Statement on Monetary Policy

NOVEMBER 2010

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The recovery in the global economy is continuing, although conditions clearly differ across regions. Growth remains solid in most of Asia, although below the rapid pace seen earlier this year. Strong growth is also continuing in parts of Latin America. In contrast, in many of the advanced economies, consumption remains subdued and the earlier boost to activity from the dynamics of the inventory cycle is waning, as are the effects of the earlier fiscal expansions.

In China and in most of east Asia, growth looks to have returned to a sustainable pace and concerns about the possibility of a larger-than-expected slowing have lessened recently. Growth also remains strong in India. In many countries in the region, the authorities have begun the process of tightening policy, although real interest rates remain low. In several countries, housing markets have been strong over the past year, which has prompted a tightening of prudential requirements and other measures to cool these markets. Inflation in the region has also increased, although this largely reflects a rise in food prices. In a number of countries, policy-makers remain concerned about the possibility of a pick-up in short-term capital inflow given the likelihood that interest rates in the advanced economies will remain low for an extended period.

The Bank's central forecast for the world economy continues to be for around trend growth over the next couple of years. In the period immediately ahead, the risks in some of the advanced economies look tilted to the downside as they grapple with necessary adjustments in household and public-sector balance sheets and, in some cases, continuing difficulties in the financial system. Inflation in a number of these countries continues to move lower and unemployment rates remain high. In the United States, this has prompted the Federal Reserve to announce a further significant expansion of its balance sheet. In Asia, the risks to growth look more balanced, particularly given that financial conditions in many countries in the region remain very accommodative.

Compared with the middle of this year, risk aversion in global markets has declined somewhat, although sentiment remains fragile, with concerns about the situation in a number of smaller European countries remaining elevated. The general improvement in conditions has been partly due to the anticipation of the Federal Reserve's decision to expand its balance sheet, which has contributed to longer-term government bond yields falling to around historical lows. In turn, low government bond yields have contributed to an increase in demand for other assets. Over recent months, equity prices have recovered to be only a little below their mid-April peaks, and conditions in money markets have improved further. Credit spreads have also generally narrowed since the August *Statement,* with corporate borrowing costs in capital markets at historic lows. As a result, bond issuance has picked up, although growth in bank lending remains weak in many countries.

In currency markets, the prospect and then the announcement of further quantitative easing in the United States has seen the US dollar depreciate against most currencies. In response, some countries have intervened in their foreign exchange markets or tightened capital controls in an effort to slow the appreciation of their currencies and restrain short-term capital inflows. In trade-weighted terms, the Australian dollar has appreciated by around 6 per cent since the August *Statement* to a post-float high.

Conditions in the domestic economy continue to evolve broadly in line with the Bank's central scenario and are consistent with recent growth being at around trend pace. There is evidence that private demand is strengthening, offsetting the scaling back in public investment as stimulus projects are completed.

The economy is continuing to benefit from the high level of commodity prices, with nominal income growing very strongly over the past year. The prices of many commodities have increased further recently and Australia's terms of trade are estimated to have reached around the highest level since at least Federation. While the terms of trade are expected to decline over the medium term, the recent strength in both resources and agricultural prices has led to an upward revision to the Bank's forecasts for the terms of trade over the next couple of years.

The high level of commodity prices continues to underpin a positive outlook for aggregate investment. Survey-based measures of business conditions and confidence remain at or above average levels, indicators of investment intentions in the resources sector are very strong, and the pipeline of work to be done is large. Notwithstanding this, determining the exact timing of the pick-up in investment remains difficult, especially given the uncertainty around the timing of some very large projects. One area of business investment that has yet to show signs of recovery is non-residential construction, with building activity remaining low relative to the likely medium-term growth in demand for commercial buildings. For some developers, access to finance remains a significant constraint, although, more broadly, financial conditions for businesses have eased somewhat from the tight conditions that applied in late 2008 and early 2009. Business credit outstanding has, however, declined over recent months, after having been largely unchanged over the first half of the year. This partly reflects a lower need for intermediated funding, with strong profit growth leading to a significant increase in businesses' internal funding, and some firms accessing global capital markets rather than borrowing from banks in Australia.

Consumer confidence has been at high levels over recent months, with consumer surveys reporting that it is a good time to buy major household items. Despite this, the Bank's liaison continues to suggest that consumers are cautious in their spending. The appetite for new debt also remains more subdued than in the past, with both housing and credit card debt currently growing at historically low rates. This has been associated with a welcome cooling in the housing market, with dwelling prices declining slightly over recent months, after increasing solidly over the year to the March quarter.

The labour market has been strong over the past year, with the unemployment rate declining to just over 5 per cent, down by around ¾ percentage point from its peak in mid 2009. The forward-looking indicators point to a continuation of solid employment growth, although below the pace seen over the recent past. Despite a high level of vacancies and the relatively low unemployment rate, firms in most industries are not reporting unusual difficulties in hiring suitable labour. The main exceptions are in some mining-related occupations, where the labour market is quite tight.

Measures of wage growth have risen in 2010, after the subdued outcomes in 2009. Despite this pick-up, wage growth in the private sector was slightly below average over the first half of 2010, while in the public sector, wages have continued to grow at a slightly above-average pace. Looking forward, a further increase in wage growth is expected over time, as the labour market tightens further.

While the overall economy is currently growing at around its trend rate, conditions differ across sectors. A number of industries are benefiting directly from the expansion of the resources sector and others are benefiting indirectly from the increase in national income arising from higher commodity prices. The accompanying appreciation of the exchange rate is, however, dampening prospects in other sectors. In the tourism industry, for example, there has been a sharp increase in the number of Australians travelling abroad rather than taking holidays domestically and overseas visitor arrivals have been soft. These differences across industries and regions are not unexpected in an economy that is being affected by large changes in relative prices.

Over the past two years, inflation has moderated significantly. In underlying terms, inflation has returned to the middle of the 2–3 per cent medium-term target band, after having been above the target in recent years as a result of the build-up in pressure associated with the strong domestic economy prior to the global downturn. In the September quarter, the CPI increased by 0.7 per cent, to be 2.8 per cent higher over the year. This outcome was slightly lower than expected, partly reflecting movements in the prices of some volatile items. One factor that has, however, boosted the CPI over the past couple of quarters has been the increase in the tobacco excise earlier in the year. Utilities price inflation has also been high, although in year-ended terms it is likely to have peaked.

The Bank's central forecast for the economy is broadly unchanged from six months ago. GDP is expected to expand by 3½ per cent over 2010 and then by 3¾–4 per cent over both 2011 and 2012. This forecast continues to be driven by the effects of the income boost flowing from the very high level of the terms of the trade and the expected substantial increase in business investment, particularly in the resources sector. While public demand is forecast to contract over the coming year as stimulus-related projects are completed, this is expected to be offset by a pick-up in private demand. This central scenario for the economy continues to assume that more of the boost to national income from the terms of trade is saved than was the case in the earlier phase of the boom a few years ago.

The near-term forecast for year-ended inflation has been lowered, partly reflecting the recent appreciation of the exchange rate. However, the medium-term outlook for inflation is largely unchanged. In underlying terms, inflation is expected to remain around 2½ per cent until mid next year, before gradually rising to 3 per cent by the end of 2012. Over this period, the economy is likely to start pushing up against supply-side constraints, given the relatively limited amount of spare capacity that currently exists. Year-ended headline inflation is forecast to remain above underlying inflation in the near term, largely due to the effect of the increase in the tobacco excise.

As usual, these forecasts are subject to a range of uncertainties. One is the scale and timing of the expected pick-up in private investment. A number of the proposed projects are very large and a change to their timing could affect the profile for investment over the next few years. Another factor that will influence how the economy evolves is the degree to which the recent change to households' attitudes to debt and spending persists. A further factor is the exchange rate. To date, the appreciation appears broadly consistent with increases in commodity prices and interest rate differentials, and the exchange rate is playing a stabilising role for the economy as a whole. However, in the current international environment it is possible that the exchange rate appreciates further for reasons unrelated to these factors. If this were to occur, both growth and inflation would likely be lower than in the central scenario. There are also the continuing uncertainties emanating from the global economy discussed above.

From June to October, the Board kept the cash rate steady at 4.5 per cent, after having moved over the previous eight months to withdraw the considerable monetary stimulus that was put in place when the outlook seemed much weaker. Over this recent period, interest rates to most borrowers have been close to their average over the past decade. With growth around trend and underlying inflation around the middle of the target band, this has provided the Board some time to observe the early effects of the previous policy changes and to monitor the evolving balance of risks to both the domestic and global economies.

For a few months now, the Board has had the view that if economic outcomes in Australia turned out broadly as expected, then it was likely that higher interest rates would be required at some point to ensure that inflation remains consistent with the target over the medium term. The economy is experiencing a large expansionary shock from the high terms of trade at a time when there are relatively modest amounts of spare capacity, with the result that the medium-term inflation risks have been to the upside. Over the past couple of months, economic developments appear to have been broadly in line with the Bank's central scenario, and the downside risks in Asia look to have lessened a little. As a result, at its November meeting the Board concluded that it was prudent to make an early and modest adjustment to monetary policy, increasing the cash rate to 4.75 per cent. The Board will continue to monitor domestic and global developments carefully and set monetary policy to ensure that inflation remains consistent with the 2–3 per cent medium-term target.

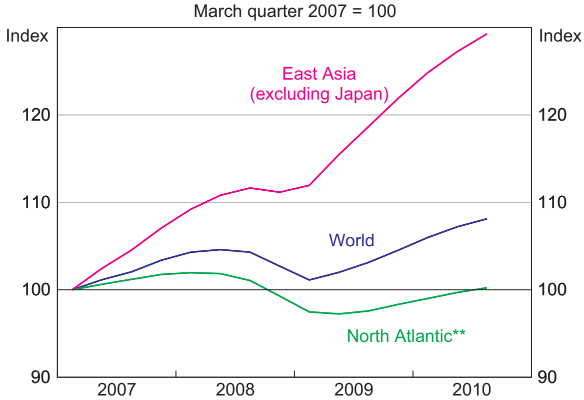
International Economic Developments

Data on the global economy over the past few months have been consistent with output growth slowing to around trend rates from the rapid pace experienced in late 2009 and early 2010. In Asia (with the exception of Japan) a strong recovery has taken place, whereas the recovery has been much more subdued in the North Atlantic economies (Graph 1). The above-trend growth in Asia in late 2009 and early 2010 has significantly reduced output gaps in the region and steps are being taken to gradually reduce the degree of policy stimulus, with output growth easing to a more sustainable pace. Asset prices in the region are generally higher than they were in mid 2007, and balance sheets are in better shape than in most of the advanced economies.

In contrast, in many of the North Atlantic economies and in Japan output remains considerably below its previous trend and the momentum of the recovery has slowed as domestic private demand struggles to gain traction. The process of repairing balance sheets continues to restrain household spending in many countries, as discussed further in 'Box A: Household Saving Rates in Advanced Economies'. Growth prospects are also likely to be affected by planned fiscal consolidation in some countries. In response to the slow recovery and high unemployment rates, the United States and Japan are undertaking additional monetary easing.

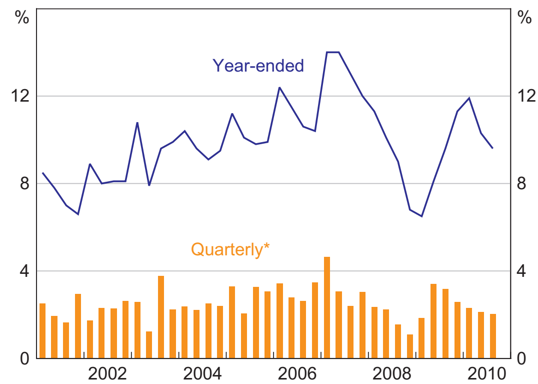
The Chinese economy continues to expand strongly, although the pace of growth has eased to a more sustainable pace. GDP is estimated to have increased by around 2 per cent in the September quarter and by 9½ per cent over the year (Graph 2). Domestic demand has driven much of the recent growth, while exports have contracted for several months, consistent with trade developments in the rest of east Asia. The fiscal stimulus is being gradually withdrawn and there have been moves to tighten monetary conditions,

Graph 1
World Output*
March quarter 2007 = 100



* Aggregated using PPP exchange rates; RBA estimates for September quarter 2010
** Canada, euro area, the UK and US
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 2
China – GDP Growth

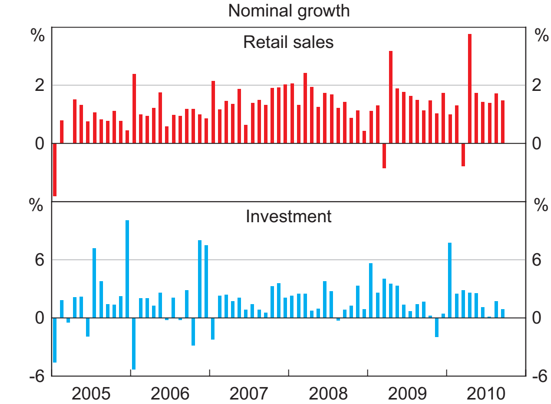


* RBA estimates
Sources: CEIC; RBA

with the People's Bank of China recently raising benchmark deposit and lending rates after having increased reserve requirement ratios earlier in the year.

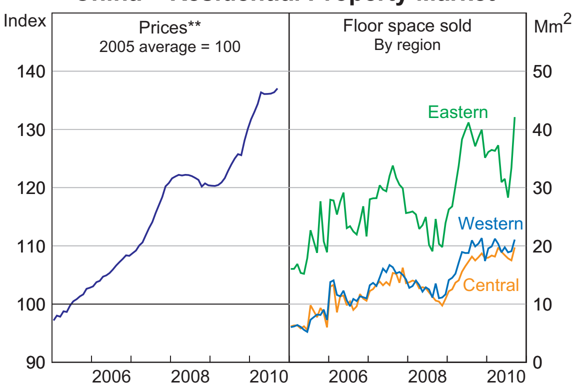
Activity indicators show that domestic demand in China has remained firm over recent months. Retail sales grew at a robust pace during the September quarter and rose by around 15 per cent over the year in real terms (Graph 3), while the level of passenger vehicle sales has grown strongly, supported by policy measures including lower sales taxes and the extension of the car scrappage scheme. Growth in urban fixed-asset investment has eased since June,

Graph 3
China – Monthly Activity Indicators*
Nominal growth



* RBA estimates
Sources: CEIC; RBA

Graph 4
China – Residential Property Market*



* RBA estimates
** Average of new and existing residential property prices
Sources: CEIC; RBA

mainly reflecting weaker growth in infrastructure investment as the government gradually withdraws its fiscal stimulus. Real estate investment has picked up in recent months and manufacturing investment has remained strong. While growth in infrastructure spending is expected to be moderate over the coming year as the effects of the fiscal stimulus fade, the level of spending is expected to remain high, especially as the government focuses on further economic development of central and western provinces.

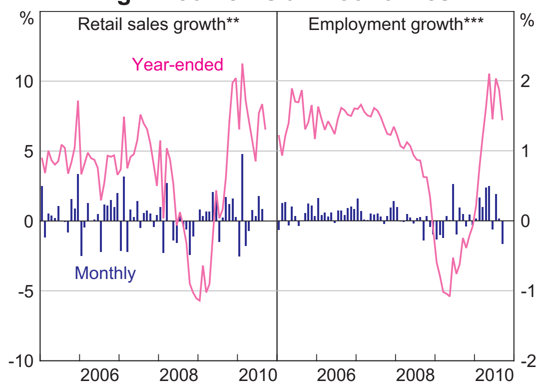
Industrial production grew solidly through the September quarter after recording weaker growth through the June quarter. Growth in production was driven by machinery and transport equipment manufacturing, which had been weak for several months, as well as by activity in the mining and chemical industries. The production of crude steel continued to fall through the September quarter partly as a result of policies aimed at curbing the activities of high-polluting and energy-intensive producers. Export volumes are estimated to have contracted by around 3 per cent in the September quarter, with weakness evident across all of China's major trading partners, although this partly reflects a fall in exports of steel after strong growth in the months leading up to the removal of export rebates on some steel products in July. Notwithstanding the weak economic conditions in the major advanced economies, the manufacturing PMIs for China are consistent with an ongoing expansion of that sector.

Conditions in the property market have strengthened recently after cooling following the introduction of policy measures in April. According to the National Bureau of Statistics, property prices were broadly flat between May and August but increased modestly in September (Graph 4). Turnover of residential property, which had fallen after the April measures, recovered strongly in September, mainly reflecting an increase in the eastern provinces. The limited effect of earlier measures on housing prices has prompted the central government to recently announce a range of policy measures to reduce borrowing for the purchase of housing. A more detailed discussion of recent property market developments in the region is provided in 'Box B: East Asian Property Markets'.

Inflation has increased in recent months, mainly due to higher food prices, which have been affected by flooding in the major food-producing regions of southern China. Non-food inflation has remained at around 1½ per cent in year-ended terms for the past five months. With higher headline inflation over the year and renewed inflationary pressures in the property market, the People's Bank of China raised deposit and lending rates in mid October. The 1-year benchmark deposit and lending rates were raised by 25 basis points, with larger increases in longer-term deposit rates.

In the June quarter, output grew by 1.7 per cent in east Asia (excluding China and Japan), down from an average rate of 2.4 per cent over the previous four quarters. Growth was broad based, with all expenditure components except stocks contributing in the quarter. With the pace of inventory rebuilding having slowed in most countries in the Asian region and demand from key trading partners easing, recent data suggest that growth in east Asia is now being driven more by domestic demand. Export volumes fell by 1¾ per cent over the three months to August, driven by falls in intra-regional exports. Soft export performance is also being reflected in weaker industrial production in the region. In contrast, retail sales grew by an average of 2¾ per cent in the high-income Asian economies in the September quarter and the outlook for consumption is being buoyed by solid labour markets and rising net wealth (Graph 5). Recent data also point to continued strength in investment.

Graph 5
High Income Asian Economies*

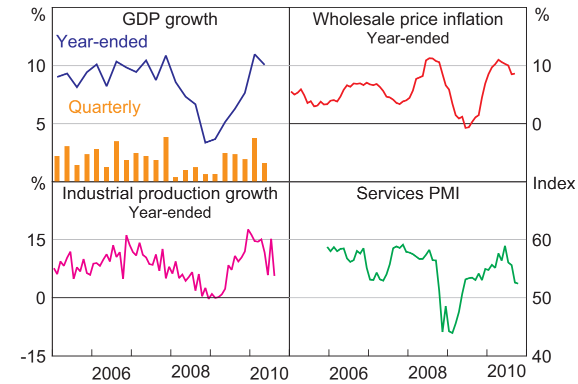


* Hong Kong, South Korea, Singapore and Taiwan
** GDP-weighted at market exchange rates; RBA estimate for September 2010
*** Excludes Singapore
Sources: CEIC; IMF; RBA

Despite strong output growth in the region over the past year, core inflation remains contained at around 2 per cent. Monetary conditions remain accommodative, although central banks have begun to tighten monetary policy gradually including, for some countries, through modest exchange rate appreciations. Low (and in some cases negative) real interest rates in east Asia have led to rapid house price growth in some economies (see 'Box B: East Asian Property Markets'), prompting – as has occurred in China – policies in Hong Kong, Taiwan and Singapore to temper house price inflation.

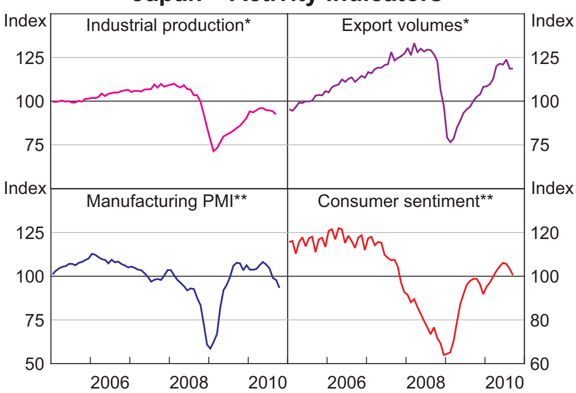
The Indian economy has continued to expand at a firm pace. GDP recorded robust growth in the June quarter to be 10 per cent higher over the year (Graph 6). There was strong growth in household and government spending, although exports fell in the quarter. Manufacturing activity slowed in the quarter, while output in the agricultural and services sectors continued to expand solidly. More timely monthly data point to a strengthening in industrial production and merchandise exports, while the services PMI is consistent with continued solid growth in that sector. Improved rainfall in the recent summer monsoon season is also likely to boost production in the agricultural sector, which accounts for about one-sixth of the Indian economy, and to help contain rises in food prices.

Graph 6
India – Economic Indicators



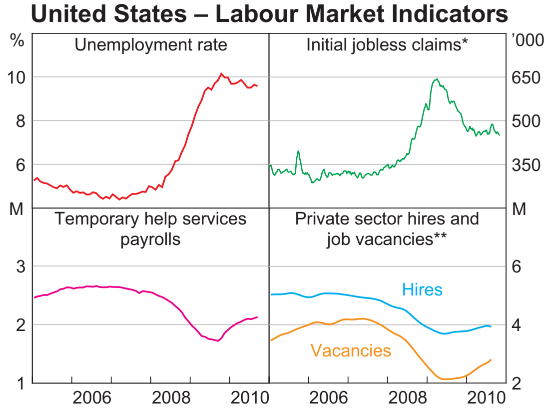
Sources: CEIC; JPMorgan Chase & Co. and Markit; RBA

Graph 7
Japan – Activity Indicators



* 2005 average = 100
** Long-run average = 100
Sources: CEIC; JPMorgan Chase & Co. and Markit; Thomson Reuters

Graph 8
United States – Labour Market Indicators



* Four-week moving average
** 13-period Henderson trend; vacancies open to external applicants
Sources: Bureau of Labor Statistics; RBA; Thomson Reuters

Over recent months, inflation in India has eased from the double-digit rates recorded earlier in the year. Non-food manufactured goods inflation, which had been a key driver of inflation developments, has moderated, bringing year-ended growth in the wholesale price index to 8½ per cent. The Reserve Bank of India increased interest rates further in November citing concerns about the level of inflation and the recent sharp rise in asset prices; cumulatively, the repo and reverse repo rates have increased by 150 and 200 basis points since the beginning of 2010.

In contrast with most other Asian economies, economic conditions in Japan remain subdued. Consumption grew only slightly in the first half of 2010 and weak labour market conditions appear set to constrain household spending going forward (although household demand was boosted in the September quarter by fiscal stimulus measures). Export growth has slowed from its very rapid pace earlier in the year as trading partner growth has eased, while industrial production has tracked broadly sideways this year (Graph 7). The softer pace of growth in exports and continued strength in the yen in nominal terms (particularly relative to the US dollar; see 'International and Foreign Exchange Markets' chapter) also appear to have weighed on business confidence in recent months.

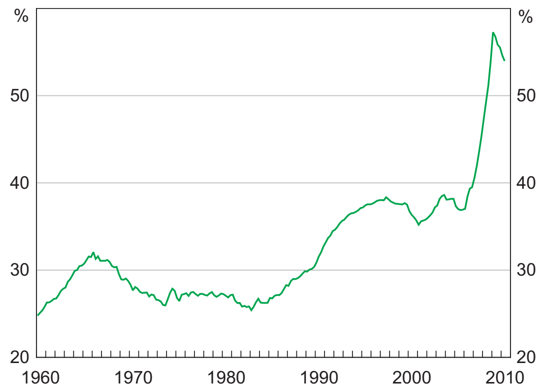
The United States economy continues to expand, although the pace of growth has slowed over the past six months. GDP rose by 0.5 per cent in the September quarter, with robust growth in business investment and a solid contribution from stocks. Although consumption grew by 0.6 per cent in the quarter, it is yet to recover its earlier fall. Consumption of durables remains weak, with purchases of motor vehicles still over 20 per cent below the average rate seen over the 2000–2007 period. Household expenditure continues to be constrained by the weak recovery in the labour market. The unemployment rate was essentially flat for the four months to September and jobless claims remain elevated, despite other indicators of labour demand such as temporary hires and private job vacancies continuing to improve (Graph 8).

Conditions in the housing market remain weak. Dwelling investment is at a post-War low as a share of GDP and, with the overhang of vacant homes still at historical highs, appears likely to remain subdued. House prices have also been broadly flat over the past 18 months, after earlier large falls contributed to a significant deterioration in household balance sheets; the gearing ratio on household property rose from around 37 per cent in 2006 to around 55 per cent as house prices fell (Graph 9). As a result, balance sheet repair is expected to continue to weigh on household demand for a protracted period. In contrast, business balance sheets are in better shape. Corporate profitability has rebounded over the past year and a half, liquid assets have increased sharply and business gearing is falling (Graph 10). While access to finance remains difficult for some firms, business investment appears to have scope to pick up further, from near the lowest levels as a share of nominal GDP in many decades, if sentiment recovers and the outlook for household spending improves. The depreciation of the US dollar has also improved the outlook for exports.

Conditions remain subdued in the euro area, notwithstanding GDP growing by a surprisingly robust 1 per cent in the June quarter. There continues to be a wide disparity in economic conditions in the region; the strong June quarter GDP outcome was largely driven by growth of 2.2 per cent in Germany, while GDP in Greece and Ireland contracted in the quarter. Investment was the key driver of growth in Germany in the quarter, rising by 4.7 per cent, although it remains at low levels as a share of GDP (Graph 11). More recently, Germany has continued to outperform the other euro area economies in a range of indicators, with relatively strong labour market outcomes and high levels of consumer and business confidence (Graph 12).

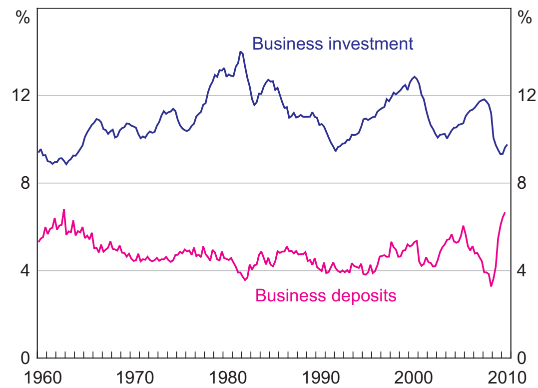
While a number of euro area economies have performed poorly over the past few years, conditions in Greece and Ireland have been particularly weak. GDP has contracted by 13½ per cent in Ireland since its peak in December 2007 and consumer prices have fallen by 4 per cent over the past 2 years.

Graph 9
United States – Household Property Gearing Ratio
Housing debt as per cent of housing assets



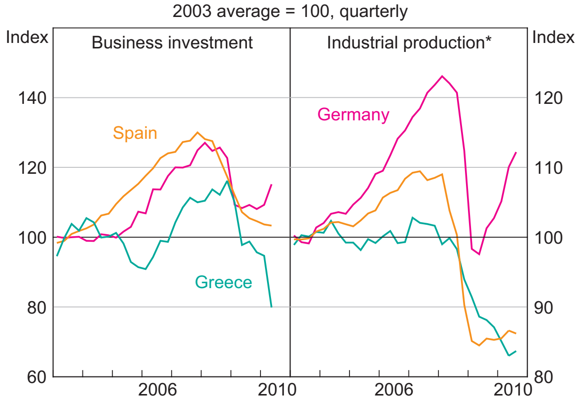
Source: Thomson Reuters

Graph 10
United States – Business Investment and Deposits
Per cent of nominal GDP



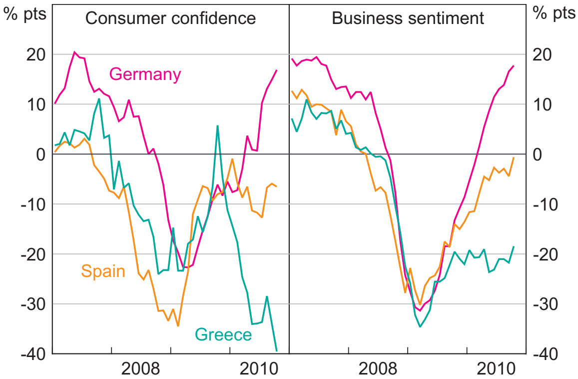
Sources: RBA; Thomson Reuters

Graph 11
Euro Area – Investment and Production
2003 average = 100, quarterly



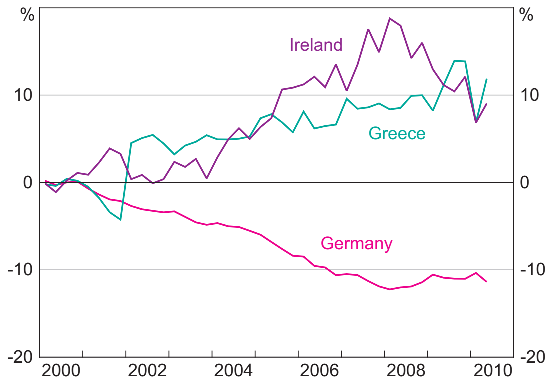
* RBA estimates for September quarter 2010 based on July and August data
Sources: Eurostat; RBA; Thomson Reuters

Graph 12
Euro Area – Sentiment Measures
Deviation from average since January 1990



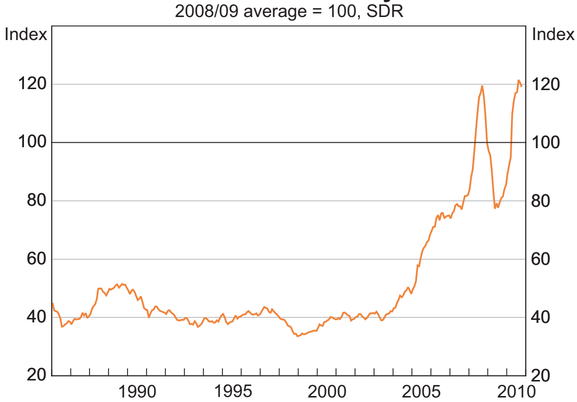
Source: Thomson Reuters

Graph 13
Euro Area – Nominal Unit Labour Costs*



* Percentage change in individual country index relative to euro area average index since 2000
Source: Eurostat

Graph 14
RBA Index of Commodity Prices
2008/09 average = 100, SDR



Source: RBA

In Greece, GDP has fallen by about 6 per cent since September 2008 and private demand has contracted by 9 per cent. Concerns over fiscal and banking problems persist in these and some other euro area countries, and governments are now undertaking significant fiscal consolidation. While fiscal measures will weigh on growth across Europe, the sovereign debt and banking issues in some countries have forced reforms that are likely to improve competitiveness in the long term, following a significant deterioration in relative competitiveness over the past decade (Graph 13).

Commodity Prices

Commodity prices have risen sharply over the past year, supported by strong demand from Asia. The RBA's Index of Commodity Prices has increased a little since the August *Statement*, and is now around 55 per cent above its trough in mid 2009 and around its previous peak in September 2008 (Graph 14). The increases in commodity prices have boosted Australia's terms of trade to a historically high level, which in turn is supporting nominal incomes, as discussed further in the 'Economic Outlook' chapter.

The increase in commodity prices over the past year has been broad based, with the prices of all commodities included in the RBA's Index of Commodity Prices having increased (Table 1). There has been a particularly large increase in the price of iron ore – the main raw material in steel-making – with export prices for iron ore rising by 110 per cent (in US dollar terms) since mid 2009. These price rises have been associated with the increase in global steel production since early 2009 – which is back to around the level prior to the financial crisis, underpinned by production in China – as well as the reasonably positive outlook for demand for steel. Strong Asian demand for steel has seen markets for iron ore and coking coal tighten over the past year, with production in Australia and other major exporters running at near full capacity.

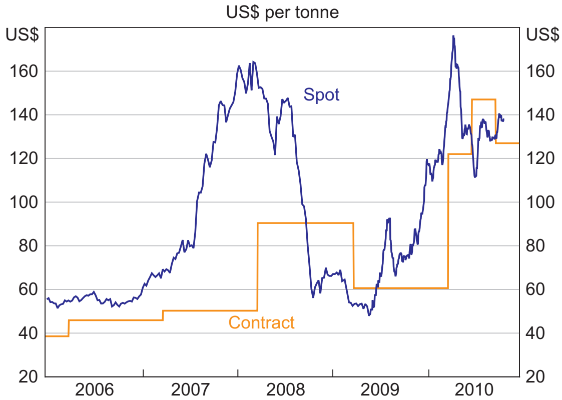
Table 1: Commodity Price Growth
Per cent, SDR terms

	Since end July 2010	Since end October 2009
RBA index	1	45
– Excluding bulk commodities	7	26
Bulk commodities	–4	68
– Coking coal[(a)]	–3	53
– Iron ore[(a)]	–6	97
– Thermal coal[(a)]	1	31
Rural	18	36
– Sugar	40	63
– Wheat	15	42
– Other	15	29
Base metals	10	25
Gold	10	30
Oil[(b)]	6	12

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

Spot prices for bulk commodities, which have typically affected the contract prices that producers receive with a lag, have increased by around 5–10 per cent in recent months, reflecting improved market sentiment about steel production and restocking of inventories, and are significantly higher than the trough in mid 2009. The increases in coal prices have also been associated with the impact of poor weather on production in Australia, Indonesia and Columbia as well as infrastructure constraints in China. Prices of iron ore and coal appear to have been little affected by policies in China aimed at curbing the activities of high polluting and energy intensive steel producers.

Graph 15
Iron Ore Prices*
US$ per tonne

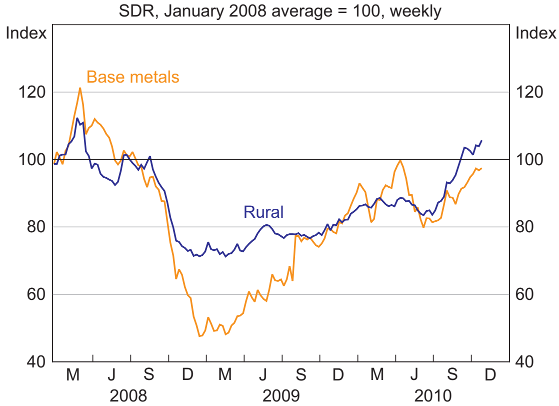


* Free on board price to China; RBA estimates for spot price used prior to December 2008 based on weekly data on China landed import price
Sources: ABARE; Bloomberg; RBA

Spot prices for iron ore in early November were around 10 per cent above the estimated December quarter contract price level, while spot prices for thermal and hard coking coal were around their respective contract prices (Graph 15). The December quarter contract prices appear to be lower than those for the September quarter, with Australian producers reportedly having settled on a price decrease of around 15 per cent for iron ore fines in the December quarter, and between 5 per cent and 20 per cent for various grades of coking coal (relative to the previous quarterly contracts).

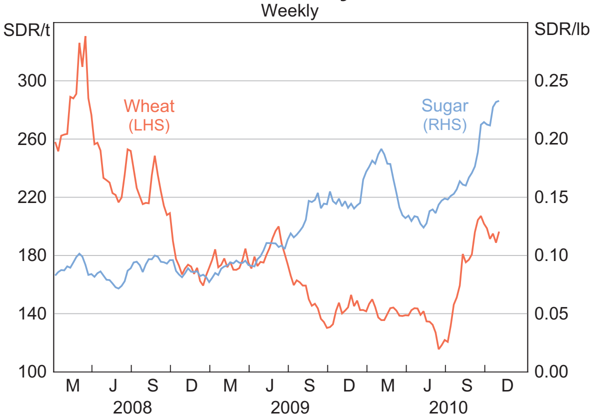
The prices of exchange-traded commodities have also risen strongly over the past year (Graph 16). The RBA index of base metals prices has risen by around 25 per cent over this period, and is up 10 per cent since the August *Statement*, reflecting the steady increase in demand for base metals as global industrial production has recovered. Crude oil prices have also risen over the quarter and are 6 per cent higher in SDR terms since the August *Statement*. Oil prices have been supported by limited increases in production and strong demand from Asia – with the volume of China's crude oil imports having increased by around 35 per cent over the year to September – though subdued demand from advanced economies has offset this to some extent, with oil stocks in the US remaining high. The price of gold has risen by around 30 per cent over the past year, partly reflecting investor unease with other assets.

Graph 16
Commodity Prices
SDR, January 2008 average = 100, weekly



Sources: Bloomberg; RBA

Graph 17
Rural Commodity Prices
Weekly



Sources: ABARE; Bloomberg

Rural commodity prices have also risen strongly over the past year, particularly in recent months, with large increases in the prices of sugar, wheat, barley and cotton (Graph 17). Strength in these prices has been largely driven by supply disruptions in key exporting countries, with concerns that supply may not keep pace with the recovery in demand. The price of cotton has increased by around 75 per cent since the August *Statement,* reflecting flooding in Pakistan, as well as increasing demand. Sugar prices have risen by around 40 per cent in recent months, reflecting weather-related effects on production in Australia and Brazil.

More generally, global food prices have been increasing over the past year; the IMF Commodity Food Price Index has increased by over 20 per cent over this period, with the increase being relatively broad based. As well as supply disruptions, there are signs that demand, particularly from Asia, has supported this rise. In China, grain import volumes increased by over 50 per cent over the year to September and sugar imports have also risen. Food and live animal imports to other east Asian economies have been growing at an annual pace of around 20 per cent. Increasing development and rising living standards in Asia, particularly in China and India, are also leading to a rise in the demand for higher-quality food and the consumption of protein.

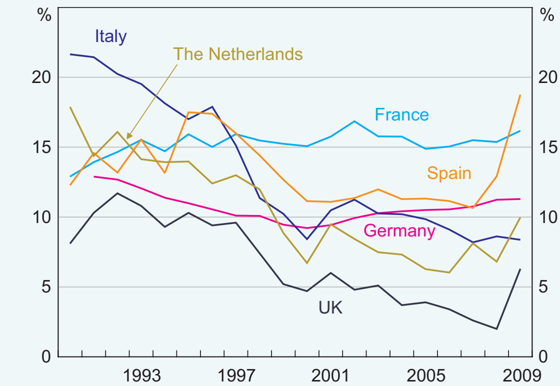
Box A

Household Saving Rates in Advanced Economies

A notable feature of the recent global downturn has been the sharp increase in household saving rates in many advanced economies. In Europe, household saving rates have generally picked up over the past few years, after having declined over recent decades in most countries (with France and Germany notable exceptions; Graph A1). In the United States, following a decline in household saving from around 10 per cent of disposable income in 1980 to around 2 per cent in 2007, the household saving rate has since risen by around 3½ percentage points. This increase in saving by US households stands in contrast to their behaviour through previous recessions over the past 30 years, where household saving typically changed little during and in the aftermath of downturns (Graph A2).

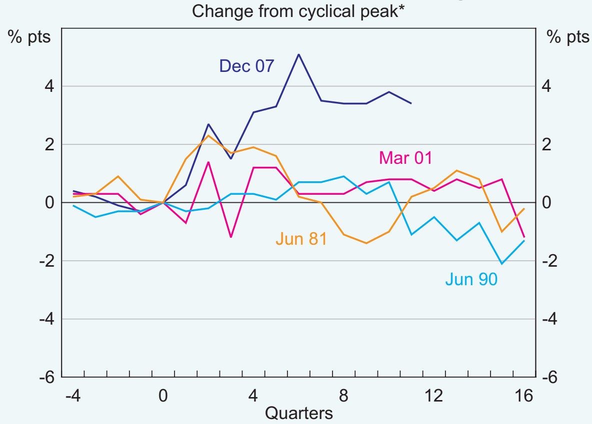
Understanding the factors driving the recent increases in household saving, and how persistent these are likely to be, is important for assessing the likely strength of domestic final demand growth in the various advanced economies over the next few years. Two factors often cited as influencing households' decisions about how much of their disposable income to save are a desire to smooth consumption (including over the lifecycle) and a desire to insure against negative shocks to income.[1] Both of these factors played a part in the long-run decline in household saving rates seen across most advanced economies prior to the recent global recession. For example, the marked decline in output volatility in almost all developed

Graph A1
Europe – Household Saving Rates*
Annual



* Net saving rates except for France, Spain and the UK, where data are gross saving rates
Source: Thomson Reuters

Graph A2
United States – Household Saving Rate
Change from cyclical peak*

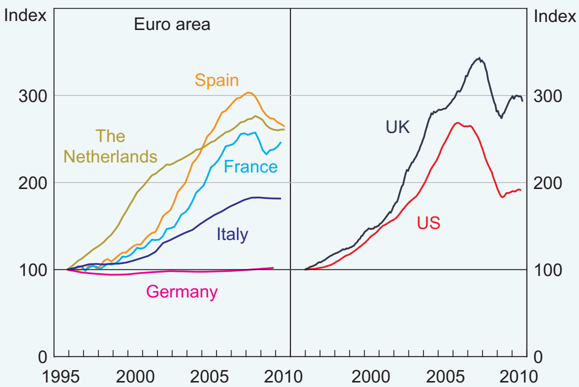


* Quarter containing month prior to NBER recession date
Source: Thomson Reuters

1 With households tending to save during their working lives and dissave during retirement, one important way in which lifecycle saving behaviour affects aggregate saving rates is through changes in demography. These tend to have fairly gradual effects at the aggregate level.

countries over the decades prior to the recent global downturn probably led to a reduction in perceived risk, and hence precautionary saving, on the part of households. The generally positive macroeconomic outcomes may also have reduced saving by boosting expectations about future income growth. The decline in saving was also the result of financial liberalisation that made it easier for households to access credit.

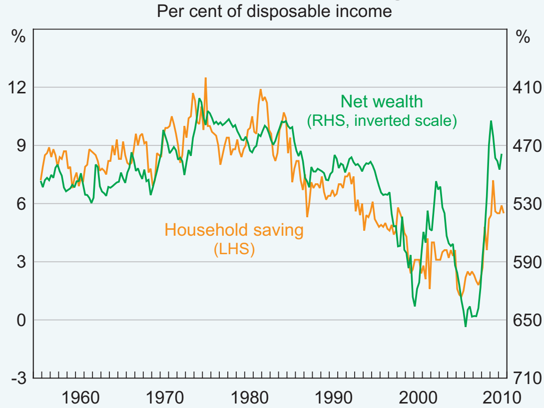
Graph A3
Nominal House Prices*
December 1995 = 100



* Euro area series are a combination of BIS and national sources; UK series is an average of the Halifax and Nationwide measures; US series is S&P/Case-Shiller 10 cities prior to 2000 and 20 cities thereafter

Sources: BIS; Standard & Poor's; Thomson Reuters

Graph A4
United States – Household Saving and Wealth
Per cent of disposable income



Source: Thomson Reuters

Developments in the financial sector are also likely to have contributed to the trend declines in household saving through their effect on asset prices. The house price booms that occurred in many developed economies over the past decade, combined with significant gains in the prices of other assets (notably shares), significantly boosted household wealth (Graph A3). In the United States, the ratio of net wealth to disposable income has been strongly correlated with the saving decisions of households for the past half century, presumably reflecting that individuals whose assets appear to have risen strongly in value feel less need to save out of current income to provide for their future retirement needs (Graph A4). Such a relationship has also been evident in some other developed economies.[2]

The severe economic turmoil of the past few years and substantial rises in unemployment rates are likely to have resulted in a substantial re-rating of perceived risk, and hence a desire to save more on insurance grounds. The recent increase in saving is also likely to reflect a reassessment of future income growth and, in some countries, the sharp decline in net wealth. This may have been amplified by uncertainty around the sustainability of government fiscal positions and a tightening of credit conditions. These explanations are consistent with the fact that the increases in household saving rates have been particularly large in those economies, such as the United States, the United Kingdom and Spain, where unemployment remains very high, consumer confidence is weak and government deficits are large. These countries also experienced some of the largest falls in asset prices, particularly house prices.

2 In theory, increases in housing wealth may be better viewed as a transfer of wealth from future to current homeowners. However, in some countries, households in aggregate appear to have treated house price gains as a substitute for saving from current income.

It is noteworthy, however, that previous recessions in these countries have not typically been associated with sustained increases in household saving rates. An additional factor in the current instance appears to be the degree to which households had previously increased their borrowing and run down their savings, so that they entered this recession with much higher debt levels. Households in these countries appear to have concluded that, in the face of weak economic conditions and elevated risk, a sustained increase in saving is required so as to achieve significant balance sheet repair. By contrast, the household saving rate has risen less in some other countries – for example France – where, although the recent economic downturn has been severe, household balance sheets were in a stronger position entering the recession.

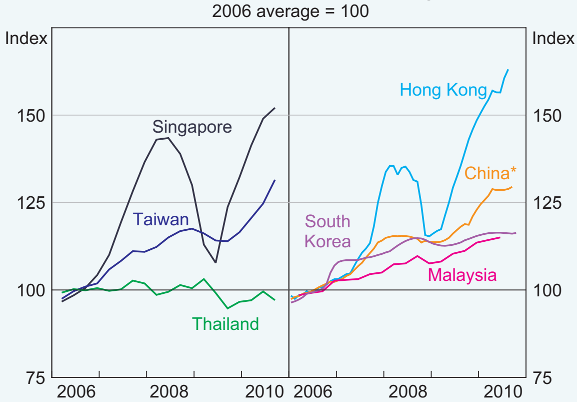
As households repair their balance sheets and maintain a higher degree of risk aversion than a few years ago, it seems plausible that saving rates in many advanced economies will remain at elevated levels relative to recent history. Combined with fiscal consolidation, this is likely to see demand growth in these economies remain subdued for some time.

Box B

East Asian Property Markets

After increasing significantly through 2007 and early 2008, residential property prices in east Asia softened in late 2008 as global credit conditions deteriorated (Graph B1). More recently, as economic activity in the region has recovered strongly and financial conditions have been generally accommodative, residential property prices have risen quickly, particularly in China, Hong Kong, Singapore, and Taiwan. This box discusses the recent pick-up in property prices in some east Asian economies and the associated policy responses.

Graph B1
East Asia – Residential Property Prices
2006 average = 100



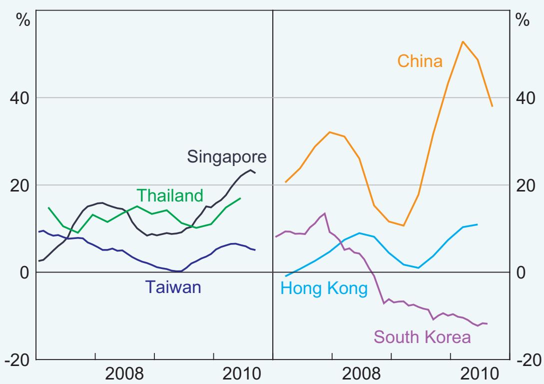
* RBA estimates
Sources: CEIC; RBA

Leading up to the global financial crisis, central banks in the region were tightening monetary conditions in response to a general pick-up in inflationary pressures. The onset of the global financial crisis saw credit become increasingly difficult to access, residential property prices slow in some economies and fall in others, and residential construction contract. Throughout the region, governments responded by significantly easing fiscal and monetary policy, with interest rates being lowered and quantitative controls relaxed, as authorities sought to stabilise residential property markets and support household balance sheets. During the global downturn, many east Asian governments also used taxation and administrative measures to support property prices and reduce risks to their financial systems. The Chinese authorities, for example, introduced policies to encourage more turnover, and in Singapore the government introduced a property tax rebate for owner-occupied properties and scaled back its land sales programs to support property prices. In Korea, the government introduced a scheme to buy land and unsold homes to support activity in the construction sector.

This policy stimulus contributed to a robust recovery in economic activity and an improvement in conditions in residential property markets. By mid 2009, residential construction had rebounded in a number of economies. In China the volume of residential floor space commenced nearly doubled between the end of 2008 and September 2010. The recovery in residential property markets was also reflected in significant increases in residential property prices, especially in China, Hong Kong, Singapore, and Taiwan. In many of these economies, real returns on deposits were close to zero or negative, while real lending rates were also low, which when combined with some of the stimulus measures, provided a strong incentive to borrow for housing. Consequently, the strengthening in housing markets has been accompanied by a rapid expansion in housing credit (Graph B2). In China, the value of housing loans outstanding has increased by around 40 per cent over the past year, while year-ended growth in the value of housing loans in Singapore is now around 25 per cent. Credit growth in Thailand is also increasing, while housing credit growth in Taiwan has moderated in recent months.

Korea has been an exception to these general trends. Residential property prices have been broadly flat, partly due to the increase in the supply of housing, and housing credit has contracted significantly, reflecting an earlier tightening of mortgage lending standards. To stimulate activity in the property market, the government has recently announced an easing of mortgage restrictions, giving banks greater flexibility on maximum loan sizes for home purchases. The government has also expanded loan guarantee programs for low-income earners and extended the temporary suspension of property sales tax for investors. In addition to these measures, the government plans to issue bonds to fund a program designed to help small builders finance new projects.

Graph B2
East Asia – Housing Credit Growth
Year-ended



Source: CEIC

In those economies experiencing strong increases in property prices, a series of measures have been implemented to cool property markets. These measures include tightening financial conditions through increasing interest rates (although they remain low) and imposing stricter prudential controls on lending by reducing maximum loan-to-valuation ratios, lowering debt servicing requirements, and tightening lending standards for investors (see Table B1). In addition, land has been released by governments for housing construction, such as in Taiwan, Hong Kong and China, and there have been changes to the taxation of property to reduce turnover in property markets.

It is difficult to tell how the combination of low interest rates and tighter prudential standards will affect property markets. In China, earlier measures to cool the property market had some effect, although property prices and turnover have strengthened recently and the authorities have since announced further measures to cool the property market. In Singapore, Hong Kong and Taiwan, property prices have continued to rise, although property sales have begun to slow in Taiwan.

Table B1: East Asia – Summary of Recent Property Market Policies

Economy	Policy Measures
China	Investors to pay a minimum 50 per cent deposit on property purchases (previously 40 per cent) Owner occupiers to pay a minimum 30 per cent deposit (previously 20 per cent on purchases of apartments less than 90 square metres) Minimum interest rate on investor loans increased to 1.1 times the benchmark lending rate Reduction in mortgage rate discounts for first home buyers Loans for the purchase of third (or more) properties prohibited Limits on property purchases in areas where housing supply is particularly tight
Hong Kong	Maximum loan-to-valuation ratio of 60 per cent on properties valued above HK$12 million For properties valued below HK$12 million, loans are capped at the lower of HK$7.2 million or 70 per cent of the valuation of the property Debt servicing ratios capped at 50 per cent (previously 60 per cent)
Singapore	Expiry of stimulus-related property tax rebate Sellers to pay stamp duty on the sale of any property sold within three years of purchase (was one year when the stamp duty was initially introduced in April 2010) Cash deposit requirements for the purchase of second properties increased
Taiwan	Loans not to exceed 70 per cent of the collateral used to purchase second properties in certain areas Banks cannot grant additional loans on same collateral Mandated that all mortgages should require some repayment of principal

Sources: central banks; government authorities

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Sources: central banks; government authorities

International and Foreign Exchange Markets

Central Bank Policy

With policy interest rates at their effective lower bounds in the United States and Japan, the US Federal Reserve and Bank of Japan recently announced further asset purchases. However, the European Central Bank's balance sheet has contracted in recent months. Financial markets continue to expect policy rates to remain unchanged in these economies and in the United Kingdom for the foreseeable future. In contrast, the People's Bank of China increased its lending and deposit policy rates after being unchanged since December 2008 and policy rates increased further in Canada, India, Sweden and Taiwan (Table 2).

Table 2: Policy Rates

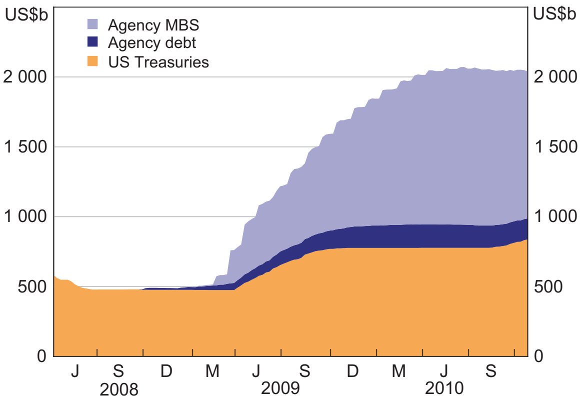
	Current level Per cent		Most recent change	Cumulative increase Basis points
Euro area	1.00	↓	May 09	–
Japan	0.05	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Brazil	10.75	↑	Jul 10	200
Canada	1.00	↑	Sep 10	75
China	5.56	↑	Oct 10	25
India	6.25	↑	Nov 10	150
Indonesia	6.50	↓	Aug 09	–
Israel	2.00	↑	Sep 10	150
Malaysia	2.75	↑	Jul 10	75
Mexico	4.50	↓	Jul 09	–
New Zealand	3.00	↑	Jul 10	50
Norway	2.00	↑	May 10	75
Russia	7.75	↓	Jun 10	–
South Africa	6.00	↓	Sep 10	–
South Korea	2.25	↑	Jul 10	25
Sweden	1.00	↑	Oct 10	75
Switzerland	0.25	↓	Mar 09	–
Taiwan	1.50	↑	Oct 10	25
Thailand	1.75	↑	Aug 10	50
Turkey	7.00	↓	Nov 09	–
United Kingdom	0.50	↓	Mar 09	–

Source: central banks

Graph 18

Federal Reserve Holdings of Securities

Weekly

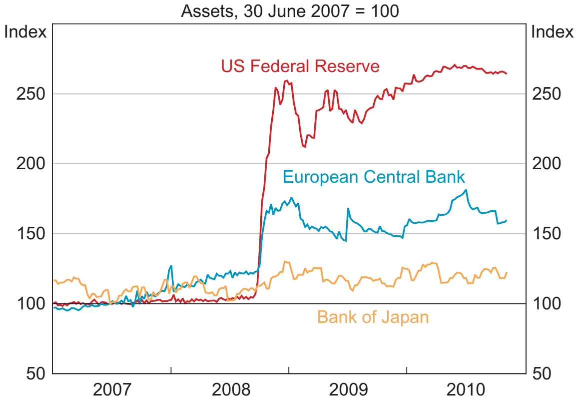


Source: Board of Governors of the Federal Reserve System

Graph 19

Central Bank Balance Sheets

Assets, 30 June 2007 = 100

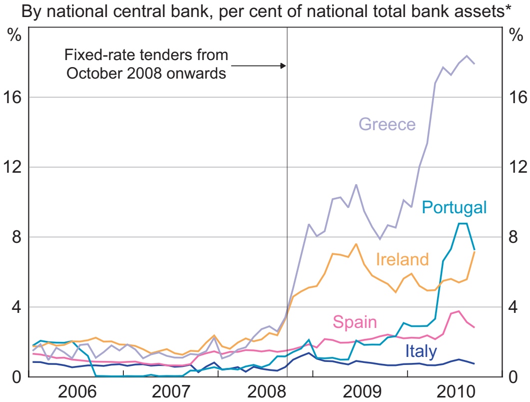


Source: Thomson Reuters

Graph 20

ECB Lending

By national central bank, per cent of national total bank assets*



* Monetary financial institutions used as a proxy for total bank assets

Source: central banks

The US Federal Reserve announced further quantitative easing in early November. The Fed intends to purchase US$600 billion of US Treasuries by end June 2011, increasing its holdings of securities to US$2.6 trillion, but will adjust asset purchases if warranted by economic conditions. In mid August the Fed had announced that it would re-invest principal payments from its holdings of agency debt and agency mortgage-backed securities (MBS) in longer-term US Treasury securities to prevent its balance sheet from contracting (Graph 18).

The Bank of Japan (BoJ) has announced a number of additional measures aimed at supporting the Japanese economy. In late August, the BoJ announced that it would provide liquidity of ¥10 trillion (2 per cent of GDP) in fixed-rate collateralised loans for 6-month terms; this is in addition to ¥20 trillion in BoJ loans announced previously. The BoJ also intervened in currency markets in mid September for the first time since 2004 in an effort to slow the yen's appreciation (see the section on Foreign Exchange). More recently, the BoJ lowered its policy rate target to a range of 0 to 0.1 per cent (from 0.1 per cent) and committed to a near-zero policy rate target until medium- to long-term price stability is expected. In an attempt to reduce longer-term interest rates and risk premia, the BoJ also announced that it will purchase assets of around ¥5 trillion.

Liquidity provided through the European Central Bank's (ECB) monetary policy operations has declined in recent months as some of its longer-term liquidity operations matured, resulting in a contraction of the ECB's balance sheet and a rise in short-term money market interest rates (Graph 19). However, data to September show that the decline in liquidity has not been uniform across national banking systems (Graph 20). While borrowing by most peripheral European banking systems has fallen, there was a marked increase in borrowing by Irish banks following S&P's downgrade of Ireland's sovereign credit rating in August – around one-fifth of ECB liquidity outstanding in September was held by Irish banks.

Government Financial Policy

The Basel Committee on Banking Supervision (BCBS) announced further details of its new capital and liquidity standards for banks. Under the BCBS reforms, banks will be required to meet a minimum common equity ratio, after capital deductions, of 4.5 per cent, a Tier 1 capital ratio of 6 per cent and a total capital ratio of 8 per cent. Banks will also be required to hold an additional 2.5 per cent 'capital conservation buffer' of common equity or face restrictions on earnings distributions. A 'countercyclical buffer' of between 0 and 2.5 per cent may also be introduced by national authorities during periods of 'excessive' aggregate credit growth. The new standards are to be phased in over a number of years.

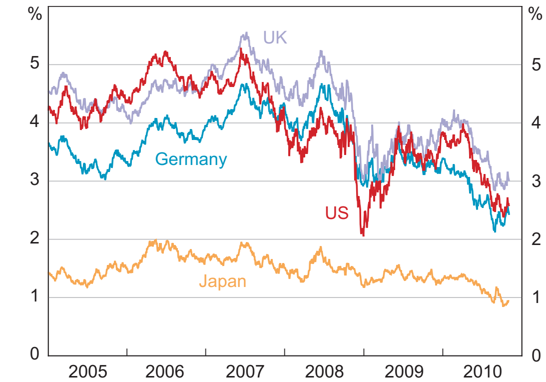
Swiss authorities proposed new capital requirements for systemically important Swiss banks. Under the proposal, banks deemed 'too big to fail' – UBS and Credit Suisse – would require minimum total capital ratios currently calculated to be 19 per cent, of which at least 10 percentage points must be in the form of common equity.

The Irish Government announced further capital injections for several lenders and a resolution plan for its most distressed bank, Anglo Irish Bank. Under the plan, Anglo Irish will be split into two separate entities: a 'funding' bank containing its deposit book and an 'asset recovery' bank containing all assets that are not transferred to the National Asset Management Agency – the Irish Government's 'bad bank'. Neither entity will be permitted to engage in any new lending and the asset-recovery bank is expected to be sold or run-off over time. The Irish Government expects total capital injections since early 2009 for all Irish banks to be around €40 billion, equivalent to 25 per cent of Ireland's annual GDP. Similarly, the German Financial Market Stabilisation Agency announced a resolution plan for the nationalised lender Hypo Real Estate, under which half of its assets will be transferred to a 'bad bank'.

During September, Greece received the €9 billion second loan tranche from its €110 billion financial assistance package, following the first quarterly review of the Greek Government's economic program by the European Commission, ECB and IMF. They noted that all quantitative performance criteria for the end of June had been met and that important reforms are ahead of schedule.

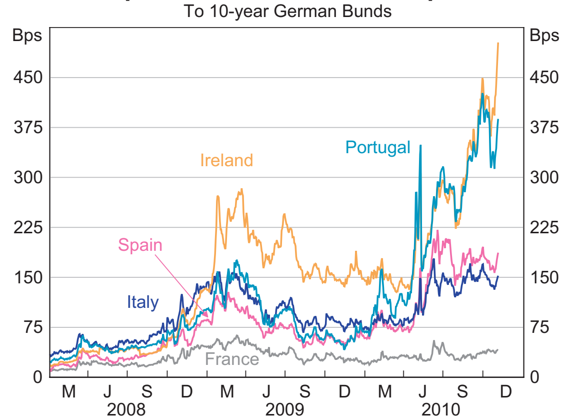
In the United States, authorities are investigating home foreclosure practices amid reports that staff at, or representing, some banks and loan servicers approved foreclosure documents without adequately meeting legal requirements. Several lenders placed a moratorium on foreclosures in order to assess foreclosure processes, although some have since been partly lifted. Of all US residential mortgages at end June, almost 5 per cent were in the process of foreclosure. Around one-fifth of all mortgages are in negative equity and the rate of negative equity is likely to be considerably higher for mortgages in foreclosure. The foreclosure issues are likely to delay any recovery in the housing market and have generated some uncertainty about banks' earnings. Separately, several US financial institutions have been required to buy back some mortgages (at principal and all interest owing) that have been securitised, in part because they have not met declared underwriting standards. Several banks have recently raised provisions related to mortgage buy-backs.

Graph 21
10-year Government Bond Yields



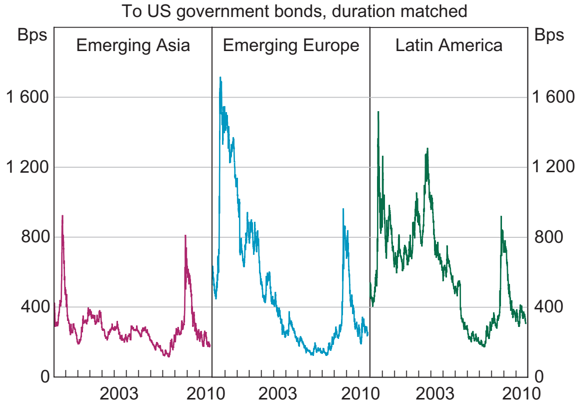
Source: Bloomberg

Graph 22
European Government Bond Spreads
To 10-year German Bunds



Source: Bloomberg

Graph 23
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched



Source: Thomson Reuters

Sovereign Debt Markets

Longer-term government bond yields in the major advanced economies have fallen further in recent months to be around historical lows (Graph 21). This reflects ongoing concerns about the global economic outlook and the expected impact of additional quantitative easing in the United States and Japan. US 10-year government bond yields fell to below 2½ per cent while 10-year bond yields in Germany and the United Kingdom fell to their lowest levels since at least the 1920s and 1950s, respectively. Short-term bond yields also declined in some countries, with the 2-year US Treasury yield reaching a new 70-year low of 0.34 per cent.

Spreads between yields on peripheral euro area sovereign bonds and German Bunds have increased over recent months (Graph 22). In the past couple of weeks, spreads on Irish government debt in particular have widened significantly to over 5 percentage points. Reflecting concerns over the fiscal cost of assistance to Irish financial institutions, S&P and Fitch have both downgraded Ireland's sovereign credit rating in recent months to AA- and A+, respectively. Moody's also downgraded Spain's credit rating to the equivalent of AA+.

Spreads of emerging market US-dollar denominated debt have been broadly stable in recent months and remain considerably lower than those prevailing mid year (Graph 23). In September, S&P raised Argentina's sovereign credit rating to B, reflecting improved government finances due to Argentina's strong economic expansion. More recently, Moody's announced a review of China's sovereign credit rating for a possible upgrade given the resilience of the Chinese economy and the stability of the government's finances.

Credit Markets

Conditions in money markets have stabilised over recent months. Spreads between both US dollar and euro LIBOR and expected policy rates (a measure of perceived bank risk) have returned to around the levels prevailing prior to the deterioration in credit market conditions in May.

Spreads on US and euro area corporate bonds have been relatively stable in recent months and remain above pre-crisis levels (Graph 24). With government yields near record lows, however, actual borrowing costs for corporates – the level of corporate bond yields – are at low levels. Partly reflecting this, corporate bond issuance has been solid in recent months, particularly for non-financial corporates in the United States (Graph 25).

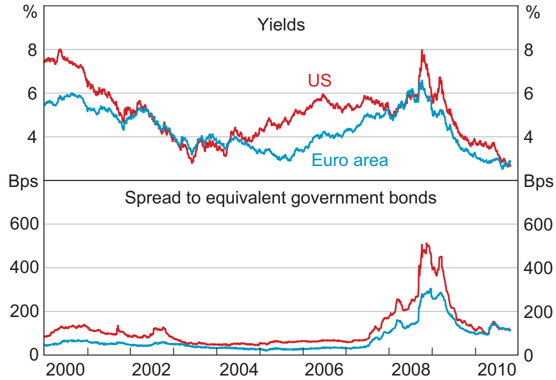
Issuance of US agency mortgage-backed securities (MBS) has trended higher this year although non-agency MBS issuance has remained negligible. Agency MBS spreads to US Treasuries have increased but both the spread and yield on these securities remain at relatively low levels. Consistent with this, interest rates on US 30-year fixed rate mortgages fell to a record low of 4.2 per cent in October. As a result, mortgage refinancing has risen sharply to reach its highest level since May 2009.

Equities

Global equity prices have recovered to be only a little below their mid-April peaks, although they are still well below the peaks in late 2007 (Graph 26, Table 3). Despite continued concerns over the global economic growth outlook, equity markets were buoyed by renewed risk appetite in part due to the anticipation of further quantitative easing by the Fed, and generally better-than-expected corporate earnings in the September quarter. A notable exception has been Japanese equity prices, which

Graph 24

US and Euro Area Corporate Bonds*



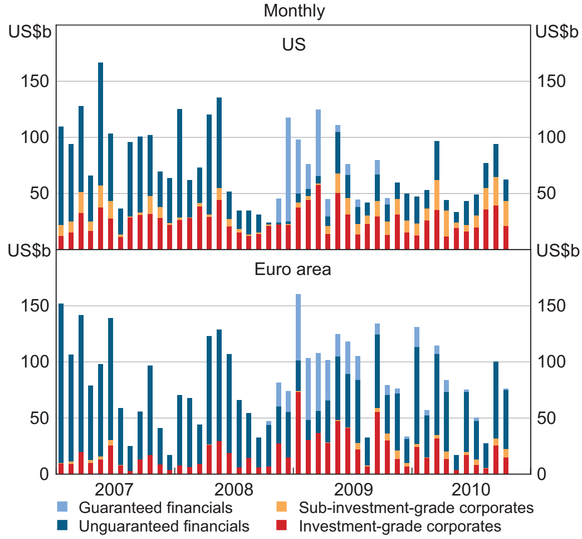
* AA-rated industrial and financial corporates; euro area comprised of European Monetary Union euro-denominated bonds

Sources: Bank of America Merrill Lynch; Bloomberg

Graph 25

Corporate Bond Issuance

Monthly

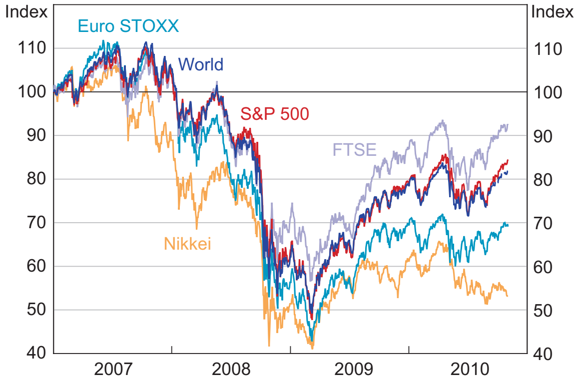


Sources: RBA; Thomson Reuters

Graph 26

Major Share Price Indices

1 January 2007 = 100



Source: Bloomberg

Table 3: Changes in International Share Prices

Per cent

	Since mid April peak	Since previous *Statement*
United States		
– Dow Jones	0	5
– S&P 500	–2	6
– NASDAQ	0	10
Euro area		
– STOXX	–4	2
United Kingdom		
– FTSE	–1	7
Japan		
– Nikkei	–19	–3
Canada		
– TSE 300	3	7
Australia		
– ASX 200	–6	4
China		
– China A	–4	15
MSCI indices		
– Emerging Asia	8	9
– Latin America	3	7
– Emerging Europe	1	7
– World	**–2**	**5**

Source: Bloomberg

have substantially underperformed other major equity markets amidst ongoing concerns about the effect of the strong yen on corporate profits. Equity market volatility has remained around its long-run average.

In the United States, banks' equity prices have underperformed the broader market (Graph 27). Contributing to the weakness have been concerns about lenders' mortgage foreclosure practices and mortgage buy-backs. US bank earnings for the September quarter were mixed. Some results beat analyst expectations as declines in loan-loss provisions were generally larger than anticipated. However, revenues generally continued to decline, typically due to lower trading revenue and income from retail operations. Technology sector equity prices, however, have risen more strongly than the broader market as reflected in the sharp increase in the NASDAQ.

In early October, the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) released their findings regarding the sharp intraday stock market decline on 6 May (the 'flash crash'). The report indicates that the fall was triggered by a severe lack of liquidity following a large order to sell S&P 500 futures contracts known as E-minis. This order was automated in such a way that the pace of sales was solely based on market trading volumes. The sell rate of the contracts automatically increased as market participants, in particular high-frequency traders, began absorbing the order and quickly re-selling the contracts. Prices of E-minis fell and triggered significant price declines in the physical equities market. The withdrawal of many market participants and the resulting lack of liquidity in both the futures and physical equities markets exacerbated the sharp price movements. The price falls stopped, and were quickly reversed, when trading in E-minis was halted on the Chicago Mercantile Exchange. Following these events, the CFTC and SEC have begun piloting circuit breaker programs.

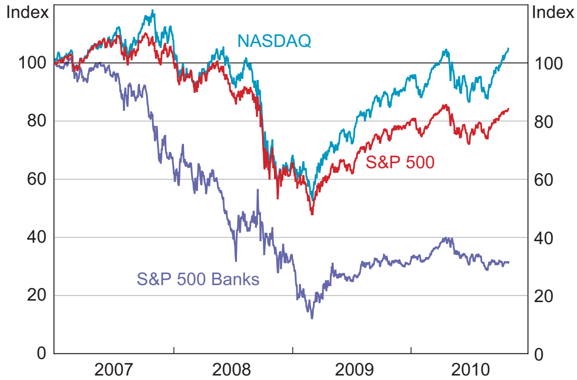
In Europe, a number of large financial institutions, including Deutsche Bank and Standard Chartered, have issued new equity partly to increase their regulatory capital ratios ahead of the expected Basel III regulatory changes. Financial institutions in Europe have so far reported mixed earnings for the September quarter. While underlying earnings were better than expected for some banks, others reported declines in revenue driven by subdued trading activity, with some also increasing their provisions for loan losses.

Emerging market equity prices have increased strongly in recent months (Graph 28). In particular, equity price indices in emerging Asia and Latin America have risen to the highest levels since mid 2008, reflecting the relatively favourable economic outlooks for these regions. While Chinese equity prices have underperformed those of other emerging economies this year, they have recently increased sharply following a number of better-than-expected economic data releases and analyst upgrades of Chinese stocks.

Hedge Funds

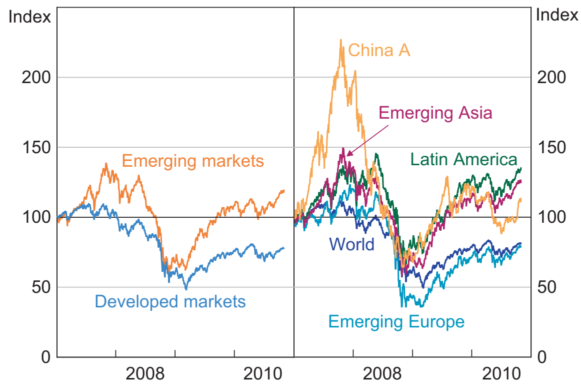
Hedge funds tended to underperform equity and bond markets in the September quarter, earning an average return of 5 per cent. Over the year, however, hedge funds have outperformed bonds and equities, returning 8 per cent. The September quarter saw the largest quarterly net inflow, of US$19 billion, into hedge funds for more than three years and funds under management are now only 8 per cent below the peak reached in mid 2008 (Graph 29).

Graph 27
US Share Price Indices
1 January 2007 = 100



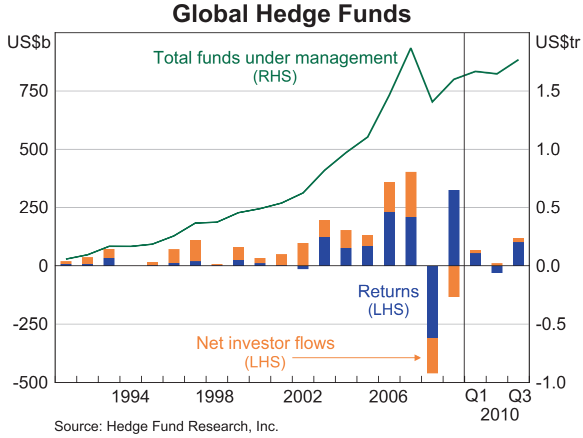
Source: Bloomberg

Graph 28
MSCI Share Price Indices
Local currencies, 1 January 2007 = 100



Source: Bloomberg

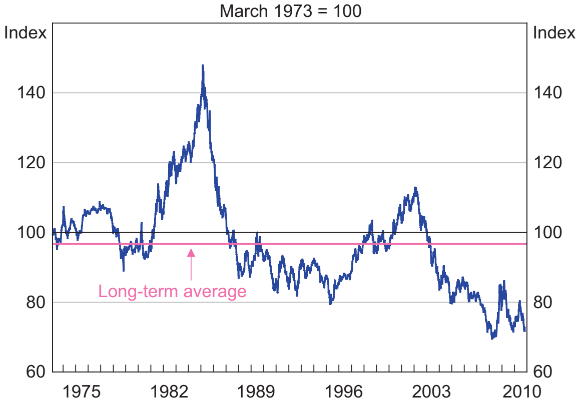
Graph 29
Global Hedge Funds



Source: Hedge Fund Research, Inc.

Graph 30

US Nominal TWI



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

Table 4: Changes in US Dollar against Selected Currencies
Per cent

	Since mid 2008 trough	Since previous *Statement*
Japanese yen	–23	–6
Thai baht	–11	–7
South African rand	–10	–6
Philippine peso	–6	–6
Singapore dollar	–5	–5
Malaysian ringgit	–4	–3
Swiss franc	–4	–8
Australian dollar	–3	–9
Indonesian rupiah	–2	0
Chinese renminbi	–2	–1
New Zealand dollar	–1	–6
New Taiwan dollar	0	–4
Canadian dollar	0	–1
Indian rupee	3	–4
Brazilian real	7	–3
South Korean won	10	–5
Swedish krona	10	–8
European euro	13	–7
Mexican peso	19	–2
UK pound sterling	25	–1
Majors TWI	**3**	**–4**
Broad TWI	**4**	**–3**

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

Foreign Exchange

Exchange rates have become a focus of international financial markets in recent months; ongoing concerns about the United States' economic recovery and growing anticipation of further quantitative easing saw the US dollar depreciate against most currencies. With some currencies close to record highs in US dollar terms, several countries have responded by increasing intervention in currency markets or strengthening capital controls. In trade-weighted terms, the US dollar is 4 per cent lower than at the time of the previous *Statement* and 11 per cent below its recent peak in June 2010 following the height of the European debt crisis. The index is now only 3 per cent above the historic lows reached in mid 2008 prior to the collapse of Lehman Brothers (Graph 30, Table 4).

Against the US dollar, a range of major currencies are currently close to or have exceeded previous highs. The Australian dollar is at a new post-float high just above US$1.00. The Swiss franc also appreciated significantly to reach a new record high in October; the Swiss authorities have not intervened in the market since April. Despite residual concerns over the fiscal position of a number of euro area countries, the euro has appreciated against the US dollar since the trough in May. However, in trade-weighted terms the euro remains 10 per cent below the high in 2008.

The Japanese yen reached a 15-year high against the US dollar during September, prompting the Bank of Japan to unilaterally sell approximately US$25 billion worth of yen, the first official intervention since 2004. Immediately following the intervention, the yen depreciated by 3 per cent against the US dollar but has since more than retraced this fall to be almost at its record high of 1995.

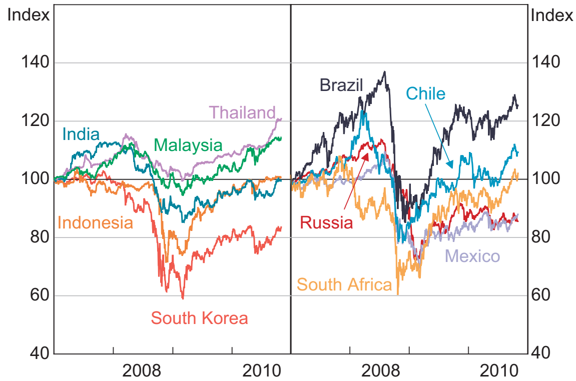
Emerging market currencies have also tended to appreciate against the US dollar as investors have sought out higher-yielding assets. In Latin America, the Brazilian real has appreciated by 11 per cent since early June to be 8 per cent below the peak in August 2008 (Graph 31). In an effort to reduce pressure on the currency, authorities in Brazil have increased the tax rate on foreign purchases of domestic bonds to 6 per cent, from 2 per cent, and have indicated that they are willing to continue accumulating US dollars to reduce pressure on the currency. Brazil has also increased the tax rate on inflows of capital required to make margin deposits on futures market trades to 6 per cent. In Asia, the Thai baht has risen by 7 per cent against the US dollar over the past few months to a post Asian crisis high. The rising baht prompted Thai authorities to remove foreigners' exemption from the 15 per cent withholding tax on income from government securities.

Several emerging market countries in Asia and Latin America have recorded large increases in the level of foreign exchange reserves. Although a portion of the change in reserves is due to valuation effects, the size of the change over the quarter suggests some countries have also been accumulating reserves at a rapid pace (Table 5). In particular, Thailand, South Korea and Brazil have been adding to reserves to alleviate the upward pressure on their exchange rates.

Graph 31

Selected Currencies against the US Dollar

1 January 2007 = 100



Source: Bloomberg

Pressure on China to accelerate the pace of the renminbi's appreciation against the US dollar has intensified. Although the renminbi has appreciated by 2 per cent against the US dollar since mid June, when the People's Bank of China announced that it would increase the flexibility of the exchange rate, in trade-weighted terms it has depreciated by around 5 per cent (Graph 32). The renminbi's appreciation against the US dollar gathered momentum in September and early October, to be around the pace seen in late 2007 and early 2008 when it was

Table 5: Selected Economies Foreign Exchange Reserves

As at end September 2010

	Three-month-ended change		Level
	US$ billion	Per cent	US$ billion
China	194	8	2 648
Japan	56	6	1 052
Russia	25	6	448
Brazil	22	9	268
Taiwan	18	5	381
Thailand	16	11	157
South Korea	15	6	285

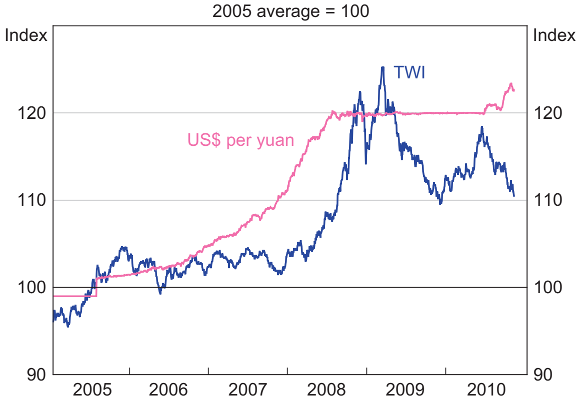
Sources: CEIC; Thomson Reuters

last on an appreciation path, but has since slowed again. Based on non-deliverable forward contracts, the market expects the renminbi to appreciate by 4 per cent over the next 12 months. Chinese reserves increased by a record US$194 billion over the September quarter, to US$2.65 trillion.

Graph 32

Chinese Renminbi

2005 average = 100



Source: Bloomberg

Australian Dollar

The Australian dollar has continued to appreciate against most currencies, as global risk appetite has rebounded and investors have sought higher-yielding assets, to reach a new post-float high in trade-weighted terms (Table 6). Increases in commodity prices over September and October have also supported the appreciation in the currency. The Australian dollar is around its post-float high against the currencies of several of its large trading partners, including the US dollar, Chinese renminbi and euro. Against the Japanese yen, however, the Australian dollar is still well below the highs recorded in 2007 (Graph 33).

After declining following the European debt crisis in May, volatility picked up in October (Graph 34). The Australian dollar moved sharply on several occasions following announcements relating to domestic and foreign monetary policy.

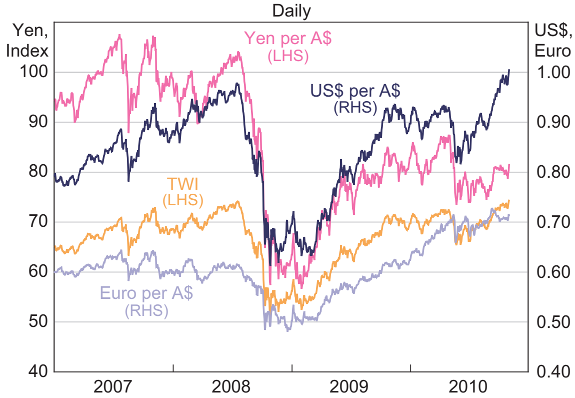
Table 6: Australian Dollar against Selected TWI Currencies

Per cent

	Change since May trough	Change since previous *Statement*	Deviation from post-float average
US dollar	23	10	38
Chinese renminbi	20	8	42
Indonesian rupiah	19	9	133
Indian rupee	17	6	65
Canadian dollar	16	8	8
Malaysian ringgit	16	7	38
Thai baht	13	1	25
South Korean won	13	4	60
Singapore dollar	12	4	4
Japanese yen	11	3	–13
UK pound sterling	10	8	39
European euro	9	2	7
South African rand	6	4	52
New Zealand dollar	5	3	5
Swiss franc	4	1	–8
TWI	**15**	**6**	**25**

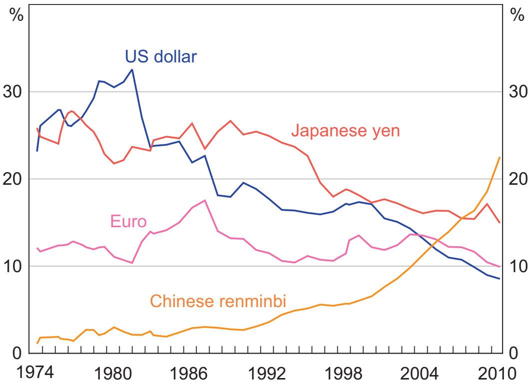
Sources: Bloomberg; Thomson Reuters; WM/Reuters

Graph 33
Australian Dollar
Daily



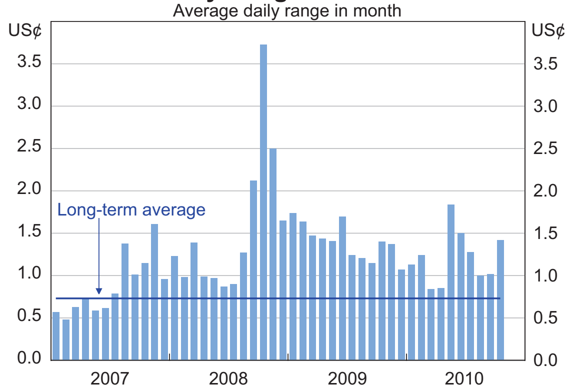
Sources: RBA; Thomson Reuters; WM/Reuters

Graph 35
Selected TWI Currency Weights



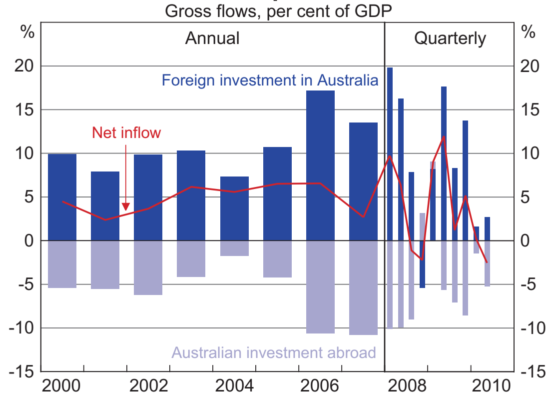
Sources: ABS; RBA

Graph 34
Intraday Range in AUD/USD
Average daily range in month



Source: Bloomberg

Graph 36
Private Capital Flows
Gross flows, per cent of GDP



Sources: ABS; RBA

New weights for the trade-weighted index (TWI) of the Australian dollar, reflecting the country composition of Australia's merchandise trade in 2009/10, were applied on 1 October 2010. The weight of Asian currencies in the TWI continues to increase, reflecting further growth of trade with the region, in particular with China, as well as a decline in the value of trade with Europe and North America. The weight of the Chinese renminbi remains the highest in the index, increasing a further 4 percentage points to 23 per cent (Graph 35). At a regional level, the combined weight of the Asia-Pacific currencies increased by 4 percentage points this year to 74 per cent, while the combined weights of the European and North American currencies fell to 15 per cent and 9 per cent respectively.

Capital Flows

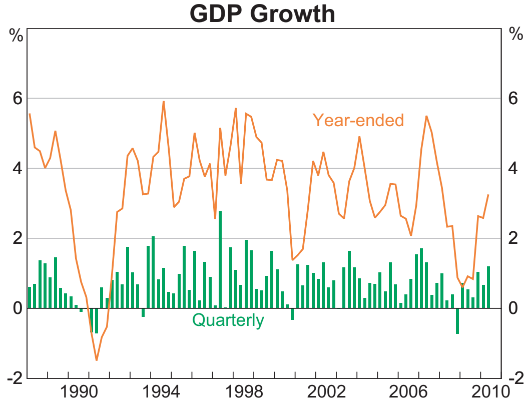
There was a net outflow of private capital in the June quarter as offshore borrowing by the domestic banking sector slowed (Graph 36). Australian banks' net short-term issuance was close to zero. Their issuance of long-term debt, which typically accounts for a large proportion of net capital inflows, was also subdued in the June quarter following several quarters of quite strong issuance. The decline in private inflows in the June quarter continued to be accommodated by stronger inflows into government debt; net foreign investment in government securities was around 6 per cent of GDP.

Domestic Economic Conditions*

The Australian economy has grown at an around trend pace over the past year, supported by the high level of commodity prices, strong public investment and ongoing solid growth in the population. Employment growth has been strong, underpinning growth in household income, and consumer confidence remains high. While public spending made a significant contribution to aggregate demand in 2009 and early 2010, this impact is now lessening, with public investment estimated to now be declining as stimulus projects are completed. The expected rebalancing of public and private demand appears to be underway, with signs that private demand is firming. Household spending has been growing at a solid pace recently, although many consumers continue to take a more cautious approach to spending and borrowing than in earlier years. The outlook for business investment remains positive, especially in the resources sector, with the large rise in Australia's terms of trade boosting national income and demand.

The latest available quarterly data for real GDP show an increase of 1.2 per cent in the June quarter and 3.3 per cent over the year, which is around the average annual growth rate for the past two decades (Graph 37, Table 7). With the terms of trade rising

Graph 37
GDP Growth



Source: ABS

Table 7: Demand and Output Growth
Per cent

	June quarter 2010	Year to June quarter 2010
Domestic final demand	1.3	5.3
– Private demand	1.4	3.0
– Public demand	1.2	13.1
Change in inventories[(a)]	–0.7	0.5
GNE	0.6	5.8
Net exports[(a)]	0.4	–2.5
GDP	1.2	3.3
Nominal GDP	3.6	10.0

(a) Contribution to GDP growth
Source: ABS

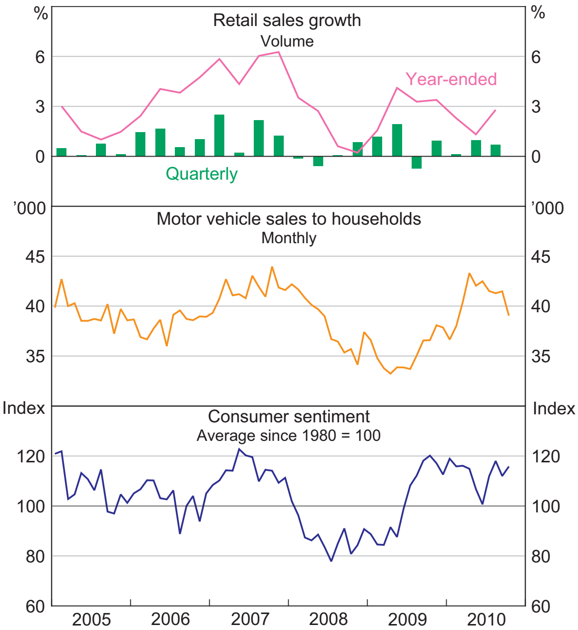
* The national accounts data used in this Chapter are from the June quarter 2010 release, rather than the 2009/10 annual national accounts.

by 25 per cent over the year to the June quarter, nominal GDP increased by 10 per cent over the year.

Household Sector

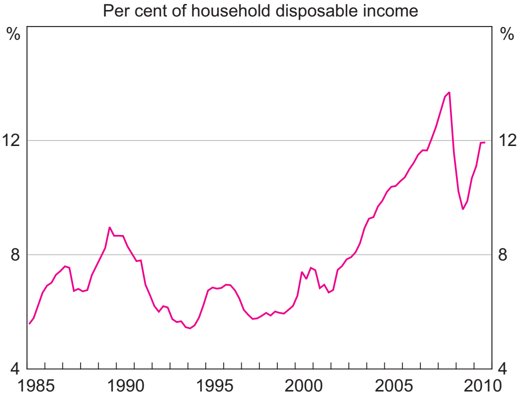
Households continue to display some caution in their behaviour, with this most evident on the financial side. Growth in mortgage debt remains well below the average for the previous decade and credit card debt has been broadly flat over 2010. In addition, the household saving rate has remained above the levels seen in the middle of the decade and there has been solid growth in the household sector's holdings of deposits. Liaison with retailers suggests that household spending has grown moderately over recent months, with sales volumes supported by ongoing discounting. Most retailers continue to report that consumers remain cautious, though the latest national accounts had suggested that overall consumer spending grew strongly in the June quarter. In the September quarter, the volume of retail sales increased at a moderate pace, rising by 0.7 per cent after increasing by 1 per cent in the June quarter (Graph 38). Motor vehicle sales have softened in recent months after having been boosted earlier this year by the replacement of hail damaged cars.

Graph 38
Consumption Indicators



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

Graph 39
Household Interest Payments*
Per cent of household disposable income



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

Household income and the high level of consumer confidence are being underpinned by strong employment growth. The recovery in household net worth is also supporting consumer sentiment; net worth is estimated to have increased by 11 per cent over the year to September to be equivalent to around six times annual disposable income and 25 per cent above its early 2009 trough. Although net worth was flat in the June quarter, it is estimated to have grown by around 2 per cent in the September quarter, reflecting an increase in equity prices.

While the pace of borrowing has moderated over recent years, the increase in mortgage rates over the past year has resulted in an increase in the ratio of household interest payments to disposable income to 12 per cent in the September quarter, although this is below the peak of 14 per cent reached in September 2008 (Graph 39). Despite the increase in debt servicing, at the aggregate level there are relatively few signs of financial stress in the household sector, with the labour market supporting households' debt-servicing capacity. Housing loans in arrears have drifted higher over the past year, but remain less than 1 per cent of the total stock of loans.

Table 8: National Housing Price Growth(a)

Per cent

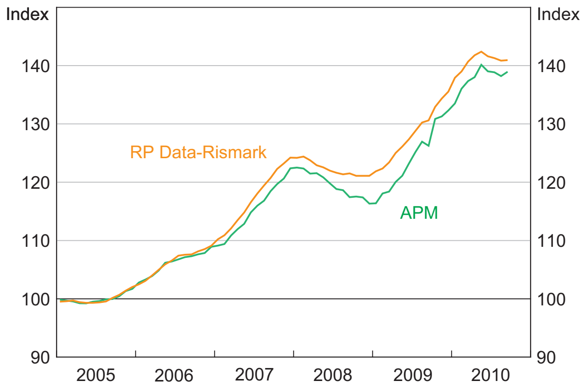
	3 months to June 2010	3 months to September 2010	Year to September 2010
Capital cities			
ABS(b)	2.0	0.1	11.5
APM	1.2	–0.1	10.1
RP Data-Rismark	0.7	–0.4	7.9
Regional areas			
APM	0.6	–0.6	5.3
RP Data-Rismark(b)	0.9	–1.9	2.7

(a) ABS and APM regional data are quarterly; all other data series are monthly
(b) Detached houses only
Sources: ABS; APM; RBA; RP Data-Rismark

The established housing market has cooled in recent months, with data from private-sector providers indicating dwelling prices in capital cities fell modestly in the September quarter (Table 8, Graph 40). After the unsustainable growth of around 1 per cent per month over 2009 and the early part of 2010, the easing in dwelling prices is a welcome development. Over the past six months, dwelling prices in lower-priced suburbs have been relatively flat, while prices have declined a little in the more expensive suburbs. By city, prices in Brisbane and Perth have declined most notably, while prices in Sydney, Melbourne and Adelaide have been relatively flat (Graph 41). Auction clearance rates, which are a timely indicator of housing market conditions, have also fallen from very high levels in the early part of the year to be around their long-run average levels.

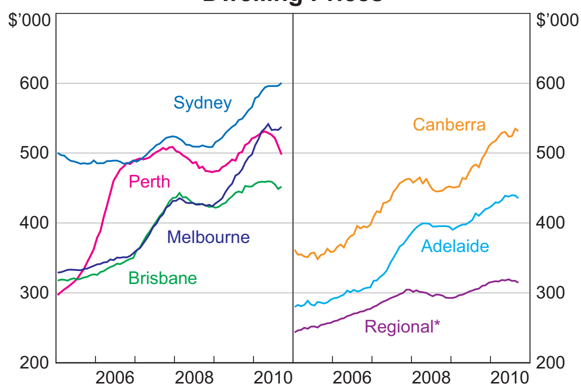
In line with developments in the housing market, housing finance activity has continued to ease from its peak in late 2009. The value of loan approvals for first-home buyers are around decade-average levels, following the expiration of the boost to federal government grants to first-home buyers. Demand for housing finance from other owner-occupiers has also slowed over the past year as mortgage rates have risen. Investor activity was broadly steady over the first half of the year, but looks to have declined in recent months.

Graph 40
Capital City Median Dwelling Prices*



* Weighted average of houses and apartments
Sources: APM; RBA; RP Data-Rismark

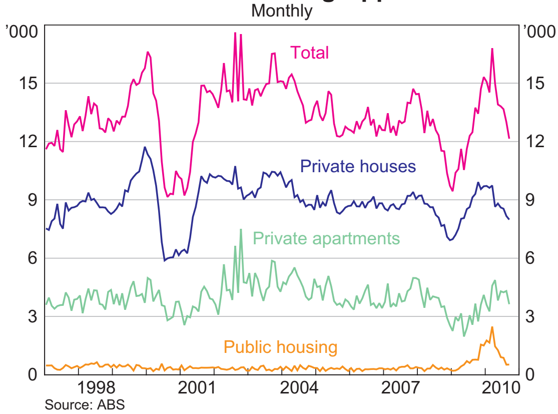
Graph 41
Dwelling Prices



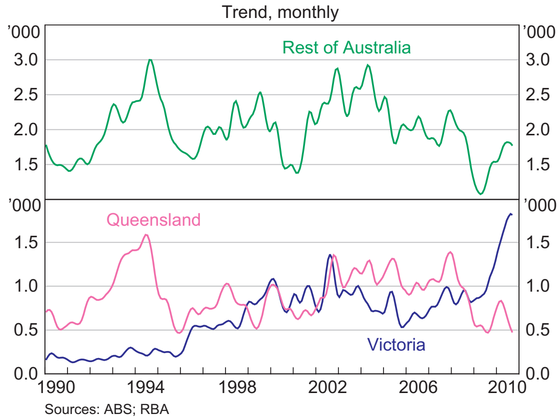
* Excluding apartments; measured as areas outside of capital cities in New South Wales, Queensland, South Australia, Victoria and Western Australia
Sources: RBA; RP Data-Rismark

After an upswing over 2009, indicators of dwelling investment have softened, reflecting a step-down in house-building activity as the boosts from higher first-home buyer grants and low interest rates have been unwound (Graph 42). Private building approvals, which rose by close to 50 per cent over 2009, have fallen by 16 per cent since late 2009, reflecting a sharp fall in building approvals for new houses. There has been a gradual recovery in apartment building, with building approvals for new apartments broadly unchanged since late 2009 and around 25 per cent higher than the average level of approvals over last year. The recovery in approvals for apartments has been particularly strong in Victoria; solid growth in demand has assisted developers to achieve the required pre-sales in order to secure finance approval and progress to construction (Graph 43). Liaison suggests that investor demand in Victoria has been underpinned by low vacancy rates, while owner-occupier demand has also gradually increased. In contrast, continuing weakness in dwelling construction is evident in Queensland.

Graph 42
Residential Building Approvals



Graph 43
Private Apartment Approvals



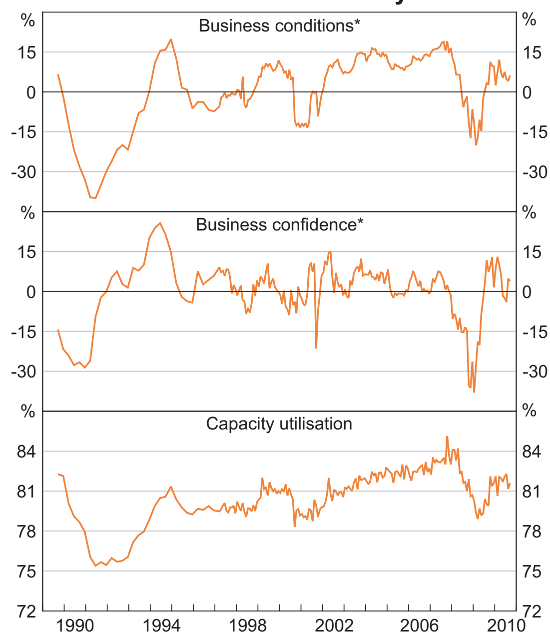
Despite the decline in total building approvals since late 2009, private dwelling investment increased by 5 per cent in the June quarter, reflecting a large amount of work done on projects that had been approved during 2009. This pipeline of work should continue to support activity over the coming quarters. Nonetheless, the pick-up in housing construction is moderate by historical standards, especially given strong demand for housing from a growing population.

Business Sector

Conditions in the business sector are broadly favourable, although there is considerable variation across industries. While measures of mining conditions are at the highest level since late 2007, with strong growth in mining employment over the past year, conditions in the construction industry have softened as the impetus from stimulus-related public building activity has faded. Conditions remain weak in the tourism industry, in part reflecting the appreciation of the Australian dollar, with overseas arrivals broadly unchanged over the past year while overseas departures have increased strongly. Overall, measures of business confidence and conditions are a little lower than earlier in the year, although they remain at or above average levels (Graph 44). Surveys also suggest that capacity utilisation is around average levels.

After being broadly unchanged over 2009/10, there are signs that private business investment is starting to pick up. The stock of engineering construction work in the pipeline is at a very high level, with the $43 billion Gorgon LNG project now under construction, and a number of other resource projects also underway (Graph 45). There are also several significant projects in the advanced stages of planning, including conventional LNG projects in Western Australia and the Northern Territory and coal-seam methane to LNG projects in Queensland.

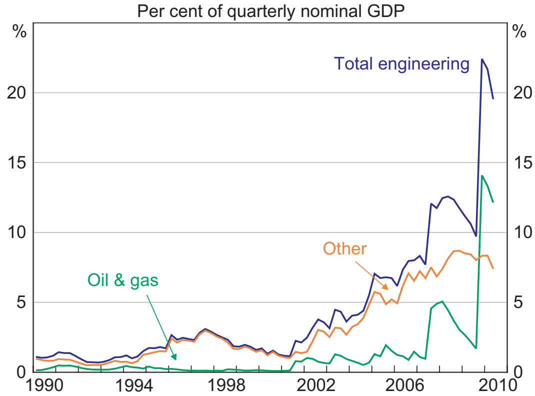
Graph 44
NAB Business Survey



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

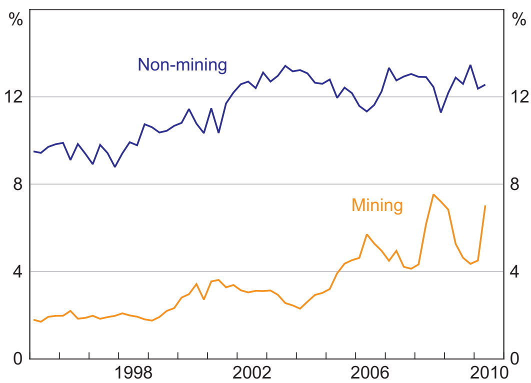
Business investment is being supported by solid internal funding, with elevated commodity prices underpinning particularly strong mining profits (Graph 46). Although the corporate sector has access to healthy levels of internal funding for capital expenditure, business credit growth remains weak, with firms continuing to repay loans and there has been little growth in commercial loan approvals. Survey measures suggest that business conditions are weaker for small businesses than large businesses, with investment intentions below average for small firms. Although liaison suggests

Graph 45
Engineering Construction Work yet to be Done
Per cent of quarterly nominal GDP



Source: ABS

Graph 46
Private Non-financial Corporation Profits*
Share of nominal GDP

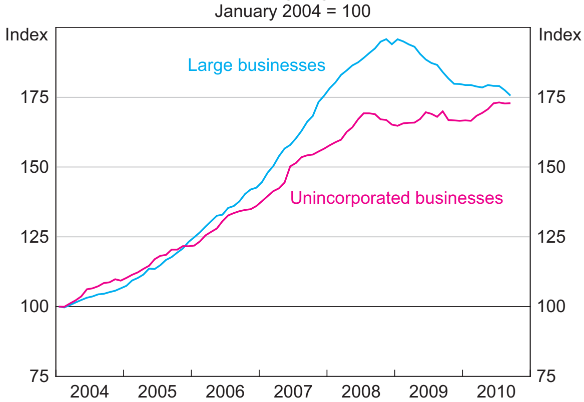


* Gross operating profits; inventory valuation adjusted
Sources: ABS; RBA

that some small businesses are encountering difficulty in accessing finance, outstanding business credit to unincorporated businesses has grown at an annualised rate of around 5 per cent over the past six months (Graph 47).

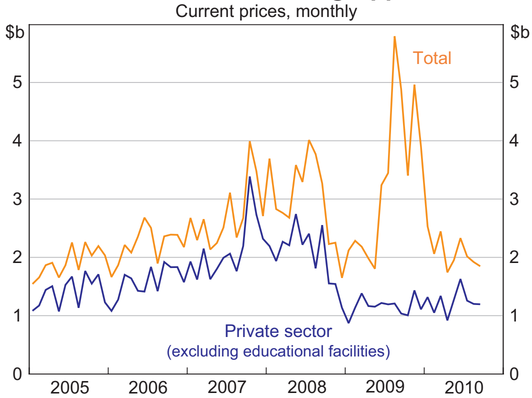
Measures of investment intentions suggest a positive outlook, particularly for the resources sector. The capital expenditure (Capex) survey's third estimate of firms' spending plans points to a large rise in mining sector investment in 2010/11, although these data may overstate the actual spending that will take place in the near-term as delays often occur given the complexity of projects. While there is uncertainty as to the timing of when some projects will ramp up, the favourable medium-term outlook for China and other trading partners in Asia suggest that strong demand for a number of Australian commodities will continue to support a high level of engineering investment activity in the period ahead.

Graph 47
Business Credit by Type of Borrower
January 2004 = 100



Sources: APRA; RBA

Graph 48
Non-residential Building Approvals
Current prices, monthly



Source: ABS

Outside of the mining sector, investment intentions are around average levels and the Bank's liaison suggests that firms remain cautious in their spending decisions. Motor vehicle sales were broadly flat in the September quarter and rose by 5 per cent in October, after declining in recent quarters. Capital imports are estimated to have fallen a little in the September quarter, though they remain at a relatively high level. While the recent pattern of machinery and equipment investment has been affected by the temporary investment tax deductions that were in place in 2009 – with investment declining over the first half of this year – the end of the tax incentives is expected to have less of an impact going forward.

Non-residential building investment remains weak, with developers' access to funding continuing to be tight and the boost to construction from the fiscal stimulus spending on school facilities starting to unwind (Graph 48). Excluding public spending on education facilities, the value of non-residential building approvals has been at a low level since early 2009. While in recent quarters there has been a tentative recovery in approvals for commercial developments, building remains subdued. Over the next few years, office markets in some capital cities are likely to tighten, due to strong tenant demand and expected modest additions to office space.

Government Spending

After making a significant contribution to GDP growth in earlier quarters, the pace of public demand growth eased in the June quarter (Graph 49). In particular, public investment was flat in the quarter following growth of around 40 per cent over the year to the March quarter 2010 due to the commencement of stimulus-related projects. Public investment is expected to fall over the period ahead as these projects are completed.

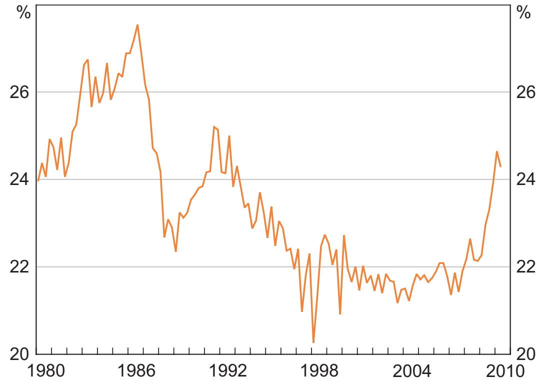
Farm Sector

The outlook for farm production in 2010/11 is positive, although there are significant divergences between the eastern and western parts of the nation. After a good start to the season, most cropping regions in the eastern states have received average or above-average rainfall in the second half of 2010 (Graph 50). A La Niña weather pattern is now well established in the Pacific Ocean, as indicated by the high level of the Southern Oscillation Index; this would typically be associated with above-average rainfall in most parts of eastern and northern Australia over the remainder of 2010. In contrast, most cropping regions in Western Australia have experienced very dry conditions and a significant fall in crop production is expected.

Overall, reflecting the higher production in the eastern states, ABARE has revised up its forecast for winter crop production to 41 million tonnes, a 16 per cent increase on 2009. However, one potential downside risk to this is damage from plague locusts. Hatchings of plague locusts have been reported in parts of New South Wales, Victoria and South Australia, and the spraying of insecticides has commenced in affected regions. In previous episodes this has been broadly effective in minimising damage to crops and pasture.

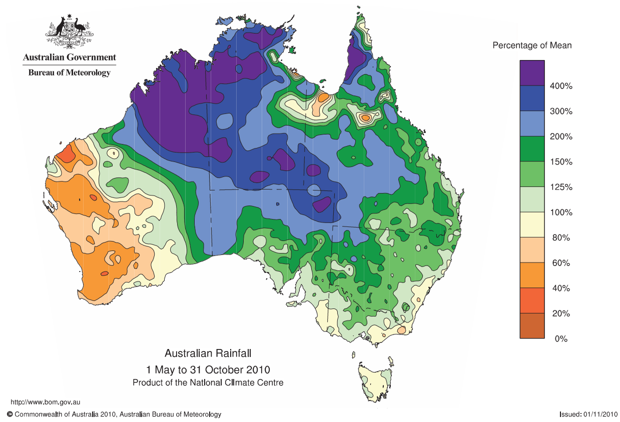
Inflows into the Murray-Darling basin surged in September, with the largest amount of water flowing into the system in any one month since 1996.

Graph 49
Public Demand
Share of nominal GDP



Source: ABS

Graph 50
Australian Rainfall
1 May to 31 October 2010



Source: Bureau of Meteorology

Non-metropolitan water storage levels in New South Wales and Victoria have increased substantially recently, and are at high levels in Queensland. The Murray-Darling Basin Authority recently released the preliminary plan for water usage in the basin. The plan recommends reduction by water users of between 3000–4000 gigalitres in order to increase the environmental allocation to the river system and boost Murray mouth outflows. The final plan is expected to be released in 2011.

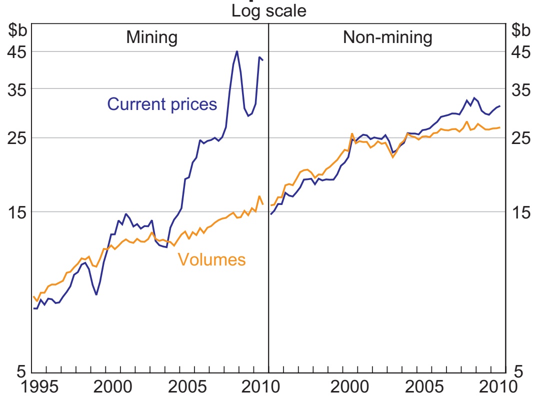
External Sector

The increase in export prices for Australia's major commodity exports has provided a significant boost to export revenue over the past year (Graph 51). As a result, in the June quarter the trade balance recorded the largest surplus since 1973 (2 per cent of GDP) and remained close to this level in the September quarter. The large increases in bulk commodity prices have also led to a sharp rise in the terms of trade over the past year to be around the highest level in 60 years (Graph 52). Although the terms of trade are expected to ease over the medium term as further supply comes online and commodity export prices decline a little, they are expected to remain at high levels.

Graph 51

Exports*

Log scale



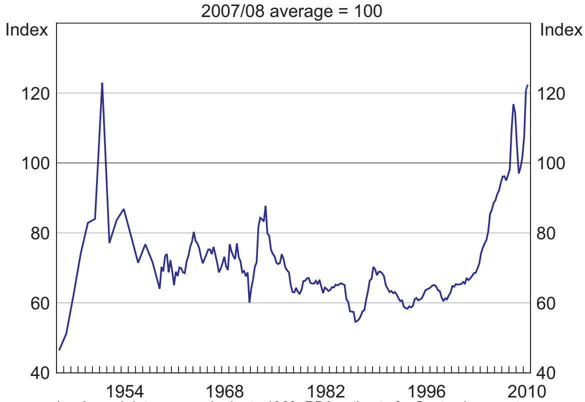
* Volumes data referenced to 2003/04 prices; RBA estimate for September quarter 2010

Sources: ABS; RBA

Graph 52

Terms of Trade*

2007/08 average = 100



* Annual data are used prior to 1960; RBA estimate for September quarter 2010

Sources: ABS; RBA

Over recent years, export volumes have increased, driven higher by resource exports. Although export volumes are estimated to have declined in the September quarter, they remain at a high level after rising sharply in the June quarter. This recent decline largely reflected lower resource exports, with iron ore exports falling in the September quarter partly due to supply issues associated with scheduled maintenance and infrastructure upgrades and a range of supply disruptions constraining coal exports. Nevertheless, the outlook remains positive, with strong demand for Australian resource commodities and high prices expected to underpin strong growth in mining investment and exports in the years ahead, particularly in iron ore, coal and LNG.

Rural exports are estimated to have increased in the September quarter, reflecting higher wheat exports. Manufactures and services exports are estimated to have declined a little in the quarter, and they remain well below their pre-crisis peaks. While trading partner growth is expected to remain solid, the high level of the Australian dollar – which, in real terms, is around 35 per cent above its post-float average – will likely weigh on manufactures and services exports going forward. Education exports have been facing a number of additional headwinds, including tighter access to student visas, and the associated decline in the number of overseas students commencing study in Australia is likely to continue into 2011.

After rebounding sharply in 2009/10, import volumes are estimated to have declined a little in the September quarter, driven by falls in capital and gold imports. Imports are expected to grow at a solid pace going forward, reflecting the high exchange rate and expected growth in domestic demand. In particular, strong growth in mining investment is expected to boost imports as this sector typically imports a significant proportion of its capital inputs.

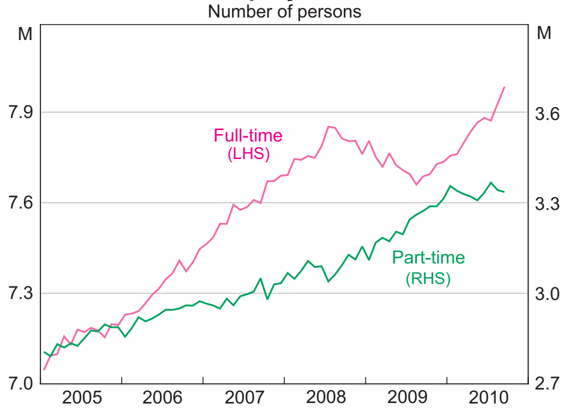
Labour Market

Employment has continued to grow strongly in recent months, and the unemployment rate has been steady at around 5.1 per cent (for further discussion, see 'Box C: Spare Capacity in the Labour Market'). Employment grew by 0.9 per cent in the September quarter, to be more than 3 per cent higher than in the corresponding quarter last year. Full-time employment has grown particularly strongly in recent months, and is now well above its earlier peak in mid 2008 (Graph 53). Average hours worked have risen by around ½ per cent in trend terms since mid 2009 – reflecting a pick-up in average hours worked by both full-time and part-time workers, as well as the strength in full-time employment – although they remain around 1¾ per cent below their recent peak in mid 2008 when the labour market was tight (Graph 54).

Employment has increased in the majority of industries over the past year or so (Graph 55). The services sector continues to record solid employment growth, particularly in professional, scientific & technical services where the level of employment has increased by around 60 000 (7 per cent) in trend terms over the past year. Mining sector employment is estimated to have grown rapidly, increasing by more than 30 000 (20 per cent) over the past year after earlier falls, while employment in manufacturing and arts & recreation services has been weak. Most states have recorded solid employment growth over the past year, with Western Australia and Victoria particularly strong. In trend terms, all mainland states have recorded declining unemployment rates over the past year; trend unemployment rates currently range between 4.4 per cent in Western Australia and 5.9 per cent in Tasmania.

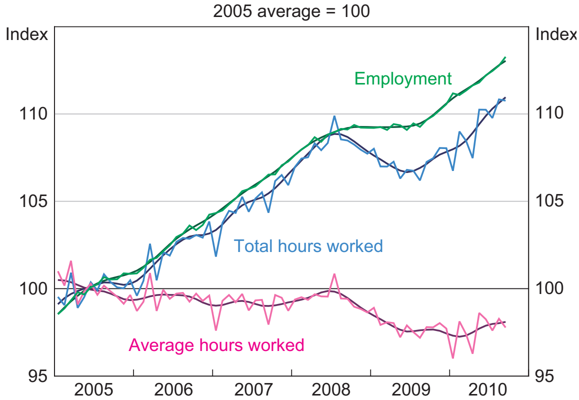
Forward-looking indicators of labour demand point to continued growth in employment in coming months, though an easing in some indicators – such as those from the business surveys – suggests that there could be some moderation from the current

Graph 53
Employment
Number of persons



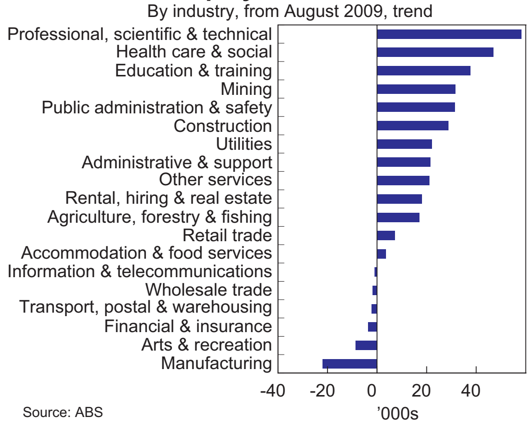
Source: ABS

Graph 54
Employment and Hours Worked*
2005 average = 100



* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

Graph 55
Employment Growth
By industry, from August 2009, trend

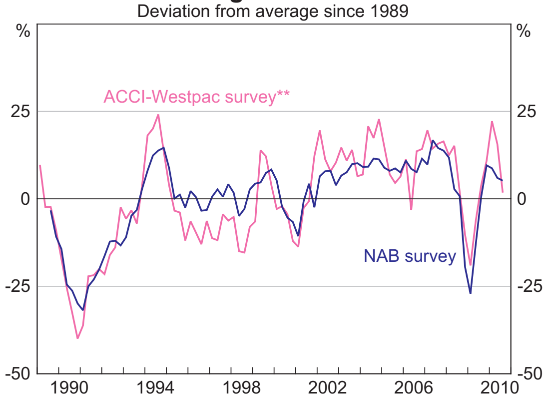


Source: ABS

Graph 56

Hiring Intentions*

Deviation from average since 1989



* Net balance of expectations for the following quarter

** Seasonally adjusted by RBA

Sources: ACCI-Westpac; NAB; RBA

strong pace of growth (Graph 56). Survey measures of hiring intentions have eased from the high levels reported earlier in the year to be closer to their average levels over the past two decades. The pace of growth in the ANZ measure of job advertisements has moderated over recent months, with the level of newspaper job advertisements broadly unchanged. In contrast, the ABS measure of job vacancies rose sharply in the three months to August, increasing by 10 per cent, following a 2½ per cent decline in the previous quarter.

Domestic Financial Markets

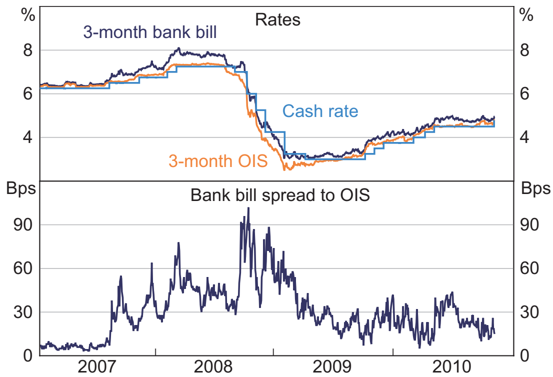
Money Markets and Bond Yields

In November, the Reserve Bank Board increased the target for the cash rate from 4.50 per cent to 4.75 per cent, the first change to the target in six months. Money market yields suggest markets currently expect a further increase in the cash rate in the first half of 2011.

Bank bill rates have largely moved in line with cash rate expectations, although spreads to overnight indexed swaps (OIS) have narrowed over recent months. Short-term bill spreads are now close to their tightest levels of the past three years and are only slightly above their pre-crisis level (Graph 57). Through its market operations, the Reserve Bank has generally maintained exchange settlement (ES) balances around $1¼ billion, and the cash rate has traded at target on all days.

In line with moves seen in global markets, long-term bond yields declined during August, with the yield on 10-year Commonwealth Government Securities (CGS) falling to around 4¾ per cent, its lowest in more than a year. The subsequent strength in economic data has seen the 10-year yield rise above 5 per cent again (Graph 58). Spreads between other highly-rated securities and CGS – including state government and supranational debt – have narrowed slightly in recent months. The stock of state government debt guaranteed by the Australian Government has continued to decline with Queensland buying back $3 billion in October against issuance of new unguaranteed lines. This follows similar actions by Queensland and NSW earlier in the year.

Graph 57
Money Market Interest Rates



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

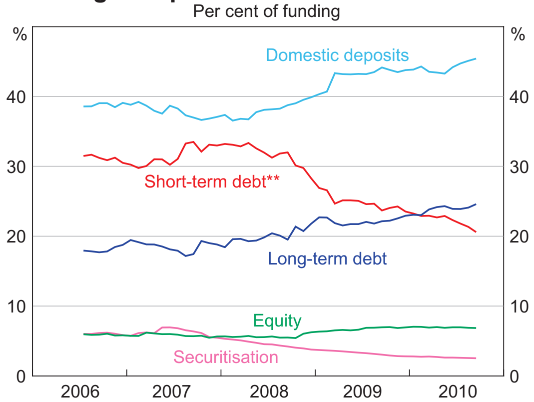
Graph 58
Australian Government Bond Yields

Source: RBA

Graph 59

Funding Composition of Banks in Australia*

Per cent of funding



* Adjusted for movements in foreign exchange rates

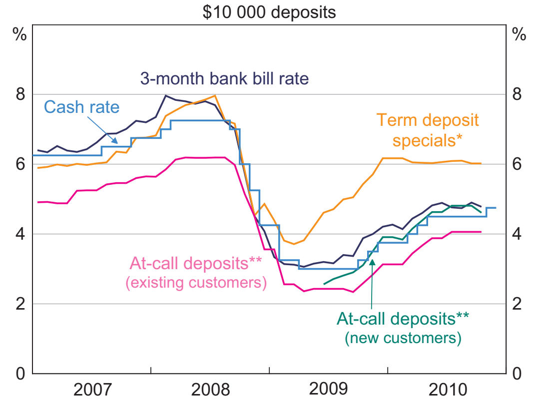
** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA

Graph 60

Deposit Rates

$10 000 deposits



* Average of 1–12, 24-, 36- and 60-month terms at the major banks

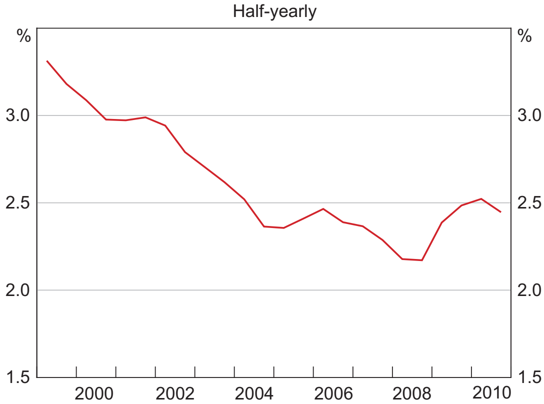
** Average of online, bonus and cash management accounts at the major banks

Source: RBA

Graph 61

Major Banks' Net Interest Margin*

Half-yearly



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis; Excludes St. George Bank and Bankwest prior to the first half of 2009

Sources: Banks' financial reports; RBA

Financial Intermediaries

The composition of banks' funding in the September quarter has continued to evolve in the same manner as it has done over the past couple of years. Notably, there was a further increase in the share of relatively high cost funds, such as deposits and long-term debt, while the share of short-term capital market liabilities continued to decline (Graph 59). These shifts reflect regulatory and market pressures.

While pressures for retaining deposit funding remain strong, in recent months there has been little movement in interest rates on new or existing at-call deposits, including online saving, bonus saver and cash management accounts (Graph 60). The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has been little changed since the previous *Statement* at just over 6 per cent. This is around 230 basis points higher than in early 2009, a considerably larger increase than that in the cash rate over the same period. The interest rate on these deposits is currently almost 100 basis points above the cost of funds of equivalent duration in the wholesale money market. On average, 'special' term deposit rates of the smaller Australian-owned banks are at similar levels to those offered by the major banks.

The average cost of the major banks' long-term funding continues to rise as maturities are rolled over at higher spreads. However, in recent months, this has been largely offset by the narrowing in the spread between bank bills and OIS rates. Overall, this suggests that, in aggregate, the major banks' funding costs are likely to have been little changed over recent months, though trends differ for individual banks depending on their mix of funding.

In terms of net interest margins, banks have recently reported mixed results; most have experienced a small decrease in margins, though some have experienced a small increase. In aggregate, the net interest margin of the major banks has fluctuated in a relatively narrow range since 2004, between 2¼ and 2½ percentage points (Graph 61).

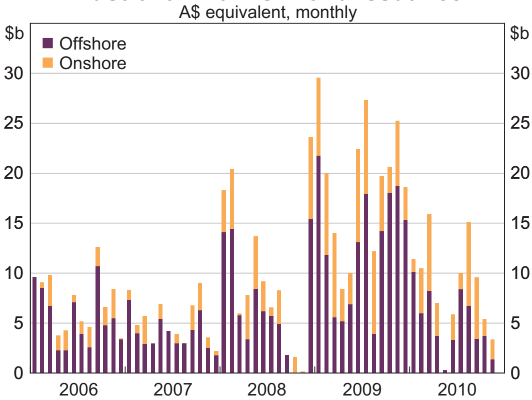
Since the previous *Statement*, Australian banks have issued a total of $33.5 billion of bonds and have continued to access a wide range of markets and currencies. Issuance was particularly strong in August following the broad improvement in global market conditions (Graph 62). Just over one-half of issuance in recent months has occurred in the domestic market, with Australian branches of overseas banks being particularly active. The cost of recent issuance has remained broadly stable since the previous *Statement*, with spreads remaining well below their peaks in late 2008 (Graph 63).

The cross-currency basis swap spread – which represents an additional funding cost for banks hedging foreign currency bond issuance into Australian dollars – has declined since the previous *Statement*, particularly for swapping euro into Australian dollars, and remains below its level early this year. This downward pressure on the basis is consistent with an increase in the volume of Kangaroo bond issuance relative to foreign currency issuance that Australian issuers hedge into Australian dollars (Graph 64). Issuance of Kangaroo bonds picked up substantially in the September quarter to total $10 billion, compared with $6 billion in the June quarter. So far this year, Kangaroo issuance has totalled $35 billion, close to the previous annual record in 2006.

Graph 62

Australian Banks' Bond Issuance

A$ equivalent, monthly



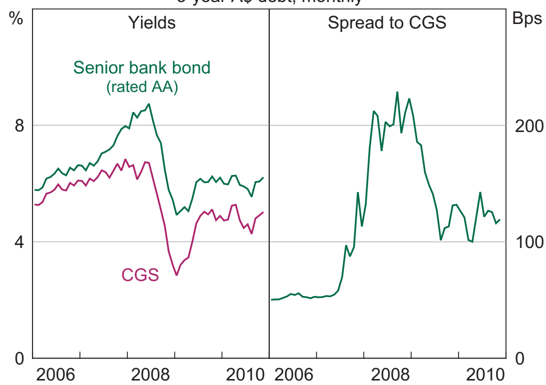
Source: RBA

Activity in the Australian securitisation market has picked up over recent months, with issuance in the September quarter totalling $8.6 billion, compared with issuance of $2.3 billion in the June quarter. The Australian Office of Financial Management (AOFM) has continued to be a key participant in

Graph 63

Major Banks' Bond Pricing

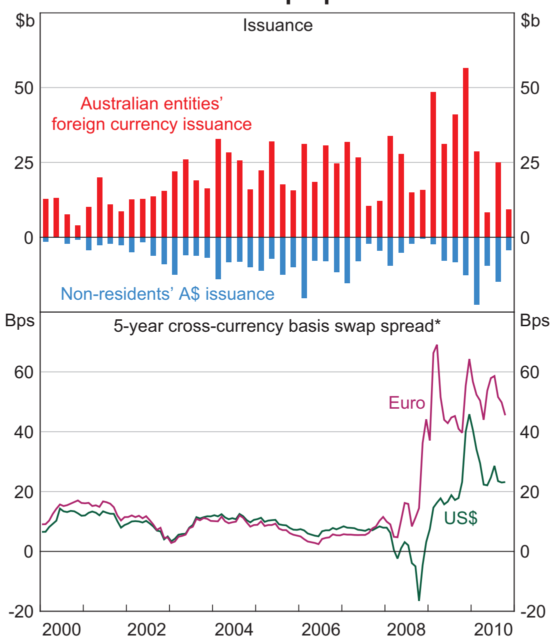
3-year A$ debt, monthly



Sources: RBA; UBS AG, Australia Branch

Graph 64

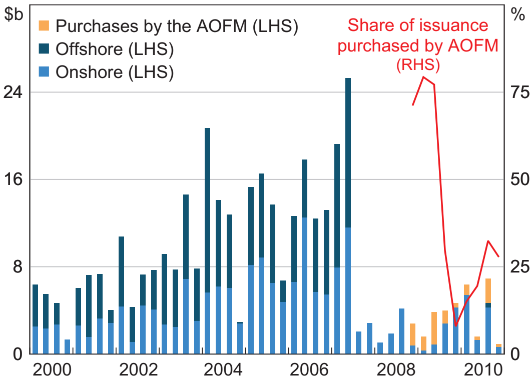
Bond Issuance and the Cross-currency Basis Swap Spread



* Monthly average

Sources: Bloomberg; RBA

Graph 65
Australian RMBS Issuance
A$ equivalent, quarterly



Source: RBA

the Australian residential mortgage-backed security (RMBS) market, purchasing up to one-third of new RMBS issuance (Graph 65). In recent months, the AOFM has purchased most of the longer-dated tranches of RMBS issues and has tended to invest at lower spreads than other participants in the market. Spreads on AAA-rated tranches trading in the secondary market have widened slightly during recent months, to around 155 basis points above the bank bill swap rate.

Credit rating agency Standard & Poor's has proposed changes to its methodology for Australian RMBS designed to reduce the dependence of the AAA-rating of Australian RMBS on lenders' mortgage insurance and to make ratings more resilient to periods of severe economic stress. Compliance with the proposed new methodology would require Australian issuers of RMBS to provide more subordination in their issues, with the headline level of subordination rising from 3.8 per cent to 5.0 per cent under the proposals. Most recent RMBS issues have been structured to include more subordination.

Household Financing

The major lenders left their variable housing interest rates unchanged over the three months to the end of October (Table 9). A couple of institutions began offering new borrowers larger discounts on housing loans, and several have raised their maximum loan-to-valuation ratios. At the time of writing, only one major lender has announced an increase in its variable housing interest rates following the increase in the cash rate in November.

Table 9: Intermediaries' Variable Lending Rates
Per cent

	Level at 31 Oct 2010	Change since: August *Statement*	Mid 2009
Housing loans			
Prime full-doc	6.82	0	1.63
Prime low-doc	7.48	0	1.68
Personal loans	12.64	0	1.70
Small business			
Term loans			
– Residentially secured	8.59	0	1.51
– Other security	9.35	0	1.45
Overdraft			
– Residentially secured	9.45	0	1.56
– Other security	10.31	0	1.50
Average actual rate	8.61	0	1.49
Large business			
Average actual rate, variable and bill funding	6.72	–0.08	1.70

Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

The major banks' interest rates on new 3-year and 5-year fixed-rate housing loans have fallen slightly in recent months. These rates have also decreased relative to their corresponding swap rates (a common pricing benchmark), although the level of these spreads is still around the average of the past couple of years. Fixed-rate lending has remained at a very low share of owner-occupier approvals, with fixed rates still above variable rates.

Overall, the average interest rate on all outstanding housing loans (fixed and variable) is likely to increase to marginally above its post-1996 average, following the increase in the cash rate in November (Graph 66).

The total value of housing loan approvals has declined in recent months, reflecting a fall in investor activity. Loan approvals to owner occupiers, including first-home buyers, have remained steady in recent months (Graph 67).

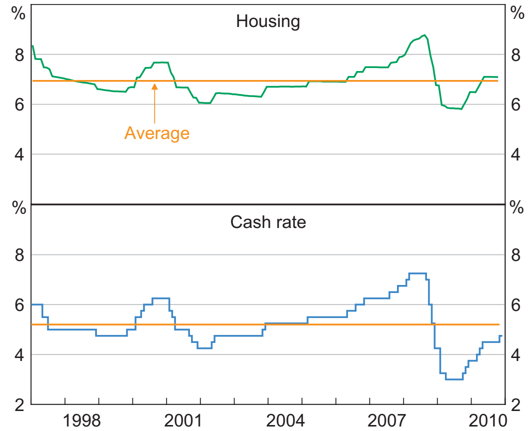
The five largest banks' share of gross owner-occupier loan approvals has declined to around 6 percentage points below its peak in early 2009 but remains well above its pre-crisis level (Graph 68). Most of this decline in market share has been picked up by other Australian-owned banks.

Housing credit growth has been steady at an annualised pace of around 7 per cent in the September quarter (Graph 69). Despite the recent decline in approvals, investor housing credit has picked up during the year, while lending to owner-occupiers has eased.

With one exception, financial institutions are yet to announce changes to variable personal loan rates following the increase to the cash rate in November. Personal credit, which is a small component of household credit, was broadly stable over the September quarter as weakness in margin lending has been offset by a pick-up in other personal lending. Credit card debt has been broadly unchanged over 2010. The weakness in margin lending, as well as an increase in the value of collateral (mainly equities) backing these margin loans has resulted in average gearing levels declining in the September quarter

Graph 66

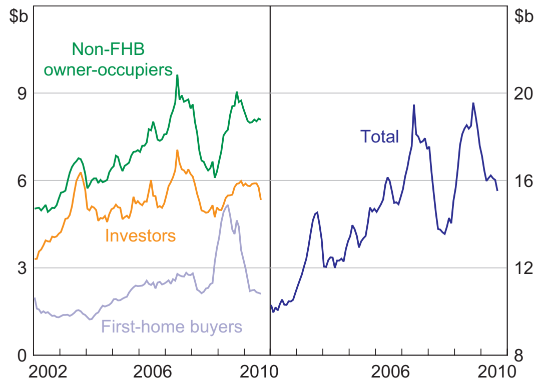
Average Interest Rates on Outstanding Lending



Sources: ABS; APRA; Perpetual; RBA

Graph 67

Value of Housing Loan Approvals*



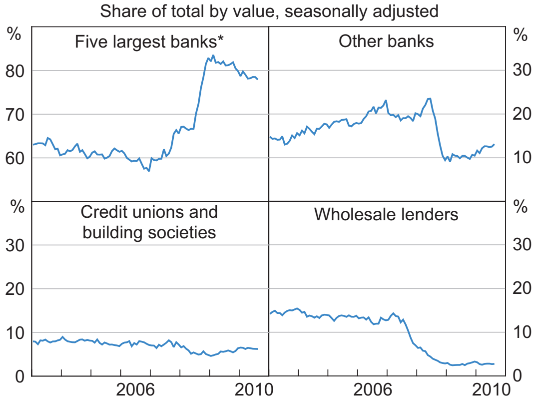
* Excludes owner-occupier refinancing, alterations and additions, investor approvals for new construction and by 'other' investors

Sources: ABS; RBA

Graph 68

Owner-occupier Loan Approvals

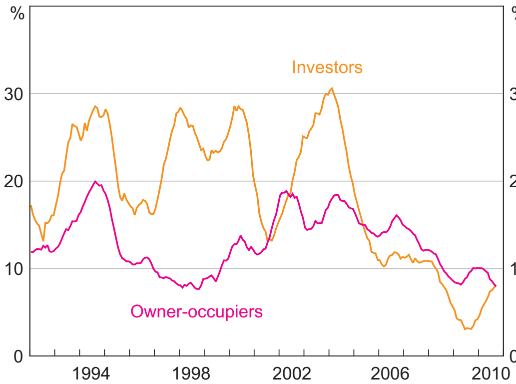
Share of total by value, seasonally adjusted



* Includes Bankwest from December 2008

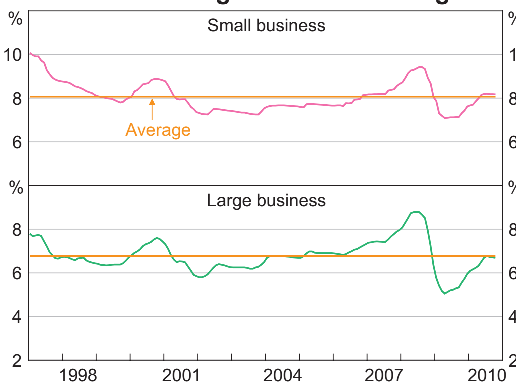
Sources: ABS; APRA; RBA

Graph 69
Housing Credit Growth
Year-ended



Source: RBA

Graph 70
Average Interest Rates on
Outstanding Business Lending



Sources: APRA; RBA

and has meant that the number of margin calls also remained very low (at less than one margin call per day per 1 000 clients).

Business Financing

At the time of writing, no major lender has announced an increase to their variable indicator rates on small business lending following the increase in the cash rate in November. Indicator rates on 1-year to 5-year fixed-rate facilities have generally increased in line with corresponding swap rates, which have risen by around 30 basis points over recent months. The average rate on outstanding small business loans remains around its post-1996 average (Graph 70).

The average interest rate on banks' outstanding variable-rate lending to large business (bill and term facilities of $2 million or more) is estimated to have decreased by almost 10 basis points since the end of July, to 6.72 per cent. These loans are repriced at regular intervals off money market benchmark rates (such as the 3-month bank bill yield), which have been slightly lower on average in the past few months. Furthermore, the risk margins that banks charge above these benchmark rates for new customers have tended to decline a little over 2010, having risen substantially over the past few years. The recent reduction in margins is flowing through to lower average margins on some facilities (especially bill facilities). While margins on variable-rate term loan facilities for some new borrowers have also fallen, the average margin on outstanding facilities has continued to rise slowly as margins on new loans are still above those on existing loans.

Syndicated loan approvals declined in the September quarter, with deals totalling around $14 billion, compared with around $20 billion in the June quarter. The decline reflected a fall in lending for the refinancing of existing facilities, while approvals for capital expenditure and general corporate purposes have picked up slightly.

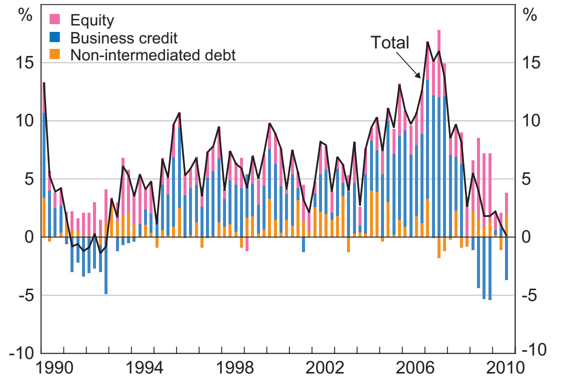
Corporate bond issuance totalled $8 billion in the September quarter, a significant pick up from volumes in the previous two quarters. Improvements in market conditions are also reflected in secondary market corporate bond spreads, which have tightened by around 50 basis points since June to around 205 basis points over CGS.

Net corporate external funding was broadly flat as a share of GDP in the September quarter (Graph 71). The decline in intermediated business credit in the September quarter was offset by equity raisings and an increase in the stock of non-intermediated debt.

Following a significant contraction over 2009, listed corporates' balance sheets expanded over the first half of 2010 and gearing ratios continued to decline. Book value gearing – the ratio of debt to the book value of shareholders' equity – declined to 53 per cent, its lowest level since the mid 1990s and around 30 percentage points lower than its peak in December 2008 (Graph 72).

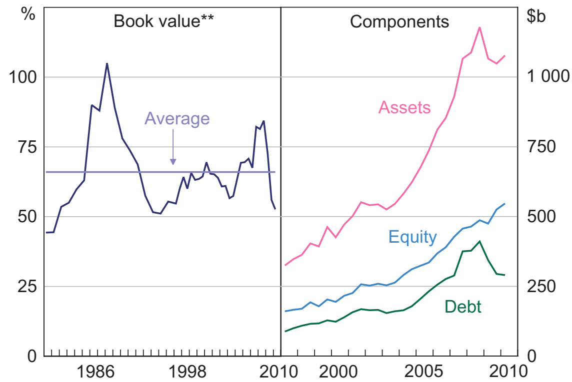
Unlike last year when gearing declined sharply as corporates raised equity to retire debt, the recent decline in gearing reflected higher retained earnings following the strong recovery in profitability. Along with higher earnings, more stable asset values meant that total asset values of Australian listed corporates rose for the first time since the December half 2008. The decline in gearing was largely driven by the resources sector, which has enjoyed a significant increase in headline profits and retained earnings (Graph 73). Gearing in other sectors was mostly unchanged.

Graph 71
Business External Funding
Net change as a share of GDP, quarterly



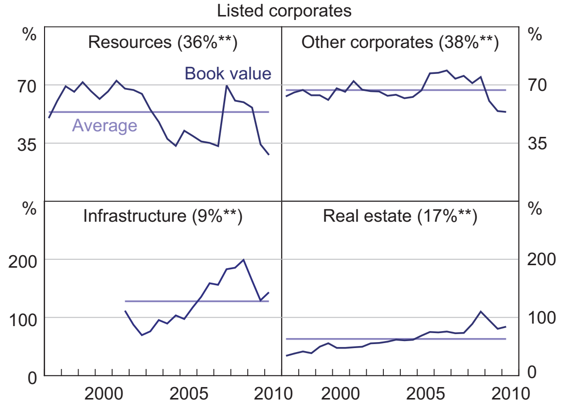
Sources: ABS; ASX; Austraclear Limited; RBA

Graph 72
Listed Corporates' Gearing*



* Excludes foreign-domiciled companies
** Data from 1997 includes real estate companies
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

Graph 73
Gearing Ratios by Sector*
Listed corporates

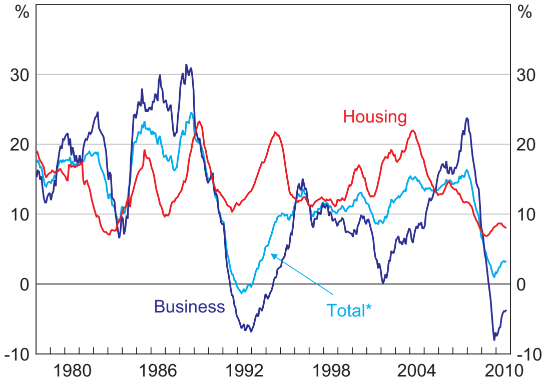


* Excludes foreign-domiciled companies
** Sectoral share of listed corporates' total assets
Sources: Bloomberg; Morningstar; RBA

Graph 74

Credit Growth

Year-ended



* Includes housing, personal and business credit

Source: RBA

Aggregate Credit

Total outstanding credit grew at an annualised rate of 1.5 per cent over the September quarter, reflecting moderate growth in household credit and weakness in lending to businesses. Business credit has declined in recent months, following six months where it remained broadly unchanged (Table 10; Graph 74). Growth in broad money has remained solid in recent months, partly reflecting a preference to hold assets in deposits. Reflecting this increase in deposits, the growth of broad money has outpaced credit since the latter half of 2007.

Table 10: Financial Aggregates

Percentage change

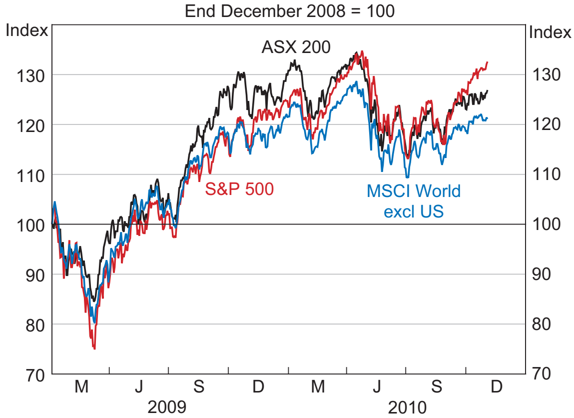
	Average monthly growth		Year to September 2010
	June quarter 2010	September quarter 2010	
Total credit	0.3	0.1	3.3
– Owner-occupier housing	0.5	0.6	7.9
– Investor housing	0.7	0.7	8.1
– Personal	–0.2	0.0	2.8
– Business	0.1	–0.6	–3.7
Broad money	0.6	0.6	5.4

Source: RBA

Graph 75

Share Price Indices

End December 2008 = 100



Source: Bloomberg

Equity Markets

Since the previous *Statement*, the ASX 200 has risen by 3½ per cent compared with an average increase of around 4½ per cent in major overseas markets (Graph 75). On a sectoral basis, gains in resources led the broader market, while financials underperformed (Table 11).

Table 11: Sectoral Movements in the ASX 200

	Per cent change since:		
	August *Statement*	Trough (March 2009)	Peak (November 2007)
Resources	7.7	56	–14
Financials	1.0	63	–40
Other	2.3	33	–32
ASX 200	**3.4**	**50**	**–31**

Sources: Bloomberg; RBA

Profits announced by ASX 200 companies during the recent reporting season were substantially higher over the year, broadly in line with expectations. Headline profits rebounded strongly as the phase of large asset write downs by real estate and resource companies came to an end. Write downs in the first half of 2010 amounted to just $0.1 billion, following a total of $44 billion over the three previous half years.

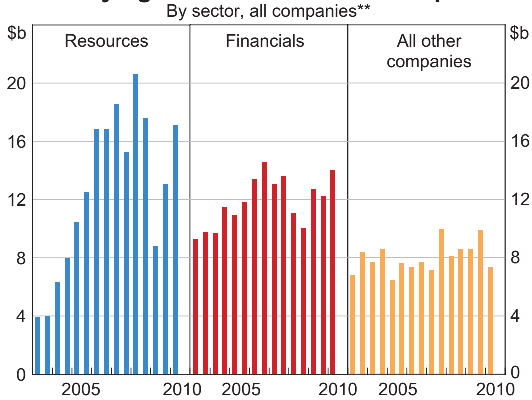
Underlying profits – which exclude significant items and asset revaluations/sales – were 30 per cent higher in the first half of 2010 compared with the corresponding period last year (Graph 76). The rise in aggregate underlying profits was largely driven by resource companies, which reported a 94 per cent increase compared with the corresponding period of 2009. The rise reflected both higher commodity prices and stronger production volumes. Financials' profits rose by 10 per cent, largely as a result of lower bad and doubtful debt charges and an increase in net interest income. Profits at insurance and real estate companies declined, although these declines were driven by a few of the sectors' largest companies. The profits of other companies declined by 9 per cent.

Aggregate dividends increased by 11 per cent, reflecting not only the significant increase in profits but also a recovery in dividend payout ratios, which had previously declined as firms acted to strengthen their balance sheets during the financial crisis. For the first time since June 2008, there were more dividend increases than cuts; 37 per cent of companies increased dividends compared with 20 per cent announcing cuts.

Graph 76

Underlying Profits of ASX 200 Companies*

By sector, all companies**



* From December 2004 figures reported under IFRS
** Excludes foreign-domiciled companies
Sources: RBA; company reports

Merger and acquisition activity has been substantial over recent months, with around $70 billion of deals announced by listed companies since the previous *Statement*. BHP's bid for Canadian group PotashCorp of around $43 billion and Singapore Exchange's $8.4 billion offer to merge with the Australian Stock Exchange account for a large share of this amount. In addition, there were other sizeable bids in the resources and energy sectors, while private equity groups placed bids for Foster's wine division and for wealth manager Perpetual. Around $100 billion of deals are pending, although recent developments suggest BHP's bid for PotashCorp will not go ahead in its current form.

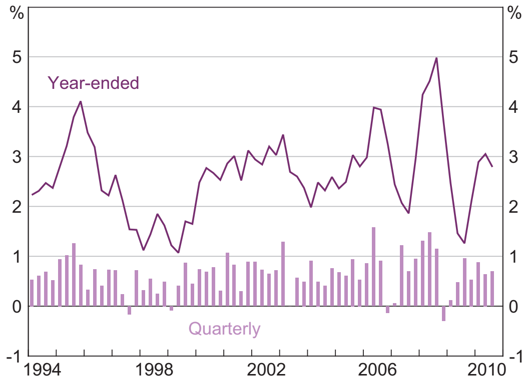
Price and Wage Developments

Recent Developments in Inflation

Over the past two years there has been a significant moderation in inflation, reflecting the easing in demand and capacity pressures in late 2008 and 2009, as well as the slowing in wage growth and the exchange rate appreciation over 2009.

The consumer price index (CPI) increased by 0.7 per cent in the September quarter, to be 2.8 per cent higher over the year (Graph 77, Table 12). In the quarter there were significant increases in the prices of utilities, tobacco (partly reflecting the remaining effects of the tobacco excise increase in late April) and property rates & charges, as well as a solid rise in rents. These were partly offset by sharp falls in the prices of automotive fuel, vegetables and audio,

Graph 77
Consumer Price Inflation*



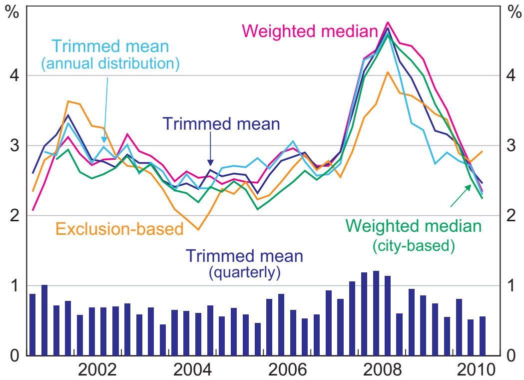
* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

Table 12: Measures of Consumer Price Inflation
Per cent

	Quarterly		Year-ended	
	June quarter 2010	September quarter 2010	June quarter 2010	September quarter 2010
CPI	0.6	0.7	3.1	2.8
– Tradables	1.0	0.2	1.4	1.4
– Tradables (excl food, fuel and tobacco)	–0.1	0.4	–1.1	–1.0
– Non-tradables (excl deposit & loan facilities)	0.4	1.2	4.0	3.8
Selected underlying measures				
Trimmed mean	0.5	0.6	2.7	2.5
Weighted median	0.5	0.5	2.7	2.3
CPI excl volatile items[(a)] and deposit & loan facilities	0.7	1.1	2.8	2.9

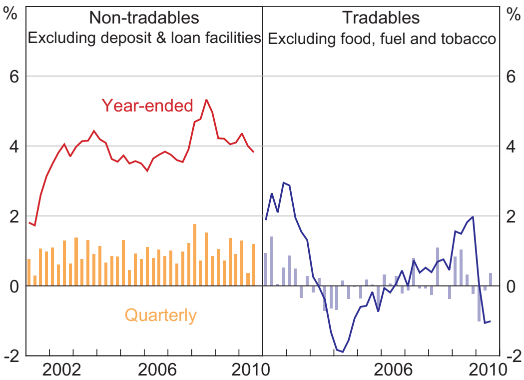
(a) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

Graph 78
Consumer Price Inflation*



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

Graph 79
Consumer Price Inflation*



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

visual & computing equipment, as well as a seasonal fall in pharmaceutical costs. The quarterly outcome was lower than had been expected at the time of the August *Statement*. This mostly reflected the unanticipated large price declines in the volatile petrol and vegetable components. There was also a smaller-than-expected increase in the price of deposit & loan facilities.

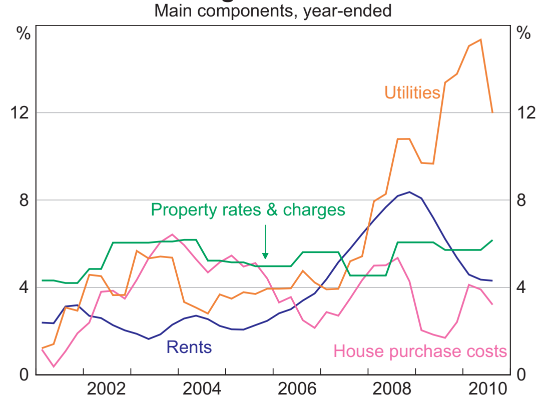
Based on a range of measures, underlying inflation is estimated to have been around ½ per cent in the September quarter. The trimmed mean and weighted median measures were 0.6 per cent and 0.5 per cent respectively. The CPI excluding volatile items and deposit & loan facilities measure was higher at 1.1 per cent, although this difference largely reflects the effects of the tobacco excise and seasonal influences. In year-ended terms, underlying inflation is estimated to have moderated to around 2½ per cent (Graph 78). This is the lowest outcome since 2005 and around 2 percentage points below the peak in late 2008. The proportion of expenditure classes recording annualised price rises of more than 2.5 per cent (by weight and seasonally adjusted) remained at around 40 per cent in the September quarter, which is low relative to outcomes over the past decade. Underlying inflation is expected to remain around 2½ per cent until mid next year, before rising gradually as the inflationary effects of stronger domestic growth and the tightening labour market outweigh the dampening influence on consumer import prices of the higher exchange rate (see the 'Economic Outlook' chapter for further discussion).

Non-tradables inflation (excluding deposit & loan facilities) remained firm at 1.2 per cent in the September quarter, although this was boosted by seasonal effects (Graph 79). The year-ended rate eased to 3.8 per cent – its slowest pace since late 2007, and substantially below its peak of 5.3 per cent a couple of years ago – although the disinflationary effects of the earlier easing in demand and wage growth mostly appear to have passed. Housing-related costs continued to rise strongly, increasing by 2.3 per cent in the quarter and 5.2 per cent over the year. Utilities price inflation has been particularly strong at around 10–15 per cent in year-ended terms for the past couple of years (Graph 80). These large utilities price increases reflect a number of factors, including the need to significantly increase investment – both to replace ageing infrastructure and expand capacity – and, to a lesser extent, rising input costs for generation fuels and infrastructure inputs, including steel. Property rates also continued to rise strongly, following the annual reset of prices in July. The quarterly rate of rent inflation remained solid at 1.1 per cent, after easing between mid 2008 and late 2009, and is expected to pick up gradually, reflecting low rental vacancy rates in most capital cities. Inflation in house purchase costs eased slightly in the quarter to 0.5 per cent, following a modest 0.6 per cent rise in the June quarter.

Tradables prices (excluding food and fuel) rose by 1.1 per cent in the September quarter, to be 1.4 per cent higher over the year. However, inflation in tradables prices over the past two quarters has been significantly affected by higher tobacco prices, partly due to the 25 per cent increase in the tobacco excise in late April. Excluding tobacco (and food and fuel), tradables prices rose by 0.4 per cent in the quarter – and declined by 1.0 per cent over the year – with the quarterly increase reflecting a pick-up in prices for items such as clothing & footwear, household contents and, to a lesser extent, motor vehicles (Graph 81). In recent quarters, free-on-board import prices for some of these items have risen in foreign currency terms, and the disinflationary effects of the tariff cuts (for clothing & footwear and motor vehicles & parts, effective from 1 January) appear to have mostly passed. However, the further appreciation of the exchange rate in recent months is expected to exert downward pressure on tradables prices in coming quarters.

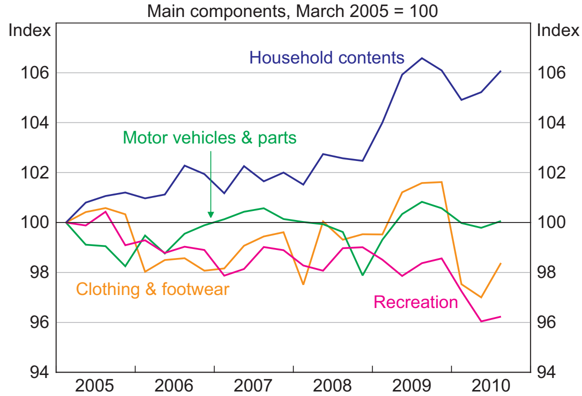
Inflation in food prices has been subdued since mid 2009 (Graph 82). Prices have declined in four of the past six quarters, and year-ended inflation is low relative to outcomes over the past 15 years. The moderation in food price inflation has been driven by a number of factors, including favourable seasonal conditions, the appreciation of the exchange rate in 2009, and the earlier easing in demand pressures, while the Bank's liaison also suggests that there has been significant competition amongst retailers. However, looking forward, strong increases in the global prices of some food commodities in recent months (as discussed in the 'International Economic Developments' chapter) are likely to exert upward pressure on food prices in coming quarters.

Graph 80
Housing Cost Inflation*
Main components, year-ended



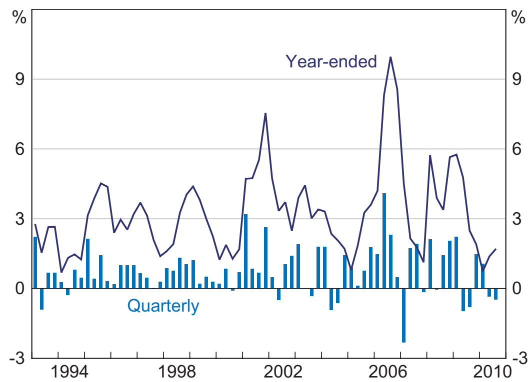
* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

Graph 81
Tradables Prices*
Main components, March 2005 = 100



* Seasonally adjusted
Sources: ABS; RBA

Graph 82
Food Price Inflation*



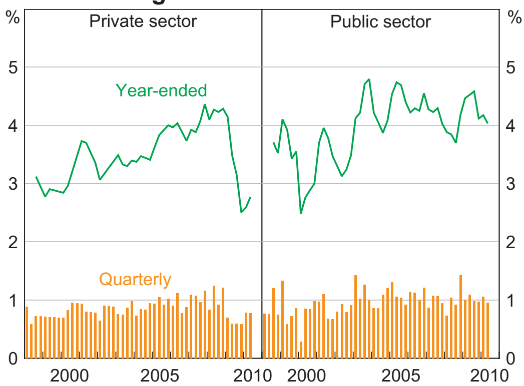
* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

Costs

Labour cost growth has picked up during 2010 – consistent with the improvement in labour market conditions – following the low outcomes in 2009. The overall wage price index (WPI) increased at an annualised rate of 3.3 per cent over the first half of 2010, which is modestly below the average since 1997, following growth of 2.9 per cent over 2009. In the private-sector, the WPI increased at an annualised rate of 3.2 per cent over the first half of 2010, which is also modestly below its average pace (Graph 83). Solid outcomes have been recorded in the mining industry, which is consistent with relatively high wage growth in Western Australia, as well as in the utilities industry (Table 13). Public-sector wages continued to grow at a solid pace, to be 4.0 per cent higher over the year.

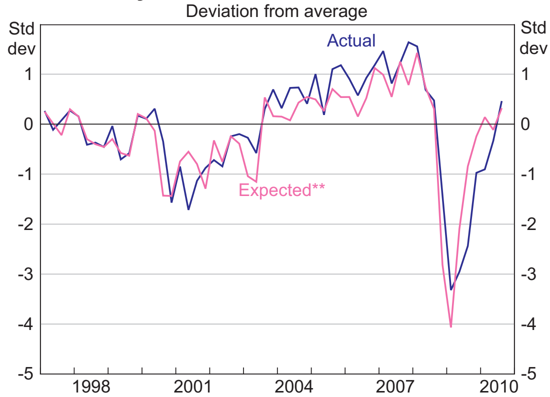
Business surveys and the Bank's liaison suggest that average labour cost growth has increased a little further recently, to around its average pace (Graph 84). This recent pick-up partly reflects the timing of the minimum wage increase – which came

Graph 83
Wage Price Index Growth



Source: ABS

Graph 84
Surveys of Business Labour Costs*
Deviation from average



* Weighted average of data from various business surveys since 1994, with weights calculated by the RBA using the principal component method
** Expectation for following quarter
Sources: CBA-ACCI; NAB; RBA; Sensis

Table 13: Wage Price Index Growth by State
Per cent

	2009	2010[(a)] (annualised)
New South Wales	2.9	3.3
Victoria	2.7	2.7
Queensland	3.2	3.8
South Australia	2.4	3.9
Western Australia	3.0	4.1
Tasmania	3.7	3.6
Australia	2.9	3.3

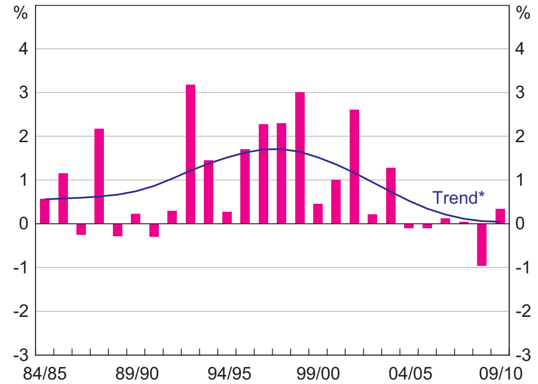
(a) State data are seasonally adjusted by the RBA
Sources: ABS; RBA

into effect on 1 July – as well as continued strength in the labour market. Despite the relatively strong labour market, firms are generally reporting that they are still able to hire employees without too much difficulty; according to survey data, the difficulty of obtaining suitable labour has risen to a little above average levels, though it remains well below its level prior to the downturn. There have, however, been reports of skills shortages in mining-related occupations and in some specialised professions.

Multifactor productivity is estimated to have risen modestly in 2009/10, after declining in the previous year (Graph 85). However, multifactor productivity growth has generally been weak since the early 2000s. Estimated labour productivity growth has been quite low in recent quarters, and combined with the pick-up in wage growth, implies that growth in labour costs per unit of output has increased, following significant weakness over 2009.

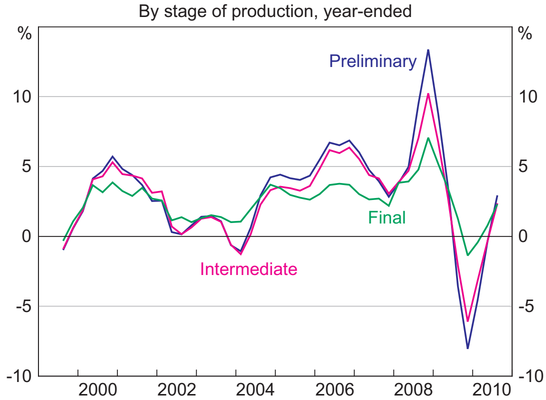
Producer price data suggest that inflation has picked up at the various stages of production over 2010, following weak outcomes over 2009 (Graph 86). Producer prices (excluding oil) rose by a little less than 1½ per cent at each stage of production in the September quarter. Solid outcomes were recorded for domestic prices, with the pace of inflation picking up in the quarter at all stages. Imported producer price inflation has also firmed over 2010, following significant deflation over 2009. Large price increases for resource and rural commodities are exerting upward pressure on producer prices, along with price rises for utilities and non-residential construction. In contrast, manufacturing prices fell slightly in the September quarter.

Graph 85
Multifactor Productivity Growth
All industries



* Estimated using a Hodrick-Prescott filter, λ = 50
Sources: ABS; RBA

Graph 86
Producer Price Inflation*
By stage of production, year-ended

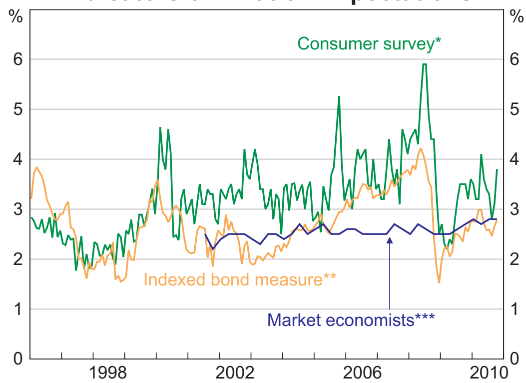


* Excluding oil
Sources: ABS; RBA

Inflation Expectations

Measures of inflation expectations are generally consistent with the medium-term inflation target. Following the release of the September quarter CPI, which was lower than market expectations, market economists surveyed by the Bank revised down their near-term inflation forecasts marginally, although inflation is expected to remain towards the top of the medium-term target over the next couple of years (Graph 87, Table 14). Union officials have lowered their expectations slightly for the next couple of years, but their medium-term expectations are unchanged. Medium-term inflation expectations derived from financial markets have risen modestly, with the indexed bond measure now around its average over the inflation-targeting period. The Melbourne Institute's measure of consumer inflation expectations for the year ahead has picked up in recent months, although this is a volatile series. Business survey measures of expected selling prices in the near term remain around or below average levels.

Graph 87
Indicators of Inflation Expectations



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

Table 14: Median Inflation Expectations
Per cent

	Year to June 2011			Year to June 2012	
	May 2010	August 2010	November 2010	August 2010	November 2010
Market economists[(a)]	3.0	3.2	3.0	2.8	3.1
Union officials[(b)]	3.0	3.0	3.0	3.2	3.0

(a) RBA survey
(b) Workplace Research Centre

Box C

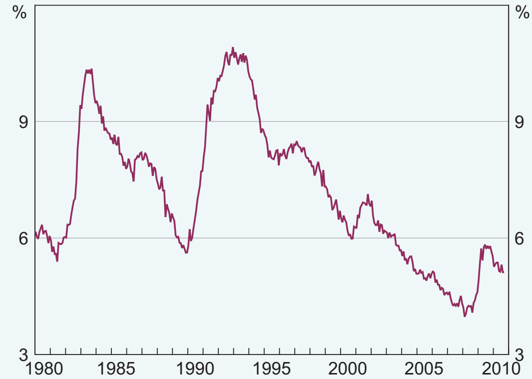
Spare Capacity in the Labour Market

The amount of spare capacity in the labour market is an important determinant of domestic wage and inflationary pressures. When suitable labour is scarce, there is a greater tendency for wages to be bid up and for firms to be faced with increasing cost pressures. This was the case prior to the 2008–2009 downturn in the labour market, when the unemployment rate fell to 4 per cent and widespread skills shortages emerged.

After easing during the downturn, conditions in the labour market have tightened over the past year. The unemployment rate has declined from its mid-2009 peak of 5.8 per cent to its current level of 5.1 per cent (Graph C1). While this is above the lows recorded in 2008, it is around the levels of late 2004 and early 2005 when growth in the wage price index picked up to around 4 per cent. The unemployment rate, however, is only one of a range of indicators of spare capacity in the labour market.

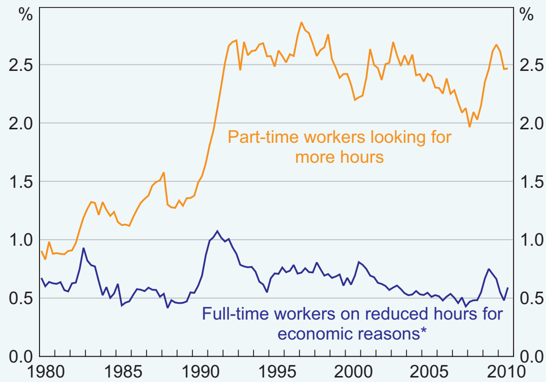
The labour market downturn was also associated with an increase in the proportion of *underemployed* workers in the labour force – those who would like to work more hours – of about 1 percentage point (Graph C2). As labour market conditions have improved over the past year or so, the share of underemployed workers has declined by around ¼ percentage point, which suggests that there is a little more spare capacity in the labour market than implied by the unemployment rate.

Graph C1
Unemployment Rate



Source: ABS

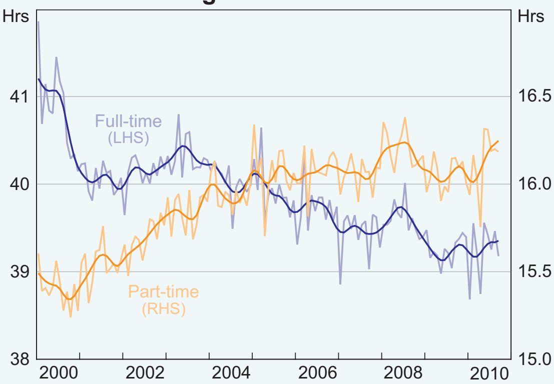
Graph C2
Underemployed Workers
Per cent of labour force



* Economic reasons include insufficient work being available
Sources: ABS; RBA

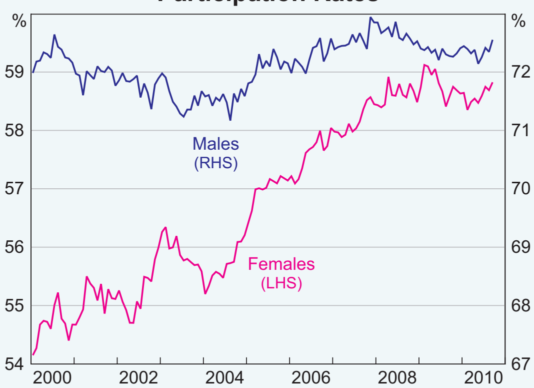
More generally, a significant amount of the reduction in labour input during the 2008–2009 labour market downturn occurred via decreasing the working hours of employees, rather than as a result of a fall in the number employed.[1] Average hours worked are estimated to have declined by more than 2 per cent in trend terms, while the number of people in employment was broadly flat. This decline was due to a fall in average hours worked by both full-time and part-time workers and an increase in the proportion of part-time workers (Graph C3).

Graph C3
Average Hours Worked*



* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

Graph C4
Participation Rates



Source: ABS

Average hours of full-time workers have since retraced less than half of the fall, which might suggest significant scope for further increases in average hours worked. However, there has been a longer-run decline in full-time average hours worked, and the increase in the level of average hours worked throughout early 2008 coincided with a tight labour market, so it is possible that some employees were then working longer hours than they desired.

The amount of spare capacity in the labour market also depends upon the likelihood of people currently not in the labour force moving into the labour force. The participation rate has exhibited an upward trend since the 1980s, with the participation rates of females and older persons increasing over time (Graph C4). The trend increase in female participation has been associated with a range of factors, including increased educational attainment, lower fertility rates (until recently), improved access to childcare, more flexible work arrangements, an increase in part-time employment opportunities and the expansion of the services sector, as well as the gradual decline in the unemployment rate since the 1990s.[2] The participation rate of older workers has also increased, consistent with improved employment opportunities, reduced retirement rates and a rise in longevity. The participation rates of both these groups, however, remain low compared with prime-age males. The male participation rate also increased over the few years prior to the 2008–2009 downturn, in contrast to the gradual decline over the previous few decades. While the overall participation rate fell modestly during the 2008–2009 downturn (e.g. as discouraged workers left the labour force), and by less than in previous downturns, it has since retraced much of the decline to again be close to the highs recorded in 2008. The male participation rate, however, is still nearly ½ percentage point below its peak in 2007.

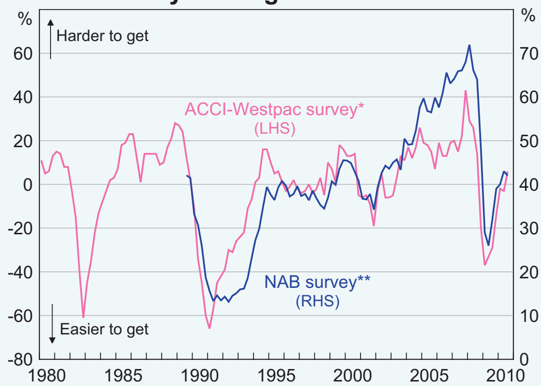
1 See Plumb M, M Baker and G Spence (2010), 'The Labour Market during the 2008–2009 Downturn', RBA *Bulletin*, March, pp 1–6.

2 See Betts T, E Connolly and D Orsmond (2007), 'Trends in Employment and Labour Supply', RBA *Bulletin*, September, pp 1–7.

As the labour market tightens, it can become more difficult for firms to find suitable employees to fill vacancies. There are presently mixed signals from employers in this regard. In business surveys and the Bank's liaison, most firms are reporting that finding labour is currently not a major issue; the difficulty of obtaining suitable labour has risen to a little above average levels, though it remains well below its level prior to the downturn when the labour market was tight (Graph C5). To date, reports of skills shortages have been largely confined to mining-related occupations and some specialised professions. In contrast, data on vacancies give a mixed picture on the tightness of the labour market (Graph C6). As a proportion of the labour force, the ABS measure of job vacancies – which is estimated from a quarterly survey of firms – is currently around its levels in early 2007 when labour market conditions were quite tight and some employers had difficulties filling vacant positions. However, the ANZ measures of print and internet job advertisements suggest the labour market is not as tight, although assessment of these data over time is complicated by changes in firms' use of internet and newspaper advertising (for example, changes in the propensity to use multiple advertisements for the same vacancy). ✠

Graph C5

Difficulty Finding Suitable Labour

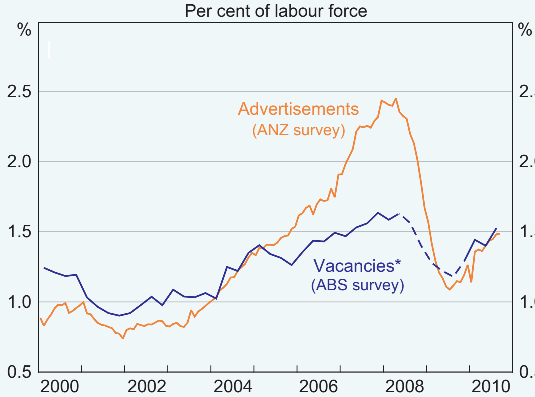


* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI-Westpac; NAB

Graph C6

Job Vacancies and Advertisements

Per cent of labour force



* This series was discontinued after May 2008 and subsequently reinstated; dashed line represents estimates for that period
Sources: ABS; ANZ

Economic Outlook

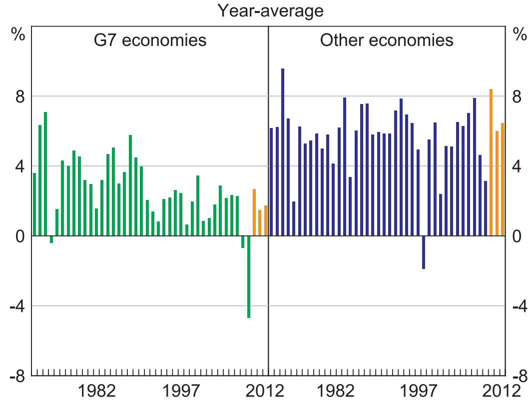
The International Economy

Since the August *Statement*, the world economy has evolved broadly in line with the Bank's assumptions, with output growth slowing in the second half of 2010 from the rapid pace seen over the previous year. In Asia, growth has returned to a more sustainable pace and a gradual withdrawal of monetary and fiscal stimulus is taking place in a number of countries, including China. Among the advanced economies, the outlook for Europe has improved modestly, due to stronger-than-expected domestic demand, although this has been offset by downward revisions to the outlook in the United States and Japan. A number of countries have begun fiscal consolidation to reduce budget deficits.

Overall, global output is estimated to have grown by around 4¾ per cent in year-average terms in 2010, which is above the average rate of global growth recorded during the decade prior to the recent global downturn (Graph 88). World output growth is then expected to be around 4 per cent in 2011 and 2012.

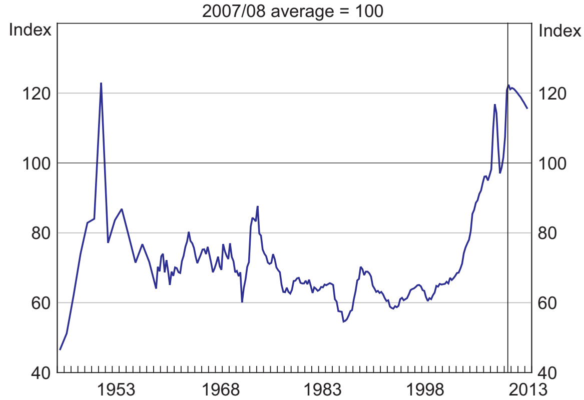
Spot prices of bulk commodities have increased by around 5–10 per cent in recent months, underpinned by solid demand from Asia. While the forecasts assume a gradual decline in iron ore and coal prices over the medium term as more supply comes on line, prices are expected to remain at a higher level over the forecast period than assumed at the time of the August *Statement*. Accordingly, while the terms of trade are still expected to soften over the medium term, the decline is now expected to be slower than previously forecast, with the terms of trade forecast to remain at high levels and to continue to support domestic incomes (Graph 89).

Graph 88
Australia's Trading Partner GDP Growth*
Year-average



* Weighted using merchandise export shares at market exchange rates
Sources: ABS; CEIC; RBA; Thomson Reuters

Graph 89
Terms of Trade*
2007/08 average = 100



* Annual data are used prior to 1960
Sources: ABS; RBA

Domestic Activity

The central forecast for the domestic economy is similar to that at the time of the August *Statement*. The outlook is positive, supported by the expected strong growth in investment in the resources sector, the income boost flowing from the elevated level of commodity prices and ongoing solid population growth, albeit at a reduced pace relative to the high rate of around a year ago. With the economy having limited spare capacity, there is likely to be an increase in inflationary pressures over the forecast period. The risks around these forecasts are discussed below.

The central forecasts are summarised in Table 15 and are based on the technical assumption that the exchange rate remains at its current level – which is around 6 per cent higher on a trade-weighted basis since the August *Statement* – and that the cash rate moves broadly in line with market expectations. As noted in previous *Statements*, the latter assumption does not represent a commitment by the Board to any particular path for policy.

GDP growth is expected to be around trend for 2010. It is then forecast to pick up to a slightly above-average pace in 2011 and through to the end of the forecast period in June 2013. This would probably result in a tightening in capacity in the economy after the period of below-average growth in 2008 and 2009. In year-ended terms, GDP growth is forecast to be around 3½ per cent over 2010 and to strengthen to 3¾ per cent over 2011 and 4 per cent over 2012. In year-average terms, GDP is forecast to grow by 3½ per cent in 2010/11, 3¾ per cent in 2011/12 and 4 per cent in 2012/13. Conditions are likely to vary significantly across the economy, with growth expected to be strongest in mining and related sectors. The central forecast for GDP growth is broadly unchanged since the August *Statement*, with the contractionary effect of the exchange rate appreciation being broadly offset by the forecast higher terms of trade.

The expected rebalancing of growth from public to private demand appears to be occurring. Public spending was prominent in driving aggregate demand over 2009/10, but the period when stimulus spending was contributing to GDP growth looks to have ended, and the winding down of stimulus programs is expected to subtract from GDP growth in the period ahead.

The pick-up in private demand in the central forecast is driven primarily by business investment. Even after applying a significant discount to stated expectations, there is likely to be a further ramp-up in mining investment to a historically very high level; large LNG projects are taking place in Queensland and Western Australia and other significant resources projects in iron ore, coal and LNG are in various stages of planning. Outside of the mining sector, liaison indicates that a degree of caution still characterises firms' spending decisions, with confidence and investment intentions around average levels. While the higher exchange rate is having an effect on some industries, the general investment outlook remains positive, with solid internal funding from profits, and equipment investment expected to gradually pick

Table 15: Output Growth and Inflation Forecasts[(a)]
Per cent, over year to quarter shown

	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013
GDP growth	3.3	3½	3½	3¾	3¾	4	4
Non-farm GDP growth	3.3	3¼	3¼	3¾	3¾	4	4
CPI inflation	3.1	2¾	2¾	2¾	2¾	3	3
Underlying inflation	2¾	2½	2½	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$1.00, TWI at 74, WTI crude oil price at US$87 per barrel and Tapis crude oil price at US$90 per barrel
Sources: ABS; RBA

up following the temporary weakness associated with the end of the tax incentives.

In the household sector there is also a degree of cautiousness still evident in borrowing and spending decisions, with growth in household deposits running ahead of borrowing. Notwithstanding this, robust growth in income and the strong labour market are expected to support growth in real household consumption over the forecast period.

Growth in exports is forecast to be above the rate of the past decade, with significant new capacity for resource exports coming on line. In contrast, non-resource export growth is expected to be modest, reflecting the high real exchange rate and policy changes in the education sector. Import growth is expected to be strong, reflecting the exchange rate appreciation and robust growth in domestic demand, particularly in investment in the resources sector which has a significant imported content.

Growth in GDP is expected to be associated with continued above-average growth in the labour force over the forecast period, reflecting both solid growth in the working-age population and a further modest increase in the participation rate. Labour market conditions are expected to tighten gradually over the forecast period.

Inflation

The medium-term outlook for inflation is broadly unchanged. Underlying inflation eased to around 2½ per cent over the year to the September quarter, its lowest outcome since 2005 and around 2 percentage points below its peak two years earlier. This overall decline has been broadly in line with the Bank's inflation forecasts since early 2009, and reflects the significant moderation in demand pressures and capacity utilisation through late 2008 and 2009, the slowing in wage growth and the exchange rate appreciation since early 2009. The bulk of the disinflationary effects from the slowdown are likely to have passed, and the subsequent strengthening in economic conditions and the labour market is expected to lead to a gradual pick-up in inflation in the medium term.

In year-ended terms, underlying inflation is forecast to remain around 2½ per cent until mid 2011, before picking up gradually to 3 per cent by late 2012. Inflation in non-tradable items is expected to remain firm, with significant contributions from rent, utilities and other housing costs. To some extent this will be offset by relatively moderate inflation for tradable items, partly reflecting the ongoing effects of the exchange rate appreciation on imported consumer prices. The near-term forecast for year-ended inflation is a little lower than at the time of the August *Statement*. This is largely due to the recent appreciation of the exchange rate and the effect of the slightly lower-than-expected September quarter outcome.

Headline CPI inflation was 2.8 per cent over the year to the September quarter. Year-ended CPI inflation is expected to remain above underlying inflation in the near term, at around 2¾ per cent, largely due to the increase in tobacco excise earlier in the year and high utilities price inflation.

Risks

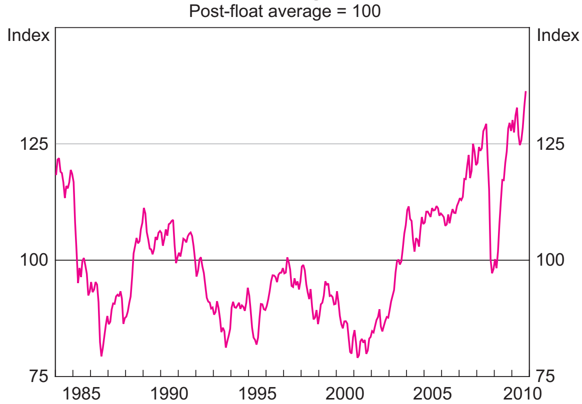
As always, there are risks in both directions around the forecasts, although overall these risks are viewed as being evenly balanced.

Domestically, one key risk concerns the expected pick-up in resources investment. Given the complexity and large scale of some of the projects, there is inevitably some uncertainty about the timing and pace of spending, which could alter the expected profile of GDP growth. Another uncertainty relates to the possibility that the current caution in behaviour of consumers and firms outside of the mining sector could wane. If this occurred in conjunction with a significant ramp-up in mining projects, capacity pressures would emerge, wage growth would rise more quickly than currently expected and there would be a significant risk that inflation expectations could increase to levels inconsistent with the medium-term target.

Internationally, developments in China and east Asia have grown in importance for Australia, and it is quite possible that growth there could surprise on the upside as it has for much of the past decade. In the case of the advanced economies, the risks that are more obvious are to the downside. Some countries still have fragile banking sectors, many face the task of consolidating their public finances, and the process of household balance sheet repair still has some way to run in a number of countries.

Another factor influencing the outlook for Australia is the exchange rate. Since the August *Statement*, the Australian dollar has appreciated by around 6 per cent on a trade-weighted basis, to be 45 per cent above its trough in late 2008 and at its highest level in real terms in the post-float period (Graph 90). The appreciation that has taken place over recent years has had a dampening effect on some sectors of the economy, particularly in import-competing and export-oriented industries such as manufacturing, farming, tourism and education. However, the appreciation has occurred in the context of strong global demand for Australia's resource exports and the significant interest rate differential with the major advanced economies. If developments in global financial markets resulted in a significant further appreciation that was unrelated to these factors, it would likely result in both growth and inflation being lower than in the central forecast. ✠

Graph 90
Real Exchange Rate*
Post-float average = 100



* Uses the latest core inflation rates
Sources: ABS; RBA; Thomson Reuters