STATEMENT ON MONETARY POLICY

8 MAY 2009

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STATEMENT ON MONETARY POLICY

The world economy experienced a marked contraction in late 2008 and early 2009, with large declines in industrial production and international trade. Almost all developed countries recorded a decline in output in the December quarter, and most appear to have experienced a further decline in the March quarter. Growth also slowed significantly in all emerging market countries.

The sharp and synchronised nature of the downturn is largely accounted for by the substantial falls in consumer and business confidence that followed the financial events in September 2008, including the failure of Lehman Brothers in the United States. As confidence declined and uncertainty and risk aversion increased, both consumers and businesses delayed or cancelled their spending and production plans, especially for consumer durables and capital goods. Credit conditions simultaneously tightened considerably around the world, as severe strains developed in the global financial system.

While the recent GDP outcomes for most countries have been very weak, there are signs that the rate of contraction in output is abating. It is likely that the half year to the March quarter will prove to have been the period of greatest contraction, with the IMF's recently revised forecasts consistent with a modest increase in global GDP over the second half of 2009. Industrial production and exports have picked up in Asia, after earlier steep falls, and growth in the Chinese economy has sped up recently. There has also been some improvement in consumer and business confidence in a range of countries from the very low levels of late last year.

These signs of a turning point are a positive development. However, given the scale and nature of the downturn, the recovery of the world economy is likely to be gradual and to involve an extended period of sub-par growth. The outlook for investment in many countries is particularly weak, weighed down by rising excess capacity, much tighter credit conditions and declining profitability.

Reflecting the recent signs of stabilisation in the global economy, sentiment in financial markets has improved in recent weeks. Global equity markets have risen by around 30 per cent from their troughs in mid March, with a number of financial institutions reporting better-than-expected profits. There has also been a further easing of credit spreads, and businesses and financial institutions have found it easier to issue debt. Encouragingly, over the past month, a number of banks – including those in Australia – have been able to issue long-term debt without a government guarantee.

The improvement in sentiment is also evident in commodity markets. After the very large falls in the second half of last year, the prices of many commodities, including base metals, have strengthened a little over recent months. While Australia's terms of trade are declining as lower contract prices take effect, they are expected to hold up at a high level.

Although sentiment in many markets and the economy more generally has improved, confidence is still clearly vulnerable to setbacks, especially the possibility of more unexpected losses by financial institutions. As has been the case for some time, prospects for a sustained recovery in the United States, in particular, depend critically on a resolution of the current problems in the financial sector.

The downturn in the global economy has had a significant effect on output growth in Australia. Activity contracted in the latter part of 2008 and this has continued into 2009. The economy is, however, still expected to record better outcomes in 2009 and 2010 than those in most other advanced countries. This reflects, among other things, the stronger state of the Australian banking system, the significant policy stimulus to date and the depreciation of the currency that took place in the second half of 2008. Since September last year, the cash rate has been lowered by 4¼ percentage points and, unlike in many other countries, the bulk of this reduction has been passed on to end borrowers, particularly households. There has also been a very substantial easing of fiscal policy.

In the current environment, household spending is being influenced by a number of countervailing forces. Disposable income has been boosted by government transfer and tax bonus payments, and households with a mortgage have benefited from the very large reduction in debt servicing costs. Working in the other direction, aggregate household wealth has seen a major decline, and households have become more concerned about the prospect of unemployment, although consumer confidence remains substantially higher in Australia than in many other countries. Overall, consumer spending appears to have grown at a modest pace over recent months.

Housing construction remains weak, but there are some signs that activity will pick up in the second half of 2009. Loan approvals for new construction have increased and a relatively high proportion of households report that now is a good time to buy a dwelling. Borrowing for housing has also increased, particularly by first-home buyers. Nationwide measures of housing prices have been mixed although, on balance, they suggest that prices were little changed in the March quarter, after declining by around 3 per cent over 2008. Strong demand by first-home buyers has seen increases in the prices of lower-priced dwellings, while prices at the top end of the market have continued to decline.

Recent indicators of business confidence suggest some improvement, although confidence remains low. After a number of years of very high levels of investment, many firms have scaled back their investment plans over recent months and there has been a sharp drop in capital imports. This reflects a number of factors including the general deterioration in the economic outlook, a significant increase in uncertainty and risk aversion, and tighter financial conditions. These tighter conditions are most evident for the property development industry, where construction activity is expected to fall further over the period ahead.

In this more difficult environment, many businesses have reduced their demand for debt as they seek to reduce leverage. This has contributed to a significant slowing in borrowing by the business sector. Credit extended by financial institutions to businesses has declined a little over recent months, although debt raisings have recorded a small increase, with some large firms tapping capital markets for funding.

Reflecting the slowing in the economy, labour market conditions have weakened. Employment has started to fall and the unemployment rate has increased to around 5½ per cent from its low of 4 per cent in early 2008. There has also been a substantial rise in the number of employees working shorter hours. Forward-looking indicators, including job advertisements and business surveys, suggest a further decline in employment over the months ahead.

Recent data confirm that price pressures are gradually abating. Over the year to the March quarter, the CPI increased by 2.5 per cent, the midpoint of the Bank's 2-3 per cent medium-term inflation target. This follows a period in which inflation was well above the target, peaking at 5.0 per cent over the year to September 2008. This recent decline in headline inflation is largely accounted for by a significant reduction in oil prices and in the ABS estimate for the price of deposit & loan facilities facing the household sector. In underlying terms, inflation was around 1 per cent in the March quarter and around 4 per cent over the year.

Taken together, the last two quarters indicate a modest decline in the pace of underlying inflation from its peak last year, and a further decline is likely over the period ahead. Capacity utilisation is declining and, with the labour market weakening, there are early signs of a slowing in wage growth. Upstream price pressures also appear to be moderating and measures of inflation expectations have moved to the bottom of the range seen over the inflation-targeting period, after they were at high levels a year ago. The decline in inflation is, however, expected to be gradual, partly due to higher prices for imported goods as a result of the depreciation of the exchange rate last year.

Overall, the marked deterioration in the global economy in the latter part of 2008 and early this year has led to considerable slowing in the Australian economy. While near-term outcomes are likely to be weak, there are reasonable grounds to expect that a recovery will begin by the end of the year, provided global conditions continue to stabilise. The recovery, however, is likely to be gradual at first, largely reflecting developments abroad, where growth is forecast to be below trend for some time.

The Board has responded to the deterioration in the global and domestic environment that has taken place since September 2008 by easing monetary policy significantly. Short-term interest rates are currently at their lowest level since the early 1960s. Much of this easing took place in expectation of the current weak economic conditions and before the emergence of clear evidence that inflation was declining. Together with the substantial fiscal initiatives, the lower interest rates are providing significant support to domestic demand, and will continue to do so over the period ahead.

With interest rates at historically low levels, and some signs of stabilisation in the world economy, the Board has recently viewed it as appropriate to make smaller and less frequent adjustments to the cash rate than was the case up until February when conditions were deteriorating rapidly. In assessing whether further reductions are appropriate over the period ahead, the Board will continue to monitor the implications of both economic and financial developments for prospects of a sustainable recovery in the Australian economy.

International Economic Developments

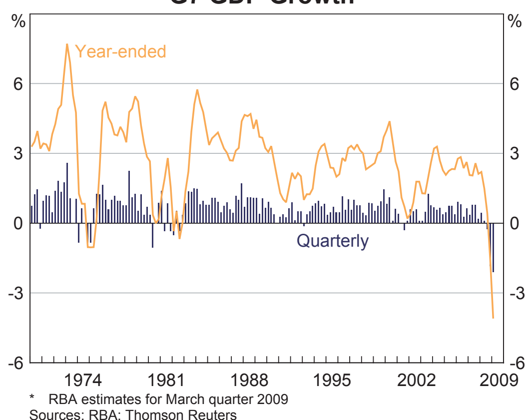
The global economy is currently experiencing an unusually severe recession, with world GDP contracting sharply in the December and March quarters (Graph 1). Output is estimated to have declined by around 4 per cent over the year to the March quarter in the G7 economies and by around 3 per cent for Australia's major trading partners as a whole. Governments and central banks around the world have responded with substantial stimulus measures, and recently there have been some signs that conditions are beginning to stabilise, with China in particular showing clear signs of recovery.

The current downturn in the world economy has been unusually widespread and synchronised across both industrialised and emerging economies. Australia's major trading partners are all experiencing growth outcomes that are far below average. Almost all industrial economies and much of Asia have seen output contract. China has experienced a very substantial slowdown in growth in the order of 5–6 percentage points over the past year or so and the Indian economy has also slowed sharply.

While the world economy had been slowing since late 2007, the recent period of extreme weakness followed the intensification of stresses in the global financial system around the collapse of Lehman Brothers in mid September. This turmoil contributed to a sudden further loss of confidence among households and businesses around the world, who quickly reduced spending, particularly for discretionary items including motor vehicles and capital goods (Graph 2). Firms responded by cutting production sharply, though in many countries they did not do so quickly enough to prevent some

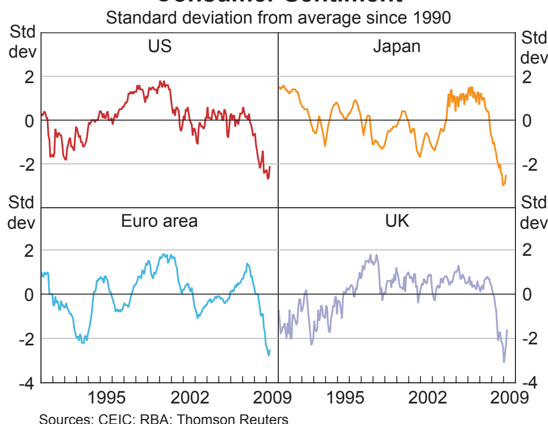
Graph 1

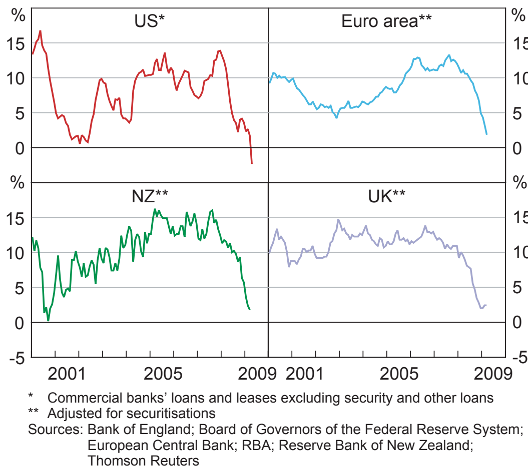
G7 GDP Growth*

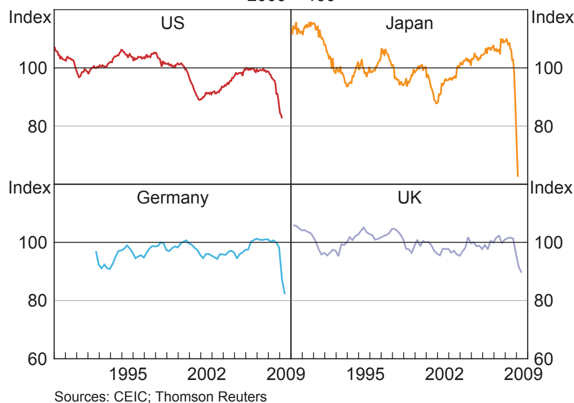


Graph 2

Consumer Sentiment







unplanned build-up in inventories. Many countries have experienced declines in international trade volumes and industrial production of around 20 per cent or more since late last year. Private-sector credit growth has also slowed sharply, but nevertheless remains slightly positive in most developed countries (Graph 3).

The slump in demand has resulted in a fall in measures of capacity utilisation to multi-decade lows in a range of developed economies (Graph 4). Combined with the current high degree of uncertainty and ongoing risk aversion, as well as falling profitability, this suggests that spending on business investment will remain weak for some time. The economic weakness is also resulting in reduced demand for labour, with the falls in employment that are now occurring likely to weigh on household spending over the next year or two.

Despite the recent weak GDP outcomes, there are some signs that the pace of decline in activity has begun to ease. Measures from business surveys, such as the various purchasing managers indices, have picked up for many countries, although they generally remain at levels consistent with further declines in output (Graph 5). In addition, data for exports and industrial production in some countries – most notably in China and elsewhere in east Asia – are showing some signs of improvement after the sharp falls in earlier months.

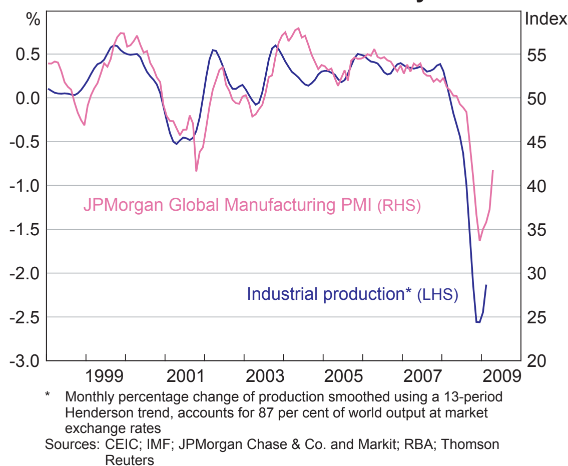
The latest GDP figures for the United States show that the economy shrank by 1.6 per cent in the March quarter, similar to the decline seen in the December quarter. After expanding modestly through much of 2008, business investment fell sharply for the second quarter in a row, while a rundown in inventories also subtracted from output. By contrast, household consumption rose slightly in the quarter, which was a marked turnaround from the large falls in the previous two quarters. While this stabilisation was encouraging, consumption fell again in the month of March and falling employment is likely to continue to weigh on consumer spending. Indeed, the

magnitude of the recent economic weakness is starkly illustrated by the labour market, where non-farm payrolls fell by 1½ per cent in the first three months of the year and have fallen by 3¾ per cent since the end of 2007, the sharpest deterioration for many decades (Graph 6). This has seen the unemployment rate rise from 4½ per cent in mid 2007 to 8½ per cent in March.

Notwithstanding the weak labour market, a growing number of business indicators in the United States have shown recent signs of improvement. In April, both the manufacturing and non-manufacturing ISM indices, while still weak, were noticeably above their levels at the end of 2008. A range of measures of housing activity and prices have also shown signs of stabilisation or even picked up modestly in recent months, and the architecture billings index, a leading indicator of non-residential construction, rebounded solidly in February and March after falling sharply over the course of 2008. Further improvement in US credit and financial markets will, however, be necessary for the modest gains in these and other indicators to develop into a sustained recovery in investment and hiring by US firms. Progress in this direction, and recent initiatives by the US government and the Federal Reserve to promote recovery in the financial sector, are discussed further in the 'International and Foreign Exchange Markets' chapter.

Graph 5

Global Industrial Activity



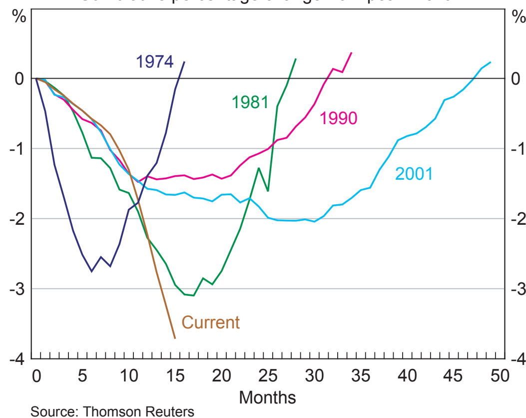
* Monthly percentage change of production smoothed using a 13-period Henderson trend, accounts for 87 per cent of world output at market exchange rates

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

Graph 6

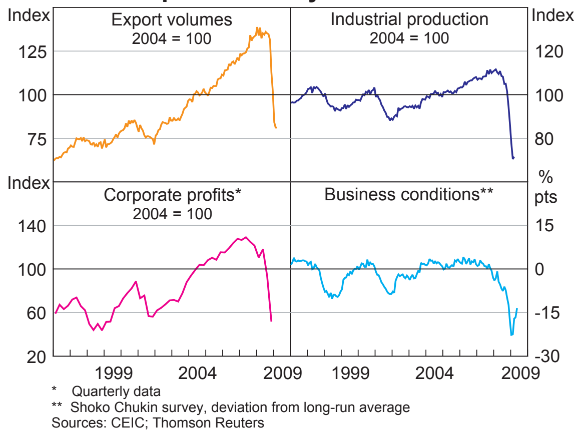
United States – Non-farm Payrolls

Cumulative percentage change from peak month



Source: Thomson Reuters

While the United States has been at the centre of the global financial crisis, the sharpest downturn in activity among the major developed economies has been in Japan, where the economy contracted by 3 per cent in the December quarter and recent monthly data suggest that GDP fell sharply again in the March quarter (Graph 7). Industrial production, which accounts for a little more than 20 per cent of the Japanese economy, fell by an unprecedented 22 per cent in the March quarter, after declining by 11 per cent in the December quarter. In large part, this reflects extremely weak external demand, with merchandise export volumes falling by around 15 per cent in the December quarter and around 30 per cent in the March quarter. Household



spending is also weak given falling employment, slowing wages growth and the depressed level of consumer confidence. Nevertheless, there have been some tentative signs of stabilisation in the economy with industrial production and exports both rising slightly in March, after falling for around nine months. Business surveys, such as the Shoko-Chukin survey of small and medium enterprises, also indicate that business conditions have recovered modestly in recent months, although they remain at very low levels.

One reason that Japan has been particularly hard-hit by the current global downturn is the relative importance to the Japanese economy of high-value manufacturing – particularly capital goods and consumer durables such as cars. Similarly, Germany is suffering a larger fall in exports, industrial production and aggregate output than most other European economies. More generally, although the deterioration in activity and demand in the developed economies is now evident across all sectors, conditions in the manufacturing sector continue to be particularly weak (as discussed in 'Box A: Global Industrial Production').

Recent activity indicators in the euro area suggest another large fall in GDP occurred in the March quarter, following the 1.6 per cent contraction in the December quarter. Industrial production in February was 7 per cent lower than in the December quarter, exports have fallen sharply, and the volume of retail sales fell further in the March quarter to be 3 per cent lower over the year. Residential building permits also fell by nearly 20 per cent over 2008, suggesting that further sizeable falls in dwelling investment are in prospect. Reflecting the weak economic conditions, the unemployment rate in the euro area rose from 7¼ per cent to nearly 9 per cent over the year to March, with unemployment in Spain rising particularly sharply. While the German unemployment rate has only risen slightly to date, there has been a large jump in the number of workers on reduced hours.

Conditions in the United Kingdom are also very weak. GDP fell by 1.9 per cent in the March quarter, after falling by 1.6 per cent in the December quarter, to be more than 4 per cent lower over the year. Despite some recovery in the month, measures of business and consumer sentiment remained very low in April. The claimant count measure of unemployment has risen by 2.1 percentage points over the past year.

The clearest signs of improvement in economic conditions are from China. While on a year-ended basis, Chinese growth slowed further in the March quarter to 6.1 per cent, RBA estimates suggest that the pace of quarterly growth picked up in the March quarter, and other indicators of activity generally tell a similar story (Graph 8). Exports appear to have levelled out after falling by roughly 25 per cent from October to February, while industrial production increased solidly in the March quarter, and particularly in the month of March, following falls in the second half

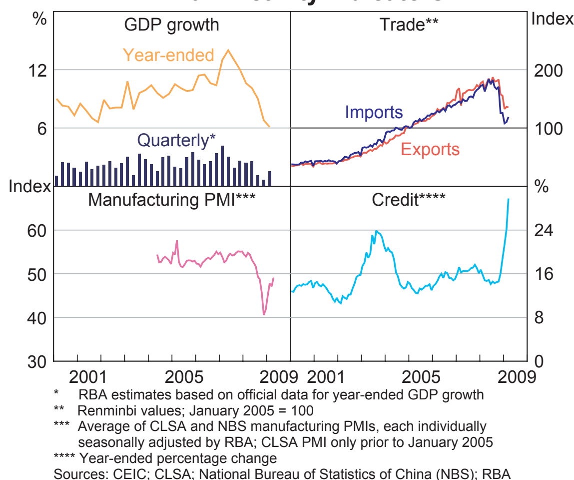
of last year (Graph 9). The Chinese PMI surveys also suggest some improvement in the manufacturing sector in recent months, while infrastructure investment and credit have increased strongly since the end of 2008, supported by a range of fiscal initiatives and lending directives. The pick-up in investment spending has been particularly pronounced in the areas of transport infrastructure and residential construction. This has flowed through to demand for Australia's resource exports and helped to support a more favourable export performance for Australia compared with many other countries. Growth of retail sales in China has eased but remained strong at around 2 per cent in the March quarter and 16 per cent over the year.

Elsewhere in east Asia, conditions have been weak, though there are also some signs that key activity indicators are beginning to stabilise. In the March quarter, real GDP was flat in Korea, after falling sharply in the December quarter, to be more than 4 per cent lower over the year. In contrast, output fell sharply again in Singapore, down by more than 5 per cent in the quarter to be 11½ per cent lower over the year. Across the region, industrial production grew modestly in February and March, following a run of precipitous monthly declines (Graph 10). Recent monthly exports data for a number of economies, including Korea, Taiwan and Hong Kong, have also shown some signs of improvement following large falls.

After appearing relatively immune to the slowing in growth

Graph 8

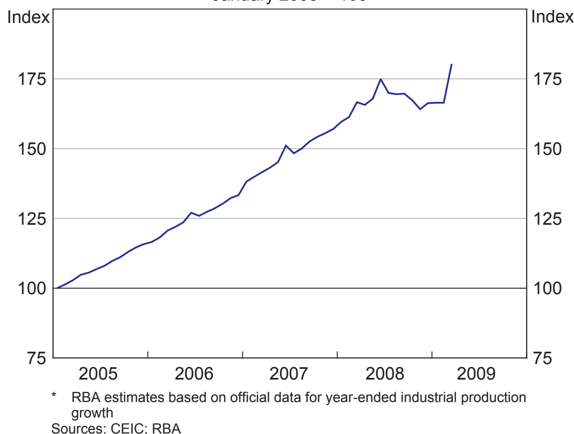
China – Activity Indicators



Graph 9

China – Industrial Production*

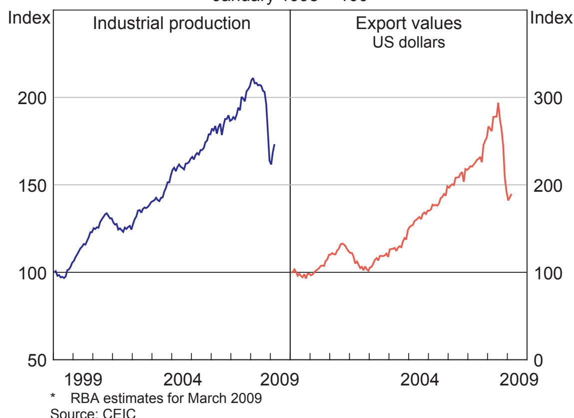
January 2005 = 100

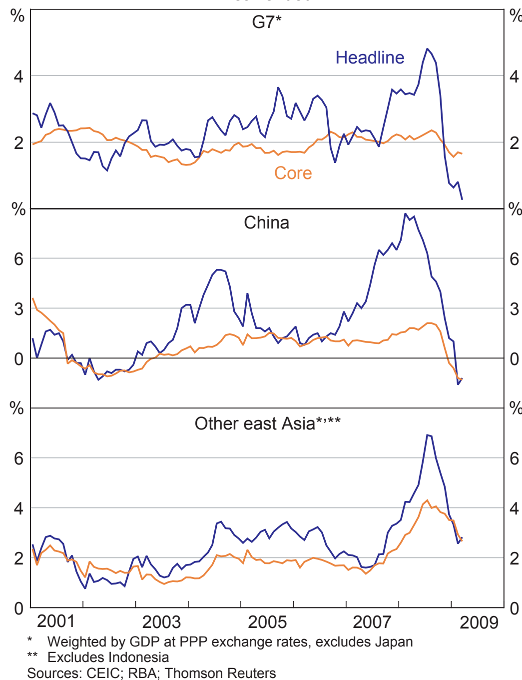


Graph 10

Other East Asia – Production and Exports

January 1998 = 100





occurring across the developed world for much of 2008, major Latin American economies including Brazil, Mexico and Chile all suffered large falls in output in the December quarter. Falls in industrial production continued in the early months of 2009 in several countries (though not in Brazil). Likewise in emerging Europe activity declined significantly in many economies in the December quarter, with industrial production falling further in early 2009.

Headline inflation has declined noticeably around the world in response to the weakness in global demand and lower commodity prices (Graph 11). In a number of countries, such as the United States, Japan and China, year-ended headline inflation is now negative largely due to the sharp decline in oil and food prices over the past year or so. However, core inflation has not fallen to the same degree and for most industrial countries remains relatively close to average rates seen over the past decade.

Policy responses and forecasts

Central banks around the world have responded to the deterioration in economic conditions with further cuts to their policy interest rates, as discussed in the 'International and Foreign Exchange Markets' chapter. A number – including the Federal Reserve and the Bank of England – have also moved to supplement ongoing measures to ease credit conditions with explicit large-scale purchases of government and private-sector debt.

Governments around the world have also enacted significant discretionary fiscal easings over recent months. In the United States the *American Recovery and Reinvestment Act* was passed in mid February, setting in train a discretionary stimulus in excess of 4 per cent of annual GDP to take effect over 2009 and 2010. Combined with the impact of the weakening economy on revenues and outlays, and the costs of various financial rescue packages, the Congressional Budget Office anticipates that the United States federal deficit for fiscal year 2009 will be around 13 per cent of GDP, more than double its previous record level since the late 1940s (Table 1). In the United Kingdom, budget projections are now for deficits of around 12 per cent of GDP for the next 2 years, with only gradual improvement thereafter.

A number of European countries have also introduced discretionary stimulus packages in recent months, and several Asian nations – most notably Japan and Korea – have announced

Table 1: Expected Fiscal Balances in Selected Countries[a]
Per cent of GDP

	2007 and 2008 Average	2009	2010
United States	–2¼	–13	–9½
United Kingdom	–4¼	–12½	–12
Germany	–¼	–4¾	–6
Japan	–4	–10	–9¾
China	¼	–3½	–3½
Korea	2¼	–3¼	–4½
Indonesia	–½	–2½	–2

(a) Estimates for the United States and the United Kingdom are from the Congressional Budget Office and Her Majesty's Treasury, respectively, and are for the relevant fiscal years for each country; other figures are RBA estimates based on national and international sources. Data for the United States refer to federal government fiscal balance.

further significant fiscal stimulus measures to supplement the sizeable discretionary easings from late last year. While the discretionary stimulus packages in European countries have generally been smaller than elsewhere this partly reflects the larger role for automatic stabilisers in these countries, which make government finances more naturally responsive to changes in economic conditions. Overall, fiscal balances around the world have moved to very large deficits, highlighting the extent of fiscal stimulus that is in place.

Notwithstanding these additional policy responses, IMF forecasts for growth in almost all large economies – China is an exception – have again been lowered significantly over the past three months. The IMF now expects world output (with countries weighted by GDP valued at purchasing power parities) to contract by 1.3 per cent in 2009, down from positive growth of 0.5 per cent forecast in late January (Table 2). Large falls in output are expected in all the major developed and many emerging or newly industrialised economies, while China and India are

Table 2: World GDP Growth
Year average, per cent[a]

	2007	2008	2009	2010
			IMF forecasts[d]	
United States	2.0	1.1	–2.8	0.0
Euro area	2.7	0.7	–4.2	–0.4
Japan	2.4	–0.7	–6.2	0.5
China	13.0	9.0	6.5	7.5
Other east Asia[b]	5.8	2.8	–3.4	1.4
India	9.2	7.4	4.5	5.6
World	5.2	3.2	–1.3	1.9
Australia's trading partners[c]	5.6	2.8	–2.0	2.1

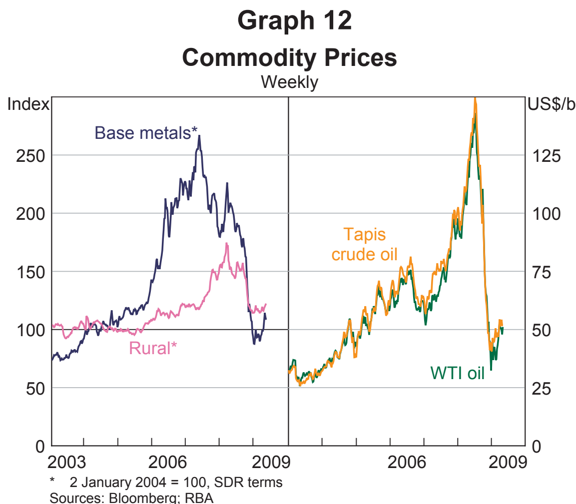
(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Weighted using GDP at market exchange rates
(c) Weighted using merchandise export shares
(d) Forecasts from the April *World Economic Outlook* (WEO)
Sources: CEIC; Consensus Economics; IMF; RBA; Thomson Financial

forecast to record growth well below trend. The IMF expects only a tepid recovery in global activity in 2010. The Bank's forecasts, discussed further in the 'Economic Outlook' chapter, are slightly weaker for global growth in 2009 but similar for 2010.

Commodity prices

Commodity price movements have been mixed in recent months, with prices for exchange-traded commodities (such as the base metals and crude oil) generally rising but spot prices for bulk resource commodities falling. Contract prices for coal have settled sharply lower, and although new iron ore contracts are yet to be settled, large falls in export prices are also expected. Overall, the April estimate for the RBA's index of commodity prices is 31 per cent below the September 2008 peak (in SDR terms). Around two-thirds of the fall is due to the inclusion of preliminary estimates for the 2009/10 coal and iron ore contract prices, with a further fall of 8 per cent expected once the lower contract prices take full effect.

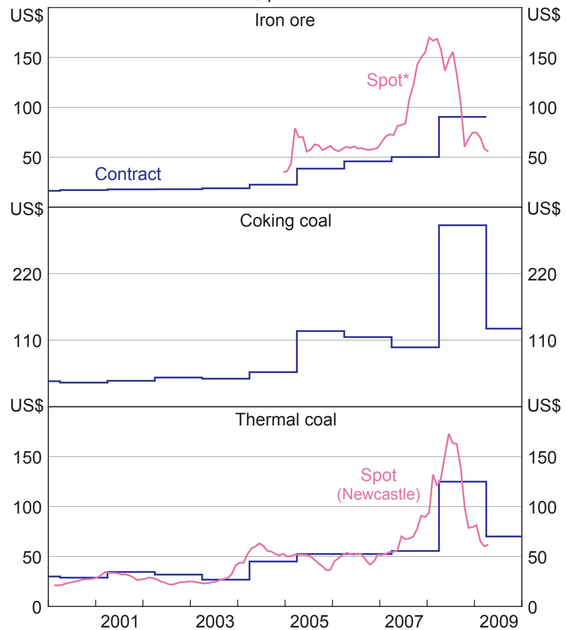
Base metals and oil prices have recently recovered some of the sharp falls in the second half of 2008, broadly similar to developments in equity and credit markets. Market commentary has attributed the recent increases to improved sentiment about economic prospects and concern by some investors about longer-term inflationary pressures, which has renewed interest in investing in commodities as an asset class. The RBA index of base metals prices has increased by 14 per cent since the time of the February *Statement*, to be about 20 per cent above its December 2008 low (Graph 12). The prices of copper, lead and zinc have all risen solidly since the previous *Statement,* although inventory levels are quite high. Prices also appear to have been supported by Chinese and Korean government stockpiling, and production cuts for some metals. Oil prices have risen by around 20 per cent since January, although there have been some divergences in developments between WTI and other benchmark prices.



Rural commodity prices are broadly unchanged since the previous *Statement*, with the RBA index of rural commodity prices about 2 per cent higher over the period. The prices of wool, sugar and canola have risen, offsetting falls in barley, beef & veal and wheat prices.

Benchmark coal contract prices for 2009/10 have been settled by a number of Australian companies at significant discounts to last year's record prices (Graph 13). Thermal coal contract prices have fallen by 44 per cent. Contract prices for the different grades of metallurgical (coking) coal have settled around 60 per cent lower, with world steel production contracting by 24 per cent over the year to March. Contract negotiations are continuing for iron ore prices, but prices

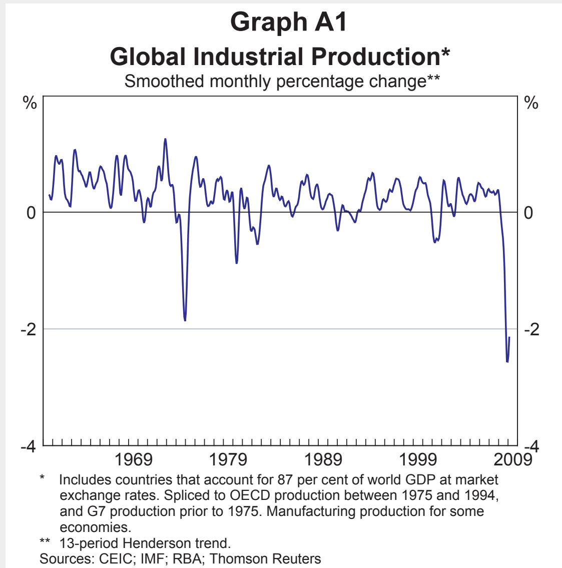
for iron ore are generally expected to fall by around 30–40 per cent, roughly in line with recent trends in spot prices. While the falls in contract prices are substantial, 2009/10 bulk contract prices are still likely to be high by historical standards, remaining around 25–35 per cent higher for thermal and coking coal than in 2007/08, with prices for iron ore also expected to be above 2007/08 prices.



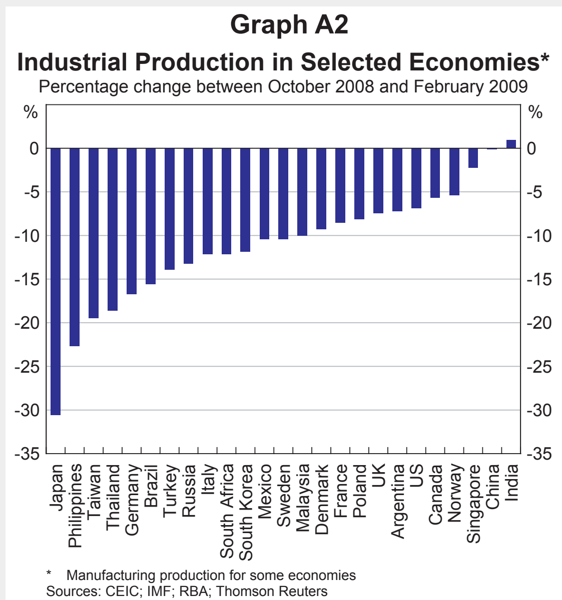
* Calculated using the spot import price in China less the spot freight rate from Australia to China

Sources: ABARE; Bloomberg; RBA

Box A: Global Industrial Production



* Includes countries that account for 87 per cent of world GDP at market exchange rates. Spliced to OECD production between 1975 and 1994, and G7 production prior to 1975. Manufacturing production for some economies.
** 13-period Henderson trend.
Sources: CEIC; IMF; RBA; Thomson Reuters



* Manufacturing production for some economies
Sources: CEIC; IMF; RBA; Thomson Reuters

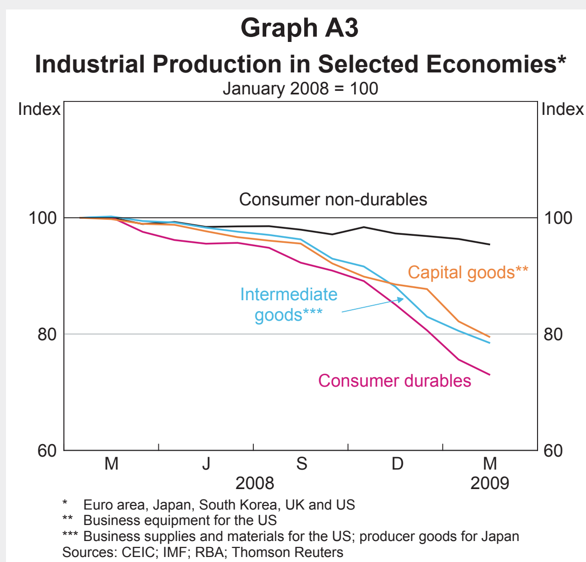
The large fall in global GDP in the December and March quarters partly reflects the sharp decline in confidence of businesses and households, which occurred in late 2008. This contributed to a fall in global demand for goods such as consumer durables and capital equipment, where there is significant discretion in the timing of purchases. Firms responded by sharply cutting production of such goods and this flowed through into global trade. Over the four months from October to February, export values fell in a broad range of countries by double digit amounts, while global industrial production fell by nearly 11 per cent. The pace of this fall in industrial production was the fastest for at least 50 years (there was a 7½ per cent fall over the four months from late 1974 to early 1975) (Graph A1). Among 25 significant economies in the world for which monthly data are available, only India recorded any growth in industrial production from October to February, while in China industrial production was broadly unchanged (Graph A2).[1] More recently a number of economies, particularly in Asia, recorded increases in industrial production in March, and business surveys, such as the various manufacturing

1 *Monthly production data are not available for Australia; however, the national accounts reported a 5 per cent fall in manufacturing output in the December quarter, and a further fall seems likely to have occurred in the March quarter based on recent business surveys and data on manufactured exports.*

purchasing managers indices, suggest that the pace of contraction in global industrial production has begun to slow noticeably.

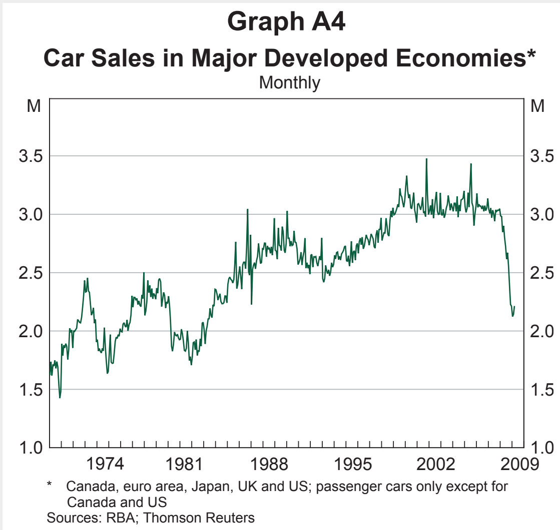
As noted in the chapter, a key trigger for the decline in production appears to have been the acute falls in confidence associated with the collapse of Lehman Brothers in mid September 2008 and the intensification of the strains in the global financial system at that time. Tighter access to various forms of credit also seems to have been a factor in the decline in activity. For example, access to finance for participants in international trade has become more restricted in some regions, and is likely to have impinged on the global flow of goods and hence production.

The largest falls in production have been for capital equipment and 'big-ticket' consumer durables (Graph A3). These are typically discretionary purchases that can be easily deferred by consumers and businesses in response to heightened concern about the economic outlook. The lower demand for these goods has also flowed through to a sharp fall in demand for intermediate goods used in the production process. In contrast, the decline in production of non-durable consumer goods, such as food and beverages, has been noticeably less pronounced.



A good illustration of how demand for 'big-ticket' items has been cut by consumers and businesses is the collapse in global motor vehicle production. Sales of cars in major developed economies in March this year were down by more than 25 per cent from the level at the end of 2007 (Graph A4). As a result, motor vehicle and parts production has also fallen abruptly. The extreme weakness in motor vehicle production has flowed through to sharp falls in the production of materials like steel, plastics and chemicals.

Governments in several countries (including China and some European nations) have responded by introducing policies to spur demand for motor vehicles, and this appears to have recently resulted in higher car sales and production, particularly in China and Germany. In Germany, the government will provide €2 500 for any car that is nine years or older that is scrapped and replaced by a new car. Following the introduction of this scheme, which runs to the end of 2009, new car registrations increased by 50 per cent in February and March. However, car



sales have remained weak elsewhere in the developed world.

At the country level, industrial production in Japan has been particularly affected, declining by more than 30 per cent from October to February and by nearly 40 per cent over the year. This has taken the level of production in Japan back to that last seen in 1983, and the contraction in GDP is expected to be the largest among the major industrial countries. The fact that Japan has been particularly hard-hit by the current global downturn is consistent with the relative importance to the Japanese economy of high-value manufacturing of capital goods and consumer durables, such as cars. Nevertheless, more recently there have been some signs of stabilisation in industrial production in Japan with a small rise in March. ✠

International and Foreign Exchange Markets

Central bank policy actions

A large number of central banks from both developed and emerging economies have eased policy further as the outlook for economic activity has deteriorated and inflationary pressures have abated. In developed economies, policy rates have been reduced where there remained scope to do so (Table 3). With policy rates at their lower bound in a number of countries, unconventional policy measures have been implemented to further ease monetary conditions and address continuing strains in credit markets.

Table 3: Policy Rates

	Current level Per cent	Most recent change	Change since start of easing phase Basis points
United States	0.125	↓ Dec 08	↓ 513
Euro area	1.25	↓ Apr 09	↓ 300
Japan	0.10	↓ Dec 08	↓ 40
United Kingdom	0.50	↓ Mar 09	↓ 525
Canada	0.25	↓ Apr 09	↓ 425
Sweden	0.50	↓ Apr 09	↓ 425
Switzerland	0.25	↓ Mar 09	↓ 250
New Zealand	2.50	↓ Apr 09	↓ 575

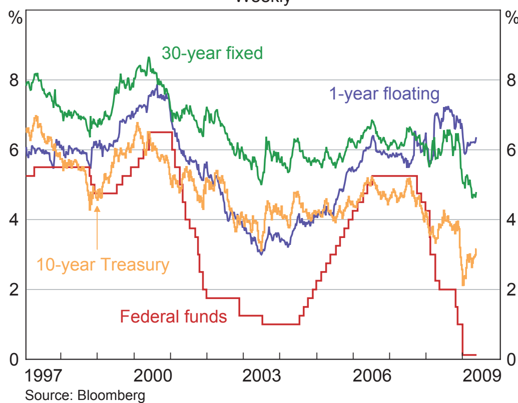
Sources: Bloomberg; central banks

In the United States, where the policy rate has been effectively zero since late 2008, the Federal Open Market Committee announced in March that it would purchase up to US$300 billion of US Treasuries before September. Yields on long-term US Treasuries fell sharply in response to this announcement. The Fed has also extended the size, coverage and duration of many of its liquidity programs. In particular, to address the elevated level of mortgage rates relative to the policy rate, the Fed announced at its March meeting that it would increase its purchases of agency mortgage-backed securities (MBS) by US$750 billion (to US$1.25 trillion) and agency debt by US$100 billion (to US$200 billion). This contributed to a sharp fall in yields on agency securities and a further fall in 30-year mortgage rates, which are now around 4½ per cent (Graph 14).

The Fed has also announced an increase in the potential size of the Term Asset-backed Securities Loan Facility (TALF) to US$1 trillion from US$200 billion (see below), extended the range of assets eligible for TALF funding and lengthened the maturity of certain loans under the

Graph 14

US Mortgage Interest Rates



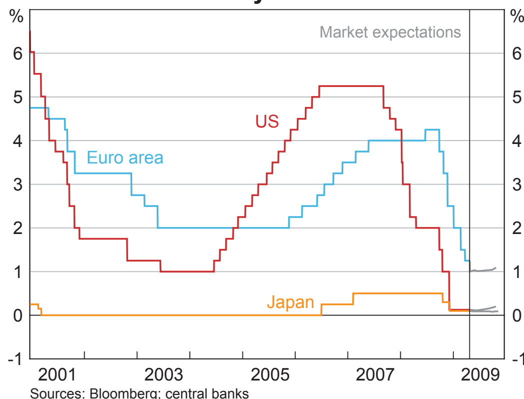
facility. The US Treasury will now provide up to US$100 billion (from US$20 billion) in credit protection to absorb the first losses of this facility. Although the TALF began operations in March, market participation has so far been very low.

Demand for other Fed facilities aimed at improving specific markets has either fallen or remained stable in recent months, signalling some improvement in the relevant financial markets. Demand for funds aimed at providing liquidity to domestic depository institutions and primary dealers has continued to fall from the peaks reached late last year. There has also been a gradual unwinding of some of the Fed's facilities aimed at improving conditions in the market for commercial paper. Similarly, demand for US dollars in international markets via the Fed's swap facility with other central banks has continued to fall, indicating a general improvement in US dollar liquidity offshore. Reductions in the use of these facilities have been broadly offset by the increase in outright purchases of US government and agency securities, leaving the size of the Fed's balance sheet relatively unchanged since late last year, but with some significant changes in its composition.

The European Central Bank (ECB) has lowered its policy rate by a cumulative 300 basis points since its easing phase began in October 2008, to 1¼ per cent. Over the same period the effective overnight rate in the euro area has fallen by around 375 basis points. In March, the ECB announced that it would continue to provide as much domestic liquidity as demanded through fixed-rate auctions, until at least the end of 2009. It also announced that it will decide on additional unconventional monetary policy measures at its meeting on 7 May. Market participants currently expect a further 25 basis point easing in policy rates at that meeting (Graph 15).

Graph 15

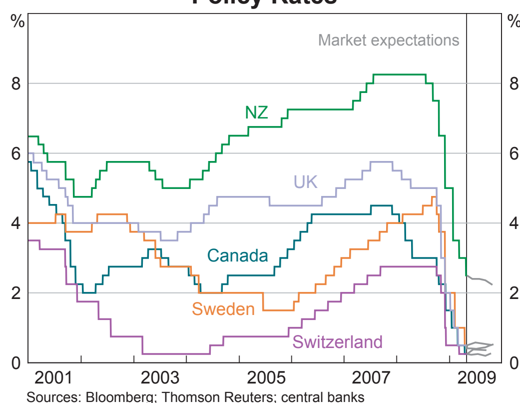
Policy Rates



The Bank of Japan (BoJ) has expanded its unconventional policy measures in a bid to stabilise domestic banks and financial markets. It has increased its outright purchases of Japanese government bonds and commercial paper, begun outright purchases of corporate bonds, increased the duration and

frequency of a number of its corporate financing programs, and extended eligible collateral in its market operations. In addition, the BoJ has outlined terms of the subordinated loans that it will make to domestic banks aimed at supporting banks' capital bases.

In the United Kingdom, the Bank of England (BoE) has lowered its policy rate by a total of 525 basis points since its easing phase began in December 2007, to a lower bound of ½ per cent (Graph 16). However, borrowing rates have fallen by considerably less. With its policy rate at its lower bound, the BoE has commenced a program of quantitative easing aimed at reflating the UK economy, by conducting unsterilised purchases of up to £150 billion in government securities (gilts) and sterling-denominated private sector securities under the Asset Purchase Facility. In the near term, the BoE plans to purchase £75 billion of securities, predominantly longer-term gilts, and to date has purchased around £45 billion in gilts, £2½ billion in commercial paper and £½ billion in corporate bonds.



A number of other central banks have also lowered their policy rates to a point where further monetary easing involves the use of unconventional policy measures. The Swiss National Bank (SNB) has lowered its policy rate by a cumulative 250 basis points, to ¼ per cent, while Sveriges Riksbank and the Bank of Canada have lowered their policy rates by a cumulative 425 basis points each, to ½ per cent and ¼ per cent respectively; Sveriges Riksbank has lowered rates by 150 basis points since the time of the last *Statement*. In all three cases, policy rates are expected to remain at these historically low levels for the foreseeable future. To further ease monetary conditions, the SNB has announced that it will begin purchases of private sector bonds and has significantly increased the scale of repo operations. In addition, it has intervened in the foreign exchange market in order to prevent any further appreciation of the Swiss franc against the euro to help address its concerns about the risk of deflation. While unconventional policy actions have been discussed at Sveriges Riksbank and the Bank of Canada, both central banks have ruled out further stimulus using these measures unless economic and financial conditions deteriorate further.

Central banks in many other economies have also lowered their policy rates as growth prospects have weakened and inflationary pressures have abated. The Reserve Bank of New Zealand (RBNZ) and the Central Bank of Norway have lowered their policy rates by a cumulative 575 and 425 basis points to 2½ per cent and 1½ per cent respectively. Central banks in many emerging markets have also eased monetary conditions by lowering their policy rates (Table 4).

Table 4: Emerging Market Policy Rates

	Current level Per cent	Change since previous *Statement* Basis points	Change since start of easing phase Basis points
Brazil	10.25	↓ 250	↓ 350
Chile	1.75	↓ 550	↓ 650
Czech Republic	1.75	↓ 50	↓ 200
Iceland	15.50	↓ 250	↓ 250
India	4.75	↓ 75	↓ 425
Indonesia	7.25	↓ 100	↓ 225
Israel	0.50	↓ 50	↓ 375
Malaysia	2.00	↓ 50	↓ 150
Mexico	6.00	↓ 175	↓ 225
Philippines	4.50	↓ 50	↓ 150
Poland	3.75	↓ 50	↓ 225
Russia	12.50	↓ 50	↓ 50
South Africa	8.50	↓ 300	↓ 350
South Korea	2.00	↓ 50	↓ 325
Taiwan	1.25	↓ 25	↓ 238
Thailand	1.25	↓ 75	↓ 250
Turkey	9.75	↓ 325	↓ 700

Sources: Bloomberg; central banks

Government financial policy actions

Many governments have continued to extend and modify existing policy initiatives and/or announce new ones to ease conditions in financial markets.

In the United States, the Government has focused on policies designed to ensure that the banking system is well capitalised and that repercussions from problems in other systemically important institutions are minimised. It has also sought to lower the high level of spreads in credit markets and ease credit conditions for consumers and small businesses.

To ensure that the banking system is adequately capitalised, the balance sheets of major financial institutions in the United States have undergone stress tests to establish their ability to continue lending and absorb further losses in adverse conditions. The results of these tests will be announced on 7 May.

In early March, American International Group reported a fourth quarter loss of US$62 billion – the largest quarterly loss in US corporate history. In response, US authorities announced a restructuring of their support for the company that includes the US Treasury exchanging its existing preferred shares for shares that more closely resemble common equity and restructuring of an earlier loan from the Federal Reserve. The US Treasury also stands ready to provide additional equity capital, of up to US$30 billion in preferred stock, if needed. In late March, Fannie Mae and

Freddie Mac received further capital injections of senior preferred stock from the US Treasury of US$15 billion and US$31 billion, respectively, as part of the terms of their conservatorship.

In March, the US Treasury announced details of its Public-Private Investment Program, which is designed to alleviate pressures in the financial system by removing 'legacy' loans and securities from the balance sheets of financial institutions. This program will establish investment funds that combine public and private equity capital with leverage provided by the US Treasury, Federal Deposit Insurance Corporation (FDIC) guaranteed debt and Fed loans through the TALF. The leverage may be up to six times for legacy loans. The private sector involvement is intended to assist with the price discovery of these assets. The US Treasury will inject public equity capital on a one-to-one basis with the equity contribution of private investors, using between US$75 billion and US$100 billion from the funds available under the Troubled Asset Relief Program.

The US authorities have also announced several programs designed to ease credit conditions for households and small businesses. In particular, US$75 billion was committed towards preventing mortgage foreclosures by assisting lenders to reduce the debt servicing burdens of 'responsible' borrowers, and providing various other incentives to ensure that repayments continue to be made. In addition, loan-to-valuation constraints on refinancing loans owned or guaranteed by Freddie Mac and Fannie Mae will be eased for certain home owners. The Consumer and Business Lending Initiative, a joint program between the US Treasury and the Fed, will expand the TALF from US$200 billion to US$1 trillion for lending against securitisations of consumer, student and small business loans. This also includes the direct purchase of US$15 billion of securities backed by Small Business Administration loans.

In the United Kingdom, the Royal Bank of Scotland (RBS) and Lloyds announced that they would participate in the UK Treasury's Asset Protection Scheme. Each institution will pay a fee in the form of convertible preferred shares to protect around £300 billion and £250 billion of assets, respectively. If all convertible preferred shares held by the UK Government are converted, it stands to own over 80 per cent of RBS and between 50 per cent and 80 per cent of Lloyds, depending on private take-up of Lloyds' announced rights issue.

Elsewhere in Europe, a number of governments have provided further support for their banking systems, primarily through capital injections. In April, Ireland announced plans to buy property-related loans from banks by issuing government bonds directly to the banks. The assets, which comprise performing as well as non-performing loans, have an estimated combined book value of up to €90 billion, possibly representing around 10 per cent of total banking sector assets. The German Government reportedly also intends to implement a plan to remove impaired assets from banks' balance sheets in a bid to improve confidence in the sector and stimulate lending.

In late March, the International Monetary Fund (IMF) introduced significant changes to its lending framework. Among other reforms, it introduced the Flexible Credit Line that provides a line of credit for countries that, despite strong economic fundamentals and a track record of sound policies, are facing increasing strains as a result of the global crisis. Since its introduction, Colombia, Mexico and Poland have all sought access to this facility on a precautionary basis. In general, financial markets have reacted positively to these announcements.

In early April, the Group of Twenty (G-20) governments supported a proposal to provide additional resources to the IMF and multilateral development banks to support growth in emerging and developing economies. In addition, the G-20 supported a general allocation of US$250 billion in Special Drawing Rights – reserve assets that allow countries to obtain freely usable currencies from other members – to increase global liquidity. Under this proposal, US$100 billion would be allocated to emerging and developing economies. In early April, the World Bank Group announced the launch of the Global Trade Liquidity Pool, which will extend credit to banks to support trade in developing markets and address the decline in trade finance. It aims to provide up to US$50 billion of trade liquidity support over the next three years.

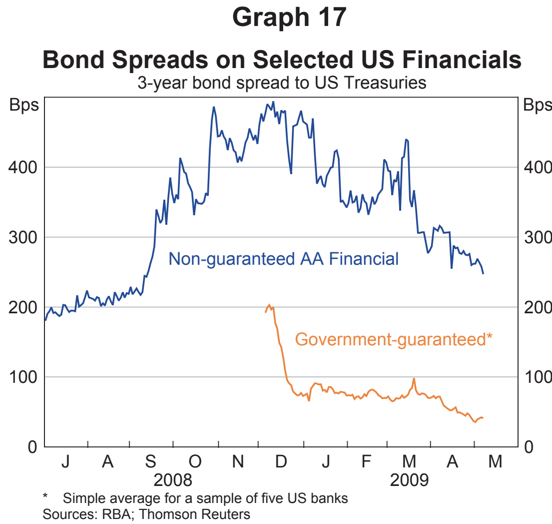


Table 5: Government-guaranteed Bank Bonds(a)

	Issuance US$ billion
United States	259.4
United Kingdom	120.7
France	82.9
Australia	61.3
Germany	41.2
Netherlands	38.4
Spain	36.6
Austria	19.0
Ireland	17.9
Sweden	17.8
Portugal	4.3
Norway	4.0
Switzerland	3.0
Greece	1.3
New Zealand	1.2
South Korea	1.0
Total	**710.0**

(a) May exclude some private placements
Sources: RBA; Thomson Reuters

Government-guaranteed bond issuance

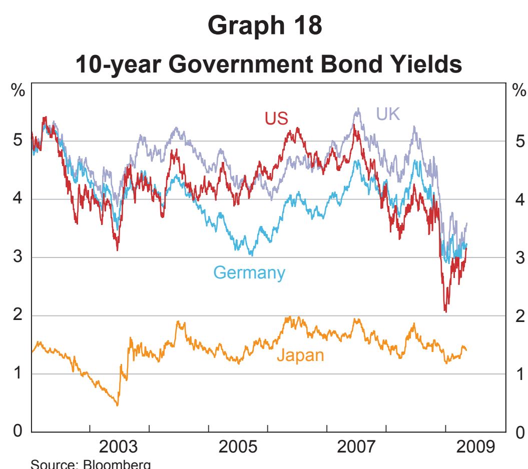
Issuance of government-guaranteed bonds by financial institutions remained strong in the March quarter, with financial institutions in a number of additional countries starting to issue guaranteed bonds, but moderated somewhat in April. Notwithstanding the guarantees, yields remain substantially higher than sovereign yields, although spreads have generally narrowed (Graph 17).

In the United States, total issuance under the FDIC's Temporary Liquidity Guarantee Program (TLGP) currently stands at US$259 billion (Table 5), and yields on most US dollar-denominated bonds are between 30 to 50 basis points above yields on US Treasuries of equivalent maturity. In March, the FDIC extended the issuance period that will be covered by the TLGP but, in an effort to gradually phase out the program, increased the fee for issuing guaranteed debt.

In the euro area, total government-guaranteed issuance under various programs currently stands at US$242 billion. Yields on most euro-denominated debt are currently between 50 and 140 basis points higher than yields on equivalent German government bonds, with yields on debt backed by lower-rated sovereigns such as Spain and Portugal at the higher end of that range. Yields on bonds guaranteed by the Irish Government are considerably higher than this, given concerns over Irish public finances. Issuance under the UK Government's Credit Guarantee Scheme currently stands at US$121 billion, with the majority of sterling issues trading at yields of between 60 and 120 basis points above yields on equivalent gilts.

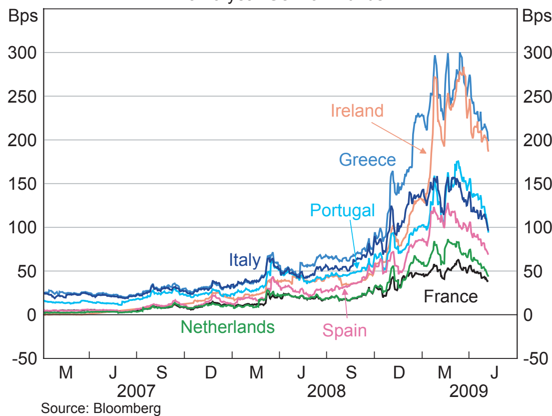
Sovereign debt markets

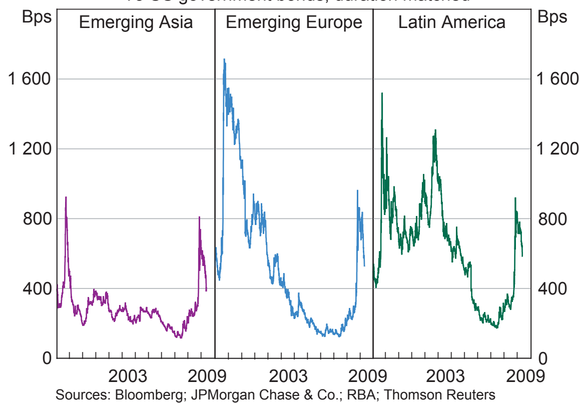
Longer-term sovereign bond yields in most major economies have risen since the beginning of the year, despite some large falls on particular occasions (Graph 18). In the United States and the United Kingdom, yields on 10-year government bonds fell particularly sharply following announcements that the Fed and the BoE would be making unsterilised purchases of longer-dated government bonds: yields on 10-year US government bonds fell by 50 basis points immediately following the Fed's announcement, while yields on 10-year gilts fell by a total of 60 basis points following the BoE's announcement. In the United Kingdom, yields retraced some of this fall following the release of the government budget, which included the announcement of a larger-than-expected bond issuance program. Earlier concerns over the expansion of the US budget deficit had also resulted in some increase in US Treasury yields. Despite this, yields remain historically low, with US 10-year government yields around 3¼ per cent and UK 10-year government yields around 3½ per cent. Yields on German long-term bonds have followed a similar, albeit more muted, pattern to those in the United States and United Kingdom, while yields on Japanese government bonds have risen as a result of a rally in domestic equities and the announcement of another stimulus package by the Government.

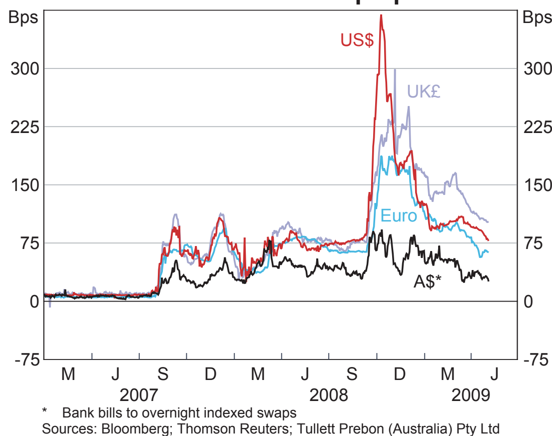


In all these countries, yields on short-term government bonds have remained at particularly low levels given expectations that policy rates will remain low for the foreseeable future.

In the first quarter of 2009, spreads between yields on sovereign debt issued by a number of European Monetary Union (EMU) member countries, including Ireland, Portugal and Greece, and yields on German government debt widened markedly (Graph 19). This reflected concerns over the impact of deteriorating economic outlooks and government support measures on budget balances in these countries. Similar concerns led to Ireland's sovereign debt rating being downgraded by Standard & Poor's and Fitch. In general, these spreads have narrowed since mid March.







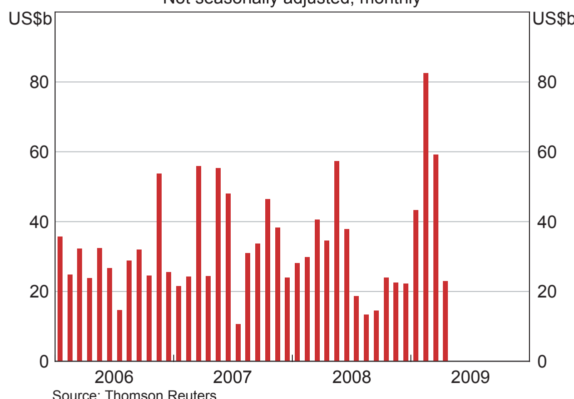
In emerging Europe, sovereign spreads increased in February on concerns over vulnerabilities in the region stemming from rapid growth of foreign currency-denominated borrowing (Graph 20). Spreads for countries in Western Europe with banking sectors exposed to the region also widened. Subsequently, a number of countries including Estonia, Hungary, Latvia and Lithuania were downgraded by rating agencies. More recently, these spreads have fallen as risk appetite has improved. In emerging Asia and Latin America, spreads on US dollar-denominated sovereign debt to equivalent US Treasuries have continued to narrow from their peaks in October 2008.

Credit markets

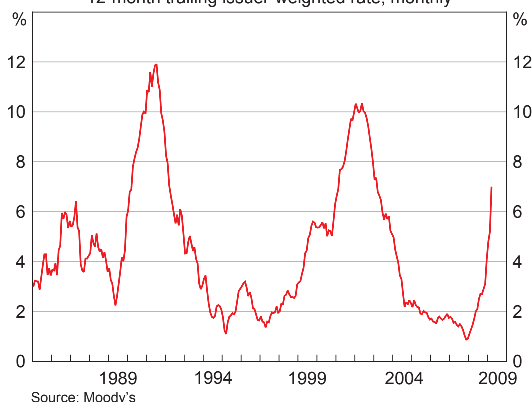
Conditions in credit markets have improved noticeably over the course of 2009. This is reflected in a considerable reduction in spreads across many credit markets and a pick-up in issuance in some markets. In money markets, spreads between LIBOR and the expected cash rate narrowed further in the major currencies (Graph 21).

Longer-term US corporate bond spreads have also narrowed and issuance of non-financial corporate debt has increased across all investment-grade rating categories in both the United States and Europe, with sizeable issuance in the March quarter (Graph 22). Notwithstanding this, there has been a sharp rise in the global corporate speculative-grade default rate (Graph 23).

Agency funding spreads to US Treasuries have narrowed since the Fed's announcement in mid March that it would significantly increase the size of its purchases of agency debt and MBS, and are around or below the bottom of the range seen since the Fed began purchases of agency-issued securities in December 2008. Agency issuance of MBS has picked up noticeably in 2009, although there has been almost no issuance of private MBS since July 2008.



Credit default swap (CDS) premia have been volatile over recent months, particularly for financials, reflecting significant changes in market sentiment. However trading in CDS markets remains thin, making these data hard to interpret. Trading conditions are particularly thin for sovereign CDS, partly because the risk on the CDS counterparty is typically greater than on the sovereign itself. In particular, CDS protection buyers will not purchase CDS on a sovereign from a seller who is domiciled in that country. In the case of the Australian market, anecdotal evidence suggests that the daily number of trades is in single digits.



The gross notional amount of outstanding CDS declined by 29 per cent in the second half of 2008 to $US39 trillion according to the International Swaps and Derivatives Association (ISDA). The decline is largely a result of voluntary multilateral terminations, or 'tear-ups', whereby CDS holders cancel offsetting trades without affecting their credit risk profiles. This decreases operational costs and capital charges, partly addressing regulators' concerns about the systemic risks in this market. ISDA has indicated that activity in CDS contracts has started to pick up again in the first quarter of 2009.

There have also been significant changes to the contract standards and trading conventions for CDS in an effort to enhance transparency and liquidity in the market. The ISDA's standardised CDS contract requires an auction to determine the value of underlying securities as part of the settlement process in the event of borrower default. In a bid to increase efficiency, North

American standardised CDS contracts will require an upfront payment by the protection buyer, will have a fixed coupon of either 100 or 500 basis points, and will not treat restructuring as a credit event. The US Treasury and the Fed are actively supporting moves to settle these standardised contracts through a central clearing house, which it is hoped will address systemic risks in the financial system. In the European CDS market, the terms of standardisation and central counterparties for clearing are still under discussion, with details likely to be outlined in May.

Equities

Equity indices for the major markets posted new lows in early March: the Nikkei index fell to its lowest level since 1982; the S&P 500 to its lowest level since 1996; and the Euro STOXX to levels last seen in early 2003 and in 1997. This occurred after a number of financials announced the issuance of additional common stock, in some cases through governments exchanging preferred stock for ordinary stock, and several reported worse-than-expected earnings for 2008.

Since mid March, however, there has been a significant rebound (Table 6). This was the result of an improvement in investor sentiment following reports of increased profitability at a number of financial institutions for early 2009 and further actions by policy-makers to address

Table 6: Changes in Global Share Prices
Per cent

	Peak to trough	Since recent trough	Since previous *Statement*
United States			
– Dow Jones	–54	30	7
– S&P 500	–57	36	10
– NASDAQ	–56	39	16
Euro area			
– STOXX	–62	34	8
United Kingdom			
– FTSE	–48	25	4
Japan			
– Nikkei	–61	27	12
Canada			
– TSE 300	–50	34	17
Australia			
– ASX 200	– 54	23	12
MSCI			
– Emerging Asia	–61	53	30
– Latin America	–57	59	22
– Emerging Europe	–71	49	40
– World	–56	32	11

Source: Bloomberg

the deterioration in the global outlook. As a result, equity markets are now at higher levels than those that prevailed at the time of the last *Statement*.

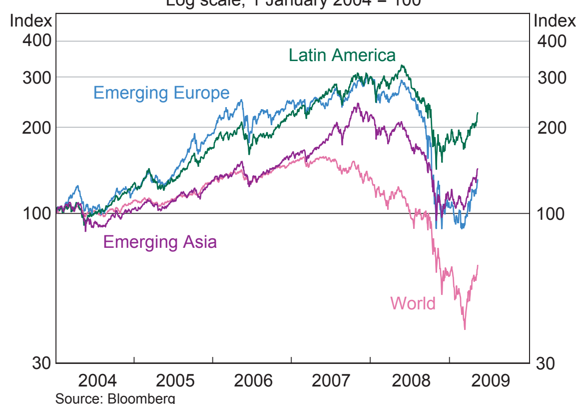
Daily movements in equity markets have been largely dictated by developments in the financial sector but in general have been less sharp than in late 2008 and early 2009. Nonetheless, volatility remains well above its long-run average.

In contrast to US financials, whose reported quarterly earnings have been mostly negative since the fourth quarter of 2007, earnings of US non-financials only turned negative in the fourth quarter of 2008 and appear to have turned around in the March quarter, with two-thirds of companies reporting earnings above expectations and the rest worse than expected.

Equities in emerging markets have risen markedly since March and have largely outperformed equities in major economies (Graph 24). Equities in these economies have been broadly supported by fiscal stimulus plans, at home and abroad, and by the G-20 commitment to increasing the resources available to the IMF and multilateral development banks. Increases in equity indices in Latin America and emerging Europe have been supported by commodity-related stocks, as the improvement in risk appetite has increased commodity prices. In emerging Europe, the financial sector posted large gains in March after the SNB announced it will act to prevent an appreciation of the Swiss franc, which eased concerns about the prospects for banks in the region with a large proportion of their loans denominated in Swiss francs.

Graph 24

MSCI Share Price Indices



Foreign exchange

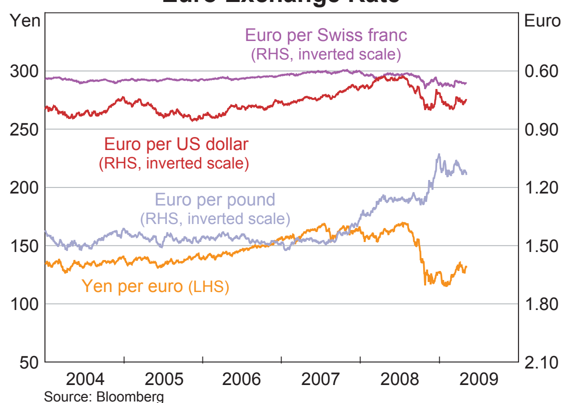
The US dollar has depreciated against most other major currencies in the period since the last *Statement* (Table 7). Flows continued to support the US dollar until early March, after which the improvement in global market sentiment and risk appetite led to a broad-based depreciation of the dollar. The unconventional monetary policy initiatives of the Federal Reserve also weighed on the US dollar, which recorded its largest weekly fall on a trade-weighted basis since 1985 following the Fed's announcement in March of its intention to purchase US Treasuries and increase its purchases of agency debt and MBS. However, the US dollar is still 16 per cent above its multi-decade low reached last year.

The euro appreciated sharply against both the US dollar and the British pound following the announcements by the Fed and the BoE that quantitative easing policies would be implemented (Graph 25). The euro also appreciated against the Swiss franc after the SNB intervened to prevent

Table 7: Change in US Dollar against Other Currencies
Per cent

	Past year	Since previous *Statement*
New Zealand	36	–13
Sweden	32	–5
United Kingdom	30	–4
Brazil	28	–8
Mexico	25	–9
South Korea	25	–8
Australia	27	–14
India	21	2
Euro area	16	– 4
Canada	16	–5
Indonesia	13	–11
Philippines	13	1
Malaysia	12	–3
Thailand	11	1
South Africa	11	–17
Taiwan	9	–1
Singapore	8	–2
Switzerland	8	–2
China	–2	0
Japan	–6	10
Majors TWI	**14**	**–2**
Broad TWI	**14**	**–1**

Sources: Bloomberg; US Federal Reserve

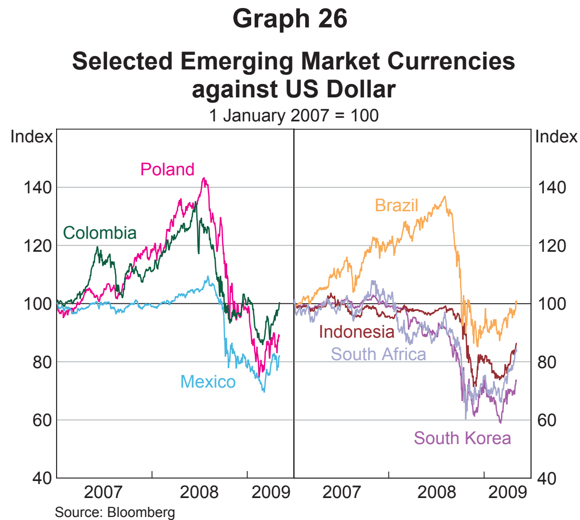


further appreciation of the currency. However, the euro depreciated in April, amid expectations the ECB will implement unconventional monetary policy measures in May, partially retracing its appreciation against the US dollar, the Swiss franc and the pound.

The Japanese yen has depreciated markedly against the US dollar and the euro since the last *Statement*. While the BoJ also adopted unconventional monetary policy measures during March, the depreciation of the yen,

which began in February, appears to be due to increased risk appetite and the poor domestic economic outlook.

Emerging market currencies have had a mixed performance against the US dollar since the last *Statement*. Downward pressure continued in February. However, increased risk appetite provided support from early March, with the commitment by the G-20 to increase the IMF's resources also supporting emerging market currencies. The positive effect of improved risk appetite on commodity prices led to particularly marked appreciations for the currencies of commodity-producing economies such as the Brazilian real and the South African rand. The Mexican and Colombian pesos and the Polish zloty appreciated in response to announcements that these countries were seeking a credit line under the IMF's recently-announced Flexible Credit Line (Graph 26). The Bank of Mexico's provision of US dollar liquidity through its swap line with the Fed further supported the peso, which remains well above its record low reached in March notwithstanding swine flu concerns temporarily weighing on the currency in late April. In Asia, both the South Korean won and Indonesian rupiah have appreciated significantly since their recent low points in March 2009 and November 2008, respectively.



Australian dollar

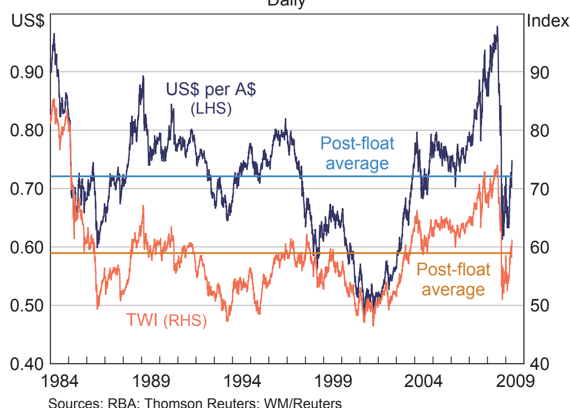
There has been a broad-based appreciation of the Australian dollar over the past few months: on a trade-weighted basis the dollar has appreciated by 13 per cent since the last *Statement* (Table 8). In part, this reflects the depreciation of a number of major currencies, including the US dollar and British pound, following the announcements that central banks in these countries would be implementing quantitative easing policies. The appreciation also reflects the general improvement in investor sentiment and the pick-up in commodity prices. The Australian dollar is now trading around its long-run average both against the US dollar and on a trade-weighted basis (Graph 27).

Improved risk appetite has reportedly seen some investors return to carry trade strategies, which is corroborated by data showing that speculative traders are holding significant net long positions in the Australian dollar for the first time since October 2008: with interest rates near zero in many developed economies, the interest rates on offer in Australia remain relatively attractive.

Table 8: Australian Dollar against Selected TWI Currencies
Percentage change

	Past year	Since previous *Statement*	Deviation from post-float average
New Zealand	6	0	4
United Kingdom	3	11	12
South Korea	–2	6	41
India	–5	16	42
Euro area	–8	10	–15
Canada	–8	8	–7
Indonesia	–11	2	117
Malaysia	–11	13	20
Thailand	–12	15	12
South Africa	–12	–3	43
Singapore	–14	12	–12
Switzerland	–15	11	–21
United States	–21	15	4
China	–23	15	10
Japan	–26	24	–22
TWI	**–15**	**13**	**4**

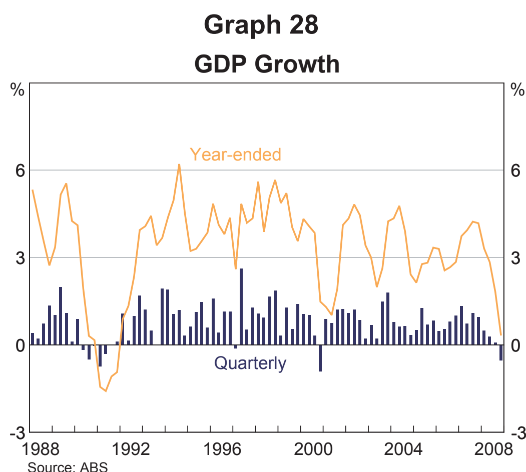
Sources: RBA; Thomson Reuters; WM/Reuters



Volatility in the exchange rate, as measured by the intraday range, has continued to decline since the last *Statement*, but remains above its long-term average. Liquidity in the AUD/USD market has improved since the end of 2008 and large intraday movements over recent months have generally been related to significant policy announcements in other countries rather than thin market conditions.

Domestic Economic Conditions

The sharp downturn in the international economy has flowed through to the domestic economy. In the December quarter, GDP declined by 0.5 per cent – the first quarterly fall since 2000 – to be 0.3 per cent higher over the year (Graph 28, Table 9). More recent economic indicators, including private-sector surveys and information from the Bank's liaison with businesses, suggest activity continued to decline in the early part of 2009, although at a significantly more gradual pace than in many other advanced countries.



The slowing in the domestic economy has been evident across most components of private-sector spending and in the labour market. Household consumption has been quite weak since the start of 2008 after having grown strongly over previous years, and dwelling investment declined in the second half of 2008, with a further decline expected in the first half of 2009. The pace of growth of business investment slowed in the second half of 2008 from the high rates seen in previous years, and indicators suggest that investment will contract through 2009. Export volumes have been broadly flat recently. As a result of the weaker economic environment, labour market conditions

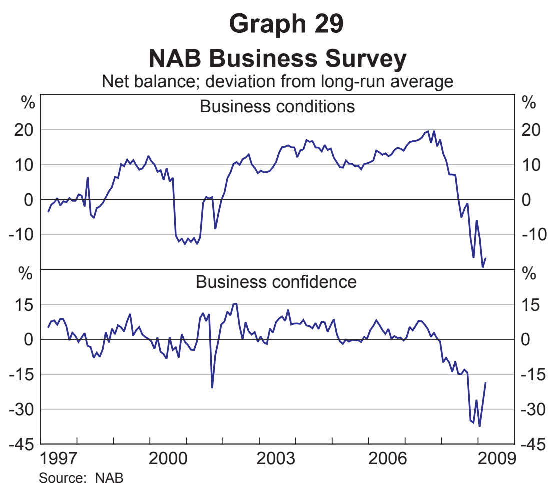
Table 9: Demand and Output
Percentage change

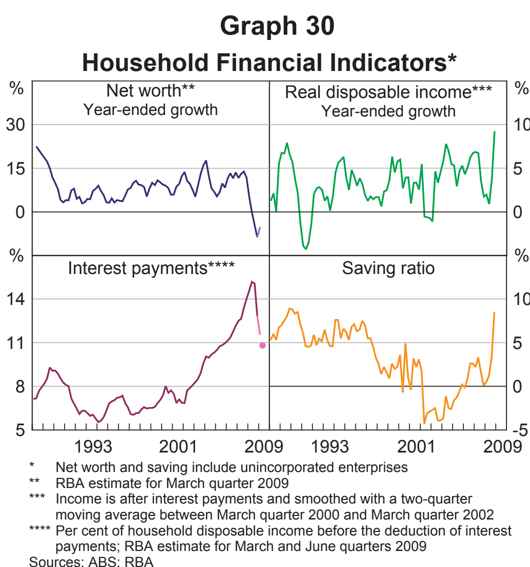
	September quarter 2008	December quarter 2008	Year to December quarter 2008
Domestic final demand	0.3	0.1	2.6
GNE[(a)]	0.5	–2.0	0.1
Net exports[(b)]	–0.4	1.5	0.2
GDP	0.1	–0.5	0.3
Non-farm GDP	–0.2	–0.8	0.0
GDP adjusted for changes in the terms of trade	1.5	–1.2	3.9

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

have deteriorated, with the unemployment rate increasing from its trough of around 4 per cent in early 2008 to 5½ per cent in April 2009.

The slowing in the economy has been associated with a marked increase in uncertainty and a decline in confidence about the near-term prospects for the global and Australian economies. However, recently there have been signs that business confidence has improved from the low levels recorded earlier in the year (Graph 29). In addition, the sizeable falls in mortgage rates and the Government's fiscal initiatives are supporting household consumption, and there are some early signs pointing to growth in housing construction later this year. Reflecting these developments, the rate of contraction in the economy is expected to slow over coming months, although much will depend on an improvement in global conditions and sentiment.



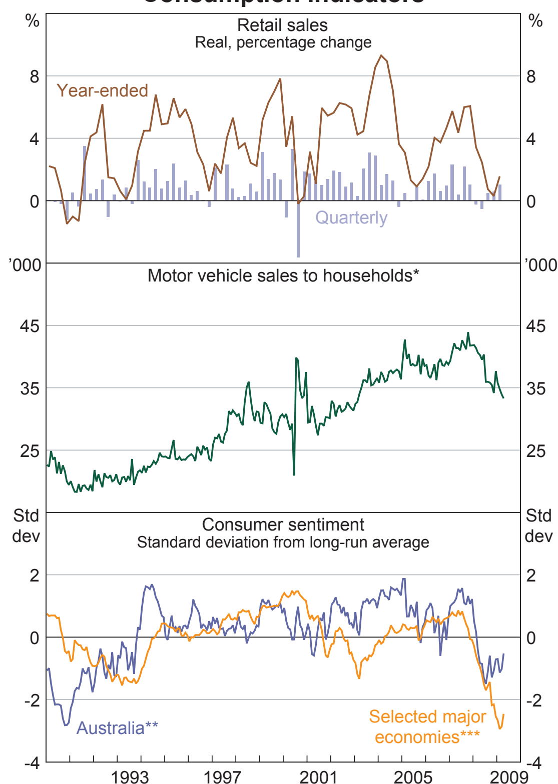


Household sector

While conditions in the Australian household sector remain more favourable than in many other countries, there has nonetheless been a significant decline in wealth and unemployment has increased. Over 2008, household net worth declined by 8½ per cent, driven by large falls in equity prices (Graph 30). Not surprisingly, many households are taking a more conservative approach to their finances, although the stresses on households in a number of other countries have not been as evident in Australia. This reflects a number of factors, including that lending standards in Australia did not decline as much as in some other countries and that, after a large run-up in house prices in the years leading up to 2003, an adjustment in household behaviour has already been under way for some time (for further details, see the March 2009 *Financial Stability Review*).

In contrast to the decline in wealth, household income has grown strongly. Real household income (after interest payments) increased by more than 9 per cent over the year to the December quarter, reflecting robust growth in labour income last year and payments of around $8 billion that were part of the Government's fiscal stimulus package announced in October 2008. In addition, the decline in mortgage rates from September has provided a significant boost to many households' budgets, with the overall reduction in household interest payments estimated at around 4½ per cent of income (Graph 30).

While households have used part of this increase in income to boost their saving and pay down debt – the December quarter data show the household saving ratio rose to 8.5 per cent, its highest level since the early 1990s – the increase has also supported spending in recent months. The volume of retail sales is estimated to have risen by 1 per cent in the March quarter, and after significant falls through much of 2008, the rate of decline in motor vehicle sales to households has slowed (Graph 31). Consistent with these data, consumer sentiment has risen from the low levels of late 2008 and is stronger than in many other economies, with Australian households remaining quite positive about the medium-term prospects for the economy. Looking ahead, the $12 billion in additional budget transfers to households (announced in early 2009 and being paid from March) is likely to continue to support household spending, although the deterioration in the labour market will work in the other direction.



* Data before 1996 are backcast using ABS motor vehicle registration data
** Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index; seasonally adjusted by the RBA
*** GDP-weighted average of euro area, Japan, UK and US
Sources: ABS; FCAI; Melbourne Institute and Westpac; RBA; Roy Morgan Research; Thomson Reuters

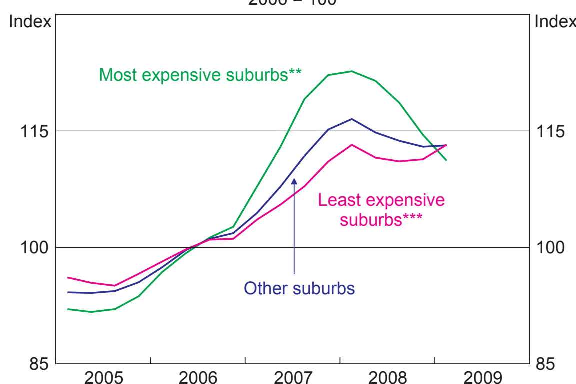
After falling modestly in 2008, nationwide housing prices were little changed in early 2009, although there is some variation in the range of available measures that use different techniques to control for changes in the composition of property transactions (Table 10). House prices in the most expensive suburbs have fallen quite significantly over the past year while prices for apartments and houses in the lower-priced suburbs have been supported by increased first-home buyer activity, partly associated with the temporary increase in grants paid to first-home buyers (Graph 32). Across the capital cities, prices have fallen most in Perth, which had the largest run-up in dwelling prices in recent years.

Table 10: National Housing Prices
Percentage change

	December quarter 2008	March quarter 2009	Year to March quarter 2009
House prices			
ABS	–1.2	–2.2	–6.7
RP Data-Rismark	–1.0	–0.1	–3.8
APM	–0.5	0.1	–3.5
Apartment prices			
RP Data-Rismark	–0.1	0.9	–0.9
APM	–0.2	0.4	–1.7

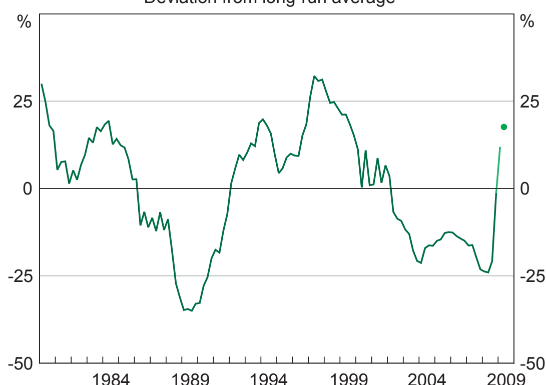
Sources: ABS; APM; RBA; RP Data-Rismark

Graph 32
Dwelling Prices*
2006 = 100



* Weighted average of houses and units in Adelaide, Brisbane, Melbourne, Perth and Sydney
** Most expensive 20 per cent of suburbs
*** Least expensive 20 per cent of suburbs
Source: RP Data-Rismark

Graph 33
Housing Affordability*
Deviation from long-run average**



* Index constructed as the ratio of average household disposable income to the required monthly repayment for the median priced home (houses and apartments) financed with a 25-year loan assuming an 80 per cent LVR at the full-doc prime mortgage rate
** Average since 1980 to present; RBA estimate for March and June quarters 2009
Sources: ABS; RBA; REIA

The softening of the housing market and deterioration in the economy have contributed to subdued housing activity in the second half of 2008 and the early part of 2009. Dwelling investment declined by 1.2 per cent in the December quarter, reflecting contractions in both new dwelling construction and renovation activity. Building activity is likely to have weakened further in early 2009, given that commencements fell by around 10 per cent in each of the September and December quarters and the number of private residential building approvals declined by 3 per cent in the March quarter, to be around 20 per cent below its level in mid 2008. Approvals and commencements for medium-density dwellings have fallen more than for houses, with high-rise developments particularly affected.

Looking ahead, low mortgage interest rates and the increase in grants for first-home buyers have made home purchase more affordable, and this is expected to help support residential building construction in the second half

of 2009 (Graph 33). There are positive signs in the forward-looking indicators and from the Bank's business liaison. Loan approvals for new construction and first-home buyer grants paid for new homes have risen in recent months (Graph 34). Consistent with these indicators, surveys of consumer sentiment report a relatively high proportion of households responding that it is a good time to purchase a dwelling. Further, after slowing in the second half of 2008, housing credit growth picked up modestly over the March quarter (Graph 35). This reflected a rise in new lending, largely to first-home buyers, that has more than offset an increase in repayments by households with existing debt.

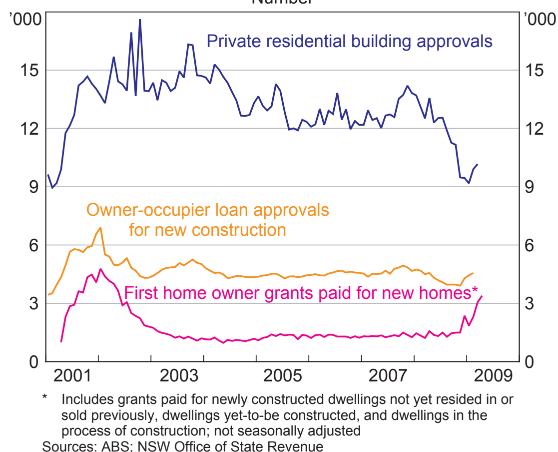
Business sector

After several years of strong profits, tight capacity utilisation and a historically high level of investment relative to GDP, conditions in the business sector have deteriorated recently (Graph 36). Given the global recession and general rise in uncertainty and risk aversion, many businesses are experiencing difficult trading conditions and have delayed or reduced investment plans while scaling back hiring intentions. Consistent with the decline in the level of activity, the capacity constraints firms were facing over recent years appear to be easing rapidly, with the NAB survey's capacity utilisation measure falling to levels last seen in 2001.

Graph 34

Housing Activity Indicators

Number

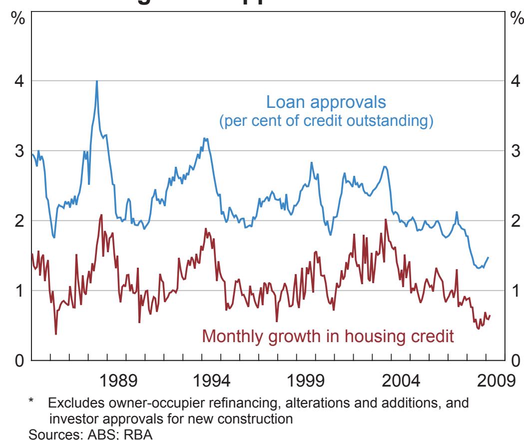


* Includes grants paid for newly constructed dwellings not yet resided in or sold previously, dwellings yet-to-be constructed, and dwellings in the process of construction; not seasonally adjusted

Sources: ABS; NSW Office of State Revenue

Graph 35

Housing Loan Approvals* and Credit

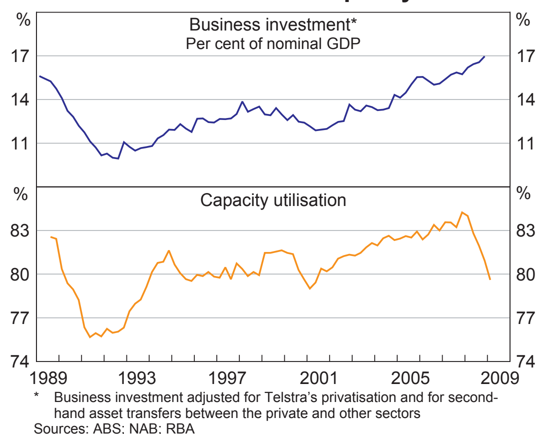


* Excludes owner-occupier refinancing, alterations and additions, and investor approvals for new construction

Sources: ABS; RBA

Graph 36

Business Investment and Capacity Utilisation



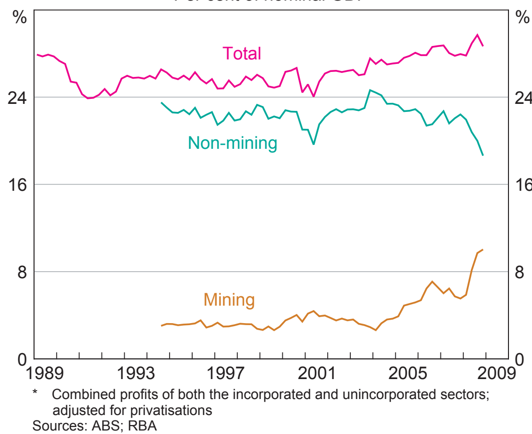
* Business investment adjusted for Telstra's privatisation and for second-hand asset transfers between the private and other sectors

Sources: ABS; NAB; RBA

Graph 37

Private Non-financial Profits*

Per cent of nominal GDP

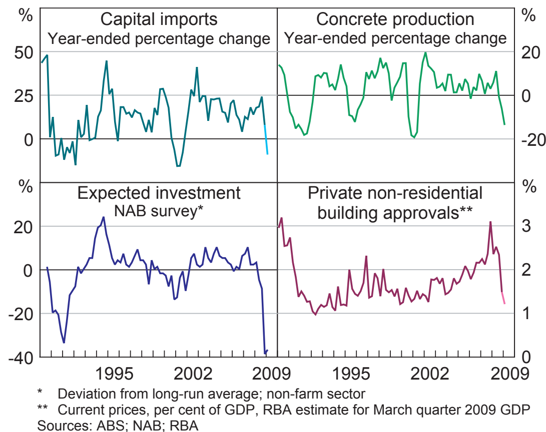


* Combined profits of both the incorporated and unincorporated sectors; adjusted for privatisations

Sources: ABS; RBA

Graph 38

Business Investment Indicators



* Deviation from long-run average; non-farm sector

** Current prices, per cent of GDP, RBA estimate for March quarter 2009 GDP

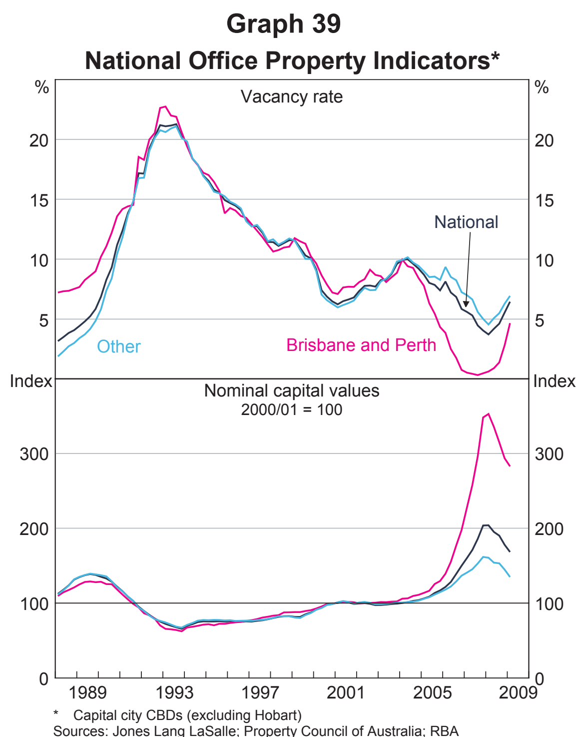
Sources: ABS; NAB; RBA

The more difficult environment is reflected in a decline in business profits. After reaching a historically high share of GDP in mid 2008, profits (excluding the financial sector) fell by 4 per cent in the December quarter and are expected to fall further in 2009 (Graph 37). Over 2008, profits in the non-mining sector (excluding the financial sector) fell by 10 per cent while, in contrast, profits in the mining sector doubled, although they will decline significantly over 2009 due to the recent falls in commodity prices.

The indicators generally point to a decline in business investment in 2009 (Graph 38). Machinery and equipment imports have fallen sharply since late last year, and surveys of business investment intentions – including the NAB and ABS Capital Expenditure surveys – suggest a fall in machinery and equipment spending over the first half of 2009. Building construction also appears to have been weak, with concrete production data (a timely gauge of construction activity) declining by around 8 per cent in the March quarter. Further falls in construction appear likely, with the value of approvals for private non-residential buildings having declined by around 50 per cent since mid 2008; approvals for large-scale projects such as offices and warehouses have fallen especially sharply. In addition, a number of large mining firms have announced reductions to capital expenditure plans for 2009, although the high level of commencements of engineering projects in the second half of 2008 suggests this spending may remain firm in the near term.

Growth in business debt has slowed markedly in recent months. There is evidence that this partly reflects reduced demand for credit as firms scale back their investment plans and attempt to consolidate their balance sheets. Nonetheless, most firms entered the slowdown in reasonably strong financial shape, with lower gearing ratios than those prevailing ahead of the early 1990s

recession (for further details, see the 'Domestic Financial Markets' chapter). Credit conditions have also tightened for many borrowers as credit risk has risen and lenders have tightened lending terms and conditions, with the impact most pronounced for borrowers in the property development industry. This change in conditions is evident in the Bank's liaison with businesses and in surveys, although the ACCI-Westpac survey and Sensis survey of small and medium enterprises suggest that access to finance is a less important concern than issues such as costs and a lack of demand.



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

Activity has declined in commercial property markets over the past year, with a decline in prices, lower turnover and a sharp fall in building approvals for offices and warehouses. Office vacancy rates have increased from recent historically low levels, although they remain lower than the average rates seen over the past two decades (Graph 39). Nationwide office capital values are estimated to have fallen by 18 per cent over the year to the March quarter, although low sales volumes make this difficult to accurately measure. The deterioration in office market conditions has been pronounced in the Perth and Brisbane markets, where high demand for office space associated with the mining sector was most concentrated.

Farm sector

Farm production is expected to have increased by around 10 per cent in 2008/09, reflecting the reasonably strong 2008 cereal harvest. The outlook for the 2009 cereal crop is mixed, with substantial rainfall required in coming months to improve soil moisture levels. Inflows into the Murray-Darling river system were at a record low between January and March, suggesting that water availability for irrigated crops is likely to remain constrained.

External sector

Export volumes are estimated to have been broadly flat in the March quarter after small falls in the second half of 2008. Australia's total export volumes to date have not been affected as much as in other countries by the global slowdown (Table 11). In large part this reflects differences in the composition of Australia's exports. In particular, while manufactured exports have fallen

Table 11: Relative performance of Australian exports

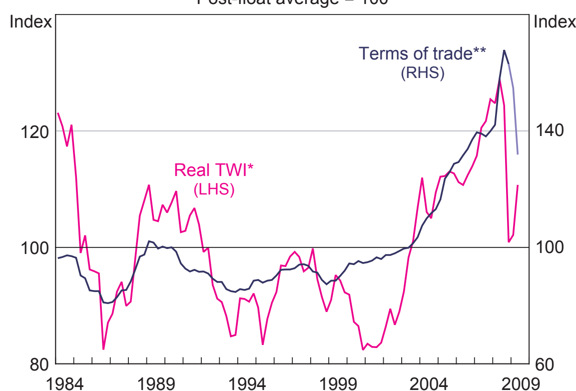
Per cent

	Growth in export volumes	Share of merchandise exports (2007/08)	
	June to December quarter	Rural and resources	Manufactures
Japan	–13	4	96
South Korea	–9	10	90
Euro area	–7	21	79
New Zealand	–6	67	33
United States	–6	22	78
Canada	–6	61	39
United Kingdom	–4	21	79
China[(a)]	–3	5	95
Australia	–1	81	19

(a) Merchandise exports only

Sources: CEIC; Eurostat; RBA; Thomson Reuters

sharply both from Australia and abroad – reflecting the significant decline in global spending on durables such as machinery, motor vehicles and other transport equipment – manufactured goods account for only around 20 per cent of the value of Australia's total merchandise exports, compared with over 90 per cent for countries such as Japan, Korea and China. In contrast, resource and rural exports account for around 80 per cent of Australia's merchandise export values (around 65 per cent of total exports, including services), which is significantly larger than for most of Australia's trading partners, and these exports have held up better over recent quarters.



* June quarter 2009 observation assumes that the nominal bilateral exchange rates on 6 May are maintained for the remainder of the quarter, and uses the latest core inflation rates.

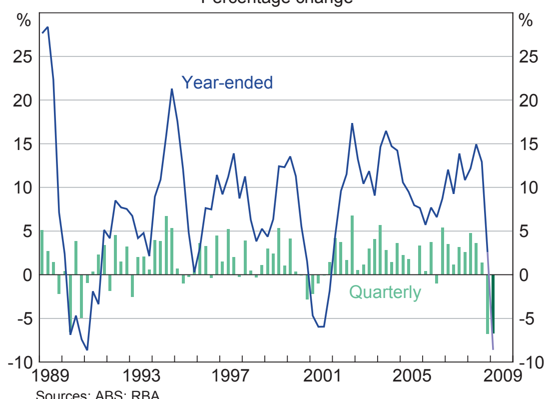
** RBA estimates for March and June quarters 2009

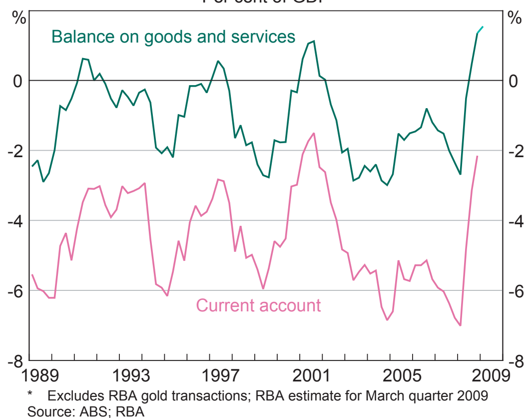
Sources: ABS; RBA; Thomson Reuters

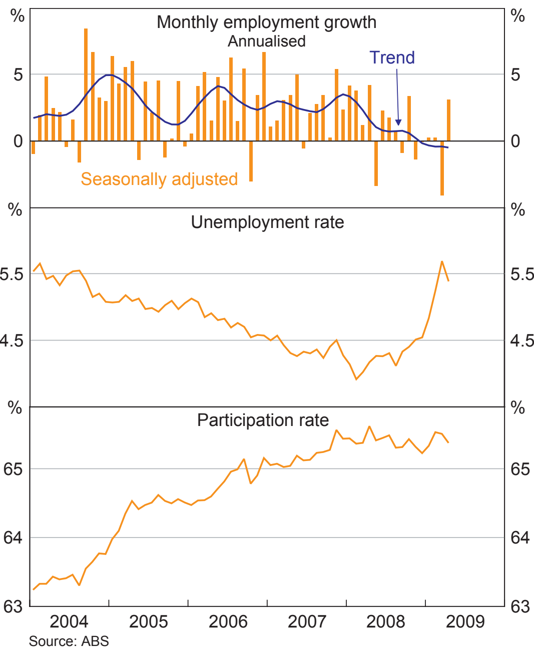
More generally, the weakening in global demand conditions has had a much more pronounced effect on resource commodity prices than on Australia's export volumes (for further details, see 'Box B: Recent Developments in Australia's Resource Exports'). The softening in commodity markets in the second half of 2008 was associated with a large depreciation of the exchange rate, although this has been partly reversed over the past few months (Graph 40). The lower exchange rate has moderated the decline in demand for Australia's other exports, including tourism and education exports. Rural exports have also

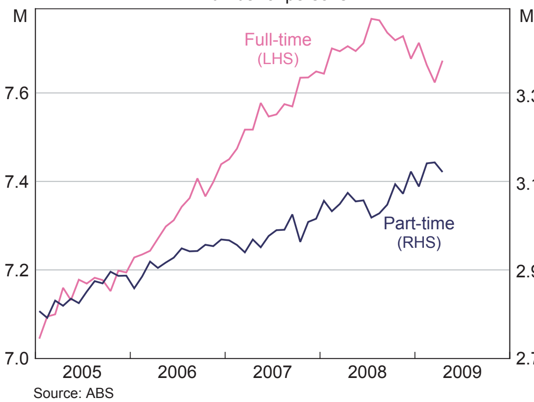
picked up in recent quarters, as the large 2008 wheat crop has been shipped.

Import volumes have declined by considerably more than export volumes, and by around as much as the falls seen in other advanced economies. Following a 7 per cent decline in the December quarter, import volumes are estimated to have fallen by a further 7 per cent in the March quarter (Graph 41). This decline reflects the weakness in domestic demand in late 2008 and early 2009, as well as the earlier depreciation of the Australian dollar. The decline has been broad-based across the categories, but – as in other countries – has been larger for imports of capital goods and transport equipment. The trade account is estimated to have remained in surplus in the March quarter, at around 1½ per cent of GDP; the full flow-on of the declines in contract prices for coal and iron ore in 2009/10 is yet to be seen in export values (Graph 42).









Labour market

The slowing in economic activity has also been reflected in a deterioration in conditions in the labour market, with the unemployment rate rising and employment contracting since its peak in late 2008. The unemployment rate stood at 5.4 per cent in April, up from around 4 per cent in early 2008 (Graph 43). While labour market conditions have varied somewhat, all states have seen their unemployment rates trending up.

The contraction in employment has been driven by the full-time component, which has been trending down since August last year (Graph 44). This pattern is consistent with previous downturns in the labour market. Full-time employment has contracted by over 1 per cent since mid 2008, while part-time employment has continued to trend upward. In part this reflects the shift of full-time workers to part-time, as employers attempt to rein in labour costs while avoiding lay-offs. In recent months, there has been a significant increase in the number of full-time workers temporarily working shorter hours. While this latter group represents only a small share of the labour force, in previous cycles significant movements in this series have tended to lead movements in the unemployment rate (Graph 45).

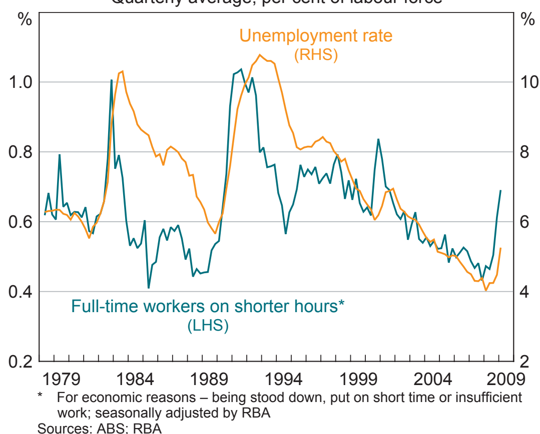
The participation rate has remained around its historical high, despite the recent weakening of the labour market. Previous downturns in the labour market have generally been characterised by declining participation, as discouraged workers exit the labour force when employment prospects diminish. The absence of any fall to date may reflect lags, as was the case in the early 1990s downturn. In addition, older workers may be delaying retirement due to the significant losses in wealth arising from falling asset values.

Forward-looking indicators of labour demand suggest that conditions will deteriorate further in coming quarters. Aggregate job advertisements, as reported by the ANZ Bank, have shown a sharp fall in 2009 for both newspaper and internet advertisements (Graph 46). In addition, measures of hiring intentions in business surveys have fallen to their lowest levels since the early 1990s. The Bank's liaison with firms also points to a broad-based softening in hiring intentions over recent months, with reports of reduced hours, hiring freezes and labour shedding becoming more common.

Graph 45

Labour Utilisation Indicators

Quarterly average, per cent of labour force

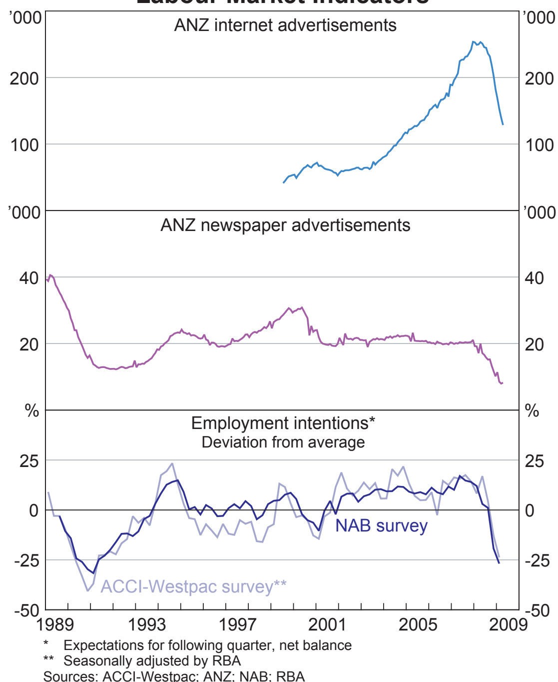


* For economic reasons – being stood down, put on short time or insufficient work; seasonally adjusted by RBA

Sources: ABS; RBA

Graph 46

Labour Market Indicators



* Expectations for following quarter, net balance

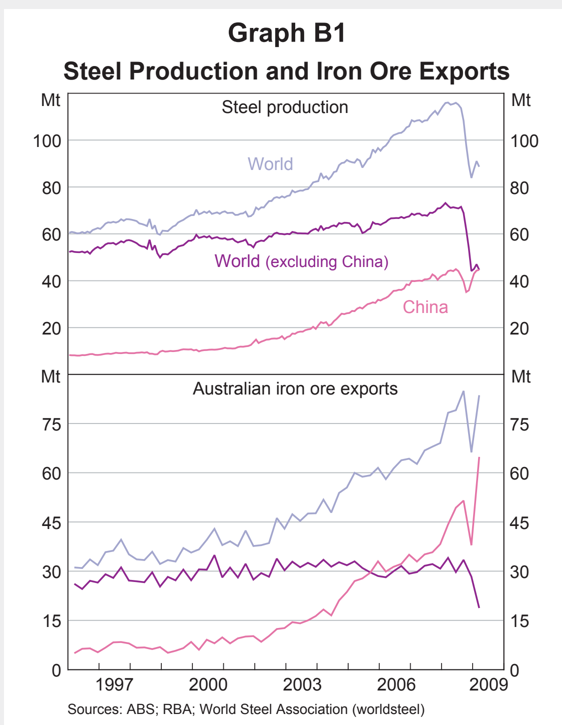
** Seasonally adjusted by RBA

Sources: ACCI-Westpac; ANZ; NAB; RBA

Box B: Recent Developments in Australia's Resource Exports

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

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



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

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

Table B1: Australian Resource Export Volumes

Per cent change, seasonally adjusted

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

Sources: ABS; RBA

Domestic Financial Markets

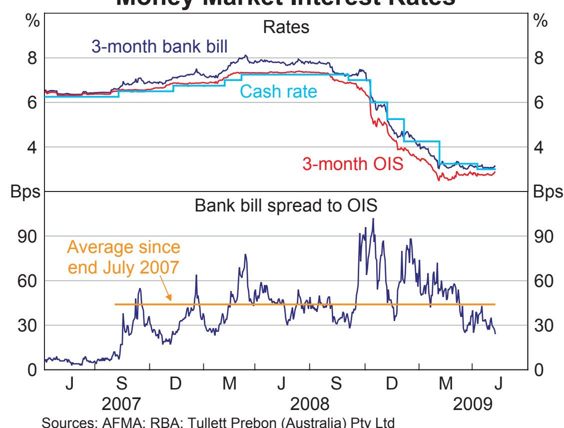
Money market and bond yields

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

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

Graph 47

Money Market Interest Rates

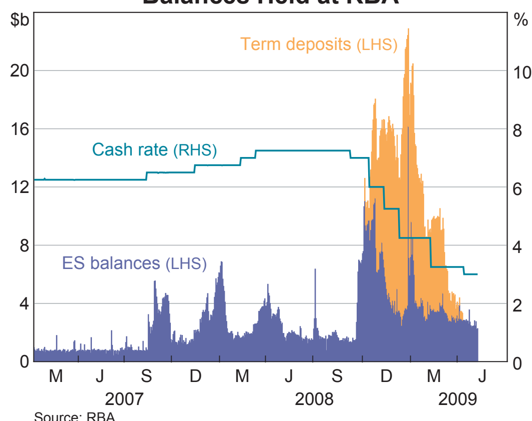


Sources: AFMA; RBA; Tullett Prebon (Australia) Pty Ltd

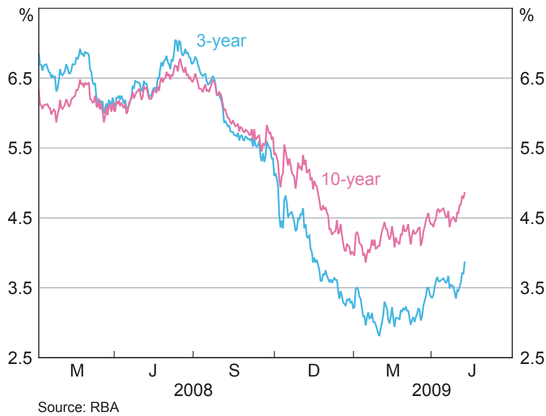
The improvement in money market conditions has allowed the Bank to adjust its own operations in the domestic market. The Bank has seen less need to accommodate large holdings of central bank balances by private banks, either in the form of overnight exchange settlement (ES) balances or term deposits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

Graph 48

Balances Held at RBA



Source: RBA

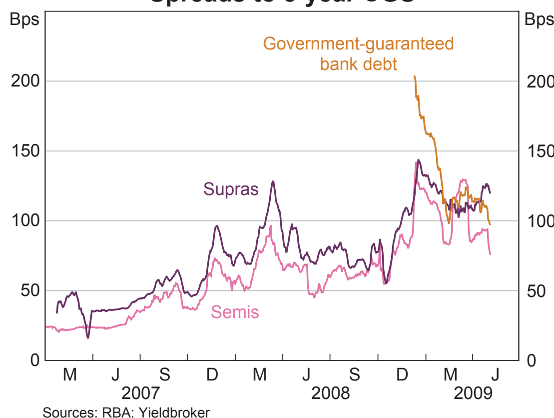


Throughout the recent period, this level of ES balances has allowed the overnight cash market to function well and the cash rate has traded at the target set by the Reserve Bank Board on all days.

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

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

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

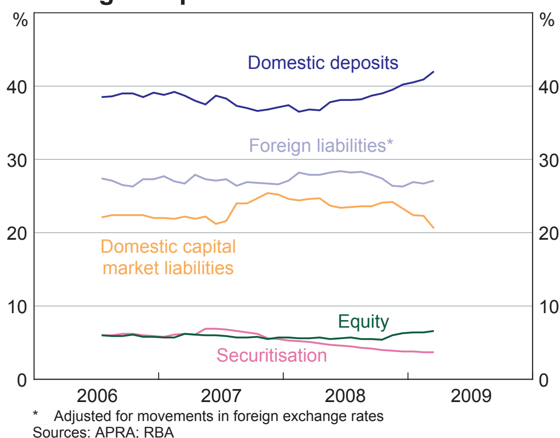


Financial intermediaries

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

Graph 51

Funding Composition of Banks in Australia

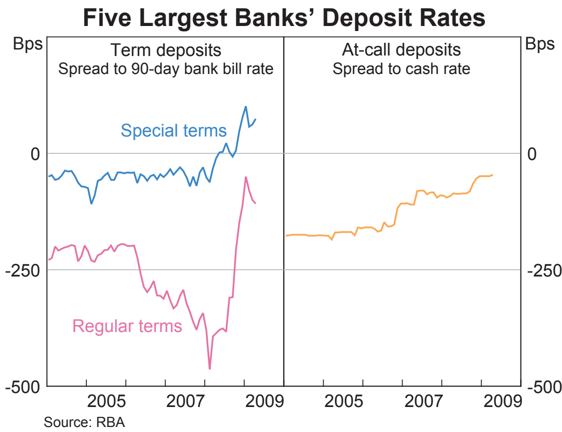


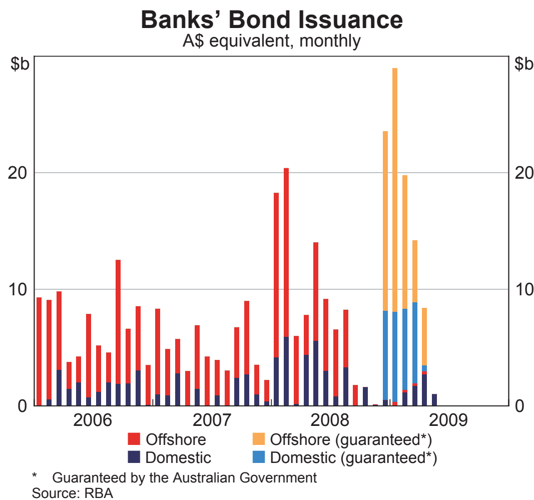
* Adjusted for movements in foreign exchange rates
Sources: APRA; RBA

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

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

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



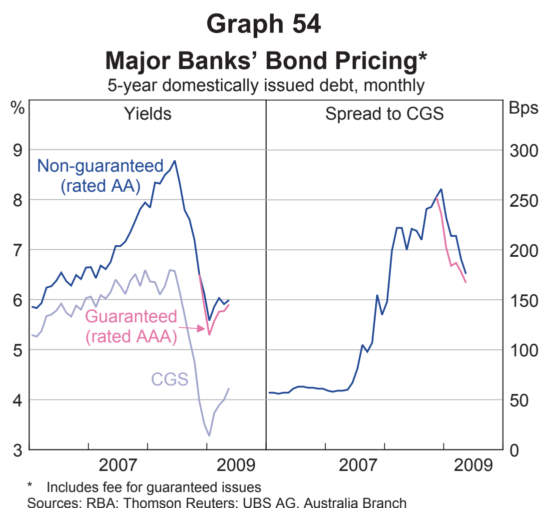


their funding plans as a result of the large amount of bonds issued earlier in the year; in addition, over the past month three of the major banks were in a blackout period prior to reporting their profit results. The banks continue to access a range of markets, providing for a diverse range of funding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

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

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

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



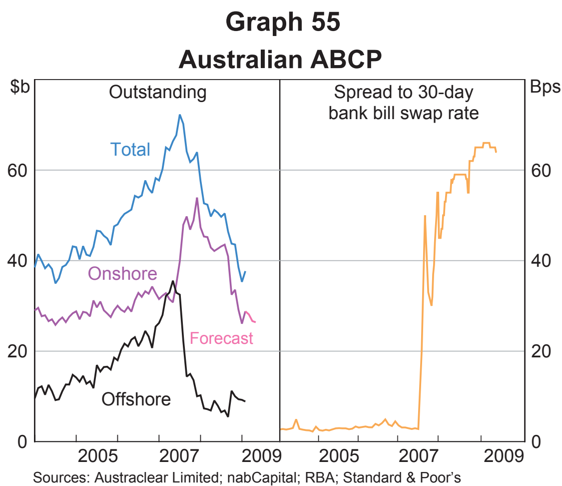
S&P and Fitch maintain the major banks on a stable outlook. In early March Moody's revised its outlook for ANZ, CBA and Westpac to negative (from stable). All of the major banks now have a rating of Aa1 from Moody's, with a negative outlook, one notch higher than the comparable ratings from S&P (NAB's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

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

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

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

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



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

Household financing

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

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

Table 12: Intermediaries' Variable Lending Rates
Per cent

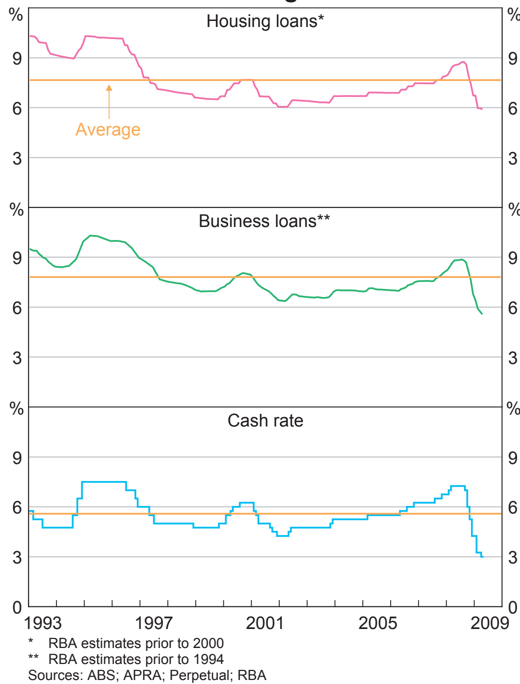
	Current level	Change since:		
	5 May 2009	End Jan 2009	End Aug 2008	End Jul 2007
Cash rate	3.00	–1.25	–4.25	–3.25
Housing loans				
Prime full-doc				
Banks	5.14	–1.07	–3.83	–2.32
Credit unions and building societies	5.27	–1.10	–3.73	–2.27
Mortgage originators	5.58	–0.93	–3.64	–1.90
Prime low-doc			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

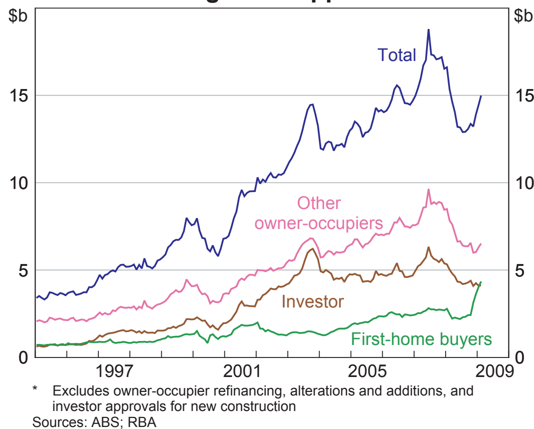
(a) RBA estimate
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

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

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

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





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

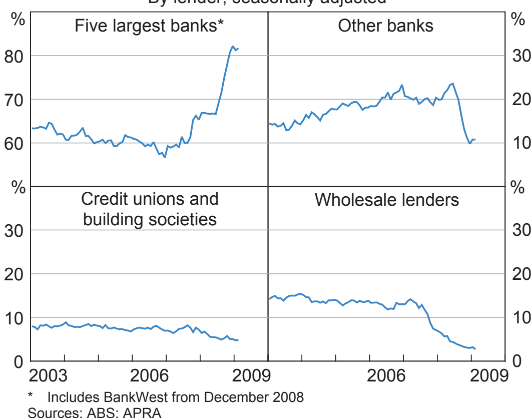
The five largest banks have continued to gain market share at the expense of the smaller lenders over recent months. The five largest banks' share of gross owner-occupier loan approvals was 82 per cent in February 2009, 21 percentage points higher than just before the onset of the financial market turbulence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

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

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

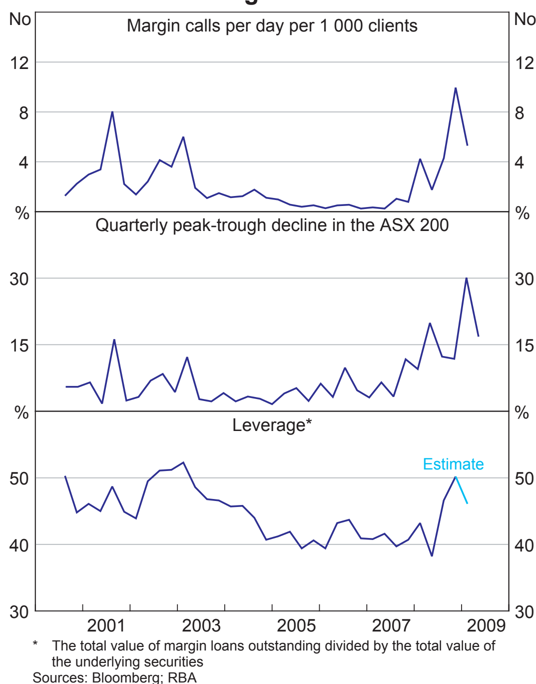
The value of margin loans outstanding declined by 12 per cent over the March quarter to $18 billion, and is now 52 per cent lower than its peak in December 2007. Volatile equity markets meant that the incidence of margin calls remained high in the March quarter, at five calls per day per 1 000 clients,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

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



Business financing

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

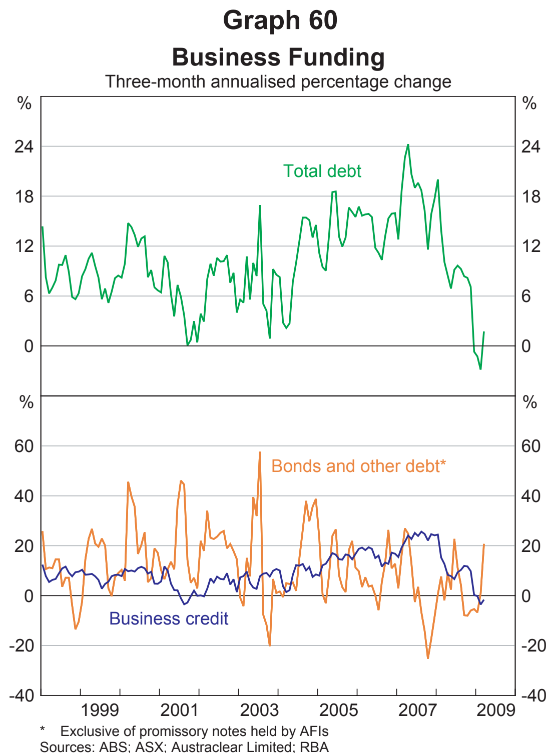


Variable interest rates on outstanding small and large business loans are estimated to have fallen by around 100–125 basis points since end January, and are about 295 and 375 basis points lower respectively since the start of the easing cycle. The declines in the average rates on outstanding small and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

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

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

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



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

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

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

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

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

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

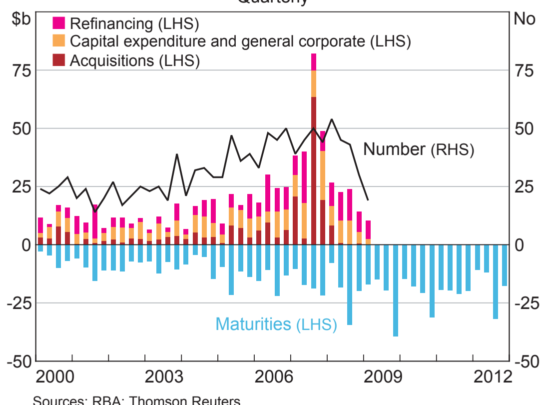
Despite the increased investor appetite for corporate bonds, spreads on recently issued debt have been much higher than for bonds issued previously by the same entities. Indeed, the increase in spreads has more than offset falls in government bond yields over the past couple of years, so that the yields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

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

Graph 61

Syndicated Loan Approvals and Maturities

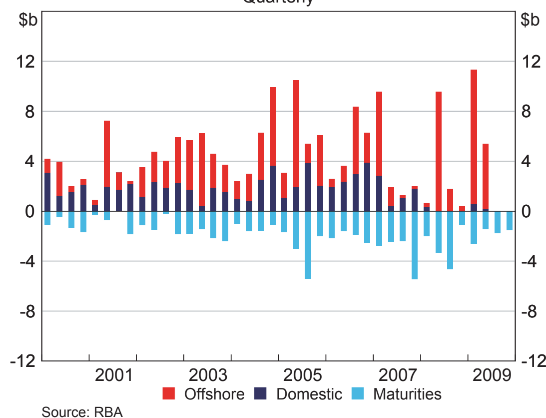
Quarterly



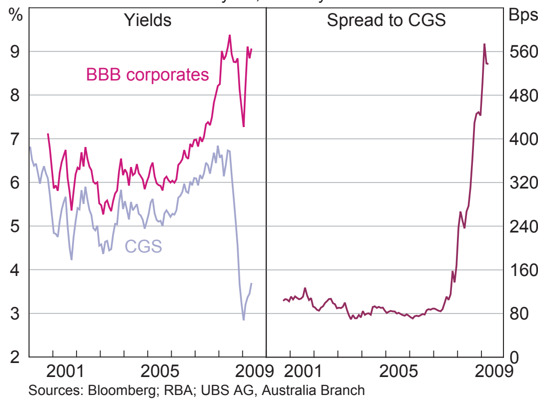
Graph 62

Australian Corporates' Bond Issuance

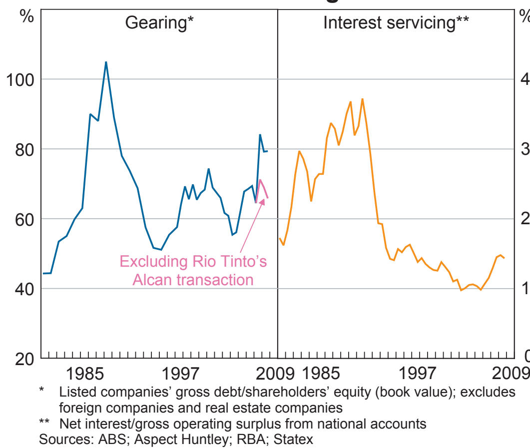
Quarterly



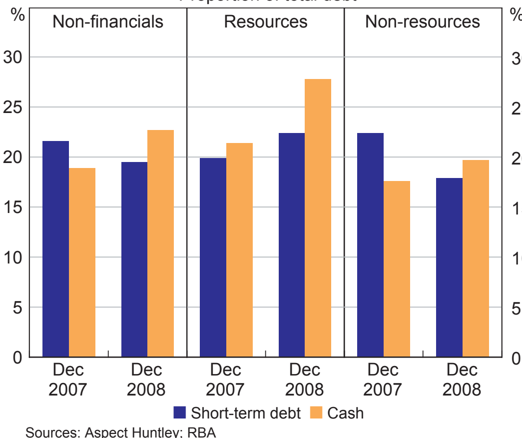
Graph 63
Australian Corporates' Bond Pricing
3-year, monthly



Graph 64
Non-financial Companies' Gearing and Interest Servicing Ratios



Graph 65
Short-term Debt and Cash
Proportion of total debt



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

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

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

Aggregate credit

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

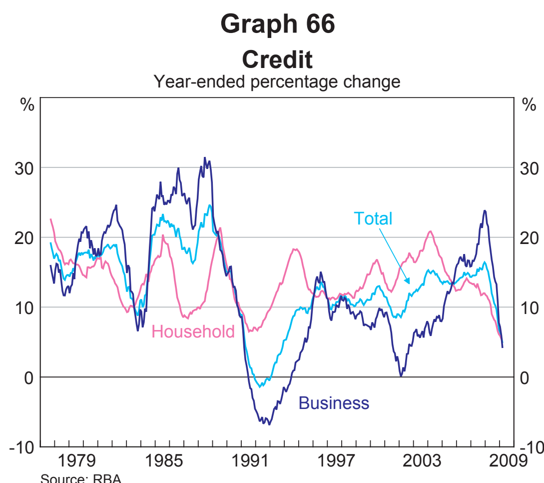


Table 13: Credit Aggregates
Average monthly growth, per cent

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

Source: RBA

Equities

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

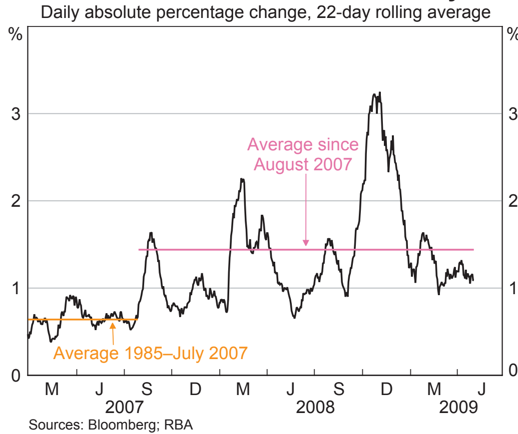
In the weeks immediately following the publication of the last *Statement*, the ASX 200 continued to decline, reaching a trough in early March which was 54 per cent below its November 2007 peak (Graph 68). Since the March trough, the ASX 200 has increased by around 25 per cent, to be slightly above end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

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

Graph 67

Australian Share Market Volatility

Daily absolute percentage change, 22-day rolling average

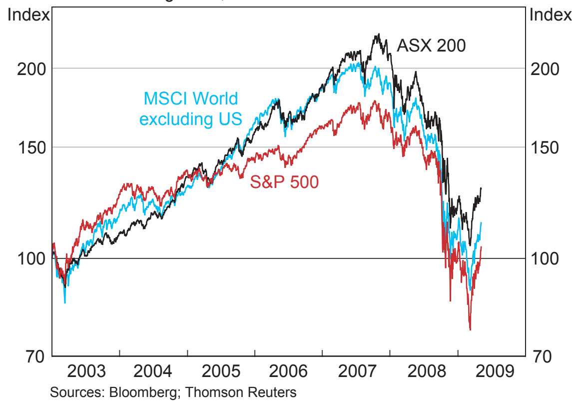


Sources: Bloomberg; RBA

Graph 68

Share Price Indices

Log scale, end December 2002 = 100

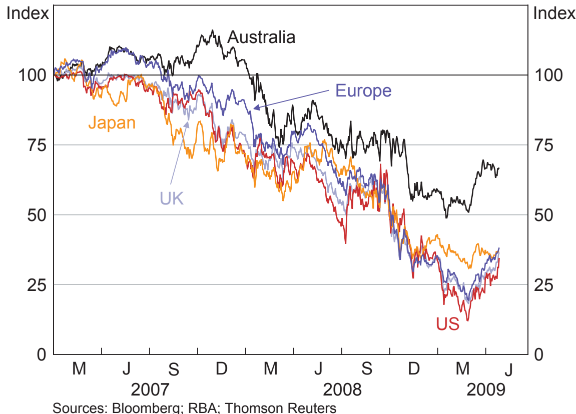


Sources: Bloomberg; Thomson Reuters

Graph 69

Commercial Banks' Share Prices

End December 2006 = 100



Sources: Bloomberg; RBA; Thomson Reuters

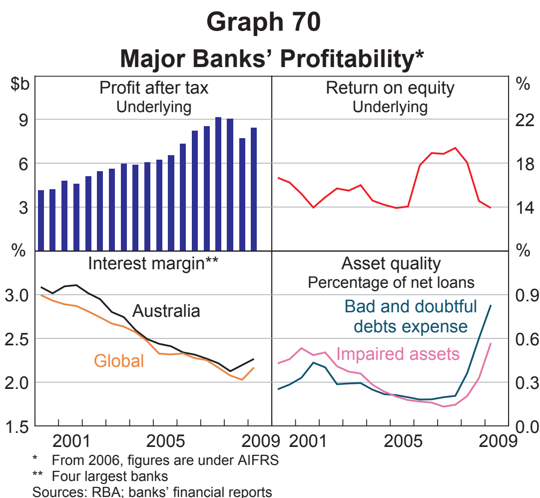
have performed well relative to major countries' banks over the past six months, though remain 42 per cent below their peak in November 2007 (Graph 69).

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

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

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

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



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

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

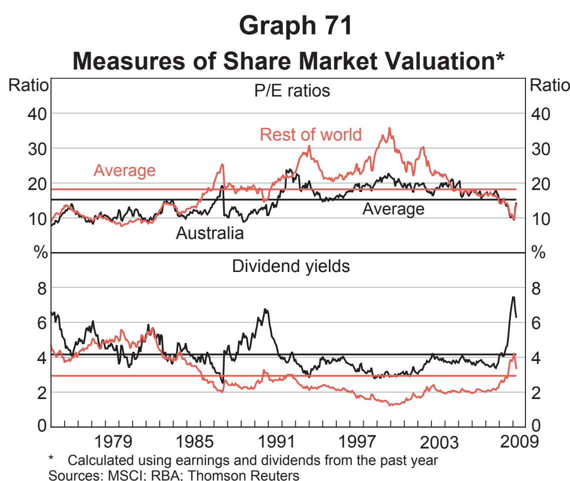
Analysts have continued to revise down their forecast profits for ASX 200 companies, albeit at a slower pace than the previous few months. Aggregate earnings are now expected to fall by 16 per cent in 2008/09, decline a little further the following year before picking up by 19 per cent in 2010/11. Downward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

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

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

Graph 71

Measures of Share Market Valuation*

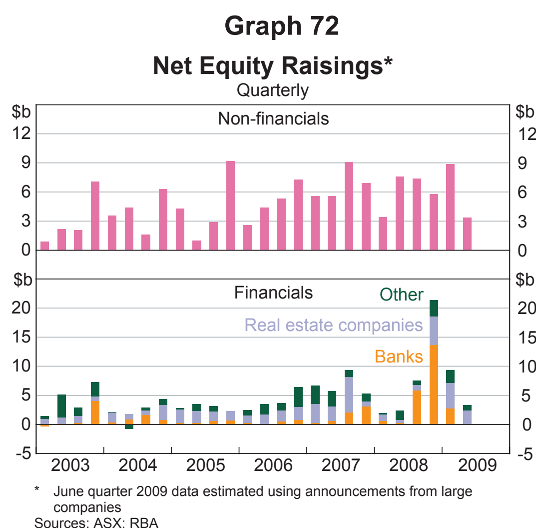


* Calculated using earnings and dividends from the past year
Sources: MSCI; RBA; Thomson Reuters

Graph 72

Net Equity Raisings*

Quarterly



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

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

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

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

Price and Wage Developments

Recent developments in inflation

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

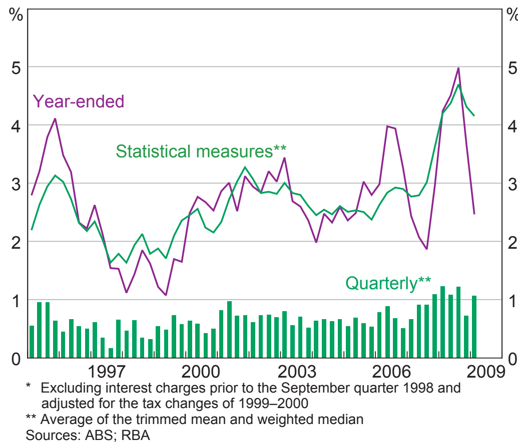
The CPI increased by 0.1 per cent in the March quarter, to be 2.5 per cent higher over the year (Table 14, Graph 73). The quarterly outcome was held down by particularly large falls in the prices of deposit & loan facilities and automotive fuel. Abstracting from these items, price pressures remained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

Table 14: Measures of Consumer Price Inflation
Per cent

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

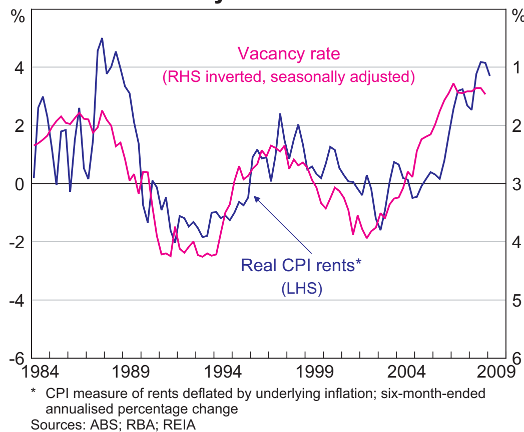
(a) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

Graph 73
Consumer Price Inflation*



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

Graph 74
Vacancy Rate and Rents



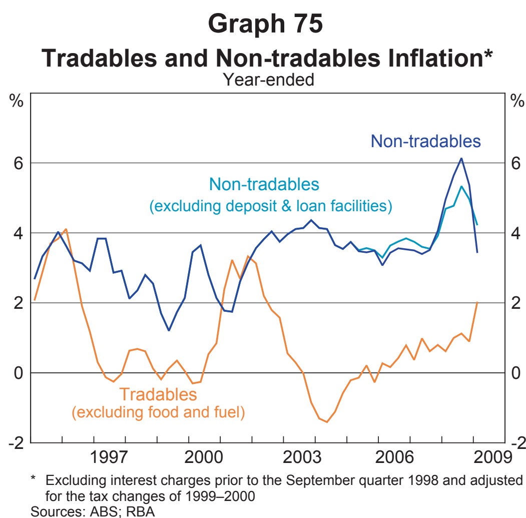
* CPI measure of rents deflated by underlying inflation; six-month-ended annualised percentage change
Sources: ABS; RBA; REIA

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

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

the impact of large changes in particular items.

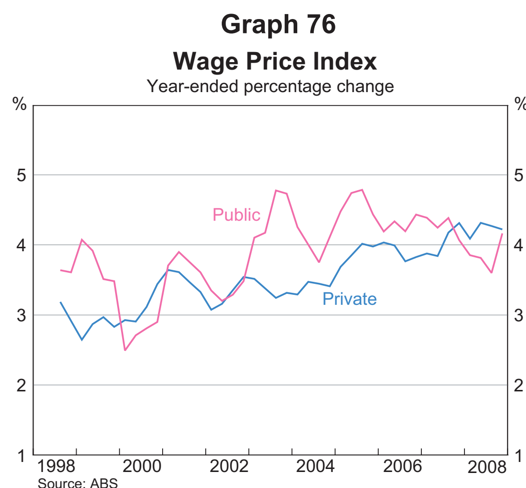
Tradables inflation (excluding food and fuel) picked up in the quarter to 0.9 per cent and 2.0 per cent over the year, which is the fastest year-ended pace since mid 2002 (Graph 75). This reflected a broad-based boost to the price of imported items from the exchange rate depreciation in the second half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



Costs and margins

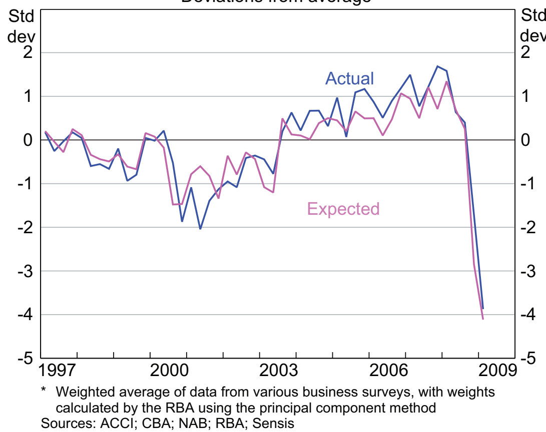
According to official measures, labour costs continued to grow at a firm pace in late 2008. However, this likely reflects wage setting decisions that were taken before the extent of the economic downturn became fully apparent. More timely indicators from business surveys and liaison suggest a noticeable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

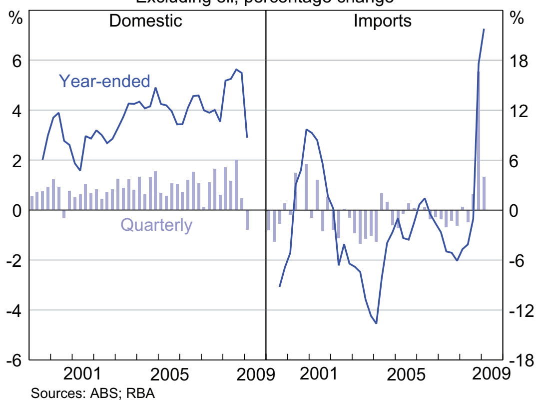
The wage price index (WPI) increased by 1.2 per cent in the December quarter and by 4.3 per cent over the year. Growth in the public-sector component was particularly strong in the quarter at 1.4 per cent, compared with 0.9 per cent in the previous quarter (Graph 76). This is partly explained by timing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



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

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

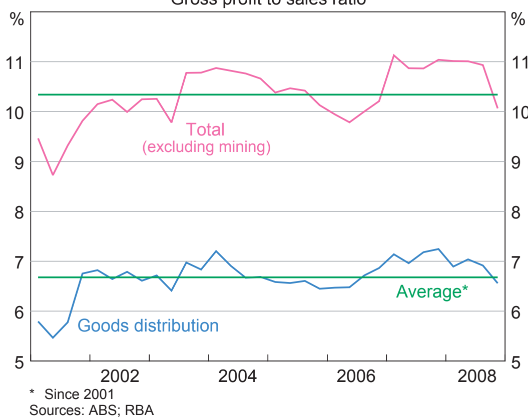




Upstream price pressures eased considerably in the March quarter, driven by a fall in construction prices and a sharp decline in prices for commodities and related items (Graph 78). At the preliminary stage, producer prices fell by 4.6 per cent in the quarter, driven by large falls in the prices of a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

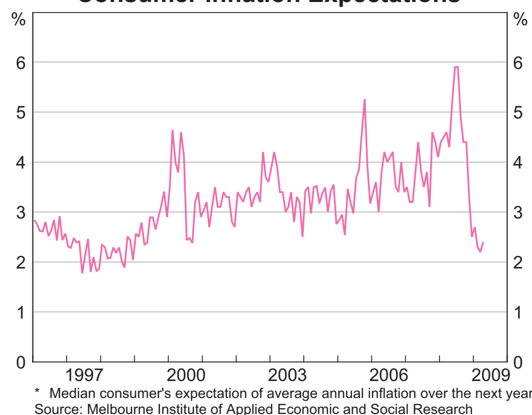
higher prices for industrial machinery & equipment. In the construction industry, the decline in prices was broad-based across both residential and non-residential sectors, and came despite persistent inflation in input costs. Property services and transport & storage prices both fell by around 2–2½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

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



Inflation expectations

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



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

Table 15: Median Inflation Expectations
Per cent

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

(a) RBA survey
(b) Workplace Research Centre

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

Economic Outlook

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

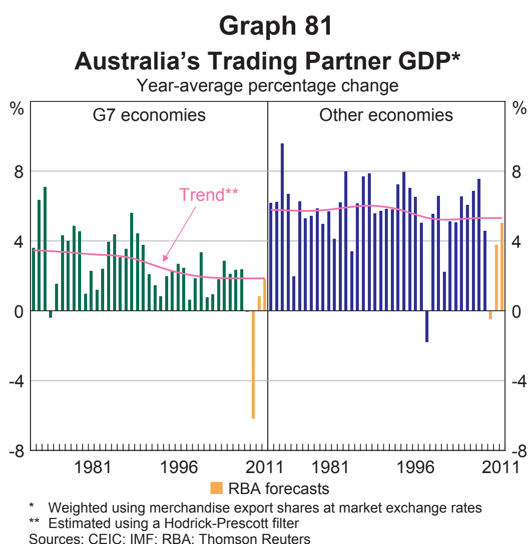
The international economy

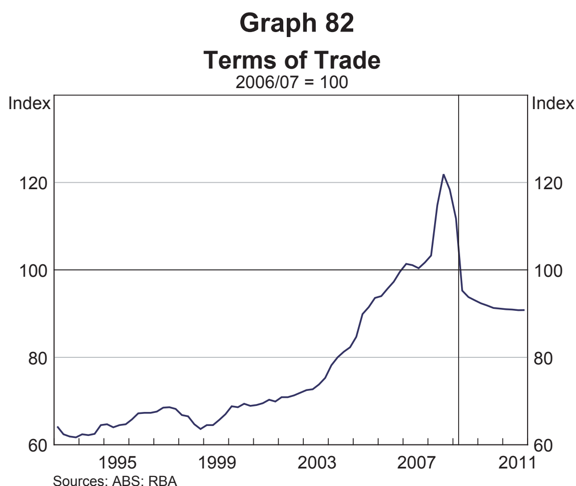
The recent weak outcomes for the world economy imply a downward revision to the 2009 year-average forecast for global growth. The magnitude and synchronisation of the contractions in output and trade seen in the December and March quarters reflect a substantial decline in confidence, particularly among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

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

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

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





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

Domestic activity

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

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

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

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

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

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

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

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

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

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

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

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

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

Inflation

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

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

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

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

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

Risks

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

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