STATEMENT ON MONETARY POLICY

Inflation in Australia has remained high in the recent period against a background of tight capacity and earlier strong growth in demand. In these circumstances, the Board has been seeking to restrain demand in order to reduce inflation over time.

Recent indications are that a significant moderation in domestic demand is now occurring. In addition to the effects of tighter financial conditions, other factors including a slowing in global growth, declining asset markets and higher fuel costs are acting to restrain domestic spending and activity. At the same time, high global commodity prices are adding to Australia's terms of trade, and this is providing a significant countervailing influence. Prospects for growth of the Australian economy and for inflation will continue to depend on the net effects flowing from these opposing forces.

The slowdown in global growth has, to date, been most evident in the major advanced economies, but there are some recent signs that emerging economies are also being affected. In the United States, growth continues to be dampened by a sharp downturn in the housing sector, though the economy overall expanded modestly in the first half of 2008. Conditions in both Japan and the euro area have weakened noticeably since the start of the year. The Chinese economy to date has continued to grow rapidly, though the pace has eased somewhat since last year. While China's domestic spending has maintained a strong pace of growth, its exports to the major economies have slowed. Growth in other emerging economies has generally remained strong, though there have been signs of moderation in some cases. Official and private sector observers generally expect global growth to be well below the pace of recent years in both 2008 and 2009.

Despite the indications of weaker demand in a number of economies, inflation remains a significant concern. Higher food and energy prices have contributed to a pick-up in consumer price inflation rates around the world over the past year, but in a number of emerging economies broader inflationary forces appear to have emerged. Reflecting these developments, monetary policy has been tightened recently in a number of these economies. In addition, the ECB increased its policy interest rate in July, and market expectations in the United States have also shifted towards tightening.

Global credit market concerns have again come to the fore in recent months. In the United States, the federal mortgage agencies have come under severe stress, a number of relatively small banks have failed, and significant asset write-downs in the financial sector have continued. Loan delinquency rates in the United States have been rising, including on prime mortgages. More broadly, credit expansion has slowed noticeably in a number of the major economies. The focus now is on the interaction between the financial sector and the wider economy. That is, as growth slows in a number of regions of the world economy, loan losses are likely to increase, which could further weaken financial institutions, hampering the provision of credit and potentially amplifying the economic slowdown.

Partly reflecting these concerns, global equity markets have recorded large falls over the past three months, with financial stocks the most heavily affected. Notwithstanding increases in provisions by some Australian banks, the local banking system remains in much stronger condition than its international counterparts. Markets did not exhibit much tendency to draw these distinctions, however, and share prices of Australian banks also declined.

Notwithstanding these developments, money market conditions have tended to stabilise or even improve a little recently, both internationally and domestically. Bond issuance by domestic borrowers has been strong, and there has been some activity in the RMBS market.

Overall, market developments have continued to result in some tightening in domestic financial conditions in recent months. Banks have experienced increases in their funding costs, and in July they raised their variable mortgage rates by a further 15 basis points. This has brought the total increase in mortgage rates since the middle of last year to a little over 150 basis points, of which 100 basis points was in response to increases in the cash rate. Other developments, including higher risk spreads in corporate bond markets, falling equity prices and tougher lending standards, have added to the tightening in domestic financial conditions.

Global commodity prices have remained high over recent months, though they have generally come off their peaks. Most notably, oil prices have retraced some of their earlier upward movement to be trading recently around US$120 a barrel, down from a peak of US$146 in early July. Base metals prices have also fallen recently, as have prices for wheat and wool. At the same time, sharply higher contract prices for coal and iron ore have now come into effect. In net terms, Australia's terms of trade are estimated to have risen by a further 20 per cent since the start of the year, and by a cumulative 65 per cent over the past five years. The income gains from this source continue to represent a significant stimulus to the economy.

The Australian economy has, until fairly recently, been in an extended period of strong growth in demand and activity, marked by increasing pressures on available productive capacity. National accounts data indicate that the economy grew strongly through 2007, and indicators of capacity utilisation and labour scarcity in the early part of this year were generally close to cyclical peaks. It is against this background, in combination with rising global commodity prices, that inflation in Australia has increased. The March quarter national accounts indicated some slowing in the overall pace of growth, though domestic spending in the quarter was still estimated to be quite strong.

Other more timely information confirms that a significant moderation in spending and activity is now underway. This has been most noticeable to date in the household sector. Retail sales volumes declined further in the June quarter following the small fall recorded in the March quarter, and consumer sentiment has fallen markedly in recent months. Rising fuel costs are likely to have contributed to the moderation in consumer spending, though an offsetting factor in the second half of the year will be the tax cuts that came into effect on 1 July. In the housing sector, forward indicators point to declines in construction activity in the near term. Conditions in the established housing market have also softened, with house prices falling slightly in the June quarter. Consistent with a softer market, auction clearance rates in Sydney and Melbourne have been well below last year's levels, though they do not appear to have fallen further in

the latest couple of months. The combination of falls in housing and equity prices means that household net wealth has declined in the first half of this year.

Indicators of business conditions have also declined over recent months. Surveys suggest that trading conditions in the June quarter returned to around average levels, down from the very strong levels that prevailed around the start of the year. Measures of capacity utilisation have started to fall, though they remain high. The latest indications of investment intentions are still relatively strong, though some scaling back of existing plans should probably be expected given recent declines in confidence and softer household demand. In the farm sector, the outlook is highly uncertain. Significant rainfall will be needed in the next couple of months if there is to be a substantial recovery in production from the drought-affected levels of the past two years.

At this stage, the general moderation in domestic conditions has been less evident in labour market indicators. Nonetheless, there are some early signs that demand for labour has begun to ease. While unemployment remains low, the pace of employment growth has slowed over recent months and there has been some softening in indicators of job vacancies and hiring intentions.

Tighter financial conditions and softening domestic demand have been associated with a sharp slowing in credit expansion to both households and businesses. Housing loan approvals have fallen significantly over the past few months, consistent with the weaker conditions prevailing in the established housing market, and overall growth in household credit has now slowed to a pace broadly in line with the growth in incomes. The most recent increase in mortgage lending rates can be expected to have some additional dampening effect. In the business sector, the overall growth of debt, from intermediated and non-intermediated sources, has slowed sharply in the first half of this year. While this has partly reflected a falling away in corporate merger activity, it also appears consistent with some scaling back in investment growth.

It is too early yet for these recent trends to have had a noticeable restraining effect on Australia's inflation rate. The June quarter CPI increase was unexpectedly high at 1.5 per cent in the quarter, for a year-ended rate of 4.5 per cent. This result needs to be interpreted with some caution, as it was boosted by a one-time correction to the financial services component. But even allowing for that, both the CPI and underlying measures suggest that inflation has remained high. Adjusting for this effect, underlying measures were a little over 1 per cent in the quarter, about the same as the March quarter result, and around 4 per cent over the year. A further strong increase in petrol prices added to the quarterly CPI, but this was offset by falls in other volatile prices, notably for fruit and vegetables. Price pressures remained strong in the non-tradables sector, where the largest contributions to the June quarter increase came from rents, house purchase and health-care costs. Producer price data also suggest that upstream price increases have remained firm, reflecting both increases in raw materials prices over the past year and higher output prices across a range of industries. To date, however, the rate of growth in aggregate wages has remained fairly stable, despite the increase in CPI inflation and generally tight labour market conditions.

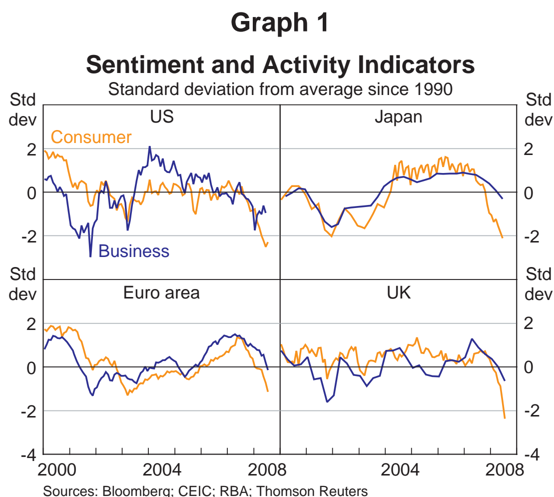
In its recent policy deliberations, the Board has focused on both the risk that inflation may remain uncomfortably high, and on the accumulating evidence of a slowing in domestic demand and activity. Given the earlier background of strong growth in domestic spending and increasing pressure on productive capacity, the Board has for some time been seeking to restrain demand,

and this has required a period of quite restrictive monetary policy. The evidence to date is that a significant moderation in demand is now occurring, and it is looking more likely that demand will remain subdued, and economic growth will be fairly slow, in the period ahead.

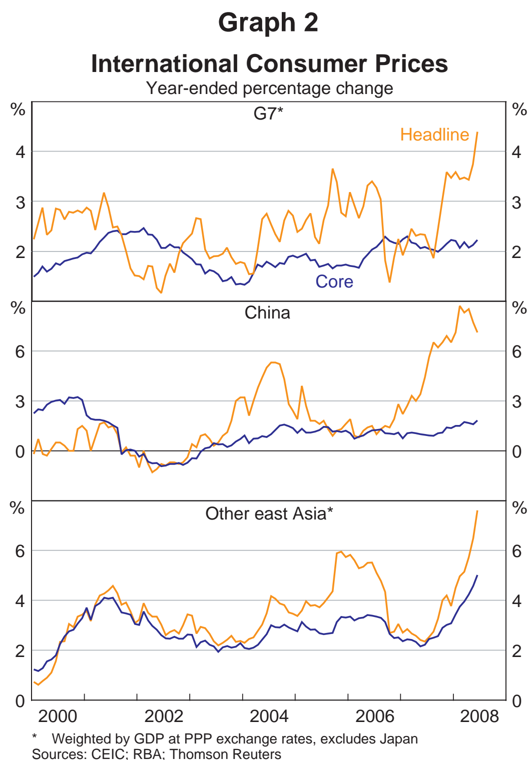
While inflation is likely to remain high in the short term, the Board judged at its August meeting that demand was slowing to an extent that could be expected to bring about a significant reduction in inflation over time. On this basis the Board decided that the existing monetary policy setting was appropriate for the time being. On the assumption that the subdued demand conditions are likely to continue, scope to move to a less restrictive monetary policy stance in the period ahead is increasing. The Board will continue to monitor developments and make adjustments as required in order to promote sustainable growth consistent with the medium-term inflation target of 2–3 per cent.

International Economic Developments

World economic growth has continued to moderate in the period since the May *Statement*, with measures of household and business confidence now at quite low levels in the major developed economies (Graph 1). Stresses in credit and equity markets have continued, and are being reflected in a slowing in lending growth in the major economies. However, consumer price inflation has increased further, reducing the scope for monetary authorities to lean against the economic slowdown (Graph 2).



Activity in the United States remains weak as financial turbulence continues to weigh on growth. The rate of growth in Europe and Japan has slowed and business sector indicators have deteriorated, narrowing the dichotomy that had existed for some time between relatively resilient measures of business sector activity and generally weak indicators of household spending and sentiment. The slowing in activity in developed economies has occurred against the backdrop of a further pick-up in inflation, although in most countries this pick-up has thus far been driven primarily by increases in oil and food prices.



In contrast to the developed economies, activity remains strong in most emerging markets, especially the oil-exporting nations that have been the beneficiary of the sharp rise

in crude oil prices over recent years. Nonetheless, there are signs that the rate of growth in China, India and other parts of east Asia has moderated somewhat, due in part to the dampening effect of slowing growth in the developed world on these countries' export sectors. In a number of emerging market economies, price pressures have become more broad-based, with consumer price inflation rising markedly even after abstracting from increases in oil and food prices.

Reflecting these developments, the IMF forecasts published in July show global growth of around 4 per cent in both 2008 and 2009 (Table 1). These forecasts were slightly stronger for 2008 than those published in April – reflecting better-than-expected growth in the March quarter – but little changed for 2009. If achieved, these growth rates would be well below the strong outcomes seen in recent years, but still above the global growth rates recorded during the slowdown in the early part of this decade. The Bank's forecasts for the domestic economy assume a similar outlook for global growth in 2008, but a weaker outlook for 2009 than both Consensus and the IMF (see the 'Economic Outlook' chapter for details).

Table 1: World GDP

Year-average percentage change[(a)]

	2006	2007	2008	2009
			IMF forecasts[(d)]	
United States	2.9	2.2	1.3	0.8
Euro area	2.9	2.7	1.7	1.2
Japan	2.4	2.1	1.5	1.5
China	11.6	11.9	9.7	9.8
Other east Asia[(b)]	5.5	5.8	4.7	4.8
India	9.8	9.3	8.0	8.0
World	**5.1**	**5.0**	**4.1**	**3.9**
Australia's trading partners[(c)]	5.1	5.4	4.2	4.2

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Weighted using GDP at market exchange rates
(c) Weighted using merchandise export shares
(d) Forecasts from the 18 July *World Economic Outlook (WEO) Update*
Sources: CEIC; IMF; RBA; Thomson Reuters

Major developed economies

Conditions in the United States remain weak, with continuing falls in employment, housing market activity and consumer sentiment over recent months. The preliminary June quarter national accounts suggest that GDP growth was a little stronger than in the previous two quarters (Graph 3), although growth in domestic demand remained weak. Exports continued to grow strongly, supported by the weaker US dollar.

Private consumption spending during the June quarter was supported by the federal government's economic stimulus package, with around US$92 billion of tax rebates, or 0.9 per cent of annual household disposable income, paid to households between late April and the end of July. However, the impact of this stimulus is expected to fade in coming months. Despite the stimulus, consumer confidence is very low, and a period of household balance sheet repair now appears to be underway, as consumers adjust to higher inflation, rising unemployment and sizeable declines in financial and housing wealth (Graph 4).

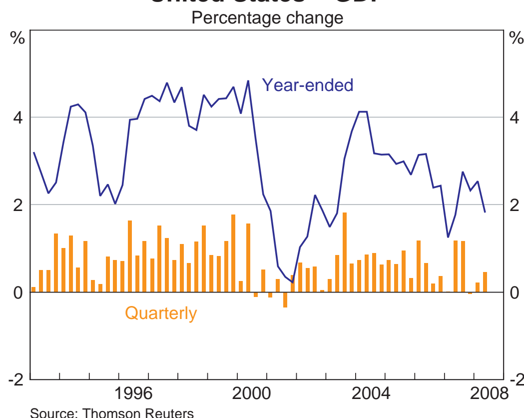
Labour market conditions are generally soft. The unemployment rate has risen by 1.3 percentage points from its low in early 2007, to 5.7 per cent in July. Payrolls employment has declined in each month since the start of the year, although job losses to date remain concentrated in the construction and manufacturing sectors and have occurred at a relatively mild pace by the standards of previous downturns (Graph 5).

Activity in the housing sector continues to be especially weak. The stock of unsold homes remains high and house prices continue to decline, with the precise size of the nationwide fall varying amongst the different measures. The Case-Shiller house price index is now 18 per cent below its peak in mid 2006, but this measure only covers houses sold in 20 major cities and appears to be overstating movements in the broader market. The more geographically representative purchase-only house price measure of the Office of Federal Housing Enterprise Oversight (OFHEO) suggests a more modest decline thus far from its peak, of around 5 per cent. However, this measure is likely to be understating the overall national decline due to its exclusion of home sales with sub-prime financing, where the extent of market distress appears to be greatest. The median house price measure produced by the National Association of Realtors shows a total decline to date of 12 per cent since late 2005.

Graph 3

United States – GDP

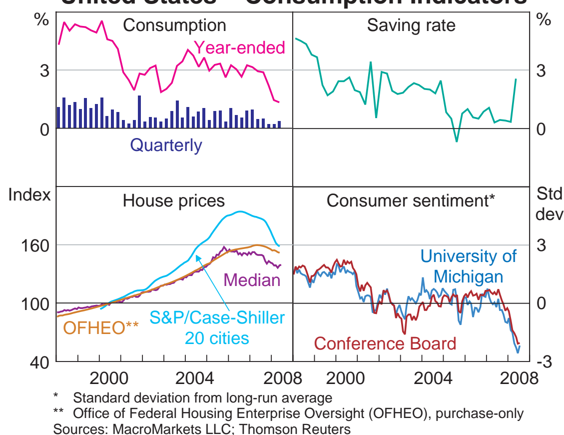
Percentage change



Source: Thomson Reuters

Graph 4

United States – Consumption Indicators



* Standard deviation from long-run average

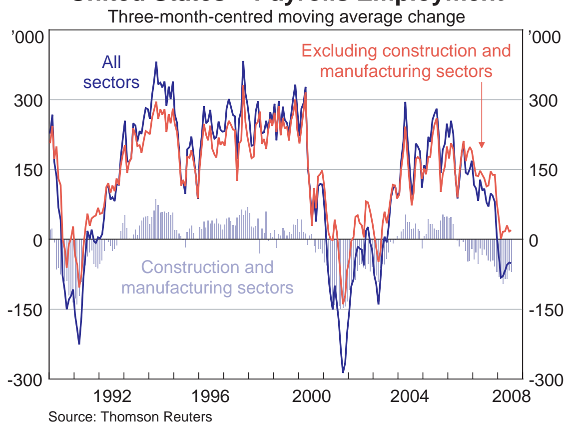
** Office of Federal Housing Enterprise Oversight (OFHEO), purchase-only

Sources: MacroMarkets LLC; Thomson Reuters

Graph 5

United States – Payrolls Employment

Three-month-centred moving average change

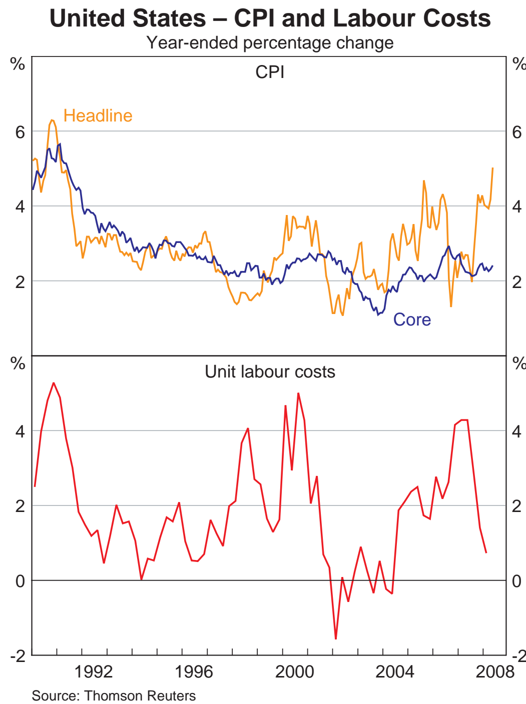


Source: Thomson Reuters

Graph 6

United States – CPI and Labour Costs

Year-ended percentage change



Source: Thomson Reuters

Increases in food and energy prices have contributed to a rise in consumer price inflation to 5.0 per cent in the year to June, the highest rate seen since the early 1990s (Graph 6). However, unit labour cost growth has moderated over the past year and the Federal Reserve expects inflation to moderate later this year and next.

In Japan and the euro area, conditions have weakened recently following unexpectedly strong growth in the March quarter. In Japan, business investment intentions for the current fiscal year have deteriorated as sentiment has continued to decline, especially among small- and medium-sized firms. Household sentiment also remains very weak and residential investment has remained low.

In the euro area, the pace of growth in industrial production has declined sharply in recent months and there are indications that the strength of the euro is hampering exports. Retail sales growth and household sentiment are low, and housing activity in a number of countries has deteriorated significantly. Developments in the UK housing market have also been negative; the Nationwide House Price Index is down by around 10 per cent from its peak in October 2007 and housing loan approvals are well below the levels seen during the early 1990s recession. Nevertheless, consumer price inflation in Europe has risen, resulting in concerns that high headline inflation might become embedded in inflation expectations and wage growth. Year-ended consumer price inflation has reached 4.1 per cent in the euro area, and 3.8 per cent in the UK. The ECB raised its policy rate by 25 basis points in early July.

Other major trading partners

After a very rapid expansion in 2006 and 2007, growth in China has recently slowed somewhat. Year-ended growth has declined from a peak of over 12 per cent in mid 2007 to around 10 per cent in the June quarter of this year. While part of the slowdown can be attributed to a series of natural disasters (major snowstorms, the earthquake in Sichuan province and recent floods in southern China), it also reflects a pronounced fall in the growth of export volumes to the major developed economies (Graph 7). Nevertheless, indicators of domestic demand generally remain strong. Nominal spending on fixed-asset investment increased by 30 per cent over the year to June and retail sales volumes are estimated to have grown by around 16 per cent over the same period. In India, the pace of expansion has also declined slightly from the rapid rates of recent

years, and industrial production growth has shown a more marked slowdown over the past few months. Despite this slowing, wholesale price inflation has recently increased, to be almost 12 per cent in year-ended terms in June.

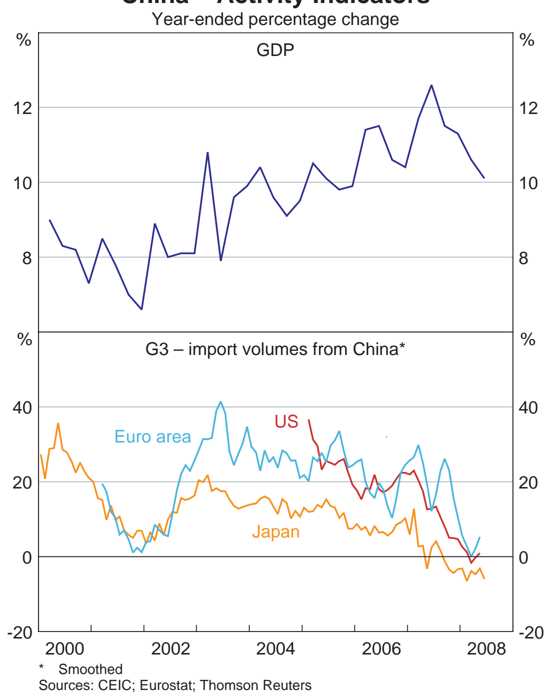
Elsewhere in the Asian region, growth appears to have remained solid in the first half of 2008, albeit also below the strong pace of recent years. Over the six months to May, industrial production growth in east Asia (excluding China) slowed significantly. Although growth in export values from this region has picked up over the same period, slowing world growth is likely to weigh on export volumes growth in the period ahead. Having provided a strong impetus to economic activity in 2007, domestic demand growth in east Asia (excluding China) no longer appears to be running above trend, and is being affected by a deterioration in the terms of trade in most countries, with rising prices for energy eroding households' real purchasing power (Graph 8).

Consumer price inflation has risen in many east Asian economies, with year-ended inflation above 9 per cent in Indonesia, the Philippines and Thailand. Recent decisions by a number of countries – including China, Indonesia, Malaysia and Thailand – to scale back the extent of their subsidies for a range of petroleum and energy products are expected to result in further increases in consumer prices in the near term. Core inflation measures – which generally abstract from the sharp rises in the prices of food and energy – have also risen markedly across much of east Asia in recent months. With real interest rates low or negative in many Asian countries, even measured using core inflation, various central banks have become concerned about the risk of higher inflation

Graph 7

China – Activity Indicators

Year-ended percentage change



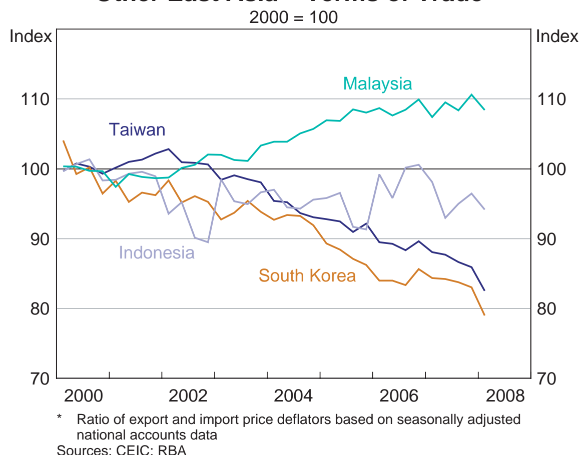
* Smoothed

Sources: CEIC; Eurostat; Thomson Reuters

Graph 8

Other East Asia – Terms of Trade*

2000 = 100



* Ratio of export and import price deflators based on seasonally adjusted national accounts data

Sources: CEIC; RBA

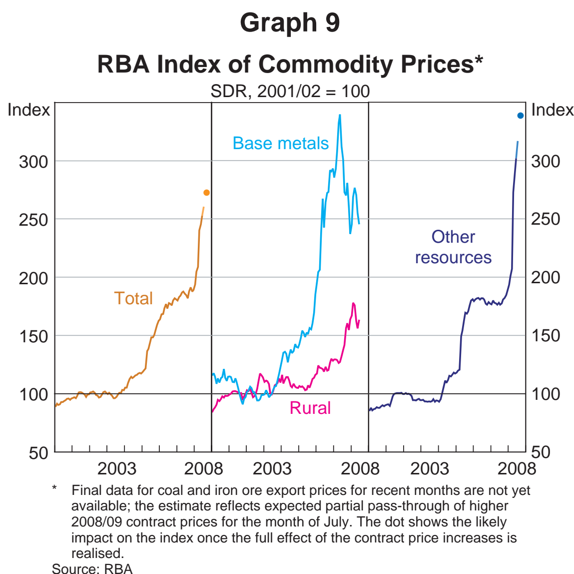
becoming entrenched. Since the May *Statement*, interest rates have been increased in India, Indonesia, the Philippines, Taiwan and Thailand.

Growth in the New Zealand economy has slowed sharply since the start of the year. GDP contracted in the March quarter and recent indicators suggest that activity remained subdued in the June quarter. Retail sales in April and May combined were weak and conditions in the housing market have continued to deteriorate, with house sales in June more than 50 per cent below end-2006 levels and the value of housing loan approvals down 30 per cent over the year to July. Year-ended CPI inflation rose to 4 per cent in the June quarter. Despite expectations that inflation will increase further in the near term, the Reserve Bank of New Zealand cut the cash rate by 25 basis points in late July, citing a deterioration in the international financial environment and the risk of a further weakening in domestic activity.

Commodity prices

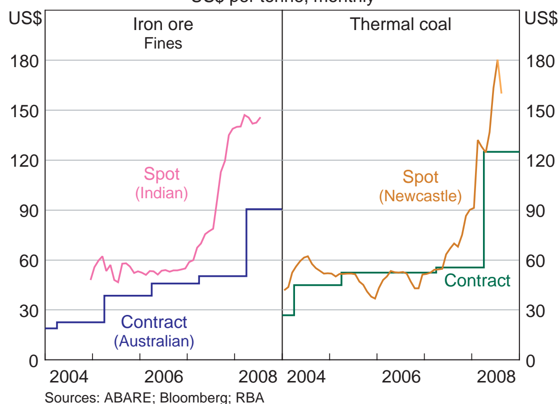
Developments in commodities markets have been mixed in recent months. Oil prices rose to nearly US$150 per barrel in early July, close to double the level of a year earlier, although they have since fallen back to around US$119 per barrel, which is around the same level as at the time of the May *Statement*. Nevertheless, prices remain around 60 per cent above the average level in 2007, reflecting a combination of strong demand from developing economies, a muted supply response and the depreciation of the US dollar.

The RBA's index of commodity prices (which excludes oil) has risen by an estimated 35 per cent (in SDR terms) since the beginning of the year, mostly reflecting the increased contract prices for coal and iron ore, and has increased by more than 160 per cent over the past five years (Graph 9). Abstracting from coal and iron ore prices, the index would be down modestly since the time of the May *Statement* but around 80 per cent higher over the past five years.



Australian producers have negotiated an average 85 per cent increase in 2008/09 contract prices for iron ore with Asian steel mills (applied retrospectively from April). Spot prices are currently well above 2008/09 contract prices (Graph 10). The outlook for coal prices has also strengthened in recent months. Although some of the developments that led to the sharp increase in contract prices earlier this year – averaging around 125 per cent for thermal coal and 220 per cent for coking coal – were transitory, the ongoing lack of spare capacity in these markets has left them extremely tight. Broad-based

strength in energy prices, coupled with uncertainty surrounding supply, has contributed to strong increases in thermal coal prices on the spot market, which are currently 30 per cent above the new contract price.

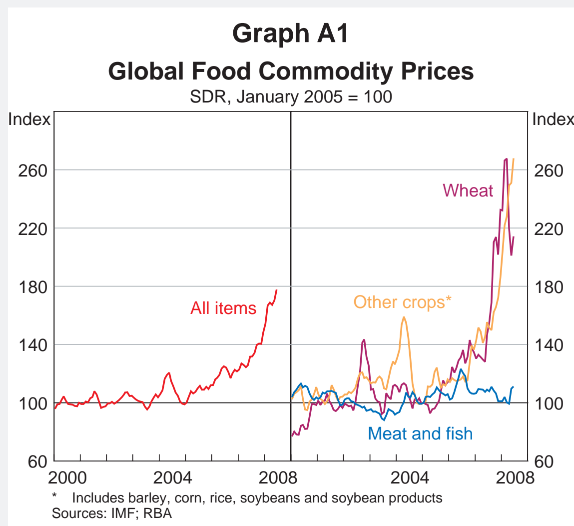


The RBA index of base metals prices has decreased by 15 per cent over the past three months, driven by falls in nickel, zinc and lead prices. Prices of these three metals are now roughly 60 per cent below their peaks, as the acute shortages that led to the dramatic increases in prices in 2006 and 2007 have been alleviated to some extent. In contrast, copper and aluminium prices are near historically high levels. Although aluminium inventory levels remain relatively high at present, recent production disruptions coupled with high energy prices have heightened concerns about the cost and availability of future supply. Overall the base metals component of the RBA index is currently around 30 per cent below the peak seen in May 2007.

Rural commodity prices were mixed over recent months, with gains in beef and sugar prices broadly offsetting weaker wheat and wool prices. Beef export prices to the United States have risen strongly since April, reflecting a tight domestic market, as well as growing competition from alternative export markets. Wheat prices have eased somewhat over the past three months on expectations of a strong increase in global production this year.

Box A: Global Food Prices

After a period of relative stability earlier this decade, the prices of a number of globally-traded food commodities have increased significantly over recent years.[1] Despite substantial falls in a number of grain prices in recent months, the IMF global food price index is around 80 per cent higher than in early 2005 and 35 per cent higher than a year ago (Graph A1). The increases have been mainly concentrated in cereal grains (wheat, corn and barley), rice and soybeans. In contrast, meat and fish prices have been relatively flat. While the strength in crop prices can be attributed to a combination of both supply and demand factors, which have resulted in global stocks falling to very low levels, the relative importance of supply factors may have been somewhat underestimated.



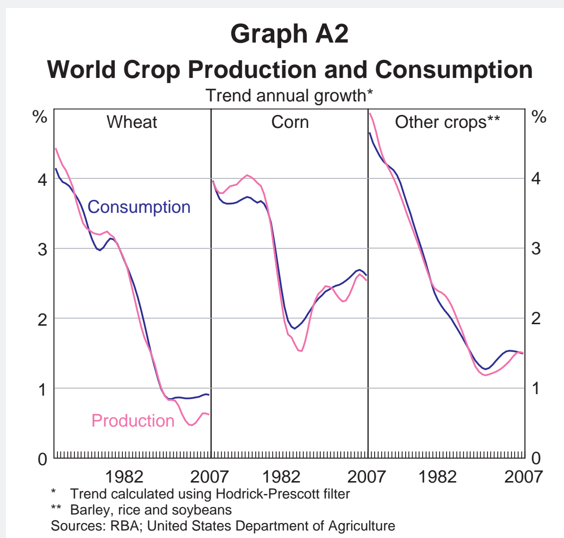
Growth in global consumption of many grain crops slowed significantly over the 1960s, 1970s and 1980s, with average trend growth rates declining from around 4 per cent per year in the early 1960s, to a little below 2 per cent in the early 1990s.[2] Since then, however, trend growth in average crop consumption has stabilised at a little under 2 per cent per year.[3] As would be expected, over time trend crop production growth generally moves closely with consumption. However, since around the beginning of the current decade, the gap between production and consumption has widened, to be the largest it has been on a sustained basis for at least 40 years. While this has been most pronounced for wheat – growth in production has been around ½ percentage point below trend growth in consumption – there have also been gaps between production and consumption for other crops to varying degrees (Graph A2). As a result, the level of crop stocks (as a ratio to use) is at, or relatively close to, its lowest in 40 years. While it is difficult to be definitive, the weakness in growth of wheat production this decade looks to have been primarily the result of an increase in weather-related disturbances, with

1 *It should be noted that while the recent increases are significant, in real terms current prices are 20 per cent below the 1980s average, with food prices having fallen in real terms for many decades – see 'The Recent Rise in Commodities Prices: A Long-Run Perspective', April 2007 RBA* Bulletin, *pp 1–9.*

2 *Simple average of wheat, corn, rice, barley and soybeans. Trend growth is calculated using the Hodrick-Prescott filter.*

3 *The slowdown in the growth of demand for grain crops has been primarily driven by developments in industrialised economies, where population growth has slowed and demand for foodstuffs is inelastic. This moderation has to an extent been offset since the 1990s by stronger demand from the developing economies.*

global production actually falling in three of the eight harvests so far this decade. Consistent with this, growth in crop yields slowed to only 1 per cent in the past five years – less than half its long-run average pace – as production faltered despite a rise in area planted. This suggests that supply disturbances have been a significant factor underpinning the tightening in grain markets over recent years.



Several additional factors have also exerted upward pressure on prices, with the effects amplified by tight markets. US-dollar-denominated prices have been boosted by the depreciation of the US dollar. More fundamentally, farmers have faced a significant increase in production costs, with fuel and fertiliser prices (both major components of the cost of production) increasing significantly. Higher energy prices have also prompted substitution towards bio-fuels,[4] increasing demand for grain, with the impact most pronounced for corn and soybeans. While bio-fuel use of these crops remains relatively small, demand for bio-fuels has been growing rapidly, with the production of ethanol taking around 20 per cent of US corn production in 2007 (10 per cent of the global crop), and slightly more than one-third of the global increase in corn production over the past five years. Many analysts have also attributed part of the increase in grain prices to increased financial trading of these commodities. However, on balance it appears likely that speculative trading has only been a marginal influence, with the rise well explained by fundamental factors. ☙

4 *Increased bio-fuel use has in large part been driven by government policy changes, with over 40 countries implementing policies to encourage usage in recent years.*

International and Foreign Exchange Markets

International financial markets have been primarily affected by two factors over the past three months: a further intensification of credit strains, particularly related to the health of the US financial system, and rising inflation. These factors have contributed to a significant decline in global equity markets, as well as greater expectations of policy rate increases in a number of economies, particularly in emerging markets.

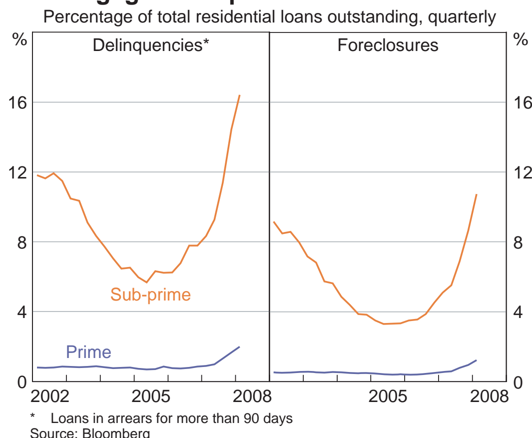
Credit and money markets

The deterioration in the US housing sector and the poor performance of securities backed by residential mortgages continue to have a negative impact on the US financial system and global markets more generally. Delinquencies and foreclosures for both sub-prime and prime loans rose further in the first quarter of 2008 (Graph 11) and data released since the last *Statement* indicate that delinquency rates on US mortgages originated in 2007 are at a higher level than earlier vintages and are on an upward trend, suggesting that further rises are in prospect (Graph 12).

Graph 11

US Mortgage Delinquencies and Foreclosures

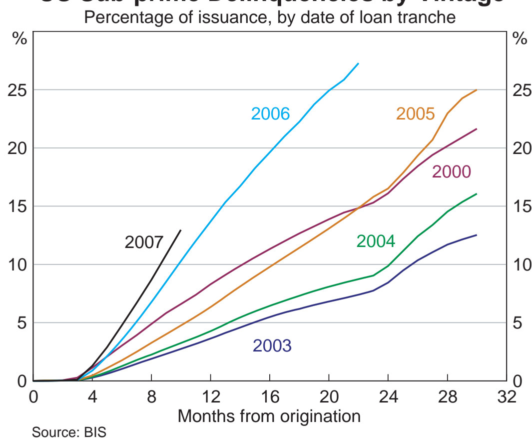
Percentage of total residential loans outstanding, quarterly



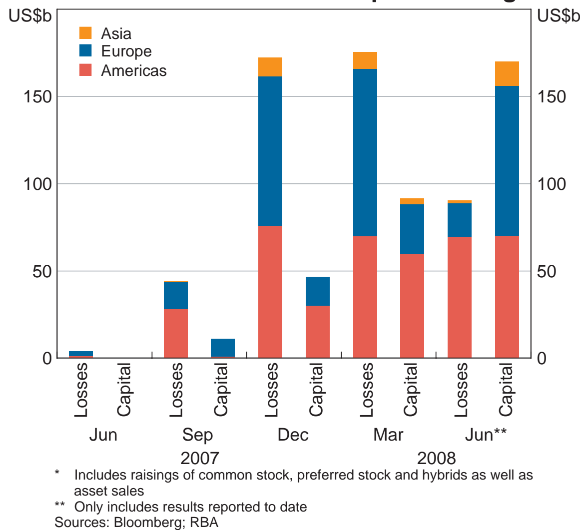
Graph 12

US Sub-prime Delinquencies by Vintage

Percentage of issuance, by date of loan tranche



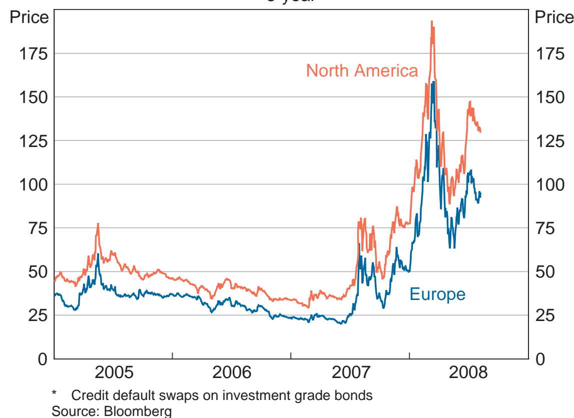
These problems have resulted in the failure of a number of smaller financial institutions in the United States recently. They have also contributed to the downgrading of the credit rating of several large financial institutions and the two largest monoline insurers, MBIA and Ambac. While some of the major financial institutions that have reported earnings for the June quarter have recorded somewhat better than expected earnings, they have all booked further credit-related



write-downs. These write-downs have included greater provisions for loans originated by the institutions themselves rather than for greater exposure to structured products which had been the primary cause of write-downs in earlier quarters. To date, around US$500 billion has been written down by global financial institutions. Against this, around US$360 billion in new capital has been raised (Graph 13).

In the United States, speculation over the solvency of the two government-sponsored enterprises, Fannie Mae and Freddie Mac, led to heightened concerns about the stability of the financial system in early July. To quell fears over the viability of the agencies, US authorities announced a plan that involved an increase in the line of credit at the Treasury, access to Federal Reserve funds at the discount rate and authorisation for the Treasury to buy shares in both companies as a last resort to shore up their capital adequacy. Nonetheless, the Treasury Secretary reiterated that the agencies would remain in their current form as privately-owned corporations.

In late July, the Fed announced further changes to increase the flexibility of its liquidity operations (see Box A in the May 2008 *Statement*). These measures include: extending the Primary Dealer Credit Facility (PDCF) and the Term Securities Lending Facility (TSLF) to January 2009 from September 2008; introducing options on loans of Treasury securities under the TSLF of up to US$50 billion in addition to the current limit of US$200 billion; and extending the maximum maturity of its Term Auction Facility (TAF) loans to three months from the existing 28 days. Reflecting the changes to the TAF, the terms of the European Central Bank's (ECB) and the Swiss National Bank's US dollar auctions have been lengthened, and the Fed's swap line with the ECB has been increased to US$55 billion from US$50 billion.



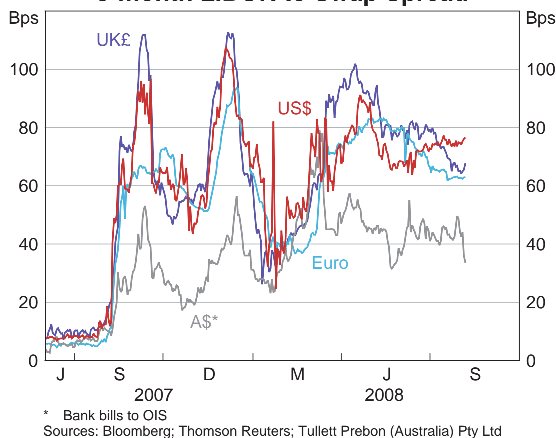
The fragility of credit markets was reflected in another sharp run-up in credit default swap (CDS) premia to mid July (Graph 14). However, CDS premia remain lower

than their peak at around the time of the Bear Stearns failure in March. Despite unsettled conditions in credit markets, risk premia in money markets have generally improved (Graph 15). The spreads on London Interbank Offered Rates (LIBOR) for the euro and pound sterling have narrowed noticeably since the last *Statement*.

Reflecting the credit turmoil, mortgage rates remain high in several major countries despite, in some cases, an easing in monetary policy. In both the United States and the United Kingdom, mortgage-related credit growth has slowed noticeably from its rapid expansion in 2007 (Graph 16). In the United States, housing credit has begun to contract outright. While it remains difficult to separate the extent to which the slowing in mortgage credit is attributable to supply-side factors or a decline in the demand for funds, both elements are likely to have played a role.

Graph 15

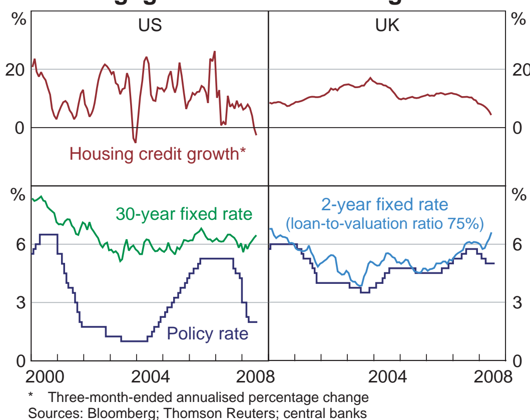
3-month LIBOR to Swap Spread



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

Graph 16

Mortgage Credit and Lending Rates



* Three-month-ended annualised percentage change
Sources: Bloomberg; Thomson Reuters; central banks

Monetary policy

Since the previous *Statement*, the focus of financial markets in developed economies has fluctuated between concerns about credit markets and growth prospects on the one hand and the risk of higher inflation outcomes driven by rising food and energy prices on the other. Accordingly, policy rate expectations have varied quite considerably. Inflation concerns have been even more prominent for emerging economies, where energy and food constitute a larger portion of consumer spending. As a result, central banks in many of these economies have raised interest rates during the period.

In the United States, the Federal Open Market Committee kept its policy rate unchanged at 2 per cent at its June and August meetings. The June meeting was the first at which rates were left on hold since September last year after cumulative reductions of 325 basis points. The statement accompanying that decision, and subsequent speeches, indicated that policy-makers were becoming more concerned about upside risks to inflation and inflation expectations amid diminishing downside risks to growth. The market's expectations for rate rises consequently

increased, with as much as three increases by the end of 2008 being priced in at one point. These expectations were subsequently pared back substantially, such that one 25 basis point rate increase is currently expected over the next six months (Table 2, Graph 17).

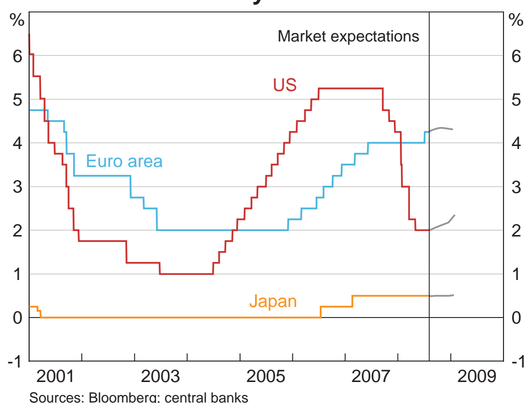
Table 2: Changes in Monetary Policy

	Current level Per cent	Most recent change	Expectations for next 6 months
United States	2.00	↓ Apr 08	↑ 25 bps
Euro area	4.25	↑ Jul 08	No change
Japan	0.50	↑ Feb 07	No change
United Kingdom	5.00	↓ Apr 08	No change
Canada	3.00	↓ Apr 08	↓ 25 bps
New Zealand	8.00	↓ Jul 08	↓ 75 bps

Sources: Bloomberg; Thomson Reuters; central banks

Graph 17

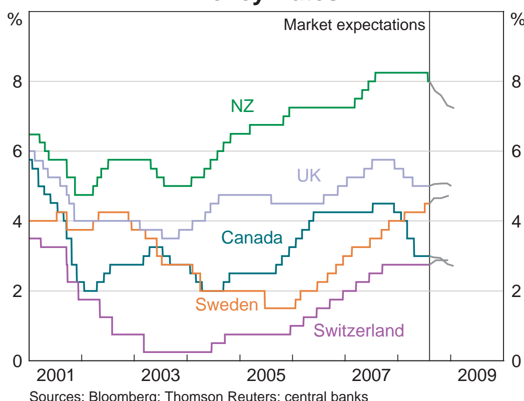
Policy Rates



Sources: Bloomberg; central banks

Graph 18

Policy Rates



Sources: Bloomberg; Thomson Reuters; central banks

The ECB raised its policy rate by 25 basis points at its July meeting, the first change to rates since June last year, as inflation in the euro area rose to its highest in over 10 years. However, market expectations for further rate increases have been scaled back recently so that no further change to the policy rate is expected for the next six months. Elsewhere in Europe, the central banks of Norway and Sweden raised their policy rates by 25 basis points, to 5¾ per cent and 4½ per cent respectively. In contrast, the Swiss National Bank left its policy rate unchanged at 2¾ per cent after judging that the current increase in inflation was likely to be transitory (Graph 18).

The Bank of Japan has kept its policy rate unchanged at ½ per cent since the previous *Statement*, and the market continues to expect the policy rate to remain unchanged in the coming months. The Bank of England also kept its policy rate unchanged at 5 per cent over the past three months, having cut rates by a cumulative 75 basis points since

December last year. The market currently does not expect any change to the policy rate in the next six months. The Bank of Canada similarly kept its policy rate unchanged and the market currently expects one 25 basis point easing over the next half year.

In contrast, the Reserve Bank of New Zealand (RBNZ) cut its policy rate by 25 basis points to 8 per cent in July. The RBNZ noted that the current reasonably tight policy settings have already restrained activity and inflation, and stated that it expects to lower the policy rate further. This has led the market to price in three more 25 basis point cuts in the next six months.

Inflation remains a primary concern in most emerging market economies, many of whom have raised interest rates since the previous *Statement* (Table 3). These include Brazil, Chile, Hungary, India, Indonesia, Israel, Mexico, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. In addition, the central banks of China and India have raised their reserve requirements a number of times over the past three months as inflation in the two countries rose to multi-year highs.

Table 3: Changes in Emerging Market Policy Interest Rates

	Increase since previous *Statement* Basis points	Current level Per cent
Brazil	125	13.00
Chile	100	7.25
Hungary	25	8.50
India	125	9.00
Indonesia	75	9.00
Israel	75	4.00
Mexico	50	8.00
Philippines	75	5.75
Poland	25	6.00
Russia	50	11.00
South Africa	50	12.00
Taiwan	12½	3.63
Thailand	25	3.50
Turkey	150	16.75

Sources: Bloomberg; central banks

Bond yields

Government bond yields for major economies have been volatile since the last *Statement*, reflecting the conflicting forces of heightened inflation concerns on the one hand and increased credit market tensions on the other.

Graph 19

US Government Bond Yields

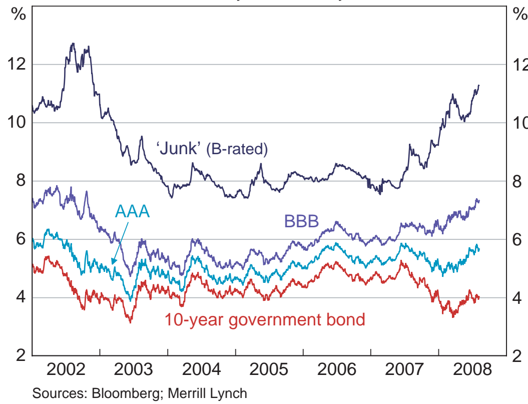
Source: Bloomberg

US bond yields had increased in June by around 100 basis points from their trough in March, following comments from Fed officials highlighting further upside risks to inflation from high commodity and food prices (Graph 19). However, this trend was partially reversed as the focus shifted to credit market concerns. The yield curve in the United States has flattened since the last *Statement*, with yields on 2-year

Graph 20

US Corporate Bond Yields

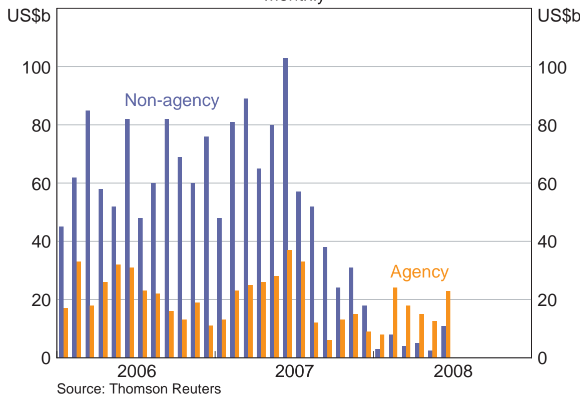
7–10 years maturity



Graph 21

US Issuance of Mortgage-backed Securities

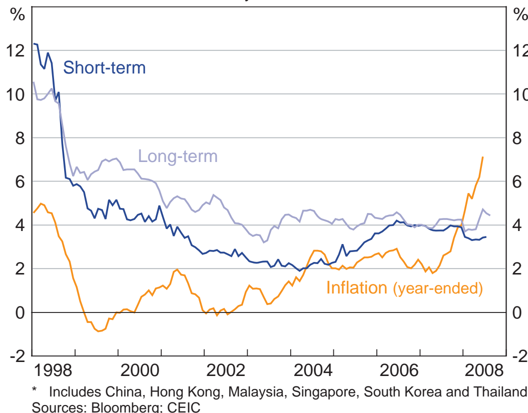
Monthly



Graph 22

East Asia* – Nominal Interest Rates

Local currency denominated debt



debt rising more sharply than longer-term yields. German government bond yields have also risen since the last *Statement* and have broadly followed similar trends to those in the United States. In contrast, Japanese yields were lower over the period.

While spreads on corporate debt moved broadly sideways throughout May and June, further credit market disturbances in July have seen investor appetite for high-yield debt diminish again. This has put upward pressure on spreads, although they remain below the peaks seen in March. Corporate yields have picked up as renewed volatility in credit markets has added to default risk, especially on sub-investment grade debt (Graph 20).

Corporate bond issuance in the United States was a little higher in the June quarter than it had been in the March quarter but remains at a low level. Issuance of mortgage-backed securities by non-agency issuers in the United States has remained very weak in the first half of 2008 (Graph 21). While the issuance by agencies has become more important over this period, it has only offset part of the slowing in overall issuance.

Spreads on US dollar denominated sovereign debt in emerging Asia, Europe and Latin America rose substantially in June and July, as rising inflation placed upward pressure on yields. East Asian local currency denominated bond yields have also risen, albeit from low levels (Graph 22). With inflation continuing to accelerate

across the region, this has resulted in declining real interest rates.

Equities

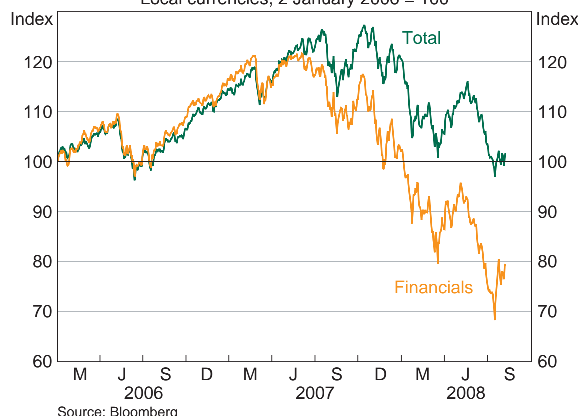
Global equity markets have fallen considerably since the last *Statement*, with broad-based weakness across industries in both developed and emerging markets (Table 4). The financial sector suffered the largest declines amid further large write-downs and costly capital raisings, particularly in the United States and Europe (Graph 23). However, share prices in the industrial and consumer-related sectors also fell significantly, reflecting expectations of slower economic growth, high oil prices, and increasing interest rates. These pressures were most notable in east Asia, Europe and the United States.

Table 4: Change in Major Country Share Prices
Per cent

	Since recent peak	Since previous *Statement*
United States		
– Dow Jones	–18	–9
– S&P 500	–18	–7
– NASDAQ	–17	–2
Euro area		
– STOXX	–28	–14
United Kingdom		
– FTSE	–19	–12
Japan		
– TOPIX	–30	–8
Canada		
– TSE 300	–11	–6
Australia		
– ASX 200	–27	–12
MSCI Emerging Asia	–30	–18
MSCI Latin America	–22	–18
MSCI World	–20	–10
– Financials	–35	–15

Source: Bloomberg

Graph 23



Foreign exchange

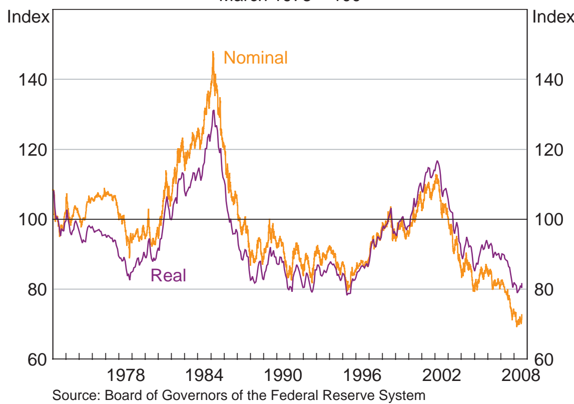
The US dollar remained around the low levels prevailing at the time of the last *Statement*. On a real trade-weighted basis, the US dollar remains around the low reached in 1995, and in nominal terms is just above the three-decade low reached in March this year (Graph 24, Table 5). Over the past three months, the US dollar is little changed against the euro but has appreciated against the yen, reflecting the movements in policy rate expectations that occurred in the three areas (Graph 25).

The performance of emerging market currencies against the dollar was mixed. Several east Asian currencies depreciated sharply over the first half of the year as the inflation outlook deteriorated (Graph 26). Foreign exchange reserves have fallen in a number of countries, most notably in South Korea, indicating that monetary authorities in the region are actively intervening to support their currencies. In contrast, the Brazilian real and Mexican peso have appreciated against the dollar due to high

Graph 24

US Major TWI

March 1973 = 100



Source: Board of Governors of the Federal Reserve System

commodity prices and several rate rises. The Chinese renminbi has also appreciated against the dollar.

There was speculation in June that the Vietnamese dong would be forced to devalue significantly. Much of this speculation was centred on the macroeconomic imbalances faced by Vietnam, including high inflation, negative real interest rates and a rapidly widening current account deficit. The government has taken some steps toward addressing these problems, including devaluing the currency by 2 per cent, widening

Table 5: Change in US Dollar against Other Currencies

Per cent

	2007	Year to date	Since previous *Statement*
Brazil	–17	–17	–6
Philippines	–16	–4	3
Canada	–14	–1	4
India	–11	4	1
Euro area	–10	–11	0
Australia	–10	–6	3
New Zealand	–8	6	9
Switzerland	–7	–11	0
China	–7	–10	–2
Sweden	–6	–9	1
Thailand	–6	–1	6
Singapore	–6	–9	1
Malaysia	–6	–6	3
Japan	–6	–8	5
South Africa	–2	5	–2
United Kingdom	–1	4	0
Taiwan	0	–6	0
South Korea	1	10	–2
Mexico	1	–9	–6
Indonesia	5	–2	–2
Majors TWI	**–11**	**–6**	**2**
Broad TWI	–8	–6	0

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

its daily trading band and raising interest rates. These measures have helped improve sentiment toward the currency, with pricing in the non-deliverable forward market now indicating that the dong is expected to depreciate by around 15 per cent over the coming year, compared with 30 per cent a month ago.

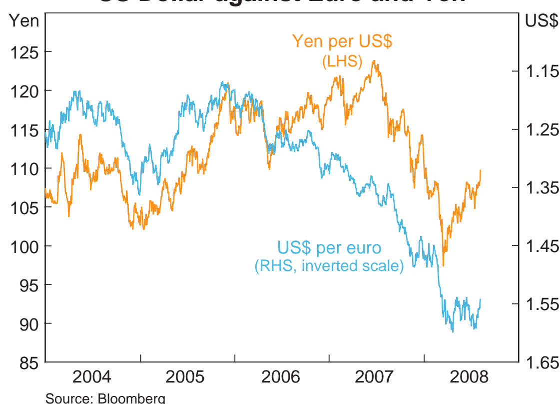
Australian dollar

The Australian dollar has depreciated against most major currencies since the last *Statement* (Graph 27, Table 6). In mid July, the Australian dollar reached a post-float high against the US dollar of just over 98½ cents, boosted by the further rise in the terms of trade in Australia stemming from strong price increases for bulk commodity exports, including coking coal, thermal coal and iron ore. On a trade-weighted basis the dollar reached its highest level since February 1985 and is currently around 19 per cent above its long-run average. Since mid July the Australian dollar has depreciated as commodity prices have declined from their recent peaks and expectations for the future path of monetary policy in Australia have changed.

Australian dollar volatility has declined marginally since the last *Statement*. Despite this fall in daily volatility, intraday ranges have remained somewhat elevated, with the Australian dollar trading in a daily average range of slightly over 0.9 cents since the last *Statement* (Graph 28).

Graph 25

US Dollar against Euro and Yen

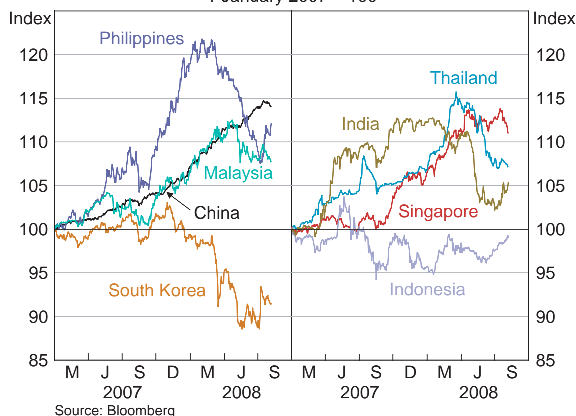


Source: Bloomberg

Graph 26

Selected Asian Currencies against US Dollar

1 January 2007 = 100

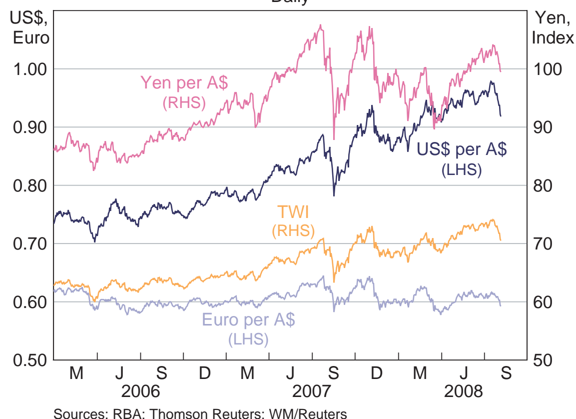


Source: Bloomberg

Graph 27

Australian Dollar

Daily



Sources: RBA; Thomson Reuters; WM/Reuters

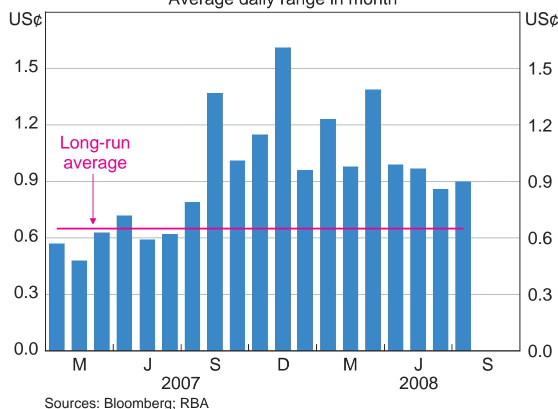
Table 6: Australian Dollar against Selected TWI Currencies
Percentage change

	Past year	Since previous *Statement*	Deviation from post-float average
South Korea	18	–3	38
New Zealand	13	5	3
South Africa	12	–5	59
United Kingdom	11	–2	6
United States	7	–3	26
Canada	6	0	2
Indonesia	5	–4	138
Taiwan	0	–2	25
Japan	–3	0	5
Singapore	–3	–1	0
Sweden	–3	–2	5
China	–3	–5	35
PNG	–5	–8	80
Euro area	–5	–3	–11
Switzerland	–6	–3	–11
TWI	**2**	**–2**	**19**

Sources: RBA; Thomson Reuters; WM/Reuters

Graph 28

Intraday Range in A$/US$
Average daily range in month



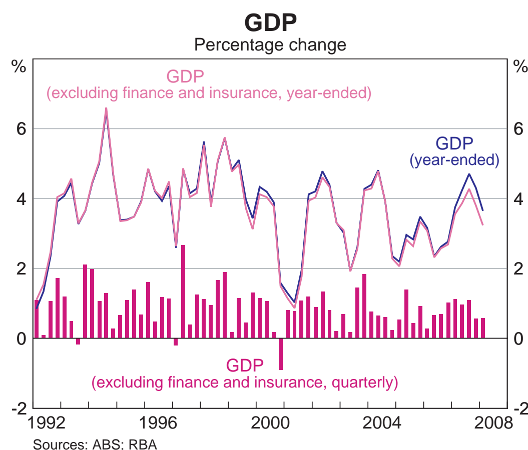
Sources: Bloomberg; RBA

The strength of the local currency has been reflected in significant capital inflows, particularly in debt and money market instruments. It is also evident in net long speculative positions in Australian dollar futures at the Chicago Mercantile Exchange which have remained elevated since the previous *Statement*.

With the Australian dollar reaching historically high levels on a trade-weighted basis and against the US dollar in mid July, the Bank has continued to purchase foreign exchange since the last *Statement*. The Bank has made net foreign exchange purchases of around $620 million over this period, in line with the rate of increase over recent years, with net reserves increasing to around $36 billion.

Domestic Economic Conditions

The Australian economy grew at a moderate pace in the March quarter, with real GDP estimated to have risen by 0.6 per cent, to be 3.6 per cent higher over the year (Graph 29, Table 7). The year-ended rate was boosted by an unusually high estimate of growth in the financial services sector. Output in this sector was estimated to have grown by 18½ per cent over 2007 and by 14½ per cent over the year to the March quarter, which appears at odds with other indicators of activity in the sector. Excluding the financial services sector, GDP is estimated to have increased by around 3.2 per cent over the year to the March quarter. Within the year, the quarterly pattern showed relatively strong growth in the first half, with growth slowing to an annualised rate of 2½ per cent over the six months to March. Domestic spending, however, continued to grow strongly, with real domestic final demand rising by 0.9 per cent in the March quarter and by 4.8 per cent over the year.



More timely indicators and the Bank's business liaison both suggest that growth in domestic demand has moderated further in recent months, and that GDP growth in the June quarter is likely to have been quite weak. Real retail trade and sales of motor vehicles both decreased in the

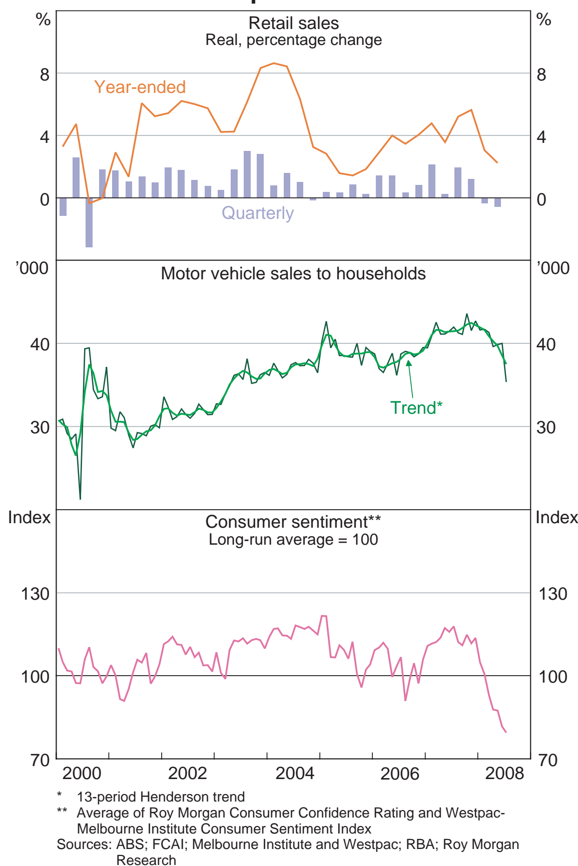
Table 7: Demand and Output
Percentage change

	December quarter 2007	March quarter 2008	Year to March quarter 2008
Domestic final demand	1.4	0.9	4.8
GNE[(a)]	1.6	1.3	5.6
Net exports[(b)]	–1.0	–0.7	–2.1
GDP	0.7	0.6	3.6
Non-farm GDP	0.6	0.7	3.6
GDP adjusted for changes in the terms of trade	0.9	0.8	3.9

(a) Adjusted for the statistical discrepancy
(b) Contributions to GDP growth
Sources: ABS; RBA

June quarter, consumer and business sentiment have fallen, household and business borrowing have slowed significantly, and conditions in the housing market have softened. However, while there has been some moderation in recent months, conditions remain reasonably firm in the labour market. In addition, the resources sector and the broader economy are experiencing a considerable income boost from the substantial increases in bulk commodity contract prices that have recently been settled.

An explosion at Apache Energy's Varanus island facility in early June reduced Western Australian domestic gas production by around one-third. While household energy supplies have been unaffected, business users of energy generated from Apache's gas have faced sharply higher energy prices and, in particular cases, have experienced a reduced supply of energy, most notably in the manufacturing and mining sectors. The disruption to production has been mitigated to some extent by firms obtaining energy from alternative supplies, such as diesel, gas from the North-West Shelf and from some power stations being returned to service. Partial gas supply resumed in early August, and is expected to rise to around two-thirds of normal production by mid August, with full production by end 2008. Overall, the disruption is expected to result in a temporary reduction in national GDP growth of around ¼ percentage point, spread across the June and September quarters.



* 13-period Henderson trend
** Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index
Sources: ABS; FCAI; Melbourne Institute and Westpac; RBA; Roy Morgan Research

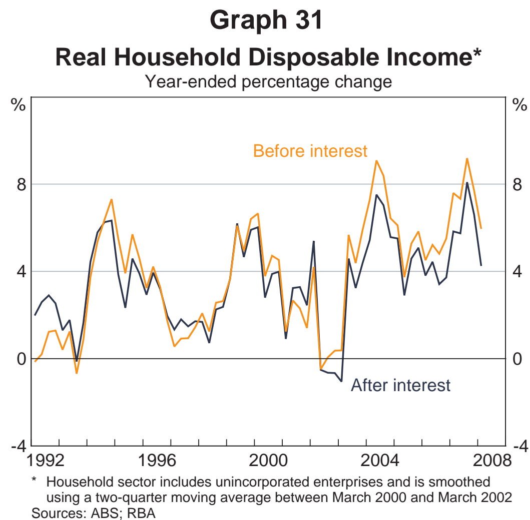
Household sector

Household consumption increased moderately in the March quarter, rising by 0.7 per cent to be 4.3 per cent higher over the year. The resilience in household spending was a little surprising given the tightening in financial conditions, rising petrol prices and falling consumer confidence, although it still represented a noticeable slowing from average quarterly growth of around 1¼ per cent during 2007. More timely data suggest that the pace of consumption growth slowed further in the June quarter. Real retail sales fell by 0.6 per cent in the quarter, while motor vehicle sales to households fell by 6 per cent in the three months to July (Graph 30). Measures of consumer sentiment have also declined further in recent

months and are now around their lowest levels since the early 1990s. The Bank's liaison with retailers suggests the weakness in consumer spending has continued into the September quarter.

The slowing in the pace of household spending is consistent with slower growth in disposable incomes and recent falls in household net worth. After accounting for increases in inflation and interest payments, growth in real household disposable income slowed to 4.2 per cent over the year to the March quarter, down from 6.6 per cent over 2007. Growth in household purchasing power is likely to have slowed further since then reflecting higher mortgage rates, the increase in inflation, and an easing in the pace of employment growth (Graph 31). Household net worth declined in the first half of the year, reflecting a sharp fall in the share market and a small decline in house prices (Graph 32).

Households have also cut back on the growth of their borrowing in response to tight financial conditions. Household credit growth has slowed from an annualised rate of around 15 per cent in mid 2007 to an annualised rate of 7 per cent over the three months to June, which is the slowest pace of growth since the early 1990s. Housing loan approvals have fallen by around 25 per cent from their peak in mid 2007 (Graph 33). Nevertheless, while household indebtedness is around historical highs and the interest burden has risen in the past



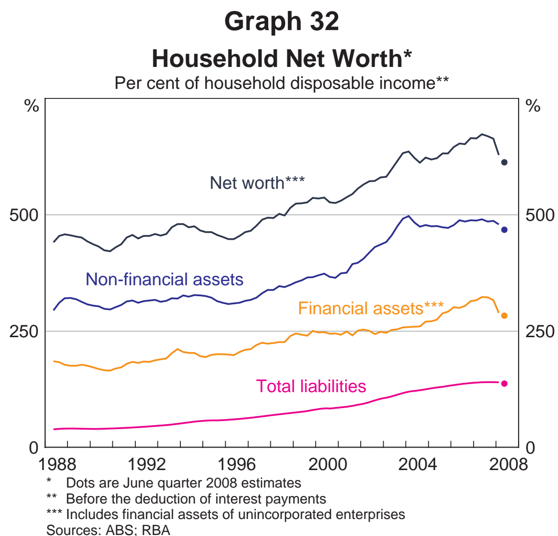
Graph 31

Real Household Disposable Income*

Year-ended percentage change

* Household sector includes unincorporated enterprises and is smoothed using a two-quarter moving average between March 2000 and March 2002

Sources: ABS; RBA



Graph 32

Household Net Worth*

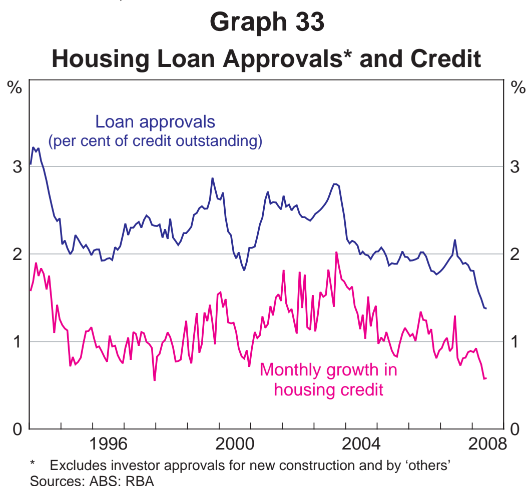
Per cent of household disposable income**

* Dots are June quarter 2008 estimates

** Before the deduction of interest payments

*** Includes financial assets of unincorporated enterprises

Sources: ABS; RBA



Graph 33

Housing Loan Approvals* and Credit

* Excludes investor approvals for new construction and by 'others'

Sources: ABS; RBA

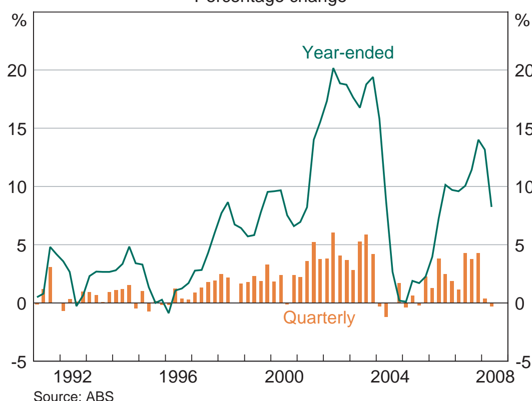
few quarters, the latest data to June suggest that only a relatively small proportion of households are in arrears on their loans: non-performing loans account for around 0.4 per cent of the value of housing loans on banks' domestic books.

Residential property markets have weakened across the country since the beginning of the year. Nationwide house prices fell slightly in the June quarter, after rising by around 13 per cent over 2007. According to the ABS measure, house prices fell by 0.3 per cent in the June quarter, although they were still around 8 per cent higher over the year (Table 8 and Graph 34). Other measures, which use different techniques to control for changes in the mix of houses sold, also show that house prices fell in the June quarter following modest growth in the March quarter, to be down slightly over the first half of the year. The softening in house prices was broad-based across the capital cities. Auction clearance rates, which are noisy but timely indicators of conditions in the established housing market, have stabilised in Sydney and Melbourne over the three months to early August, following a significant decline through the first half of the year.

Table 8: National House Prices
Percentage change

	March quarter 2008	June quarter 2008	Year to June quarter 2008
ABS	0.4	–0.3	8.2
RP Data-Rismark	1.1	–1.5	6.2
APM	0.8	–1.4	6.8

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



Housing construction activity also remains relatively subdued. Over the year to the March quarter, investment in the construction of new dwellings fell slightly, while renovation activity was little changed. Forward-looking indicators point to continued weakness in construction activity. The number of building approvals fell by 3½ per cent in the June quarter, with falls in both houses and the medium-density sector (Graph 35). Information from liaison with builders also suggests

that activity is expected to remain soft over coming quarters.

Business sector

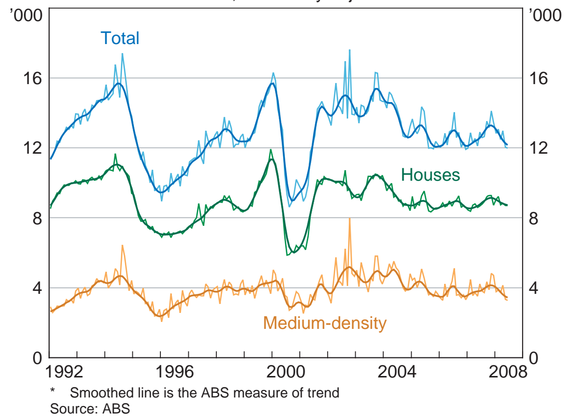
Private-sector surveys indicate that business conditions weakened noticeably in the June quarter, falling below long-run average levels for the first time since 2001 (Graph 36). Business confidence fell in the June quarter, to be around 15 per cent below its average level and at its weakest level since the early 1990s. The NAB survey's measure of capacity utilisation has also fallen from the record levels reported in late 2007 and early 2008 although it remains high. Surveyed business conditions have fallen in all states since the start of the year. In the June quarter, business conditions were strongest in Western Australia and Tasmania and weakest in New South Wales and Queensland.

New business investment increased by 2 per cent in the March quarter, to be around 7 per cent higher over the year. The rise in the quarter was driven by a solid increase in non-residential construction activity, which in turn reflected strong growth in engineering construction. As a share of nominal GDP, new business investment remains around its highest level since the 1980s. Much of the recent growth in investment has been attributable to the significant increase in mining investment – especially mining-related engineering construction – as mining companies have sought to increase their capacity to meet the rising demand for resources. This has resulted in investment in the mining sector almost doubling as a share of nominal GDP since 2004. In contrast, investment in other industries has

Graph 35

Building Approvals

Number, seasonally adjusted*



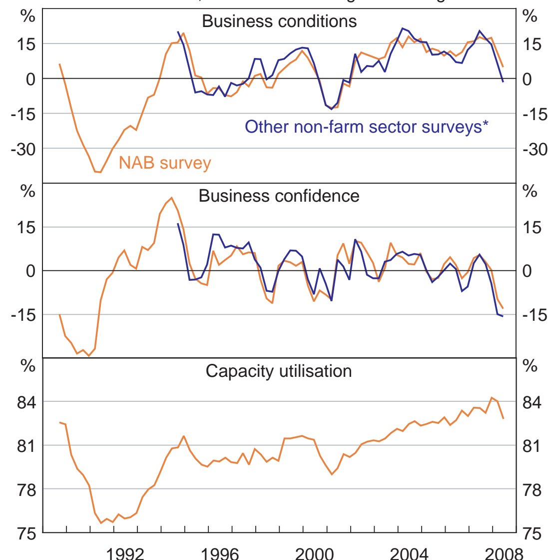
* Smoothed line is the ABS measure of trend

Source: ABS

Graph 36

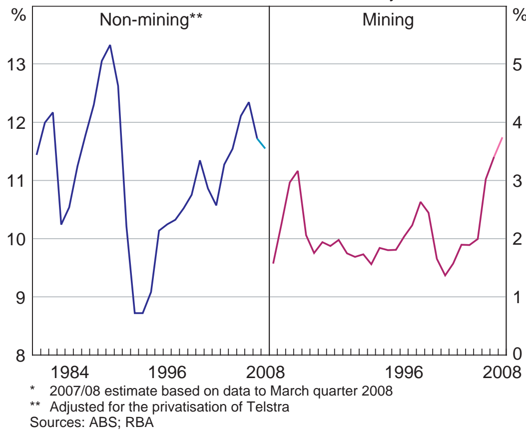
Business Surveys

Net balance; deviation from long-run average



* Weighted average of data from other business surveys, scaled to match the NAB series

Sources: ACCI; CBA; NAB; RBA; SAI Global; Sensis



fallen modestly as a share of nominal GDP over the period (Graph 37).

Forward-looking indicators continue to suggest that the near-term outlook for business investment is positive, particularly in the mining sector. The most recent capital expenditure survey (taken in April and May) pointed to strong growth in firms' investment plans in 2008/09, though some scaling back of plans may have occurred since then. Much of the growth was expected to be resource-related, reflecting the large pipeline of work that has commenced but has not yet been completed. Project-level data also indicate that some large mining-related projects are due to commence in the next year or so. However, the outlook for the non-residential building sector has deteriorated, as the tightening of financial conditions has reduced the viability of commercial property projects.

Private-sector profit growth slowed to around 6½ per cent over the year to the March quarter, down from 11½ per cent over the previous year. Nonetheless, the profit share remained close to record levels, at 31.5 per cent of GDP. Looking ahead, the recent large increases in coal and iron ore contract prices will provide a substantial boost to mining profits while slower growth in domestic demand and continuing cost pressures, particularly high oil prices, may dampen growth in non-mining profits.

Growth in businesses' external funding has slowed since late last year, in response to the higher cost of debt, tighter lending standards and reduced access to capital markets (for further details see the 'Domestic Financial Markets' chapter). However, the balance sheet of the business sector as a whole remains in good health according to the standard metrics. Measures of corporate gearing have increased over recent quarters (especially market-based measures that have been affected by falls in the equity market). Net interest payments have also increased in recent years, in line with rising interest rates and earlier rapid growth in business credit, but remain at relatively low levels as a share of corporate profits.

Conditions in the office property market have been significantly affected by ongoing stress in global financial markets, with higher funding costs and general caution among lenders and investors weighing on prices and turnover in the first half of 2008. While there is considerable uncertainty around recent trends in capital values – with few market transactions to serve as a benchmark – estimates based on Jones Lang LaSalle data suggest national capital values have fallen by 5 per cent since the end of last year, following growth of almost 80 per cent over

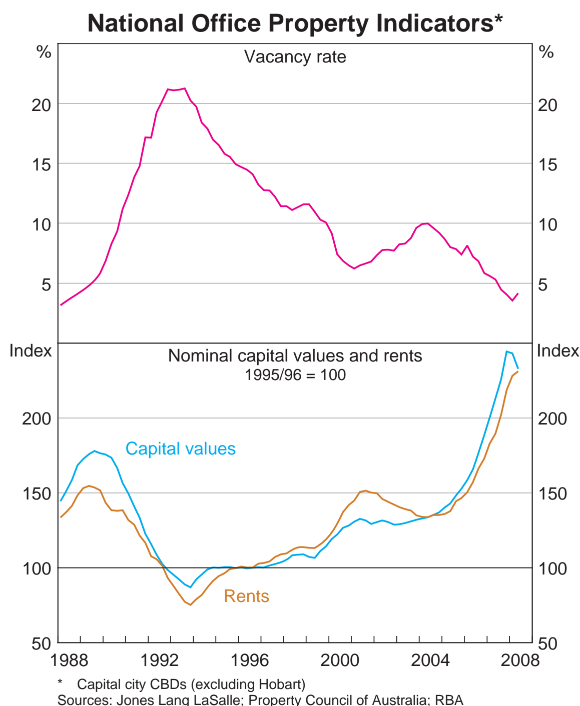
the previous three years (Graph 38). Office capital values may continue to be negatively affected by poor sentiment among lenders and investors, asset sales by some leveraged property trusts, and the expansion in office supply currently in the pipeline. Nonetheless, the fundamentals underpinning the office property market generally remain in reasonable shape; vacancy rates are close to historical lows, rents have continued to increase and employment has continued to grow.

Government budgets

The Australian Government Budget, tabled in May, showed a small increase in the expected general government surplus for 2007/08 relative to the mid-year estimates (Table 9). As with previous years, the upward revision was largely due to higher-than-expected revenue estimates, particularly for personal income tax and collections from superannuation funds. The surplus is expected to increase slightly in 2008/09, reflecting continued strength in personal income and company tax receipts and a moderation in the pace of spending growth. State budgets for 2008/09, handed down over May and June, forecast that the aggregate state general government balance will remain essentially unchanged in 2008/09. Continuing the pattern of recent years, state government trading enterprises plan to increase their capital expenditures significantly in the coming year.

Graph 38

National Office Property Indicators*



* Capital city CBDs (excluding Hobart)
Sources: Jones Lang LaSalle; Property Council of Australia; RBA

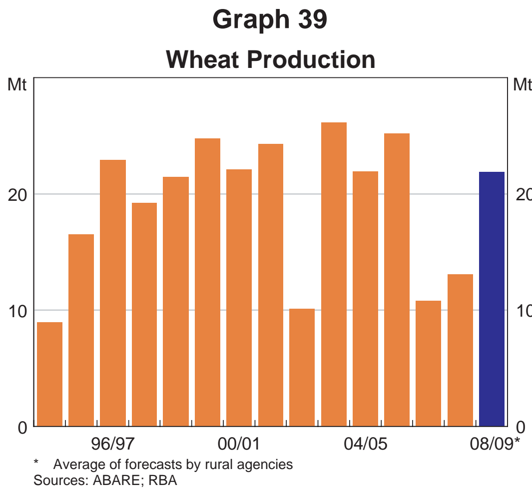
Table 9: Fiscal Balance – General Government Sector[(a)]
Estimates, $billion

	2007/08	2008/09
General government		
Federal government	20.4	23.1
– Per cent of GDP	1.8	1.9
State governments	–4.3	–6.2
– Per cent of GDP	–0.4	–0.5
Total (federal and state)	16.2	16.9
– Per cent of GDP	1.4	1.4
Public trading enterprises (capital spending)		
States	20.1	27.2
– Per cent of GDP	1.8	2.3

(a) ABS Government Finance Statistics basis
Sources: Australian Treasury; RBA; state Treasuries

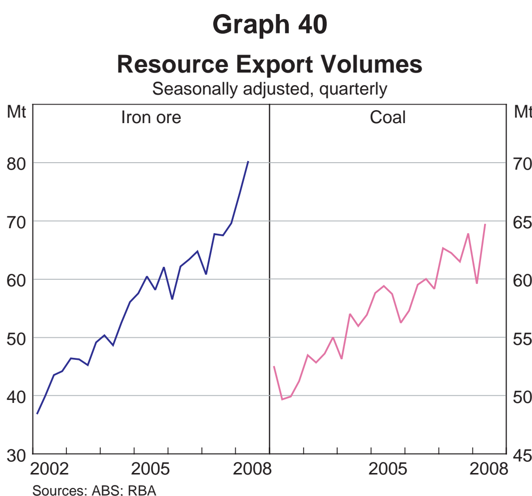
Farm sector

Conditions in the rural sector have deteriorated a little since the summer, with a large number of agricultural regions experiencing below-average rainfall. As a result, estimates of the area planted with wheat and other winter crops have been revised down, although parts of the wheat belt received good rains in July, particularly in Western Australia. Flows into the Murray-Darling river system have remained very low, with inflows in June the lowest on record for that month, suggesting that conditions for irrigated crops are likely to remain difficult over the coming year. At this stage, based on information from the Australian Bureau of Agricultural and Resource Economics (ABARE) and other rural agencies, farm output is expected to rise by around 15 per cent in 2008/09 from the drought-affected level of 2007/08. However, these estimates assume a recovery in rainfall to seasonally normal levels in the months ahead. The forecast mainly reflects an increase in the wheat crop and other cereals, with livestock production likely to be subdued (Graph 39).



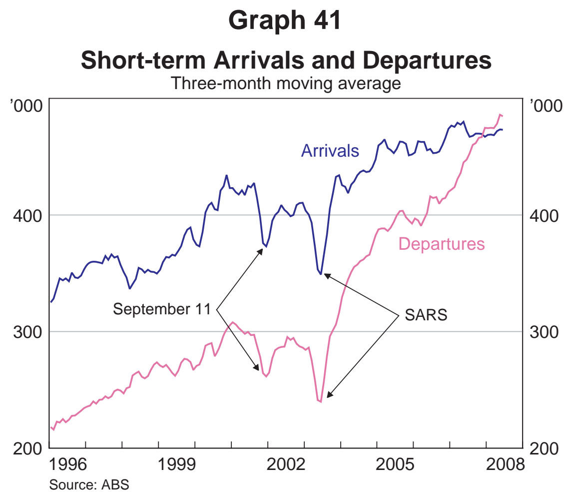
External sector

Export volumes are estimated to have increased in the June quarter, to be around 5 per cent higher over the year. Resource export volumes are estimated to have risen solidly in the June quarter. Coal exports recovered from the floods in Queensland that disrupted production earlier in the year, while the volume of iron ore exports also rose, boosted by the first shipments from Fortescue Metals' Pilbara project (Graph 40). In value terms, there was a much more pronounced increase in coal and iron ore exports in the June quarter as the substantial increases in contract prices that were recently settled took effect. In contrast, the disruption to Apache Energy's gas supplies in Western Australia has caused some difficulties for parts of the resources sector. Nevertheless,



the medium-term outlook for resource export volumes remains positive. The completion of the North-West Shelf Project's fifth train will boost LNG exports in the second half of this year and, more generally, growth in resource export volumes is likely to be underpinned by infrastructure expansions.

Manufactured exports appear to have risen solidly in the June quarter, to be around 11 per cent higher over the year. Although service export volumes also rose solidly in the June quarter, the year-ended growth rate has slowed noticeably over the past 18 months. The moderation in the pace of service exports growth has been particularly concentrated in travel services – in line with the weakness in short-term visitor arrivals to Australia – possibly reflecting the contractionary impact of the higher exchange rate. By contrast, the number of short-term departures has grown rapidly over recent years with growth to most destinations, though departures to the Asian region have been particularly strong (Graph 41). The noticeable pick-up in Australians travelling abroad over recent years likely reflects the strength in domestic incomes as well as the higher Australian dollar that has reduced the cost of overseas travel.



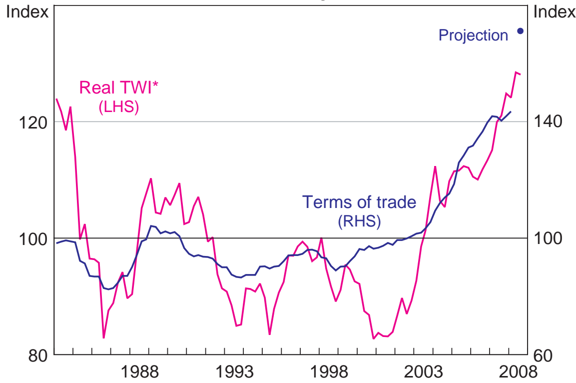
Import volumes are estimated to have increased solidly in the June quarter, to be roughly 12 per cent higher over the year. The increase in the June quarter followed particularly strong growth in the March and December quarters and indicates some slowing in the pace of import growth, albeit not quite to the same extent as suggested by some indicators of domestic demand growth.

The current account deficit widened slightly to 6.9 per cent of GDP in the March quarter, but looks to have narrowed significantly in the June quarter due to the strong growth in export values (mostly reflecting the substantial increase in the terms of trade).

The real trade-weighted index has been little changed over the past three months, and is around 28 per cent above its post-float average (Graph 42). While the appreciation of the exchange rate in recent years has adversely affected some parts of the traded sector, the associated increase in Australia's terms of trade has benefited the economy as a whole. Once the increases in annual iron ore and coal contract prices take full effect, the level of the terms of trade is projected to be around 65 per cent higher than five years ago.

Graph 42

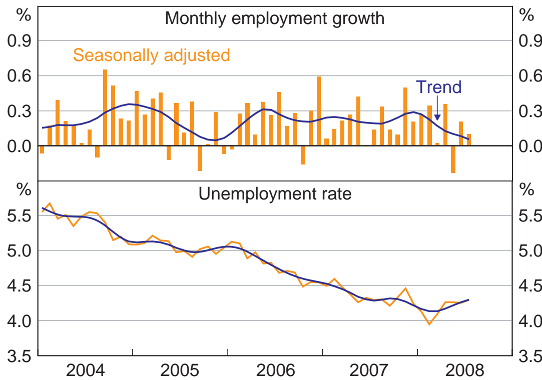
Real Exchange Rate and Terms of Trade



* September quarter 2008 observation assumes that the nominal bilateral exchange rates on 6 August are maintained for the remainder of the quarter, and uses the latest core inflation rates.
Sources: ABS; RBA

Graph 43

Labour Market



Source: ABS

Labour market

There has been some easing in labour market conditions over the past few months, although unemployment remains low. Employment growth slowed in the three months to July, although it was still 2.3 per cent higher in trend year-ended terms. The national unemployment rate was 4.3 per cent in July, only modestly above the multi-decade low recorded earlier in the year (Graph 43). Unemployment is lowest in the resource-rich states of Queensland and Western Australia (Table 10).

Forward-looking indicators of labour demand provide some evidence of a softening in conditions. The vacancy rate implied by the job vacancies measure from the ABS survey of employers was broadly flat over the first half of the year, after an extended period when it rose steadily (Graph 44). Likewise, the ANZ and SEEK measures of job vacancies suggest a noticeable slowing of growth in the number of advertised

Table 10: Labour Market by State
Trend measure, per cent

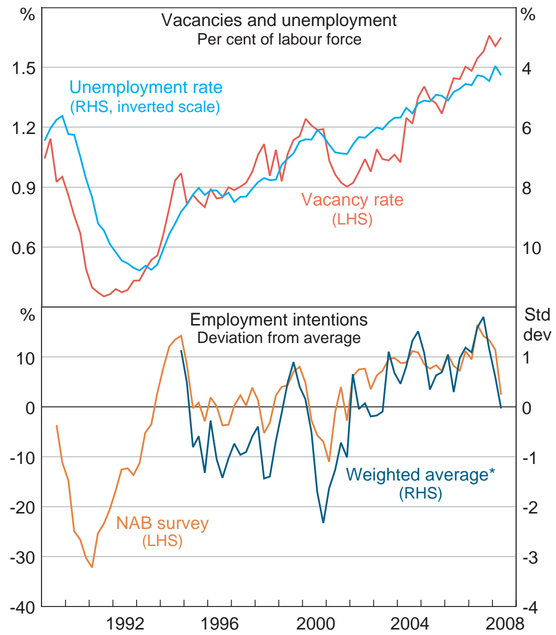
	Employment growth Year to July 2008	Unemployment rate July 2008
NSW	2.0	4.7
Victoria	1.5	4.6
Queensland	2.7	3.8
WA	2.7	3.3
SA	2.7	4.8
Tasmania	4.1	4.3
Australia	**2.3**	**4.3**

Source: ABS

vacancies. The various business surveys and information from the Bank's liaison program also generally report some easing in firms' hiring intentions, although they suggest that the demand for labour is still around the average of the past two decades.

Graph 44

Labour Market Indicators



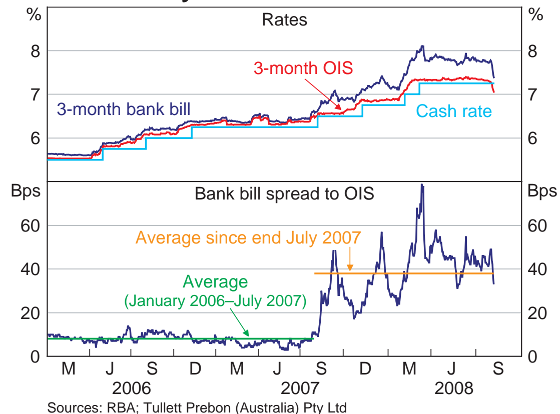
* Weighted average of data from various business surveys, with weights calculated by the RBA using the principal component method

Sources: ABS; ACCI; CBA; NAB; RBA; Sensis; Westpac

Domestic Financial Markets

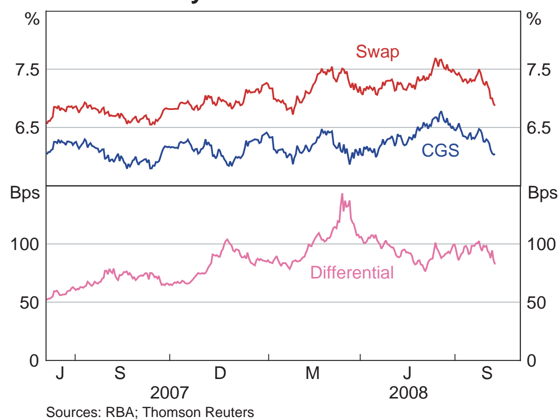
Money market and bond yields

The funding pressures which emerged in global money markets in August 2007 have remained evident in the Australian market during the past three months, although they have not intensified. Three-month funding rates for banks are around 35 basis points above expectations for the cash rate, just below the average spread during the past year but much higher than in earlier years (Graph 45). Recently, bill rates have declined significantly as market participants have shifted their expectations of the future direction of monetary policy. In early June, the market was pricing in an additional tightening in monetary policy in 2008, but with mounting evidence that domestic demand is easing the market now expects two reductions in the cash rate in the coming months.



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Long-term interest rates have declined since the last *Statement* (Graph 46). Generally, long-term yields have moved in line with global yields, but in the past month, domestic yields have fallen further, with the market now projecting that the cash rate has peaked. The spread between the Australian 10-year bond rate and that in the United States has narrowed by around 40 basis points. The spread between government bond and swap rates has also contracted as long-term rates have declined.



Sources: RBA; Thomson Reuters

In May, the Australian Government announced that it would increase the outstanding amount of Commonwealth Government securities (CGS) on issue by $5 billion during 2008/09 – and by up to $25 billion over the coming years – in order to improve liquidity within the market. At the

time, this announcement contributed to some narrowing in the spread between CGS yields and swap rates. The Government also announced its intention to remove interest withholding tax on state government paper issued onshore. This is likely to result in the consolidation of offshore and onshore lines issued by state authorities.

In its market operations recently, the Bank has generally maintained aggregate exchange settlement (ES) balances at around $1½–2 billion. This is a higher level than that which prevailed before the onset of market turmoil in August 2007. Anticipating that there may be funding pressures surrounding June quarter-end, the Bank increased ES balances to over $6 billion on 30 June, before reducing balances swiftly in the following days. These actions were successful in ensuring that the domestic cash market functioned smoothly and on all trading days since the last *Statement* the cash rate has traded at the target level set by the Board.

Equities

In line with international markets, the ASX 200 has experienced a substantial decline over the past three months. Since the peak in November last year, equities have fallen by 27 per cent, the largest fall in the past 20 years and one of the largest since the beginning of the 20th century (Graph 47, Table 11). The largest decline occurred between February 1973 and December 1974 when share prices halved. While movements in the ASX 200 have broadly tracked global equity markets, the local market has underperformed in 2008, falling by more than other major markets after rising by more in 2007. The equity market has also experienced considerable volatility since the onset of the credit turmoil, with daily movements averaging 1.2 per cent, around twice the size of average fluctuations in the past 20 years.

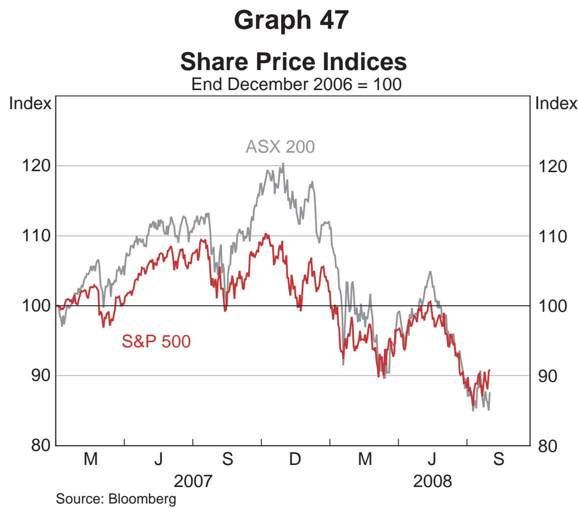


Table 11: Largest Falls in Australian Equities since 1900

	Peak to trough (per cent)	Duration (months)
1973	–49	22
1929	–45	24
1987	–45	5
1981	–32	11
1970	–31	20
1951	–29	10
2007	**–27**	**8**
1937	–26	59

Sources: ASX; Bloomberg; RBA

The decline in equity markets has been concentrated among financials and other non-resource stocks (Graph 48). The share prices of financial institutions have generally moved in line with those globally, despite the markedly stronger balance sheets of the Australian banks compared with many of

their counterparts offshore. The announcements by a couple of the major Australian banks that they were increasing provisions saw prices fall heavily late in July. Since their peak in late last year, banks' share prices have fallen by about 35 per cent.

Listed property trusts have also experienced substantial declines in their share prices which have fallen by 21 per cent since end April on earnings downgrades and continued concerns about leverage. Resource share prices held up relatively well over the past year, supported by strong commodity prices and speculation of foreign interest in investing in Australian mining companies. However, they too have fallen sharply in recent months, declining 24 per cent since their peak in mid May, as some commodity prices have come off their peaks.

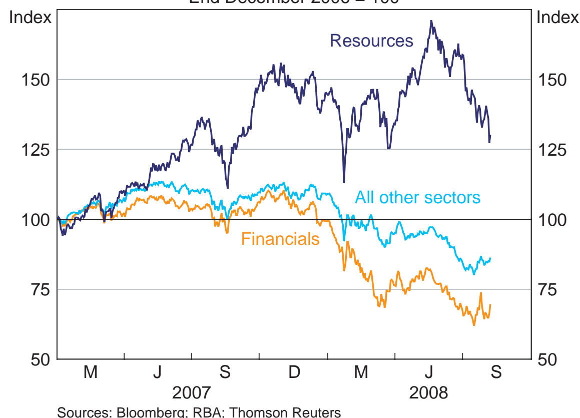
Falls in share prices this year have contributed to negative returns for most superannuation funds. Australian superannuation funds had a median return of –8½ per cent over the 2007/08 financial year, the lowest annual return in at least two decades (Graph 49).

The decline in the share market has also led to falls in both the trailing P/E ratio (which is based on earnings for the past year) and forward P/E ratio (based on expected earnings for the next financial year) (Graph 50). Both remain well below their long-run averages, with ratios falling to levels last seen in the early 1990s. There continues to be divergence in valuations across

Graph 48

Australian Share Price Indices

End December 2006 = 100

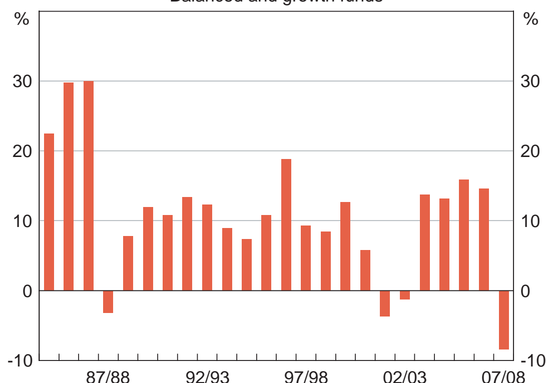


Sources: Bloomberg; RBA; Thomson Reuters

Graph 49

Superannuation Funds' Median Returns*

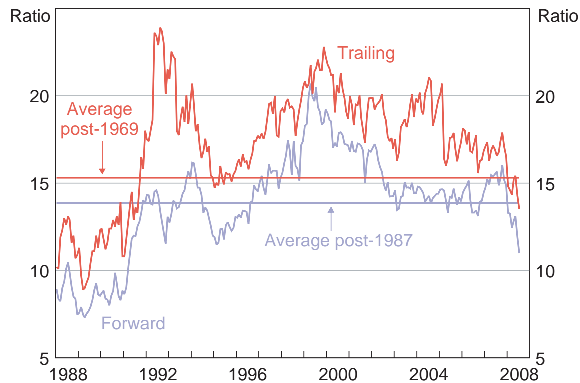
Balanced and growth funds



* Net of taxes and ongoing fees
Source: Intech Desktop Consultant

Graph 50

MSCI Australia P/E Ratios*



* July 2008 estimate assumes earnings unchanged
Sources: MSCI; RBA; Thomson Reuters

sectors – financials' trailing P/E ratio remains well below average, while resources' P/E ratio is a little above average.

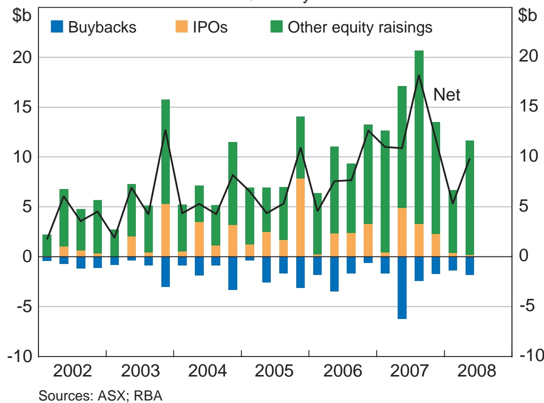
Analysts have generally revised down earnings expectations for the current year in line with weaker earnings guidance provided by some companies and the recent announcements by some of the major banks of increased provisions. Profits for the ASX 200 for 2007/08 – which will mostly be reported in August – are expected to be broadly flat, following average annual growth of around 15 per cent in recent years (Table 12). This would be the slowest pace of growth since 2001/02. Over the next two years, a pick-up in growth in resource earnings, reflecting tight global supplies and large increases in iron ore and coal contract prices, is expected to underpin strong growth in profits. Financials' profits are expected to grow at a modest pace over the next two years. Growth in other companies' earnings is forecast to slow a little next year on cost pressures and a moderation in domestic demand.

Table 12: Earnings Growth
Per cent

	Average	Analysts' forecasts		
	2002/03–2006/07	2007/08	2008/09	2009/10
Resources	29	0	49	18
Financials	8	–2	4	7
Other	17	7	2	8
ASX 200	15	1	16	11

Sources: RBA; Thomson Reuters

Graph 51



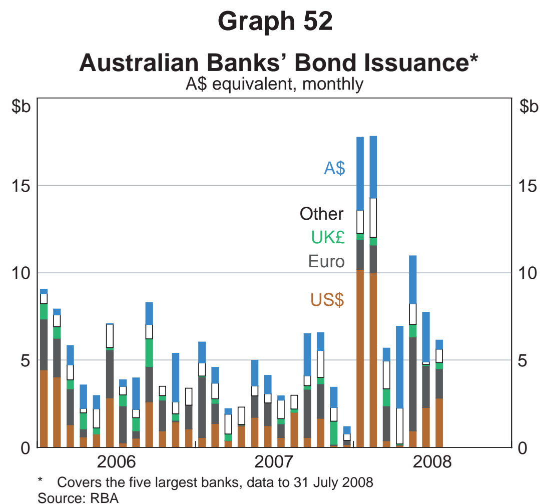
Net equity raisings picked up in the June quarter, to be close to average levels (Graph 51). While IPOs were limited due to the volatile equity market and lower share market valuations, other equity raisings were robust, particularly for resource companies and other non-financials. Buy-backs were modest, with companies preferring to retain cash to boost reserves rather than rely on access to debt markets in the current environment.

M&A activity has eased a little in recent months, with few large deals announced amidst the volatility in markets. Nonetheless, two large deals are pending: the proposed merger between Westpac and St. George, and BHP's bid for Rio Tinto.

Financial intermediaries

The turbulence in capital markets continues to affect the cost and composition of financial intermediaries' funding. Institutions that rely heavily on capital markets, particularly securitisation, to fund their lending have been more affected than institutions with sizeable deposit bases.

Banks' bond issuance for the first half of 2008 was particularly large at around $67 billion (Graph 52), significantly higher than the average issuance in the first half of the previous three years of $32 billion. Investor demand has been strong, with many issues oversubscribed. Over two-thirds of bond issuance has been offshore and denominated in foreign currencies, particularly US dollars and euros. The major banks have also diversified their funding sources during the credit market turmoil by issuing in the Japanese 'Samurai' market for the first time. This market has been more liquid than many others and has also enabled the banks to issue at longer tenors than in some other markets. Samurai bonds have accounted for around 10 per cent of offshore issuance in 2008 so far.



The large banks have indicated that the strong issuance was partly precautionary in case conditions in financial markets were to worsen, and that they are ahead on their funding plans. As well as financing balance sheet growth, which in part reflected re-intermediation, these funds are being used to pay down short-term debt, thereby reducing banks' refinancing risks.

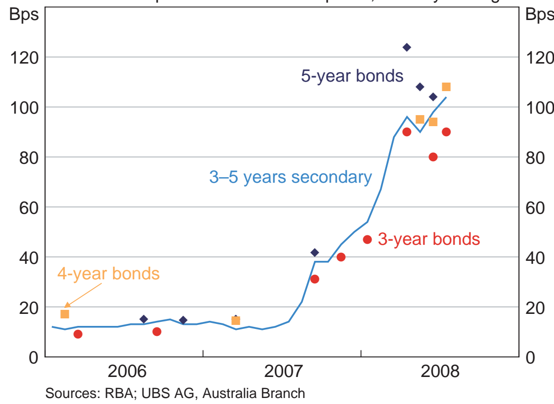
The average maturity of bonds issued by the major banks has varied considerably in 2008. The average maturity lengthened in the June quarter, having an average tenor of 5½ years, after falling to around 2½ years in the March quarter. Overall, the average maturity of total outstanding bonds has only declined a little.

Spreads on banks' bonds at issuance remain wider than usual. There were some signs of spreads narrowing in the June quarter, but more recently spreads have increased again. Spreads for 3-year and 4-year bank bonds issued in July increased by 10–15 basis points, consistent with the increase in secondary market spreads (Graph 53). The increase in banks' bond spreads occurred in an environment of increases in the price of bank risk globally following Fannie Mae and Freddie Mac's difficulties, the failure of several US banks and monoline downgrades (Graph 54). Credit default swap (CDS) premia on Australian banks rose by at least 25 basis points, similar to those on banks in most other countries but much less than the 60 basis points for US banks. These increases were partly offset more recently as sentiment improved somewhat in the United States. Late in July, CDS premia in Australia rose a further 7 basis points following

Graph 53

Major Banks' Bond Pricing at Issuance*

Domestic – spread to bank bill swap rate, monthly average

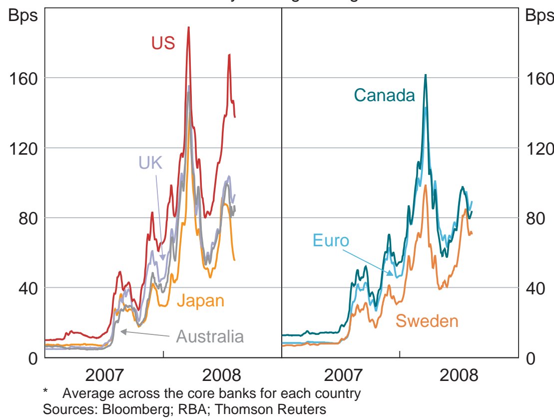


Sources: RBA; UBS AG, Australia Branch

Graph 54

Commercial Banks' 5-year Credit Default Swap Premia*

5-day moving average



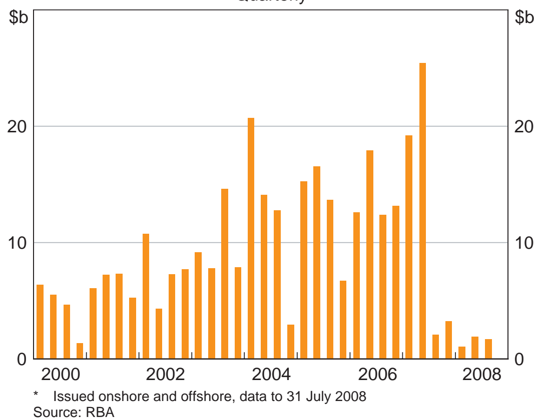
* Average across the core banks for each country

Sources: Bloomberg; RBA; Thomson Reuters

Graph 55

RMBS Issuance*

Quarterly



* Issued onshore and offshore, data to 31 July 2008

Source: RBA

the announcement of increases in provisions by a couple of the major banks, though this was later retraced.

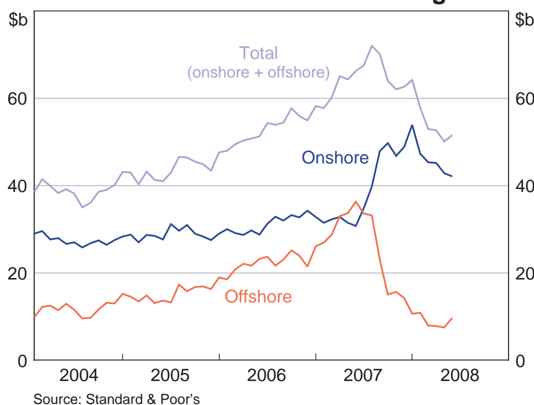
There have been some signs of improvement in the securitisation market in recent months, with a number of public issues taking place, though activity remains subdued compared to a year ago. On average, residential mortgage-backed securities (RMBS) deal sizes continue to be smaller than prior to the credit turbulence ($380 million versus $1.6 billion), with fewer investors and deals often tailored for specific investors. The stock of RMBS outstanding has fallen by 25 per cent to $130 billion since mid 2007, reflecting the limited issuance as well as amortisation (Graph 55). There has been no offshore issuance in the past year and so the fall in the stock of offshore RMBS has been greater than that of onshore RMBS (35 per cent versus 10 per cent).

Spreads on RMBS remain elevated. Recently, AAA-tranches of full-doc RMBS have priced at spreads to swap of around 110–120 basis points, compared to spreads of less than 20 basis points prior to the credit market turbulence. This is down from the spreads of 150–200 basis points seen in the secondary market in early 2008 during the liquidation by structured investment vehicles. Spreads would need to fall somewhat further for securitisation to become an attractive source of funding for financials.

Investors are demanding a premium for RMBS with equivalent credit ratings that are backed by

higher-risk loans, such as low-doc, non-conforming, or interest-only loans. Spreads on AAA-tranches of low-doc RMBS have priced at around 180 basis points in recent months, and around 300 basis points for the AAA-rated tranche of a non-conforming issue. Both prime and non-conforming senior tranches have been structured with more subordination than required to obtain a AAA rating.

There has also been a trend towards prime RMBS being structured so that the rating of the senior tranche is independent of the credit enhancement provided by lenders' mortgage insurance (LMI), following concerns about the mortgage insurance and bond insurance sector. For most RMBS issued this year, the AAA-rated tranches have around 1½ times the subordination required to be immune to LMI downgrades. In July, Moody's downgraded the Australian operations of the main LMI providers in the Australian market, PMI and Genworth, to AA- from AA, following downgrades to the US-based parent companies after they suffered losses in the US housing market. PMI was downgraded by S&P in April. Both rating agencies acknowledged the strength of the local operations of PMI and confirmed it has been successfully 'quarantined' so as to maintain a higher rating than its parent. The downgrades of PMI and Genworth have flowed through to around 190 subordinated tranches being downgraded to AA- from AA, though these account for less than 5 per cent of outstanding prime RMBS. The AAA rating of all senior tranches were affirmed, as they have sufficient levels of subordination.



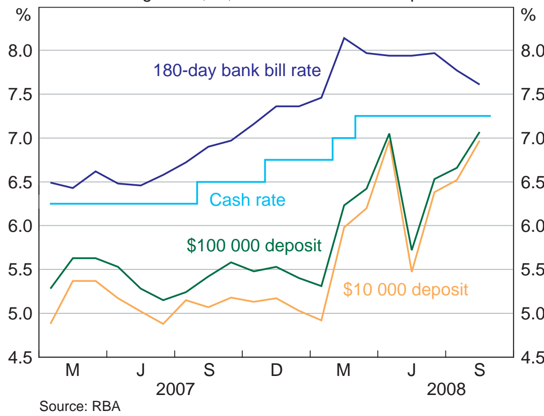
Conditions in the asset-backed commercial paper (ABCP) market remain tight, with some programs only able to issue at short maturities, and spreads near record levels. In May – the latest data available – the stock of ABCP outstanding rose 3 per cent (the first increase since December 2007), though it is still 30 per cent below its peak mid last year (Graph 56). Prime residential mortgages and RMBS continue to account for the bulk of underlying collateral. A couple of institutions are winding down warehouse facilities funded by ABCP that they used to provide to smaller originators, causing them to seek an alternative source of temporary finance until the RMBS market recovers. Some originators have been able to switch to warehouses provided by other banks, though typically these new programs are more expensive.

Deposit growth was particularly strong in the June quarter with both household and non-financial corporate deposits growing significantly. Growth in deposits has been driven by increased demand for low-risk assets and strong competition for deposits from financial institutions. The average interest rate on the major banks' 3-, 6- and 12-month term deposits was 50 basis points higher in the June quarter than in the March quarter, and rose further in July (Graph 57). Financial intermediaries' rates on online savings, cash management and bonus saver accounts also increased through the June quarter.

Graph 57

Term Deposit Rates

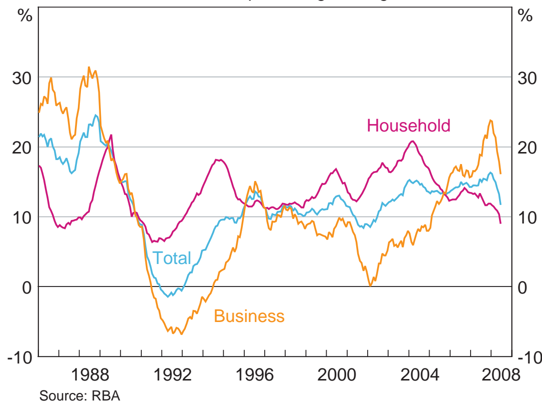
Average of 3-, 6-, and 12-month term deposits



Graph 58

Credit

Year-ended percentage change



Funding costs remain elevated for financial institutions although the recent decline in bill yields should alleviate this to some extent. These higher funding costs have been passed on to borrowers through higher lending rates (as detailed below). As a result of these higher interest rates, and some tightening of lending standards for some types of borrowing, aggregate credit growth has eased considerably since the end of 2007. After peaking at an average monthly growth rate of 1.3 per cent over the December quarter 2007, total credit grew at an average monthly rate of 0.5 per cent over the June quarter. Year-ended growth has slowed from 16.3 per cent over 2007 to 11.7 per cent over the year to June (Table 13; Graph 58). The slowdown in credit growth is consistent with other indicators of softer demand in the June quarter as discussed in the 'Domestic Economic Conditions' chapter. Growth in broad money has continued to ease over the June quarter, following the strong expansion through 2007.

Table 13: Credit Aggregates

Average monthly growth, per cent

	September quarter 2007	December quarter 2007	March quarter 2008	June quarter 2008
Total credit	1.1	1.3	0.8	0.5
Household	0.7	0.9	0.8	0.6
– Owner-occupier housing	0.8	0.9	1.0	0.7
– Investor housing	0.7	0.7	0.7	0.6
– Personal	0.0	1.2	0.0	0.1
Business	1.9	1.8	1.0	0.3

Source: RBA

Household financing

Over the past three months, interest rates on loans to households have continued to rise, despite the unchanged cash rate. The majority of these increases took place in early July in response to the ongoing high funding costs of financial institutions.

Variable indicator rates on prime full-doc housing loans have risen by an average of 18 basis points since the end of April 2008, to be 156 basis points higher than at the end of July 2007 (Table 14). Banks and mortgage originators have increased their interest rates by a little more than credit unions and building societies (CUBS). Interest rates on riskier housing loans have also continued to rise. Since the end of April, the average variable rate on prime low-doc loans (7 per cent of outstanding housing loans) has increased by 24 basis points, while the average interest rate on non-conforming loans (1 per cent of outstanding loans) has increased by around 15 basis points.

The five largest banks' average 3-year fixed rate on prime full-doc housing loans has increased by 40 basis points since the end of April 2008. The 3-year fixed rate is currently 38 basis points

Table 14: Intermediaries' Variable Lending Rates
Per cent

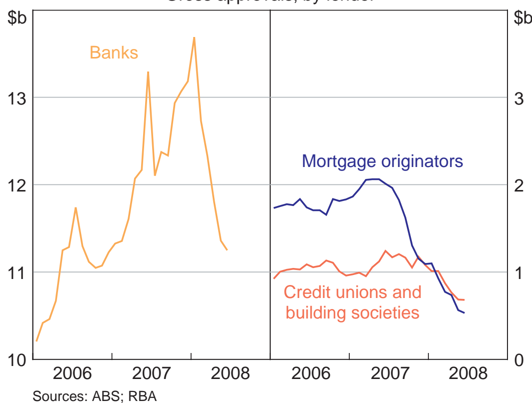
	Current level	Change since:	
	6 August 2008	End April 2008	End July 2007
Cash rate	7.25	0.00	1.00
Housing loans			
Prime-full doc			
Banks	8.98	0.18	1.55
CUBS	8.83	0.17	1.46
Mortgage originators	9.14	0.21	1.76
Prime low-doc			
Banks	9.46	0.23	1.70
Mortgage originators	9.79	0.30	1.99
Non-conforming	11.71	0.15	2.09
Personal loans			
Margin loans	10.54	0.14	1.57
Standard credit cards	19.66	0.14	1.88
Low-rate credit cards	12.88	0.33	1.72
Unsecured term loans	14.85	0.26	2.23
Small business			
Term loans			
Residentially secured	10.10	0.24	1.80
Other security	10.69	0.23	1.80
Overdraft			
Residentially secured	10.88	0.26	1.94
Other security	11.78	0.26	1.94
Average actual rate[(a)]	10.21	0.24	1.57
Large business			
Average actual rate[(a)]	9.22	0.15	1.66

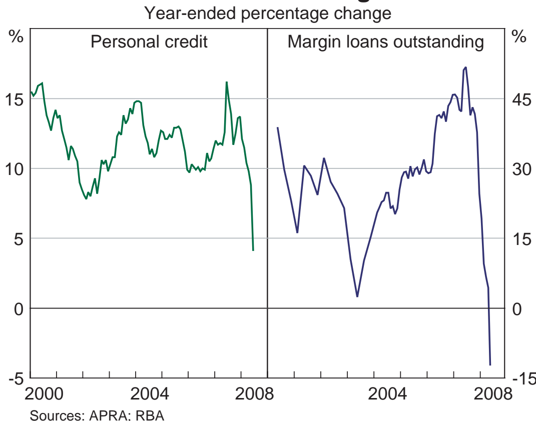
(a) RBA estimate for end of July
Sources: ABS; APRA; RBA

higher than the variable rate on prime full-doc housing loans. Partly reflecting this, the share of owner-occupier loan approvals at fixed rates has roughly halved since March to be broadly in line with its decade average of 12 per cent.

Overall, we estimate that the average interest rate on outstanding household loans has risen by about 20 basis points since the previous *Statement*, to be around 100 basis points above its post-1993 average.

The increase in borrowing costs, combined with some tightening in lending standards (particularly for riskier borrowers) have contributed to a decline in the value of new housing loans over the first half of 2008. Since December, housing loan approvals have fallen by 20 per cent. The share of owner-occupier loans approved by mortgage originators has continued to decline, to around 4½ per cent in June, compared to 12 per cent in mid 2007, while the banks have continued to increase their market share (Graph 59).





Reflecting the reduction in new loans, housing credit growth has slowed noticeably over the past few months. Monthly growth in housing credit averaged 0.6 per cent over the June quarter, down from 0.9 per cent over the December quarter.

Interest rates on personal loans have also risen over recent months. Average variable interest rates on margin loans, unsecured personal loans and credit cards have increased by between 15 and 35 basis points since the end of April 2008. While higher interest rates on personal loans are likely to be discouraging borrowing, the recent volatility in personal credit growth appears to be largely related to volatility in equity markets. The falls in equity markets have reduced demand for new margin loans, and increased repayments of existing loans – the number of margin calls remained elevated at around 1.7 calls per 1 000 accounts in the June quarter, after peaking at 3.9 calls per 1 000 accounts in the March quarter (Graph 60). With the

stock of outstanding margin loans falling by a further 2 per cent in the June quarter to be 16 per cent below its December 2007 peak, personal credit grew by 4.1 per cent over the year to June, its slowest pace of growth in 14 years.

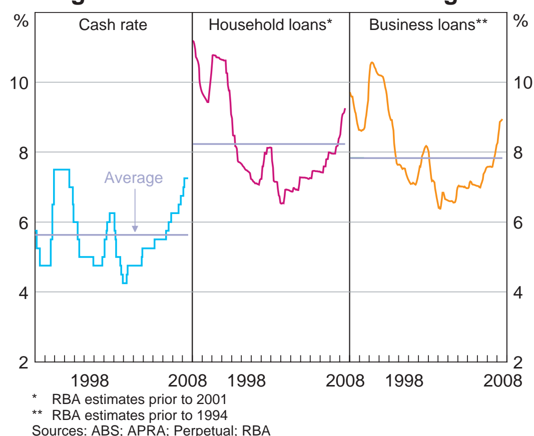
Business financing

The cost of borrowing has also increased for businesses. Variable interest rates on large business loans, which are mostly priced off bank bill rates, have increased by 15 basis points since the end of April, while variable indicator rates on small business loans have risen by 24 basis points. In contrast, rates on new 3-year fixed loans for small businesses have fallen by 60 basis points over the same period, although much of the decline occurred since mid July, broadly in line with the decline in the 3-year swap rate. Overall, we estimate that the average interest rate on all outstanding business loans is around 8.88 per cent, 100 basis points above the post-1993 average (Graph 61).

In line with higher borrowing interest rates, as well as tighter lending standards, particularly for property, growth in total business debt has eased sharply over the first half of 2008. Total debt grew at an annualised rate of 8 per cent over the first six months of this year, down from an annual rate of 17 per cent over the previous six months. The slower growth in the first half of 2008 largely reflected a pronounced slowing in intermediated borrowing from the rapid growth in the second half of 2007. Intermediated business credit growth weakened in the June quarter, expanding at an average monthly rate of 0.3 per cent, following average monthly growth of 1.8 per cent during 2007. This partly reflects a slowing in the pace of re-intermediation (Graph 62). The stock of outstanding non-intermediated debt has increased over recent months, after falling in the second half of last year, as access to capital markets has improved somewhat for large well-known credit-worthy borrowers.

Graph 61

Average Interest Rates on Outstanding Loans

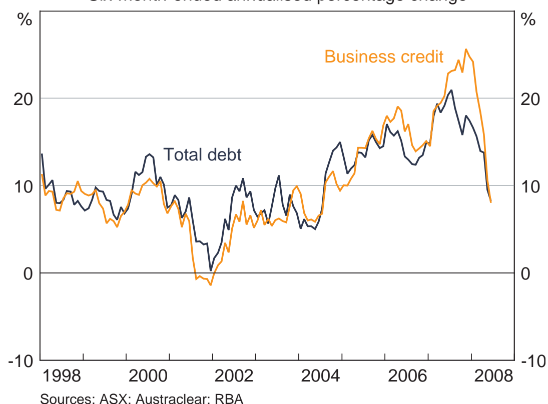


* RBA estimates prior to 2001
** RBA estimates prior to 1994
Sources: ABS; APRA; Perpetual; RBA

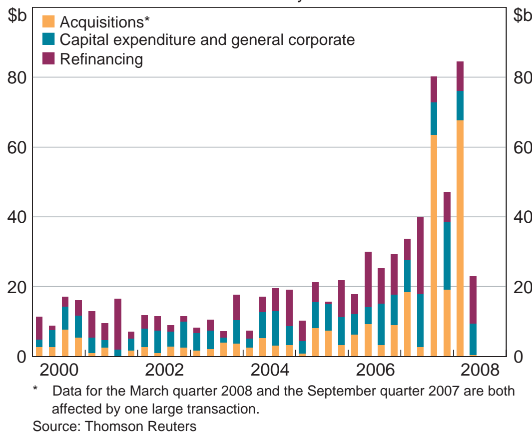
Graph 62

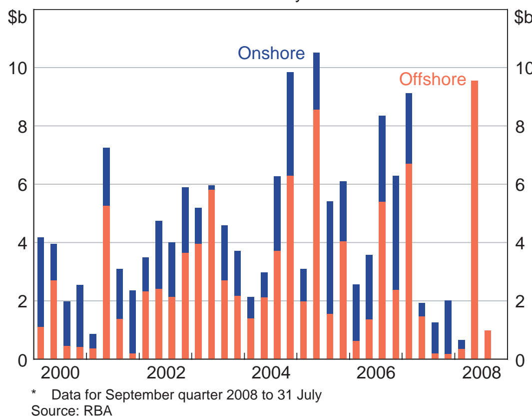
Business Funding

Six-month-ended annualised percentage change



Sources: ASX; Austraclear; RBA





Commercial loan approvals have also fallen significantly in recent months, suggesting demand for borrowing by businesses could remain soft in the near term.

The slowdown in borrowing in the June quarter has been evident across large and small business borrowers. Companies in the finance & insurance and wholesale & retail trade sectors have led the slowdown. Borrowing by mining companies has also slowed. Some of the slowdown in borrowing by large corporates in recent months reflects a sharp fall in borrowing for acquisitions, with these being equity-funded instead (Graph 63).

The value of corporate bond issuance was $10 billion in the June quarter, around the average level of issuance prior to the credit turbulence (Graph 64). While this pick-up in issuance suggests that there has been some improvement in corporates' access to the bond market, issuance has been by large companies that have a well-established presence in US wholesale markets. The bulk of issuance in June was due to Rio Tinto refinancing debt related to its acquisition of Alcan. Issuance in July was modest, with four relatively small corporate issues.

Spreads on recently issued corporate bonds remain elevated compared to a year ago. In secondary markets, corporate bond yields have fallen by 30 basis points since April, though remain around the highest level in at least a decade (Graph 65). As CGS yields have fallen by more than corporate bond yields over this period, spreads widened further.

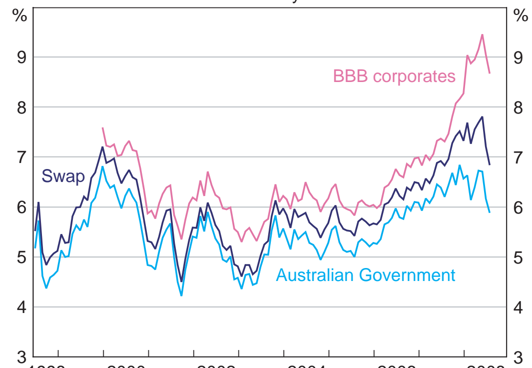
As well as higher spreads, investors have increasingly demanded tighter bond covenants following the global reappraisal of risk. There has been an increased use of covenants in corporate bonds issued in 2008 providing greater protection to investors from either a change in ownership or a ratings downgrade. The Australian corporate bond market has also been affected by the recent widespread rating downgrades of monolines, resulting in credit-wrapped

spreads on some corporate bonds rising significantly (see 'Box B: The Domestic Credit-wrapped Bond Market').

Graph 65

Australian Corporate Bond Yields*

Monthly

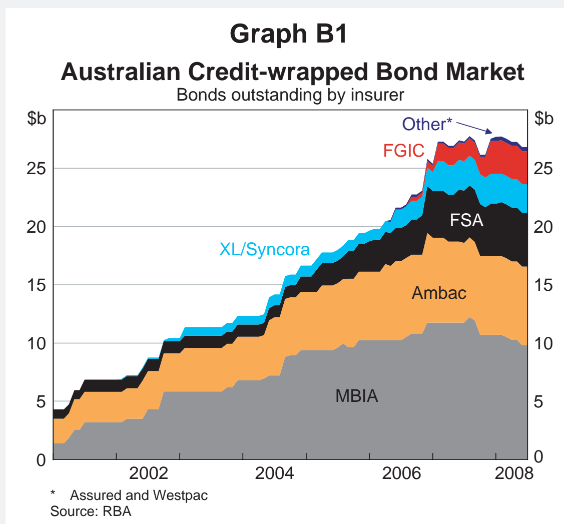


* Yields on bonds issued by the Australian Government and swap rates are 3-year maturities. Corporate bond yields are a weighted average of bonds with remaining maturities of 1 to 5 years.

Sources: Bloomberg; RBA; UBS AG, Australia Branch

Box B: The Domestic Credit-wrapped Bond Market

Credit wrapping is a type of credit enhancement whereby a bond insurer guarantees to meet interest and principal payments if the issuer cannot. In Australia, credit wrapping is primarily used by lower-rated (generally BBB) investment-grade corporates – typically airports, utilities and infrastructure related issuers – to obtain a higher rating on their bonds. This is because the rating of a credit-wrapped bond is generally set at the higher of the insurer or issuer's rating. It also enables issuers to issue at longer maturities and lower spreads than otherwise. Very few structured credit products, such as asset-backed securities, are credit-wrapped in Australia, in contrast to the United States.



There are currently around $27 billion credit-wrapped bonds outstanding in Australia, accounting for 7 per cent of the domestic non-government bond market (Graph B1). Almost all of these bonds are insured by US financial guaranty insurers, also known as monolines.[1] The two largest monolines operating in Australia are MBIA and Ambac, which have a market share of around 60 per cent.

Most of the monolines that are active in the Australian market have been downgraded this year, reflecting increased expected losses for US sub-prime RMBS and related securities, and the effect these losses – combined with the low expected business growth – would have on the monolines' capital (Table B1). These downgrades have flowed through to the insured bonds, with around 80 per cent of the domestic credit-wrapped bond market having been downgraded below AAA. Thus far, most of the bonds have been downgraded to the same rating as the insurer – typically AA.

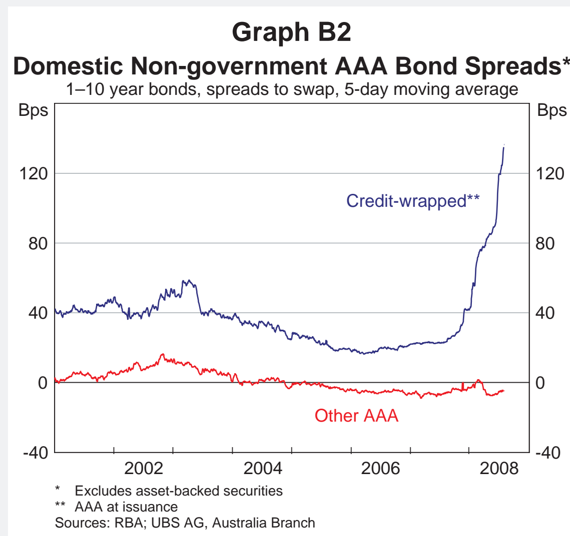
Partly in anticipation of the monoline downgrades, the margin between credit-wrapped bonds and other non-government unsecured AAA-rated bonds in the secondary market has increased from an average of 25 basis points prior to the credit market turmoil to around 140 basis points (Graph B2). While the spreads on credit-wrapped bonds have increased, they remain significantly below spreads on bonds with similar ratings to the underlying issuers.

1 *For more information on the monolines, see 'Box A: Financial Guaranty Insurers (Monolines)', RBA* Financial Stability Review, *March 2008, pp 16–17.*

Table B1: Monoline Ratings

	Market share	2007	Current		
	Per cent		S&P	Moody's	Fitch
MBIA	37	AAA	AA	A2	–
Ambac	25	AAA	AA	Aa3	–
FSA	17	AAA	AAA	Aaa	AAA
FGIC	11	AAA	BB	B1	CCC
XL/Syncora	9	AAA	BBB-	B2	CCC
Assured	1	AAA	AAA	Aaa	AAA

Sources: Fitch; Moody's; RBA; Standard & Poor's



* Excludes asset-backed securities
** AAA at issuance
Sources: RBA; UBS AG, Australia Branch

Around half of credit-wrapped bond investors (banks, insurers, ABCP conduits and structured investment vehicles) have mandates to only hold highly rated bonds and may be required to sell, or have already sold, bonds that have been downgraded below AA. At the end of July, the value of credit-wrapped bonds downgraded below this by all of the major rating agencies was $5 billion. Most of the other investors are fund managers who can only hold investment-grade bonds. However, as the actual issuers of the bonds are generally rated at least investment grade, this would be likely to put a floor under the rating of these bonds, even if the monolines were to be downgraded below that. ✠

Price and Wage Developments

Recent developments in inflation

The CPI data for the June quarter confirmed that inflation remained high over the first half of 2008. The CPI increased by 1.5 per cent in the quarter, to be 4.5 per cent higher over the year (Table 15, Graph 66). The increase reflected broad-based strength in price pressures, with measures of underlying inflation at around 1.2 per cent in the quarter and between 4¼ and 4½ per cent over the year.

Table 15: Measures of Consumer Prices
Percentage change

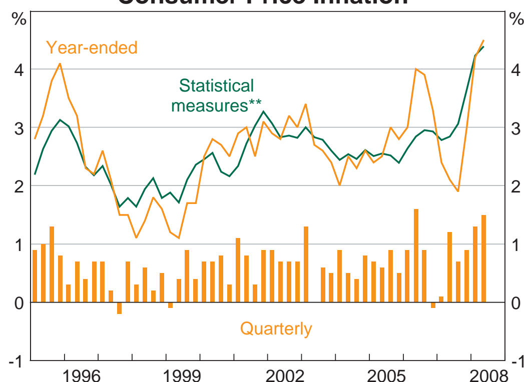
	Quarterly		Year-ended	
	March quarter 2008	June quarter 2008	March quarter 2008	June quarter 2008
CPI	1.3	1.5	4.2	4.5
– Tradables	0.8	1.5	3.3	2.9
– Tradables (ex food and petrol)	–0.2	1.1	0.6	1.0
– Non-tradables	1.7	1.4	5.0	5.6
Underlying measures				
Weighted median	1.3	1.0	4.4	4.5
Trimmed mean	1.2	1.2	4.0	4.3
CPI ex volatile items[(a)]	1.2	1.3	3.6	4.2

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

The largest contributor to inflation in the quarter was the deposits & loans component, which rose by 9.5 per cent to be 16.2 per cent higher over the year. The sharp quarterly increase largely reflected a correction in the quarter by the ABS for previous underestimates in this series. The deposits & loans component is mainly driven by the difference between banks' lending and deposit rates, which – based on other data available – appear to have moved broadly together in the quarter. Partially offsetting this

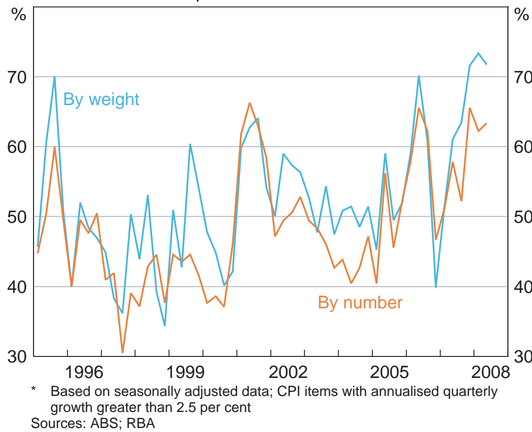
Graph 66

Consumer Price Inflation*



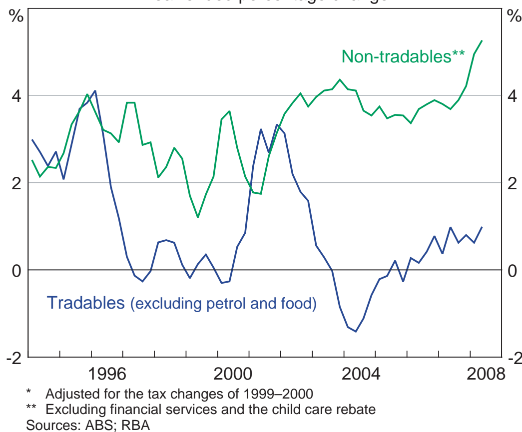
* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
** Average of the trimmed mean and weighted median
Source: ABS

upward adjustment, the ABS also included a downward correction to the other financial services component, which had been overestimated during the past year. When financial services and the effect of the change in the child care rebate in 2007 are excluded, CPI inflation was 1.2 per cent in the June quarter and 4.2 per cent over the year. Measures of underlying inflation on this basis were around 1.1 per cent in the quarter and 4 per cent over the year.



* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent

Sources: ABS; RBA



* Adjusted for the tax changes of 1999–2000

** Excluding financial services and the child care rebate

Sources: ABS; RBA

Overall, the June quarter data suggest that aggregate inflation may be levelling out, but is yet to show any sign of easing. Price pressures were relatively broad-based in the quarter, which is in contrast to other developed countries, where inflation pressures outside of food and fuel have remained contained (see Box C for further discussion). Around 70 per cent of items in the CPI (by expenditure weight) grew at an annualised rate of more than 2.5 per cent in the June quarter (Graph 67).

Non-tradables inflation remained strong, at 1.0 per cent in the quarter and 5.3 per cent over the year (excluding financial services and the child care rebate changes; Graph 68). The largest contributor to non-tradables inflation over the year was housing costs, in large part due to a 7.7 per cent increase in rents that reflected the current low rental vacancy rates.

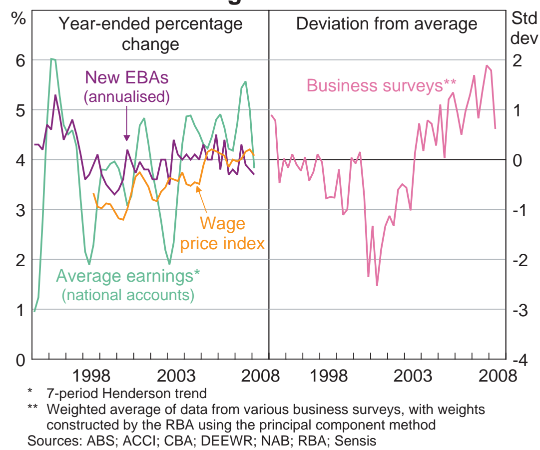
Tradables inflation picked up to 1.5 per cent in the quarter, boosted by price changes in volatile items: a 9 per cent rise in petrol prices more than offset a 7 per cent fall in fruit & vegetable prices. Excluding fuel and food prices, tradables inflation picked up to 1.1 per cent in the quarter and 1.0 per cent over the year as prices rose across a wide range of items, especially clothing, furniture, overseas travel and alcohol & tobacco. The strength of the price pressures in some of these components appears somewhat at odds with the continued decline in Australian-dollar import prices.

Costs and margins

Labour cost pressures remain firm, due to the ongoing tight labour market and shortage of suitable labour. However, the different measures of wage costs are subject to significant volatility as well as differences in coverage. The wage price index, which should be free of most forms of compositional change, rose by 0.9 per cent in the March quarter, with year-ended growth firm at 4.1 per cent (Graph 69). The national accounts measure of average earnings, which is conceptually the broadest measure of earnings but very volatile, increased by 4.0 per cent over the year to the March quarter; in trend terms, its pace eased a little to 3.8 per cent. The average annualised increase for new federal enterprise bargaining agreements (EBAs) formalised in the March quarter (adjusted for industry composition) was relatively stable at 3.7 per cent. Private-sector surveys of firms – which provide a broader measure of labour costs – have also shown above-average increases, with a broad upward trend in labour costs in recent years. Overall, based on these data and information from liaison, it appears that recent growth in labour costs has been relatively firm by the standards of the past decade or so, but has not accelerated over the past couple of years.

Graph 69

Wage Growth



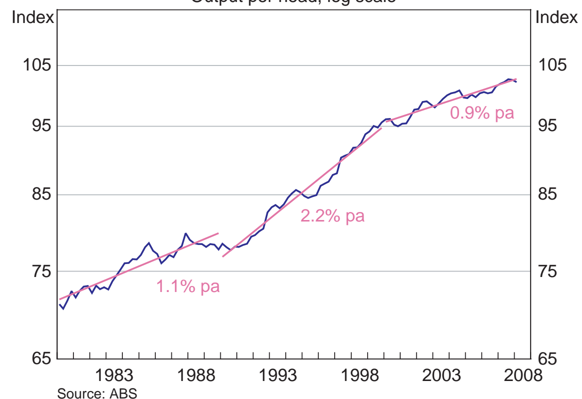
* 7-period Henderson trend
** Weighted average of data from various business surveys, with weights constructed by the RBA using the principal component method
Sources: ABS; ACCI; CBA; DEEWR; NAB; RBA; Sensis

The relatively steady growth in wages in recent years has, however, been accompanied by slower growth in labour productivity than that seen in the 1990s (Graph 70). In the current decade to date, trend non-farm output per head has grown at an annual rate of 0.9 per cent, compared with 2.2 per cent during the 1990s. This implies that labour costs per unit of output have been growing at around 3–4 per cent in recent years.

Graph 70

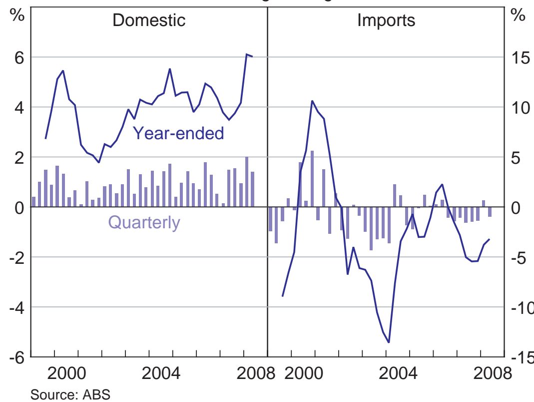
Non-farm Labour Productivity

Output per head, log scale



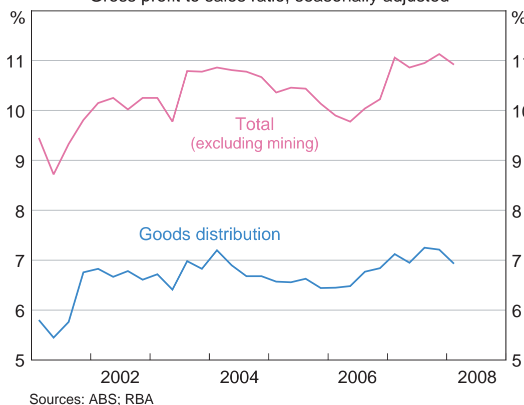
Source: ABS

The Australian Fair Pay Commission's 2008 wage decision, announced in July, granted a $21.66 per week increase in the Federal minimum and all other adult award wages effective from October. For workers on minimum wages, this is equivalent to a 4.1 per cent increase, which is around the pace of economy-wide wages growth. The implied increase across all award-wage workers – who comprise around one-fifth of employees – is around 3 per cent.



Producer price data suggest that upstream cost pressures also remained firm in the June quarter. At the final stage, prices rose by 1.0 per cent in the quarter to be 4.7 per cent higher over the year. Falling import prices (–1.0 per cent in the quarter and –3.2 per cent over the year) continued to exert restraint on overall final-stage prices (Graph 71). The net effect of volatile items at the final stage was modest in the quarter, with a large rise in petroleum prices partly offset by falls in fruit & vegetable prices.

Upstream cost pressures were broad-based across industries. Manufacturing price inflation picked up further in the quarter and is now growing at around its fastest pace since 1990. Construction prices posted a further solid increase, as increased steel and timber costs were passed on to customers. Prices for property & business and transport & storage services also rose considerably over both the quarter and the year.



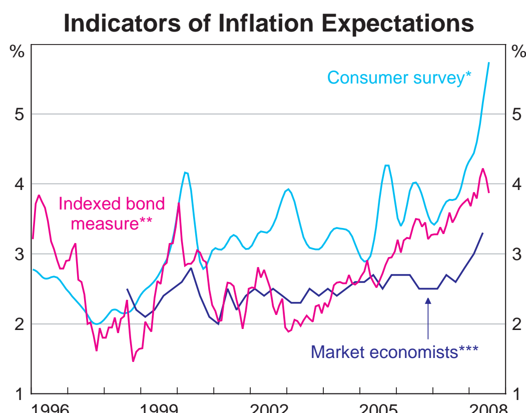
Business margins remain strong, although there is some evidence that they are no longer widening. Estimates based on profits data from the ABS suggest that margins in both the broader economy and goods distribution sector – which includes retail and wholesale trade and transport – were at relatively high levels in the March quarter (Graph 72). More recent data from the NAB survey suggest margins may have eased in the June quarter.

Inflation expectations

Inflation expectations are at high levels, and an upward trend is evident across various measures. According to the Melbourne Institute survey of households, the median expectation for CPI inflation over the year ahead was close to 6 per cent in July, compared with 4¼ per cent in April; recent increases may have been partly influenced by the sharp increase in petrol prices that took place up to mid July (Graph 73). Medium-term inflation expectations implied by indexed bond yields are around their highest level in a number of years, although tightness in the supply of indexed bonds could be influencing this outcome. Market economists surveyed by the Bank following the release of the June quarter CPI have continued to increase their near-term inflation expectations. The median expectation for headline inflation over the year to the June quarter 2009 is now 3.3 per cent, up from 3.0 per cent in May (Table 16). Over the year to the June quarter 2010, the median inflation expectation is unchanged at 2.8 per cent. Union officials have left their inflation expectations for the next two years broadly unchanged, while surveys report that the proportion of businesses expecting to increase prices in the near term remains above long-run average levels.

Graph 73

Indicators of Inflation Expectations



* Median consumers' expectation of average annual inflation over the next year; 13-period Henderson trend
** Break-even 10-year inflation rate on indexed bonds
*** Median market economists' expectation of headline inflation for the year ahead
Sources: Melbourne Institute of Applied Economic and Social Research, University of Melbourne; RBA

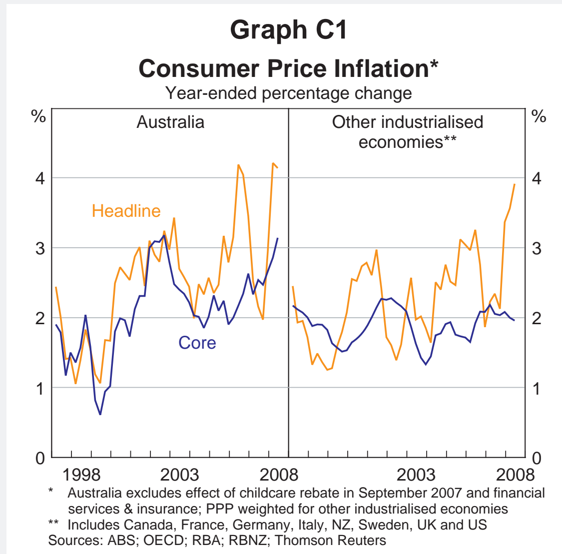
Table 16: Median Inflation Expectations

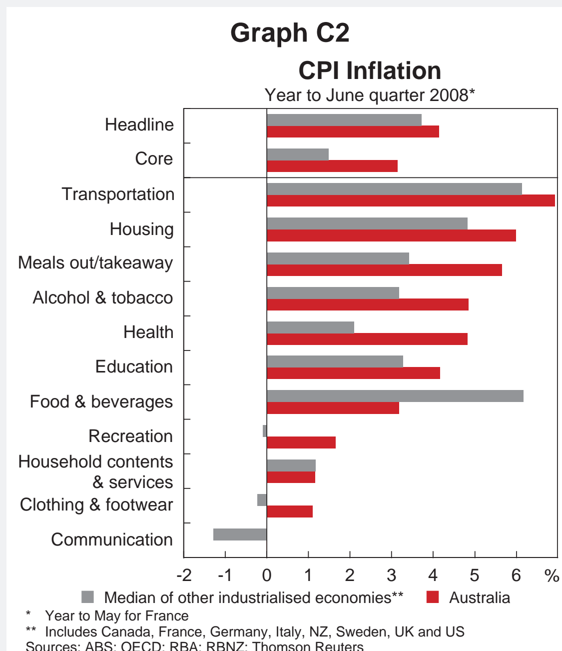
Per cent

	Year to June 2009			Year to June 2010	
	February 2008	May 2008	August 2008	May 2008	August 2008
Market economists[(a)]	2.8	3.0	3.3	2.8	2.8
Union officials[(b)]	3.5	4.0	4.0	3.5	3.6

(a) RBA survey
(b) Workplace Research Centre

Box C: Inflation in Australia and Other Industrialised Economies





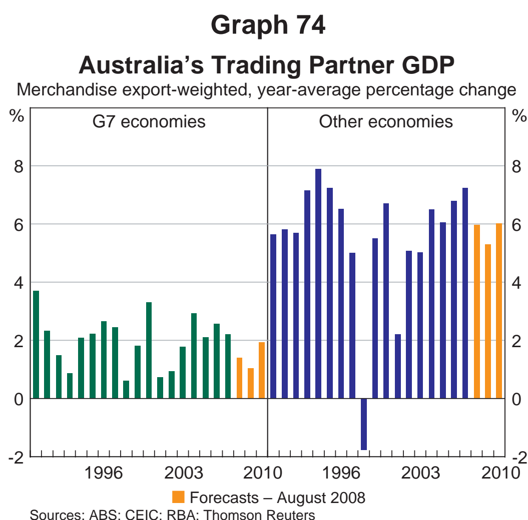
Consumer price inflation has increased significantly in a range of industrialised economies over the past year, with the rate of year-ended inflation in many countries the highest it has been since the early to mid 1990s. The increase has been relatively uniform across these countries, with the weighted-average inflation rate of a representative group of countries (the G7 excluding Japan, plus New Zealand and Sweden) increasing from around 2¼ per cent in mid 2007 to nearly 4 per cent in mid 2008 (Graph C1). The increase over the past year in most industrialised economies has been mainly a result of rising energy and food prices; measures of 'core' inflation that exclude these factors have generally been relatively stable or fallen.

In contrast, the increase in CPI inflation in Australia is not due only to energy and food prices. Measuring 'core' inflation in a broadly similar manner to that used in other industrial countries, inflation excluding food and energy and financial services has increased from around 2 per cent to 3 per cent over the past few years in Australia. This calculation indicates that inflation pressures here have been more broadly based over the past couple of years than in other countries. Indeed, inflation in Australia is now higher than the median of comparable countries in nearly all of the 11 major CPI categories (Graph C2).

Economic Outlook

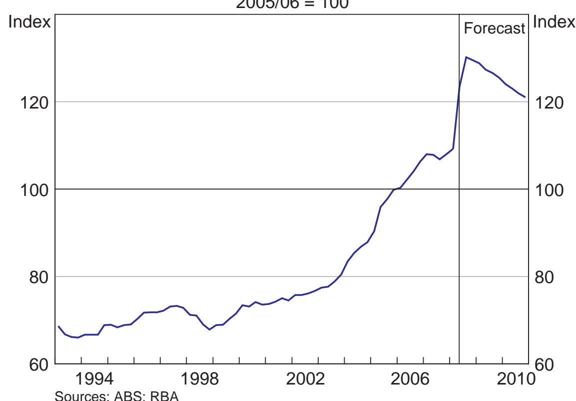
The international economy

The domestic forecasts are based on the expectation that growth in Australia's major trading partners will be around 4¼ per cent in 2008 and then slow to 3¾ per cent in 2009, down from 5¼ per cent on average in 2006 and 2007. A modest recovery in global growth is then projected for 2010. Growth in the developed economies is expected to be well below trend in both 2008 and 2009, with slowing activity in Europe, Japan and New Zealand and continuing weak growth in the United States (Graph 74). Growth in the emerging economies of Asia is also forecast to slow further from the very rapid rates of recent years, due to weakening external demand, and a slowing in domestic demand growth reflecting both the effect of higher commodity prices on real incomes and some tightening in monetary policy.



The forecasts for growth in 2008 are in line with those of the IMF and many external forecasters, and are a little higher than those presented in the May *Statement*: this revision reflects the generally stronger-than-expected growth outcomes recorded in the March quarter. The forecast for trading partner growth in 2009 has been revised downwards somewhat and is below the IMF and Consensus forecasts. This assessment reflects both an expectation of softer growth in Asia and a general view that the problems in global financial markets are proving to be deeper and more persistent, and will weigh on global growth outcomes for longer, than had generally been expected earlier.

Australia's terms of trade are expected to have increased by around 20 per cent over the year to the September quarter but are then forecast to gradually decline (Graph 75). However, with coal and iron ore spot markets tightening somewhat since the time of the May *Statement*, the expected easing in the terms of trade over the forecast period has been scaled back slightly.



Domestic activity

The forecasts for the domestic economy are based on the technical assumption that the cash rate will remain at its current level of 7.25 per cent through to the end of the forecast period (December quarter 2010). The forecasts also incorporate the effect of the tightening in credit markets since mid 2007. Variable lending rates to households and businesses have now risen by around 60 basis points more than the cash rate over this period. There has been some additional contractionary effect from tighter lending standards and reduced access to capital markets, as well as from the decline in equity markets. The forecasts also assume that the exchange rate remains around its current level, which is broadly unchanged in trade-weighted terms from the level at the time of the May *Statement*.

The outlook for the domestic economy continues to reflect the interaction of several opposing forces. The significant tightening in financial conditions and the global slowdown have continued to weigh on domestic financial markets. Since May there have been additional increases in bank variable lending rates (around 15 basis points in the case of households) and prices on the Australian share market have declined by around 15 per cent. Developments in financial markets over the past year have clearly begun to weigh on the domestic economy, as indicated by the sharp slowing in credit growth and broader slowing in a number of indicators.

At the same time, the global boom in commodity prices is having different effects on sectors depending on whether they are users or producers of energy and other commodities. Households and oil-intensive sectors such as transport and agriculture are facing higher fuel prices, prompting reduced household spending and cost cutting by businesses. While the mining sector is also facing escalating input costs, this is far outweighed by the higher prices for coal, iron ore and other commodities that mining firms are receiving. Overall, the rise in global commodity prices and the terms of trade can be expected to support growth, although the stimulatory effects will take some time to feed through to the broader economy. In the near term, the surge in export prices is raising domestic incomes by around 4 per cent, boosting corporate profits and government revenues. While foreign ownership of the minerals sector is significant, domestic shareholders have also benefited. Higher commodity prices should also boost investment spending by resources companies, although capacity pressures are expected to constrain the ability of the sector to increase investment significantly in the near term.

One other factor that is affecting economic performance in the near term is the early June explosion at the Apache gas plant in Western Australia. The high level of capacity utilisation in

the economy increases vulnerability to such short-term supply disruptions. At this stage, staff estimates indicate that the disruption may result in a temporary reduction in national GDP of around ¼ percentage points spread over the June and September quarters, with the mining and manufacturing sectors most affected.

The staff's assessment is that the net effect of these forces is a softening in the outlook for the domestic economy since the time of the May *Statement*. The modest lowering of the forecasts also reflects information from the Bank's liaison program and some of the indicators of domestic activity, including retail sales, credit growth, building approvals, and measures of consumer sentiment and business conditions. Although the March quarter national accounts suggested growth in late 2007 and early 2008 was stronger than expected, the more timely information implies that spending may now be slowing noticeably. This is likely to be reflected in a weak GDP growth outcome for the June quarter.

The staff is now expecting that growth in non-farm GDP will slow from the year-ended rate of 3.6 per cent estimated for the March quarter 2008 to 1½ per cent over the year to the December quarter 2008, before gradually picking up to 2¾ per cent over 2010. With farm sector output expected to recover from the drought over the next year or so, total GDP growth is forecast to be slightly stronger over this period. Given the strong growth in the capital stock, these rates of output growth imply a significant easing in capacity pressures in the economy.

The slowing in growth is likely to be concentrated in household spending. Retail sales declined in real terms over the first half of 2008 and measures of consumer sentiment and the Bank's liaison suggest that subdued spending is likely in the near term despite the recent tax cuts. Overall household consumption is expected to grow only modestly over the second half of 2008 in response to the tightening of financial conditions, the high level of petrol prices and falling household wealth, before gradually picking up later in the forecast period. Housing investment is expected to contract over the next year reflecting developments in the cost and availability of finance and the subdued state of the housing market, but further out should be supported by strong immigration and rising rents. While the high level of commodity prices is expected to contribute to further growth in mining investment, investment in the non-mining sector is forecast to be relatively weak given the slowing economy and the tightening of financial conditions; commercial property development is expected to be particularly adversely affected. Public demand growth is expected to be moderate as a result of some fiscal consolidation by the Commonwealth and state governments, although state budgets indicate that public trading enterprises will increase their investment spending over 2008/09. Resource exports are expected to grow strongly over the forecast period, while growth of non-commodity exports is forecast to be moderate due to the high level of the Australian dollar and the slowing in the growth of our major trading partners.

The forecast slowing in GDP growth implies that labour demand will continue to ease, following a period of considerable strength in recent years. Annual employment growth is forecast to average ¾ per cent over the next year, before picking up gradually. With the rate of employment growth expected to remain below that of the working-age population, the unemployment rate is expected to rise.

Inflation

The forecasts do not yet incorporate any effects, notably on inflation, from the Government's proposed Carbon Pollution Reduction Scheme (CPRS). Based on the Government's consultation paper released in July 2008, the introduction of the proposed measures would be expected to boost CPI inflation near the end of the forecast period. However, the precise details of the CPRS are yet to be determined, particularly the starting date, the starting price of carbon and its likely trajectory over time. The Bank will incorporate estimates of initial and ongoing effects into its forecasts as further details are released.

The forecasts for inflation have been revised upwards in the near term, but are broadly unchanged towards the end of the forecast period. The upward revision in the near term mostly reflects the slightly higher-than-expected outcome for both CPI and underlying inflation in the June quarter. In addition, petrol prices have been higher than expected at the time of the May *Statement* and inflation expectations appear to have risen somewhat.

It is expected that the annual rate of CPI inflation will rise further in the September quarter, in part due to the effect of higher petrol prices over the year. Underlying inflation is expected to be around 4½ per cent over the year to the December quarter and then to decline gradually to 2¾ per cent by the end of 2010 (Table 17). CPI inflation is expected to be higher in the short run, at around 5 per cent in the December quarter, reflecting the effects of higher petrol prices and the recent correction to estimates of financial services inflation, before declining thereafter. Excluding financial services and the effect of the child care tax rebate, underlying inflation would peak at 4¼ per cent while CPI inflation would peak at 4¾ per cent.

Table 17: Output and Inflation Forecasts[(a)]

Percentage change over year to quarter shown

	Dec 2007	Mar 2008	June 2008	Dec 2008	June 2009	Dec 2009	June 2010	Dec 2010
GDP	4.3	3.6	2¾	2	2¼	2½	2½	2¾
Non-farm GDP	4.2	3.6	2½	1½	1¾	2½	2½	2¾
CPI	3.0	4.2	4.5	5	3¾	3¼	3	2¾
Underlying inflation	3.6	4.2	4.4	4½	3¾	3¼	3	2¾

(a) Actual GDP data to March 2008 and actual inflation data to June 2008. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.91, TWI at 70, cash rate at 7.25 per cent, and WTI crude oil price at US$118 per barrel and Tapis crude oil price at US$122 per barrel.

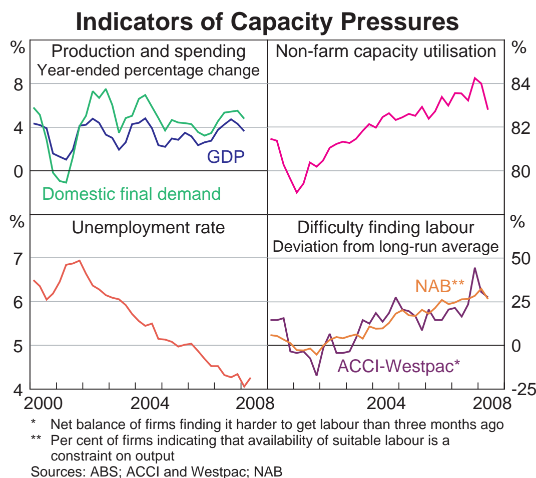
Sources: ABS; RBA

The current forecast profile implies that year-ended inflation will remain outside the target range until mid 2010. This extended period of high inflation is a reflection of the extent of price pressures evident in recent quarters, which in turn are the result of the high level of resource utilisation in the economy over recent years as well as increases in input costs resulting from global factors (Graph 76). However, demand pressures in the economy now appear to be easing and the forecasts project a significant period of slower growth, which will result in a moderation of capacity pressures. As this occurs, the pricing power of businesses is likely to fall. With the

unemployment rate forecast to rise in line with slowing domestic activity and employment, growth in labour costs is likely to moderate. In addition, with global growth expected to slow, the forecasts assume no significant additional inflationary impulse from international factors, with oil prices assumed to remain around current levels.

Graph 76

Indicators of Capacity Pressures



* Net balance of firms finding it harder to get labour than three months ago

** Per cent of firms indicating that availability of suitable labour is a constraint on output

Sources: ABS; ACCI and Westpac; NAB

There are risks to these forecasts in both directions. The June quarter inflation data provided some indication that inflation pressures may no longer be rising, but evidence of this was quite tentative. If the recent easing in demand is not as long-lasting as the forecasts envisage or if the stimulus to domestic activity from the terms of trade causes demand to be stronger than expected, the easing in inflation may be more modest than forecast. This could leave inflation expectations entrenched at unacceptably high levels, and feed back into the setting of wages and prices.

However, any further deterioration in the outlook for global growth would represent a significant downside risk to the domestic activity profile, particularly if it led to a marked slowing in growth in China and India. This could lead to a significant deterioration in the outlook for the Australian economy and commodity markets, which could lead to further moderation in inflation over time as growth of domestic incomes and spending eased and oil prices fell. In addition, the ongoing turmoil in capital markets could exacerbate the slowing in domestic growth by further reducing the availability of credit to households and businesses.