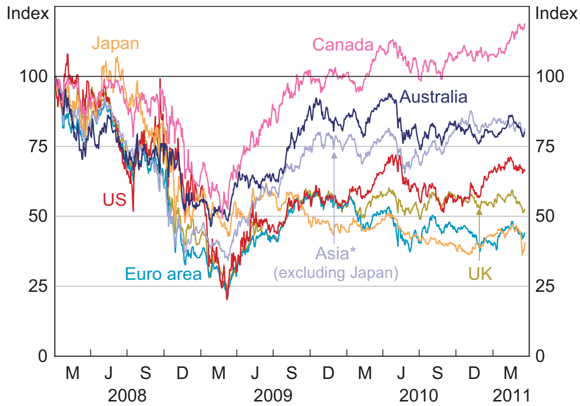
1. The Global Financial Environment

Confidence in major banking systems has recovered further over the past six months. Assisted by generally improving economic conditions, large banks have continued to report profits and repair their balance sheets. In particular, many banks have further strengthened their capital positions; this, together with previous gains, has left many banks better placed to withstand future adverse shocks and meet tougher upcoming regulatory capital requirements. Partly in response to this, bank share prices generally increased over the past six months, along with broader share market indices, though they have fallen in recent weeks reflecting the unrest in North Africa and the Middle East, and the natural disaster in Japan (Graph 1.1). There remains considerable variation across and within some countries: some banking systems are still under considerable strain, most notably in parts of Europe, where recovery has been undermined by market concerns about sovereign debt sustainability.

Banks in the major advanced countries still face significant challenges. Even though loan loss provisions have been falling recently, non-performing asset ratios remain around historical highs and property markets are still weak in many countries. Banks are also seeking to improve their funding structures. Many need to refinance their government-guaranteed debt in the next few years, but funding conditions are still fairly fragile and sovereign debt issuance is competing with theirs.

While overall global financial stability has improved over the past six months, there has been a setback to market sentiment in recent weeks associated with the unrest in North Africa and the Middle East, and the recent natural disasters. These events have focused attention on the resilience of financial systems to external shocks. This comes after a few years in which concerns about financial instability had primarily focused on vulnerabilities generated within financial systems. While it is still too early to assess the full impact of these events, they highlight that financial systems remain susceptible to sudden shifts in market sentiment.

Graph 1.1
Banks' Share Prices
1 January 2008 = 100



* MSCI financials index
Source: Bloomberg

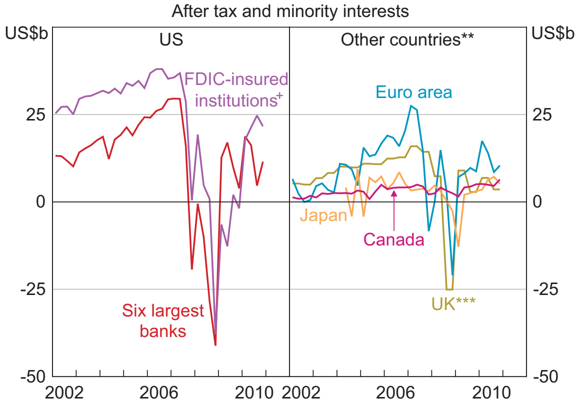
Profitability and Capital

Large banks in the major advanced countries have continued to report profits, although profit levels and returns on equity are subdued compared with the pre-crisis period. While banking sector profits were generally much higher in 2010 than in the previous year, they tended to ease in the second half of the year (Graph 1.2). In the United States, aggregate profits of the six largest banking groups (representing around one half of US domestic banking system assets) have been volatile in recent reporting periods, in large part due to significant goodwill impairment charges at one of these banks. Profits of the remaining five large banks have been steadier, and were up about 40 per cent in 2010 compared with 2009. Profits of all US Federal Deposit Insurance Corporation (FDIC) insured institutions increased considerably in 2010. In the euro area, recent profit results for large banking groups have been mixed: some were affected by difficulties in funding and trading markets that followed the sovereign debt downgrades in some euro area countries. Even so, aggregate profits of the ten largest euro area banks (including two Swiss banks) were up around 50 per cent in 2010. The large UK banks' results remain dispersed; some banks recorded significant profit rises for 2010 as a whole, while others recorded further losses.

Banks in non-Japan Asia and Canada largely avoided the damaging securities write-downs seen in some other banking systems during the crisis, and their loan losses have also been more modest. They generally continued to post firm profit results in 2010, consistent with their more favourable domestic economic conditions. Accordingly, bank share prices in these regions have outperformed those in the United States, euro area, United Kingdom and Japan over the past few years. Profitability of the New Zealand banking system increased during 2010, after higher provisions had weighed on profits in 2009. However, a number of NZ finance companies failed during the past year due to losses on property development loans and/or funding difficulties; consolidation in the NZ non-bank financial sector is ongoing.

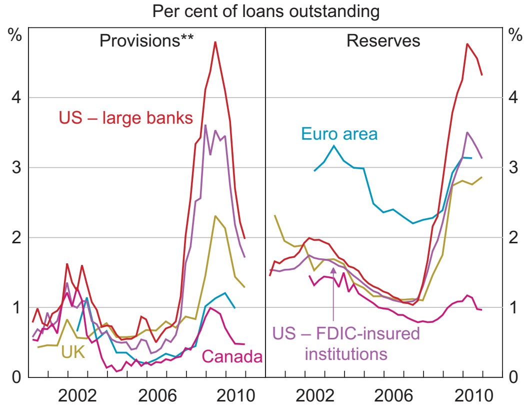
The main driver of bank profits in recent reporting periods has been further declines in the flow of provisions for bad loans, as economic conditions have gradually improved. The decline in loan loss provisions has been particularly noticeable in the United States, where the largest banks' (annualised) provision charges in late 2010 were equivalent to around 2 per cent of their loans, compared with a peak of 4.8 per cent in mid 2009 (Graph 1.3). Some larger banks have also begun to reduce their loan loss reserves. Despite this, provisions and loan loss reserves are still above historical averages for the

Graph 1.2
Banks' Profits*
After tax and minority interests



* Adjusted for significant mergers and acquisitions
** Ten largest listed euro area banks (including Switzerland), five largest UK banks, four largest Japanese banks and six largest Canadian banks
*** Implied from semi-annual data
\+ Includes the six largest banks, but the timing and magnitude of some goodwill impairment charges in 2009 and 2010 differ
Sources: Bloomberg; FDIC; banks' annual and interim reports

Graph 1.3
Banks' Loan Loss Provisioning and Reserves*
Per cent of loans outstanding



* Six largest US banks, ten largest listed euro area banks (including Switzerland), five largest UK banks and six largest Canadian banks for which data are available; adjusted for significant mergers and acquisitions
** Annualised values of quarterly (US, FDIC, Canada and euro area) or semi-annual (UK) provisions
Sources: Bloomberg; FDIC; banks' annual and interim reports

major banking systems, reflecting the high level of non-performing loans and weakness in property markets (discussed further in the section on 'Asset Quality and Credit Conditions').

For larger banks, the boost to profits from lower loan loss provisions has been partly offset by falls in non-interest income from the elevated levels seen in 2009; trading and investment banking income was boosted in that period by market volatility and increased capital market raising activity. While net interest margins continue to benefit from steep upward-sloping yield curves, credit growth remains relatively weak across the major banking systems, and so growth in banks' net interest income is still quite subdued.

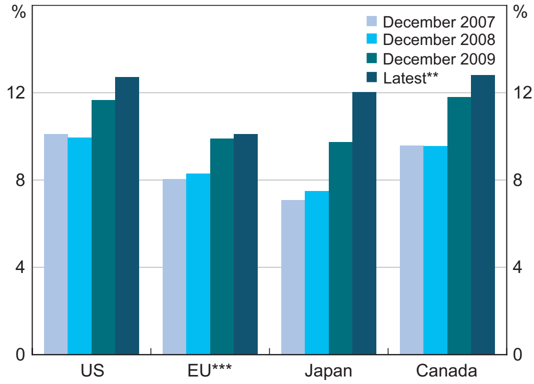
The return to profitability in recent years has helped many banks increase both the level and quality of their capital. Tier 1 capital ratios, for example, have increased markedly since the start of the crisis, although less so in those banking systems in Europe that remain under the most stress (Graph 1.4). Much of the increase has been in the form of common equity – mainly ordinary shares and retained earnings – which absorbs losses most readily. The improvements to banks' capital positions mean they should be better placed to meet the more demanding Basel III capital standards that will be phased in over the next decade.

Higher capitalisation has also improved banks' ability to withstand adverse shocks, but, for a given level of profits, it reduces their returns on equity. Across the major regions, large banks' returns on equity in 2010 averaged between 4 and 7½ per cent, below the average rates recorded over the 2004–07 period (Graph 1.5). As banks reorient their business models in light of the crisis and forthcoming regulatory changes, they may find it more difficult to achieve the rates of return seen before the crisis. But there will inevitably be pressure on banks to boost returns as economic conditions strengthen, which could encourage banks to take on additional risks.

Graph 1.4

Banking System Tier 1 Capital*

Per cent of risk-weighted assets

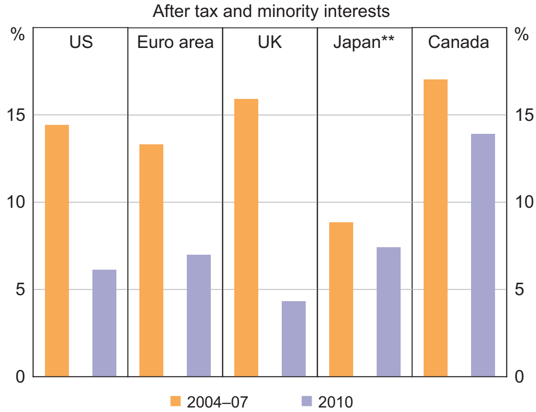


* Caution should be used in comparing Tier 1 capital ratios across banking systems given definitional differences; Japan includes three largest banks
** June 2010 for Europe, December 2010 for US, Japan and Canada
*** December 2007 is the average of IFRS and non-IFRS reporting countries
Sources: Bloomberg; ECB; FDIC; OSFI; RBA

Graph 1.5

Large Banks' Return on Equity*

After tax and minority interests



* Annual average return on equity of the six largest US banks, ten largest listed euro area banks (including Switzerland), five largest UK banks, four largest Japanese banks, six largest Canadian banks; where banks have not reported their final result, profit is annualised and total equity is assumed constant from last reporting date
** 2004–07 results are to fiscal year ended 31 March
Sources: Bloomberg; RBA; banks' annual and interim reports

As profits have recovered, recent additions to banks' capital have been increasingly sourced from retained earnings rather than capital raisings. There was little capital raised by large banks in 2010, unlike in 2009 when banks' capital was boosted by common equity raisings and, in some cases, public capital injections. Restrictions on dividend payments have helped to boost some banks' retained earnings, but there is now increasing market pressure for banks to increase these payments.

Banks have also used retained earnings to repay the public capital that was injected into them during the crisis. In the United States, 86 per cent of the US$245 billion in capital support extended to banks under the Troubled Asset Relief Program (TARP) has been repaid. All of the largest banks have now fully repaid public capital following the US Treasury's sale of its remaining stake in Citigroup in December 2010, but many smaller institutions still have public capital support in place; 569 of the 707 institutions that received capital assistance in the United States are yet to fully repay. (As discussed below, the US Government also retains significant exposure to the balance sheets of the troubled insurer, AIG, and the government-sponsored mortgage agencies, Fannie Mae and Freddie Mac.) Progress in repaying public capital has been mixed across Europe: large banks in some countries have fully repaid this capital (including Switzerland and France), while those in other countries are still dependent on it (including Ireland, the United Kingdom and Germany).

Despite the general improvement in global bank profitability recently, banking systems in some countries remain weak, reflecting their economic and financial conditions. This is particularly the case in some European countries, such as Ireland, Greece, Portugal and Spain, where the interaction of weak economic growth, fiscal strains and bank exposures to troubled property sectors is undermining bank performance. The problems have been particularly acute in Ireland, where the large banks recorded further substantial losses on their property exposures in the second half of 2010. The Irish banks had expanded their balance sheets rapidly over the decade leading up to the crisis, with a significant portion of new lending directed towards property construction and development. A large oversupply of property developed, and the ensuing downturn in the property market has been severe. A government-sponsored 'bad bank' has been acquiring the large banks' troubled property exposures at significant haircuts. The ongoing loan losses have resulted in a number of large Irish banks requiring additional capital injections from the Irish government.

In some countries, bank difficulties are more acute among the smaller, regionally focused lenders, which account for a sizeable share of the banking sector in some cases. In Spain, for example, the savings banks (cajas), which hold around one half of banking sector loans, have been performing worse than the larger and more diversified commercial banks. The savings banks' difficulties mainly stem from large exposures to the troubled property development sector and excess capacity, though this has been compounded by weak governance and other structural problems. The Spanish authorities have introduced legislative changes to address some of the structural difficulties in the sector, and public funds have been used to facilitate restructuring and consolidation. More recently, in response to ongoing market concerns about the sector, the authorities have introduced tighter capital requirements – to be met by public funds if necessary – and measures to enhance transparency for all banks.

In the United States, the smaller deposit-taking institutions in aggregate returned to profitability in 2010, but their average return on equity remains below that of the larger banks. In 2010, 157 mainly small institutions failed in the United States, a little higher than the number in 2009 (Graph 1.6). However, these failed institutions only accounted for about 2 per cent of all FDIC-insured institutions. The ongoing high number of failures partly reflects the large exposure of some smaller institutions to the troubled commercial property and property development sectors. More than 10 per cent of US institutions are still considered vulnerable by the FDIC, which is higher than the 1990 peak. These institutions account for around 3 per cent of FDIC-insured institutions' assets.

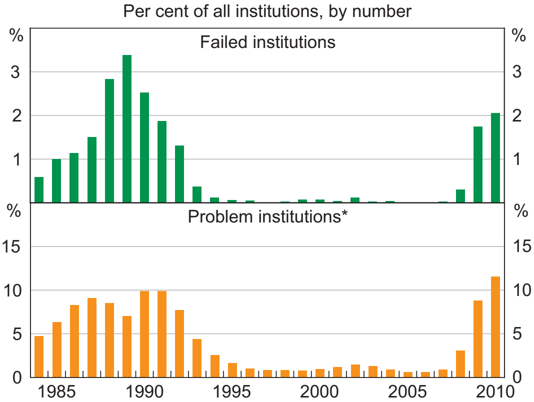
Some small savings banks in South Korea have also encountered difficulties recently, though they account for a very low share of banking system assets. In February 2011, authorities suspended the operations of seven small savings banks following significant deposit withdrawals, and activated the Korean deposit insurance scheme. Depositor concerns had built up after some of these banks were found to be insufficiently capitalised as a result of losses on property development loans.

Authorities in the major jurisdictions are responding to the still-challenged outlook for banks by conducting a further round of stress tests in the first half of 2011. The European Banking Authority is co-ordinating a stress test of European banks' capital resilience under adverse economic conditions and shocks to interest rates and asset prices. This test will be based on banks' 'core' Tier 1 capital, which is stricter than the Tier 1 capital definition used in the previous stress test conducted in mid 2010. The final results of this stress test will be released in June. A separate study of banks' funding and liquidity risks is also being undertaken, though the results will not be made public. In the United States, regulators have undertaken another stress test of the 19 large banks; the results were not made public, but regulators have approved some banks' plans to increase dividends, buy back private capital or repay public capital.

Conditions remain difficult for the large non-bank financial institutions in the United States that still have significant public capital in place. The government-sponsored mortgage agencies, Fannie Mae and Freddie Mac, recorded further losses in the second half of 2010. Authorities have recently announced options to reduce the role of these agencies in the mortgage market and ultimately wind them down; remaining government involvement in the mortgage market would target only a limited range of borrowers, although there are alternative proposals to expand the government's role during times of housing stress, such as by offering reinsurance for certain mortgage-backed securities. The troubled US insurer, AIG, returned to profitability in the second half of 2010 as it sold some assets. Along with TARP funds, the proceeds from asset sales were used to repay loans from the Federal Reserve Bank of New York. The US Treasury has converted some of its preference share holdings into common shares, leaving it with a 92 per cent stake in AIG, which it plans to sell down gradually.

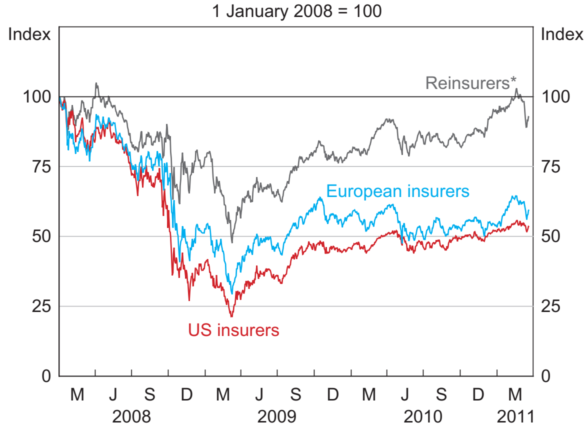
More broadly, general insurers in the United States and Europe mostly maintained their profitability in the second half of 2010. Market sentiment towards insurers had generally been improving over the past six months, but share prices have fallen recently in response to the natural disaster in Japan (Graph 1.7). Reinsurers' profits have recently been under downward pressure from sizeable natural catastrophe losses, and this is expected to continue in 2011. For a number of large global reinsurers, natural catastrophe losses so far this year, including from the Christchurch earthquake, have been quite high. The earthquake and associated tsunami in Japan will further add to losses in the reinsurance

Graph 1.6
FDIC-insured Institutions in Difficulty
Per cent of all institutions, by number



* Those assessed as having financial, operational or managerial weaknesses that threaten their continued financial viability
Source: FDIC

Graph 1.7
Insurers' Share Prices
1 January 2008 = 100



* Market-capitalisation-weighted index of seven large reinsurers
Sources: Bloomberg; RBA

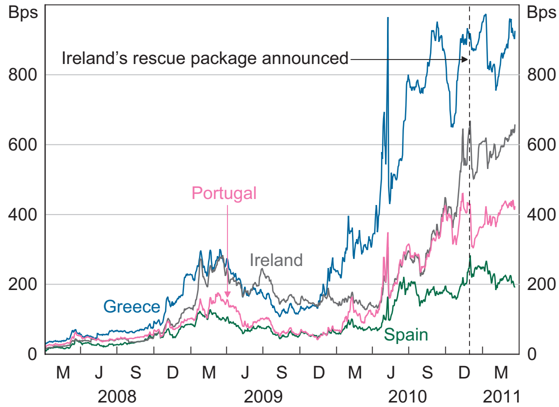
industry, although it is too early to evaluate their extent. Global reinsurers' share prices have fallen since this catastrophe, but remain a little higher than at end September 2010. For life insurers, the low interest-rate environment continues to weigh on profits. This has prompted concerns that some insurers will seek to boost investment returns by taking on additional risks, for example by investing in unfamiliar assets such as emerging market bonds.

Market and Funding Conditions

Bank wholesale funding markets have generally been stable over the past six months, though there continue to be market concerns over sovereign debt sustainability, particularly in Europe. Pressures eased somewhat around the middle of 2010, after measures were put in place to support Greece and the European stress test results were released. However, concerns over European sovereign risks intensified in the final months of 2010 and have carried through to 2011. The focus in late 2010 was initially on Ireland, where the weak economy and the need to recapitalise the large Irish banks generated considerable strain on its public finances and in financial markets. These pressures led to a joint European Union (EU) and International Monetary Fund (IMF) rescue package announced in November. Sovereign spreads for other euro area countries with fiscal strains and/or weak banks have also been elevated in recent months, creating funding challenges for their banking systems and raising the spectre of further bank and sovereign bail-outs (Graph 1.8). Reduced access to private markets means some of these banking systems are still heavily dependent on central bank funding support, and bank credit default swap premia in these countries have increased significantly.

While only a few countries' sovereigns and banking systems are currently distressed, there is potential for strains to propagate to other European countries via cross-border connections. Some of the larger European banking systems have large exposures to the banks and sovereigns of the affected countries. Many large European banks are also exposed

Graph 1.8
European Government Bond Spreads
To 10-year German Bunds



Source: Bloomberg

through their lending to households and businesses in these countries; the performance of these loans would be expected to deteriorate if sovereign or banking strains worsened the downturn in local economic conditions.

Concerns about possible contagion effects have prompted the European authorities to bolster euro area support mechanisms. In late 2010 the European Council endorsed the creation of a permanent scheme to support euro area financial stability, the European Stability Mechanism (ESM), which will replace the European Financial Stability Facility (EFSF) after it expires in 2013. It was subsequently agreed that the ESM will have a lending capacity of €500 billion, around double that of the EFSF. There have also been discussions about expanding the lending capacity and flexibility of the EFSF in the interim, including providing it with the option to buy sovereign bonds issued under certain conditions.

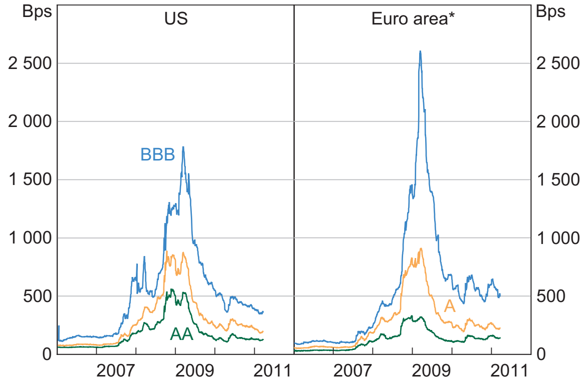
Pricing of bank debt has generally been resilient to the renewed focus on sovereign risk in Europe. Spreads have been broadly stable in most of the major short-term inter-bank funding markets since September 2010, though they have been more volatile in the euro area. Spreads on long-term bank debt have narrowed a little over the past six months in the United States and been broadly unchanged in other major markets (Graph 1.9).

Following the expiry of a number of European schemes at the end of last year, most wholesale funding guarantee schemes are now closed to new borrowing. Banks have generally maintained access to funding markets despite the closure of these schemes, with senior debt issuance picking up in the past few months in most major markets (Graph 1.10). Institutions in Europe have increased their issuance of covered bonds, and some banks in a number of other countries, such as New Zealand and South Korea, have also begun to issue covered bonds for the first time. Banks are being attracted to covered bond markets in the current funding environment because the higher credit ratings attached to these instruments allow them to diversify their funding by tapping into a different investor base (see 'Box A: Covered Bonds'). Despite these recent developments, overall wholesale debt issuance by banks is still fairly subdued by historical standards, largely reflecting weak credit growth in the major banking systems. Moreover, issuance of structured finance instruments remains very low relative to pre-crisis levels (Graph 1.11). Most of the recent issuance of residential mortgage-backed securities (RMBS) in the United States has been by the government-sponsored mortgage agencies, with private label markets still effectively closed.

In response to market and regulatory pressures, many banks are seeking to make their funding structures more robust, including by lengthening and diversifying their funding. They have further increased the share of long-term debt securities and retail deposits in their total funding, while reducing their reliance on short-term wholesale funding. Banks are therefore competing more aggressively for deposits, particularly term deposits. Deposit growth in the major regions remains subdued, however, partly because growth in incomes is below average (Graph 1.12). Some banks have also recently altered the pattern of their shorter-term wholesale funding, for example by using longer-dated repos, typically of two to seven years.[1]

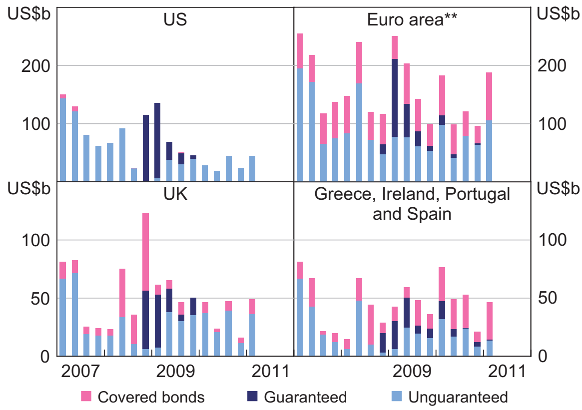
1 Bank of England (2010), 'Box 3: Recent developments in bank funding markets', *Financial Stability Report*, December, pp 38–39.

Graph 1.9
Banks' Bond Spreads
Spread to equivalent maturity government bonds



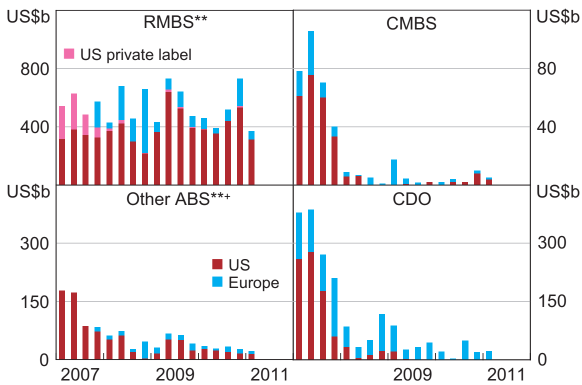
* Euro-denominated bonds issued by financials
Source: Bloomberg

Graph 1.10
Banks' Bond Issuance*



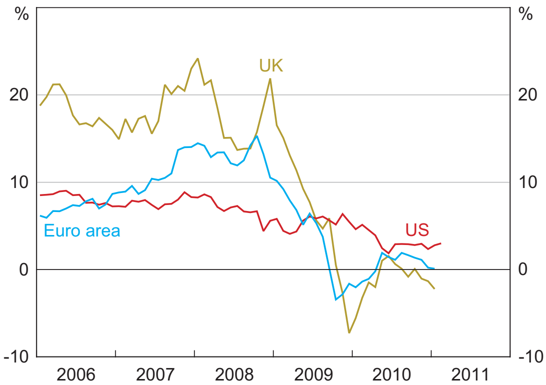
* March 2011 is quarter-to-date
** Excludes Greece, Ireland, Portugal and Spain
Sources: Dealogic; RBA; Thomson Reuters

Graph 1.11
Structured Finance Issuance*



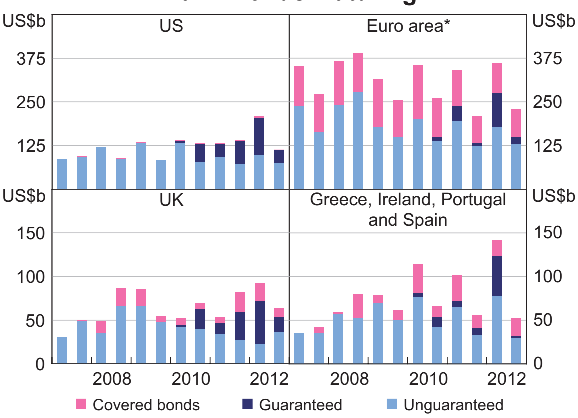
* Includes 'structure-to-repo' issuance; March 2011 is quarter-to-date
** Includes some agency CMBS for US; data prior to fourth quarter 2007 are unavailable for Europe
+ Includes credit cards, home equity, auto and other loans
Sources: CRE Finance Council; JPMorgan; SIFMA

Graph 1.12
Deposit Growth
Year-ended*



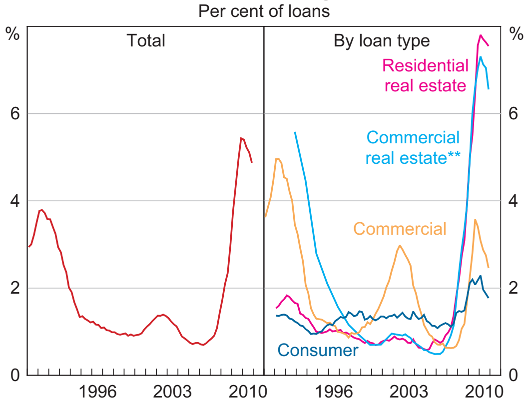
* Adjusted for some series breaks
Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB

Graph 1.13
Bank Bonds Maturing



* Excludes Greece, Ireland, Portugal and Spain
Sources: Dealogic; RBA; Thomson Reuters

Graph 1.14
US Non-performing Loans*
Per cent of loans



* FDIC-insured institutions
** Includes construction and development loans
Source: FDIC

Banks in some countries, particularly in Europe, face a significant wholesale debt refinancing challenge in the next few years, and will therefore remain susceptible to any stress in funding markets. Estimates suggest that around 40 per cent of bank wholesale debt will mature in 2011 and 2012. Around one quarter of bond maturities in this period will be government-guaranteed bonds that were issued in the past few years (Graph 1.13). Some of the investors in these guaranteed bonds may be unwilling or unable to assume the higher credit risk of unsecured bank debt, particularly as banks will be competing with a large amount of sovereign issuance. In Europe, there has recently been increasing investor concern about potential future private-sector burden-sharing in bank resolution, which could adversely affect the demand for unsecured bank debt.

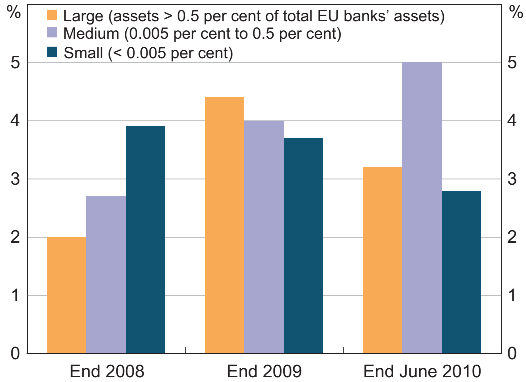
Asset Quality and Credit Conditions

Asset quality remains a key vulnerability in many banking systems, even though loan loss provisions and stocks of non-performing assets have fallen. In the United States, the share of total non-performing loans across all FDIC-insured institutions has declined from the peak of about 5½ per cent, but remained high, at 4.9 per cent as at December 2010 (Graph 1.14). The available data for Europe suggest that non-performing loan ratios have declined across the large banks that accounted for much of the earlier deterioration, though they also remain elevated (Graph 1.15). In contrast, these ratios continued to increase for some of the smaller banks. Outcomes at the individual country level still vary significantly: non-performing loan ratios have declined in some of the larger banking systems (such as Germany), but are continuing to rise in other countries where economic and financial conditions are relatively weak (such as Greece and Spain).

Property-related exposures remain an area of focus because of their prominent role in banks' loan losses during the crisis. In the United States, non-performing loan ratios for both residential and commercial real estate have declined since early 2010, but remain around their respective historical highs at 7½ per cent and 6½ per cent. As noted earlier, some smaller US banks have particularly large exposures to commercial property and property developers. A few large banks in the United States are also facing the prospect of having to buy back some poorly performing residential mortgages from investors given flaws in the origination process, though resolution of this process is likely to be slow. In Europe, property also continues to feature prominently in banks' non-performing loans. Non-performing housing loan ratios have shown modest improvement in some European countries recently, however, such as Spain and the United Kingdom (Graph 1.16). Comparable data are generally not available for commercial property, but data from a number of large banks with significant commercial property exposures suggest that losses in this business segment have been more severe than for housing.

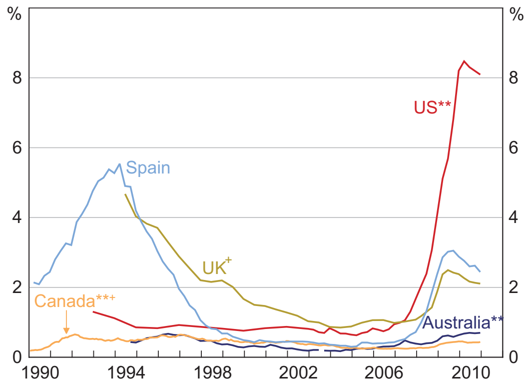
How property-related exposures play out for bank profitability in the future will depend to a large extent on developments in the economy and asset prices. Many commercial and residential property exposures are likely to be in negative equity, as prices remain well below their peaks in many countries. Commercial property prices in the United States and United Kingdom, for example, are currently around 40 per cent and 35 per cent below their respective peaks (despite some mild gains in the United Kingdom) (Graph 1.17). Prices are still falling in Ireland and Spain – countries that have experienced particularly large booms and busts in property development. Residential property prices in the United States are still falling, though at a slower rate than in recent years, and they are now around 30 per cent below their peak (Graph 1.18). The inventory of properties that are in foreclosure or have already been repossessed remains large, and this is weighing on prospects for the US housing market. Residential property prices in some European countries are also at much lower levels

Graph 1.15
EU Banks' Non-performing Loans
Per cent of loans, by bank size



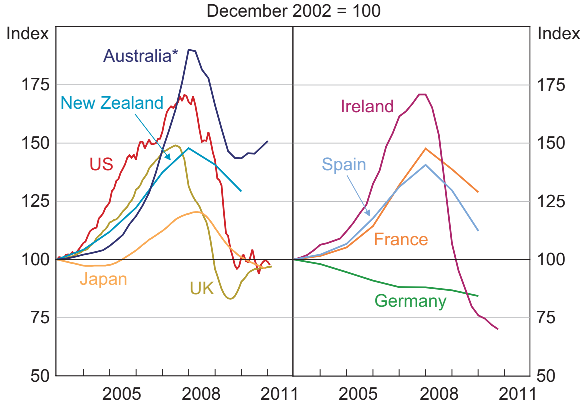
Source: ECB

Graph 1.16
Non-performing Housing Loans
Per cent of loans*



* Per cent of loans by value; includes 'impaired' loans unless otherwise stated; for Australia, only includes loans 90+ days in arrears prior to September 2003
** Banks only
\+ Per cent of loans by number that are 90+ days in arrears
Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

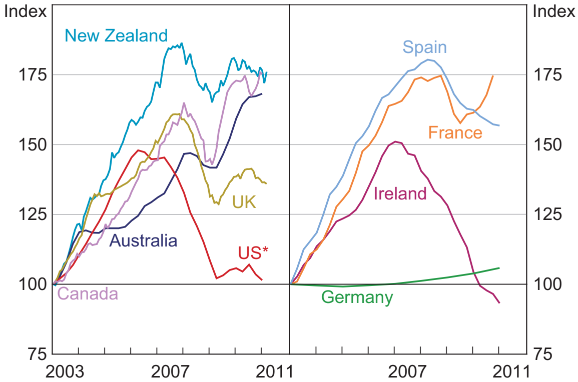
Graph 1.17
Commercial Property Prices
December 2002 = 100



* Prime office space only
Sources: Bloomberg; Jones Lang LaSalle; Property Council of Australia; RBA

Graph 1.18
Dwelling Prices

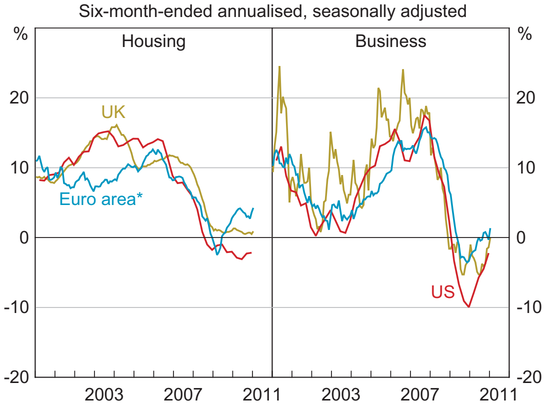
December 2002 = 100



* Prices of detached houses only
Sources: APM; Bloomberg; Canadian Real Estate Association; RBA; Real Estate Institute of New Zealand; Thomson Reuters

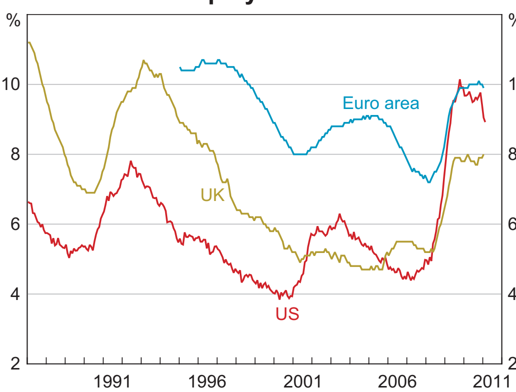
Graph 1.19
Credit Growth

Six-month-ended annualised, seasonally adjusted



* Euro area data are not adjusted for securitisations
Sources: Bank of England; ECB; RBA; Thomson Reuters

Graph 1.20
Unemployment Rates



Source: Thomson Reuters

than a few years ago, though they are picking up in some countries, such as France.

The low level of interest rates may have helped some property borrowers continue to service their loans, enabling banks to forbear on some problem loans (such as by extending loan maturities or converting loans to interest-only terms), and thus limiting forced property sales into already depressed markets. Banks' property-related exposures could therefore be negatively affected by the withdrawal of macroeconomic policy stimulus in some countries, especially where there is a large share of these loans in negative equity.

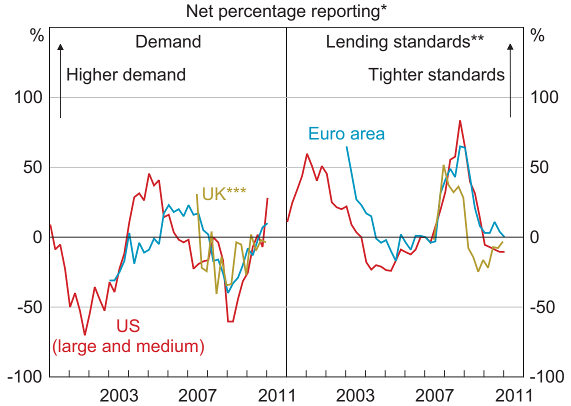
Private financing activity is still fairly weak in many countries, despite accommodative monetary policy, and this is weighing on the recovery of property markets and the economic situation more broadly. Growth in housing credit has picked up a little in the euro area over the past year, but it remains weak in the United Kingdom, and the level of credit is still falling in the United States (Graph 1.19). Households' confidence and capacity to take on new debt continues to be constrained by subdued growth in incomes and high unemployment. Annual growth in household disposable income across the major regions remains below average rates of growth seen over the past decade. Despite having declined since late 2009, the unemployment rate in the United States remains around double the level seen before the onset of the crisis, while rates in the euro area and the United Kingdom are close to their respective peaks of 10 per cent and 8 per cent (Graph 1.20).

Bank lending to businesses has been even weaker than for housing, falling in most major markets over the second half of 2010, though the rate of contraction has eased compared with 2009. This weakness in credit growth reflects both demand and supply factors. Loan officer surveys indicate that demand for credit and banks' willingness to lend have both improved since the extremes of the crisis, but are still generally soft overall (Graph 1.21). Some authorities have been particularly concerned about the weakness in lending to small businesses given how reliant these firms are on banks for their funding.

In contrast to intermediated financing, capital market funding flows in the major economies generally held up during the crisis, as some larger businesses switched away from bank debt and others raised equity to deleverage. Non-financial corporate bond issuance has recently been strong; this is particularly the case for sub-investment grade debt in the United States, as the credit quality of lower-rated issuers has improved and investors have sought higher yields (Graph 1.22).

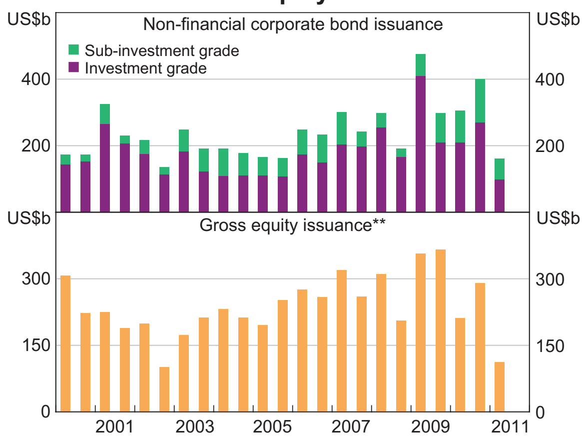
The financial stability challenges confronting policy-makers in many emerging market economies are quite different from those of the major advanced economies. In contrast to advanced economies, non-performing loan ratios are around, or a little below, their pre-crisis levels across a range of emerging Asian economies. But stronger economic growth rates compared with the advanced economies, combined with still-low real interest rates, have contributed to robust credit growth and significant rises in asset prices in some of these countries. Share prices in emerging Asia and Latin America have significantly outperformed those in the advanced

Graph 1.21
Business Loans
Net percentage reporting*



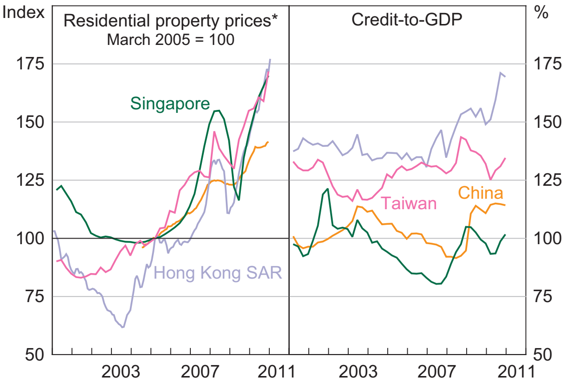
* UK survey applies twice the weight to a 'considerably' answer relative to a 'somewhat' answer; US and Europe apply an equal weight
** US and Europe ask whether lending standards have changed in the quarter; UK asks whether the supply of credit has changed
*** Demand from large businesses; lending standards for all businesses
Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB

Graph 1.22
Bond and Equity Issuance*



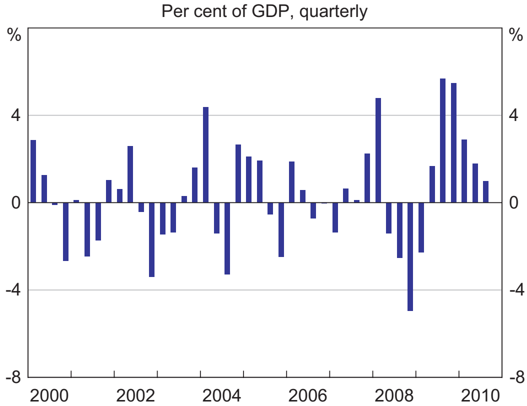
* Euro area, Japan, UK and US; first half 2011 is half year-to-date
** Includes financials; also includes Denmark, Iceland, Norway, Sweden and Switzerland
Sources: Dealogic; RBA; Thomson Reuters

Graph 1.23
Asset Prices and Credit



* For China, data are an average of new and existing residential property prices
Sources: CEIC; Central Bank of Taiwan; Hong Kong Monetary Authority; Monetary Authority of Singapore; RBA

Graph 1.24
Net Private Capital Flows to Asian Economies*
Per cent of GDP, quarterly



* Financial account transactions less reserves; includes Hong Kong SAR, India, Philippines, Singapore, South Korea, Taiwan and Thailand
Sources: CEIC; IMF

world since the end of 2008, with broad market indices recording rises of around 60 per cent to 80 per cent compared with around 35 per cent in advanced countries. In Asia, residential property prices in China, Hong Kong SAR, Singapore and Taiwan have grown strongly over the past couple of years, more than reversing earlier falls (Graph 1.23).

Large capital inflows, attracted by growth prospects and in some cases interest-rate differentials, have generated pressures for Asian currencies to appreciate (Graph 1.24). But for countries with managed exchange rate regimes, the result has instead been domestic monetary expansion that has exacerbated the strength in credit and asset prices. Authorities in some of these countries have been responding with targeted measures to cool speculative pressures in residential property markets, including increasing mortgage down-payment requirements, raising stamp duties, and imposing restrictions on bank lending. Measures have also been introduced to control capital inflows in a number of countries. For example, South Korea and Thailand have imposed taxes on foreign investors' earnings on government bonds, while Indonesia has increased the reserve requirement ratio on commercial banks' foreign-currency holdings. Net private capital flows to some of the Asian economies have moderated from the strong levels seen in the second half of 2009; in some cases there have recently been net outflows. Some countries have also tightened monetary policy a number of times over the past year, and in a few cases, their exchange rates have appreciated. However, given that real interest rates remain low in many of these strongly growing economies, further policy action could be required over the coming period to guard against the build-up of macroeconomic and financial imbalances.