STATEMENT ON MONETARY POLICY

12 NOVEMBER 2007

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The material in this *Statement on Monetary Policy* was finalised on 8 November 2007. The next *Statement* is due for release on 11 February 2008.

The *Statement on Monetary Policy* is published quarterly in February, May, August and November each year. All the *Statements* are available on the website when released and are reproduced in the following issue of the *Bulletin*. Expected release dates are advised ahead of time on the Bank's website. For copyright and disclaimer notices relating to data in the *Statement* see the Bank's website.

ISSN 1448–5133 (Print)

ISSN 1448–5141 (Online)

STATEMENT ON MONETARY POLICY

Recent data have continued to indicate strong growth in the Australian economy, with demand and activity rising faster than trend, confidence high and labour market conditions tight. In recent quarters these conditions have been accompanied by an increase in underlying inflation.

Growth of the Australian economy has for some time been assisted by strong global demand and high commodity prices. Supportive conditions appear likely to continue, though some moderation in the pace of global expansion is now occurring, partly as a result of recent strains in financial markets. In the United States, the sharp downturn in the housing sector is weighing on growth, and may do so for a while longer. Nonetheless, other parts of the US economy have so far been resilient, with recent outcomes for aggregate output and employment remaining relatively strong. The Japanese and euro area economies have been slowing recently, though moderate growth appears to be continuing. In contrast, the major developing countries, especially China, are growing rapidly, and indeed have strengthened further since the start of the year. The net effect of these contrasting trends is that world growth in 2008 is likely to moderate, though most official and private-sector observers still expect the pace to remain higher than average.

Global financial markets have experienced a period of significant volatility over the past three months, as the strains emanating from the sub-prime debt market in the US spilled over, particularly to other credit markets. There was also considerable volatility in share markets and currency markets.

For some time, it had been apparent that markets had held an optimistic view on risk, with spreads at historically low levels. In early August there was a marked reassessment of that view, which saw risk premia on many financial instruments rise significantly. There was also a sharp tightening in the terms at which intermediaries were willing to provide funding to each other, which saw short-term money market rates spike higher. These concerns in large part stemmed from uncertainty as to the size of the exposure that financial institutions had to structured credit instruments, either directly or indirectly through lines of credit to various off-balance sheet vehicles. Central banks, including the RBA, responded to these pressures by injecting a substantial amount of funds into money markets. These actions were designed to ensure that markets continued to function as normally as possible as the re-pricing of risk occurred. They were not intended to change the stance of monetary policy. As conditions subsequently improved, these injections of liquidity were gradually unwound.

Since August, sentiment in financial markets has improved although it remains fragile. The Federal Reserve's decision to reduce its policy rate by 50 basis points at its September meeting contributed to a marked easing in the strains in financial markets, but concerns have reappeared at various times, particularly about the extent of the exposure of large financial institutions to the affected credit instruments. Investment banks that were holding inventories of these instruments have sustained substantial valuation losses. Some institutions which were particularly reliant on credit markets for short-term funding have also been significantly affected.

The major development in currency markets has been the large depreciation of the US dollar against every major currency except the yen. The dollar has fallen to multi-year lows on a trade-weighted basis as well as against a number of other major currencies including the euro, the Canadian dollar, the pound and the Australian dollar. Thus far the depreciation of the US dollar has been orderly and has helped boost output in the US economy. The Australian dollar has traded in a very large range over the past three months, but has recently reached multi-year highs.

Domestically, credit market conditions have generally been less affected throughout the episode, and recently have improved by at least as much as in other countries. In recent weeks, a number of mortgage-backed securities have been issued, albeit at spreads which are around 30 basis points higher than earlier in the year. Bond issuance has also returned to more normal levels, but again at higher spreads. This increase in funding costs for banks has been passed on to business borrowers and riskier housing loans, but at the time of writing, no major institution had changed its benchmark home lending rate in response to these pressures. Money market rates also rose in response to the publication of the September quarter CPI.

Notwithstanding the recent credit market strains, strong global demand has continued to support high commodity prices. World oil prices have risen further in recent months while base metals prices have remained at high levels, though they have come off the peaks they reached earlier in the year. Prospects for coal and iron ore prices appear to have strengthened, with analysts generally expecting further large increases in contract prices for these commodities next year. The general run-up in commodity prices over recent years has provided a substantial stimulus to domestic incomes and spending. Australia's terms of trade have increased by 40 per cent over the past four years, their largest cumulative increase since the early 1950s. This has added around 1½ percentage points per annum over this period to the growth of Australia's real gross domestic income.

During 2007, the pace of growth in demand and output in Australia has increased. The latest national accounts show that GDP grew by an estimated 4.3 per cent over the year to the June quarter, with the non-farm economy growing by 5.2 per cent. Even allowing for an element of volatility in these estimates, it is clear that the non-farm economy has been growing at a faster-than-trend pace. Recent data suggest that considerable momentum continued in the September quarter. Retail sales posted a further large rise in the quarter, and employment continued to expand. Business surveys report that trading conditions in the quarter were well above average.

While growth of the non-farm economy remains strong, conditions in the farm sector have deteriorated over recent months. A lack of rainfall, particularly in the eastern states, has led to sharp downward revisions to expected crop yields. Inflows to the Murray-Darling system are running close to record lows for the second successive year, which is likely to mean severe cutbacks in water allocations to irrigators. These developments are resulting in subdued farm output for a second year in a row.

Domestic demand has continued to grow strongly, with consumption, business investment and public spending all making significant contributions. In total, domestic demand grew by more than 5 per cent over the year to the June quarter, well above the trend growth in the economy's productive capacity. A significant part of the increase in demand continues to be met by imports. At the same time, there has been a modest pick-up in the growth of export volumes, notwithstanding recent declines in rural exports.

Housing loan approvals declined in August and September and household credit growth moderated, partly due to the effect of the August increase in interest rates, though the slowing in credit may also reflect some unwinding of superannuation-related borrowing in June. Despite these indications of softer demand for housing credit, the market for established houses has remained buoyant in most parts of the country. Nationally, house prices rose by around 10 per cent over the year to the September quarter. Price rises have been particularly strong in Melbourne, Brisbane and Adelaide. Sydney prices have also picked up recently, though the lower end of the market remains flat. Auction clearance rates in Sydney and Melbourne have stayed high in recent months, consistent with strong demand at the upper end of the market where auctions are most prevalent.

Business credit posted another strong increase in September to be growing at an annual rate of 26 per cent over the past six months, its fastest pace since the late 1980s. Some of the recent pick-up could reflect borrowers turning to their bankers due to tougher conditions for direct debt raisings in the capital markets.

The continued strength in demand and activity at this stage of a long expansion has brought the Australian economy to a position where productive capacity is stretched and labour market conditions are tight. While growth in labour costs has been contained at this stage, and high levels of investment are adding to productive capacity in some sectors, aggregate demand has been growing at a pace that has put upward pressure on underlying inflation.

Both the June and September quarter CPI data showed larger underlying price increases than in the previous two quarters. Measures of underlying inflation in the September quarter were around 0.9 per cent in the quarter and 3 per cent over the year. The headline CPI figures were lower as a result of a number of temporary influences. The quarterly CPI increase of 0.7 per cent was held down by a change to the treatment of child care rebates, which reduced the CPI by 0.2 per cent; the annual CPI increase was additionally affected by earlier sharp movements in petrol and banana prices, both of which were lower in the September quarter 2007 than a year earlier. Given the recent quarterly outcomes, it is likely that both the CPI and underlying measures of inflation will be above 3 per cent on a year-ended basis by early next year.

The Bank's forecasts have for some time incorporated the view that there was likely to be upward pressure on inflation as a result of strong demand and tight capacity. The September quarter CPI provided some additional confirmation of that view, and it suggested that the trajectory of underlying inflation was a little higher than previously projected. Price increases in the non-tradables sector have been running at relatively high rates and they picked up in the September quarter, reflecting increases in a range of services prices. To date, there has been relatively little dampening effect on final traded goods prices from the higher exchange rate, and the experience of recent years has been that such effects tend to be relatively muted.

In summary, the economic situation under consideration by the Board at its recent meetings has been one in which the key domestic data on prices, demand and activity were pointing to the likelihood of stronger medium-term inflation pressures. In formulating its response to these domestic trends, the Board has also given careful attention to international developments, and particularly to the strains in global credit markets. These strains were most pronounced in the period around the Board's September meeting. Hence, while domestic factors were suggesting stronger inflationary risks during this period, international market conditions were adding to uncertainties about the global outlook.

By the time of the Board's November meeting, global market conditions were somewhat more settled. The general assessment of conditions was that the global economy, though slowing, was still likely to grow at an above-average pace, led by strong growth in China and other parts of Asia. The Board also noted that, in Australia, the tightening in credit conditions resulting from the global turmoil had been relatively contained, and hence that the effect of these developments on domestic growth was likely to be modest. The September quarter CPI data, which became available for that meeting, provided additional evidence that domestic inflation pressures had strengthened. Weighing up these international and domestic factors, the Board judged that a further increase in the cash rate was needed in order to contain inflation in the medium term.

In the short term, as noted, both headline and underlying inflation are likely to exceed 3 per cent on a year-ended basis as a result of high CPI outcomes that have already occurred. Looking further ahead, and taking into account the recent monetary policy decisions along with other factors such as the higher exchange rate and the expected moderation in global demand, the Bank projects that inflation will settle at a rate a little below 3 per cent over the next two years. Somewhat lower outcomes could eventuate if global economic conditions prove to be weaker than expected, which might occur if there were further significant disturbances in global financial markets. But it is also possible at this stage of a long economic expansion that inflation will be more difficult to contain, particularly if domestic demand does not moderate.

International Economic Developments

The world economy grew strongly in the first half of 2007, and momentum appears to have remained solid in the September quarter in most economies. Global financial markets experienced significant turbulence in August and September as the fallout from the deteriorating conditions in the US housing sector led to a general re-pricing of risk across a range of assets. While conditions have been more settled in the past month or so – helped in large part by the Federal Reserve's 50 basis point reduction in the fed funds rate in mid September – credit spreads have remained wider than before the onset of these developments (for more details, see the 'International and Foreign Exchange Markets' chapter).

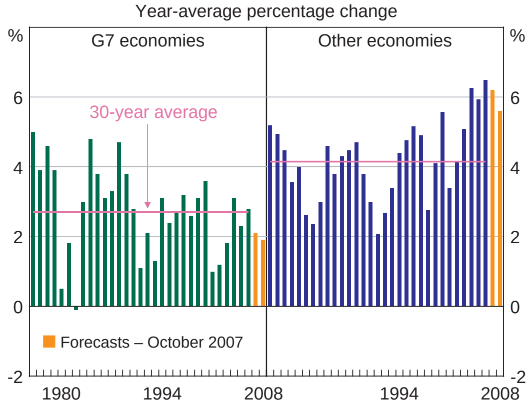
In response to these developments, most forecasters have revised down their outlook for global growth. The IMF has lowered its forecast for 2008 by around ½ percentage point, to 4¾ per cent, although if achieved this would still be well above the long-run average pace (Table 1). Much of this downgrade reflects a reduction in expected growth in the larger developed economies; emerging economies are expected to continue to grow strongly (Graph 1). Growth in the United States is expected to remain below trend in 2008, and forecasts for Japan and the euro area have been revised down to around long-run average rates, reflecting both domestic and external factors. Strong growth is expected to continue in India, China and the rest of east Asia. Growth in Australia's major trading partners is forecast to slow by ½ percentage

Table 1: World GDP
Year-average percentage change[a]

	2006	2007	2008
		IMF forecasts (October 2007)	
United States	2.9	1.9	1.9
Euro area	2.9	2.5	2.1
Japan	2.2	2.0	1.7
China	11.1	11.5	10.0
Other east Asia[b]	5.4	5.2	4.9
India	9.6	8.9	8.4
World	5.4	5.2	4.8
Australia's trading partners[c]	5.2	5.1	4.5

(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
Sources: CEIC; IMF; RBA; Thomson Financial

Graph 1
World GDP
Year-average percentage change

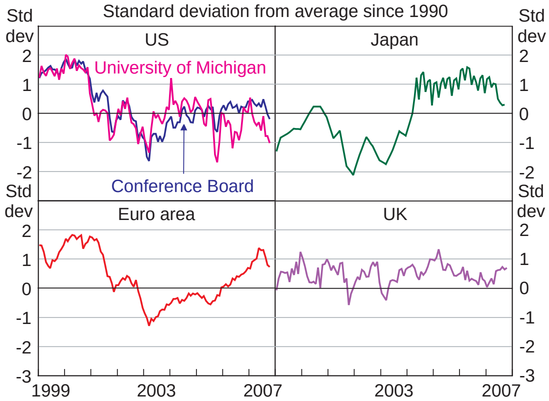


Source: IMF

Graph 2

Consumer Sentiment

Standard deviation from average since 1990

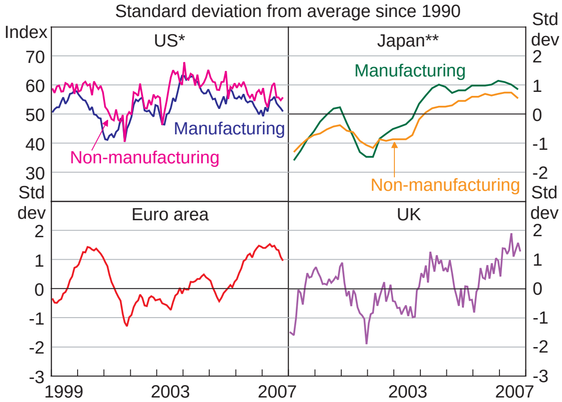


Sources: Bloomberg; CEIC; Thomson Financial

Graph 3

Business Sentiment

Standard deviation from average since 1990



* ISM indices – values greater than 50 indicate expansion
** Tankan survey
Sources: Bank of Japan; Thomson Financial

point in 2008 to 4½ per cent, which would still be above average.

Although forecasts have been revised down, most available activity indicators still cover the period before the onset of the financial turbulence and hence there is little evidence so far of the impact of these events on global activity. The timeliest indicators are for consumer and business confidence, although it must be recognised that these surveys have sometimes proven unreliable signals of the strength of activity. Bearing this caveat in mind, these indicators suggest that sentiment in September and October weakened to a little below average levels in the United States but remained above average in Japan and Europe (Graphs 2 and 3).

Notwithstanding the turbulence in financial markets, commodity prices have increased over the past three months. Rural prices have continued to rise, partly reflecting higher wheat prices. The outlook for bulk commodity prices has strengthened since the last *Statement*; analysts are expecting contract prices for iron ore and coal to rise significantly in 2008 due to ongoing strong demand from emerging Asia. While base metals prices fell in August as risk aversion affected commodity markets, they have since recovered. Oil prices have also reached record nominal levels over the past month.

Major developed economies

Recent data for the United States indicate that moderate growth is continuing, notwithstanding the downturn in housing construction. GDP grew by 1.0 per cent in the September quarter and by 2.6 per cent over the year (Graph 4). Consumption growth picked up in the quarter after posting a weak result in the June quarter, while modest growth in business investment continued. Exports grew at a healthy pace in the quarter, and are expected to be boosted further by the depreciation of the US dollar.

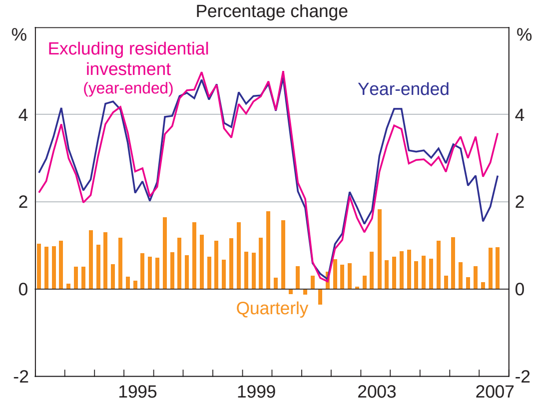
Residential investment fell by 5½ per cent in the September quarter, to be 24 per cent below its peak in late 2005. Forward indicators of construction activity, such as housing starts and permits, are at their lowest levels since the early 1990s and suggest further falls in activity in the period ahead (Graph 5). In addition, the inventory of unsold homes has increased to around 10 months of sales, up from around 5 months two years ago, which is placing downward pressure on house prices. Nationwide house price growth has slowed significantly, with some measures suggesting that prices have fallen over the past year. The ongoing interest rate resets on sub-prime loans and tightening of lending standards are likely to prolong these weak conditions.

Despite the downturn in housing construction and prices, household consumption growth was solid in the September quarter. Consumption increased by 0.7 per cent, to be 3.0 per cent higher over the year, aided by strong growth in real household disposable income. However, the outlook is for softer growth; the pace of housing-backed borrowing has eased with the slowing of house prices, and the tightening in financial conditions may reduce the availability of consumer credit. Growth in monthly payrolls employment has declined a little in recent months, to around 110 000 jobs per month (equivalent to 1 per cent annualised growth) over the four months to October compared with average monthly growth of around 135 000 jobs in the first half of the year; this primarily reflects a fall in jobs in the housing construction industry (Graph 6). Thus far, however, the weakening in labour market conditions has not been large; weekly initial jobless claims, which are a timely indicator of labour market conditions, remained relatively low in late October.

Graph 4

United States – GDP

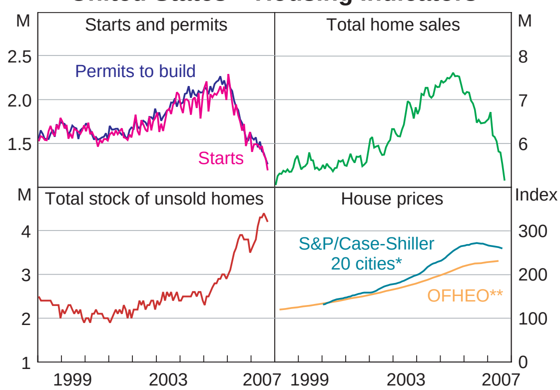
Percentage change



Source: Thomson Financial

Graph 5

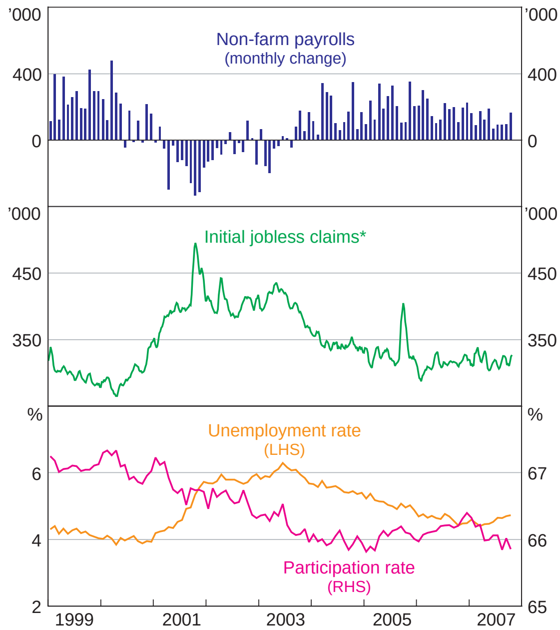
United States – Housing Indicators



* Monthly
** Office of Federal Housing Enterprise Oversight (OFHEO), purchase-only; quarterly
Sources: MacroMarkets LLC; Thomson Financial

Graph 6

United States – Labour Market

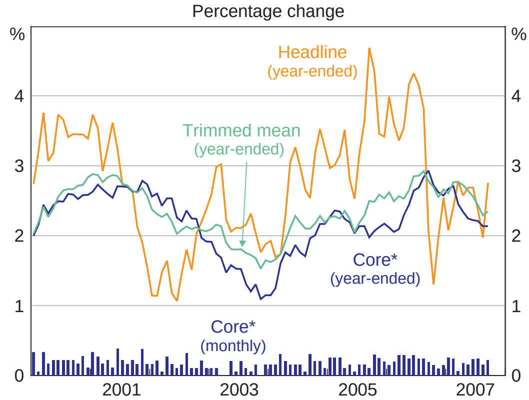


* Four-week-moving average
Sources: Bloomberg; Thomson Financial

Graph 7

United States – Consumer Prices

Percentage change



* Excluding food and energy
Sources: Federal Reserve Bank of Cleveland; Thomson Financial

Business investment increased by 1.9 per cent in the September quarter, to be about 5 per cent higher over the year. Growth in non-residential construction continued, and the pace of growth in equipment investment picked up, boosted by a rebound in spending on motor vehicles. While timely indicators of investment – such as core capital goods orders – have increased only modestly in recent months, the fundamentals continue to suggest a favourable outlook: capacity utilisation remains high, corporate balance sheets are healthy and profits are high.

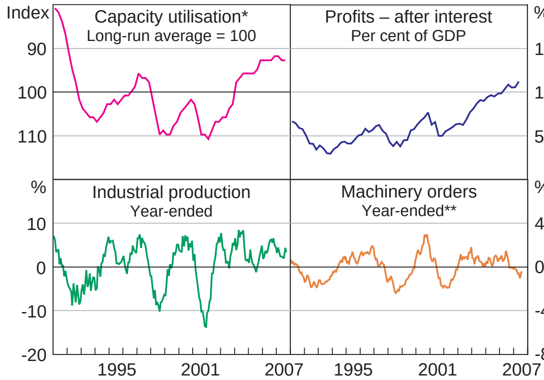
Headline consumer price inflation has been volatile during 2007, and stood at 2.8 per cent over the year to September (Graph 7). Measures of underlying inflation have moderated in line with the slower pace of growth in activity; core CPI inflation (which excludes food and energy) was 2.1 per cent over the year to September, compared with around 2¾ per cent late last year. The easing of inflation in the United States has increased the scope for monetary policy to respond to potential weakness in the economy; the fed funds rate was reduced by 50 basis points in mid September and by a further 25 basis points in late October.

In Japan, GDP was estimated to have fallen slightly in the June quarter and year-ended growth slowed to 1.7 per cent, with much of the weakness due to unexpected falls in business and residential investment. However, more timely data suggest a firmer picture. Growth of industrial production has been solid and picked up in the September quarter, and business conditions remain positive; sentiment has stayed above average levels, capacity utilisation is high, corporate balance sheets are healthy, and firms' investment intentions point to solid growth in the coming year (Graph 8). Labour market conditions are also generally favourable. Employment growth has been solid and the unemployment rate is around its decade low, although it has ticked up a little in recent months. Firms' hiring intentions are at high levels and consumer surveys indicate households are also positive about their employment prospects. Changes in building standards, however, led to a sharp fall in housing starts in the September quarter, which will further reduce residential investment in the short term.

While there is some evidence that price pressures at the firm level in Japan are increasing, this has not flowed through to sustained increases in consumer prices. Corporate goods prices increased by 1.7 per cent over the year to September, but the headline and core CPI (which excludes food and energy prices) both fell by around ¼ percentage points over the same period.

Graph 8

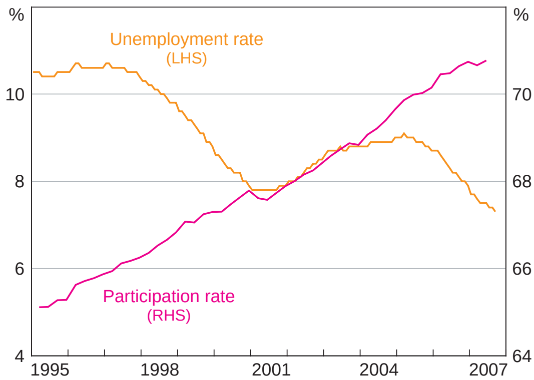
Japan – Corporate Sector



* Tankan survey – lower numbers imply higher utilisation
** Three-month-moving average
Sources: Bank of Japan; CEIC; Thomson Financial

Graph 9

Euro Area – Labour Market



Sources: Eurostat; RBA; Thomson Financial

Growth in the euro area has slowed somewhat, with the moderation in growth broad-based across countries. Slower growth has been mostly attributable to a moderation in business investment from its rapid pace in 2006. Nonetheless, business conditions generally remain at high levels, despite the large appreciation of the euro. Household consumption growth has also been solid. Labour market conditions continue to improve, with large increases in participation over several years supporting growth in real disposable income. The unemployment rate fell to 7.3 per cent in September, its lowest rate in more than 15 years (Graph 9).

Headline inflation picked up to 2.6 per cent in October, well above the European Central Bank's reference value. This largely reflected movements in food and energy prices; core inflation (which excludes food, energy, alcohol and tobacco) was steady at 1.8 per cent in September.

The UK economy has continued to expand at a solid pace, with GDP increasing by 0.8 per cent in the September quarter, to be 3.3 per cent higher over the year. Despite a run on deposits at Northern Rock, the United Kingdom's fifth largest mortgage lender, consumer sentiment remained firm in October and other indicators suggest the economy has continued to grow solidly (for further details on Northern Rock, see the 'International and Foreign Exchange Markets' chapter). Headline inflation has eased to below the Bank of England's target of 2 per cent, with year-ended inflation in September at 1.9 per cent. Core inflation (which excludes food, energy, alcohol and tobacco) has also eased in recent months, and stood at 1.5 per cent over the year to September.

Other major trading partners

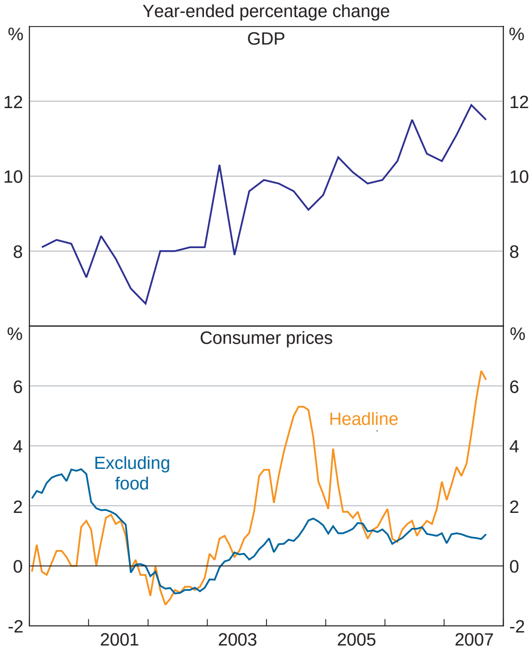
Conditions in Australia's other major trading partners remain strong, with continued rapid growth in China and India, and strong growth in the rest of east Asia.

China's growth eased only slightly to 11.5 per cent over the year to the September quarter (Graph 10). The external sector has continued to make a solid contribution to growth, reflecting strong export growth; although exports to the US economy have remained significant, Europe has recently overtaken the United States as China's largest export market. However, in recent years the expansion in domestic demand – both consumption and investment – has made the largest contribution to China's growth. The pace of investment has been especially strong in 2007 after a policy-induced slowdown in late 2006. Consumption indicators have been growing at a slower pace than investment, with much of the recent pick-up in growth in retail sales values due to rising food prices (for further discussion of China's growth performance, see 'Box A: The Composition of China's Growth').

Graph 10

China – GDP and Consumer Prices

Year-ended percentage change



Sources: CEIC; RBA

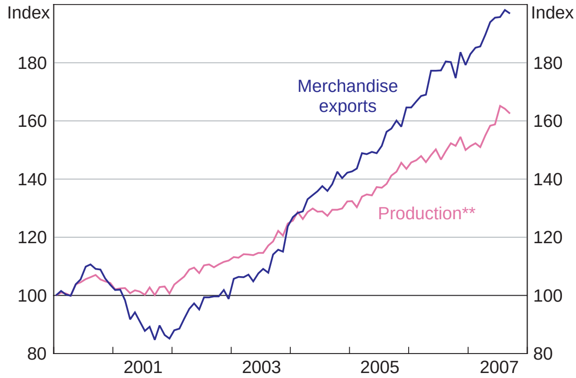
Inflation has picked up in China, with both the headline CPI and corporate goods prices rising by around 6 per cent over the year to September. Much of this growth reflects higher prices for food, which accounts for around one-third of the CPI; excluding food, consumer price inflation has been broadly steady at around 1 per cent. The People's Bank of China has further increased the reserve requirement ratio and benchmark deposit and lending rates, citing rising inflation pressures.

Growth has also been strong elsewhere in east Asia, with GDP increasing by 5.7 per cent over the year to the June quarter, mostly attributable to the expansion in domestic demand. Preliminary estimates for Korea and Singapore suggest these economies continued to expand at a strong pace in the September quarter. Across the region, growth in industrial production has picked up in recent months, partly reflecting a rebound in ITC goods production. Growth in merchandise exports has also been solid (Graph 11). Labour market conditions remain favourable. In headline terms, inflation has been picking up in the region, rising to 3.1 per cent over the year to September. This increase has been mostly due to higher food prices; excluding food and energy, core inflation has been around 2½ per cent.

Graph 11

East Asia* – Business Indicators

January 2000 = 100



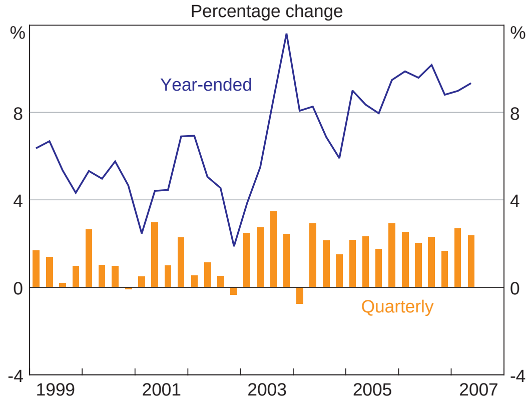
* Excluding China and Japan
** Excluding Hong Kong and Indonesia
Sources: CEIC; RBA

Growth in India has remained rapid, with real GDP increasing by 9.3 per cent over the year to the June quarter, driven by growth in the services and manufacturing sectors (Graph 12). More recently, industrial production grew by 11 per cent over the year to August, and export growth has also been strong. Year-ended wholesale price inflation has eased to 3.3 per cent in September, below the Reserve Bank of India's target rate of 5 per cent.

Graph 12

India – GDP

Percentage change



Source: CEIC

In New Zealand, GDP increased by 3.2 per cent over the year to the June quarter and the unemployment rate has continued to fall. Some recent data, including for retail sales and housing turnover, suggest that earlier increases in official interest rates may now be restraining spending, although the recent run-up in the price of dairy exports will be an offsetting influence. Headline CPI inflation slowed to 1.8 per cent in the September quarter, while underlying inflation was around 2½ per cent.

Graph 13

RBA Index of Commodity Prices

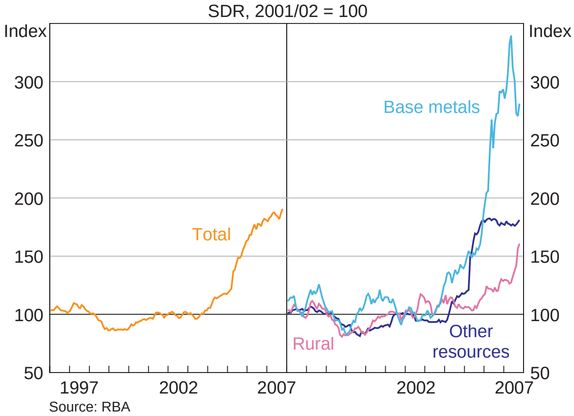


Table 2: Commodity Prices

Percentage change; SDR

	Three months to October 2007	Year to October 2007
RBA index	3	6
Rural	17	27
– Wheat	36	51
– Beef & veal	3	–3
– Wool	6	44
Base metals	–7	–4
– Aluminium	–12	–13
– Copper	–1	1
– Nickel	–8	–9
– Zinc	–18	–26
– Lead	19	131
Other resources	3	3
– Coking coal[(a)]	–1	–12
– Steaming coal[(a)]	4	9
– Iron ore[(a)]	–5	3
– Gold	12	22
Memo item		
Oil in US$[(b)]		
– WTI	16	46
– Tapis	12	39

(a) Latest available data are for September.
(b) Oil prices are not included in the RBA Index.
Sources: ABS; AWB; AWEX; Bloomberg; Meat and Livestock Australia; RBA

Commodity prices

During the period since the release of the August *Statement*, commodity prices initially weakened in response to the financial sector developments, but have since strengthened noticeably. Overall the RBA's index of commodity prices rose by 3 per cent (in SDR terms) over the three months to October, to show growth of 6 per cent over the year, a more modest pace than in recent years (Graph 13, Table 2). Much of the recent growth reflects price increases for gold and rural commodities.

Rural prices rose by 17 per cent over the past three months, largely driven by a sharp increase in the price of wheat. Wheat prices have risen by around 36 per cent since July as downward revisions to Australian crop production for 2007/08 have added to existing tight conditions in the global market (Graph 14). Futures markets suggest prices will ease somewhat by the time the northern hemisphere crop is harvested in the middle of next year, but that they will remain well above the average levels of recent years. Consistent with movements in wheat and a number of other food prices, the IMF commodity food price index has risen by around 20 per cent (in SDR terms) over the past year, to be at its highest level since the mid 1980s.

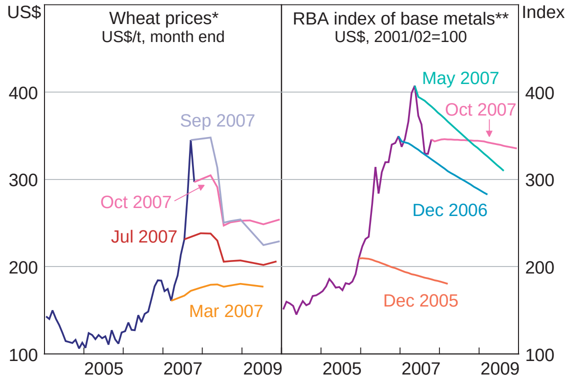
Base metals prices have recently been close to the levels prevailing at the time of the last *Statement*, but significantly lower than the peaks seen in early May. Prices of base metals initially fell amid the market turmoil in August and early September, but have since recovered due to tight supply conditions and increased investment demand. Futures markets suggest base metals prices will remain around current levels – which are still well above their long-run averages – over coming years.

The outlook for iron ore and coal prices has strengthened since the last *Statement*. Robust growth in demand, capacity constraints and the depreciation of the US dollar have contributed to expectations that iron ore and coal contract prices will rise further next year. Strong growth in Chinese steel production continues to underpin growth in demand for iron ore and, while the growth in supply from countries such as Australia and Brazil has been sizeable, the market remains tight. Reflecting this, spot iron ore prices have increased sharply in recent months. The consensus forecast is for iron ore contract prices to rise by around 30 per cent for the year starting in April 2008, compared with an expectation of around 15 per cent three months ago (Graph 15). Coal prices on the spot market also remain well above this year's contract price, fuelling expectations of a sizeable increase in contract prices next year.

While the financial market turbulence weighed on oil prices during August, prices recovered during September and in nominal terms have recently reached record

Graph 14

Commodity Futures Prices

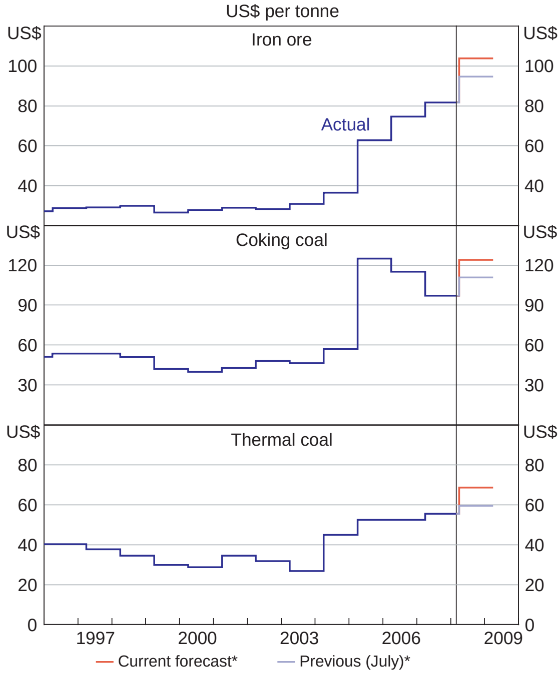


* Chicago Board of Trade futures prices
** Aggregate LME futures curves are based on futures prices for each of the five base metals, compiled using RBA Index of Commodity Prices weights
Sources: Bloomberg; RBA

Graph 15

Bulk Commodity Contract Prices

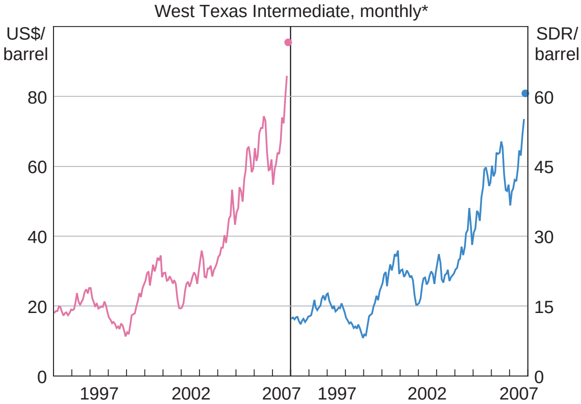
US$ per tonne



* Average of market analyst forecasts
Sources: Consensus Economics; RBA

Graph 16

Oil Prices



* November 2007 observation based on data up to 7 November

Sources: Bloomberg; RBA

highs (Graph 16). The price rise in part reflects falls in inventories and geopolitical tensions, although US dollar weakness has also contributed; oil prices rose somewhat more modestly in SDR terms. As of early November, West Texas Intermediate traded at around $95 a barrel, while Malaysian Tapis – the benchmark crude most relevant for Australian petrol prices – traded slightly higher. Futures markets point to some easing in oil prices over coming months.

Box A: The Composition of China's Growth

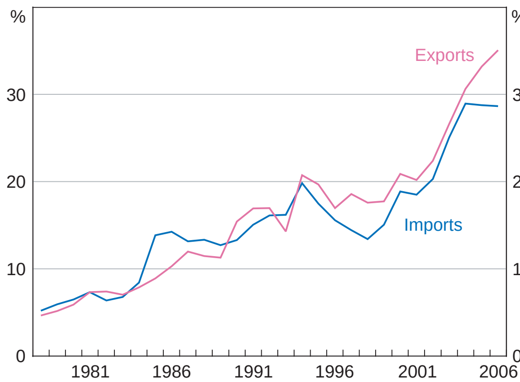
Growth in the Chinese economy has been rapid for an extended period, with annual real GDP growth rising from around 8 per cent to over 11 per cent over the past five years. Continued strong growth has seen China's share of the world economy increase by 3½ percentage points over this period, to 15 per cent in 2006 when measured in purchasing power parity (PPP) terms, with China accounting for around one-quarter of world growth. At market exchange rates, China has increased its share of the world economy by 1½ percentage points over the past five years, to 5½ per cent in 2006 (for a discussion on differences between PPP and market exchange rates, see 'Box A: Measuring Global Growth' in the August 2007 *Statement*). Notwithstanding this performance, China's level of GDP per capita is still comparatively low by world standards – about US$8 000 in PPP terms or around one-fifth of the level in the United States – and most forecasters are expecting further rapid growth in the Chinese economy for an extended period of time.

China's economy has a large and rapidly growing traded sector compared with other major economies. The value of exports has grown by around 30 per cent a year over the past five years, and exports accounted for around 35 per cent of GDP in 2006 (Graph A1). Much of this reflects growth in the processing of goods that have been imported from other countries, particularly east Asia: imports have grown at an annual pace of around 25 per cent over the same period, and are now around 30 per cent of GDP. Nonetheless, the domestic value-added component of recent exports has been rising over time, and much of the growth in imports is for domestic use.

Graph A1

China – Trade

Share of nominal GDP



Source: CEIC

Despite the large traded sector, the expansion of domestic demand has accounted for much of China's recent growth.[1] GDP component data – which are only available in nominal terms – show that domestic demand grew at an annual rate of 14 per cent over the past five years compared with growth of 15 per cent in nominal GDP over this period. More specifically, annual investment growth averaged 19 per cent over this period, and investment is estimated to

1 *In a technical sense, net exports accounted for only around 15 per cent of the increase in China's GDP over the past five years, leaving the bulk of the contribution to growth due to the increase in domestic consumption and investment.*

now account for around 40 per cent of nominal GDP. Household consumption has also been growing strongly, averaging around 10 per cent over the same period, although its share in nominal GDP has declined over time given the rapid pace of investment spending.

The growth in investment appears to be quite broad-based. Not surprisingly, a significant component has been in manufacturing. However, much of the growth has also been development-related, such as the building of extensive subway systems and inter-provincial highways. Notwithstanding the limited quality of the data, the urban fixed-asset investment survey (which measures spending rather than value-added) suggests that around one-quarter of investment has been on infrastructure, utilities and water & environmental management; the real estate category, which includes housing construction (and the purchase of land) accounted for an additional one-quarter (Table A1). This investment has been both a consequence of, and a reason for, the rapid increase in urbanisation in China; the urban population has increased to 44 per cent of the total, up from 30 per cent a decade ago. Given the ongoing large population movements, infrastructure needs seem likely to remain strong in the period ahead.

Table A1: Urban Fixed-asset Investment Expenditure in China

Per cent of GDP

	2004	2006
Total[(a)]	37	42
Of which:		
Primary industry	1	1
Secondary industry	14	18
– Manufacturing	9	12
– Utilities	3	4
– Other	2	2
Tertiary industry	22	24
– Real estate	9	10
– Infrastructure	4	5
– Water & environmental management	3	3
– Other	6	6

(a) Includes land sales

Source: CEIC

China's growth in general, and infrastructure spending in particular, has been resource-intensive. Over the past five years, China has accounted for most of the growth in the world's production of steel and now accounts for around one-third of world steel production. China has also been a large producer of electricity, and accounted for 17 per cent of world electricity production in 2005, up from 10 per cent a decade ago; China's coal-fired power generating capacity is now increasing each year by around the size of the entire British electricity grid. This growth has substantially added to world demand for resources, which has put upward pressure on commodity prices. China now accounts for around 40 per cent of world iron ore imports, between 10 and 20 per cent of copper and nickel imports and 4 per cent of coal imports[2] (Table A2). This demand has been a major benefit to commodity exporters like Australia, where iron ore and coal are the two largest exports, and explains much of the growing importance of China in Australia's export share over the past five years (for further details, see 'Box A: The Changing Country Composition of Australia's Trade' in the November 2006 *Statement*).

2 *Despite producing a large amount of coal, China became a net importer of coal this year.*

Table A2: China's Production and Imports
Per cent

	Share of world		Annual growth
	2001	2006	2006
Production			
Steel	17	35	20
Electricity	12	17[a]	13[a]
Aluminium	14	28	20
Imports			
Coal	1	4	46
Copper	12	12	–32
Iron ore	18	41	19
Nickel	5	22	8

(a) Data for 2005
Sources: ABARE; AME Mineral Economics; International Aluminium Institute; International Iron and Steel Institute; Customs General Administration; CEIC; Energy Information Administration; RBA

The financial sector turbulence associated with the US housing market and the subsequent re-pricing of risk and tightening of credit markets globally appear to have had little direct impact on China's economy to date. This reflects both the large level of saving in China relative to its investment – and hence its large current account surplus – and the relatively closed nature of some Chinese financial markets. Nonetheless, slower GDP growth in the major developed economies would be expected to have some impact on Chinese growth via trade linkages, and IMF forecasts for China have been revised down by ½ percentage point in light of these concerns. However, growth is still projected to be very strong, at around 10 per cent in 2008.

International and Foreign Exchange Markets

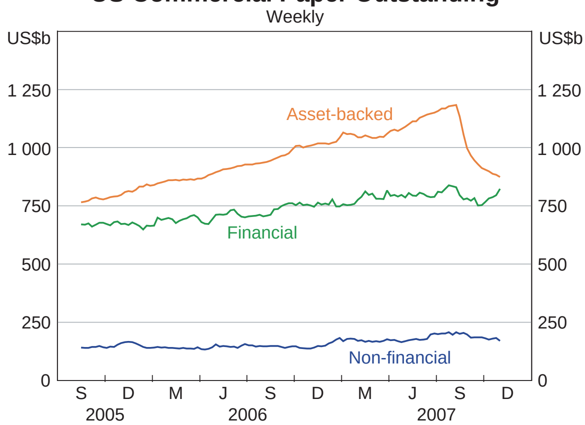
Credit and money markets

The period since the previous *Statement* has been one of considerable turbulence in global financial markets. Credit markets in particular have been very unsettled. Sentiment in financial markets has improved recently, but markets remain vulnerable to further adverse news. While the outlook remains unclear, it does seem, at this stage, that there has been a general repricing of risk in credit markets following a period of several years in which risk spreads had been overly compressed. Assuming that spreads remain at these more elevated levels, there is likely to be a moderation in those financial activities which were dependent on access to unusually cheap funding.

As discussed in the previous *Statement,* the initial trigger for this current episode of volatility was the collapse of investor confidence in securities backed by US sub-prime mortgage debt. Data had been indicating for some time that US housing market conditions were deteriorating and delinquencies on sub-prime mortgages, in particular, were rising rapidly. A catalyst was the announcement on 9 August by the French bank, BNP Paribas, that it was suspending withdrawals from two of its funds with large exposures to US sub-prime debt. This led to a general reassessment of the risks of participating in structured credit markets.

Graph 17

US Commercial Paper Outstanding

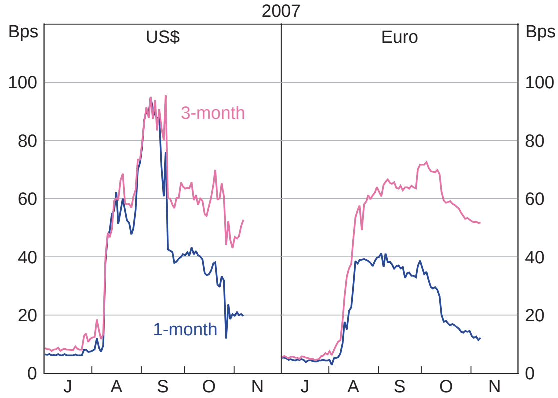


Source: Board of Governors of the Federal Reserve System

This increased risk aversion manifested itself in an unwillingness to rollover asset-backed commercial paper (ABCP) (Graph 17). There are two main types of issuer in this market: the largest group are the ABCP 'conduits' which are sponsored by banks providing them with contingent liquidity lines that can cover up to 100 per cent of their liabilities; and the second are structured investment vehicles (SIVs) which are not funded exclusively by ABCP and therefore require less liquidity back-up. As the ABCP market dried up, financial vehicles that had funded long-term investments with short-term ABCP turned to their sponsoring banks for liquidity support. But with banks themselves becoming more cautious and less willing to lend to each other, this additional demand for credit was not easily met. Moreover, other markets

Graph 18

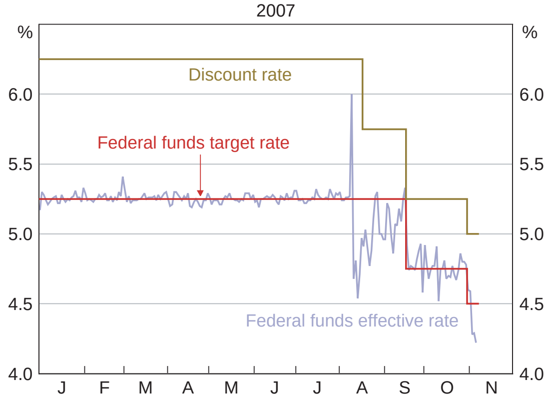
LIBOR Spread to OIS



Source: Bloomberg

Graph 19

US Policy Rates



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

such as the primary issuance market for collateralised loan obligations virtually closed as investors shunned new issues, forcing banks to expand their own balance sheets and retain the loans they had originated but had been intending to package and sell to investors.

These pressures on liquidity in the interbank funding markets saw interest rates in short-term money markets spike higher (Graph 18). Spreads between the London Interbank Offered Rate (LIBOR) and the expected fed funds rate rose by over 80 basis points. Central banks, including the RBA (see Box D), responded to these developments by injecting substantial cash into the banking system and, in some cases, extending the range of collateral against which they would lend in order to ease the strains on liquidity.[1] The US Federal Reserve also cut its discount rate (the penalty window at which banks can source additional funds during times of stress) by 50 basis points, and extended the terms of the loans from overnight to 30 days (Graph 19). These central bank operations were not intended to change the overall stance of monetary policy; rather they were aimed at breaking up the log-jams in money markets and encouraging funds to flow more freely. These operations were successful in offsetting the squeeze on overnight cash rates, but the cost of term funding remains elevated relative to overnight indexed swap rates (OIS). As the strains in the short-term money market have eased over the period, central banks have withdrawn some of the additional liquidity that they provided.

The tight liquidity conditions in credit markets have affected the profitability of banks, especially those highly reliant on capital-market funding. Earnings reported by major international banks for the third quarter were typically significantly down on a year ago and

1 *See Battellino R (2007), 'Central Bank Open Market Operations', RBA* Bulletin, *September, pp 19–26.*

several institutions booked an outright loss. Write-downs in asset values were mainly related to securities associated with US sub-prime mortgages and lending to SIVs.

In late September, a large mortgage bank in the UK, Northern Rock, became concerned about its ability to access funding in wholesale markets and sought emergency liquidity from the Bank of England (BoE). In recent years, Northern Rock had experienced rapid growth in market share owing in part to access to cheap funding in global wholesale markets. In the event, the emergency BoE loan and assurances from the Financial Services Authority attesting to the bank's solvency were not sufficient to prevent a depositor 'run' on Northern Rock. The run was only halted after the government extended a guarantee on bank deposits.

Money market conditions improved noticeably when the Federal Reserve cut the federal funds target rate by 50 basis points at its September meeting. The improvement in short-term funding conditions was more apparent in the US than European markets.

While liquidity conditions have improved, concerns still remain about SIVs. Many SIVs have invested in fixed income securities including a large portion of structured credit products, which are difficult to price and whose secondary market liquidity is generally very low. In October, a consortium of banks, led by Bank of America and Citibank, announced an in-principle agreement to establish a US$80–100 billion fund to enhance liquidity for the assets of SIVs – which are believed to total around US$320 billion. While terms are yet to be finalised, the fund is expected to hold ABCP and medium-term notes issued by SIVs, thereby preventing a fire sale of their fixed income assets.

Official policy rates

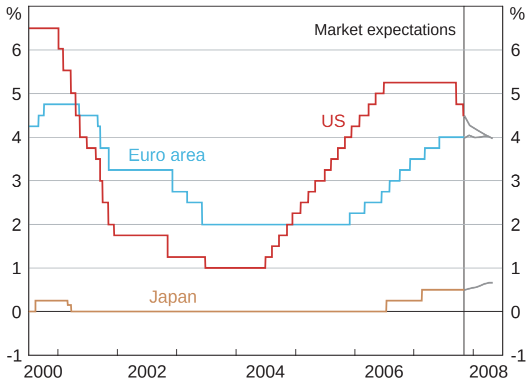
At the time of the previous *Statement*, most major central banks were expected to tighten policy further in the period ahead with the exception of the US where there were already some concerns about economic prospects. In the wake of recent credit market disturbances, expectations of rate increases have been reassessed by the market. In some counties, expectations have been pared back, reflecting the tightening in credit conditions and the increase in lending costs that have resulted. In other countries, interest rates are still expected to rise, reflecting the strength of the economy and/or a smaller impact of the credit market disturbances.

As noted, the Federal Open Markets Committee (FOMC) cut the federal funds rate by 50 basis points in September, to 4¾ per cent. In its accompanying statement, the FOMC cited the strains in credit and money markets as posing downside risks to the housing sector and the economy more broadly. Prior to this, the fed funds rate had been left unchanged for over a year. Further negative news concerning financial markets and fresh concerns over the housing sector prompted the Fed to cut rates by an additional 25 basis points to 4½ per cent at its October meeting. However, the decision was not unanimous and the accompanying statement indicated that the Fed regarded the downsides to growth as being balanced by upside risks to inflation. Current market expectations are for rates to decline a further 50 basis points to 4 per cent over the coming six months (Graph 20).

Notwithstanding the Bank of Japan's (BoJ) commitment to a gradual normalisation of rates, softer economic data has led the market to become less certain that there will be scope to increase the policy rate by another 25 basis points in the next six months.

Graph 20

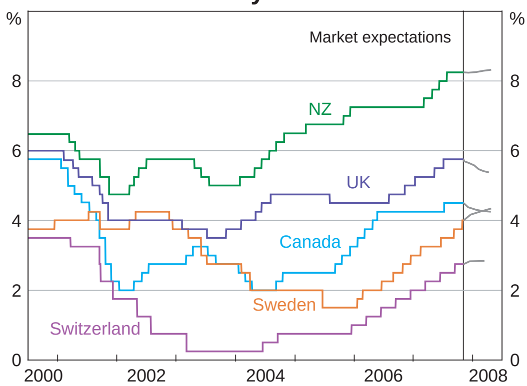
Policy Rates



Sources: Bloomberg; central banks

Graph 21

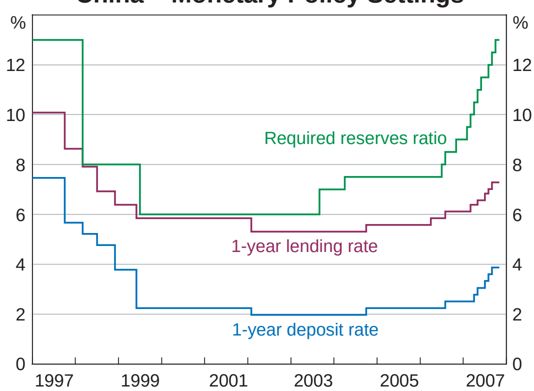
Policy Rates



Sources: Bloomberg; Reuters; central banks

Graph 22

China – Monetary Policy Settings



Sources: CEIC; The People's Bank of China

The European Central Bank (ECB) has left its policy rate unchanged. While noting the turbulence in financial markets, ECB officials have continued to highlight their concern over the inflation outlook. The market currently expects the ECB to maintain the policy rate at 4 per cent for the foreseeable future, having previously expected a further tightening. The market has also removed its expectations of further policy tightening by the Bank of England. Indeed, with the tightening of credit conditions in the UK, coupled with a downward revision to the BoE's inflation forecast, the market currently expects a 25 basis point cut in the policy rate in the next six months.

Elsewhere in Europe, over the past three months, policy rates were lifted by 50 basis points in Norway and Sweden and 25 basis points in Switzerland to 5 per cent, 4 per cent and 2¾ per cent, respectively (Graph 21). Both the Reserve Bank of New Zealand and the Bank of Canada kept their policy rates unchanged over the past three months. While rates are expected to be left unchanged in New Zealand, a 25 basis point cut is expected in Canada within the next six months.

Reflecting the strength of the Chinese economy and the continuing rapid growth in money and credit, monetary conditions in China continued to be tightened (Graph 22). Since the previous *Statement*, the People's Bank of China (PBoC) has raised the required reserves ratio for banks twice, by a total of 100 basis points, to 13 per cent. It also lifted the official one-year lending and deposit rates by over 25 basis points to 7.29 per cent and 3.87 per cent, respectively. Action was taken to cool speculation in China's property market, with both mortgage rates and deposit requirements increased for those buying a second property, or a property for commercial use.

Similarly, with ongoing inflation pressures and strong economic conditions in a number of other emerging market economies, policy rates were raised in Taiwan, Mexico, Israel, Poland and the Czech Republic, with particularly large increases in South Africa and Chile. In contrast, central banks in Hungary, Turkey, Brazil and the Philippines all eased policy in the last three months, citing abating inflationary pressure and concerns over their growth outlook.

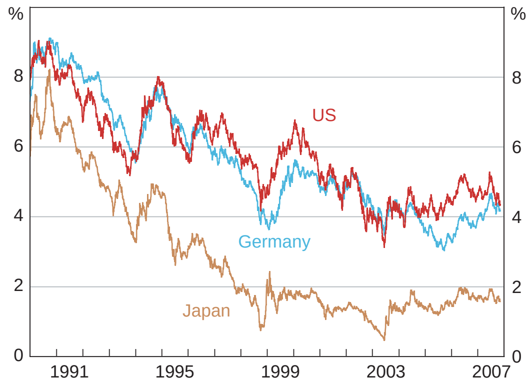
Bond yields

Major market government bond yields have declined since the previous *Statement* and have exhibited some volatility. Movements in the US bond market have primarily been driven by the credit market developments discussed above and US policy moves (Graph 23). The two policy actions by the Fed both saw yields move higher, but credit market concerns have seen yields decline to lows of around 4.30 per cent. German and Japanese government bond markets largely took their lead from the US, although the decline in yields was less pronounced than for the US.

The credit concerns in the financial sector resulted in spreads on higher-rated US corporate debt increasing in August and September, before narrowing slightly in October. However, the increase in spreads since the previous *Statement* has largely reflected the fall in US government bond yields, so that the yields for higher-rated corporates have actually fallen (Graph 24). This has been reflected in the rebound of corporate bond issuance in the US to more normal levels, following a period in late July and August where issuance was particularly low. Spreads for US speculative grade corporate debt have widened noticeably, in line with

Graph 23

10-year Government Bond Yields

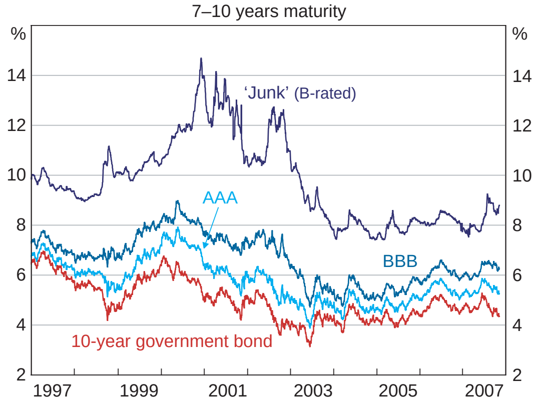


Source: Bloomberg

Graph 24

US Corporate Bond Yields

7–10 years maturity

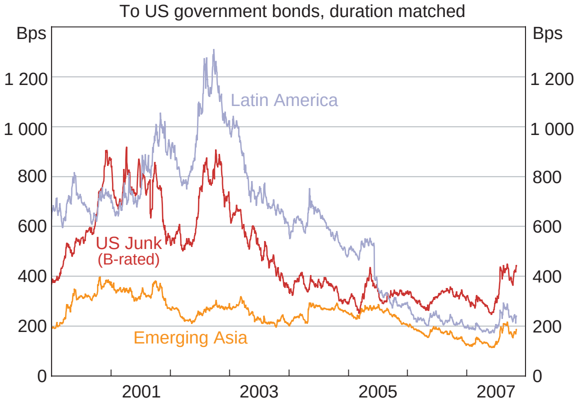


Sources: Bloomberg; Merrill Lynch

Graph 25

Market Spreads

To US government bonds, duration matched

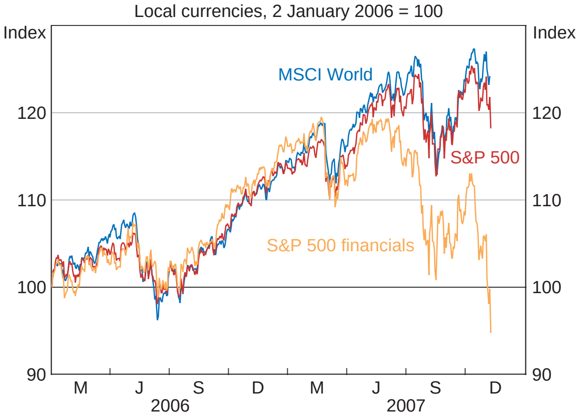


Sources: Bloomberg; Merill Lynch; RBA; Thomson Financial

Graph 26

Share Price Indices

Local currencies, 2 January 2006 = 100



Source: Bloomberg

the expected slowdown in the US economy.

Spreads on emerging market debt have widened slightly since the previous *Statement*, although they still remain at relatively low levels (Graph 25). Again the widening in spreads largely reflected movements in US government yields rather than a tightening in credit conditions in these economies.

Equities

Global equity markets have been extremely volatile over the past three months reflecting the fluctuation in sentiment about credit markets (Graph 26, Table 3). Markets fell sharply in August as risk retrenchment took hold, but rose sharply following the Federal Reserve's September rate cut. Financial stocks have been most affected by the credit market concerns, and remain significantly below their level prior to the onset of the current difficulties. The large write-downs by international banks of their credit market exposures in recent weeks has had a mixed impact on their share prices. In some cases, the share price rose sharply following the earnings announcements but in other cases, it fell noticeably.

While share markets in the US and Europe are generally little changed in net terms since the previous *Statement*, and the Japanese market has fallen, emerging market equities have posted sizeable gains, notwithstanding some sharp falls in August and again in late October (Graph 27). Gains have been particularly strong in Asian markets, led by the Hong Kong and Chinese markets, as foreign investors sought further exposure to the rapidly expanding Chinese economy. In India, regulations that were aimed at limiting foreign inflows precipitated a sharp fall in prices which dragged down other share markets in the region and spilled over to developed markets. However, after regulators rescinded the proposed measures, markets rebounded firmly. Share prices in India are now up by 50 per cent over the past year, and have recorded average

Table 3: Changes in Major Country Share Prices
Per cent

	Since 2000 peak	Past year	Since previous *Statement*
United States			
– Dow Jones	13	9	–3
– S&P 500	–3	7	–1
– NASDAQ	–46	16	5
Euro area			
– STOXX	–10	9	0
United Kingdom			
– FTSE	–8	2	0
Japan			
– TOPIX	–11	–4	–7
Canada			
– TSE 300	24	15	3
Australia			
– ASX 200	92	22	10
MSCI Emerging Asia	82	56	19
MSCI Latin America	273	45	12
MSCI World	6	12	3

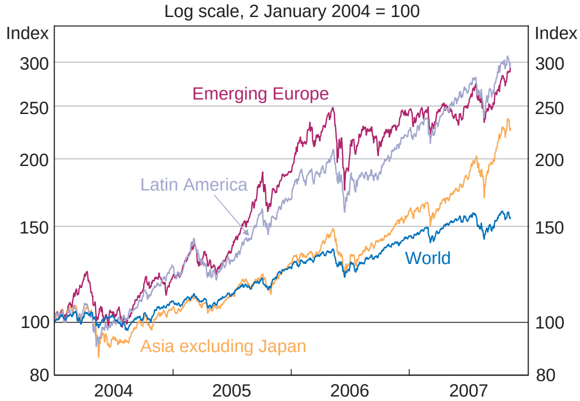
Source: Bloomberg

annual growth of 45 per cent over the past five years.

Graph 27

MSCI Share Price Indices

Log scale, 2 January 2004 = 100



Source: Bloomberg

Exchange rates

The major development in foreign exchange markets has been the depreciation of the US dollar against all major currencies (Table 4). On a trade-weighted basis, the nominal exchange rate is at its lowest level in over thirty years, and the real exchange rate is only slightly above its 1995 trough (Graph 28). While the US dollar initially rose against most other currencies amid the financial market uncertainty of August, the combination of weaker-than-expected US economic data, the easings by the Fed and expectations of a further decline in interest-rate differentials with other economies contributed to a sizeable depreciation in the dollar over the remainder of the period.

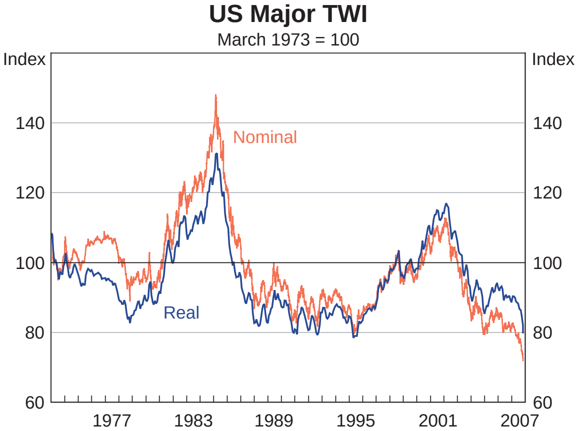
Table 4: Change in US Dollar against Other Currencies

	Past year	Since previous *Statement*
Brazil	–19	–8
Canada	–18	–11
Australia	–17	–9
New Zealand	–14	–1
Euro area	–13	–6
Philippines	–13	–4
Sweden	–12	–6
India	–12	–3
South Africa	–11	–7
United Kingdom	–9	–3
Malaysia	–9	–3
Switzerland	–9	–5
Singapore	–8	–5
Thailand	–7	0
China	–5	–2
Japan	–4	–6
South Korea	–3	–2
Taiwan	–1	–2
Mexico	–1	–1
Indonesia	0	–1
Majors TWI	–13	–8
Broad TWI	–9	–5

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

Graph 28

US Major TWI



Source: Board of Governors of the Federal Reserve System

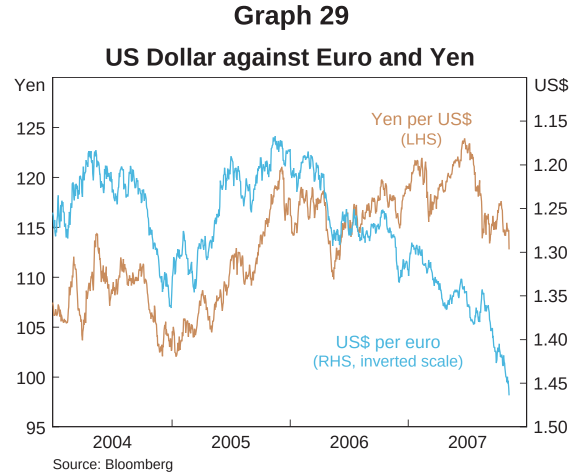
The euro has appreciated strongly against the US dollar since the last *Statement*, and is trading at its highest level since the introduction of the currency in 1999. However, the movement of the dollar against the yen has fluctuated markedly with the changes in risk appetite in financial markets (Graph 29). The increased risk aversion in August saw a large unwinding of carry trades as investors chose to book profits from their investments in high-yielding currencies such as the New Zealand and Australian dollars (see below), in part to cover losses on other investments. Renewed risk appetite in the following months, along with weaker Japanese economic data and expectations the BoJ will delay raising interest rates, has seen the re-establishment of carry trades again weigh on the yen.

The Canadian dollar has risen particularly sharply against the US dollar since the last *Statement*, reaching parity for the first time since 1976 (Graph 30). The Canadian dollar has been supported by rising oil prices along with the narrowing interest rate differential with the US. In contrast, the British pound has appreciated more modestly against the US dollar over the same period, primarily reflecting the concerns surrounding the mortgage lender, Northern Rock.

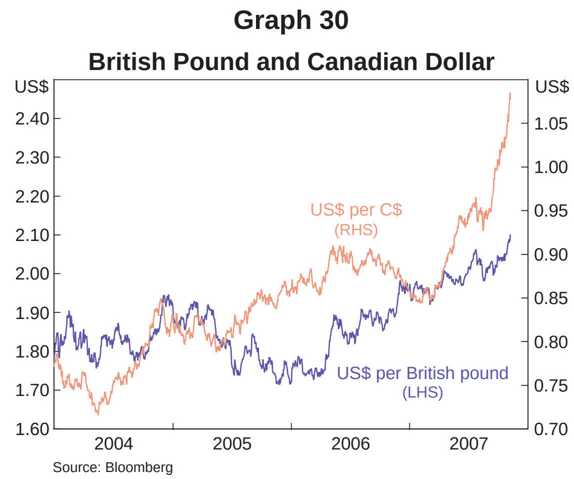
Emerging market currencies mostly appreciated against the

US dollar over recent months, notwithstanding a depreciation during the risk aversion of August. The Brazilian real experienced one of the strongest appreciations among emerging market currencies supported by improved economic fundamentals. Emerging Asian currencies have appreciated modestly, among the largest gains being for the Singapore dollar and Malaysian ringgit.

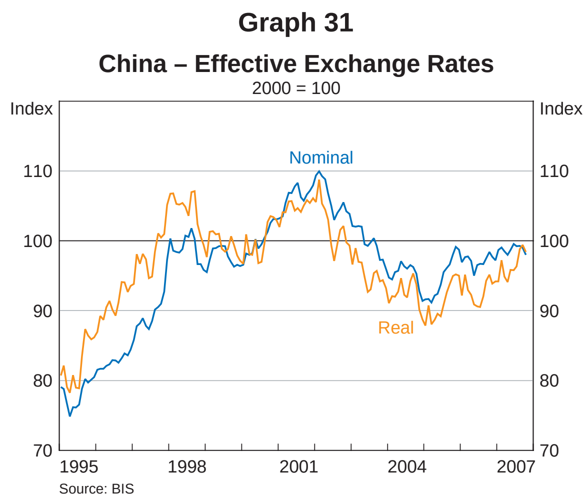
The Chinese renminbi has appreciated moderately against the US dollar since the last *Statement* (Table 5). However, on a nominal trade-weighted basis the renminbi has been little changed as most other currencies have appreciated more strongly against the US dollar over the period (Graph 31). Pricing in the non-deliverable forwards market indicates expectations of a 7 per cent appreciation in the renminbi against the US dollar over the next year. The continued intervention by the Chinese authorities to limit the pace of nominal appreciation of the renminbi has seen foreign reserves reach US$1.4 trillion in September.



Source: Bloomberg



Source: Bloomberg



Source: BIS

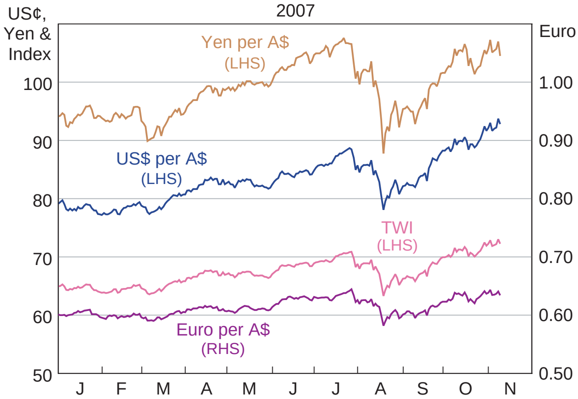
Table 5: Change in Renminbi against Other Currencies
Per cent

	Since end 2000	Since revaluation[(a)]	Past year
United States	11	9	6
Japan	10	11	1
Euro area	–28	–9	–8
Taiwan	9	12	4
Korea	–20	–3	2
Hong Kong	11	9	5
Malaysia	–3	–5	–3
United Kingdom	–21	–9	–4
Singapore	–8	–5	–2
Canada	–31	–17	–13
Russia	–3	–7	–3
Thailand	9	12	4
Australia	–34	–12	–13
Mexico	24	10	5
India	–6	–1	–7
TWI	–5	3	0

(a) 21 July 2005
Sources: BIS; Bloomberg; Reuters

Graph 32

Australian Dollar



Sources: RBA; Reuters

Australian dollar

The Australian dollar has traded in a very large range of over 17 US cents since the previous *Statement* (Graph 32), but in net terms has appreciated strongly to reach multi-year highs of 73 on a trade-weighted basis and 94 US cents (Graph 33, Table 6). Movements in the Australian dollar over the past few months have been largely driven by swings in investor risk appetite, with sizeable intraday movements in the currency in both directions. Volatility in the currency spiked higher in August to reach its highest level since early 1985

(Graph 34). There was a particularly sharp depreciation in mid August as the rise in global risk aversion arising from the credit market crunch triggered an unwinding of carry trades. In response to the thin and disorderly conditions in foreign exchange markets at the time, the Reserve Bank dealt in the market to add liquidity by selling foreign exchange and purchasing Australian dollars. This is the first time that the Bank has bought Australian dollars in the market since 2001.

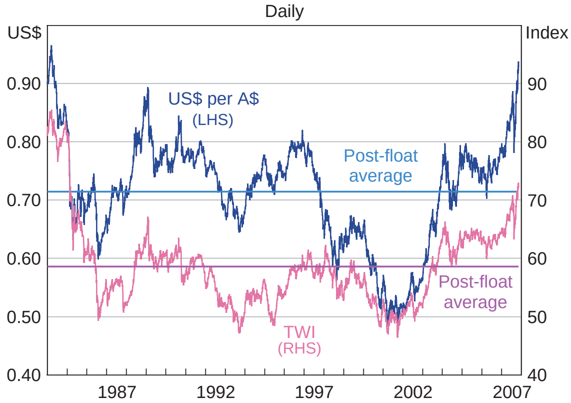
Since then, the Australian dollar has largely tracked upwards as market conditions have begun to normalise, and signs of renewed appetite for risk have appeared. Over this period however, the currency has been particularly sensitive to global financial market developments, with any reports of problems in financial intermediaries and/or evidence of a slowdown in the global economy tending to lead to a depreciation. Reflecting the sensitivity to risk, the local currency has tended to move in line with equity markets, with the correlation between the two assets recently reaching very high levels (Graph 35).

While part of the appreciation reflects the broad-based depreciation of the US dollar, the Australian dollar has been boosted by a number of other factors. The terms of trade remain at an historically high level, reflecting the strength in commodity prices

Graph 33

Australian Dollar

Daily



Sources: RBA; Reuters

Table 6: Australian Dollar against Selected TWI Currencies

Percentage change

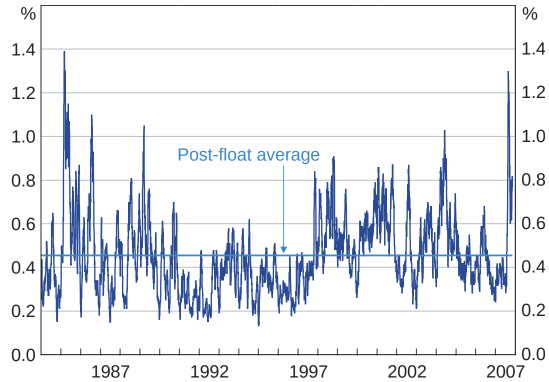
	Past year	Since previous *Statement*	Deviation from post-float average
Indonesia	20	5	156
US	20	7	30
Taiwan	18	6	35
South Korea	16	5	27
Japan	15	1	10
China	13	6	51
PNG	13	3	105
Singapore	11	2	7
Switzerland	9	2	–3
UK	9	4	0
South Africa	6	–1	47
Sweden	6	1	11
Euro area	5	1	–5
Philippines	4	3	32
New Zealand	4	6	–3
Canada	–1	–5	–8
TWI	**12**	**4**	**23**

Sources: RBA; Reuters

Graph 34

Australian Dollar Volatility*

Against US$, per trading day



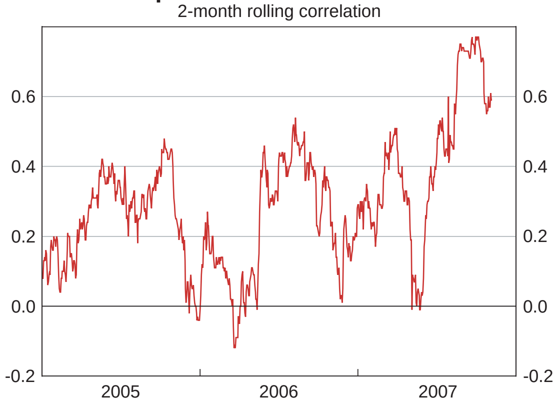
* 22-day average of absolute daily percentage change

Sources: RBA; Reuters

Graph 35

MSCI Asia Equities Index and Australian Dollar

2-month rolling correlation

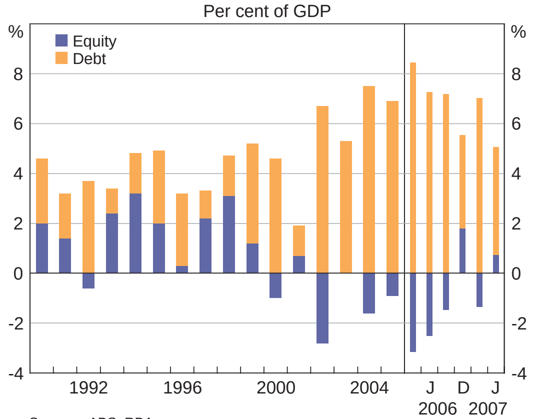


Sources: MSCI; RBA; Reuters

Graph 36

Net Capital Inflows

Per cent of GDP



Sources: ABS; RBA

(see the chapter on 'International Economic Developments'). Also, the strength of the local economy and the resulting level of yields compared to other major economies have provided support. Positive interest rate differentials have attracted significant capital inflows into Australia, with the bulk of these inflows in debt markets and money market instruments (Graph 36). Net equity flows have tended to be smaller in size, with an inflow of equity capital from abroad offsetting the outflow of equity in the June quarter (the most recent data available).

Net long speculative positions in Australian dollar futures on the Chicago Mercantile Exchange were significantly unwound in August, but have since increased again to around half the record level reached at the end of 2006 (Graph 37). Similarly, risk reversals, which provide a measure of the market's expectations of the future direction of the exchange rate, fell to record levels in August as participants became more concerned about the prospect of a sizeable depreciation of the Australian dollar.[2] While risk reversals have partially retraced their path, they remain well below their long-term average.

With the Australian dollar reaching a 23-year high against the US dollar, the Reserve Bank has continued its purchases of foreign exchange in recent months. Net purchases of foreign exchange and earnings over the year to date total $5 billion, bringing net reserves to around $33¼ billion. The

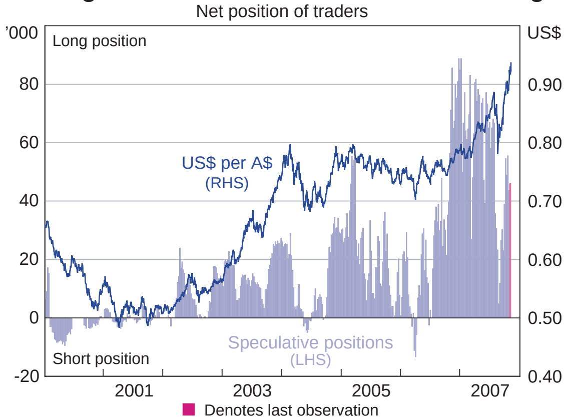
2 *A risk reversal is an option portfolio consisting of two out-of-the-money options: a long call option and a short put option. The risk reversal's price is the price of the call option minus the price of the put option.*

Bank's holdings of foreign exchange under swap agreements are around $3 billion, down from $47½ billion at the end of the June quarter. This reflects a shift in domestic operations towards bank bill repurchase agreements that began during the recent turmoil in credit markets, and some reduction in the Bank's deposit liabilities to the government sector.

Graph 37

Trading in Australian Dollar Futures in Chicago

Net position of traders



Sources: Commodity Futures Trading Commission; RBA; Reuters

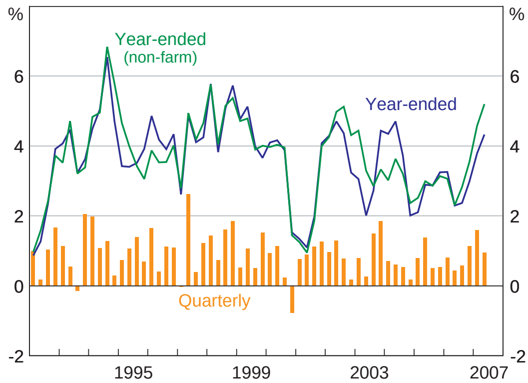
Domestic Economic Conditions

The data released since the last *Statement* suggest that the economy has continued to grow strongly. Real GDP was estimated to have risen by 0.9 per cent in the June quarter, to be 4.3 per cent higher over the year, with the non-farm economy growing by 5.2 per cent over the year – the strongest outcome since the December quarter 1998 (Graph 38, Table 7). There were substantial increases in investment in the quarter. More timely indicators for the September quarter suggest that activity has remained firm. Retail sales and export volumes have risen solidly, consumer confidence remains high, employment has continued to grow and business surveys report stronger-than-average conditions.

However, the farm sector continues to be affected by drought, and has been subtracting from overall GDP growth. Weather conditions have deteriorated significantly over recent months, with hot and dry conditions persisting over much

Graph 38

GDP Growth



Source: ABS

Table 7: Demand and Output

Percentage change

	March quarter 2007	June quarter 2007	Year to June quarter 2007
Domestic final demand	1.8	1.8	5.6
Change in inventories[(a)]	0.6	–0.4	0.9
GNE[(b)]	1.9	1.0	5.8
Net exports[(a)]	–0.4	–0.1	–1.7
GDP	1.6	0.9	4.3
Non-farm GDP	1.8	1.2	5.2
Farm GDP	–6.8	–10.9	–26.3
Memo item:			
Real GDP adjusted for changes in the terms of trade	1.9	0.9	5.6

(a) Contributions to GDP growth

(b) Adjusted for the statistical discrepancy

Sources: ABS; RBA

of the country and inflows to the Murray-Darling river system exceptionally low. This has prompted significant downward revisions to forecasts of the 2007 wheat crop and other rural production.

The recent difficulties in global credit markets do not seem to be having any significant direct effects on demand and activity in Australia. Australia's financial system appears to have fared better than those in many other countries. The impact on borrowing costs faced by households has generally been quite limited, although it has been more significant for some businesses. In addition, the Bank's liaison has suggested only a modest tightening in the availability of credit. While there has been some moderation in the pace of borrowing for housing, this is likely to at least partly reflect other factors, such as the August increase in the cash rate. Overall, the outlook for the domestic economy remains strong, partly reflecting the large increase in the terms of trade in the current commodity cycle.

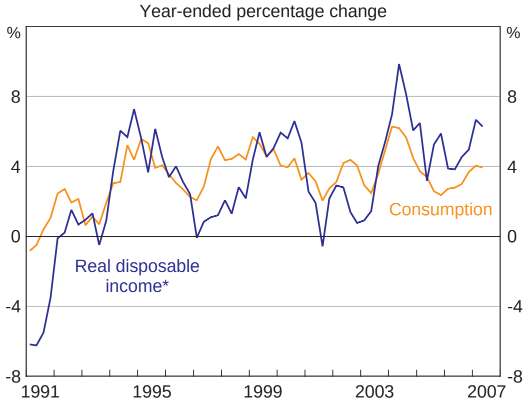
Household sector

Strong growth in household income and wealth has supported a pick-up in consumer spending in recent quarters while also allowing a modest increase in the household saving rate. Real household disposable income grew by 0.7 per cent in the June quarter, to be 6.3 per cent higher over the year (Graph 39). The strong labour market, together with the income tax cuts in July, is likely to have supported continued strong growth in disposable income in the September quarter.

Graph 39

Household Income and Consumption

Year-ended percentage change



* Household sector includes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.

Sources: ABS; RBA

Household balance sheets are also generally in good shape. Household net worth is high relative to household income, having risen strongly over the past couple of years as growth in assets has exceeded that in liabilities. Strong asset growth has been underpinned by buoyant equity markets and rising house prices in recent quarters. While there has been some increase in loan arrears and other indicators of financial stress, they remain at low levels (for further details, see the September 2007 *Financial Stability Review*).

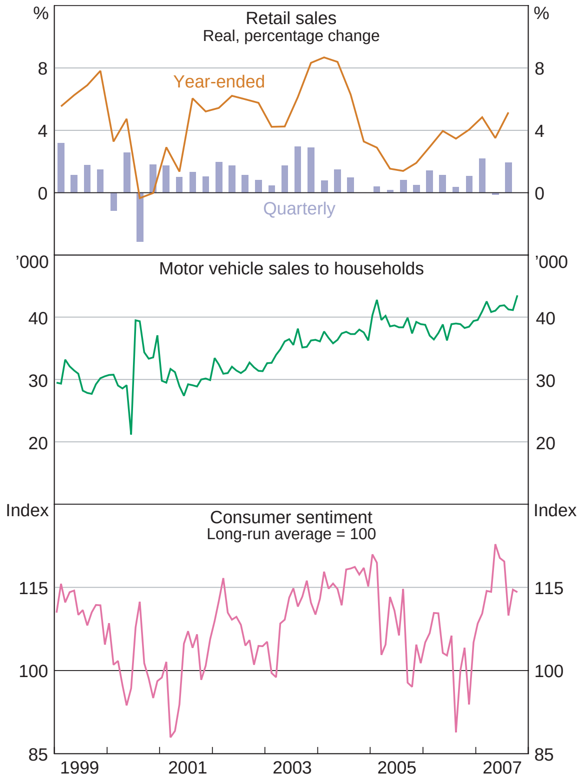
Household consumption grew by 3.9 per cent over the year to the June quarter, and more timely data suggest consumption continued to grow strongly in the September quarter. Real retail sales increased by nearly 2 per cent in the September quarter, to be around 5 per cent higher over the year (Graph 40). Motor vehicle sales to households remained at a relatively high level up to October, while the Westpac-Melbourne Institute consumer sentiment index continues to be well above its long-run average. Consistent with this, the Bank's liaison indicates continued broad-based strength in spending across retailers.

Housing

Residential building activity has been broadly stable over the past couple of years after declining from the cyclical peak earlier in the decade. Current levels of building approvals and commencements suggest that activity in the sector is likely to remain flat in the short term although, looking further ahead, residential construction activity is expected to pick up as the number of dwellings being built is currently well below estimates of underlying demand (Graph 41). Recently updated estimates based on data from the 2006 Census suggest that underlying demand due to demographic factors is around 180 000 dwellings per year, whereas only around 150 000 new dwellings were commenced over the past year. The weakness in new housing construction has been most pronounced in New South Wales, which has recorded its lowest annual number of private dwelling commencements since 1987. The recently announced cuts in development levies may boost building activity in NSW, although this may take some time to feed through.

Graph 40

Consumption Indicators

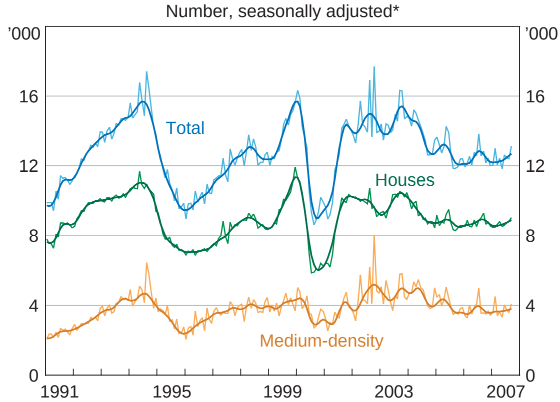


Sources: ABS; FCAI; Melbourne Institute and Westpac; RBA

Graph 41

Building Approvals

Number, seasonally adjusted*

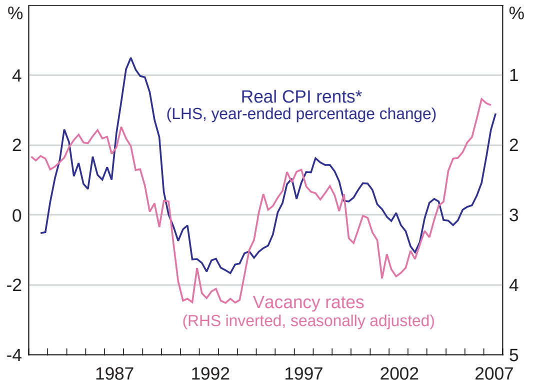


* Smoothed line is the ABS measure of trend

Source: ABS

Graph 42

Vacancy Rates and Rents



* Ratio of the CPI measure of rents to underlying inflation

Sources: ABS; RBA; REIA

Table 8: House Prices

Percentage change

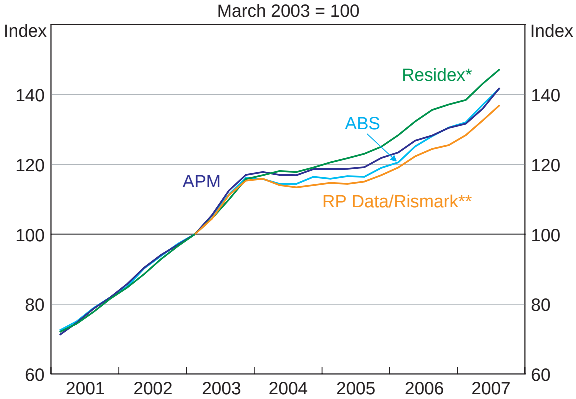
	June quarter	September quarter	Year to September quarter
Sydney	3.4	1.5	5.2
Melbourne	5.9	6.7	17.8
Brisbane	6.3	4.0	18.1
Adelaide	5.7	5.1	16.2
Perth	–2.2	1.1	2.8
Canberra	3.7	3.9	11.2
Hobart	2.8	3.9	11.6
Darwin	–0.4	5.1	13.1
Australia	**3.7**	**3.5**	**10.6**

Source: ABS

Graph 43

Australian House Prices

March 2003 = 100



* Excludes Adelaide and Hobart

** Excludes Hobart; excludes Canberra and Darwin prior to March quarter 2004

Sources: ABS; APM; RBA; Residex; RP Data/Rismark

The shortfall in housing construction can be seen in the rental market, where the vacancy rate remains around its historical lows (Graph 42). An exceptionally tight rental market has contributed to rapid growth in rents across all capital cities, with the CPI measure of rents increasing by 1.6 per cent in the September quarter, to be 5.8 per cent higher over the year. Data from the state Real Estate Institutes indicate that rents for newly negotiated agreements continue to grow more strongly than the average increase measured by the CPI.

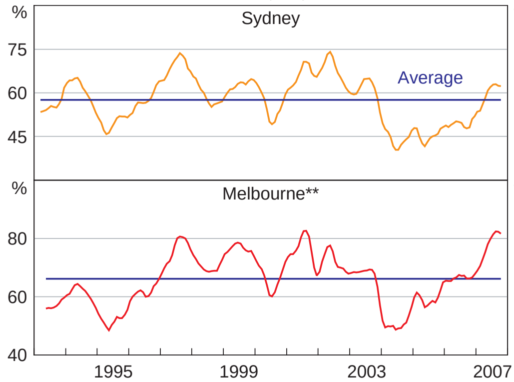
House prices have generally continued to grow at a solid pace in the September quarter, with ABS data indicating that capital city prices rose by 3.5 per cent in the quarter, to be around 10 per cent higher over the year (Table 8). Other measures of house prices, which use different techniques to control for changes in the composition of houses sold, show a similar picture (Graph 43). In the September quarter, house prices grew in all capital cities, with particularly strong increases in Melbourne and Adelaide.

In Melbourne and Sydney, price increases have been most pronounced in the more expensive suburbs. Median prices in Melbourne's most expensive suburbs have risen by 30 per cent over the year to the September quarter, while those in the least expensive suburbs were up by around 3 per cent. In Sydney, prices in the most expensive suburbs have risen by around 10 per cent over the past year, while those in the least expensive suburbs appear to have levelled out after several years of declines. These patterns have been consistent with strength in the Sydney and Melbourne auction markets, which tend to reflect developments in the upper end of the housing market where auctions are more prevalent (Graph 44). The most recent data for Sydney and Melbourne suggest that auction clearance rates have remained high, though they are a little below their August peaks.

Graph 44

Auction Clearance Rates*

Seasonally adjusted



* Adjusted for withdrawals where possible; three-month moving average
** APM data prior to November 2004; REIV data post-November 2004
Sources: APM; RBA; REIV

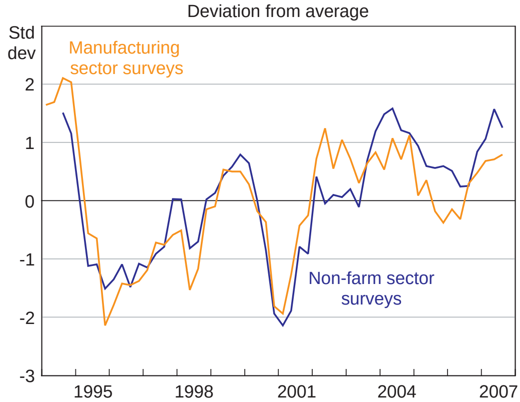
Business sector

Business conditions in the non-farm sector continue to be favourable. Private-sector surveys suggest that aggregate conditions eased only slightly in the September quarter and remain well above average levels. As has been the case for several years, conditions in the manufacturing sector have been somewhat weaker than for the rest of the economy, but are also above-average levels (Graph 45). Firms continue to report high levels of capacity utilisation, though there are signs of capacity constraints easing in some sectors, possibly reflecting the benefits of several years of strong investment.

Graph 45

Actual Business Conditions*

Deviation from average

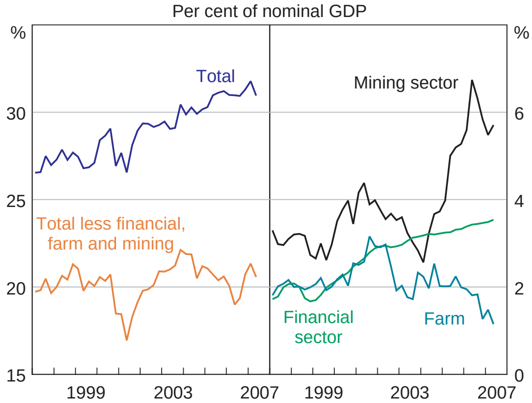


* Weighted average of data from various business surveys, with weights calculated by the RBA using the principal component method
Sources: ACCI; AIG; NAB; PricewaterhouseCoopers; SAI Global; Sensis; St. George Bank; Westpac

Total private-sector profits have continued to grow at a solid rate, with the national accounts measure increasing by around 8½ per cent over the year to the June quarter (abstracting from the reclassification of Telstra from the public to the private sector). As a result, the profit share has remained close to its 30-year high, at 31 per cent of GDP (Graph 46). However, there has been a shift in the drivers of profit growth. Profits have picked up in the non-mining sector, while financial corporations have continued to post strong growth. Profit growth has slowed in the mining industry reflecting the levelling out in commodity prices, higher input costs and the appreciation of the exchange rate. Farm profitability has fallen significantly as a result of the severe drought conditions. While equity analysts' expectations for non-mining, non-

Graph 46

Profits*



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

Sources: ABS; RBA

financial sector profit growth have been revised down in recent months, business surveys generally suggest that firms' own expectations of profitability remain around long-run average levels. Despite the recent problems in credit markets, and the resultant higher external funding costs, the high level of total corporate profitability continues to provide firms with a solid base of internal funds and businesses appear well placed to finance their investment decisions.

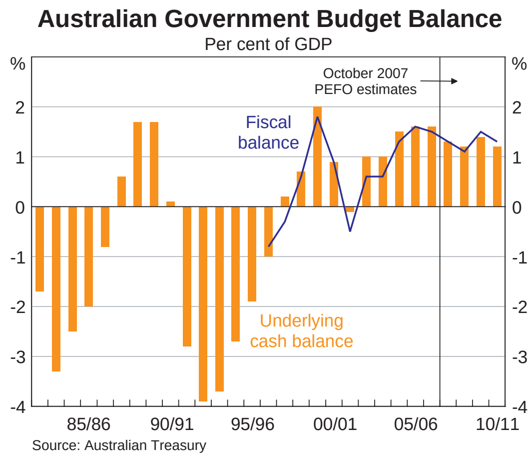
In the June quarter, new business investment increased by 4.6 per cent, to be around 10 per cent higher over the year (abstracting from the reclassification of Telstra). The recent growth in business investment has been driven by increased spending on non-residential construction, particularly in resource-related industries, although spending on infrastructure more generally has also been strong. Forward-looking indicators of private business investment suggest further solid growth. The pipeline of non-residential construction work yet to be done remains very high while the capital expenditure (Capex) survey's third estimate of firms' spending plans for 2007/08 points to further growth in machinery and equipment investment. Conditions remain particularly tight in office property markets, which should support non-residential construction (for further details see 'Box B: Recent Developments in the Office Property Market').

More broadly, the high rate of investment over recent years has added significantly to the productive capacity of the economy. Measures that include investment by both the private and public sectors suggest that the investment/GDP ratio has risen to its highest level in nearly two decades. The capital stock is growing rapidly after an extended period in the 1990s when its growth was quite weak.

Australian Government Budget

The Australian Government announced that the budget recorded an underlying cash surplus of $17.2 billion in 2006/07, or 1.6 per cent of GDP, which was $3.6 billion higher than projected in May (Graph 47). Taxation revenue was boosted by higher-than-expected corporate profits and contributions to, and earnings of, superannuation funds. On the outlays side, expenditure on unemployment and other social benefits was lower than expected. Updated economic forecasts and budget estimates were released in the Mid-Year Economic and Fiscal Outlook (MYEFO) and the Pre-Election Economic and Fiscal Outlook (PEFO) in October. The estimates incorporate the net effects of budget parameter variations and policy commitments undertaken up to that time. The expected underlying cash surplus for 2007/08 was revised up by $3.7 billion, to $14.4 billion, or 1.3 per cent of GDP, largely due to stronger taxation revenues. In subsequent years, the surplus is projected to remain broadly stable.

Graph 47



Farm sector

After an encouraging start to the year, conditions in the rural sector have deteriorated significantly, with most regions receiving below-average rainfall over the past few months. Based on information from the Australian Bureau of Agricultural and Resource Economics (ABARE) and other rural agencies, farm output is expected to rise by around 5 per cent in 2007/08, which would be a much more muted recovery in the farm sector than had been expected at the time of the previous *Statement* (Table 9).

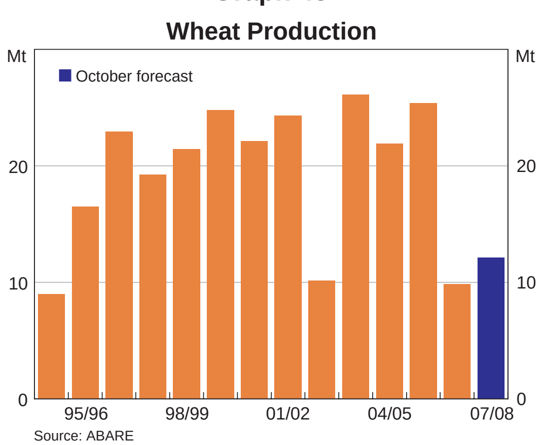
Table 9: Volume of Farm Production
Per cent

	Share of gross production	Growth	
	2005/06	2006/07	2007/08(f)
Crops	45	–31	7
– Cereals	17	–61	33
– Non-cereal crops	29	–13	0
Livestock products	43	–5	0
Farm GDP[(a)]		–25	5

(a) Gross farm production less farm inputs
Sources: ABARE; ABS; RBA

With little rainfall over the winter-spring growing period, yield forecasts for the 2007 winter crop have been revised down significantly over the past two months. ABARE estimates are for a wheat crop of around 12 million tonnes, down from estimates of around 22½ million tonnes in June, with below-average crops in all the major producing states, particularly in New South Wales (Graph 48). The outlook for non-cereal crops has also been downgraded. After a period of herd

Graph 48



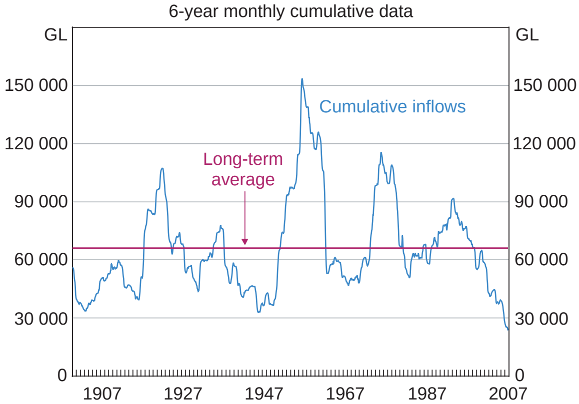
rebuilding earlier in the year, livestock slaughter rates in south-eastern Australia have recently picked up, reflecting dry conditions and increases in feed prices. With cattle and sheep numbers well down on levels of a few years ago, meat and wool production is likely to be subdued for some time.

While the deterioration in the farm outlook primarily reflects below-average rainfall over recent months, it is also a function of the persistence of the dry conditions over several years. There was an unusually short gap between the severe drought in 2002 and that in 2006, which has been compounded by the weakness of the rebound in inflows to the major river systems, making the present period exceptional by historical standards. Over the previous 100 years, severe droughts were generally followed by a year of rainfall sufficient to see a significant rebound in the inflows to the major rivers. However, in 2003 the recovery of inflows to the Murray Darling river system was much weaker than following the two previous droughts, a pattern which has been repeated so far in 2007. Taken together, this has resulted in the lowest level of inflows in any six-year period since data were first collected in 1891 (Graph 49).

Graph 49

Murray-Darling Basin Inflows

6-year monthly cumulative data

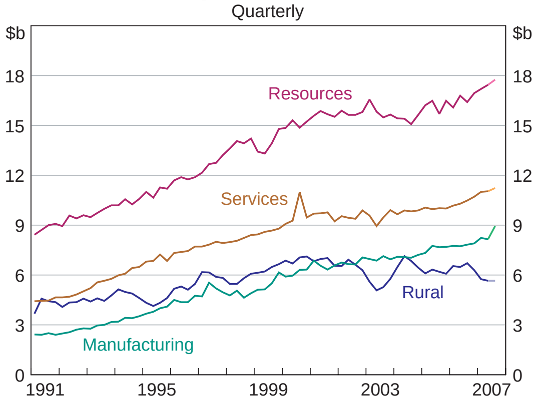


Source: Murray-Darling Basin Commission

Graph 50

Export Volumes*

Quarterly



* Excludes RBA gold transactions and 'other' exports; RBA estimate for September quarter

Sources: ABS; RBA

External sector

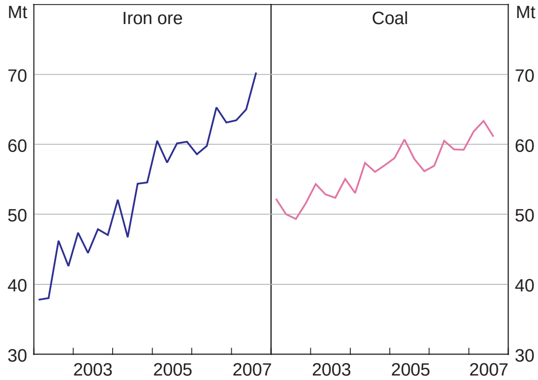
Export volumes are estimated to have risen by 2 per cent in the September quarter, to be around 5 per cent higher over the year. Non-rural export volumes rose by around 8½ per cent over the year, the fastest pace of growth since the turn of the decade, while rural exports have fallen by around 15 per cent due to the drought (Graph 50).

Resource export volumes have continued to grow solidly, rising by an estimated 2 per cent in the September quarter to be roughly 8 per cent higher over the year. Iron ore export volumes rose by around 8 per cent in the September quarter, to be up by 22 per cent since mid 2005 with further strong growth likely over the coming year or two as significant additional supply comes online (Graph 51). For example, Rio Tinto's Yandicoogina mine expansion has recently commenced production and BHP has started work on its Rapid Growth 3 project. Exports of oil and LNG fell in the September quarter but this follows particularly strong growth in 2006/07, when a number of large projects commenced production. After increasing solidly in the June quarter, coal exports fell modestly in the September quarter. Infrastructure bottlenecks, such as those associated with construction activity at the Dalrymple Bay Coal Terminal and insufficient rail rolling stock, continue to hinder export growth in the coal industry. Overall, resource export volumes are expected to grow strongly in the period ahead as a number of new projects and capacity upgrades at ports are completed.

Graph 51

Bulk Resource Export Volumes

Seasonally adjusted, quarterly



Sources: ABS; RBA

Manufactured export volumes have continued to expand strongly over the past year. Services export volumes have also grown solidly over the past 18 months, underpinned by increases in education services exports.

Import volumes grew by around 2 per cent in the September quarter, and by 13 per cent over the year, consistent with the strength of domestic demand and the higher exchange rate. All major components of imports have grown strongly over the year, particularly capital imports.

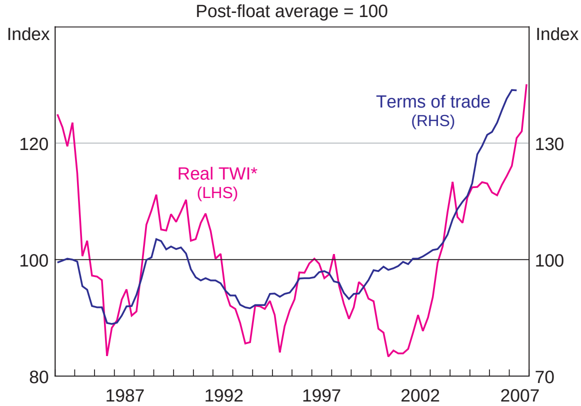
The current account deficit widened to 6.0 per cent of GDP in the June quarter, with the trade deficit increasing slightly while the net income deficit was broadly steady. At 4.5 per cent of GDP, the net income deficit remains large relative to history, reflecting both high net equity payments due to the strong profitability of foreign-owned enterprises operating in Australia, and high net interest payments due to the rising stock of net debt.

As is discussed in the chapter on ‘International and Foreign Exchange Markets’, the nominal exchange rate has appreciated significantly over the past few months. As a result, the real trade weighted exchange rate has appreciated to be around 30 per cent above its post-float average, its highest level in three decades (Graph 52). The appreciation of the exchange rate over recent years has coincided with a substantial increase in Australia’s terms of trade, which are nearly 45 per cent above their

Graph 52

Real Exchange Rate and Terms of Trade

Post-float average = 100



* December quarter 2007 observation assumes that the nominal bilateral exchange rates on 7 November are maintained for the remainder of the quarter and uses the latest core inflation rates.

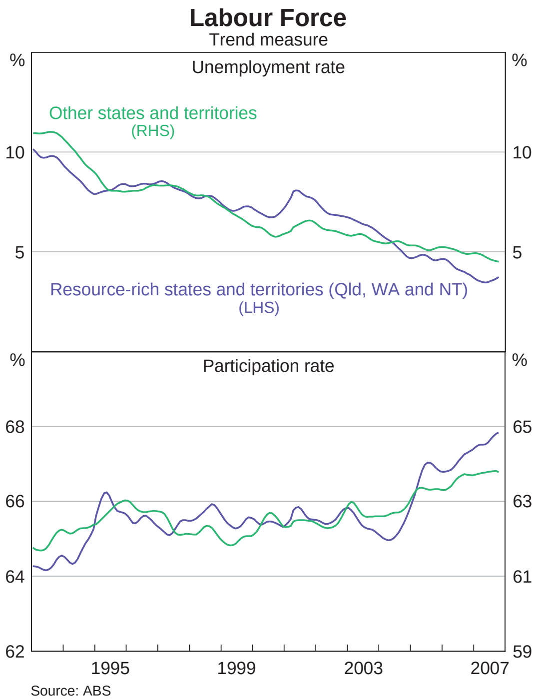
Sources: ABS; RBA

post-float average. The increase in the terms of trade represents a sizeable boost to national income, adding around 1½ percentage points per annum to the growth of Australia's gross domestic income over the past four years.

Labour market

Conditions in the labour market have remained strong, with employment rising by 0.5 per cent over the three months to October, to be 2.7 per cent higher over the year. Growth over the year has been concentrated in full-time employment.

Graph 53



The participation rate has remained around record highs in October, at 65.0 per cent, and the unemployment rate is close to multi-decade lows, at 4.3 per cent. While the strong labour market performance has been shared across all states and territories, it has been particularly evident in Western Australia, Queensland and the Northern Territory, which have benefited most directly from the commodity price boom (Graph 53, Table 10).

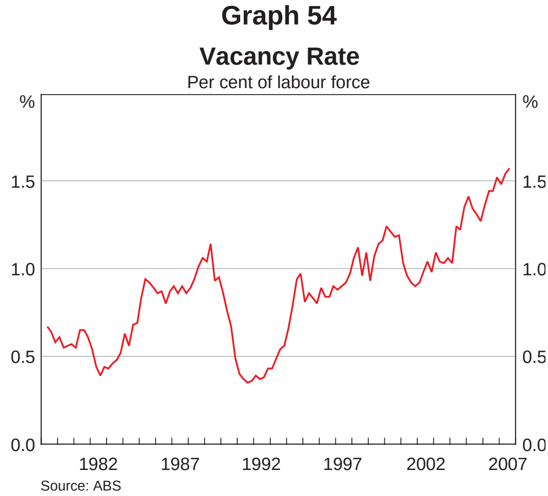
Looking ahead, a number of indicators suggest that strong labour market conditions are set to continue. The ABS measure of job vacancies increased by 2.9 per cent in the three months to August and, as a share of the labour force, vacancies are at a multi-decade high of 1.6 per

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

	Employment growth	Unemployment rate	
	Year to October 2007	October 2006	October 2007
NSW	1.7	5.0	4.6
Victoria	2.7	4.8	4.3
Queensland	3.1	4.2	3.8
WA	4.2	3.4	3.5
SA	1.2	5.0	5.0
Tasmania	2.3	6.1	5.3
Australia	**2.5**	**4.6**	**4.3**

Source: ABS

cent (Graph 54). The strength of labour demand is also evident in employment surveys and the Bank's liaison with firms, which continue to report strong employment intentions and labour shortages.

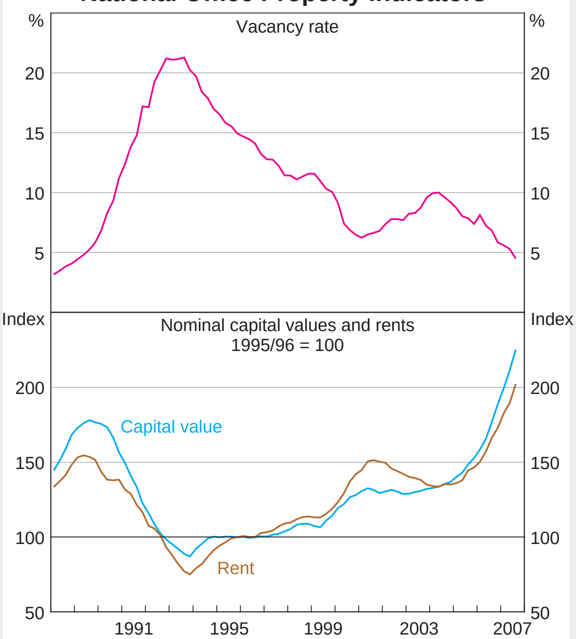


Box B: Recent Developments in the Office Property Market

Conditions in the national office property market have tightened significantly over the past couple of years, with the national vacancy rate falling to nearly 20-year lows, and rents and property prices increasing sharply. However, additions to national office supply have picked up much more moderately than in the late 1980s cycle. With no sign so far of the significant overbuilding that resulted in the collapse of the late 1980s office boom, the current upswing in office construction seems likely to continue for some time yet.

Reflecting strong demand and relatively modest additions to the stock of office space, the national office vacancy rate has fallen significantly over recent years, from 10 per cent in 2004 to 4.5 per cent in the second half of 2007, which is its lowest level since the late 1980s (Graph B1). The decline has been relatively broad-based across the major cities, with vacancy rates now below 7 per cent in all cities compared with peaks of around 20–30 per cent in most capitals in the early 1990s. However, the tightening in the Perth and Brisbane markets has been particularly pronounced, reflecting the general economic strength of these regions and the boom in the resources sector. The vacancy rates for offices in Brisbane and Perth are extraordinarily low at just 0.2 per cent and 0.5 per cent.

Graph B1
National Office Property Indicators*



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

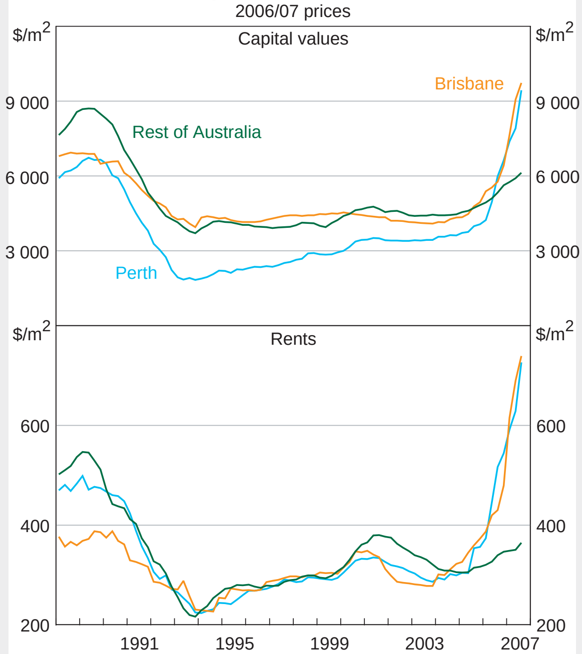
This tightening has in turn seen the rate of growth in office property prices and rents increase significantly over the past two to three years, although this follows a long period of relatively modest outcomes. Office prices (or capital values) are estimated to have risen by 28 per cent over the year to the September quarter nationally and rents by 22 per cent. However, it has only been in the past year that average nationwide office property prices have surpassed their previous nominal peak seen during the boom of the late 1980s, and in real terms they remain around 20 per cent below the heights seen during that period. Similarly, while nationwide nominal rents are around 30 per cent higher than in 1989, they are also still around 20 per cent lower in real terms.

The recent strong growth in prices and rents has occurred across all of the mainland capitals. In Sydney and Melbourne office prices are estimated to have risen by more than 30 per cent over the past two years, while rents have increased by around 25 per cent and 15 per cent respectively. However, the strongest price and rent gains have been seen in Brisbane and Perth, with growth in estimated capital values in excess of 60 per cent over the past year alone (Graph B2). After more than doubling over the past two years, office prices per square metre in Brisbane and Perth now exceed the national average, and are second only to prices in Sydney, while rents in Brisbane and Perth are now higher than in all other cities. Office prices and rents in these two markets now far exceed their levels in the late 1980s, in both real and nominal terms, reflecting the extremely low vacancy rates in these markets.

Graph B2

Office Capital Values and Rents*

2006/07 prices



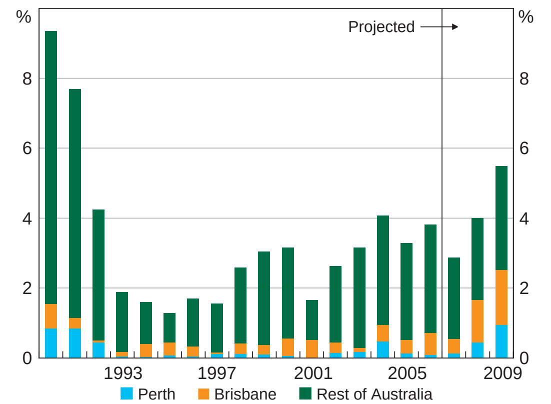
* Deflated using underlying inflation

Sources: Jones Lang LaSalle; Property Council of Australia; RBA

Graph B3

National Office Supply Additions*

Per cent of national stock



* Data are gross of conversions and deletions

Source: Property Council of Australia

The tightening in office property conditions has prompted a noticeable pick-up in planned office supply. Office building approvals, commencements and the value of office projects in planning stages have all increased strongly over the past couple of years. Reflecting this, data from the Property Council of Australia indicate that gross additions to the national office stock should accelerate in 2008 and 2009 (Graph B3). Nevertheless, as a per cent of the total stock annual additions are expected to remain well below those seen in the early 1990s, when new construction was causing the national office stock to grow by nearly 10 per cent per annum. The largest planned expansions in office supply are in Perth and Brisbane, where the stock of office space looks set to rise by around 20–25 per cent cumulatively over the next three years. However, with practically no vacant office space in these markets, likely pent-up demand (as suggested by recent declines in space per worker) and expectations of continuing economic growth, many market observers suggest that the expansions underway are unlikely to result in significant oversupply, although there could be some easing in pressure on prices and rents. This is consistent with reports from the Bank's liaison program which also suggest that conditions in the office property market are expected to remain tight over at least the next year.

Domestic Financial Markets and Conditions

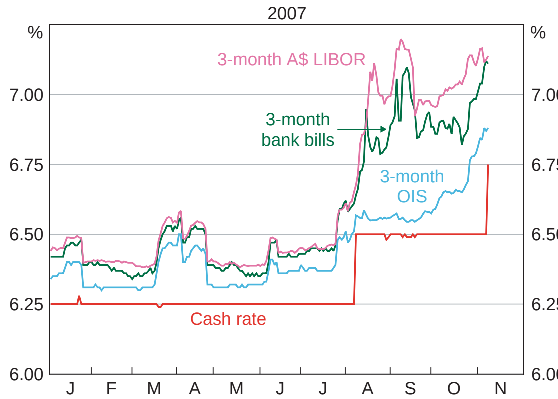
Interest rates and equity prices

Money and bond yields

As described in the chapter on 'International and Foreign Exchange Markets', there was a significant tightening in global credit and money markets triggered by developments in the US sub-prime mortgage market. Short-term market interest rates in Australia rose substantially in the weeks following the last *Statement*. Through August and early September, as conditions in overseas markets tightened, local banks reported a significant rise in the cost of raising funds in offshore markets. In response, domestic banks began switching their offshore funding to domestic sources, which in turn helped push short-term domestic rates higher. By mid September, the 3-month Australian-dollar LIBOR interest rate, the benchmark rate for offshore funding, had risen to 7.2 per cent, 60 basis points higher than levels in late July, while yields on 3-month bank bills, a benchmark for domestic funding costs, had risen by around 45 basis points, to 7.1 per cent (Graph 55).

Graph 55

Short-term Interest Rates



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

As conditions in global funding markets deteriorated from early August, the Reserve Bank experienced a sharp increase in demand for funding by domestic financial institutions in its daily open market operations. The Bank responded to the demand by providing additional liquidity to the cash market through these operations, in order to keep the cash rate as close as possible to the target set by the Bank's Board which at the time was 6½ per cent (see 'Box C: Reserve Bank Open Market Operations'). The extra liquidity provided by the Bank through its market operations contributed to an easing of concerns in domestic markets.

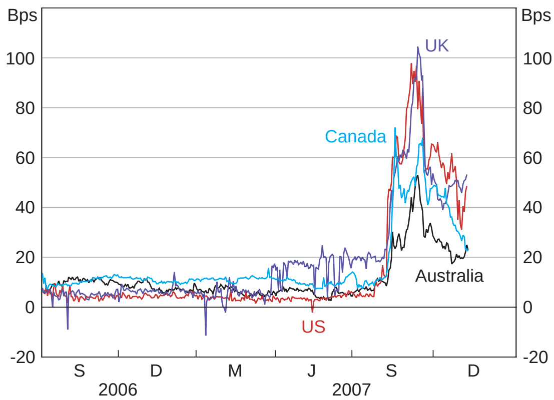
Short-term interest rates fell back in mid September as conditions in overseas credit markets began to improve. The decision by the US Federal Reserve on 18 September to ease monetary policy by a larger-than-expected 50 basis points proved to be a key factor underlying the improvement, though the attractiveness of yields also began to entice investors to return to the market. Many local financial institutions reported a steady improvement in their access to funding both onshore and offshore over the second half of September and throughout

October. As conditions improved, the Bank withdrew liquidity from the cash market in line with reduced demand.

Short-term rates moved higher again in October, though this time it was not because of credit developments but rather expectations of a change in monetary policy as concerns about the turbulence on global markets gave way to renewed focus on the strength of the domestic economy. The release of the September quarter CPI saw these expectations intensify, so that by late October the market had fully priced in a 25 basis point tightening at the November meeting and an additional 25 basis point tightening to 7 per cent next year. The rates on 3-month Australian dollar LIBOR and 3-month bank bills are now around 7.1 per cent. Both rates are around 20–25 basis points above the corresponding overnight indexed swap (OIS) rate, compared with an average of about 6 to 8 basis points that had prevailed over the first half of 2007. The wider spreads are a reflection of the market's reassessment of the risks underlying short-term funding transactions, though the spreads in the Australian market have remained below those seen in other major financial markets (Graph 56).

Graph 56

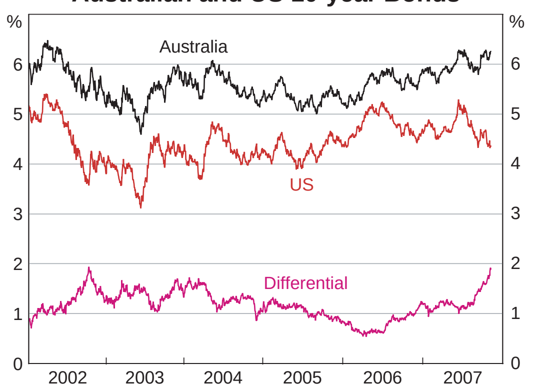
Short-term Spreads – 3-month Bills to OIS



Sources: Bank of England; Bloomberg; RBA; Tullett Prebon (Australia) Pty Ltd

Graph 57

Australian and US 10-year Bonds



Source: RBA

In contrast to the movement in global bond yields, domestic long-term interest rates have risen since the release of the last *Statement* (Graph 57). In August, yields on domestic government bonds declined slightly as US bond yields fell, with the domestic yield reaching a low of 5.8 per cent. Since then, yields have generally moved higher as conditions in global markets improved and with the release of data indicating the strength in the domestic economy. Reflecting their divergent movements and the relative strength of the two economies, the Australia/US 10-year spread has risen from around 120 basis points at the time of the last *Statement* to around 185 basis points, its highest level since late 2002.

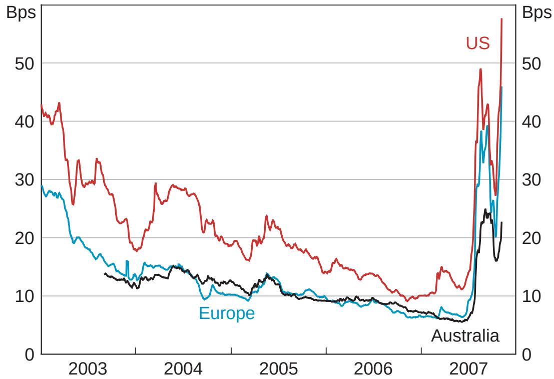
The heightened credit market volatility has had a greater effect on perceptions of credit risk for financial institutions than for the rest of the corporate sector, with premia on credit default swaps

(CDS) – financial derivatives that provide insurance against defaults on debt – for local banks increasing more sharply than for corporates in August and September (Graph 58). CDS premia for corporates have eased in recent weeks and are little changed from levels seen at the time of the last *Statement* (Graph 59). Premia for Australian banks remain elevated, but are notably below those for comparable US and European banks.

Graph 58

Banks' 5-year Senior CDS Premia

5-day moving average

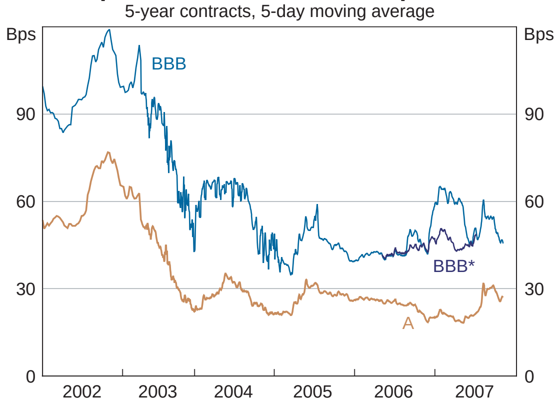


Sources: Bloomberg; *The Banker*

Graph 59

Corporate Credit Default Swap Premia

5-year contracts, 5-day moving average



* Excluding companies targeted for takeovers

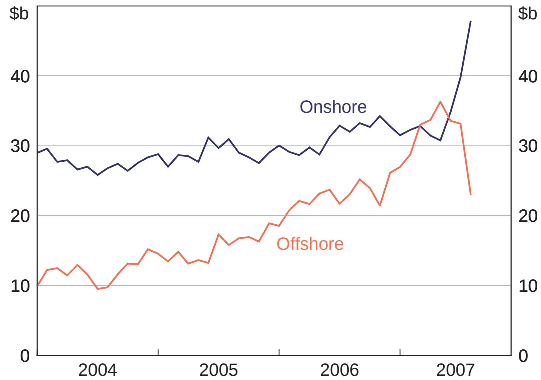
Sources: AFMA; Bloomberg; RBA

As has been the case overseas, conduits in Australia issuing asset-backed commercial paper (ABCP) have been among the entities most affected by the recent volatility in credit markets. Around two-thirds of the collateral backing Australian ABCP is residential mortgages, though this only accounts for just under 4 per cent of the value of Australian housing loans.[1] In August, domestic conduits shifted much of their ABCP funding onshore, in response to the more difficult conditions offshore: data from Standard and Poor's (S&P) indicate that ABCP outstanding onshore increased $8 billion (20 per cent), while offshore the amount outstanding fell $10 billion (31 per cent) (Graph 60). Overall, Australian ABCP outstanding – issued both onshore and offshore – fell by 3 per cent in August, compared to a decline of 20 per cent for US ABCP. Some Australian conduits called on their liquidity providers, although it appears that liquidity providers largely purchased ABCP rather than extending a loan. Partial data suggest that some funding continued to be switched onshore in September, with the level outstanding onshore rising 3 per cent. Conditions appear to have improved somewhat in October; a non-conforming lender has issued a new $400 million ABCP program, the first new program to be set up since the turmoil in markets began. Liaison with market participants suggests that spreads on ABCP picked up sharply in August, as in the US, to be around 30–40 basis points above the bank bill rate, relative

1 *For more details refer to 'Box A: The Australian Asset-Backed Commercial Paper Market', RBA* Financial Stability Review*, September 2007, pp 32–35.*

Graph 60

Australian ABCP Outstandings

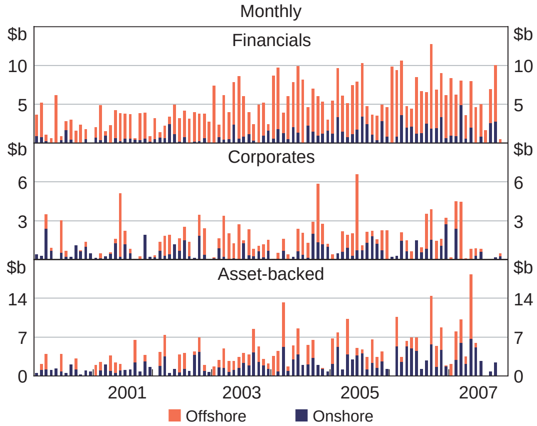


Source: Standard & Poor's

Graph 61

Australian Entities' Bond Issuance

Monthly

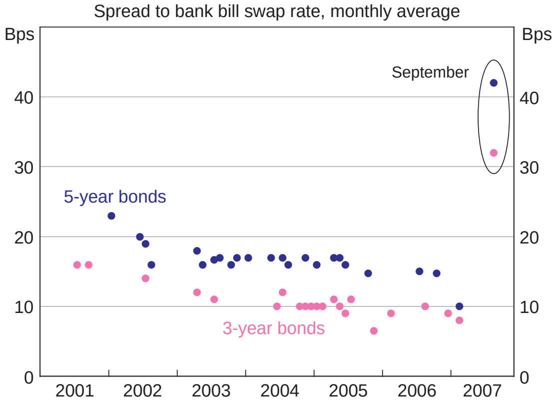


Source: RBA

Graph 62

Major Banks' Bond Pricing at Issuance

Spread to bank bill swap rate, monthly average



Source: RBA

to 2–5 basis points over recent years. Spreads have subsequently fallen back a little.

Reflecting the turbulence in offshore markets, domestic banks raised a slightly higher than usual share of their funding in local capital markets (see 'Box D: Banks' Funding'). While bond issuance by banks was relatively low in August, it picked up to be above average by October, albeit at higher spreads than earlier in the year. The issuance by banks has accounted for the bulk of bond issuance since end July (Graph 61).

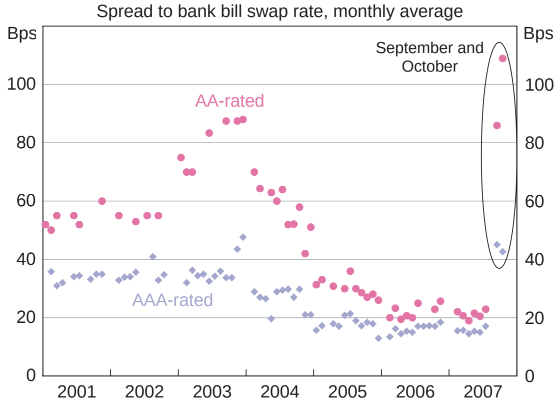
Private bond placements – for which details are often not publicly available – appear to be higher than usual. Reportedly, only half of the residential mortgage-backed securities (RMBS) that investors are reviewing are public issues. For those bonds that have been issued, the spread to the swap rate has been wider than in recent years. Major banks have issued bonds in the domestic market at spreads of around 30 and 40 basis points for 3- and 5-year bonds respectively, compared with average spreads over the past year of around 10 and 15 basis points (Graph 62).

The longer-term securitisation market in Australia was also affected by the strains in global financial markets, with no RMBS issuance taking place in August. Since reopening in September with two RMBS issues coming to market, it has continued to recover. There were seven RMBS priced in October. The RMBS issues have been undertaken by both banks and mortgage originators. The deals have tended to be small, though there are signs that investor demand may be strengthening with the size of several recent issues being increased prior to their completion. However, spreads on RMBS have widened substantially from the low levels in recent years, and are around levels last seen in 2003 (Graph 63).

Graph 63

Spreads on Domestically Issued Prime RMBS

Spread to bank bill swap rate, monthly average



Source: RBA

S&P placed PMI – a provider of lenders' mortgage insurance (LMI) to around 45 per cent of securitised Australian housing loans – on negative credit watch, after the US parent company announced larger-than-expected losses in the third quarter. S&P has put the subordinated AA-rated tranches of around 200 Australian prime RMBS on negative credit watch, as typically the subordinated tranche of a prime RMBS is rated the same as the lowest-rated insurer of loans in the RMBS. While this affects around three-quarters of outstanding RMBS, the subordinated tranche only makes up a few percentage points of the value of an RMBS. The AAA ratings on the senior tranches have been affirmed as there is sufficient subordination to support the high rating.

Default rates on all domestic issues remain low. The last (rated) corporate bond default in Australia was mid 2004. In early October, Moody's issued a report stating that the recent credit crunch has had no immediate impact on the stable rating outlook of Australian banks.

Intermediaries' interest rates

The 25 basis point increase in the cash rate in August has been fully passed on to borrowers, though at the time this *Statement* was finalised, the November increase in the cash rate had yet to flow through to borrowing rates.

The turbulence in capital markets over the past few months has increased the funding costs of financial intermediaries over and beyond the effect of the higher cash rate. On average, with spreads at current levels, it has caused intermediaries' funding costs to rise by about 10–15 basis points. Institutions that rely heavily on capital markets to fund their lending (such as mortgage originators and some regional banks) have been more affected than the major banks, credit unions and building societies which have large deposit bases.

There has been limited pass-through of this increase in funding costs to prime full-doc loans, which account for over 90 per cent of outstanding housing loans. Banks' variable housing loan rates have only increased in line with the August increase in the cash rate, rising by 25 basis points since the previous *Statement* to 7.65 per cent. However, reflecting the larger increase in

Table 11: Intermediaries' Variable Mortgage Rates
As at 31 October 2007

	Per cent of outstanding loans	Change Basis points			Level Per cent
		Aug	Sep	Oct	
Cash rate		**25**	**0**	**0**	**6.50**
Prime full-doc	**91**				
Banks	78	25	0	0	7.65
Credit unions and building societies	5	25	0	0	7.43
Mortgage originators	8	25	5	6	7.83
Prime low-doc	**8**				
Banks	5	25	8	2	8.04
Mortgage originators	3	25	13	5	8.19
Non-conforming	**1**	**40**	**62**	**0**	**9.90**

Sources: ABS; Cannex; RBA

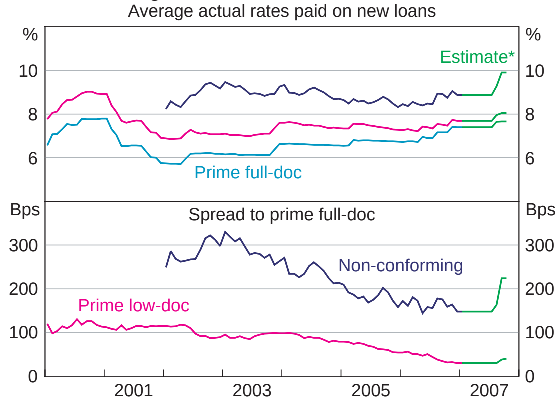
their funding costs, mortgage originators' rates have risen by around 35 basis points over the same period (Table 11).

Interest rate increases have been more common for riskier housing loans, reflecting the larger increase in the cost of funding these loans. For prime low-doc loans, which account for around 8 per cent of outstanding housing loans, the average variable rate of banks has risen by 35 basis points since July, 10 basis points more than the increase in the cash rate, with the smaller banks increasing rates by more than the larger banks. Mortgage originators' average prime low-doc rate has risen by 43 basis points. Interest rates on non-conforming loans (1 per cent of outstanding housing loans) have risen by around 100 basis points. Several large non-conforming lenders have also tightened their lending standards and discontinued some of their lower margin loans.

Graph 64

Housing Loan Variable Interest Rates

Average actual rates paid on new loans



* Estimates are based on movements in advertised rates
Sources: ABS; APRA; RBA; company reports

The larger increases in interest rates on prime low-doc and non-conforming loans relative to prime full-doc loans over recent months reverses only part of the trend over the preceding few years. Between 2004 and 2006, the spread between interest rates on prime low-doc loans and prime full-doc loans declined from 100 basis points to 30 basis points (Graph 64). The spread on non-conforming housing loans declined by 120 basis points over the same period. The falling spreads reflected the low realised losses on these loans (relative to the interest premium that was being charged), and greater competition between lenders, particularly in the prime low-doc loan market. Even after the recent increases, spreads on prime low-doc loans are still low by historical standards.

The five largest banks' average 3-year fixed rate on prime full-doc housing loans is currently 7.9 per cent, 20 basis points higher than at the time of the last *Statement*. Smaller banks' and mortgage originators' 3-year fixed rates have increased by 30–35 basis points, a little less than the rise in the 3-year swap rate, the benchmark rate for funding these loans. The share of owner-occupier loans approved at fixed rates increased to 19 per cent in September (the latest month for which data are available), well above its decade average of 12 per cent. Interest rates on personal loans are generally 30–40 basis points higher than at the time of the last *Statement*.

Large businesses have experienced significant pass-through of the increase in wholesale funding costs. These higher interest rates reflect the effects of the August monetary policy tightening, expectations of the November rate rise and future cash rate rises, and the increase in spreads resulting from the recent market turbulence. Around 45 per cent of large business loans (loans greater than $2 million) are directly priced off bank bills, and interest rates on these loans are estimated to have risen by about 15 basis points in August and a further 30 basis points over the next two months (Table 12). Another 40 per cent of large loans are at variable rates, and a sizeable proportion of these are also priced off bank bills, rather than the cash rate. Rates on these loans are estimated to have increased by a cumulative 35 basis points over the past three months. Large businesses also source about 20 per cent of their debt funding from capital markets, where variable rate debt is typically priced off bank bills.

Small businesses have been less affected than large businesses. About 50 per cent of small business loans (loans less than $2 million) are at variable rates, and at the time this *Statement* was finalised the five largest banks' indicator rates had increased by 25 basis points since end July, in line with the August increase in the cash rate. Another quarter of loans are at fixed rates, and because only new loans are affected by the recent market turbulence, the weighted-average

Table 12: Banks' Business Lending Rates[(a)]
As at 31 October 2007

	Share Per cent	Change Basis points			Level Per cent
		Aug	Sep	Oct	Oct
Cash rate		**25**	**0**	**0**	**6.50**
Large loans[(b)]	**65**	**14**	**11**	**10**	**7.28**
– bills	29	13	16	15	7.42
– variable-rate	27	19	8	7	7.27
– fixed-rate	9	1	1	2	6.82
Small loans[(b)]	**35**	**17**	**3**	**6**	**8.34**
– bills	7	13	16	15	7.69
– variable-rate	18	25	0	0	8.85
– fixed-rate	9	3	4	5	7.88

(a) Interest rates are RBA estimates.
(b) Large loans are those greater than $2 million; small loans are those less than $2 million.
Sources: ABS; Cannex; RBA

interest rate on the stock of outstanding loans has increased by less than the cash rate. The interest rates on loans priced off bank bills have risen more significantly; these loans account for around one-quarter of small businesses' lending.

Prior to the November increase in the cash rate, financial institutions' interest rates on online savings accounts, cash management accounts and bonus saver accounts had risen by 15–30 basis points since the last *Statement*.

Financing activity

Credit growth has remained strong over recent months with total credit expanding by 16 per cent over the year to September – its fastest pace of growth since the late 1980s (Table 13, Graph 65). Lending to businesses has grown particularly rapidly while there have been some signs of moderation in household credit growth.

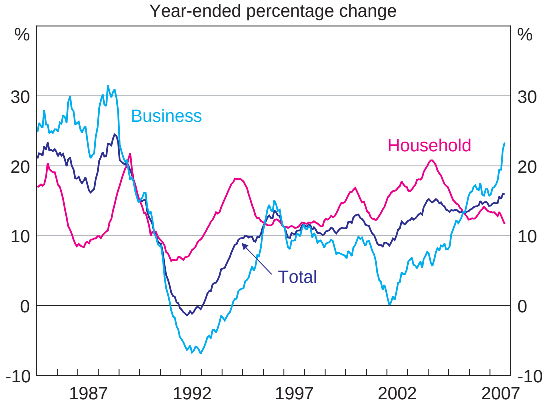
Table 13: Financial Aggregates
Average monthly growth, per cent

	December quarter 2006	March quarter 2007	June quarter 2007	September quarter 2007
Total credit	1.0	1.3	1.4	1.2
Household	0.8	1.0	1.2	0.7
– Owner-occupier housing	0.9	1.0	1.1	0.8
– Investor housing	0.7	0.9	1.1	0.7
– Personal	0.7	0.9	2.2	–0.1
Business	1.3	1.8	1.8	2.1
Broad money	0.8	1.2	1.5	1.3

Source: RBA

Graph 65

Credit Growth
Year-ended percentage change



Source: RBA

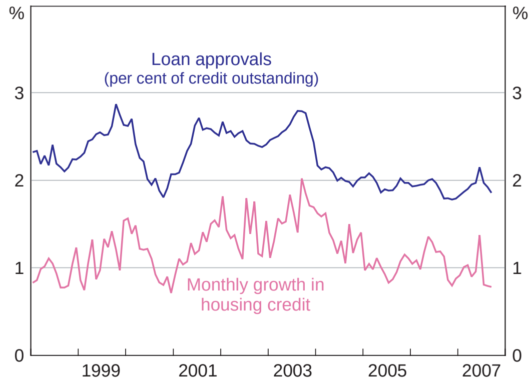
Household financing

Housing credit growth has moderated in recent months (Graph 66). This is likely to be a reflection of the August cash rate rise, as well as recent developments in credit markets. While volatility resulting from a spike in borrowing in June ahead of the superannuation rule changes may have affected recent figures, housing credit growth appears to have settled at about 0.8 per cent per month in August and September compared with the rates of around 1 per cent per month earlier in the year.

The outstanding stock of personal credit has fallen slightly over recent months following a sharp increase in June which was reportedly driven largely by households borrowing to invest in superannuation. While subdued growth over recent months is likely to reflect some unwinding of this effect, a 1 per cent decrease in margin lending over the September quarter has also contributed to slower personal credit growth.[2] The decline in margin loan outstandings was driven by a 4 per cent fall in the average loan size, with many borrowers choosing to meet their August margin calls by paying down their loans. The high level of equity market volatility in August caused the number of margin calls per day per 1 000 clients to rise sharply to 1.04 in the September quarter, the highest level since December 2004. Despite the increase, the frequency of margin calls is still low by historical standards, largely due to borrowers' low average gearing levels.

Graph 66

Housing Loan Approvals* and Credit Growth



* Excludes investor approvals for new construction and by 'others'
Sources: ABS; RBA

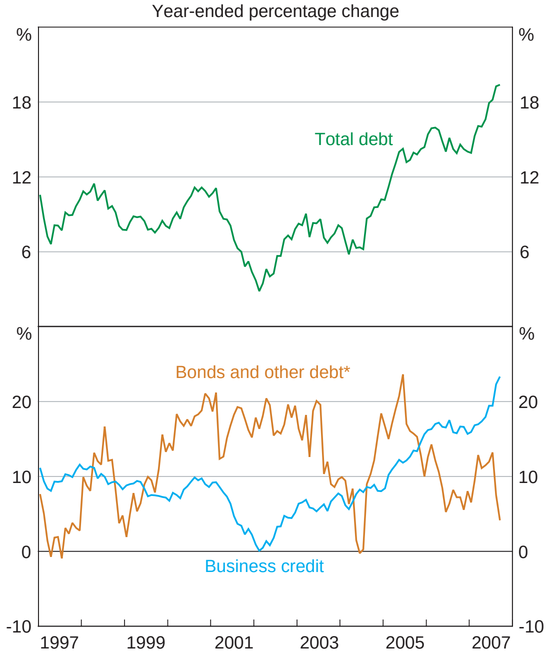
Business financing

Total business debt increased by almost 20 per cent over the year to September 2007, the fastest growth since the late 1980s. Within the total, intermediated credit has grown very strongly, possibly reflecting some return to intermediation following the recent difficulties in credit markets (Graph 67). Much of the strength in business credit reflects robust growth in large loans (greater than $2 million), although growth in small loans has also accelerated recently. Part of the growth in large loans can be attributed to strength in syndicated lending, which is estimated to have increased by about 45 per cent over the year

Graph 67

Business Funding

Year-ended percentage change



* Exclusive of promissory notes held by AFIs
Sources: ABS; ASX; Austraclear; RBA

2 *Some margin loans are made to businesses and trusts, and hence are captured in business credit rather than personal credit.*

to September 2007. A large proportion of recent syndicated lending has been funded by the Australian subsidiaries of foreign banks. Syndicated loans have been mainly used to fund merger and acquisition (M&A) activity, though there has also been a pick-up in lending for general corporate purposes and capital expenditure. Companies in the finance & insurance and mining sectors have recorded the strongest growth in borrowing.

The non-intermediated debt market has not been as strong. Corporates had some difficulty rolling over their short-term commercial paper in August and September; short-term onshore debt outstanding fell by 20 per cent in both August and September. There were some signs of improvement in October, although outstandings remain well below the level at end July. There have only been a couple of non-financial corporate bond issues since mid July. Corporate bonds outstanding fell 4½ per cent between end July and end October.

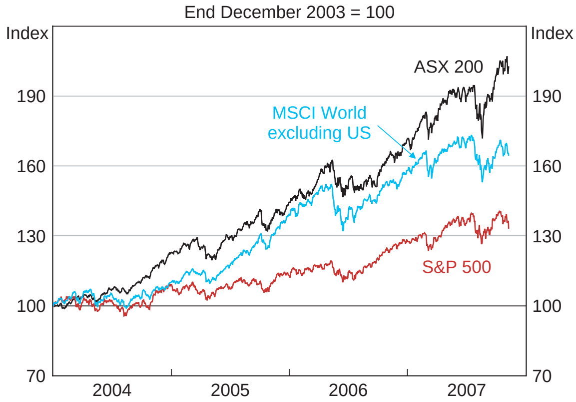
Following strong raisings in July, net equity raisings slowed in August amid the volatility in global equity markets. However, in September and October net equity raisings have returned to more normal levels.

Equity markets

Equity markets have been volatile in recent months. The ASX 200 fell 12 per cent from its peak in July to its low in mid August. Since then it has more than regained these losses, reaching a new high in November. Over the year so far, the ASX 200 is up 18 per cent compared to a 4 per cent increase in the S&P 500, and a 4 per cent increase in the MSCI World excluding US (Graph 68).

Graph 68

Australian and World Share Price Indices



Sources: Bloomberg; Thomson Financial

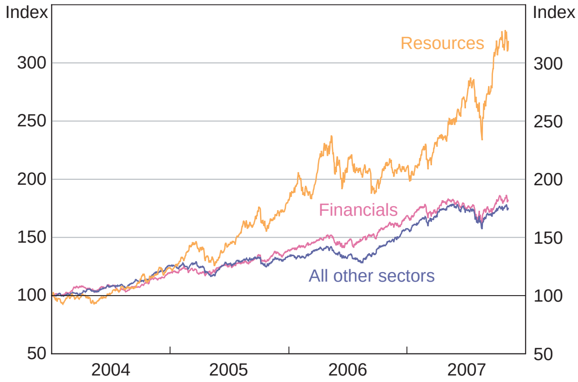
The out-performance of the domestic market reflects the strength of the resources sector and the better performance of the share prices of Australian financial institutions (Graph 69). The share prices of Australian banks followed US banks lower in August amid the initial credit market developments and on concerns that widening credit spreads may affect funding costs. In contrast to US banks, which have issued weak earnings reports related to losses in credit markets, prices for Australian banks have recovered since then (Graph 70). The major Australian banks have almost no exposure to US sub-prime mortgages and rely less on proprietary trading for their profits. Banks' underlying profits rose strongly over the past year, reflecting solid growth in net interest income and non-interest income (wealth management, insurance, trading and fee income) and limited cost increases.

Share prices of Australian companies generally have been supported by relatively strong profit results. Almost two-thirds of ASX companies that reported recently announced an increase in underlying profits (which exclude significant items and asset revaluations/sales). In aggregate, underlying profits after interest and tax were 9 per cent higher than in the corresponding period of 2006. Growth was underpinned by the financial and non-resource sectors. Resource companies' profits were broadly unchanged, as the high level of commodity prices and increased output offset higher labour costs and infrastructure constraints. Nonetheless, resource companies' profits are at a very high level following average growth of around 60 per cent in recent years. Overall, profit results were generally in line with expectations.

Graph 69

Australian Share Prices

End December 2003 = 100

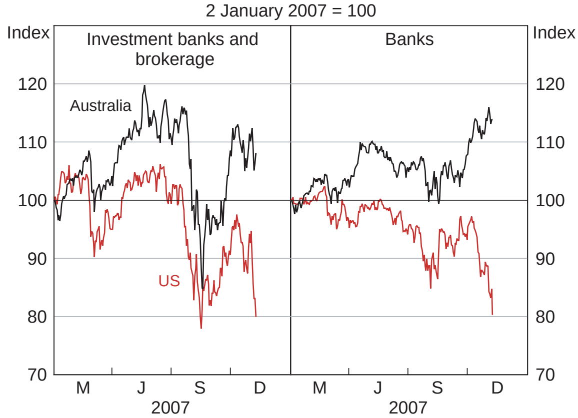


Sources: Bloomberg; RBA

Graph 70

Australian and US Financial Indices

2 January 2007 = 100



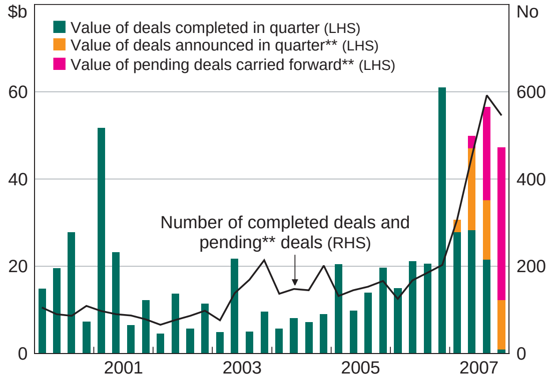
Source: Bloomberg

Earnings expectations were little changed following the profit reporting season, but more recently analysts have revised their earnings forecasts for non-financial companies. Analysts continue to expect earnings growth for resource companies to slow from almost 30 per cent in 2006/07 to 5 per cent in 2007/08, though they now expect growth to pick up again to 19 per cent the following year. Financials' and other companies' growth forecasts remain steady for the next few years, ranging between 8 and 10 per cent. Analysts lowered their earnings forecasts for other non-financial companies in 2007/08 to 4 per cent partly due to concerns about US demand, but continue to forecast 11 per cent growth the following year.

The most recent increase in share prices has been broadly matched by profit growth. As a consequence, the P/E ratio is still around the levels of the past six months, which is a few points above its long-run average. The dividend yield currently stands at 3.4 per cent, a little below its long-run average of 3.8 per cent.

Graph 71

Mergers and Acquisitions by Listed Australian Entities*



* Excludes real estate transactions; data to 7 November 2007

** Transactions announced since January 2007 but not completed

Sources: RBA; Thomson Financial

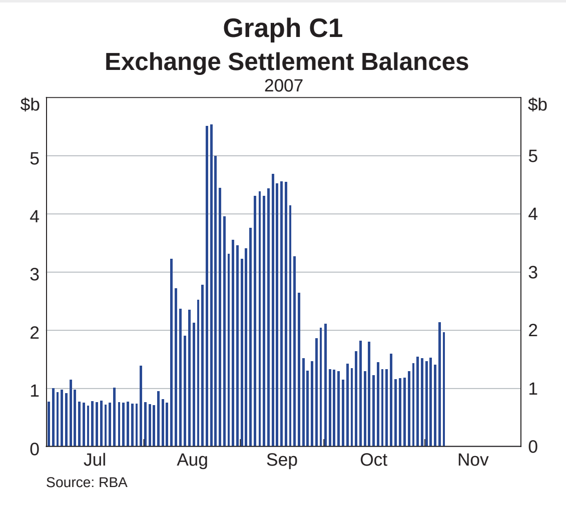
Despite the volatility in markets, M&A activity has remained strong (Graph 71). M&A activity has been broad-based across different sectors. Currently almost $45 billion of deals are pending. Several large takeovers were completed in recent months.

Box C: Reserve Bank Open Market Operations

The Domestic Markets Department of the Reserve Bank conducts open market operations on a daily basis in order to keep the cash rate as close as possible to the target rate established by the Reserve Bank Board. By injecting or withdrawing funds, open market operations affect the aggregate balance of financial institutions' Exchange Settlement (ES) accounts at the Bank – these balances are used for settling transactions with each other and the Commonwealth Government. Typically, these operations are conducted by engaging in repurchase agreements ('repos') with financial market participants for Australian dollar securities, though occasionally large flows to or from the Government need to be accommodated by transactions undertaken by the Bank in the foreign exchange swap market.

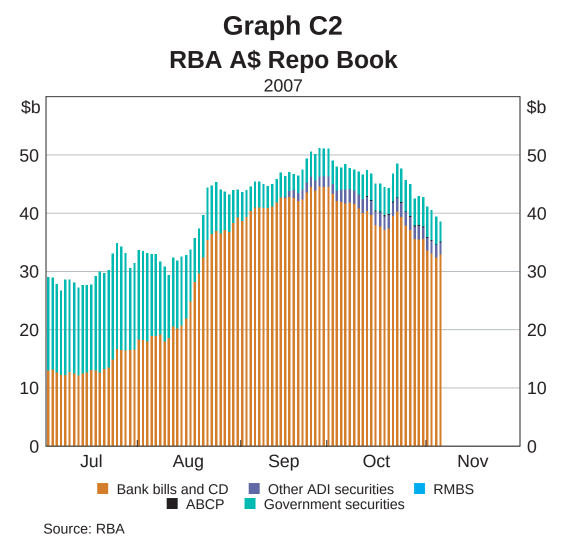
The shock to money markets around the world in mid August, described in the main text, saw the demand for settlement funds rise sharply. Pressures in money markets intensified over the following weeks, with 3-month funding rates in Australia peaking at over 7 per cent in mid September, more than 50 basis points above the corresponding rate that measures expectations of the cash rate (the overnight indexed swap rate). In response to these developments, the Reserve Bank injected additional liquidity through its open market operations to help money markets function as smoothly as possible. Other central banks undertook similar operations in their own markets.[1]

During this period, market participants' greater demand for liquidity was evident in the Bank's domestic market operations in several ways: there was an increased number of market participants bidding for cash, their bids were larger and they were willing to pay more for that cash. In order to keep the cash rate as close as possible to the target rate, the Bank responded to this increased demand for liquidity by injecting a significant amount of funds into the market, resulting in a rise in ES balances. The aggregate balance of ES accounts rose as high as $5.5 billion on 23 August, compared with an average balance of around $750 million over recent years (Graph C1). Because demand was substantially greater, the bids at which the Bank conducted repos were higher than they had been, despite the larger injections of liquidity.



1 *See Battellino R (2007), 'Central Bank Market Operations', RBA* Bulletin, *September, pp 19–26.*

In response to pressures in the bank funding markets – particularly for longer term loans – the Bank altered its market operations in a couple of ways. The Bank conducted a greater share of its operations as repos collateralised by bank bills and certificates of deposit (CDs), with an offsetting decline in the share collateralised by government securities. The Bank also increased the maturities of the repos it conducted in response to the difficulties faced for longer-term funding. As a result, the share of the Bank's holdings of bank bills and CDs in its domestic securities increased, from an average of around 40 per cent over the past year to around 80 per cent in early November (Graph C2). The maturity of the Bank's outstanding repos increased from an average of around 20 days to over 50 days by mid September, with a significant portion of the repos entered into in this period having terms extending beyond three months.



Over this period, the Bank also allowed its foreign exchange swaps to decline, both to facilitate an increase in the holdings of domestic securities and to accommodate changes in the size of the Bank's balance sheet. The Bank's foreign exchange swaps declined from just over $45 billion in early August to close to zero by early November. Over recent years, foreign exchange swaps had gradually built up to accommodate the increase in the Bank's balance sheet, without adding to pressures in domestic asset markets.

In early September, the Reserve Bank announced an expansion of the range of securities that could be used for repos in the Bank's domestic market operations to include other high quality securities.[2] This represented the latest stage in the progressive broadening of the range of securities accepted for repos that has occurred over the past decade but its timing also provided an avenue for the Bank to assist the functioning of a broader range of markets. The list of authorised deposit-taking institutions (ADIs) whose bank bills and CDs were eligible for Reserve Bank repos was broadened and longer-term securities issued by ADIs (with a high credit rating) were accepted for the first time. The Bank has also begun to accept both short- and long-term securities backed by residential mortgages – asset-backed commercial paper (ABCP) and residential mortgage-backed securities (RMBS) respectively – as collateral. As was previously the case, the Bank will only accept securities from unrelated parties. Overall, these securities now account for about $3 billion, or around 5 per cent, of the Bank's domestic portfolio.

2 *These changes were announced in the Reserve Bank press release 'Domestic Market Dealing Arrangements' on 6 September 2007.*

As conditions in the money market have improved, the Bank has withdrawn much of the liquidity it has injected. ES balances have been around $1.4 billion in recent weeks. This is still higher than the average level before the recent turbulence, reflecting the desire of some financial institutions to operate with a higher level of cash balances than previously. Throughout the whole period, the Bank's actions in the money market have seen the cash rate remain very close to the target, deviating only very occasionally and by no more than two basis points.

Box D: Banks' Funding

Australian banks currently source just over a quarter of their funding from offshore capital markets. Another quarter is sourced from domestic capital markets, with the balance coming from domestic deposits.[1] The turbulence in global capital markets in August and September significantly affected debt markets, including the short-term debt markets in which banks raise some of their offshore funds.

However, the market volatility does not appear to have had a significant impact on the operations of banks in Australia. Banks continued to lend normally through this period, with their domestic loan book increasing by $40 billion over August and September, slightly faster than the average rate of growth seen over the year to date (Table D1, Graph D1). Banks' holdings of domestic debt securities and other financial assets rose by $69 billion, largely reflecting increased holdings of other banks' certificates of deposit.

Table D1: Banks' Sources and Uses of Funds[(a)]

	Level in July 2007	Change over August and September 2007	
	$ billion	$ billion	Per cent
Sources of funds	**1 804**	**143**	**7.9**
Domestic deposits	759	29	3.8
Domestic capital markets	401	73	18.3
– Certificates of deposit	216	66	30.6
– Other	185	8	4.1
Offshore capital markets	486	13	2.7
Other liabilities	158	27	17.0
Uses of funds	**1 918**	**145**	**7.6**
Domestic loans	1 221	40	3.3
Domestic debt securities and other financial assets	354	69	19.5
– Certificates of deposit	71	49	69.8
– Other	283	20	7.0
Offshore assets	149	17	11.1
Other assets	194	19	9.8

(a) Excludes securitisation
Sources: APRA; RBA

Banks were still able to source some of their funding from offshore capital markets during this period, though increased investor risk aversion meant that much of the borrowing was at higher spreads and for shorter terms than usual. Despite the difficulties, banks' foreign liabilities increased by $13 billion over August and September, a similar pace to which they had been

1 *Certificates of deposit have been included in domestic capital market funding, whereas financial corporations' deposits have been included in deposits.*

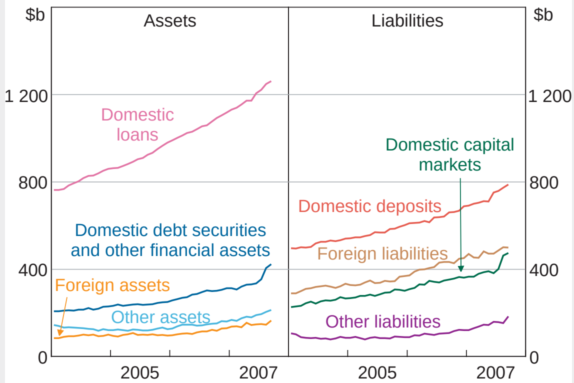
growing over the past few years. The growth in foreign liabilities was broad-based across deposits, long-term debt securities and short-term debt securities.

Funds raised in domestic capital markets increased by $73 billion. Much of the growth was due to banks issuing certificates of deposit to each other in August. A significant part of this was a precautionary move to boost assets that could be used as collateral for repos with the Reserve Bank should capital markets deteriorate further, and did not provide any net funding to the banking system. But even excluding these transactions, domestic capital market funding rose by $24 billion, suggesting that banks relied a little more than usual on domestic capital markets during this period.

Domestic deposits increased by $29 billion over August and September, with strong growth in deposits from both households and non-financial corporates. The increases in banks' other assets and other liabilities were largely offsetting, and mainly reflected changes in the fair values of the banks' derivative positions.

Graph D1

Balance Sheets of Banks in Australia

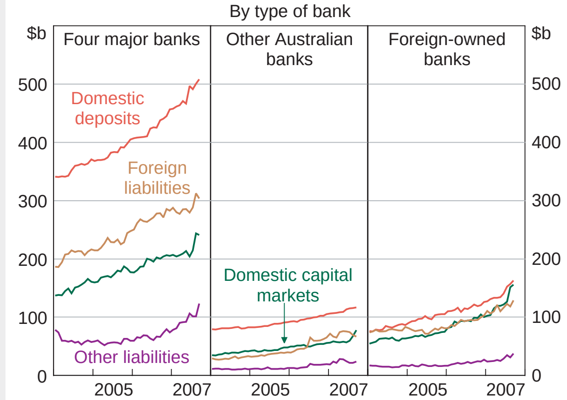


Sources: APRA; RBA

Graph D2

Liabilities of Banks in Australia

By type of bank



Sources: APRA; RBA

There was relatively little variation across the different types of banks (Graph D2). Major banks' and foreign banks' lending both increased by about 4 per cent over the two months, with particularly strong growth in business lending in August. Other Australian banks' lending also rose steadily over the period. Foreign liabilities increased by similar amounts across the different types of banks. Increases in domestic liabilities ranged from 8 per cent for the four major banks, through to 14 per cent for foreign-owned banks. The issuance of certificates of deposit increased markedly in August for all banks, though the four majors and the smaller Australian banks recorded the strongest growth. The smaller Australian banks and foreign banks also increased their sales of securities under repo to boost their liquidity. Deposits grew steadily across all banks.

The fact that banks continued to have good access to offshore capital markets during the market turbulence is related to their robust financial positions and their solid reputations with investors. Australian banks' profits and assets have been growing strongly, their impaired assets are low by historical and international standards, and they have very little exposure to US sub-prime mortgages and leveraged loans (the two asset classes that triggered the recent capital market turbulence). This strong position is reflected in listed banks' share prices, which have risen by 8 per cent since the end of June, compared with a 6 per cent fall for overseas banks.

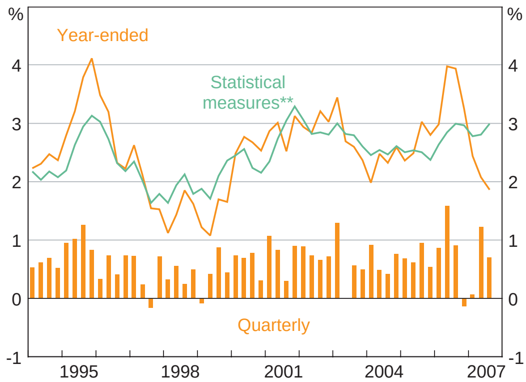
Inflation Trends and Prospects

Recent developments in inflation

The headline rate of CPI inflation has been highly volatile over the recent period. After peaking at 4 per cent in mid 2006, CPI inflation fell to 1.9 per cent in the year to the September quarter, and it is likely to pick up markedly over the next two quarters. These large movements mostly reflect changes in the prices of just a few items during the past year, notably fruit and petrol prices. Given this volatility, it is important to look at measures of underlying inflation to get a better sense of the trend in inflation. Based on a range of measures, underlying inflation appears to have been around 0.9 per cent in the September quarter, similar to the outcome in the June quarter, and to have been running close to 3 per cent over the past year (Table 14, Graph 72).

Graph 72

Consumer Price Inflation*



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

Headline inflation was 0.7 per cent in the September quarter. The

Table 14: Measures of Consumer Prices
Percentage change

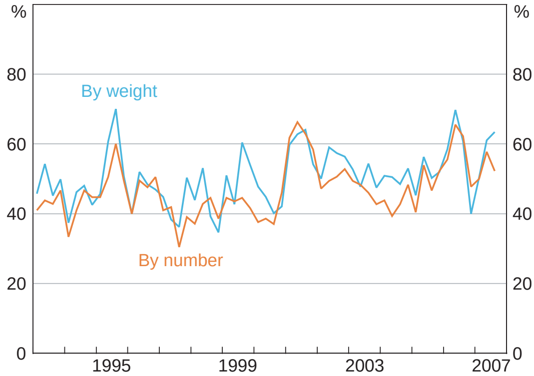
	Quarterly		Year-ended	
	June quarter 2007	September quarter 2007	June quarter 2007	September quarter 2007
CPI	1.2	0.7	2.1	1.9
– Tradables	2.0	0.2	0.3	–0.3
– Tradables (ex food and petrol)	0.8	0.0	1.0	0.6
– Non-tradables	0.7	1.1	3.4	3.5
Underlying measures				
Weighted median	0.9	1.0	2.9	3.1
Trimmed mean	0.9	0.9	2.7	2.9
CPI ex volatile items[(a)]	0.7	0.7	2.6	2.6

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

Graph 73

CPI Items Rising Faster than 2.5 Per Cent*

Proportion of all CPI groups



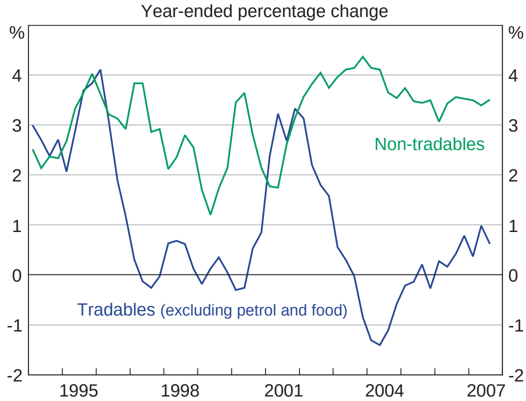
* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent

Sources: ABS; RBA

Graph 74

Tradables and Non-tradables Prices*

Year-ended percentage change



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

largest positive contributions came from fruit & vegetable prices, housing costs, financial service costs, and holiday travel & accommodation prices. Retail petrol prices declined in the quarter; the increase in world crude oil prices was more than offset by the appreciation of the Australian dollar and a fall in refinery margins. In addition, child care costs made a significant negative contribution in the quarter due to a change in the treatment by the ABS of the government's child care rebate. Overall, there was broad-based strength in inflation; measured by expenditure weights, the share of items in the CPI that grew at an annualised rate of more than 2.5 per cent remained above 60 per cent in the September quarter (Graph 73).

Non-tradables inflation increased to 1.1 per cent in the quarter, driven in part by higher rents and house purchase costs. In year-ended terms, non-tradables inflation rose slightly, to 3.5 per cent; these outcomes would have been around 0.3 percentage points higher in the absence of the change in the treatment of the child care rebate. Excluding petrol and food, tradables prices were broadly flat in the quarter, to be 0.6 per cent higher over the year (Graph 74). It is likely that tradables inflation is being held down somewhat by the appreciation of the exchange rate over recent years, especially the appreciation that has taken place since early 2007.

Producer prices increased at a solid pace in the September quarter. Final-stage prices increased by 1.1 per cent in the September quarter, although the year-ended rate remained broadly steady at 2.4 per cent. Excluding oil, domestic producer price inflation remained high at 4.0 per cent over the year, driven by strong price increases in the construction sector and in property services (Graph 75). In contrast, import prices fell in both the quarter and over the year, partly reflecting the appreciation of the exchange rate.

Labour costs

Consistent with the strong labour market conditions, the pace of growth in wages has been firm. The wage price index (WPI) grew by 1.1 per cent in the June quarter, to be 4.0 per cent higher over the year, around the same year-ended pace that has prevailed during the past two years (Graph 76). Broader indicators of wages growth, as measured by the national accounts, have been somewhat stronger – and in the upper range of recent experience – although these measures have historically been volatile. Average earnings from the national accounts – which include both wage and non-wage labour costs – rose by a strong 2.2 per cent in the June quarter, to be 5.5 per cent higher over the year. Private-sector surveys of firms also suggest the pace of labour cost growth has gradually increased over recent years (Graph 77). However, with the national accounts suggesting a pick-up in productivity growth in recent quarters, it is likely that the growth in unit labour costs is less than indicated by the pick-up in the broader measures of labour costs.

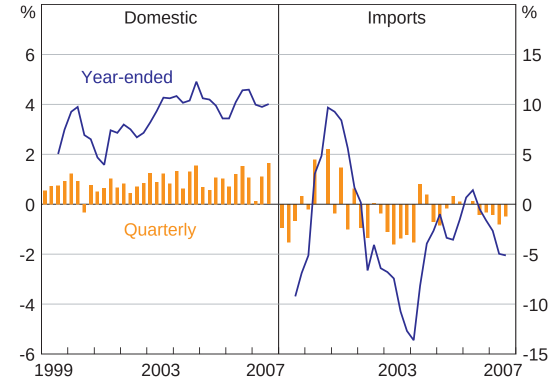
Inflation expectations

Based on a number of measures, inflation expectations in the economy remain relatively high. According to private-sector surveys, the proportion of businesses expecting to increase prices in the near term has picked up, to be above long-run average levels.

Graph 75

Producer Prices at Final Stage of Production

Excluding oil, percentage change

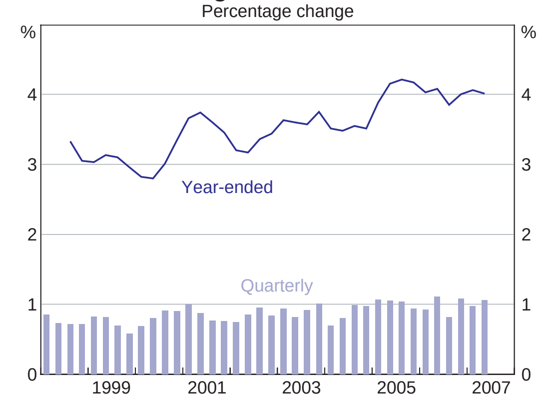


Sources: ABS; RBA

Graph 76

Wage Price Index

Percentage change

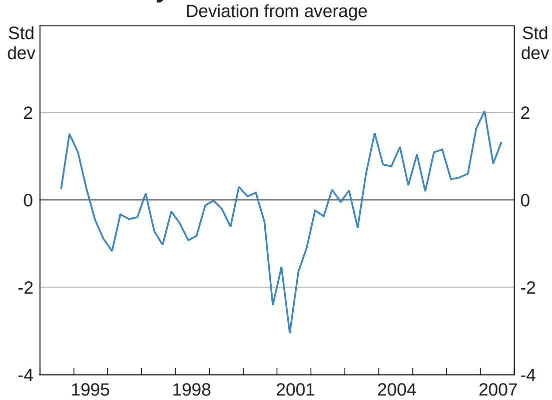


Source: ABS

Graph 77

Surveyed Labour Costs Growth*

Deviation from average



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

Sources: ACCI; AIG; NAB; PricewaterhouseCoopers; Sensis; St. George Bank

The Melbourne Institute survey of households reports that the median expectation for consumer price inflation over the year ahead averaged 3.8 per cent over the three months to October, well above the average expectation over the inflation-targeting period. Market economists surveyed by the Bank following the release of the September quarter CPI have also increased their near-term inflation forecasts. The median expectation for headline inflation over the year to the June quarter 2008 is now 2.9 per cent, up from 2.7 per cent in August (Table 15). Union officials' inflation expectations have remained stable at 3 per cent.

Table 15: Median Inflation Expectations
Per cent

	Year to June 2008			Year to June 2009	
	May 2007	August 2007	November 2007	August 2007	November 2007
Market economists[(a)]	2.5	2.7	2.9	2.7	2.6
Union officials[(b)]	3.0	3.0	3.0	3.0	3.0

(a) RBA survey
(b) Workplace Research Centre

Inflation outlook

The outlook for growth in demand and output is broadly similar to that presented in the previous *Statement*. The most recent data indicate that the economy had more momentum than expected through the middle of 2007. On its own, this pushes up forecasts for near-term growth. But forecasts for global growth have been revised down, and some market-driven tightening of credit conditions in addition to the rise in the cash rate has occurred. Over time, these will act in an offsetting direction.

Growth in domestic demand should slow from its recent above-trend pace over the next couple of years, with tighter financial conditions trimming private spending, and public spending growth moderating if the assumptions in the MYEFO projections for federal and state spending are borne out. Export growth should pick up as increased capacity in the resource sector comes on stream, and as the contractionary effect of the drought on rural exports eventually abates. With the forecast recovery in the farm sector now delayed and more gradual, overall GDP growth could be 3¾ per cent over 2007/08 and 3½ per cent over 2008/09. Non-farm GDP should expand at an annual rate of about 3½ per cent over the forecast period. Given that this includes a significant contribution from the resources sector, this rate of non-farm output growth would allow pressures on capacity in the non-resource sectors of the economy to begin to ease, though only quite slowly.

Recent quarterly inflation outcomes have been a little higher than forecast, after a period in late 2006 and early 2007 when they were surprisingly low. In the near term, given tight capacity conditions in many sectors, the recent inflation pressures are likely to persist. Given the recent pattern of quarterly outcomes, both CPI inflation and underlying measures are likely to rise above 3 per cent on a year-ended basis over the next two quarters.

Over the medium term, upward pressure on the inflation rate should diminish, helped in part by the rise in the exchange rate, assuming it is sustained, and some moderation in the pace of demand growth. But with demand growth still close to trend, and pressure on capacity only diminishing gradually, inflation is unlikely to decline far. Underlying and CPI inflation are accordingly both forecast to be close to 3 per cent during 2008 and 2009 (Table 16).

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

	Dec 2006	June 2007	Dec 2007	June 2008	Dec 2008	June 2009	Dec 2009
Consumer price index	3.3	2.1	2¾	3¼	3	2¾–3	2¾–3
Underlying inflation	3.0	2.8	3¼	3¼	3	2¾–3	2¾–3

(a) Actual data to September 2007. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.93, TWI at 73, cash rate at 6.75 per cent, and WTI crude oil price at US$90 per barrel and Tapis crude oil price at US$92 per barrel.

Sources: ABS; RBA

Risks to this forecast can be identified in both directions. Global growth could slow by more than assumed, if the US economy weakens significantly further, and/or global credit markets take a significant turn for the worse. The impact on Australia would probably be more serious if China's economy slowed abruptly as well, though in that case, the exchange rate could well decline significantly, which would lessen the impact both on growth and prices.

On the other hand, inflation could prove more difficult to contain and reduce than forecast here, especially if demand in Australia did not moderate as much as expected, if higher headline inflation added to wage and price expectations, or if firms' price setting was more responsive to tight capacity conditions than it has been to date.