in the central forecast.

More broadly, there is some uncertainty surrounding the growth outlook resulting from the significant structural change that is occurring in the economy. History offers little basis on which to judge the net impact on the economy of, on the one hand, a once-in-a-century investment boom in the resources sector and, on the other, a high real exchange rate. The Bank has been expecting for some time that the economy would undergo a period of significant structural adjustment, with resources shifting into the mining sector and with other parts of the economy adjusting to the higher level of the exchange rate. Over the past year there has been considerable evidence that this structural change is occurring, with subdued conditions in the manufacturing, tourism and education sectors. One risk is that this adjustment process leads to larger job shedding in some sectors over the next few years and that employment growth is weaker than in the central forecast. However, given the very high level of investment, especially in the mining sector, it is possible that aggregate output growth could be stronger than the around-trend pace of the central forecast.

The risks to the inflation outlook appear evenly balanced. The major downside risk to inflation emanates from the risk of a heightening of the problems in Europe resulting in slower domestic growth. The risks on the upside relate more to domestic factors. In particular, the inflation outcomes over the past two years have been helped by falls in the prices of tradable goods and services as a result of the appreciation of the exchange rate that started in the first half of 2009. While non-tradables inflation has recently been lower than the peak rates seen in 2008, it has been running at a higher rate than would appear to be consistent with inflation being around the centre of the medium-term target range if tradables inflation was no longer being held down by an appreciation of the exchange rate. Accordingly, some modest easing in domestic cost pressures, including from stronger productivity growth in the domestically oriented services sectors, is likely to be required in the medium term. Inflation could be expected to be higher than in the central scenario if this easing in cost pressures does not occur. ✎

