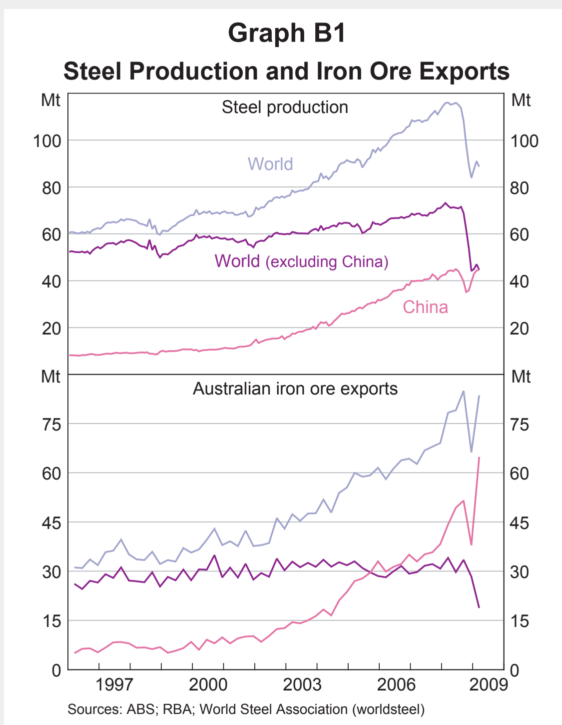
Box B: Recent Developments in Australia's Resource Exports

Global trade volumes have contracted rapidly since late 2008, with particularly sharp declines in manufactured goods trade. In contrast, Australia's exports have not declined as much, partly because Australia's resources exports – which comprise over half of the value of Australia's exports of goods and services – have shown only a relatively modest decline. This box examines the drivers of the recent strength in the volume of Australia's resource exports.

Australia's resource export volumes are estimated to have been broadly flat in the six months to March compared with the previous six months, with significant differences in the performance of different commodities. Exports of iron ore and coking coal volumes have fallen, reflecting the reduction in global steel demand for use in construction and manufactured goods. However, recent monthly data point to some reversal of this weakness, reflecting the pick-up in steel output in China in recent months, with steel production there now close to its mid-2008 peak (Graph B1). This recovery in Chinese production stands in marked contrast to the sharp fall in production in the rest of the world. It appears to have been driven by a nascent recovery in China's transport and construction sectors – indicators such as residential fixed asset investment have increased noticeably of late – as well as reported rebuilding of inventories by Chinese steel mills and traders. It is, however, too soon to tell how durable this pick-up in Chinese demand for bulk resources will prove to be. Regardless, Australia is a low-cost supplier of iron ore and coal – in terms of both the cost of production and for shipping to major markets in Asia – compared with other potential suppliers. This should provide some support for these commodity exports in the period ahead. Chinese production, for instance, is relatively high-cost and hence is less economic at lower iron ore and coal prices.



Other types of Australia's resource exports have shown considerably more strength of late (Table B1). Some bulk commodity

exports are intensively used in the output of products that have not shown the same exceptional decline in global demand as for steel-based products. In particular, thermal coal exports (used in electricity production) have continued to expand, rising by 12 per cent in the six months to March compared with the previous six months. Australia's exports of other energy-related commodities have also continued to expand in recent quarters: with processing beginning at the North West Shelf's fifth processing train, LNG export volumes rose strongly in the December and March quarters, and oil export volumes have also picked up recently.

Table B1: Australian Resource Export Volumes

Per cent change, seasonally adjusted

	Share of resource export values (2008)	Six months to March on previous six months
Iron ore	20	–12
Coking coal	21	–23
Thermal coal	10	12
LNG	6	22
Oil	7	15
Gold	10	6

Sources: ABS; RBA

Domestic Financial Markets

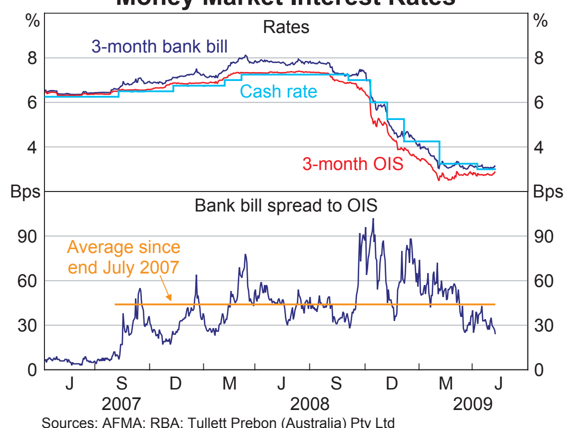
Money market and bond yields

The Reserve Bank Board lowered the target for the overnight cash rate by a further 25 basis points in April, to 3 per cent. This brought the cumulative reduction in the cash rate to 425 basis points since September 2008. Money market yields imply there is an expectation of a further policy easing in the next six months, with the cash rate expected to reach a low of 2½–2¾ per cent. This is higher than in early March – when expectations were for the cash rate to reach a low point of under 2 per cent – reflecting the subsequent improvement in market sentiment.

Short-term interest rates in Australia have also remained close to historical lows since the last *Statement*. The yield on the 3-month bank bill is around 3.1 per cent, close to where it has been since February. The funding pressures that have been evident within money markets since mid 2007 have eased, with volatility declining and the spread between bank bill rates and the expected path of the cash rate narrowing to be at the lower end of the range over the crisis period (Graph 47).

Graph 47

Money Market Interest Rates

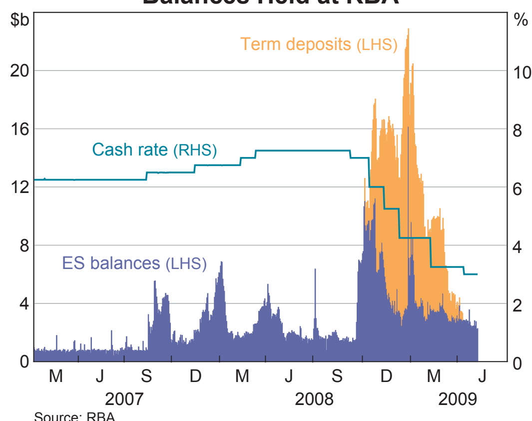


Sources: AFMA; RBA; Tullett Prebon (Australia) Pty Ltd

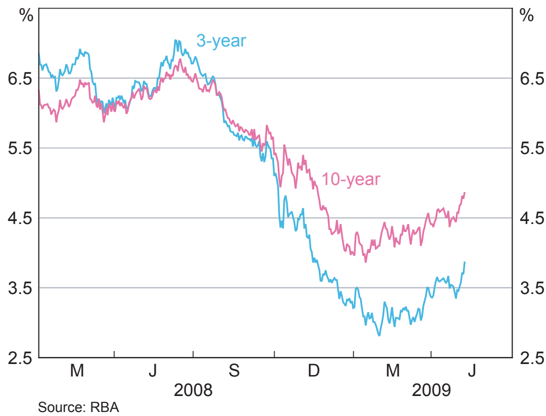
The improvement in money market conditions has allowed the Bank to adjust its own operations in the domestic market. The Bank has seen less need to accommodate large holdings of central bank balances by private banks, either in the form of overnight exchange settlement (ES) balances or term deposits (Graph 48). Indeed, the Bank ceased offering its term deposit facility in late March. ES balances have been gradually reduced to around $2½ billion, well below the peak levels of late 2008.

Graph 48

Balances Held at RBA



Source: RBA

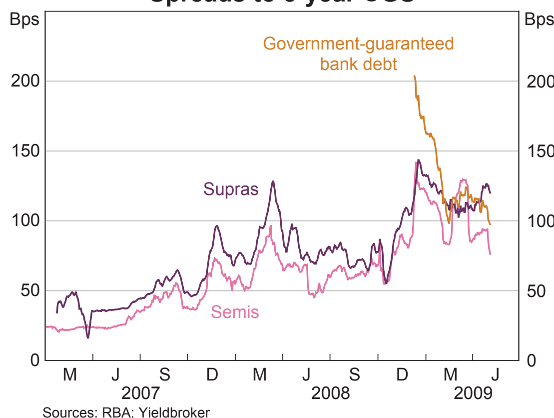


Throughout the recent period, this level of ES balances has allowed the overnight cash market to function well and the cash rate has traded at the target set by the Reserve Bank Board on all days.

Government bond yields have increased from the historical lows reached at the start of the year (Graph 49). The 10-year yield is around 4.9 per cent, with the spread between US and Australian yields increasing by 20 basis points since the last *Statement* to be around 165 basis points.

The Australian Office of Financial Management (AOFM) has significantly increased its issuance of Commonwealth Government securities (CGS) this year and, in March, recommenced the issuance of short-term Treasury Notes for the first time since 2003. Auctions for both bonds and notes have been well subscribed. The bid-to-cover ratio on bonds has been around 3½ in recent months, a little above its average over the past couple of decades, while the bid-to-cover for Treasury notes has averaged five. The yield at auction of Treasury notes has tended to be a little under the overnight index swap rate (OIS) for 3-month notes, similar to where they traded at the beginning of the decade, while yields on 6-month notes have genereally been around 10 basis points over OIS. Given the wider spreads on bank bills, these yields on Treasury notes are at a significantly lower margin to bank bills compared with when they were last issued.

In contrast, the market for state government debt has been somewhat dislocated in recent months with heightened uncertainty and low liquidity. The downgrade to the Queensland Government's credit rating in February saw spreads over CGS widen further (Graph 50). In March, the Australian Government announced that it would be willing to guarantee the debt of the states. The fees payable for such a guarantee (between 15 and 35 basis points per annum) will be significantly less than those levied on the (lower-rated) authorised deposit-taking institutions. While the relevant legislation is still to be passed by Federal parliament, spreads on their debt have narrowed significantly.

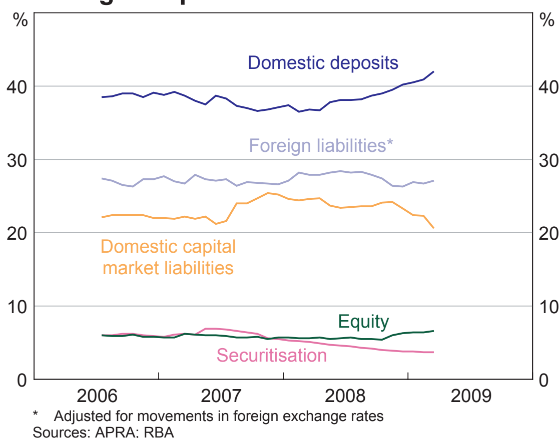


Financial intermediaries

The ongoing turbulence in capital markets continues to affect the cost and composition of financial intermediaries' funding. Over the March quarter 2009, the shares of banks' funding that were sourced from deposits and long-term debt increased further (Graph 51). Strong ongoing demand for low-risk assets such as deposits, and improved access to long-term debt markets, has allowed banks to reduce their issuance of short-term debt. In addition, reflecting the improvement in financial market conditions, banks have slightly reduced their precautionary holdings of liquid assets, some of which had been short-term debt of other banks, that they had built up in the early stages of the crisis. In recent months long-term debt raisings have tended to be issued under the Government guarantee, however, only a very small share of short-term debt issuance has been guaranteed.

Graph 51

Funding Composition of Banks in Australia

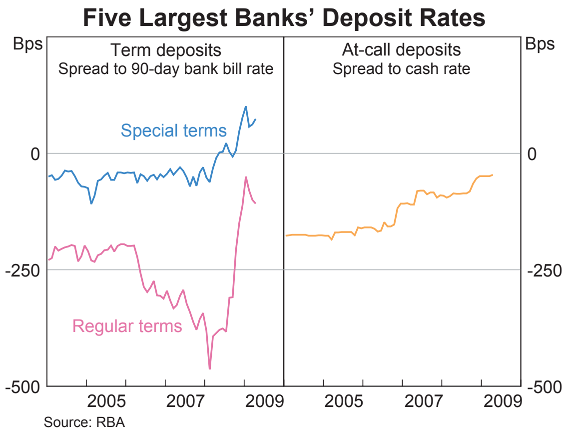


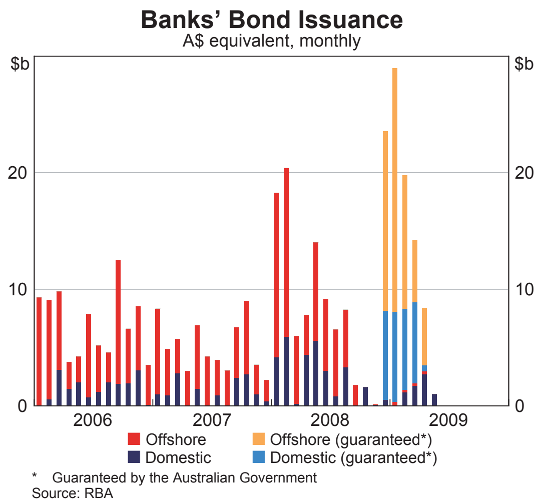
* Adjusted for movements in foreign exchange rates
Sources: APRA; RBA

Competition for deposits remains strong. The average rate on financial intermediaries' at-call deposits – including online savings, cash management and bonus saver accounts – has fallen by 115 basis points since end January, a little less than the decrease in the cash rate over this period.

The average rate offered by the five largest banks on $10 000 term deposits has decreased by 65 basis points since end December, less than the falls in bank bill rates which traditionally serve as pricing benchmarks for these deposits. The five largest banks' average rate on their term deposit 'specials' remains about 75 basis points above the 90-day bank bill rate (prior to the capital market turbulence, specials rates were about 40 basis points below the bank bill rate) and the proportion of term deposit indicator rates that are 'specials' has increased by 15 percentage points since December 2008 to about 35 per cent (Graph 52). The five largest banks' average term deposit rate (including both specials and regular rates) is currently about 50 basis points below the 90-day bank bill rate, compared with about 75 basis points below in December 2008. The regional banks' and foreign banks' rates on $10 000 term deposits have fallen by an average of 115 basis points and 95 basis points, respectively, since end December. Competition for large deposits also remains reasonably strong with falls in average rates for $250 000 term deposits roughly in line with the decrease in bank bill rates.

Australian banks have issued $43 billion of bonds since the last *Statement*, highlighting their good access to funding from capital markets (Graph 53). About half of this issuance has been into the domestic market, with the remainder offshore mainly in US dollars and yen. The slowing of issuance in recent months is consistent with the major banks being well ahead on



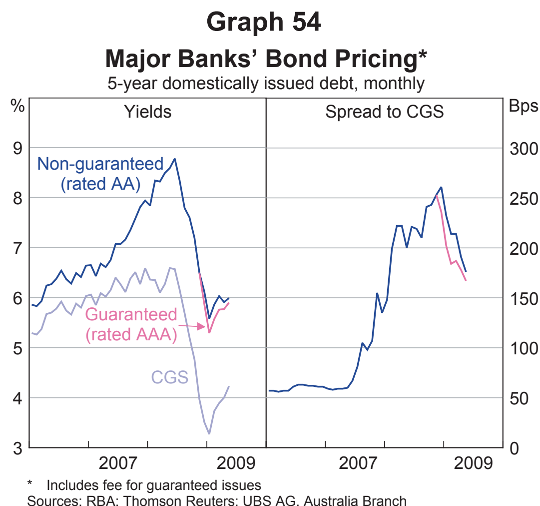


their funding plans as a result of the large amount of bonds issued earlier in the year; in addition, over the past month three of the major banks were in a blackout period prior to reporting their profit results. The banks continue to access a range of markets, providing for a diverse range of funding sources.

In the few months after the Australian Government Guarantee Scheme became operational on 28 November 2008, most bank bonds were issued under the Scheme, and are accordingly rated AAA. There has been robust investor demand for this debt, with many issues being oversubscribed and spreads at issuance falling. However, in the past month there has been a substantial pick-up in the issuance of non-guaranteed debt by the major banks. In April and early May, three major banks issued large non-guaranteed bonds domestically, totalling $3.7 billion. The non-guaranteed bonds attracted a wide range of investors and were all upsized and/or had allocations scaled back due to strong demand. They were the largest non-guaranteed bonds issued in the domestic market in six months.

Spreads on banks' bonds have continued to decline in recent months (Graph 54). Including the cost of the Government guarantee fee, spreads on 5-year domestically-issued guaranteed major bank debt are currently around 170 basis points above CGS, about 30 basis points below where they were trading at end January. Non-guaranteed debt of equivalent maturity is trading at a slightly wider spread. In contrast, for 3-year bonds, recent trade indicates that spreads on non-guaranteed debt are roughly equivalent to those on guaranteed debt (including the guarantee fee). Overall, the pick-up in 3-year and 5-year CGS yields has more than offset the fall in spreads, so that yields on banks' (guaranteed and non-guaranteed) debt is higher than at the time of the last *Statement*.

The introduction of the Government guarantee has allowed banks to issue bonds with a longer tenor than non-guaranteed bonds issued since the onset of the turbulence in financial markets. The average tenor of banks' bonds issued in the March quarter was four years, one year longer than debt issued in the few months before the Guarantee Scheme became operational.



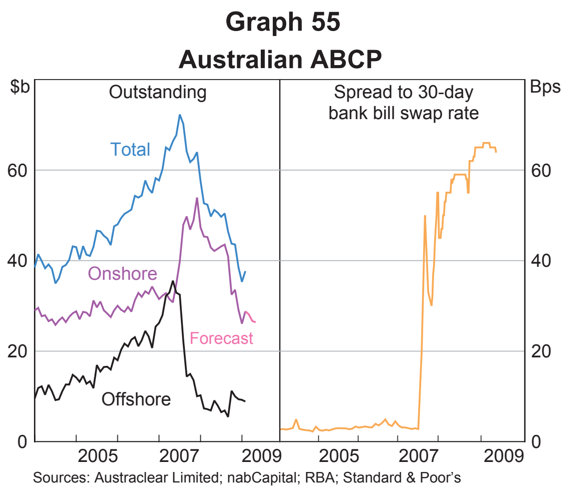
S&P and Fitch maintain the major banks on a stable outlook. In early March Moody's revised its outlook for ANZ, CBA and Westpac to negative (from stable). All of the major banks now have a rating of Aa1 from Moody's, with a negative outlook, one notch higher than the comparable ratings from S&P (NAB's outlook was revised to negative in August 2008). Moody's commented that even in a severe downturn they expect the major banks to remain comfortably within the Aa rating band. Consequently, the major banks are likely to remain among the highest-rated banks in the world. Moody's downgraded the banking operations of Suncorp to A1 from Aa3 in March, reflecting the impact of the economic downturn on its asset quality and earnings.

Securitisation markets remain dislocated, with the bulk of residential mortgage-backed securities (RMBS) issued since the last *Statement* purchased by the AOFM. Six prime RMBS were issued, amounting to $3.5 billion, each with the AOFM as a cornerstone investor. The AOFM purchased $2.75 billion of the senior tranches (rated AAA or A-1+); private investor interest has largely been confined to the most senior tranches with an expected life of less than one year. The AOFM has now invested $4.75 billion in RMBS, with the remainder of the Government's $8 billion injection into the market expected to be allocated in coming months, beginning with three transactions to be issued in May.

The AAA-rated tranches of the RMBS issued in recent months priced at an average of 130 basis points above BBSW, well above the 15–20 basis point spread in the few years prior to the onset of the turbulence in financial markets. Part of the reason for the low private investor demand for recent RMBS deals appears to be the higher secondary market spreads on existing RMBS. While the secondary market is illiquid, with small volumes and values of transactions, reports of spreads in excess of 300 basis points are typical. These higher spreads initially reflected an overhang of supply as some investors, particularly foreign, looked to deleverage and liquefy their portfolios, though there has been a pick-up in demand in recent months that has contributed to some fall in secondary market spreads. Given the underlying mortgages in an RMBS pool are repaid relatively quickly, the stock of outstanding RMBS, at around $120 billion, is 30 per cent lower than its peak in June 2007. Australian RMBS issued offshore are down over 40 per

cent due to a cessation of offshore issuance, while domestic RMBS outstanding are down a little over 10 per cent.

The elevated spreads on RMBS in both primary and secondary markets do not appear to reflect investor concern about the credit quality of Australian RMBS. While losses on prime RMBS (after the proceeds from property sales) increased slightly in the December quarter 2008 – the latest data available – they remained quite low as a share of outstanding loans (at less than 2 basis points) and were predominantly covered by lenders' mortgage insurance. Losses on non-conforming RMBS were higher (around 25 basis points of outstanding loans), with the bulk continuing to be covered by RMBS credit enhancements (mainly the profits of securitisation vehicles). No investor in a rated tranche of an Australian RMBS has suffered a loss of principal stemming from default on the underlying mortgages.



Despite a slight pick-up in February – the latest comprehensive data available – the amount of asset-backed commercial paper (ABCP) has fallen to $38 billion, 50 per cent below its peak in July 2007 (Graph 55). Preliminary data suggest that ABCP outstanding onshore fell in March and April. Falls in onshore ABCP over the past 18 months have been reasonably broad-based among issuers, though ABCP issued by non-Australian banks has fallen the most. Spreads on ABCP remain elevated, at around 65 basis points above BBSW.

Household financing

Interest rates on household loans have fallen significantly since end January (Table 12). Variable rates for new prime full-doc housing loans, including discounts, have fallen by an average of 106 basis points, with the major banks reducing their rates by a little more than the smaller lenders. At 5.16 per cent, this rate is around 380 basis points lower than just prior to the start of the current monetary policy easing cycle in September 2008, and at its lowest level since 1964. Interest rates on riskier housing loans have also declined noticeably since the last *Statement*, with rates on prime low-doc loans and non-conforming loans around 100 basis points lower.

The five largest banks' average 3-year fixed interest rate is broadly unchanged since end January, and at 5.85 per cent, is close to its lowest level in at least 15 years. Nonetheless, with variable rates below fixed rates at present, and borrower expectations of further cuts to variable housing rates in coming months, the share of owner-occupier loan approvals at fixed rates remains very low. In February, only 2½ per cent of owner-occupier loan approvals were at fixed rates; close to its lowest share in at least 17 years, and markedly lower than the decade average of 11½ per cent.

Table 12: Intermediaries' Variable Lending Rates
Per cent

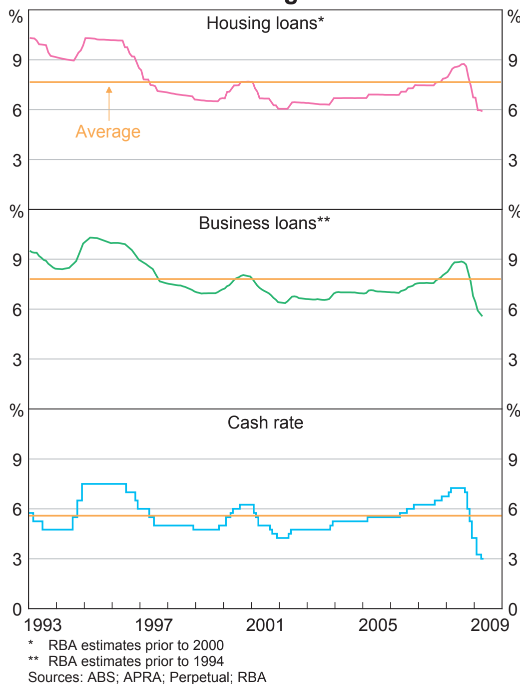
	Current level	Change since:		
	5 May 2009	End Jan 2009	End Aug 2008	End Jul 2007
Cash rate	3.00	–1.25	–4.25	–3.25
Housing loans				
Prime full-doc				
Banks	5.14	–1.07	–3.83	–2.32
Credit unions and building societies	5.27	–1.10	–3.73	–2.27
Mortgage originators	5.58	–0.93	–3.64	–1.90
Prime low-doc				
Banks	5.90	–1.00	–3.55	–1.86
Mortgage originators	6.49	–0.73	–3.34	–1.31
Non-conforming	9.40	–1.00	–2.51	0.24
Personal loans				
Margin loans	8.01	–0.92	–2.57	–0.96
Standard credit cards	17.90	–0.71	–2.03	0.12
Low-rate credit cards	12.02	–0.23	–0.91	0.85
Unsecured term loans	13.52	–0.57	–1.38	0.91
Home equity loans	5.89	–1.04	–3.69	–2.33
Small business				
Term loans				
Residentially secured	7.08	–1.20	–3.01	–1.22
Other security	7.90	–1.11	–2.80	–1.00
Overdraft				
Residentially secured	7.90	–1.20	–3.01	–1.15
Other security	8.81	–1.11	–2.77	–0.90
Average actual rate[a]	7.21	–1.26	–2.95	–1.43
Large business				
Average actual rate, variable and bill funding[a]	4.88	–0.98	–3.75	–2.44

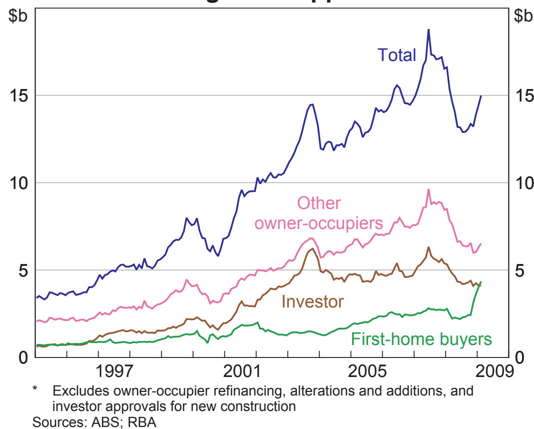
(a) RBA estimate
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

Financial institutions' average variable rates on unsecured personal loans, margin loans and standard credit cards have fallen by 60 to 90 basis points since end January, but average rates on low-rate credit cards have declined by only 25 basis points.

Overall, the average interest rate on all outstanding housing loans (variable and fixed) is estimated to have declined by about 80 basis points since end January, to 5.90 per cent (Graph 56). Since the peak in borrowing costs in August 2008, this interest rate has fallen by 285 basis points, to be around 175 basis points below its post-1993 average, and 15 basis points below its trough in early 2002.

In response to the decline in borrowing costs and the increase in grants paid to first-home buyers, the value of housing loan approvals has continued to rise in 2009, and in February was 16 per cent above its recent trough in July 2008. The increase since July mainly reflects a sharp





increase in the value of approvals to first-home buyers (Graph 57). However, recently there has been some tentative evidence that the pick-up in approvals is becoming more broad-based.

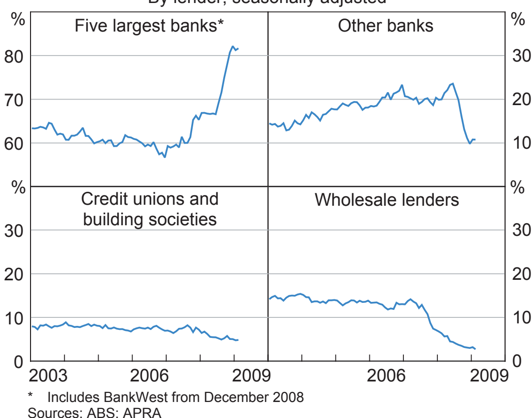
The five largest banks have continued to gain market share at the expense of the smaller lenders over recent months. The five largest banks' share of gross owner-occupier loan approvals was 82 per cent in February 2009, 21 percentage points higher than just before the onset of the financial market turbulence in mid 2007, with only a very small part of this reflecting the acquisition of BankWest by CBA (Graph 58).

The increase in housing loan approvals is consistent with a slight increase in the pace of housing credit growth, which averaged 0.6 per cent a month over the March quarter, up from 0.5 per cent a month over the second half of 2008. This predominantly reflected faster growth in owner-occupier credit, whereas growth in investor credit was little changed over the quarter.

Personal credit, which is a much smaller component of household credit, has declined further during the March quarter as ongoing stock market volatility reduced margin loan debt and credit card lending has continued to slow. Personal credit fell by 6.2 per cent over the year to March.

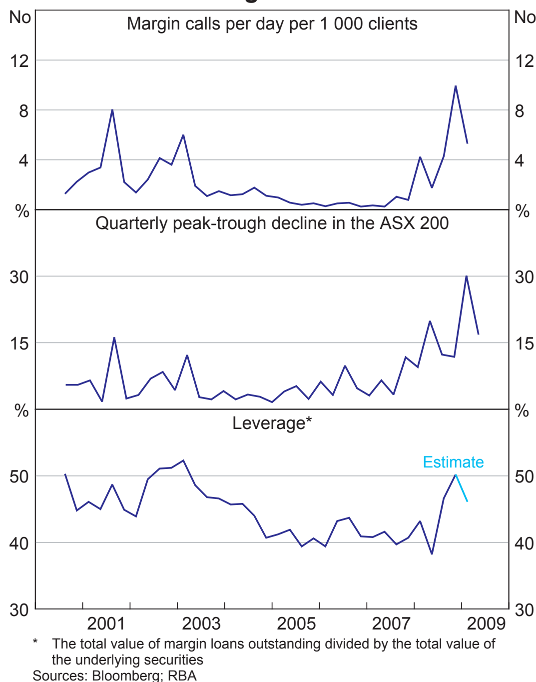
The value of margin loans outstanding declined by 12 per cent over the March quarter to $18 billion, and is now 52 per cent lower than its peak in December 2007. Volatile equity markets meant that the incidence of margin calls remained high in the March quarter, at five calls per day per 1 000 clients, though this was down from a record 10 calls in the December quarter

(Graph 59). Investors' average gearing level declined slightly over the March quarter, as the value of collateral was little changed in net terms, and investors continued to pay down their loans.



Business financing

Benchmark interest rates for business loans have also fallen in recent months, however, higher margins on new and refinanced facilities have offset this to some extent. Because the higher margins only apply to new and refinanced lending, the average interest rate on the outstanding stock of business borrowing has fallen significantly further than that for new lending.

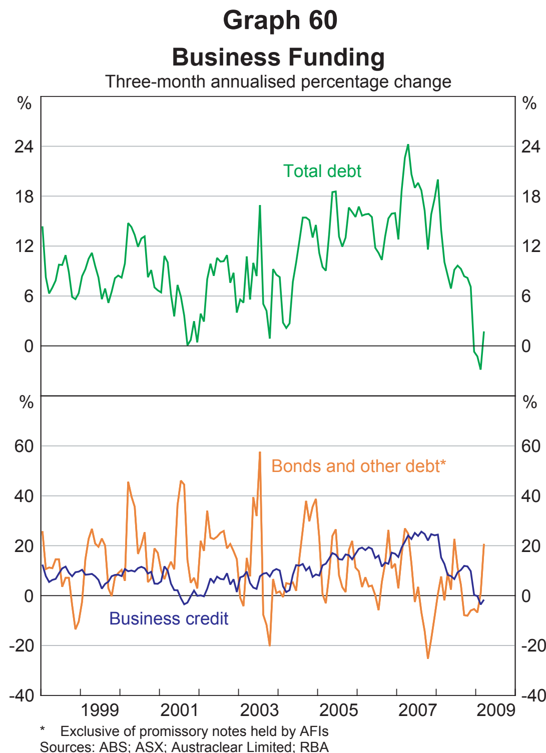


Variable interest rates on outstanding small and large business loans are estimated to have fallen by around 100–125 basis points since end January, and are about 295 and 375 basis points lower respectively since the start of the easing cycle. The declines in the average rates on outstanding small and large business loans over the past three months have reflected greater pass-through of cash rate reductions to small business indicator rates, and the ongoing rolling-over of large business loans at the current low bank bill rates. However, interest rates on new and refinanced business loans have fallen by considerably less, as lenders have revised up their margins.

The spread between the major banks' average indicator rate on residentially secured small business term loans and the cash rate has risen by 5 basis points since the last *Statement*, to be around 200 basis points higher since mid 2007. The major banks' small business indicator rates are currently around their late 2003 levels, even though the cash rate is at its lowest level since

1960. In comparison, the average variable interest rate on outstanding large business loans is estimated to be at its lowest level since at least the early 1970s.

The major banks' average indicator rate on 3-year fixed small business loans has risen by around 40 basis points since end January, a little less than the increase in the 3-year swap rate. At 6.60 per cent, the rate is 330 basis points lower than its peak in mid 2008, and in line with levels last seen in mid 2003.



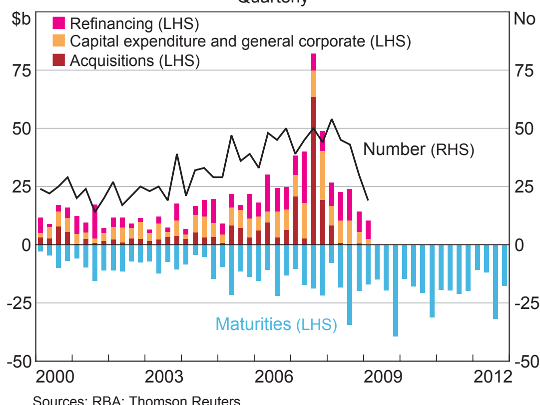
The average interest rate on all outstanding business loans is estimated to have fallen by around 325 basis points since the start of the easing cycle to a little over 5.50 per cent. This is around 225 basis points below its post-1993 average, and 80 basis points below its trough in early 2002. The estimate takes account of any increase in margins that occurred up until the end of March 2009, but does not take account of any subsequent widening in risk margins.

Total business debt has grown by an annualised 1½ per cent over the March quarter (Graph 60). The slowdown in the growth of business debt mainly reflects reduced demand from some firms due to lower planned investment and lower desired gearing levels, as well as some tightening in lending standards. A rise in the volatile capital market debt component more than offset a fall in intermediated business credit, which declined by an annualised 1.6 per cent over the three months to March. Commercial loan approvals have declined further in early 2009, consistent with the weakness in business credit.

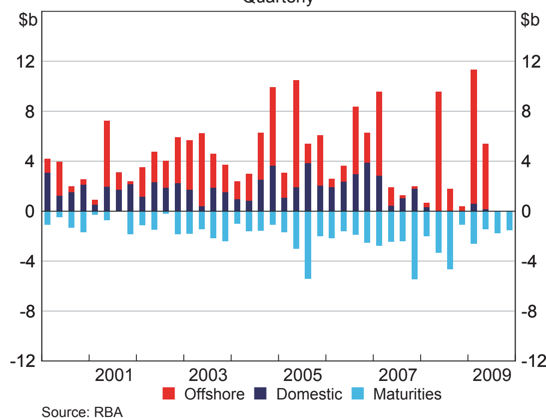
The slowdown in business credit growth in the March quarter was more evident for larger loans (those greater than $2 million) and was reasonably broad-based across industry sectors. The five largest banks' and foreign banks' outstanding business loans have fallen slightly over recent months, while lending by the smaller Australian banks has risen a little.

In the March quarter, 19 syndicated loan approvals totalling $10½ billion were recorded, compared with $17 billion in maturities. About $8 billion of the syndicated loan approvals written in the March quarter were for refinancing, with only $2½ billion of lending being for capital expenditure and general corporate purposes, and $250 million for acquisitions (Graph 61). Of the maturing syndicated loans, the available evidence indicates that all ongoing

companies were able to obtain replacement financing. Foreign lenders do not appear, at present, to be withdrawing from syndicated lending to Australian businesses. For individual loan facilities refinanced during the March quarter, there was no evidence of a systematic withdrawal by foreign lenders, with foreign lenders participation in recent approvals similar to their share over the past year. Over the remainder of 2009 and 2010, there are about $156 billion of syndicated loans to Australian companies that mature, with about 10 per cent of these loans being to real estate companies.



In recent months, there has been evidence of an increase in investor appetite for corporate debt, with the first such bonds issued since October 2008. Australian corporates have issued a record $16.7 billion of bonds since the last *Statement*, almost all of which was issued offshore (Graph 62). The bulk of issuance was accounted for by BHP Billiton and Rio Tinto, which issued bonds denominated in US dollars and euros.



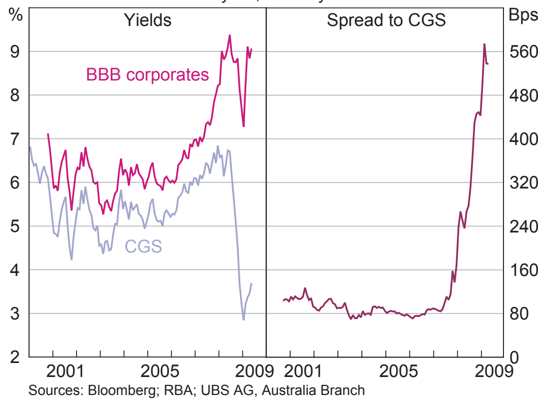
Despite the increased investor appetite for corporate bonds, spreads on recently issued debt have been much higher than for bonds issued previously by the same entities. Indeed, the increase in spreads has more than offset falls in government bond yields over the past couple of years, so that the yields on these bonds at issuance were higher than on previously issued debt. This is also evident in the secondary market, where spreads and yields on BBB-rated bonds remain high by the standards of the past decade (Graph 63). This is consistent with the increased cost of intermediated corporate finance exhibited over recent months.

Listed non-financial companies' response to the turmoil in financial markets was evident in changes to the structure of their balance sheets over the December half 2008. While the aggregate book value gearing ratio was little changed, abstracting from the effects of Rio Tinto's 2007 debt funded purchase of Alcan it fell (Graph 64). This fall reflected a decline in gearing by a handful of large resource companies. Although non-resource companies' gearing picked up slightly in

Graph 63

Australian Corporates' Bond Pricing

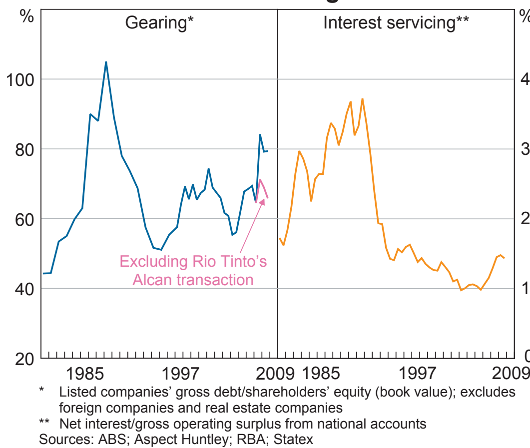
3-year, monthly



Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 64

Non-financial Companies' Gearing and Interest Servicing Ratios



* Listed companies' gross debt/shareholders' equity (book value); excludes foreign companies and real estate companies

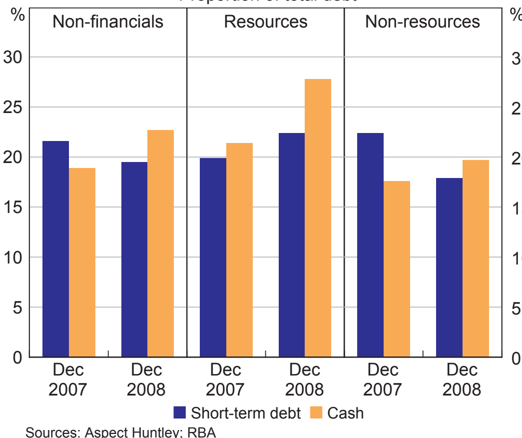
** Net interest/gross operating surplus from national accounts

Sources: ABS; Aspect Huntley; RBA; Statex

Graph 65

Short-term Debt and Cash

Proportion of total debt



Sources: Aspect Huntley; RBA

the December half, it is likely to fall in coming months as debt levels are reduced using funds from recent equity raisings. Overall, current levels of gearing are comparable to those around 1990, though because interest costs are lower, in aggregate, listed companies are better placed to service existing debt than they were at that time.

Listed companies also increased the liquidity of their balance sheets over 2008 by holding more cash. Cash holdings of these companies are currently at a high level compared with history, at around 7½ per cent of assets. Reflecting the pick-up in cash holdings and a fall in the proportion of debt that is short term, in aggregate listed companies have more cash than short-term debt on their balance sheets (Graph 65); at the individual company level, over 50 per cent of companies have more cash than short-term debt. There is evidence to suggest that companies' cash conserving behaviour has continued into 2009; for example, around half of ASX 200 companies that recently reported their profit results announced cuts to dividend payments to shareholders.

In response to concerns that foreign lenders could withdraw from the market for commercial property finance, the Federal Government has proposed establishing the Australian Business Investment Partnership (ABIP) as a contingency measure. Under the current proposal, ABIP would be able to provide up to $30 billion of finance for commercial property projects.

Aggregate credit

Total credit grew at an annualised rate of around 3 per cent over the March quarter, a similar pace to growth over the December quarter. The slowing in business credit growth over the March quarter was offset by an increase in the rate of growth of household credit (Table 13; Graph 66). Growth in broad money has been solid over recent months.

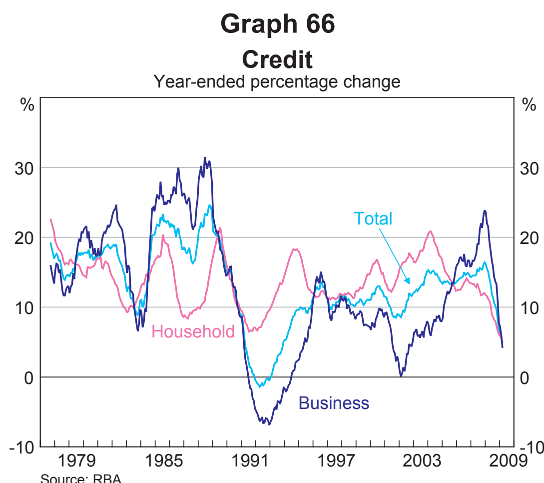


Table 13: Credit Aggregates
Average monthly growth, per cent

	June quarter 2008	September quarter 2008	December quarter 2008	March quarter 2009
Total credit	0.5	0.6	0.2	0.2
Household	0.5	0.4	0.4	0.5
– Owner-occupier housing	0.7	0.5	0.7	0.8
– Investor housing	0.5	0.4	0.2	0.2
– Personal	–0.1	–0.6	–1.0	–0.4
Business	0.5	0.9	0.0	–0.1

Source: RBA

Equities

Volatility of the Australian share market has continued to decline, with absolute daily movements now averaging close to 1 per cent, well below the peak of more than 3 per cent following the collapse of Lehman Brothers last year (Graph 67). Current levels of volatility are below the average since the onset of turbulence in financial markets in 2007, but still nearly twice the long-run historical average.

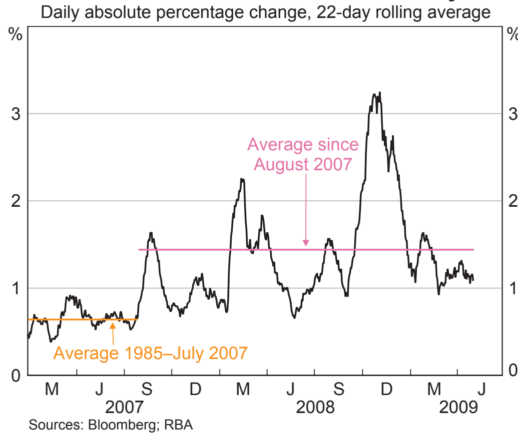
In the weeks immediately following the publication of the last *Statement*, the ASX 200 continued to decline, reaching a trough in early March which was 54 per cent below its November 2007 peak (Graph 68). Since the March trough, the ASX 200 has increased by around 25 per cent, to be slightly above end 2008 levels, but still around 40 per cent below its peak.

The gain in the Australian share market since early March has been broad-based, though there have been particularly large gains among financials, which are up around 30 per cent, partly reversing their earlier large falls. Non-financials' share prices are up around 20 per cent. The relatively large increase in financials since early March predominantly owes to banks, whose share prices have benefited from improvements in sentiment stemming from developments overseas. Reflecting the health of the domestic banking system, Australian banks' share prices

Graph 67

Australian Share Market Volatility

Daily absolute percentage change, 22-day rolling average

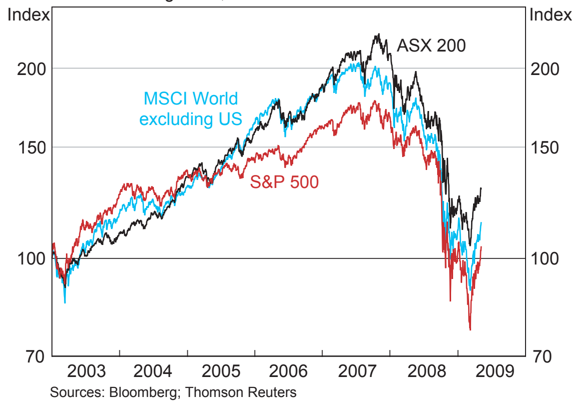


Sources: Bloomberg; RBA

Graph 68

Share Price Indices

Log scale, end December 2002 = 100

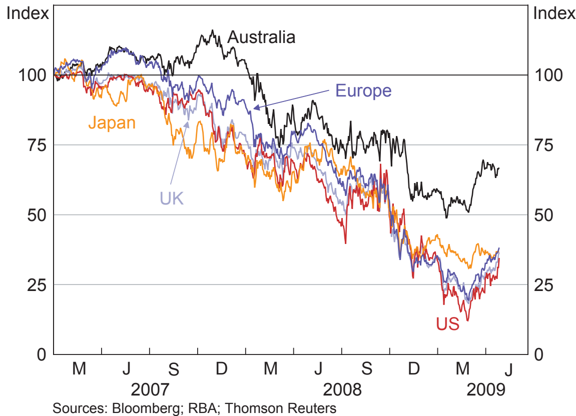


Sources: Bloomberg; Thomson Reuters

Graph 69

Commercial Banks' Share Prices

End December 2006 = 100



Sources: Bloomberg; RBA; Thomson Reuters

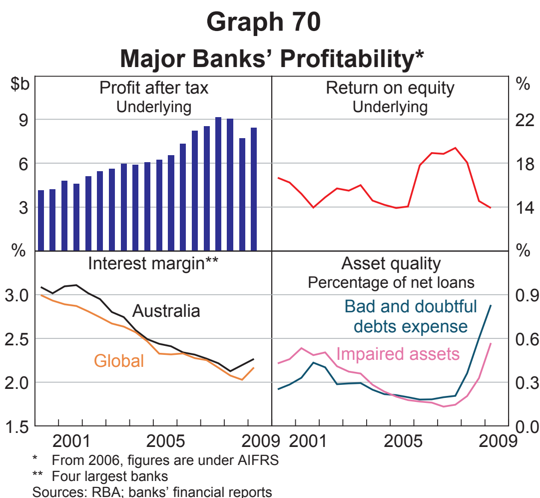
have performed well relative to major countries' banks over the past six months, though remain 42 per cent below their peak in November 2007 (Graph 69).

Profits announced by ASX 200 companies during the recent reporting season declined, though large companies' results were broadly in line with expectations. Underlying profits – which exclude significant items and asset revaluations/sales – were 3 per cent lower than in the corresponding period of 2007. Headline profits were around 81 per cent lower, with the sharp fall largely due to asset write-downs by resource and real estate companies.

By sector, resource companies' profits increased by 15 per cent, bolstered by strong production volumes in the third quarter of 2008 and the depreciation of the Australian dollar. Underlying profits for financials were around 18 per cent lower, with profits significantly lower for insurance companies and diversified financials as a result of investment losses, higher borrowing costs and lower fee revenue. Real estate companies also reported lower profits partly due to a fall in rental income from property assets. Profits for companies in other sectors fell by 13 per cent, led by a sharp fall in profits by some large infrastructure companies.

For the first half of the 2009 financial year, the major banks' reported underlying, after-tax profit was 7 per cent lower than the first half of 2008 at $8.4 billion, but 9 per cent higher than in the second

half of 2008 and not far below its peak in 2007 (Graph 70). The banks' underlying, after-tax return on equity fell by 4 percentage points to 14 per cent, reflecting both the slightly lower profits and the increase in shareholder equity as the banks strengthened their balance sheets during the second half of 2008.



The banks' profits were underpinned by strong results from their Australian operations. Net interest income increased, driven by a 14 basis point rise in the net interest margin as higher lending spreads more than offset the increased cost of deposits, and solid balance sheet growth. However, the banks' overseas operations recorded lower profits, mainly due to sharp falls in their net interest margins, as they were unable to fully recover their higher funding costs in these markets.

The banks' bad and doubtful debt expense (as a proportion of assets) was twice as high as in the first half of 2008, but was only a little higher than in the second half of 2008. The increase was driven by higher specific provisions on the banks' corporate loan books, but there was also an increase in collective provisions reflecting the weakening economic outlook in Australia and overseas. The three major banks to most recently report reduced their half-year dividends per share by 20–25 per cent, to help further boost their very strong capital ratios.

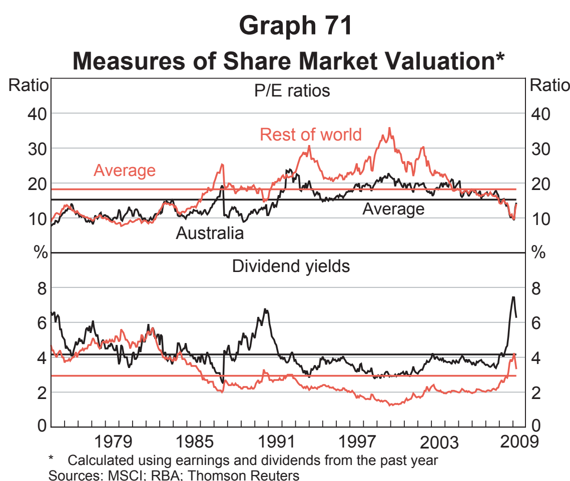
Analysts have continued to revise down their forecast profits for ASX 200 companies, albeit at a slower pace than the previous few months. Aggregate earnings are now expected to fall by 16 per cent in 2008/09, decline a little further the following year before picking up by 19 per cent in 2010/11. Downward revisions have been widespread among ASX 200 companies, with earnings being downgraded for an average of 140 companies each month since the last *Statement,* compared with upgrades for an average of around 40 companies per month. However, considerable uncertainty about the outlook remains, with the dispersion of analysts' forecasts remaining at a very high level.

Measures of share market valuation have moved closer to their historical averages in recent months, in part due to the increase in share prices since early March. The Australian trailing P/E ratio – based on earnings for the past year – is up around 5 points over the past couple of months; of this increase, about a third owes to gains in share prices and the remainder reflects a decline in earnings. The Australian P/E ratio is currently 1 point below its long-run average (Graph 71).

The dividend yield on Australian shares has declined by 1 percentage point over recent months, though it remains high at around 6 per cent. The recent decline in the Australian dividend yield predominantly reflects gains in share prices. Australian shares have traditionally been higher yielding than the rest of the world, as dividend imputation provides a stronger incentive for Australian companies to pay dividends.

Graph 71

Measures of Share Market Valuation*

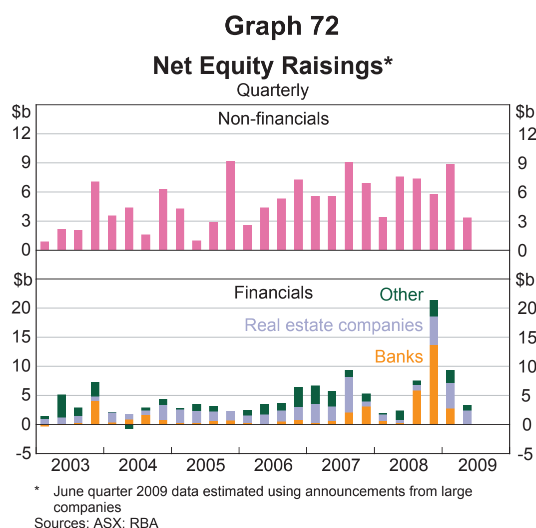


* Calculated using earnings and dividends from the past year
Sources: MSCI; RBA; Thomson Reuters

Graph 72

Net Equity Raisings*

Quarterly



* June quarter 2009 data estimated using announcements from large companies
Sources: ASX; RBA

Equity raisings have been robust, with $17 billion raised by listed entities in the March quarter and a further $7 billion raised in the June quarter to date. The bulk of this was raised by non-bank entities, following banks' record raisings in the December quarter (Graph 72). The discounts on equity raisings have been broadly similar to those historically for large issues of equity. Most equity was raised through placements, with funds predominantly used by non-bank entities to strengthen balance sheets by paying down debt. Consequently, it is likely listed companies' gearing will fall in coming months. In contrast to the strength of equity raisings, IPO activity remains at a low level and buybacks also remain subdued, reflecting companies' preference to retain cash.

Merger and acquisition activity remained robust in the March quarter, though deal volumes are well below the levels seen in 2007 due to a fall in leveraged buyouts. Listed companies announced around $30 billion of deals in the March quarter, of which $19 billion was accounted for by Chinalco's proposed purchase of equity in a number of Rio Tinto mining projects. A further $7.5 billion of deals were announced in April and May. There are currently $41 billion of deals pending, of which a little less than half is the proposed Rio Tinto-Chinalco transaction.

The Australian Securities and Investments Commission (ASIC) extended its ban on covered short selling of financial companies – where an investor takes a short position and has arrangements already in place for the delivery of securities, typically by borrowing them – to 31 May 2009 from 6 March 2009. While naked short selling (of both financial and non-financial stocks) is banned indefinitely, covered short selling of non-financial companies has been permitted by ASIC since 19 November 2008. Since then, short sales have averaged around 15 per cent of the value of trades in ASX 200 companies, with materials companies tending to be most short sold.

Price and Wage Developments

Recent developments in inflation

A range of information suggests that inflation pressures are beginning to ease in line with the weakening in the economy. Inflation expectations have fallen since mid 2008 to be at quite low levels and growth in labour costs appears to be slowing, as are upstream producer price pressures. While it will take some time for these factors to fully flow through to consumer prices, the CPI data for the March quarter suggest that inflation is easing, albeit from quite a high rate. This is consistent with the gradual moderation in price pressures that the Bank has been expecting.

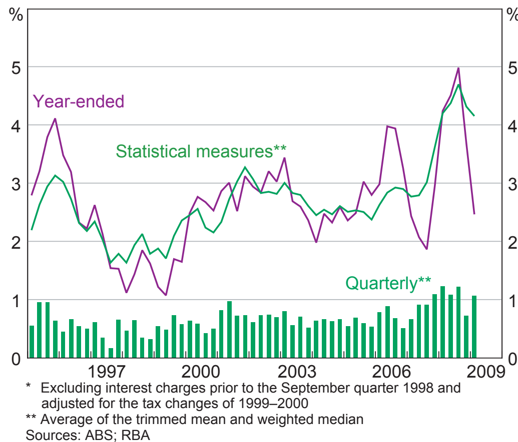
The CPI increased by 0.1 per cent in the March quarter, to be 2.5 per cent higher over the year (Table 14, Graph 73). The quarterly outcome was held down by particularly large falls in the prices of deposit & loan facilities and automotive fuel. Abstracting from these items, price pressures remained relatively broad-based. As a result, measures of underlying inflation were considerably stronger, at around 1 per cent in the quarter and 4 per cent over the year. However, this followed a lower-than-expected outcome of around ¾ per cent for underlying inflation in the December quarter and, looking through this volatility, a reasonable assessment is that the pace of quarterly underlying inflation has moderated to a little less than 1 per cent, compared with close to 1¼ per cent in the first three quarters of last year.

Table 14: Measures of Consumer Price Inflation
Per cent

	Quarterly		Year-ended	
	December quarter 2008	March quarter 2009	December quarter 2008	March quarter 2009
CPI	–0.3	0.1	3.7	2.5
– Tradables	–1.8	0.5	1.2	0.8
– Tradables (ex food & fuel)	–0.2	0.9	0.9	2.0
– Non-tradables	0.6	–0.1	5.4	3.4
Underlying measures				
Weighted median	0.9	1.2	4.5	4.4
Trimmed mean	0.6	1.0	4.2	3.9
CPI ex volatile items[(a)] and deposit & loan facilities	0.6	1.1	3.8	3.7

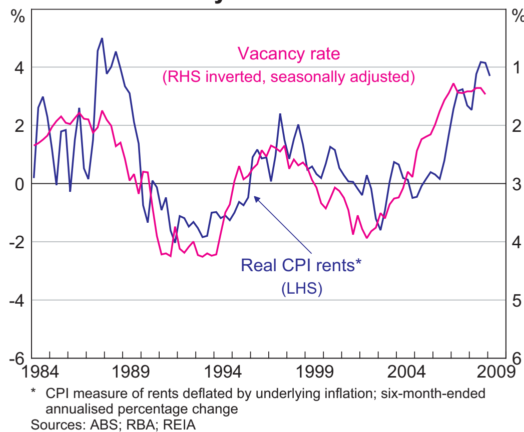
(a) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

Graph 73
Consumer Price Inflation*



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

Graph 74
Vacancy Rate and Rents



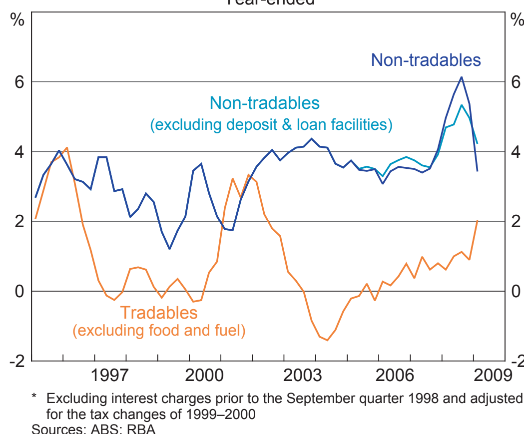
* CPI measure of rents deflated by underlying inflation; six-month-ended annualised percentage change
Sources: ABS; RBA; REIA

The main contributors to the rise in the CPI in the March quarter were higher prices for rents and a range of food items, alongside seasonal increases in prices for health, education and utilities. Rental accommodation prices, which have a weight of around 6 per cent in the CPI, have been growing strongly in recent years reflecting very low vacancy rates in all major cities (Graph 74). However, the pace of increase in rents has slowed in recent quarters, as conditions in the rental market have levelled out. The CPI measure of rents increased by 1.7 per cent in the March quarter, after increases averaging more than 2 per cent per quarter in 2008. Data from the state Real Estate Institutes indicate that rents for newly negotiated agreements have also moderated.

In contrast, automotive fuel prices fell by 8 per cent in the quarter due to declines in global oil prices, holiday travel costs declined sharply due to lower airfares and the price of new housing fell. The CPI outcome in the quarter was also held down by a 14 per cent fall in the ABS estimate of deposit & loan facilities prices, which has a weight of around 4 per cent in the CPI and subtracted 0.7 percentage points from the quarterly rate of CPI inflation. This component represents the ABS estimate of margins on deposit and loan products used by households (as well as the explicit fees and charges on these products) and appears to have been significantly affected by reductions in the cash rate. Over the past half year, mortgage rates have fallen significantly as the cash rate has fallen, while average deposit rates have fallen by less, reflecting both the inertia in some (low- or zero-interest) transaction accounts and strong competition for interest-bearing deposits (see the 'Domestic Financial Markets' chapter). The large fall in the March quarter – together with a small fall in the previous quarter – more than unwound the large increase in this component over the prior year. More broadly, this component has had a significant effect on CPI inflation over the past two years, but a relatively small impact on the statistical measures which downweight

the impact of large changes in particular items.

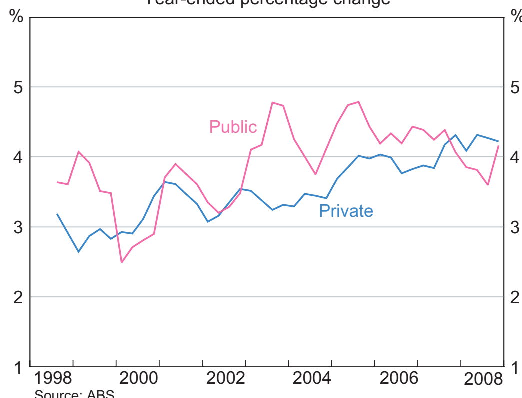
Tradables inflation (excluding food and fuel) picked up in the quarter to 0.9 per cent and 2.0 per cent over the year, which is the fastest year-ended pace since mid 2002 (Graph 75). This reflected a broad-based boost to the price of imported items from the exchange rate depreciation in the second half of 2008, along with a reduction in discounting of motor vehicle prices. In contrast, non-tradables inflation has slowed from its earlier rapid pace. Abstracting from the sharp fall in deposit & loan facilities prices, non-tradables prices rose by 1.0 per cent, following a similar increase in the December quarter and rates of around 1½ per cent in previous quarters.



Costs and margins

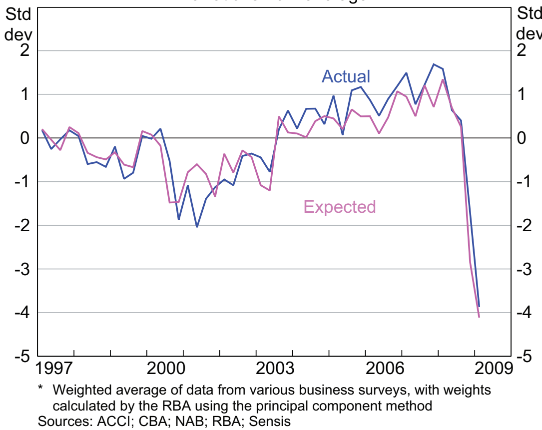
According to official measures, labour costs continued to grow at a firm pace in late 2008. However, this likely reflects wage setting decisions that were taken before the extent of the economic downturn became fully apparent. More timely indicators from business surveys and liaison suggest a noticeable slowing in labour cost growth during 2009, consistent with the weakening conditions in the labour market.

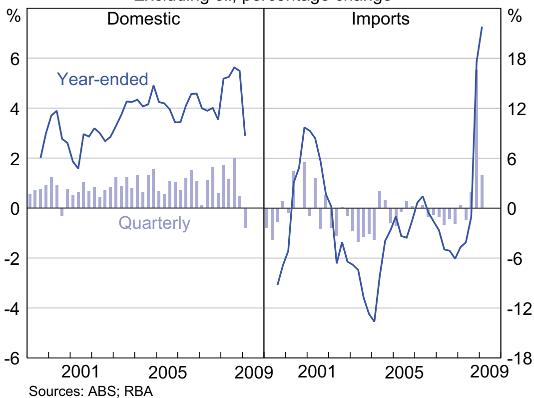
The wage price index (WPI) increased by 1.2 per cent in the December quarter and by 4.3 per cent over the year. Growth in the public-sector component was particularly strong in the quarter at 1.4 per cent, compared with 0.9 per cent in the previous quarter (Graph 76). This is partly explained by timing issues, as some major public-sector agreements that had been delayed due to protracted negotiations took effect in the quarter. The private-sector component grew by 1.1 per cent in the quarter, around the rates recorded in the past couple of years, to be 4.2 per cent higher over the year. The strongest annual growth in the WPI continued to be in Western Australia, where wages grew by 5.7 per cent. Other measures of wages – the national accounts measure of average earnings, the average weekly



earnings survey measures, and those in federal enterprise bargaining agreements – also grew at an above-average pace in the quarter.

Although these measures all suggest that wage growth was solid in the final quarter of 2008, a range of business surveys suggest that growth in labour costs is likely to fall in coming quarters, although these surveys may be capturing expected falls in the number of employees as well (Graph 77). The Bank's liaison with firms also suggests that wage pressures have begun to ease. This is consistent with reports of some firms restraining labour costs by postponing pay rises and implementing wage freezes. Overall, the wage setting environment may be more responsive to economic conditions than in past downturns, which should help to moderate the fall in employment over the coming year or so.

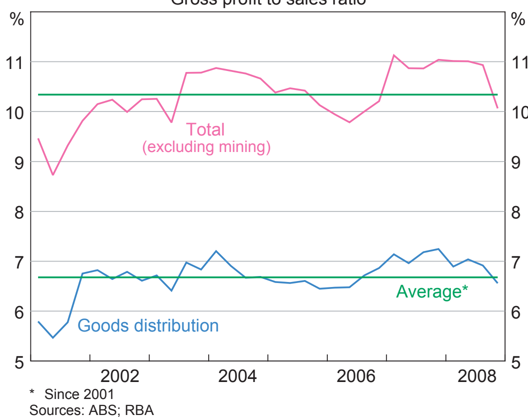




Upstream price pressures eased considerably in the March quarter, driven by a fall in construction prices and a sharp decline in prices for commodities and related items (Graph 78). At the preliminary stage, producer prices fell by 4.6 per cent in the quarter, driven by large falls in the prices of a range of resources (oil & gas, non-ferrous metals and iron & steel). At the final stage (excluding oil), producer prices fell by 0.2 per cent, to be 5.2 per cent higher over the year. Final-stage domestic prices fell by 0.8 per cent in the quarter, which is the first fall in domestic prices since September 2000 and largely reflects substantial declines in building prices. In contrast, final-stage import prices rose by 4 per cent due to the ongoing effects of the currency depreciation in the second half of 2008, which more than offset any weakness in world prices flowing from the global economic downturn. Manufacturing prices fell due to declines in petroleum and basic metals prices, as well as for some foodstuffs, with a partial offset from

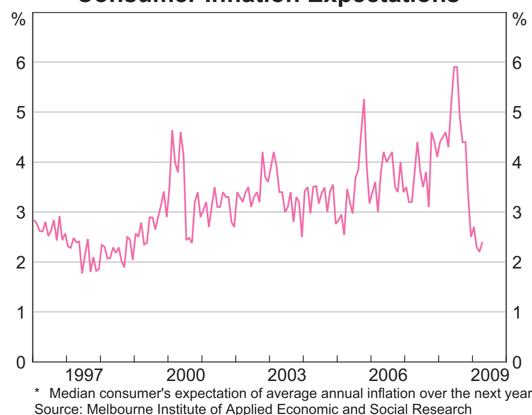
higher prices for industrial machinery & equipment. In the construction industry, the decline in prices was broad-based across both residential and non-residential sectors, and came despite persistent inflation in input costs. Property services and transport & storage prices both fell by around 2–2½ per cent, while business services prices rose.

Data on business margins, based on ABS profits data, suggest that margins in both the broader economy and the goods distribution sector – which includes retail & wholesale trade and transport – narrowed in late 2008, to be slightly below the average level of recent years (Graph 79). The NAB survey suggests that margins remained at below-average levels in the March quarter, consistent with the Bank's liaison with firms, which points to considerable pressure on margins across a range of industries. Distributors and retailers continue to report that soft consumer demand and ongoing competitive pressures are making it difficult to fully pass on the higher cost of imports.



Inflation expectations

Inflation expectations are currently below the average of the past decade or so, after they were well above average in late 2007 and the first half of 2008 (Graph 80). Consumer inflation expectations, as measured by the Melbourne Institute survey, have been between 2 and 2½ per cent in recent months after peaking at around 6 per cent in mid 2008. Measures of inflation expectations derived from financial markets have been around 2–2½ per cent in recent months.



Market economists surveyed by the Bank following the release of the March quarter CPI expect inflation to moderate further in the near term. The median expectation for headline inflation over the year to

Table 15: Median Inflation Expectations
Per cent

	Year to December 2009			Year to December 2010	
	November 2008	February 2009	May 2009	February 2009	May 2009
Market economists[(a)]	2.6	2.5	2.1	2.4	2.4
Union officials[(b)]	4.1	3.0	2.1	3.0	2.7

(a) RBA survey
(b) Workplace Research Centre

the December quarter 2009 is now 2.1 per cent, compared with 2.5 per cent in February (Table 15). Over the year to the December quarter 2010, the median inflation expectation is 2.4 per cent, unchanged from February. Surveys of both businesses and union officials also generally suggest that inflation expectations have fallen noticeably in recent months.

Economic Outlook

Activity in the international and domestic economies has been weaker than was envisaged in the February *Statement*. The Bank's revised forecasts for the Australian economy show a fall in GDP in the first half of this year, and a recovery beginning in late 2009. With output expected to remain below trend for an extended period, the inflation forecasts have also been revised down. Underlying inflation is expected to decline gradually to around 1½ per cent by end 2011. As in past *Statements*, the forecasts do not incorporate any effects from the Government's Carbon Pollution Reduction Scheme.[1]

The international economy

The recent weak outcomes for the world economy imply a downward revision to the 2009 year-average forecast for global growth. The magnitude and synchronisation of the contractions in output and trade seen in the December and March quarters reflect a substantial decline in confidence, particularly among businesses, following the extreme events in financial markets in September 2008. This loss of confidence and the significant rise in risk aversion magnified the slowing that was already underway in the major advanced economies flowing from the problems in the US sub-prime mortgage market.

Given the unprecedented nature of the current circumstances, any set of forecasts is inevitably subject to a high degree of uncertainty. That said, the Bank's central forecast is based on the view that the signs of stronger growth in China and early signs of stabilisation in east Asia and the United States will prove durable, as the extraordinary fiscal and monetary policy measures and the efforts to resolve the problems in the US financial system begin to have greater effect. Accordingly, modest growth in the advanced economies is expected to resume around the end of this year, following an overall contraction in G7 GDP of over 5 per cent. Average growth in Australia's non-G7 trading partners is expected to be somewhat stronger, reflecting both a slightly earlier recovery of some east Asian economies and the stronger performance of China and India. In year-average terms, output in Australia's major trading partners is projected to contract by around 2¾ per cent in 2009 on an export-weighted basis, compared with growth averaging around 5 per cent in 2006 and 2007 (Graph 81). These forecasts are a little weaker than implied by the forecasts released by the IMF in late April.

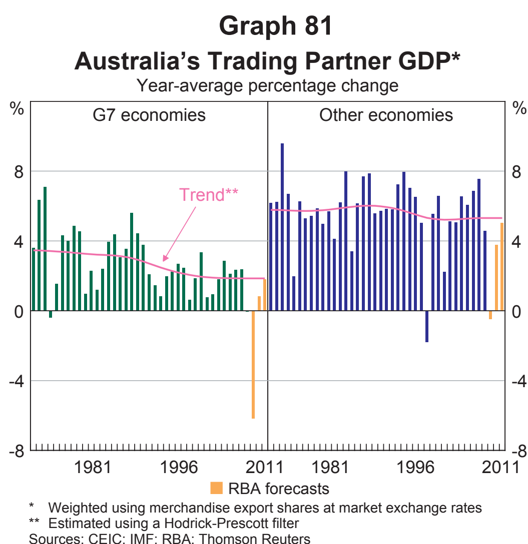
The recovery in world growth in 2010 and 2011 is assumed to be relatively subdued, in contrast to the strong bounce-back typically seen after earlier recessions. This is consistent with past experiences in the aftermath of financial crises. An additional element constraining the recovery will be the pressures on budget positions of some of the major advanced economies, which may require fiscal consolidation at an early stage in the recovery.

1 *For further details, see 'Box C: Climate Change Mitigation Policy and the Macroeconomy' in the February 2009* Statement on Monetary Policy.

Graph 81

Australia's Trading Partner GDP*

Year-average percentage change



* Weighted using merchandise export shares at market exchange rates

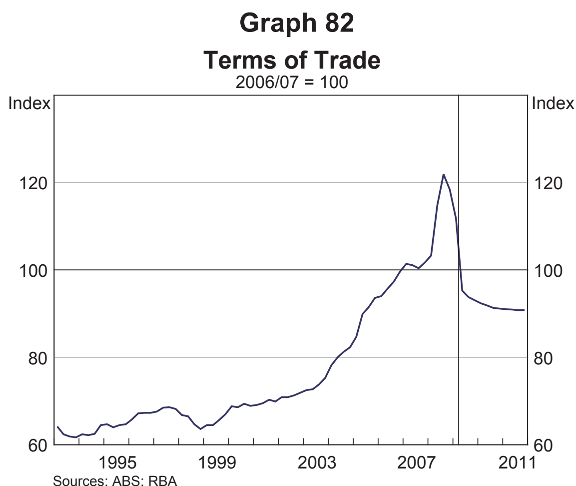
** Estimated using a Hodrick-Prescott filter

Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 82

Terms of Trade

2006/07 = 100



Sources: ABS; RBA

The weakness in the world economy has been reflected in a softening in commodity markets. Recently agreed contracts for coal prices entail falls of 45–60 per cent relative to the 2008/09 contracts, although prices remain above the levels of the 2007/08 contracts. Iron ore export prices are also expected to fall significantly, but to remain high by historical standards. These falls mean that a significant decline in Australia's terms of trade is taking place, which will weigh on domestic incomes over 2009 (Graph 82). Nonetheless, while a terms of trade decline of around 20 per cent is expected through 2009, this would still mean that the terms of trade are 40 per cent above the average level that prevailed between 1980 and 2000.

Domestic activity

As usual, the forecasts are prepared based on a number of technical assumptions. These include the cash rate and exchange rate remaining at their current levels, and oil prices broadly in line with near-term futures pricing. The forecasts also incorporate fiscal policy decisions announced in late 2008 and early 2009, and some impact from the early stages of the implementation of the national broadband network program. In addition, some modest additional stimulus from the 2009/10 federal budget has been assumed.

Indicators of domestic activity, information from the Bank's liaison program and business surveys all suggest that the economy has been contracting since late 2008. A significant contraction in GDP is estimated for the first half of 2009, with the peak-to-trough contraction in GDP a little smaller than during the recession in the early 1990s. The economy is forecast to begin to grow from late 2009, although the recovery is expected to be gradual, partly reflecting the slow recovery in global demand (Table 16). In year-average terms, GDP is forecast to decline by ½ per cent in 2009/10 before growing by 2¼ per cent in 2010/11.

Factors that would suggest a less severe recession here than in many other countries include the bigger decline in interest rates to end-borrowers, the healthier state of the financial sector,

Table 16: Output and Inflation Forecasts[(a)]
Percentage change over year to quarter shown

	Dec 2008	June 2009	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011
GDP	0.3	–1¼	–1	½	2	3¼	3¾
Non-farm GDP	0.0	–1½	–1	½	2	3¼	3¾
CPI	3.7	1½	2¼	2½	2	1½	1½
Underlying inflation	4.3	3¾	3¼	2½	2	1½	1½

(a) Actual data to December 2008. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.75, TWI at 61, cash rate at 3.00 per cent, and WTI crude oil price at US$65 per barrel and Tapis crude oil price at US$67 per barrel.
Sources: ABS; RBA

Australia's export mix (a relatively low share of exports of capital goods and high-value manufactures, where global trade has fallen most), the recent recovery in the Chinese economy, and the exchange rate depreciation in the second half of 2008.

On the other hand, Australia's terms of trade have fallen significantly. The combination of a contraction in real GDP and the sharp fall in the terms of trade implies a significant fall – around 5 per cent – in nominal incomes over the first half of 2009. Of course, part of the income losses will be shared with foreign investors, just as the preceding gains were. In addition, the impact on the level of real production in the economy will be partly dampened by the depreciation of the exchange rate that has occurred since mid 2008. Nevertheless, just as the run-up in the terms of trade in recent years was stimulatory for the economy, the current fall will be a contractionary force. The effect on the domestic economy is through a number of channels, including reduced business investment as a result of lower profitability and less demand for commodities, and falls in household wealth and consumption as a result of falls in the equity prices of resource companies. Reduced government revenues from company taxes will also have implications for government finances. Given that significant falls in bulk commodity prices have been expected since late last year, some of these effects are already being felt, although there will also be significant ongoing effects.

Growth in household spending is expected to remain subdued over much of the forecast period, given the deterioration of the labour market and large decline in household net worth over the past year. This implies a higher household saving rate over the forecast period relative to recent years, albeit below the level recorded in the December quarter. Consumption spending has been supported in the first half of 2009 by the government payments to households, but is forecast to soften as the labour market deteriorates. Growth in consumption is expected to return to more normal rates by late 2010 as the economy recovers. Dwelling investment is contracting significantly in the first half of 2009, although the increases in first-home buyer grants and the significant falls in borrowing rates are expected to contribute to some growth in dwelling investment from late 2009.

Business investment is forecast to fall significantly, particularly over the next year. Consistent with the recent weakness in capital imports, building approvals and commencements, non-residential building and spending on plant and equipment are estimated to have begun to decline

in the first half of 2009. Particular weakness is expected for large construction projects such as offices and warehouses where, in addition to the weak level of demand, developers are having greater difficulty accessing finance. The falls in commodity prices and resource share prices are also expected to result in a significant scaling-back of mining-related investment. Given the substantial amount of work in the pipeline, engineering construction appears likely to remain at high levels in 2009, but to fall significantly in 2010. Offsetting part of this expected weakness, announced public investment plans for education, rail, road and communications infrastructure spending are likely to provide significant support in the coming period.

Exports of resources, manufactures and services are also forecast to contract through most of 2009. However, given the depreciation of the exchange rate from earlier peaks and the large build-up of production capacity in recent years, non-rural exports are expected to grow strongly towards the end of the forecast period once global growth recovers.

Reflecting the slowing in domestic activity, conditions in the labour market have weakened since late 2008. Business survey measures of hiring intentions have declined to their lowest levels since the early 1990s, and job advertisements have continued to fall. In trend terms, employment is now contracting and the unemployment rate rising, with a further deterioration expected in coming quarters.

Inflation

Relative to the February *Statement*, the inflation forecasts incorporate a weaker outlook for global and domestic growth, a higher exchange rate and higher oil prices. The net effect has been a downward revision to the inflation forecasts.

Underlying inflation has begun to moderate in year-ended terms, albeit from quite high levels, and further easing in price pressures is expected as excess capacity increases. With the unemployment rate projected to rise significantly, labour costs can be expected to abate; evidence from business surveys and liaison suggests that this may already be underway. Measures of inflation expectations have declined significantly since mid 2008, which should also contribute to the projected decline in inflation pressures.

While a significant decline in underlying inflation is expected, this decline is forecast to be gradual. Price pressures for non-tradables goods and services have been significant and broad-based in recent years, and have begun to clearly moderate only in the past two quarters. It will take time for rising spare capacity in the domestic economy to translate fully into lower non-tradables inflation. Further, inflation in tradable goods prices picked up in the March quarter, and this firmer pace is likely to continue for at least the next year, reflecting the sharp increase in import prices following the exchange rate depreciation in the second half of 2008. Overall, year-ended underlying inflation is expected to decline to a low of around 1½ per cent in 2011.

The near-term profile for year-ended CPI inflation will be significantly affected by movements in a few CPI components. In particular, the large falls in petrol prices and the ABS estimate of deposit & loan facilities prices from their peaks in the September quarter 2008 will together subtract up to 2 percentage points from inflation in the year to the September quarter 2009, when year-ended CPI inflation is expected to fall to below 1½ per cent. However, these particular

effects should drop out of the calculation of the annual rate by early 2010, after which CPI inflation is forecast to move in line with the forecast for underlying inflation.

Risks

Given the speed with which the outlook has deteriorated over the past six months and the extraordinary policy responses that have followed, these central forecasts are subject to a number of significant near-term risks. One is that further bad news emerges about the US and European financial systems, undermining the gradual recovery in confidence and causing a further increase in risk aversion. If this were to occur, the scope for policy-makers in many advanced countries to take further steps to restore confidence may be constrained by the already large fiscal deficits and the fact that interest rates in many countries are already close to zero. Another downside risk is that the recent signs of recovery in China do not turn out to be durable.

In the other direction, significant policy stimulus has been put in place in many countries and there has been a more positive tone in financial markets recently. There is some possibility that as signs of stabilisation emerge, and the lack of confidence and risk aversion that has characterised the world economy over recent months is reversed, firms that have delayed investment plans will decide to move forward more quickly than currently expected, contributing to a stronger global recovery. ✠